Chapter 14

Banking Governance: Perspective of Islamic Banking

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ABSTRACT

This chapter discusses governance in the context of Islamic banking. The discussion begins with various theories that underlie the concept of governance and empirical research in the application of governance. The theory and empirical research become the necessary foundation to understand the perspective of governance in Islamic banks. Both conventional banks and Islamic banks use governance as a control mechanism in providing some value addition by increasing protection of depositors’ and investors’ rights, facilitating access to finance, reducing capital costs, improving operational performance, and also improving the health of institutions against external/market shocks. This concept is basically in line with Chapra and Ahmed (2002), in that the primary concern in Islamic law is closely related to the idea of fair protection of the rights of all stakeholders, regardless of shareholders.

INTRODUCTION

A series of failures by giant global companies gave shocks to stakeholders to increase their attention on corporate governance issues. After the global financial crisis, this attention led to an increase in corporate transparency in general, especially financial institutions (Setiyono & Tarazi, 2014). Furthermore, Setiyono and Tarazi (2014) explained that disclosure is expected to reduce asymmetric information, and therefore stakeholders can control bank management risk-taking. Disclosure of governance in the annual report is an indicator of the extent to which the company tries to ensure that stakeholders have high confidence in the management of the company. Bhat, Hope, and Kang (2006) show that knowledge of corporate governance practices is a tool to assess the credibility and quality of financial information and facilitate users in estimating future conditions.

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Corporate governance is basically about responsibilities and fulfillment to shareholders and stakeholders. Good governance is a critical element of building banks and financial institutions. Similar to conventional banks, proper governance in Islamic banks is also an urgent priority, one of the alternatives and complementary business models that has experienced significant growth, especially after the presence of the Islamic Development Bank (IDB) in 1975, this then triggered the presence of Islamic banks in several countries in the world (Rafay & Farid, 2017), for example, Dubai Islamic Bank (Dubai) in 1975, Faisal Islamic Bank (Egypt & Sudan) in 1977 and Kuwait Finance House (Kuwait) in 1977. Until 2017, global Islamic bank assets in the whole world reaches US$ 1.72 trillion, 505 Islamic banks, and 6% share of Islamic banks to total global banking assets (IFDI, 2018).

Islamic banks are, in principle, different from conventional banks. Various economic and financial policies refer to Islamic law (Shari‘ah) which have an impact on the business model and transactions of the Islamic banking industry, some of these things such as excessive risk-taking (Gharar), gambling (Maysir), investing in “unethical business” (for example, pornography), investing in something that does not have underlying economic assets or activities, and receiving or paying interest (Riba). Furthermore, Islamic legal principles provide limits for banks not to invest in specific sectors (conventional banks), transfer risk, or speculate through derivatives (for example, credit default swaps-CDS) or provide or receive regular credit (for example, bonds and traditional loans).

Farag, Mallin, and Ow-Yong (2018) state is adding that the principles of finance and Islamic banks depend on two basic Islamic laws and principles: that all transactions must contain an element of risk-sharing, and that all purchase must be supported by (or based on) tangible assets. The first principle requires the parties involved in the transaction to carry proportional risks related to the business or assets to be financed; the second principle avoids the risk of establishing a debt-based relationship, where only the exchange of money for money is happening. In this way, it will promote equity-based finance and finance into activities to support real economic activity.

Accurately for Islamic banking, various parties will observe the proactive attitude of regulators so that it challenges them to improve the regulatory and supervisory framework in support of higher Islamic financial institution governance standards. Therefore, it requires a better structure in corporate governance for these institutions. The uniqueness of Islamic banks requires governance standards following their nature, and several related organizations issued such guidelines and regulations, such as the central banks of each country, the Islamic Financial Services Board (IFSB) and the Accounting and Auditing Organizations of Islamic Financial Institutions (AAOIFI).

This chapter will discuss governance based on the perspective of Islamic banks. The discussion will begin with various theories that underlie the concept of governance and empirical research in the application of governance. The theory and empirical research become the necessary foundation to understand the perspective of governance in Islamic banks, because basically both conventional banks and Islamic banks make governance as a control mechanism in providing added value by increasing protection against depositors and investor rights, facilitating access to finance, reduce capital costs, improve operational performance, and improve the health of institutions against external / market shocks. This conception is basically in line with what was stated by Chapra and Ahmed (2002), that the primary concern in Islamic law (Shari‘ah) is closely related to the idea of fair protection of the rights of all stakeholders regardless of shareholders or vice versa, whereas, from the perspective of the Islamic financial institution. Compliance with Islamic law (Shari‘ah) is a matter of priority (Sulaiman, Abd Madjid, & Moh Arifin, 2015).