CORPORATE GOVERNANCE OF ISLAMIC FINANCIAL INSTITUTIONS*

Zulkifli Hasan**

ABSTRACT

Corporate governance is one of the essential elements of corporation as it plays roles to design and promote principles of fairness, accountability and transparency. Western concept of corporate governance either the neo-liberal approach that promotes shareholder-value system or the continental model that upholds the stakeholder-value system has been subject of continuing debate for well over a century. It is observed however that there is not much discussion or literature on the issue of corporate governance from the Islamic perspective. It is strongly indicated that any Islamic corporation particularly Islamic financial institution needs to have a solid governance model and proper strategies that will promote the adoption of strong and effective corporate governance within the Islamic paradigm. This paper is intended to provide an overview on the corporate governance from Islamic perspective focuses on the Islamic financial institution.

1.0 Introduction

Corporate governance in banking has been analyzed very extensively in the context of conventional banking markets. By contrast, little is written on corporate governance from Islamic perspective or *Islamic* corporate governance particularly the governance structures of Islamic finance sector, despite its rapid growth since the mid 1970s and their increasing presence on world financial markets[1].

Undeniably, corporate governance is one of the vital elements of any corporation development and it is even bigger challenge to Islamic finance system due to its additional risk as compared to the conventional banking system. For instance the depositors would become exposed with various kind of risks when the Islamic banks started moving into the risk-sharing modes i.e. *mudharaba* and *musyaraka*[2]. Therefore, it is strongly indicated that any Islamic corporation particularly Islamic financial institution

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** Faculty of Syariah and Law, Islamic Science University of Malaysia, Tel: +44 (0) 1913772571 Mobile: +44 (0)7761457686 E-mail: zul361977@yahoo.com
[1] Yunis, H. *Corporate Governance for Banks*. In Rifaat, A.A.K. and Archer, S. (Ed.s) (2007). *Islamic Finance: The Regulatory Challenge*. Singapore: John Wiley & Sons (Asia). p. 308. The surveys of Siddiqi, M.N., (1981) and Haneef, M.A., (1995), on the contemporary literatures on Islamic economic thought prove that there are lack of references and discussion on the topic of corporate governance from Islamic perspective. In addition, Mannan, M.A. (1984) in his compilation of abstract of researches in Islamic economics also further shows the absence of specific research on Shari'ah corporate governance. Only in 2002, Chapra, M.U. and Ahmed, H, published their research entitled Corporate Governance in Islamic Financial Institution, an academic project sponsored by the Islamic Development Bank to study the corporate governance issues in the Islamic financial institution.
[2] Chapra, M. U. *Challenges Facing the Islamic Financial Industry.* Hassan, M.K and M.K. Lewis. (Ed.s) (2007). *Handbook of Islamic Banking*. Cheltenham, UK: Edward Elgar Publishing Limited. p. 338.

needs to have a proper governance framework to ensure its growth and success. This paper attempts to provide a brief overview on the concept of corporate governance from Islamic perspectives. The initial study submits that Islam presents distinctive values and special characteristics of corporate governance with aim to uphold and maintain the principle of social justice not only to the shareholders of the firm but to the all stakeholders.

2.0 Conceptual Definition of Corporate Governance

2.1 Defining Corporation

Literally, the word corporation derives from the *latin* word "corpus" which means body, aggregate, or mass. *Corpus* might be used to mean a human body, or a body or group of laws. American Heritage Dictionary defines it as a body of persons granted a charter legally recognizing them as a separate entity having its own rights, privileges and liabilities distinct from those of its members.

Although the concept of partnership in the form of *musyarakah* or *mudharabah* is well known since in the early period of Islam, it is found that there is less discussion on a concept akin to the corporation[3]. In fact, Kuran, T., writes that the corporation was absent from the Middle East until the nineteenth century[4]. Muslim jurists have already accepted a concept of corporation known as *Shahsiyah I'tibariyah* based on principles of *qiyas* (analogy) and *istihsan* or *masalih mursalah* (public interest. In fact, the existence of public treasury (*Bayt al-Mal*) and the endowment (*Waqf*) implies the recognition on the concept of corporation with separate legal entity in Islam. Nyazee, I.A.K.,[5] clearly states that the earlier Muslim jurists were fully aware of the concept of corporate personality but they rejected it for the system they were dealing with. He further mentions that most of Muslims modern scholars claim that this concept was known to Islamic law and only some of the scholars are doubtful on this position. As the study focuses on the issue of corporate governance, the paper does not intend to discuss in depth the debates on the concept of corporation. It is submitted that the concept of artificial personality or a corpus with a separate legal entity is clearly accepted in Islam.

2.2 Defining Governance

[3] There were discussions by Muslim jurists on the concept of *Syahsiyah I'tibariyah* or corporation in Islam since 6th century but only in 19th century the concept is materialized through the establishment of the first Muslim-owned corporation namely *Sirket Hariye*..

[4] Kuran, T. (2005). *The Absence of the Corporation In Islam: Origins and Persistence.* American Journal of Comparative Law, Vol. 53, pp. 785-834. He views that the Middle East have failed to develop efficient modern economic institution in the form of corporation. This is not because of Islam is inherently incompatible with economic growth, innovation or progress but because of unintended interactions among Islamic institutions derived from the *Shariah*.

[5] Nyazee, I.A.K. (2006). *Islamic Law of Business Organization*. Kuala Lumpur: The Other Press. pp.297-301.

The word governance derived from the *latin* word "*gubernare*" which means to steer or to govern[6]. The Oxford English Dictionary defines to govern as to guide, direct or steer society. According to Stoker[7], governance refers to the emergence of governing styles in which the boundaries between and within public and private sectors have blurred. These definitions present a very wide meaning of governance as it may cover area of politic, economy, social justice and public administration. The paper only attempts to discuss the issue of corporate governance.

2.3 Defining Corporate Governance

Generally, the definition of corporate governance can be divided into two senses. Firstly, in narrower sense corporate governance can be defined as a formal system of accountability of senior management to the shareholders[8]. Secondly, in expansive term, corporate governance includes the entire network of formal and informal relations involving the corporate sector and their consequences for society in general[9].

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. Uniquely, in the context of corporate governance within the Islamic paradigm it presents distinct characteristics and features in comparison with the conventional system as it refers as a special case of a broader decision-making theory that uses the premise of Islamic socio-scientific epistemology which is premised on the divine oneness of God[10].

3.0 A Brief Overview on the Corporate Governance in Islamic Financial System

Interestingly, from early age of Islam, Muslims were able to establish financial system free from element of interest by practicing various modes of financing such as *mudharabah, musharaka* and *al-qard* (benevolent loan). Although there are no empirical data available about the financial system during the early stage of Islam but historical evidence in many literatures provides indication of the existence of such system. For

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[6] Cadbury Report. 1992. *Report of the Committee of Financial Aspects of Corporate Governance*, London (Chairman: Sir Adrian Cadbury).

[7] Stoker, G. 1998. *Governance as Theory*. International Social Science Journal, 155. p. 17.

[8] Shleifer and Vishny states that it deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment. Shleifer., A and R.,Vishny. 1997. *A Survey of Corporate Governance.* Journal of Finance 52:737-783. Cadbury Report explains corporate governance as the system by which companies are directed and controlled. Cadbury Report. 1992. *Report of the Committee of Financial Aspects of Corporate Governance*, London (Chairman: Sir Adrian Cadbury).

[9] Mesnooh, Christopher J. views it as a code aiming at greater managerial transparency, responsibility and shareholder equality. Mesnooh, Christopher J. 2002. *Corporate governance in France.* Corporate Finance, Supplement, pp.8-12. Another broad definition regards it as an institutional framework in which the integrity of the transaction is decided. It encompasses not only the internal structure of corporation but also external environment including capital and labor markets, bankruptcy systems and governmental competition policies. Salacuse, J.W. 2003. *Corporate Governance, Culture and Convergence: Corporation American Style or With European Touch.* Law and Business Review of the Americas. Vol. 9. pp. 33-62.

[10] Choudury, M,A. and Hoque, M.Z. (2004). *An Advanced Exposition of Islamic Economics and Finance.* New York: Edward Mellen Press

instance Udovitch writes that the Islamic modes of equity financing were able to mobilize the resources of the Islamic world for financing agriculture, crafts, manufacturing and international trade[11]. In fact, there were many early Muslim jurists have already discussed the concept of economy in general such as Abu Yusuf, *Kitab Al-Kharaj* (731-798CE), Muhammad bin al Hasan, *Kitab Al-Iqtisad fi al-Rizq al-Mustatab* (750-804CE), Abu Ubaid, Kitab Al-Amwal, (838CE), Harith bin Asad al-Muhasibi, Kitab Al-Makasib, (858CE), Mawardi, *Al-Ahkam Al-Sultaniyah*, (1058CE), Al-Ghazzali, *Ihya' Ulum al Din*, (1055-1111CE), Ibnu Taymiyah, *Al Hisbah fi al-Islam*, (1263-1328CE) and Ibnu Khaldun, *Muqaddima*, (1332-1404CE)[12].

The term "bank"[13] is alien to the early Muslim period where the term *Bayt al-Mal* was extensively used. *Bayt Al-Mal* was considered as the state owned bank where it played the role of an agricultural credit bank, commercial banks and clearing house for the merchants to facilitate commercial activities since from the time of the Umayyads. It is reported that during the time of Hajjaj Ibnu Yusuf, he granted benevolent loan to the pheasants in the amount of two million *dirhams*[14] (Imamuddin, S.M., 1997).

In the 8th and 9th century, financiers were known as *Sarrafs* or *Djahbadh* which functioning as modern bankers in pre-modern Islam. *Sarrafs*[15] provided banking facilities to the public as well as private sector while *Djahbadh* served mainly the public sector[16]. Both institutions however were not bank as it did not receive deposit and issue cheques as normal modern banks did and therefore Udovitch prefers the term *Sarrafs* to mean bankers without bank rather than the bank[17]. It is reported that the Abbasid caliph Al-Muqtadir (908-932) had started introducing the modern banks by performing most of the functions of financial intermediaries such as providing financing for commerce, industry and agriculture. *Sarrafs* also provided financing facilities primarily on the basis of *mudharabah* and *musyarakah*, negotiable instruments and trade facilities by cashing

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11 Supra note 2 p. 328.

12 See Siddiqi, M.N. *Islamic Economic Thought: Foundations, Evaluation and Needed Direction*. Sadeq, A.M., Pramanik, A.H. and Mustapha, N. (Ed). (1991). *Development and Finance in Islam*. Petaling Jaya, Selangor: International Islamic University Press. pp. 21-39. Siddiqi, M.N. briefly explains the development of Islamic economic thought since 1058CE.

13 The term bank is originated from the Italian word "*banco*" which means table as in the past moneychangers from Lombardy used to place in money on a table. Baldwin, D. and Wilson, R. *Islamic Finance in Principle and Practice*. Mallat, C. (Ed) (1988). *Islamic Law and Finance*. London: Graham & Trotman Limited. pp. 178. The first modern bank was started in Venice in 979H or 1584CE known as *Banco di Rialto*.

14 Imamuddin, S.M. (1997). *Bayt Al-Mal and the Banks in the Medieval Muslim World*. Taher, M. (Ed). *Studies in Islamic Economics*. New Delhi: Anmol Publications Pvt. Ltd. pp. 128-138.

15 In the Ottoman Empire, *ṣarrāf*s were moneylenders, brokers and pawnbrokers and many *ṣarrāf*s became large financiers with well-recognised international connections, and played a significant role in the economy and politics of the Ottoman Empire. Sarrafs also functioned as moneychanger to provide facilities of currency exchange.

16 *D̲j̲ahbadh played its* functions as an administrator of deposits and as a remitter of funds from place to place through the medium of the *ṣakk* and especially of the *suftad̲j̲a*. Fischel, W.J. "D̲j̲ahbad̲h̲ (pl. d̲j̲ahābid̲h̲a)." *Encyclopaedia of Islam*. Edited by: P. Bearman , Th. Bianquis , C.E. Bosworth , E. van Donzel and W.P. Heinrichs. Brill, 2008. Brill Online. Available at: <http://www.brillonline.nl/subscriber/entry?entry=islam_SIM-1932> Access Date: 16 April 2008.

17 Udovitch, A. L. (1970) provides comprehensive commercial law and economic history particularly the practice of partnership and profit in medieval Islam.

cheques, issued promissory notes and letter of credits. In 313H or 924CE, the caliph Al-Muqtadir received *suftajah*[18] (bill of exchange) of 147,000 *dinars* send by the Governor of Egypt and Syria. *Suftajah* as one of the financial instruments was commonly used by Abbasid Empire and the Fatimid State in commercial, government and private transactions[19]. These financial instruments enabled the Muslim to mobilize the financial resources and further provided a great boost to trade not only in the Middle East but included Europe in the West, China in the East, Central Asia in the North and Africa in the South[20]. The existence of the above Islamic financial system although in unsystematic form provides clear evidence that the banking system was fairly well-known since the early Muslim period.

The issue of corporate governance in *Sarrafs* and *Djahbadh* was not significant as compared to the modern banks. In fact, *Sarrafs* as financier owned by the individual or family[21] or tribes and *Djahbadh* possessed by the state and both of them were not corporation which normally experienced agency problems. There are few factors that contributed to this phenomenon and they include common practice of Islamic values, nature of communities, economic environment, absence of agency problems, extensive legal instrument for trade and independence of judiciary. *Sarrafs* and *Djahbadh* operated in communities which were far smaller that the modern banks operate. The parties involved such as the providers, users of funds and *Sarrafs* personnel were known each other as the participants normally consisted of individual in tribes, guilds, fraternities or *sufi* orders. The economic environment during that period was also less complex and the nature of *Sarrafs* and *Djahbadh* whereby there was no agency problem such as the issue of separation of ownership and control as experienced by the modern financial institutions. In addition, the financial system was supported by the strength and independence of judiciary which led to the economic stability[22]. All of these factors contributed the earlier Islamic financial system to work effectively. The issue of corporate governance as a mechanism of control did not arise during the period of *Sarrafs* and *Djahbadh* and therefore lead to the lack of discussion and theoretical framework by Muslim scholars.

At the end of the 19th century, the Muslim role in *ṣarrāf* business was radically reduced by the increasing of non-Muslim *ṣarrāf* families and the emergence of modern banks, established largely by Europeans and by Armenian and Greek *ṣarrāf*s[23]. Only in 23 July

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[18] *Suftajah* or bill of exchange is a loan of money repayable by the borrower to a third party other than the lender in a place which could be different from the place where the money was handed over to the borrower. The main purpose of *suftajah* is to avoid the risk of carrying a big amount of money. In the modern context, it refers to the function of *cheque*. Saleh, N.A. *Financial Transactions and the Islamic Theory of Obligations and Contracts.* Mallat, C. (Ed). (1988). *Islamic Law and Finance*. London: Graham and Trotman Limited. pp.13-21

[19] Supra note 13. p.137.

[20] Supra note 2. p. 328.

[21] The *ṣarrāf* families included the Baltazzis, the Rallis, Zarafis, the Rodoconachis and Duzuoglus. These families played big roles in most of the major private and public banks that were established in the second half of the 19th century, starting with the Istanbul Bankasi̇ (Bank of Istanbul) in 1845.

[22] Supra note 2. p. 329-330.

[23] Saeed, Abdullah. "Ṣarrāf (a.)." *Encyclopedia of Islam*. Edited by: P. Bearman , Th. Bianquis , C.E. Bosworth , E. van Donzel and W.P. Heinrichs. Brill, 2008. Brill Online. Available at: http://www.brillonline.nl/subscriber/entry?entry=islam_SIM-8886 Access Date: 16 April 2008. See also

1963, the first Islamic bank was established in Egypt known as Mitr Ghams Savings Bank and followed by the Nasser Social Bank in 1972 and the Dubai Islamic Bank in 1975. The establishment of the Islamic Development Bank in Jeddah in 1975 further stimulated the spread of the Islamic banking around the world[24]. In 1990s there are few international infrastructure institutions established with purpose to support the Islamic financial sector particularly on the issue of corporate governance and these include the Accounting and Auditing Organisation for Islamic Financial Institution (AAOIFI) and the Islamic Financial Services Board (IFSB).

The AAOIFI was established on 26 February 1990 in Algiers and was registered on 27 March 1991 in the Kingdom of Bahrain. To date, the AAOIFI has issued 56 standards and 4 of them are specifically related with the shari'ah corporate governance namely the standard on Shari'ah Supervisory Board: Appointment, Composition and Report, Shari'ah Review, Internal Shari'ah Review and Audit and Governance Committee for Islamic Financial Institutions[25] (Iqbal. M, 2007: 373). The IFSB was established in Kuala Lumpur, Malaysia on 3 November 2002 and started operation on 10 March 2003 The IFSB has issued a few prudential standards on Capital Adequacy, Governance of Investment Funds, Corporate Governance in Takaful Operations, Shari'ah Governance and Market Conduct. There are few standards which specifically providing guidelines on corporate governance namely the Guiding Principles of Risk Management for Institutions (other than Insurance Institutions) offering only Islamic Financial Services (GPCG) issued in December 2005 and the Guiding Principles On Corporate Governance For Institutions Offering Only Islamic Financial Services (Excluding Islamic Insurance (*Takaful*) Institutions And Islamic Mutual Funds) issued in December 2006 (IFSB, 2008).

4.0 Corporate Governance Model from Islamic Perspective

Becht. M and Barca. F[26] provides a literature review of a number of western corporate governance models as possible solutions to solving the collective action problem among dispersed shareholders. There are two main corporate governance systems namely the Anglo-Saxon and the European models. The Anglo-Saxon model of corporate governance is considered as the most dominant theory championed by the United States and the United Kingdom. The stakeholders' model of corporate governance is practiced by majority of the European countries such as German, France, Italy, Spain and Greece where many large firms are part of social and economic structure. As the western concept of corporate governance is dominated by these two models, the main issue here is what is

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There were many European banks established in the Ottoman Empire such as the Deutsche Orient Bank, the Deutsche Bank,the Credit Lyonnais and the Banque Ottomane and all of these big banks were controlled by foreign entity. El Ashker, A.A.F. (1987). *The Islamic Business Entreprise*. London: Croom Helm Limited.

[24] Meenai, S.A. writes extensively on historical, legal framework, policies and procedures, operations, assistance to Muslim communities, mobilization of resources, financial management, research and training and performance evaluation of the Islamic development bank. Meenai, S.A. (1989). *The Islamic Development Bank, A Case Study of Islamic Co-operation.* London: Kegan Paul International Limited.

[25] Iqbal, M. *International Islamic Financial Institution.* Hassan, M.K and M.K. Lewis. (Ed) (2007). *Handbook of Islamic Banking*. Cheltenham, UK: Edward Elgar Publishing Limited.p.373.

[26] Becht, M and Barca., F. (Ed.s). (2001). *The Control Of Corporate Europe.* Oxford : Oxford University Press.

an Islamic approach towards corporate governance issues in Islamic corporation particularly to Islamic financial institutions?

Effective corporate governance within Islamic framework is the epicenter of Islamic financial business so as to protect the stakeholders' interest as a whole. In the Islamic context, the interest of stakeholders is beyond the financial return or profit maximization; it covers the element of ethic, Shari'ah or Islamic law and principle of *Tawhid* i.e. the oneness of Allah. There are two major Islamic corporate governance models discussed by Muslims scholars namely the business model based on the principle of consultation where all stakeholders share the same goal of *Tawhid* or the oneness of Allah[27] and adopting the stakeholders' value system with some modifications[28].

4.1 *Tawhid* and *Shura* Based Model

Although all the Islamic economists or Muslim jurists agree on the concept of *Tawhid* as one of the philosophical pillars of Islamic economic[29], it is observed that little is written or discussed on the *Tawhid* epistemological methodology to the issue of corporate governance. Fortunately, Choudhury, M,A. and Hoque, M. Z, discuss the fundamental Islamic epistemology of reference of *Tawhid* on their corporate governance model[30].

As the foundation of Islamic faith is *Tawhid*, the basis for the corporate governance framework also emanates from this concept. Allah says in *al-Quran* "*Men who celebrate the praises of Allah standing, sitting, and lying down on their sides, and contemplate the wonders of creation in the heavens and the earth, (with the thought): "Our Lord! Not for naught Hast thou created all this! Glory to Thee! Give us Salvation from the penalty of the Fire*" (3: 191). This verse provides fundamental principle of governance where everything created by Allah has a purpose and human being is created to be the world's vicegerent. By putting a trust to mankind as a vicegerent, Allah plays actively roles to monitor and involve in every affairs of human being and He is aware and knowing everything all the times[31]. Allah says al-Quran "*O my son! If it be (anything) equal to the weight of a grain of mustard seed, and though it be in a rock, or in the heavens or on the earth, Allah will bring it forth. Verily, Allah is Subtle, Well-Aware"* (31:16)[32]. As Allah knows everything and all mankind is answerable to Him, the principle of Tawhid shall be the foundation of the corporate governance model in Islam.

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[27] Supra note 9.

[28] Iqbal, Z, and Mirakhor, A. (2004). *Stakeholders Model of Governance in Islamic Economic System.* Islamic Economic Studies. Vol. 11. No. 2. IRTI: Islamic Development Bank. 43-64. See also Chapra, M.U. and Ahmed, H. (2002). *Corporate Governance in Islamic Financial Institutions*. IRTI: Jeddah

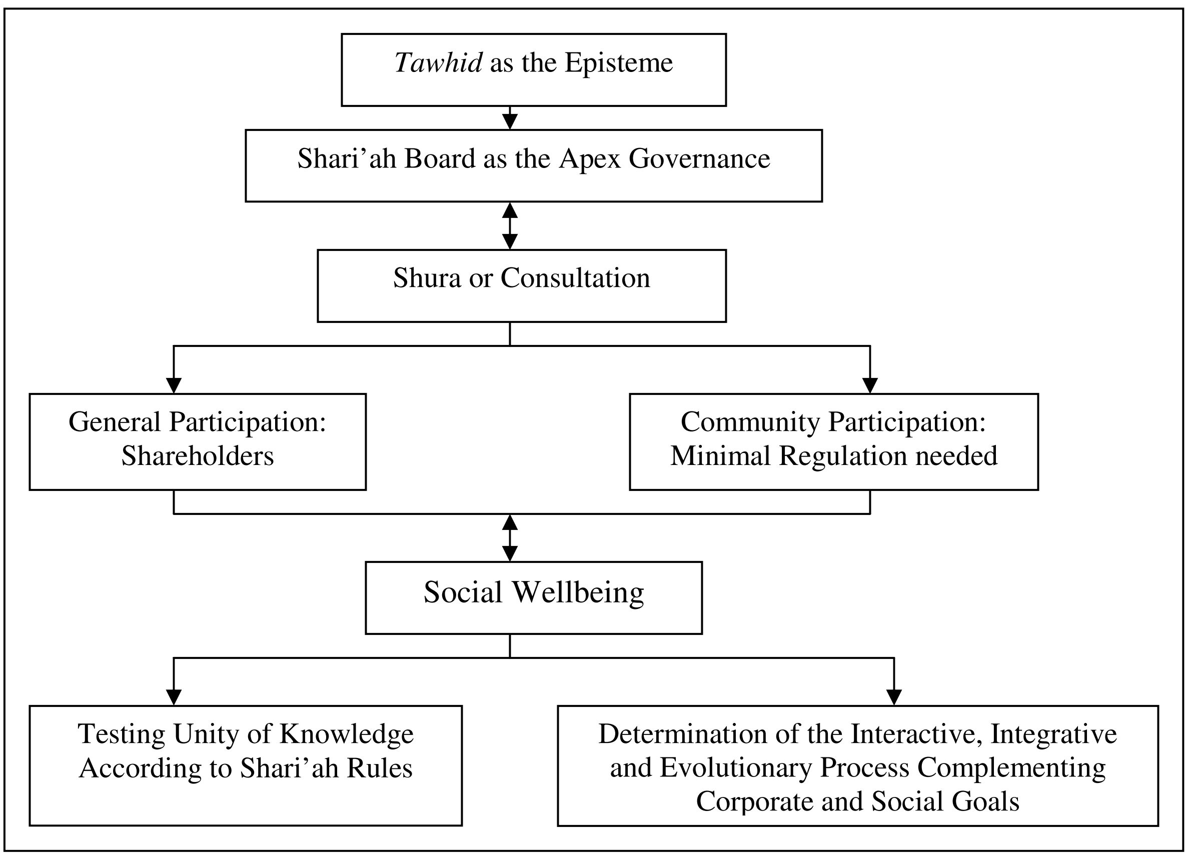
[29] See Mannan, M.A. (1970), Siddiqi, M.N. (1978), Kahf, M. (1978), Ahmad, K. (1980), Naqvi, S.N.H., (1981), Taleghani, S.M., (1982), Al-Sadr, M.B., (1982) and Choudhury, M.A. and Malik, U.A. (1992).

[30] Choudury, M,A. and Hoque, M.Z. 2004. *An Advanced Exposition of Islamic Economics and Finance.* New York: Edward Mellen Press. Although Choudhury, M.A. and Malik, U.A. (1992) discussed the principle of *Tawhid* and human solidarity in Islamic political economy, they do not provide any specific model for corporate governance.

[31] Chapra, M.U. (1992). *Islam and the Economic Challenge.* Leicester: The Islamic Foundation. p. 202.

[32] See also al-Quran 99: 7-8 where Allah says "*So, whosoever does good equal to the weight of a speck of dust shall see it. And whosoever does evil equal to the weight of a speck of dust shall see it*". The verse reminds the human being that Allah knows everything even to things that were to be hidden inside a solid rock, not even the weight of a speck of dust in the heavens or on the earth.

According to Choudhury, an Islamic corporation is a legal entity where the principle and proportionate of the firm's shares owned by the shareholders based on equity participation and profit sharing ratios. Meanwhile, governance of corporation deals with legal and organizational structures that control the internal governance of a firm with an objective to define and attain an objective criterion by way of understanding the relations between variables supported by policies, programs and strategic coalition[33]. As an Islamic corporation, it has to have a distinct corporate governance values that enable to differentiate it with the western concept of corporate governance. There are four principles and instruments governing Islamic governance i.e. extension of Tawhid unity of knowledge via interactive, integrative and evolutionary process to the interacting environing factors, the principle of justice, the principle of productive engagement of resources in social and the principle of economic activities and recursive intention amongst the above stages. All of these principles are the main premises of the Islamic corporate governance where the Shari'ah rules embedded in *al-Quran* and *al-Sunnah* make the Islamic corporation market driven and at the same time uphold the principle of social justice[34]. The concept of corporate governance in Islamic perspective is summarized by Choudhury in Figure 1.



The figure 1 shows that the Islamic corporate governance approach is premised on the *Tawhid* epistemological model whereby the functional roles of corporation are working

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[33] Supra note 30. pp. 58 and 83.
[34] Supra note 30. pp. 57-83.

via the *Shari'ah* rules. The principle of Tawhid derives important concept of vicegerency (*khilafah),* and justice or equilibrium (*al-adl wal Ihsan*[35]). The stakeholders as vicegerent of Allah have fiduciary duty to uphold the principle of distributive justice via the *Shuratic* process. Chapra, M.U.[36] mentions that the practice of Shura is not an option but it is rather an obligation. The constituent of Shura provides widest possible participation of the stakeholders in the affairs of the state including corporation either directly or via representatives.

There are two main institution involved in the above process of corporate governance namely the *Shari'ah* board and the constituent of shura's groups of participants i.e. all the stakeholders. In determining the scope of *Shari'ah*, the institution of *Shari'ah* board comes into a picture and it plays crucial role to ensure that all corporation activities are in line with the *Shari'ah* principles. In addition, the shareholders also play a big role as active participants and conscious stakeholders in the process of decision making and policy framework by considering the interest of all direct and indirect stakeholders rather than maximize their profit alone. The other stakeholders including community should also play their roles to provide mutual cooperation to protect the interest as a whole and to stimulate the social wellbeing function for social welfare. All of these processes are centered on toward fulfilling the ultimate objective of Islamic corporate governance of complementing the private and social goals via upholding the principle distributive justice[37].

4.2 Stakeholders Based Model

Chapra, M.U. and Ahmed, H,[38] in their research on corporate governance of Islamic financial institution emphasize on the notion of equitably protecting the rights of all stakeholders irrespective of whether they hold equity or not. This seems to support the model proposed by Iqbal, Z, and Mirakhor, A, where they view that the corporate governance model in Islamic economic system is a stakeholder-centered model in which the governance style and structures protect the interest and rights of all stakeholders rather than the shareholders per se[39]. Their main arguments are based on two fundamental

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[35] Naqvi, S.N.H. defines *al-adl wal ihsan* as a state of social equilibrium. The principle of social equilibrium in the context of economy provides a best configuration of the production, consumption and distribution activities where the needs of all members in the society constitute the first priority over the individual. Naqvi, S.N.H. (1994). *Islam, Economics and Society*. London: Kegan Paul International Ltd. Pp. 27-28.

[36] Supra note 31. p. 234.

[37] Supra note 30. pp. 85-88.

[38] Chapra, M.U. and Ahmed, H. (2002). *Corporate Governance in Islamic Financial Institutions*. IRTI: Jeddah. pp. 13-20.

[39] Chapra, M.U. and Ahmed, H. (2002). *Corporate Governance in Islamic Financial Institutions*. IRTI: Jeddah. pp. 43 and 48. Archer, S. and Rifaat, A.A.K. impliedly view that the corporate governance of Islamic financial institution is inclined toward the stakeholders value based model. This is because the nature of corporation particularly of the directors and the management owe fiduciary duties of care and loyalty to the shareholders and also other stakeholders including especially the investment account holders. Archer, S. and Rifaat, A.A.K. *Specific Corporate Governance Issues in Islamic Banks*. In Rifaat, A.A.K. and Archer, S. (Ed.s) 2007. *Islamic Finance: The Regulatory Challenge*. Singapore: John Wiley & Sons (Asia). pp. 295-309. Wajdi, A.D. further supports the notion of stakeholder oriented model in Islamic financial sector where he provides the pyramid of *maslahah* as a devise or mechanism to protect rights and

concepts of Islamic law namely principle of property rights and commitment to explicit and implicit contractual agreements that govern the economic and social behavior of individuals, society and state. These two principles provide strong justification for the notion of classifying Islamic corporate governance as a stakeholder-oriented model. In addition, Nienhaus, V. [40] states that Islamic corporate governance should be based on value oriented and promote the principle of fairness and justice with respect to all stakeholders.

The principle of property rights in Islam clearly provides a comprehensive framework to identify, recognize, respect and protects interest and rights of every individual, community, the state and corporation. In fact, rights of ownership, acquisition, usage and disposition of the property itself are considered as property (*al-mal*) which has beneficial use and value. In term of the rights of ownership, Islam declares that Allah is the sole owner of property and human being is just a trustee and custodian in whom it implies the recognition to use and manage the properties in accordance with Shari'ah rules[41]. There are various verses of *al-Quran* mentioned the principle of property rights and one of them is in surah 57:7 Allah says: *Believe in Allah and His Messenger and spend of that whereof He made you trustee"*[42]. The implied meaning of this verse lays down the principle of property's ownership where the mankind is only regarded as a trustee of God.

Beside, Islam recognizes private and society or state ownership. This implies the recognition of individual ownership in corporation as shareholders and at the same time Shari'ah rules provide guidelines to the individual, corporation and the state on how to deal with the property ownership. In short, the concept of property rights in Islam is based on these fundamental principles i.e. the rights on the property is subjected to Shari'ah, the enjoyment of rights to property is balanced with the rights of society and the state, every individual, society and the state is stakeholders and the recognition of rights of stakeholders by Islamic law[43].

Contractual framework is also very unique in Islam. In *al-Quran surah* 5:1 Allah clearly reminds the Muslims on the principle of fulfilling each of their contractual obligations where He says: "*O you who believe, fulfill contracts*". This verse presents a basic foundation the notion of contract that every individual, society, corporation and the state

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interests of various stakeholders. Wajdi, A.D. *Corporate Governance and Stakeholder Management: An Islamic Approach*. In Bakar. M.D. and Rabiah, E.A. (Ed.s) (2008). *Essential Readings in Islamic Finance*. Kuala Lumpur: CERT. pp. 391-413.

[40] Nienhaus, V. *Corporate Governance in Islamic Banks*. In Khan, T. and Muljawan, D. (Ed.s). (2006). *Islamic Financial Architecture: Risk Management and Financial Stability*. Jeddah: IRTI. p. 290. Interestingly, Nienhaus, V. (2006: 298-301) puts an issue whether the depositors of Islamic banks need for representative in boards for more efficient corporate governance supervision as in some corporation in Germany. He concludes however that the said notion will not be effective in the case of Islamic banks are exposed to competition. This strongly implies that the corporate governance of Islamic financial institution is more toward the stakeholders' value model.

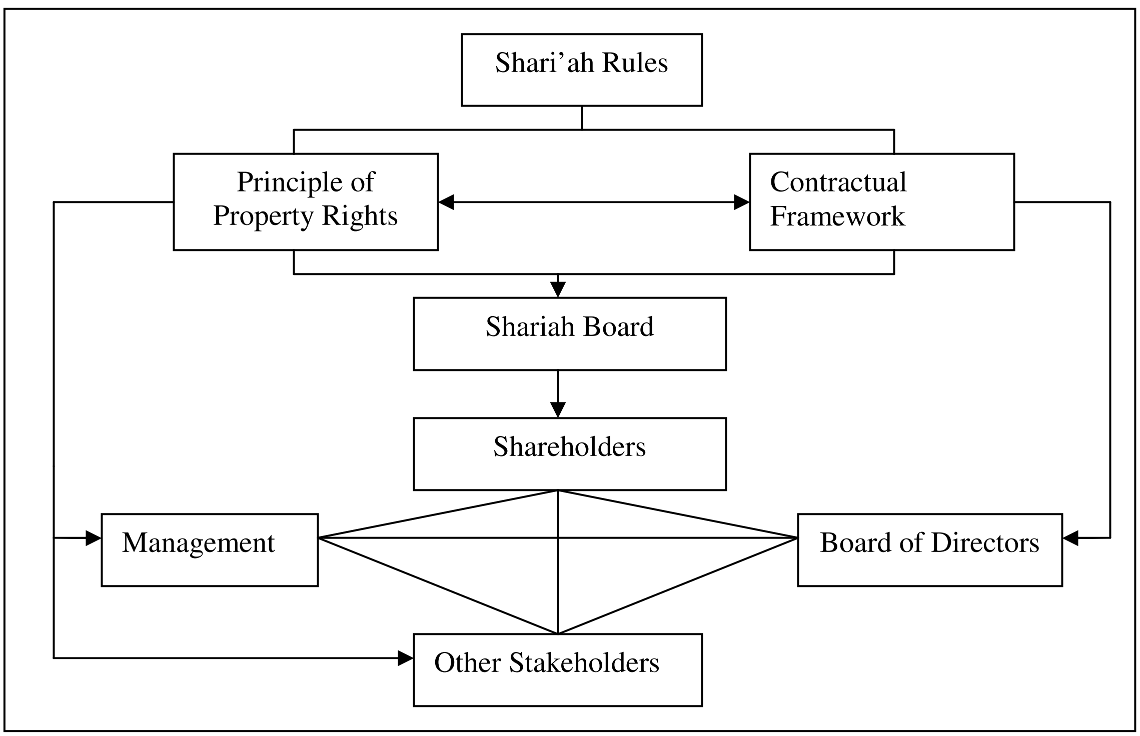
[41] Supra note 28. p. 50.

[42] In another verses Allah says "*He it is who has created for you all that is on earth*" (2: 29) and " *Do not give your resources that Allah has made you its preservers on to the foolish"* (4:5).

[43] Supra note 28. p. 54.

are bound by their contracts which defines the rights and obligations of the parties. In relation with the issue on corporate governance, each stakeholder has duty to perform his contractual obligations in accordance with the term stipulated in the contract directly or indirectly. For example, the shareholders has duty to provide business capital, the management to manage and run the business, the employees to perform their respective duties and the state to ensure enforceability of the contracts in case of violation by any party. All of these duties arise through contractual framework and they are subjected to the rules of Shari'ah. In short, the principle of contract in Islam establishes guideline to identify and qualify who is a rightful stakeholder.

Figure 4 summarized the Islamic corporate governance based on stakeholders-oriented model. It presents an overview on the stakeholders' model for Islamic corporate governance which is preoccupied by two fundamental concepts of Shari'ah principles of property rights and contractual frameworks. The governance of any corporation in Islam is ruled by Shari'ah where all the stakeholders including the shareholders, the management, other stakeholders such as the employees, the suppliers, the depositors and the community.



The Shari'ah board plays a role to advise and supervise the operation of the corporation so as to ensure that it complies with the Shari'ah principles. The board of directors acting on behalf of the shareholders has duty to monitor and oversee overall business activities and the managers have fiduciary duty to manage the firm as a trust for all the stakeholders and not for the shareholders alone. The other stakeholders such as employees, depositors, customers have duty to perform all of their contractual obligations. In addition, the state as a stakeholder will be the external institution to provide regulatory framework and its enforcement. The definition of stakeholders does not necessary refer to the shareholders per se or to those who have active participation in the decision making process but it includes non-investor or non-owner stakeholders i.e. any party who has direct or indirect participation in the corporation.

Based on the preceding discussion, it is observed that the notion of classifying Islamic corporate governance as stakeholders-oriented model is premised on two fundamental concepts namely the principle of property rights and the principle of contractual obligations. Hence, there are two tests to determine any individual to qualify as a stakeholder, firstly, whether the individual or group has any explicit and implicit contractual obligations and secondly, whether the one whose property rights are at risk due to business exposure of the corporation[44].

5.0 Conclusion

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 models. The study summarizes the distinct features of Islamic corporate governance into four aspects namely the episteme, the corporate objective, the nature of management, the management board and the capital-related ownership structure. In the aspect of epistemological method, Islam puts *Tawhid* as the episteme while the corporate objective is premised on protecting of all the stakeholders interest and rights in line with the principle of *maqasid Shari'ah*[45]. The nature of management of Islamic corporate governance model is centered on two fundamental principles of *shura* and interactive, integrated and evolutionary process and the apex level of management is the Shari'ah board that is responsible to supervise and oversee the overall corporate activities so as to comply with the *Shari'ah* principles.

The model of corporate governance system in western perspective raises an issue of the design of an efficient corporate governance structure of the Islamic financial institution. Based on the foregoing discussion on the two models of *Tawhid* and *Shura* based model and the Stakeholder based model, it is concluded that that the Islamic corporate governance is premised on the epistemological of *Tawhid*. In addition, the nature of corporate governance's goal is inclined toward the stakeholder value model where its governance style aims at protecting the stakeholders as a whole. In considering an Islamic view of the definition of the stakeholders, it enhances the interpretation beyond to those participate in governance of the corporation to the religion of Islam itself. Therefore, the corporate governance model from *Shari'ah* perspective considers Islam as the supreme stakeholders beside the other stakeholders' entity. The concept of Islam as the sovereign stakeholder affects the structure of the corporate governance system where it puts the *Shari'ah* as the governing law of all affairs of the corporation in which leads to the establishment of the *Shari'ah* Board as part of the corporate governance institutions.

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[44] Supra note 28. p. 58. This is in line with the saying of Prophet: "*A Muslim is the one from whose hand others are safe"* (Sahih Bukhari, Volume 1, Book 2, Number 10).

[45] *Maqasid Shari'ah* means protection of the wellfare of the people, which lies in safeguarding their faith, life, intellect, posterity and wealth (Al-Ghazali, 1937: 139-140).

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