Chapter 12

Shari’ah Governance for Islamic Banking: Evidence From Diverse Regulatory Environments

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ABSTRACT

Due to the rapid global growth in Islamic banking and finance industry, supervisory authorities in many countries have developed different Shari’ah governance (SG) regulatory systems to regulate this industry. However, the current SG practices across jurisdictions still suffer from some drawbacks. This chapter highlights some issues related to the differences across jurisdictions in adopting various SG regulatory practices and supports the discussion using descriptive analysis. The findings indicate that Islamic banks (IBs) demonstrate higher levels of financial performance, on average, when located in regulated jurisdictions, in jurisdictions that restrict cross-membership of scholars in Shari’ah Supervisory Boards (SSBs), and in jurisdictions adopting Centralized supervision model (CSGM). The findings also show that IBs in jurisdictions adopting Reactive regulatory model report the worst performance in comparison with the other models (Passive, Pro-active, Interventionist and Minimalist).

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1. INTRODUCTION

In recent years, the regulations, supervision and corporate governance (CG) practices of banking systems have attracted attention from researchers and businesses especially after the global financial crises of 1997 and 2008 since many considered the weakness of these practices, especially CG mechanisms, as among the main reasons causing the world financial collapse (Minton, Taillard, & Williamson, 2010; Alam, 2013). Basically, sound CG practices play an important role in enhancing financial institutions’ performance with most of the studies confirming that good governance improve institutions’ profitability, productivity, competitiveness and decreases risk (Todorovic, 2013). This impact would be reflected in improving the financial system and then the economies especially for the developing economies (Abdurrouf, 2011).

In the current practices, conventional banks (CBs) are not operating alone in the market. This is because Islamic banks (IBs) have become their most competitive rival. The Islamic banking industry has grown rapidly in the recent decades due to many reasons, led by the religious aspect that increases the demand on Shari’ah compliant products particularly in a Muslim majority country (Ashraf, Robson, & Sekhon, 2015; Ullah & Khanam, 2018). Unlike CBs, IBs are prohibited from charging or paying of interest, therefore they offer profit-sharing investment accounts, such that investors’ return depends on the return on the assets financed by the investors’ funds (Karim, 2001). In general, Islamic business should bring benefits to the society and the welfare of the people as well in align with the goal of Islamic economics which is to achieve economic well-being (Mohammed & Muhammed, 2017; Safiullah & Shamsuddin, 2018). Therefore, a sound Shari’ah governance (SG) framework helps in achieving sustainable development with equitable distribution of both opportunities and wealth, which are the main objectives of the concept of economic development in Islam (Ruzlan, 2018).

Further, the Islamic financial system has become a viable alternative to the conventional one after the series of failures of several conventional financial institutions as the result of the 2008 crisis (Kassim & Majid, 2010). According to Zeineb and Mensi (2014), the principles of interest-based transactions and risky investments which the CBs is based on, may perhaps be the cause of the crisis. In addition, many CBs collapsed due to the weak nature of internal wealth (Hussien, Alam, Murad, & Wahid, 2019). In contrast, IBs is proposed to be more resilient to the financial shocks compared to CBs due to their distinctive nature in which all the financial transactions must be trade based and asset linked (Kassim & Majid, 2010). During the crisis of 2008, while CBs was in crisis due to banking failures, IBs were said to have remained resilient (Zeineb & Mensi, 2018). Despite this, Zeineb and Mensi (2014) indicated that some IBs were affected negatively by the crisis. For example, the performance of GCC IBs has been indirectly affected during the crisis, despite their strong resilience in resisting the direct impact of the crisis (Hussien et al., 2019). This is due to some reasons especially the CG weakness as will be shown later in this study.

The differences between IBs and CBs in the functions and structure have resulted in the IBs having additional agency problem besides the common agency problems that occur between managers and shareholders, e.g., in any case managers deviate from their duty to ensure Shari’ah implementation (Zainuldin, Lui, & Yii, 2018). Hence, IBs have additional internal governance mechanism i.e., Shari’ah Supervisory Board (SSB) besides the Board of Directors (BoD) with both aiming at moral and legal monitoring, respectively and consequently mitigate agency problems (Abdelsalam, Dimitropoulos, Elnahass, & Leventis, 2016).