CORPORATE GOVERNANCE FROM SHARIAH PERSPECTIVE: A COMPARATIVE STUDY OF PAKISTANI AND MALAYSIAN CORPORATE GOVERNANCE FRAMEWORKS FOR ISLAMIC FINANCIAL INSTITUTIONS

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Mohammad Ayaz
DEDICATION

This thesis is dedicated to my parents and Brother Umar Ziad.
STATEMENT OF DECLARATION

I, Mr. Mohammad Ayaz, do hereby declare and affirm that the thesis titled “Corporate Governance From Shari’ah Perspective: A Comparative Study of Pakistani and Malaysian Corporate Governance For Islamic Financial Institutions” has been accomplished by me on the basis of the most authentic sources on the relevant subject under the supervision of Professor Dr. Mohammad Tahir Mansoori, Department of Shari’ah, Faculty of Shari’ah and Law, International Islamic University, Islamabad. I also declare that this thesis is for seeking the Doctoral degree in Islamic Banking and Finance.

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ABSTRACT

Corporate governance is basically the system of internal structure (rules, practices and procedures) for operating, directing and controlling the companies, and involves protecting the interests of company’s stakeholders such as directors, managers, auditors and shareholders. With the emergence of Islamic financial institutions (IFIs), a new aspect of Shari’ah compliance has been introduced into corporate governance’s goals. If these institutions do not withhold Shari’ah compliance in their activities, there seems no reason for their existence. This goal of Shari’ah compliance therefore becomes integral part of the governance in the IFIs. Therefore, this study is conducted to assess the compatibility of provisions of the existing Pakistani and Malaysian governance systems, with the Islamic corporate governance principles. The study also includes comparative analysis of the provisions of Pakistani legal regime relating to corporate governance practices inside Islamic banks with the Malaysian regime. The purpose of this comparison is to highlight the distinctive characteristics of Malaysian corporate governance system, and based on such distinctions, to further suggest measures for more viable and efficient shariah complaint corporate governance system for Islamic banks in Pakistan.

The research methodology followed in this work is qualitative in nature. The provisions of Pakistani and Malaysian corporate governance regimes are analyzed in the light Islamic corporate governance principles. Both primary and secondary has been used. The data relating to existing literature is mainly collected from books and journal papers of secondary nature. For the purpose of analysis, the Pakistani statutory laws, that is, the Banking Companies Ordinance, 1962 and Companies Ordinance 1984 have been taken from statutes, whereas Malaysian statutory Act i.e. the Islamic Financial Services Act, 2013 has been referred from the Malaysian central bank’s website. All other guidelines, instructions and shari’iah governance frameworks of both the countries have been accessed from the websites of respective central banks of both
the countries, except the code of corporate governance, 2012 of Pakistan, which has been obtained from the website of Securities and Exchange Commission of Pakistan (SECP). As far as the Islamic corporate governance principles namely *khilafah* (vicegerency), *amana* (trusteeship), *mas'oliyyah* (accountability) and *shafafiyyah* (transparency) are concerned, they have been obtained from the original sources of Islamic law i.e. *Quran*, *Sunnah* of the Prophet Mohammad (Peace Be On Him) and the *Ijma*’ (Consensus of Legal Opinion).

The researcher found that most of the provisions of both the regimes are compatible with the Islamic principles; however, there are some provisions from which these principles cannot be verified such as the provisions of the SGF do not provide any punishments for the non-compliances with the Islamic Law. Further, by comparing the Pakistani and Malaysian regimes of corporate governance, the researcher found that Malaysian regime have distinctive characteristics, such as proper statutory law that defines roles and responsibilities of different corporate governance players; at least one members of *Shariah* Committee is appointed on BODs; SC members have specialized degree in Islamic financial matters; presence of *Shariah* Risk Management and *Shariah* Research Function. These are the strengths of Malaysian regime, which are lacking in the Pakistani regime. Therefore, it is suggested that Pakistani regime also cover the above functions so that the goal of more viable and *shariah* compliant system of corporate governance is achieved.
CHAPTER 1: INTRODUCTION

I. Corporate Governance

Companies are legal entities, which have distinct legal personality from their owners (shareholders). They are entitled to perform all their actions in their own name\(^1\). However, the companies are unable to perform their actions by themselves; therefore, they need some natural persons, like board of directors\(^2\) and management, who will act on behalf of the companies. The board is an important part of a whole structure (system) inside companies.

Corporate governance got attention in early 90s when large corporations\(^3\) and banks\(^4\) collapsed\(^5\). In 1991, a committee on the financial aspect of corporate governance (known as the Cadbury Committee) was established under the supervision of Sir Adrian Cadbury\(^6\). Sir Adrian Cadbury’s definition of corporate governance is given below.

A. Definitions of Corporate Governance

In his report, Sir Adrian Cadbury has given the following definition of corporate governance.

“Corporate governance is the system by which companies are directed and controlled”\(^7\).

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\(^2\) Ibid, p. 114.
\(^3\) Such as Polly Peck and Maxwell in UK, and Enron and WorldCom in USA.
\(^4\) Like Baring Bank in Singapore.
\(^5\) These collapses caused people to explore their reasons. Most important among the reasons was corporate governance failure. For example, the top corporate governance player of poly peck, Asil Nadir was involved in fraudulent activities. Similarly, the directors of WorldCom used fraudulent methods to increase share prices. Likewise, huge losses in the projects of Enron due to mismanagement were concealed by directors.
\(^6\) This was because of ever increasing lack of public confidence in listed companies, and especially when two big companies namely Wallpaper group Coloroll and Asil Nadir’s Polly Peck collapsed. (See generally, Cadbury Committee, Cadbury Report, at Cadbury Archive, 1992, np.http://www.jbs.cam.ac.uk/cadbury/report/committee.html Lastly accessed on 23/05/2013).
To run an organization a system is required, and this system, according to the above definition, is called corporate governance. Further, in the words of the Securities and Exchange Commission of Pakistan\(^8\) (SECP) corporate governance refers to:

“the system by which companies are directed and controlled, focusing on the responsibilities of directors and managers for setting strategic aims, establishing financial and other policies and overseeing their implementation, and accounting to shareholders for the performance and activities of the company with the objective of enhancing its business performance and conformance with the laws, rules and practices of corporate governance”\(^9\).

This definition further elaborates the system of corporate governance by stimulating roles and responsibilities of corporate governance players. The system focuses on responsibilities of directors and managers, who set up strategic objectives of the company, and establish policies as well as oversee their implementation. They are accountable to shareholders for all the activities of the company.

The State Bank of Pakistan\(^10\) (SBP) has defined corporate governance in almost similar words. The definition is given below.

“Corporate Governance is the system by which business corporations are directed and controlled by structuring rights and responsibilities of different participants in the corporation, such as, the board, managers, shareholders and stakeholders. By doing this, it provides structure for setting corporate objectives and mustering resources to attain those goals without compromising fairness, ethics, transparency and accountability”\(^11\).

Like the above two definitions, this definition also calls corporate governance as the system by which companies are directed and controlled, which defines rights and responsibilities of director, managers, shareholders and other stakeholders. Through such structuring, corporate objectives are set up and resources are sought to achieve these objectives.

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From the above definitions of corporate governance it is inferred that Sir Adrian Cadbury, SBP and SECP agree that corporate governance is a system for directing and controlling companies. The SBP and SECP further explain the system by mentioning roles and responsibilities of key players involved in the system. However, they differ on the point that SECP requires the players to follow laws, rules and regulations, whereas, the SBP require them to adhere to the principles of fairness, ethics, transparency and accountability.

B. Islamic Corporate Governance

About the Islamic corporate governance, Zulkifli Hasan states that “a concept of corporate governance from Islamic perspective does not differ much with the conventional definition as it refers to a system by which companies are directed and controlled with a purpose to meet the corporation’s objective by protecting all the stakeholders’ interest and right”12.

In the above definition of corporate governance, Zulkifli Hasan resembles the concept of Islamic corporate governance with the conventional one. However, the difference between the two systems arises on the basis of the objective of the Shariah compliant affairs. In the former system, it is the object of the shariah compliance that justifies the existence of the Islamic banks, whereas in the latter system, shariah compliance is of no concern.

C. Stakeholders of Corporate Governance System

The company is a separate legal entity, which has distinct personality from its owners-the shareholders. But, it can neither make its decisions nor implement them by herself, because it has no mind13 or other organs. Therefore, it needs some natural persons who can act as its mind and organs for performing its actions. Hence, there are important

stakeholders who involve in the affairs of the companies including the shareholders, directors, managers and auditors.

1. Shareholders

Shareholders hold an important place in the system of governance of companies. Shareholders are persons who provide capital to the company and are considered owners of company. They do not directly manage or operate the business of company. They appoint directors for this purpose. It is believed that management of business is entrusted to managers of company, who are responsible for operations of business on behalf of shareholders. The managers are considered as agents on behalf of shareholders (principles).

2. Directors

Directors are the persons usually appointed by shareholders, who provide central leadership to the companies. Fred R. Kaen refers them representatives of shareholders for the protection of their rights. They have all the powers to do with respect to business of companies. They either manage the business of companies themselves or appoint the management (CEO and its staff) for the purpose, who works under the directions of

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BODs. The board’s job is policy making and monitoring that such policies are implemented.

3. Management

Before the emergence of modern corporations, owners were the managers of their businesses. They managed their businesses themselves. However, when large corporations emerged in the late 19th century, the management was separated from ownership. Since then, the owners do not manage the company, and the management is vested into the hands of professional managers. These managers are considered as agents of the owners in the current corporate governance structure.

Managers of company are usually appointed by Directors or management, and are entrusted with the responsibilities to implement the strategies, policies and decisions made by directors. Management includes CEOs, CFOs, Company’s Secretary and Heads of Treasure, Internal Audit, Credit, Risk Management, Operations, Compliance, Human Resource, etc.

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21 The term modern corporation was first used by Adolf Berle and Gardiner Means. “it is a limited liability company (limited liability means that the owners are not personally liable for the debts or any other legal obligations of the firm) in which management is separated from ownership and corporate control falls into the hands of the managers”. See, Adolf Berle and Gardiner Means, The Modern Corporation and Private Property, Macmillan, New York: (1933).
22 Equity-holders.
26 Ibid.
4. Auditors

The word audit is derived from Latin word “audire”, which means to hear. Auditors also play an important role in the system of corporate governance. They are watchdogs of companies. They are appointed to conduct audit of companies. “Audit is an official examination of the accounts (or accounting systems) of an entity (by an auditor)” The objective of an audit is to verify whether the financial statements are prepared in accordance with applicable rules and standards of a particular country or not. The auditors conduct audit to ensure that financial statements represent true and fair view of the state of a company’s affairs.

5. Audit Committee (AC)

Audit Committee is an important committee responsible for overseeing the area of Audit. The AC shall include at least three members (all non-executive directors). The chairman of the committee shall be an independent director-other than the chairman of the BODs. At least one member of the AC shall have relevant financial expertise and experience. The Committee is directly responsible to the BODs.

From the roles of the above mentioned key players it is inferred that as the owners (shareholders) do not manage their businesses, therefore, they entrust such powers into the hands of directors. The directors make policies with respect to business of the owners.

To implement such policies, they appoint managers. Managers implement decisions of
directors and prepare financial statements on the affairs of the company. Auditors then evaluate such statements to give opinion that the statements represent true and fair view of the state of the company’s affairs. Such statements along with the auditor’s report are put before members in AGM. This whole process is corporate governance.

6. Shariah Board

In addition to the existing corporate governance structure, the Islamic banking institutions have a Shariah Board (SB). The number of its members differs from jurisdiction to jurisdiction\(^37\). The members of the SB are usually Shariah Scholars having strong background of Islamic law. In Pakistan, the BODs appoints the members of the SB, who are responsible to ensure Shariah compliance in the activities of the IBIs\(^38\).

D. Significance of the Study

“The survival of organizations depends on complete adherence to ‘Good Corporate Governance’ only”\(^39\). Good corporate governance ensures competitive market. In countries, where there is good corporate governance working, there is robust growth in corporate sector, and has greater ability to attract capital than those countries in which relatively there is loose governance\(^40\).

Banks are important organizations, which act as custodian of the public money. As intermediaries between depositors and borrowers, the banks must have good reputation, which cannot be achieved without proper corporate governance system. The functions of banks are sustained as long as its customers as well as the general public have confidence

\(^{37}\) For example in Pakitan, the SB shall consist of at least three (3) members, whereas, in Malaysia the Shariah Committee has at least five (5) Shariah scholars.


in them. To maintain their confidence, it is very much crucial that the banks must have implemented a strong and good corporate governance system\(^{41}\).

With the emergence of Islamic financial institutions, a new aspect has been introduced into corporate governance goals i.e. *Shari‘ah* compliance. The only rationale that justifies the existence of Islamic financial institutions is, the *Shari‘ah* compliant businesses and operations of the IFIs. If these institutions cannot withhold *Shari‘ah* compliance in its activities, then in the opinion of the researcher, there seems no reason for their very existence. This goal of *Shari‘ah* compliance cannot be achieved without proper and good governance in these IFIs.

Islamic Financial Institutions, having been emerged as alternative to interest-based financial institutions in Pakistan, are expected to be asset-based rather than interest-based. These interest-free financial institutions are also expected to be free from all other prohibited practices in Islam, such as *gharar*\(^{42}\), gambling\(^{43}\), speculations etc., where all transactions, if not totally *Shari‘ah*-based (based on principles of Islamic law), at least, would be *Shari‘ah*-compliant (not contradictory to any principle of Islamic law). Also business profitability and protection of all stakeholders’ interests would be its objectives. Therefore, IFIs need to reassure their stakeholders that the institutions’ activities fully comply with the percept of Islamic Jurisprudence, and that they will actively promote their financial interests, and prove to be efficient, stable, and trustworthy providers of financial services to them\(^{44}\).


\(^{43}\)Gambling is a form of *gharar* because the gambler is ignorant of the result of the gamble. A person puts his money at stake wherein the amount being risked might bring huge sums of money or might be lost or damaged. (See Understanding Islamic Finance by Muhammad Ayub, published by John Wiley & Sons, Ltd, 2007, p. 62).

In Pakistan, Islamic financial institutions started over its operations in early 80s in the shape of modaraba companies when the concept of Modaraba was legalized to conduct the business of Islamic finance under the umbrella of Modaraba Management Companies, registered as Mudarib with the Registrar Modaraba, Securities and Exchange Commission of Pakistan.\textsuperscript{45}

Major business groups took interest in modaraba businesses mainly because of substantial tax incentives. Initially, the business of modarabah in Pakistan showed growth and commendable performance. In those days more than 50 Non-banking Islamic financial institutions were performing with total assets of $425 million and the total profits were about $108 million.\textsuperscript{46} However, the business of modarabah did not sustained for long, and its fall back started after 1996. About 23 non-banking IFIs stopped operations in Pakistan.\textsuperscript{47}

In his article, “Beneath the Failed Islamic Financial Institutions”, Imran Hussain Minhas has pointed out number of reasons for the closures of the NBIFIs, most of which are related to corporate governance failure, such as incompetency of board of directors and senior management, weak internal control, absence of risk management policies, moral hazards-frauds and greed, regulatory failure and non-compliance of Shari‘ah.

All these reasons for the failure of the NBIFIs suggest that the NBIFIs were involved in unethical as well as un-Islamic business practices. And being Muslims, according to our belief, so long as all the activities of organizations are Shari‘ah compliant, they would never meet self-driven failure, because, the activities would be free from fraud, misconduct, breach of trust, selfishness and speculations. Where there would be favourable business environment for IFIs, based on high moral and ethical standards


\textsuperscript{46}Ibid.

\textsuperscript{47}Ibid.
of justice, amanah, shooora, public interests. For this purpose, a strong corporate governance system based on Shari’ah rules and principles is the need of the hour.

Besides modaraba sector, so far there is no statutory law in the country which deals with the establishment and workings of Islamic banking institutions. A full sector of Islamic banking is working only under guidelines, directives and circulars issued by central bank\(^48\) of the country. The Laws relating to conventional banks have been extended to this newly formed sector\(^49\). The Banking Companies Ordinance 1962 deals with the operation of conventional banks only\(^50\). It is also considered as outdated law which only dictates banking sector to make banking business according to Islamic principles but does not mention the mechanism for this sake\(^51\).

There is no law in the country, which deals with the appointment of Shariah Advisors as well as their remuneration and removal. SBP has given these powers to board of directors\(^52\). Further, for transparency in Islamic Banks, Naeem Chohan criticized the SBP that it does not clearly require Shari’ah advisors to publish all rulings and fatwas relevant to the IFIs transactions and to submit it to the SBP along with Shari’ah compliance report\(^53\). It is a question mark on the transparency of IFIs.

In the presence of the above loopholes in the current Pakistani legal regime for Islamic banking institutions, the activities of the IBIs become doubtful as far as their shariah compliance is concerned. Therefore, the researcher felt it necessary to evaluate the

\(^{48}\) The instructions and guidelines include The Instructions for Shariah Compliance of Islamic Banking Institutions, The Guidelines for Shariah Compliance in Islamic Banking Institution and the Guidelines for Setting up of Islamic Banking Institutions.


\(^{50}\) Although, a commitment has been made in the “Strategic Plan for Islamic Banking (2014-2018)” that a chapter shall be introduced in the BCO, 1962 to accommodate the IBIs, but the Government has not introduced it yet. And, so far only a i.e. clause (aa) has been added to the Section 23 of the BCO, 1962. The clause (aa) allows the banking companies to establish the subsidiary companies to carry on their business in conformity with the injunctions of Islam.

\(^{51}\) Ibid.

\(^{52}\) Ibid. (now a days, these are included in the newly issued Shari’ah Governance Framework by SBP for IBIs).

\(^{53}\) Ibid, p. 8.
compatibility of the current corporate governance practices of IFIs with Shari‘ah rules and principle, and to suggest a more viable, efficient as well as Shari‘ah compliant corporate governance system. Hence, research questions put are as follow:

1. Whether Islamic Law has any principles relating to corporate governance?
2. Whether the current corporate governance practices of Islamic banking Institutions in Pakistan and Malaysia are compatible with the Shari‘ah principles?
3. Whether the current Pakistani and Malaysian corporate governance regimes have any similarities or dissimilarities? Whether the dissimilarities are significant enough to be adopted in the Pakistani corporate governance regime for IBIs?
4. In the light of this comparison, what measures could be suggested for setting up a reformed corporate governance system for the IBIs in Pakistan, that would be efficient as well as Shari‘ah compliant?

E. Objectives of the Study

Objectives of the study may be summarized in the following points.

1. To investigate and explore Shari‘ah rules and principles relating to corporate governance in the original sources of Islamic law, and to build a theoretical framework thereupon.
2. To examine compatibility of contemporary practices of corporate governance, with Shari‘ah rules and principles, in respect of Islamic Banking Institutions in Pakistan and Malaysia.
3. To compare corporate governance for Islamic Banking Institutions in Pakistan Vs. Malaysia in terms of similarities and dissimilarities.
4. To give suggestions for a more viable, efficient and Shari‘ah compliant corporate governance system for Islamic Banking Institutions in Pakistan.

F. Limitations and Scope of the Research
With respect to this study, corporate governance means Islamic corporate governance system, which includes two layers of governance namely corporate governance and shariah governance. Similarly, the Islamic corporate governance practices in Pakistan and Malaysia include the theoretical regimes of both the jurisdictions, which are related to corporate governance practices.

Further, the Islamic financial institutions in the current study shall mean the Islamic banking institutions, hence only those provisions of the frameworks shall be brought under discussion which deal with the IBIs. Therefore, other IFIs, such as mutual funds and takaful companies, are excluded in the current study.

The Malaysian regime relating to corporate governance practices in IBIs includes the following laws, regulations, instructions and guidelines:

a. The Islamic Financial Services Act, 2013
b. The Companies’ Act, 1965
c. The Guidelines on Corporate Governance for Licensed Islamic Banks in Malaysia
d. Financial Reporting For Islamic Banking Institutions
e. Fit and Proper Criteria for Key Responsible Persons
f. BNM’s Guidelines on External Auditors
g. Shariah Governance Framework for IFIs, issued by BNM

It is clarified here that the provisions of the Malaysian Code of corporate governance are not included in this study because the Guidelines on Corporate Governance for Licensed Islamic Banks are fully aligned with the principles of Malaysian Code of Corporate Governance (MCCG), as provided in paragraph 1.05 of the Guidelines on CG.

The MCCG includes general principles, which are not mandatory for IBIs, rather voluntarily they may be adopted. Nonetheless, instead of these principles, the BNM has issued its own guidelines specific to IBIs, which include guiding principles on corporate
governance for IBIs, which are almost similar to those given in MCCG. Therefore, the MCCG is excluded in this study.

Like Malaysia, the relevant laws, rules and guidelines of Pakistani regime shall include the following:

a. The Companies Ordinance, 1984
b. The Banking Companies Ordinance, 1962
c. The Revised Code of Corporate Governance, 2012
d. The Prudential Regulations for Corporate/Commercial Banking, issued by the SBP (2011 and updated 2015)
e. The Instructions for Shariah Compliance in Islamic Banking Institutions in Pakistan (2007)

G. Research Methodology

The research work undertaken is qualitative in nature. The provisions of Pakistani and Malaysian regime relating to corporate governance practices are analysed in the light of Islamic corporate governance principles. Both primary and secondary data is used in this study. The data relating to existing literature is mainly collected from books and journal papers of secondary nature. For the purpose of the analysis, the Pakistani statutory laws, that is, the banking companies ordinance, 1962 and Companies Ordinance 1984 are taken from statutes, whereas Malaysian statutory Act i.e. the Islamic Financial Services Act, 2013 is collected from the Malaysian central bank’s website. All other guidelines, instructions and shariah governance frameworks of both the countries are collected from the websites of respective central banks of the countries, except the code of corporate
governance, 2012 of Pakistan, which is collected from the website of Securities and Exchange Commision of Pakistan (SECP). As far as the Islamic corporate governance principles i.e. *khilafah* (vicegerency), *amanah* (trusteeship), *mas’oliyyah* (accountability) and *shafiyyah* (transparency) are concerned, they are collected from the original sources of Islamic law i.e. *Quran*, *Sunnah* of the Prophet Mohammad (S.A.W.W) and *Ijma* (Consensus of Legal Opinion). Further, only relevant and important proisions of the two regimes are analysed in the light of these principles. The provisions are also comparatively analysed, wherein the distinctive characteristics of Malaysian regime are highlighted.
CHAPTER 2

LITERATURE REVIEW

Thorough examination of the available literature on corporate governance reveals the acknowledgement of the fact that corporate governance received fresh impetus only after the collapses of financial giant corporations\textsuperscript{54} and banks\textsuperscript{55} in 1990s, which caused people to explore the reasons for such collapses. Eventually, the most important among these factors was found to be governance failure\textsuperscript{56}. As, Franklin R. Edward has said that the failure of WorldCom, Enron and other corporations has raised questions on the effectiveness of corporate governance, which fails to control the misbehaviors of corporate managers or directors\textsuperscript{57}. Hence, corporate governance remained the central point of concern among researchers and academicians. And now a days bulk of literature is available on it covering each and every aspect of corporate governance, ranging from its concept and definitions to different theories and models. Although, corporate governance received fresh attention after the 1990’s scandals, writings on it are available from the era of Adam Smith\textsuperscript{58} and Berle and Means\textsuperscript{59}.

In the United Kingdom, the Committee on the financial aspect of Corporate Governance (known as Cadbury Committee) was established in May 1991. This was because of ever increasing lack of public confidence in listed companies, and especially when two big

\textsuperscript{54} Such as Polly Peck and Maxwell in UK, whereas, Enron and WorldCom in the US.
\textsuperscript{55} Such as Baring Bank in Singapore.
\textsuperscript{56} For example, the top corporate governance player of poly peck, Asil Nadir was involved in fraudulent activities. Similarly, the directors of WorldCom used fraudulent methods to increase share prices. Likewise, huge losses in the projects of Enron due to mismanagement were concealed by directors.
\textsuperscript{58} In his book titled “Wealth of Nation” Adam Smith has discussed the natural self maximization behavior of management of firms, being humans.
\textsuperscript{59} Berle and Means, in 1932 have discussed the agency problem that arises between shareholders and managers of firms.
companies namely Wallpaper group Coloroll and Asil Nadir’s Polly Peck collapsed\(^\text{60}\).

The task of the committee was to prepare a comprehensive report on the failure of corporations under the supervision of Sir Adrian Cadbury. In the Cadbury committee’s report, Sir Adrian Cadbury defines corporate governance as “the system by which companies are directed and controlled”\(^\text{61}\). Further the report states that “board of directors is responsible for the governance of their companies. The shareholders’ role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place. The responsibilities of the directors include setting the company’s strategic aims, providing the leadership to put them into effect, supervising the management of the business and reporting to shareholders on their stewardship. The Board’s actions are subject to laws, regulations and the shareholders in general meeting”\(^\text{62}\).

A much relevant concept to corporate governance is “agency problem”. The first author who pointed out the agency problem though did not termed it agency problem as such, was Adam Smith. In his book “Wealth of Nation” written in 1776, he stated that “the directors of companies, being managers of other people’s money than their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own”\(^\text{63}\).

The problems were also discussed by Berle and Means in 1932. According to them agency problem arises when ownership and control are separated i.e. ownership of corporations is widely dispersed among shareholders (the principals), and management of the corporation is vested in directors who act as agents for the owners (the


\(^{61}\) Ibid.

\(^{62}\) Ibid.

shareholders). To resolve such agency problems, scholars have suggested a theory called “agency theory”. The scholars, who proposed proper agency theory in general are Barry M. Mitnick and Stephen Ross. In his article titled “Origin of the Theory of Agency: An Account by one of the Theory’s Originators”, Barry M. Mitnick stated that “the first scholars to propose, explicitly, that a theory of agency be created, and to actually begin its creation, were Stephen Ross and Barry Mitnick”. It was 1973 when they were working on the theory independently and roughly concurrently. Ross is responsible for the origin of the economic theory of agency, and Mitnick for the institutional theory of agency, though the basic concepts underlying these approaches are similar.

The Stephen Ross’s article “The Economic Theory of Agency: The Principal’s Problems” was published in 1973, while the Barry M. Mitnick’s article “The Theory of Agency: The Policing “Paradox” and Regulatory Behaviour” was published in 1975, although he had worked out on it two years back in 1973.

Then, with respect to corporate governance the theory was discussed in detail by Jensen and Meckling in 1976. In their work “Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure”, they proposed that the relation between shareholders and management of firms is that of agency relationship. They stated that the management pursue their own interests instead of shareholders’ interests, hence a conflict arises between management and shareholders, which is called agency conflict. Hence, they suggested a mechanism to resolve such agency conflict. According to David Pastoriza and

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Miguel A. Arino, the central problem for agency theory is, how the principals ensure that executives act in the shareholders’ interests rather than their own.\textsuperscript{66}

In a recent article by Zelhuda Shamsuddin and Abdul Ghafar Ismail, i.e. “Agency Theory in Explaining Islamic Financial Contracts” they have explored the concept of agency theory in a conventional perspective to understand the types of agency problems emerging in the contractual relationship context. They stated two types of agency problems that can arise in the agency relation. “Firstly, it is when the principal and agent have different goals or objectives. Secondly, when it is difficult for the principal to access accurate information and behavior of the agent. The agency theory assumes that the role and function of the agency relationship is asymmetric because the principal is only concerned about profit or return as the job is done by the agent. Meanwhile, the agent agrees on his own benefit in terms of the compensation rather than the interest of the principal or organization. There is a potential of lack of addresses by the agency theory in alignment of goals, preferences and action between the principal and the agent.”\textsuperscript{67}

In words of A.C. Fernando, agency theory may be summarized in the following words: Managers are required to maximize profits of shareholders; however, in the present day world the managers do not do so. They are agents of the principles (shareholders). The loss, incurred on the principles due to managers’ deviation from the maximization of the principle’s interests, is called “agency loss”. Therefore, agency theory suggests mechanism to reduce such agency loss. The mechanism includes schemes whereby senior executives obtain shares at reduced prices. In this way the interests of the managers are aligned with the interest of shareholders. Similarly, the executive compensations are tied up with the levels of benefits to shareholders. In this scheme, a part of the executives’


profits is deferred to the future to reward long-run value maximization of the corporation and deter short-run executive action which harms corporate value.\(^\text{68}\)

Kathleen M. Eisenhardt has written an article on agency theory with the title “Agency Theory: An Assessment and Review”, in 1989.

According to the author, the agency theory tends to resolve mainly two problems which may arise in the agency relationship. The first agency problem arises in two cases. The problem arises when agents’ and principals’ goal conflict with each other. The agency problem also arises when it is difficult for principals to be aware of the actions and performance of the managers (agents). The problem here is that the principal cannot verify that the agent is behaving appropriately. The second problem is the problem of risk sharing that arises when the principal and agent have different attitude towards risk. The problem here is that the principal and the agent may prefer different actions because of the different risk preferences.\(^\text{69}\)

According to Donaldson and Davis, the “model of man” underlying the organizational economics and agency theory is that of self-interested actor rationally maximizing their own personal economic gain. The model is individualistic and is predicated upon the notion of an in-built conflict of interest between owner and manager. Moreover, the model is one of an individual calculating likely costs and benefits, and thus seeking to attain rewards and avoid punishment, especially financial ones.\(^\text{70}\)

They further state that there are however, other “models of man” which originate in organizational psychology and organizational sociology. Under these models organizational role-holders are conceived as being motivated by a need to achieve, to gain


intrinsic satisfaction through successfully performing inherently challenging work, to
er exercise responsibility and authority\textsuperscript{71}. Hence Donaldson and Davis suggest another
theory, which is termed as \textit{stewardship theory}.

According to this theory the executive manager tends to be a good steward of the
corporate assets, who wants a good job, and does not behave selfishly\textsuperscript{72}. The
“assumptions made in agency theory about individualistic utility motivations resulting in
principal-agent interest divergence may not hold for all managers. Therefore, exclusive
reliance upon agency theory is undesirable because the complexities of organizational life
are ignored”\textsuperscript{73}.

So in their article “\textit{Stewardship Theory or Agency Theory: CEO Governance and
Shareholder Returns}”, Lex Donaldson and James H. Davis have laid foundation of
stewardship theory, although the article is basically an empirical study in which the role
of CEO and Board’s Chairman has been discussed in terms of agency as well as
stewardship theory. They argued that agency theory suggested the separation of the roles
of chairmanship and CEO-ship for the protection of shareholders’ interests, whereas, the
stewardship theory proposes for alignment of the role of CEO with Chairman of the board
for better protection of right of shareholders. However, in the results of their study it was
found that the assumption of agency theory was incorrect, however, the stewardship
theory’s assumption was somehow verified.\textsuperscript{74}

In their later work with the co-authorship with F. David Schoorman, undertaken in 1997,
titled “\textit{Towards stewardship Theory of management}”, stewardship theory assumes that
the behavior of steward is collective because he seeks to attain the objectives of the

\textsuperscript{71}Ibid.
\textsuperscript{72}Ibid.
\textsuperscript{73}James H. Davis, F. David Schoorman, and Lex Donaldson, “Toward a stewardship theory of
\textsuperscript{74}Lex Donaldson and James H. Davis, “Stewardship theory or agency theory: CEO governance and shareholder
organization. In this theory the model of man is a pro-organizational character who behaves in the interests of the firm. “Given a choice between self-serving behavior and pro-organizational behavior, a steward’s behavior will not depart from the interests of his or her organization. A steward will not substitute or trade self-serving behaviors for cooperative behaviors. Thus, even where the interests of the steward and the principal are not aligned, the steward places higher value on cooperation than defection (terms found in game theory)”75.

In this study they have critically analyzed agency theory, and then discussed stewardship in more detail than the previous study. They have not denied the agency theory absolutely, rather a reconciliation has been sorted out between the two theories that there is no hard and fast rule to check which theory is correct or wrong. Psychological attributes of human and organization’s characteristics have been considered basic factors which change a manager’s (being human) priorities76.

Raising objection on the stewardship theory, David Pastoriza and Miguel A. Arino have undertaken their work as “When Agents Become Stewards: Introducing Learning in the Stewardship Theory”. According to them the stewardship theory emerged as counterweight to agency theory, which addresses some of the reductionist assumptions of agency theory but it suffers from being static as it considers the relationship of principal and agent at a single point of time and assumes no learnings of individuals as a result of their interactions. They objected the H. Davis and other’s work by saying that their theory is correct to the extent that situational and psychological factors may influence the behavior of manager to either behave as agent or steward, but it does not explore which factors make an executive as steward or agent, especially in the case when conflicting factors (one factor influencing him towards stewardship and the other towards

76 Ibid, p. 20-47.
individualistic) surround him. In this paper learnings of agents have been introduced which they get from their interactions with people. According to the author, the agents learn from their interactions, which can change their preferences.77

Recently an article “Let’s Move to Universal Corporate Governance Theory”, has been written by Sheila Nu Nu Htay and others in which they proposed a universal theory of corporate governance. According to them corporate governance theories, namely agency theory, stewardship theory and stakeholder theory have been used in developing the best practices of corporate governance. However, corporate scandals leading to the downfall of financial giants such as Enron and WorldCom in 2003 and the global financial crisis of 2008-2009 have revealed serious inadequacies in the effectiveness of corporate governance. Therefore, these governance failures motivate the researchers to revisit and evaluate corporate governance theories from the ethical point of view. Hence they developed the universal theory on the basis of ethical teachings of all religions such as Christianity, Judaism, Islam, Sikh, Hinduism and Buddhism, which, according to them, is expected to be applicable and acceptable for all types of organizations at any space and time. Their proposed theory is that “corporate players must be responsible and accountable in discharging their duty to achieve socio economic justice”.

According to them, if this theory is followed by the top corporate players, it would bring the social and economic justice what we are dreaming to achieve.78

Further, the basic point of discussion between the agency theory and stewardship theory is the positive behavior of management i.e. how does it behave? However, to the current researcher, the normative aspect of management’s behavior is more significant than its positive behavior. The normative aspect of management’s behavior is that ‘how should’

they behave? In other words, it is the question of ‘should’ which matters most to the current researcher. To answer the question of ‘should’ two dominant models of corporate governance namely the Anglo-American Model and Franco-German Model, become necessary to be discussed.

The Anglo-American model is also called the Shareholder Model of corporate governance, which is prevailing in the United States and the United Kingdom. The model focuses exclusively on the maximization of shareholders value. This model is characterized by three propositions, which are; (1) shareholders ought to have control, (2) managers have a fiduciary duty to serve shareholder interests alone, and (3) the objective of the firm ought to be the maximization of the shareholders’ wealth. This model advocates only shareholders by protecting their interest, which implies that if there is conflict of interest between shareholders and other stakeholders, the interests of the stakeholders shall be ignored.

As opposed to shareholder model, there is another model called the stakeholder model. According to this model, the interests of all stakeholders of corporation shall be protected. This model rejects all the three propositions of the shareholder model, and argues for the following three propositions; (i) all stakeholders have a right to participate in corporate decisions that affect them, (ii) managers have a fiduciary duty to serve the interests of all stakeholder groups, and (iii) the objective of the firm ought to be the

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83 “Any group or individual who can affect or is affected by the achievement of the organization’s objectives” is called stakeholder. (Freeman, R.E. See Strategic Management: A Stakeholder Approach by R. E. Freeman, London: Pitman Press. 1984).
promotion of the interests of all and not only those of shareholders.  

According to this model the interests of stakeholders shall not be ignored, rather management shall balance the interests of all stakeholders.

As far as Islamic corporate governance is concerned a much less literature is available in this regard. No theory has yet been developed with respect to Islamic corporate governance. Even, according to M. S. Sourial, there is not as yet a unified expression in Arabic to represent the meaning of corporate governance, although in Egypt an official translation has been reached for governance pronounced 

hawkama and accredited by the Egyptian Linguistic Department. In view of the current researcher, hence corporate governance may be termed as Hawkamat-e Al-Sharikaat.

Esfandyar Malekian and Abbas Ali Daryaei state that although, there may not be in Islam official juristic recognition of the concept of corporate governance as such, an examination of the principal legal sources of the Holy Quran and sunna reveals clear guidelines about decision-making processes in Islamic context. And according to Mervyn K. Lewis, Islamic corporate governance is all about decision making i.e. by whom, for whom, and with what resources as well as to whom accountability is due? He says that decision-making in Islamic corporate governance is: By whom: Through Mutual Consultation; For Whom: For Allah, and through compliance with Shari'ah; with what resources and to whom accountability is due: through religious supervision, and to God accountability is due.

In Zulkifli Hassan’s view, the concept of Islamic corporate governance does not much differ from its concept in western literature, as in Islamic finance too it refers to a system through which companies are directed and controlled so that their objectives are achieved, and ultimately to protect the interests of all the stakeholders of the corporations. Rahmatina Awaliah Kasri argues that the main difference between Islamic and conventional corporate governance is found with regard to philosophical aspects. This difference is rooted in the fact that Islam sees the corporate governance practices as Muslim’s obligation to God, which leads to the existence of ‘implicit’ contract with God and ‘explicit’ contract with human beings. Western point of view on corporate governance only focuses on material aspects.

Shari’ah scholars, such as Rahmatina Awaliah Kasri, Asyraf Wajdi Dusuki, Umar Chapra, Esfandiar Malekian and Abbas Ali Daryaei are of the view that Islamic corporate governance model has its own unique features and it presents distinctive characteristics. According to Rahmatina Awaliah kasri, God and Islam itself are the key stakeholders in the Islamic corporate governance. According to Umar Chapra and Ahmad, Islam is the key stakeholder in the Islamic corporate governance system because, the first target of opponents would be Islam if an IFI does not comply with Shar ‘ah rules and principles.

As discussed earlier, no theory has yet been developed with respect to Islamic corporate governance. Zelhada Shamsuddin and others, however, have undertaken research work on “Agency Theory in Explaining Islamic Financial Contracts” in which they have pointed out agency problems in the conventional agency theory and then tried to explain it on the

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basis of epistemology of tawheed so that to extend the theory to Islamic Financial
Institutions. In this article he has also provided an initial baseline to understand how
Tawheed epistemology elements, such as unity, vicegerency (khilafah), ihsan and
commitment to fulfill promise can be used to facilitate and deter different goals, different
levels of information, also the opportunism behavior in Islamic Financial Institutions.94
Unlike, Nu Nu Htay, Zelhuda Shamsuddin and others have provided baseline to agency
theory based on tawhid epistemology, however they suggested no new theory as the Nu
Nu Htay did.

Similarly, Shaukat amir and others undertook research on “Mudarabah-A New Paradigm
for Corporate Governance”. According to them, in the current scenario when
shareholders have lost control on their wealth in the hands of professional managers, it is
necessary to have an efficient and effective monitoring environment in which
shareholders participation in policy-making and other major decision-makings, is
ensured. Hence, they proposed the formation of new form of business organization based
on mudharabah. According to them this form of business organization shall resolve the
corporate governance problems arising from the limited liability and separation of
ownership, and the interests of all stakeholders shall be protected.95 In this article they
proposed to change the whole structure of current form of business organization, which
falls beyond the scope of this thesis.

As far as the corporate governance model from Shari‘ah perspective is concerned, M.A.
Choudury, M.Z. Hoque, Zamir Iqbal, Abbas Mirakhor, Zulkifli Hassan and Dr Asyraf
Wajdi Dusuki have written in this regard. The studies these scholars seem to suggest that
islamic corporation may adopt a totally different model of corporate governance or a

94 Zelhuda Shamsuddin and Abdul Ghafar Ismail, "Agency theory in explaining Islamic financial
95 Muhammad Anees, Shaukat Amer and Muhammad Sajjad. "Mudarabah-A New Paradigm for Corporate
modified version of the Stakeholder-oriented model as an alternative for its corporate governance framework. The former model proposed by M.A. Choudury and M.Z. Hoque\textsuperscript{96}, refers to the corporate governance model based on the principle of consultation where all stakeholders share the same goal of tawhid or the oneness of Allah, and the latter model, supported by the rest of the scholars, is basically the existing stakeholders’ value system with some modifications\textsuperscript{97}.

The model proposed by M.A. Choudury and M.Z. Hoque is however criticized by Zulkifli Hassan by saying that the model seems to be unclear and ambiguous as to how it could be adopted and implemented in the current corporate governance system\textsuperscript{98}.

The work undertaken by Choudury and Hoque does not explain as to how are the different groups of participants constituted? It does not mention that who can become member of these groups. The criterion to differentiate between \textit{Shari’ah} Board and \textit{shura’s} groups of participants is also unclear.

Zamir Iqbal and Mirakhor, while discussing the Islamic stakeholder oriented model, have criticized the conventional stakeholder model that it has yet to offer strong arguments with regards to who is a stakeholder and why firm has any obligation to non-owner stakeholders because of absence of theoretical foundation to incorporate morals, ethics and trust in the economic theory. Further, they argued that the governance model in Islamic economic system is a stakeholder-oriented model where governance structure and process at system and firm level protect rights of stakeholders who are exposed to any risk as a result of firm’s activities\textsuperscript{99}. According to them, the stakeholder model is based on the Islamic principles of property rights, commitment to explicit and implicit contractual

\textsuperscript{96}Masudul Alam Choudhury and Mohammad Ziaul Hoque, \textit{An advanced exposition of Islamic economics and finance} 25, Edwin Mellen (2004).
\textsuperscript{98}Ibid.
agreements and implementation of an effective incentive system. In their view, the objective of firms is to minimize transaction cost to maximize profits and returns to investors subject to constraints that these objectives do not violate property rights of any party whether it interacts with the firm directly or indirectly.\(^{100}\)

Zulkifli Hassan in his article “Corporate Governance: Western and Islamic Perspectives” has undertaken a comparative study of corporate governance models in western and Islamic perspectives. In this study, he supported the stakeholder oriented model.

However, his study is limited in scope, which is mere a comparison of already existing literature on corporate governance models in western and Islamic perspectives. From Islamic perspective, he took the already existing two studies as sample, conducted by M.A. Choudry & M.Z. Hoque and Zamir Iqbal & Abbas Mirakhor. He does not explore any principle of Islamic law relating to corporate governance.

Dusuki also acknowledges in his study “corporate governance and stakeholder management: an Islamic approach”, that the model of corporate governance in Shari’ah is stakeholder-oriented. He states that western scholars have noted that constructing a model to devise a principle for making trade-offs among diverse stakeholders is the toughest problem of ethics that usually emerged. Further, according to them, this issue becomes more acute for Islamic Financial Institutions, especially when corporate governance objectives would include reassuring stakeholders that they are likely to receive a fair return on their investments and equally important, that the business practices are in conformity with Shari’ah. Therefore, he attempts to address this issue by providing Shari’ah prescription that provides a framework for managers to resolve problems arising from potential conflicting responsibilities towards various stakeholders.

\(^{100}\)Ibid, p. 48.
In particular, the pyramid of maslahah may serve as a viable and effective model to devise a decision framework for managing conflicts and interest of various stakeholder groups\textsuperscript{101}.

Another scholar, Kasri has undertaken a comparative study on corporate governance from conventional and Islamic perspective. According to him main differences between the two systems are found with regard to philosophical aspects including objectives of the company, types of contract involve, key players in the corporate governance practice and their relationship (governance structure). According to him this difference is rooted in the fact that Islam sees the corporate governance practices as Muslim’s obligation to God, which leads to the existence of ‘implicit’ contract with God and ‘explicit’ contract with human beings. Western point of view on corporate governance only focuses on material aspects. Moreover, mechanism and tools are the same in both perspective, however, IFIs are facing with more complicated financial transactions, hence a stronger internal control system would be required than the conventional one\textsuperscript{102}.

The study undertaken by the above scholar is mere a descriptive type. He has just described the current prevailing corporate governance from Shari‘ah perspective. His study lacks critical analysis of the current corporate governance practices from Shari‘ah perspective. Further, the scope of his study is limited only to the five aspects of corporate governance.

Malekian and Daryaei view that the design of corporate governance model in Islam has its own unique features and presents distinctive characteristics in comparison with the western concept of the Anglo-Saxon and the European model. Islamic values expressed in ethical conduct are an integral part of the obligations laid upon the individual and the


community. Rules of corporate governance derive from the underlying principle of assuring the economic well-being of the whole community on the basis of universal brotherhood, justice, mutual accountability, truthfulness and transparency, protection of minorities, adequate disclosure and equitable distribution of wealth.\textsuperscript{103}

Malekian’s study does not cover all the underlying principles of Islamic corporate governance. They have just mentioned the four building blocks of Islamic corporate governance system namely \textit{shura}, \textit{hisba}, \textit{Shari’ah} supervisory process and religious audit but did not relate these underlying principles with corporate governance. They did not discuss that how these principles should be applied to corporate governance practices. Further, they suggested that Islamic corporate governance should be \textit{shura}-based but did not explain as to how this model works?

Miftahuddin\textsuperscript{104} has undertaken his M.Phil research work on corporate governance in Pakistan and its \textit{Shari’ah} analysis. The main theme of his research is the examination of the practices of corporate governance in Pakistan in the light of principles provided by \textit{Shari ‘ah}. In his research he has discussed some associated values of corporate governance namely \textit{Shari’ah} audit, accountability, transparency and trustworthiness. However, his study is different from the current study. On one hand his study is broader in nature i.e. discussion on corporate governance in general, in contrast to that, the current study is restricted to corporate governance practices in Pakistan’s Islamic financial institutions. On the other hand his study is restricted only to Pakistani corporate governance, while the current study is extended to Malaysian corporate governance system, which is a comparative study in nature.


\textsuperscript{104} Miftahuddin is currently offering his valuable services as lecturer to \textit{Shari ‘ah} Academy, International Islamic university, Islamabad. He has written his M Phil thesis on title “Corporate governance in Pakistan: An analytical study from Shari’ah perspective”.

The current study is a detail study in which principles of Islamic law relating to corporate governance shall be explored. Then corporate governance practices of Pakistani and Malaysian’s IFIs shall be analyzed in light of those principles. Also both corporate governance systems for IFIs shall be compared in terms of similarities and dissimilarities. In last, a more viable, efficient as well as Shari‘ah complaint corporate governance system shall be presented for IFIs in Pakistan. All these aspects are lacking in the study of Miftah.

Some scholars, such as Mervyn K Lewis, Sharifa Hayati, Shaukat Amir, Malik M. Hafeez etc. have also discussed some principles of Islamic law in relation to corporate governance. Mervyn K. Lewis argues that shoora, hisba, and the Shari‘ah supervisory process and religious audit establish the basic building blocks of a system of Islamic corporate governance. Through process of shoora it is ensured that corporate activities and strategies are fully discussed and that a consensus-seeking consultative process is applied. In the process of shoora, directors and senior executives would be expected to listen to the opinions of other executives before making a decision. The shoora members would include, as far as possible, representatives of shareholders, employees, suppliers, customers and other interested parties. The institution of hisba offers a framework of social ethics, relevant to monitor the corporation, with the objective of encouraging the correct ethical behaviour in the wider social context. It also empowers individual Muslims to act as ‘private prosecutors’ in the cause of better governance by giving them a platform for social action. The third pillar of the system is the discipline provided by Islamic religious auditing, which is a device to solicit juristic advice, monitor compliance with the Islamic precepts and collect zakah. This extra layer of auditing and
accountability for resource use ensures that the enterprise operates as an Islamic concern\textsuperscript{105}.

Zamir Iqbal and Abbas Mirakhor have discussed two basic principles of Islamic law relating to corporate governance. The Islam’s principles of property rights and commitment to explicit and implicit contractual agreements provide strong base for Islamic corporate governance\textsuperscript{106}.

According to Malik M. Hafeez\textsuperscript{107} Islamic principles of corporate governance determine the three dimensions of decision-making i.e. by whom: through shoora (mutual consultation), for whom: to attain grace of Allah and being His trustees in decision-making to protect the interest of Allah’s people, and with whom and to who: through effective religious supervision to ensure that all operations are Shari ‘ah compliant. In this regard, he has discussed that Islamic institution of Hisba is to ensure Shari ‘ah compliance in corporate and business affairs. He further stated that Islamic concept of Ameer (group leader) reflects that team members should follow the commands of group leader either he is CEO or Chairman of the board. Also he stated that the life of Prophet Mohammad (PBUH) in war-time as well as in peace provides the concept of Al-Takhteet (planning and strategy), which may be considered as basis for corporate strategy.

In this article Malik has tried to analyze corporate governance from Islamic perspective, and mentioned some Islamic principles relating to corporate governance, but did not explore all the principles of Islamic law relating to corporate governance. The study shows that the writer has just tried to show that Islam as religion being complete code of life having guiding principles relating to all aspects of life has also provided the guiding principles relating to corporate governance. Anyhow, the study confirms that there are

\textsuperscript{106} Zamir Iqbal and Abbas Mirakhor, "Stakeholders model of governance in Islamic economic system." Islamic Economic Studies 11, no. 2 (2004): 43-64.
guiding principles in Islamic law, which relate to corporate governance, and that corporate governance can be shaped into Islamic corporate governance.

Dusuki suggests that the principle of Maslaha should be used to resolve conflicts arising among different stakeholders of companies. In the history of Islam this principle has been widely used to resolve issues being arisen from corresponding rights and responsibilities among people. He argues that Islam stresses more on preference of public interest over individual interests, there, in Islam the masalah are categorized into dharooriat (essentials), hajiyyat (complimentary) and tahsiniyyat (embellishments) respectively. Dr Asyraf Dusuki suggests managers to use the principle of maslah while making decisions with respect to business activities.

Zelhuda Shamsuddin and Abdul Ghafar Ismail have conducted a study with the title “Agency Theory in Explaining Islamic Financial Contracts”, in which they have discussed the agency problems as well as agency theory from conventional perspective. Also they have discussed the flaws arising from the conventional agency relationship. They are of the opinion that several relationships can be created while setting up IFIs. For instance, depositors deposit their monies in Islamic financial institutions for investments purposes. The IFIs make transaction on behalf of the depositors. Therefore, the staff of the IFIs, must have legal capacity to enter into transactions and make decisions on their behalf. Here the authority given to the IFIs by the depositors is the authority of agency.

Further, according to him, most of the products of Islamic banks (both equity based such as musharakah, mudharabah and debt based such as ijarah and salam) are based on the

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blocks of partnership among depositors, borrowers and investors. In this scenario, the IFIs act as agents (wakeel) when performing any transaction on behalf of such stakeholders\textsuperscript{111}. Hence, onward in their article, they discussed in detail, the Islamic contract of agency as well as its implications on IFIs with respect to agency problems. According to them the IFIs may face the same agency problems as that the conventional financial institutions do, such as information asymmetry, conflict of goals and behaviours. For example, the management make some irresponsible decisions with respect to usage of the account-holders’ money. In this case, they would not perform their fiduciary duty towards these account holders\textsuperscript{112}.

This contract of wakalah is one of the important principles of Islamic law relating to corporate governance, however, the management of IFIs does not act as wakeel (agent) of depositors and shareholders. The wakalah is relevant to the relationship between the BODs and IFIs, as BODs act as agent of IFI. Furthermore, it is not only the principle of wakalah which relates to corporate governance, rather, there are so many principles of Islamic law which provide basis for corporate governance, such as shoora (mutual consultation), amanah (trusteeship), khilafah (vicegerency) and Mas‘oliyyah (accountability).

Shaukat Amer and others have discussed the principle of mudharaba in corporate governance. According to them, in the current scenario when shareholders have lost control on their wealth in the hands of professional managers, it is necessary to have an efficient and effective monitoring environment in which shareholders participation in policy-making and other major decision-makings, is ensured. Hence, they proposed the formation of new form of business organization based on the Islamic principle of mudharabah. They argued that this form of business organization shall resolve the

\textsuperscript{111}Ibid, p. 538.
\textsuperscript{112}Ibid.
corporate governance problems arising from the limited liability and separation of ownership, and the interests of all stakeholders shall be protected\textsuperscript{113}.

Another study has been carried out by Abdussalam Mahmoud Abu-Tapanjeh on “Corporate Governance from the Islamic Perspective: A Comparative Analysis with OECD Principles”, in which he has discussed some Islamic principles relating to corporate governance in comparision with OECD’s principles. The Islamic principles include business ethics, shoora (mutual consultation), hisbah (to ensure shariah compliance), the Islamic principle of accountability, and book keeping and final account\textsuperscript{114}.

In Islamic business ethics, the absolute ownership belongs to Allah the Almighty, and human beings are considered as His vicegerents, who hold things as trust. Muslims are entitled to conduct their business activity as guided by the Shari’ah code of conduct, which encourage [Muslims] to be just, fair and honest to all the people involved in the business. Therefore, Muslim business people are taught to possess a high moral conduct, so not to betray, deceive or exploit his fellowships. And the Muslims should not stick only to the profit-maximization\textsuperscript{115}.

Shoora (mutual consultation) should be used as the process of decision-making. Quran clearly emphasizes on consultation in decision-making, and whom to consult. The best benefited ways to whom to consult are those good men who respond to God and fear God, and who can conduct fair mutual justice with equal importance to all. Thus, this conveys the Muslims to “live true in mutual consultation and forbearance, and rely on


\textsuperscript{115}Ibid, p. 561-562.
Allah\textsuperscript{116}. \textit{Hisba} ensures compliance with the \textit{Shari‘ah} requirements, particularly in the business affairs\textsuperscript{117}.

The Islamic principle of accountability implies to produce true and fair disclosure and transparency. The fundamental concept of Islamic accountability is believed that all resources are made available to individuals in a form of trust, for which they are accountable to Allah and human beings. Hence true disclosure of financial facts, and accurate information should freely available to users. Another important point involved in disclosure is to provide the users adequate information which needed for sound financial decisions. This will lead in paying accurate Zakat which is the third pillar of Islam\textsuperscript{118}.

With respect to Islamic principle of \textit{book keeping and final account}, Abu Tapanjeh states that Islam encourages to deal business ensuring fair and just financial transaction between each other and that the ultimate accountability is due to Allah. For this purpose Quran requires from Muslims to have transactions in writing. All transactions in any business dealing should be written down by a good man who possesses high moral conduct and can be just fair to each party\textsuperscript{119}.

Chapra and Ahmad undertook a comprehensive research work on “\textit{Corporate Governance in Islamic Financial Institutions}”, in 2002. According to them, the depositors of IFIs are exposed to additional risk as a result of their profit and loss sharing deposits, therefore, on the corporate governance side, it is important to make the board and senior management more effective in their roles and responsibilities. They also suggested that effective tools of corporate governance should be maintained and enhanced. The tools according to them include internal control, risk management, transparency, \textit{Shari‘ah} clearance and audit, \textit{Shari‘ah} audit, loan accounting and

\begin{flushright}
\textsuperscript{116}Ibid, p. 562. \\
\textsuperscript{117}Ibid, p. 563. \\
\textsuperscript{118}Ibid. \\
\textsuperscript{119}Ibid. 
\end{flushright}
disclosure, and prudential regulation and supervision. Further, in the absence of shared institutions, there is apprehension of failure of IFIs, hence they suggested for co-operation among Islamic banks, the regulatory authorities and fuqaha to cope with the overwhelming challenge of the failure of IFIs\textsuperscript{120}.

Ramiz and Mangla undertook study on “Corporate Governance and Performance of Financial Institutions in Pakistan: A Comparison between Conventional and Islamic Banks in Pakistan” in 2010. According to them, corporate governance plays a significant role in the performance of conventional as well as Islamic banks in Pakistan. The Shari‘ah boards of IBIs affect their returns and technical efficiency\textsuperscript{121}.

Zulkifli Hasan has also worked on somehow ignored dimension of corporate governance i.e. ethical dimension. In his article, “Corporate Governance in Islamic Financial Institutions: An Ethical Perspective”, he argues that significant concerns have been invoked on the material aspects of Islamic finance such as financial growth and products sophistication, nonetheless, equal emphasizes have not been given on the issue of ethics. Hence, in his work he aimed at expanding the faith based moral horizon by advocating ethics as one of the foundational dimensions of corporate governance in Islamic Financial Institutions. According to him the western business morality is derived from the “secular humanist”, which is socially constructed through human reason and experience. The Islamic ethical principles, on the other hand, are divine and religiously constructed, as profounded by Quran and Sunnah\textsuperscript{122}. This is very much important aspect of corporate governance he has worked on, yet an ignored one.

\textsuperscript{120}M. Umer Chapra and Habib Ahmed, “Corporate governance in Islamic financial institutions.” Occasional paper 6 (2002).
In December 2006, the Islamic Financial Services Board (IFSB) published the ‘Guiding Principles on corporate governance for institutions offering only Islamic financial services(excluding Islamic insurance (takaful) institutions and Islamic mutual funds)’ and has since set up a working group to address implementation issues\textsuperscript{123}.

The IFSB’s document contains seven guiding principles, which can be divided into four parts:

1. General governance approach of IIFS;
2. Rights of investment account holders (IAH)
3. Compliance with Islamic Shari‘ah rules and principles; and
4. Transparency of financial reporting in respect of investment accounts\textsuperscript{124}.

The guiding principles are designed to help IIFS establish and implement effective corporate governance practices.

However, these guiding principles are not mandatory for IFIs in Pakistan, hence, currently they do not follow these principles. Nonetheless, SBP being its founding member is likely to consider the IFSB’s standards for Islamic Banking Industry and to adopt these with appropriate amendments, wherever required\textsuperscript{125}.

Similarly, the Accounting and Auditing Organization for Islamic Financial Institution (AAOIFI) has issued Governance Standards for Islamic financial institutions, which are related to appointment, composition and removal of the Shari‘ah Supervisory Board. The standards also cover the SSB’s report, its publication along with the publication of rules and fatawas of the SSB. However, these standards are not mandatory for IFIs in Pakistan, neither the IFIs have adopted them voluntarily. Therefore, there is need for setting up of Islamic Financial Accounting, Auditing and governance standards for IFIs in Pakistan.

\textsuperscript{124}Ibid.
In Pakistan, it was the Institute of Chartered Accountants of Pakistan (ICAP) which took initiatives to develop good corporate governance in 1998. In this regard, a committee was established having representation from Institute of Cost and Management Accountants of Pakistan (ICMAP), the ICAP, the Securities and Exchange Commission (SEC) and all the three stock exchanges (KSE, LSE & ISE). A sub-committee was also established, which was assigned the task to formulate recommendations for the preparation of draft on corporate governance. In this way, a draft was prepared and issued by SEC in 2002.\textsuperscript{126}

Then by exercising its powers by SEC, conferred to it by section 34(4) of the Securities and Exchange Ordinance, 1969 of Pakistan it directed all the three stock exchanges of Pakistan to incorporate the Code in their respective listing regulations, and accordingly they did so. And then onward the code (hereinafter called the Code, 2002) was applicable to all listed companies of Pakistan.\textsuperscript{127}

The code, 2002 was basically a code of best practices, where most of its provisions were not mandatory. Later on a survey was conducted by SECP, ACCA, and PICG in Collaboration with International Finance Corporation (IFC) on corporate governance practices in Pakistan. In this survey contemporary corporate governance practices have been analyzed and recommendations have been given for bringing improvements in the current corporate governance system of Pakistan. Such recommendations also included development of a revised code of corporate governance. Subsequently, a revised code was issued in 2012.

Primarily, this Code is also applicable to listed companies in Pakistan. However, according to prudential regulation G-1, it shall be applicable to banks/DFIs so long as it does not contradict with the provisions of BCO, 1962, the Prudential Regulations and the


\textsuperscript{127} Ibid.
instructions/guidelines issued by the State Bank of Pakistan. It is inferred that the code, 2012 is applicable to IBIs being a bank, so long as it does not contradict the provisions of the above mentioned laws. It means that it is not the code, 2012 which is a core governance code for banks, rather these are BCO, 1962 and other instructions and guidelines issued by SBP, which govern banks.

But the BCO, 1962’s provisions basically concern about conventional banking companies and not Islamic banking companies. Islamic banking in Pakistan is not recognized in legal framework, and mere accommodated through the instructions, where IBIs have been allowed to offer Islamic modes of banking and finance.

To accommodate IBIs, the SBP had issued Instructions and Guidelines for Shari’ah Compliance in Islamic Banking Institutions, as Annexure 1 and Annexure 2 to IBD Circular No. 02 of 2008 respectively. According to section 4 of the circular, in exercise of the powers conferred by clause (o), subsection (1) of section 7 of Banking Companies Ordinance, 1962, State Bank of Pakistan through these instructions has specified Shari’ah-compliant modes of banking and finance for IBIs. Hence, according to section E of the instructions, IBIs may offer such modes as well as products based on these modes.

However, clause 4 of section E clarifies that such modes does not preclude the possibility of developing new products by the IBIs with prior approval of their Shari’ah Advisor. Further in addition to these modes, IBIs may also engage in other businesses as authorized under section 7 of BCO 1962, provided they are Shari’ah compliant.


129 These modes are: (a) Participatory modes including Mudarabah, Musharaka, Diminishing Musharaka and Equity Participation in the form of shares in a corporate entity; (b) trading modes including ijarah or ijarah wa itqina’, murabahah, musawamah, salam, istisna’ and tawarruq may also be used in exceptional cases requiring specific prior approval of Islamic Banking Department of SBP; (c) Debt based mode such as qardh and (d) other modes including wakalah, assignment of debt and kafalah. (See *Instructions for Shirsah Compliance in Islamic Banking Institutions*, issued by SBP, p. 3)
The instructions in IBD Circular No. 02 of 2008 cover various areas related to appointment, removal and working of Shari‘ah Advisors; conflict resolution in Shari‘ah rulings; Shari‘ah compliant modes; use of charity fund, introduction of new products and services and schedule of services charges etc.\textsuperscript{130} Whereas, the guidelines are meant for providing guidance in areas like Shari‘ah compliance, internal Shari‘ah audit, investment in shares, policy for profit distribution with PLS account holders and financial reporting and general disclosure etc.\textsuperscript{131}

Section F of the instructions provide ‘Essentials of Islamic Modes of Financing’ in Appendix-A to the instructions, as \textit{minimum requirements} for Shari‘ah compliance in respect of products developed on the basis of such modes. IBIs may include additional conditions and controls in their procedures for the sake of more effective Shari‘ah Compliance and prudence. Further, for the Islamic modes for which essentials have not been prescribed, AAOIFI Shari‘ah Standards may be used as guidelines by IBIs in consultation with their SA\textsuperscript{132}. Untill now, the Shari‘ah Standards are not mandatory for IBIs in Pakistan. The SBP in collaboration with ICAP has planned to adopt the AAOIFI Shari‘ah Standards with necessary modifications.

Then keeping in view the developments taken place in the Islamic banking industry over recent years, some of the instructions and guidelines have been revisited and a comprehensive “Shari‘ah Governance Framework” has been issued. The primary objective of the framework is to further strengthen the overall Shari‘ah compliance environment in the IBIs\textsuperscript{133}. Accordingly, Section A, B, C & D of Annexure-1 (Instructions) and Section I & II of Annexure 2 (Guidelines) of IBD Circular No. 2 of

\textsuperscript{130} State Bank of Pakistan, \textit{Instructions for Shariah Compliance in Islamic Banking Institutions}, Annexure 1 of IBD Circular no. 02 of 2008.

\textsuperscript{131} Ibid.

\textsuperscript{132} Ibid, Section F.

2008 stood replaced with the *Shari’ah Governance Framework*, whereas all other instructions contained in the said Circular shall remain the same\(^\text{134}\).

The recently issued ‘*Shari’ah Governance Framework*’ (SGF) is somewhat comprehensive document as far as *Shari’ah Governance* is concerned, which covers role of Board of Directors (BOD), role of Executive Management, *Shari’ah Board*, Resident *Shari’ah Board* member (RSBM), *Shari’ah Compliance Department*, Internal *Shari’ah Audit*, External *Shari’ah Audit*, Conflict Resolution, competence of the organs dealing with *Shari’ah governance framework*, report of *Shari’ah Board*. However, it will not be unjustified to say that overall corporate governance provisions with respect to IBIs in Pakistan are in scattered form.

The existing applicable *financial accounting* and *reporting* architecture for IBIs is based on conventional banking and finance transactions, whereas Islamic banking is substantially different from conventional banking\(^\text{135}\). It has its own distinctive characteristics and peculiar transactions for which the conventional standards are not always suitable. Therefore, IBIs require to have followed standards appropriated for/to IBIs’transactions.

Unfortunately, neither IBIs have Islamic Financial Accounting Standards nor separate presentation and disclosure framework available. So far, only three Islamic financial accounting standards i.e. IFAS-1 and IFAS-2 have been issued by ICAP for IFIs in Pakistan. IFAS-1 deals with murabaha, IFAS-2 with ijarah, whereas, IFRS-3 with Profit & Loss Sharing Deposits. Therefore, the IBIs in Pakistan, are compelled to follow the provisions of BCO, 1962, Companies Ordinance, 1984, The Code, 2012, which are basically related to conventional banks.

\(^{134}\text{Ibid., para 4.}\)

For Example, the format given under section 234(2)(i) & (ii) of CO, 1984, for the preparation of Profit and Loss Accounts and Balance Sheet, are not applicable under its proviso to banks, for which requirements are specified by its own governing laws. So, section 34(1) of BCO becomes relevant in this regard, which requires from banks to prepare its Balance Sheet and Profit and Loss Accounts to the extent possible, in accordance with second schedule of the BCO.

It means that Banks (including IBIs) shall prepare its Balance Sheet and Profit and Loss Accounts according to second schedule, however, sub-section (4) of Section 34 of BCO, gives power to SBP to make amendments in the format provided in second schedule. Therefore, the SBP, under its BSD Circular no. 4 of 2006 has required banks to follow the format provide therein.

Besides, section 34(3) of BCO, declares that although, the Balance sheet and profit & loss accounts of banks are not prepared in accordance with the provisions of the CO, 1984, all other provisions of the CO relating to Balance Sheet and Profit and Loss Accounts shall be applicable to banks. Hence, keeping view this provision, it is said that section 234(3)(i) of the CO, is applicable to banks, according to which, the international accounting standards and other standards as notified by the SECP, shall be applicable to Banks(including IBIs) in preparation of its financial statements.

Out of these standards, the SBP has held in abeyance the IFRS-7, IAS-39 and IAS-40\textsuperscript{136}. 

It is inferred that provisions of the following are applicable to IBIs in Pakistan:

1. CO, 1984
2. BCO, 1962
3. SBP Directives
4. IFRS notified by SECP
5. IFAS issued by ICAP

So the accounting, auditing and governance Framework is so scattered for IBIs, which is un-organized and not uniformed in character. On the other hand Malaysia has a comprehensive framework. It has proper statutory law for IFIs. It has issued its own standards called Malaysian Financial Reporting Standards (MFRS) which are fully convergent with IFRS.

From the above discussion it is concluded that following gaps are found in the current literature on corporate governance:

1. Not all underlying \textit{Shari’ah} rules and principles relating to corporate governance have yet been explored in the original sources of Islamic law, but some.
2. No comparative study has yet been undertaken in terms of similarities and dissimilarities of corporate governance for IBIs in Pakistan and Malaysia.
3. Similarly, current corporate governance practices of IBIs in Pakistan and Malaysia have not yet been analyzed from \textit{Shari’a}h perspective simultaneously.
4. There is no separate Corporate Governance Code for IFIs in Pakistan.
5. There is no legal recognition of IBIs in Statutory Law.
6. There are no separate Islamic Financial Accounting, Auditing and Governance Standards for IBIs in Pakistan.

7. No comprehensive corporate governance system is available in Pakistan in isolation for IBIs, therefore, such IBIs rely on conventional corporate governance system, which may create doubts in the minds of general public regarding their Shari‘ah compliance. By filling up the gaps suggestions shall be given for more viable, efficient and Shari‘ah compliant corporate governance system for Islamic banking institutions in Pakistan. However, the study is restricted to the following objectives:

1. To investigate and explore Shari‘ah rules and principles relating to corporate governance in the original sources of Islamic law.

2. To examine compatibility of contemporary practices of corporate governance, with Shari‘ah rules and principles, in respect of Islamic Banking Institutions in Pakistan and Malaysia.

3. To compare corporate governance for Islamic Banking Institutions in Pakistan Vs. Malaysia in terms of similarities and dissimilarities.

4. To give suggestions for more viable, efficient and Shari‘ah compliant corporate governance system for Islamic Banking Institutions in Pakistan.

It is hereby reminded that the current researcher is inclined towards the stakeholder oriented model from Islamic perspective, which means that the existing stakeholder model shall be reformed so that the objective of shariah compliant and efficient corporate governance system is achieved for Islamic banking institutions in Pakistan.
CHAPTER 3

CONCEPTUAL FRAMEWORK: CORPORATE GOVERNANCE THEORIES AND MODELS

In this chapter, we will first discuss all the relevant theories of corporate governance, and then dominant models. The chapter is divided into two sections. Section I covers theories of corporate governance, whereas Section II deals with the two dominant models of corporate governance.

Section I

I. Theories on Corporate Governance

The corporate governance theories discussed under this section, include agency theory, stewardship theory, shareholder theory, stakeholder theory and universal theory of corporate governance. However, there is another much relevant concept relating to corporate governance i.e. agency problem, therefore, the researcher feels it appropriate to discuss the agency problem before the theories.

A. Agency Problem

According to OECD principles, corporate governance addresses “the problems that result from the separation of ownership and control”\(^\text{137}\). Before the emergence of modern corporations\(^\text{138}\), owners were the managers of their businesses. They managed their businesses themselves. However, when large corporations emerged in the late

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\(^{138}\) The term modern corporation was first used by Adolf Berle and Gardiner Means. “it is a limited liability company (limited liability means that the owners are not personally liable for the debts or any other legal obligations of the firm) in which management is separated from ownership and corporate control falls into the hands of the managers”. See, Adolf Berle and Gardiner Means, *The Modern Corporation and Private Property*, New York: Macmillan, 1933.
19th century, the management got separated from ownership. Since then owners do not manage the company, and the management is vested into the hands of professional managers. These managers are considered as agents of the owners.

So, according to the definition, the problems arising from such separation of ownership and control are addressed by corporate governance. The problems arising from the separation of ownership and control are called agency problems because the relationship emerged from such separation is considered as agency relationship.

Shareholders are considered owners of company in which they have shareholdings, hence entitled to the profits earned from the business operations of the company. Management is responsible for its overall business operations. Typically speaking, the management runs business of the company, which in turn earns profit. The profit is then distributed among shareholders. It means that management act in the interest of shareholders. However, it is not that simple. Not all managers are selfless, and they may act selfishly in their own interest by ignoring the interests of shareholders. This phenomenon has been first discussed in detail by Michael Jensen and William Meckling in 1976. They called this phenomenon as agency problem because according to them the management acts as agent of shareholders (the principles). Such agency problem is always there, whenever the management does not act in the best interest of its principle (shareholders), or in case of conflict of interests between the management and shareholders, the management ignores the interests of shareholders. For example, a manager might not be willing to spend money on staff training because, in short run, it might reduce his salary. But this type of investment (spending money on staff training) might have the potential to increase

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141 Ibid.
profit in the long run, while the manager might no longer be offering his services to the company that time. Hence, a potential conflict of interest between the manager (agent) and the shareholders (principle) would occur. This conflict of interest is an agency problem.

The agency problem had been pointed by Adam Smith in his well-known treatise “Wealth of Nation” in 1776 by saying:

“The directors of companies, being managers of other people’s money than their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own.”

These problems were also discussed by Berle and Means in 1932. According to them agency problem arises when ownership and control are separated i.e. ownership of corporations is widely dispersed among shareholders (the principles), and management of the corporation is vested in directors who act as agents for the owners (the shareholders).

According to Zelhuda Shamsuddin and Abdul Ghafar Ismail “two main problems can arise from the agency relationship. Firstly, it is when the principal and agent have different goals or objectives. Secondly, when it is difficult for the principal to access accurate information and behavior of the agent. To resolve such agency problems, scholars have suggested a theory called “agency theory”.

B. Agency theory

With respect to corporate governance the agency theory was discussed in detail by Jensen and Meckling in 1976. In their work “Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure”, they proposed that the relation between

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shareholders and management of firms is that of agency relationship. They stated that the management pursues its own interests instead of shareholders’ interests; hence a conflict arises between management and shareholders, which is called agency conflict. Therefore, they suggested that there must be some mechanism to resolve such agency conflict. According to David Pastoriza and Miguel A. Arino, the central problem for agency theory is, how the principals ensure that executives act in the shareholders’ interests rather than their own.”

According to this theory as agents are not always working in the interest of their principals, therefore, to protect their own interests, the principals seek some control mechanism to monitor the acts of the agents.

If ownership and management control of a company are not separated, and they rest with the same person (the owners/shareholders), the owners shall receive a normal/actual rate of return on their shares, but, according to agency theory, due to separation of ownership and control, the agency problem may cause reduction in the normal rates of return. This loss in the returns to the residual claimants, the owners, is termed as Agency loss. To minimize such prospective agency loss, some agency costs are incurred by the principle. These costs required to monitor the agency behavior because of lack of trust in the good faith of agents, are called agency costs.

The mechanism to reduce agency loss includes some incentive schemes for managers in terms of financial rewards. For example, shares at reduce prices are awarded to managers for maximization of shareholders’ wealth. Hence, the interests of managers are aligned

with those of the shareholders. “Other similar schemes tie executive compensation and levels of benefits to shareholders returns and have part of executive compensation deferred to the future to reward long-run value maximization of the corporation and deter short-run executive action which harms corporate value.”

The above mentioned tactics are used to align the interests of managers with stakeholders. D.R. Dalton, M.A. Hitt, S.T. Certo and C.M. Dalton suggest three ways to resolve the agency problems. These are: (i) board independence to force and improve the director monitoring of managers, (ii) principal’s monitoring the market for corporate control, which refers to the merger and acquisition market that improves on the mischievous managers and (iii) equity ownership to agent that offers managers to share the ownership of the organization.

According to them, first make the managers as shareholders so that their interests are aligned with the interests of other shareholders, and then subject them to independent check by the Board.

From the above mentioned solutions, it appears that only material aspect has been focused and moral (religious moral) aspect based on the concept of amanah has been totally ignored. According to which it must be realized to the managers that property and its management by the managers is a kind of trust with them, and about which they shall be asked on the Day of Judgment.

1. Implications of the Agency Theory

Implication of the theory is that all rules and laws are made in favor of shareholders. All the CG players are bound to work for the protection of shareholders’ rights alone. Boards

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151 Ibid.
shall make policies keeping in mind the interests of shareholders. Similarly, management would employ their efforts, while implementing such policies, to protect the interests of the shareholders.

a) Criticism on the Agency Theory

Criticizing Agency Theory, Donaldson and Davis argue that the “model of man” underlying the organizational economics and agency theory is that of self-interested actor rationally maximizing their own personal economic gain. The model is individualistic and is predicated upon the notion of an in-built conflict of interest between owner and manager. Moreover, the model is one of an individual calculating likely costs and benefits, and thus seeking to attain rewards and avoid punishment, especially financial ones.\(^\textit{153}\) They further state that there are however, other “models of man” which originate in organizational psychology and organizational sociology. Under these models organizational role-holders are conceived as being motivated by a need to achieve, to gain intrinsic satisfaction through successfully performing inherently challenging work, to exercise responsibility and authority.\(^\textit{154}\) Hence Donaldson and Davis suggest another theory, which may be termed as \textit{stewardship theory}.

C. Stewardship Theory

The stewardship theory has been proposed by Lex Donaldson and James H. Davis in 1991.\(^\textit{155}\) As opposed to agency theory, the stewardship theory assumes that managers are good people and they act as stewards. According to this theory, the behaviours of the managers are aligned with the interests of the shareholders, and that there is no conflict of


\(^{154}\) Ibid.

interests between them (owners and managers). Hence, no controlling or monitoring mechanism for the conduct of management is required.

According to this theory the executive manager tends to be a good steward of the corporate assets, who wants a good job, and does not behave selfishly. Donaldson and Davis have criticized Agency Theory that the “assumptions made in agency theory about individualistic utility motivations resulting in principal-agent interest divergence may not hold for all managers. Therefore, exclusive reliance upon agency theory is undesirable because the complexities of organizational life are ignored.”

So, in the stewardship theory the model of man is a pro-organizational character who behaves in the interests of the firm. “Given a choice between self-serving behavior and pro-organizational behavior, a steward’s behavior will not depart from the interests of his or her organization. A steward will not substitute or trade self-serving behaviors for cooperative behaviors. Thus, even where the interests of the steward and the principal are not aligned, the steward places higher value on cooperation than defection (terms found in game theory).”

1. Implications of the Stewardship Theory

Like agency theory, the implication of this theory is that all the laws and rules shall be made in the best interest of shareholders. The CG players shall work to protect the interests of shareholders alone. Board’s policy-makings are subject to safeguarding the interests of shareholders. The management shall also employ their efforts for the protection of shareholders’ interests, while implementing the policies made by the board.

However, the difference between the implications of the two theories would arise only in approaches towards the protection of shareholders’ interests, while making laws in policies. For example, in the case of agency theory, controlling rules and policies shall be made, whereas, in stewardship theory case, facilitating laws and policies shall be made.

a) Criticism on the Agency and Stewardship Theories

The above two theories, describing the relationship between owners and managers, are quite opposite to each other. *Agency Theory* adheres to the supposition that managers are selfish and opportunistic. They give priority to their own self-interests. *Stewardship Theory* presumes that management is not selfish, rather trustworthy. They work for the betterment of the organization, hence protect the interests of the owners.

The drawback of these two theories is that the philosophy behind them is the protection of shareholders interests alone. Both want to have protection of interests of shareholders. The former theory keeps check on management in order to protect the interests of shareholders, whereas the latter facilitates management for the protection of shareholders interests. They do not take into consideration the stakeholders other than shareholders.

Furthermore, the basic point of discussion between the two theories is the positive behavior of management i.e. “how does it behave?”, which is of less importance to the current researcher. The normative aspect of management’s behavior is more significant to the researcher than its positive behavior. The normative aspect of management’s behavior is that ‘how should’ they behave?

To answer the question of ‘should’ following two theories become necessary to be discussed.

D. Shareholders’ Theory

Milton Friedman is the original proposer of Shareholder Theory in his book “Capitalism and Freedom” in 1962. He is a strong proponent of free economy. According to him in
free economy “there is one and only one social responsibility of business to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition, without deception or fraud”160.

So he suggests that the interests of the owners should be protected. Further he argues that “if businessmen do have a social responsibility other than making maximum profits for stockholders, how are they to know what it is? Can self-selected private individuals decide what the social interest is? Can they decide how great a burden they are justified in placing on themselves or their stockholders to serve that social interest? Is it tolerable that these public functions of taxation, expenditure and control be exercised by the people who happen at the moment to be in charge of particular enterprises, chosen for those posts by strictly private groups? If businessmen are civil servants rather than the employees of their stockholders then in a democracy they will, sooner or later, be chosen by the public techniques of election and appointment”161. And long before this occurs, their decision-making power will have been taken away from them”162.

1. Implications of the Shareholder Theory

The shareholder theory has the same implications as that of the agency theory because the underlying assumption of the two theories is the protection of shareholders’ rights. Therefore, all the laws and rules shall be made in order to protect the interests of shareholders. The board shall also make such policies, which best suit with the interests of shareholders. Likewise, the management is also be bound to implement the policies in such manner to safeguard the interests of shareholders.

162 *Ibid*.
a) **Criticism on the Shareholder Theory**

Just as the underlying assumption in agency and stewardship theory is shareholders’ value maximization, so too in this theory stockholders’ rights are advocated. It means all other stakeholders, who can affect or be affected by the organizations’ objectives, are ignored. In contrast with the shareholder theory, the stakeholder theory has taken into consideration, all the stakeholders. The theory is discussed below.

**E. Stakeholder Theory**

Stakeholder Theory was originated by R. Edward Freeman in 1984 in his book “Strategic Management: A Stakeholder Approach” in which he discussed Strategic Management from stakeholders’ perspective. He focused on how executives can use the concept, framework, philosophy and processes of the stakeholder approach to manage their organizations more effectively. He argued for all those (individuals or groups), who can affect or is affected by the achievement of the organization’s objectives, to be taken into account while formulating corporate and business strategies\(^{163}\).

Edward Freeman argues that “we must reconceptualize the firm around the question: For whose benefit and at whose expense should the firm be managed”? He has set forth such reconceptualization in the form of a *stakeholder theory of the firm*. His thesis is to revitalize the concept of managerial capitalism by replacing the notion that managers have a duty to stockholders with the concept that managers bear a fiduciary relationship to stakeholders\(^{164}\).

According to him “management, especially top management, must look after the health of the corporation, and this involves balancing the multiple claims of conflicting stakeholders. Owners want higher financial returns, while customers want more money

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spent on research and development. Employees want higher wages and better benefits, while the local community wants better parks and day-care facilities.\textsuperscript{165} From his discussion it is clear that Freeman proposes that the interests of all stakeholders should be protected. So according to stakeholders theory firms have to protect the interests of all stakeholders.

1. Implications of the Stakeholder Theory

The stakeholder theory has different implications from all the other three theories of corporate governance. In this case, all the laws and rules shall be made in order to protect the interests of all stakeholders. The policy-makers (BODs) shall make policies that will bring harmony among rights of different stakeholders. The managers shall implement such polices in the manner to make balance among rights of different stakeholders. However, one confusion shall always be faced by the lawmakers, the policy-makers and those who implement such laws and policies. The conclusion would be as to who should be included in the list of stakeholders and on what basis?

a) Criticism on the Stakeholder Theory

“The major problem with the Stakeholder Theory stems from the difficulty of defining the concept as to who really constitutes a genuine stakeholder”\textsuperscript{166} The word “stakeholder” first appeared in the management literature in an internal memorandum at the Stanford Research Institute (now SRI International, Inc.), in 1963. It was originally defined as “those groups without whose support the organization would cease to exist. The list of stakeholders originally included shareowners, employees, customers, suppliers, lenders and society”\textsuperscript{167}.

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\textsuperscript{165} ibid, p. 150.
According to Edward Freeman “a stakeholder in an organization is (by definition) any group or individual who can affect or affected by the achievement of the organization’s objectives”\(^\text{168}\). But they are not known in certainty.

Further, Zamir Iqbal and Abbas Mirakhor pointed out that conventional stakeholder theory has yet to offer strong arguments with regards to who is a stakeholder and why firm has any obligation to non-owner stakeholders because of absence of theoretical foundation to incorporate morals, ethics and trust in the economic theory\(^\text{169}\).

F. Universal Theory of Corporate Governance

Recently, Sheila Nu Nu Htay and others have proposed a new theory of corporate governance i.e. Universal Theory of Corporate Governance. They have strongly criticized the existing corporate governance theories. According to them, it has not been a good practice that the developers of corporate governance theories “are influenced by their own preferred way of thinking and their emotional thought. Moreover, due to the limited capability of human thinking power and knowledge level, they cannot consider all the possible situations and conditions”\(^\text{170}\).

They argued that both the agency theory and stewardship theory focused on the relationship between directors and shareholders, which seems that other stakeholders are ignored\(^\text{171}\). According to them, there is a moral flavor in developing the stakeholder theory; however, the source of such moral values is mere human thinking and experience\(^\text{172}\). They claimed that “the happiness and satisfaction that could be achieved by the top corporate players by following the ethical and religious teachings is totally ignored in the existing theories. Furthermore, the current corporate governance theories

\(^{168}\text{Ibid, p. 46.}\)

\(^{169}\text{Zamir Iqbal and Abbas Mirakhor, "Stakeholders model of governance in Islamic economic system." Islamic Economic Studies 11, no. 2 (2004): p. 43-64.}\)


\(^{171}\text{Ibid, p. 1049.}\)

\(^{172}\text{Ibid.}\)
are focused on short-sighted and do not able to highlight the spiritual motiv[at]ing factor that will persuade the top corporate players to perform their bests for the betterment of all parties involved and to bring the social and economic justice\textsuperscript{173}.

So they suggested a new theory of corporate governance i.e. universal corporate governance theory. The proposed “Universal Theory of Corporate Governance”, according to their belief, if followed by top corporate players, would bring the social and economic justice what we are dreaming to achieve. Their theory is stated as “\textit{corporate players must be responsible and accountable in discharging their duty to achieve socio economic justice}”. This theory is based on the teachings of all the religions of the world i.e. Islam, Christianity, Judaism, Hinduism, Budhism and Sikhism.

1. Criticism on the Universal Theory of Corporate Governance

The proposed universal theory of corporate governance also has problems. First, it neither explains ethical rules nor ethical framework, which would be followed by corporate players. Second, it does not clarify as to who are the corporate players? Third, it does not explain the extent of responsibility of such corporate players. Also, it does not clarify that who are they responsible to? Most importantly, the theory is based on six religions, which in the opinion of the researcher is the major drawback of the universal theory, and this is the point which inspired the researcher to suggest a new theory of corporate governance that is derived from the teachings of Islam. Further, it is criticized for motivational factor that is mere spiritual and religious satisfaction of corporate players. Can only moral and religious satisfaction be considered as sufficient compensation (incentive) for a corporate player? There must be some other grounds as incentives for his satisfaction, such as life of eternal happiness in heaven or of misery in hell. Further, the theory does not provide for any steps necessary to be taken for the implementation of the theory. It is also not

\textsuperscript{173}Ibid.
clear that on what parameters it would be decided that a corporate player has worked for achieving socio-economic justice. In case, a corporate player does not work for achieving such goal, what would be the consequences of his non-doings?

**Conclusion**

From the the above mentioned theories of corporate governance, it is clear that each theory has some problems. No one of the theories has been able to answer the particular questions posed by the other theory. The agency theory is unable to explain the position of a manager who really acts as steward, who works for the benefits of the organization. Similarly, the stewardship theory is unable control the selfish manager who prefers his own interest instead of shareholders. The shareholder theory ignores all stakeholders who affect/or be affected by the organization’s activities. Although the stakeholder theory takes them into account but it cannot materialize the word “stakeholder” i.e. it can’t explain that who actually the stakeholder is? Also, it cannot answer to the question as to why a firm has any obligation to non-owner stakeholders without theoretical foundation to incorporate morals, ethics and trust in the economic theory. As far as the universal theory is concerned, it is unable to explain ethical rules and framework, which will be followed by corporate players. Similarly, it is unable to explain the extent of responsibility of corporate players as well as who are they responsible to? It is also not clear that on what parameters it would be decided that a corporate player has worked for achieving socio-economic justice?

It is concluded that the need for new corporate governance theory is still there, especially in the case of Islamic Financial Institutions. In this regard, the foundational principles of Islamic corporate governance seem to be helpful. These principles shall be discussed in detail in the next chapter.
Section II

I. Corporate Governance Models

Conventionally, there are two dominant models of corporate governance namely the Anglo-American Model and Franco-German Model. The two models are discussed below.

A. The Anglo-American Model of Corporate Governance

This Model is also called the Shareholder Model of corporate governance, which is prevailing in the United States and the United Kingdom\(^\text{174}\). The model focuses exclusively on the maximization of shareholders value\(^\text{175}\). This model is characterized by three propositions, which are; (1) shareholders ought to have control, (2) managers have a fiduciary duty to serve shareholder interests alone, and (3) the objective of the firm ought to be the maximization of the shareholders’ wealth\(^\text{176}\).

This model advocates only shareholders by protecting their interest, which implies that if there is conflict of interest between shareholders and other stakeholders, the interests of the stakeholders shall be ignored\(^\text{177}\).

In the U.S. and U.K. corporate governance is concerned with ensuring that firm is run in the interests of shareholders and its objective is to create wealth for them. According to Franklin Allen, underlying this view of corporate governance is Adam Smith’s notion of the invisible hand of the market that he laid out in his seminal book The Wealth of Nations\(^\text{178}\). In view of Adam Smith, if firms maximize the wealth of their

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shareholders, and individuals pursue their own interests then the allocation of resources is efficient in the sense that nobody can be made better off without making somebody else worse off. In this view of the world the role of firm in society is precisely to create wealth for shareholders. This fundamental idea is embodied in the legal framework in the U.S and U.K. In these countries managers have a fiduciary duty (i.e. very strong duty) to act in the interests of shareholders.\(^{179}\)

The underlying assumption of this model is that when everyone in society pursues his own self-interests, it is presumed that, an equilibrium point will occur, and the interests of all shall automatically be protected by balancing them.

### 1. Implications of the Anglo-American Model

As the model is based on the shareholder theory, therefore, this model has the same implications as that of the shareholder theory. The law-makers make such laws and rules, which protect the interests of shareholders alone. The board makes decision-makings and policy-makings subject to the interests of shareholders. Likewise, the management implements such policies in order to safeguard the interests of shareholders.

#### a) Criticism on the Anglo-American Model

Franklin Allen has criticized the view of Adam Smith that the requirements for this assumption to work are strong. These include perfect and complete markets so that there are no transactions costs or other similar frictions. There must be no missing markets or externalities such as those arising from pollution. Everybody must have the same information so that nobody has an unfair advantage over others. Markets must be perfectly competitive. These are strong requirements and are unlikely to hold in most

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\(^{179}\)Ibid.
economies. So, when most of the times, there would be no perfect market, the self maximization objective cannot better off all the individuals of the society.

From Islamic perspective it is argued that the model is against the Islamic Principle of *Tasarruf* (lawful dealings with one’s own property/rights). According to this principle, one should not be allowed to do lawful dealings with respect to his property/rights, which are detrimental to others in any way. This is the view of majority jurists. Their view is based on the Hadith of the Prophet Muhammad (S.A.W.W.) regarding owner of date tree (*Sahib al-Nakhlah*).

As conventionally, the management of a company is regarded as agent of its shareholders (principle). And according to contract of agency an agent is not entitled to use his powers on behalf of his principle beyond the powers of the principle. So the way the principle is not allowed to use his rights in a way detrimental to others, the same way his agent is also not allowed to act on behalf of his principle in contravention of others’ rights. Therefore, in this case the management (agent) is not allowed to protect the interests of shareholders (principle) by ignoring the rights of other stakeholders.

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182 Abu Ja‘far Muhammad bin ‘Ali reported from Samurah ibn Jundub that he had a row of palm-trees in the garden of a man of the Ansar. The man had his family with him. Samurah used to visit his palm-trees, and the man was annoyed by that and felt it keenly. So he asked him (Samurah) to sell them to him, but he refused. He then asked him to take something else in exchange, but he refused.
So it is concluded that the shareholder model of corporate governance is against the injunctions of Islam because this model protects the interests of shareholders by ignoring the interests of the other stakeholders.

B. The Franco-German Model of Corporate Governance

As opposed to shareholder model, there is another model called the stakeholder model. According to this model, the interests of all stakeholders \(^{186}\) of corporation shall be protected. \(^{187}\) This model rejects all the three propositions of the shareholder model, and argues for the following three propositions; (i) all stakeholders have a right to participate in corporate decisions that affect them, (ii) managers have a fiduciary duty to serve the interests of all stakeholder groups, and (iii) the objective of the firm ought to be the promotion of the interests of all and not only those of shareholders. \(^{188}\) According to this model the interests of stakeholders shall not be ignored, rather management shall balance the interests of all stakeholders. \(^{189}\)

Unlike UK and USA, it is not agreed upon in Japan for example, that the firm’s objective should be to create wealth for shareholders. “Instead of focusing on the narrow view of the firm, corporate governance in Japan has traditionally been concerned with ensuring that firms are run in such manner that resources of the society are used efficiently by taking into account so many stakeholders such as employees, customers and suppliers, in addition to shareholders. \(^{190}\) This stakeholder-centered view is dominant in France and Germany like Japan.

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\(^{186}\) "Any group or individual who can affect or is affected by the achievement of the organization's objectives" is called stakeholder. (See R. Edward Freeman, "Strategic management: A stakeholder perspective." *Boston: Pitman* (1984).


In fact in Germany the legal system is quite explicit that firms do not have a sole duty to pursue the interests of shareholders. This is the system of *codetermination*. In corporations in Germany, half of the members of supervisory board are appointed by the employees of the corporations. Obviously, the supervisory board would take employees (as stakeholders) into account while making strategies for the corporations because, the supervisory board is ultimately responsible for the strategic decisions of the companies. According to this model, the answer to the question of ‘should’, regarding the behavior of management, is that management should behave in a way to protect the interests of all stakeholders, and not only of shareholders.

1. Implications of the Franco-German Model

As this model is based on the stakeholder theory, therefore, its implications are similar to Stakeholder theory. The law-makers make laws for the protection of the interests of all stakeholders. The policy-makers (board of directors) make policies while taking into account all the stakeholders of the firm. Similarly, the management of the firm implements such policies in the manner to safeguard the interests of all stakeholders.

a) Criticism on the Franco-German Model

From Islamic perspective it is argued that this model qualifies the Islamic principle of *tassruf* (lawful dealings) in one’s rights, which should not be detrimental to others. Hence, it is argued that the shareholders cannot enforce their rights detrimental to other stakeholders. But, according to Islamic scholars, such as Rahmatna Awalia Kasri, Zamir Iqbal and Abbas Mirakhor, this model fails to prove as to who can qualify as stakeholders? And why managers have fiduciary duty to protect the interests of the non-

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owners stakeholders? In other words, why managers would bother themselves to balance among rights of different stakeholders? Which rules and principle make them bound to do so? These questions are yet to be answered from conventional perspective.

A survey on senior managers of major corporations in UK, USA, France, Germany and Japan, was conducted, who were asked about following choices:

(a) “A company exists for the interest of all stakeholders.

Or

(b) Shareholder interest should be given the first priority.

And

(c) Executives should maintain dividend payments, even if they must lay off a number of employees.

Or,

(d) Executive should maintain stable employment, even if they must reduce dividends”.

With respect to question number one i.e. choice between (a) and (b), 97% managers of Japanese firms chose option (a), likewise, in Germany and France, 83% and 78% respectively chose option (a), whereas, in UK and US corporations, 71% and 76% managers chose option (b).

It means, in France, Germany and Japan, managers view that firm is for all stakeholders, while in UK and USA, shareholders’ interest is given priority.

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193 Number of firms surveyed: In Japan, 68 and 68; In USA, 82 and 83; In United Kingdom, 78 and 75; In Germany, 100 and 105; In France, 50 and 68.


195 Ibid.
As far as the question regarding dividends payment and employees lay off is concerned i.e. choice between option (c) and (d), 97%, 59% and 60% of managers of French, German and Japanese firms chose option (d) respectively, while, 89% managers of firms of UK as well as USA chose option (c)\textsuperscript{196}.

Again it is confirmed that stakeholders’ (as employees) interests are ignored (they are laid off for the sake to increase dividends for shareholders) when conflict with the interests of shareholders (when shareholders’ dividends decline) in UK and USA. However, in Germany, France and Japan stable employment is still maintained, even if it reduces dividends for shareholders.

Moreover, “in the U.S. and U.K. wages are based on the nature of the job done. Employees’ personal circumstances generally have no effect on their compensation. In Japan and Germany it is common for people to be granted family allowances and special allowances for small children. In France vacation allowances based on family are common. These differences underline the fact that in the U.S. and U.K. the firm is designed to create wealth for shareholders whereas in Japan, Germany and France the firm is a group of people working together for their common benefit”\textsuperscript{197}.

It is concluded that the corporate governance model in UK and USA i.e. Anglo-US Model, is structured to protect the interests of shareholders, whereas the German and Japanese models i.e. Franco-German Model, tends to protect the interests of all stakeholders.

**Conclusion**

It is concluded that there are two dominant models on corporate governance around the world. The anglo-american model is applicable in UK and USA, whereas, the franco-german model is followed in France, Germany and Japan. The former model is based on

\textsuperscript{196}Ibid.

\textsuperscript{197}Ibid, p. 5-6.
the shareholders’ theory, therefore, in UK and USA the firms’ managers are required to work for the welfare of shareholders alone. In contrast with this, the latter model require managers of firms in Germany, Japan and France to work for the betterment of all stakeholders.
CHAPTER 4

ISLAMIC CORPORATE GOVERNANCE: CONCEPT, MODEL AND FOUNDATIONAL PRINCIPLES

With the emergence of Islamic finance, corporate governance got attention in Islamic financial institutions because the institutions’ survival is dependent on complete adherence to good corporate governance\(^{198}\). Since then, the Islamic corporate governance has been subject of many debates and discussions. Many Muslim scholars such as Esfandiyar Malekian, Rahmatina Awaliah Kasri, Abbas Mirakhor and Zulkifli Hassan have attempted to provide Islamic concept of corporate governance. Therefore, in this chapter, we will deal with the concept, foundational principles and models of Islamic corporate governance.

I. The Concept\(^{199}\) of Islamic Corporate Governance

Esfandiyar Malekian and Abbas Ali Daryaei state that although, there may not be in Islam official juristic recognition of the concept of corporate governance as such, an examination of the principal legal sources of the Holy Qur'an and sunna reveals clear guidelines about decision-making processes in Islamic context\(^{200}\). And according to Mervyn K. Lewis, corporate governance is all about decision making i.e. by whom, for whom, and with what resources as well as to whom accountability is due? He says that decision-making in Islamic corporate governance is, by whom: Through Mutual Consultation; for whom: For Allah, and through compliance with Shari‘ah; with what


\(^{199}\) According to M. S. Sourial, there is not as yet a unified expression in Arabic to represent the meaning of corporate governance, although in Egypt an official translation has been reached for governance pronounced *hawkama* and accredited by the Egyptian Linguistic Department\(^{199}\). In view of the current researcher, if governance is termed as hawkama in Arabic Literature, then corporate governance may be termed as *Hawkamah Fi Al-Sharikaat*. (See M. S. Sourial, *Corporate Governance in the Middle East and North Africa: An Overview*, Mimeo, Cairo: Ministry of Foreign Trade, (2004).

resources and to whom accountability is due: through religious supervision, and to God accountability is due\textsuperscript{201}.

Shari‘ah scholars, such as Rahmatina Awaliah Kasri, Asyraf Wajdi Dusuki, Umar Chapra, Esfandiar Malekian and Abbas Ali Daryaei are of the view that Islamic corporate governance model has its own unique features and it presents distinctive characteristics. According to Rahmatina Awaliah kasri, God and Islam itself are the key stakeholders in the Islamic corporate governance\textsuperscript{202}. According to Umar Chapra and Ahmad, Islam is the key stakeholder in the Islamic corporate governance system because, the first target of opponents would be Islam if an IFI does not perform in profitable manner\textsuperscript{203}.

From Islamic Perspective, an additional layer of Shari‘ah governance is added to conventional corporate governance to form an Islamic corporate governance system. In this context the Shari‘ah governance means: objectives of the system should be Shari‘ah-compliance, an SSB or Shari‘ah advisors are included in mechanism for corporate governance, and Shari‘ah audit system is added to tools for corporate governance.

So, it is concluded that governance means the manner to direct/control, corporate governance means the manner for directing/controlling a company, and Islamic corporate governance means to direct/control a company in accordance with Islamic rules and principles (Shari‘ah).

II. Islamic Corporate Governance Models

From Islamic perspective, Muslim scholars have discussed two models of corporate governance namely Tawhid or shoora based model\textsuperscript{204} and stakeholders oriented model\textsuperscript{205}.

\textsuperscript{204}M.A. Choudury and M.Z. Hoque suggested this model.
\textsuperscript{205}Umar Chapra, Zamir Iqbal, Abbas Mirakhor suggest that Islamic corporate governance model is stakeholder based model.
The former model is based on the principle of consultation, where all the stakeholders share the same goal of *tawhid* or the oneness of Allah. In the later model Muslim scholars have adopted the stakeholders’ value system with some modifications.

The two models are discussed below.

**A. Tauheed or Shoora based Model**

This model has been proposed by M.A. Choudury and M.Z. Hoque in their book “An Advance Exposition of Islamic Economics and Finance” in 2004. The Islamic Philosophy of *tawheed* (Oneness of God) has been used as basic principle for Islamic corporate governance. According to them two institutions are involved in the process of corporate governance namely *Shari’ah* board and constituent of shura’s groups of participants (all stakeholders). *Shariah* board has the responsibility to ensure that activities of corporations are in conformity with the principles of *Shari’ah*. In addition, shareholders being stakeholders play active role in decision making and policy framework by companies, to protect the interests of all stakeholders instead of their profit maximization. Similarly, other stakeholders (including community) should play their respective roles of mutual cooperation to protect their collective interests and to promote the social welfare function.

However, Zulkifli Hassan has criticized this model. According to him the shoora-based approach is unclear and ambiguous. It is not clear as to how this model can be adopted and implemented. Further, he argues that major corporations including Islamic Financial Institutions follow the existing conventional corporate governance model which is based

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on rationality and rationalism\textsuperscript{209}. So, he suggested to follow the existing stakeholder oriented model as modified in accordance with the principles of \textit{Shari’ah}.

The model is discussed below.

**B. Stakeholder-Oriented Model**

Muslim scholars, such as Umar Chapra, Habib Ahmad, Zamir Iqbal, Abbas Mirakhor, Rahmatina Awaliah Kasri and Asyrif Wajdi Dusuki are of the view that corporate governance model from \textit{Shari’ah} perspective is stakeholder-centered model.

In this type of model conventional corporate governance model is adopted with some modifications\textsuperscript{210}. The governing law is shariah, where compliance with the shariah is the responsibility of Shariah Board. BODs acting on behalf of shareholders, has the responsibility of monitoring and oversight over the activities of IFIs. The State acts as regulator in this model, whereas all other stakeholders such as employees, depositors and customers have to perform their respective contractual obligations\textsuperscript{211}.

Currently the design of proper governance structure in Islamic Financial Institutions, in addition to corporate governance, is manifested in the form of \textit{Shari’ah Governance}


\textsuperscript{210}The difference between conventional stakeholder model and its Islamic version is that the conventional model fails to answer as “to who is a stakeholder and why firm has any obligation to non-owner stakeholders because of absence of theoretical foundation to incorporate morals, ethics and trust in the economic society. On the other hand, the Islamic principles of property rights and contracts (explicit as well as implicit obligations) provide theoretical foundations to acknowledge the rights of all stakeholders. (See generally, Zamir Iqbal and Abbas Mirakhor, "Stakeholders model of governance in Islamic economic system." \textit{Islamic Economic Studies} 11, no. 2 (2004).

Zamir Iqbal and Abbas Mirakhor define stakeholders as:

"In Islam, a stakeholder is the one whose property rights are at stake or at risk due to voluntary or involuntary actions of the firm. In case someone’s rights are encroached or threatened as a result of firm’s operations, that individual, group, community or society becomes a stakeholder.”

They also mentioned the principles on the basis of which these stakeholders are taken into account while decisions are made in firms. These principles are:

(a) “Collectivity (community, society, state) has sharing rights with the property acquired by either individuals or firms;

(b) Exercise of property rights should not lead to any harm or damage to property of others (including stakeholders);

(c) Rights of others are considered as property and therefore are subject to rules regarding violation of property rights."\textsuperscript{210}

structure which includes Shari’ah Supervisory Board, Shari’ah Compliance Department, and Internal/External Shari’ah Audit with slight variations in different jurisdictions. The purpose of Shari’ah governance is to ensure Shari’ah compliance in IFIs.

The structure also demands from BODs, Management and other key executives to have sufficient knowledge of Shari’ah. For this purpose training and orientation sessions are required to educate and aware key corporate governance players. This education should not be restricted to worldly consequences for their shariah compliant/non-compliant actions, but should be extended to consequences, for their actions, in the life hereafter. In this way, the management’s interests in IFIs as well as in the life hereafter, shall be aligned, and the management shall work with more zeal and better way to achieve the IFI’s objectives.

It is concluded that Muslim scholars have suggested two model of corporate governance. The tauheed based model is based on the principle of oneness of God, which suggests active participation of all stakeholders (including community) in the Islamic corporations. As this model is ambiguous and unimplementable in the contemporary situation, therefore, the conventional stakeholder model is suggested for IFIs to adopt it with some modifications. The necessary modification is the additional layer of shariah governance, which provides structures for ensuring shariah compliance in the activities of IFIs. The structure includes Shariah Board, Shariah Review and Shariah Audit (internal/external) in addition to BODs, Management and conventional audit.

Some parameters are required to be set so that the roles of the above corporate governance players are brought within it to be considered as shariah compliant. The parameters are discussed below.

III. Foundational Principles of Islamic Corporate Governance
Islam, being a natural as well as universal Deen (religion), covers all aspects of human life, especially their conducts and behaviors, and its relevance to the world hereinafter. The creator has not let the humans unbridled to live their lives purposeless. Allah first kept a goal for them i.e. to achieve the eternal happiness in the next life, and then required them to follow Islamic general principles pertaining to life. In this world every mankind has to perform his part according to his capacity. Like, a doctor has some capacity and patient has other capacity. Similarly, a male has different capacity than female. Although all these humans are responsible to perform different acts according to their different situations and positions, still they are subject to almost similar rules and principles, which they have to observe all times. In this way corporate governance players\textsuperscript{212} have their own capacity to work and are subject to the same rules and principles like other human beings are subjected to. These rules and principles relating to Islamic corporate governance players\textsuperscript{213} are termed as foundational principles of Islamic corporate governance system in the current study. These foundational principles are discussed below.

A. Vicegerency (Khilafah)

The most important principle of Islamic corporate governance system is human’s vicegerency (khilafah) on the earth. Khilfah starts with the creation of Human being as vicegerent of Allah, when Allah asked angels that He was willing to create his vicegerent on the earth:

\textit{“And when thy Lord said to the angels: “I will create a vicegerent on earth”}\textsuperscript{214}.

In the explanation of verses 28-30 of SoorahAl-Baqarah, the Great thinker of Islam, Molana Maudoodi (R.A.) states that Allah demands obedience (to worship Him) from human beings on two bases. First reason is that Allah is the creator of human being,
whose life and death lies in the Hands of their Lord, and the Universe in which they live belongs to Him, hence the human has no choice but to worship him. The second reason is that Allah has sent him as His vicegerent in this world, so being Allah’s vicegerent man has to worship Him. This character of man’s vicegerency also enjoins him to obey Allah’s commands in all aspects of his life\textsuperscript{215}, so that all his actions conform to the Allah’s commands. This is because vicegerent is the one who uses his delegated authority as sub-ordinate to his master. Being vicegerent, he has no personal authority except that delegated by his master, thus one cannot act according to his own wishes rather than to fulfill his master’s wishes. In case he acts otherwise than the delegated authority, this leads to his betrayal from his Lord\textsuperscript{216}.

From the above explanation of khaleefah and his authority, by Maulana Maudoodi (R.A.), it is easily inferred that corporate governance players are also vicegerent of Allah, who have no authority to act beyond the commands of Allah. Being Allah’s vicegerents, they are bound to perform according to the wills of Allah and must not act beyond their authority as given to them as vicegerent.

The principle of vicegerency is equally applicable to all corporate governance players with no exception, no matter he is in the capacity of Director, CEO or auditor. This is because every corporate governance player, being human, is a vicegerent of Allah. Being vicegerents of Allah, all the corporate governance players must act within the parameters prescribed by Allah SubhanahuWaTa’ala. The parameter in this case for performing actions, is the delegated authority of vicegerency given by Allah.

It is further stated that the expected behavior from a company (and in this case Islamic bank) is similar to the expected behavior from an individual\textsuperscript{217}. However, the company is

\begin{thebibliography}{9}

\bibitem{216}Ibid, p. 62.
\end{thebibliography}
unable to perform its actions by its own, therefore, the board of directors acts as its brain\textsuperscript{218}. So, the expected behavior from a company is demonstrated in the form of expected behavior of the board\textsuperscript{219}. Similarly, the way the company does not have any mind, it also does not have any organs. So, in the opinion of the researcher, the managers of companies (including Islamic banking companies) act as organs of the companies, hence the expected behavior from companies, is also extended to the expected behaviors of their managers.

Thus it is concluded that the rule of vicegerency is equally applicable to Islamic banks in the manner it is applicable to individuals. Further, it is also concluded that as the Islamic banks do not have any mind and organs, therefore, the expected role of vicegerency from the IBIs, is shifted to the board of directors and managers of the IBIs. So, on behalf of Islamic banks, the board and the managers of the IBIs act as vicegerents.

As, the principle of vicegerency is linked to shariah compliance, therefore, the Islamic banks as well their corporate governance players are bound to ensure shariah compliance in the activities of the IBIs.

With respect to the current research work, the delegated authority of corporate governance players, is linked to the shariah compliance in the activities of Islamic financial institutions as well as the authority-holders of the IFIs. As a result of the principle of khilafah, the authority holders are bound to observe as well as ensure shariah compliance in their activities.

For the purpose of ensuring shariah compliance in the activities of Islamic banks in Pakistan and Malaysia, the respective central banks have issued Shariah Governance Frameworks (SGFs). Therefore, the provisions of these SGFs shall be analyzed in the

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light of the principle of khilafah to verify that whether these provisions are in conformity with this principle or not?

**B. Amanah (Trusteeship)**

According to Al-Raghib Al-Asfahani, the term *amanah* is from Arabic word ‘*amn*’, which means tranquility of heart and demise of fear. It means security, protection, peace, safety and shelter. In the sense of *amn*, it can be said that the thing given as *amanah* shall remain safe in the custody of the *amanah*-holder, who shall never make breach of trust.

The very first covenant, which was made between *Allah* and all human beings, is called the covenant of *amanah* (trust). The covenant has been referred to in the following verse of the Holy Quran.

“We offered our amanah to heavens, earth and mountains, but they refused to bear it and they afraid, but human bore it”.

Before the *amanah* was offered to Adam (A.S.), the same was offered to the heavens, earth and mountains but they refused to take it, so it was offered to Adam (A.S.), who asked *Allah*, what does it involve? *Allah* said that if you do good, you shall be rewarded, and if you do evil, you shall be punished, so Adam (A.S.) took the *Amanah* and bore it.

Further, according to a *hadith* of the Prophet Mohammad (S.A.W.W.), authority is also a trust. It has been narrated on the authority of Abu Dhar who said:

“I said to the Prophet (S.A.W.W.): Messenger of *Allah*, will you not appoint me to a public office? He stroked my shoulder with his hand and said: Abu Dharr, thou art weak and authority is a trust. And on the Day of Judgment it is a cause of humiliation and

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222 *Al-Quran*, 33:72.
repentance except for one who fulfills its obligations and (properly) discharges the duties attendant thereon".224

In this hadith of the Prophet of Mohammad (S.A.W.W.) it is expressly mentioned that authority is a trust, and it should be entrusted into the hands of trustworthy people and not those who betray or those who are weak.

It has also been reported on the authority of Abu Dhar that the Messenger of Allah said:

“Abu Dhar, I find that thou art weak and I like for thee what I like for myself. Do not rule over (even) two persons and do not manage the property of orphan”225.

It may be inferred from these two Ahadith that being a trust, authority should not be entrusted into the hands of weak people. Here the word weak may include persons who are expected to make betrayal in amanah. He who makes betrayal in amanah is deterred and shall be punished on the Day of Judgment.

Further, it is narrated from Buraida that the Prophet Mohammad (S.A.W.W.) said:

“When we appoint someone to an administrative post and provide him with an allowance, anything he takes beyond that is unfaithful dealing"226.

Furthermore, it has been reported on the authority of ‘Abd b. ‘Amira al-Kindi who said, I heard the Messenger of Allah saying:

“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”227.

On the basis of these ahadith of the Holy Prophet (PBUH) it is said that the authority given to corporate governance players is also amanah. Therefore, they have to fulfill the amanah with great care and not to make any betrayal by misusing their authority.

224 Sahih Muslim, 1825.
225 Sahih Muslim, 1826.
226 Sunane Abu Dawood, 2943.
227 Sahih Muslim, 1833.
The consequences of *amanah* is that if a person holds something on the basis of *amanah*, he is not liable for any loss to the object held unless the holder has made any breach of trust\textsuperscript{228}. Breach of trust occurs when one makes negligence or any fault intentionally\textsuperscript{229}.

From the above discussion on *amanah* the following four results are obtained:

1. Authority is *amanah* with authority-holders;
2. Hence, the roles and responsibilities, along with ancillary requirements thereof, of corporate governance players are *amanah* with the players;
3. The *amanah* of authority shall be handed over to competent persons;
4. In case of negligence and misconduct (intentionally) in performing their duties, the ICG players shall be liable for their actions.

**C. Mas’oliyyah (Accountability)**

Another important principle of Islamic corporate governance system is accountability. Mohammad Ali has defined accountability as “the process via which a person or group can be held to account for their conducts”\textsuperscript{230}. It is the accountability of a person for his/her actions. Whatever a person does, he/she has to give account for it. In the corporate governance perspective, accountability means the accountability of corporate governance players. It is one of the important element of good governance\textsuperscript{231}. The Islamic corporate governance principle of accountability is discussed below.

1. **Accountability in the Islamic Corporate Governance System**

Every human being is responsible and accountable for his actions in the capacity of his work. This is inferred from the following hadith of the Prophet Mohammad (PBUH).
Abdullah Ibn-e ‘Umar reported, The Messenger of Allah (P&BUH) said, “Everyone of you is a shepherd and is responsible for his flock. The leader of people is a guardian and is responsible for his subjects. A man is the guardian of his family and he is responsible for them. A woman is the guardian of her husband’s home and his children and she is responsible for them. The servant of a man is the guardian of the property of his master and he is responsible for it. Surely, everyone of you is a shepherd and responsible for his flock”\textsuperscript{232}.

From Islamic perspective, accountability of human beings is dual in nature. It means that human beings are accountable for their actions in this world as well as in the life hereafter.

a) Accountability of Human Beings in the Life Hereafter

Accountability of individuals for their actions in the life hereafter is evidenced from following texts of Quran and Sunnah.

“To Allah belongs whatever is in the heavens and whatever is in the earth. Whether you show what is within yourselves or conceal it, Allah will bring you to account for it”\textsuperscript{233}.

“And fear a Day when you will be returned to Allah. Then every soul will be compensated for what it earned. And they will not be treated unjustly”\textsuperscript{234}.

“On the day when every soul will be confronted with all the good it has done, and all the evils it has done, it will wish there were great distance between it and its evil. But Allah cautions you (to fear) Him. And Allah is full of kindness to those who serve Him”\textsuperscript{235}.

“Then on that day you shall most certainly be questioned about business”\textsuperscript{236}.

“The hearing, sight and hearts will all be questioned”\textsuperscript{237}.

\textsuperscript{232}Sahih Bukhari, 6719; Sahih Muslim, 1829.
\textsuperscript{233}Al-Quran, 2:284.
\textsuperscript{234}Al-Quran, 2:281.
\textsuperscript{235}Al-Quran, 3: 30.
\textsuperscript{236}Al-Quran, 102: 8.
\textsuperscript{237}Al-Quran, 36: 17.
“Then shall anyone who has done an atom’s weight of good, shall see good. And anyone who has done an atom’s weight of evil, shall see evil.”

From all the above texts of the Holy Quran, it is clear that human beings are responsible and accountable for their actions to God in the next life.

The philosophy of accountability of humans in the life hereafter is that they shall be asked about their actions on the Day of Judgement. If they have followed Allah’s commands, they shall be rewarded. Otherwise, they shall be punished for the evil deeds. All their deeds (goods and evils) shall be weighed. He who has done more good deeds than evils shall enter jannah (heaven) and the rest of wrong-doers whose evil deeds are heavier than their good deeds shall go to hell.

b) Accountability of Human Beings in This World

Everyone knows individuals’ responsibility and accountability in Islam in this world as is apparent from the Islamic judicial system. In this system, if anyone commits any crime, he is punished through court. In Islam, the wisdom of punishment to individuals in this world is to prevent them from the punishment on the Day of Judgment, which is very much painful. Nonetheless, if any individual escapes from the punishment for his evil deeds (means crimes), then the philosophy of jannah (heaven) and jahannam (hell) comes into play. It means that human beings shall be punished for their bad deeds on the Day of Judgment. Their accountability on the Day of Judgment is discussed under the next heading.

Apart from the criminal rights of individuals against other individuals, they also have civil rights against each others. Normally, such rights of individuals arise from different transactions among themselves (including business transactions). People are free to do

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240 As in the case of Qisas and Hudood Laws.
businesses and enter into transactions among themselves as long as they are not contrary to the texts of Quran and Sunnah.

Islamic maxim regarding this permissibility is that:

“The initial rule (or presumption) for all things is Permissibility”

All the covenants made regarding businesses and transactions are necessary to be performed and executed, as Allah says in Quran:

“O you who believe! Fulfill your contracts”

Here, if any party does not fulfill the covenant, the other party has the right to make suitable claims through court.

Similarly, where public rights (public money, for example) are involved, then people have the right to ask authority-holders, and the authority holders are liable to give accounts for their actions. The authority for this rule is that the Khaleefa Umar (R.A) was asked by a man to give account for extra cloth than the normal share of every companion, who had given proper account in that time.

So, from the above discussion it is clear that human beings are accountable for their actions in this world as well as in the life hereafter.

Based on the above discussion, it is concluded that the corporate governance players have two folded accountability in Islamic perspective. First, they are accountable for their

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242 Al-Quran, 5:1.
243 It is narrated that 'Umar (RA) received from Yemen, sheets of cloth. He distributed it among people each of whom received one length as his share. 'Umar ‘s share was that of one Muslim. He tailored it, wore it. The next day he ascended the pulpit to give orders to the people for preparation of Jihad. A Muslim stood up and said, “We neither listen to you nor obey you.” “Why so?” asked 'Umar (RA). He answered, “Because you have preferred yourself to us.” 'Umar again asked, “In what way I have done so?” He replied, “When you distributed the Yemen lengths of cloth, each one received one and so you too. But one length would not make you a garment; we see you have tailored it into a whole shirt and you are a tall man too. If you had not taken more, you could not have made a shirt of it.” 'Umar (RA) turned to his son 'Abdallah and said, “‘Abdallah! Reply him”. He stood up and said, “When the commander of the faithful 'Umar wished to tailor this length of cloth, it was not sufficient, so I gave him enough of my length to complete it for him.” The man said, “Now we listen and obey you”. (See Mohammad Ali Taba Taba, Al Fakhri, trans. C.E.J. Whitting, (London: Luizac & Co. 1947), p. 25).
actions in this world. In case they do not give proper accounts for their actions in this world, they shall give full accounts for their actions in the life hereafter.

The Islamic corporate governance principle of accountability is related to the roles and responsibilities of all corporate governance players. This principle shall be applied to the theoretical frameworks relating to corporate governance practices of Islamic banks in Pakistan and Malaysia. As the idea of accountability in the life hereafter cannot be tested on the basis of the theoretical frameworks, therefore, this principle shall be applied only to the extent of accountability of CG players in this world.

D. Transparency (Shafafiyyah)

Transparency originates from Latin word “transparere”, “trans” means through and “parere” means appear. Transparency refers to the degree to which information flows freely within an organization, among managers and employees, and outward to stakeholders. Corporate transparency is the extent to which a corporation’s actions are observable by outsiders.

Investopedia defines the term transparency as “the extent to which investors have ready access to any required financial information about a company such as price levels, market debt and audited financial reports.”

Transparency is one of the key elements of good corporate governance, which ensures that management is not engaged in any improper or unlawful activities as their acts would be observable. For achieving transparency, there requires proper accounting methods as

244 www.oxforddictionaries.com/definitionenglish/transparent> Last accessed on 08/10/2015.
246 Ibid, p. 73.
247 A leading online Finance Dictionary.
well as disclosure of all relevant information, such as conflict of interests of directors and controlling shareholders

In Islam the proper word used for transparency is *shafafiyyah*. It is one of the important values of Islamic corporate governance. The roots of *shafafiyyah* in Islam lies in the concepts of transparency in actions of authority-holders, disclosure of defect (‗*ayb*‘) in things being sold, prohibition of *gharar* (uncertainty) in transactions and documenting of transactions.

1. **Transparency in Actions of Authority-Holders**

There are *ahadith* of the Prophet Mohammad (S.A.W.W.) which directly relate to transparency in actions of the authority holders. For example, it is narrated from Buraida that the Prophet Mohammad (S.A.W.W.) said:

“When we appoint someone to an administrative post and provide him with an allowance, anything he takes beyond that is unfaithful dealing.”

Further, it has been reported on the authority of ‘*Abd b. ‘Amira al-Kindi who said, I heard the Messenger of Allah saying:

“For 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.”

From these two *ahadith* it is inferred that the authority holders are allowed to take only those benefits which are expressly disclosed to them and not beyond that. The second *hadith* prohibits any authority-holder from any concealment, which in turn emphasizes on

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251 *Sunan Abu Dawood*, 2943.
252 *Sahih Muslim*, 1833.
transparency. So, it is said that the authority holders in Islamic corporate governance should ensure transparency in the affairs of corporations.

2. **Prohibition of Gharar(Uncertainty)**

*Gharar* literally means indeterminacy, speculation, hazard and risk.\(^{253}\) Technically it means uncertainty about the ultimate outcome of a contract.\(^{254}\) It is related to all types of contracts and transactions. *Gharar* is prohibited to protect parties from future disputes and litigations.\(^{255}\)

According to Dr. Muhammad Tahir Mansoori, *gharar* in contracts, is found in following cases:

(a) “An occurrence about which the parties are unaware whether such an event will take place or not;

(b) A thing that is not within the knowledge of the parties;

(c) A thing about which it is not known whether it exists or not;

(d) A thing whose acquisition is in doubt; and

(e) A thing whose quantum is unknown.”\(^{256}\)

In Islam, all those transactions are prohibited in which *gharar* is involved.

From the principle of prohibition of *gharar* in transactions, it is inferred that Islam promotes the principle of transparency in transactions. The prohibition of *gharar* also guides us to transparency in the actions of authority-holders. As the corporate governance players are also authority-holders, hence it is said that the actions of the corporate governance players must be transparent. For ensuring their actions as transparent, there requires proper disclosure of all material information. The more material and relevant information are disclosed, the more transparency is ensured.


\(^{254}\) *Ibid.*

\(^{255}\) *Ibid.*

\(^{256}\) *Ibid.*

Principally, in Islam it is the responsibility of the seller to disclose any defects present in the things being sold to the buyer. This principle is based on a hadith of the Prophet Mohammad (S.A.W.W) who said:

“it is not permitted for seller to sell things which are defective unless he points it out to buyer”257.

From this hadith it is clear that Islam promotes transparency in sale transactions. There is another hadith258 of the Prophet Mohammad (S.A.W.W.) which is related to transparency in transactions. It is stated below.

“He who deceives is not of me (is not my follower)”259.

This hadith also is basically related to sale transaction, however, like the previous hadith, it also guides us to the principle of transparency in other transactions as well.

It is concluded that all the above mentioned Islamic concepts have the objective to achieve transparency so that the contracting parties make well-informed decision-makings. It also brings with it the protection of their respective rights and duties as well as their protection from potential disputes in future.

Further, the concept of transparency is also linked to accountability of Islamic corporate governance players. This is because it is the principle of transparency and disclosure which ensures accountability of the players. Without disclosure it is difficult to make a corporate governance player accountable.

In order to ensure that all the actions of the corporate governance players are in accordance with the Allah’s commands, transparency in their actions is necessary. The

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258 “it is narrated on the authority of Abu Huraira that the Messenger of Allah (S.A.W.W.) happened to pass by a heap of eatables (corn). He thrust his hand in that (heap) and his fingers were moistened, He said to the owner of that heap of eatables (corn): what is this? He replied: Messenger of Allah, these have been drenched by rainfall. He (the Holy Prophet) remarked: Why did you not place this (the drenched part of the heap) over other eatables so that the people could see it? He who deceives is not of me (is not my follower)” (See Sahih Muslim, 102)
259 Sahih Muslim, 102.
transparency becomes more significant when public money and their other rights are involved as trust with corporate governance players.

This principle of transparency is related to the roles and responsibilities of different corporate governance players. The principle shall be applied to the theoretical framework of Pakistani and Malaysian regimes relating to CG practices in Islamic banking Institutions of both jurisdictions.

IV. Implications of the Islamic Corporate Governance Principles

A. Khilafa

Implication of *khilafah* is that all the authority holders are bound to observe as well as ensure *shariah* compliance in their activities.

B. Amanah

1. Authority is *amanah* with authority-holders; hence,

2. the roles and responsibilities, along with ancillary requirements thereof, of corporate governance players are *amanah* with the players;

3. The *amanah* of authority shall be handed over to competent persons;

4. In case of negligence and misconduct (intentionally) in performing their duties, the ICG players shall be liable for their actions.

C. *Mas‘oliyyah*

The corporate governance players have two folded accountability in Islamic perspective. First, they are accountable for their actions in this world. In case they do not give proper accounts for their actions in this world, they shall give full accounts for their actions in the life hereafter.

As the idea of accountability in the life hereafter cannot be tested on the basis of the theoretical frameworks, therefore, this principle shall be applied only to the extent of accountability of CG players in this world.
D. *Shafafiyyah*

Implication of this principle is that the actions of all the corporate governance players shall be transparent.

V. **Conclusion**

The above discussed foundational principles of Islamic corporate governance system are basically important values relating to human’s behavior, who are required to hold tight on such values, no matter on any position they are. For instance, directors, CEOs, key executives, SB members, auditors etc, being Islamic corporate governance players are required to bring their actions within the parameters put by the above mentioned foundational principle of Islamic corporate governance system.

Moreover, the foundational principles cover two broader areas namely *transparency* and *roles and responsibilities* of corporate governance players. The principle of *shafafiyyah* is related to the practice of transparency/disclosure, whereas the other three principles i.e. *mas’ooliyyah, khilafah* and *amanah* are related to roles and responsibilities of different corporate governance players. In the coming two chapters, these foundational principles shall be applied to theoretical framework relating to corporate governance practices of IBIs in Pakistan and Malaysia to check their compatibility with these principles.
CHAPTER 5

COMPATIBILITY OF MALAYSIAN CORPORATE GOVERNANCE FRAMEWORK FOR ISLAMIC BANKS WITH THE ISLAMIC PRINCIPLES

In the previous chapter, the four foundational principles of Islamic corporate governance system have been discussed in detail. Now in this chapter, these principles shall be applied to the theoretical framework of Malaysian regime relating to corporate governance practices in Islamic banking institutions of the country. For this purpose, the Malaysian regime includes: The Islamic Financial Services Act, 2013, The Companies Act, 1965, The Guidelines on Corporate Governance for Licensed Islamic Banks in Malaysia, Financial Reporting for Islamic Banking Institutions, Fit and Proper Criteria for Key Responsible Persons, The Guidelines on External Auditors issued by BNM, Shariah Governance Framework for IFIs. The provisions of these laws and guidelines are limited to Islamic corporate governance practices of board of directors, management, Shariah committee, internal audit/shariah audit, external audit/shariah audit and disclosure. These practices are discussed in light of the foundational principles below.

I. Application of Amanah (Trusteeship)

From discussion on the Islamic corporate governance principle of amanah (trusteeship) in the previous chapter, the following results have been inferred:

a. Authority is amanah with authority-holders;

b. Hence, the roles and responsibilities, along with ancillary requirements\(^{260}\) thereof, of corporate governance players are amanah with the players;

c. The amanah of authority shall be handed over to competent persons;

\(^{260}\) Such as fulfilling qualification and experience criteria etc.
d. In case of negligence and misconduct (intentionally) in performing their duties, the ICG players shall be liable for their actions.

These four implications of the principle of *amanah* shall be applied to the theoretical framework relating to corporate governance practices in Malaysia to verify whether the principle of *amanah* (trusteeship) is complied with in such practices or not? For the sake of convenience, the discussion is divided into three parts. **Part A** covers provisions other than the provisions of *Shari’ah* Governance Framework (SGF) as these are covered in **Part B**. In **Part C**, those provisions shall be covered, which are related to non-compliant actions of corporate governance players.

**Part A**

**Application of the Principle of Amanah to the Provisions of Malaysian Regime Other Than Shariah Governance Framework**

In this part, the provisions of Malaysian Shariah Governance Framework are not included because those provisions are discussed in the next part (part B) of the chapter.

**A. Directors and Board of Directors**

Directors are the persons usually appointed by shareholders, who provide central leadership to the companies. They have unlimited with respect to business of companies. The board’s job is policy making and monitoring to ensure that such policies are implemented. Board of directors holds central position in any organization. It acts as mind of firms. Being key position-holders, the directors are trustees of their authority. According to principle of trusteeship, the authority of trust shall be handed over

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to those who are competent to appropriately execute their trusts. To ensure the competency of directors, the Bank Negara Malaysia (BNM) has issued Fit and Proper Criteria (MFPC).

1. **Malaysian Fit and Proper Criteria (MFPC)**

The Malaysian Fit and Proper Criteria includes three elements namely (a) probity, personal integrity and reputation; (b) competency and capability; and (c) financial integrity.

a) **Probity, Personal Integrity and Reputation of Directors**

Based on the provisions of paragraph S. 11.2 of the Malaysian “Fit and Proper Criteria”, the characters of probity, personal integrity and reputation of a person are broadly discussed from following two aspects:

1. When he acts as an individual
2. When he acts as part of a business

1. **Probity, Integrity and Reputation of a Person when acting in Individual Capacity**

When a person acts in his individual capacity, he becomes ineligible in the following cases.

(a) Ineligibility on the basis of violation of any rules, standards and regulations

(b) Ineligibility on the basis of malpractices of business

(c) Ineligibility on the basis of investigation or proceedings against him.

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265The criteria is equally applicable to directors as well as chairman of the board, CEO and other Senior officers, therefore, the provisions of the MFPC shall not be re-discussed in the management portion.

266Sub-section (1) of section 69 of IFSA, 2013 states that the Fit and Proper Criteria to be specified by the BNM, for appointing and electing chairman, director, CEO and other senior officers by FIs, may include a minimum criteria relating to (a): probity, personal integrity and reputation; (b): competency and capability; and (c): financial integrity. Pursuant to which, the BNM has set out the fit and proper criteria, which included these elements.
(a) Ineligibility of an individual for violation of any rules, standards and regulations

Under clause (ii) of the MFPC, a person is ineligible if he has violated any law made for the protection of general public from financial losses\textsuperscript{267}. Similarly, according to clause (iii) of the criteria, the person is ineligible if he has violated any requirements or standards made by any regulatory or professional body, or government agency\textsuperscript{268}. Further, under clause (xii) of the criteria, if the person has shown unwillingness to cooperate with any regulatory or professional body, which has resulted or may result any such violation of law or standards, he becomes ineligible\textsuperscript{269}.

It will be unwise to handover the affairs of custodians of public monies\textsuperscript{270} (banks) into the hands of those who have already violated the law relating to the protection of public money. It shows that they have already not properly executed their amanah, rather violated. Therefore, public will never trust these persons, and will be reluctant to keep their amount with the banks, whose governance is in the hands of persons with such a bad reputation. Similarly, requirements of regulators\textsuperscript{271}, professional bodies\textsuperscript{272} and other government agencies\textsuperscript{273} are necessary for ensuring smooth operations and maintaining standard of organizations like banks. If any organization’s management or BODs does not comply with the requirements of, or standards set up by these bodies, the smooth operations of their organizations become doubtful, and also such non-compliance affects the reputation of the organizations. Therefore, when there is apprehension regarding


\textsuperscript{268} Ibid, Paragraph S. 11.2(iii).

\textsuperscript{269} Ibid, Paragraph S. 11.2(xii).


\textsuperscript{271} Like SBP in Pakistan and BNM in Malaysia.

\textsuperscript{272} Such as Institute of Chartered Accountants of Pakistan (ICAP).

\textsuperscript{273} Credit rating agencies like Standard & Poors rating agency of USA.
persons that public money may not be considered safe in their hands, or they will not follow (for example, by showing misconduct or negligence) the law relating to safety of the public money, or they will not fulfill the requirements of banks’ regulators or other relevant professional bodies, such persons should not be entrusted with the affairs of sensitive institutions\textsuperscript{274} like banks and especially Islamic banks. Because, these affairs are amanah, and the rule of amanah is that it shall not be handed over to those who commit misconduct or show negligence in executing their trusts. As the above provisions prohibit from handing over the amanah of directorship to such violators, therefore, it is argued that Islamic corporate governance principle of amanah is complied with here in these provisions.

(b) Ineligibility of an individual for conducting malpractice business

Under clause (v) of the MFPC, if a person is involved in deceitful, oppressive or otherwise improper business, he is ineligible\textsuperscript{275} to become director.

Directors give strategic directions to banks. They make all significant decisions on behalf of banks as well as make policies for them. The key decision-makings and policy-makings cannot be handed over to persons with bad reputation because their reputation shall directly affect the reputation of Islamic banks. Once, Islamic banks lose reputation, they lose public confidence. Losing public confidence may lead to failure of Islamic banks. Therefore, in order to maintain good reputation of Islamic banks and ultimately to ensure their efficiency and profitability in addition to shariah compliance, the key positions like directorship are necessary to be handed over to persons with good

\textsuperscript{274} Banks are sensitive institutions because public monies are lying in their custody as trust (like deposits of investment account-holders), and they are subjected to stricter rules.

reputation, who will not be involved in any deceitful\textsuperscript{276} or improper businesses. This is because such positions are *amanah*, and *amanah* cannot be handed over to those who might betray. As the above provisions declare all those persons as ineligible for appointment of directorships, who are involved in some sort of malpractice businesses, therefore, it is argued that these provisions are in conformity with the Islamic corporate governance principle of *amanah*.

(c) **Ineligibility an Individual on the Basis of Investigation or Proceedings Against Him**

The criteria to judge a person’s probity, integrity and reputation on the basis of investigations and proceedings against him seems stringent because, according to clause (i) and (iv) of MFPC, his integrity comes in question:

1. merely if he has *remained* subject to any criminal or disciplinary proceedings.
2. Even if he has been *notified* of any *impending proceedings*.
3. More even if he has been *notified* of any *investigation* which may lead to such impeding proceedings\textsuperscript{277}.

It seems that the Malaysian Fit and Proper Criteria is very much cautious in handing over the *amanah* of authority of directorship or any other office. From these provisions, it is inferred that extra care is taken while considering any person as eligible for such authority. However, it is unclear here whether the person will be ineligible only during

\textsuperscript{276} Double Shah used to take public monies and promised to give double profits on original investments. The business was deceitful because the underlying intention of the business was to loot public, which he did ultimately. (See generally, Rauf Klausra, Roznama Dunya, Dec, (2013) available at www.currentaffairspk.com/rauf-klausra-column-exposing-musharika-mudaraba-scandal/ Lastly accessed on 12/06/2016. Similarly, Mufti Ihsan of Lal Masjid and a driver named Nisar Ali of Thailand Embassy collected public money on mudharabah basis and transferred the money to Thailand, where they registered companies in their own names. This was deceitful business because their intention was to usurp the pubic money. (See generally, Zulqernain Tahir, Dawn News, June, 13, (2014) available at www.dawn.com/news/1112453 Lastly accessed on 13/06/2016. So, people like Double Shah, Mufti Ihsan and Nisar Ali cannot be appointed in any position like directorship, CEOship or other senior officership.

the course of any impending proceedings, investigations and its notification, or his ineligibility continues once he has been subjected to any proceedings or notified of any investigations. Ineligibility of the person in the former case is justified, however, his ineligibility in the later case is objectionable. Whatever, the case is, the above provisions show that Malaysian regime takes extra care while handing over the *amanah* of authority to authority-holders. This shows that the above provisions are in conformity with the Islamic corporate governance principle of *amanah*.

(2) **Probity, Integrity and Reputation of a Person when acting as Part of Business**

A person becomes ineligible for appointment under clause (vii), if he has remained in any management or ownership capacity of a company whose license or authorization has either been refused or cancelled, as the case may be\(^{278}\). Similarly, according to clause (x) of the MFPC, if the person was acting in the capacity of director of a company whose license has been revoked, he is ineligible for appointment as corporate governance player\(^{279}\). Clause (viii) and (ix) of the criteria declare a person as disqualified if he was director or in any management capacity of a company which went into liquidation or insolvency\(^{280}\).

In the above provisions, it appears that the person might not have been involved directly in any fraud or misconduct, which led to liquidation of the company, or cancellation of its license in which he was acting as key corporate governance player. Even, he might not have been involved indirectly in any activity, which led to such undesirable results. But, still the Malaysian regime disqualifies him from appointment on any key position like directorship. His disqualification in this case is meaningful because cancellation of

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\(^{278}\) *Ibid, Paragraph S. 11.2(vii).*  
\(^{279}\) *Ibid, Paragraph S. 11.2(x).*  
\(^{280}\) *Ibid, Paragraph S. 11.2(viii) & (ix).*
license or going under insolvency proceedings, while in the presence of key players, reflects incompetency of the players. Non-handing over of key positions to persons whose competency is in doubt, is exactly in conformity with the Islamic principle of *amanah*. It shows that Malaysian regime takes extra care in handing over the *amanah* of authority.

**b) Competency and Capability Under MFPC**

Clause (i) of paragraph S. 12.2 of MFPC requires from the CG players that they should have appropriate qualification, experience and skills whereas, its clause (ii) requires a satisfactory past performance from them so that they are considered as eligible for appointment as director, CEO or senior officer\(^{281}\).

Words of this paragraph are vague because it neither quantifies the relevant qualification or experience of the corporate governance players nor their past performance, and it has been stated in general terms that the corporate governance players are required to have appropriate qualifications, experiences, skills and that they have performed satisfactorily in the past\(^ {282}\). In the opinion of the researcher, fixation of some level of educational qualification and some years of experience for the players, is necessary so that their capability and competency is ensured.

Although no particular qualification or some years of experience has been fixed for the corporate governance players, however, expecting appropriate qualification, knowledge and experience from them suggests that competency of the CG players is the priority of the MFPC. Hence, it is opined that the above provisions of the MFPC are in line with the Islamic corporate governance principle of *amanah*.

\(^{281}\) *Ibid, Paragraph S. 12.2(ii).*

\(^{282}\) *Ibid, Paragraph S 12.2.*
c) Financial Integrity of MFPC

Clause (i) of Paragraph S. 13.2 of MFPC is related to a person’s past as well as future in his individual capacity that he has not been in default of payments in the past, and would be able to satisfy his personal financial obligation in future, no matter inside or outside Malaysia\textsuperscript{283}. However, it is clarified in paragraph G. 13.3 of the MFPC that if a person has limited financial means, this condition does not in itself renders him as ineligible person\textsuperscript{284}. Clause (ii) of paragraph S. 13.2 also judges financial integrity of the person on the parameter of court’s decision against him, who has been ordered to pay the debt amount due against him, and he has been in default of such payments, no matter partially or fully\textsuperscript{285}.

Like every other trust, repayment of loan is \textit{amanah}. He who does not repay his debts cannot be trusted. He who cannot be trusted, cannot be entrusted with \textit{amanah} of authority. As in the above provisions it is required that a person cannot be appointed in the capacity of director, CEO or any other senior officer unless he has not been in default of repayment of debts in the past.

So, the \textit{amanah} of directorship is entrusted to those who have sound financial record, and are expected to better perform his financial obligations in the future. Hence, it is opined that the Islamic corporate governance principle of \textit{amanah} is complied herewith in the above provisions too.

2. Composition of the BODs

According to paragraph 2.20 of the Malaysian guidelines on CG, for the effectiveness of the board of an IBI, it is necessary that the board has an adequate number of directors that commensurates with the complexity, size, scope and operations of the Islamic bank.

\textsuperscript{283}Ibid, Paragraph S. 13.2(i).
\textsuperscript{284}Ibid, Paragraph G. 13.2.
\textsuperscript{285}Ibid, Paragraph S. 13.2(ii).
The board should comprise of directors who as a group provide a mixture of core competencies such as finance, accounting, legal, business management, information technology and investment management\textsuperscript{286}. Also, according to paragraph 2.62, for the purpose of ensuring that the board of an Islamic bank has the required mix of skills and experience to discharge its duties, the members of the board should be from diverse backgrounds, with knowledge and experience in different pertinent disciplines which may include finance, accounting, legal, business management, information technology and investment management\textsuperscript{287}.

It is well established that all the decision-making and policy-making powers inside institutions rest with board of directors. The board is the ultimate authority inside organizations. They make policies and decisions on number of matters, which include legal, finance, accounts, business management, risk management, profit distribution and information technology. When their decision-makings cover such range of different areas, therefore, it is necessary that the board should include experts from each field. The presence of experts on board from different fields having different backgrounds, qualifications, skills and experience shall make it easy for the board to make correct decisions about the fate of the institution. Expert of a particular field shall give better opinion regarding any matter relating to his field. In this way the board shall act efficiently. On the other hand, if the board lacks experts from different fields, then there is apprehension that some critical issues may be mishandled, which may cause loses to the organization.

As in the above provisions it has been suggested that boards of Islamic banks should comprise experts from diversified backgrounds, therefore, it is acknowledged that the


\textsuperscript{287} \textit{Ibid}, paragraph 2.62.
authority of directorship is ensured to be handed over to competent board. Such requirement of handing over of amanah of authority to competent board is the requirement of the Islamic corporate governance principle of amanah, therefore, it is opined that the above provisions are in conformity with the principle of amanah.

3. Directors’ Fiduciary Duties Towards Islamic Banks

According to paragraph 2.06 of the Malaysian guidelines on corporate governance the directors have certain fiduciary duties towards Islamic banks, which are:

a. To act in good faith, and in the best interest of IBIs;
b. To exercise due care and diligence with the knowledge and skills he has, and which are reasonably expected from directors with the same responsibilities;
c. To exercise only those powers conferred on him;
d. To avoid conflict of interest situations288.

Like position of authority, all the respective roles and responsibilities relating to the position are also amanah. The roles and responsibilities may be expressed as well as implied. Implied responsibilities (as amanah) of a position-holder are those which are expected from all those persons who hold similar positions. Expressed responsibilities are those which are explicitly mentioned289 to the authority holder when he is entrusted with the authority. In the above provisions all the expressed duties are amanah with the directors. In the former two points directors are expected to act in good faith, in the best interests of Islamic banks and to exercise as much care and diligence, as can be expected from directors in the same position. These two expressly mentioned duties are also implied expectations of amanah. It is the rule of amanah that with respect to amanah, the amanah-holder shall use his due care and diligence to the extent which can be expected

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289 Or given in written form etc.
from a prudent man in his own case. In the third point, the authority of directors is restricted to those powers which are expressly given to them. So, they cannot act beyond their authority expressly given to them. But if he does something, that must be in good faith and should fall within the expected duties of directors of the same position. Then in the last point, directors are expressly required to avoid conflict of interests situations. Therefore, such avoidance of conflict of interests is *amanah* with the directors. It is concluded from the above discussion that although it is not expressly provided in the above provisions that if directors commit some misconduct or show negligence while performing their *amanah*, but still these duties are their *amanah*.

4. Major Responsibilities of BODs

Paragraph 2.10 of the Malaysian Guidelines on CG provides major responsibilities of directors, which are given below:

According to clause (i) of paragraph 2.10 of the guidelines, it is the responsibility of board, first to approve business plans, significant policies and strategies, and second, to monitor the performance of management in the implementation of such strategies and policies\(^{290}\). Clause (ii) of the paragraph 2.10 requires from BODs to set clear lines of responsibilities and accountabilities for different corporate governance players\(^{291}\). Clause (iii) of the paragraph declares the board responsible for ensuring that management of IBIs is in hands of competent officers, for which purpose they shall ensure that an effective process is in place for appointment of qualified management\(^{292}\). Further, it is the responsibility of BODs under clause (iv) of the paragraph, that Islamic banks’ operations are performed with prudence, and that all relevant laws and policies are followed in this


\(^{291}\)Ibid, paragraph 2.10(ii).

\(^{292}\)Ibid, paragraph 2.10(iii).
The board is also responsible to make shariah compliance policies for Islamic banks under clause (vi) of the paragraph 2.10. The purpose of such policies is to ensure that all products, services and other activities of the IBI are in accordance with principles of shariah. It is also required from the board under clause (vii) of the paragraph to establish internal audit department in Islamic banks, staffed with qualified officers, who shall be responsible to conduct internal audit function. Apart from financial and management audit, the function shall also include shariah audit. Similarly, protection of interests of depositors, especially the investment account holders, is the responsibility of board under clause (ix).

As has been established that all expressed and implied roles of authority-holders are amanah with the holders. The implied roles shall be performed in the manner expected from the holders of similar positions. The expressed roles shall be performed in the manner they are explicitely required to be performed. Such performance of the roles in the prescribed manner is amanah. In the above paragraphs explicit responsibilities have been put on directors, the performance of which is amanah with the board. For example, clause (i) of the above paragraph 2.10 requires from the board to make strategies and significant policies and to monitor that management implements such strategies and policies. Here two points are very important. First one is policy making. In order to put an organization on the right direction so that its objectives are achieved, there requires clear lines and policy. Without proper policy, goals of an organization cannot be achieved. It is this policy which provides procedures and the manner for achieving the organization objectives. Such policy making is the responsibility of directors. Similarly, under clause (vi) of the paragraph, the board is responsible to make policy on shariah compliance.

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293 Ibid, paragraph 2.10(iv).
294 Ibid, paragraph 2.10(vi).
295 Ibid, paragraph 2.10(vii)
296 Ibid, paragraph 2.10(ix)
the only rationale that justifies the very existence of Islamic financial institutions, is conformity of their activities with the Islamic principles. In order to achieve the objective of *shariah* compliance, proper *shariah* compliance policy is necessary. Such policy-making on *shariah* compliance is *amanah* with the directors.

Under clause (ii) of the paragraph, board is responsible to make proper division of roles and responsibilities of different corporate governance players. The proper segregation of duties shall enable all players to know their sphere of authority as well as the extent of their accountability. Without proper segregation of duties, it will be difficult to make the players accountable in instances of non-compliance. Therefore, proper segregation is necessary. Such segregation of responsibilities of different corporate governance players is *amanah* with the board.

Further, under clause (iii), the board is responsible to ensure that management includes qualified and competent persons. Ensuring competent management in Islamic banks is important responsibility (*amanah*) of the board. In any organization, the second most important player is management (the implementor of policies) after the policy makers (BODs). A comprehensive and significant policy is useless unless it is properly implemented. Proper and result oriented implementation of policies is possible only when management is competent and qualified. Therefore, it is necessary that Islamic banks have competent and qualified management. Ensuring competent management inside IBIs is the responsibility of BODs, hence it is *amanah* with the board.

Moreover in banks, the operational activities are derived from relevant law of the respective country as well as internal policy of banks. The law as well as internal policy are very much significant for smooth operations of the banks. Without observing legal provisions and internal policies by banks, they are unable to achieve their objectives. Therefore, in order to ensure prudence in the activities of IBIs as well as achieve their
goals, the board is responsible under clause (iv) of the above paragraph to ensure that operations of Islamic banks are run in accordance with law and policies. This responsibility is *amanah* with the board.

Under clause (vi) of the above paragraph 2.10, establishment of internal audit function is the responsibility of BODs, which shall perform shariah audit too. Internal audit is an independent assessment of all activities of organization, which involves systematic evaluation of efficiency of risk management, control and management process. It adds value to the functions of companies and enhances them\(^{297}\). Internal audit function is part of internal control system inside companies (including Islamic banking companies). In the above paragraph the function is also required to conduct shariah audit. Shariah audit is the audit to verify that the activities of Islamic banks are shariah compliant\(^ {298} \). Performing internal shariah audit is important for Islamic banks. It checks whether the activities of Islamic banks are in conformity with Islamic principles. Such verification is necessary because, the only reason for the establishment of Islamic banks is their shariah compliant business. If the IBIs are not earning shariah compliant profits, then no reason lefts for their existence. Establishment of such an important function is the responsibility of BODs, which is amanah with the board. If the boards of Islamic banks have established the internal audit function inside Islamic banks, then it is opined that they have executed their *amanah*.

Under clause (xi) of paragraph 2.10, the board of directors of Islamic banks is responsible to protect the interests of investment account-holders (IAHs). Investment account-holders are important stakeholders of Islamic banks. The interests of these account-holders in Islamic banks are that according to the agreed terms, they need to receive


shariah-compliant profits on their investments. Further, they need relevant and timely information regarding affairs of Islamic banks. Proper policy making on profit distribution and information disclosure is also an interest of the IAHs. Protection of all the above-mentioned interests of the IAHs is the responsibility of directors on board. Such responsibility is *amanah* with the board.

From the above discussion it is inferred that the above-mentioned roles and responsibilities of directors are expressly required from them to perform. Hence they are *amanah* with them, who shall not commit any misconduct or show negligence in its performance. Although, the above provisions are silent in case any misconduct is committed by the directors, nonetheless, in the opinion of the researcher still the above-mentioned roles are *amanah* with the directors, who shall be accountable for it on the day of judgement.

5. **Conflict of Interests of Directors**

Conflict of interest is divergence in the interests among company and its different stakeholders such as the board, shareholders and employees of the company.

According to paragraphs 2.06 and 2.09 of the Malaysian guidelines on CG, only directors are required to avoid conflict of interest situations, whereas, under principle 9 of the guidelines, all persons empowered with decision-making (including directors) are required to avoid conflict of interest situations. Further, under clause (viii) of paragraph 2.10 of the guidelines, it is the responsibility of directors to make policies and procedures in order to appropriately handle the conflict of interest situations. The board is also

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responsible under this clause to monitor management that they have implemented the policies and procedures for conflict of interest situations. In the above provisions, a three folded responsibility is imposed on directors regarding conflict of interest situations. First, they are required to avoid the conflict of interest situations. Second, they are required to make policy on such situations, whereas, in third fold, it is required from them to monitor management that they have effectively implemented such policies. However, these provisions do not define the conflict of interests, which directors of Islamic banks may face. A director may have conflicts with Islamic banks as well as shareholders and investment account-holders. For example, he may want higher salary, bonus and other allowances. Whereas, the bank may want business expansion, while the shareholders and IAHs may want higher returns, which are also shariah compliant. All these situations may lead to conflict between these stakeholders. Therefore, the above provisions require directors to avoid conflict of interest situations and make policies in this regard as well as to actively monitor its implementation in order to achieve the objectives of the policy. Avoidance of conflict of interest by directors is their selfwillingness. The more the directors have selfwillingness to avoid conflict of interests, the more the situations will disappear. Similarly, inorder to control the conflict of interest situations, properly policy as well as ensuring its implementation is necessary. In this way conflict of interest situations shall be controlled to large extent. And the more the conflict of interest situations are controlled, the efficient the activities of the IBIs will be. This avoidance of conflict situations, and making policies in this regard as well as their proper implementation, is amanah with directors.

B. Management

300 *Ibid*, paragraph 2.10(viii).
301 Such as medical, rental, travel and family allowances.
In a company, decision-making and policy-making is entrusted to BODs, whereas, implementation of such decisions and policies is the responsibility of the management. They are responsible to manage business of companies. They include CEO and other senior officers, who are responsible for day to day management of business. If board of directors is mind of companies, management are organs of the companies because the board decides and management perform. So, it is inferred that the second most important function after BODs is management inside any organization including Islamic banks.

1. CEO

According to sub-section (1) of Section 63 of Islamic Financial Services Act, 2013 (hereinafter called IFSA, 2013), every institution (including IBIs) in Malaysia shall at all time have a Chief Executive Officer. This is because the sound operation of an Islamic bank depends critically on its CEO.

Though, the management powers rest with managers, but CEO is on top of management. More or less, it is the CEO who holds all the management powers. On management side, CEO is the most important position. According to Islamic corporate governance principle of amanah such position-holder is trustee of the position of CEO-ship.

Under Malaysian regime, the role of CEO is discussed below.

a) Role of CEO

Paragraph 2.40 of the Guidelines on CG provides that the key role of CEO, among others, include:

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(i) Developing the strategic direction of the Islamic bank;
(ii) ensuring that the Islamic bank’s strategies and corporate policies are effectively implemented;
(iii) ensuring that board decisions are implemented and board directions are responded to;
(iv) providing directions in the implementation of short and long-term business plans;
(v) providing strong leadership; i.e. Effectively communicating a vision, management philosophy and business strategy to the employees;
(vi) keeping board fully informed of all important aspects of the Islamic bank’s operations and ensuring sufficient information is distributed to board members; and
(vii) ensuring the day-to-day business affairs of the institutions are effectively managed.

From the above role of CEO, it appears that CEO’s role is that of oversight, monitoring and giving directions to other managers. For example, under the above paragraph 2.40, the CEO is responsible to ensure that all the decisions and strategies made, and policies set up by directors are effectively implemented. He is also responsible to ensure that day-to-day business activities are effectively managed. Here his role is oversight and monitoring of managers. Likewise, he gives directions to managers in the implementation of long term and short term business plans. Here his role is of director. Nonetheless, he also provides a good leadership to managers. Further, the CEO discloses relevant information to board about the activities of Islamic banks. This disclosure of information to board strengthens and enhances the ultimate oversight and monitoring role of board of directors.

All the above-mentioned are the functions of CEO of Islamic banks, which have been expressly provided in the guidelines. Such functions are *amanah* with the CEO. Although the provisions do not provide for consequences of negligence or misconduct of CEO while performing the *amanah*, but still under the principle of *amanah*, he is expected to avoid any negligence or misconduct.

**C. Audit**

Auditors are watchdogs of companies. They are appointed to conduct audit of companies. “Audit is an official examination of the accounts (or accounting systems) of an entity (by an auditor)” The objective of an audit is to verify and ensure that financial statements are prepared in accordance with applicable rules and standards of a particular country. They also ensure that financial statements represent true and fair view of the state of a company’s affairs.

Auditors play an important role in the overall compliance of companies with laws, regulations and standards of the country in which they do businesses.

Being opinion givers, they hold important position of authority. According to Islamic corporate governance principle of *amanah*, such authority is a trust, which shall not be entrusted into the hands of incompetent auditors. Following is the qualification criteria for auditors.

**1. Qualification and Eligibility of Auditors**

Under the Islamic corporate governance principle of *amanah*, the *amanah* of authority shall be handed over to those, who are competent enough to discharge their duties efficiently and effectively. In order to ensure competency of auditors, the Malaysian

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310 The Institute of Chartered Accountants of Pakistan, *Audit and Assurance*, Emile Woolf International, 2015, p. 3.

311 Ibid.

312 *The Companies Ordinance*, 1984 (XLVII of 1984), Section 255(1).
Central Bank (BNM) has issued the following qualification criteria for them, who shall fulfill this criteria to become eligible for appointment as auditors. The provisions of the criteria are discussed below.

2. Independence of Auditors

Clause (i) of paragraph S. 7.3 of Malaysian Guidelines on External Auditors (guidelines on EA) requires from an auditor to be registered with Audit Oversight Board for conducting audit of public interest entity. Then clause (iv) of the paragraph S. 7.3 requires that the auditor shall not have relationships with their clients, nor shall he have any interests in such financial institutions. For instance, he must not hold shares of those financial institutions of which he conducts audit.

Audit is basically an independent assessment of the correctness of financial statements of companies that the information, which appears on the face of these statements are factually correct. For independent assessment, independenc of auditor from its client institutions is necessary. An auditor, who has any interests in his client company, or he is relative of any director, CEO or any other employee of the company, he cannot be expected to give a correct opinion over its financial statements. Resultantly, he can authenticate information, which are misleading or incorrect. The incorrect or misleading information may include material misstatements which exaggerate the financial position as well performance of the IBIs. Therefore, inorder to identify frauds or other misleading information, in addition to correct opinion giving, the auditors’ independence is necessary. For the purpose of ensuring the auditors’ independence in giving their correct opinion, the above provisions prohibits the auditors from appointment in the institutions...

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313 Audit Oversight Board is the Board established by the Commission under S. 31C of SCA, 1993. The responsibilities of the Board are given in S.31E of the SCA, 1993.
314 According to S. 31A of SCA, 1993 of Malaysia, “Public Interest Entity” means the entity specified in Schedule “1”. There are seven public interests entities in schedule 1 including Islamic Banks.
in which they are interested or who have relationships\textsuperscript{316} with the institutions or their directors/employees. The independent opinion giving is amanah with the auditors.

Clause (ii) of the paragraph requires that the auditor must not have been convicted under any law of Malaysia\textsuperscript{317}.

Every authority is \textit{amanah}, hence the authority of auditorship is \textit{amanah} as well. This \textit{amanah} cannot be handed over to a person who has any criminal record in the past. Such restriction on the appointment of the person as auditor, is necessary to maintain the character of good reputation of the institution. If the person is appointed as auditor, the public (especially its customers) will never trust him. They will see his report doubtful.

Further, an auditor is declared disqualified, if any disciplinary action has been taken against him by the Malaysian Institute of Accountants as provided in clause (v) of paragraph S. 7.3 of the Guidelines on EA.

Malaysian Institute of Accountants (MIA) is basically a professional accountancy body established under the Accountants Act, 1967 of Malaysia. It acts as regulator and is responsible for quality assurance of chartered accountants and auditors. If the MIA has taken any disciplinary action against any auditor, it shows that the auditor has not complied with the requirements of the regulatory body. And the auditor, who does not comply with the requirements of any professional or regulatory body, is not eligible to be appointed as auditor of any Islamic bank. Such restriction is imposed on the auditors so that the law, rules and standards abiding auditors are ensured to be appointed. The rules and standards abiding auditors are more trustworthy than the non-abiding. And those who cannot be trusted cannot be entrusted with the authority of trust.

\textsuperscript{316} The auditors may have business relationships as well.

Similarly, under clause (iii), necessary skills, knowledge and audit experience are required from auditor.

For any post, the relevant past experience and required skills are very much important. They ensure competency of authority-holders, who perform their tasks with great efficiency. Therefore, these requirements are necessary for auditors as well. Persons with relevant audit knowledge, required audit experience and necessary skills, will be capable to make better assessments of financial statements and verify its correctness.

Further, the Malaysian regime also restricts any person, under clause (vi), from appointment as an auditor of the same institution, if the person has remained as auditor of the institution for five years, unless a term of five has passed318.

The basic philosophy behind changing external auditors after every five years, is to prevent institutions and their auditors from developing mutual relations between them. In this way the independence of auditors shall be maintained. Similarly, the ban on the same auditors to conduct audit of the institution for next five years, has also the same rationale behind it. In the period of five years, board members as well as top management of the institution may change, which minimize to greater extent, the chances of developing mutual relations among the auditors and the institutions. Ultimately, the auditors will be able to perform their amanah of opinion giving in independent manner. On the other hand, when the auditors and institutions develop mutual relationships, in this case the independence of the auditors become doubtful. Therefore, they cannot be expected to make objective judgements and give correct opinions.

From the above discussion it is concluded that auditors being authority-holders (being opinion-givers) are trustees. The trust of audit shall be handed over to qualified and competent auditors. As the above provisions put some criteria for persons in order to

318Ibid, paragraph S. 7.3(vi).
ensure their eligibility and competency for auditorship, therefore, it is opined that these provisions are in compliance with the Islamic corporate governance principle of *amanah*.

**3. Roles and Responsibilities of Auditors**

Being authority holders, the roles and responsibilities of auditors are *amanah* with them. Under the Malaysian regime, following are the roles and responsibilities of auditors.

**a) Audit of Accounts, Balance-Sheet and Profit & Loss Accounts**

Under section 174(1) of CA and 78(1) of IFSA, the auditors are required to conduct audit of the following documents.

1) Accounts *(including consolidated accounts)* and books of accounts of IBIs.

2) Accounting and other records relating to accounts of IBIs.

3) Business and affairs of IBIs.

While auditing these accounts, the auditors shall verify and state in their report the following:

Clause (a) sub-section (3) of Section 174 of CA, 1965 requires auditors to state whether they have acquired all the information and explanation necessary for audit? Under sub-section (3) and clause (b) of sub-section (2) of the Section 174, auditor is responsible to confirm whether proper books of accounts are kept by the company. Similarly, According to clause (ii) of sub-section (2) of the Section 174, auditor shall state in his report whether the accounts are properly drawn up in accordance with the provisions of the CA, 1965 of Malaysia. He is also responsible under sub-clause (i) of clause (a) of sub-section (3) of

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319 According to interpretation clause of Section 4 of Companies Act, 1965, ‘*accounts*’ means profit and loss accounts and balance sheets and includes notes or statements required by this Act (other than auditors’ reports or directors’ reports) and attached or intended to be read with profit and loss accounts or balance sheets”.

320 *The Companies Act, 1965 (Revised-1973), Section 174(1).*

321 *The Islamic Financial Services Act, 2013, Section 78(1).*

322 Under the interpretation clause of section 4 of Companies Act, 1965, ‘*accounting records*’ includes invoices, receipts, orders for payment of money, bills of exchange, cheques, promissory notes, vouchers and other documents of prime entry and also includes such working papers and other documents as are necessary to explain the methods and calculations by which accounts are made up”.

323 *The Companies Act, 1965 (Revised-1973), Section 174(1).*

324 *The Islamic Financial Services Act, 2013, Section 78(1).*
Section 172 to state whether the accounts give true and fair values of matter given in section 169 of the Act. Under subsection 14 of the said section i.e. S.169 of the Act, the matter is *state of affairs* in case of balance sheet, and it is *profit and loss* in case of profit and loss account. We can say that Malaysian regime also requires an auditor to state that the balance sheet prepared represent true and fair view on affairs of the business, whereas, the profit and loss account represent true and fair view on the profit and loss accounts. Also the Malaysian regime requires an auditor under clause (c) of sub-section (3) of Section 174 to report whether returns received from branch offices are adequate? Further, it is required by clause (d) of sub-section (2) of Section 174, from an auditor to state any defect or irregularity in the accounts, or any other matter not set out in the accounts, without which a true and fair view cannot be made.

Further, if in the opinion of the auditor, accounts are not prepared in accordance with the provisions of accounting standards, then under clause (aa) of sub-section (2) of Section 174 CA, 1965, the Malaysian regime requires the auditor to state in his report:

1. that if the accounts would have been prepared in accordance with the particular accounting standards, they would have given true and fair value of the matters required under S. 169 of the CA;
2. that as the accounts are not prepared according to the particular accounting standards, therefore, they are not giving any true and fair value;
3. his opinion on the particulars of quantified financial effects on accounts, as given by directors;
4. or if directors have not given such particulars, shall give particulars of the quantified financial effect of such non-compliant statements on accounts.

With respect to consolidated accounts, the auditors are bound under clause (c) of sub-section (2) of Section 174 of CA, 1965, to state in their report:
a) the names of the subsidiaries of which he has not acted as auditor;

b) whether he has taken into accounts the accounts and auditors’ reports thereon on the accounts of such subsidiaries;

c) whether the auditors’ report on account of subsidiaries is subject to any qualification, or any comment is included in the report on the accounts, and if so, the particular of such qualification or comment.

By verifying all the above mentioned information and stating them in their report, the auditors help ensure smooth operations of affairs of companies (including Islamic banking companies). It is an important check on the activities of companies and their employees. It is also helpful in detecting managerial frauds. It examines that what appears on the face of financial statements are factually correct. For this purpose, verification and disclosure of all the above mentioned information is *amanah* with the auditors.

**b) Immediate Report on Matters of Material Significance to Central Bank**

When we say that auditors are watchdogs of companies and they verify correctness of financial statements and detect frauds. Then what is their authority in instances of finding frauds or irregularities in the business activities of companies? This has been answered in Section 81 of Islamic Financial Services Act, 2013. The section requires auditors to immediately report to BNM in the following circumstances:

1. Breach or contravention of any provision of IFSA, 2013

2. Non-Compliance of any Standards as specified by BNM

3. Commission of offence by the institution, its director or officer, involving fraud or dishonesty under any written law

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4. Irregularity having material effect on the financial position of the institution, including that which jeopardizes/may jeopardize the interests of customers.
5. Uncertainty in confirmation that claims of customers are covered by the assets of the institution
6. Weakness in internal control relating to financial reporting process
7. Situation in which financial position of institution is likely to be or has been materially affected by an event, conduct or activity of the institution.

The above mentioned are the situations of material interests under Malaysian regime, which need to be reported to BNM on immediate basis. Reporting of the above mentioned significant information to BNM is necessary because the BNM acts as regulator of Islamic banking institutions in Malaysia. Besides the statutory law of Malaysia, all the regulations, standards and guidelines for Islamic banking institutions are issued by the BNM. All these policies, guidelines and standards have the objectives to regulate activities of the IBIs and to keep them on the right direction of shariah compliance as well profitability. For this purpose of ensuring activities of the IBIs in the right track, it is necessary that the BNM is informed in the above mentioned circumstances. Such information disclosure shall enable the BNM to suggest corrective measures and to take necessary actions against the culprits involved in the above-mentioned frauds and irregularities. The BNM can take such actions only when it is informed in the above mentioned circumstances. Such information disclosure is the responsibility of auditor, who holds such responsibility as trust.

From the above discussion it is clear that all the above corporate governance players (directors, managers and auditors) being authority-holders are holding their respective authorities as trust. Further, being trustees, the respective roles and responsibilities of the auditors

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326 The Islamic Financial Services Act, 2013, Section 81.
CG players, are also trust with them, no matter they are expressly provided in the legal regime or impliedly expected from them in the manner expected from holders of similar offices. However, the deficiency in the above provisions is that they do not expressly provide for any consequences in case of negligence or misconduct of the CG players while performing their *amanah*.

Apart from the above provisions, there are some other provisions which make these players accountable for non-performance of their *amanah*. The provisions shall be discussed in **part C** of the chapter.

**Part B**

**Application of Principle of *Amanah* to Provisions of Malaysian Shariah Governance Framework (MSGF)**

In the above part (part A), the provisions of Malaysian regime are relevant to overall roles and responsibilities of the corporate governance players. Here in this part, the provisions of the MSGF are discussed, which are specifically related to *shariah* compliance in the activities of Islamic banking institutions. In the light of Islamic corporate governance principle of *amanah*, the provisions of the MSGF are discussed below.

**A. Role of Board of Directors**

Board of directors acts as mind of institutions\(^{327}\) (including Islamic banking institutions). All the decision-making and policy-making powers rest with the board. Being the most important player inside financial institutions, Islamic financial institutions of Malaysia also have board of directors. The IFIs are established to provide shariah compliant products and services to its customers. In order to ensure shariah compliance in the products and services of the IFIs, the central bank of Malaysia (BNM) has issued a Shariah Governance Framework (MSGF). The MSGF assigns particular roles to different

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corporate governance players including board of directors. The role of the board is discussed below.

1. **Ultimate Accountability and Responsibility for Shariah Compliance**

According to paragraph 2.1 of MSGF, the BODs has ultimate responsibility and accountability for shariah compliance as well as overall shariah governance framework. In this paragraph of the MSGF the board is ultimately responsible and accountable for two things namely shariah compliance and overall SGF. Responsibility for shariah compliance means that the board is responsible/accountable to ensure shariah compliance in the activities of Islamic banks. Here it is not clear as to who the board is responsible to, and to what extent? But in the opinion of the researcher, the directors on board are accountable to shareholders and BNM. They are accountable to shareholders because shareholders appoint them, and they are required to work for the protection of interests of shareholders. Similarly, they are accountable to BNM because the BNM as regulator requires shariah compliance from the board as envisaged in this Shariah Governance Framework. As far the responsibility of the board for the overall SGF is concerned, it means that the board is responsible for the implementation of the SGF.

The above mentioned two responsibilities are *amanah* with the directors on board. In case of any negligence or misconduct in performance of their *amanah*, they shall be accountable. They need to be accountable but actually there are no provision which provide for their accountability. In order to execute their *amanah* of shariah compliance, the MSGF requires the following functions from the board.

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2. Diligent Oversight

Under paragraph 2.1 of MSGF, the board is responsible for diligent overseeing the functioning of the SGF. As stated above, the BNM has issued the SGF in order to ensure shariah compliance in the activities of Islamic banks. Therefore, it is necessary that the SGF is efficiently implemented. Such efficient implementation of the SGF is possible only when board of directors diligently oversees its functioning. According to this paragraph, the board has the oversight responsibility, which is amanah with the board.

3. Approval of Policies Relating to Shariah Matters

Paragraph 2.2 of MSGF declares the board responsible for the policy-making on shariah matters. Also the board is responsible to ensure that the policies are implemented\textsuperscript{329}. In addition to MSGF, internal policy is necessary for Islamic banks. Such policy on shariah matters shall further strengthen the shariah compliance environment in the IBIs. Similarly, the SGF is an external document for Islamic banks. The IBIs are required to observe its provisions, however, how well the SGF could be internalize, it needs internal policy of Islamic banks. Further, the SGF and internal policies cannot be useful unless they are properly implemented. Therefore, the above paragraph not only requires board to make policy on shariah matters but also requires its implementation from the board. With such implementation of the policy, the overall shariah compliance environment shall be further strengthened. A strong shariah compliant environment inside Islamic banks shall ensure efficiency in the activities of the IBIs. The above mentioned policy-making as well as its implementation is amanah with the BODs.

\textsuperscript{329}Ibid, paragraph 2.2.
4. Appointment of SC Members

MSGF under paragraph 2.3, empowers the board to appoint members of Shariah Committee. Earning profits in conformity with the principles of shariah is the prime objective of Islamic banks. To ensure shariah compliant business and profit earning, Islamic banks in Malaysia have internal shariah body called Shariah Committee (SC). The SC is responsible to ensure that products and services of Islamic banks are shariah compliant. According to the above paragraph, it is the authority of board of directors to appoint members of the SC. The board is expected to appoint qualified, competent and experienced members on the SC because it is the board itself, which is ultimately responsible and accountable for ensuring shariah compliance in the activities of IBIs. If the activities of the IBIs are not in conformity with the principles of shariah, then board is accountable for that as stated in paragraph 2.1 of the MSGF. This shall certainly affect the reputation of the board, in addition to the reputation of SC and the IBI. The appointment of SC members is amanah with the BODs.

5. Appointment of SC Member on Board

According to paragraph 2.4 of MSGF, the board has the power to appoint a member of SC on the board. Such member shall serve as bridge between SC and BODs. The appointment of one member of SC on board of directors, has many benefits. In this way knowledge sharing shall occur among the members of board and the SC members. They will easily understand each other’s point of view and the rationale for their opinion while discussing matters before arriving at any decision. As a result, better shariah compliant decisions shall be made, which shall enhance the efficiency of the board as well the SC. For this purpose the appointmet of at least one member of SC on the BODs is amanah with the BOD.

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330 Ibid, paragraph 2.3.
331 Ibid, paragraph 2.4.
On the basis of the above mentioned functions of the board, it is stated that the board plays significant role in ensuring *shariah* compliance in Islamic banks. The board is ultimately accountable for *shariah* compliance, therefore, it is empowered to make policy on *shariah* matters and to diligently monitor and oversee that such policy is implemented, in addition to the oversight over the functioning of the SGF. All the above mentioned functions are *amanah* with the board.

**B. Management**

If board of directors is mind of companies\(^3\) management are organs of the companies because the board decides and management perform. So, it is inferred that the second most important function inside organizations, is management after BODs. In Islamic banks also the management plays very significant role. In the following provisions of MSGF, the role of management of Islamic banks is discussed in the light of Islamic corporate governance principle of *amanah*.

1. **Observance and Implementation of Shariah Rulings and Decisions**

Under paragraph 2.11 of MSGF, it is the responsibility of management to observe and implement the decisions and rulings made by Shariah Advisory Council of BNM or Shariah Committee\(^4\). In Malaysia, the Shariah governance system is two tiered\(^5\). There is a centralized Shariah body called Shariah Advisory Council (SAC) on central bank level. SAC is the final authority to decide on shariah matters\(^6\). Then on institutional level, there is shariah body called Shariah Committee (SC)\(^7\). Inside institutions, the SC ensures that products and services offered by the institutions are shariah compliant.

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5. Ibid, paragraph 1.2.
6. Ibid, paragraph 1.3.
7. Ibid, paragraph 1.4.
Although, inside institutions, board acts as mind whereas management as organs. But, in case of Islamic banking institutions, an additional mind is also there, which acts as supplemental mind (the SC). However, in this case too the function of organs is performed by management.

Under the above paragraph, management is not only responsible to observe the decisions made by SC or BAC, but also it is its responsibility to implement these decisions. Like, decisions of the BODs, the decisions of SC and SAC are useless, unless they are properly implemented. Observance and proper implementation of SC’s and SAC’s decisions shall strengthen shariah compliance in the activities of IBIs. This observance as well as implementation of shariah decisions is *amanah* with the management.

2. Provision of Learning and Training Programs in Shariah and Finance Matters

Paragraph 2.14 of MSGF requires management to provide continuous learning and training programs to BODs, SC and other relevant staff on shariah and finance matters.\(^{337}\)

The CG players of Islamic banks have either of the two backgrounds. Either they have conventional educational background such as members of BODs, some members of SC, CEO and other officers. Or, they hold degree in *shariah* like majority members of SC and Shariah Research officers. The *shariah* scholars normally know less about finance. Similarly, the other conventional degree-holders lack knowledge about *shariah*.\(^{338}\) So, those who lack knowledge about finance (shariah scholars) should be exposed to trainings and orientations in finance. In this way their understanding on finance will develop and they will be able to apply the *shariah* knowledge into Islamic finance. This will enhance efficiency of Islamic banks. Similarly, those who do not know about *shariah* shall

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\(^{338}\) Even they may not know about finance. This is because not all conventional degree holders have degree in finance, they me be law graduates, marketing or HR graduates etc.
begiven trainings in *shariah* so that they become able to perform their tasks in conformity with the principles of *shariah*. In this way *shariah* compliant activities shall be ensured. Further, the above trainings will minimize the knowledge gap between the players of the IBIs, which shall create a *shariah* compliant environment inside the banks. Such *shariah* compliant environment shall certainly enhance efficiency\(^{339}\) in the performance of the IBIs. As, according to the above paragraph 2.14 of the MSGF, management is responsible for providing such trainings, therefore, they play important role in the knowledge enhancement of CG players, and ultimately in the overall efficiency and *shariah* compliance in the activities of Islamic banks. This role is *amanah* with the management.

**3. Role of Management in Case of Non-Compliant Operations**

In case of any non-compliant operations, it is the responsibility of management under clause (i) and (ii) of paragraph 2.17 of MSGF, to immediately stop such non-compliant business and to report it to the board, SC and BNM. Clause (iii) of the paragraph 2.17 also requires from management to furnish plan for rectification of such non-compliant operations within thirty days, which shall be endorsed by SC and approved by the BODs\(^{340}\).

In the above provisions management have three responsibilities. First, when they find any non-compliant operation inside the Islamic bank, they shall at once stop the business. The business is stopped to avoid *shariah* non-compliant profit earning. Second, the management gives report of such non-compliant event to BODs, SC and BNM. Such reporting shall enhance transparency in the activities of the IBIs. The disclosure to BODs shall maintain reputation of the board because it is the board, which is ultimately accountable for ensuring *shariah* compliance. Similarly, disclosure of the non-compliant operation to SC

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\(^{339}\) Efficiency in terms of smooth running, enhanced profitability etc.

is also necessary because, ensuring shariah compliance in the activities and business operations of the IBIs is the responsibility of the SC. In this way the SC shall be able to suggest corrective measures for the rectification of the non-compliant event. Similarly, timely disclosure of the non-compliance to BNM is also necessary to avoid from actions to be taken by the BNM in the future, when it will come to know about such non-compliance.

The third responsibility, which management is required to perform is suggesting rectification plan. This is very much important because stopping any business is no solution. The actual solution is the continuation of the rectified business so that the bank’s performance is maintained. Here, the management is responsible to suggest the rectification measures for the non-compliant operations.

From the above discussion it is inferred that management plays a significant role in the shariah compliance of IBIs. Such role is amanah with the management.

C. Shariah Committee (SC)

With the emergence of Islamic financial institutions, a new aspect has been introduced into corporate governance goals i.e. Shari‘ah compliance. This goal of Shari‘ah compliance cannot be achieved without proper and good governance structure inside the IFIs. Inside Malaysian Islamic banks, the highest authority, which deals with shariah matters, is Shariah Committee (SC). In the following paragraphs, we will discuss the provisions of Malaysian SGF, which are related to Shariah Committee.

1. Education/Qualification

In Malaysia, under paragraph 2 of appendix 2 (qualification) of MSGF, the minimum educational qualification required from majority of members of Shariah Committee, is
bachelor degree in fiqh (the origin of Islamic law) or Fiqh al-Mu ‘amalat (Islamic Commercial Law).\footnote{Bank Negara Malaysia, Shariah Governance Framework For Islamic Financial Institutions, Appendix 2, paragraph 2(qualification), <http://www.bnm.gov.my/guidelines/05_shariah/02_Shariah_Governance_Framework_20101026.pdf> Lastly accessed on 26/09/2015.}

In Malaysian Islamic financial institutions, the highest authority dealing with shariah matters is Shariah Committee. Therefore, it is necessary for members of the SC to be competent and qualified enough to handle all shariah matters properly. Ensuring competency of the SC members is of the requirements of Islamic corporate governance principle of amanah. In order to ensure their capability and competency, the MSGF required from the members to hold at minimum, bachelor degree in fiqh (origin of law) or fiqh al-mu’amalat (Islamic commercial law).

Fiqh is the knowledge (Science) of practical shariah rulings pertaining to conduct that are derived from the detailed (individual) evidences of shariah\footnote{Karim Ginena and Azhar Hamid, Foundations of Shariah Governance of Islamic Banks, John Wiley & Sons, (2015), p. 8; Abdul Karim Zedan, Al-wajeez fi ‘Usool al-Fiqh, Dar Nashr ul-kutub al-islamiyyah, (1976), p. 8; Mahmood Ahmad Ghazi, Mahadhirat-e Fiqh, Al-Faisal Nashran, (2005), p. 36.}. This definition suggests that fiqh deals with practical conducts of human beings, which include acts of worship (such as prayer is subject of fiqh al-‘ibadat), acts of transactions (such as sale/purchase is subject of fiqh al-mu ‘amalat) and acts of crime (qisas and hudood are subjects of fiqhal-jinayat)\footnote{Ahkam (rules) relating to aqeeda (such as trust in God and Day of Judgement) and akhlaq (such as obligation of telling truth and prohibition of telling lie) are excluded from the subject of fiqh. (See, Abdul Karim Zedan, Al-wajeez fi ‘Usool al-Fiqh, Dar Nashr ul-kutub al-islamiyyah, (1976), p. 9.}. These three are the main subjects\footnote{Dr. Mahmood Ahmad Ghazi has divided the subject of fiqh into two main divisions. One is related to acts of state the other is related to acts of subjects (citizens) of state. The former type of fiqh includes muslim administrative law, muslim criminal law, muslim procedural law and muslim international law. The latter includes acts of worship, muslim family law, transactions and social dealings. (See generally, Mahmood Ahmad Ghazi, Mahadhirat-e Fiqh, Al-Faisal Nashran, (2005).} of fiqh. Fiqh is broader than Fiqh al-mu ‘amalat. The later is a special subject of the former. However, both include the knowledge relating to individuals’ mutual transactions. It also includes knowledge of business transactions such musawamah\footnote{Sale without mentioning the cost price or profit margin.}, murabaha\footnote{}, salam\footnote{}, mudharabah\footnote{}}.
Persons with degree in fiqh or fiqh al-mu’amalat shall be able to tackle financial matters of Islamic banks with better understanding. Islamic banking business is based on the Islamic business transactions, hence the shariah scholars holding degrees in the above mentioned fields are most suitable to be members of SC. Members of SC other than shariah scholars may have expertise in business, accounts and finance. In the presence of shariah and non-shariah scholars on SC, all aspects of matters in hands shall be discussed. In this way better shariah compliant decisions shall be made, which are expected to be profitable as well.

Based on the above discussion it is argued that the above provision of Malaysian regime is in conformity with the Islamic corporate governance principle of amanah because, in conformity with the Islamic principle of amanah, the authority of SC membership is handed over to those who are sufficiently qualified and competent to execute their amanah with required efficiency.

2. Role of Shariah Committee

As is clear from paragraph 3 and 4 of MSGF that ensuring compliance is the responsibility of Shariah Committee, therefore, to fulfill such amanah, the SC members are required/expected to perform the following roles and responsibilities:

a) Rigorous Deliberations

The Malaysian SGF, under its paragraph 2.7 expects from SC members to rigorously deliberate on all issues. The rigorous deliberation on shariah issues means that the issues shall be brought under proper discussion. Based on his knowledge, each member

346 Sale by mentioning the cost price as well as profit margin.
347 Contract of advance payment and deferred delivery of goods.
348 Contract of participation in which one party provides capital while the other party provides skills.
349 Contract of participation in which both the parties provide capital.
350 Contract of manufacturing.
shall give his opinion. Pros and cons of the matters shall be discussed and its results in Islamic banking shall be foreseen. Resultantly, no matter shall be decided blindly. This shall ultimately minimize the *shariah* non-compliance risk in the decision-making process, which shall enhance efficiency in the activities of Islamic banks.

The element of rigorous deliberation on issues in hand shows that the principle of *shoora*\(^{352}\) (mutual consultation) is followed by the SC in the process of decision-makings. Such decision-making on the basis of *shoora* is *amanah* with the members of SC.

**b) Decision-Making**

Under paragraph 1 of appendix 5 (decision-making) of MSGF, all decisions shall be made on the basis of 2/3 majority of SC members out of which 2/3 members must be from *shariah* background\(^{353}\). After rigorous deliberation on *shariah* matters, the above paragraph requires that the matter shall be decided on the basis of two third (2/3) majority of members of SC out of which 2/3 members shall be *shariah* scholars. This provision is also in conformity with the Islamic principle of *shoora* (mutual consultation), because in *shoora* the decisions are made on the basis of mutual consultation (where all members give consent). But, in case if all the members do not give consent on some issue, then the opinion of majority shall be taken\(^{354}\). Thus, it is inferred that the minimum requirement of *shoora* for decision-making, is consent of majority of scholars.

Moreover, decision-makings, on the basis of 2/3 majority out of which 2/3 members shall be *shariah* scholars, shall stop doors for non-*shariah* scholars to make decisions on

\(^{352}\)In Quran Allah refers to the principle of *shoora* along with some other characteristics of believers as: “*Those who respond to their Lord, and establish regular prayer; who conduct their affairs by mutual consultation, who spend out of what we bestow on them for sustenance*.” (See, Al-Quran, 42:38). In other place in Quran Allah says that “*And consult them on affairs (of moment). Then, when you have taken a decision, put your trust in Allah*.”. (See, Al-Quran, 3:159).


\(^{354}\)Muhammad Yousuf Farooqi, *'Ahd-e Risalat main Mu'ashira Aor Mumlikat ki Tashkil*, Izhar ul-Quran: 2006, p. 140.
shariah matters. In this way, the risk of shariah non-compliant decision-making shall also be minimized. Such decision-making on the basis of two third (2/3) majority members is amanah with the SC.

c) Accountability and Responsibility for Fatawas and Decisions

The shariah committee, according to Malaysian SGF under paragraph 1 of appendix 4, is responsible and accountable for all its rulings, fatawas, decisions and opinions. The above responsibility and accountability of members of SC for all their rulings and fatawas is meaningful. This is actually a control over the functioning of the members of SC. In this way, they shall be careful while making any decision or issuing any fatwa. Their opinions shall be based more on reasons and evidences from shariah. However, it is not clear as to who are they responsible to and to what extent. But, at least members of the SC shall be blamed for any incorrect opinion or fatwa, which shall obviously damage their reputation. The accountability of the SC demonstrates that the decisions making and issuing fatawas are amanah with them.

d) Advice to Board of Directors

According to paragraph 2 of appendix 4 (advice to board and IFI), the Shariah Committee is expected to give advice to Board on shariah matters. Like all other companies, the decision-making powers of Islamic banks also rest with the board of directors. As under paragraph 2.1 of the MSGF, the board is ultimately responsible and accountable for shariah compliance, therefore, the board needs advice from members of SC. Giving advice to the board is the responsibility of SC. As a result, the risk of shariah non-compliance is expected to be reduced.

355 Members with less knowledge of shariah can be expected to agree on shariah non-compliant product/service. Such apprehension is justified when none of the shariah scholars shall be in favor of the decision taken by the non-shariah scholars.
357 Ibid, Appendix 4, paragraph 2.
compliant decision-making by less knowledgable board (means board having less knowledge of Islamic law) on shariah matters shall be minimized. Hence, the board shall make decisions in conformity with the principles of shariah. Therefore, such advice-giving is also amanah with the SC.

e) Oversight over Shariah Matters

The oversight on shariah matters in Islamic banking institutions vests with SC of the IBIs under paragraph 2.8 of MSGF, therefore, the SC shall oversee the shariah activities of the IBIs\(^{358}\). The prime objective of shariah compliance in the activities of Islamic banks can be ensured only with the diligent oversight over the activities of the IBIs. To the extent of shariah matters, in the above paragraph of MSGF, the oversight role is assigned to Shariah Committee. The oversight role of the SC maintains the overall shariah compliant environment in the IBIs. With the help of two important functions\(^{359}\), the Shariah Committee can effectively perform the oversight role. The functions are discussed below.

f) Proposing Corrective Measures on the Basis of Shari'ah Audit and Shari'ah Review

The Malaysian SGF under its paragraph 2.8, requires submission of Internal Shariah Audit and Shariah Review Reports to SC on regular basis to identify issues in the activities of Islamic banks and to rectify them. The SC is responsible under paragraph 2.8 of the SGF to propose corrective measures for non-compliant instances identified by the Shariah Review and Shariah Audit Functions\(^{360}\).

The oversight role of SC shall be effective only when there are proper internal shariah audit and internal shariah review functions conducted on regular basis and their reports

\(^{358}\)Ibid, paragraph 2.8.

\(^{359}\)Shariah Review and Shariah Audit Functions.

are submitted to SC. Shariah Review is “review of overall business activities of IBIs for verifying level of compliance with shariah”\(^{361}\). If the function identifies any shariah non-compliant instance, then under paragraph 7.6(iii), it shall report such instance to SC, in addition to management. Similarly, shariah audit “is the assessment of all aspect of IBIs business operations and activities (including financial statements). Here the purpose is to verify whether sound and effective internal control system for shariah compliance has been implemented in the IBI\(^{362}\). Then under paragraph 7.13(v) of the MSGF, any finding or results of the audit are reported to SC, in addition to Board Audit Committee (BAC). So, as a result if any instance of non-compliance with shariah is identified, the SC suggests corrective measures for that. In this way the oversight role of the SC is ensured and the overall shariah compliant environment is maintained. Proposing corrective measures in instances of shariah non-compliance is amanah with the SC.

All the above functions of Shariah Committee help in ensuring shariah compliance in the overall environment of IBIs. Performing all these functions are amanah with the SC.

D. Shariah Compliance Function

To strengthen the overall shariah compliant environment in Islamic banking institutions, the SGF has suggested the IBIs to establish four important functions namely shariah review function, internal shariah audit function, shariah risk management function and shariah research function. If these four functions work properly then the chances of shariah non-compliant instances will be minimized to greater extent. These functions are discussed below.

1. Shariah Review Function

“The shariah review function refers to regular assessment on shariah compliance in the activities and operations of the IFI by qualified shariah officer(s), with the objective of

\(^{361}\)Ibid, paragraph 7.5(i).

\(^{362}\)Ibid, paragraph 7.12.
ensuring that the activities and operations carried out by the IFI do not contravene with the shariah.\textsuperscript{363}

Under the above paragraph, the sharih review function is responsible for regular assessment of all affairs of IFIs in order to verify and ensure that such affairs are shariah compliant\textsuperscript{364}. The function is performed by qualified shariah officers, who shall have minimum qualification of bachelor degree in shariah under paragraph 7.3 of MSGF\textsuperscript{365}.

**a) Scope of the Shariah Review Function**

The scope of the internal shariah review is overall business operations including end-to-end product development process of Islamic banks\textsuperscript{366}.

**2. Internal Shariah Audit**

“Shariah audit refers to the periodical assessment conducted from time to time to provide an independent assessment and objective assurance designed to add value and improve the degree of compliance in relation to the IFI’s business operations, with the main objective of ensuring a sound and effective internal control system for shariah compliance.”\textsuperscript{367}

In the above paragraph it is stated that in order to verify the effectiveness and soundness of the internal control system for shariah compliance, the shariah audit is conducted on periodic basis. The function is conducted by Internal Auditors, who have acquired shariah related knowledge and training\textsuperscript{368}. The auditors may also engage the expertise of shariah officers of the IFI, while conducting the shariah audit\textsuperscript{369}.

\textsuperscript{363}Ibid, paragraph 7.3.
\textsuperscript{364}Ibid, paragraph 7.3 & 7.5.
\textsuperscript{365}Ibid, paragraph 7.3.
\textsuperscript{366}Ibid, paragraph 7.5.
\textsuperscript{367}Ibid, paragraph 7.7.
\textsuperscript{368}Ibid, paragraph 7.7.
\textsuperscript{369}Ibid, paragraph 7.8.
a) Scope of Internal Shariah Audit

Under paragraph 7.12 of MSGF, the scope of Internal shariah audit covers all aspects of Islamic financial institutions business operations and activities including:

i. audit of the financial statements of the IFIs;

ii. compliance audit on organizational structure, people, process and information technology application systems;

iii. Review of adequacy of the shariah governance process\textsuperscript{370}.

Auditing all the above three functions of financial statements, organizational structure and information technology system, and shariah governance process shows that the purpose of the audit is to check the governance structure and internal control system of IBIs.

3. Shariah Review VS Shariah Audit Function

Apparently, the functions of Internal shariah audit and shariah review, inside Islamic banking institutions seem similar, hence objectionable as to why two similar functions are working inside an IBI, while both have the objective of ensuring shariah compliance. To verify whether the two functions are similar or they have any differences, the roles of the two functions are analysed here. From paragraph 7.4 of MSGF, it is clear that the functions of shariah review deals with the following three areas;

1. IBIs level of compliance with shariah;

2. Corrective measures for the rectification of any non-compliance;

3. Providing control mechanism to avoid recurrence of such non-compliance in future\textsuperscript{371}.

In simple words it is stated that the shariah review function reviews activities of IBIs. If the function finds any shariah non-compliant activity, it suggests corrective measures for

\textsuperscript{370}Ibid, paragraph 7.12.

\textsuperscript{371}Ibid, paragraph 7.4.
that. It also provides a control mechanism in order to stop any such non-compliance in future.

On the other hand the shariah audit deals with financial statements, compliance audit on organizational structure, people and process and IT application systems, and review of adequacy of the shariah governance process.\textsuperscript{372} Here the purpose of the audit is to verify whether the IBI has implemented a sound and effective internal control system for shariah compliance or not?

So, the difference between the two functions is that shariah review is the function conducted by management (shariah officers), whereas, shariah audit is conducted by internal auditors. Similarly, the shariah review verifies shariah compliance in the activities of the IBIs and suggests rectification measures in instances of non-compliance, whereas, the shariah auditors assess such rectification measures and give their recommendations on them. Further, the shariah review suggests control system to stop any such non-compliance instances in the future. Here, the function of internal shariah audit is to assess the soundness and effectiveness of internal control system suggested by management for stopping shariah non-compliance instances in future.

4. Shariah Risk Management Function (SRMF)

Literally risk is that "something bad could happen"\textsuperscript{373}. It is "the probability and magnitude of a loss, disaster, or other undesirable event"\textsuperscript{374}. In this sense, Shariah risk will mean that something bad could happen with respect to shariah. Or it is the probability and magnitude of loss to shariah rules and principles.

\textsuperscript{372}Ibid, paragraph 7.12.
\textsuperscript{374}Ibid.
Shariah risk is defined as “the chance that an Islamic financing institution is challenged on grounds that it does not comply with Islamic law”\textsuperscript{375}. This is actually a shariah non-compliance risk, which may “result from failure of an IFI’s internal control system or corporate governance”\textsuperscript{376}. The risk is operational in nature, which is unique to Islamic financial institutions\textsuperscript{377}. As the objective of Islamic financial institutions is to ensure shariah compliance in all its activities, therefore, the minimization of risk (management of risk) of non-compliance with shariah is the responsibility of the IFIs.

Risk management is “being smart about taking chances”\textsuperscript{378}. It is “the identification, assessment, and prioritization of risks followed by co-ordinated and economical application of resources to minimize, monitor, and control the probability and/or impact of unfortunate events”\textsuperscript{379}. This is the definition of risk management but when the risk is related to shariah, then the term shariah risk management can be defined as the “identification, assessment, and prioritization of shariah risk followed by co-ordinated and economical application of resources to minimize, monitor and control the probability and/or impact of the non-compliant events”.

In order to mitigate the shariah non-compliance risk, an effective internal shariah control system is necessary\textsuperscript{380}. For this purpose, the Malaysian SGF requires IBIs to establish internal control function called Shariah Risk Management Function (SRMF).


\textsuperscript{379} Ibid.

“Shariah Risk Management is a function to systematically identify, measure, monitor and control of Shariah non-compliance risks to mitigate any possible of non-compliance events”\textsuperscript{381}.

The SFRM is an internal function inside Islamic financial institutions, which forms part of integrated risk management framework of the IFIs\textsuperscript{382}. It is responsible to foresee the non-compliance instances before its occurrence and to properly mitigate them so that a shariah compliant environment is ensured in the IFIs. The function shall be carried out by those risk officers who are suitably qualified and experienced in this regard\textsuperscript{383}. This is because shariah matters involve technicalities, which can be understood as well as tackled only by those officers, who have sufficient knowledge and training of shariah.

The process of the SRMF includes:

(i) To facilitate the process of identification, measurement, controlling and monitoring shariah non-compliance risks inherent in the IFIs’ operations and activities;

(ii) To formulate and recommend shariah non-compliance risk management policies and guidelines; and

(iii) To develop and implement the processes for shariah non-compliance risk’s awareness in the IFIs\textsuperscript{384}.

Two approaches are very much helpful for ensuring shariah compliance in an institution’s activities. According to one approach, whenever any non-compliance activity is identified, it is rectified. This approach is adopted in the shariah review and shariah audit functions as discussed earlier. The second approach is that to anticipate any shariah non-compliance risks before their occurrence so that proper shariah risk management policy is

\textsuperscript{381} Bank Negara Malaysia, Shariah Governance Framework For Islamic Financial Institutions, paragraph 7.15, \textless http://www.bnm.gov.my/guidelines/05_shariah/02_Shariah_Governance_Framework_20101026.pdf\textgreater  Lastly accessed on 26/09/2015.

\textsuperscript{382} Bank Negara Malaysia, Shariah Governance Framework For Islamic Financial Institutions, paragraph 7.16, \textless http://www.bnm.gov.my/guidelines/05_shariah/02_Shariah_Governance_Framework_20101026.pdf\textgreater  Lastly accessed on 26/09/2015.

\textsuperscript{383} Ibid, paragraph 7.7.

\textsuperscript{384} Ibid, paragraph 7.7.
made timely, and the event is avoided or stopped from occurrence. For this purpose, the presence of a proper SRMF inside IBIs, is very much significant. Performing the shariah risk management function is *amanah* with the *shariah* risk officers.

### 5. Shariah Research

The fourth most important function, which forms part of overall shariah compliance function of IFIs in Malaysia, is the Shariah Research Function (SRF). It refers to “the conduct of performing in-depth research and studies on Shariah issues…”[385](#). It is performed by qualified *shariah* officers.[386](#) The function is very much significant for SC because shariah issues in hand shall not be decided abruptly, rather proper research shall be conducted on it. In this regard, all the relevant principles of shariah shall be studied. All aspects of the issues shall be discussed, hence the chances of non-complianc of shariah shall be minimized, and a consistent shariah compliant environment shall be ensured.

It is concluded that all the above mentioned corporate governance players are authority holders, hence trustees of their positions. Being on such positions, all their respective roles (both expressed and implied) are *amanah* with them. However, it is not verified from the above provisions whether in case of any negligence or misconduct in performing their roles, the players shall be held accountable or not? It is worthily mentioned here however, that there are so many provisions from which the accountability of the players is verified. These provisions shall be discussed in the following part C of this chapter.

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Part C

Accountability of Corporate Governance Players for Committing Misconduct in Their Amanah

In this part, the provisions of Malaysian regime shall be discussed to verify whether, the authority holders (being trustees) are accountable for their misconducts and negligence in performing their responsibilities or not? The provisions are discussed below.

A. Auditor’s Accountability

Clause (a) of Sub-Section (8) of Section 174 of CA, 1965

Section 174 of CA, 1965 deals with the auditor’s report on accounts. Under sub-section 8(a) of the Section, it is the duty of an auditor to report to the registrar on any breach or non-observance of the provisions of the CA, 1965. If he fails to comply with this requirement then under the same sub-section 8(a), he shall be imprisoned for two (2) years or fined thirty thousand ringgits or both\(^{387}\). In this sub-section, the auditor is held responsible for non-performance of his *amanah* of disclosure.

Sub-Section 8A of Section 174 of CA, 1965

Sub-section 8A of Section 174 requires an auditor to report to the registrar, if in his opinion, a series of offence relating to fraud or dishonesty has been committed. If he does not communicate such offence to the registrar then under the same sub-section 8A, he shall be imprisoned for 7 years or fined two hundred and fifty thousand ringgits or both\(^{388}\). Under this sub-section too, an auditor is held liable for non-performance of his *amanah* of disclosure.

\(^{387}\) *The Companies Act, 1965 (Revised-1973), Section 174(8)(a).*

\(^{388}\) *Ibid, Section 174(8A).*
B. Directors’ Accountability

Sub-Section (1) and (3) of Section 124 of CA, 1965

According to sub-section (1) of the Section 124 of CA, 1965, it is required from a person to hold certain qualification shares to become eligible for appointment of directors. If the person does not obtain such qualification shares, then under sub-section (3) of the Section, he shall be fined one thousand ringgits for such default. This sub-section declares a director accountable for non-compliance in holding qualification shares.

Sub-section (1) (3) of Section 66 of IFSA, 2013

Under clause (c) of sub-section (1) of Section 66 of IFSA, 2013, a director is entitled to exercise his powers for the purpose for which such powers are given to him. Therefore, if he does not do so, then under sub-section (3) of the Section 66, he shall be liable up to eight years of imprisonment or fine up to 25 million ringgits or both. According to this sub-section a director is liable if he does not execute his authority as amanah for the purpose for which it is given to him.

Sub-Section (1) and (8) of Section 131 of CA, 1965

Under sub-section (1) of the Section 131 of CA, 1965, it is required from interested directors to disclose before BODs, their interests in any contract or arrangements with the company. If the interested director does not disclose his interests, then under sub-section (8) of the Section, he shall be imprisoned up to seven years or fined up to one hundred and fifty thousand ringgits or both. This section makes a director liable for his misconduct of non-disclosure of his interests.

Sub-Section (1) and (4) of Section 131A of CA, 1965
Sub-section (1) of the Section 131A of CA, 1965 requires from interested directors not to participate in discussion and voting on the transactions in which he has interests. If any director contravenes this requirement, then under sub-section (4) of the Section, he shall be imprisoned up to five years or fined up to one hundred and fifty thousand ringgits or both. Under this Section a director is held liable for his misconduct by participation or voting in a meeting regarding any transaction in which he has interests.

**Sub-Section (1) and (7) of Section 132D of CA, 1965**

Directors are restricted from issuing any shares under sub-section (1) of Section 132D of CA, 1965, unless it is approved by the company in GM. If any director makes contravention of this sub-section, then he shall be liable to compensate the company as well as the transferee of the shares for any loss or damages under sub-section (7) of the Section. The above section also holds a director responsible for his misconduct in performing his actions as *amana* with him.

**Sub-Section (4) of Section 133 of CA, 1965**

The section 133 restricts the company from giving loans to directors or providing security or guarantee for the loans of directors. Any director, who is involved in authorizing such loan or giving such guarantee or security, shall be liable under sub-section (4) to a fine up to ten thousands ringgits. Under this section too, any director is held liable, who commits any misconduct with respect to approval of loans or giving guarantee.

**Sub-Section (4) of Section 133A of CA, 1965**

Sub-section (1) of the Section 133A restricts a company from giving loans or providing guarantee or security to a *personconnected* to its directors. Any director, who is involved in contravention of this restriction, shall be fined ten thousand ringgits under sub-section

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392 *Ibid, Section 131A(4).*  
393 *Ibid, Section 132D(7).*  
394 *Ibid, Section 133(4).*
(4) of the Section. So, under this section, any director who violates his authority as *amanah* by giving loans or security to a person connected to him is held liable.

**Sub-Section (1) of Section 135 of CA, 1965**

It is required from directors under sub-section (1) of Section 135, to disclose the particulars with respect to their holdings of shares, debentures and rights or options. If he does not do so, then under clause (d) of the sub-section, he shall be imprisoned up to three years or fined up to fifteen thousand ringgits. In this section a director is held liable for non performance of his *amanah* of disclosure.

**Sub-Section (1) and (2) of Section 173 of CA, 1965**

According to sub-section (1) of the Section 173, it is required from a company to disclose to shareholders and members of the company, all payments and receivable of auditors and other persons related to the auditors, who provide services other than audit services to the company. If any default is made by any director in this regard, then under sub-section (2) of the section, he shall be fined two thousand ringgits. Under this section, directors are liable for their misconduct with respect to payments and receipts to auditors and other persons related to the auditors.

So, it is clear from the above provisions that directors are held liable for non-performance of their *amanah*. Hence, it is argued that the above provisions are in conformity with the Islamic corporate governance principle of *amanah*.

**C. Accountability of All Persons Involved in Non-Compliance**

The above provisions were related to the accountability of directors for committing any misconduct with respect to their *amanah*. Here in the provisions below, in addition to

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396 *Ibid, Section* 135(1)(d).
397 *Ibid, Section* 173(2).
directors, all other persons, who are involved in such misconduct, shall be held accountable. The provisions are discussed below.

**Sub-Section (1), (3) and (5) of Section 28 of IFSA, 2013**

According to sub-section (1) of the Section, it is the responsibility of an IBI to ensure that all its activities are in compliance with the principles of shariah\(^{398}\). In case of carrying on any shariah non-compliant operations, it is the responsibility of the institution under sub-section (3) of the Section to immediately take following actions:

a) To inform BNM and SC of such non-compliance;

b) To stop the non-compliant business;

c) Submit plan to BNM for rectification of the non-compliance operation\(^{399}\).

Sub-section (5) of the Section declares any person liable, who does not comply with the above sub-section (1) or (3), to fine up to twenty five million ringgits or up to eight years imprisonment or both\(^{400}\).

Under this section, all CG players involved in non-performance of their amanah, are held liable.

**Sub-Section (1) and (6) of Section 29 of IFSA, 2013**

Under sub-section (1) of Section 29, the BNM has power to specify standards on shariah matters. If any person does not comply with any such standards, then under sub-section (6) of the Section, he shall be liable to fine up to twenty five million ringgits or up to eight years imprisonment or both\(^{401}\). This section holds any person accountable in case of any non-performance of his amanah of complying with any standard as specified by the BNM.

**Sub-Section (1) and (14) of Section 134 of CA, 1965**

\(^{398}\)The Islamic Financial Services Act, 2013, Section 28(1).

\(^{399}\)Ibid, Section 28(3).

\(^{400}\)Ibid, Section 28(5).

\(^{401}\)Ibid, Section 29(6).
Sub-section (1) of the Section 134 of CA, requires from a company to enter into register, particulars of shares, debentures and rights or options of directors. If any person is involved in non-compliance with this requirement, then under sub-section (14) of the Section, he shall be imprisoned for three years or fined for fifteen thousand ringgits. According to this section, all CG players are held accountable who do not perform their actions as amanah with respect to entering into register, particulars of shares and debentures of directors.

Sub-Section (1), (2) and (10) of Section 142 of CA, 1965

Under sub-section (1) of the Section, a company is required to hold “statutory meeting” after one month from commencement of business but not later than three months from such commencement. Prior to this meeting, it is required from directors under sub-section (2) to forward “statutory report” to members. In case of default in compliance with these requirements, every director and other officer who is involved in such default, shall be liable under sub-section (10) of the Section, to a fine of five thousand ringgits.

If a director or any other officer makes default while performing his actions as amanah with respect to statutory meeting and statutory report, he shall be liable for his actions.

Sub-Section (1) and (4) of Section 143 of CA, 1965

Section 143(1) of CA, 1965 requires companies to hold AGM every year. If the said meeting is not held, then under sub-section (4) of the Section, every officer who is part of such non-compliance shall be fined for five thousand ringgits. Under this section, any CG player, who does not perform his part in executing the amanah of holding AGM, shall be liable.

Sub-Section (1) and (4) of Section 156 of CA, 1965

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402 The Companies Act, 1965 (Revised-1973), Section 134(14).
403 Ibid, Section 142(1).
404 Ibid, Section 142(2).
405 Ibid, Section 142(10).
406 Ibid, Section 143(4).
It is required from a company under sub-section (1) of Section 156 of CA, 1965, to properly record the minutes of meetings of its members, directors and managers. If any default is made in respect of the recording of minutes, then under sub-section (4) of the Section, every officer who is involved in such default, shall be fined for two thousand ringgits \(^{407}\). This section declares every officer liable for non-performance of his *amanah* of recording minutes of different meetings.

**Sub-Section (1), (2) and (3) of Section 157 of CA, 1965**

It is mandatory for every company under sub-section (1) of Section 157 of CA, 1965, to keep the books of minutes at its registered office, which shall be open for inspection of its members, whereas, sub-section (2) of the Section entitles the members to receive a copy of the books of minutes. If the copy so requested is not provide to any member, then under sub-section (3) of the above Section, every officer who is involved in such non-compliance, shall be fined up to five thousand ringgits \(^{408}\). Under this section, any officer is made liable, who does not execute his *amanah* of entitling members to receive copy of books of minutes.

**Sub-Section (1), (2) and (7) of Section 167 of CA, 1965**

Sub-section (1) of Section 167 of CA, 1965 requires maintenance of accounting and other records, whereas sub-section (2) of the section requires such records to be kept for the last seven preceding years. Any director or manager, who makes default in such record keeping, shall be liable under sub-section (7) of the Section, for imprisonment for six months or for fine of five thousand ringgits or both \(^{409}\). A director and manager is held liable for committing any misconduct while performing their *amanah* of record keeping for seven years.

\(^{407}\) *Ibid, Section* 156(4).
\(^{408}\) *Ibid, Section* 157(3).
\(^{409}\) *Ibid, Section* 167(7).
Sub-Section (1) and (3) of Section 170 of CA, 1965

It is the right of members and debenture holders under sub-section (1) of Section 170 of CA, 1965 to receive copies of balance sheet, profit and loss account and auditor’s report from the company. In case of default, every officer who is involved in such default, shall be fined under sub-section (3) for two thousand and five hundred ringgits\textsuperscript{410}. Under this section, every CG player is held liable, who is involved in making any default in performing his *amanah* of delivering copy of balance sheet, profit and loss account and auditor’s report to members.

Sub-Section (9) of Section 174 of CA, 1965

Under sub-section (9) of the Section 174, if a person has relevant information in his custody, and he refuses to provide such information to auditor without any lawful excuse, such person shall be imprisoned for two years or fined thirty thousand ringgits or both\textsuperscript{411}. According to this section, any CG player, who does not perform his *amanah* of disclosing relevant information to auditor, is held liable. In the above provisions it has been verified that corporate governance payers are held liable for committing misconduct or willful defaults in performing their actions. So, it is argued that these provisions are usually compatible with the Islamic corporate governance principle of *amanah* because, the rule of *amanah* is that in case of negligence or misconduct (intentionally) in performing their *amanah*, the *amanah*-holders shall be held liable. However, rest of all the provisions of Malaysian regime relating to corporate governance are silent and do not provide any expressed consequences for the non-compliant actions of the corporate governance

\textsuperscript{410}Ibid, Section 170(3).

\textsuperscript{411}Ibid, Section 174(9).
Where the Islamic corporate governance principle of *amanah* cannot be verified to the extent of non-availability of consequences in case of any non-compliance on the part of any corporate governance player.

Further, the Malaysian SGF is silent regarding the accountability of corporate governance in case of their non-compliance with the provisions of the SGF (which expressly mentions the roles and responsibilities of different corporate governance players). So, it is concluded that the principle of *amanah* is not verified to the extent of accountability of Islamic corporate governance players for their non-compliance with the provisions of the MSGF.

II. *Application of* Mas’uliyyah (Accountability)

The Islamic corporate governance principle of *mas’uliyyah* (accountability) means that human beings are accountable for their actions in this world as well as in the life hereafter. Based on this principle, the Islamic corporate governance players (inside Islamic financial institutions) are also accountable for their actions. The accountability of these players in the life hereafter is beyond doubt, however, its verification is impossible from the Malaysian theoretical framework relating to corporate governance. Therefore, our focus shall remain on the worldly accountability of these players. So, we will discuss only those provisions of Malaysian regime from which the worldly accountability of corporate governance players’ accountability can be verified to the extent of the consequences.

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412 All provisions other than the provisions brought under discussion in this study.


414 These are some text from Quran which proves that human beings are accountable to Allah on the Day of Judgement: “To Allah belongs whatever is in the heavens and whatever is in the earth. Whether you show what is within yourselves or conceal it, Allah will bring you to account for it” (Al-Quran, 2: 284); “And fear a Day when you will be returned to Allah. Then every soul will be compensated for what it earned. And they will not be treated unjustly” (Al-Quran, 2: 281); “On the day when every soul will be confronted with all the good it has done, and all the evils it has done, it will wish there were great distance between it and its evil. But Allah cautions you (to fear) Him. And Allah is full of kindness to those who serve Him” (Al-Quran, 3:30); “Then on that day you shall most certainly be questioned about business” (Al-Quran, 102: 8); “The hearing, sight and hearts will all be questioned” (36: 17); “Then shall anyone who has done an atom’s weight of good, shall see good. And anyone who has done an atom’s weight of evil, shall see evil” (Al-Quran, 99: 7-8).

415 There is no way to prove it in this manner. It is illogical to attempt to prove the corporate governance player’s accountability from the theoretical regime.
accountability of corporate governance is proved. Here, non-compliance in the actions of corporate governance players shall be taken as test for the verification of the principle of accountability.

A. Worldly Accountability of ICG players in Case of Their Non-Compliant Actions

From the examination of the relevant provisions of Malaysian regime, it is clear that there are at least two consequences for non-compliant actions of the ICG players, which are:

1. Removal from office;
2. Imposition of penalty or imprisonment for some period.

As far as the imposition of fine or imprisonment for some period is concerned, this has been discussed in detail in Part C\textsuperscript{416} of the Islamic corporate governance principle of amanah. Therefore, there is no need to reproduce those provisions here. Hence, only those provisions shall be discussed below, which deal with the removal of corporate governance players for their non-compliant actions.

1. Removal of Directors

Under Section 70 of IFSA, 2013, Islamic banks have the power to remove directors\textsuperscript{417}.

a) Reasons for Removal of Directors

According to paragraph 2.52 of Guidelines on CG, incompetent and negligent directors shall be removed from their office. Similarly, under clause (a) of sub-section (2) of Section 70 of IFSA, 2013, a director shall be terminated by Islamic Banking Institution, if he becomes disqualified under sub-section (1) of Section 68 of the IFSA, 2013. Further,

\textsuperscript{416} Please refer to page no. 132 of this chapter.
\textsuperscript{417} The Islamic Financial Services Act, 2013, Section 70.
under clause (b) of the same sub-section, a director shall also be removed from his office if he no longer complies with fit and proper criteria as set out in Section 69 of IFSA\textsuperscript{418}. From the above provisions it is inferred that there are three reasons for removal of directors from their office. The first two reasons are their incompetency and negligence. The third reason is non-compliance with the fit and proper criteria. Non-compliance with fit and proper criteria also leads to directors’ incompetency, so, it is argued that there are two main reasons for the removal of directors namely their negligence and incompetency. The negligence and misbehavior is very much harmful to Islamic banks. This is because negligence and misbehavior of top corporate players like directors leads to corporate governance failure\textsuperscript{419}, which has been the main reason for the historical collapse of big companies\textsuperscript{420}, banks\textsuperscript{421} and even Islamic financial institutions\textsuperscript{422}. Removal of directors from their offices because of their incompetency, negligence or any other non-compliant actions shows that they are accountable for their actions. The removal of negligent and incompetent directors suggests that Islamic corporate governance principle of accountability is complied with here in the above provisions.

2. Removal of CEO

Section 70 of IFSA, 2013 empowers Islamic banks to remove CEO from his office.

a) Reasons for Removal of CEO

Under paragraph 2.52 of Guidelines on CG ineffective, errant or negligent CEO shall be removed from his office. Clause (a) of sub-section (2) of Section 70 of IFSA, 2013, entitles the Islamic Bank to terminate CEO, if he becomes disqualified under sub-section

\textsuperscript{418} Ibid, Section 68(1)(b).

\textsuperscript{419} For example, the top corporate governance player of poly peck, Asil Nadir was involved in fraudulent activities. Similarly, the directors of WorldCom used fraudulent methods to increase share prices. Likewise, huge losses in the projects of Enron due to mismanagement were concealed by directors.

\textsuperscript{420} Such as Polly Peck and Maxwell in UK, whereas, Enron and WorldCom in the US.

\textsuperscript{421} Such as Baring Bank in Singapore.

(1) of Section 68 of the IFSA, 2013. Under clause (b) of the same sub-section, CEO shall also be removed from his office if, he no longer complies with fit and proper criteria as set out in Section 69 of IFSA\textsuperscript{423}.

From the above provisions it is clear that negligent, ineffective and incompetent CEO shall be removed from his office. His removal is also beneficial for Islamic banks, otherwise, being top corporate player and holding the most important position of management, his misbehavior, incompetency or even slight negligence may lead to failure of Islamic banks.

Like directors, removal of CEO from his office on the basis of his non-compliant actions, demonstrates that CEO is also accountable for his actions. Hence it is argued that the Islamic corporate governance principle of accountability is complied with here the above provisions too.

3. Removal of Shariah Committee Members

According to paragraph 1 and 2 of Appendix 2 of MSGF, Islamic Banking Institution has power to dismiss any member of SC for valid reason, however, such dismissal shall not take effect unless approved by the BNM and SAC\textsuperscript{424}. Further, paragraph 1 of Appendix 2, empowers BNM to remove any member of SC\textsuperscript{425}.

a) Reasons for Removal of SC Members by the Institution

In case of removal of SC members by an institution, there must be some reasons as required in above paragraph (1), to be sent to BNM. His dismissal shall be effective only if the BNM approves it. Though, no specific reasons have been shown for the removal of

\textsuperscript{423}The Islamic Financial Services Act, 2013, Section 68(1)(b).
\textsuperscript{425}Ibid, paragraph 2.
any SC member by an IBI, however, they cannot be removed without reasons which shall be related to the members’ actions.

Here the reason must be valid for both the IFI and BNM. If an IFI dismisses any member for some reason, the reason shall be sent to BNM. If the BNM finds the reason invalid, then it is upon discretion of the BNM either to approve his dismissal or not to approve.

It is inferred from the above discussion that removal of SC members for some reason implies that they will be incompetent or negligent in performing their duties. If this is the case, then their removal also suggests that they are held accountable for their misconducts. Hence, it is argued that the members of SC are held accountable for their actions, therefore, the above mentioned provision is in conformity with the Islamic corporate governance principle of accountability.

**b) Reasons for the Removal of SC Members by BNM**

As far as, the removal of SC members by BNM is concerned, reasons for their removal have been given in paragraph 1 (disqualification) of Appendix 2 of MSGF, which are:

1) If any SC member’s fitness for holding the membership becomes doubtful because of his actions;

2) He was unable to attend at least 75% meetings of SC without any reasonable excuse;

3) He was found guilty of any serious offence punishable with imprisonment of one year or more\(^{426}\).

In the first case if a member’s fitness or membership becomes doubtful because of his actions, he can no longer be trusted because there will always be apprehension that he may show negligence or misconduct while performing his authority. A misconducting and negligent member of SC is harmful for IBIs, therefore his removal is necessary.

\(^{426}\) *Ibid*, paragraph 1.
From the removal of member for his doubtful actions, it is clear that every member of SC is accountable for his actions.

Similarly, in the second case, the inability of a member to attend at least 75% meetings of SC without valid reasons, shows his misconduct and negligence. This shows non-fulfillment of his responsibility. So, the removal of members of SC, who do not fulfill their responsibilities, demonstrates that they are held accountable for their actions.

In the third case, a member who is found guilty of any serious offence must be removed because his presence on the SC shall badly damage the reputation of the SC as well as the IFI. Such removal of the criminal from the membership of SC demonstrates that members are held accountable for their actions. Holding the members accountable for his actions, is in conformity with the Islamic principle of accountability.

It is concluded that the provisions of Malaysian regime relating to Islamic corporate governance practices in IBIs are usually compatible with the Islamic corporate governance principle of mas’oliyyah. In the above provisions, the principle of accountability is verified to the extent that the ICG players are held accountable for their non-compliant actions.

It is worthily mentioned however, that the above mentioned are some provisions, which hold the corporate governance players accountable for their non-compliant actions. Nonetheless, there are so many other provisions⁴²⁷, which are silent regarding the accountability of the corporate governance players in case of their non-compliant actions.

Similary, under the Malaysian SGF only SC members are held liable for their non-compliant actions, and no other player is held liable in this regard. Therefore, it is argued that the principle of mas’oliyyah cannot be verified in the provisions of the SGF to the

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⁴²⁷ All the provisions of the Malaysian regime, other than those which are brought under discussion in this study.
extent of the ICG players’ accountability for their non-compliant actions, except members of SC.

III. Application of Shafafiyyah (Transparency)

The Islamic corporate governance principle of Shafafiyyah (transparency) has been discussed in chapter 3 in quite detail. The concept of transparency in Islam is that the actions of human beings must be disclosed so that their role is visible to all. On the same logic, the actions of authority holders (and in this case the actions of corporate governance players) must be transparent. This is because it is the principle of transparency, which helps ensure that authority holders perform in responsible manner and that they are held accountable for their actions in case of instances of violation of their authority. Holding the players accountable is possible only when their actions are exposed.

To verify that the theoretical framework relating corporate governance practices in Islamic banking institutions in Malaysia is compatible with the principle of shafafiyyah, the researcher feels it necessary that minimum disclosure criteria should be set up. Based on such minimum disclosure requirements, the researcher will be able to make opinion regarding the compatibility of corporate governance practices with the principle of transparency. For disclosure purposes, companies use some disclosure tools such as

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428 It is narrated that ‘Umar (RA) received from Yemen, sheets of cloth. He distributed it among people each of whom received one length as his share. ‘Umar’s share was that of one Muslim. He tailored it, wore it. The next day he ascended the pulpit to give orders to the people for preparation of Jihad. A Muslim stood up and said, “We neither listen to you nor obey you.” “Why so?” asked ‘Umar (RA). He answered, “Because you have preferred yourself to us.” ‘Umar again asked, “In what way I have done so?” He replied, “When you distributed the Yemen lengths of cloth, each one received one and so you too. But one length would not make you a garment; we see you have tailored it into a whole shirt and you are a tall man too. If you had not taken more, you could not have made a shirt of it.” ‘Umar (RA) turned to his son ‘Abdallah and said, ‘‘Abdallah! Reply him’. He stood up and said, “When the commander of the faithful ‘Umar wished to tailor this length of cloth, it was not sufficient, so I gave him enough of my length to complete it for him.” The man said, “Now we listen and obey you”. (See Mohammad Ali Tabataba, Al Fakhri, trans. C.E.J. Whitting, (London: Luizae & Co. 1947), p. 25; See also the Islamic concept of avoidance of gharar in transactions and disclosure of ‘ayb in things being sold in Mansoori, 2011.

429 As in the case of apparent violation of authority the Caliph Umar (R.A.) was asked for the use of extra part of cloth.
Balance Sheet, Profit and Loss Account, notes appended thereto and Directors’ report. As these tools are related to affairs of companies, therefore, provisions relating to these tools shall be analyzed. Likewise, provisions regarding auditor’s report shall also be analyzed as the report is made on the correctness of balance sheet, profit and loss account and notes on such statements. Further, since, the current study is related to Islamic Banking Institutions, therefore, provisions regarding Shari’ah compliance disclosure shall also be analyzed here. The analysis shall be limited to internal Shari’ah review report, internal Shari’ah audit report, external Shari’ah audit report and Shari’ah Committee’s report.

The provisions of Malaysian regime relating to these corporate governance practices are discussed below.

A. Financial Statements

Financial statements are the principal means of providing general-purpose information to users regarding organizations. Based on these statements, the users evaluate financial position, profitability and future prospects of businesses. Companies use four important financial statements, which are: (1) balance-sheet (statement of financial position), (2) profit and loss account (income statement or statement of comprehensive income), (3) statement of owners’ equity, and (4) Statement of cash-flows.

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431 The Institute of Chartered Accountants of Pakistan, Audit and Assurance, Emile Woolf International, 2015, p. 3.
434 Ibid.
435 Balance sheet gives financial position of a company at the end of financial year by disclosing assets and liabilities of the company, and amount of its owner’s equity.
436 Profit and loss account shows profitability of a company over the financial year, by showing its profit and loss.
437 It discloses changes in the owners’ equity in the financial year.
438 It includes cash receipts and cash payments of company over the financial year.
Under Malaysian Companies Act, 1965, balance sheet shall give true and fair view of the state of affairs of company at the end of financial year\(^{439}\), whereas, Profit and Loss Account shall give true and fair view of the profit or loss of company for the financial year\(^{440}\).

1. To Whome Financial Statements are Disclosed?

In Malaysia, under sub-section (1) and (3) of Section 169 of Companies Act, 1965, the annual financial statements (AFSs) shall be kept before the company for approval in AGM. Prior to keeping the AFSs before members at AGM, section 170 of CA, 1965 requires that the AFSs shall be sent to members before AGM. After their approval, according to paragraph S. 13.1 of Guidelines on Financial Reporting (FRs) for IBs, the annual audited financial statements shall be sent to the Bank Negara Malaysia\(^{441}\).

The Guidelines on FRs for IBs, further require some additional methods of disclosure of Annual Financial Statements. For example, according to clause (b) of paragraph S. 15.1 of the Guidelines, a full set of the Annual Financial Statements shall be published on the website of the respective bank\(^{442}\). An abridged version of the AFSs shall also be published in two newspapers, according to paragraph clause (a) of paragraph S. 15.1 of the Guidelines. Further, the Guidelines on FR for IBs under paragraph S. 15.4 also require that a copy of such AFSs shall be kept at each branch office of the bank\(^{443}\).

From the foregoing discussion it is concluded that balance sheet and profit and loss account of Islamic Banks shall be disclosed to following persons:

\(^{439}\)The Companies Act, 1965 (Revised-1973), Section 169(14).
\(^{440}\)Ibid.
\(^{442}\)Ibid, Paragraph S. 15.1.
\(^{443}\)Ibid, Paragraph S. 15.4.
a) Members of IBIs

Important members of companies are shareholders and directors. Disclosure of the information to directors will enable them to evaluate the past results of the Islamic banks as well as to make future strategies for enhancing the IBIs performance in future\(^{444}\). Similarly, disclosure of the information to shareholders will give them an opportunity to know about the financial position as well as performance of their investee IBI. This transparency in the action of the IBI shall also give confidence to the shareholders, especially in the case when the IBI is performing profitably.

One important aspect of disclosure of information is the disclosure about shariah compliance in the activities of IBIs. The disclosure on shariah compliance to directors, shall confirm and enhance the oversight role of directors in ensuring the shariah compliant activities in Islamic banks. The disclosure on shariah compliance shall give confidence to shareholders that their amounts are invested in halal (permissible) businesses and that they're earning halal profits\(^{445}\).

The above disclosure of all information, which also evidences shariah compliance in the activities of Islamic banks, is in accordance with the Islamic principle of shafafiyyah because, Islam requires more transparency in the activities from authority-holders.

b) Bank Negara Malaysia

Besides the statutory law of Malaysia, regulations, policies, standards and guidelines for IBIs are issued by the BNM. All these policies, guidelines and standards have the objective to regulate the activities of the IBIs and keep them on the right track of shariah compliance, efficiency and profitability. For this purpose of ensuring the activities of the IBIs on the right track, it is necessary that the activities of the IBIs are disclosed to BNM.

If any instance of non-compliance is found during the course of transparency, the BNM


\(^{445}\)This is the prime concern of depositors of Islamic banks.
shall give corrective measures. From such disclosure, the broader objective of shariah compliance and the specific objective of transparency shall be achieved.

B. Auditor’s Report

Auditor’s report is prepared by auditors of companies. In their report, the auditors state whether the financial statements of a company give a true and fair view of the company’s affairs or profit or loss or not? To verify the correctness of the information provided in financial statements in Malaysian companies, the auditors verify and include in their report, all significant information regarding the financial statements. The information provided in auditor’s report demonstrates that the financial statements are extensively analysed by the auditors. As a result of the extensive analysis of financial statements, identification of any fraud or irregularity in the statements becomes very easy. The

\[446\]\begin{align*}
\text{The Companies Act, 1965 (Revised-1973), Section 174(2)(a).}
\end{align*}

\[447\]\begin{align*}
\text{Clause (a) sub-section (3) of Section 174 of CA, 1965 requires auditors to state whether they have acquired all the information and explanation necessary for audit? Under sub-section (3) and clause (b) of sub-section (2) of the Section 174, auditor is responsible to confirm whether proper books of accounts are kept by the company. Similarly, According to clause (ii) of sub-section (2) of the Section 174, auditor shall state in his report whether the accounts are properly drawn up in accordance with the provisions of the CA, 1965 of Malaysia. He is also responsible under sub-clause (i) of clause (a) of sub-section (3) of Section 172 to state whether the accounts give true and fair values of matter given in section 169 of the Act. Under subsection 14 of the said section i.e. S.169 of the Act, the matter is state of affairs in case of balance sheet, and it is profit and loss in case of profit and loss account. Hence, it is said that Malaysian regime also requires an auditor to state that the balance sheet prepared represent true and fair view on affairs of the business, whereas, the profit and loss account represent true and fair view on the profit and loss accounts. Also the Malaysian regime requires an auditor under clause (c) of sub-section (3) of Section 174 to report whether returns received from branch offices are adequate? Further, it is required by clause (d) of sub-section (2) of Section 174, from an auditor to state any defect or irregularity in the accounts, or any other matter not set out in the accounts, without which a true and fair view cannot be made. Further, if in the opinion of the auditor, accounts are not prepared in accordance with the provisions of accounting standards, then under clause (aa) of sub-section (2) of Section 174 CA, 1965, the Malaysian regime requires the auditor to state in his report:
\begin{enumerate}
  \item that if the accounts would have been prepared in accordance with the particular accounting standards, they would have given true and fair value of the matters required under S. 169 of the CA;
  \item that as the accounts are not prepared according to the particular accounting standards, therefore, they are not giving any true and fair value;
  \item his opinion on the particulars of quantified financial effects on accounts, as given by directors;
  \item or if directors have not given such particulars, shall give particulars of the quantified financial effect of such non-compliant statements on accounts.
\end{enumerate}
With respect to consolidated accounts, the auditors are bound to state under clause (c) of sub-section (2) of Section 174 of CA, 1965, in their report:
\begin{enumerate}
  \item the names of the subsidiaries of which he has not acted as auditor;
  \item whether he has taken into accounts the accounts and auditors’ reports thereon on the accounts of such subsidiaries;
  \item whether the auditors’ report on account of subsidiaries is subject to any qualification, or any comment is included in the report on the accounts, and if so, the particular of such qualification or comment.
\end{enumerate}
extensive analysis of financial statements by the auditors is a control over the functioning of management and provision of correct information in the financial statements. So, it ensures timely, relevant and correct information disclosure. In other words, the auditors ensure transparency in the activities of the companies (including Islamic banks). Ensuring such transparency in the activities of the IBIs is in conformity with the Islamic corporate governance principle of *shafafiyyah*.

1. **To Whome Auditors’ Report is Disclosed?**

   In Malaysia, according to sub-section (1) of Section 170 of CA, 1965, the auditors’ report shall be sent to members before AGM, whereas, the same shall be submitted to members in AGM according to clause (b) of sub-section (1) of Section 78 of IFSA, 2013 and sub-section (1) of Section 174 of CA, 1965. Further, the report shall also be submitted to BNM under the clause (b) of sub-section (1) of Section 78 of IFSA and clause (c) of paragraph 13.1 of the Guidelines on FR for IBs. In short it is said that the auditor’s report shall be disclosed to following persons:

   **a) Members**

   As stated earlier that the Malaysian Companies Act, 1965, requires companies that their balance sheets shall give true and fair view of the state of affairs of company at the end of financial year\(^{448}\), whereas, the Profit and Loss Account shall give true and fair view of the profit or loss of company for the financial year\(^{449}\). This is because these statements are the basis, which users use to evaluate financial position, profitability and future prospects of businesses\(^{450}\). Therefore, the users need some surety to believe that the information given in the statements are correct. This surety to the users is provided by the auditors through their report. The auditors report is the most important document that can affect (change)

\(^{448}\) *The Companies Act, 1965 (Revised-1973), Section* 169(14).

\(^{449}\) *Ibid.*

mind of members while making decision with respect to their investments. If the report verifies that the information in the financial statements are correct, this will give confidence to members that their investee company is performing efficiently. On the other hand, if the auditors report finds some major mistakes, irregularities or incorrect information, the members will be able to make suitable decisions in those particular circumstances.

Members being important stakeholders have right to know whether the financial statements represent true and fair view of the state of company’s affairs or not? This can be ensured when the auditor’s report on the correctness of such financial statements, is disclosed to the members. Therefore, it is opined that the disclosure of the auditors’ report to members, is in line with the Islamic principle of transparency.

b) BNM

BNM acts as regulator of banking companies. The regulator can take appropriate actions only when appropriate information are disclosed to it. The auditor report is very much significant in this regard as it will enable the BNM to take appropriate measures in instances of non-compliance. Therefore, it is argued that disclosure of auditor’s report to BNM is in compliance with the Islamic corporate governance of *Shafafiyyah* (transparency).

C. Directors’ Report

A report prepared by directors of a company is called directors’ report. It deals with the state of the affairs of the company at the end of financial year[^451]. In Malaysian regime, Clause (a), (b) and (c) of sub-section (6) of the Section 169 of CA, 1965 require directors to disclose the principle activities of company along with significant changes therein. Disclosure of principle activities as well as changes therein, is necessary in order to assure the users that the activities of the companies are compliant to the principle of

[^451]: The *Companies Act, 1965 (Revised-1973), Section 169(5).*
This is because investment account-holders and shareholders of Islamic banking companies are concerned more about shariah compliant profits. Disclosure of shariah compliant business activities shall give confidence to the investors. If the IBIs are unable to assure them that its activities are carried out in accordance with the principles of shariah, then the IBIs may lose the confidence of the investors, in which case there is apprehension that they may finish their business relations with the IBIs.

Under clause (h) of subsection (6) of the above-referred Section, the report shall disclose the amount of dividends recommended by directors to be paid to shareholders. Disclosure of the amounts of dividends to be paid to shareholders is necessary because such disclosure shall increase transparency in the profit distribution process. Disclosure to investment account holders about the dividend amounts, is significant because it will give an opportunity to the IAHs to decide about their business relationships with the banks in future. For example, if the IAHs have some concerns over the profit ratio of shareholders, they might not continue their business relations with the IBIs in future.

Further, sub-clause (i) of clause (g) of sub-section (6) of Section 169 requires directors to state in their report that whether, any person, who was director at the end the financial year, has (according to the registers of the company) any interests in the shares or debentures of the company or any other body corporate, and if so, the directors shall report the numbers of shares or amount of debentures. Furthermore, sub-clause (ii) of the clause (g) requires directors to state in their report about the person(director) who was so interested at the beginning of the year, or if he was not director at the beginning, when he becomes director. Sub-clause (iii) of the clause (g) requires in the report, disclosure

\[452\textit{Ibid, Section 169(6) ((h)).}\]
\[453\textit{Ibid, Section 169(g)(i).}\]
\[454\textit{Ibid, Section 169(6)(g)(ii).}\]
of total number of shares and debentures bought and sold during the financial year, by the person so interested\textsuperscript{455}.

In the above two provisions it is required from directors to disclose in their report, all information regarding their sale/purchase of securities during financial year, as well as holding alike securities at the end of the year. With this disclosure, the interests of directors shall be disclosed. Such disclosure is necessary so that to find out the interest of directors in any transactions by the company. It shall be found out that lest the interested directors are not unduly persuading other directors for the transactions, which are in fact in the favor of these interested directors?

According to sub-section (8) of Section 169 of CA, directors shall state in their report about the benefit, which a director has received after the end of the financial year, or he has become entitled to receive such benefit, by reason of a contract made between the company or its related company and the director or firm in which he is member, or company in which such director has substantial interests, and if so, the general nature of the benefits shall also be disclosed\textsuperscript{456}.

As I mentioned in the previous paragraph that the interests of directors shall be disclosed so that it is verified whether they have obtained such benefits by any undue means? For this purpose the above provision 169(8)(a) of CA, 1965, of the Malaysian regime requires directors to disclose all those benefits which they have obtained during the financial year. Such disclosure is necessary so that appropriate actions are taken in time, if the interested directors were found to be involved in any undue process of obtaining any benefits in any transaction of the company.

\textsuperscript{455}Ibid, Section 169(6)(g)(iii).
\textsuperscript{456}Ibid, Section 169(8)(a).
Under clause (q) of sub-section (6) of section 169, any event, transaction or item of material or unusual nature\textsuperscript{457}, which occurs between the end of the financial year and the date of the report shall be disclosed in the directors’ report, if in the opinion of directors such events would likely affect substantially the results of the operations for the years in which the report is made\textsuperscript{458}.

Normally information relating to last preceding year (till the end of the year) are disclosed. However, according to above paragraph, all transactions of material or unusual nature shall be disclosed, even if the events occur after the end of the financial year. All such information are disclosed, which can affect the results of operations of the last year. Such information disclosure is necessary, otherwise, the financial statements shall be considered as misleading which shall include misstatements. Such misstatements shall obviously misguide the users while making their decisions.

Therefore, the directors are also responsible under sub-clause (i) clause (m) of sub-section (6) of Section 169 to disclose in their report about any charge on the assets of the company arisen after the end of the financial year, which secures the liabilities of any other person. According to this provision, particulars of the charge, and as far as practicable, the amount so secured shall be disclosed\textsuperscript{459}. Sub-clause (ii) of the clause (m) requires disclosure of any contingent liability existing on the date of the report, which has arisen after the end of the financial year. If such contingent liability exists, the provision

\textsuperscript{457} According to Sub-section (7) of section 169 the item, transaction or event of material or unusual nature include:

\textsuperscript{458}\textit{The Companies Act, 1965 (Revised-1973), Section 169(6)(q).}

\textsuperscript{459}\textit{Ibid, Section 169(6)(m)(i).}
requires disclosure of its general nature, and as far as practicable the maximum or estimated maximum amount to which company may be liable, shall be disclosed.\textsuperscript{460} By disclosing such charge on assets as well as contingent liability arisen after the end of fiscal year, the correct state of affairs of the company shall be disclosed. It will help the users in making informed decisions.

Disclosure of above-mentioned matters in directors’ report suggests that sufficient and relevant information are disclosed in the report. Based on such disclosure requirements, it is argued that the Islamic principle of transparency is complied with, hence the above mentioned provisions are compatible with the Islamic principle of transparency.

1. To Whom Directors’ Report is Disclosed?

Sub-section (5) of Section 169 of CA, 1965 requires that directors’ report is attached to every balance sheet, hence, it is said that the report is disclosed to all those persons to whom a balance sheet is disclosed. As discussed earlier in the disclosure portion of Annual Financial Statements that the AFSs shall be disclosed to members\textsuperscript{461} of IBIs and Bank Negara Malaysia\textsuperscript{462}, therefore, the directors’ report shall also be disclosed to members of IBIs and Bank Negara Malaysia.

a) Members of IBIs

Members are important stakeholders in the form of shareholders, directors and other officers of company, therefore, it is mandatory that all relevant information, such as directors’ report must be disclosed to them. Disclosure of the report and the interests of directors therein, to member directors, is necessary because the members will be able to understand if the interested directors unduly persuaded them in their own favor or not. If

\footnotesize{\textsuperscript{460}Ibid, Section 169(6)(m)(ii).}
\footnotesize{\textsuperscript{461}Ibid, Section 169(5).}
so, necessary measures could be taken to stop such practice in future. Similarly, disclosure to shareholders, of information like the charge on assets of the company and its contingent liability arisen after the financial year is necessary because, the shareholders will come to know about the actual position of the company, which was not possible on the basis of information disclosed in the financial statements, because the financial statements include information, which are related till the end of the last preceding year, and not after that.

b) Bank Negara Malaysia

BNM acts as regulator of companies (including Islamic banking companies), which needs to know all material information regarding the affairs of the companies. Directors’ report is one of the tools of disclosure, which include significant information such as charge on assets of the company and its contingent liability arisen after the end of financial year. Similar material information disclosure to BNM shall increase transparency in the actions of the company and will enable the BNM to take necessary actions in time, in case of any violations by the company.

D. Shariah Review Report

Shariah Review is the “review of overall business activities of IBIs for verifying their level of compliance with shariah”\textsuperscript{463}. If the function identifies any shariah non-compliant instance, then under paragraph 7.6(iii) of MSGF, it shall report such instance to Shariah Cmmittee (SC), in addition to management.

Shariah Review function is basically a part of overall shariah compliance function in Islamic banks in Malaysia. It reviews all activities of Islamic banks to verify whether they are shariah compliant? If it finds any shariah non-compliant instance, the same is reported

to SC and management. The matter is reported to SC because the highest authority dealing with shariah matters inside Islamic banks in Malaysia is the Shariah Committee. The SC suggests corrective measures for such instances. Thus, shariah compliant activities are ensured inside the Islamic banks. As far as disclosure of any findings of the review to management is concerned, the same is disclosed to management for the purpose to increase transparency in the activities of the IBIs. This is because, the review function is managerial in nature, and logically it is the inherent requirement of transparency to disclose the lower managerial functions to higher managers. In this way transparency shall be ensured in the activities of the managers (shariah review officers).

Based on the above discussion, it is argued that the Islamic corporate governance principle of *shafafiyyah* is complied with here in the above provison.

**E. Shariah Audit Report**

Independent assessment of products and services offered by Islamic banks is necessary in order to verify whether they are in conformity with Islamic law or not? If not, necessary measures shall be suggested to make the defaults good and shariah compliant. The independent assessment of shariah compliance in the activities of IBIs is called shariah audit.

M. G Mohiuddin defines shariah audit in the following words:

> “Shariah audit is the examination of an IFI’s compliance with the Shariah, in all its activities particularly the financial statements and other operational components of the IFI that are subjected to the risk of compliance including but not limited to products, the technology supporting the operations, operational processes, the people involved in key areas of risk, documentation and contracts, policies and procedures and other activities that requires adherence to shariah principles.”

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From this definition of shariah audit two points are inferred. First is that shariah audit is the assessment of financial statements and other operational components of IFIs for ensuring that they are shariah compliant. The second point is that all those activities are audited, which may be exposed to shariah non-compliance risk.

The Malaysian Shariah Governance Framework (MSGF) defines shariah audit as follows:

"Shariah audit refers to the periodical assessment conducted from time to time to provide an independent assessment and objective assurance designed to add value and improve the degree of compliance in relation to the IFI's business operations, with the main objective of ensuring a sound and effective internal control system for shariah compliance."\(^{465}\).

In the above paragraph it is stated that in order to verify the effectiveness and soundness of the internal control system of an IBI made for shariah compliance, the shariah audit is conducted on periodic basis. The function is conducted by Internal Auditors, who have acquired shariah related knowledge and training\(^{466}\). The auditors may also engage the expertise of shariah officers of the IFI, while conducting the shariah audit\(^{467}\).

1. **Scope of Internal Shariah Audit**

Under paragraph 7.12 of MSGF, the scope of internal shariah audit covers all aspects of Islamic financial institutions business operations and activities including:

i. audit of the financial statements of the IFIs;

ii. compliance audit on organizational structure, people, process and information technology application systems;

iii. Review of adequacy of the shariah governance process\(^{468}\).

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\(^{466}\)Ibid, paragraph 7.8.

\(^{467}\)Ibid.

\(^{468}\)Ibid, paragraph 7.12.
Assessment of financial statements for shariah compliance shall include verifying compliance with shariah, of the business of Islamic banks, its investment avenues, cash receipts and payments and profits earned by the IBIs. Similarly, compliance audit on organization structure and IT application system shall include verification of proper human resource\textsuperscript{469} for shariah compliance, inside the IBIs that commensurate with the size of the IBIs. Further, in the modern world, banking activities and operations require application of proper IT system for recording and managing information. The shariah audit function with respect to IT system applied, shall include verification of compatibility of the system with sharih principles. In other words, it shall be verified whether the unique technical transactions of Islamic banks are dealt with sufficient care while putting them into the IT system.

Moreover, the most important shariah audit is the audit on the adequacy of shariah governance process involved inside Islamic banks. In this type of audit, the current shariah governance structure, its size and roles and responsibilities shall be analysed. This may include the frequency of SC meetings, and their deliberation on shariah matters. Similary, the processes and functions of shariah review, shariah risk management and shariah research as well as their reporting to SC, BAC and management shall be evaluated. The persons involved in all such functions shall be evaluated in terms of their qualifications and competences.

From the above role of shariah audit function, it is concluded that the function palys a significant role in ensuring the overall shariah compliant environment in the Islamic banking institutions, hence increases transparency.

\textsuperscript{469} Such as shariah officers for Shariah risk management function, shariah review function, shariah research function and shariah audit function.
F. Disclosure of Findings of Shariah Audit to BAC and SC

According to paragraph 7.13(v) of MSGF it is the responsibility of the shairah audit function to communicate any results or findings of the audit to Board Audit Committee and Shariah Committee.

Disclosure of the shariah audit findings to SC is necessary because, the SC plays an oversight role over the activities of IBIs through shariah audit function in addition to shariah review. In this way non-compliance instances are identified, for which the SC suggests appropriate corrective measures so that the activities are made shariah compliant. As far as the disclosure of the findings to BAC is concerned, the primary objective of such disclosure is to ensure transparency in the activities of the IBIs. This is because, the high authority inside any organization (including Islamic banks) is board of directors, who should be aware of all the affairs of the organizations (Islamic banks).

From the above discussion it is concluded that the above provisions of Malaysian SGF, which are related to shariah audit, are in conformity with the Islamic corporate governance principle of shafafiyyah.

G. Shariah Committee’s Report

The highest authority to deal with shariah matters inside Islamic banking institutions in Malaysia, is the Shariah Committee. Paragraph S. 11.4 of the Malaysian guidelines on financial reporting for Islamic Banking Institutions, requires Shariah Committee to publish its report as part of Annual Reports470.

From the provisions471 of Malaysian regime relating to disclosure of financial statements, it is clear that the annual accounts shall be disclosed to members of companies as well as Bank Negara Malaysia (BNM). Therefore, the shariah committee’s report shall also be

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470 Bank Negara Malaysia, Financial Reporting For Islamic Banking Institutions, Paragraph S 11.4,
471 Please refer to page 152 of this thesis.
disclosed to members of Islamic banks as well as BNM. Disclosure of the SC’s report to members shall give confidence to members that the activities of the IBIs are run in conformity with the principles of *shariah*. Similarly, sending the report to BNM shall assure the BNM that the IBI is complying with the guidelines, policies, standards and Shariah governance framework of the BNM, hence with the principles of *shariah*.

1. **Contents of SC Report**

Under the paragraph S. 11.4 of Guidelines on MFRS for IBIs, the contents of SC report shall include the following elements:

**a) Introductory Paragraph**

The introductory paragraph acknowledges the management’s responsibility for ensuring shariah compliance and purpose of Shariah Committee’s Engagement472.

**b) Scope Paragraph**

This paragraph describes the work performed by the SC473.

**c) Opinion Paragraph**

This paragraph states the opinion of the SC on following matters to know:

i. Whether the contracts and related documents are shariah compliant?

ii. Whether the shariah basis provided for profit distribution between investment account holders and shareholders are appropriate?

iii. Whether earnings, if any, from non-compliant sources have been disposed for charitable purposes?

iv. Whether zakat has been computed in accordance with shariah?

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v. Whether there found any non-compliance instance and any corrective measures have been suggested\textsuperscript{474}?

From the contents of the SC’s report it appears that it shall disclose sufficient information regarding the compliance of the activities of an IBI, with shariah rules and principles. Such information disclosure on the degree of shariah compliance suggests that Islamic principle of transparency is complied with here in this report. The disclosure shall give confidence to shareholders, investment account-holders and other stakeholders of the IBI regarding its shariah compliance.

It is concluded that Islamic corporate governance principle of \textit{shafafiyyah} is that actions of authority holders must be transparent, which shall be disclosed to all relevant stakeholders. Here, the relevant provisions relating to roles and responsibilities of different Islamic corporate governance players were brought under discussion. It was found that almost all the relevant provisions of the Malaysian regime relating to corporate governance practices in IBIs are in conformity with the Islamic principle of \textit{shafafiyyah}.

\section*{IV. Application of \textit{Khilafah} (Vicegerency)}

According to the Great thinker of Islam, \textit{Maulana Maudoodi} (RA), the character of human’s vicegerency enjoins him to obey \textit{Allah}’s commands in all aspects of his life\textsuperscript{475}, so that all his actions conform to the \textit{Allah}’s commands. This is because vicegerent is the one who uses his delegated authority as sub-ordinate to his master. Being vicegerent, he has no personal authority except the authority, delegated by his master, thus one cannot act according to his own wishes rather than to fulfill his master’s wishes. In case he acts otherwise than the delegated authority, this leads to his betrayal from his Lord\textsuperscript{476}.

\footnotesize\textsuperscript{474} \textit{Ibid}, Paragraph S 11.4(c)(i)-(v).
\footnotesize\textsuperscript{476} \textit{Ibid}, p. 62.
From the above explanation of *khaleefah* and his authority, by Maulana Maudoodi (R.A.), it is easily inferred that corporate governance players are also vicegerents of Allah, who have no authority to act beyond the commands of Allah. Being Allah’s vicegerents, they are bound to perform according to the wills of Allah and must not act beyond their authority as given to them as vicegerent.

The principle of vicegerency is equally applicable to all corporate governance players with no exception, no matter he is in the capacity of Director, CEO or auditor. This is because every corporate governance player, being human, is a vicegerent of Allah. Being vicegerents of Allah, all the corporate governance players must act within the parameters prescribed by Allah *SubhanahuWaTa‘ala*. The parameter in this case for performing actions, is the delegated authority of vicegerency given by Allah. With respect to this study, the vicegerency demands shariah compliant activities.

It is further stated that the expected behavior from a company (and in this case Islamic bank) is similar to the expected behavior from an individual\(^\text{477}\). However, the company is unable to perform its actions by its own, therefore, the board of directors acts as its brain\(^\text{478}\). So, the expected behavior from a company is demonstrated in form of expected behavior of the board\(^\text{479}\). Similarly, the way the company does not have any mind, it also does not have any organs. So, in the opinion of the researcher, the managers of companies (including Islamic banking companies) act as organs of the companies, hence the expected behavior from companies, is also extended to the expected behaviors of their managers.

Thus it is concluded that the rule of vicegerency is equally applicable to Islamic banks in the manner it is applicable to individuals. Further, it is also concluded that as the Islamic


banks do not have any mind and organs, therefore, the expected role of vicegerency from the IBIs, is shifted to the board of directors and managers of the IBIs. So, on behalf of Islamic banks, the board and the managers of the IBIs act as vicegerents. As, the principle of vicegerency is linked to shariah compliance, therefore, the Islamic banks as well their corporate governance players are bound to ensure shariah compliance in the activities of the IBIs.

For the purpose of ensuring shariah compliance in the activities of Islamic banks in Malaysia, the central bank of Malaysia (BNM) has issued Shariah Governance Framework (MSGF). Therefore, the provisions of the MSGF shall be analyzed in the light of the principle of khilafah to verify whether these provisions are in conformity with this principle or not?

A. Application of Principle of Khilafah to Malaysian Shariah Governance Framework (MSGF)

In Malaysia, the Islamic financial institutions are established to provide shariah compliant products and services to its customers. In order to ensure such compliance in the products and services of the IFIs, the central bank of Malaysia (BNM) has issued a Shariah Governance Framework (MSGF). The MSGF assigns particular roles to different corporate governance players. One of these players is board of directors of Islamic banks.

1. Role of Board of Directors

As the directors hold key position inside the IBs, therefore, it is checked whether the role of the board of Islamic banks is in conformity with the Islamic corporate governance principle or not? For this purpose, the provisions of the MSGF relating to directors have already been discussed\(^480\), where the BODs:

\(^480\) Refer to page no. 115-116 of the thesis.
(i) has the responsibility and accountability for shariah compliance as well as overall shariah governance framework\textsuperscript{481}.

(ii) is responsible to diligently oversee the functioning of the SGF\textsuperscript{482}.

(iii) is responsible for the policy-making on shariah matters as well as to make sure that the policies are implemented\textsuperscript{483}.

From the above mentioned functions of the directors on board, it is evident that they are responsible for ensuring Shariah compliance in the activities of IBIs. As, the shariah compliance is associated with the principle of khilafah, therefore, it is argued that all the above mentioned functions are in conformity with the principle of khilafah.

2. Management

Management of Islamic banks also plays a significant role in the process of shariah compliance, which has already been discussed in detail\textsuperscript{484}. Under the MSGF, they are responsible:

(i) to observe and implement the decisions and rulings made by Shariah Advisory Council of BNM or Shariah Committee\textsuperscript{485}.

(ii) For provision of relevant information to SC\textsuperscript{486}.

(iii) For provision of learning and training programs in Shariah and finance matters to the BODs, SC and other relevant staff\textsuperscript{487}.

(iv) For immediate stoppage of shariah non-compliant business and to report it to the board, SC and BNM\textsuperscript{488}.

\textsuperscript{481} Refer to page no. 116 for detail role of the management.
\textsuperscript{482} For detail, please refer to page no. 116-117.
\textsuperscript{483} See page no. 117 of the thesis.
\textsuperscript{484} Refer to that page no. 118.
\textsuperscript{485} For further details, see page no. 118 of the thesis.
\textsuperscript{486} See details on page no. 120.
\textsuperscript{487} See page no. 120 for more details.
\textsuperscript{488} For more details, refer to page no. 121-122.
(v) to furnish plan for rectification of such non-compliant operations within thirty days\textsuperscript{489}.

From these roles of the management it is inferred they play a significant in ensuring shariah compliance in the IBIs, hence their actions conform to the Islamic principle of vicegerency.

3. Shariah Committee (SC)

The SC, being responsible to make sure shariah compliant operations of the IBs, for which purpose, it is further responsible under the MSGF to:

(i) To rigorously deliberate on all the shariah issues before it\textsuperscript{490}.

(ii) To make decisions on the basis of 2/3 majority of SC members out of which 2/3 members must be from shariah background\textsuperscript{491}.

(iii) For all its rulings, fatawas, decisions and opinions\textsuperscript{492}.

(iv) to give advice to Board on shariah matters\textsuperscript{493}.

(v) To oversee the shariah activities of the IBIs\textsuperscript{494}.

(vi) to propose corrective measures for non-compliant instances identified by the Sharaih Review and Shariah Audit Functions\textsuperscript{495}.

From all these actions of the SC, it is evident that the SC performs such actions in order to ensure shariah compliance. Ensuring shariah compliance shows that Islamic corporate governance principle of vicegerency is complied with here in the above provisions.

4. Shariah Compliance Function

As discussed earlier\textsuperscript{496} that in order to strengthen the overall shariah compliant environment inside the IBs, and to ultimately comply with the principle of khilafah, the

\textsuperscript{489} Find more details on page no. 121-122.
\textsuperscript{490} Refer to page no. 124 for more details.
\textsuperscript{491} See further details on page no. 124.
\textsuperscript{492} More elaborated on page no. 125-126.
\textsuperscript{493} See its detail on page no. 126-127.
\textsuperscript{494} For explanation, see page no. 127-128.
\textsuperscript{495} Page. 128-129.
MSGF\textsuperscript{497} has suggested the IBs to establish the four important functions namely *shariah* review function\textsuperscript{498}, internal *shariah* audit function\textsuperscript{499}, *shariah* risk management function\textsuperscript{500} and *shariah* research function\textsuperscript{501}. If these four functions work properly then the chances of *shariah* non-compliant instances will be minimized to greater extent. Thus, it is argued that the functions are conforming to the Islamic principle of *khilafah*.

On the basis of the foregoing discussion, it is concluded that Islamic corporate governance principle of *khilafah* requires that actions of *khaleefa* shall be in conformity with the wills of his Master-Allah. Therefore, this principle is linked to the *shariah* compliance in the actions of all Islamic corporate governance players. From all the above provisions of the Malaysian *Shariah* Governance Framework, it is clear that the roles of directors, management, SB and other supporting players are aimed to ensure *shariah* compliance, therefore, it is confirmed that the provisions of the SGF are fully compliant with the Islamic corporate governance principle of *khilafah*. This shall give confidence to Investment Account-Holders, depositors, customers and other stakeholders that in the presence of such a comprehensive *Shariah* Governance Framework, the actions of all corporate governance players are expected to be *shariah* compliant. Hence, all the products and services offered by the IBIs shall be *shariah* compliant as well.

**Conclusion**

In this chapter, the Malaysian regime relating to corporate governance practices in Islamic banking institutions, has been analysed in light of Islamic corporate governance principles. The principles have been applied one by one. First, the principle of *amanah* (trusteeship) has been applied to the Malaysian regime.

\textsuperscript{496} Please see page no. 128 for details.
\textsuperscript{497} From paragraph 7.1 to 7.19 of the MSGF.
\textsuperscript{498} Refer to page no. 128-131 for more explanation.
\textsuperscript{499} Consult page no. 129-131 for details.
\textsuperscript{500} Find its detail discussion on page. 131-133.
\textsuperscript{501} It has been elaborated on page no. 133.
From discussion on the Islamic corporate governance principle of *amanah* (trusteeship), the following results have been inferred:

a. Authority is *amanah* with authority-holders;

b. Hence, the roles and responsibilities, along with ancillary requirements of corporate governance players are *amanah* with the players;

c. The *amanah* of authority shall be handed over to competent persons;

d. In case of negligence and misconduct (intentionally) in performing their duties, the corporate governance players are liable for their actions.

These four implications of the principle of *amanah* have been applied to the theoretical framework relating to corporate governance practices in Malaysia to verify whether the principle of *amanah* (trusteeship) is complied with in such practices or not? For the sake of convenience, the discussion is divided into three parts. **Part A** covers provisions other than the provisions of *Shari’ah Governance Framework (SGF)* as these are discussed in **Part B**. In **Part C**, those provisions are covered, which are related to non-compliant actions of corporate governance players.

In **part (A)** the analysis of the provisions of Malaysian regime demonstrated that all the corporate governance players (directors, managers and auditors) being authority-holders are holding their respective authorities as trust. Further, being trustees, the respective roles and responsibilities of the CG players, are also trust with them, no matter they are expressly provided in the legal regime or impliedly expected from them in the manner expected from holders of similar offices. However, the deficiency in these provisions is that they do not expressly provide for any consequences in case of negligence or misconduct of the CG players while performing their *amanah*. It means that the principle of *amanah* is not verified to the extent of accountability of corporate governance players.

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502 Such as fulfilling qualification and experience criteria etc.
for their non-compliant actions. Nonetheless, there are some provisions\textsuperscript{503} which make these players accountable for non-performance of their *amanah*. The provisions are discussed in \textbf{part C}.

From analysis of the provisions in \textbf{part (C)}, it has been verified that corporate governance players are held liable for committing misconduct or willful defaults in performing their actions. So, it is argued that these provisions are usually compatible with the Islamic corporate governance principle of *amanah* because, the rule of *amanah* is that in case of negligence or misconduct (intentionally) in performing their *amanah*, the *amanah*-holders shall be held liable.

Further, by analyzing the provisions of Malaysian Shariah Governance Framework (MSGF) in \textbf{part (B)}, it is concluded that all the corporate governance players are authority holders, hence trustees of their positions. Being on such positions, all their respective roles (both expressed and implied) are *amanah* with them. However, it is not verified from these provisions, whether in case of any negligence or misconduct in performing their roles, the players shall be held accountable or not? Hence, it is argued that the Islamic corporate governance principle of *amanah* cannot be verified from these provisions to the extent of the accountability of the players in case of their non-compliance with the provisions of the MSGF.

Similarly, the provisions of Malaysian regime have been analysed in the light of Islamic corporate governance principle of *masʿoliyyah* (accountability). *Masʿoliyyah* (accountability) means that human beings are accountable for their actions in this world.

\textsuperscript{503} These provisions are: Clause (a) of Sub-Section (8) of Section 174; Sub-Section 8A of Section 174; Sub-Section (1) and (3) of Section 124; Sub-Section (1) and (8) of Section 131; Sub-Section (1) and (4) of Section 131A; Sub-Section (1) and (7) of Section 132D; Sub-Section (4) of Section 133; Sub-Section (4) of Section 133A; Sub-Section (1) of Section 135; Sub-Section (1) and (2) of Section 173; Sub-Section (1) and (14) of Section 134; Sub-Section (1), (2) and (10) of Section 142; Sub-Section (1) and (4) of Section 143; Sub-Section (1) and (4) of Section 156; Sub-Section (1), (2) and (3) of Section 157; Sub-Section (1), (2) and (7) of Section 167; Sub-Section (1) and (3) of Section 170; Sub-Section (9) of Section 174 of *The Companies Act, 1965*; and Sub-section (1) (3) of Section 66; Sub-Section (1), (3) and (5) of Section 28; Sub-Section (1) and (6) of Section 29 of *The Islamic Financial Services Act, 2013* of Malaysia.
as well as in the life hereafter. Based on this principle, the Islamic corporate governance players (inside Islamic financial institutions) are also accountable for their actions. The accountability of these players in the life hereafter is beyond doubt, however, its verification is impossible from the Malaysian theoretical framework relating to corporate governance. Therefore, our focus has remained on the worldly accountability of these players. Therefore, the provisions of the Malaysian regime have been discussed from the perspective of accountability of corporate governance players in this world.

It was found that the provisions of Malaysian regime relating to Islamic corporate governance practices in IBIs, are compatible with the Islamic corporate governance principle of mas’oliyyah. It is worthily mentioned however, that these are only some provisions, which hold the corporate governance players accountable for their non-compliant actions. Nonetheless, there are so many other provisions, which are silent regarding the accountability of the corporate governance players in case of their non-compliant actions. Similarly, under the Malaysian SGF only SC members are held liable for their non-compliant actions, and no other player is responsible in this regard. Therefore, it is argued that the principle of mas’oliyyah cannot be verified in the provisions of the SGF to the extent of the ICG players’ accountability for their non-compliant actions, except members of SC.

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505 These are some texts from Quran which proves that human beings are accountable to Allah on the Day of Judgement: “To Allah belongs whatever is in the heavens and whatever is in the earth. Whether you show what is within yourselves or conceal it, Allah will bring you to account for it” (Al-Quran, 2: 284); “And fear a Day when you will be returned to Allah. Then every soul will be compensated for what it earned. And they will not be treated unjustly” (Al-Quran, 2: 281); “On the day when every soul will be confronted with all the good it has done, and all the evils it has done, it will wish there were great distance between it and its evil. But Allah cautions you (to fear) Him. And Allah is full of kindness to those who serve Him” (Al-Quran, 3:30); “Then on that day you shall most certainly be questioned about business” (Al-Quran, 102: 8); “The hearing, sight and hearts will all be questioned” (36: 17); “Then shall anyone who has done an atom’s weight of good, shall see good. And anyone who has done an atom’s weight of evil, shall see evil” (Al-Quran, 99: 7-8).
506 There is no way to prove it in this manner. It is illogical to attempt to prove the corporate governance player’s accountability from the theoretical regime.
507 All the provisions of the Malaysian regime, other than those which are brought under discussion in this study.
Further, provisions of the Malaysian regime have also been analysed in the light of Islamic corporate governance principle of shafafiyyah. Shafafiyyah (transparency) means that actions of human beings must be disclosed so that their role is visible to all. On the same logic, the actions of authority holders (and in this case, the actions of corporate governance players) must be transparent. This is because it is the principle of transparency, which helps ensure that authority holders perform in responsible manner and that they are held accountable for their actions in case of instances of violation of their authority. Holding the players accountable is possible only when their actions are exposed (disclosed).

By applying the principle of shafafiyyah to Malaysian regime, it was found that its provisions promote transparency in the activities of the IBIs as well as their players. Therefore, it is argued that almost all the relevant provisions of the Malaysian regime relating to transparency in IBIs are in conformity with the Islamic principle of shafafiyyah.

Finally, the Islamic corporate governance principle of khilafah (vicegerency) was also applied to the Malaysian regime relating to corporate governance practices.

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508 It is narrated that 'Umar (RA) received from Yemen, sheets of cloth. He distributed it among people each of whom received one length as his share. 'Umar’s share was that of one Muslim. He tailored it, wore it. The next day he ascended the pulpit to give orders to the people for preparation of Jihad. A Muslim stood up and said, “We neither listen to you nor obey you.” “Why so?” asked 'Umar (RA). He answered, “Because you have preferred yourself to us.” 'Umar again asked, “In what way I have done so?” He replied, “When you distributed the Yemen lengths of cloth, each one received one and so you too. But one length would not make you a garment; we see you have tailored it into a whole shirt and you are a tall man too. If you had not taken more, you could not have made a shirt of it.” 'Umar (RA) turned to his son 'Abdallah and said, “'Abdallah! Reply him”. He stood up and said, “When the commander of the faithful 'Umar wished to tailor this length of cloth, it was not sufficient, so I gave him enough of my length to complete it for him.” The man said, “Now we listen and obey you”. (See Mohammad Ali Taba Tabba, Al Fakhri, trans. C.E.J. Whitting, (London: Luizae & Co. 1947), p. 25; See also the Islamic concept of avoidance of gharar in transactions and disclosure of ‘ayb in things being sold in Mansoori, 2011.

509 As in the case of apparent violation of authority the Caliph Umar (R.A.) was asked for the use of extra part of cloth.
From the view of Maulana Maudoodi (R.A) about khaleefah and his authority, it is easily inferred that corporate governance players are also vicegerents of Allah, who have no authority to act beyond the commands of Allah. Being Allah’s vicegerents, they are bound to perform according to the wills of Allah and must not act beyond their authority as given to them as vicegerent.

The principle of vicegerency is equally applicable to all corporate governance players with no exception, no matter he is in the capacity of Director, CEO or auditor. This is because every corporate governance player, being human, is a vicegerent of Allah. Being vicegerents of Allah, all the corporate governance players must act within the parameters prescribed by Allah SubhanahuWaTa’ala. The parameter in this case for performing actions, is the delegated authority of vicegerency given by Allah. With respect to this study, the vicegerency demands shariah compliant activities.

It is further stated that the behaviour expected from a company (and in this case Islamic bank) is similar to the behaviour expected from an individual. However, the company is unable to perform its actions by its own, therefore, the board of directors acts as its brain. So, the expected behavior from a company is demonstrated in form of expected behavior of the board. Similary, the way the company does not have any mind, it also does not have any organs. So, in the opinion of the researcher, the managers of companies (including Islamic banking companies) act as organs of the companies, hence the

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510 According to the Great thinker of Islam, Maulana Maudoodi (RA), the character of human’s vicegerency enjoins him to obey Allah’s commands in all aspects of his life, so that all his actions conform to the Allah’s commands. This is because vicegerent is the one who uses his delegated authority as sub-ordinate to his master. Being vicegerent, he has no personal authority except the authority, delegated by his master, thus one cannot act according to his own wishes rather than to fulfill his master’s wishes. In case he acts otherwise than the delegated authority, this leads to his betrayal from his Lord. (See, Syed Abu al-‘A’la Maudoodi, Tafheem ul-Qur’an, Lahore: Idara Tarjuman ul Qur’an (1949): p. 61-62.


expected behavior from companies, is also extended to the expected behaviors of their managers.

Thus it is concluded that the rule of vicegerency is equally applicable to Islamic banks in the manner it is applicable to individuals. Further, it is also concluded that as the Islamic banks do not have any mind and organs, therefore, the expected role of vicegerency from the IBIs, is shifted to the board of directors and managers of the IBIs. So, on behalf of Islamic banks, the board and the managers of the IBIs act as vicegerents.

As, the principle of vicegerency is linked to shariah compliance, therefore, the Islamic banks as well their corporate governance players are bound to ensure shariah compliance in the activities of the IBIs. For the purpose of ensuring shariah compliance in the activities of Islamic banks in Malaysia, the central bank of Malaysia (BNM) has issued Shariah Governance Framework (MSGF). From the analysis of Malaysian SGF it was found that the roles of directors, management, SC and other supporting players are aimed to ensure shariah compliance, therefore, it is confirmed that the provisions of the SGF are fully compliant with the Islamic corporate governance principle of khilafah.
CHAPTER 6

COMPATIBILITY OF PAKISTANI CORPORATE GOVERNANCE FRAMEWORK FOR ISLAMIC BANKS WITH THE ISLAMIC PRINCIPLES

Like previous one, in this chapter too, the Islamic corporate governance practices in Pakistani Islamic banking institutions are analysed in the light of foundational principles of Islamic corporate governance system. It shall be verified in this chapter whether these practices are compatible with foundational principles or not? With respect to this study, the Pakistani regime includes: The Companies Ordinance, 1984, The Banking Companies Ordinance, 1962, The Revised Code of Corporate Governance, 2012, The Prudential Regulations for Corporate/Commercial Banks issued by SBP, The Instructions for Shariah Compliance of Islamic Banking Institutions, The Guidelines for Shariah Compliance of Islamic Banking Institutions, Shariah Governance Framework for Islamic Banking Institutions. Like in the case of Malaysia, the provisions of these laws and regulations are also limited to practices of board of directors, management, Shariah board, internal audit/Shariah audit, external audit/Shariah audit and disclosure. These practices are discussed below.

I. Application of Amanah (Trusteeship)

We have inferred the following results from the principle of amanah (trusteeship).

a. Authority is amanah with authority-holders;

b. Hence, the roles and responsibilities, along with ancillary requirements\(^{514}\) thereof, of corporate governance players are also amanah with the players;

c. The amanah of authority shall be handed over to competent persons;

\(^{514}\) Such as fulfilling qualification and experience criteria etc.
d. In case of negligence and misconduct (intentionally) in performing their duties, the ICG players shall be liable for their actions.

Like previous chapter, the above four implications are applied to the theoretical framework relating to corporate governance practices in Pakistan to verify whether the principle of amanah (trusteeship) is complied with in such practices or not? This chapter is also divided in three parts. **Part A** covers provisions of Pakistani regime other than *Shari’ah* Governance Framework (PSGF). The provisions of the PSGF are discussed **Part B**. In **Part C**, those provisions are discussed, which are related to non-compliant actions of corporate governance players.

**Part A**

**Application of Amanah to the Provisions of Pakistani Regime Other than the SGF**

**A. Directors and Board of Directors**

Directors hold central position in any company. The Board of directors make all decisions on behalf of the company, therefore, under Islamic principle the authority of directorship should given to competent persons. To make sure that directors are competent, the State Bank of Pakistan (SBP) has issued Fit and Proper Test (FPT) for them.

1. **Pakistani Fit and Proper Test (PFPT)**

   The Pakistani Fit and Proper includes three important elements: (a) integrity, honesty and reputation, (b) solvency and financial integrity, and (c) track record. The provisions of the criteria are discussed below.

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515 The criteria is equally applicable to directors, CEO and other key executives, therefore, the provisions of the PFPT shall not be re-discussed in the management section.

a) **Integrity, Honesty and Reputation of Directors**

Clause (i) and (ii) of Section 1 (Integrity, Honesty and Reputation) of PFPT judges integrity of a person on the basis of:

1. his conviction for fraud, forgery or crime;
2. his involvement in fraud, forgery or crime\(^{517}\).

Any person who is involved or has been convicted for any fraud, forgery or crime, proves his bad character. By doing any fraud or crime, he has shown dishonesty. He is a person of bad reputation, who cannot be trusted anymore. Therefore, he cannot be entrusted with any position of trust like directorship. Because, the rule of amanah is that, it shall be handed over to those who are trustyworthy. If they commit any misconduct or or negligence in their amanah, they shall not be handed over the *amanah* of authority. As, the above provisions prohibit the handing over of *amanah* of directorship to such violaters, therefore, it is argued that these provisions are in conformity with the Islamic corporate governance principle of *amanah*.

Similarly, clause (iii) of Section 1 of PFPT sets the parameter for a person’s integrity on the basis whether he has contravened any of the requirements or standards set out by the SBP or any other regulatory authority or professional body\(^{518}\). If he has done so, he is not eligible to be appointed as such corporate governance player.

The requirements of regulators\(^{519}\) and professional bodies\(^{520}\) are necessary for ensuring smooth running and maintaining standard of organizations like banks. If any organization’s management or BODs does not comply with the requirements of/standards set up by these bodies, the smooth running of the organizations becomes doubtful, or at

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\(^{517}\) State Bank of Pakistan, Prudential Regulations for Corporate/Commercial Banking, Fit and Proper Test, (Annexure VII-B),Section 1(i) & (ii), <http://sbp.org.pk/publications/prudential/PRs-Jan-2011.pdf> Lastly accessed on 22/12/2012.

\(^{518}\) Ibid, Section 1(iii).

\(^{519}\) Like SBP in Pakistan and BNM in Malaysia.

\(^{520}\) Such as Institute of Chartered Accountants of Pakistan (ICAP).
least such non-compliance affects the reputation of the organizations. Therefore, the persons involved in such violations, shall not be entrusted with the affairs of sensitive institutions like banks and especially Islamic banks. Because, observing the requirements are *amanah* with them, and the rule of *amanah* is that it shall not be handed over to those who cannot be trusted.

Similarly, the PFPT requires under clause (iv) and (v) of Section 1 that the person is fit only if he has not remained in the company or firm etc, in any capacity whether in the management or conduct of affairs, the license/registration of which has either been refused or revoked/cancelled.

In the above provisions, it appears that the person might not have been involved directly in any fraud or misconduct, which led to revocation or cancellation of the license of the company in which he was acting as key corporate governance player. Even, he might not have been involved indirectly in any activity, which led to such undesirable results. But, still the Pakistani regime disqualifies him from appointment on any key position like directorship. His disqualification in this case is meaningful because, cancellation of the company’s license or its revocation, while in the presence such key player, makes competency of the player doubtful. Non-handing over of key positions to persons whose competency is in doubt, is exactly in conformity with the Islamic principle of *amanah*. It shows that Pakistani regime takes extra care in handing over the *amanah* of authority.

It is evident from the above provisions of the PFPT that the *amanah* of directorship is entrusted only to those persons who have integrity and good reputation. Entrusting the authority of directorship to such persons shows that the provisions of the Fit and proper

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521 Banks are sensitive institutions because public monies are lying in their custody as trust (like deposits of investment account-holders), and they are subjected to stricter rules.

criteria relating to the director’s probity, integrity and reputation are in compliance with the Islamic principle of *amanah*.

**b) Solvency and Financial Integrity of Directors**

Clause (i) to (iv) of Section 3 (solvency and financial integrity) of the Pakistani Fit and Proper Test declares a person as in-eligible for directorship if he is not solvent or has no financial integrity. These characters are judged on the basis of the following:

1) His link in any unlawful activity, which is related to banking business etc\(^{523}\);  
2) His default in payment due to any financial institution, or taxes due to any government body etc. The obligation in the later case makes him in-eligible too if the institution, of which he was director or CEO etc, has made default in payment of government taxes etc\(^{524}\).

In the above provisions, if a person involved in any unlawful activity in relation banking activities, he is not eligible for the post of directorship or CEO-ship etc. This is because, by doing any such activity he has proved himself as untrustworthy, who has no financial integrity. Therefore, he cannot be trusted. And the one, who cannot be trusted, cannot be entrusted with the amanah of authority like directorship.

Similarly, the ineligibility of any person on the basis of his default in payment is also in conformity with the Islamic corporate governance principle of amanah because, like every other *amanah, repayment* of loan is also an *amanah*. He who does not repay his debts cannot be trusted. He who cannot be trusted, cannot be entrusted with *amanah* of authority.

From these provisions relating to financial integrity of the directors, it is inferred that the *amanah* of directorship is entrusted to those who have sound financial record. Hence, it is

\(^{523}\text{Ibid, Section 3(i).}\)

\(^{524}\text{Ibid, Section 3(ii) & (iii).}\)
stated that the Islamic corporate governance principle of *amanah* is complied with here in the above provisions too.

c) **Track Record of Directors**

According to clause (i) and (ii) of Section 2 (track record) of Pakistani Fit and Proper Test, a person is eligible for appointment of directorship on the basis that he must have faultless track record in the past in any capacity he has served any institution, and that he has not been demoted, dismissed or removed from his post by the institution or any government or regulatory body\(^{525}\).

The faultless track record of a person, who has served organizations in any capacity in the past, shows his honesty and good reputation. It means that the person has proved himself as man of integrity and reputation. Persons of sound integrity and reputation are trustworthy, who can be trusted to be entrusted with the *amanah* of authority. In the above provisions, entrusting persons of faultless past track record, with the trust of *amanah* of directorship shows that these provisions are in compliance with the Islamic principle of *amanah*.

From above discussion it is concluded that the authority of directorship is entrusted to those who are honest, trustworthy, and who can be trusted. Therefore, it is opined that the above provisions of the Pakistani Fit and Proper Test are in conformity with the Islamic corporate governance principle of *amanah*.

2. **Powers of Board of Directors**

Under subsection (1) of section 196 of CO, 1984, directors have the powers to manage the business of a company, who are entitled to exercise all those powers on behalf of a company, even if these powers are not expressly provided, by the CO, 1984, AOA or by a

\(^{525}\)Ibid, Section 2(i) & (ii).
special resolution passed in AGM, to be exercised by the company\textsuperscript{526}. So, it can be said that powers of directors in Pakistani regime are unlimited. Clauses (a) to (m) of subsection (2) of section 196 mention powers of directors, which are given below.

The directors have the powers to:

a) To issue shares and call on shareholders for payment of remaining amounts;
b) To borrow money and issue debentures;
c) To make loans and investments;
d) To approve periodic Accounts (annual, half yearly, and yearly);
e) To declare interim dividends
f) To approve bonus to employees
g) Writing off of bad debts and advances;
h) To define situations in which a law suit may be compromised and any claim may be released or relinquished\textsuperscript{527}.

The Pakistani regime, under sub-section (1) of section 196 of CO, 1984, gives all business management powers to board of directors. Under this sub-section, the powers of directors are unlimited. They are entitled to exercise all powers, even if the powers are not expressly provided in the CO, 1984 and Articles of Association (AOA). However, under the Islamic corporate governance principle of \textit{amanah}, the directors are expected to exercise all those powers on behalf of the companies, which are in the interest of the companies. They shall work for the enhancement of performance of businesses. Their decisions shall be beneficial for the companies. They shall not protect their own interests alone. They shall avoid conflict of interest situations. Acting on behalf of the company, and exercising powers in the interests of companies is \textit{amanah} with the directors.

\textsuperscript{526} \textit{The Companies Ordinance}, 1984 (XLVII of 1984), Section 196(1).
\textsuperscript{527} \textit{Ibid}, Section 196(2).
Beside the unlimited powers of directors as envisaged in the sub-section (1) of the Section 196 of CO, 1984, sub-section (2) of the section expressly mentions the powers of directors. Like position of authority being *amanah*, all the respective powers relating to the position are also *amanah*. The powers may be expressed as well as implied. Implied powers (as *amanah*) of a position-holder, are those which are expected from all those persons who hold similar positions. Expressed powers are those, which are explicitly mentioned\textsuperscript{528} to the authority holder when he is entrusted with the authority.

Thus, all the expressed powers in the above provisions, are *amanah* with the directors. For example, issuing of shares and call on shareholders for payment of remaining amounts, borrowing of money and issuing of debentures, making loans and investments, approving periodic Accounts (annual, half yearly, and yearly), declaring interim dividends, approving bonus to employees, writing off of bad debts and advances and defining situations in which a law suit may be compromised and any claim may be released or relinquished are the expressed powers of directors as envisaged in the sub-section (2) of section 196 of CO, 1984. All these roles of the directors are *amanah* with them, who are responsible to perform such roles and responsibilities in the best interest of the companies. These are the powers of directors, which are expressly provided in the Pakistani regime. According to Islamic principle of *amanah*, such expressly provided powers are *amanah* with them.

Further, under the principle of *amanah*, the directors are expected not to commit any misconduct or negligence in performance of their *amanah*.

3. **Major Responsibilities of BODs**

The above mentioned are the *powers* of directors, which means that it is upon the *discretion* of directors to exercise such powers, as and when they feel appropriate. Under

\textsuperscript{528} Or given in written form etc.
this heading, major responsibilities of directors are provided. Here in this case, the board of directors is bound to perform these responsibilities.

So, according to Section B of Prudential Regulations (G-1), the board of directors has the following responsibilities:

a) To make policies, oversee and supervise the affairs of banks;

b) Approving and monitoring the objectives and strategies of banks;

c) Overseeing that all the affairs are carried out in accordance with existing laws and regulations;

d) Clearly defining the roles and responsibilities of directors and senior management;

e) Ensuring that management is in the hands of qualified persons. These are the expressed responsibilities of board of directors of banks (including Islamic banks). As stated above, the expressed responsibilities of authority holders are amanah with them, therefore, on the same grounds, the above mentioned responsibilities are amanah with the board of directors. For example, under the prudential regulation (G-1), it is the responsibility of the board to make policies for banks and to oversee and supervise its affairs. In order to put the banks on the right track so that its objectives are achieved, internal policies are necessary for them. Without proper policies, goals of banks cannot be achieved. These are the different policies, which provide procedures and and the manners for achieving the banks goals. Such policy-making is amanah with the board of directors. Here, the board is also responsible to oversee and supervise all the affairs of the banks. The oversight role of the board is very much beneficial for banks. Although, the board is not responsible for day-to-day management of affairs of banks, as this is the responsibility of the management, but, overseeing the management in running the affairs of the banks, is the responsibility of the board. Such overseeing of affairs by the board

will enhance compliance with laws and policy, and ultimately it will ensure efficiency in the affairs of the banks.

Similary, the board is responsible to approve as well as monitor objectives and strategies of banks. A bank is incomplete without objectives. Objectives of banks specify directions in which they will be governed. Such objectives’ setting is the responsibility of the board. Similary, objectives of banks cannot be achieved without proper strategies. Both the setting up of objectives and strategies for achieving such objectives, are the responsibility of the board. In other words, the board has amanah to set up objectives and strategies for banks.

The board is also responsible under the prudential regulation (G-1) to ensure that affairs of the banks are carried out in accordance with the existing laws and regulations. Laws and regulations are necessary for smooth operations of banks. All the activities of banks are derived from laws and regulations of the country in which the banks are operating. Without observing legal provisions, the banks cannot achieve its objectives. Therefore, in order to ensure prudence in the activities of banks as well as achieve their goals, the board is responsible under the prudential regulation (G-1) to ensure that all the activities of the banks are run in accordance with the applicable laws. Ensuring such compliance with the law is amanah with the board.

Similarly, clear division among roles and responsibilities of directors and senior management is the responsibility of the board. Such division of duties and responsibilities of directors and managers shall enable them to know their respective roles and responsibilities in clear terms. The proper segregation of the duties will be helpful in defining the extent of accountability of each corporate governance player. This division is amanah with the board.
Further, the board is also responsible to ensure that management is in the hands of competent persons. Because, in banks the second most important player is management (the implementor of policies) after the policy-maker (BODs). Even, a comprehensive policy is useless until it is properly implemented. Proper and result oriented implementation of policies is possible only when management is competent and qualified. Therefore, it is necessary for banks (including Islamic banks) to have competent and qualified management. Ensuring competent management in the banks is amanah with the board.

From the above discussion it is inferred that all the above mentioned are the responsibilities of directors, which are expressly provided in the Pakistani regime. Under the Islamic corporate governance principle of amanah, the expressly provided responsibilities are amanah with the board. Being trustees of their responsibilities, the directors are expected not to commit any misconduct or show negligence in performing the amanah. Although, the above provisions are silent in case misconduct is committed by the directors, nonetheless, in the opinion of the researcher, still the above-mentioned roles are amanah with the directors, who shall be accountable for it on the day of judgement.

**B. Management**

Management is also a significant function inside Islamic banks. Operations of businesses, is the responsibility of the management\(^\text{530}\). The most important position on the management side is CEO-ship. Therefore his role is discussed below:

**1. CEO**

In Pakistan, subsection (1) of section 198 of the Companies Ordinance, 1984 (hereinafter called the CO, 1984) requires every company to have a Chief Executive.

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a) Role of CEO

Pakistani regime relating to corporate governance does not expressly provide for the role of CEO, however, under definition clause 5 of Prudential Regulations, he is an individual who has significantly all the powers to manage the affairs of banks. So the CEO of Islamic Banks is empowered to manage the affairs of the IBs.

More or less, it is the CEO who holds all the management powers. On management side, CEO is the most important position. Such position-holder is trustee of the position of CEO-ship. Unfortunately, Pakistani regime does not expressly define powers and responsibilities of CEO. CEO-ship is a important position. His role needs to be defined in clear terms. The expressly defined role of CEO will make him accountable for his actions. Otherwise, how can one be held liable for actions when he has not be entrusted with those responsibilities. Further, it will also ensure efficiency in the activities of the IBIs. But, according to Islamic corporate governance principle of amanah, it is understood that he has all those management powers, which are impliedly expected from CEOs. Such impliedly expected role of CEO is amanah with him. Here, the CEO is expected to avoid negligenc and misconduct while performing his role of amanah.

b) Qualification and Experience of CEO

As CEO is the most important position on management side. Therefore, the post shall be entrusted into the hands of those persons, who are sufficiently qualified and competent. Because, it is the requirement of Islamic corporate governance principle of amanah, that the amanah of authority must be entrusted into the hands of competent persons. In order to ensure competency of CEO, the Pakistani regime fixes some minimum qualification criteria for him. Under section 4(ii) of PFPT, the minimum qualification in terms of

degree i.e. graduation in banking, finance, economic, business, along with minimum experience of 5 years (at senior level) has been set for a person to become eligible for CEO-ship of Banking Institutions in Pakistan. In this provision of Pakistani regime, the competency of CEO has been quantified in terms of graduation degree and five (5) years of managerial experience. The minimum requirement of five years of management experience is sufficient for efficient handling of management affairs. Hence, it is argued that this provision is in conformity with the Islamic corporate governance principle of amanah, according to which the position of authority (like CEO-ship) shall be handed over to competent persons.

C. Auditors

As we said earlier that the auditors play an important role in the overall compliance of the companies with the laws, regulations and standards of the country in which they do businesses. Therefore, under the Islamic principle of amanah the authority of amanah needs to be handed over to competent auditors. To make sure that the auditors competent, the Pakistani regime requires from the auditors the followings:

1. Conflict of Interests Situations of Auditors

Clause (xxxviii) of the code, 2012 of Pakistani regime prohibits the appointment of auditor who is close relative of CEO, CFO, Director or internal auditor of the client company/bank. According to clause (a) of subsection (3) of Section 254 of CO, a person cannot be appointed as auditor of a company if he was director, employee or other officer of the company in the last three preceding years, or is currently working as such director, employee or other officer of the company. Under clause (b) of the section (3) a person is ineligible for such appointment if he is partner or employee of any director, employee

534 Under this clause close relatives mean spouse, parent, dependants and non-dependent children.
535 The Companies Ordinance, 1984 (XLVII of 1984), Section 254(3)(a).
or other officer of the company\textsuperscript{536}. Even, under clause (d) of the subsection (3), a person indebted\textsuperscript{537} to the company cannot be appointed as auditor of the company\textsuperscript{538}.

Audit is basically an independent assessment of the correctness of financial statements of companies that the information, which appears on the face of these statements are factually correct. For independent assessment, independence of auditor from its client institutions is necessary. An auditor who has any interests in his client company, he is prohibited to be appointed as auditor of banks. For example, if the auditor is director, CEO or other key position-holder of the bank, or he is close relative of any director, CEO or any other employee of the company, he is not allowed to be appointed as auditor. This is because he cannot be expected to give a correct opinion over its financial statements.

Further, a person indebted to a bank is also not eligible to be appointed as auditor of the bank, because he cannot be expected to give independent opinion regarding the correctness of financial statements. The independent and correct opinion giving is \textit{amanah} with the auditors. They cannot execute their \textit{amanah} with independence, if they have any interests in the institutions. So, the above provisions prohibit auditors to conduct audit of those banks in which they have interests. Therefore, it is argued that these provisions are compatible with the Islamic corporate governance principle of \textit{amanah}.

Being opinion givers, they hold important position of authority. According to Islamic corporate governance principle of \textit{amanah}, the authority is a trust, which shall not be entrusted into the hands negligents or those who commit misconduct in performing their \textit{amanah}. Hence it is expected that the authority holder shall not use his powers in his own interests, which is equivalent to betrayal (\textit{khianat}) in \textit{amanah}. Further, the authority holder

\begin{footnotesize}
\textsuperscript{536} \textit{Ibid}, Section 254(3)(b).
\textsuperscript{537} However, under Subsection 3A (a) of the Section 254 of CO, 1984, a person shall not be called as indebted to the credit card issuer company.
\textsuperscript{538} \textit{The Companies Ordinance}, 1984 (XLVII of 1984), Section 254(3)(f).
\end{footnotesize}
shall not favor any person at the cost of any other person, nor shall he give any undue
favor to any one.

2. Roles and Responsibilities of Auditors

Under the Pakistani regime, following are the roles and responsibilities of auditors. Being
authority-holders, the roles and responsibilities are *amanah* with the auditors, who shall
perform such roles as *amanah*.

a) **Audit of Accounts, Balance-Sheet and Profit & Loss Accounts**

External auditors are responsible to conduct audit of the followings:

1. Balance-Sheet of Islamic Banks;
2. Profit & Loss accounts of Islamic Banks\(^{539}\);
3. All other relevant documents such as note and schedules attached thereto\(^{540}\).

While assessing the above documents, the auditors shall verify and state in their report,
the following information:

S. 255(3) (a) of CO, 1984 requires auditors to state whether they have acquired all the
information and explanation necessary for audit? Under S. 35(7)(a) of BCO, 1962, he will
also state whether such information are satisfactory for the audit purpose. Similarly,
Section 255(3)(b) of CO, 1984 requires auditor to confirm whether proper books of
accounts are kept by the company. The regime also requires an auditor under
section255(3)(c) to confirm that balance sheet and profit and loss accounts are prepared in
accordance with the provisions of the CO, 1984 of Pakistan. Furthermore, sub-clauses (i)
and (ii) of clause (d) of subsection (3) of section 255 of CO, 1984, require auditor to state
whether the accounts give true and fair view of the profit and loss and affairs of the
company. Clause (c) of subsection (7) of Section 35 of BCO, requires auditors to report
whether returns received from branch offices are adequate? Under section 35(7)(e) of

\(^{539}\) The Banking Companies Ordinance, 1962 (LVII of 1962), Section 35(1).

\(^{540}\) The Companies Ordinance, 1984 (XLVII of 1984), Section 254(3).
BCO of Pakistan, an auditor is empowered to disclose any other matter which in his opinion is necessary to be brought into the notice of shareholders\(^{541}\).

Moreover, the Pakistani regime, requires an auditor under section 35(7)(b) of BCO to state whether the transaction entered into by the banking company is within the powers of the bank. Similarly, according to section 255(3)(e)(i) & (ii) of CO, the auditor has to confirm that the expenditures incurred by the company were for the purpose of the company and the business conducted, investment made is in conformity with the company’s objects\(^{542}\).

So it is concluded that auditors’ report shall include information about:

1) Completeness of information required for audit purpose;
2) Proper book keeping of accounts by the company;
3) Preparation of balance-sheet and profit and loss accounts in conformity with BCO, 1962;
4) True and fair view of state of affairs of company;
5) True and fair view of the profit and loss;
6) True and fair view of changes in financial position of company or of sources and uses of funds;
7) Confirmation of expenditures that they were made for the purpose of company’s business;
8) Confirmation of businesses and investments that they were in conformity with the objectives of the company;
9) Confirmation about the deduction of zakat and its deposit in the Central Deposit Fund;
10) Satisfactory position of information received by auditors;

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\(^{541}\) *The Banking Companies Ordinance*, 1962 (LVII of 1962), Section 35(7)(e).

\(^{542}\) *The Companies Ordinance*, 1984 (XLVII of 1984), Section 255(3)(e)(i) & (ii).
11) Confirmation of transactions that they fall within the powers of the bank;
12) Adequateness of returns received from branch offices of the banking company\textsuperscript{543}.

By verifying all the above mentioned information and stating them in their report, the auditors help ensure smooth operations of affairs of companies (including Islamic banking companies). The verification of correctness of the above information by independent auditors is an important check on the activities of companies and their employees. It is also helpful in detecting managerial frauds. Therefore, it is the responsibility of the auditors to conduct audit with quite prudence and independence of mind. Performing such audit is \textit{amanah} with the auditors.

On the basis of the foregoing discussion it is concluded that all the directors, managers and auditors are trustees of their authorities. They are required to perform their responsibilities as trust, who shall be accounted for their any misconduct or negligence in performance of their \textit{amanah}. But unfortunately, these provisions do not expressly provide for any consequences in case of negligence or misconduct of the CG players while performing their \textit{amanah}. However, there are some provisions which make these players accountable for non-performance of their \textit{amanah}. The provisions shall be discussed in \textbf{part C} of the chapter.

\textbf{Part B}

\textbf{Application of Principle of \textit{Amanah} to Provisions of Pakistani \textit{Shari'ah Governance Framework (PSGF)}}\textsuperscript{544}

The overall roles and responsibilities of the corporate governance players were discussed in the above part. In this part, the provisions of the PSGF are discussed, which are related

\textsuperscript{543} \textit{Ibid}, Section 255(3).
to shariah compliance in the activities of the IBs. The provisions of the SGF are discussed with reference to Islamic principle of amanah below:

A. Role of Board of Directors

The role of the board of directors, as envisaged in the PSGF, is discussed below.

1. Ultimate Accountability and Responsibility for Shariah Compliance

Under Section 1 of PSGF, BODs has ultimate responsibility and accountability for shari’ah compliance in IBIs. The responsibility for shariah compliance means that the board is responsible/accountable to ensure shariah compliance in the activities of Islamic banks. Here it is not clear as to who the board is responsible to? But in the opinion of the researcher, the directors on board are accountable to shareholders and SBP. They are accountable to shareholders because shareholders appoint them, and they are required to work for the protection of interests of shareholders. Similarly, they are accountable to SBP because the SBP as regulator, requires shariah compliance from the board as envisaged in this Shariah Governance Framework. Ensuring shariah compliance, is amanah with the board, which means that in case of any negligence or misconduct in performance of their amanah, the board shall be accountable. However, the PSGF is silent in this regard.

In order to execute its amanah of shariah compliance, the PSGF requires the following functions from the board.

2. Awareness From Shari’ah Non-Compliance Risks

Under clause (i) of Section 1 of PSGF, BODs should be aware of the Shari’ah non-compliance risks as well as its potential implications on the business and reputation of IBIs.
Shariah risk is defined as “the chance that an Islamic financing institution is challenged on grounds that it does not comply with Islamic law”\(^{545}\). This is actually a shariah non-compliance risk, which may “result from failure of an IFI’s internal control system or corporate governance”\(^{546}\). The risk is operational in nature, which is unique to Islamic financial institutions\(^{547}\). As the objective of Islamic financial institutions is to ensure shariah compliant in all its activities, therefore, the minimization of risk (management of risk) of non-compliance with shariah is the responsibility of the IFIs.

In the above provisions, the BODs is responsible to be aware of shariah non-compliance risk as well as its potential implication on the business and reputation of Islamic banks. Such awareness of the board is necessary, because proper and adequate policy making on shariah risk management is possible only when the board is fully aware of the areas as well as magnitude of the risk. According to Islamic corporate governance principle of amanah, the above expressed responsibility of awareness of shariah risk is amanah with the board.

**3. Diligent Oversight**

According to the above clause (i) of the Section 1 of PSGF, the board is also responsible to diligently oversee the functioning of the SGF as well as to oversee that all decisions, rulings and guidelines of SB are complied with. The purpose of the SGF is to ensure shariah compliance in the activities of the IBIs in Pakistan. Under this SGF, the most important organ which deals with the shariah matters is the Shariah Board. The Shariah board has the authority to make shariah compliant decisions with respect to business of the IBIs. The SGF as well as decisions of the SB are less useful unless they are properly

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implemented. Ensuring implementation of the SGF and the decisions of the SB is the responsibility of the BODs. Therefore, the above provision requires the board to diligently oversee the functioning of the SGF and ensure that the decisions of SB are complied with. Such overseeing over the functioning of the SGF and implementation of decisions made by Shariah board, has very much significant. It shall ensure shariah compliance in the activities of the IBIs, which shall ultimately enhance efficiency in the performance of the IBIs. This role of diligent oversight is also *amanah* with the board.

### 4. Appointment of SB Members

Under clause (iii) of Section 1 of PSGF, BODs appoints *shariah* scholars on SB. To ensure *shariah* compliant business and profit earning, Islamic banks in Pakistan have internal shariah body called Shariah Board (SB). The SB is responsible to ensure that products and services of Islamic banks are *shariah* compliant. According to above clause it is the authority of board of directors to appoint members of the SB. The board is expected to appoint qualified, competent and experienced members on the SB because it is the board itself, which is ultimately responsible and accountable for shariah compliance in the activities of IBIs. If the activities of the IBIs are not in conformity with the principles of *shariah*, then board is accountable for it. This shall certainly affect the reputation of the board, in addition to the reputation of SB and the IBI. So, appointment of competent and qualified *shariah* scholars on the *Shariah* board is *amanah* with the board of directors.

### 5. Fiduciary Duty Towards IAHs/PLS Depositors

Clause (ii) of Section 1 of PSGF expects from directors on board that they are aware of their fiduciary duties towards Investment Account-Holders (IAHs) and PLS depositors, hence further it is expected from the board to put in place a proper mechanism for the
protection of IAH’s interests, and to ensure that the returns paid to them are in conformity with *shari’ah*.

It is expressly provided in the above section that board of directors acts as fiduciaries on behalf of investment account holders and profit and loss sharing depositors. Under the fiduciary duty of the board towards IAHs and PLS depositors, the board act as *trustee* to work for the protection of interests of these important stakeholders. It means that the authority is *amanah* with the board. Therefore, the board is not allowed to conduct any negligence or misconduct while performing their duty towards these account holders.

It is concluded that according to the Islamic principle of *amanah*, the above mentioned expressed roles are amanah with the board, who shall be accountable for committing any negligence or misconduct while performing such roles.

**B. Management**

The role of management of Islamic banks, as envisaged in the PSGF, is discussed in the light of amanah below:

**1. Implementation of Decisions of Shari‘iah Board**

The PSGF declares management responsible for the implementation of the SB’s rulings and decisions under clause (ii) of Section 2. Further, under this clause, each group-head is responsible to implement such decisions and *fatawas* in his respective capacity (functional area).\(^{548}\)

As stated above, the board is mind and management is organs of organizations. But, the Islamic financial institutions also have additional mind in the form of Shariah board. So, in order to ensure shariah compliance in the activities of Islamic banks, the power to decide on *shariah* matters rests with the Shariah Board. However, such decisions are less useful unless they are properly implemented. The responsibility for the implementation of

the SB’s decision is that of the management. Such responsibility is *amanah* with the management. It is inferred that management plays a significant role in ensuring the overall shariah compliance environment in the Islamic banking institutions.

2. Responsibility of Imparting Adequate Training Program

In Pakistani SGF, according to clause (v) of section 2, IBIs are expected to arrange training and orientations programs on Islamic banking and finance for the board of directors and senior executives. Also under clause (vi) of Section 2, management is expected to regularly initiate orientation and sensitization programs for BODs and key executives to educate them about the business utility and importance of enabling *shari‘ah*-compliant environment and key distinctive characteristics of *shariah* compliant products.

The minimum qualification required from directors CEO is graduation. So, normally they do not know more about Islamic business transactions. Similarly, other key executives also lack knowledge of Islamic finance. Therefore, it is necessary that they should be properly trained in the field of Islamic banking and finance. In this way, these corporate governance players shall be enabled to work in the Islamic banks in accordance with the principles of Islamic commercial law.

Further, the management highlights the key distinctive characteristic of *shari‘ah* compliant products, to the members of board and management, so that their knowledge regarding the products is enhanced. The management also highlights to them, the efficiency of business in a shariah compliant environment. In this way the directors and managers are motivated, who take interest to work with more potential. Being their expressed responsibility, this role is *amanah* with management.
3. Providing Complete Information to SB

In case any matter is referred to SB by management, it is the responsibility of management under clause (iii) of Section 2 of Pakistani SGF that complete information are provided to SB for taking its opinion, guidance or fatwa. The more relevant information are disclosed to SB, the more decision shall be correct, and the more the decisions are correct, the more efficient the performance of the SB will be. The correct decisions as well as efficient performance of the SB shall ensure more enabling shariah compliant environment inside Islamic banks. The efficient and more shariah compliant decision-makings of the SB shall give confidence to shareholders and investment account holders that they are earning good profits, which are shariah compliant.

In the above process, the informed decision-making by the SB is the result of complete information disclosure by management. Hence, it is argued that management of Islamic banks plays a significant role in the shariah compliant decision-making by SB. Such role is amanah with the management.

It is concluded from the above role of management that it plays a crucial role in the ensuring overall shari`ah compliant environment inside Islamic banks. The responsibility of shari`ah compliance is amanah with management. In order to fulfill their amanah, the Pakistani SGF requires management to impart adequate training program to all officers, to tolerate no shari`ah non-compliant instances and to provide all relevant information to SB so that the members of the SB are enabled to make shari`ah compliant decisions.

C. Shari`ah Board

Clause (i) of Section 3(A) of the PSGF requires every IBI to have a shari`ah board (SB). The objective of Shari`ah compliance cannot be achieved without proper and good governance structure inside the IB. The most important organ of the structure is the SB inside IBs. The members of the SB are shariah scholars with strong background in
shariah. In the following paragraphs, we will discuss the provisions of the PSGF, which are related to SB.

1. Education/Qualification

In Pakistan the educational system is categorized into two types namely the religious institutions’ educational system and modern educational system. So, if a person studies in religious institutions, then according to Fit and Proper Criteria for Shariah Advisors issued by SBP, he must hold degree of ShadatulAlamiya (Dars-e Nizami) from recognized board of madaris with minimum 70% marks, and Bachelor degree from modern educational institution with minimum 2nd class, to become eligible for appointment of member of SB549. However, if a person is a degree-holder from modern educational institution, then the minimum qualification to become eligible for appointment as member of SB, is postgraduate degree in Islamic Jurisprudence, Usooluddin, LLM in Shariah with minimum CGPA of 3:00 out of 4:00 or equivalent550. Holding a degree from madrasa (religious institution) in case of Pakistan is not useful in the view of the researcher because of two reasons. First, the scholar will not be an expert in fiqh al-mu ‘amalat (Islamic law of contracts and business transactions). Second, he will not be able to practically apply such knowledge in Islamic finance. Similarly, degree-holder in Islamic jurisprudence is also not a suitable candidate for the post of shariah scholar because the Islamic jurisprudence is the field which does not directly deal with Islamic commercial transactions. It is the science of principles and comprehensive551 evidences, on the basis of which ahkam are derived552. Likewise, post graduate degree in Islamic Studies (Usooluddin) also does not enable a candidate to be competent enough to

549 State Bank of Pakistan, Fit and Proper Criteria for Shariah Advisors of IBIs, Annexure-IV to IBD Circular No. 2 of 2004, Revised vide IBD Circular 2 of 2007, Section 1.
550 Ibid, Section 2.
551 For example, Quran and sunna as a whole, are comprehensive evidences. They are different from detailed (individual) evidences (for example, the verse of quran dealing with cutting of hands of a thief, is detailed evidence).
act as efficient shariah scholars inside Islamic banks because the focus of Islamic studies remains more on acts of worship than mu ‘amalat (transactions) especially mu ‘amalat al-maliyyah (financial matters).

On the other hand, the requirement of degree in fiqh or fiqh al-mu'amalat, from shariah scholars is beneficial for Islamic banks. Fiqh is the knowledge (Science) of practical shariah rulings pertaining to conduct that are derived from the detailed (individual) evidences of shariah. This definition suggests that fiqh deals with practical conducts of human beings, which include acts of worship (such as prayer, is subject of fiqh al-‘ibadat), acts of transactions (such as sale/purchase, is subject of fiqh al-mu'amalat) and acts of crime (qisas and hudood, are subjects of fiqhal-jinayat). These three are the main subjects of fiqh. Fiqh is broader than Fiqh al-mu'amalat. The later is a special subject of the former. However, both include the knowledge relating to individuals’ mutual transactions. It also includes knowledge of Islamic business transactions such as musawamah, murabaha, salam, mudharabah, musharakah, and istisna.

Persons with degree in fiqh or fiqh al-mu'amalat shall be able to tackle financial matters of Islamic banks with better understanding. Islamic banking business is based on the Islamic business transactions, hence the shariah scholars holding degrees in the above mentioned fields are most suitable to become members of SB. Therefore, in the opinion

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554 Ahkam (rules) relating to aqeeda (such as trust in God and Day of Judgement) and akhlaq (such as obligation of telling truth and prohibition of telling lie) are excluded from the subject of fiqh. (See, Abdul Karim Zedan, Al-wajeez fi ‘Usool al-Fiqh, Dar Nashr ul-kutub al-islamiyyah, (1976), p. 9.

555 Dr. Mahmood Ahmad Ghazi has divided the subject of fiqh into two main divisions. One is related to acts of state the other is related to acts of subjects (citizens) of state. The former type of fiqh includes muslim administrative law, muslim criminal law, muslim procedural law and muslim international law. The latter includes acts of worship, muslim family law, transactions and social dealings. (See generally, Mahmood Ahmad Ghazi, Mahadhirat-e Fiqh, Al-Faisal Nashran, (2005).

556 Sale without mentioning the cost price or profit margin.

557 Sale by mentioning the cost price as well as profit margin.

558 Contract of advance payment and deferred delivery of goods.

559 Contract of participation in which one party provides capital while the other party provides skills.

560 Contract of participation in which both the parties provide capital.

561 Contract of manufacturing.
of the researcher, the minimum qualification required from shariah scholar of Islamic banks should be a degree in *fiqh al-mu’amalat* (Islamic law of contracts and business transactions). For this purpose, it is suggested that universities should start specific degree in *fiqh al-mu’amalat*.

However, it is clarified that requirement of *ShadatulAlamiya (Dars-e Nizami)* from recognized board of *madaris*, or postgraduate degree in Usooluddin (Islamic study) or Islamic Jurisprudence is itself shariah compliant, though not efficient. Entrusting the authority of shariah position to persons holding any of the above degrees, is compatible with the Islamic corporate governance principle *amanah*, because ensuring shariah compliance is *amanah*, and the *amanah* is entrusted into the hands of those who know shari‘ah.

### 2. Experience

The Pakistani SGF fixes certain term of experience to become eligible for membership of SB. Clause (i) of Section 3(A) of Pakistani SGF requires that shariah scholars shall be appointed as per criteria specified by SBP for *shar’iah* advisors. According to Section 2 of the Fit and Proper Criteria for *Shar’iah* Advisors, the minimum experience required is either 4-years in giving shariah rulings, or 5-years post qualification experience in teaching or Research & Development in Islamic Banking and Finance.\(^{562}\)

So it can be said that any person having the above mentioned experience is eligible to become member of shariah board. However, the very next clause i.e. clause (ii) of Section 3(A) of the Pakistani SGF states experience criteria for chairman and members of SB. According to this provision, the minimum experience required from the person to become

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562 State Bank of Pakistan, Fit and Proper Criteria for Shariah Advisors of IBIs, Annexure-IV to IBD Circular No. 2 of 2004, Revised vide IBD Circular 2 of 2007, Section 2.
chairman of the SB is 5-years as shariah advisor or member of shariah board of an IBI\textsuperscript{563}. According to the same clause i.e. (ii) of Section 3(A), the minimum experience for other members is 3-years as shariah advisor\textsuperscript{564}, member of Shariah Supervisory Board (SSB) of an IBI, member of shariah team of an IBI or deputy to shariah advisor of an IBI\textsuperscript{565}. Here arises contradiction regarding the experience requirement of members of SB. Clause (i) of Section 3 (A) of the SGF states that shariah members of the SB shall be appointed according to Fit and Proper Criteria as notified by the SBP, which also includes the experience criteria among others, for shariah advisors. Then the very next clause i.e. ii of 3(A) of the SGF states experience criteria which is different from that mentioned in the Fit and Proper Criteria. This issue can be resolved in one case i.e. all other provisions of the Fit and Proper Criteria are applicable for appointment of shariah scholars as required by clause (i) of Section 3(A) of the SGF except the provisions relating to experience criteria for such shariah scholars. The requirement of experience in the Fit and Proper Criteria shall be considered as superseded by the experience requirement as given in clause (ii) of Section 3(A) of the Pakistani SGF. So, the experience for chairman will be 5-years as SA or member of SB. And for other members, it will be 3-years as SA or in any such capacity as are mentioned above.

The above mentioned is the criteria, which shall be fulfilled by the SB members in order to be competent enough to discharge their \textit{amana}h of shari`ah compliance. According to Islamic corporate governance principle of \textit{amana}h, the \textit{amana}h of authority cannot be handed over to incompetent persons, in which case there would be apprehension of breach of trust in the form of their negligence and misconduct. So the above requirements


\textsuperscript{564} It means the shariah advisor who was working as shariah advisor before the SGF was made.

of some years of experience show that the provisions of the PSGF are in conformity with the Islamic corporate governance principle of *amanah*.

3. **Role of Shari’ah Board**

a) **Responsibility for Shari'ah Compliance**

According to clause (iii) of Section 3(B) of PSGF, the SB is responsible to ensure that the IBIs’ products and services and other related documents, transactions, structures and product manuals etc are in accordance with the principles and rules of *shari’ah*.

In order to achieve the prime objective of shariah compliance, the Shariah board is entitled to review all the products, services and related transactions and documents of the IBIs. Such ensuring *shariah* compliance in the activities of the IBIs is *amanah* with the Shariah board.

b) **Rigorous Deliberations**

The PSGF, under clause (v) of Section 3(B) requires that before issuing any ruling or arriving at any decision, rigorous deliberations shall be made on all issues, which shall be properly recorded and documented along with the rationale for allowing or disallowing any product or service.

Rigorous deliberation on shariah issues means that the issues shall be brought under proper discussion. Based on his knowledge, each member shall give his opinion. Pros and cons of the matters shall be discussed and its results in Islamic banking shall be foreseen. Resultantly, no matter shall be decided blindly. This shall ultimately minimize the *shariah* non-compliance risk in the decision-making process, which shall enhance efficiency in the activities of Islamic banks. The element of rigorous deliberation on issues

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566 *Ibid*, Section 3(B)(iii).
567 *Ibid*, Section 3(B)(v).
in hand shows that the principle of shoora\textsuperscript{568} (mutual consultation) is followed by the SB in the process of decision-makings. Further, the rigorous deliberation on all issues is \textit{amanah} of the SB.

c) Accountability and Responsibility for Fatawas and Decisions

The SB in Pakistan is responsible and accountable under clause (i) of Section 3(B), for all its decisions and rulings. This responsibility and accountability of members of the SB for all their rulings and \textit{fatawas} is a good control over the functioning of the members of SB. In this way, they shall be careful while making any decision or issuing any \textit{fatwa}. Their opinions shall be based more on reasons and evidences from \textit{shariah}. However, it is not clear as to who are they responsible to and to what extent. But, at least members of the SB shall be blamed for any incorrect opinion or fatwa, which shall obviously damage their reputation. Holding these members accountable for their decisions and opinions is in conforming to the Islamic principle of \textit{amanah}.

d) Advice to Board and Management

Under clause (i) of Section 3(B) of PSGF, the SB is responsible for giving advice to BODs and management on \textit{shari’ah} related matters. We know that the decision-making powers of Islamic banks also rest with the board of directors, whereas its implementation is the responsibility of management. Under this section, the board is ultimately responsible and accountable for shariah compliance, therefore, the board needs advice from members of SB. Giving advice to the board is the responsibility of SB. As a result, the risk of shariah non-compliant decision-making by less knowledgable board (means

\textsuperscript{568}In Quran Allah refers to the principle of shoora along with some other characteristics of believers as: “\textit{Those who respond to their Lord, and establish regular prayer; who conduct their affairs by mutual consultation, who spend out of what we bestow on them for sustenance}”. (See, Al-Quran, 42:38).In other place in Quran Allah says that “\textit{And consult them on affairs (of moment). Then, when you have taken a decision, put your trust in Allah}”. (See, Al-Quran, 3:159).
board having less knowledge of Islamic law) on *shariah* matters shall be minimized. Hence, the board shall make decisions in conformity with the principles of *shariah*.

Similarly, the management also needs advice in relation to day-to-day management and implementation of decisions of BODs and SB. This is because due to technicalities of Islamic commercial transactions, the management may face difficulties in their implementation. So, to ensure that the decisions of the board and SB are properly implemented and that the Islamic banking activities are managed in conformity with the Islamic principles, the SB is responsible to advice management of the IBIs.

The responsibility of giving advice to board and management is *amanah* with the SB.

It is concluded from above discussion that all the above mentioned roles and responsibilities of the shariah board are *amanah*. Because the rule of amanah is that like authority, all the expressed roles and responsibilities associated with such authority, are also amanah with the holders of the authority. However, the above provisions are silent regarding instances of non-compliance of the board in performing their role.

4. **Resident Shari’ah Board Member (RSBM)**

Out of the members of *Shari’ah* Board, one member shall be designated as Resident *Shari’ah* Board Member (RSBM) under Section 4 of PSGF, who shall provide guidance to IBIs on routine matters relating to *shariah*. RSBM of one IBI shall not be appointed as RSBM of another IBI\(^{569}\).

**a) Role of the RSBM**

Under clause (i) of Section 4 of PSGF, the RSBM will provide guidance on day to day or routine shariah related issues raised by the management and the staff of IBI.

While performing their functions in Islamic banks, management and other staff of the IBIs may face issues relating to shariah, in which case they seek guidance from the RSBM. The RSBM is responsible to guide them in this regard.

According to clause (ii) of the above section 4, the RSBM will provide post product approval clarifications on various shariah related issues and queries of management, staff, and approve routine documents, process flows etc. After a product is developed, still questions may raise in mind of management, who need clarifications. Such clarification is the responsibility of the RSBM.

Similarly, clause (iii) of the section 4 requires the RSBM to facilitate and provide guidance to the IBI’s product development function regarding the shariah aspects of new products/ideas. In Islamic banks the product development function has the responsibility to develop new products and ideas. In this process, it may face problems with respect to shariah, therefore, proper guiding of the department in product development process is the responsibility of the RSBM.

Further, under clause (iv) of the section, the RSBM will guide, advise and lead the SCD in conducting shariah compliance reviews of key business areas on sample and test check basis. Conducting periodic shariah reviews for the purpose of verifying the degree of compliance of the Islamic banks’ activities with shariah rules and principles, is the responsibility of the SCD. While performing such function, the SCD shall seek guidance from the RSBM. Providing such guidance is the responsibility of the RSBM.

He will also respond to the shariah related queries of IBI’s present/prospective clients regarding IBI’s products, services and shariah practices received through SCD, as required in clause (v) of Section 4 of the PSGF. Current and prospective clients of Islamic banks are usually concern more about shariah compliance in addition to profitability.
Providing shariah clarifications on products and services to the IBI’s present and prospective clients, is also the responsibility of the RSBM. Such clarification shall give confidence to the clients that the IBI’s activities are running in conformity with the principles of shariah. It will also attract prospective clients to develop business relations with the IBIs.

Further, clause (vi) of the Section 4 empowers the RSBM to supervise the preparation of shariah training material and collaborate with SCD and Training Department in designing and delivering shariah related trainings. In order to educate directors and management on the importance and efficiency of the Islamic finance transactions, proper training is necessary for them. The materials developed for such trainings shall be supervised by the RSBM so that relevant shariah materials are developed, which will help the board and management in enhancing their knowledge regarding shariah and its better applications.

Furthermore, the RSBM is required under clause (vii) of the above section 4 of the PSGF, to respond to all shariah related queries made to him through SCD by different departments of the IBI. Any department inside Islamic bank, which may face any problem regarding shariah, will seek guidance of the RSBM, who shall properly respond to such queries and give clarifications to their queries. This is because the departments of Islamic banks are expected to keep concern about shariah compliance, in addition to smooth operations of the departments. With respect to shariah issues, providing proper guidance to all departments is the responsibility of the RSBM. This responsibility is amanah with the RSBM.

So, the RSBM provides guidance to management, staff, SCD, Product Development Function on routine shariah related matters, and respond to shariah related queries raised by the management, staff, clients and prospective clients etc.\(^{570}\)

\(^{570}\)Ibid.
ensures shariah compliance in all the affairs of the IBIs. He also ensures smooth functioning of the activities of the IBIs. It means that he plays a significant role in ensuring smooth and shariah compliant operations of the overall affairs of the IBIs. Performing all the above functions are amanah with the RSBM.

D. Shari’ah Compliance Department (SCD)

According to S. 5 of PSGF, there shall be a full-fledged Shari’ah Compliance Department (SCD) inside each Islamic bank, headed by RSBM or any other qualified person as suggested by the SB\textsuperscript{571}.

The shariah compliance department is an important function inside Islamic banks. As the name suggests, the department is managerial in nature, which helps in ensuring shariah compliance in all the activities of the IBIs. For this purpose, the SCD is required to perform the following roles and responsibilities. Such roles are amanah with the SCD.

1. Shari’ah Compliance Review

Under clause (iv) of Section 5 of PSGF, the SCD is responsible to oversee all the shariah governance organs, (such as the BODs oversight mechanism, internal shariah audit, and enforcement of SB’s directives by executive management), that they are operating well, and performing their roles efficiently. The department shall conduct regular internal control shariah review to ensure and monitor the compliance of IBI’s operations with Shari’ah, SB’s instructions, and SB’s Fatawas and guidelines\textsuperscript{572}.

From the above role of the SCD it is clear that the department acts as watchdog over different departments of the IBIs. The SCD examines whether the other departments entrusted with the amanah of performing shariah complaint activites, are in fact fulfilling their amanah? To examine efficiency and shariah compliance in the activities of Islamic banking business units, branches and Head Office departments, the SCD conducts regular

\textsuperscript{571}Ibid, Section 5.
\textsuperscript{572}Ibid, Section 5(iv).
review of the functioning of the departments. Based on this review, the RSBM submits periodic reports to SB. As the role of the SB is to ensure shariah compliance in all the activities of the IBIs, therefore, based on the report of the RSBM, if any non-compliance instance is detected in the activities of the different functions, the SB shall give corrective measures to make the default good and shariah compliant, which shall be implemented by the SCD. So, it is argued that the SCD performs a very significant role in ensuring overall shariah compliant environment inside Islamic banks. It ensures smooth operations inside Islamic banks. The function is *amanah* with the SCD.

2. **Disclosure of Information to SB and Implementation of Its Measures**

For the purpose of information and prescription of appropriate actions by the Shariah Board, all the external and internal *shari’ah* audit reports along with extract of SBP’s Inspection Report on shariah compliance, shall be communicated to the SB, under clause (v) of Section 5 of PSGF. In this regard the SCD is also responsible to execute the enforcement actions prescribed by the SB\(^{573}\).

Under the above provison, the SCD has two responsibilities. First, the department is responsible to disclose to SB, all information including internal and external shariah audit reports and SBP’s inspection team’s report on shariah compliance. By disclosing such information to the SB, transparency shall be ensured in the activities of the IBIs. Further, based on such information, if any shariah non-compliant instance in the activities of the IBIs, is identified, the SB shall suggest corrective measures for that.

The second responsibility of the SCD is that it shall implement the corrective measures suggested by the SB. The implementation of the measures has very much significance because the measures are useless unless they are properly implemented. By implementing

\(^{573}\) According to the same clause i.e. (v) of Section 5 of PSGF, such unresolved issues shall be taken up with management by the SB, and if warranted the unresolved issues shall be disclosed in Annual *Shari’ah* Compliance Report by SB.
the suggested corrective measures, shariah compliance shall be ensured in the activities of the IBIs. So, we can say that the SCD plays an important role in maintaining overall shariah compliant environment in the IBIs. The above mentioned disclosure of information is *amanah* with the SCD.

3. **Training on Shari’ah Compliance**

Under clause (vi) of Section 5 PSGF, it is the responsibility of the SCD, in collaboration with the Training Unit of Human Resource Department, to provide shariah trainings and develop materials for such trainings\(^5\)\(^7\)\(^4\). For the purpose of keeping the staff up-to-date on developments in the field, the SCD is responsible to ensure that necessary training has been given to Islamic banks’ staff, and that periodic refresher courses are organized for them\(^5\)\(^7\)\(^5\).

In order to keep the Islamic banks’ staff up to date on relevant aspects of Islamic banking, periodic refresher courses and trainings are necessary. In this manner, efficiency and compliance in operations of the IBIs shall be ensured. For ensuring such compliance as well as efficiency in the activities of the IBIs, the SCD has the responsibility to impart trainings on shariah matters to the staff of IBIs. In this regard, the SCD also has the responsibility to ensure that necessary training has been given to all the staff members, and that refresher courses are organized for them on periodic basis. Such periodic refresher course shall keep the staff up to date in the field of Islamic banking and finance.

So, it is concluded that the Shariah compliance department plays a significant role in education of the Islamic bank’s staff on Islamic banking as well as in enhancing efficiency and shariah compliance in the activities of the IBIs.

\(^5\)\(^7\)\(^4\) Although under the same clause (vi), the management and SB shall approve such training materials.

All the above functions are very much significant for ensuring shari’ah compliance in Islamic banks. From the perspective of Islamic corporate governance principle of amanah, these functions are amanah with the SCD.

E. Internal Shari’ah Audit

Clause (i) of Section 6 of PSGF provides that Internal Shari’ah Audit shall be performed by Internal Shairah Audit Unit (ISAU). The ISAU shall either be part of Internal Audit Department (IAD) or shall be a separate Independent Unit. Clause (ii) of the Section 6 further requires that staff of Internal Shari’ah Audit shall be appropriately qualified and trained.

M. G Mohiuddin defines shariah audit in the following words:

“Shariah audit is the examination of an IFI’s compliance with the Shariah, in all its activities particularly the financial statements and other operational components of the IFI that are subjected to the risk of compliance including but not limited to products, the technology supporting the operations, operational processes, the people involved in key areas of risk, documentation and contracts, policies and procedures and other activities that requires adherence to shariah principles.”

From this definition of shariah audit two points are inferred. First is that shariah audit is the assessment of financial statements and other operational components of IFIs for ensuring that they are shariah compliant. The second point is that all those activities are audited, which may be exposed to shariah non-compliance risk.

Independent assessment of products and services offered by Islamic banks is necessary in order to verify whether they are in conformity with Islamic law or not? If not, necessary measures shall be suggested to make the defaults good and shariah compliant. The independent assessment of shariah compliance in the activities of IBIs is shariah audit.

576 Ibid, Section 6(i).
577 Ibid.
Although the Pakistani SGF under its Section 6 requires Islamic banks to establish Internal Shariah Audit Function, but it does not define any scope of the function. The scope setting is left to description of the Shariah board. In view of the researcher, defining scope of the internal shariah audit is necessary, so that the auditors are made bound to assess the important areas. For example, it should be provided in the SGF to require auditors to audit financial statements, all transactions and relevant documents thereto, appropriateness of shariah governance structure and information technology system.

Further, the PSGF does not define any qualification criteria for internal shariah auditors, which puts a question mark on the competency of the auditors in conducting shariah audit. Speaking from shariah perspective, the incompetent auditors may not understand the technicalities of Islamic finance transactions, hence cannot be expected to make correct assessments of the transactions. Therefore, in the opinion of the researcher, there should be some minimum educational criteria set for the internal shariah auditors. Currently some special Certificates in Shariah audit can be required from the auditors.

In the presence of all such discrepancies however, it is concluded however, that the existence of external shariah audit function inside Pakistani Islamic banks, has its own significance because, it will help in ensuring shariah compliance environment inside Islamic banks. The function is amanah with the department.

**F. External Shari’ah Audit**

Under Section 7 of Pakistani SGF, external shariah audit is the “independent and objective assessment of conformity of IBI’s operations with shariah rules and principles”. According to this section, the scope of the external shariah audit is limited to financial arrangements, contracts and transactions. The external shariah audit shall be performed
by external auditors, therefore, they are required to have appropriate human resource and methodology\textsuperscript{579}.

Under statutory law in Pakistan, the responsibility of external auditors is to verify the financial statements of companies represent true and fair of the companies’ affairs or not\textsuperscript{580}. But, when they conduct audit of Islamic banks, the PSGF requires them to make additional assessment of the IBIs to verify whether the IBIs’ activities are shariah compliant? Such assessment is necessary because it verifies whether the IBIs are stick to their ultimate goal of shariah compliance or not? If not, then there remains no reason that can justify the very existence of the IBIs.

Further, the external auditors are required to have qualified persons who can be able to conduct shariah audit of IBIs. Due to technicalities of Islamic finance transactions, some experts are required who can verify whether any transaction is shariah compliant or not? Therefore, under the above section 7 of the PSGF, it is required from external auditors to have such experts, which means that the above provision is in conformity with the Islamic principle of amanah, because undere the above section, the amanah of verifying shariah compliance is handed over to those who are competent enough to examine transactions for such verification.

However, the above provison does not mention any qualification criteria for external auditors who will be eligible for conducting external shariah audit of Islamic banks. Therefore, there is an apprehension that sometimes external auditors may not understand the technicalities of Islamic commercial transactions, hence will not be able to give correct opinion regarding shariah compliance in the activities of the IBIs.

It is concluded that all the above mentioned corporate governance palyers are authority holders, hence trustees of their positions. Being on such positions, all their respective


\textsuperscript{580} \textit{The Companies Ordinance}, 1984 (XLVII of 1984), Section 255(1).
roles (both expressed and implied) are *amanah* with them. However, it is not verified from the above provisions whether in case of any negligence or misconduct in performing their roles, the players shall be held accountable or not? It is highlighted here however, that there are so many provisions from which the accountability of the players is verified. These provisions shall be discussed in the following part C of this chapter.

**Part C**

**Accountability of Corporate Governance Players for Committing Misconduct in Their Amanah**

In this part, the provisions of Pakistani regime shall be discussed to verify whether, the authority holders (being trustees) are accountable for their misconducts and negligence in performing their responsibilities or not? The provisions are discussed below.

**A. Accountability of Directors**

**Section 189 of CO, 1984**

Section 187 of CO, 1984 describes criteria on the basis of which directors and CEO shall be disqualified from their respective offices. Under Section 189 of CO, 1984, if the disqualified director or CEO still represents himself as director or CEO, he shall be fined up to two hundred rupees per day\(^{581}\). Representing themselves as directors by disqualified directors is misconduct of the directors, hence under the above section, they are held liable for their misconduct.

**Sub-Section (4) of Section 196 of CO, 1984**

This Section 196 deals with the powers and responsibilities of directors. Under subsection (4) of the Section, a director shall be fined up to one hundred thousand rupees, in case of non-performance of his responsibilities\(^{582}\). These responsibilities are *amanah* with

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\(^{581}\) *The Companies Ordinance*, 1984 (XLVII of 1984), Section 189.

\(^{582}\) *Ibid*, Section 196(4).
the directors. Non-performance of the *amanah* tentamounts to misconduct of the directors who are held liable for such misconduct.

**Sub-Section (1) and (6) of Section 214 of CO, 1984**

Sub-section (1) of the above Section 214, requires directors to disclose in the meeting of BODs, his interests in any transactions made by the company. If he fails to do so, then under sub-section (6) of the Section, he shall be fined up to five thousand rupees\(^{583}\). Disclosure of interests of directors is amanah with the directors, if they do not disclose their interests, they are held liable for their actions.

**Sub-Section (1) and (3) of Section 216 of CO, 1984**

According to sub-section (1) of the Section 216 of CO, 1984, interested directors are restricted from voting and participating in the particular meeting, in which the arrangement or contract in which he has interests, shall be discussed\(^{584}\). If the director contravenes such restriction, then under sub-section (3) of the Section, he shall be fined up to five thousand rupees\(^{585}\). According to this section, directors are held liable for misconduct in their *amanah*.

**Sub-Section (1) and (6) of Section 219 of CO, 1984**

Under sub-section (1) of the Section 219 of CO, 1984, all the particulars of the contracts and arrangements in which directors have interests, shall be entered into register. If any director willfully does not comply with this requirement, under sub-section (6) of the Section, he shall be fined up to five thousand rupees, and be further fined up to two hundred rupees per day if the default continues\(^{586}\). Directors are held responsible for their willful misconduct in disclosing their actions.

**Sub-Section (4) of Section 236 of CO, 1984**

\(^{583}\)Ibid, Section 214(1) & (2).

\(^{584}\)Ibid, Section 216(1).

\(^{585}\)Ibid, Section 216 (3).

\(^{586}\)Ibid, Section 219(6).
The above section 236 of CO deals with directors’ report, its contents and other relevant requirements thereof. If the company makes default in complying with the requirements of this section, then according to sub-section (4)(a) of the section, its CEO and every director, who is cause for such default, shall be imprisoned up to one year and fined from fifteen to twenty thousand rupees, and shall also be liable to a further fine up to five thousand rupees per day in case the default continues. CEO and directors are held accountable for their misconduct under the above section.

From the above provisions it is clear that directors are accountable for their non-compliant actions. Such accountability is in conformity with the Islamic corporate governance principle of *amanah*.

**B. Accountability of All Corporate Governance Players**

The above provisions were related to the accountability of directors for committing any misconduct with respect to their *amanah*. Here in the provisions below, in addition to directors, all other persons, who are involved in such misconduct, shall be held accountable. The provisions are discussed below.

**Section 157 of CO, 1984**

Under sub-section (1) of Section 157 of CO, 1984, a “statutory meeting” is the first meeting, which is held after three months from the date of commencement of the company’s business, but not later than six months from such commencement. Similarly, a “statutory report” under sub-section (2) of the Section, is the first report prepared by directors before “statutory meeting” is held. Sub-section (3), (4) and (5) of Section 157 state contents of statutory report, which include the following:

a) Number of allotted shares;

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587 *Ibid, Section 236(4)(a).*  
588 *Ibid, Section 157(1)*  
589 *Ibid, Section 157(2).*
b) Amount received with respect to such shares;

c) Information regarding directors, CEO, Company Secretary, legal advisor and auditors with respect to their names, occupation and addresses;

d) Extent of carrying out and non-carrying out of underwriting contracts, if any, along with reasons;

e) Particulars of brokerage/commission fees paid for issuing of shares;

f) Account of state of affairs of company in brief.\(^{590}\)

Under sub-section (2) of Section 157, the statutory report shall be sent by directors to every member before Statutory Meeting, whereas, subsection (6) of the Section requires them to ensure that five copies of the report are sent to registrar for registration.\(^{591}\) If any person is involved in making default with respect to any of the above mentioned requirements of Section 157, he shall be liable under clause (a) of sub-section (11) of the Section, to a fine from ten to twenty thousand rupees, and to a further fine of two thousand rupees per day if the default continues.\(^{592}\)

All the above mentioned CG players are held accountable for their actions, who make willful defaults.

**Sub-Section (1) to (4) of Section 158 of CO, 1984**

Section 158 of CO, deals with holding AGM every year, its notice to members and place of holding. Any person, who makes default with respect to AGM in the above cases, shall be liable under clause (a) of sub-section 4 of the Section, to fine from forty thousand rupees to five hundred thousand rupees, and to a further fine up to two thousand rupees per day, in case the default continues.\(^ {593} \) Under this section, any CG player who makes willful default in performing his *amanah*, is held accountable.

\(^{590}\) Ibid, Section 157(3),(4) & (5).

\(^{591}\) Ibid, Section 157(6).

\(^{592}\) Ibid, Section 157(11)(a).

\(^{593}\) Ibid. Section 158(4)(a).
Sub-Section (8)(a) of Section 159 of CO, 1984

The Section 159 deals with calling of Extra Ordinary General Meeting (EAGM) by directors or members of the company and requirements relevant thereto. In case of any default by any person, an amount of ten thousand to twenty thousand rupees shall be imposed as fine on him under sub-section (8)(a) of the Section 159, and to a further fine up to two thousand rupees per day under the same sub-section, if the default continues. According to this sub-section every person is held accountable, who does not perform his amanah.

Sub-Section 8(a) of Section 160 of CO, 1984

This section is related to General Meeting, quorum and voting rights of members therein. Under its sub-section (8)(a), if any officer of the company makes default with respect to above functions as provided in the Section, he shall be fined up to fifty thousand rupees, and be further fined up to two thousand rupees per day in case the default continues. Under this section, any CG player is accountable who makes default in performing his amanah.

Section 173 of CO, 1984

Under sub-section (1) of the Section 173 of CO, 1984, it is required from companies to record minutes of meetings of members, directors and committees of directors, in proper books, which shall be kept at the registered office of the companies under sub-section (4) of the Section. In case of default, sub-section (5) of the Section makes every person, being involved in such default, shall be fined up to five thousand rupees, and be further fined up to one hundred rupees per day in case the default continues. Further, under sub-section (6) and (7) of the Section, the books shall be open for inspection by members,
and every member has the right to receive attested copy of the minutes respectively. If any officer makes default in these cases, then under sub-section (8), he shall be fined up to one thousand rupees and be further fined fifty rupees per day, in case of continuance of such default. Under the above Section all those persons are held accountable who make willful defaults in performing their actions.

**Sub-Section (1) and (2) of Section 197 of CO, 1984**

Sub-section (1) of the Section 197 of CO, 1984 prohibits companies from political contributions. If any director or other officer is involved in such contribution, he shall be liable to imprisonment up to two years under clause (ii) of sub-section (2) of the Section. We can say that a director or any other officer, who commits misconduct in performing his *amanah*, is held accountable under the sub-section (2).

**Sub-Section (1) and (2) of Section 197-A of CO, 1984**

Companies are prohibited from distribution of gifts to its members under sub-section (1) of Section 197-A of CO, 1984. If any person contravenes this sub-section, then under sub-section (2) of the Section, he shall be fined up to five hundred thousand rupees. This section holds any person as responsible who makes default while performing his *amanah*.

**Section 198 to 204 of CO, 1984**

Section 198 to 203 of CO, 1984 deal with appointment of first CEO, his sub-sequent appointment, terms of his appointment, restriction on his appointment, his

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598 *Ibid,* Section 173(8).
599 *Ibid,* Section 197(2)(ii).
600 *Ibid,* Section 197-A(2).
601 *Ibid,* Section 198(1).
602 *Ibid,* Section 199(1).
603 *Ibid,* Section 200(1).
604 *Ibid,* Section 201(1).
removal\textsuperscript{605} and restriction on his competing business with the company\textsuperscript{606} respectively. If any person makes default in the above mentioned functions, he shall be liable under Section 204 to fine up to ten thousand rupees, and may also be restrained from becoming director or CEO for a term not more than three years\textsuperscript{607}. In this section all those CG players are held accountable for misconduct in performing their actions which are amnah with them.

\textbf{Section 215 of CO, 1984}

Sub-section (1) of Section 215, restricts interested officer from entering into any contract or arrangements with the company unless the contract or arrangement is approved by BODs. If any person does not fulfill this requirement, then under sub-section (2) of the Section, the defaulter shall be fined up to five thousand rupees\textsuperscript{608}. Under this section the persons are held accountable in case of non-observance of \textit{amanah} in performing their actions.

\textbf{Section 220 of CO, 1984}

Sub-section (1) of Section 220 requires every company to keep register in which shares and debentures of directors, CEO, Secretary, Chief Accountant and auditor are to be entered. Under sub-section (7) of the Section, it is required that the register shall be open for member during the AGM\textsuperscript{609}. If default is made in keeping the register or recording the shares and debentures then under sub-section (8) of the Section, the person who involves in such default shall be fined up to ten thousand rupees. Further, if the register is not accessible to members during the AGM, the same sub-section (8) also imposes a fine up to ten thousand rupees upon the person who is part of such default\textsuperscript{610}. This sub-section

\textsuperscript{605}Ibid, Section 202(1).
\textsuperscript{606}Ibid, Section 203(1).
\textsuperscript{607}Ibid, Section 204.
\textsuperscript{608}Ibid, Section 215(2).
\textsuperscript{609}Ibid, Section 220(7).
\textsuperscript{610}Ibid, Section 220(8).
declares any CG player as liable for his actions, who commits misconduct in performance of his *amanah*.

**Sub-Section (1) and (3) of Section 221 of CO, 1984**

Directors, CEO and other officers of the company are required under sub-section (1) of Section 221 of CO, 1984, to disclose those matters to the company that would enable the company in registering their shares and debentures. If any person willfully does not do so, then under sub-section (3) of the Section 221, he shall be imprisoned up to two years or fined up to five thousand rupees or both\(^{611}\). This sub-section declares the director and CEO responsible who do not execute their *amanah* of disclosure properly.

**Section 230 of CO, 1984**

Under sub-section (1) of Section 230 of CO, 1984, a listed company is required to keep proper books of accounts. The accounting records shall be kept for last ten years under sub-section (6) of the Section\(^{612}\). If default is made in such record keeping, then under sub-section (7), every director, CEO and Chief Accountant shall be imprisoned up to one year and fined from twenty to fifty thousand rupees, and to a further fine of five thousand rupees per day in case the default continues\(^{613}\). According to this section all directors, CEO and Chief Accountant are held responsible for misconduct during the course of executing their *amanah*.

**Section 233 of CO, 1984**

According to sub-section (1) of Section 233 of CO, 1984, it is the duty of directors to keep before members of the company in AGM, the Annual Accounts and Balance Sheet. The accounts and balance sheet duly audited under sub-section (3) of the Section and accompanied by reports of auditor and directors, shall be sent to SECP and concerned

\(^{611}\) *Ibid*, Section 221(3).

\(^{612}\) *Ibid*, Section 230(6).

\(^{613}\) *Ibid*, Section 230(7).
Stock Exchange as required in sub-section (4) of the Section\(^{614}\). If any default is made with respect to above requirements, then under sub-section (7) of the Section 233 of CO, any person involved in such default shall be imprisoned up to one year and fined from twenty to fifty thousand rupees, and to a further fine up to five thousand rupees per day, if the default continues\(^{615}\). Under this section all those CG players are held accountable who commit misconduct in their *amanah*.

**Sub-Section (1) and 3(a) of Section 242 of CO, 1984**

Sub-section (1) of the above Section 242 of CO, 1984 requires that at least three copies of balance sheet, profit and loss account and reports thereon, duly signed by directors, CEO, Chairman and auditors, shall be sent to registrar. If default is made by the company in this regard, then according to sub-section (3)(a) of the Section, every person who is part to such default, shall be fined up to ten thousand rupees, and further up to two hundred rupees per day, in case the default continues\(^{616}\). According this section those CG players are made liable for their actions who commit misconduct while performing their *amanah*.

**Sub-Section (1) and (3) of Section 245 of CO, 1984**

Under clauses (a) and (b) of Section 245(1) of CO, 1984, at least three copies of quarter financial statements shall be prepared and transmitted to members, concern Stock Exchange at which its shares are listed, and Registrar/SECP. In case of default by the company, any director, CEO and Chief Accountant who were involved in such default, shall be fined up to one hundred thousand rupees, and in case the default continues, to a further fine up to two thousand rupees per day as provided in sub-section (3) of the Section\(^{617}\). The director, CEO and Chief Accountant, who misconduct in their actions, are liable under above section.

\(^{614}\) *Ibid*, Section 233(4).

\(^{615}\) *Ibid*, Section 233(7).

\(^{616}\) *Ibid*, Section 242 (3)(a).

\(^{617}\) *Ibid*, Section 245(3).
Sub-Section (1) and (2) of Section 246 of CO, 1984

The Commission is empowered under sub-section (1) of Section 246 of CO, 1984 to require from any company to prepare any periodical statements or other reports in the manner the commission thinks fit, and be sent to any person as the commission directs, including members, registrar and the concern Stock Exchange at which its shares are traded. If the company does not comply with such requirement of the Commission, then under sub-section (2) of the Section, every officer who was willfully involved in such default shall be fined up to one million rupees and be further fined up to ten thousand rupees per day if the default continues. Under this section, all those CG players are made liable who do not perform their amanah in the manner they are required. They shall be further fined up to ten thousand rupees per day if the default continues.

Sub-Section (7) of Section 255 of CO, 1984

Any person, who does not let an auditor to access information in his custody, or does not give notice to auditor for AGM, shall be fined up to five thousand rupees under sub-section (7) of Section 255, and in case of continuance of such default, shall be fined up to one hundred rupees per day. Here under this section too, any CG player who does any misconduct while performing his amanah, shall be liable.

Section 261 of CO, 1984

Under sub-section (1) of Section 261 of CO, 1984, registrar has the power to call for any information, books or paper etc from the company and its past as well as present directors, officers and auditor. It is their duty under sub-section (2) of the Section, to provide such information to the registrar. If any person does not comply with this requirement, he shall be punished for a term of one year imprisonment and be fined under

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618 Ibid, Section 246(2).
619 Ibid, Section 255(7).
620 Ibid, Section 261(2).
sub-section (4) of the Section\textsuperscript{621}. Under the section 261 of CO, 1984, any CG player shall be liable who is involved in any misconduct during the course of performing his *amanah*. In the above provisions it has been verified that corporate governance players are held liable for committing misconduct or willful defaults in performing their actions. So, it is argued that these provisions are usually compatible with the Islamic corporate governance principle of *amanah* because, the rule of *amanah* is that in case of negligence or misconduct (intentionally) in performing their *amanah*, the *amanah*-holders shall be held liable. However, rest of all the provisions of Pakistani regime relating to corporate governance are silent and do not provide any expressed consequences for the non-compliant actions of the corporate governance players\textsuperscript{622}. Where the Islamic corporate governance principle of *amanah* cannot be verified to the extent of non-availability of consequences in case of any non-compliance on the part of any corporate governance player.

Further, the Pakistani SGF is silent regarding the accountability of corporate governance in case of their non-compliance with the provisions of the SGF (which expressly mentions the roles and responsibilities of different corporate governance players). So, it is concluded that the principle of *amanah* is not verified to the extent of accountability of Islamic corporate governance players for their non-compliance with the provisions of the PSGF.

**II. Application of *Mas’oliyyah* (Accountability)**

Like we did in the case of Malaysia, here we will discuss only those provisions of Pakistani regime from which the worldly accountability of corporate governance is proved. The non-compliance in the actions of the corporate governance players shall be taken as test for the verification of the principle of accountability.

\textsuperscript{621}Ibid, Section 261(4).

\textsuperscript{622}All provisions other than the provisions brought under discussion in this study.
A. Worldly Accountability of ICG Players for Their Non-Compliant Actions

Like Malaysia, from the examination of the relevant provisions of Pakistani regime relating to corporate governance also, it is inferred that there are at least two consequences for non-compliant actions of the ICG players namely their removal from the office and imposition of penalty or imprisonment for some period\textsuperscript{623}. Here, only those provisions shall be discussed below, which deal with the removal of corporate governance players for their non-compliant actions.

1. Removal of Directors

Under sub-section (1) of Section 181 of CO, 1984, company has the power to remove directors.

a) Reason for Removal of Directors by Members

In Section 181 of CO, 1984, no expressed reasons for the removal of directors have been given, which means that members have absolute power to remove directors for no reasons. However, normally they would be removed when they do not protect the interests of the members.

Removal of directors by members without any reason shows that they are absolutely accountable to members for their actions. As nothing, in the removal of directors for their actions, is against the Islamic corporate governance principle of *amanah*, therefore it is argued that the above provision is compatible with the principle.

2. Removal of CEO

Under Section 202 of CO, 1984, directors as well the company have the power to remove CEO.

\textsuperscript{623} For discussion on imposition of fine and imprisonment for some period, please refer to page …. Of Part C of this chapter.
a) **Reasons for Removal of CEO**

Noting has been provided in the above section 202 of CO, 1984, as to why CEO can be removed from his office? Their removal by the company and directors suggests that they are responsible to directors and members, because they may be removed at any time as and when the COE’s actions are detrimental to the interests of the company.

As nothing, in the removal of CEO for his actions, is against the Islamic corporate governance principle of *amanah*, therefore it is argued that the above section is compatible with the principle.

b) **Powers of SBP to Remove Directors, CEO and Other Officers**

Sub-Section (1) of Section 41-A of BCO, 1962 mentions some reasons on the basis of which the SBP has the power to remove directors, CEO and other officers. The reasons are:

a) When their actions are detrimental to the interests of the bank and its depositors;

b) When their actions are undesirable to SBP

c) When it is in public interest\(^{624}\).

Banks are important organizations, which act as custodian of the public money. As intermediaries between depositors and borrowers, the banks must have good reputation, which cannot be achieved without proper corporate governance system. The functions of banks are sustained as long as its customers as well as the general public have confidence in them. To maintain their confidence, it is very much crucial that the banks must have implemented a strong and good corporate governance system\(^{625}\). The directors, CEO and other officers are important players of the corporate governance system. If they show misbehave or misconduct by not protecting the interests of the banks or their depositors, they are not entitled to remain on their positions. Therefore, under the above provisions,

\(^{624}\) *The Banking Companies Ordinance*, 1962(LVII of 1962), Section 41-A(1).

the SBP has the power to remove them from their offices. Further, the SBP acts as regulator of banks. If it thinks fit that any director, CEO or other officer of the bank is no more desirable to remain as director or other employee, or it decides in the public interest that a director or other officer should no more remain on his post, the SBP has the power to remove him from his office.

Removal of directors, CEO and all other officers by the SBP, for the reasons mentioned above shows that they are accountable to SBP for their actions, which shows that this section is in conformity with the Islamic principle of accountability.

3. Removal of SB Members

Under clause (ix) of Section 3(A) of PSGF, an Islamic banking Institution has the power to remove members of SB, however, prior approval shall be sought from SBP for such removals.626

a) Reasons for Removal of SB Members

The Pakistani SGF does not mention any specific reason for the removal of SB members. Clause (ix) of Section 3(A) of Pakistani SGF, only requires detailed rationale and documentary evidences to be submitted to SBP for the removal of the members of SB.627 Submitting detailed rationale and documentary evidences for the removal of SB members shows that the SB members are removed for some reasons. Although no expressed reasons have been provided such removals, but it is inferred that any negligent or incompetent member can be removed. Similarly, if any member does not perform his responsibilities required from him under the PSG, he may be removed.

The removal of the SB members from their offices for incompetency, negligence or any other non-compliant act, reflects that they are accountable for their actions, hence it is


627Ibid.
argued that the Islamic principle of accountability is complied with here in the above clause.

4. Removal of Auditor

a) Removal By Members

Under Sub-Section (1) of Section 252 of CO, 1984, auditor is removed by members through special resolution\textsuperscript{628}.

In the above section no reason has been specified for the removal of auditors by the members.

b) Removal by Directors

Clause (xxix) of the Code, 2012 empowers directors to remove auditor upon the recommendation of the Audit Committee\textsuperscript{629}. In this clause too, no reason for his removal has been specified.

c) Removal by SBP

According to sub-Section (3) of Section 35 of BCO, 1962, SBP has the power to revoke an auditor’s appointment or to remove him from his office\textsuperscript{630}.

d) Reasons for Removal of Auditors

As mentioned above, neither the Code, 2012 nor the CO, 1984 mentions any reason for removal auditor, therefore, directors and members can remove auditors as and when they think fit. It means that auditors are absolutely accountable for their actions to members. However, the SBP gets such power to remove an auditor on the basis of some reasons, which are mentioned in para (6) of BSD Circular No. 03 of 2003.

The reasons are:

\textsuperscript{628} The Companies Ordinance, 1984 (XLVII of 1984), Section252(1).
\textsuperscript{630} The Banking Companies Ordinance, 1962(LVII of 1962), Section 35(3).
(i) If substantial misstatements are found in the report that would have material impact on the position of the bank if statements would have been stated otherwise;

(ii) If incorrect information are provided in the application form submitted to SBP for upgradation etc;

(iii) If the auditor fails in maintaining periodically (every two years) a satisfactory position on the Quality Control Review program of ICAP;

(iv) If any material change in structure or nomenclature was not communicated to SBP within 14 days from such change;

(v) Similarly, if information required by SBP are not provided by the auditor within the time limit.\textsuperscript{631}

The above mentioned are the situations in which the SBP attains powers to remove auditor from his office. From these instances it is clear that the auditors are accountable to SBP when their actions are in non-compliance with the requirements of SBP. For example, material misstatement in the auditor’s report that might effect the position of bank, is a misconduct on the part of auditor. Similarly, providing incorrect information to SBP is also a misconduct. Further, non-maintainability of a periodic satisfactory position on the Quality Control Review Program of ICAP, show incompetency of auditors. Likewise, Non-disclosure of change in the structure or nomenclature of audit firms, or negligence in disclosure of any information as and when required by the SBP also tentamount to misconduct of auditor.

So, it is inferred that all misconducting, incompetent and negligent auditors are removed from their offices by the SBP. Removal of the auditors for committing any of the above mentioned misconducts, shows that they are accountable for their actions. The

accountability of the auditors for their non-compliant actions suggests that this practice is in compliance with the Islamic corporate governance principle of accountability.

From the above discussion, it is concluded that the provisions of Pakistani regime relating to Islamic corporate governance practices in IBIs are conforming to the Islamic corporate governance principle of mas’oliyyah. In the above provisions, the principle of accountability is verified to the extent that the ICG players are held accountable for their non-compliant actions. But these provisions are fewer in number, and there are so many other provisions⁶³², which are silent regarding the accountability of the corporate governance players in case of their non-compliant actions, especially, in the cases of non-compliances with shariah. Therefore, it is argued that the principle of mas’oliyyah cannot be verified in the provisions of the SGF to the extent of the ICG players’ accountability for their non-compliant actions, except the members of the SB.

III. Application of Shafafiyyah (Transparency)

In the previous chapter i.e. chapter no. 4, for the sake clarity we defined some disclosure elements to be discussed in the light of the Islamic corporate governance principle of shafafiyyah. The elements are: Balance Sheet, Profit and Loss Account, notes appended thereto, Directors’ report, auditor’s report, internal Shar’iah review report, internal Shar’iah audit report, external Shar’iah audit report and Shar’iah Board report. So, in this chapter the above mentioned elements shall be analysed in the light of Islamic corporate governance principle of shafafiyyah.

A. Financial Statements

With respect to this study, the financial statements include balance sheet and profit and loss account. Balance sheet shows assets and liabilities of a company, whereas, profit and loss accounts shows performance of a company in a financial year. It is mandatory under

⁶³² All the provisions of the Pakistani regime, other than those which are brought under discussion in this study.
sub-section (1) of S. 234 of CO, 1984 that profit and loss account and balance sheet give “true and fair view” of profit and loss of the company for financial year and financial position at the end of the year respectively.

1. To Whom Financial Statements are Disclosed?

Under sub-section (1) of section 233 of CO, 1984, financial statements are disclosed before members in AGM. Sub-section (4) of the Section requires company to keep its copies at registered office for inspection of the members. Further, sub-section (5) of the section requires that five copies of financial statements shall be disclosed to SECP/Registrar and respective Stock Exchange at which shares of the company are registered. Further, three copies of the statements shall also be submitted to SBP under section 36 of BCO, 1962.

From this discussion it is inferred that financial statements shall be disclosed to the following important users.

a) Disclosure to Members

The shareholders and directors are among important members of companies and banks, hence they need to be well-aware about their activities. This will help the directors in evaluating the past results of the Islamic banks as well as in making strategies for enhancing the IBIs performance in future. Likewise, the information’s disclosure to shareholders will provide them an opportunity to know about the financial position and performance of their investee IBI. Based on the disclosure of financial statements to members, it is argued that Islamic principle of disclosure is complied with herein the above provisions.

633 The Companies Ordinance, 1984 (XLVII of 1984), Section 233(4).
634 Ibid, Section 234(1).
635 Ibid, Section 233(5).
b) Disclosure to SBP

The information disclosure to the SBP is the responsibility of the banks, because it acts as their regulator. The regulator keeps the banks on the right track by issuing guidelines and policies. The regulator can be able to take necessary measures only when it will be aware of the instances of non-compliances. This information disclosure to the SBP is *amanah* of the IBI.

c) Disclosure to SECP

The SECP regulates listed companies in Pakistan. Islamic banks, being public listed companies are also regulated by the SECP, in addition to SBP. Therefore, it is necessary that all affairs of Islamic banks are open to SECP. As the financial statements are important tools of disclosure of financial position and performance of a company, hence the above provision requires that these tools of disclosure shall be disclosed to SECP. With such disclosure, transparency in the activities of the IBIs shall be enhanced. It will also enable the SECP to take corrective measures in instances of non-compliances, if any.

Based on the disclosure of financial statements to all the important stakeholders, it is argued that the Islamic corporate governance principle is complied with in the above provisions.

B. Auditor’s Report

In the auditors’ report, it is stated whether the financial statements of a company give a true and fair view of the company’s affairs or profit or loss or not? To make sure the correctness of the information provided in financial statements of the Pakistani

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637 State Bank of Pakistan, Policies for Promotion of Islamic Banking, BPD Circular No. 01 of 2003, Annexure-1 clause (i), <http://www.sbp.org.pk/bpd/2003/C1.htm> Lastly accessed on 05/01/2015.
638 Such as non-compliance with the provisions of the revised code of corporate governance, 2012.
639 The Companies Ordinance, 1984 (XLVII of 1984), Section 255(1).
companies, the auditors check and include in their report, all significant information regarding the affairs of the companies. The information provided in the auditors’ report shows that the financial statements are extensively analysed by the auditors. Resultantly, it makes it easier to identify any fraud or irregularity in the financial statements. So, the job of auditors is basically an important check over the activities of the companies through increased transparency. This job of the auditors is confirming to the Islamic principle of *shafafiyyah*.

1. To Whom Auditor’s Report is Disclosed?

Under sub-section (1) and (4) of S. 233 of CO, 1984, the auditors’ report shall be disclosed to members of company in AGM and before AGM respectively. The same sub-section (4) also requires keeping of the audit report on the registered office of the company. Under S. 255(3)(a) of CO, 1984 requires auditors to state whether they have acquired all the information and explanation necessary for audit? Under S. 35(7)(a) of BCO, 1962, he will also state whether such information are satisfactory for the audit purpose. Similarly, Section 255(3)(b) of CO, 1984 requires auditor to confirm whether proper books of accounts are kept by the company. The regime also requires an auditor under section 255(3)(c) to confirm that balance sheet and profit and loss accounts are prepared in accordance with the provisions of the CO, 1984 of Pakistan. Furthermore, sub-clauses (i) and (ii) of clause (d) of subsection (3) of section 255 of CO, 1984, require auditor to state whether the accounts give true and fair view of the profit and loss and affairs of the company. Clause (c) of subsection (7) of Section 35 of BCO, requires auditors to report whether returns received from branch offices are adequate? Under section 35(7)(e) of BCO of Pakistan, an auditor is empowered to disclose any other matter which in his opinion is necessary to be brought into the notice of shareholders.

Moreover, the Pakistani regime, requires an auditor under section 35(7)(b) of BCO to state whether the transaction entered into by the banking company is within the powers of the bank. Similarly, according to section 255(3)(e)(i) & (ii) of CO, the auditor has to confirm that the expenditures incurred by the company were for the purpose of the company and the business conducted, investment made is in conformity with the company’s objects.

So it is concluded that the contents of auditors’ report shall include information about:

1. Completeness of information required for audit purpose;
2. Proper book keeping of accounts by the company;
3. Preparation of balance-sheet and profit and loss accounts in conformity with BCO, 1962;
4. True and fair view of state of affairs of company;
5. True and fair view of the profit and loss;
6. True and fair view of changes in financial position of company or of sources and uses of funds;
7. Confirmation of expenditures that they were made for the purpose of company’s business;
8. Confirmation of businesses and investments that they were in conformity with the objectives of the company;
9. Confirmation about the deduction of zakat and its deposit in the Central Deposit Fund;
10. Satisfactory position of information received by auditors;
11. Confirmation of transactions that they fall within the powers of the bank;
12. Adequateness of returns received from branch offices of the banking company.

The above list suggests that reasonable and relevant information are disclosed in auditors’ report under Pakistani regime. Hence, it is said that auditors follow the Islamic corporate governance principle of transparency.
company for members’ inspection. Further, sub-section (5) of the Section 233 of CO, 1984, requires companies to send auditor’s report to SECP, registrar and the Stock Exchange on which securities of the company are listed. Section 36 of BCO, 1962, requires that auditors’ report shall be sent to SBP.

Based on this discussion it is stated that the auditor’s report is disclosed to the following important stakeholders.

a) Members of Company

It is mandatory under sub-section (1) of S. 234 of CO, 1984 that profit and loss account and balance sheet give “true and fair view” of profit and loss of the company for financial year and financial position at the end of the year respectively. This is because these statements are the basis, which users use to evaluate financial position, profitability and future prospects of businesses. Therefore, the users need some reasonable assurance to believe that the information given in the financial statements are correct. This reasonable assurance to the users is provided by the auditors through their report. The auditors report is the most important document that can affect (change) mind of members while making decision with respect to their investments. If the report verifies that the information in the financial statements are correct, this will give confidence to members that their investee company is performing efficiently. On the other hand, if the auditors report finds some major mistakes, irregularities or incorrect information, the members will be able make suitable decisions in those particular circumstances. The responsibility of the auditors, to verify the correctness of information given in financial statements, and subsequently disclosing their report to members, is in conformity with the Islamic corporate governance principle of shafafiyyah.

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641 The Companies Ordinance, 1984 (XLVII of 1984), Section 233(4).
642 Ibid, Section 234(1).
b) SBP

As stated earlier that the SBP can take appropriate actions only when all information are disclosed to it. The auditor’s report is very much significant in this regard because the report is expected to disclose all the instances of non-compliance to the SBP. In this way the SBP will be able to suggest corrective measures to make the default good. Thus a law abiding as well shariah compliant environment shall be ensured.

c) SECP

All the listed companies in Pakistan are regulated by the SECP, which ensures compliance of the companies with provisions of corporate governance framework, therefore, it is the duty of the companies to disclose all relevant and correct information to it. As the correctness of information is verified by the auditors, therefore, it is required that auditors’ report is also sent to SECP in addition to all other information. With the help of auditor’s report, the instances of non-compliance\textsuperscript{644} or irregularities if any, shall be identified and transmitted to SECP, and the SECP shall be able to propose corrective measures. So, it is clear that disclosure of auditor’s report to SECP is necessary. Based on disclosure of the auditor’s report to the above mentioned important stakeholders, it is opined that the above provisions of the Pakistani regime are compatible with the Islamic corporate governance principle of \textit{shafafiyyah}.

C. Directors’ Report

A report prepared by directors of a company is called directors’ report. It deals with the state of affairs of the company at the end of financial year\textsuperscript{645}. Sub-section (1) of Section

\textsuperscript{644} Such as non-compliance with the provisions of the revised code of corporate governance, 2012.

\textsuperscript{645} The Companies Ordinance, 1984 (XLVII of 1984), Section 236(1).
236 of CO, 1984 requires directors to disclose the recommended amounts of dividends to be paid to shareholders.\textsuperscript{646}

Disclosure of the amounts of dividends to be paid to shareholders is necessary because such disclosure shall increase transparency in the profit distribution process. Disclosure to investment account holders about the dividend amounts, is significant because it will give an opportunity to the IAHs to decide about their business relationships with the banks in future. For example, if the IAHs have some concerns over the profit ratio of shareholders, they might not continue their business relations with the IBIs in future.

Under clause (a) of the sub-section (2) of the section, any material changes or commitments made by the company, which occur between the end of the financial year and the date of the report, shall be disclosed in the directors’ report if such events affect financial position of company.\textsuperscript{647}

Normally information relating to last preceding year (till the end of the year) are disclosed. However, according to above provision, if any material changes in transaction or commitments of the company occur, even if the events occur after the end of the financial year. It shall be disclosed in the directors’ report. Such information disclosure is necessary, otherwise, the financial statements shall be considered as misleading which shall include misstatements. Such misstatements shall obviously misguide the users while making their decisions.

Clause (c) of the sub-section (2) requires disclosure of full information and explanation in directors’ report on any observations, reservations, qualification or adverse remarks, which auditors have, with respect to financial statements. The auditors’ report has very much significance. If the report does not verify that the financial statements represent true and fair view of the company’s affairs, it will certainly create a panic among stakeholders...

\textsuperscript{646} Ibid.
\textsuperscript{647} Ibid, Section 236(2)(a).
(especially shareholders and investment account-holders). They will need answers and explanation regarding the company’s affairs. In this case the report of directors (being policy makers and decision makers) has very much significance. To erase the doubts of the depositors and shareholders and satisfy them, full information disclosure and explanation in this regard, is the responsibility of the BODs.

In clause (g) of the section, directors shall disclose in their report, reasons for the losses if any to the company along with reasonable indications of future profits\textsuperscript{648}. If unfortunately, any company undergoes any loss in business, the directors shall disclose reason of such loss. They are also required to disclose reasonable indications of profits in future, if any. From disclosure of such information in the directors’ report it appears that directors are working in responsible way. Similary, disclosure of future prospects of on profits will give confidence to shareholders and investment account holders.

Further, clause xvi of the Code, 2012 also requires from listed companies to attach to the directors’ report a “statement” relating to following information:

i. That the financial statements disclose cash flows, changes in owners’ equity, results of company’s operations and fair state of company’s affairs;

ii. That the company has kept proper books and accounts;

iii. That prudent judgments have been applied in making accounting estimates;

iv. That IFRS have been followed, and proper disclosure has been made in case of departure;

v. That internal control system has been soundly implemented;

vi. That the company is able beyond doubt to continue as going concern.\textsuperscript{649}

\textsuperscript{648}Ibid, Section 236(2)(g).

Reporting on the correctness as well as completeness of information in the financial statements, which are made according to approved accounting standards, shall enhance confidence of the users that the information appearing on the face of financial statements are correct. Such confidence of the users shall further strengthen business relationships between the company (including Islamic banking company) and its clients. It will also persuade the prospective clients to develop business relations with the company.

Similarly, stating in the report that internal control system has been soundly implemented shall give confidence on smooth operations of the company, to the users. This is because, policy-making on the internal control system is the responsibility of the board, whereas, its implementation is the job of management. The board is also responsible to oversee that such policy is implemented. When the board itself testifies that sound internal control system has been implemented, it will for sure give confidence to users.

Further, the board is also required to state that the company is capable of carrying on its business in near future. Such surety to users of going concern is necessary because, the functions of banks are sustained as long as its customers as well as the general public have confidence in them. It means, if the bank is not expected to be as going concern in the near future, public will not trust it any more. Once, it loses public confidence, it loses all its deposits and the bank will collapse in no time. So, in order to protect public (at least prospective clients) from any loses, directors are required under the above clause (xvi) of the Code, 2012 to verify whether the company will be a going concern business in the near future beyond doubt?

From all the above-mentioned information disclosure in directors’ report, it appears that significant information are disclosed in the report. Based on such disclosure requirements,

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it is argued that the Islamic principle of transparency is complied with in the above provisions.

1. To Whom Directors’ Report is Disclosed?

From the wordings of Section 236(1) of Companies Ordinance, 1984 of Pakistan, it is clear that directors’ report is attached to every balance sheet, hence, it is clear that the report is disclosed to all those persons to whom a balance sheet is disclosed. As under Section 233(1), (4) and (5) of CO, 1984 and Section 36 of BCO, 1962, balance-sheet is to be disclosed to members of company, SECP and SBP therefore, directors’ report is also disclosed to them.

a) Members of company

Disclosure of director’s report to members is their right because they are important stakeholders in the form of directors, officer and shareholders, who have stakes attached to the company. Such disclosure to members enhances transparency in the activities of company. The information are helpful to the members in their decision makings with respect to their business relationships with the company in future. This disclosure of information to these stakeholders is in line with the Islamic corporate governance principle of transparency.

b) SECP

SECP acts as regulator of listed companies (including Islamic banking companies), which needs to be informed of material information such as director’s report to take appropriate measures in case of any violations of the provisions of the corporate governance regime. Therefore, disclosure of the above information to SECP suggests that Islamic corporate governance principle of shafafiyyah is being observed.
c) SBP

All the banking companies are regulated by the SBP, which requires that all significant matters are disclosed to it so that it can satisfy itself that all operations of the bank are in compliance with laws and practices of banks as well as shariah principles. The SBP has the powers to take corrective measures in instances of non-compliances of the banks. Therefore, directors’ report shall be disclosed to SBP. From here also, it is clear that Islamic corporate governance principle of Shafafiyyah is complied with.

D. Internal Shariah Auditor’s Report

According to clause (v) of Section 6 of PSGF, Internal Shariah Audit Unit shall prepare a report, which shall be submitted to SB for prescribing corrective measures. For the purpose of information and ensuring compliance with the instructions of the SB, clause (vi) of the Section 6 requires submission of the final report, along with corrective measures prescribed by SB, to Board Audit Committee (BAC).

Independent assessment of products and services offered by Islamic banks is necessary in order to verify whether they are in conformity with Islamic law or not? If not, necessary measures shall be suggested by the SB to make the defaults good and shariah compliant. Suggesting corrective measures in instances of non-compliance is possible only when the SB is aware of the instances. Here the internal shariah audit plays a significant role of disclosing the internal shariah audit report to SB. The corrective measures are implemented by the Shariah Compliance Department of Islamic banks.

Further, the above provision also requires disclosure of the shariah audit report along with corrective measures suggested by the SB, to Board Audit Committee (BAC).

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652 Ibid, Section 6(v) & (vi).
653 Ibid, Section 5(v).
Disclosure of the information to BAC has the purpose to enhance transparency as well as shariah compliance in the activities of the IBIs. The disclosure of the internal shariah audit report in the above manner is conformity with the Islamic corporate governance principle of transparency.

E. External Shariah Audit Report

External Auditors shall prepare a report independently on shariah compliance of IBIs under Section 7 of PSGF. This section requires that the report shall be published as part of Annual Accounts of Islamic Banks. Under statutory law in Pakistan, the responsibility of external auditors is to verify whether the financial statements of companies represent true and fair of the companies’ affairs or not? But, when the auditors conduct audit of Islamic banks, the PSGF requires them to make additional assessment of the IBIs to verify whether the IBIs’ activities are shariah compliant? Such assessment is necessary because it verifies whether the IBIs are stick to their ultimate goal of shariah compliance or not? If not, then there remains no reason that can justify the very existence of the IBIs.

After examination of the IBI’s activities for verifying shariah compliance therein, the external auditors prepare their report, which is published with annual accounts of the IBIs. From the relevant provisions of Pakistani regime it is clear that annual accounts are disclosed to members of the company, SECP and SBP. So, the external auditor’s report on shariah compliance, shall also be disclosed to these users (stakeholders). Disclosure of the report to members shall give confidence to them if the report verifies that all the activities of the IBIs are in conformity with the principle of shariah. Similary, disclosure of the report to the regulators of Islamic banks shall enhance

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654 Ibid, Section 7.
655 The Companies Ordinance, 1984 (XLVII of 1984), Section 255(1).
656 The Companies Ordinance, 1984 (XLVII of 1984), Section 233(1), (4) and (5); The Banking Companies Ordinance, 1962, Section 36(1).
transparency in the activities of the IBIs. It will also enable the SBP to suggest corrective measures in case any IBI does not comply with *shariah* principles.

Based on the above discussion it is argued that disclosure of the external shariah audit report to stakeholders is in conformity with the Islamic corporate governance principle of *transparency*.

**F. Shari‘ah Board’s Report**

Under Section 3(E) of PSGF, the Shariah Board shall prepare a report on the overall shariah compliance environment and conditions of Islamic Banking Institution, which shall be published in the annual reports of the IBI\(^\text{657}\).

As stated above that annual financial statements are disclosed to members of the companies, SBP and SECP, therefore, the Shariah board’s report shall also be disclosed to these users. Sending the SB’s report to members shall give confidence to them that the IBIs’ activities are shariah compliant. Disclosure of the report to SBP will ensure the regulator that the IBI is complying with the shariah principles, SBP’s instructions, guidelines and Shariah governance framework. Similarly, disclosure of the report to SECP will enhance transparency in the activities of the IBIs, as well as ensure the regulator that the IBI’s activities are shariah compliant. Therefore, it is argued that such disclosure is in conformity with the Islamic corporate governance principle of *shafafiyyah*.

**1. Contents of Shariah Board’s Report**

According to Section 3 (E) of PSGF, the minimum contents of a Shariah Board’s report are given in Annexure-A to the SGF. By going through the format of the SB report, it is found that following elements are included in the report:

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a) In the first paragraph, the management accountability for shariah compliance as well as the SB responsibility to report on such shariah compliance is acknowledged;
b) It is stated in paragraph two that the SB report is formed on the basis of internal shariah review report, internal and external shariah audit reports;
c) In the opinion clause, opinion regarding following is given:
   (i) That Islamic bank has complied with Shariah rules and principles;
   (ii) That whether a comprehensive framework is in place to ensure shariah compliance;
   (iii) That sound system is in place to ensure that earnings from prohibited sources have been credited to charity account and properly utilized;
   (iv) That SBP instructions on profit and loss distribution and on pool management have been complied with;
   (v) That adequate resources have been provide to the SB to discharge its duties effectively.\(^\text{658}\)

From the contents of the SB’s report it is clear that sufficient information regarding compliance of the activities of the IBIs with shariah, are disclosed in the report. Such information disclosure on the degree of shariah compliance of the IBIs suggests that Islamic principle of transparency is complied with here in this report. Such disclosure shall give confidence to all the stakeholders such as the shareholders and investment account-holders. Thus the section 3 of the PSGF is conforming to the Islamic principle of shafafiyyah.

From the examination of the above provisions, it is concluded that they promote transparency in the activities of the Islamic banks as well as their CG players. Therefore, they are conforming to the Islamic corporate governance principle of shafafiyyah.

\(^{658}\)Ibid.
IV. Application of Principle of Khilafah

From the view\(^{659}\) of Maulana Maudoodi (R.A) about khaleefah and his authority, it is easily inferred that corporate governance players are also vicegerents of Allah, who have no authority to act beyond the commands of Allah. Being Allah’s vicegerents, they are bound to perform according to the wills of Allah and must not act beyond their authority as given to them as vicegerent.

Further, as mentioned earlier that the principle of vicegerency is linked to shariah compliance, therefore, the Islamic banks as well their corporate governance players are bound to ensure shariah compliance in their activities. As the SBP has issued the SGF to make sure that the businesses and operations of the IBs are conforming to the Islamic law, hence, in this part, the provisions of the SGF are analysed in the light of the principle of khilafah.

A. Role of Board of Directors\(^{660}\)

With respect to Islamic banks, the SGF requires particular role from the board. From the examination of the provisions of the SGF it was found that the BODs:

(i) has the ultimate responsibility and accountability for shari‘ah compliance in IBs\(^{661}\).

(ii) should be aware of the Shari‘ah non-compliant risks as well as its potential implications on the business and reputation of IBIs\(^{662}\).

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\(^{659}\) According to the Great thinker of Islam, Maulana Maudoodi (RA), the character of human’s vicegerency enjoins him to obey Allah’s commands in all aspects of his life, so that all his actions conform to the Allah’s commands. This is because vicegerent is the one who uses his delegated authority as sub-ordinate to his master. Being vicegerent, he has no personal authority except the authority, delegated by his master, thus one cannot act according to his own wishes rather than to fulfill his master’s wishes. In case he acts otherwise than the delegated authority, this leads to his betrayal from his Lord. (See, Syed Abu al-‘A’la Maudoodi, Tafheem ul-Qur’an, Lahore: Idara Tarjuman ul Qur’an (1949): p. 61-62.

\(^{660}\) Refer to page no. 115-116 for detail discussion on the role of BODs.

\(^{661}\) For further, details see page 195.

\(^{662}\) Refer to page no. 195 for more details.
(iii) Is also responsible to diligently oversee the functioning of the SGF as well as to oversee that all decisions, rulings and guidelines of SB are complied with\textsuperscript{663}.

(iv) To appoints members of the SB\textsuperscript{664}.

From all the above mentioned roles of the board it is clear that the board is working for ensuring shariah compliance in the activities of Islamic banks. As, shariah compliance is associated with the Islamic corporate governance principle of vicegereny, therefore, it is argued that being responsible for shariah compliance, the board is complying with the principle of khilafah.

**B. Management\textsuperscript{665}**

The management, being an important part of the internal structure of the IBs, to implement the rules of shariah, is important vicegerent of Allah. Therefore, under section 2 of the SGF, the management has the responsibility:

(i) To implement the decisions of the SB\textsuperscript{666}.

(ii) For arranging training and orientations programs on Islamic banking and finance for the board of directors and senior executives\textsuperscript{667}.

(iii) For initiating the orientation and sensitization programs for BODs and key executives to educate them about the business utility and importance of enabling shari’ah-compliant environment and key distinctive characteristics of shariah compliant products\textsuperscript{668}.

(iv) Of providing complete information regarding the matter referred to the SB, in which the guidance or fatwa from the SB is sought\textsuperscript{669}.

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\textsuperscript{663} See page no. 196 for details.
\textsuperscript{664} For details see page no. 197.
\textsuperscript{665} For detail discussion on the functions of management of IBs, please refer to page no. 118 of the thesis.
\textsuperscript{666} For explanation, see page no 198.
\textsuperscript{667} Find more details on page no. 199.
\textsuperscript{668} Consult page 199 for further details.
\textsuperscript{669} Refer to page no. 200 for complete explanation.
(v) To show no tolerance for any *shariah* non-compliant instances, and to take strict actions against those involved in the *shariah* non-compliant activities in his respective area\(^\text{670}\).

From all the above functions of management, it is clear that management is working for ensuring *shariah* compliance in the operations of Islamic banks. Hence, it is argued that they are fulfilling their responsibility of vicegerency because, as vicegerents of Allah, managers have responsibility to ensure *shariah* compliance. As the above provisions require the managers to ensure *shariah* compliance, therefore, in the opinion of the researcher, these provisions are in compliance with the Islamic corporate governance principle of vicegerency.

**C. Shariah Board**\(^\text{671}\)

Under section 3 of the SGF, the SB is:

(i) responsible to ensure that the IBIs’ products and services and other related documents, transactions, structures and product manuals etc are in accordance with the principles and rules of *shari’ah*\(^\text{672}\).

(ii) Required that before issuing any ruling or arriving at any decision, rigorous deliberations shall be made on all issues, which shall be properly recorded and documented along with the rationale for allowing or disallowing any product or service\(^\text{673}\).

(iii) Accountable for all its decisions and rulings\(^\text{674}\).

(iv) Responsible for giving advice to BODs and management on *shari’ah* related matters\(^\text{675}\).

\(^{670}\) See page no. 200 of the thesis for further details.

\(^{671}\) Please refer to page no. 200 of the thesis for further detailed role of the SB.

\(^{672}\) Find more details on page no. 205.

\(^{673}\) Please refer to page no. 205 for explanation.

\(^{674}\) Refer to page no. 206-207, where it has been discussed in detail.

\(^{675}\) See page no. 206-207 for explanation.
Further, it is preferred that the decisions are made through consensus of all the members of SB, however, in case of differences of opinions, decisions may be made on the basis of majority of shariah scholar members\textsuperscript{676}.

From the above mentioned roles of SB, it is clear that the SB ensures shariah compliance in the activities of Islamic banks, hence following the Islamic corporate governance principle of \textit{khilafah}.

\textbf{D. Shari’ah Compliance Department (SCD)\textsuperscript{677}}

According to S. 5 of the SGF, the SCD is responsible to/for:

(i) shariah compliance review\textsuperscript{678}

(ii) disclosure of all information including internal and external shariah audit reports and the SBP’s inspection team’s report on shariah compliance, to the SB\textsuperscript{679}.

(iii) implementation of the corrective measures suggested by the SB\textsuperscript{680}.

(iv) Ensure that necessary training has been given to the Islamic bank’s staff, and that refresher courses are organized for them\textsuperscript{681}.

From the above functions of SCD it is inferred that the department plays a significant role in ensuring shariah compliance in the overall activities of Islamic banks. As the shariah compliance is associated with Islamic corporate governance principle of vicegerency, therefore, it is argued that the provisions of the Pakistani SGF relating to the role of SCD, are in conformity with the principle of vicegerency.

\textbf{E. Internal Shari’ah Audit}

Independent assessment of products and services offered by Islamic banks is necessary in order to verify whether they are in conformity with Islamic law or not? If not, necessary

\textsuperscript{676} Section 3(C)(iii) of the PSGF.
\textsuperscript{677} For detailed role of the SCD refer to page no. 210
\textsuperscript{678} See more details on page no. 210-211.
\textsuperscript{679} For explanation see page no. 211.
\textsuperscript{680} Find more details on page no. 211.
\textsuperscript{681} Refer to page no. 212 for further explanation.
measures shall be suggested to make the defaults good and shariah compliant. The independent assessment for shariah compliance in the activities of IBIs is shariah audit. Although the Pakistani SGF under its Section 6 requires Islamic banks to establish Internal Shariah Audit Function, but it does not define any scope of the function. The scope setting is left to the description of the Shariah board. Further, the PSGF does not define any qualification criteria for internal shariah auditors, which puts a question mark on the competency of the auditors in conducting shariah audit.

In the presence of these discrepancies however, it is concluded that the existence of external shariah audit function inside Pakistani Islamic banks, has its own significance because, it will help in ensuring shariah compliance environment inside Islamic banks. Hence, its function is in conformity with the Islamic corporate governance principle *khilafah*.

**F. External Shari’ah Audit**

In Pakistan, the responsibility of external auditors is to verify the financial statements of companies represent true and fair of the companies’ affairs or not? But, when they conduct audit of Islamic banks, Section 7 of the SGF requires them to make additional assessment of the IBs to verify whether the IBs’ activities are shariah compliant? Such assessment is necessary because it verifies whether the IBs are stick to their ultimate goal of shariah compliance or not? Further, under the section 7, the external auditors are required to have experts for conducting shariah audit.

The requirement of conducting external *shariah* audit from the IBs is a significant step towards ensuring overall shariah compliance environment inside the IBIs. Hence, it is argued that the function is in conformity with the Islamic corporate governance principle of *khilafa*.

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682 *The Companies Ordinance*, 1984 (XLVII of 1984), Section 255(1).
However, the SGF does not mention any qualification criteria for external auditors who will be eligible for conducting external shariah audit of Islamic banks. This is a big flaw in the current SGF.

G. Conflict Resolution

In Pakistan, the final authority to decide on shariah matters is the Shariah Supervisory Board (SSB) of SBP. The Pakistani SGF specifically mentions situations of conflicts, which shall be referred to Shariah Board of SBP. According to Section 8 of the PSGF, an unresolved shariah matter shall be sent to SSB of SBP in the following cases:

a) In case of differences of opinion between SB and management on any shariah matter, fatwa or opinion of SB etc;

b) In case of difference of opinion between IBI and SBP’s inspection team, regarding conformity of IBI’s products, services and transactions with shariah principles;

c) In case of difference of opinion between IBI and IBD of SBP, on conformity of any existing or proposed product with shariah\(^{683}\).

Apart from the above conflict of opinion situations, the SB of an IBI may, on its own motion too, refer any matter to SSB of SBP to seek its guidance\(^ {684}\).

In order to have uniform judgments on shariah matters, there must be some final authority. Such final authority in case of Pakistan is Shariah Supervisory Board of the SBP. The SSB decisions on any shariah matters shall be final. The SSB makes decisions on the basis of Shariah rules and principles, hence ensures shariah compliance in the activities of IBIs in Pakistan. Therefore, it is argued that the Islamic corporate governance principle of vicegerency is complied with herein the above section too.


\(^{684}\) Ibid.
It is concluded that Islamic corporate governance principle of *khilafah* requires that actions of *khaleefa* shall be in conformity with the wills of his Master-*Allah*. Therefore, this principle is linked to the *shariah* compliance in the actions of all Islamic corporate governance players. From all the above provisions of the Pakistani *Shariah Governance Framework*, it is clear that the roles of directors, management, SB and other supporting players are aimed to ensure *shariah* compliance, therefore, it is confirmed that the provisions of the PSGF are fully compliant with the Islamic corporate governance principle of *khilafah*. This shall give confidence to Investment Account-Holders, depositors, customers and other stakeholders that in the presence of such a comprehensive *Shariah Governance Framework*, the actions of all corporate governance players are expected to be *shariah* compliant. Hence, all the products and services offered by the IBIs shall be *shariah* compliant as well.

**Conclusion**

In this chapter, the Pakistani regime relating to corporate governance practices in Islamic banking institutions, has been analysed in light of Islamic corporate governance principles. The principles have been applied one by one. First, the principle of *amanah* (trusteeship) has been applied to the Pakistani regime.

From discussion on the Islamic corporate governance principle of *amanah* (trusteeship), the following results have been inferred:

a. Authority is *amanah* with authority-holders;

b. Hence, the roles and responsibilities, along with ancillary requirements\(^{685}\) thereof, of corporate governance players are *amanah* with the players;

c. The *amanah* of authority shall be handed over to competent persons;

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\(^{685}\) Such as fulfilling qualification and experience criteria etc.
d. In case of negligence and misconduct (intentionally) in performing their duties, the corporate governance players are liable for their actions.

These four implications of the principle of *amanah* have been applied to the theoretical framework relating to corporate governance practices in Pakistan to verify whether the principle of *amanah* (trusteeship) is complied with in such practices or not? For the sake of convenience, the discussion is divided into three parts. **Part A** covers provisions other than the provisions of *Shari’ah* Governance Framework (SGF) as these are discussed in **Part B**. In **Part C**, those provisions are covered, which are related to non-compliant actions of corporate governance players.

In part (A) the analysis of the provisions of Pakistani regime demonstrated that all the corporate governance players (directors, managers and auditors) being authority-holders are holding their respective authorities as trust. Further, being trustees, the respective roles and responsibilities of the CG players, are also trust with them, no matter they are expressly provided in the legal regime or impliedly expected from them in the manner expected from holders of similar offices. However, the difficiency in these provisions is that they do not expressly provide for any consequences in case of negligence or misconduct of the CG players while performing their *amanah*. It means that the principle of *amanah* is not verified to the extent of accountability of corporate governance players for their non-compliant actions. Nonetheless, there are some provisions686 which make these players accountable for non-performance of their *amanah*. The provisions are discussed in **part C**.

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686 These provisions are: Section 189; Sub-Section (4) of Section 196; Sub-Section (1) and (6) of Section 214; Sub-Section (1) and (3) of Section 216; Sub-Section (1) and (6) of Section 219; Sub-Section (4) of Section 236; Section 157; Sub-Section (1) to (4) of Section 158; Sub-Section (8)(a) of Section 159; Sub-Section 8(a) of Section 160; Section 173; Sub-Section (1) and (2) of Section 197; Sub-Section (1) and (2) of Section 197-A; Section 198 to 204; Section 215; Section 220; Sub-Section (1) and (3) of Section 221; Section 230; Section 233; Sub-Section (1) and 3(a) of Section 242; Sub-Section (1) and (3) of Section 245; Sub-Section (1) and (2) of Section 246; Sub-Section (7) of Section 255 and Section 261 of The Companies Ordinance, 1984 of Pakistan.
From analysis of the provisions in part (C), it has been verified that corporate governance players are held liable for committing misconduct or willful defaults in performing their actions. So, it is argued that these provisions are usually compatible with the Islamic corporate governance principle of *amanah* because, the rule of *amanah* is that in case of negligence or misconduct (intentionally) in performing their *amanah*, the *amanah*-holders shall be held liable.

Further, by analyzing the provisions of Pakistani Shariah Governance Framework (PSGF) in part (B), it is concluded that all the corporate governance players are authority holders, hence trustees of their positions. Being on such positions, all their respective roles (both expressed and implied) are *amanah* with them. However, it is not verified from these provisions, whether in case of any negligence or misconduct in performing their roles, the players shall be held accountable or not? Hence, it is argued that the Islamic corporate governance principle of *amanah* cannot be verified from these provisions to the extent of the accountability of the players in case of their non-compliance with the provisions of the PSGF.

Similarly, the provisions of Pakistani regime have been analysed in the light of Islamic corporate governance principle of *mas‘oliyyah* (accountability). *Mas‘oliyyah* (accountability) means that human beings are accountable for their actions in this world as well as in the life hereafter. Based on this principle, the Islamic corporate governance players (inside Islamic financial institutions) are also accountable for their actions. The accountability of these players in the life hereafter is beyond doubt,
however, its verification is impossible from the Pakistani theoretical framework relating to corporate governance. Therefore, our focus has remained on the worldly accountability of these players. Therefore, the provisions of the Pakistani regime have been discussed from the perspective of accountability of corporate governance players in this world.

It was found that the provisions of Pakistani regime relating to Islamic corporate governance practices in IBIs, are compatible with the Islamic corporate governance principle of mas'oliyyah. It is worthyly mentioned however, that these are only some provisions, which hold the corporate governance players accountable for their non-compliant actions. Nonetheless, there are so many other provisions, which are silent regarding the accountability of the corporate governance players in case of their non-compliant actions. Similarly, under the Pakistani SGF only SB members are held liable for their non-compliant actions, and no other player is responsible in this regard. Therefore, it is argued that the principle of mas'oliyyah cannot be verified in the provisions of the SGF to the extent of the ICG players’ accountability for their non-compliant actions, except members of SB.

Further, provisions of the Pakistani regime have also been analysed in the light of Islamic corporate governance principle of shafafiyyah. Shafafiyyah (transparency) means that actions of human beings must be disclosed so that their role is visible to all. On the

that day you shall most certainly be questioned about business” (Al-Quran, 102: 8); “The hearing, sight and hearts will all be questioned” (36: 17); “Then shall anyone who has done an atom’s weight of good, shall see good. And anyone who has done an atom’s weight of evil, shall see evil” (Al-Quran, 99: 7-8).

All the provisions of the Pakistani regime, other than those which are brought under discussion in this study.

It is narrated that 'Umar (RA) received from Yemen, sheets of cloth. He distributed it among people each of whom received one length as his share. 'Umar’s share was that of one Muslim. He tailored it, wore it. The next day he ascended the pulpit to give orders to the people for preparation of Jihad. A Muslim stood up and said, “We neither listen to you nor obey you.” “Why so?” asked 'Umar (RA). He answered, “Because you have preferred yourself to us.” 'Umar again asked, “In what way I have done so?” He replied, “When you distributed the Yemen lengths of cloth, each one received one and so you too. But one length would not make you a garment; we see you have tailored it into a whole shirt and you are a tall man too. If you had not taken more, you
same logic, the actions of authority holders (and in this case, the actions of corporate
governance players) must be transparent. This is because it is the principle of
transparency, which helps ensure that authority holders perform in responsible manner
and that they are held accountable for their actions in case of instances of violation of
their authority. Holding the players accountable is possible only when their actions are
exposed (disclosed).

By applying the principle of *shafafiyyah* to Pakistani regime, it was found that its
provisions promote transparency in the activities of the IBIs as well as their players.
Therefore, it is argued that almost all the relevant provisions of the Pakistani regime
relating to transparency in IBIs are in conformity with the Islamic principle of
*shafafiyyah*.

Finally, the Islamic corporate governance principle of *khilafah* (vicegerency) was also
applied to the Pakistani regime relating to corporate governance practices.

From the view of Maulana Maudoodi (R.A) about *khaleefah* and his authority, it is
easily inferred that corporate governance players are also vicegerents of Allah, who have
no authority to act beyond the commands of Allah. Being Allah’s vicegerents, they are
bound to perform according to the wills of Allah and must not act beyond their authority
as given to them as vicegerent.

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692. As in the case of apparent violation of authority the Caliph Umar (R.A.) was asked for the use of extra part of
cloth. 693. According to the Great thinker of Islam, Maulana Maudoodi (RA), the character of human’s vicegerency
enjoins him to obey Allah’s commands in all aspects of his life, so that all his actions conform to the Allah’s
commands. This is because vicegerent is the one who uses his delegated authority as sub-ordinate to his master.
Being vicegerent, he has no personal authority except the authority, delegated by his master, thus one cannot act
according to his own wishes rather than to fulfill his master’s wishes. In case he acts otherwise than the
delegated authority, this leads to his betrayal from his Lord. (See, Syed Abu al-‘A’la Maudoodi, *Tafheem ul-
The principle of vicegerency is equally applicable to all corporate governance players with no exception, no matter he is in the capacity of Director, CEO or auditor. This is because every corporate governance player, being human, is a vicegerent of Allah. Being vicegerents of Allah, all the corporate governance players must act within the parameters prescribed by Allah SubhanahuWaTa’ala. The parameter in this case for performing actions, is the delegated authority of vicegerency given by Allah. With respect to this study, the vicegerency demands shariah compliant activities.

It is further stated that the behaviour expected from a company (and in this case Islamic bank) is similar to the behaviour expected from an individual. However, the company is unable to perform its actions by its own, therefore, the board of directors acts as its brain. So, the expected behavior from a company is demonstrated in form of expected behavior of the board. Similary, the way the company does not have any mind, it also does not have any organs. So, in the opinion of the researcher, the managers of companies (including Islamic banking companies) act as organs of the companies, hence the expected behavior from companies, is also extended to the expected behaviors of their managers.

Thus it is concluded that the rule of vicegerency is equally applicable to Islamic banks in the manner it is applicable to individuals. Further, it is also concluded that as the Islamic banks do not have any mind and organs, therefore, the expected role of vicegerency from the IBIs, is shifted to the board of directors and managers of the IBIs. So, on behalf of Islamic banks, the board and the managers of the IBIs act as vicegerents.

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As, the principle of vicegerency is linked to shariah compliance, therefore, the Islamic banks as well their corporate governance players are bound to ensure shariah compliance in the activities of the IBIs.

For the purpose of ensuring shariah compliance in the activities of Islamic banks in Pakistan, the central bank of Pakistan (SBP) has issued Shariah Governance Framework (PSGF). From the analysis of Pakistani SGF it was found that the roles of directors, management, SB and other supporting players are aimed to ensure shariah compliance, therefore, it is confirmed that the provisions of the SGF are fully compliant with the Islamic corporate governance principle of khilafah.
CHAPTER 7

COMPARATIVE ANALYSIS OF PAKISTANI AND MALAYSIAN CORPORATE GOVERNANCE PRACTICES IN ISLAMIC BANKING INSTITUTIONS

This chapter includes comparative analysis of Pakistani and Malaysian corporate governance practices in Islamic banking institutions. Thorough examination of the Pakistani 697 and Malaysian 698 corporate governance regimes show that there are so many similarities as well as dissimilarities in the corporate legal regimes of both the countries (refer to table 1 on page 274). However, most of the similarities and dissimilarities given in the table 1, are minor in nature, which might have no significant effect on the Pakistani corporate governance system. Therefore, only those distinctive characteristics of Malaysian regime are discussed, which, in the opinion of the researcher, if incorporated in the Pakistani regime, will significantly enhance efficiency and shariah compliance in the corporate governance system for Islamic banking institutions. These are discussed below:

I. Separate Statutory Law in Malaysia

In Malaysia, there is separate statutory law for Islamic financial institutions 699, which provides for roles and responsibilities of different corporate governance players. The Act covers duties of Islamic banking institutions to ensure compliance with shariah

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699 The Islamic Financial Services Act, 2013. It has 291 sections and 16 schedules.
principles, powers of BNM to specify standards on shariah matters, provisions relating to shariah committee, appointment of auditors for audit on shariah compliance, provisions on prudential matters, and roles, responsibilities and powers of directors, chairman of BODs, CEO and other senior officers.

In Pakistan, there is no separate statutory law for Islamic banks. Although in strategic plan for Islamic banks (2014-2018), it has been planned to introduce one chapter in the Banking Companies Ordinance, 1962 of Pakistan, in order to accommodate Islamic banks, but it has not yet been introduced so.

Rationale of the separate statutory law for Islamic banks in Pakistan is that the IBIs shall be statutorily recognized, and the banks shall derive their authority from proper statutory law. The proposed law (Islamic Banking Act) shall define authorized businesses and activities of Islamic banks. Roles and responsibilities of different corporate governance shall be included in the Act. Proper eligibility criteria shall be covered in it. Minimum qualification and experience shall be statutorily introduced. By covering all these areas in statutory law, they shall be made mandatory. So, if any IBI or any of its corporate governance players does not comply with requirements of the Act, necessary actions shall be taken against the responsible persons.

Although the current Companies Ordinance, 1984 have some provisions, which hold the corporate governance players accountable for non-compliances in their actions. But,
the powers and duties of these players, with respect to Islamic banks, are dealt with in the Shariah Governance Framework. And the provisions of the SGF are silent in case of non-compliance of the corporate governance players with the provisions of the SGF. In view of the researcher, it is the fear of punishment, which compels the corporate governance players to perform their duties in conformity with the set parameters. Therefore, it is opined by the researcher that Islamic banks needs separate statutory law so that roles and responsibilities of different corporate governance players are streamlined and properly segregated as well as necessary actions are taken against those who do not comply with the provisions of the law.

II. Appointment of at Least One Shariah Scholar on BODs

Directors are the persons usually appointed by shareholders, who provide central leadership to the companies. They have all the powers to do with respect to business of companies. The board’s job is policy making and monitoring to ensure that such policies are implemented. Board of directors holds central position in any organization. It acts as mind of firms.

In Malaysia, according to paragraph 2.4 of MSGF, the board has the power to appoint at least one member of SC on the board. Such member shall serve as bridge between SC and shareholders.

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173; Sub-Section (1) and (2) of Section 197; Sub-Section (1) and (2) of Section 197-A; Section 198 to 204; Section 215; Section 220; Sub-Section (1) and (3) of Section 221; Section 230; Section 233; Sub-Section (1) and 3(a) of Section 242; Sub-Section (1) and (3) of Section 245; Sub-Section (1) and (2) of Section 246; Sub-Section (7) of Section 255 and Section 261 of The Companies Ordinance, 1984 of Pakistan.

174 The actions shall include removal from office, imposition of fine and imprisonment for some period.


BODs\textsuperscript{712}. The Pakistani regime does not provide for any such appointment on the board of directors.

According to paragraph 2.20 of the Malaysian guidelines on CG, for the effectiveness of the board of an IBI, it is necessary that the board has an adequate number of directors that commensurates with the complexity, size, scope and operations of the Islamic bank. The board should comprise of directors who as a group provide a mixture of core competencies such as finance, accounting, legal, business management, information technology and investment management\textsuperscript{713}. Also, according to paragraph 2.62, for the purpose of ensuring that the board of an Islamic bank has the required mix of skills and experience to discharge its duties, the members of the board should be from diverse backgrounds, with knowledge and experience in different pertinent disciplines which may include finance, accounting, legal, business management, information technology and investment management\textsuperscript{714}.

A board comprising of directors from different educational backgrounds, is useful for Islamic banks. Because, they make policies and decisions on number of matters, which include legal, finance, accounts, business management, risk management, profit distribution and information technology. When their decision-making cover such range of different areas, therefore, it is necessary that the board should include experts from each field. The presence of experts on board from different fields having different backgrounds, qualifications, skills and experience shall make it easy for the board to make correct decisions about the fate of the institution. Expert of a particular field shall give better opinion regarding any matter relating to his field. In this way the board shall

\textsuperscript{714}\textit{Ibid}, paragraph 2.62.
act efficiently. On the other hand, if the board lacks experts from different fields, then there is apprehension that some critical issues may be mishandled, which may cause loses to the organization.

Maintaining such diversification in the BODs, the Malaysian SGF empowers the board under paragraph 2.4, to appoint at least one member of SC on the board. Such member shall serve as bridge between SC and BODs\textsuperscript{715}.

As in Malaysia, according to paragraph 2 of appendix 2 (qualification) of MSGF, the minimum educational qualification required from the members of Shariah Committee, is bachelor degree in \textit{fiqh} (the origin of Islamic law) or \textit{Fiqh al-Mu’amalat} (Islamic Commercial Law)\textsuperscript{716}. Therefore, the requirement of degree in \textit{fiqh} or \textit{fiqh al-mu’amalat}, from shariah scholars is beneficial for Islamic banks. Fiqh is the knowledge (Science) of practical \textit{shariah} rulings pertaining to conduct that are derived from the detailed (individual) evidences of \textit{shariah}\textsuperscript{717}. This definition suggests that \textit{fiqh} deals with \textit{practical conducts} of human beings, which include acts of worship (such as prayer, is subject of \textit{fiqh al-‘ibadat}), acts of transactions (such as sale/purchase, is subject of \textit{fiqh al-mu ‘amalat}) and acts of crime (\textit{qisas} and \textit{hudoood}, are subjects of \textit{fiqhal-jinayat})\textsuperscript{718}. These three are the main subjects\textsuperscript{719} of \textit{fiqh}. \textit{Fiqh} is broader than \textit{Fiqh al-mu ‘amalat}. The later is a special subject of the former. However, both include the knowledge relating to individuals’ mutual transactions. It also includes knowledge of business transactions such

\textsuperscript{715}Ibid, paragraph 2.4.
\textsuperscript{716}Ibid, Appendix 2, paragraph 2.
\textsuperscript{718}Ahkam (rules) relating to \textit{aqeeda} (such as trust in God and Day of Judgement) and \textit{akhlaq} (such as obligation of telling truth and prohibition of telling lie) are excluded from the subject of fiqh. (See, Abdul Karim Zedan, \textit{Al-wajeez fi ‘Usool al-Fiqh}, Dar Nashr ul-kutub al-islamiyyah, (1976), p. 9.
\textsuperscript{719}Dr. Mahmood Ahmad Ghazi has divided the subject of fiqh into two main divisions. One is related to acts of state the other is related to acts of subjects (citizens) of state. The former type of fiqh includes \textit{muslim} administrative law, \textit{muslim} criminal law, \textit{muslim} procedural law and \textit{muslim} international law. The latter includes acts of worship, \textit{muslim family law}, \textit{transactions} and \textit{social dealings}. (See generally, Mahmood Ahmad Ghazi, \textit{Mahadhirat-e Fiqh}, Al-Faisal Nashran, (2005).
Persons with degree in fiqh or fiqh al-mu‘amalat shall be able to tackle financial matters of Islamic banks with better understanding. Islamic banking business is based on the Islamic business transactions, hence the shariah scholars holding degrees in the above mentioned fields are most suitable to become members of SC.

Thus as a result, appointment of at least one member of SC on board of directors, has many benefits to Islamic banks. In this way knowledge sharing shall occur among the members of board and the SC members. They will easily understand each other’s point of view as well as the rationale for their opinion while discussing matters before arriving at any decision. As a result, better shariah compliant decisions shall be made, which shall enhance the efficiency of the board as well the Shariah Committee.

III. Detailed Responsibilities of the CEO

On management side, the most important position in any organization (including Islamic banks) is CEOship. Though, the management powers rest with managers, but CEO is on top of management. More or less, it is the CEO who holds all the management powers. In Malaysia, paragraph 2.40 of the Guidelines on CG, provides that the key role of CEO, among others, include:

(i) Developing the strategic direction of the Islamic bank;

(ii) ensuring that the Islamic bank’s strategies and corporate policies are effectively implemented;

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720 Sale without mentioning the cost price or profit margin.
721 Sale by mentioning the cost price as well as profit margin.
722 Contract of advance payment and deferred delivery of goods.
723 Contract of participation in which one party provides capital while the other party provides skills.
724 Contract of participation in which both the parties provide capital.
725 Contract of manufacturing.
(iii) ensuring that board decisions are implemented and board directions are responded to;

(iv) providing directions in the implementation of short and long-term business plans;

(v) providing strong leadership; i.e. Effectively communicating a vision, management philosophy and business strategy to the employees;

(vi) keeping board fully informed of all important aspects of the Islamic bank’s operations and ensuring sufficient information is distributed to board members; and

(vii) ensuring the day-to-day business affairs of the institutions are effectively managed\textsuperscript{727}. The Pakistani regime does not expressly mention any role of CEO.

From the above role of CEO under Malaysian regime, it appears that CEO’s role is that of oversight, monitoring and giving directions to other managers. For example, under the above paragraph 2.40, the CEO is responsible to ensure that all the decisions and strategies made, and policies set up by directors are effectively implemented. He is also responsible to ensure that day-to-day business activities are effectively managed. Here his role is oversight and monitoring of managers. Likewise, he gives directions to managers in the implementation of long term and short term business plans. Here his role is like director. Nonetheless, he also provides a good leadership to managers. Further, the CEO discloses relevant information to board about the activities of Islamic banks. This disclosure of information to board strengthens and enhances the ultimate oversight and monitoring role of board of directors. From this role of the CEO, it is clear that CEO plays a significant role in Islamic banks in Malaysia.

Holding such an important position of management, still the Pakistani regime ignores him because it does not expressly provide his role in detail\textsuperscript{728}. This is a big flaw in the

Pakistani regime. Therefore, it is suggested that the role of the CEO (especially of Islamic banks) shall be provided in the statutory law as soon as possible. Otherwise, it will be difficult to hold him accountable for any non-compliance on the part of management. Holding any person accountable is possible only when his role and responsibilities are expressly provided by law.

IV. Scope of Internal Shariah Audit

The Malaysian Shariah Governance Framework (MSGF) defines shariah audit as follows:

“Shariah audit refers to the periodical assessment conducted from time to time to provide an independent assessment and objective assurance designed to add value and improve the degree of compliance in relation to the IFI’s business operations, with the main objective of ensuring a sound and effective internal control system for shariah compliance”729.

In the above paragraph it is stated that in order to verify the effectiveness and soundness of the internal control system of an IBI made for shariah compliance, the shariah audit is conducted on periodic basis. The function is conducted by Internal Auditors, who have acquired shariah related knowledge and training730. The auditors may also engage the expertise of shariah officers of the IFI, while conducting the shariah audit731.

Under paragraph 7.12 of MSGF, the scope of Internal shariah audit covers all aspects of Islamic financial institutions business operations and activities including:

i. audit of the financial statements of the IFIs;
ii. compliance audit on organizational structure, people, process and information technology application systems;

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728 Only in definition clause, prudential regulation it has been provided that ...............
730 Ibid, paragraph 7.8.
731 Ibid.
iii. Review of adequacy of the shariah governance process\textsuperscript{732}.

Assessment of financial statements for shariah compliance shall include verifying compliance with shariah, of the business of Islamic banks, its investment avenues, cash receipts and payments and profits earned by the IBIs. Similarly, compliance audit on organization structure and IT application system shall include verification of proper human resource\textsuperscript{733} for shariah compliance, inside the IBIs that commensurate with the size of the IBIs. Further, in the modern world, banking activities and operations require application of proper IT system for recording and managing information. The shariah audit function with respect to IT system applied, shall include verification of compatibility of the system with shariah principles. In other words, it shall be verified whether the unique technical transactions of Islamic banks are dealt with sufficient care while putting them into the IT system.

Moreover, the most important shariah audit is the audit on the adequacy of shariah governance process involved inside Islamic banks. In this type of audit, the current shariah governance structure, its size and roles and responsibilities shall be analysed. This may include the frequency of SC meetings, their deliberation on shariah matters. Similarly, the processes and functions of shariah review, shariah risk management and shariah research as well as their reporting to SC, BAC and management shall be evaluated. The persons involved in all such functions shall be evaluated in terms of their qualifications and competences.

From the above role of shariah audit function, it is concluded that the function palys a significant role in ensuring the overall shariah compliant environment in the Islamic banking institutions.

\textsuperscript{732} Ibid, paragraph 7.12.
\textsuperscript{733} Such as shariah officers for Shariah risk management function, shariah review function, shariah research function and shariah audit function.
The Pakistani SGF does not mention any scope of internal Shari‘ah audit. The task to define scope of internal shariah audit, has been assigned to Shariah Board under clause (iii) of Section 6. This is a deficiency in the Pakistani SGF. Therefore, it is suggested that the Pakistani SGF provides scope for the Internal Shariah Audit Function.

The scope of the internal shariah audit is important. Therefore, it is necessary that it is expressly provided in the PSGF. In this way, the auditors shall be able to understand their duty in expressed terms, who shall perform it clearly. If in case they do not follow the requirements of the SGF relating to scope and process of the shariah audit, they shall be accountable for such non-compliance. Further, it will bring uniformity in the scope and process of shariah audit among Islamic banks in Pakistan.

V. Qualification of Members of Shariah Committee

In Malaysia, according to paragraph 2 of appendix 2 (qualification) of MSGF, the minimum educational qualification required from the members of Shariah Committee, is bachelor degree in fiqh (the origin of Islamic law) or Fiqh al-Mu‘amalat (Islamic Commercial Law).734

On the other hand, in Pakistan the educational system is categorized into two types namely the religious institutions’ educational system and modern educational system. So, if a person studies in religious institutions, then according to Fit and Proper Criteria for Shariah Advisors issued by SBP, he must hold degree of ShadatulAlamiya (Dars-e Nizami) from recognized board of madaris with minimum 70% marks, and Bachelor degree from modern educational institution with minimum 2nd class, to become eligible for appointment of member of SB.735 However, if a person is a degree-holder from

735 State Bank of Pakistan, Fit and Proper Criteria for Shariah Advisors of IBIs, Annexure-IV to IBD Circular No. 2 of 2004, Revised vide IBD Circular 2 of 2007, Section 1.
modern educational institution, then the minimum qualification to become eligible for appointment as member of SB, is postgraduate degree in Islamic Jurisprudence, Usooluddin, LLM in Shariah with minimum CGPA of 3:00 out of 4:00 or equivalent\textsuperscript{736}. Holding a degree from madrasa (religious institution) in case of Pakistan is not useful in the view of the researcher because of two reasons. First, the scholar will not be an expert in fiqh al-mu ‘amalat (Islamic law of contracts and business transactions). Second, he will not be able to practically apply such knowledge in Islamic finance. Similarly, degree-holder in Islamic jurisprudence is also not a suitable candidate for the post of shariah scholar because the Islamic jurisprudence is the field which does not directly deal with Islamic commercial transactions. It is the science of principles and comprehensive\textsuperscript{737} evidences, on the basis of which ahkam are derived\textsuperscript{738}, and not a direct study of ahkam (rulings) especially ahkam of mu’amalat (rulings on transactions). Likewise, postgraduate degree in Islamic Studies (Usooluddin) also does not enable a candidate to be competent enough to act as efficient shariah scholars inside Islamic banks because the focus of Islamic studies remains more on acts of worship than mu ‘amalat (transactions) especially mu ‘amalat al-maliyyah (financial matters).

On the other hand, the requirement of degree in fiqh or fiqh al-mu’amalat, from shariah scholars is beneficial for Islamic banks. Fiqh is the knowledge (Science) of practical shariah rulings pertaining to conduct that are derived from the detailed (individual) evidences of shariah\textsuperscript{739}. This definition suggests that fiqh deals with practical conducts of human beings, which include acts of worship (such as prayer, is subject of fiqh al-

\textsuperscript{736}Ibid, Section 2.
\textsuperscript{737} For example, Quran and sunna as a whole, are comprehensive evidences. They are different from detailed (individual) evidences (for example, the verse of quran dealing with cutting of hands of a thief, is detailed evidence).
‘ibadat), acts of transactions (such as sale/purchase, is subject of fiqh al-mu ‘amalat) and acts of crime (qisas and hudood, are subjects of fiqhal-jinayat). These three are the main subjects of fiqh. Fiqh is broader than Fiqh al-mu ‘amalat. The later is a special subject of the former. However, both include the knowledge relating to individuals’ mutual transactions. It also includes knowledge of business transactions such as musawamah, murabaha, salam, mudharabah, musharakah, and istisna.

Persons with degree in fiqh or fiqh al-mu’amalat shall be able to tackle financial matters of Islamic banks with better understanding. Islamic banking business is based on the Islamic business transactions, hence the shariah scholars holding degrees in the above mentioned fields are most suitable to become members of SC. Therefore, in the opinion of the researcher, the minimum qualification required from shariah scholar of Islamic banks should be a degree in fiqh al-mu’amalat (Islamic law of contracts and business transactions). For this purpose, it is suggested that universities should start specific degree in fiqh al-mu’amalat.

VI. Shariah Risk Management Function (SRMF)

In order to mitigate shariah risk, the Malaysian Shariah Governance Framework (MSGF), under its paragraph 7.1, requires Islamic banks to establish a shariah risk management function (SRMF). The Pakistani SGF does not require Islamic banks to establish such an important function.

740 Ahkam (rules) relating to aqeeda (such as trust in God and Day of Judgement) and akhlaq (such as obligation of telling truth and prohibition of telling lie) are excluded from the subject of fiqh. (See, Abdul Karim Zedan, Al-wajeez fi ‘Usool al-Fiqh, Dar Nashr ul-kutub al-islamiyyah, (1976), p. 9.

741 Dr. Mahmood Ahmad Ghazi has divided the subject of fiqh into two main divisions. One is related to acts of state the other is related to acts of subjects (citizens) of state. The former type of fiqh includes Muslim administrative law, Muslim criminal law, Muslim procedural law and Muslim international law. The latter includes acts of worship, Muslim family law, transactions and social dealings. (See generally, Mahmood Ahmad Ghazi, Mahadhirat-e Fiqh, Al-Faisal Nashran, (2005).

742 Sale without mentioning the cost price or profit margin.
743 Sale by mentioning the cost price as well as profit margin.
744 Contract of advance payment and deferred delivery of goods.
745 Contract of participation in which one party provides capital while the other party provides skills.
746 Contract of participation in which both the parties provide capital.
747 Contract of manufacturing.
Risk management is “being smart about taking chances”\textsuperscript{748}. It is “the identification, assessment, and prioritization of risks followed by co-ordinated and economical application of resources to minimize, monitor, and control the probability and/or impact of unfortunate events”\textsuperscript{749}. This is the definition of risk management but when the risk is related to shariah, then the term shariah risk management can be defined as the “identification, assessment, and prioritization of shariah risk followed by co-ordinated and economical application of resources to minimize, monitor and control the probability and/or impact of the non-compliant events”.

Shariah risk is defined as “the chance that an Islamic financing institution is challenged on grounds that it does not comply with Islamic law”\textsuperscript{750}. This is actually a shariah non-compliance risk, which may “result from failure of an IFI’s internal control system or corporate governance”\textsuperscript{751}. The risk is operational in nature, which is unique to Islamic financial institutions\textsuperscript{752}. As the objective of Islamic financial institutions is to ensure shariah compliant in all its activities, therefore, the minimization of risk (management of risk) of non-compliance with shariah is the responsibility of the IFIs.

In order to mitigate the shariah non-compliance risk, an effective internal shariah control system is necessary\textsuperscript{753}. For this purpose, the Malaysian SGF requires IBIs to establish internal control function called Shariah Risk Management Function (SRMF).

\textsuperscript{748} Douglas W. Hubbard, \textit{The Failure of Risk Management: Why it’s Broken and How to Fix It?} John Wiley & Sons, (2005), p. 10.
\textsuperscript{749} Ibid.
“Shariah Risk Management is a function to systematically identify, measure, monitor and control of Shariah non-compliance risks to mitigate any possible of non-compliance events”  

The SFRM is an internal function inside Islamic financial institutions, which forms part of integrated risk management framework of the IFIs. It is responsible to foresee the non-compliance instances before its occurrence and to properly mitigate them so that a shariah compliant environment is ensured in the IFIs. The function shall be carried out by those risk officers who are suitably qualified and experienced in this regard. This is because shariah matters involve technicalities, which can be understood as well as tackled only by those officers, who have sufficient knowledge and training of shariah. 

Two approaches are very much helpful for ensuring shariah compliance in an institution’s activities. According to one approach, whenever any non-compliance activity is identified, it is rectified. This approach is adopted in the shariah review and shariah audit functions of the IFIs as discussed chapter 4. The second approach is that to anticipate any shariah non-compliance risks before its occurrence so that proper shariah risk management policy is made timely, and the event is avoided or stopped from occurrence. For this purpose, the presence of a proper SRMF inside IBIs, is very much significant. But the Pakistani regime does not cover this important function. Therefore, it is suggested that the PSGF should provide for the establishment of the function inside Islamic banks.

**VII. Shariah Research**

Paragraph 7.1 of Malaysian SGF requires from Islamic banks to establish a Shariah Research Function (SRF), which forms part of overall shariah compliance function of IFIs in Malaysia. It refers to “the conduct of performing in-depth research and studies on

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Shariah issues…”\textsuperscript{757}. It is performed by qualified shariah officers\textsuperscript{758}. The Pakistani regime does not provide for the establishment of this function.

The function is very much significant for SC because shariah issues in hand shall not be decided abruptly, rather proper research shall be conducted on it. In this regard, all the relevant principles of shariah shall be studied. All aspects of the issues shall be discussed, hence the chances of non-compliance of shariah shall be minimized, and a consistent shariah compliant environment shall be ensured. Therefore, a shariah research function needs to be established inside Islamic banks in Pakistan.

\textsuperscript{757}Ibid, paragraph 7.12.
\textsuperscript{758}Ibid, paragraph 7.19.
Table 1.

In the table 1 below, the tick mark represents either of the two features i.e. similarity and
dissimilarity, in the CG practice between the Pakistani and Malaysian Frameworks. The
tick mark put in the column of similarity means that the feature is similar between the
frameworks. Similary, the tick mark put in the column of dissimilarity means that the
practice is dissimilar between them.

<table>
<thead>
<tr>
<th>Practice</th>
<th>MalaysianRegime</th>
<th>PakistaniRegime</th>
<th>Similarity</th>
<th>Dissimilarity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Appoinment of first directors</td>
<td>In Malaysia, according to Subsection (1) of Section 16 of the Companies Act, 1965, a company is registered when its MOA and AOA, if any, are registered. For the registration of a proposed company, its MOA or AOA shall have contained the names of at least two persons to be its first directors. Under Sub-section (1) of Section 123 of the CA, 1965, a person shall not be so named as director unless he has signed the memorandum for qualification shares if any, and that he has made a statutory declaration with the registrar that such number of shares are registered against his name.</td>
<td>In case of Pakistan, when a company is newly formed, its first directors shall be appointed by the majority of the members of the company, however, so long as they are not so appointed, all the members who are natural persons shall be considered as first directors according to Section 176 of CO, 1984.</td>
<td>✓</td>
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<tr>
<td>Appointment of subsequent directors</td>
<td>Subsection (4) of Section 123 of CA of Malaysia, also requires from a potential director to give his consent in writing to act as director, to the registrar on the prescribed form.</td>
<td>In pursuance of Section 178 of the CO, 1984 of Pakistan, the first directors shall fix the number of subsequent directors to be elected in the first AGM of the company. Sub-section (3) of the Section 178 requires the candidate, who wishes to contest election for directorship to file his consent notice with the company, and also under subsection (1) of Section 184 of CO, 1984, he shall, for such purpose, submit his consent in writing on the prescribed form with the registrar.</td>
<td>✓</td>
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<tr>
<td>Tenure of directors</td>
<td>The Malaysian Regime does not fix any such tenure for directors; however, it has been provided in article 63 of Schedule (4) of CA, 1965 that, after the retirement of first directors on first AGM, 1/3 of the existing directors shall stand retired on each sub-sequent AGM.</td>
<td>The Pakistani Regime, under subsection (1) of Section 180 of CO, 1984, has expressly mentioned that a director of a bank is basically elected for three years, upon the expiration of which, he is eligible for re-election. If he is re-elected so, he may continue for next three years. Further, under the sub-section (1), a director other than a chief executive, cannot serve as director for more than six years in his whole life.</td>
<td></td>
<td>✓</td>
</tr>
<tr>
<td>Tenure of first directors</td>
<td>In Malaysia, under article 63 of Schedule (4) of the CA, 1965, first directors shall hold office till the</td>
<td>according to subsection (2) of section 176 of CO, 1984, unless they resign, or are removed earlier, the first directors shall hold office till the election of</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>Topic</td>
<td>Malaysia</td>
<td>Pakistan</td>
<td>Notes</td>
<td></td>
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<tr>
<td><strong>Minimum quorum for BODs’ meeting</strong></td>
<td>In Malaysia, under paragraph 2.75 of the Guidelines on CG, the minimum quorum for the meetings of the board is presence of three (3) members or 50% of the total members, whichever is higher. Malaysian regime requires 50% attendance to complete quorum.</td>
<td>The Pakistani regime under subsection (1) of Section 193 of CO, 1984 requires that minimum quorum for board of listed companies shall not be less than one third (1/3) of the total directors or four (4) directors, whichever is higher. Pakistani regime requires 33.33% attendance from directors for completion of quorum.</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td><strong>CEO</strong></td>
<td>According to sub-section (1) of Section 63 of Islamic Financial Services Act, 2013, every institution (including IBIs) in Malaysia shall at all times have a Chief Executive Officer.</td>
<td>In Pakistan, subsection (1) of section 198 of the Companies Ordinance, 1984 (hereinafter called the CO, 1984) requires every company, other than a company managed by a managing agent, to have a Chief Executive.</td>
<td>✓</td>
<td></td>
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<tr>
<td><strong>Appointment of auditor</strong></td>
<td>According to subsection (1) of S. 76 of IFSA, 2013, the Malaysian Regime requires an institution to appoint auditor every year.</td>
<td>Likewise, under section 252 of CO, 1984 of Pakistani regime too, an auditor shall be appointed on yearly basis.</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td><strong>Appointment of first auditor</strong></td>
<td>Under sub-section (1) of Section 172 of CA, 1965 of Malaysian regime, first auditor shall be appointed before the first Annual GM, who may be appointed either by the directors, or if they fail to do so, by the company at GM.</td>
<td>Pakistani regime too according to proviso (b) of sub-section (3) of 252 of CO, the first auditor shall be appointed by the directors, and if they do not do so, then under clause (b) of sub-section (3) of the section, he may be appointed by the company in general meeting.</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td><strong>Appointment of subsequent auditor</strong></td>
<td>In Malaysia, sub-section (2) of Section 172 of CA, 1965 provides that subsequent auditors shall be appointed by the company in each AGM.</td>
<td>Pakistani regime too under sub-section (1) of section 252 of CO, 1984 requires that auditors of companies shall be appointed every year, which means that subsequent auditor shall be appointed each year.</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td><strong>Panel of auditors</strong></td>
<td>No provision was found in this regard</td>
<td>Section 35(1) of BCO, 1962 requires from an auditor to have borne his name on the panel of auditors as maintained by the SBP, to become eligible to conduct the audit of banks and DFIs.</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td><strong>Right of auditor to access information</strong></td>
<td>The Malaysian regime under Section 174(1) recognizes the right of auditor to access to all records and information, which are necessary for the purpose of audit.</td>
<td>Section 255(1) of CO, 1984 entitles auditor to access to all such information.</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td><strong>Disclosure of directors’ interest</strong></td>
<td>In Malaysia, according to section 131 of CA, 1965 a director who is interested in a contract or proposed contract shall disclose his interest in the board’s meeting. The same has also been provided in section 67 of IFSA, 2013 that a director interested in any material transaction/arrangement, shall disclose his interests to BODs.</td>
<td>Pakistani regime, under section 214 of CO, 1984 also requires disclosure to the board, from interested directors.</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td><strong>Participation of interested director in BODs’ meeting</strong></td>
<td>Sub-section (1) of Section 131A of CA, 1965 of Malaysian regime requires an interested director, not to participate in any discussion on the proposed transaction, nor to vote in this regard, however his presence shall be counted for participation.</td>
<td>In Pakistan too, under sub-section (1) of Section 216 of CO, 1984, neither the interested director shall take part in any such discussions regarding the transaction in which he has interests, nor shall he be present in such meeting, nor can he vote in this regard.</td>
<td>✓</td>
<td></td>
</tr>
</tbody>
</table>
The Malaysian regime does not provide for any such disclosure. Under clause (a) of Sub-section (1) of Section 218 of CO, 1984 of Pakistani regime, a company is required to disclose with the directors’ report, the interests of directors in appointment of a Chief Executive and whole-time directors. His interests in the appointment of CEO shall also be disclosed to members under sub-section (2) of the Section.

- **Disclosures of interest of director in appointment of CEO and whole time director**
  - The board of directors is ultimately accountable and responsible for shariah compliance of IFIs, under paragraph 2.1 of Shariah Governance Framework.
  - The Pakistani SGF, under clause (i) of Section 1 declares BODs as ultimate responsible and accountable for shariah compliance of IBIs.

- **Ultimate responsibility and accountability of BODs for shariah compliance**
  - The Pakistani SGF, under clause (iv) of Section 1 requires BODs to have at least meeting with SB on half year basis.

- **Appointment of SB/SC member**
  - According to paragraph 2.3 of Malaysian SGF, members of SC shall be appointed by BODs.
  - Clause (iii) of Section 1 of Pakistani SGF entitles BODs to appoint members of SB.

- **Meeting of BOD with SB**
  - The Malaysian regime is silent in this regard.
  - The Pakistani SGF under clause (iv) of Section 1 requires BODs to have at least meeting with SB on half year basis.

- **Management responsibility**
  - In Malaysian SGF under paragraph 2.11, it is the responsibility of the management to implement fatwas and decisions made by the Shariah Committee.
  - The Pakistani SGF also declares management responsible for the implementation of the SB’s rulings and decisions under clause (ii) of Section 2.

- **Establishment of SB/SC**
  - Under clause (ii) of paragraph 1.3 of MSGF, there must be a Shariah Committee in each IFL.
  - Clause (i) of Section 3(A) of the Pakistani SGF requires every IBI to have a shariah board (SB).

- **Appointment of member of SB/SC**
  - According to paragraph 1 of Appendix 2 (Appointment of the Shariah Committee) of Malaysian SGF, members of the Shariah Committee shall be appointed by the board of directors.
  - In Pakistan too, members of SB shall be appointed by the board under clause (iii) of Section 1 of PSGF.

- **Number of members of SB/SC**
  - The Malaysian SGF, under paragraph 2.3 requires that the minimum number of members of the SC shall be five (5) with majority of shariah scholars.
  - In Pakistan, the minimum number of SB members is three shariah scholars, under clause (i) of Section 3A of Pakistani SGF.

- **Muslim/individual shariah**
  - Paragraph 1 of Appendix 2 (qualification) of the Malaysian SGF declares that only an
  - Pakistani regime is silent in this regard
<p>| Scholar on SC | In case of Malaysia, the SGF under paragraph 2 of Appendix 5 (frequency of meetings and attendance) requires the SC to meet at least once in every two months. The Malaysian SGF requires holding of more frequent meetings from SC members than the meetings to be held by SB members in case of Pakistan. |
| SB/SC’s meeting | In Pakistan, it is mandatory under clause (i) of Section 3(C) of Pakistani SGF to meet on quarter basis. In addition to the mandatory meetings, the chairman of the SB has the power to convene meeting as and when he deems it necessary. |
| Individua-l member attendance | Paragraph 3 of Appendix 5 (frequency of meetings and attendance) of Malaysian SGF requires individual board member to attend at least 75% of meetings in a year. Clause (i) of Section 3(C) of Pakistani SGF requires individual board member to attend at least 75% of meetings in a year. |
| Quorum of SB/SC members | In Malaysia according to paragraph 1 of Appendix 5 (quorum), the minimum quorum of SC members is 2/3 with majority of Shariah scholars. In Pakistan, minimum quorum for SB members, under clause (iii) of Section 3(C) of Pakistani SGF is 2 Shariah scholars. |
| Decision making by SB/SC | Paragraph 1 of its Appendix 5 (decision-making) of MSGF requires that decisions shall be made on the basis of 2/3 majority of SC members out of which 2/3 members must be from shariah background. Under clause (iii) of Section 3(C) of Pakistani SGF, it is preferred that decisions are made through consensus of all members of SB, but in case of differences of opinions, decisions may be made on the basis of majority of Shariah scholar members. |
| Recording of necessary details in minutes of meeting of SB | The Malaysian regime is silent in this regard. According to clause (vii) of Section 3(C) of Pakistani SGF, necessary details of all decisions made, ruling issued by the SB, differences of opinions and dissenting notes, if any, shall be recorded in minutes along with rationale. The minutes shall be signed by all members present in meeting. |
| Accountability of SB/SC for fatwas/decisions | Shariah committee in Malaysian SGF under paragraph 1 of Appendix 4, is responsible and accountable for all its rulings, decisions and opinions. SB in Pakistan is responsible and accountable under clause (i) of Section 3(B) of SGF. |
| Rigorous deliberations before arriving at any decision | The Malaysian SGF, under its paragraph 2.7 expects from SC members to rigorously deliberate on all issues. The Pakistani SGF, under clause (v) of Section 3(B) requires that before issuing any ruling or arriving at any decision, rigorous deliberations shall be made on all issues. |
| Separate Statutory Law in Malaysia | In Malaysia there is separate statutory law for Islamic financial institutions (including Islamic banks) There is no separate law for IBIs in Pakistan |
| Appointment of at least | In Malaysia, according to paragraph 2.4 of MSGF, the In The Pakistani regime does not provide for any such appointment on the board of |</p>
<table>
<thead>
<tr>
<th>Title</th>
<th>Description</th>
<th>Pakistani SGF</th>
<th>Remarks</th>
</tr>
</thead>
<tbody>
<tr>
<td>one shariah scholar on BODs</td>
<td>board has the power to appoint at least one member of SC on the board. Such member shall serve as bridge between SC and BODs.</td>
<td>directors.</td>
<td></td>
</tr>
<tr>
<td>Role of CEO</td>
<td>Paragraph 2.40 of Malaysian guidelines on corporate governance provides role of CEO of Islamic banks.</td>
<td>Pakistani SGF is does not provide any such role of CEO</td>
<td>✓</td>
</tr>
<tr>
<td>Scope of internal shariah audit</td>
<td>Paragraph 7.12 of MSGF provides scope of internal shariah audit.</td>
<td>The Pakistani SGF does not provide any scope of internal shariah audit, rather under clause (iii) of section 6, it has assigned this job to the SB to define scope of internal shariah audit</td>
<td>✓</td>
</tr>
<tr>
<td>Qualification of members of SB/SC</td>
<td>In Malaysia, according to paragraph 2 of appendix 2 (qualification) of MSGF, the minimum educational qualification required from the members of Shariah Committee, is bachelor degree in fiqh (the origin of Islamic law) or Fiqh al-Mu’amalat (Islamic Commercial Law).</td>
<td>According to fit and proper criteria issued by SBP, the educational qualification is ShadatulAlamiya (Dars-e Nizami) from recognized board of madaris with minimum 70% marks, and Bachelor degree from modern educational institution with minimum 2nd class. Or postgraduate degree in Islamic Jurisprudence, Usooluddin, LLM in Shariah with minimum CGPA of 3:00 out of 4:00 or equivalent.</td>
<td>✓</td>
</tr>
<tr>
<td>Shariah Risk Management Function (SRMF)</td>
<td>Malaysian Shariah Governance Framework (MSGF), under its paragraph 7.1, requires Islamic banks to establish a shariah risk management function (SRMF).</td>
<td>The Pakistani SGF does not require Islamic banks to establish such an important function.</td>
<td>✓</td>
</tr>
<tr>
<td>Shariah Research</td>
<td>Paragraph 7.1 of Malaysian SGF requires from Islamic banks to establish a Shariah Research Function (SRF).</td>
<td>Pakistani SGF does not require any such function from Islamic banks.</td>
<td>✓</td>
</tr>
<tr>
<td>Disclosure of annual financial statement -s and SC’s report on website of Islamic banks</td>
<td>According to clause (b) of paragraph S. 15.1 of the Malaysian guidelines on financial reporting, a full set of the Annual Financial Statements shall be published on the website of the respective bank. Similarly, Paragraph S. 11.4 of the Malaysian guidelines,</td>
<td>Pakistani SGF is silent in this regard.</td>
<td>✓</td>
</tr>
</tbody>
</table>
Conclusion

Thorough examination of the Pakistani\textsuperscript{759} and Malaysian\textsuperscript{760} corporate governance regimes show that there are so many similarities as well as dissimilarities between the two regimes. As most of the dissimilarities are minor in nature therefore, the researcher did not brought them all under discussion, and only major dissimilarities on the part of Malaysia are discussed. For example, in Malaysia, there is proper statutory law that defines roles and responsibilities of different corporate governance players; at least one members of Shariah committee is appointed on BODs; SC members have specialized degree in Islamic financial matters; presence of shariah risk management and shariah research function. These are the strengths of Malaysian regime, which are lacking in the Pakistani regime. Therefore, it is suggested that Pakistani regime also covers the above functions so that a more viable and shariah compliant system of corporate governance is achieved.


CHAPTER 8

CONCLUSIONS AND RECOMMENDATIONS

From the current study, it is concluded that corporate governance is the system required to direct and control and organization. The Islamic corporate governance system too, is the system required to direct and control organizations, but the main objective of the Islamic corporate governance system is to ensure Shari‘ah compliance in such organizations. For this purpose, the Islamic corporate governance system adds an additional layer of Shari‘ah governance to the existing corporate governance system. The additional layer includes shariah board, shariah compliance department and internal/external shariah audit.

From the conventional perspective, there are four theories of corporate governance namely the agency theory, stewardship theory, shareholder theory and stakeholder theory. Each of these theories has some issue. For example, the agency theory and stewardship theory advocate only the interests of shareholder by ignoring the interests of all other stakeholders such as customers and suppliers. The shareholder theory also supports this idea.

On the other hand, the stakeholder theory suggests for the protection of the rights of other stakeholders as well, however, this theory is criticized by modern Muslim scholars, such as Zamir Iqbal and Abbas Mirakhor that the theory can neither define stakeholders with certainty nor justify in the absence of theoretical base, as to why to protect the interests of other stakeholders?

Similarly there are two dominant models of corporate governance from conventional perspective. The Anglo-American model of corporate governance (applicable in UK and
USA), suggest for the protection of shareholders’ interests, whereas, the Franco-German model (applied in France, Germany and Japan), suggests for the protection of the rights of all stakeholders. However, these models are rejected on the same grounds on which the conventional corporate governance theories have been rejected. For instance, the shareholder model is rejected because this model advocates shareholders’ interests alone, whereas, the stakeholder model is not accepted because this model fails to declare as to who can be included in the list of stakeholders and on what basis? Therefore, the modern Muslim scholars suggested an alternative model of corporate governance from Islamic perspective. The Islamic corporate governance model is obtained by modifying the existing stakeholder model of corporate governance. In the Islamic model, Allah and Islam are included in the list of stakeholders along with the all those persons whose property rights are at stake or at risk due to voluntary or involuntary actions of the companies. According to Zamir Iqbal and Abbas Mirakhor, protection of stakeholders’ interests is based on the following Islamic principles:

(a) Collectivity (community, society, state) has sharing rights with the property acquired by either individuals or firms;

(b) Exercise of property rights should not lead to any harm or damage to property of others (including stakeholders);

(c) Rights of others are considered as property and therefore are subject to rules regarding violation of property rights;

(d) Any property leading to the denial of any valid claim or right would not qualify to be recognized ‘al mal’ and therefore will be considered unlawful according to shari‘ah.

Moving on to the research questions, they are answered one by one. The first question is that “whether Islamic Law has any principles relating to corporate governance?”

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After examination of original sources of Islamic law i.e. Quran, Sunnah of the Prophet Mohammad (S.A.W.W) and Ijma‘ the researcher found that there are four principles of Islamic law namely khilafah (vicegerency), amanah (trustworthiness), mas‘oliyyah (accountability) and shafafiyyah (transparency), which provide base for corporate governance.

In order to answer to question no. 2 that is “whether the current corporate governance practices of Islamic banking Institutions in Pakistan and Malaysia are compatible with the Shari‘ah principles?”, and 3, which is “whether the current Pakistani and Malaysian corporate governance regimes have any similarities or dissimilarities, the provisions of Malaysian and Pakistani regimes were analysed in the light of the four foundational principles of Islamic law in chapter 4 and 5 respectively. In chapter 4 and 5, from discussion on the Islamic corporate governance principle of amanah (trusteeship), the following results have been inferred:

a. Authority is amanah with authority-holders;

b. Hence, the roles and responsibilities, along with ancillary requirements thereof, of corporate governance players are amanah with the players;

c. The amanah of authority shall be handed over to competent persons;

d. In case of negligence and misconduct (intentionally) in performing their duties, the corporate governance players are liable for their actions.

These four implications of the principle of amanah have been applied to the theoretical frameworks relating to corporate governance practices in Pakistan and Malaysia to verify whether the principle of amanah (trusteeship) is complied with in such practices or not?

For the sake of convenience, the discussion is divided into three parts. Part A covers provisions other than the provisions of Shari‘ah Governance Framework (SGF) as these

762 Such as fulfilling qualification and experience criteria etc.
are discussed in Part B. In Part C, those provisions are covered, which are related to non-compliant actions of corporate governance players.

In part (A) the analysis of the provisions of Pakistani and Malaysian regimes demonstrated that all the corporate governance players (directors, managers and auditors) being authority-holders are holding their respective authorities as trust. Further, being trustees, the respective roles and responsibilities of the CG players, are also trust with them, no matter they are expressly provided in the legal regime or impliedly expected from them in the manner expected from holders of similar offices. However, the deficiency in these provisions is that they do not expressly provide for any consequences in case of negligence or misconduct of the CG players while performing their amanah. It means that the principle of amanah is not verified to the extent of accountability of corporate governance players for their non-compliant actions. Nonetheless, there are some provisions which make these players accountable for non-performance of their amanah. The provisions are discussed in part C.

From analysis of the provisions in part (C), it has been verified that corporate governance players are held liable for committing misconduct or willful defaults in performing their actions. So, it is argued that these provisions are usually compatible with the Islamic corporate governance principle of amanah because, the rule of amanah is that in case of negligence or misconduct (intentionally) in performing their amanah, the amanah-holders shall be held liable.

Further, by analyzing the provisions of Pakistani and Malaysian Shariah Governance Framework in part (B), it is concluded that all the corporate governance players are authority holders, hence trustees of their positions. Being on such positions, all their respective roles (both expressed and implied) are amanah with them. However, it is not verified from these provisions, whether in case of any negligence or misconduct in
performing their roles, the players shall be held accountable or not? Hence, it is argued that the Islamic corporate governance principle of *amanah* cannot be verified from these provisions to the extent of the accountability of the players in case of their non-compliance with the provisions of the SGFs.

Similarly, the provisions of Pakistani and Malaysian regimes have been analysed in the light of Islamic corporate governance principle of *mas'oliyyah* (accountability). *Mas'oliyyah* (accountability) means that human beings are accountable for their actions in this world as well as in the life hereafter. Based on this principle, the Islamic corporate governance players (inside Islamic financial institutions) are also accountable for their actions. The accountability of these players in the life hereafter is beyond doubt, however, its verification is impossible from the Pakistani and Malaysian theoretical frameworks relating to corporate governance. Therefore, our focus has remained on the worldly accountability of these players. Therefore, the provisions of the Pakistani and Malaysian regimes have been discussed from the perspective of accountability of corporate governance players in this world.

It was found that the provisions of Pakistani and Malaysian regimes relating to Islamic corporate governance practices in IBIs, are compatible with the Islamic corporate governance principle of *mas'oliyyah*. It is worthily mentioned however, that these are only some provisions, which hold the corporate governance players accountable for their non-compliant actions. Nonetheless, there are so many other provisions, which are silent regarding the accountabililty of the corporate governance players in case of their non-compliant actions. Similary, under the Malaysian SGF only SC members are held liable for their non-compliant actions, and no other player is responsible in this regard. Therefore, it is argued that the principle of *mas'oliyyah* cannot be verified in the
provisions of the SGF to the extent of the ICG players’ accountability for their non-compliant actions, except members of SC in case of Malaysia.

Further, the provisions of the Pakistani and Malaysian regime have also been analysed in the light of Islamic corporate governance principle of *shafafiyyah*. *Shafafiyyah* (transparency) means that actions of human beings must be disclosed so that their role is visible to all. On the same logic, the actions of authority holders (and in this case, the actions of corporate governance players) must be transparent. This is because it is the principle of transparency, which helps ensure that authority holders perform in responsible manner and that they are held accountable for their actions in case of instances of violation of their authority. Holding the players accountable is possible only when their actions are exposed (disclosed).

By applying the principle of *shafafiyyah* to Pakistani and Malaysian regimes, it was found that its provisions promote transparency in the activities of the IBIs as well as their players. Therefore, it is argued that almost all the relevant provisions of the Pakistani and Malaysian regime relating to transparency in IBIs are in conformity with the Islamic principle of *shafafiyyah*.

Finally, the Islamic corporate governance principle of *khilafah* (vicegerency) was also applied to the Pakistani and Malaysian regime relating to corporate governance practices. From the view point of Maulana Maudoodi (R.A) about *khaleefah* and his authority, it is easily inferred that corporate governance players are also vicegerents of Allah, who have no authority to act beyond the commands of Allah. Being Allah’s vicegerents, they are bound to perform according to the wills of Allah and must not act beyond their authority as given to them as vicegerent.

The principle of vicegerency is equally applicable to all corporate governance players with no exception, no matter he is in the capacity of Director, CEO or auditor. This is
because every corporate governance player, being human, is a vicegerent of Allah. Being vicegerents of Allah, all the corporate governance players must act within the parameters prescribed by Allah SubhanahuWaTa’ala. The parameter in this case for performing actions, is the delegated authority of vicegerency given by Allah. With respect to this study, the vicegerency demands shariah compliant activities.

It is further stated that the behaviour expected from a company (and in this case Islamic bank) is similar to the behaviour expected from an individual. However, the company is unable to perform its actions by its own, therefore, the board of directors acts as its brain. So, the expected behavior from a company is demonstrated in form of expected behavior of the board. Similarly, the way the company does not have any mind, it also does not have any organs. So, in the opinion of the researcher, the managers of companies (including Islamic banking companies) act as organs of the companies, hence the expected behavior from companies, is also extended to the expected behaviors of their managers.

Thus it is concluded that the rule of vicegerency is equally applicable to Islamic banks in the manner it is applicable to individuals. Further, it is also concluded that as the Islamic banks do not have any mind and organs, therefore, the expected role of vicegerency from the IBIs, is shifted to the board of directors and managers of the IBIs. So, on behalf of Islamic banks, the board and the managers of the IBIs act as vicegerents.

As, the principle of vicegerency is linked to shariah compliance, therefore, the Islamic banks as well as their corporate governance players are bound to ensure shariah compliance in the activities of the IBIs. For the purpose of ensuring shariah compliance in the activities of Islamic banks in Pakistan and Malaysia, the respective central banks of Pakistani and Malaysia have issued Shariah Governance Frameworks. From the analysis of these SGFs it was found that the roles of directors, management, members of SC and
SB, and other supporting players are aimed to ensure *shariah* compliance, therefore, it is confirmed that the provisions of the SGF are fully compliant with the Islamic corporate governance principle of *khilafah*.

Further, by comparing Pakistani and Malaysian regimes relating to corporate governance, the researcher found that there are so many similarities as well as dissimilarities between the two regimes. As most of the dissimilarities are minor in nature therefore, the researcher did not brought them all under discussion, and only major dissimilarities on the part of Malaysia are discussed. For example, in the absence of separate statutory law for Islamic banks in Pakistan, the research feels its need for IBIs because, the IBIs shall be statutorily recognized, and the banks shall derive their authority from proper statutory law. The proposed law (Islamic Banking Act) shall define authorized businesses and activities of Islamic banks. Roles and responsibilities of different corporate governance shall be included in the Act. Proper eligibility criteria shall be covered in it. Minimum qualification and experience shall be statutorily introduced. By covering all these areas in statutory law, they shall be made mandatory. So, if any IBI or any of its corporate governance players does not comply with requirements of the Act, necessary actions shall be taken against the responsible persons.

Similarly, there is no representation of shariah scholars on board of directors in Pakistan, although, board comprising of directors from different educational backgrounds, shall be very beneficial for Islamic banks. Because, they make policies and decisions on number of matters, which include legal, finance, accounts, business management, risk management, profit distribution and information technology. When their decision-makings cover such range of different areas, therefore, it is necessary that the board should include experts from each field. The presence of experts on board from different fields having different backgrounds, qualifications, skills and experience shall make it
easy for the board to make correct decisions about the fate of the institution. Expert of a particular field shall give better opinion regarding any matter relating to his field. In this way the board shall act efficiently. On the other hand, if the board lacks experts from different fields, then there is apprehension that some critical issues may be mishandled, which may cause loses to the organization. Based on the same logic, the researcher feels that it is necessary that shariah scholars are also given representation on BODs of Islamic banks so that the prime objective of shariah compliance is ensured in decision-making process. In this way knowledge sharing shall occur among members of board of directors the Shariah scholars. They will easily understand each others’ point of view as well the rationale for their opinion while discussing matters before arriving at any decision. As a result better shariah compliant decisions shall be made, which shall enhance the efficiency of the BODs in decision-makings.

Further, on management side, the most important position in any organization (including Islamic banks) is CEOship. Though, the management powers rest with managers, but CEO is on top of management. More or less, it is the CEO who holds all the management powers\textsuperscript{763}. Holding such an important position of management, still the Pakistani regime ignores him because it does not expressly provide his role. This is a big flaw in the Pakistani regime. Therefore, it is suggested that the role of the CEO (especially of Islamic banks) shall be provided in the statutory law as soon as possible. Otherwise, it will be difficult to hold him accountable for any non-compliance on the part of management. Holding any person accountable is possible only when his role and responsibilities are expressly provided by law.

Likewise, the Pakistani SGF does not mention any scope of internal Shari‘ah audit. The task to define scope of internal shariah audit, has been assigned to Shariah Board under

clause (iii) of Section 6. This is a deficiency in the Pakistani SGF. The scope of the internal shariah audit is important. Therefore, it is necessary that it is expressly provided in the PSGF. In this way, the auditors shall be able to understand their duty in expressed terms, who shall perform it clearly. If in case they do not follow the requirements of the SGF relating to scope and process of the shariah audit, they shall be accountable for such non-compliance. Further, it will bring uniformity in the scope and process of shariah audit among Islamic banks in Pakistan.

In view of the researcher, holding degree from madrasa (religious institution) as required by SBP in fit and proper criteria for shariah advisors, is not useful because of two reasons. First, the shariah scholar will not be an expert in fiqh al-mu‘amalat (Islamic law of contracts and business transactions). Second, he will not be able to practically apply such knowledge in Islamic finance. Similarly, degree-holder in Islamic jurisprudence is also not a suitable candidate for the post of shariah scholar because the Islamic jurisprudence is the field which does not directly deal with Islamic commercial transactions. It is the science of principles and comprehensive evidences, on the basis of which ahkam are derived, and not a direct study of ahkam (rulings) especially ahkam of mu‘amalat (rulings on transactions). Likewise, post graduate degree in Islamic Studies (Usooluddin) also does not enable a candidate to be competent enough to act as efficient shariah scholars inside Islamic banks because the focus of Islamic studies remains more on acts of worship than mu‘amalat (transactions) especially mu‘amalat al-maliyyah (financial matters).

On the other hand, the requirement of degree in fiqh or fiqh al-mu‘amalat, from shariah scholars is beneficial for Islamic banks. Fiqh is the knowledge (Science) of practical

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764 For example, Quran and sunna as a whole, are comprehensive evidences. They are different from detailed (individual) evidences (for example, the verse of Quran dealing with cutting of hands of a thief, is detailed evidence).

shariah rulings pertaining to conduct that are derived from the detailed (individual) evidences of shariah. This definition suggests that fiqh deals with practical conduct of human beings, which include acts of worship (such as prayer, subject of fiqh al- ‘ibadat), acts of transactions (such as sale/purchase, subject of fiqh al-mu ‘amalat) and acts of crime (qisas and hudood, are subjects of fiqhal-jinayat). These three are the main subjects of fiqh. Fiqh is broader than Fiqh al-mu ‘amalat. The later is a special subject of the former. However, both include the knowledge relating to individuals’ mutual transactions. It also includes knowledge of business transactions such as musawamah, murabaha, salam, mudharabah, musharakah, and istisna.

Persons with degree in fiqh or fiqh al-mu ‘amalat shall be able to tackle financial matters of Islamic banks with better understanding. Islamic banking business is based on the Islamic business transactions, hence the shariah scholars holding degrees in the above mentioned fields are most suitable to become members of SC. Therefore, in the opinion of the researcher, the minimum qualification required from shariah scholar of Islamic banks should be a degree in fiqh al-mu ‘amalat (Islamic law of contracts and business transactions). For this purpose, it is suggested that universities should start specific degree in fiqh al-mu ‘amalat.

767 Ahkam (rules) relating to aqeeda (such as trust in God and Day of Judgement) and akhlaq (such as obligation of telling truth and prohibition of telling lie) are excluded from the subject of fiqh. (See, Abdul Karim Zedan, Al-wajeez fi ‘Usool al-Fiqh, Dar Nashr ul-kutub al-islamiyyah, (1976), p. 9.
768 Dr. Mahmood Ahmad Ghazi has divided the subject of fiqh into two main divisions. One is related to acts of state the other is related to acts of subjects (citizens) of state. The former type of fiqh includes muslim administrative law, muslim criminal law, muslim procedural law and muslim international law. The latter includes acts of worship, muslim family law, transactions and social dealings. (See generally, Mahmood Ahmad Ghazi, Mahadhirat-e Fiqh, Al-Faisal Nashran, (2005).
769 Sale without mentioning the cost price or profit margin.
770 Sale by mentioning the cost price as well as profit margin.
771 Contract of advance payment and defred delivery of goods.
772 Contract of participation in which one party provides capital while the other party provides skills.
773 Contract of participation in which both the parties provide capital.
774 Contract of manufacturing.
The researcher argues that there are two approaches are very much helpful for ensuring shariah compliance in an institution’s activities. According to one approach, whenever any non-compliance activity is identified, it is rectified. This approach is adopted in the shariah review and shariah audit functions of the IFIs as discussed chapter 4. The second approach is that to anticipate any shariah non-compliance risks before its occurrence so that proper shariah risk management policy is made timely, and the event is avoided or stopped from occurrence. For this purpose, the presence of a proper Shariah risk management function (SRMF) inside IBIs, is very much significant. But the Pakistani regime does not cover this important function. Therefore, it is suggested that the PSGF should provide for the establishment of the function inside Islamic banks.

Like SRMF, the Pakistani corporate governance system lacks shariah research function. Proper shariah research function is very much significant for shariah board because shariah issues in hand shall not be decided abruptly, rather proper research shall be conduct on it. In this regard, all the relevant principles of shariah shall be studied. All aspects of the issues shall be discussed, hence the chances of non-complianace of shariah shall be minimized, and a consistent shariah compliant environment shall be ensured. Therefore, a shariah research function needs to be established inside Islamic banks in Pakistan.

In the opinion of the researcher, if the above mentioned reforms are properly adopted, the corporate governance system for Islamic banking institutions shall become more efficient as well as shariah compliant.

The above mentioned practices are the strengthes of the Malaysian regime, which are borrowed for Islamic banks in Pakistan. Nonetheless, in addition to the above recommendations, the researcher gives some more suggestions to further enhance the Pakistani corporate governance framework for IBs. Further suggestions are:
A. For example, no member of a Shari’ah Board of one Islamic bank should be allowed to work on the Shari’ah Board of any other Islamic bank as is currently allowed under clause (vi) of Section 3(A) of the Pakistani SGF. However, it is suggested that a good understanding and co-ordination among members of different board of different Islamic banks shall be encouraged. Such co-ordination shall ensure harmonization in the decisions of the different Shari’ah Boards.

B. Similarly, the current shariah governance framework does not fully ensure independence of shariah board’s members from the expected influence of the BODs as long as the board is entitled to appoint the members of the SB. Therefore, in order to ensure their independence, the researcher suggests that the SB members need to be directly appointed by the SBP.

C. The external Shari’ah audit firms shall be required to have Shari’ah officers (Shari’ah auditors) as their partner, so that the firms are enabled to conduct the external Shari’ah audit function correctly. In future it would be preferred if all partners of the external Shari’ah audit firms are Shari’ah auditors (Shari’ah officers). The Shari’ah auditors shall have degree in Shari’ah.

D. The Human Resource and Remuneration Committee shall be divided into Nomination Committee and Remuneration Committee. Each committee shall be assigned with particular role in expressed terms. Currently, except Audit Committee, no expressed roles have been assigned to any other committee in Pakistan. Besides, there should be Islamic Corporate Governance Committee (ICGC) and Shari’ah Risk Management Committee in the Islamic banks in Pakistan. The Shari’ah Risk Management Committee (SRMC) shall be responsible for the Shari’ah risks in the business and transactions of the Islamic banks. In this regard, the Shari’ah Risk Management Function (SRMF) shall report to the SRMC. The Islamic Corporate Governance
Committee shall ensure the overall Islamic corporate governance compliance in the IBIs. Here the Islamic corporate governance compliance means compliance of BODs, SB, Management, Internal and External Shari'ah Audit with the requirements of competency, eligibility, qualification, composition and their roles.

E. The Pakistani corporate governance regime also does not provide for the responsibilities of individual directors of Islamic banks. In section 1 of the SGF, role of board of directors has been given only. Therefore, the researcher suggests that the SGF specially assigns/mentions duties of individual directors of Islamic banks.

F. The regime does not state any responsibility of Independent directors of Islamic banks. Therefore, along with the independent judgment on Shariah compliant decisions of the board, the independent directors of IBIs should be assign expressed role specifically with respect to Islamic banks. For this purpose new clause should be added in the existing Shariah Governance Framework for IBIs.

G. The Pakistani regime also does not expressly provide for the role of the chairman of the board of directors of Islamic Banks. Therefore, the researcher feels deficiency in the current regime and suggests for inclusion of roles of chairman of Islamic banks. His role may include to make sure smooth function of board and that procedures and guidelines are in place for the operation of board of Islamic banks. Most importantly the chairman shall ensure that the members of the board have prime objective of shariah compliance, and that all matters are resolved subject to the objective of Shariah compliance.

H. Currently, under Section 193(1) of CO, 1984, the minimum quorum for meeting of board of directors is 1/3 or 4 members. This shall be increased to at least 51% members of the board, which shall be mandatory.
I. Similarly, under para (vi) of BSD Circular No. 15 of June, 13, 2002, it is required from every director that he should attend at least 50% meetings of the board of directors. Such individual attendance shall be increased to 75% and be made mandatory.

J. The Pakistani SGF does not assign any detailed role to CEO of an Islamic bank. Therefore, the researcher suggests that the SGF include the role of CEO of Islamic banks. In addition to implementation of board’s policies and decisions, the prime objective of CEO must be shariah compliance while performing the day-to-day operations of Islamic banks.

Areas for Further Research

Shariah Compliance Rating of Islamic banks in Pakistan
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