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THE SIGNIFICANCE OF CORPORATE GOVERNANCE IN ISLAMIC BANKING: ENHANCING ACCOUNTABILITY AND PERFORMANCE

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ABSTRACT

Corporate governance plays a pivotal role in shaping the operations and outcomes of Islamic banking institutions. This research paper delves into the importance of corporate governance within the context of Islamic banking, focusing on its role in promoting accountability and improving performance. By adopting a comprehensive and Sharia-compliant framework for corporate governance, Islamic banks can enhance their transparency, ethical behavior, and stakeholder engagement. The paper explores the principles and values underpinning corporate governance in Islamic banking, emphasizing the need for effective governance structures, board practices, risk management mechanisms, and disclosure standards. Furthermore, it highlights the impact of robust corporate governance practices on the financial stability, public trust, and long-term sustainability of Islamic banks. The findings of this research underscore the vital role of corporate governance in fostering the growth and development of Islamic banking, contributing to a more resilient and responsible financial system.

Keywords: Corporate governance, Islamic banking, Accountability, Performance, Sharia-compliant framework
JEL Codes: G30, E50

1. INTRODUCTION

The availability of finances plays a vital role in the development process of an economy (Ali, 2015; Ali, 2018; Ali and Bibi, 2017; Sajid and Ali, 2018; Ali, 2022; Audi and Ali, 2019). Corporate governance in the banking sector has traditionally been analyzed within the framework of the conventional banking market. However, recent discussions in risk management have shed light on the significance of "market discipline" in influencing the behavior of depositors and bank shareholders, aiming to mitigate risky behavior (Hermalin & Weisbach, 2012). Additionally, the prevailing bank structures in countries such as Germany have attracted considerable attention, as the analysis of banks and the role of shareholders play a pivotal role in shaping effective corporate governance practices (Arping & Sautner, 2010; Ali, 2022; Ali, 2022). Despite the substantial presence and rapid growth of Islamic finance since the 1970s, there exists a noticeable dearth of literature examining the governance structure and criticisms associated with Islamic finance (Obaidullah & Khan, 2008). Islamic finance operates under specific guidelines outlined by international financial institutions, with around 180 destinations worldwide, including Europe, North America, and several Muslim-majority countries (International Monetary Fund, 2019). The expansion of Islamic financial institutions across 45 countries demonstrates the increasing recognition and adoption of Islamic banking and finance principles in both the international market and the Muslim world (International Islamic Financial Market, 2019).

The inclusion of Islamic banking subsidiaries in various institutions, such as the Islamic Development Bank, City Investment, Bahrain, and Citicorp Western banks, has garnered significant attention (Alkassim Farid, 2019). Islamic finance, as a departure from traditional banking practices, encompasses distinctive characteristics that revolve around risk-sharing, participatory arrangements, and adherence to Islamic principles (Saeed, 2016). Unlike conventional banking which relies on interest-based transactions (Riba), Islamic banking operates on the principles of profit-sharing and risk-sharing (Haron & Shanmugam, 2013). Depositors in Islamic banks receive returns based on profit-sharing ratios, reflecting a fair allocation of funds and incentivizing investments (Haneef & Pervez, 2019).

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Islamic banking stands apart from traditional banking in terms of the relationship between the bank and its depositors. In Islamic banking, depositors are treated as partners rather than lenders, engaging in mutually beneficial business partnerships (Ali, 2017). This distinct approach allows Islamic banks to direct depositors' funds toward productive and ethically sound investments (Siddiqui, 2019). Consequently, the ownership and governance structures of Islamic banks differ significantly from the traditional model, as stakeholders actively participate in financial management decisions and investment activities (Rammal & Zurbruegg, 2007). Moreover, the operation of Islamic banks is guided by strict adherence to Islamic law (Shariah), meeting the expectations and requirements of the Muslim community (Askari, Iqbal, & Mirakhor, 2011). Islamic banking has created unprecedented opportunities for governments to align investment and financing practices with Islamic principles, catering to the specific needs of the Muslim population (Archer & Karim, 2011).

To understand corporate governance in Islamic banking, it is essential to consider the unique characteristics and principles that govern Islamic finance (Ahmed, Hassan, & Siddiqi, 2018). Islamic banks adhere to Sharia principles, which require them to establish Sharia boards or seek guidance from individual consultants well-versed in Islamic law (Iqbal & Molyneux, 2016). These boards or consultants ensure compliance with Islamic principles and oversee the ethical aspects of the bank's operations (Hossain & Leo, 2019). When discussing corporate governance in Islamic banking, it is important to compare the governance structures of Islamic banks with those of conventional banks and explore the specific rules and regulations of Islamic finance (Iqbal & Molyneux, 2016). Islamic banking operates under a distinct financial model that aligns with Islamic principles and emphasizes profit-sharing, risk-sharing, and the avoidance of interest-based transactions (Riba) (Warde, 2000). These principles have implications for the governance structures of Islamic banks, as they prioritize ethical and socially responsible practices (Kahf & Khan, 2015). The governance structure of Islamic banks is designed to ensure compliance with Sharia principles and meet the expectations of society by providing financial services in a manner consistent with Islamic legitimacy (Iqbal & Mirakhor, 2011). This includes adhering to profit and loss-sharing arrangements, which foster a closer relationship between the bank and its stakeholders compared to traditional interest-based lending (Rammal & Zurbruegg, 2007). Islamic banking emphasizes the establishment of a unique corporate culture based on collective morality and spirituality, integrating business activities with the advancement of the Islamic way of life (Wilson, 2006). In short, corporate governance in Islamic banking is shaped by the principles of Islamic finance and the need to comply with Sharia guidelines. The unique structure of Islamic banks, their emphasis on profit and loss sharing, and their alignment with Islamic principles set them apart from conventional banking practices. As a result, Islamic banks prioritize ethical conduct, societal expectations, and the promotion of the Islamic way of life within their governance frameworks.

1.2. GOVERNANCE STRUCTURES

Technically, the conceptual framework of corporate governance in Islamic banking is characterized by two key elements, which are reflected in the organizational structures. Firstly, there is the presence of the Sharia Supervisory Board (SSB), which plays a crucial role in ensuring compliance with Islamic principles and ethical standards within the bank's operations. The SSB consists of knowledgeable Islamic scholars who provide guidance and oversight on matters related to Sharia compliance in financial transactions and products (Haniffa & Hudaib, 2007). Their expertise helps maintain the integrity of the bank's operations and ensures adherence to the principles of Islamic finance. Secondly, the internal controls within Islamic banks support the governance framework. These controls are designed to monitor and manage risks, ensure transparency, and maintain accountability. Internal control mechanisms include robust risk management frameworks, independent audit functions, and effective board oversight (El-Masry & Abd-Elsalam, 2018). These controls are essential in safeguarding stakeholders' interests and upholding the principles of good corporate governance. The combination of the Sharia Supervisory Board and internal controls establishes a comprehensive governance structure in Islamic banking. This framework aims to ensure compliance with Sharia principles, promote transparency, and foster responsible and ethical business practices.

1.3. GOVERNANCE MODEL IN ISLAMIC CORPORATE GOVERNANCE FRAMEWORK

The concept of corporate governance in the Islamic economic context differs significantly from that of national and international economies. The Islamic perspective emphasizes principles such as Shura (consultation), justice, equality, and human dignity as the foundation for the social and political organization (Suleiman, 1999). Shura, in particular, holds a prominent position and is regarded as one of the fundamental principles guiding governance in Islam. It entails consultation and decision-making based on the Quran and the Prophet Muhammad's teachings, with the aim of administering the affairs of society in accordance with Islamic principles (Suleiman, 1999). In Islamic financial institutions, the adoption of effective strategies for corporate governance is essential to align business management with Islamic values and principles. Historically, many Islamic countries and organizations have inherited economic policies from the colonial era, influenced by Western thought and shareholder wealth maximization (Hassan, 2009). However, the emergence of Islamic economics as a discipline aimed to create or restore economic systems based on Islamic principles, including the concept of corporate governance (Lewis, 2006). Islamic corporate governance entails decision-making processes within the framework of Islam, considering the interests of various stakeholders such as shareholders, financial management, suppliers, customers, competitors, and employees (Hassan, 2009). To ensure compliance with Islamic principles, Islamic corporate governance incorporates mechanisms such as Shura-based decision-making, accountability, resource utilization, and the establishment of audit processes (Suleiman, 1999). These mechanisms provide a framework for transparent and responsible governance, guided by the principles of Islamic law.

1.4. ECONOMIC SYSTEM AND ACCOUNTABILITY

The structure of the economic system, particularly in planned economies, often prioritizes materialistic gains and individual benefits. However, the literature on economic behavior in the Muslim community highlights the importance of incorporating economic incentives that align with Islamic values and principles. Research suggests that the proportion of individuals who prioritize non-monetary aspects in their decision-making is higher compared to those solely focused on financial gains (Clark, 1997). The Quran emphasizes the concept of "accountability" in various contexts, emphasizing that every Muslim has a responsibility towards their actions and the consequences thereof. The notion of "account" or "hesab" appears repeatedly in the Quran, reinforcing the idea of being answerable for one's deeds. This reference to accountability extends beyond the conventional understanding and encompasses ethical considerations in the utilization of resources and building trust among people (Clark, 1997). In Islamic governance, there is a parallel emphasis on adhering to general rules derived from Islamic principles. Historical examples, such as the implementation of Ibn Khaldun's government role, highlight the serious commitment to ethical and legal considerations in Muslim societies. Political power, when not corrupted, plays a crucial role in addressing morally reprehensible actions in the economic and social spheres (Clark, 1997). Corporate governance is a vital aspect of the Islamic industry, ensuring the fulfillment of responsibilities towards shareholders, the company, and the public. In an increasingly aggressive global economy, the institutional framework must be designed to serve the interests of Takaful providers (Islamic insurance) and manage potential threats. The Islamic perspective on corporate governance emphasizes three key factors: accountability, transparency, and reliability (Clark, 1997).

1.5. CORPORATE SOCIAL RESPONSIBILITY

Corporate social responsibility (CSR) can be defined as the voluntary integration of social and environmental concerns by businesses in their operations and interactions with stakeholders. The concept of CSR aims to motivate organizations to consider the interests of various stakeholders, including customers, employees, shareholders, society, and the environment, in all aspects of their operations (Carroll, 1979). When discussing CSR, it is crucial to acknowledge the role of the government in the economic system. The central question revolves around whether the government should intervene in organizing economic affairs or allow the private sector to take the lead. This debate often leads to discussions about government intervention, economic management, and market regulation. The government's involvement in the economic system determines the correlation between state regulations, the functioning of the market, and the vitality of labor and capital (Khan, 2017).

From an Islamic perspective, accepting responsibility and accountability is deeply ingrained. Muslims believe that every action and word should be in accordance with the teachings of Islam, as they view life as a test and strive to align their actions with the will of God. Islamic teachings emphasize the importance of accountability in human life, as exemplified by the Prophet Muhammad's statement that each individual should be a guardian and protector of others (Kuran, 2004). This notion of social responsibility highlights the obligation of individuals to contribute to the well-being of society and foster a sense of interconnectedness. In the Islamic economic system, the overall goal is for people to live in accordance with the principles of Islam and to pursue profit without exploiting others. The welfare of the Muslim community and the protection of individual rights are emphasized. Zakat, a form of obligatory charity, is widely accepted and utilized by Muslims for the betterment of society (Siddiqi, 2008).

2. PURPOSE OF ISLAMIC BANKING

The marketing of Islamic financial institutions is closely tied to the financial situation of consumers. Islamic finance offers opportunities for cost-effective and socially equitable distribution of resources, appealing to both Muslims and non-Muslims in various countries. Major projects in the UK, for example, require parties to consider Islamic financing options, emphasizing the importance of affordable pricing (El-Gamal, 2006). Investors from the Middle East, Far East, and the UK recognize the significance of Islamic institutions in Pakistan that offer affordable services (Ashraf, 2015). In Pakistan, there are numerous Islamic institutions that provide services at reasonable prices, contributing to the industry's revenue growth (State Bank of Pakistan, 2009).

From January to May 2009, sales strategies, financing, and investments in Islamic institutions in Pakistan increased significantly, resulting in revenue growth (State Bank of Pakistan, 2009). The sector has experienced rapid growth in recent decades, surpassing its traditional alternatives in terms of development (Hassan & Lewis, 2007). However, it is important to note that the availability of new low-cost systems in the market has influenced the performance indicators of Islamic institutions. The focus should be on improving payment platforms and enhancing operational skills to effectively manage income and achieve higher returns on assets (ROA) and returns on equity (ROE) (Ashraf, 2015). While the initial years demonstrated a higher ROA and ROE for Islamic institutions, primarily due to investments and the development of management systems, subsequent years showed a decline in these indicators (Ashraf, 2015). The industry's focus should be on improving ROA and ROE, particularly with the emergence of new profitable institutions. Adapting to changes in the macroeconomic environment will play a crucial role in enhancing the performance of Islamic institutions (Hassan & Lewis, 2007).

3. SCOPE OF SHARIA COMPLIANCE MAQASID AL - THE PURPOSE OF THE SHARIA

Islam, as a comprehensive belief system, incorporates celestial and spiritual sources to shape its legal framework, known as Sharia. The primary sources of Sharia are the Quran and the Sunnah of the Prophet Mohammad. Sharia can be divided into two categories: ibadat (worship-related matters) and muamalat (social and economic matters). Islamic finance is closely connected to the principles derived from these sources, emphasizing the relationship between individuals, Allah (God), and the broader community, as well as the objectives of a person's life in this world. The central tenet of Islamic finance is the connection between an individual and Allah through the concept of Tawhid (Oneness of God). This concept requires complete submission to the will of Allah, encompassing both wealth distribution and individual lifestyle choices. According to Islamic teachings, all resources in the universe belong to Allah, and humans are mere custodians with financial privileges but not absolute ownership. Therefore, financial decisions and actions should be guided by principles such as iqtisad (moderation), adl (justice), ihsan (excellence), amanah (trustworthiness), and fulfilling obligations (faq). Conversely, negative principles such as zulm (tyranny), bukhl (greed), isr (usury), iktinaz (hoarding), and israf (waste) should be avoided. These principles form the foundation of the Islamic financial system (Hassan & Lewis, 2007). The Sharia not only governs financial matters but also encompasses self-care in terms of physical, emotional, and temporal aspects of an individual's life. By adhering to the quality of the Sharia, individuals can ensure that their work and agreements are based on the principles of Amanah (trustworthiness) and are accountable to Allah, themselves, clients, and partners (Hassan & Lewis, 2007). Complying with the maqasid al-sharia (objectives of Sharia) requires individuals to fulfill their moral, public, and business obligations. Muslims are encouraged to fulfill all their responsibilities, not only to themselves but also to the broader society. This approach promotes a win-win situation in which individual efforts, faith, lifestyle choices, and intelligent financial management in Islamic financial transactions contribute to the well-being of both commercial and moral realms (Hassan & Lewis, 2007).

4. LITERATURE REVIEW

Crespi et al. (2004) conducted a study to examine the relationship between state intervention and the return on savings in the commercial banking system. Their findings suggested that there is no significant relationship between state intervention and the performance of the banking system. However, Thibault (year) argued that these results can vary depending on the specific context and the level of state intervention. In a separate study conducted in Los Angeles, it was observed that there is a negative association between state intervention and the performance of commercial banks. This negative effect was particularly evident in the executive compensation structure and the overall profitability of the banks (Crespi et al., 2004). The research indicated that a higher proportion of state intervention led to a decline in executive compensation and financial performance of commercial banks in Los Angeles.

Rasiah and Kim (2010) conducted a study to investigate the relationship between corporate governance and performance in Mexican banks before and after financial crises. The banks were categorized into two groups: privately owned domestic banks and foreign-owned domestic banks. The research findings revealed a positive and significant correlation between corporate governance and bank performance in Malaysia. However, this association was not observed during the financial crisis period. The study highlighted that domestically owned private banks demonstrated better performance compared to foreign banks and state-owned banks, largely due to the effective implementation of corporate governance practices and the central bank's role in promoting good governance.

The Anglo-Saxon model, also known as the American or British model, is based on the principles followed in the United States and the United Kingdom. This model emphasizes the maximization of shareholder value and prioritizes the interests of shareholders to enhance profitability and efficiency (Hassan, 2009). According to the International Chamber of Commerce, the Anglo-Saxon model places a strong focus on concentrated ownership, with a few individuals or entities holding significant control over the company's management (Lehtinen, 2018). This concentration of power often results in the appointment of independent directors to safeguard the interests of minority investors (United Nations, 2015).

5. MODEL FOR EUROPE

In contrast to the Anglo-Saxon model, the European model of corporate governance presents a different approach. The European model is based on the idea of balancing the interests of various stakeholders, not only focusing on maximizing shareholder value as in the Anglo-Saxon model (Mirakhor & Iqbal, 2004, p. 46). This model emphasizes the importance of considering the rights and concerns of all stakeholders when making business decisions (Lehtinen, 2018). The corporate governance characteristics in Iran can be described by the presence of creditor banks and Al-Qaida. Internal governance structures are approximated by the characteristics held by all resources in the country, and significant shareholders, including the government, exert control over private activities such as inventory management and purchasing. Institutional shareholders have a limited role, while minority shareholders have minimal supervision (Mchaakhi, 2008).

In recent years, the Government Code of Iran has undergone significant development and presented evidence of progress in 2004. The code consists of 22 substantive articles that define management, board and shareholder responsibilities, financial disclosure, accountability, and audit concepts. The code was officially issued in 2005, taking into consideration ownership structure and capital sector regulations. The second edition of the Code of Good Governance in Iran consists of five chapters and 37 clauses, and it has been widely disseminated through various media channels and organizations (Mchaakhi, 2008).

Pakistan has implemented reforms in its capital market to attract foreign investment and enhance corporate governance practices. Assistance from the Asian Development Bank (ADB) and the United Nations Development Programme (UNDP) has supported the restructuring of the capital markets. The Securities and Exchange Commission of Pakistan (SECP) has been responsible for consolidating and expanding the regulatory framework. Notable revisions have been made to the code in this process. The legal framework for corporate governance in Pakistan can be categorized into several aspects:

- Laws pertaining to business and industry organizations.
- Regulations and guidelines for the implementation of the Companies Act.
- Listing rules and regulations of the stock exchanges.
- General authority for civil code, which covers claims and recovery processes.
- Penal laws addressing embezzlement, fraud, and related offenses.
- Special provisions under the National Accountability Act of 1999 to address fraud and embezzlement of company funds.

The SECP views corporate governance as a process that aims to ensure the highest standards of business administration and ethical conduct while protecting the interests of all stakeholders. It emphasizes principles such as goodwill, trust, transparency, and accountability in relationships. Corporate governance encompasses the design, management, and administration of businesses and institutions to promote prosperity and the long-term interests of shareholders, taking into account the interests of other stakeholders (SECP, n.d.).

According to the Anglo-Saxon model, corporate governance encompasses various mechanisms aimed at achieving a suitable equilibrium between the rights of shareholders and the expectations placed upon the Board of Directors. It involves the effective management, administration, and leadership of an institution to ensure optimal returns for shareholders within the context of business operations. At its core, corporate governance within the Anglo-Saxon model revolves around the following key aspects: Effective leadership entails efficient management practices, guiding principles rooted in honesty, and assuming responsibility for leadership roles. It emphasizes the importance of transparent and accountable management practices (Tricker, 2015). The Anglo-Saxon model of corporate governance emphasizes the need for strong leadership and governance structures within organizations. This model focuses on maximizing shareholder value and ensuring that management acts in the best interests of shareholders. It emphasizes transparency, accountability, and ethical decision-making in corporate practices (Solomon, 2013).

6. METHODOLOGY

Corporate governance is an essential framework that upholds the principle of social justice by ensuring the involvement of all stakeholders, including shareholders and employees (Solomon, 2018). It serves as the guiding force for maintaining transparency, accountability, and fairness within the operations of a company (Solomon, 2013). The principles of corporate governance aim to safeguard the interests of shareholders while considering the broader impact on society (Solomon, 2018). In the pursuit of understanding corporate governance, researchers often rely on secondary data sources for their investigations. Utilizing secondary data offers several advantages. One significant advantage is the time and cost savings associated with using existing data. Researchers can bypass the need to collect data from the field, allowing them to focus their efforts on analyzing and interpreting the information at hand. Moreover, employing secondary data can be a cost-effective alternative, as it eliminates the need for extensive on-site visits or data collection processes (Panneerselvam, 2014). However, it is crucial to exercise caution when working with secondary data. The accuracy and authenticity of such data can be challenging to verify. Researchers must exercise due diligence in selecting and utilizing secondary data, taking responsibility for any inaccuracies that may arise (Panneerselvam, 2014). In short, corporate governance plays a vital role in upholding social justice and ensuring the involvement of all stakeholders in decision-making processes. Researchers often rely on secondary data sources to gain insights into corporate governance practices, leveraging the advantages of time and cost savings. However, it is essential to carefully evaluate the accuracy and reliability of secondary data to ensure the integrity of research findings.

7. CONCLUSIONS

Pakistan has made significant efforts in implementing reforms and promoting the presence of Islamic banking within its financial market. The introduction of Islamic banking institutions in the country has set a precedent for other nations around the world (Naeem, 2018). However, to ensure the success of this sector, it is crucial for the government, regulatory bodies, judiciary, researchers, practitioners, and educational institutions to actively participate in establishing a strong foundation for the industry (Iqbal & Mirakhor, 2007). Legal and regulatory challenges, along with the lack of awareness and understanding, have hindered the penetration of Islamic banks in the financial sector of Pakistan (Rahman & Akhtar, 2016). Overcoming these obstacles requires the development of appropriate laws and governance codes that cater to the unique aspects of Islamic banking (Ali et al., 2017). By adhering to Islamic values and principles, such as ethical behavior, social responsibility, justice, and transparency, the industry can ensure the economic welfare of society and enhance corporate performance (Ali et al., 2017; Rahman & Akhtar, 2016). In terms of corporate governance, the Islamic economic system emphasizes earning a livelihood without engaging in exploitative practices and aims to benefit all stakeholders involved (Kettell, 2015). The principles of corporate governance in Islam are derived from the concept of community and aim to promote social justice, mutual responsibility, transparency, and trust (Ali et al., 2017; Naeem, 2018). By aligning corporate practices with these principles, companies can mitigate the risks of corporate fraud, enhance accountability, and improve overall performance (Kettell, 2015). In conclusion, Pakistan has made progress in fostering Islamic banking reforms, but further efforts are needed to overcome legal and regulatory challenges and promote awareness. Adhering to the principles of Islamic values and incorporating effective corporate governance practices are essential for the success of the Islamic banking sector and the achievement of its socio-economic goals.

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