

Developing Inclusive and Sustainable
Economic and Financial Systems

Ethics, Governance and Regulation in Islamic Finance

Volume 4



Editorial Board

Dr. Hatem A. El-Karanshawy

Dr. Azmi Omar

Dr. Tariqullah Khan

Dr. Salman Syed Ali

Dr. Hylmun Izhar

Wijdan Tariq

Karim Ginena

Bahnaz Al Quradaghi

SELECTED PAPERS PRESENTED TO THE 8TH AND 9TH INTERNATIONAL CONFERENCE
ON ISLAMIC ECONOMICS AND FINANCE

جامعة حمد بن خليفة
HAMAD BIN KHALIFA UNIVERSITY



كلية الدراسات الإسلامية في قطر
QATAR FACULTY OF ISLAMIC STUDIES



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Foreword

Hatem A. El-Karanshawy

Founding Dean, Qatar Faculty of Islamic Studies, Hamad bin Khalifa University, Qatar Foundation, Doha

The International Conference on Islamic Economics and Finance (ICIEF) is the leading academic conference in the discipline organized by the International Association for Islamic Economics (IAIE) in collaboration with other key stakeholders, including the Islamic Research and Training Institute, Islamic Development Bank. It is the pioneering international conference on Islamic economics organized first in Makkah Al Mukaramah, Kingdom of Saudi Arabia, in 1976 under the auspices of King Abdulaziz University and has since been held in numerous locations around the world. The conference as such has contributed immensely to the promotion of Islamic economics and finance. Since 2011, the Qatar Faculty of Islamic Studies (QFIS), of Hamad bin Khalifa University, Qatar Foundation, has also become a key partner in organizing the conference.

The global economy continues to face the perennial problems of poverty, persistent youth unemployment, excessive inequalities of income and wealth, high levels of inflation, large macroeconomic and budgetary imbalances, exorbitant debt-servicing burdens, inadequate and aging public utilities and infrastructure, skyrocketing energy prices, and growing food insecurity. The reoccurring regional and global financial crises further intensify and magnify these problems, particularly for the underprivileged segments of the world population. As a result, many countries are at the risk of failing to achieve by 2015 the Millennium Development Goals (MDGs) set by the United Nations. Hence the achievement of an inclusive and sustainable economic and financial system has remained highly illusive.

The ICIEF presents an excellent opportunity for those interested in Islamic economics and finance to present their research and contribute to the development of an inclusive and sustainable global economic and financial system. It is

through such a setting that thoughts can be debated with the objective of advancing knowledge creation, facilitating policymaking and promoting genuine innovation for the industry and the markets. Disseminating research presented at ICIEF to the greatest number of researchers interested in the topic is important. It not only advances the discourse, but also grants those who did not have the privilege of attending the conference to partake in the discussion.

To this end, this series of five volumes (two in Arabic to follow) presents the proceedings of 8th and 9th conferences, which were held in Doha and Istanbul respectively in 2011 and 2013. Each volume focuses on a particular sub-theme within the broader theme of *Developing Inclusive and Sustainable Economic and Financial Systems*.

The volumes are as follows:

- Volume 1: Access to Finance – Essays on Zakah, Awqaf and Microfinance
- Volume 2: Islamic Economics and Social Justice – Essays on Theory and Policy
- Volume 3: Islamic Banking and Finance – Essays on Corporate Finance, Efficiency, and Product Development
- Volume 4: Ethics, Governance, and Regulation in Islamic Finance
- Volume 5: Financial Stability and Risk Management in Islamic Financial Institutions

We hope that this academic endeavor in partnership with the Bloomsbury Qatar Foundation Publishing will benefit the Islamic economics and finance community and policy makers and that it will promote further academic study of the discipline.

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Tariqullah Khan

President, International Association for Islamic Economics

At the International Association for Islamic Economics (IAIE), we are grateful to acknowledge the unprecedented success of the 8th and 9th International Conferences on Islamic Economics and Finance, which were respectively organized in the Qatar National Convention Centre, Doha, December 19–21, 2011, and in the WoW Convention Centre Istanbul, September 9–10, 2013. We greatly appreciate the financial, academic and logistic support provided by the Qatar Faculty of Islamic Studies, Hamad bin Khalifa University at Qatar Foundation; Islamic Research and Training Institute at the Islamic Development Bank; and the Statistical, Economic and Social Research and Training Centre for Islamic Countries.

We offer our sincere thanks to the sponsors of the 8th International Conference on Islamic Economics and Finance in Doha. Without their partnership and generous contributions, the conference would not have been possible. In addition to the Qatar Foundation and the Islamic Development Bank, other sponsors included: Qatar Central Bank (QCB), Qatar Financial Centre Authority (QFCA), Qatar National Research Fund (QNRF), Qatar National Bank, Qatar Islamic Bank, Qatar International Islamic Bank, Masraf Al Rayan, and Qatar Airways.

We owe our deepest gratitude to the highly-esteemed panel of reviewers who volunteered to dedicate their time and energy in reviewing all the thousands of abstracts and papers that were submitted to the conferences. The reviewers of the English papers and abstracts included: Abdallah Zouache, Abdel Latef Anouze, Abdelaziz Chazi, Abdul Azim Islahi, Abdullah Turkistani, Abdulrahim AlSaati, Ahmet Tabakoğlu, Anowar Zahid, Asad Zaman, Asyraf Dusuki, Ercument Aksak, Evren Tok, Habib Ahmed, Hafas Furqani, Hafsa Orhan Astrom, Haider Ala Hamoudi, Hossein Askari, Humayon Dar, Ibrahim Warde, Iraj Toutounchian, Jahangir Sultan, John Presley, Kabir Hassan, Karim Ginea, Kazem Yavari, Kenan Bagci, Mabid Al-Jarhi, Maliah Sulaiman, Marwan Izzeldin, Masooda Bano, Masudul Alam Choudhury, Mehdi Sadeghi, Mehmet

Asutay, Moazzam Farooq, Mohamad Akram Laldin, Mohamad Aslam Haneef, Mohamed Ariff Syed Mohamed, Mohammed Benbouziane, Mohammed El-Komi, Monzer Kahf, Muhammad Syukri Salleh, Murat Çizakça, Nabil Dabour, Nafis Alam, Nasim Shirazi, Nazim Zaman, Necdet Sensoy, Nejatullah Siddiqi, Rifki Ismal, Rodney Wilson, Ruhaya Atan, Sabur Mollah, Salman Syed Ali, Savas Alpay, Sayyid Tahir, Serap Oguz Gonulal, Shamim Siddiqui, Shinsuke Nagaoka, Simon Archer, Tariqullah Khan, Toseef Azid, Turan Erol, Usamah Ahmed Uthman, Volker Nienhaus, Wafica Ghoul, Wijdan Tariq, Zamir Iqbal, Zarinah Hamid, Zeynep Topaloglu Calkan, Zubair Hasan, and Zulkifli Hasan. The reviewers of the Arabic papers and abstracts included Abdelrahman Elzahi, Abdulazeem Abozaid, Abdullah Turkistani, Abdulrahim Alsaati, Ahmed Belouafi, Ali Al-Quradaghi, Aly Khorshid, Anas Zarqa, Bahnaz Al-Quradaghi, Layachi Feddad, Mabid Al-Jarhi, Mohammed El-Gamal, Nabil Dabour, Ridha Saadallah, Sami Al-Suwailem, Seif El-Din Taj El-Din, Shehab Marzban and Usamah A. Uthman.

The primary objective of the conferences is to further the frontiers of knowledge in the area of Islamic economics and finance. Without the hard work and creativity of the researchers who shared their work with us, the pool of knowledge generated in the form of the conference papers and presentations would not have been possible. We thank all the authors who submitted their abstracts and papers to the two conferences.

The IAIE has always endeavored to publish most of the significant research papers contributed to its conferences. Currently the selected papers of the 8th and 9th conference are being published in five volumes under the common theme of *Developing Inclusive and Sustainable Economic and Financial Systems*. On behalf of the Editorial Board we acknowledge that the partnership with the Bloomsbury Qatar Foundation Publishing in this regard will be highly beneficial in disseminating research output and in promoting the academic cause.

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Preface

Dr. Moh'd Azmi Omar

Director General, Islamic Research & Training Institute (IRTI)

Over the past two decades the Islamic finance industry has grown at an increasing rate. During this time, issues of ethics, governance, and regulation have defied the sector, and they continue until this day to challenge many jurisdictions across the globe. Weakness observed in these important domains has direct implications on overall financial stability, development of the Islamic financial industry, and the perception of current and prospective consumers. For example, the moral grounding of Islamic finance is one of the strongest value additions that it presents to world markets. It is, therefore, essential for the industry to maintain its ethical nature and not sever this bond for the sake of a quick profit that is devoid of value. On the same note, *Shariah* compliance of banking activities differentiates this industry from its counterpart. It should, therefore, be perceived by consumers and other stakeholders as a strategic advantage and not a burden on market players. However, due to human capital challenges as well as gaps and inefficiencies in practices, *Shariah* compliance is sometimes perceived to be an impediment rather than a value addition. Researching *Shariah* issues and devising solutions to solve these problems is thus critical. Closely related to this are matters of governance that have been brought to prominence as a result of scandals that have resulted in the failure of international financial institutions and other corporations. The Islamic financial industry can afford to shun these experiences, learn from them, and work toward strengthening their governance practices. Finally, regulation is vital for healthy growth of the industry. Without the involvement

of regulatory authorities, much of the efforts expounded at the institutional level are contained within limited organizational boundaries and yet the risks emerge on the macro level.

This volume titled *Ethics, Governance, and Regulation in Islamic Finance* is an attempt to highlight these important inter-related topics. It consists of 14 papers that focus on their numerous dimensions. The papers were selected from the 8th International Conference on Islamic Economics and Finance held in Doha, 19–21 December 2011, and from the 9th International Conference on Islamic Economics and Finance held in Istanbul, 9–11 September 2013. They are presented here in their original form, with changes limited to copyediting and correcting typographical errors. The conferences were organized by the Center for Islamic Economics and Finance, Qatar Faculty of Islamic Studies (QFIS), Hamad bin Khalifa University; Islamic Research and Training Institute (IRTI), Islamic Development Bank (IDB); International Association for Islamic Economics and Finance (IAIE); and Statistical, Economic, and Social Research and Training Centre for Islamic Countries (SESRIC).

I hope that the papers selected in this volume not only reflect the diverse academic research conducted on ethics, governance, and regulation, but also motivate researchers to dedicate extra time and effort to studying these fundamental topics that influence the present and future direction of the Islamic financial industry.

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Ethics, governance and regulation in Islamic finance:

An introduction to the issues and papers

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For over twenty years, Islamic financial markets have demonstrated strong growth in both the Eastern and Western hemispheres, thereby signaling continued interest by consumers and investors in this niche financial sector. Such growth, however, should not be taken for granted as it comes with its own set of challenges that need to be studied and aptly addressed. The recent financial crisis, which shook markets and economies around the globe, is great evidence that market corrections eventually occur irrespective of astounding growth rates that may be experienced at times. Years have passed since the onset of the recent financial crisis, the worst since the Great Depression of 1929, yet we continue to witness some of its aftershocks on a daily basis. Researchers and policy makers in Islamic finance should take heed of the crisis, lest it spread to the young and vibrant Islamic financial sector. Early prevention and weakness correction is important because by the time a crisis hits, the powerful waves of market correction will be too strong to withstand, potentially devastating the Islamic financial industry.

To this end, Volume IV: *Ethics, Governance and Regulation in Islamic Finance*, addresses some of the most challenging contemporary issues that the industry faces. Although there is plenty of common ground between these themes, the volume has been divided into three sections to allow for better comprehension of each of the topics discussed. The first part, *Shariah Issues and Business Ethics in Islamic Finance*, blurs the boundaries of ethics and *Shariah* as disciplines, since Islamic jurisprudential teachings within a transactional context endorse ethical business practices. *Shariah* compliance is a primary concern for stakeholders of the industry. Nonetheless, jurists and consumers alike have voiced pleas for endorsing more genuine Islamic legal rulings. Some have argued that the current process of *ijtihad*, as practiced in the industry, needs to be revisited to address shortcomings, which have led to jurists issuing rulings with negative implications on a macro scale. In the broader scheme of things, focusing on issues of business ethics is vital, since it is this premise of moral grounding that is often invoked when attempting to characterize the Islamic financial industry. Moreover, such ethics are critical to sound development of the sector in the long run.

The second part, *Governance and Corporate Social Responsibility in Islamic Finance*, contributes to calls for Islamic banking institutions to adopt a more *maqasidic* orientation in conducting business that transcends profitability goals. This is in line with the stakeholder theory that R. Edward Freeman and others have long promoted. In this vein, one may ask whether Islamic banks are too preoccupied with satisfying the financial ambitions of shareholders at the expense of other foundational goals. Is it time for these institutions to reconsider their objectives in light of proactive attempts by corporations to more positively contribute to their communities? Isn't such a purposeful contribution a key objective of the Islamic economic system? While corporate governance research has increased considerably in the wake of corporate scandals that continue to rock the business world, these studies have rarely examined the practices of Islamic financial intuitions.

The third part, *Legal and Regulatory Issues in Islamic Finance*, is an attempt to fill an institutional void in legal and regulatory matters that has certainly limited the growth of the industry. Disputes occur in the Islamic financial world among transacting parties, just like they occur in the conventional financial sphere between participants. Robust legal and regulatory frameworks enable parties to resolve their disputes in an efficient manner. The lack of standardization that the Islamic financial industry suffers from, however, makes it much harder for authorities to introduce legal and regulatory measures. Moving forward, this lack of consensus amongst participants has to be overcome. In fact, some jurisdictions have successfully introduced such measures after engaging stakeholders in the discussion. What follows is a short summary of the papers listed under each of the three themes of the volume.

Part I: Shariah issues and business ethics in Islamic finance

In the first paper on *Shariah* issues and business ethics, *Islamic Finance Ijtihad in the Information Age: quo vadis?*, Ahmed highlights the current information

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overload problem, links it to the gap that has emerged between the theoretical ideals and practical realities of Islamic finance, and highlights the consequent trust deficit that this rift has caused. He raises questions about the *ijtihad* of contemporary *Shariah* supervisory boards of Islamic banking institutions, the resulting resolutions that preserve the letter of the law at the cost of its spirit, and the practices of *Shariah* arbitrage and *fatwa* shopping. He proposes overcoming doubts that have crept up on the industry using a framework grounded in authenticity, curiosity and evolution (ACE).

In the second paper, *Determinants of Ethical Identity Disclosure Among Malaysian and Bahraini Islamic Banks*, Abdul Rahman and Saimi study ethical identity disclosure of 16 Malaysian and 5 Bahraini Islamic banks by examining their annual reports from 2007 to 2011. The authors find a low level of ethical disclosure in both countries, with Bahrain having an edge over Malaysia. With respect to the determinants of ethical identity disclosure at the banks studied, a positive significant relationship is established between board size, *Shariah* Supervisory Board, investment account holders and significant ethical identity disclosure. In contrast, the relationship between independent directors of Islamic banks and ethical identity disclosure was found to be insignificant. The author recommends that banks improve their disclosure on the following dimensions: vision and mission statements; product; *Zakāt*, charity and benevolent loans; community; environment, and *Shariah* supervisory boards.

In the third paper, *Islamic Business Ethics and Finance: An Exploratory Study of Islamic Banks in Malaysia*, Musa examines the practices of Islamic financial institutions in Malaysia to determine the extent to which they align with Islamic ethical norms of business. Using a 45-item survey, the author assesses the perception of 105 executives of Islamic banks using five dimensions: the general ethics of the banks, attitudes and behavior of employees, treatment of employees, code of ethics, management and social responsibilities. The author concludes that the studied Islamic banks generally conform to Islamic ethical norms; nevertheless, there are areas for improvement.

In the fourth paper, *Articulation of Spirituality in the Workplace: The Case of Malaysia*, Kamil, Al-Kahtani and Sulaiman enrich the discourse on spirituality in the workplace by studying the determinants of Islamic spirituality in an organizational setting. Data for the study was captured using a 17-item questionnaire. 405 Malaysian Muslim respondents were randomly selected from 50 companies to participate in the study. The authors found four determinants of Islamic spirituality: rituals (*ibadat*), forgiveness/repentance (*al a'fw*), belief (*iman*) and remembrance of Allah (*dhikrullah*). The authors recommended that the study be replicated in other contexts and that the impact of several contextual variables be assessed.

Part II: Governance and corporate social responsibility in Islamic finance

In the first paper on governance and corporate social responsibility *Corporate Governance of Islamic Financial Institutions in Malaysia*, Sulaiman, Majid, and Ariffin examine the quality of corporate governance disclosure

of Islamic financial institutions operating in Malaysia. Using a corporate governance index developed in an earlier study on the basis of guidelines issued by the Central Bank of Malaysia as well as corporate governance guidelines promulgated by the Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI) and the Islamic Financial Services Board (IFSB), the authors examine the annual reports of 16 Islamic financial institutions in Malaysia. The index used contains 14 dimensions under which there is a total of 123 different items. The dimensions are categorized into general-governance related information (GCGi), which focuses on operational efficiency and economic achievement, and specific-governance related information (SCGi), which focus on achieving ethical and socially corporate values. Islamic financial institutions were generally found to have “good” disclosure with more attention being paid to GCGi than SCGi. Nevertheless, the authors remark that there is plenty of room for improvement.

In the second paper, *The Effect of the Board of Directors' Characteristics on Corporate Social Responsibility Disclosure by Islamic Banks: Evidence from Gulf Cooperation Council (GCC) Countries*, Bukair and Abdul Rahman study the effect of the board of directors' characteristics, such as board size, composition, and the separation roles of CEO and chairman, on corporate social responsibility (CSR) disclosure using the annual reports of 53 Islamic banks in the GCC, while controlling for bank size, financial performance and relevant public (percentage of Muslim population to the total population in the country). A positive and significant relationship is found between bank size and CSR disclosure as well as financial performance and CSR disclosure. The authors, thus, recommend that policy makers impose additional constraints on the board of directors' characteristics.

In the third paper, *Islamic Corporate Social Responsibility (CSR) in Islamic Banking: Towards Poverty Alleviation*, Yusuf and Bahari attempt to identify criteria which are essential for Islamic CSR to have meaningful impacts on society. The authors derive six such criteria from Qur'an and hadith as well as the literature: (1) *Shariah* compliance; (2) equality; (3) responsibility in work; (4) guarantee of welfare; (5) guarantee of environmental sustainability and (6) charity for preservation of virtue. The authors then develop an instrument to measure Islamic CSR at Islamic banking institutions through the identification of 34 items under the criteria. Five individuals with expertise in academia, *Shariah* supervisory boards, directing and regulating Islamic banks were asked to opine on the 34 items proposed for the instrument. The experts generally agreed that the 34 items identified by the authors were suitable. The paper ends by recommending that *maslaha* (public interest) and social capital guide the application of Islamic CSR.

In the fourth paper, *Social Responsibility Dimension in Islamic Investment: A Survey of Investors' Perspective in Malaysia*, Barom studies the perception of investors of the social responsibility dimension of Islamic investments and the factors that influence such perception. The study involves 415 investors of Islamic funds from 3 fund management companies in Malaysia (Public Mutual Berhad, CIMB-Principal Asset Management Berhad, and Prudential Fund Management Berhad). The author

identifies three main concerns (*fiqh* injunctions, economic, and social responsibility) for a holistic approach to Islamic investment. Underneath these concerns, the author lists 10 criteria that he derives from the literature. The study finds that investors consider *fiqh* injunctions the most important consideration. Furthermore, social responsibility concerns are perceived by the majority of respondents to be as or more important than economic concerns. Ethnicity, religion, level of commitment to *Shariah* principles in investment, income, age, level of SRI awareness, as well as gender, marital status and participation in pro-social activities are all variables that are found to affect the importance attached by respondents to social responsibility.

In the fifth paper, *The Corporate Social Performance Indicators for Islamic Banks – The Manager’s Perception*, Bani, Ariffin, and Abdul Rahman investigate Corporate Social Performance (CSP) indicators for Islamic banks through conducting a survey of 152 Islamic bank managers in Malaysia. The study reports 47 important CSP indicators, with *Shariah* compliance being among the most important indicators. Additionally, the authors find that the majority of respondents are in favor of a model of social responsibility that considers explicit responsibility to multiple stakeholders as part of the CSP of Islamic banks. Respondents also identify the interests of employee, customers, zakat recipients, regulators and community as factors that contribute toward Islamic banks fulfilling their social duty.

Part III: Legal and regulatory issues in Islamic finance

In the first paper about legal and regulatory issues titled *The Continuing Influence of Common Law Judges and Advocates in the Adjudication of Islamic Finance Disputes in Nigeria*, Sambo and Abdulkadir assess the effect of common law judges on the resolution of Islamic finance disputes in Nigeria. The authors find that the current institutional arrangements result in a misplacement or miscarriage of justice due to the influence that these judges and advocates have on the adjudication of cases without possessing sufficient Islamic jurisprudential knowledge or background. Because the Islamic finance industry is in its early stages in Nigeria, the authors emphasize the importance of developing institutional frameworks to enable it to operate and grow in the right direction. They recommend that additional judges who have a strong background in Islamic transactional jurisprudence be appointed to the appellate courts to decide on Islamic finance cases. Alternatively, they suggest the inception of a *Shariah* Supreme Court separate from the regular Supreme Court through a constitutional amendment.

In the second paper, *Dispute Resolution in Islamic Finance: A Case Analysis of Malaysia*, Oseni and Ahmad employ direct observation and case analysis to examine the potential for

resolving Islamic finance disagreements between parties using alternative dispute resolution (ADR) mechanisms. The authors examine the ADR mechanisms currently employed in the industry and investigate the legal and institutional ADR framework in Malaysia. The importance of addressing this topic arises from the need to establish an efficient ADR framework that would swiftly deliver justice in Islamic finance disputes in an amicable manner, given the need to maintain long-term business relationships. Additionally, having such a framework in place saves time and costs associated with litigation. The authors recommend that the civil court scheme be complemented with expert determination via mediation and arbitration, such that issues relating to Islamic jurisprudence are referred to experts in the field who would issue binding decisions enforceable in court.

In the third paper, *Regulatory and Financial Implications of Sukuk’s Legal Challenges for Sustainable Sukuk Development in Islamic Capital Market*, Nazar scrutinizes legal impediments to *sukuk* structures that are inherent in current day contracts. In doing so, the author attempts to harmonize *Shariah* with the western legal framework in order to better govern *sukuk* transactions. The author concludes that legal infrastructures in several jurisdictions have not been “supportive enough” for true *sukuk* transactions, and that each jurisdiction has its challenges. Thus, the legal rights of *sukuk* holders to securitized assets remain unprotected. The author recommends that key players of the industry engage in serious discussions to resolve the outstanding issues.

In the fourth paper, *Overcoming the Divergence Gap Between Applicable State Law and Shariah Principles: Enhancing Clarity, Predictability and Enforceability in Islamic Finance Transactions within Secular Jurisdictions*, Sacarcelik examines contractual dimensions of *sukuk* transactions within the German legal setting and the rift that emerges between the legal structures of these transactions and *Shariah* guidelines that govern their implementation. The author points to the problematic ownership status of *sukuk* holders and highlights the complications that could arise in case of obligor bankruptcy. To protect the rights of *sukuk* holders, the paper suggests that a true sale be effectuated under German law, or that the concept of *Treuhand* be utilized. In spite of the concerns raised, the author contends that German law is capable of providing the necessary environment required for *sukuk* transactions.

In conclusion, the research presented in this volume advances our knowledge on matters of ethics, governance, and regulation, as related to the Islamic financial realm. It is an attempt to fill gaps that have challenged our progress, and to advance our knowledge of these domains. Nevertheless, a wealth of issues within each of these streams awaits exploration, and I hope that future researchers will continue to dedicate attention to these important topics.

Islamic Finance *ijtihad* in the information age: Quo vadis?

Tayyab Ahmed

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Abstract - Islamic finance faces an unprecedented existentialist threat from the exponential explosion of knowledge in the current Information Age. Excessively legalistic current practices such as Shariah arbitrage, fatwa shopping, and the use of legal ruses have collectively exacerbated a pre-existing deficit of trust with ordinary Muslims. The pervasive spread of information overload today highlights this present trust deficit and compounds it with additional unique complications for the future development of Islamic finance. The independent reasoning (*ijtihad*) exercised by Islamic scholars to these present and potential problems may well determine the extent to which such present and potential problems are successfully overcome. Yet contemporary Islamic finance *ijtihad* is both a victim and perpetrator: scarred by its own loss of both contextual focus and practical finesse, Islamic finance *ijtihad* is also actively hastening Islamic finance's possible demise by creating conditions for wider disillusionment with the industry amongst lay Muslims. Even though some of these conceptual concerns are already known to industry practitioners at the operational level, this article argues that a meaningful exploration of the relationship between the changing nature of information and the role of *ijtihad* is still lacking at the strategic level. Hence, this paper constructively sets forth some possible embryonic macrocosmic solutions to help reduce the debilitating effects of information overload upon Islamic finance's overall feasibility.

Keywords: *Ijtihad*, Information Age, Islamic law, Islamic finance

1. Introduction

At the dawn of the third millennium (C.E.), we face an unprecedented threat from information overload. More than ever, we are bombarded with practically infinite volumes of instantly accessible information and intellectual stimuli which challenge our cognitive capacities beyond their natural abilities and limits. As a result, human beings suffer increasingly from an "attention deficit," made constantly worse by the snowballing changes in information technology and the impact such technological challenges are having on both the intensity of our work lives and our employment patterns (Klingberg, 2009, pp. 4–5). Even in a fairly young industry such as Islamic finance, the repercussions of these sea changes and their collective onslaught on our organizational and cognitive abilities are inescapable. Although theoretically such unprecedented access to information holds out positive possibilities for the advancement of humankind, the actual reality is that there is a general struggle for meaning and useful knowledge in the current Information Age. Herein lays the paradox: the more information overload we experience, the less efficient our knowledge distillation processes become.

It is not just that information is increasing: there is cause for concern about the calculus by which this transformation

in information is taking place. Access to a virtually infinite amount of documents, presentations and databases online does not equate to meaningful knowledge, which is far more than the simple agglomeration of disparate information sources and raw, unprocessed data. Knowledge creation is more a process whereby form is imposed upon chaos to create something previously unknown or unnoticed, which becomes a useful epistemological commodity worth sharing. This is the second paradox: the infinite savings in time created by information dissemination platforms such as the World Wide Web and popular search engines such as Google, however worthwhile, is counteracted by the vast increase in our tasks, thus creating backlogs of knowledge for us all. Consequently, the tempestuous flood of information overload threatens to render obsolete the current structures and frameworks of references with which we have previously made sense of the fast-paced developments in the burgeoning field of Islamic finance. With these circumstances in mind, this article proffers some modest thoughts and solutions regarding this existential threat of information overload to the Islamic finance industry.

Knowledge creation backlogs are occurring precisely because humanity has yet to devise accessible, affordable

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and intelligent systems to organise or contain the flood of information. But just as we can tap into the ocean's resources and make sensible use of these natural resources, then it stands to reason that similar techniques can be applied to information as well. Such techniques are already being developed in efforts such as the Semantic Web, but are not yet accessible to those with little knowledge of computer programming techniques. Governments and large corporations may have access to more reliably intelligent next-generation systems, but these are obviously beyond the financial reach of most ordinary academic institutions, let alone individual researchers or workers. At present therefore, in the absence of such tools and their effective utilisation, *ijtihad* remains our best hope for the contemporary renewal of Islamic finance.

Ijtihad is the application of independent reasoning by Islamic scholars to interpret the revealed sources of Islamic law in light of the problems faced by Muslims of their age. Giving a succinct and singular definition of what *ijtihad* entails is almost impossible, as classical scholars such as Ibn Ashur and Al-Shatibi demonstrate. Ibn Ashur (2006 pp. 5–6) provides a definition of *ijtihad* which has five distinct aspects, whilst Al-Shatibi provides a two-stage definition of *ijtihad* which inextricably links the practice of *ijtihad* to the higher objectives of Islamic law, the *Maqasid al-Shariah* (al-Raysuni:331). For convenience's sake therefore, these definitional intricacies are left aside and focus is rather on the issues arising from the application of contemporary Islamic finance *ijtihad*. In this paper, *ijtihad* is denoted interchangeably as either "legal interpretation" or "independent reasoning."

2. Current Issues Affecting Islamic Finance

The trust deficit of Islamic finance

The primary contention of this paper is that *Shariah* today suffers from a credibility gap between theoretical ideals and practical realities stemming from two main factors: a significant over-reliance on debt-based *Shariah*-compliant instruments; and the virtual unenforceability of *Shariah* in a modern cross-border transactional context. Along with unfortunate and excessively legalistic practices such as *Shariah* arbitrage, *fatwa* shopping and legal ruses, these two main factors continue to fuel a deficit in trust which harms the Islamic finance industry's reputation amongst lay Muslims, who constitute the lifeblood of Islamic finance as depositors and shareholders in Islamic financial institutions. For instance, according to El-Gamal (2006:20, 177), *Shariah* arbitrage is a "peculiar form of regulatory arbitrage," which merely mimics "Western regulatory arbitrage methods aiming to reduce tax burdens on high-net-worth individuals." The pervasive spread of information overload today highlights this present trust deficit and compounds it with additional complications for the future development of Islamic finance. First, there is a significant over-reliance on debt-based *Shariah*-compliant instruments and structures as opposed to equity-centred *Shariah*-based products. This preference for debt over equity damages the credibility of Islamic finance, and thus harms the industry's long-term viability and sustainability. On the one hand, the present legalistic approach to Islamic finance helps legitimize a

distressingly myopic preoccupation with the practice of Islamic finance with a *Shariah*-compliance certificatory system for predominantly debt-based modes of finance, which is criticised to be grounded more in the letter than the spirit of Islamic jurisprudence. On the other hand, however, the normative evolution of Islamic finance towards more equity-based modes of finance, e.g., "profit-loss sharing" partnerships, holds out rich possibilities for *Shariah*-based product development, which is firmly rooted in the spirit of Islamic commercial jurisprudence (Lewis, 2007). Quite understandably, the current *status quo* in the practice of Islamic finance is in many respects not viable, as Islamic financial institutions have to continuously strive to seek a balance between the provision of authentic *Shariah* compliant financial products and financially viable products – the two basic requirements for depositors and shareholders in their endorsement of Islamic financial products (Rehman, 2010, pp. 115–121).

Second, *Shariah* today is virtually unenforceable in a cross-border transactional context (DeLorenzo & McMillen, 2007, p. 136). Recent cases which have come before the courts of secular jurisdictions, such as England, as well as commentaries on them, proffer ample evidence of the problems in enforcing a non-national legal system open to equally authoritative interpretations (Bälz, 2005; "Beximco," 2004; Godden & Miller, 2010; "Symphony Gems," 2002; "Jivraj," 2009; "Musawi," 2007). Moreover, such problems with respect to enforceability are further compounded by the problematic nature of relying on religious texts as authoritative legal sources in private international law (Warde, 2000, p. 234). This unenforceability of Islamic law creates uncertainty in the Islamic banking and finance industry, which works against the general public interest ("*Maslaha*") of Muslims. Perhaps now is the time to gradually move away from the piecemeal mimicry of common law and reliance on Western legal traditions and shift towards more novel fusions of the Islamic and Western legal traditions, such as incorporating elements of Islamic arbitration within the global framework of international commercial arbitration (Nadar, 2009, p. 189).

Finally, there is also ample criticisms from academic quarters that an Islamic finance built upon compliance foundations and the certificatory functions of *Shariah* scholars, whilst technically abiding by the letter of the *Shariah*, fails to implement the wider spirit of the *Shariah* and its original intended sentiments (Abdul-Rahman, 2010, p. 237). This preference for form over intent has led, perhaps inevitably, to the emergence of several interrelated criticisms of Islamic banking practices (Ayub, 2007, pp. 445–456). Regardless of the merits of such criticisms, they still represent symptomatic discontentment by ordinary Muslims, who have misgivings over whether Islamic finance in practice is sufficiently distinct from conventional operational practices in areas such as *murabahah* finance, *bay al inah* practices and *tawarruq* financing (Iqbal & Molyneux, 2005, p. 126). So until and unless the *Shariah* becomes legally enforceable in transactional contexts; improves its value proposition to stakeholders; and derives an adequate mechanism for dispute resolution, the trust deficit will remain. In this context, the pervasive spread of information overload will only serve to starkly highlight such shortcomings in industry practice to the industry's own detriment.

Sub-optimal *Ijtihad* through excessive legalism

Ijtihad in contemporary Islamic finance is essentially the product of *Shariah* scholars' intellectual efforts to legally realise Islamic economic principles in light of the contemporary global financial and banking system. These efforts at juristic interpretation are central to the development of Islamic finance, as *Shariah* supervisory boards provide the certificatory services for Islamic financial products which financiers, as non-experts in Islamic commercial jurisprudence, cannot by themselves provide (Jobst, 2007, p. 27). Logically therefore, the presence of sub-optimality in *ijthadic* processes would not augur well for Islamic finance. Such sub-optimality does exist, and is perpetuated in large part through excessively legalistic practices such as *Shariah* arbitrage; *fatwa* shopping; and the use of legal artifices (*hiyal*). All of these three practices harm the industry and stunt its future development, whilst also reflecting a broader tension in Islamic finance between legal forms and economic substance. As Dusuki and Abozaid (2007:164) note, in certain contexts it may be best to ignore the legal form of a transaction where the net effect is merely to replicate the economic substance of a prohibited conventional transaction.

First, as Islamic financial institutions require external certification and are commercially-driven to enhance their products with the best brand endorsement possible, there is a tremendously strong demand for *Shariah* experts. Whilst obtaining input from *Shariah* scholars is innocuous on the surface, on another level, actual practice gives rise to serious concerns: these highly-prized scholars can and do leverage their "celebrity status" in this captive market to excessively influence the development of Islamic finance industry. This phenomenon is commonly known as "*Shariah* arbitrage." El-Gamal, a firm critic of such practices, avers that such practices are inherently futile, as they result in declining *Shariah* arbitrage profit margins and an inevitable dilution of the "Islamic" brand name and value: (El-Gamal, 2006). Moreover, the negative impact of such dilution of the "Islamicity" of products is increased by the use of legal artifices in Islamic finance, which help subvert the original aims and objectives of the "*maqasid al-Shariah*."

Second, there is a distinct lack of unique value propositions, which not only draw upon the rich heritage of classical Islamic jurisprudence, but also noticeably build upon the legacies of the past to create products with both strong *Shariah* authenticity and strong financial demand. Scholars such as Hegazy (2005:141–149) have pointed out at length the dangers that can arise from the abuse of *fatwas* as instruments for change in Islamic finance. In particular, such procedural abuses further harm the authenticity of the Islamic finance industry by undermining the authority of *fatwas* as religio-legal opinions of persuasive authority, and support the view that present-day Islamic finance will continue to operate at a trust deficit with both depositors and shareholders alike. In this regard, the unfortunate abuse of *fatwas* in Islamic finance *ijtihad* today through practices such as *fatwa* shopping has led us to a point where Islamic finance *ijtihad* is severed from both its religious underpinnings and, more importantly, the well-meaning foundational aspirations of Islamic economics (Hegazy, 2005, p. 149). Again, without

the genuine reassertion of *Shariah*'s authenticity through fields such as "Islamic Finance Law," Islamic finance will continue to harm itself as an emerging industry.

Third, legal artifices – "*hiyal*" (sing. "*hila*") – were a feature of Islamic jurisprudence even in the classical period of Islamic law: (Habil, 2007). In fact, some scholars such as Rosly (2010: 134) even employ legalistic approaches to the issue of legal artifices, arguing that they serve a useful ancillary function to the achievement of internal consistency with respect to the fundamental legal building blocks of Islamic commercial law and finance: (1) 'aqd; (2) *maqasid al-Shariah*; (3) financial reporting; and (4) legal documentation. Be that as it may, legal artifices still pay only lip service to the economic substance of Islamic finance transactions, and thus lead to absurd results and effects such as, for example, the giving and receiving of interest by another name via structures and mechanisms such as *tawarruq*. Finally, as Habil pointed out in his discussion on legal artifices, "*aside from its ethical vagueness and irrationality, hila is casuistic and its applicability is limited by its very nature ... sooner or later, hila leads to a dead end.*" (Habil, 2007).

Sub-optimal *Ijtihad* and Islamic finance

Yet contemporary Islamic finance *ijtihad* is both a victim and perpetrator: scarred by its own loss of both contextual focus and practical finesse, Islamic finance *ijtihad* is also actively hastening Islamic finance's possible demise by creating wider disillusionment with the industry amongst lay Muslims. These losses of focus and finesse give rise to serious doubts over the feasibility of Islamic finance as a whole, and are inherently linked to the sub-optimality of contemporary Islamic finance *ijtihad*.

3. Future Issues Affecting Islamic Finance

Quantitative quagmires: The loss of focus in *Ijtihad*

With the increasing complexity in Islamic finance and the application of Islamic commercial law, and the resulting human capital trend towards increased specialisation, there is a clear and present danger that this phenomenon of specialisation may well interact with the wider fragmentation of knowledge currently being experienced in the Information Age by Muslims and non-Muslims alike. The emphasis on micro over macro; rules over principles; and form over substance; are all symptoms of a dominant '*compliance is king*' mentality that predominates in Islamic finance today. Such a mentality at the organisational level has inevitably led to wider confusion at the regulatory level of what the actual focus of Islamic finance should be: it is, in short, precisely these quantitatively induced quagmires which leave Islamic finance open to accusations of a perceived lack of authenticity. For Hamoudi (2008:463), this clash between theoretical macro-ideals and practical micro-realities signifies "*nothing more than careful mediation, between the necessity of adopting conventional finance models and a desire to retain the appearance of a populist fundamentalist vision of economic justice in finance*" (Hamoudi, 2008, p. 463). Whatever one's views on the potency of such a statement, it is fairly indisputable that somewhere along the way towards making the dreams of Islamic economics come true, Islamic finance *ijtihad* has strayed considerably.

Qualitative quagmires: The loss of finesse in Ijtihad

The quantitative quagmires and loss of focus in Islamic finance are grimly complemented by the existence of qualitative quagmires and a resultant loss of finesse in Islamic finance *ijtihad*. Much has already been written about the numerous corporate governance issues surrounding both the practices of *Shariah* Supervisory Boards in deriving their rulings and the various conflicts of interest which bring into question their ability to remain truly independent of their client Islamic financial institutions (Archer & Karim, 2007; Grais & Pellegrini, 2006; Nakajima & Rider, 2007; Warde, 2005; Yunis, 2007). Suffice to say, such conditions are far from conducive to the reputation of Islamic law in general, and its application to Islamic finance in particular through the use of *ijtihad*. One may at this point call to mind Gresham's Law, i.e., "bad money drives out good," and readily muse whether sub-standard or inadequately prepared *fatwas* will drive out potentially better *fatwas* simply because the latter emanate from lesser well-known younger scholars, who are likely to be passed up by Islamic financial institutions in favour of more well-known older scholars. This type of pecking order seems perversely removed from the meritocratic nature of Islam, and seems increasingly anachronistic in this day and age. Hopefully, this situation will be suitably remedied by the widely-reported efforts and plans of AAOIFI to address this crisis in scholars by 2013, although according to recent media reports, even that is an optimistic timeframe.

Ijtihad as victim and perpetrator: The loss of feasibility in Islamic finance

Until 2013 though, the loss of both focus and finesse in Islamic finance will continue to worsen as demand for Islamic financial services increases amidst a background of insufficient human capital supply (Volker Nienhaus, 2007, p. 381). More importantly, the loss of focus and finesse in Islamic finance, taken together, support and fuel a wider malaise of confidence in Islamic finance's overall feasibility as an industry with aims to make a difference to the world of finance and well-being of humanity. In this day and age of innovation *par excellence*, only countries and industries which take the initiative to adapt boldly to novel technologies and paradigms will prosper – countries such as Germany, the "land of ideas", and industries such as life sciences, where high trial failure rates are offset and made profitable by the minority of game-changing success stories. It is ironic and somewhat puzzling that for an industry founded upon legal maxims such as "no risk, no profit", Islamic finance remains heavily imitative of conventional interest-based structures and mechanisms. Hence, contemporary Islamic finance *ijtihad* is both a victim and perpetrator: scarred by its own loss of both contextual focus and practical finesse, Islamic finance *ijtihad* is also actively hastening Islamic finance's possible demise by creating conditions for wider disillusionment with the industry amongst lay Muslims.

4. Islamic Finance: Quo Vadis?

Islamic finance as an industry has a myriad of potential destinies awaiting it. The focus of this paper is, however, on two particular issues. The first scenario assumes Islamic finance will meander along with little change to the issues raised above, and this promotes an inherently bleak

outlook for the industry. The second scenario however, no less possible but infinitely more promising, assumes that Islamic finance will realign its strategic development in favour of authenticity, curiosity and evolution. In particular, 'the development of "Islamic Finance Law" is central to achieving such aspirations and answering the question "Islamic finance: Quo vadis?" ("Islamic finance: Where are you going?").

Scenario 1: Wider disillusionment

On a wider level, practices such as "*Shariah* arbitrage" are dangerous for the cohesiveness and unity of contemporary Muslim society. It is ironic indeed, that for an economic system which prides itself on the ability to offer more inclusivity than incumbent economic systems such as Western capitalism, there is a risk of increasing marginalisation of future generations of Muslims in Islamic finance. "*Shariah* arbitrage" supports the monopolisation of Islamic finance *ijtihad* by concentrating key decision-making within the hands of a select few *Shariah* scholars. The rest of the Muslim society, rather than feeling comforted, feels marginalised as such a clerical clique fights to maintain its purported indispensability in an age of increasing competition. This marginalization of wider Muslim society by the scholarly community in Islamic finance today is similar in many respects to the abject and continuing failure of the doctrine of "*guardianship of the jurist*" (*wilayat-i faqih*) as practised in the state of Iran, where the safeguarding of parochial privileges through doctrinal rigidity has led to resentment among the younger generation of Iranians (Amanat, 2007, p. 134).

Also, it has been noted in previous literature on Islamic political economy that ethical values are indispensable to the establishment of an Islamic economic system (Asutay, 2007, p. 4), which would by definition include the operation of an Islamic financial system. However, in practice, Islamic finance has come up short on the ethical front in many respects. Looking ahead, one way forward for the development of earnest ethical credentials for Islamic finance in practice may be to operationally focus on "glocalization" – that is, to "think globally and act locally", by emphasising local-scale action and initiatives over global cross-border transactions. Otherwise, continuing the present industry practices may simply compound the disenfranchisement of ordinary Muslims and their considerable disillusionment with Islamic finance (Balala, 2011, p. 8).

Scenario 2: "Islamic finance law" and the golden opportunity for Ijtihad

The hypothesis of this paper is that the credibility gap in Islamic finance discussed in Section II above can be significantly reduced by re-establishing the authenticity of the *Shariah* through the systematic development and evolution of "Islamic Finance Law" as a separate discipline and emergent legal system, and this hypothesis is strongly supported at the outset by the need for the solutions discussed and outlined below. Even though some of these conceptual concerns are already known to industry practitioners at the operational level, a meaningful exploration of the relationship between the changing nature of information and the role of *ijtihad* is still lacking

at the strategic level. “Islamic finance law”, whilst by no means a panacea, nonetheless offers a viable *ijtihad*-centric alternative to the current malaise in confidence over *Shariah* authenticity in Islamic finance today. Hence, this paper constructively sets forth some possible embryonic macrocosmic solutions to the debilitating effects of information overload on Islamic finance’s feasibility in the following section.

5. Playing the “Ace” Card: An Embryonic Solution

Of course, uncomfortable truths are hard to swallow, as to some extent they entail the tacit acceptance of prior error in judgment. But the benefits of embracing knowledge creation techniques far outweigh the costs of stubbornly adhering to obsolete methods of learning and knowledge assimilation on flimsy and irrelevant grounds of culture, heritage or tradition. Islamic finance itself is an interdisciplinary field born out of the union between Islamic law and Islamic economics: its very birthright consists of both thoughtful industry-driven solutions by practitioners and industry-aware thoughtfulness from academicians. As such, this paper proposes a composite “ACE” card paradigm, whereby the Islamic finance industry can effectively counter the growing doubts over both its conceptual validity and practical feasibility. This prototype of a solution is but a mere sketch, and it is important to emphasise that the further illustration of such a paradigm is less important than understanding the centrality of the three key pillars: authenticity, curiosity and evolution.

Authenticity

One possible way forward for Muslims today to achieve authenticity in Islamic finance *ijtihad* would be to reassess the classical scholarship with an emphasis on purpose-based reinterpretations. By distilling the wisdom from classical texts and reviewing their application to the needs of our current era, we may perhaps get closer towards more meaningful *ijtihad* which takes account of the spirit as well as the letter of the law. Questions relating to authenticity in contemporary *ijtihad* in Islamic finance will, like other areas of Islamic law, inevitably overlap with questions relating to the general public interest (“*maslahah*”) of Muslims today. In order to move beyond previous models which apply *maslahah*, or at least reframe them in light of present-day concerns in Islamic finance, it is necessary to acknowledge the relevance of changes in Muslim societies at large. Tomorrow’s *Shariah* scholars who will exercise their *ijtihad* in Islamic finance will bring with them the benefits of higher standards of formal education in Islamic law and finance specifically; more diverse previous work experience in an age of ever-changing employment patterns; and will live in an age where the provision of information becomes ever-more ubiquitous and instantaneous. The influence of these educational, occupational and historical realities will determine their approaches to important concepts such as *maslahah*: (Opwis, 2007, p. 82). As such, we would do well as a community of Muslims to better make sense of and prepare for these sea changes in Islamic human capital.

Also, the tension between the need for certainty in an emerging field like Islamic finance and the inherent flexibility in Islamic law’s application and interpretation

makes the discussion of *ijtihad*’s authenticity especially relevant today at the operational level as well. In many respects, allowing events to simply play out for themselves between the institutional and organic levels of the Islamic finance industry may be the most feasible avenue towards an increased yet moderate degree of certainty and uniformity in Islamic *ijtihad* (Foster, 2007, p. 178). Of course, standardisation *per se* is not a bad thing, provided it does not stifle the diversity of opinions inherent in Islamic finance *ijtihad*, and this flexible form of standardisation has been achieved in several instances of Islamic insurance law (Bakar, 2002, p. 88). As such, endeavours such as a flexible system of codification in Islamic finance law would form a substantial and much-needed part of solutions to this question of balance in future *ijtihad* relating to Islamic finance (McMillen, 2011, p. 38).

Curiosity

“Islamic Finance Law” is very much an emergent legal system (Foster, 2007, p. 187). In other words, there is still much conceptual work yet to be done, which is urgently needed to cement the legal aspects of contemporary Islamic transactional jurisprudence into a coherent system of laws. With the increasing spread of globalization to Muslim lands, the need to seek out innovative and yet fundamentally authentic solutions to the problems of *ijtihad* in contemporary Islamic finance will become ever more pressing (Krämer, 2007, p. 37). It goes without saying therefore, that in such a scenario “Curiosity is key”.

Furthermore, the systematic development of “Islamic Finance Law” as a separate discipline is one of the best methods available to re-establish *Sharia*’s authenticity in the modern age. Effective Islamic finance, based around a sound application of the *Shariah* to Muslim societies’ socio-economic problems, would greatly help underdeveloped Muslim economies. Moreover, with rapidly changing political landscapes in the Middle Eastern nation states, the onus is on the Muslim communities of the world to build upon such developments in the socio-economic fields through more extensive use of Islamic finance techniques which genuinely benefit the masses. If *Ijtihad* is ignored or dismissed as unimportant in the field of Islamic finance’s normative development and evolution, there is a clear danger that instead of being a transformative tool for widening the constituency of Islamic finance, *ijtihad* will be used in Islamic finance discourse to justify the desperate existing state of Islamic finance. Such a legitimising effect would be undesirable at best, and at worst, destructive of the very ethos of reform which *ijtihadic* processes seek by their very nature to uphold (Codd, 1999, p. 131).

Historically, the decline of innovation and creativity in knowledge discovery stems from the abdication of responsibility by scholars. This abdication of responsibility threatens once more to derail Islamic jurisprudence in the field of Islamic finance, as the current information overload dictates that independent thought be eschewed in favour of mere knowledge management and the dissemination of existing knowledge sources. It is not hard to see, then, how a culture of rote-dominant rather than innovation-dominant learning springs from the proliferation and engendering of such a stifling mindset. Ironically, such a mindset stands distinctly in opposition to the flourishing of pluralistic

thought in the Golden Age of Islamic legal scholarship and should be sensibly resisted. In sum, the times we now live in called for curiosity, not conformity, in thought.

Evolution

The needs of today call for an evolution in “Islamic Finance Law”. It is not simply, and cannot be, a mere accumulation of various fragmented laws or regulations relating to transactions in Islamic finance: “Islamic Finance Law” must offer a unique value proposition of its own as an emergent legal system in this post-financial crisis era. Otherwise, the credibility of Islamic finance, which crucially derives its legitimacy from the *Shariah*, will suffer irreparably. Practices such as “*Shariah* arbitrage” have already had undesirable effects on the industry’s reputation (El-Gamal, 2005), as have conflicts of interest and concerns over independence which plague the operation of *Shariah* Supervisory Boards (V Nienhaus, 2007, pp. 136–137).

Also, the majority of contemporary Muslim countries are demographically made up of young people. These digital natives need to be actively encouraged to think independently, innovatively and insightfully in order to chart a bright new path for “Islamic Finance Law”. At present, despite the increasing growth of the Islamic capital markets and refinement of products such as *sukuk* (Islamic investment certificates) and overall brusque pace of Islamic finance’s development (Archer & Karim, 2007, p. 400), the actual level of sophistication in Islamic finance remains limited (Mirakhor & Smolo, 2010, p. 377) and clearly requires substantial further improvements (Al-Salem, 2009, p. 194).

As Vogel (2000) obliquely points out in his extended study of Islamic law as applied to the Saudi Arabian legal system, innovation and originality by legal scholars of Islam was sacrificed at the altar of expediency. Applying this historical lesson to our present times, we may well find that in today’s age of hyper specialization and the increasing fragmentation of knowledge, such recourse to expediency is becoming increasingly threatening to the role of *ijtihad* in Islamic finance today. Doctrines once alien to Islamic jurisprudence, such as the doctrine of binding precedent (*stare decisis*), are now wholeheartedly embraced by the Islamic scholarly community in the name of practicality and ummatic “*maslahah*”.

This rich plurality may well be the underestimated and ignored antidote to the suffocating monoculture that is affecting Muslim scholarship today under the guise of “consensus” and “public policy”. As several commentators on Islamic legal history point out, this rich plurality of opinions has been conveniently forgotten and emphatically airbrushed out of the historical accounts of Muslim scholarship. Hallaq (2004: 61), for instance, cites the examples of independent *mujtahids* such as Abu Thaw, Muzani and the “Four Muhammads” to illustrate how a tradition of plurality is intricately and unmistakably woven into the history of Islamic law and *ijtihad*, noting with interest that these and other scholars more or less forged their own legal philosophies. From this perspective, the “closing of the gates of *ijtihad*” is still very much debatable (Hallaq, 1984, p. 33), and it is a healthy debate which should be aired more often in Islamic banking and finance discourse.

Recently, there have been calls for standardisation of Islamic legal principles and structures in controversial products such as *Shariah*-compliant derivative products, in order to help open up new markets and opportunities for the nascent industry (Fagerer, Pikiel, & McMillen, 2010, p. 16). However, building a doctrine of binding precedent indistinguishable from the common law system may not be in the best interests of the Islamic legal framework at large. On the contrary, as Hallaq (2004: 62) avers, “*the doctrine of the closure of the gate can now be seen as an attempt to enhance and augment the constructed authority of the founding imams, and had little to do with the realities of legal reasoning, the jurists’ competence, or the modes of reproducing legal doctrine.*” What is particularly interesting here is that such an analysis may well apply to the doctrine of standardisation, as it is not dissimilar to the attempts to close the gates of *ijtihad* several hundred years ago.

Standardisation is not about the triumph of the most sensible methods of legal reasoning or the prevalence of the most competent jurists’ opinions; it is about the mere templating and reproduction of old doctrines through a process of doctrinal crystallization which is counterproductive for two reasons. Firstly, it harms Islamic finance’s flexibility and fluidity as an emergent legal system; and secondly, it goes against the very grain of the historical reality of Islamic law, i.e. its inherent respect for reasonable differences amongst reasonable people. As Imam Shaf’i stated in his *Risala* when discussing the matter of *Ijtihad*, Allah in His infinite wisdom has ‘*endowed men with reason by which they can distinguish between differing viewpoints, and He guides them to the truth either by [explicit] texts or indications [on the strength of which they exercise ijtihad].*’ (al-Shaf’i & Khadduri, 1997, p. 302)

Inherent in Shaf’i’s quoted statement is an overt acknowledgment that reason and intellect are key tools in the formation of *ijtihad*, and that since men’s intellects differ in stature and their powers of cognizance, the resultant *ijtihad* they perceive and construe will similarly differ. As a result, in today’s age of hyper specialization, a range of *ijtihad* is required, not a monoculture of a purportedly omniscient “grand *ijtihad*”. Such a monolithic construction of legal interpretation is, it is submitted, anathema to the true tenets of Islam, and calling it standardisation or associating such views with the wider ummatic *maslahah* are mere window-dressing and obfuscating ruses. If *ijtihad* were to be a tree, it would better be a palm tree rather than an oak tree – flexible and responsive as opposed to inflexible and unbending – so as to better weather the epistemological tempests in which we find ourselves today. In this regard, Vogel’s remarks on the “rule against *ijtihad* reversal” are also particularly insightful. Vogel (2000; 86) surmises that the rationale for this rule is that, in the absence of primary source certainty amidst a need for *ijtihad* to be exercised, “*all mujtahids are equal and no one has priority, whether caliph or scholar, and that any other rule would defeat the autonomy of the qadi’s conscience.*”

6. Conclusion

The short-term and long-term difficulties posed by an inability to adequately respond to the flood of information do not augur well for the industry. In fact, the existence of a medium term event horizon in the development of Islamic

finance would effectively render the industry irrelevant in a post-industrial global economy, as previously envisaged (El-Gamal, 2006, p. 25). Nonetheless, there is ample hope for the industry's salvation and cause for optimism, provided it adopts collective corrective measures over the medium-term horizon. This paper's suggestions for the centrality and primacy of "Islamic Finance Law" are a tentative start towards such corrective measures, but of course, will need to be further researched and augmented by other like-minded researchers and regulators. Courage, not complacency, is the order of the day: tomorrow is simply a day away.

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Determinants of ethical identity disclosure among Malaysian and Bahrain Islamic banks

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Abstract -In Islam, the practice of transparent and adequate disclosure is stressed and recommended, especially with regard to the ethical identity of Islamic institutions. This is to ensure that the business activities are in line with *Shariah* principles since *Shariah* is the main component and the foremost salient feature in Islamic banks, which differentiate them from conventional banks. Thus, this study examines the ethical identity disclosure of sixteen (16) Malaysian and five (5) Bahrain Islamic banks for five consecutive years, 2007 to 2011. The study further identifies the determinants affecting the ethical identity disclosure in both countries. The ethical identity disclosure index developed for measuring the level of ethical identity disclosure comprises nine dimensions consisting of 81 constructs. The results indicate that the overall disclosure level in both countries is 51.6%, which suggests a low level of ethical identity disclosure. Room for improvement includes information on vision and mission statement product; *Zakat*, charity and benevolent loans; community; environment, and *Shariah* Supervisory Board. In examining the determinants affecting the ethical identity disclosure, the results show that independent directors do not affect the level of ethical disclosure. However, board size, *Shariah* supervisory board and investment account holders significantly influence the disclosure level by both banking industries. Hence, contrary to the agency theory, the results indicate that independent directors in both Malaysian and Bahrain Islamic banks are not effective or competent in performing their role in monitoring the performance and activities of the management of Islamic banks. However, in line with the institutional theory, having greater monitoring by the board of directors, *Shariah* supervisory Board and investment account holders could enhance the disclosure compliance by Malaysian and Bahrain Islamic banks, and, thus, could attract more Muslim investors to participate in the Islamic banking industry.

Keywords: ethical identity disclosure, Islamic banks, Malaysia, Bahrain

1. Introduction

Islamic Banks, similar to conventional banks, are profitable organizations that aim to gain profit. However, in doing so, Islamic banks avoid interest and other aspects that are prohibited by Islam, which therefore characterizes Islamic banks as having an ethical identity (Gray and Balmer, 2001; Haniffa and Hudaib, 2007). Islamic banks need to disclose ethical information (both qualitative and quantitative) based on the Islamic ethical business and *Shariah* framework, which is vital in assisting the stakeholder in making economic religious decisions as well as assisting the management, *Shariah* Supervisory Board and external auditor in demonstrating the accountability to society. Since one of the aims of Islamic Banks is to promote and develop the application of Islamic principles, laws and traditions concerning transactions of financial, banking

and related business affairs, they should exhibit their own ethical identity in setting them apart from other types of organization.

In Islam, the practice of transparency and adequate disclosure is highly recommended, especially in business dealings. This is to ensure that the business transaction is free from any form of exploitation. In Al Quran, numerous verses have emphasized the demand for fair, transparent and ethical behavior in all business transactions. For example, in Chapter 2 *Surah Al Baqarah*, Verse 282, Muslims are required to have contracts written by a scribe as well as to have witnesses comprising at least two men or one man and two women in the business transaction. This is to ensure that the obligation and transactions are executed clearly without any doubt from any party. From this verse, it is

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clear that transparency should be the hallmark of Islamic institutions, as it will ensure justice to all parties involved in the transaction.

Kayed and Hassan (2011) further implied that having adequate and consistent disclosure is necessary for the Islamic banking industry to remain relatively positive and resilient. To ensure the financial stability of the Islamic financial system, Islamic banks need to ensure that their transparency is proper and consistent, especially with regard to their ethical identity as an Islamic institution. They have to ensure that their activities are in line with *Shariah* principles since *Shariah* is the main component and the foremost salient feature in Islamic banks that differentiates them from conventional banks. Such features include the prohibition of interest and the use of profit sharing investment. Failure to comply with *Shariah* may lead to losses by the Islamic banks since they might not be able to recognize the income (IFSB, 2005). The greatest loss that they need to consider is the possibility of losing their investors and investment account holders, who are mostly Muslims, who are really particular about *Shariah* compliance issues and the ethical identity in their dealings.

In addition, a bank's ability to maintain its capital at a sufficient level, as well as its ability to realize rates of return equal to the assumed investment risk is a means of measurement to both shareholders and investment account holders (Mohd Ariffin, Archer and Abdel Karim, 2009). These criteria are important for their evaluation and confidence in making decisions. The lack of such confidence may stop any Muslim from having a business deal with the Islamic banks. In order to prevent the possibility of such incidence, proper disclosure is needed in the financial reports of Islamic banks, which are prepared according to the standards applicable to Islamic banks. As such, studies assessing the strength of the communicated ethical identity of Islamic banks are important since Islamic banks are accountable not only to society but also to God. In addition, transparency in the ethical identity of Islamic banks is essential to society, as it is one of the approaches to ensure the ethical and social activities of Islamic banks. For example, matters pertaining to Islamic bank products, financing activities and community activities.

Due to the extensive and progressive approach to Islamic banking and finance, the Kingdom of Bahrain is chosen for this study as it is acknowledged to be the hub of Islamic banking worldwide and represents the best practice of Islamic banks (Hidayat and Abduh, 2012). Bahrain established its first Islamic bank, Bahrain Islamic Bank, in 1979, and, currently, has 26 Islamic banks, which comprise 6 retail Islamic banks and 20 (twenty) wholesale Islamic banks registered under the Central Bank of Bahrain (Central Bank of Bahrain, 2012). Similarly, Malaysia has also observed progressive and robust development of Islamic banking since 1986 in order to serve the needs of the Malaysian economy as well as enhance the sustainable and economic growth of Malaysia (Bank Negara Malaysia, 2012). Therefore, by comparing the ethical identity disclosure of Malaysian Islamic banks with Bahrain Islamic banks, the position of Malaysian Islamic banks could be identified when compared to the pioneer of Islamic banking. Examining the level of ethical disclosure among

Islamic Banks in Malaysia and Bahrain can fill the gap from previous studies where the focus was more on corporate social responsibility disclosure.

Besides determining the level of communicated ethical identity disclosure among Islamic Banks in Malaysia and Islamic banks in Bahrain, this study also examines the determinants of the level of ethical identity disclosure (board size, board independence, *Shariah* Supervisory Board and Investment Account Holders). Therefore, by exploring the ethical identity in Islamic banks, this study would be of interest to the stakeholders since they would perceive banks with higher ethical indent disclosure as being more favorable, especially for Muslim stakeholders as they are very particular about the source of investment.

The remainder of this paper is organized as follows. The next section reviews the relevant literature, which discusses corporate ethical identity. The third section discusses hypothesis development, sampling methodology, data collection and data analysis followed by discussion on the research findings in the fourth section. Finally, the paper ends with a summary and conclusion of the research.

2. Literature review and hypotheses development

Berrone *et al.* (2005) argued that ethical identity is a good investment in business as it can produce a positive environment and have a good impact on the organization, for instance, by exercising and implementing an ethical code of conduct in the organization, the head of the organization can instill and influence the ethical behavior of the employees. Hosmer (1994) and Jones (1995) claimed that ethical identity could generate a positive atmosphere in the organization like the sense of trust and commitment, and, thus, it can attract more investors as they believe that the ethical identity of the organization is one of the important pillars in order to have successful performance. Further, an organization with a strong ethical identity can maximize the satisfaction of the stakeholder, which would lead to greater achievement by the organization.

Accordingly, Haniffa and Hudaib (2007) argued that Islamic banks have ethical identity, and, therefore, such an institution needs to attain not only its financial goal, but also its social goal since the foundation of Islamic banks is based on religious and *Shariah* principles, the ultimate goal of which is for the betterment of society. In addressing the practice of social reporting, the ethical identity disclosure in Islamic banks should be different from that of conventional banks since the emphasis and the underlying principles in these two banks are different (Haniffa, 2002). In conventional banks, the disclosure of their identity only considers the material and moral aspects, while, in contrast, the Islamic banks need to include the material and moral aspects together with the *Shariah* framework and ensure their alignment with Islamic principles.

By referring to the previous studies, empirically, this study used corporate governance characteristics as a determinant in assessing the factors affecting the ethical disclosure of the Islamic banks. Specifically, the board composition, which comprises three perspectives, namely, board size (Said *et al.*, 2009), board independence (Khan,

2010; Bhasin, Makarov and Orazalin, 2012) and *Shariah* Supervisory Board, as well as Investment Account Holders (Farook, Hassan and Lanis, 2011) are used to assess the ethical identity disclosure of Islamic banks, thus relating each variable to the theoretical assumption.

3. Board size

The board of directors is one of the important elements in corporate governance and is responsible for supervising and overseeing the organization to ensure it is being properly managed. According to Jensen (1993), the larger the number of board members, the more ineffective the communication and coordination of the board and the more likely it is controlled by the CEO. This argument is supported by the agency theory, which proposes that large boards can be costly to the organization due to the increase in the potential conflict and operational complexity among board members, which lead to poor decision making (Lipton and Lorsch, 1992; Jensen, 1993). Ning, Davidson and Wang (2010) suggested that an increase in board size would likely cause an increase in agency problems, which would contribute to internal conflict as well as the free-riding problem among the directors. Said *et al.* (2009) also acknowledged that ineffective communication and inefficiency in decision-making would lead to the low quality of disclosure in financial reporting since the board is not able to perform their role efficiently.

However, Clemente and Labat (2009) claimed that large board size would increase the monitoring capabilities. Due to a significant relationship between the organization and their stakeholder, they tend to increase their disclosure level and release more information, as suggested by the stakeholder theory. In a study by Akhtaruddin, Hossain, Hossain, and Yao (2009), they found that board size is a significant predictor of the voluntary disclosure in Malaysian listed firms, as they found that large board size produced a greater level of voluntary disclosure. Moreover, in Rouf (2011), who studied how corporate characteristics and governance attributes would affect the voluntary disclosure in Bangladeshi firms, the study found there is a significantly positive connection between board size and voluntarily disclosure. In a study concerning the impact of corporate governance on social and environmental information disclosure in Malaysian banks by Htay, Ab. Rashid, Adnan and Mydin Meera (2012), it was found that board size has a positive significant impact on the social and environmental information disclosure as large board size seems to produce a better effect on disclosure in the banking sector. Thus, based on the stakeholder theory, this study expects that there is a positive relationship between board size and disclosure level, which leads to the hypothesis which states:

H1 (a): There is a positive significant relationship between board size and ethical identity disclosure.

4. Board independence

In Jensen and Meckling (1976), according to the agency theory, boards need to be observed and supervised by another party because of the nature of their opportunistic behavior. As the decision experts, independent directors are the ones who suit the role of monitoring and controlling the

management performance since they have to be professional and have a positive influence over the director's decision (Fama and Jensen, 1983; Weisbach, 1988). Lim, Matolcsy and Chow (2007) found that independent directors would influence the disclosure level of firms concerning corporate information, as they are a part of the decision making by the board. On the other hand, Ho and Wong (2001) found no significant association between board independence and disclosure due to the low level of compliance in Chinese firms even with the presence of independent directors. In addition, it also supported the findings by Mohd Ghazali and Weetman (2006) who found that board independence has no significant relationship with voluntary disclosure as they discovered that the existence of independent directors on the board of directors could not influence the voluntary disclosure of Malaysian listed companies.

The findings from Mohd Ghazali (2007) and Hossain (2008) showed that board independence is significantly positive towards the disclosure level of the organization, which is consistent with the suggestion by the agency theory that claims that involvement from the board of directors is necessary in order to monitor any self-interest activities by managers. In addition, this theory suggests that a high proportion of independent directors will be able to monitor any self-interest action by the management, and, thus, may encourage the management to disclose more information (Williams, Duncan, Ginter and Shewchuk, 2006). This is consistent with the study by Bhasin *et al.* (2012) who examined the voluntary disclosure determinants in the banking sector of Kazakhstan, and found that board composition has a positive significant impact on the voluntary disclosure by Kazakhstan banks. This is supported by the findings by Htay, Ab. Rashid, Adnan and Mydin Meera (2011) who found that independent directors are one of the significant factors affecting the voluntary disclosure in Malaysian listed banks as they can provide more sources of information to the dependent directors. Consequently, based on the stakeholder and agency theory, this study expects that Malaysian and Bahrain Islamic banks tend to disclose more information on ethical identity with the presence of independent directors as board members:

H1 (b): There is a positive significant relationship between board independence and ethical identity disclosure

5. Shariah supervisory board

In this study, the *Shariah* Supervisory Board is included, as the board is one of the corporate elements in Islamic banks and is considered as crucial concerning the level of disclosure in Islamic banks. The *Shariah* Supervisory Board is a unique element in the governance of Islamic banks. In Scott (2004), he explained that the institutional theory is a kind of social structure that has been set up as an authoritative guideline, which consists of schemes, norms and routines to structure the social behavior. Based on this theory, in his paper, Hasan (2009) mentions that the *Shariah* Supervisory Board institution plays a vital role in ensuring that the activities of Islamic banks harmonize with *Shariah* ethics and principles. As the institution that governs the Islamic banks, the *Shariah* board is responsible for guiding and controlling the behavior of organizations so that the interests of society can be protected. Karim (1995) stressed in his paper that the authority of the *Shariah*

Supervisory Board is equal to other conventional auditors since they need to “investigate” whether the Islamic banks adhere to Islamic ethics and *Shariah* principles. According to Farook *et al.* (2011), the nature of *Shariah* compliance is not only based on the assurance of compliance through the *Shariah* Supervisory Board report but also on the greater involvement in social activities as well as the social disclosure. Thus, it is expected that the existence of the *Shariah* Supervisory Board in the governance of Islamic banks would lead to the greater disclosure level of Islamic banks itself.

Farook *et al.* (2011) also stated that the higher the number of the members of the *Shariah* Supervisory Board, the greater the disclosure level of Islamic banks since the ability of the *Shariah* Supervisory Board to monitor the Islamic banks governance also increases. Their study, which examines the *Shariah* Supervisory Board as one of the factors that may influence the corporate social responsibility disclosures in Islamic banks, found that the *Shariah* Supervisory Board is the most significant factor that affects the level of corporate social disclosure. As suggested by the institutional theory, the *Shariah* Supervisory institution plays an important role in influencing the level of disclosure of Islamic banks, as they are a part of the *Shariah* governance, which governs the *Shariah* matters in Islamic banks. Hence, applying the institutional theory, this study proposes that disclosure is positively related to the *Shariah* Supervisory Board of Islamic banks, which can be formulated in the following hypothesis:

H1(c): There is a positive significant relationship between the Shariah Supervisory Board and ethical identity disclosure.

6. Investment account holders

Farook *et al.* (2011) argued that Muslim investors would prefer to make an investment as investment account holders rather than invest their funds as shareholders. This is because they are usually interested in the services offered by Islamic banks compared to the share ownership of that particular bank. However, Archer and Karim (1997) argued with regard to the agency theory that the form of profit sharing loss contract used by Islamic banks in managing and mobilizing the investment account holder’s fund might lead to agency problems. Since Islamic banks act as the agent of the shareholders as well as for the Investment Account Holders, this relationship would increase the possibility of having a conflict of interest in dealing with the investment account holders’ funds (Archer *et al.*, 1998). Pertaining to the Islamic banks risk, *Shariah* compliance is one the important elements in Islamic banks. Therefore, the investment account holders might face the risk of non-compliance with *Shariah*, which may contribute to the agency problem in Islamic banks when the banks fail to meet the obligation of *Shariah* principles (Bank Negara Malaysia, 2010). Therefore, in order to solve these agency problems, adequate disclosure of reporting information, especially information with regard to the *Shariah* compliance, might reduce the occurrence of the agency problem among the investment account holders, since they have enough information to assess the risk (Karim 2001).

Karim (1990) also stated that in the context of the *Shariah* Supervisory Board report, if Islamic banks are going

to publish a negative report, the group of investment account holders would begin to doubt the management’s commitment towards *Shariah* and they may start to avoid dealing with that particular Islamic bank. As the investment account holders are more interested in the *Shariah* compliance issues in the Islamic banks, the presence of investment account holders could have greater influence concerning the extent of disclosure. Further, in a study by Farook *et al.* (2011), which examines investment account holders as one of the factors that may influence corporate social responsibility disclosure in Islamic banks, it was found that investment account holders are among the significant factors that affect the level of corporate social disclosure. This is consistent with the stakeholder theory that claims the responsibility of Islamic banks towards the investment account holders. As investment account holders are the backbone in the operation of Islamic banks, the banks should strive to meet and maintain the expectation of the investment account holders through ethical identity disclosure. Thus, the final proposition on the relationship between the investment account holder and ethical identity disclosure level could be hypothesized as below:

H2: There is a positive significant relationship between investment account holders and ethical identity disclosure.

7. Research methodology

The sample size of this study consists of 16 Malaysian Islamic banks, which are registered under the Central Bank of Malaysia, and 5 Bahrain retail Islamic banks, which are licensed under the Central Bank of Bahrain (Bank Negara Malaysia, 2011). Currently, the Kingdom of Bahrain has 26 Islamic banks, which comprise 6 retail Islamic banks and 20 wholesale Islamic banks, in which the operation of the retail banks is more towards commercial banks and the wholesale Islamic banks is similar to that of investment banks, merchant banks and other financial institutions that deal with larger institutions. Since Bahrain only has six retail banks, this study only considered five banks because one bank just started their Islamic bank operation in 2010 (Central Bank of Bahrain, 2012).

The main source of this study is based on secondary data that were obtained from the annual reports of Islamic banks from 2007 to 2011, as annual reports are significant and relevant sources, which may communicate the information to all types of stakeholders and enable them to understand the information easily. The list of licensed Islamic banks in Malaysia was obtained from the website of the Central Bank of Malaysia, which lists sixteen Islamic banks comprising ten Islamic local banks and six Islamic foreign banks (Bank Negara Malaysia, 2011). Whereas for the Islamic banks in Bahrain, the list of registered Islamic Banks was obtained from the website of the Central Bank of Bahrain (Central Bank of Bahrain, 2012).

The study used content analysis to identify the items for measuring the ethical identity disclosure practices of Islamic banks. Content analysis is a method of compressing and codifying the text and putting it into various categories based on the criteria for coding (Haniffa and Hudaib, 2007; Weber, 1990; Krippendoff, 2004; Stemler, 2001). The items and categories for the research instrument

chosen takes into account the disclosure requirement by the Accounting and Auditing Organization for Islamic Financial Institution (AAOIFI, 1997) and is similar to that developed by Haniffa and Hudaib (2007), and Zubairu, Sakariyau, and Dauda (2011). The Ethical Identity Index developed comprises nine dimensions that consist of 80 constructs, which are Vision and Mission Statement, Board of Directors and Top Management, Product, Zakat, Charity and Benevolent Loan, Employees, Debtors, Community, Environment and *Shariah* Supervisory Board. The possible total score obtained by each of the banks amounts to 80 points.

As for the independent variables, board size is measured according to the number of directors on the board (Said *et al.*, 2009; Akhtaruddin *et al.*, 2009), board independence is measured by looking at the percentage of independent directors to the total number of directors (Chau and Gray, 2010; Huafang and Jianguo, 2007). While the *Shariah* Supervisory Board is measured by looking at the number of members on the *Shariah* Supervisory Board (Farook *et al.*, 2011) and investment account holders (IAH) is measured by dividing the IAH funds to the paid up capital in shareholders' equity (Farook *et al.*, 2011).

The current study also used a control variable, in which the bank's size is measured based on the logarithm of the total assets of the banks at the end of the reporting year (Fungacova and Weill, 2009). According to Heflin and Shaw (2000), in minimizing and reducing the impact of heteroscedasticity and extreme values when analysing the data, the total assets of the banks need to be in the form of natural logarithm (ln). For the second controlled variable, banks' profitability is measured through the return on equity (ROE) of the Islamic banks (Berger and Black, 2011). Finally, the third control variable, country, is measured using a dummy variable where 0 represents Malaysian Islamic banks while 1 represents Bahrain Islamic banks. The usage of country as a control variable was employed in the study of Bashir (2001).

Since content analysis will be used as the method for determining the disclosure level of ethical identity in Islamic banks, the total score for Islamic bank disclosure is computed and expressed in the form of an ethical identity index, as follows (Haniffa and Hudaib, 2007; Zubairu, Sakariyau, and Dauda, 2011):

Model 1:

$$EII_j = \frac{\sum X_{ij}}{n_j}$$

where EII_j = Ethical Identity Index

X_{ij} = 1 if *i*th construct is disclosed, 0 if *i*th construct is not disclosed

n_j = Number of constructs to be disclosed by banks

Multiple Linear Regression equation analysis is also developed in this study to test whether the four variables chosen could influence the disclosure level of ethical identity disclosure. The relationship between the independent and dependant variables is determined by using this model (Khan, 2010; Farook *et al.*, 2011)

Model 2:

$$EID = \beta_0 + \beta_1 BSIZE + \beta_2 BINDE + \beta_3 SSB + \beta_4 IAH + \beta_5 SIZE + \beta_6 PROFIT + \beta_7 COUN + \epsilon$$

where

- EID = Ethical Identity Disclosure
- BSIZE = Board's size
- BINDE = Board's independence
- SSB = *Shariah* Supervisory Board
- IAH = Investment Account Holder
- SIZE = Banks' size
- PROFIT = Banks' profit
- COUN = Country
- B_i = Parameter to be estimated
- i = 1, 2, 3, 4, 5, 6, 7
- ε = Error term

8. Results and discussion

Ethical identity disclosure analysis

Table 1 presents the ethical identity disclosure index for nine dimensions for both the Malaysian and Bahrain Islamic banks. It shows that the overall disclosure for ethical identity for both countries is only 51.7%, which suggests that there is low level of disclosure for both countries.

Table 1. Ethical identity disclosure index.

Ethical identity index	Malaysia	Bahrain	Total mean	Sig.
Vision and Mission statement	47.1%	56%	51.6%	0.001
BOD and top management	62%	76.6%	69.3%	0.000
Product	36.8%	53.6%	45.2%	0.000
Zakāt, charity and benevolent loans	30.1%	49.8%	39.9%	0.000
Employees	62.5%	75%	68.8%	0.000
Debtors	84.4%	71%	77.7%	0.000
Community	38.3%	76.7%	57.5%	0.000
Environment	13.2%	0%	6.6%	0.005
<i>Shariah</i> Supervisory Board	49%	48.7%	48.8%	0.914
Total	47%	56.4%	51.7%	0.000

Table 2. Descriptive statistics of ethical identity disclosure determinants.

Determinants	Malaysian Islamic Banks		Bahrain Islamic Banks		Total	
	Mean	Std. Deviation	Mean	Std. Deviation	Mean	Sig
BSize (No of member)	7.53	1.646	8.68	1.773	7.8	0.003
BINDE (%)	50.63%	0.133788	48.56%	0.223694	50.14%	0.571
SSB (No of member)	4.20	1.152	4.04	0.935	4.16	0.529
IAH (%)	2001.67%	31.838083	426.73%	3.635097	1626.69%	0.016

Note: EID is Ethical Identity Disclosure. BSize is Board Size BINDE is Board Independence. SSB is Shariah Supervisory Board. IAH is Investment Account Holder.

Further, it can be seen that the disclosure of Bahrain Islamic banks is significantly higher (56.4%) than that of the Malaysian Islamic banks (47%). However, even though the level of disclosure of the Bahrain banks is greater than that of the Malaysian banks it is still low as both countries only disclosed about 50% of the disclosure requirements.

Table 1 also illustrates that the most communicated dimension by both banks is the debtors' dimension (77.7%) followed by board of directors and top management dimension (69.3%). While the least communicated dimension is the environmental dimension with 6.6% of disclosure. This implies that neither country prioritizes environmental issues, which, perhaps, is because they considered that environmental issues are not influenced by their operation.

The results further indicated that the Malaysian and Bahrain Islamic banks need to improve their disclosure on vision and mission statement, product, *Zakat*, charity and benevolent loans, community, environment and *Shariah* Supervisory Board dimension, since the level of disclosure for these dimensions is either below or around 50%.

9. Descriptive statistical analysis

Table 2 shows that, on average, most of the Islamic banks in Malaysia and Bahrain employed about seven to eight members as the members of the board of directors, which is an optimal number for the board size, as having more than that would interfere with the group dynamics (Jensen, 1993). As for the board's independence (BINDE),

the mean is 50.14%, which means that half of the board of directors in Islamic banks consists of independent directors. This indicates that the banks have met the corporate governance requirements for Islamic banks. For *Shariah* Supervisory Board (SSB), the results indicate that most of *Shariah* Supervisory Boards in Islamic banks consist of four members. This shows that both countries have complied with the regulators requirement. Finally, the mean for investment account holders of 1626.69% implies that most of the investment account holders in Islamic banks are about sixteen times more than the paid up capital of the Islamic banks.

10. Correlation analysis

Table 3 presents that there is a negative significant correlation between the board size and investment account holders where r is -0.377 at a 1% significance level. This medium relationship indicates that a larger board size would reduce the investment account holders. Table 3 also illustrates that there is a positive significant correlation between board independence and investment account holders, which has a medium strength of relationship, as r is 0.304 at 1% significance. This shows that a large proportion of independent directors would increase the number of investment account holders.

11. Multivariate analysis

In this section, the analysis on the normality test and multicollinearity test will be presented. In order to establish a connection between the independent variables and how

Table 3. Pearson correlation coefficient.

	BSize	BINDE	SSB	IAH	SIZE	PROFIT	COUN
BSize	1						
BINDE	-0.023	1					
SSB	0.002	0.031	1				
IAH	-0.377**	0.304**	-0.033	1			
SIZE	-0.275**	0.240*	0.336**	0.439**	1		
PROFIT	0.126	0.096	0.019	0.007	-0.137	1	
COUN	0.284**	-0.056	-0.062	-0.236*	-0.809**	0.171	1

**Correlation is significant at the 1% level (2-tailed).

*Correlation is significant at the 5% level (2-tailed).

Note: EID is Ethical Identity Disclosure. BSize is Board Size BINDE is Board Independence. SSB is Shariah Supervisory Board. IAH is Investment Account Holder.

they would affect the dependent variable, the multiple linear regression analysis model has been applied in this study as well as the discussion between the independent and dependant variables. Below is the model that has been used in this study together with the regression result.

12. Test of normality

Before running the multiple linear regression analysis, the data was tested for normality and multicollinearity. The Kolmogorov-Smirnov test indicates that the data are not normally distributed. However, according to Pallant (2010), it is common for a large sample size to be abnormally distributed, through which the data violates the assumption of normality, however, it will not cause any serious problem. In addition, according to the Central Limit Theorem, when the sample size is large, more than 30 per group, the sampling distribution will take a normal distribution shape, regardless of the population shape from which the sample is drawn (Field, 2009). Therefore, what can be justified here is that distribution can be converged to the normal distribution for sample study when it involves a large sample size in the study. The data also indicates that there is no collinearity problem as the Variance Inflation Factor (VIF) is not more than ten (Alauddin and Nghiemb, 2010).

Table 4 tabulates the results for Multiple Linear Regression analysis that examines the determinants for ethical identity disclosure. The Durbin-Watson value shows 1.710, which implies that there is no presence of auto-correlation, thereby indicating the data independence between the independent variable and ethical identity disclosure.

Table 4 also highlights that there is a positive significant relationship between the board size (BSIZE) and ethical

identity disclosure (EID) of Islamic banks for which the t-value is 2.509 at the 5% significance level, thus accepting hypothesis H1 (a). The finding of this study is supported by Akhtaruddin *et al.* (2009), Rouf (2011) and Htay *et al.* (2012) who found a positive relationship between board size and voluntary disclosure, which suggests that a large board will provide more voluntary disclosure compared to a smaller board.

The findings of this present study are consistent with the stakeholder theory, which claims that the Islamic banks tend to increase their disclosure level and release more information concerning their operations and activities due to the significant relationship between Islamic banks and their stakeholder. Therefore, having a large number of board members would increase the level of disclosure in Islamic banks, which helps the board to satisfy the needs of the stakeholders (Clemente and Labat, 2009). This study implies that board size is one of the important factors in Malaysian and Bahrain Islamic banks as it plays a significant role in influencing the disclosure of the ethical identity by the banks. It can be seen that most of the Malaysian and Bahrain Islamic banks have seven to nine members on the board, which is considered as large enough to have dynamic decision making. Further observation indicates that most of the Islamic banks in Malaysia and Bahrain that have a high-level of disclosure are those banks that have a large board size.

As tabulated in Table 4, the results show that hypothesis H1 (b) is rejected as this study found no significant relationship between the proportion of independent members on the board of directors and ethical identity disclosure. This finding is in contrast with the agency theory that suggests that to influence the decision making as well as monitor and control the opportunistic behavior of management

Table 4. Multiple linear regression analysis: Determinants of ethical identity.

Model	Coefficients	t-value	p-value
(Constant)		-2.855***	0.005
BSIZE	0.196	2.509**	0.014
BINDE	0.025	0.333	0.740
SSB	0.284	3.320***	0.001
IAH	0.235	2.397***	0.008
SIZE	0.609	3.667***	0.000
PROFIT	-0.054	-0.748	0.456
COUN	0.897	6.326***	0.000
R ²		0.529	
Adjusted R ²		0.495	
F-value		15.541	
p-value		0.000	
Durbin-Watson		1.710	
N		105	

*** P-value is significant at the 0.01 level

** P-value is significant at the 0.05 level

Note: Dependent variable - EID is Ethical Identity Disclosure. Independent variables – BSIZE is Board Size BINDE is Board Independence. SSB is Shariah Supervisory Board. IAH is Investment Account Holder. Control variables - SIZE is Banks' Size. PROFIT is Banks' Profit. COUN is Country.

and other board members, independent directors need to be among the board members. This is because, besides incentives, effective monitoring is one of the safeguards that have been proposed to minimize the agency problem that occurs in organizations (Jensen and Meckling, 1976). However, the results corroborate Mohd Ghazali and Weetman (2006), and Khodadadi, Khazami and Aflatooni (2010), as the authors found no significant relationship between board independence and voluntary disclosure in Malaysia and Iranian listed firms. In addition, this study is supported by other findings from Haniffa and Cooke (2002), as they found that the proportion of independent directors could not influence the level of disclosure due to the ineffective monitoring role by the directors.

Hence, the issue that needs to be addressed in the findings of the current study concerns the independence of independent directors as well as their monitoring effectiveness, as most of them are appointed by the Chairman or CEO. This result suggests that most independent directors in Malaysian and Bahrain Islamic banks are not really performing their role effectively and competently in monitoring the performance of Islamic banks. The data collected also show that the proportion of independent directors is similar for most of the banks, and that even banks with the highest and lowest disclosure level are similar in terms of their proportion of independent directors.

Similar to the studies by Hassn (2011), and Farook *et al.* (2011), the regression results in Table 4 further indicate that there is a significant positive relationship between the *Shariah* Supervisory Board and ethical identity disclosure in Malaysian and Bahrain Islamic banks and the relationship, thus accepting hypothesis H1 (c). This finding is consistent with the institutional theory that suggests that to ensure the organization is successful in achieving its goals and objectives, the organizations' corporate governance mechanism must be effective. The institution of the *Shariah* Supervisory Board is responsible for guiding and controlling the conduct and performance of the Islamic banks to ensure that the interests of society are protected. Thus, the existence of the *Shariah* Supervisory Board members may result in greater governance and monitoring, and, consequently, greater compliance with *Shariah* principles by the Islamic banks. Increasing the level of integrity of the *Shariah* Supervisory Board may increase the level of confidence of Muslim society, especially Muslim investors towards the Islamic financial institution.

Similar to the study by Farook *et al.* (2011), further analysis in this study shows that investment account holders (IAH) have a significant positive relationship with ethical identity disclosure in Malaysian and Bahrain Islamic banks; thus, hypothesis H2 is accepted. This finding is consistent with the stakeholder theory, where having greater monitoring by the investment account holders as one of the stakeholders is needed in the Islamic banks to ensure that the investment account holders are managed and mobilized appropriately by the banks. As the Islamic banks need to act as the agent to the investment account holders as well as to the shareholder, the conflict of interest or agency problem would arise. Therefore, the presence of monitoring from investment account holders may reduce the agency problem, and, thus, influence the management of Islamic banks pertaining to the compliance and disclosure issues (Archer *et al.*, 1998).

The investment account holders' influence may apply more pressure on the management of Islamic banks to disclose more information as required by the regulators. Thus, by disclosing the ethical identity information, it may establish a connection with the Muslim investor.

13. Summary and conclusion

This study explores the area of ethical identity disclosure, in which emphasis was given to Islamic banks in Malaysia and Bahrain since both countries have a considerably developed Islamic banking industry. Hence, the main objective of this study is to compare the level of ethical identity disclosure of Islamic banks in Malaysia and Bahrain, and also examine the determinants affecting the ethical identity disclosure in these banks.

From the ethical identity index model, it could be seen that the overall disclosure level in both countries is 51.6%, which suggests a low level of disclosure by both countries, since they only disclose 50% of their total disclosure. Further, the overall disclosure shows that the disclosure level of Bahrain Islamic banks is significantly higher (56.4%) than Malaysian Islamic banks (47.1%). The results further indicate that the information in the vision and mission statement; product; *Zakat*, charity and benevolent loans; community; environment; and *Shariah* Supervisory Board dimension need to be emphasized by the regulators as well as the Islamic banks as they are among the least communicated activities by both banks. Since all the dimensions involved in this study portray the identity of Islamic banks as Islamic financial institutions, it needs to be emphasized and highlighted by the management and regulator of Islamic banks. When these dimensions are not appropriately disclosed, it could have a severe impact on the image of Islamic banks as Islamic financial institutions.

Further analysis suggests that independent directors in both Malaysian and Bahrain Islamic banks are not really effective and competent in performing their role in monitoring the performance and activities of the management of Islamic banks, which means the presence of independent directors in Islamic banks does not influence the level of ethical identity disclosure of Islamic banks. While the *Shariah* Supervisory Board is found to be the most significant factor that would influence the level of ethical identity disclosure in Islamic banks. This is consistent with the idea suggested by the institutional theory in which the *Shariah* Supervisory Board is one of the significant means of governance in Islamic banks that needs to supervise and control the Islamic banks activities and performance and ensure that they conform to *Shariah* principles (Hasan, 2009). Thus, the current findings show that the *Shariah* Supervisory Board plays a critical role in influencing the level of ethical identity disclosure in Islamic banks as they could govern the Islamic banks effectively with their expertise.

Further, this study implies that investment account holders are among the monitoring mechanisms that could be applied by the Islamic banks to enhance the disclosure activity of important and relevant information appropriately. As suggested by the stakeholder theory, investment account holders could be a good monitoring tool in observing the activities of Islamic banks. As Muslim investors are particularly interested in the

compliance with *Shariah* principles and Islamic law, the management of Islamic banks need to pay extra attention towards this matter, especially when the Muslim investors possess little knowledge about the application of Islamic law in relation to the operation of Islamic banks. Therefore, Islamic banks need to be transparent about this information and let the Islamic investors monitor the banks operation externally. By having this kind of monitoring, greater compliance would be fulfilled by the banks, and, as suggested by Jensen and Meckling (1976), the ownership structure can determine the level of monitoring and thus enhance the level of disclosure. Since Muslim investors are more likely to invest their funds in the *Shariah* investments, the Islamic banks need to carefully manage their operation and ensure that everything is based on *Shariah* law.

Further, board size is found to have a significant influence on the level of ethical identity disclosure in Islamic banks, which is consistent with the stakeholder theory, which claims that the larger the board size, the greater the level of disclosure in Islamic banks; thus the more the stakeholders' needs as well as expectations could be fulfilled by the Islamic banks (Clemente and Labat, 2009).

There are many aspects that could still be explored in future research. As this study used secondary data in examining the level of disclosure in Islamic banks, future research may consider using other methodological approaches, other forms of media as well as improving the research instruments by adding any other aspects that could be used in examining the ethical identity disclosure in Islamic banks. Future studies could also consider comparing the determinants for both countries and identifying which determinants would be more important under different Islamic governance settings.

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Islamic business ethics and finance: An exploratory study of Islamic banks in Malaysia

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Abstract - Ethics has become increasingly important in the financial services sector on the grounds that the aim of business activities in general and financial services in particular is the creation of value for the consumer. Furthermore, an ethical environment in the business and financial sectors provides vital support for maximising long-term owner value. If ethics played a larger role in the financial services sector, the recent global financial crisis might have been averted. Islamic finance which claims to offer global financial stability and high ethical standards should reflect Islamic values in all facets of behaviour to bring about collective morality and spirituality, which when integrated with the production of goods and services advance the Islamic way of life. However, there is an apparent lack, in the current literature around Islamic finance and Islamic business ethics, of an evaluation of the extent to which the ideal ethical norms of Islam are implemented by Islamic Financial Institutions (IFIs). International standard setting organisations such as the Islamic Financial Services Board (IFSB) and the Accounting and Auditing Organisation for IFIs (AAOIFI) have published the Guiding Principles and Conduct of Business for Institutions offering Islamic Financial Services and the Code of Ethics for the Employees of IFIs respectively. While the relevant authorities may issue appropriate frameworks or standards, which are necessary to ensure that public interest is adequately served, joint commitment from the IFIs concerned is essential. Against the above-mentioned background, this paper attempts to investigate the consistencies or, if any, inconsistencies and explore the relationship between the Islamic business ethical norms and the practices of Islamic banks in Malaysia. In doing so it tries to address the current imbalance of emphasis and the lack of a comprehensive discussion on business ethics from a wider cultural and religious perspective with reference to Islam, particularly focussing on selected Islamic banks in Malaysia. The main research question of this study is: How do the current practices in Malaysian IFIs mirror the Islamic ethical norms in business? The findings in this paper would potentially assist in the improvement of practices among IFIs to conform with the ethical norms established by Islam, which are in fact the core of their existence.

Keywords: religion, business ethics, Islamic finance, ethical perception

1. Introduction

Ethics has always been a part of business. However, the business ethics movement is relatively new and can be traced back to the 1960s, which witnessed the rise of social issues in business where business came under attack due to the lack of social consciousness and the harm it inflicted upon society in various ways (De George, 1995). The 1980s saw business ethics being institutionalized as an academic field, where a growing number of books, journals, institutes, professors, consultants and university

courses in business ethics emerged (De George, 1987; Jones, Parker and Ten Bos, 2005). Both public awareness of the scandals in the business world which appear to result from too little regard for morality, and the problems related to business which expose the fact that laws and regulations, have failed to a certain extent, have contributed to the rise of interest in business ethics (Chryssides and Kaler, 1993). Furthermore, the recent global financial crisis, which began in the USA, has once again redirected business ethics in the glare of publicity.

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For Muslims, Islam is considered as a way of life and not merely a religion. Hence, business ethics cannot be separated from ethics in other aspects of a Muslim's daily life (Beekun and Badawi, 2005; Hasanuzzaman, 2003). It is claimed that in the climate of Islamic philosophy, it is ethics that dominates economics and not vice versa (Naqvi, 1981), and that Islamic economics is characterized as being ethical (*akhlāqī*) besides being Godly (*rabbānī*), humane (*insānī*) and balanced (*wa'a'ī*) (Al-Qara'āwi, 1995). The concept of *Tawīd* (monotheism, singularity, oneness or unity of God) has been identified as the core of Islamic ethics, along with trusteeship or stewardship (*khilāfah*), justice or equilibrium (*al-'adl*), free will or freedom (*ikhtiyār*), responsibility (*far'*) and benevolence (*I'sān*) (Faruqi, 1992; Naqvi, 1981; Rice, 1999; Beekun, 1997; Haneef, 2005). On a more practical level, the manner for proper Islamic ethical conduct in business is based on leniency, which encompasses good manners, forgiveness, removal of hardship and compensation; service motive, where businesses provide needed services to the community; and consciousness of Allāh, which requires Muslim businessmen to be mindful of Allāh in their conduct of business (Abeng, 1997).

In the financial services sector, ethics has become increasingly important on the basis that the purpose of business activities in general and financial services in particular is the creation of value for the consumer (Duska and Clarke, 2002). The financial services environment should not be an environment where there is a dichotomy between the personal ethical attitudes and the attitudes governing one's business life (Duska and Clarke, 2002). Moreover, it is suggested that an ethical environment will coincidentally pave the way to improved performance as in the case of the British Cooperative Bank's ethical policy (Kitson, 1996), and provides essential support for maximizing long-term owner value (Sternberg, 2000). The recent global financial crisis might have been averted if ethics played a larger role in the financial services sector.

Islamic finance has been recognized as a rapidly increasing integrated compartment of global finance (Warde, 2000) with assets worldwide estimated to be worth \$700 billion as a result of growth at a rate of more than 10% annually during the past decade (Standard & Poor's, 2009). With respect to ethics, IFIs are considered to be ethical since the foundation of their business philosophy is grounded in the *Shariah*, often referred to as ethics in action, which is concerned with promoting justice and welfare (*al-'adl wa al-I'sān*) in society and seeking God's blessing (*al-barakah*) (Haniffa and Hudaib, 2007). The difference between Islamic and conventional financial systems is that the former has to preserve certain social objectives and is based on equity rather than debt (Venardos, 2005).

Malaysia's Financial Sector Master-Plan explicitly mentions that it would like to "epitomize Malaysia as a regional Islamic financial centre" (BNM, 2001). A distinguishing feature of the Malaysian economy is that Islamic finance has been fully integrated into its existing financial system, which demonstrates the sector's inventiveness and capacity for innovation (Venardos, 2005). It is also worth highlighting that the Malaysian Islamic finance market is considered to be well developed with a huge future potential (Al-Omar and Abdel-Haq, 1996). The first IFI established in Malaysia was

the Malayan Muslims Pilgrims Savings Corporation, which began operations in 1963. Twenty years later, in 1983, the first Islamic bank—Bank Islam Malaysia Berhad—started operations after continuous pressure on the Malaysian government to assist in establishing an Islamic bank (Man, 1988). The seriousness of the Malaysian government in furthering the cause of Islamic finance can be seen in the Financial Sector Master-Plan's vision to see Islamic banking evolve in parallel with conventional banking to achieve 20% of the banking market share, represented by a number of strong and highly capitalized Islamic banking institutions, offering financial products and services which are underpinned by a comprehensive and conducive *Shariah* and regulatory framework (BNM, 2001).

2. Current predicament

It is claimed that the issue of ethics in business was primarily theological and religious prior to the 1960s (De George, 1987). However, theological contributions could have been ignored in the current discourse and literature of business ethics, when in fact an understanding of religious traditions would put ethics with regard to business in a broader perspective (Wilson, 1997). Furthermore, the current trend is to treat business ethics more narrowly as an applied philosophy and social science despite that on a practical level, religion matters to business ethics since religion's moral precepts and narratives inform and shape the morality of a substantial portion of the population making business ethical decisions (Calkins, 2000). It must be noted that voluntarily held ethical mores which stem from religious beliefs that are accepted by believers as binding cannot be substituted by non-binding general frameworks of ethical rules and norms (Naqvi, 2003). Despite the trend towards globalization, the current discussion on business ethics is strongly Western oriented and informed by Western social, religious and cultural values, overlooking other religious and cultural perspectives in the wider global context (Mohammed, 2007).

On the other hand, though business ethics is considered to be integrated within the large framework of established Islamic ethical values, a large part of Islamic literature on the subject is either theologically oriented or superficial and inadequate in its assessment of Islamic business principles and to date remains fragmented and spread over a variety of sources, which does not sufficiently provide a systematic model or framework of business ethics despite the existence of a rich vein of the concept in Islam (Mohammed, 2007). Furthermore, in most cases, the literature on Islamic economics, in which businesses operate, though full of reference to primary sources, deals with basic principles in a rhetoric and simplistic style and lacks a comprehensive discussion of the basic beliefs and values (Khan, 2007). IFIs also tend to emphasise the Islamic legality of the products and services offered at the expense of giving due attention to the ethical dimensions of their business practices. Muslim scholars (*'ulamā'*) have also mainly been restating the position of the *Shariah* on various issues, and although their discourse contains an implicit awareness of the social reality, their emphasis has been on the legal dimension (Khan, 2007).

It is observed that currently the financial services sector operates in a culture where the pursuit of money, an instrumental good, turns into the ultimate goal of human

beings, leading towards ethical corruption (Duska and Clarke, 2002). It is claimed that this is in stark contrast to the climate of Islamic philosophy, which dictates that ethics should dominate economics, as previously highlighted. Moreover, IFIs should reflect Islamic values in all facets of behaviour to create a collective morality and spirituality, which, when combined with the production of good and services, advances the Islamic way of life (Lewis and Algaoud, 2001). At the operational level, it has been mentioned that the difference between Islamic and conventional finance is that the former is equity based while the latter is based on debt. As such, the conventional financial system has been shaken by frequent crises, due to its instability, in spite of the existence of various regulatory and supervisory frameworks (Mirakhor and Krichene, 2009b). In contrast, the Islamic financial system which is void of interest, un-backed credit, abundance of liquidity, high leveraged financial transactions and speculation, ensures inherent stability (Mirakhor, 2009a).

There is an apparent lack in the current literature of Islamic finance and Islamic business ethics of an evaluation of the extent to which the ideal ethical norms of Islam are implemented by IFIs. Though there are rare cases of financial scandals involving IFIs, Bank Islam Malaysia Berhad recorded a loss of over RM500 million and RM1.3 billion for its financial years of 2005 and 2006 respectively, after tax and *zakāt* (BIMB, 2008), in one of Malaysia's worst financial 'scandals'. Consequently, the then Malaysian Prime Minister, Abdullah Badawi, directed Bank Islam Malaysia Berhad to take stern action against its officers who were responsible for such a huge loss as a result of approving lending that should not have been approved (Basri, 2005). This demonstrates that in spite of the claimed resilience, stability and ethicality of IFIs, there are chances of failure due to inconsistencies between theory and practice.

3. Islamic business ethics and finance

3.1. Business ethics

In the first place, is there a need for ethics in business? Without ethics, neither businesses nor individuals could function. The absence of an ethical framework governing actions leads to the non-existence of behaviour standards of a civil society, which would result in chaos and disorder (Stewart, 1996). Hence, it is no wonder that ethics has always been a part of business and many have written about ethics in business for centuries. Although business ethics is sometimes considered an extension of an individual's personal ethics, it is argued that specialised knowledge and skills are required in dealing ethically with complex decisions in business (Dean, 1997).

In tracing the developments of the business ethics movement, De George (1995) identifies the 1960s as the period of the rise of social issues in business where business came under attack due to its lack of social consciousness and the harm it inflicted upon society in various ways. The 1970s then witnessed the entry of a significant number of philosophers into the field, which helped shape the structure of what developed into business ethics (De George, 1987). The 1980s saw business ethics being institutionalized as an academic field, where a growing number of books,

journals, institutes, professors, consultants and university courses emerged (De George, 1987; Jones, Parker, ten Bos, 2005).

Chryssides and Kaler (1993) observe that both public awareness of the scandals in the business world, which appear to result from too little regard for morality, and the problems related to business, which expose the fact that laws and regulations have failed to a certain extent, have contributed to the rise of interest in business ethics. More generally, Jones and Pollitt (1998) observe that the "growing disillusionment" with materialism in most Western countries has contributed to a "renewed interest" in all aspects of morality. On the other hand, pressure on businesses to perform ethically and the realisation that good ethics is good business has also contributed to the increased emphasis on ethics within business (Dean, 1997).

There is no a single definition for business ethics. This is not surprising as business ethics is a relatively new distinctive academic field. No wonder there is great confusion when business ethics is mentioned in any discourse (Jones, Parker and ten Bos, 2005). Obviously and simply, business ethics refers to ethics as it is applied to business, i.e. it is concerned with moral issues in the field of business (Chryssides and Kaler, 1993). The term could also refer to "the rules of conduct according to which business decisions are made" (Jones and Pollitt, 1998) and deals with the expectations and requirements of society from businesses (Grace and Cohen, 1995). Jones, Parker and ten Bos (2005) in an attempt to clear the confusion about business ethics, describe the academic inquiry on business ethics as the "discipline of business ethics", while the applied practices of business ethicists who are involved in explaining legal and ethical issues, writing legal codes for businesses etc. is described as "applied business ethics". This is similar to Masden's (1995) call for looking at business ethics from two different angles; business ethics as a doing or a practice, and business ethics as a theorising about business and its ethical context.

Business ethics is not safe from criticisms. Friedman (1998) opposes the notion that businesses have social responsibilities though individuals might have certain social responsibilities. The sole responsibility of businesses is to make as much money as possible while abiding to the basic rules of the society embodied in both law and ethical customs. He views the call for businesses to have social responsibilities as "preaching pure and unadulterated socialism", which is against free market mechanisms. However Donaldson (1982) refutes the notion that the only responsibility of businesses is to increase profits as they owe society for the basis of their very existence. He views businesses as being morally obliged to produce goods and services efficiently for society. In a similar vein French (1979) argues that though corporations are not literally individuals, they qualify as individuals on the pretext that their decision-making structure permits the use of moral reasons. Hence, corporations, like individuals, have obligations to behave in an ethical manner.

Stark (1993)—in *What is the Matter with Business Ethics?*—describes the discipline as being too general, theoretical and impractical for those involved in business and that a new direction is needed for business ethics to be worthy of

attention. Some see the term as an oxymoron and that it is impossible to apply business ethics as generally there is so much disagreement about ethics in the first place (Grace and Cohen, 1995). The most profound division in Western ethical theory is between cognitivism, which claims that there are objective moral truths, and non-cognitivism, which in contrast argues that objective assessment of moral belief is not possible as all are subjective. Thiroux (1990) elaborates that under cognitivism, two major perspectives emerge: consequentialism, which is based on or concerned with consequences, and non-consequentialism where acts are to be judged regardless of consequences. Most textbooks on business ethics would provide an introduction to ethical theory, which in a sense supports the notion that the field is being dominated by philosophy. The strong philosophical approach towards business ethics can be traced to the fact that the field has been primarily “populated” by academicians with an academic background in philosophy, who are concerned with teaching business ethics courses and publishing research in journals dedicated to ethical issues in business (Masden, 1995). Ironically, moral philosophy is not a pre-requisite to being ethical as ethics is often expressed in the lives of individuals who have never heard a “philosophical syllable” in their lives (Grace and Cohen, 1995). It is interesting to note that Vinten (1990) suggests that the slow demise of philosophy in universities may have led to the current philosophical interest in business.

Despite the apparent emphasis on the “discipline of business ethics” within academic circles, as opposed to “applied business ethics”, there is a slight shift in trend, where research is being done on the practice of business ethics. Clegg, Kornberger and Rhodes (2007) for instance propose the “ethics as practice” approach, which is concerned with understanding and theorising ethics as a form of practice. There is also a realisation that the “discipline of business ethics” should produce workable and usable tools, which could assist businessmen in dealing with moral issues that typify business decision-making (Masden, 1995). In this sense Phillips (1992) is correct to say that business ethics should depart from highly abstract philosophical discussions and deal with the difficulties faced by “real” individuals in “real” situations with the aim to assist them in making ethical choices.

4. Religion and business ethics

Calkins (2000) observes that business ethics is currently treated more narrowly as an applied philosophy and social science though on a practical level, religion matters to business ethics since religion’s moral precepts and narratives inform and shape the morality of a substantial portion of the population making business ethical decisions. Furthermore, Wilson (1997) opines that theological contributions could have been ignored in the current discourse and literature of business ethics, when in fact an understanding of religious traditions would put ethics with regard to business in a broader perspective.

Naqvi (2003) proposes that the integration of ethics and economics provides a richer view of human motivation and conduct than that offered by value-neutral positivism. He also points out that ethical mores which stem from religious beliefs that are accepted voluntarily by believers, as binding,

cannot be substituted by non-binding general frameworks of ethical rules and norms. In a similar vein, Wilson (2001) states that belief in God provide the imperative for adhering to a set of standards grounded in moral certainty. Conroy and Emerson (2004) and Parboteeah, Hoegl and Cullen (2007) respectively discovered that religiosity affects ethical attitudes and that behavioural aspects of religion are negatively related to justifications of ethically suspect behaviours.

In analysing the development of business ethics in the United States, De George (1987) identifies that the first stage was the ‘ethics in business’ stage where theology and religion were the primary driving forces. He admits that religion and theology do play a role till today albeit the emergence of business ethics as a constituted distinctive academic field where philosophers tend to take the lead. Jones, Parker and ten Bos (2005) posit that currently business ethics is expected to fill the “moral vacuum” as a result of the apparent gap between business and religion, whereas in the past religion regulated public morality. According to them, despite the fact that there are many people who are religious, religion has increasingly lost its awe in regulating business and politics. Others such as Vinten (1990) argue that since religious texts do not primarily address the issue of a religious perspective on the world of business, interpretations of the texts are full of ambiguity and uncertainty. However, Wilson (1997) believes that the legal framework needed to regulate markets effectively could be derived from religious laws.

Prince Philip of Great Britain and Prince Hassan bin Talal of Jordan initiated consultations in 1984 with the objective to produce a common inter-religious (between Abrahamic/monotheist faiths; Judaism, Christianity and Islam) declaration on ethics in international business (Dion, 2002). As a result, in 1993, a Code of Ethics in International Business for Christians, Muslims and Jews was finalised in Amman, Jordan. The declaration identifies justice, mutual respect, stewardship and honesty as four key concepts that form the basis of human interaction. The declaration also includes guidelines on business and political economy, the policies of business and conduct of individuals at work, which should be adopted as a basis for the relationship between parties in international business (Webley, 1996). This code of ethics, which is spiritually driven, can provide a greater depth of understanding of many ethical problems that arise in international settings (Jackson, 1999). Jackson (1999) interestingly proposes that if “law controls/directs/guides business”, and “morality control/directs/guides law”, while “spirituality controls/directs/guides morality”, then “spirituality controls/directs/guides business”.

Schwartz (2006) argues that God is and should be considered a managerial stakeholder for business individuals and corporations that accept God exists and can affect the world. This would potentially entail greater meaning for those involved in business, lead towards more socially responsible decisions, enhance ethical decision making and improve profitability (Schwartz, 2006). This is highly contested in modern times, as modernism, which is increasingly dominant in the West, addresses ethical issues without referencing God (Kim, Fisher and McCalman, 2009). However, disregarding God results in moral relativism that is unable to determine absolute standards

of good or ethical behaviour (Shaw and Barry, 1992). Ven de Ven (2008) suggests that business ethics is a “pioneering moral-theological inquiry” and in order to remain relevant, moral theologians have to join the business ethics debate as a lack of understanding and communication characterises the relationship between religion and business.

5. Islamic business ethics

Muslims regard Islam as a way of life and not merely a religion. Therefore, business ethics cannot be separated from ethics in the other aspects of a Muslim’s daily life (Beekun and Badawi, 2005; Hasanuzzaman, 2003). In the climate of Islamic philosophy, it is claimed that ethics dominate economics and not vice versa (Naqvi, 1981), and that Islamic economics is characterized as being ethical (*akhlāqī*) besides being Godly (*rabbānī*), humane (*insānī*) and balanced (*wahāī*) (Al-Qara’āwi, 1995). The concept of *Tawhīd* (monotheism, singularity, oneness or unity of God) has been identified as the core of Islamic ethics (Faruqi, 1992; Naqvi, 1981; Rice, 1999; Beekun, 1997; Haneef, 2005), along with trusteeship or stewardship (*khilāfah*), justice or equilibrium (*al-‘adl*), free will or freedom (*ikhtiyār*), responsibility (*farh*) and benevolence (*I’sān*). On a more practical level, the manner for proper Islamic ethical conduct in business is based on leniency, which encompasses good manners, forgiveness, removal of hardship and compensation; service motive, where businesses provide needed services to the community; and consciousness of Allāh that requires Muslim businessmen to be mindful of Allāh in their conduct of business (Abeng, 1997).

The Qur’an, which Muslims believe to be the word of God dating back more than fourteen centuries ago, speaks about ethics in business. Ahmad (1995) lays a set of norms contained in the Qur’an, which provides a comprehensive guidance for the conduct of Muslim businessmen. In his PhD thesis, *Business Ethics in the Qur’an—a Synthetic Exposition of the Qur’anic Teachings Pertaining to Business*, the vital question he attempts to answer is what characterises a Muslim’s behaviour in business life? Rather than limiting his work on exposition of Islāmic laws, which many have written on, he highlights the ethical dimension of business from the Qur’anic perspective. Al-Sharbātī (2005), on the other hand, analysed the methodology and approaches of the Qur’an in establishing ethics related to financial transactions.

In light of the fact that Prophet Muhammad was born in Makkah, which was a major trading centre during that period, and that he spent a considerable period of his life as a businessman before his Prophethood, many Prophetic Traditions related to business ethics can be found in books of *Hadīth* under the chapter of trade (*al-Tijārah*) or buying and selling (*al-Buyū’*). For example, al-Tirmidhī records a tradition on the authority of Abū Sa’īd al-Khudrī where Prophet Muhammad is reported to have said, “The honest and trustworthy businessman [on the Day of Resurrection] will be amongst the Prophets, those who are truthful and the martyrs”, which Nik Yusoff (2002) sees as being the highest possible recognition for honest and trustworthy businessmen due to their considerable contribution to society’s prosperity. Musa (2007) presents ethics related to business as established by Prophet Muhammad and

reported in the major books of *Hadīth*. The author also identifies the approaches adopted by Prophet Muhammad in establishing ethics related to business imitating the work of al-Sharbātī previously mentioned. Al-Nabahānī (1990) collected verses of the Qur’an, Prophetic Traditions and sayings of scholars, which he felt should be given attention by those involved in business, in his treatise which serves as a simple reference for those who would like to look up for narrations on ethical issues related to business.

The discussions of Muslim scholars of jurisprudence (*fuqahā’*) in matters related to business transactions would normally touch on the ethical dimension of business though it can be argued that the legal dimension tends to overshadow it as highlighted by Khan (2007). Moreover the distinction between the ethical and legal aspects of business seems vague in Islamic literature. In addition, for Muslims private morals are not seen as distinct from business ethics (Wilson, 2001). Beekun and Badawi (2005) observe that the great cultural diversity of Muslims worldwide and the different levels of religious commitment and practice are major challenges for understanding business ethics from an Islamic perspective, partly resulting in the scarcity of forthcoming articles on Islamic business ethics. Hence, the limited literature specifically on Islamic business ethics compared to that in the West. Despite that, there is a considerable amount of literature on Islamic ethics in business though Wilson (2001) is correct by saying that contemporary literature on Islamic economics, Islamic finance and Islamic banking is extensive compared to Islamic business ethics. The distinction between “ethics in business” and “business ethics” is as described by De George (1987) where the former refers to promotion of ethics in the conduct of business as in all other aspects of life and is primarily theological and religious in nature, whereas the latter refers to a constituted distinctive field.

There are a number of works in the Arabic language worth mentioning that address the issue of ethics in business from an Islamic perspective. Classical scholars of Islam such as Al-Ghazālī (2005) in his encyclopaedia *Ihyā’ ‘Ulūm al-Dīn* (Revival of Islamic Sciences) for instance, dedicates a chapter on the ethics of earning and living (*Kitāb al-Ādāb al-Kasb wa al-Ma’āsh*), which precedes the chapter on lawful and unlawful matters (*Kitāb al-halāl wa al-haram*), indicating the importance of ethical behaviour in earning a livelihood. Scrutinising this chapter of *Ihyā’*, al-Ghazzālī identifies justice, truthfulness and benevolence as the main ethical values that must be internalised by parties involved in business transactions. Al-Mihri (1986), in *al-Tijārah fī al-Islām* (Business in Islam), explores the foundations of business and its manners in Islam, identifying mercy, trustworthiness, honesty, tolerance and justice as constituting the essentials of Islamic ethics in business. According to Yūsuf (1990) economic pursuits are related to a Muslim’s creed, worship and morals, and the primary Islamic ethical maxims in business are honesty, trustworthiness, fulfilment of rights and good conduct. Muhammad (1990), in *Ādāb al-Tājir wa Shurūh al-Tijārah* (Ethics of the Businessman and the Conditions of Business Transactions), preceded the discussion on the jurisprudential dimension of business transactions with a chapter highlighting the effect of the Islamic creed on parties in a business transaction and the ethics which should govern those involved in business.

Al-Qarahāwī (1995) observes that only in recent years has Islamic economics been given due attention by Muslim scholars and researchers. He describes Islamic economics as being Godly, ethical, humane and balanced, and is of the opinion that it is the responsibility of the state to ensure that the theories of Islamic economics are implemented through the legislation of laws to uphold righteousness and ethics. Shahātah (1999) presents an Islamic model for a code of business ethics, realising the attention given by those in the West to ethics in the field of business, which is seen effective in deterring business failures and at the same time increasing long term profitability and growth. The author derived thirty-four Islamic codes of business ethics from the sources of the *Shariah* along with existing international codes and outcomes of various business conventions in line with the *Shariah*. He goes further by urging Muslim businessmen to take the lead in business and prove that adherence to Islamic principles does not compromise progress.

Wilson (2001) is of the opinion that the most notable study of Islamic business ethics to date is *Business and Accounting Ethics* in Islam by Gambling and Karim (1991) who are both accountants by training and profession. Karim was formerly the Secretary General of the Islamic Financial Services Board (IFSB), which “promotes the development of a prudent and transparent Islamic financial services industry through introducing new, or adapting existing international standards consistent with *Shariah* principles” (IFSB, 2009). Gambling and Karim (1991) expose the fact that accounting, which must always involve some sort of faith, is somehow absurd in the current secular economising spirit found in business and administration. Throughout their book, the authors repeatedly mention the concept of *khilāfah* (vicegerency of man), which entails adherence to certain divinely ordained ethical axioms. The authors also look into the history of religious control in business and propose an Islamic alternative to regulate economic affairs in a modern economy. They highlight that Islam views human beings as “naturally committed to good” in contrast to Christianity, which sees human beings as “fallen creatures”, and humanism, which supposes that human beings are by nature “rampant egoists”.

Naqvi (1981), a noted economist originating from Pakistan, identifies unity, equilibrium, free will and responsibility as four ethical axioms, which form the thrust of the Islamic system, around which all of man’s life must revolve. Employing these ethical axioms, the author derives the essentials of Islamic economics, which sets it apart from all other economic systems. Mohammed (2007) in his PhD thesis on Corporate Social Responsibility (CSR) in Islam uses Naqvi’s axiomatic principles to elaborate on the conceptual framework of CSR in Islam and provides empirical evidence to determine the extent to which it may be practiced and implemented in Islamic organisations. In presenting the axioms of Islamic ethical philosophy, Beekun (1997) also adopts Naqvi’s ethical axioms but adds benevolence as an additional axiomatic principle. He then applies these axioms to business ethics by describing normative business ethics in Islam and provides a sample code of ethics for Muslim businesses, outlining the behaviour towards the multiple stakeholders of a business organisation. Ayub (2007) identifies just and fair dealing, fulfilment of covenants and payment of liabilities, mutual

cooperation and removal of hardship, free marketing and fair pricing, and freedom from detriment as important norms in the Islamic framework of business. He highlights that the accountability of human beings before God is a unique norm that departs from the norms of mainstream business ethics. The author also stresses that *Shariah* principles governing business transactions are in fact important pillars of business ethics.

According to Hasanuzzaman (2003) “there is nothing to discover with regard to business ethics in Islam” as he claims that the “edifice of the entire Islamic way of life rests on absolute ethical values”. He also suggests that most Islamic ethical values are not unique to Islam and are universal in nature. Nik Yusoff (2002) suggests that the most significant concept of business in Islam is that business has economic, social as well as religious functions. He derives that absolute honesty in all business transactions and an open market as one of the important tenets of business in Islam. In *Business Ethics in Islamic Context – Perspectives of a Muslim Business Leader*, Abeng (1997) summarises the manner for proper ethical conduct in business to leniency, service motive and consciousness of God. He elaborates that leniency is the foundation of good manners that include politeness, forgiveness, removal of hardship and compensation, while service-motive provides the imperative for carrying out business activities to provide a needed service to the community, and consciousness of God demands one to be mindful of his business activities, ensuring that they are compatible with morality and higher values prescribed by God.

Beekun and Badawi (2005) propose that enforcement of Islamic business ethics begin at the level of the individual, which operates through the awareness and love of God, and the anticipation of His blessings in this world and the hereafter. Realising that most of the work done with regard to Islamic business ethics are normative in nature, they suggest that it would be interesting to investigate how far such ideal norms are currently implemented in the Muslim world. Jamal Uddin (2003) is also of the opinion that an empirical study to investigate the extent to which the affairs of businesses in the Muslim world mirror the prescribed model is worth pursuing. He stresses that in Islam the decision making process in a business situation should be substantially influenced by religious ethical principles. Blurring the distinction between the ethical and legal dimensions of business in Islam, he suggests that Islamic legal rulings pertaining to business transactions are applicable to everyone irrespective of their religious affiliations. In fact, Muhammad (2008) posits that one of the aims of the *Shariah* is to control human behaviour in order to establish Islamic ethics and that both the *Shariah* and ethics are two inseparable elements of Islamic legal theory.

Despite what has been mentioned above, Mohammed (2007) observes that a large part of Islamic literature on business ethics is either theologically oriented or superficial and inadequate in its assessment of Islamic business principles and to date remains fragmented and spread over a variety of sources, which does not sufficiently provide a systematic model or framework of business ethics despite the existence of a rich vein of the concept in Islam. Khan (2007) further elaborates that in most cases, the literature on Islamic economics, in which businesses

operate, though full of reference to primary sources, deals with basic principles in a rhetorical and simplistic style and lacks a comprehensive discussion of the basic beliefs and values. He is also of the opinion that Muslim scholars (*'ulamā'*) have mainly been restating the position of the *Shariah* on various issues and their discourse contains an implicit awareness of the social reality, but their emphasis has been on the legal dimension.

6. Ethics and Islamic finance

Ethics has become increasingly important in the financial services sector on the grounds that the aim of business activities in general and financial services in particular is the creation of value for the consumer (Duska and Clarke, 2002). Duska and Clarke (2002) further opine that there shouldn't be a dichotomy between personal ethical attitudes and the attitudes governing one's business life in the financial services sector. Good ethics should also mean good business for financial institutions as in the case of the British Cooperative Bank, where its ethical policy paved the way to improved performance (Kitson, 1996). Sternberg (2000) suggests that an ethical environment in the business and financial sectors provides vital support for maximising long-term owner value. If ethics played a larger role in the financial services sector, the recent global financial crisis might have been averted.

The reality of the financial services sector paints a picture of a culture where the pursuit of money, an instrumental good, evolves to become the ultimate goal of human beings, leading towards ethical corruption (Duska and Clarke, 2002). This is in stark contrast to the climate of Islamic philosophy which dictates that economics should be subservient to ethics and not vice versa (Naqvi, 1981). Lewis and Algaoud (2001) reiterate that Islamic values in all facets of behaviour should be reflected in IFIs to bring about collective morality and spirituality, which when integrated with the production of goods and services advance the Islamic way of life. Islamic faith-based finance claims to offer global financial stability and ethics in business and banking, which in a sense are shared by all major faith-based traditions (Phoon, 2004). Elmelki and Ben Arab (2009) identify the establishment of justice and elimination of exploitation in business transactions as the most important objectives of Islamic finance, which are achieved through the prohibition of "illegal unjustified enrichment" and excessive risk and speculation.

Islamic finance has been recognised as a rapidly increasing integrated compartment of global finance (Warde, 2000). Standard & Poor's (2009) report that the past decade witnessed the Islamic financial services sector growing at a rate of more than 10% annually and has accumulated assets estimated to be worth \$700 billion worldwide. It is identified that the major difference between Islamic and conventional finance, at their operational level, is that the former is equity based while the latter is based on debt. Due to this fact, Mirakhor and Krichene (2009b) claim that the conventional financial system has been rattled by frequent crises, as a result of its instability, despite the existence of various regulatory and supervisory frameworks. In contrast, the Islamic financial system, which is void of interest, un-backed credit, abundance of liquidity and high leveraged financial transactions and speculation, is

inherently unwavering (Mirakhor 2009a). In his keynote speech at the World Market Capitals Symposium held in Kuala Lumpur, Raja Nazrin Shah proposes that Islamic finance can assist in breaking the vicious cycle of boom and bust that has characterised global finance (Parker, 2009). Therefore, Hasan (2009) claims that many have turned to *Shariah*-compliant finance as a remedy for the recent credit-crunch, which evolved into a full-blown economic crisis.

It is claimed that Islamic finance is based on a system of ethics derived from revealed and divine texts, which are then applied through *Shariah* law (Walsh, 2007). Hence, Haniffa and Hudaib (2007) opine that IFIs are considered to be ethical since the foundation of their business philosophy is grounded in the *Shariah*, often referred to as ethics in action, which is concerned with promoting justice and welfare (*al-'adl wa al-ihsān*) in society and seeking God's blessing (*al-barakah*). Obaidullah (2005) states:

In an Islamic financial system, by definition, concerns about conformity to norms of Islamic ethics dominate all other concerns. All transactions in an Islamic system must be governed by norms of Islamic ethics as enunciated by the *Shariah*. Islamic systems are, in essence, ethical systems.

He further distinguishes the injunctions against *ribā* (usury), *qimār* (gambling) and *maysīr* (unearned income) as the significant differences between Islamic and mainstream financial systems. On a more fundamental level, the stark difference between Islamic and conventional financial systems is that the former has to preserve certain social objectives and is based on equity rather than debt (Venardos, 2005). Moreover, Islamic finance is said to lay emphasis on community values, socio-economic justice and a balance between material and spiritual needs of human beings (Elmelki and Ben Arab, 2009).

However, Wilson (2002) observes that despite the claim of IFIs to provide ethical financial services, no attempt is made to link what is ethical with the specific modes of carrying out financial transactions. He criticises IFIs for repeating emphasis on the standing of their *Shariah* regulators in their publicity material instead of projecting the moral teachings governing Islamic finance. This is supported by Haniffa and Hudaib (2007), who in their exploration of the discrepancies that exist between the communicated ethical identities via annual reports of seven Islamic banks in the Gulf and the ideal ethical identities based on the Islamic ethical business framework, discovered that six out of the seven Islamic banks they studied suffer from inconsistencies between the communicated and ideal ethical identities. However, Mohammed (2007) discovered in his study of Corporate Social Responsibility and Islam that many current practices of Islamic banks mirror the expected practices generated in the Islamic framework. Moreover, he observes that the Islamic banks he surveyed implement the Islamic code of conduct rather extensively.

At the operational level, bodies such as the Islamic Financial Services Board (IFSB) and the Accounting and Auditing Organisation for IFIs (AAOIFI) have published the Guiding Principles and Conduct of Business for Institutions offering Islamic Financial Services and the Code of Ethics for the

Employees of IFIs respectively. IFSB explicitly states the aim of its guiding principles is to “strengthen the relevant moral, social and religious dimensions in conducting business” in addition to providing a framework which “promotes a climate of confidence and a supportive environment that upholds transparency and fair dealing comparable to the conventional frameworks” (IFSB, 2009). However, the extent to which the items in the codes of ethics are being incorporated in and communicated to employees of IFIs is not well publicised.

More fundamentally, there have been criticisms on how Islamic finance is currently practiced. For instance, El-Gamal (2006) observes that modern Islamic finance aims to “replicate in Islamic forms the substantive functions of contemporary financial instruments, markets and institutions”, which has arguably caused its failure in serving the objectives of the *Shariah* (*maqāhid al-sharī'ah*) and economic purpose. He proposes that attention should instead be given to the substance of Islamic finance rather than form. This would subsequently shift the current paradigm of Islamising every financial practice to emphasising on the social and economic ends of financial transactions. Foster (2009), who describes the Islamic financial system as being based on ethics and principles of fairness, similarly calls for the reconsideration of aims, institutional frameworks and contractual methodologies of the modern Islamic financial sector in order to provide a genuine alternative to the current operating financial systems. He quotes Tarek El-Diwayn who views that the products currently offered by IFIs are often indistinguishable from interest-based institutions as both share the same material goals and employ the same institutional framework. Barom (2008) observes that recent debates on the practice of Islamic finance highlight the increasing divergence between theory and actual practice, as critics argue that faith-based ethical principles are being overridden by IFIs’ pursuit of profit maximisation and shareholder value. This is not surprising as when the benchmark of corporate performance is money, it is often difficult to place ethics before self-interest, even when an Islamic system is in place (Rosly and Abu Bakar, 2003).

7. Islamic financial institutions in Malaysia

The Malaysian Islamic finance market is considered to be well developed with a huge future potential (Al-Omar and Abdel-Haq, 1996). Islamic finance has been fully integrated into Malaysia’s existing financial system, which demonstrates the sector’s inventiveness and capacity for innovation (Venardos, 2005). The seriousness of the Malaysian government in furthering the cause of Islamic finance can be seen in the Financial Sector Master-Plan’s, which states that it would like to “epitomize Malaysia as a regional Islamic financial centre”. It also visions to see Islamic banking evolve in parallel with conventional banking to achieve 20% of the banking market share, represented by a number of strong and highly capitalised Islamic banking institutions, offering financial products and services, which are underpinned by a comprehensive and conducive *Shariah* and regulatory framework. Interestingly, code of ethics is identified as one of the core determinants in regulating IFIs, which would eventually result in less intervention of the central bank. (BNM, 2001).

The Malaysian International Islamic Financial Centre (MIFC), which was selected as the Best International Islamic Finance Centre 2008 at the second annual London Sukuk Summit Awards of Excellence, claims:

Malaysia’s Islamic financial industry distinguishes itself as one of the proven platforms for conducting Islamic finance activities. The vibrancy and dynamism of Malaysia’s Islamic financial system is reflected by its continual product innovation, a diversity of domestic and international financial institutions, a wide range of Islamic financial instruments, a comprehensive Islamic financial infrastructure and adoption of global regulatory, legal and *Shariah* best practices. Malaysia also holds the distinction of being the world’s first country to have a full-fledged Islamic financial system operating in parallel to the conventional banking system; and has placed strong emphasis on human capital development in Islamic finance to ensure the availability of Islamic finance talent. (MIFC, 2009)

The first IFI established in Malaysia was the Malayan Muslims Pilgrims Savings Corporation which began operations in 1963 to assist Malaysian Muslims in saving for performing the *hajj* (pilgrimage to Makkah). It then evolved into the Pilgrims Management and Fund Board or *Tabung Haji*, as it is popularly known, in 1969 (Warde, 2000). *Tabung Haji* acts as a finance company, which invests the savings of its depositors in accordance with the *Shariah*. However, its role is quite limited to a non-banking financial institution (Lewis and Algooud, 2001). In 1983, the first Islamic bank, Bank Islam Malaysia Berhad, started operations after continuous pressure on the Malaysian government to assist in establishing an Islamic bank (Man, 1988). This was made possible when the Malaysian parliament passed the Islamic Banking Act 1983, which provides strict but flexible regulations and supervision in Islamic banking (Al-Omar and Abdel-Haq, 1996). Malaysia witnessed the incorporation of its first *takaful* operator in 1984 after the enactment of the *Takaful* Act 1984, which was to a large extent triggered by the Malaysian National *Fatwā* Committee’s ruling that life insurance in its form then as non-*Shariah* compliant due to the presence of uncertainty, *ribā* and gambling (BNM, 2004). It is worth noting that the Malaysian experience of Islamic finance has had a significant impact on neighbouring countries such as Indonesia and Brunei, which established their first Islamic banks in 1992 and 1993 respectively (Al-Omar and Abdel-Haq, 1996).

In 1997, Bank Negara Malaysia formed the National *Shariah* Advisory Council on Islamic Banking and *Takaful* as the highest *Shariah* authority to provide advice on Islamic finance operations, coordinate *Shariah* issues, and evaluate and analyse *Shariah* aspects of new products and schemes (Venardos, 2005). However, many “conservative”, mostly non-Malaysian Muslim, scholars observe that Islamic finance in Malaysia was “cutting too many corners” and too lax in its definition of acceptable products, which call for scrutiny not only by *Shariah* scholars in Malaysia, but also scholars from other countries to enhance its legitimacy (Warde, 2000; Al-Omar and Abdel-Haq, 1996). As a result, Malaysia became a founding member and host country of the IFSB in 2002, which is an international standard-setting body consisting of regulatory and supervisory agencies, to ensure soundness and stability in the Islamic

financial sector (MIFC, 2009). As of October 2009, there are 17 Islamic banks, 16 Islamic windows, 3 international Islamic banks, 8 takaful operators, 4 retakaful operators and 1 international takaful operator operating in Malaysia (Abd Kadir, 2009).

In spite of the claimed resilience, stability and ethicality of IFIs, there are chances of failure due to inconsistencies between theory and practice. In Malaysia for instance, Bank Islam Malaysia Berhad recorded losses of over RM500 million and RM1.3 billion for its financial years of 2005 and 2006 respectively, after tax and *zakāt* (BIMB, 2008), in one of Malaysia's worst financial 'scandals', attributed to officers who were responsible for approving lending which should have not been approved (Basri, 2005). In another case, two senior general managers of *Tabung Haji* were found guilty of criminal breach of trust and cheating involving RM200 million and were sent to jail for 10 years (Mageswari, 2009).

8. Methodology

This research involves an empirical study of executives working in four diverse Islamic banks in Malaysia; two full-fledged stand-alone Islamic banks, an Islamic full-fledged subsidiary of a Malaysian conventional bank and a foreign Islamic bank established under Malaysia's Islamic Banking Act 1983. Four banks were chosen as Teddlie and Tashakkori (2009) mention that as a general rule, "case studies of institutions vary from a minimum of approximately four to twelve organisations". Islamic banks were purposely chosen to study Islamic business ethics in practice (i.e. applied business ethics) as they constitute a highly prominent sector with claims of operations based on the *Shariah* (Mohammed, 2007), which is often described as ethics in action. Therefore, it is presumed that the norms and practices of Islamic banks would be consistent with Islamic business ethics.

Quantitative data were collected by means of a 45-item survey. Items included an assessment of the perception of the executives of the Islamic banks along the following dimensions: the general ethics of the banks, attitudes and behaviour of employees, treatment of employees, code of ethics, management and social responsibilities. The survey was loosely designed based on the questionnaire developed by Bourne and Snead (1999) in their study on the Environmental Determinants of Organisational Ethical Climate, which was also adopted by Miller (2008) in his Doctoral of Business Administration dissertation on the Impact of Certain Determinants on the Ethical Perceptions and Attitudes of Corporate Managers in Malaysia.

Survey items were designed in a way that respondents could indicate their level of agreement with the statement under consideration. The data measurement entails a five-point Likert scale where respondents have a choice of answering: (1) strongly disagree to (5) strongly agree. To ensure content or face-validity of dimensions measured, the questionnaire was subjected to pre-testing where selected respondents who are familiar with the Islamic banking industry in Malaysia provided feedback via email regarding the content, clarity and relevance to the study. Since the items in the questionnaire have been primarily

adapted from a previous validated study, it is safe to assume that the constructs measured in the questionnaire have been previously researched and is constructively valid.

A simple analysis to determine the mean of the responses to each item was undertaken using the Statistical Package for Social Science (SPSS), which provided a descriptive analysis of the ethical perception of the banks' executives to each item in the questionnaire. A Cronbach's α reliability test was also conducted on the scale of each of the dimension in the questionnaire.

9. Limitations

This is an exploratory study and the findings and results cannot be generalized as it only involves the study of four Islamic banks in Malaysia. At present there are seventeen Islamic banks in Malaysia, five international Islamic banks and six development financial institutions offering Islamic banking schemes. The findings presented in this paper are a component of the author's PhD research on Islamic Business Ethics in Malaysian IFIs. His PhD research employs a mixed-method approach, where qualitative and quantitative approaches were adopted to answer the research question at hand. The quantitative component of the research only provides an overview of the Islamic banks' executives' ethical perception of what is being in their respective banks. A combination of both the qualitative and quantitative data would better answer the research question at hand.

10. Preliminary research findings and discussion

Table 1 below summarises the results in relation to the descriptive data regarding the individual statements measuring ethical perception of the Islamic banks' executives in the questionnaire. Generally, high mean values were obtained for most positive individual statements. Some statements could also be considered to be neither positive nor negative such as item B-2. Some items were purposely phrased in a negative sense and most of such statements recorded low mean scores such as items B-10, B-11, B-13, B-14 and C-9.

Based on the results presented in Table I, the executives of the Islamic banks concerned viewed the bank as generally ethical. More than 90% of the respondents agreed that the operations of the bank they are working at are consistent with *Shariah* requirements. The author did not specify what *Shariah* requirements meant and left it to the respondents to determine what constituted *Shariah* requirements. Most probably, the respondents would have understood it as the *Shariah* compliancy of the products and services provided by the bank. A mean of above 4 was scored for the statement on the banks' concern over their social impact and their truthfulness to customers despite it being potentially detrimental to their business. A mean of 3.981 was achieved for the statement on ethical values prevail of profit realisation. This is quite encouraging as one might argue that the prime purpose of Islamic banks as with conventional banks is to remain profitable while ethical considerations would become secondary.

Table 1. Results of descriptive analysis.

#	Statement	1 f(%)	2 f(%)	3 f(%)	4 f(%)	5 f(%)	Mean
General Ethics of the Bank							
A-1	Operations consistent with <i>Shariah</i>	0 (0.0%)	2 (1.9%)	6 (5.7%)	43 (41.0%)	54 (51.4%)	4.4190
A-2	Concerned with social impact	0 (0.0%)	2 (1.9%)	10 (9.5%)	51 (48.6%)	42 (40.0%)	4.2667
A-3	Truthfulness	0 (0.0%)	4 (3.8%)	18 (17.1%)	47 (44.8%)	36 (34.3%)	4.0952
A-4	Prevalence of ethics over profits	1 (1.0%)	1 (1.0%)	24 (22.9%)	52 (49.5%)	27 (25.7%)	3.9810
Attitude and Behaviour of Employees							
B-1	Consistency of personal and bank's view of ethics	0 (0.0%)	2 (1.9%)	20 (19.0%)	50 (47.6%)	33 (31.4%)	4.0857
B-2	Ethical norms is personal	18 (17.1%)	26 (24.8%)	22 (21.0%)	26 (24.8%)	13 (12.4%)	2.9048
B-3	Religious motivation to behave ethically	1 (1.0%)	3 (2.9%)	16 (15.2%)	37 (35.2%)	48 (45.7%)	4.2190
B-4	Exert best effort	0 (0.0%)	3 (2.9%)	15 (14.3%)	42 (40.0%)	45 (42.9%)	4.2286
B-5	Respect working hours	0 (0.0%)	7 (6.7%)	21 (20.0%)	46 (43.8%)	31 (29.5%)	3.9619
B-6	Adhere to outlined procedures	0 (0.0%)	4 (3.8%)	24 (22.9%)	52 (49.5%)	25 (23.8%)	3.9333
B-7	Honesty with each other	1 (1.0%)	7 (6.7%)	38 (36.2%)	48 (45.7%)	11 (10.5%)	3.5810
B-8	Avoid hurting each other	2 (1.9%)	14 (13.3%)	38 (36.2%)	41 (39.0%)	10 (9.5%)	3.4095
B-9	Gifts in return for favour is normal	40 (38.1%)	28 (26.7%)	26 (24.8%)	4 (3.8%)	7 (6.7%)	2.1429
B-10	False expenses claims are normal	62 (59.0%)	24 (22.9%)	12 (11.4%)	7 (6.7%)	0 (0.0%)	1.6571
B-11	Bank's assets often used for personal gain	44 (41.9%)	35 (33.3%)	14 (13.3%)	10 (9.5%)	2 (1.9%)	1.9619
B-12	Advise one another	0 (0.0%)	4 (3.8%)	28 (26.7%)	49 (46.7%)	24 (22.9%)	3.8857
B-13	Envy, malice, back-biting and picking on others are common	32 (30.5%)	16 (15.2%)	34 (32.4%)	14 (13.3%)	9 (8.6%)	2.5429
B-14	Acting ethically are the minority	23 (21.9%)	28 (26.7%)	22 (21.0%)	20 (19.0%)	12 (11.4%)	2.7143
B-15	Highly ethical	1 (1.0%)	10 (9.5%)	40 (38.1%)	43 (41.0%)	11 (10.5%)	3.5048
B-16	Involved in corporate social responsibility activities	1 (1.0%)	6 (5.7%)	31 (29.5%)	44 (41.9%)	23 (21.9%)	3.7810
Treatment of Employees							
C-1	Respect	1 (1.0%)	4 (3.8%)	38 (36.2%)	50 (47.6%)	12 (11.4%)	3.6476
C-2	Fairly compensated	4 (3.8%)	11 (10.5%)	43 (41.0%)	34 (32.4%)	13 (12.4%)	3.3905
C-3	Equality	2 (1.9%)	9 (8.6%)	53 (50.5%)	28 (26.7%)	13 (12.4%)	3.3905
C-4	Appropriately trained	1 (1.0%)	2 (1.9%)	24 (22.9%)	60 (57.1%)	18 (17.1%)	3.8762
C-5	Trained on <i>Shariah</i> principles for Islamic banking	0 (0.0%)	1 (1.0%)	9 (8.6%)	43 (41.0%)	52 (49.5%)	4.3905
C-6	Encouragement to observe personal <i>Shariah</i> obligations	1 (1.0%)	3 (2.9%)	14 (13.3%)	30 (28.6%)	57 (54.3%)	4.3238

Table 1. (Continued)

#	Statement	1 f(%)	2 f(%)	3 f(%)	4 f(%)	5 f(%)	Mean
C-7	Facilities for personal <i>Shariah</i> obligations	0 (0.0%)	3 (2.9%)	5 (4.8%)	26 (24.8%)	71 (67.6%)	4.5714
C-8	Not exploited and good working conditions	1 (1.0%)	2 (1.9%)	25 (23.8%)	53 (50.5%)	24 (22.9%)	3.9238
C-9	Pressure to conform	19 (18.1%)	39 (37.1%)	28 (26.7%)	15 (14.3%)	4 (3.8%)	2.4857
C-10	Welfare	1 (1.0%)	6 (5.7%)	31 (29.5%)	43 (41.0%)	24 (22.9%)	3.7905
Code of Ethics							
D-1	Bank's values clearly communicated	0 (0.0%)	2 (1.9%)	17 (16.2%)	62 (59.0%)	24 (22.9%)	4.0286
D-2	Code of ethical conduct clearly communicated	0 (0.0%)	3 (2.9%)	21 (20%)	53 (50.5%)	28 (26.7%)	4.0095
D-3	Reward for ethical behaviour	6 (5.7%)	23 (21.9%)	45 (42.9%)	23 (21.9%)	8 (7.6%)	3.0381
D-4	Regulations essential to avoid exploitation	1 (1.0%)	1 (1.0%)	26 (24.8%)	41 (39.0%)	36 (34.3%)	4.0476
D-5	Whistle-blowers not victimised	9 (8.6%)	4 (3.8%)	20 (19.0%)	31 (29.5%)	41 (39.0%)	3.8667
D-6	Encouragement to report breach	0 (0.0%)	1 (1.0%)	12 (11.4%)	42 (40.0%)	50 (47.6%)	4.3429
Management							
E-1	Trust	1 (1.0%)	5 (4.8%)	41 (39.0%)	43 (41.0%)	15 (14.3%)	3.6286
E-2	Respect	1 (1.0%)	2 (1.9%)	33 (31.4%)	46 (43.8%)	23 (21.9%)	3.8381
E-3	Caring	1 (1.0%)	7 (6.7%)	34 (32.4%)	48 (45.7%)	15 (14.3%)	3.6571
E-4	Highly ethical	1 (1.0%)	5 (4.8%)	38 (36.2%)	44 (41.9%)	17 (16.2%)	3.6762
Social Responsibility							
F-1	Supports organizations that benefit society	0 (0.0%)	0 (0.0%)	26 (24.8%)	50 (47.6%)	29 (27.6%)	4.0286
F-2	Participates in government social activities	0 (0.0%)	3 (2.9%)	24 (22.9%)	56 (53.3%)	22 (21.0%)	3.9238
F-3	Without ulterior motive	0 (0.0%)	4 (3.8%)	26 (24.8%)	51 (48.6%)	24 (22.9%)	3.9048
F-4	Sponsors Islamic educational and social events	0 (0.0%)	2 (1.9%)	17 (16.2%)	47 (44.8%)	39 (37.1%)	4.1714
F-5	Writes off debt as charity	19 (18.1%)	25 (23.8%)	35 (33.3%)	16 (15.2%)	10 (9.5%)	2.7429

As for the dimension on attitude and behaviour of employees, the respondents were divided on whether ethical norms is something personal and hence cannot be imposed on employees or otherwise. All the negative statements under this dimension (B-10, B-11, B-13 and B-14) recorded relatively low means, indicating disagreement that employees often used the banks' assets for personal use, submitted false claims, malice was common and that ethical employees are the minority.

Having said that, when asked whether employees behaving ethically are the minority, the mean (2.7143) was close to neutral.

Mean scores of below 4 were recorded for 7 out of 10 items under the dimension of treatment of employees. 50.5% of the respondents were neutral when asked about equal treatment without discrimination, which would be worth exploring and investigating. It is encouraging to note that

most respondents felt that their employers encourage the observation of *Shariah* personal obligations and provided good facilities for them to do so. Moreover a mean of 4.3905 was achieved for training in the understanding of *Shariah* principles for Islamic banking.

As for the code of ethics of the Islamic banks, most items under this dimension scored a mean of above 4 except for items D-3 and D-5 which asked the respondents whether acting in ethical manner is rewarded and whether whistleblowers were not victimised respectively. The mean for item D-3 was 3.0381, which was close to neutral. This might indicate that the banks have yet to have an ethical reward system in place to encourage ethical behaviour among employees of the bank. Nearly 75% of the respondents felt that regulations are necessary to ensure that the management of the banks does not exploit customers and employees. As for the items under management, all achieved a mean of below 4 but above 3.6, indicating that perception of the respondents towards management is not as high as desired. This might be caused by the complexity of the management-employee relationship and reasons behind this are worth exploring.

The banks scored fairly well on social responsibility except that it wasn't the banks norm to write off debt as charity in certain circumstances where debtors are not in a position to settle their debts. This might be attributed

to the nature of Islamic banking products and services offered, which are not termed as loans, but known as financing. This might lead to perception of the absence of the creditor-debtor relationship between the banks and other parties. It would also be disadvantageous on the part of the banks, if clients did not service their financing, taking advantage of the fact that the banks would write off their debts. However, in genuine cases where clients of the banks are not able to fulfil their financing contracts, the banks should be lenient to its customers and try to restructure the financing agreement or in certain extreme cases relieve the clients of fulfilling their financing contracts. A system should be in place to deal with such circumstances to differentiate between Islamic and conventional banking systems. Having said that, Ayub (2007) reiterates that:

"IFIs have to work as business institutions so as to properly perform the functions of mobilisation and efficient allocation of resources. The myth in some circles that Islamic banks need to work as social security centres, providing charity to the needy and for benevolence are two separate things... Subject to the policies of their boards and in consultation with stakeholders, they can also take part in social and welfare activities, but this will not be their normal course of business."

Table 2 below summarises the results of the Cronbach's α reliability test to ascertain the reliability of the items under each pre-determined dimension. Except for the

Table 2. Results of Cronbach's α reliability test (*shaded rows excluded from analysis*).

#	Statement	Scale mean if item deleted	Scale variance if item deleted	Corrected item – total correlation	Cronbach's α if item deleted
General Ethics of the Bank: Cronbach α 0.794 (4 items)					
A-1	Operations consistent with <i>sharī'ah</i>	12.3429	3.593	0.580	0.755
A-2	Concerned with social impact	12.4952	3.272	0.704	0.695
A-3	Truthfulness	12.6667	3.032	0.666	0.710
A-4	Prevalence of ethics over profits	12.7810	3.538	0.586	0.802
Attitude and Behaviour of Employees: Cronbach α 0.770 (15 items)					
B-1	Consistency of personal and bank's view of ethics	52.800	46.662	0.453	0.753
B-2	Ethical norms is personal	53.7905	51.533	-0.068	0.807
B-3	Religious motivation to behave ethically	52.6667	47.205	0.330	0.761
B-4	Exert best effort	52.6571	46.074	0.482	0.750
B-5	Respect working hours	52.9238	44.494	0.572	0.742
B-6	Adhere to outlined procedures	52.9524	45.180	0.581	0.743
B-7	Honesty with each other	53.3048	44.925	0.590	0.742
B-8	Avoid hurting each other	53.4762	46.752	0.353	0.759
B-9	Gifts in return for favour is normal	53.0268	48.432	0.131	0.783
B-10	False expenses claims are normal	52.5429	45.731	0.426	0.753
B-11	Bank's assets often used for personal gain	52.8476	43.996	0.488	0.746
B-12	Advise one another	53.0000	46.404	0.450	0.753
B-13	Envy, malice, back-biting and picking on others are common	53.4286	42.747	0.449	0.750
B-14	Acting ethically are the minority	53.6000	44.858	0.305	0.768
B-15	Highly ethical	53.3810	44.950	0.555	0.744
B-16	Involved in corporate social responsibility activities	48.7733	30.313	0.372	0.555

Table 2. (Continued)

#	Statement	Scale mean if item deleted	Scale variance if item deleted	Corrected item – total correlation	Cronbach's α if item deleted
Treatment of Employees: Cronbach α 0.784 (10 items)					
C-1	Respect	34.1429	19.797	0.589	0.750
C-2	Fairly compensated	34.4000	18.685	0.577	0.748
C-3	Equality	34.4000	18.646	0.658	0.738
C-4	Appropriately trained	33.9143	20.291	0.537	0.757
C-5	Trained on <i>Shariah</i> principles for Islamic banking	33.4000	20.800	0.506	0.761
C-6	Encouragement to observe personal <i>Shariah</i> obligations	33.4667	20.097	0.450	0.766
C-7	Facilities for personal <i>Shariah</i> obligations	33.2190	21.365	0.385	0.773
C-8	Not exploited and good working conditions	33.8667	19.790	0.570	0.752
C-9	Pressure to conform	35.3048	24.252	-0.91	0.844
C-10	Welfare	34.0000	18.962	0.599	0.746
Code of Ethics: Cronbach α 0.695 (6 – 2 = 4 items)					
D-1	Bank's values clearly communicated	12.4000	2.877	0.618	0.550
D-2	Code of ethical conduct clearly communicated	12.4190	2.746	0.573	0.569
D-3	Reward for ethical behaviour				
D-4	Regulations essential to avoid exploitation	12.3810	3.007	0.360	0.716
D-5	Whistle-blowers not victimised				
D-6	Encouragement to report breach	12.0857	3.233	0.401	0.676
Management: Cronbach α 0.892 (4 items)					
E-1	Trust	11.1714	4.701	0.833	0.835
E-2	Respect	10.9619	5.287	0.633	0.908
E-3	Caring	11.1429	4.720	0.800	0.847
E-4	Highly ethical	11.1238	4.763	0.790	0.851
Social Responsibility: Cronbach α 0.772 (5 items)					
F-1	Supports organizations that benefit society	14.7429	6.962	0.591	0.719
F-2	Participates in government social activities	14.8476	6.669	0.661	0.697
F-3	Without ulterior motive	14.8667	6.463	0.663	0.692
F-4	Sponsors Islamic educational and social events	14.6000	6.877	0.571	0.723
F-5	Writes off debt as charity	16.0286	6.028	0.387	0.827

dimension on Code of Ethics, all the other dimensions achieved a Cronbach α of above 0.7. The Cronbach α of the Code of Ethics was 0.695, which could be safely approximated to 0.7 if rounded to the nearest decimal point. Items D-3 and D-5 were excluded as its inclusion would result in the Cronbach α of the Code of Ethics to be significantly low. It is realized that these items were in fact not directly related to the Code of Ethics and its removal from the Cronbach's α reliability test is therefore deemed to be reasonable.

With respect to the Cronbach's α reliability results in Table 2, it is generally assumed that a score of above 0.7 would deem the data to be reliable. The α coefficient ranges from 0 to 1, where the reliability of the findings would be greater as the coefficient reaches 1. Generally, researchers are not in agreement as to the acceptable

size of the coefficient and Cronbach's α of 0.60 to 0.70 are deemed to be at the lower end of acceptability (Miller, 2008).

Notably, the Cronbach α for the group of items under the management dimension is highest at 0.892 compared to the other dimensions. The lowest Cronbach α is 0.695 for the dimension on the code of ethics, and this was achieved after removing items D-3 and D-5. If item D-4 was deleted, the Cronbach α would increase to 0.716. This might be due to the fact the ethics is often described as being more than abiding to rules and regulations, and hence the exclusion of the requirement of regulation from this dimension would increase the Cronbach α of this dimension. The removal of item F-5, which is related to the writing of a debt as a social responsibility of the bank, would increase the Cronbach α of the social responsibility dimension to 0.827. The reason

for this has been explained in the discussion of the low mean score of the mentioned item.

11. Conclusion

Generally, from the descriptive quantitative analysis of the data presented, it can be fairly assumed that the practices of the Islamic banks in Malaysia under study do conform with the Islamic ethical norm in business based on the perception of executives working in the banks concerned. Individual positive and negative statements, which scored a mean of less than 4 and more than 2, respectively, are areas where the Islamic banks concerned must strive to improve. Particularly, the perception of the management among employees of the banks must improve as it is the management who determines the issue of business conduct and principles in a business organisation. Issues surrounding the treatment of employees such as equality and fair wages must also be addressed in line with business ethical norms established by Islam.

A preliminary look into the qualitative data of the PhD research of the author, which is not presented in this paper, suggests that the senior management, *Shariah* heads and *Shariah* Supervisory Board members of the Islamic banks under study are aware of the importance of incorporating Islamic ethics in the operations of their respective banks. However, the climate in which the banks operate does not necessarily support such notions. Furthermore, Islamic banks might not feel compelled to abide by Islamic ethical norms in business if the consumers of their products and services do not strongly demand so.

The emphasis on *Shariah* compliancy of products and services has arguably resulted in the ethical dimension of Islamic finance to be somehow sidelined. *Shariah* compliancy is indeed the essence of Islamic finance but beyond that, Islamic banks should be at the forefront of ethical banking, whereby they take into consideration the impact of their activities on the society at large. Islamic banks must also strive to adopt the recommendations by the IFSB and AAOIFI in their published Guiding Principles and Conduct of Business for Institutions offering Islamic Financial Services and the Code of Ethics for the Employees of IFIs respectively as best practices in the industry.

12. Future research

It is desirable that this research be extended to a wider scale, where more respondents, from different Islamic banks are included in the study. This would allow for more generalisations to be made. Qualitative approaches could also be adopted to further explain the findings of what has been presented to gain a more in-depth account of any issues at hand. As the research only involved executives of the banks, other stakeholders' perceptions of the ethicality of Islamic banks are also worth pursuing and could be compared to each other.

Research needs to be conducted using various techniques to answer the questions at hand. Realising that, the author in his PhD study has interviewed the senior management, *Shariah* heads and *Shariah* Supervisory Board members of the banks concerned to obtain their views on Islamic business ethics in relation to Islamic banking practices in

Malaysia. The author also included in his PhD research the ethical identities of the banks concerned based on their annual reports and other materials accessible to the public such as the banks' websites and other publications.

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Articulation of spirituality in the workplace: The case of Malaysia

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Abstract - Although the phenomenon of spirituality in the workplace has received enormous attention from other religious faiths, the construct of Islamic spirituality has not been much explored. This empirical study attempts to enrich the understanding of the spirituality in the workplace phenomenon from the Islamic management perspective. The surveyed data used for this empirical research was drawn from 405 Muslim employees in business organizations in Malaysia. After yielding an instrument to measure Islamic spirituality, exploratory (using SPSS version 18.0) and confirmatory (using AMOS version 18.0) factor analyses were conducted. The construct validity of Islamic spirituality led to the major finding of the research, thus, Islamic spirituality in the organizational context is explained by four determinants: rituals (Ibadat), forgivingness/repentance (Al a'fw), belief (Iman) and remembrance of Allah (Dhikrullah). The incorporation of these determinants in contemporary organizations can lead to several benefits towards improving sustainable growth, economic development and profitability.

Keywords: Islamic spirituality, Islamic management, rituals (Ibadat), forgivingness (al a'fw), belief (Iman), remembrance of Allah (Dkhikrullah)

1. Introduction

Most businesses in recent times are facing daunting behavioral repercussions from employees' attitudes, from theft cases to sexual harassment, which in turn lead to inherent effects towards organizations' overall sustainable and economic developments. As posited by Al-Attas (2001), Islam can provide meaningful solutions to these organizational challenges faced by nations worldwide. Leaders as well as organizations are looking for meaning and higher purpose that brought spirituality, religion and faith to the world of business (Kouzes and Posner, 2002).

However, until recently, there is insufficient research geared towards Islamic spirituality and its contribution to the overall development of modern organizations. As asserted by Tayeb (1997) and Junaidah (2009), everywhere in the Islamic world, stretching from Morocco to Malaysia, and Iran to Indonesia, Muslims have witnessed a "return" to Islamic traditions and the fundamentals of their faith as a way of asserting their identity, a means to fight the unjust social and political oppression experienced in their

societies, and an alternative to avert materialism and pressures of the twentieth century.

Junaidah (2009) further contended that many Muslim countries have begun their efforts to re-institute their territories in their own indigenous ways of running the social, educational and commercial organizations. These contentions by Junaidah (2009) and Tayeb (1997) lead us to the belief that Islam's role has become more evident and significant in shaping people's attitudes, values and behaviors.

2. Research problem

This empirical study attempts to study spirituality from the Islamic perspective as captured in the Islamic texts, the Qur'an and the *ahadith* (sayings of the Prophet Muhammad, peace be upon him). This need has become imperative due to the fact, that the current spirituality studies emanating from the western value systems do not give apt consideration to the Islamic perspective of spirituality.

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Another important fact that needs mention with respect to Islamic spirituality (IS) is the comprehensive characteristics together with that intrinsic motivation embedded in IS, that has the tendency to propel employees in general and Muslim employees in particular towards exhibiting generous behaviors in organizations. Although there has been some research works that look into these characteristics and the intrinsic motivations, no sufficient research has been conducted with respect to Islam's perspective. In addition to this, there is also a dearth of research conducted with respect to inculcating IS concepts in Muslim employees working in western organizations or even in Muslim employees working in Muslim organizations. Islam is the religion on the sight of Allah (*Qur'an*, 3:19). It is the religion with a complete set of rules, regulation, ethics, guidance and mercy to mankind as espoused in several verses and chapters of the *Qur'an* and the *Sunnah*, i.e., the teachings of the Prophet Muhammad (p.b.u.h.). The *Qur'an* and the *Sunnah* have been in existence for over 1400 years.

The empirical research is guided by the following research questions; (1) what are the underlying dimensions of the Islamic spirituality (IS) construct? (2) What determinants explain the Islamic Spirituality construct in the organizational context?

3. Islamic spirituality

Islam recognizes that human being consists of two parts. The first part is the body, which is the physical dimension. The second part is the spirit, which is called "*nafs*" (in Arabic language) whiles the human is living and "*ruh*" (soul) when the human dies. Al-Gazzali (2004) indicated that human beings have four distinguished classes of characteristics: animal characteristics, evil characteristics, wild characteristics and spiritual characteristics. Spirituality is rooted in faith (*Iman*) demonstrated by the Islamic rituals of prayer, fasting, pilgrimage to Mecca (*haj*) and charity (*zakah*). These rituals according to Nasr (1987) are the means by which Muslims get closer to the Creator.

Al-Gazzali (2004) stated that *Ibadah* such as prayers (*salat*), fasting, (*zakah*), and pilgrimage to Mecca (*haj*) should improve a person's relationship with Allah and people, otherwise humans then become just empty rituals with no value. All the rituals Allah instructed the believers to carry out such as fasting and prayer are only for their benefits so they could reach to the highest state of spiritual and physical fitness (Ibrahim, 1997). In line with this contention, Hawa (2004) posits that spirituality could not be maintained unless all rituals (*Ibadah*) of fasting, pilgrimage to Mecca (*haj*) and charity (*zakah*) are observed regularly. Allah had imposed these rituals (*Ibadah*) on Muslims to provide them with daily, weekly and yearly meals for their spirits, which can strengthen and renew their beliefs and cleans their hearts from stains of sins and impurity. In view of the contention by Hawa (2004) and Al-Gazzali (2004), it is worth noting that spirituality does not depend on facial looks or wealth, personal backgrounds or race, but depends on how clean one's heart is from stains of sins and disobeying Allah's commands.

In strengthening this position, Hawa (2006) also captured that purification of soul is achieved through performing rituals (*Ibadah*) such as prayers, charity (*zakah*), pilgrimage

to Mecca (*haj*), reading Qur'an and fasting. Recitation of the Qur'an is a significant way to enlighten the spirit and it complements what prayer, charity, fasting and *haj* do in realizing the spiritual potential of human beings. In much the same way, Al-Helali (2000) mentioned that spending in Allah's ways gets a person closer to Allah as in the following verse: "And of the Bedouins there are some who believe in Allah and the last day, and look upon what they spend (in Allah's cause) as means of nearness to Allah, and a cause of receiving the messenger's invocations. Indeed the expenditures are a means of nearness for them" (*Qur'an*, 9:99).

To add to the elaboration of the benefits and importance of spirituality, (Hawa, 2004) explained that Islamic spirituality is capable of producing a complete Muslim who would worship Allah and also be a valuable member to his society through kindness. Ali (2005, p. 34) also captured that: "Spiritual and mental needs strengthen the quest for perfection and actualization of one's potential in serving the community and organization, while pursuing his/her activities." Spiritual people enjoy minds that are motivated towards good deeds and "complete satisfaction and self-actualization" (Ali, 2005, p. 28).

From the Western perspective, it is difficult to find a common definition for spirituality (Laabs, 1995; Strack and Flotter, 2002). As highlighted by Krishnakumar and Neck (2002), there are three views as regards spirituality. The first view considers spirituality as internal matter, the second links it to religion, and the third view sees it as involving meaning (Krishnakumar and Neck, 2002). To Griffin (1988), spirituality is an inherent human characteristic that does not intrinsically refer to any religious meaning. According to Mitroff and Dento (1999), spirituality is "the basic feelings of being connected with one's complete self, others, and the entire universe" (p. 86). According to Dehler and Welsh (1994, p. 19), spirituality is "a specific form of work feeling that energizes action". Strack (2001) considers spirituality as defined by Beazley to have two dimensions. The first dimension is called definitive dimension of spirituality, which is composed of living the faith relationship and prayer or mediation involving the transcendent. The second dimension is called correlated dimension of spirituality, which is composed of honesty, humility and service to others. It is called correlated because it might exist with or without spirituality. However, the common grounds of spirituality among the different definitions are that spirituality has to do with personal relations and experience with supreme power (Tischler, Biberman, and Mckeage, 2002).

Comparing the Islamic view of spirituality with the above definitions, a common ground exists among most of them, which is the realization of the existence of supreme power and the importance of the relationship with this supreme power. In this study, spirituality encompasses more than prayer and it includes the conformity of other obligations. According to Mohsen (2007) Islamic spirituality is a concept that is embedded in *Taqwa* (God-consciousness/piety). To identify the characteristics of IS, the concept of *Taqwa* was thoroughly explored from the Qur'an, found in six areas of the Qur'an; (2:3-4), (2:177), (2:183), (3:133-136), (5:8-9), (23:1-11) and (25:63-76). From these verses, the characteristics of the *Muttaqqeen* (pious people) was collected and grouped under two main categories; namely, Islamic Spirituality (IS) which is defined as the relationship

between the Creator and man (Mohsen, 2007); and Islamic social responsibility (ISR) which is defined as the relationship between man and his fellow man, nature, and other creations (Mohsen, 2007).

Owing to the scope covered by this study, only the IS aspect is captured in this research. The IS as captured in the Qur'an comprises of certain salient spiritual aspects associated with the pious people. These include; careful observance of the Rituals (*Ibadat*) which comprises of prayers (*salat*), fasting (*saum*), charity (*zakat*) and pilgrimage to Mecca (at least once in a life time) i.e. (*haj*); Forgivingness attitude (*Al a'fw*); Belief in Allah (*Iman bil-lah*) and constant Remembrance of Allah (*Dhikrullah*). Preceding sections discuss the theoretical and operational definitions of these IS aspects used this study.

4. Prayer (*salat*)

Prayer (*salat*) is the second pillar of Islam. Muslims are encouraged to perform *salat* in congregation to enhance their social relationship (Al-Khalifah, 1994). When prayer is performed in congregation, it promotes a bond of brotherhood and unity among worshippers. As held by Al-Gazali (2004), avoiding wrongdoing is the core and real benefit of prayers, which leads to righteousness. Prayer includes "do'a" which brings "barakah" and reduces stress (Al-Helali, 2000). *Operationally, prayer implies increasing the bond between oneself and Allah, which brings a robust support for enjoining good and forbidding all kinds of evil.*

5. Obligatory spending in Allah's course (*Zakat*)

Zakat is the third pillar of Islam. Spending in Allah's ways purifies the soul and corrects behaviour (Al-Helali, 2000). Spending in Allah's ways strengthens the brotherhood and establishes social cohesion. The person who spends in Allah's ways is close to the hearts of the people (Mohsen, 2007). A penny, when spent in Allah's course, make the giver feels more satisfied, which motivates him to work harder and give more. Helping and concerns for other drive out fear, anger, jealousy and guilt and provide joy, peace and serenity that in turn lead to loyalty, high organizational commitment, reduces stress and improve productivity (Fry, 2003). *Operationally, zakat implies the act of living in a state of readiness to offer financial help and support to co-workers in organizations.*

6. Fasting (*Saum*)

Fasting during the month of *Ramadhan* is the fourth pillar of Islam that all capable Muslims must perform (Qur'an, 2:183). Apart from the obligatory fasting of the month of *Ramadhan*, there are other optional fastings that Muslims are encouraged to observe. Fasting, among its several salient benefits, leads to physical fitness, which is a characteristic of effective people.

According to the medical experts, fasting has several health benefits including lowering blood sugar, cholesterol and blood pressure (Athar, 2001). In addition to the health benefits, it also has some psychological effects including peace and tranquillity, with personal hostility at the minimum. All these benefits lead to better stability in the blood glucose (Athar, 2001). *Operationally, fasting signifies*

enjoining optional and obligatory fasting and encouraging co-workers to observe optional and obligatory fasting in the right manner in order to strengthen one's bond with Allah and enjoy the several positive outcomes to oneself which may lead to quality job at the workplace.

7. Pilgrimage to Mecca (*Haj*)

Performing *haj* is the fifth pillar in Islam, which is mandatory for all capable Muslims to observe it once in their lifetime (Qur'an, 2:196–200). It may be repeated by capable individuals as (*Sunnah*) but the first time experience is the most required of all Muslims to observe. *Operationally, haj implies the act of enjoining the pilgrimage to Mecca and encouraging Muslim co-workers in organizations to observe haj when they are capable which may strengthen ones bond with Allah, and leads to enjoying the guidance and barakah of Allah, which will lead to positive guidance in ones dealings in organizations.*

The four pillars of Islam (*salat* (prayer), *zakat* (mandatory spending in Allah's course), *Saum* (fasting) and *haj* (pilgrimage to Mecca)) together with *Kalimat Shahada* (which is the first pillar) are all termed as *Ibadat*, i.e., rituals. The practice of the *ibadat* (rituals) lead to reinforcement of loyalty, sensitivity, and identity among Muslims' groups (Ali, 2005).

8. Remembrance of Allah (*Dhikrullah*)

The frequent remembrance of Allah with the heart and the tongue is one of the main characteristics of the people who possess *Taqwa*. Due to its importance in the lives of Muslims, *Dhikrullah* has been mentioned in several places of the Qur'an. For instance in Qur'an (33:35), Allah says "....the men and the women who give *sadaqat* (i.e., *zakat* and alms), and the men and the women who observe *saum* (i.e., fast, the obligatory fasting during the month of *Ramadhan* and the optional (*nawafil*) fasting), the men and the women who guard their chastity (from illegal sexual acts), and the men and the women who remember Allah much with the hearts and tongues Allah has prepared for them forgiveness and a great reward (i.e., Paradise)." *Operationally, Dhikrullah implies the frequent remembrance of Allah by an employee whilst at the workplace in order to strengthen the bond with Allah which will lead to receiving a divine intervention from Allah in the decisions one make in the workplace.*

9. Forgivingness/repentance (*Al A'fw*)

When a person forgives another's faults and mistakes, peace and tranquillity is established and one feels satisfied in the heart. As mentioned in the Qur'an (41:34) "Good and evil are not alike. Repel evil with what is better. Then he, between whom and you there was hatred, will become as though he was a bosom friend." Forgivingness describes individuals who have good intentions towards others, fear Allah, have the softness of heart to forgive those who have hurt them, and feel happy if others are successful even if they have harmed them before (Al-Amar, 2008).

They cannot go longer than three days without seeking to reconcile with others who have upset them and they always look at positive side of things. As mentioned by the scholars, all good behaviors are united in the quality of being forgiving.

According to Stone (2002), for employees to exhibit their talents and innovative skills, they need to feel a sense of freedom which could be experienced only if forgivingness is practiced in the workplace, and this enhances organizational performance. *Operationally, forgivingness refers to tolerating and leaving the burden of guilt and reciprocating evil with good towards those who have offended them in order to obtain the good pleasure of Allah.*

10. Belief in Allah (Iman Bil-Lah)

Iman provides the believers with the motives for self-examination and actualization, as it supplies the believers with the ability to realize their role in life. This role shall continue even after his death through his good deeds and good offspring. According to Ali (2005), belief in Allah signifies a deep realization of the unity of direction (*Tawhid*), clarity of goals, prevention of misconduct, and of equality between people. *Operationally, belief in Allah (Iman) implies being steadfast on Allah's course at the workplace whilst striving to achieve organizational goals and objectives.*

In view of these developments, this research hypothesizes; that *the determinants of Islamic Spirituality (IS) in the organizational context is explained by four dimensions of Rituals (Ibadat), Forgivingness (Al a'fw), Belief in Allah (Iman bil-lah) and Remembrance of Allah (Dkhikrullah).*

11. Research methodology

The technique of disproportionate stratified random sampling was applied in selecting the respondents of the study in three stages. In stage one, 50 Muslim majority companies in Malaysia (from the list of companies in Malaysia) were chosen at random. In the second stage, employees were grouped under two strata (Muslim and non-Muslim employees) in all 50 companies. In the third stage, Muslim employees (in all 50 companies) were picked at random to answer questionnaires for the main study. The total number of questionnaires distributed per company varies (disproportionate) owing to the size of the company and the total number of Muslim employees.

The questionnaire used for this consisted of 17 items. Owing to the sensitivity of this study with regard to examining the spirituality aspects of employees, the authors used a scale of "1 – Never" to "7 – Always." This is to provide respondents with ample flexibility in responding to the survey instrument. The instrument was translated from English to Bahasa Melayu by a Malaysian professional translator. To assess the credibility of the translation, a back-translation (Bahasa Melayu-English) of the same earlier translated document was given to another professional translator. It was found that both versions (original and the back-translated) were similar. The questionnaire was printed out with a coloured cover page with the logo of the International Islamic University Malaysia on it to attract respondents to the questionnaire.

To estimate the hypothesis put forward by this research, SPSS (version 18.0) for Principal component analysis (PCA) and AMOS (version 18.0) for confirmatory factor analysis (CFA) were used. Out of the 1000 questionnaires distributed, only 419 were returned, out of which 14 comprise of serious missing information (more than

25%) at various parts of the questionnaire. Following the guideline by the scholars (Sekaran and Bougie, 2010), these questionnaires were excluded from the total usable questionnaires. Also, out of the 405 total usable questionnaires left, only 9 questionnaires (approximately 2%) have two or three items unanswered.

Considering the fact that the scale used by this study satisfies the missing at random assumption (MAR) (i.e. the probability of missing data on a certain variable is independent on the values of that variable for the IS, ISR and OCBIP items), and the small number of missing values (2%), the similar response imputation approach was employed, whereby the researcher logically deduced a response to the few missing items. According to Wang, Sedransk and Jinn (1992), this approach is better than listwise, casewise, or the mean imputation method, especially when MAR assumption is satisfied and missing information is less.

12. Profile of respondents

The demographic results of respondents showed that, in terms of experience (duration in position), a total number of 173 (n=173) respondents (i.e., 42.7%) had work experience between 2 to 5 years, followed by respondents with 6 to 10 years of work experience, 19.3%. 17.3% of respondents had 1 year or less work experience, followed in percentage by respondents with 50 years and above work experience. Respondents with 11 to 15 years of work experience numbered the least (8.1%) among the group.

It was also noted from the demography results that the gender of respondents drawn from the survey was quite close, with male respondents constituting 50.9% and female respondents 49.1%. The age of respondents also show some sharp contrast, whereby majority of the respondents (up to 37.3%) were aged 31 to 40, which is considered the working class group. This is followed by respondents between 26 and 30. This type of respondents consists mainly of newly graduated students from the university who now join the company with high aspirations to build a career for themselves. This assertiveness to develop themselves and to succeed may have accounted for them responding more eagerly to the survey compared to other class groups. Next after this was the respondents aged 41 to 50 making up 15.6% of respondents aged below 25 (up to 10.1%) and last but not least, respondents 51 years old and above constituted up to 5.2%. This class of respondents (aged 51 years and above) was mostly composed of retired employees who were on consultancy services, or maybe old employees who were about to retire. This may have accounted for their small number partaking in the survey of this study as most consultants only visit the company at odd hours.

13. Dimensions of Islamic spirituality

The study aimed to identify the construct validity of IS on the basis of data collected from 405 respondents (n = 405) who were Muslim employees of companies in Malaysia. The dimensionality of the IS was sought through a principal component analysis (PCA) after which a confirmatory factor analysis (CFA) was conducted to confirm the dimensionality obtained through PCA.

14. Exploratory factor analysis (principal component analysis)

The PCA was to explore the underlying dimensions of IS within the Malaysian organizational context. First, the statistical assumptions of PCA were tested. The exercise revealed that a substantial number of variables were correlated ($r \geq .30$). In addition, the two measures for inter-correlations among variables supported the use of PCA. Bartlett's Test of Sphericity was statistically significant [$\chi^2 (136) = 3083.677, p = .001$], while the Kaiser-Meyer-Olkin (KMO) measure of the sampling adequacy (MSA) was .883, indicating that the inter-correlations were sufficient for PCA.

PCA with Varimax rotation was performed on the data collected. Four latent factors were extracted with eigenvalues greater than one, explaining 63.753% of total variance. Thus, the results show that four latent IS factors were successfully extracted on 17 variables. Table 1 shows that factor loadings are between .857 and .522. Following the guideline provided by the scholars (Byrne, 2010; Hair et al., 2010, Kline, 2011) to consider higher factor loadings and adequate number of items, all four factors were named

as rituals (*Ibadat*), forgiveness (*Al-a'fw*), belief (*Iman*) and remembrance of Allah (*Dhikrullah*), respectively.

The internal consistency of all the factors were obtained by computing the Cronbach's Alpha coefficient on the three extracted factors for IS that were retained by PCA. In view of the guidelines by researchers (Sekaran and Bougie, 2010), Cronbach's Alpha was employed to estimate the reliability of the extracted factors of the IS as presented in Table 1. All four factors [rituals (*Ibadat*), forgiveness (*Al-a'fw*), belief (*Iman*) and remembrance of Allah (*Dhikrullah*)] had good reliability indices of .819, .821, .712 and .821, respectively.

15. Construct validity of IS

This section presents the results of CFA to support the construct validity of IS. CFA was performed to examine the following hypothesis:

The hypothesized measurement model of Islamic Spirituality (IS) in the organizational context is explained by four dimensions, i.e. rituals (Ibadat), forgiveness (Al-a'fw), belief (Iman) and remembrance of Allah (Dhikrullah).

Table 1. Factor loadings and internal consistency of four rotated factors for IS.

IS	Item	Rituals (<i>Ibadat</i>)	Forgiveness (<i>Al-a'fw</i>)	Belief (<i>Iman</i>)	Remembrance of Allah (<i>Dhikrullah</i>)
4.	I encourage my co-workers to pray together at work	.784			
3.	I practice optional fasting	.751			
1.	Whenever possible, I encourage my co-workers to visit the prayer rooms for prayers	.748			
2.	I inspire my co-workers to fast and breakfast collectively	.704			
5.	When I am confronted with competing alternatives in decision making, I perform <i>istikhara</i> prayer	.703			
17.	I apologize for my mistakes when I realize them at work		.783		
13.	I ask forgiveness from my co-workers that I have wronged		.774		
14.	I deal with co-workers with justice and generosity		.766		
12.	I do my best in my work because Allah is watching me		.522		
16.	I stay away from haram acts in my work to avoid Allah's divine wrath			.724	
15.	I direct my dedication to Allah alone			.693	
10.	I do my best to perform all five prayers regardless of how busy I am			.661	
11.	I do my duties in the best way I could and leave the outcomes to be determined by Allah			.541	
6.	Whenever I pay my <i>zakat</i> , I make sure I calculate it correctly			.522	
8.	I supplicate Allah whenever I face difficulty in my work				.857
7.	I ask Allah to help me when I make important decisions at my work				.823
9.	Whenever I make a mistake I ask Allah's forgiveness				.647
Eigen Value		6.310	2.275	1.191	1.061
% of Variance Explained		37.117	13.385	7.007	6.244
Reliability (Cronbach α)		.819	.821	.712	.821
KMO (MSA)		.883			

16. Model specification

The four factors derived from the results of the PCA were hypothesized as the latent variables of IS. The hypothesized measurement model, as shown in Figure 1, contains the four latent variables loaded on 17 indicators. The first latent variable is Rituals (*Ibadat*), second latent variable is Forgiveness (*Al-A'fw*), third is Belief (*Iman*) and fourth is Remembrance of Allah (*Dhikrullah*). The internal consistencies of the four latent factors were .819, .821, .712 and .821, respectively, based on the data collected from 405 Muslim employees ($n = 405$).

The interrelationships among the 17 measures of IS were checked and it was shown that the indices were statistically significant (See Table 2). For normality, the use of AMOS (version 18.0) showed, through the indices of skewness and kurtosis, that there was no serious violation of the assumption of normality (thus, all values of skewness were negative and less than 0.1). Also, there was no outlier in the Mahalanobis distance (observations farthest from the centroid). This is the justification for the researcher's adoption of CFA to answer Question.

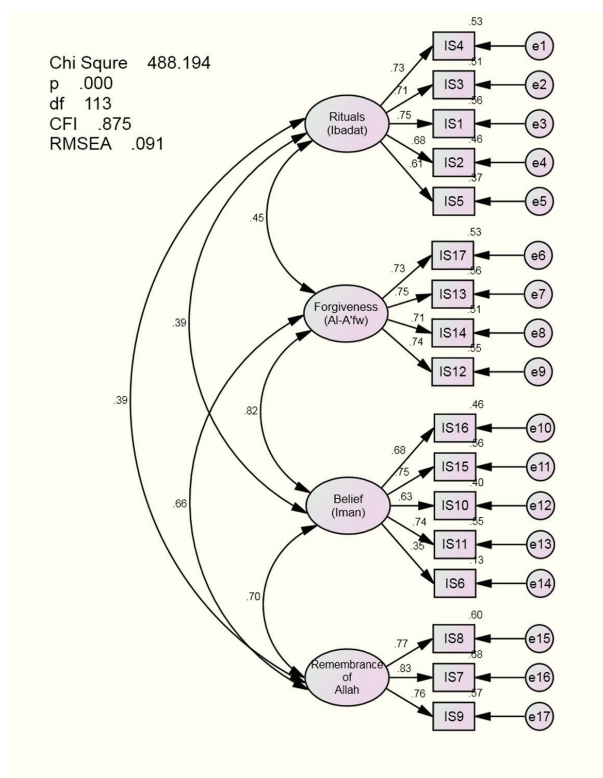


Figure 1. The hypothesized measurement model of the IS construct.

17. Model estimation

A CFA was performed on the data collected from 405 Muslim employees through AMOS (Version 18.0), using maximum likelihood (ML) estimation (Byrne, 2010). The measurement model of the four latent exogenous variables showed that the overall fit of the model was $\chi^2 (113) = 488.194$, $p = 0.000$, which was statistically significant, indicating an inadequate fit between the covariance matrix of the observed data and the implied covariance matrix of the model.

Other indices of model fit were also used following the guideline by the scholars (Byrne, 2010; Hair et al., 2010) whereby at least one absolute fit index and one incremental fit index was used in addition to the χ^2 statistic and the associated degree of freedom. Following this guideline, the normed chi-square (i.e. CMIN/DF), the Comparative Fit Index (CFI) and the Root Mean Square Error of Approximation (RMSEA) were adopted in estimating the model in addition to the χ^2 statistic and the associated degree of freedom.

The CFI was found to be 0.875, which is below the threshold value of 0.92 (Hair et al., 2010). Also, the Normed chi-square was 4.32, which is above the acceptable ≤ 3 cut-off. Similarly, the RMSEA value for the hypothesized model was .091, thus, falls outside the acceptable range of .05 and .08. However, the values of loadings for the observed variables of the model ranged from .35 (IS6) to .83 (IS7), which were all statistically significant. Accordingly, the fit indices presenting the overall fit of the model were not encouraging as the normed chi-square, CFI and RMSEA were not found to be within their various acceptable limits.

Owing to the less encouraging data-model fit, the study sought a better-fit model. Careful examination of indicators with lower loadings was carried out. A total of five indicators were found to be problematic and were excluded from the model, doing which improved the goodness-of-fit of the model. These items include: item IS6 loading .35 on the belief latent variable, item IS16 loading .68 also on the belief latent variable, item IS5 loading .61 on the rituals latent variable, item IS3 loading .71 also on the rituals latent variable and item IS17 loading .73 on the forgiveness latent variable.

In addition, post hoc model modification indexes were examined in order to identify a more parsimonious model. The model was re-estimated, and three inter-correlations among six errors were freed based on the suggestions of the parameter of Modification Indices (MIs). The following connections were established: error 9 (item IS12) and error 13 (item IS11); error 11 (item IS15) and error 15 (item IS8); and error 15 (item IS8) and error 16 (item IS7). These connections were allowed to co-vary to reduce the total amount of 361.996 chi-square and hence, increase the fit indices. These inter-correlations were supported methodologically through the use of AMOS and theoretically because the two elements of measurements errors were correlated, showing commonalities among pairs of observed behaviors.

Table 2. Inter-variable correlation, mean and standard deviation of IS items.

	IS1	IS2	IS3	IS4	IS5	IS6	IS7	IS8	IS9	IS10	IS11	IS12	IS13	IS14	IS15	IS16	IS17
IS1 Pearson Correlation	1																
Sig. (2-tailed)																	
N	405																
IS2 Pearson Correlation	.572**	1															
Sig. (2-tailed)	.000																
N	405	405															
IS3 Pearson Correlation	.498**	.452**	1														
Sig. (2-tailed)	.000	.000															
N	405	405	405														
IS4 Pearson Correlation	.584**	.472**	.502**	1													
Sig. (2-tailed)	.000	.000	.000														
N	405	405	405	405													
IS5 Pearson Correlation	.343**	.366**	.551**	.469**	1												
Sig. (2-tailed)	.000	.000	.000	.000													
N	405	405	405	405	405												
IS6 Pearson Correlation	.275**	.191**	.293**	.276**	.402**	1											
Sig. (2-tailed)	.000	.000	.000	.000	.000												
N	405	405	405	405	405	405											
IS7 Pearson Correlation	.240**	.242**	.270**	.134**	.221**	.197**	1										
Sig. (2-tailed)	.000	.000	.000	.007	.000	.000											
N	405	405	405	405	405	405	405										
IS8 Pearson Correlation	.207**	.110*	.206**	.091	.111*	.149**	.689**	1									
Sig. (2-tailed)	.000	.027	.000	.068	.025	.003	.000										
N	405	405	405	405	405	405	405	405									
IS9 Pearson Correlation	.314**	.289**	.298**	.219**	.282**	.229**	.598**	.550**	1								
Sig. (2-tailed)	.000	.000	.000	.000	.000	.000	.000	.000									
N	405	405	405	405	405	405	405	405	405								
IS10 Pearson Correlation	.218**	.050	.232**	.182**	.123*	.219**	.355**	.372**	.392**	1							
Sig. (2-tailed)	.000	.313	.000	.000	.013	.000	.000	.000	.000								
N	405	405	405	405	405	405	405	405	405	405							
IS11 Pearson Correlation	.220**	.175**	.232**	.195**	.248**	.274**	.433**	.412**	.511**	.452**	1						
Sig. (2-tailed)	.000	.000	.000	.000	.000	.000	.000	.000	.000	.000							
N	405	405	405	405	405	405	405	405	405	405	405						
IS12 Pearson Correlation	.264**	.246**	.284**	.208**	.257**	.230**	.433**	.369**	.547**	.486**	.676**	1					
Sig. (2-tailed)	.000	.000	.000	.000	.000	.000	.000	.000	.000	.000	.000						
N	405	405	405	405	405	405	405	405	405	405	405	405					
IS13 Pearson Correlation	.292**	.251**	.282**	.261**	.277**	.224**	.383**	.297**	.469**	.377**	.444**	.513**	1				
Sig. (2-tailed)	.000	.000	.000	.000	.000	.000	.000	.000	.000	.000	.000	.000					
N	405	405	405	405	405	405	405	405	405	405	405	405	405				
IS14 Pearson Correlation	.140**	.192**	.158**	.136**	.153**	.208**	.332**	.254**	.384**	.330**	.487**	.504**	.574**	1			
Sig. (2-tailed)	.005	.000	.001	.006	.002	.000	.000	.000	.000	.000	.000	.000	.000				
N	405	405	405	405	405	405	405	405	405	405	405	405	405	405			
IS15 Pearson Correlation	.192**	.149**	.165**	.135**	.115*	.195**	.381**	.450**	.423**	.493**	.535**	.491**	.310**	.437**	1		
Sig. (2-tailed)	.000	.003	.001	.007	.021	.000	.000	.000	.000	.000	.000	.000	.000	.000			
N	405	405	405	405	405	405	405	405	405	405	405	405	405	405	405		
IS16 Pearson Correlation	.225**	.173**	.191**	.196**	.171**	.303**	.283**	.303**	.378**	.426**	.431**	.412**	.332**	.400**	.617**	1	
Sig. (2-tailed)	.000	.000	.000	.000	.001	.000	.000	.000	.000	.000	.000	.000	.000	.000	.000		
N	405	405	405	405	405	405	405	405	405	405	405	405	405	405	405	405	
IS17 Pearson Correlation	.264**	.287**	.237**	.181**	.228**	.203**	.410**	.275**	.446**	.266**	.422**	.463**	.628**	.536**	.423**	.423**	1
Sig. (2-tailed)	.000	.000	.000	.000	.000	.000	.000	.000	.000	.000	.000	.000	.000	.000	.000	.000	
N	405	405	405	405	405	405	405	405	405	405	405	405	405	405	405	405	405
Mean	4.36	3.93	3.64	3.43	3.13	4.48	6.09	6.28	5.82	6.16	6.02	5.91	5.45	5.82	6.19	6.18	5.77
Standard Deviation	1.77	1.75	1.46	1.72	1.81	1.91	1.14	1.08	1.28	1.27	1.08	1.10	1.32	1.03	0.99	1.11	1.13

* Correlation is significant at the 0.05 level (2-tailed). ** Correlation is significant at the 0.01 level (2-tailed).

18. The revised model of IS

As indicated in Figure 2, the goodness of fit indices show that the overall fit for the revised model was consistent with the data. The chi square statistic was statistically significant [$\chi^2 (45) = 126.198, p = 0.000$], implying that there is no difference between the covariance matrix of the observed data and the implied matrix of the revised model.

However, the revised model fits the observed data, since the value of the normed chi square (CMIN/DF) was 2.80, the cut off recommended by statisticians is ≤ 3 for χ^2/df to reflect good fit for the model (Hair et al., 2010). Similarly, other fit indices showed good indicators for the revised model (CFI = .960 and RMSEA = .067). Following the guideline by the scholars (Byrne, 2010; Hair et al., 2010), for the complexity of this model (i.e. four latent constructs, 12 total indicators and 405 sample size (n = 405), CFI threshold of more than .92 and RMSEA threshold of less than .07 reflects a good fitting model.

In addition to this, the parameter estimates were also examined and were found them to be statistically significant (See Figure 2). They were free from any offending estimates and showed logical direction. Also, the squared multiple correlations (SMC) provided reasonable values to explain the variance in the 12 observed variables, ranging from .731 (IS9) to .394 (IS10) (See Table 3).

Table 3. Squared multiple correlation (SMCs) of items in the revised model.

	Estimate
IS9	.731
IS7	.497
IS8	.410
IS11	.579
IS10	.394
IS15	.469
IS12	.611
IS14	.462
IS13	.483
IS2	.473
IS1	.705
IS4	.474

Table 4. Goodness-of-fit, parameter estimates and variance explained for the hypothesized model and the revised model.

Fit indices	Model comparison	
	Hypothesized model	Revised model
Model Chi-square (χ^2)	488.194	126.198
P value	.000	.000
CMINDF (χ^2/df)	4.32	2.80
CFI	.875	.960
RMSEA	.091	.067

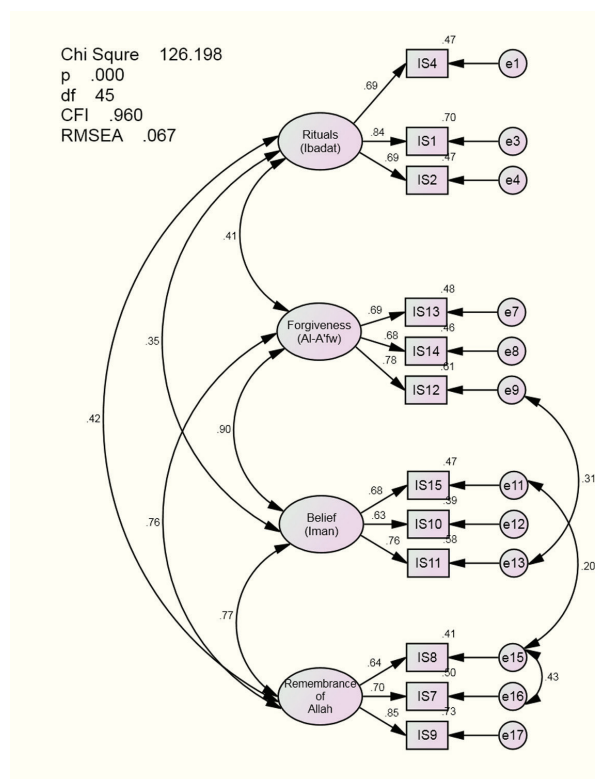


Figure 2. The fit indices of the revised model of the IS construct.

19. Comparison between the hypothesized model and the revised model

It is worth noting from Table 4 that the hypothesized model did not show encouraging goodness of fit indices; the χ^2 value was statistically significant ($\chi^2=488.194, p=.000$), which implies that there was different between the two matrices for the observed sample and implied population. Other indices also did not show reasonable fit, i.e., CFI (.875), and RMSEA (.091).

The revised model also showed a significant chi square statistic owing to the large sample size (n=405) ($\chi^2 = 126.198, p = .000$). However, other fit indices showed that the revised model has a good data model fit, i.e. CMINDF (2.80), CFI (.960), and RMSEA (.067).

20. Relevance of findings to sustainable growth and economic development

The findings from the present empirical study are quite relevant towards sustaining growth and improving economic development. As posited by economists and business researchers, sustainable growth for one, cannot be possible without paying heed to the twin cornerstones of growth strategy and growth capability (Sowinski, 2006). Companies that are unable to balance their efforts in these

areas are tantamount to failure in their efforts to sustainable growth and overall economic development practices.

It is worth noting, that the employees of a particular company form an integral part of its development in all facets of organizational goal achievements, from analysis of growth strategy, through formulation and to implementation of the strategy. These in turn lead to growth capability which can go a long way towards increasing the company's competitive advantage with which the company stands a high chance of outcompeting its rivals. In other words, no matter how excellent a growth strategy or economic development strategy or Islamic economic model is, it remains a mere promise on paper without the necessary qualified and highly motivated workforce to materialize it.

In view of this, the present empirical research has shown that Muslim employees who in most cases dominate Muslim corporate organizations in Muslim nations in particular, need a unique aspect of motivation which comes through realizing the cornerstones of their spirituality. Increasing the understanding towards employees' Islamic spirituality and their values, and making attempts to create awareness to it can lead Muslim employees to portray all positive behaviors at the workplace. Non Muslim employees may also benefit from this study as it may increase their awareness of the values of their Muslim co-workers, respecting which will lead to mutual co-existence and increased understanding at the workplace, which can lead to sustainable growth and overall economic development in the organization. With highly motivated employees equipped with a sense of purpose in life as shown via the determinants of Islamic spirituality, thus, rituals, forgivingness, belief in Allah and the remembrance of Allah, the formulation and implementation of growth strategies and capabilities can be realized.

21. Conclusion and recommendation for further research

In the recent times, most research on spirituality was conducted from the Judeo-Christian and Hinduism faiths. What has not been explored sufficiently in this field is the potential of looking at the spirituality in the workplace phenomenon from other socio-cultural and religious contexts, and specifically from the Islamic perspectives. This study, therefore, has sought to narrow this research gap by attempting to develop and present new knowledge through the findings from an empirical study of important issues pertinent to Islamic spirituality.

It has particularly focused on some relevant aspects of spirituality in the Qur'an and the prophet tradition, which represent the viewpoints of one of the major religions of the world, i.e., Islam. Due to this, the study has played a pioneering role into determining the determinants of Islamic spirituality from the two major sources of knowledge: *Qur'an* and the *Sunnah*, which when followed are expected to result in higher levels of outcomes. Conducting this empirical study has led to the major finding that Islamic spirituality in the organizational context is explained by its four determinants, namely, rituals (*Ibadat*), forgivingness (*Al a'fw*), belief in Allah (*Iman bil-lah*) and remembrance of Allah (*Dhikrullah*).

Economists, business researchers and human resource development scholars and professionals may use the findings of this research to rationalize their efforts in designing, developing, and implement appropriate learning and performance improvement interventions, so that Islamic spirituality could be improved incessantly among Muslim employees. This could lead to attaining high ethical and moral values of employees that might control many undesirable behaviors, such as greed, corruption, disobedience, etc., of employees that are negatively affecting contemporary organizational performance.

In addition, non-Muslim professionals and employees can also take relevant initiatives in this regard. Particularly, the research finding will provide new insights to the people of other faiths in proper understanding Muslim employees' values and spiritual inclinations. The increased understanding of the values and organizational perspectives of people from various faiths will help in developing increased tolerance among members of increasing multi-cultural, multi-religious organizations of today's changing social and business environments.

In the future, this research could be replicated in other contexts (other Muslim majority countries with different socio-cultural values), and study the impact of several contextual variables in this regard. Since this is the first research on the contemporary issues of Islamic religion and spirituality, findings from this study may trigger more research interests among the current and future scholars who might be interested in this field.

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Corporate governance of Islamic financial institutions in Malaysia

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Abstract - Given the phenomenal increase in Islamic banking activities globally, it is important that there exists good governance practice around Islamic financial institutions (IFIs). This is primarily to ensure its sustainability in the long run. More importantly, in order for Islamic banks to play an optimum role in the development of Islamic countries, it is pertinent to develop regulatory structures to control fraud, exploitation, and un-Islamic behavior. Additionally, the development of strong governance practices will win public confidence and thereby promote trust amongst equity holders, investors and other parties dealing with these IFIs. However, promulgating and developing standards and guidelines on corporate governance (CG) may not be adequate. What is needed is to examine the extent IFIs are actually following such guidelines. This is precisely what we have attempted to do. There are two stages to the study. A disclosure index is first developed using the guidelines issued by the Central Bank of Malaysia (BNM), the standard on CG promulgated by the Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI) and the framework introduced by the Islamic Financial Services Board (IFSB). The index developed in the first stage is then used to assess the annual reports of all 16 IFIs operating in Malaysia. This paper reports on the second stage of the study. The results do not appear too promising. On a scale of 0 to 100, the CG disclosure index ranges from a low of 42.28 to a high of 68.29, with the average score hovering around 51.42. The implications of the results, the limitations of the study and suggestions for future research are also discussed.

Keywords: Islamic financial institutions (IFIs), corporate governance, general governance guidelines, specific governance guidelines, Malaysia

1. Introduction

A series of corporate failures of “giant” corporations worldwide (e.g., Enron, Tyco, Worldcom, Pharmalat, etc.) has shaken the confidence and trust of stakeholders. Consequently, this has brought increasing attention to corporate governance (CG) issues. Increasing CG disclosures in annual reports may be interpreted as a way by which companies try to secure the level of confidence and trust of its stakeholders. More importantly, the issue of transparency has now become pertinent. Bhat, Hope and Kang (2006) opine that the knowledge of a firm’s governance practices is useful in assessing the credibility of financial information presented in its annual report. This is because governance-related disclosure aids users in assessing the quality of information and guides stakeholders in more accurately setting expectations about the future of an organization’s performance. Specific to Islamic banking,

one observes a proactive stance on the part of regulators to improve the regulatory and supervisory framework in supporting higher CG standards for Islamic financial institutions (IFIs). Given the uniqueness of IFIs, an international guideline developed by OECD or the Cadbury Report may not address CG issues of IFIs, as governance structures are industry specific (Adam and Mehran, 2005).

In line with the global focus on CG, various regulatory bodies for IFIs have moved a considerable distance toward improving the regulatory and supervisory framework in developing higher CG standards. The CG Guidelines and standards issued by the Accounting and Auditing Organizations of Islamic Financial Institutions (AAOIFI), the Islamic Financial Services Board (IFSB) and the Central Bank of Malaysia (BNM) are some examples. These guidelines may well assist IFIs to establish their

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governing structures. Consequently, such guidelines may improve the governance practices of IFIs and thus enhance its transparency. However, promulgating and developing standards and guidelines on CG are insufficient. What is needed is to examine the extent IFIs are actually complying with such guidelines. This is precisely what the study attempts to do. Specifically, this research will examine CG disclosure practices of IFIs in Malaysia using a two-stage process. The first stage is the development of a comprehensive CG index. Consistent with prior studies, the index acts as a proxy for disclosure quality. The comprehensive corporate governance disclosure (CGD) Index used in this study is based on three governance guidelines and codes promulgated by AAOIFI, IFSB and the Central Bank of Malaysia (later on collectively referred as “Guidelines”). The CG index developed is then used to assess the quality of CG of IFIs in Malaysia. This constitutes the second stage of the study, which is the focus of this paper.

The study contributes to the literature in several important respects. The use of a comprehensive index to examine CG practices of IFIs in Malaysia will greatly enhance the literature on CG in IFIs. Second, the CG index developed from three recently released governance guidelines available to IFIs (2006, 2007 and 2008) speaks of the currency of the research. Finally, the division in terms of general and specific governance related information, to the authors’ knowledge, is a first in studies concerning CG and IFIs. Understanding the quality of CG disclosure by examining its extent and focus is a fundamental starting point in gaining insights into the preference of IFIs on CG disclosure information. The remainder of the paper is structured as follows: The following section discusses the literature review while section 3 focuses on the theoretical framework of the study. Section 4 describes the data collection and the findings, while section 5 concludes.

2. Literature review

Corporate governance (CG), broadly defined, is a set of processes, policies and laws affecting the way an organization is directed, administered and controlled. Bansuch, Pate and Thies (2008) defined CG as a set of formalised values and procedures implemented by the owners, directors and the management of the business in its various operations as well as its interactions with stakeholders. Holder-Webb, Cohen, Nath and Wood, (2008) defined CG as the provision of effective boards, strong shareholder rights, and broad disclosures in managing a business. From the perspective of IFIs, governance specifically addresses issues pertaining to the role and conduct of the *Shariah* Supervisory Boards (SSB). More specifically, CG of IFIs should include the following:

- i. Safeguarding interests of investment account holders
- ii. Compliance with *Shariah*
- iii. Governance and risk management of Mudaraba and Musharaka contracts
- iv. Establishment of a comprehensive CG framework articulating the fiduciary responsibilities of the board and senior management

A focus on all the above will lead to an improvement in the level of trust and confidence in the Islamic finance industry

(Iqbal and Greuning, 2008). More importantly, AAOIFI claims that strong governance practices will win public confidence and thereby promote trust amongst their equity holders, investors and other parties dealing with them. Subsequently, this would enhance *Shariah* compliance.

In order to examine if indeed there exists differences between CG of IFIs and other organizations, it is important to understand what are the unique characteristics of IFIs in the first place. The uniqueness of IFIs emanates from its fundamental principle to conduct its operations in accordance with Islamic *Shariah*, the primary issue being the prohibition of the receipt and payment of *riba* (interest). A pre-determined fixed rate of return on capital – where one party bears the risk while the other party receives a reward irrespective of the outcome of the use of the borrowed amount—would mean an uneven distribution of risk and reward in the transaction. More importantly, *riba* also leads to the concentration of wealth by transferring wealth from the poor to the rich. This is primarily why *riba* is prohibited. The alternative to avoid dealing with interest is the various forms of profit-sharing contracts that are peculiar to Islamic banking. These contracts are said to enhance justice and equitable distribution of profits and risks in investment (Bashir, 1984).

Archer and Karim (2007) identified two main types of accounts offered by IFIs to mobilize funds from its customers. The first is the profit-sharing and loss bearing *mudharabah* contract. This type of limited duration investment account is distinct from equity shares. The relationship between the investment account holders (IAH) and the bank is that of a provider of funds and a fund manager. More importantly, there is a transfer of control over investment decisions from the IAHs to the bank as a *mudharib*. Thus, the IAHs have no right to intervene in the *mudharib*’s decisions over the funds. Further, IAHs do not possess any right of governance or oversight, making this a unique feature of IFIs and IAHs. This then gives rise to the importance of proper governance procedures in order to ensure that the rights of IAHs are not compromised. In the absence of a right to manage, the only choice possible to IAHs is the right to withdraw their funds when there is dissatisfaction in the bank’s performance. Udovitch (1970) argued that in a *mudharabah* contract, the bank as a *mudharib* acts as a steward with respect to the capital entrusted to him. As such, the bank is not liable for any losses occurring in the normal course of business and if there is no negligence (Archer and Karim, 2007: 315).

Another major issue pertinent to IFIs is the need for IFIs to balance financial performance with ethical behavior. The latter provides an incentive to disclose specific-governance information, which may not necessarily attribute to financial outcomes, but could moreso serve the purpose of attaining fairness and equity for a wider group of stakeholders. In several important respects, the specificities of IFIs impact how CG should be structured. According to Erricco and Farahbaksh (1998), depositors of Islamic banks have more incentive to assess the performance of banks because their capital value and returns on investment deposits are not fixed and guaranteed. The outcomes of their investment depend on the bank’s performance in investing depositors’ funds. Indeed the incentive for depositors to scrutinize the performance of banks is to ensure protection of the capital value of their funds as well as to ensure that

the rates of return paid to them reflect a fair application of the Profit and Loss Sharing (PLS) principles (Erricco and Farahbaksh, 1998:14).

Lewis (2005) contends that there are two aspects that give shape to the nature of Islamic corporate governance (ICG). The first aspect is the *Shariah*. *Shariah* claims sovereignty over all aspects of human life, including ethical and social matters. Thus, every act of believers must conform to *Shariah* and ethical standards derived from Islamic principles. The ethical principles defined what is true, fair and just, the nature of corporate responsibilities, and the priorities to society, along with some specific governance standards. Ethical production and distribution are regulated by the halal-haram code and adhered to the notion of “*adl*” (justice). The second aspect is the specifics of Islamic economics and financial principles. For example, issues such as *zakah* (the alms tax), the ban on *riba* (usury) and the prohibition on speculation have a direct impact upon corporate practices and policies.

Specific to the appointment of the board of directors, Chapra (2007) identified three matters of importance. The first pertains to the need for board members to possess a high degree of moral integrity and professional competence in the banking business. These qualities may help them to effectively perform their expected duties toward the institutions. Second is to ensure that the board member is well-versed in *Shariah* matters concerning Islamic banking. Finally, board members must make sure that there is adequate transparency in the disclosure of activities of IFIs. More specifically, IFIs must adhere to guidelines/standards laid down by the supervisory authority of the country. In Malaysia, for example, the guidelines issued by the Central Bank of Malaysia would rank supreme.

Hameed and Sigit (2005) conducted a comparative study of CG disclosures in annual reports of Malaysian and Indonesian IFIs between the period of 2000 and 2003. A CG disclosure index developed important issues related to IFIs, such as the internal *Shariah* review; social responsibilities for stakeholders; bases for profit allocation between owner equity and IAHs; the PER (profit equalization reserve); IRR (investment risk reserve), and the SSB. The score obtained for each bank was rated using the rule of classification suggested by Irwanto (2002). Irwanto (2002) grouped the scores into four (4) categories: 81–100 (very informative); between 66 and 81 (sufficiently informative); between 51 and 66 (less informative) and between 0 and 51 (not informative). Overall, there was an increasing trend of CG disclosures for both Malaysian and Indonesian IFIs from 2000 to 2003. Additionally, the scores for Malaysian IFIs were higher, ranging from “not informative” to “sufficiently informative” (a score between 0 and 81). On the other hand, scores for IFIs in Indonesia range from 0 to 51 (not informative). What comes as a surprise is the fact that none of IFIs disclosed specific items that are unique to them, such as internal *Shariah* review and bases for profit allocation between owner equity and IAHs.

Hassan and Christopher (2005) examined corporate governance disclosure of one IFI in Malaysia. The study was unable to offer an extensive list of governance requirements due to the limited number of governance guidelines for

IFIs at the time the study was undertaken. They argued that IFIs operate on a different set of rules to comply with the requirements of the *Shariah*. Specifically, IFIs, to meet the expectations of the Muslim community, must provide financing that accords with *Shariah*. As indicated earlier, because of the prohibition of *riba*, the PLS contracts are prevalent in IFIs. This suggests a different relationship from those offered by conventional banking. In line with this argument, the authors inferred that IFIs should be selective with regards to the appointment of board members and managers in terms of specific qualification requirements. Emanating from the notions of unity in Islam, universal brotherhood, trust and accountability in *Shariah*, IFIs are expected to provide greater transparency in disclosure (Hassan and Christopher, 2005).

3. Theoretical framework

The theoretical framework of this study merely concentrates on the quality of CG information disclosure practices by IFIs in Malaysia. It focuses on examining the extent that CG information is disclosed by IFIs and the difference of CG disclosure quality between local and foreign owned IFIs in terms of their preference to prioritize either specific or general kinds of governance information in their annual reports in 2009. More specifically, the primary objective of this study is thus to examine the quality of CG disclosure provided by IFIs in Malaysia in their annual report. Figure 1 below presents the research framework.

The stewardship theory was chosen as a framework for this study on account of the contextual characteristics of IFIs. Contextually, the multifaceted objectives, which focus on more than just economic factors, include having an ideal composition of board structure supported by strategic board committees – nominating, remuneration, risk management, and audit. The good structure of these elements supports proper accounting for risk, handling effective internal control systems, related parties transactions, an adherence to issued guidelines, and the production of various management reports for achieving operational efficiency among IFIs. However, the integration of the PLS mechanism in the basic operation and the ethical conduct of business attached to the “ultimate goal of Maqasid *Shariah*” (Bhatti and Bhatti, 2009:72) of the Islamic financial industry has been perceived as being in the best interests of the group, as opposed to individual financial rewards. This context means accountability to a broader group of the community (*ummah*). The essence of Maqasid *Shariah* substantially curbs any endeavour to acquire wealth by unlawful means, which leads to social inequality and social waste (Bhatti and Bhatti, 2009). As such, the governance structure in IFIs should include the establishment of a *Shariah* and governance committee, the performance of an internal *Shariah* review as an assurance of continuous *Shariah* compliance and the provision of relevant information intended to govern the relationship with IAHs.

The first type of governance information targeted operational efficiency, which is common in all kinds of governance entities. However, the second type of governance information is to pursue and exclusively secure the attainment of goals set by Maqasid *Shariah*. The concern for both types of governance information by stewards may be seen as an equilibrium response to the wide

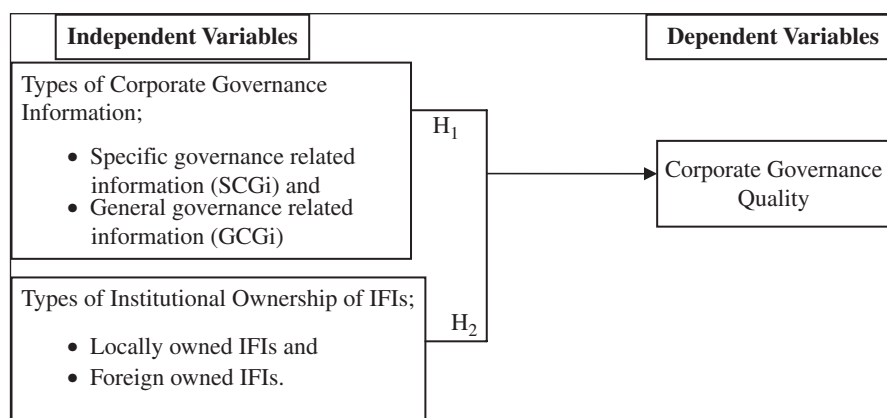


Figure 1. Research framework.

spectrum of an institution's obligation to commercial and religious affairs. The two types of governance information are: GCGi (general CG information), which is related to institutional efficiency in operation, and SCGi (specific CG information), which is related to the type of activities to protect the proper application of *Shariah* requirements. The SCGi is of particular importance as the philosophy of Islamic financial business dealings, as enshrined by the *Shariah*, promote relatively greater reliance on the equity (*Mudharabah* and *Musyarakah*) or the PLS modes of financing (Chapra and Ahmed, 2002:1). In such arrangements, IFIs and their stakeholders (particularly IAHs) become partners in the relationship. In such a relation, the partnership attributes (i.e., commitment, coordination and trust) and communication behavior are vital as determinants of the successful relationship between partners.

Based on the stewardship theory, the emphasis is on coordination where the relationship is based on trust and personal power (respect and expertise) (Davis et al., 1997). As stewards, the managers and directors of IFIs need to focus on managing the interaction process with their wide array of stakeholders by "increased value commitment and identification" (Davis et al., 1997). This ultimately aims at creating trust and enhancing goal alignment between the IFIs and their stakeholders. The establishment of CG information in the annual report, in particular the SCGi, is argued to be a direct expression of IFIs to gain the trust of stakeholders. Once confidence is achieved, it facilitates the collaboration and serves as an important lubricant of the social system (Sundaramurthy and Lewis, 2003) between IFIs and their stakeholders.

The application of a liaison device such as communication also enables firms to establish mutual understanding and cooperation. This is in line with the general theme of Islamic social order, which emphasises cooperation and mutual consultation (*Shura*) (Sulaiman, 2005: 22). This study proposes that the means of building shared understanding among managers, directors and executives with their stakeholders is through communication. Such disclosure may include the presentation of respective governance concerns and contributions (i.e., GCGi and SCGi) about the risks that they can assume through

their involvement with the institutions to regulators and other stakeholders. This approach can provide a basis for dialogue between the firms and stakeholders, as they can evaluate the appropriate disclosure to match their expectations. Under the implicit assumption of stewardship theory, the study hypothesizes that the tendency of IFIs is to prioritize specific kinds of governance information (H1) as it is considered an expression by IFIs attempting to gain trust from their stakeholders. Furthermore it is directed to achieve goal alignment based on shared culture and norms strictly followed the requirements made in *Shariah*.

Theoretically, the PLS system practiced in IFIs is inextricably intertwined with collectivism spirits promoted in *Shariah* requirements. In this arrangement, management of IFIs are beneficiaries of trust. Similar claims were made by Bundt (2000:761) that "the principal-stewardship relationship depends on trust, where trust in this relationship is the expectation that the other will act in good faith in situations in which that party has the power to affect one's own interests." By adopting the stewardship perspective, this study expects that the management of IFIs would voluntarily adopt activities that can enhance the trust of stakeholders to enter into collaboration with IFIs.

The underlying ideas in reference to their focus on governance related information is that GCGi is usually pursued with the aim of maximising the financial performance of the banks. Meanwhile, the specific-governance information, which may not be directly related to the financial implications for the banks, might be important to serve as a basis "to build trust, elicit cooperation and create a shared vision amongst those involved in the firms" (Lewis and Algaoud, 2001:160). As the theory assumes that the steward possesses of a high value commitment, Bundt (2000:761) argued that,

"the principal must believe that the steward will make decisions in the best interests of the organization and will be capable of carrying the decisions out. Failure to meet this condition may constrain the steward—either literally by rules and regulations or psychologically by demoralization."

This argument may partly clarify the claim made by Brown and Caylor (2006), who stated that governance matters, which are unrelated to firm value (in such case, SCGi does not necessarily directly contribute to economic enhancement), might be of importance for other purposes, such as for the case of IFIs. As the IFIs alter their policies to exactly match the intrinsic organizational motivations with their stakeholders' of creating a shared portfolio focusing on the preferred mix of financial and religious issues in business affairs.

Drawing on a simple steward and principal model, this study hypothesizes that firms will be particularly motivated to disclose specific-governance related information as and when they realize that these elements are the antecedent of their trustworthiness to guarantee their accountability towards the fair operation of the banks. Thus, the following hypothesis is formulated.

H1: IFIs will disclose more specific-governance related information (SCGi) compared to general-governance related information (GCGi).

Additionally, under the implicit assumption of stewardship theory, the study hypothesizes that foreign owned IFIs have a broader group of community (ummah). Foreign owned IFIs are likely to make more disclosure relating to governance information as their status to put them in a position to adopt foreign governance guidelines in addition to domestic standards to attract the confidence of stakeholders both at home and abroad. This study argues that foreign owned IFIs will exhibit different levels of compliance to the Guidelines (hence CGD quality) to reflect the different quality of governance, which is dependent upon their operational specificity and motivations. It is an expectation that the roles played by foreign IFIs in the global marketplace also contribute to the disparity of their CG quality. The twin roles of institutions operating in foreign countries as identified by Kim, Prescott and Kim (2005), are that of specialized contributor and local implementer. These roles are assumed to have an effect on the stewardship objective of managing the IFIs interactions with their wider range of stakeholders, hence, the quality of their governance reporting.

As a specialized contributors, foreign banks are highly dependent on the global scale of stakeholders. As the case may be, the foreign banks may be subjected to close supervision by the headquarters (if they are subsidiaries) or the regulators of their origin countries. Thus, this study assumes that foreign banks are also affected by the standards and guidelines applied to headquarters for control purposes. Regulators in their country of origin may impose rules on foreign banks, which might not be the same as the rules of the domicile country. The tendency to adopt several standards in addition to the domestic guidelines is highly likely for foreign banks. Thus, this study assumes that higher governance information disclosure can be expected from foreign banks.

Porter (1986) argued that being local implementers, foreign banks seek to "meet unusual local needs in products, channels, and marketing practices in each country" (Kim et al., 2005: 50). As a result, this study assumes that foreign banks might comply with domestic governance guidelines

as well as they are able. This approach can be seen as an effort by foreign owned banks to gain the trust of the local regulators concerning their capability to suit the local needs. Thus, it is an assumption of this theory to expect to see more CG disclosures in annual reports of foreign owned IFIs as compared to their local counterparts. On the basis of the above argument, the following hypothesis is developed.

H2: The quality of corporate governance of foreign owned banks is likely to be of better quality than that of locally owned banks.

4. Data collection and findings

The index

A comprehensive CG index was first developed using the guidelines issued by the Central Bank of Malaysia (BNM), the standard on CG promulgated by the Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI) and the framework introduced by the Islamic Financial Services Board (IFSB). Altogether there were 123 items grouped into 14 dimensions as follows:

D1: Board structure and functioning	(D1–1:21)*
D2: Nominating committee	(D2–25:32)
D3: Remuneration committee	(D3–33: 41)
D4: Risk management committee	(D4–42: 49)
D5: Audit committee/audit and governance committee	(D5–50: 61)
D6: <i>Shariah</i> committee/ <i>Shariah</i> supervisory board	(D6–62: 76)
D7: Risk management	(D7–77: 85)
D8a and 8b: Internal audit and control	(D8–86: 93)
D9: Related parties transaction	(D9–94: 95)
D10: Management report	(D10–96: 97)
D11: Non-adherence to guidelines	(D11–98: 99)
D12: Customers/investment account holders	(D12–100: 113)
D13: <i>Shariah</i> committee	(D13–114: 119)
D14: <i>Shariah</i> compliance	(D14–120: 123)

*Items in brackets denote the number of items in the dimension.

The maximum score that IFIs can achieve is 123 items. Disclosing all 123 items will indicate full compliance with the CGD Index. Further, in order to examine if IFIs are actually disclosing items that reflect their unique nature, the present study divides the dimensions into two specific categories: general-governance related information (GCGi) and specific-governance related information (SCGi). The former (i.e., GCGi) comprises D1 (board structure and functioning), D2 (nominating committee), D3 (remuneration committee), D4 (risk management committee), D5 (audit committee or audit and governance committee), D7 (risk management), D8 (internal audit and control; (a) general-governance information and (b) specific-governance information), D9 (related parties transaction), D10 (management report), and D11 (non-adherence to guidelines). These dimensions are oriented towards the achievement of operational efficiency to lead to an achievement in economic objectives. The SCGi

consists of D6 (*Shariah* committee or *Shariah* supervisory board), D12 (customers/investment account holders), D13 (governance committee), and D14 (*Shariah* compliance). These dimensions extend the orientation towards the realization of ethical and socially corporate values through the application of partnership-based business principles. The split into 10 dimensions of general-governance related information, and 4 dimensions of specific-governance related information, provides an opportunity to understand the inclination of the type of CG information being disclosed by IFIs in Malaysia. Specifically, the CG information (SCGi) constitutes dimensions that align with the unique characteristics of IFIs, such as *Shariah* compliance, *Shariah* committee, Governance committee (specifically indicated in the IFSB guidelines) and Investment Account Holders (IAH).

5. The results

We examined the annual reports of 16 IFIs in Malaysia; 10 local banks and 6 foreign owned banks. Content analysis was used to determine the extent IFIs comply with the index. A score of “1” was given if a particular item was reported, and a score of “0” if the item was not included in the annual report. A CGD Index score, consistent with Pahuja and Bhatia (2010), was then computed using the following formula

$$\text{CGD Index} = \frac{\text{Total Score of the Individual Bank}}{\text{Maximum Possible Score Obtainable by the Bank}} \times 100$$

Table 1 presents the overall CG disclosure index score of each IFI. The extent of compliance indicates the quality of disclosure. Thus, the assumption taken in the study is that greater disclosure of CG information (according to the index) will be regarded as having higher quality CG disclosure. Theoretically, the CGD Index could range from zero (0) to one hundred (100) percent. A bank that reports all 123 items will score 100 percent.

As indicated in Table 1, RHB Islamic Bank Berhad had the highest score at 68.29%, while Standard Chartered Saadiq Berhad and OCBC Al-Amin Bank Berhad had the lowest at 42.28% in 2009. The highest score for foreign owned IFIs was Asian Finance Bank Berhad at 57.72%. Interestingly, it is the foreign owned IFIs that had the lowest CG score. The average score for all IFIs was 51.42%, which is just above the half way mark. Additionally, the results revealed that of the 16 IFIs, 10 (62.5%) had an index of more than 50%. Following Mohd Ghazali and Weetman (2006), it has been argued that IFIs having an index of more than 50% can be considered as “good disclosers.” Thus, one may conclude that overall IFIs in Malaysia may be regarded as “good”

Table 1. CG disclosure quality of each IFI (N = 16).

No.	Names of IFIs	Total score	Disclosure as % of maximum possible score	Overall rank
Local owned banks				
1	<i>Affin Islamic Bank Berhad</i>	53	43.09	12
2	<i>Alliances Islamic Bank Berhad</i>	76	61.79	2
3	<i>Bank Islam Malaysia Berhad</i>	62	50.41	8
4	<i>Bank Muamalat Malaysia Berhad</i>	66	53.66	6
5	<i>CIMB Islamic Bank Berhad</i>	69	56.10	4
6	<i>EONCAP Islamic Bank Berhad</i>	54	43.90	10
7	<i>Hong Leong Islamic Bank Berhad</i>	66	53.66	6
8	<i>Maybank Islamic Bank Berhad</i>	57	46.34	9
9	<i>Public Islamic Bank Berhad</i>	66	53.66	6
10	<i>RHB Islamic Bank Berhad</i>	84	68.29	1
	Total	653	530.90	
	Average score (N=10)	65.3	53.09	
Foreign owned banks				
11	<i>Al Rajhi banking & Investment Corporation (Malaysia) Berhad</i>	63	51.22	7
12	<i>Asian Finance Bank Berhad</i>	71	57.72	3
13	<i>HSBC Amanah Malaysia Berhad</i>	67	54.47	5
14	<i>Kuwait Finance House (Malaysia) Berhad</i>	54	43.90	11
15	<i>OCBC Al-Amin Bank Berhad</i>	52	42.28	13
16	<i>Standard Chartered SaadiqBerhad</i>	52	42.28	13
	Total	359	291.87	
	Average score (N=6)	59.83	48.65	
	Grand total	1012	822.77	
	Average Score (N=16)	63.25	51.42	

disclosers of CG information. Further, it can be observed that the mean score recorded by locally owned IFIs at 53.09% is slightly higher than foreign-owned IFIs (48.65%). This evidence seems inconsistent with the expectation in the hypothesis (H2) that CG quality is better in foreign owned IFIs.

We then examined the extent IFIs are reporting on each CG dimension (D1 to D14). A comparison between local and foreign owned IFIs was also undertaken. Table 2 presents the results of the overall mean scores for each dimension partitioned by ownership classification of IFIs (i.e., whether local or foreign owned). The rankings for the overall mean scores are given to illustrate the relative importance of CG disclosure practices of IFIs. Additionally, a bar chart is included in the appendix for ease of reference on the overall rankings.

As can be observed, the overall results of the CG disclosure analysed by dimensions indicate that the most frequently reported elements are on the risk management committee (Dimension 4) followed closely by information on the nominating committee (Dimension 2). Interestingly, information on risk management had a score of only 54.86; a score that is way below that of the risk management committee. This appears to indicate that while IFIs do have risk management committees, they are not willing to provide as much information on their risk management procedures. Alternatively, this may signal a lack of proper risk management procedures in place. Thus, it may be

interpreted that a well-established risk management committee does not necessarily lead to an enhanced disclosure on risk management issues or the presence of proper risk management procedures. The scores for Dimension 8a (internal audit and control; mean score of 33.33) and Dimension 14 (*Shariah* compliance; mean score of 28.12) were also considerably low. The least disclosed dimension was information pertaining to customers/investment account holders (mean score of 2.68). However, what is most alarming is the total absence of information on the governance committee (Dimension 13).

A Mann-Whitney U test was then undertaken to examine if there exists any significant difference in the disclosure scores between local and foreign owned IFIs on each dimension. The only significant differences detected (at a 10% level of significance) were for D11 (Non-adherence to guidelines), D6 (*Shariah* committee) and D14 (*Shariah* compliance). For both D11 and D14, it is the foreign banks that were disclosing more. Accordingly, the hypothesis that foreign owned IFIs have better quality CG disclosure may be *partially* supported. On issues pertaining to the *Shariah* committee, however, it is the local IFIs that were disclosing more.

The literature advocating CG disclosures in IFIs emphasizes the necessity of reporting specific governance information unique to their nature such as the internal *Shariah* review and bases for profit allocation between owner equity and IAHs (Hameed and Sigit, 2005). In line with this, we

Table 2. CG Disclosure of IFIs Partitioned into GCGi and SCGi.

Dimensions	No. of sub-items	Overall mean (N = 16)	Overall mean rank	Local owned IFIs mean (N = 10)	Sig.	Foreign owned IFIs mean (N = 6)
GCGi						
D1: Board structure and functioning	24	66.67	4	69.58	0.172	61.81
D2: Nominating committee	8	81.25	2	82.50	0.262	79.17
D3: Remuneration committee	8	69.53	3	85.00	0.106	43.75
D4: Risk management committee	8	85.16	1	87.50	0.415	81.25
D5: Audit committee/audit and governance committee	12	62.50	7	60.83	0.695	65.28
D7: Risk management	9	54.86	9	53.33	0.861	57.41
D8a: Internal audit and control	6	33.33	10	33.33	1.00	33.33
D9: Related parties transactions	2	65.63	5	70.00	0.628	58.33
D10: Management reports	2	62.50	6	55.00	0.182	75.00
D11: Non-adherence to guidelines	2	9.38	13	0.00	0.059*	25.00
Overall for GCGi	81	60.95		60.10	0.355	60.37
SCGi						
D6: <i>Shariah</i> committee/SSB	16	59.38	8	63.13	0.086*	53.13
D8b: Internal audit and control	2	9.38	12	15.00	0.150	0.00
D12: Customers/investment account holders	14	2.63	14	2.10	0.439	3.50
D13: Governance committee	6	0.00	15	0.00	–	0.00
D14: <i>Shariah</i> compliance	4	28.13	11	22.50	0.059*	37.50
Overall for SCGi	42	26.37		27.07	0.151	25.20
Overall for CGDs index	123	51.42		53.09	0.301	48.64

(*) A significant difference at the 10 percent level (2-tailed).

examined the difference between SCGi and GCGi for all IFIs on an overall basis (i.e. all IFIs). Subsequently, the analysis for local and foreign owned IFIs were undertaken separately. Finally, we examined each individual IFI. The results of these analyses are presented in Tables 2 and 3.

Overall, it can be observed that IFIs in Malaysia were focusing more on general governance information (60.95%) as compared to specific CG information (26.37%). Overall, the percentage score for GCGi was higher (63.95%) as compared to the score for SCGi (26.37%). This seems to indicate that less emphasis is being placed by IFIs on matters related to its specificity (to demonstrate its uniqueness). To examine if the focus on SCGi and GCGi was statistically significant, a Wilcoxon Signed Rank test was undertaken. The results indicate a significant difference between disclosure on SCGi and GCGi. Similar results were obtained when local and foreign IFIs were examined. On the basis of this, we may conclude that HI is not supported. Accordingly, one may conclude that IFIs in Malaysia appear to disclose CG information of a more generic nature. Further, the percentage of specific-governance information (SCGi) met by IFIs ranged from 19.51% for Bank Islam

Malaysia Berhad and EONCAP Islamic Bank Berhad to 34.15% for Maybank Islamic Bank Berhad and RHB Islamic Bank Berhad. Thus, one may conclude that CG disclosure of SCGi is still at a nascent stage amongst IFIs in Malaysia. On the other hand, the percentage for GCGi lies within a range from 50% (Affin Islamic Bank Berhad) to 85.37% (RHB Islamic Bank Berhad).

6. Conclusion

Over the past decade, CG of IFIs has moved to become main stream and is increasingly prevalent in both academic debates, and, more generally, the international business media and conference circuit. IFIs pursue two primary objectives: sound financial performance and ethical operations that align with the *Shariah*. More importantly, IFIs exist to serve the needs of the *ummah*. The unique aspect of IFIs emanates from its fundamental principle to conduct and operate in accordance with the Islamic *Shariah*, the primary issue being the prohibition of *riba* (interest). Given this, IFIs emphasize the PLS system. In such a system, transparency issues become pertinent as investment depositors would be exposed to the risk of

Table 3. The CG Disclosure Score of each IFI Partitioned by GCGi and SCGi.

No.	Names of IFIs	GCGi (Max. 81 items)	Disclosure as % of maximum possible score	SCGi (Max. 42 items)	Disclosure as % of maximum possible score	Sig.
Local owned banks						
1	<i>Affin Islamic Bank Berhad</i>	41	50.00	12	29.27	
2	<i>Alliances Islamic Bank Berhad</i>	65	79.27	11	26.83	
3	<i>Bank Islam Malaysia Berhad</i>	54	65.85	8	19.51	
4	<i>Bank Muamalat Malaysia Berhad</i>	54	65.85	12	29.27	
5	<i>CIMB Islamic Bank Berhad</i>	58	70.73	11	26.83	
6	<i>EONCAP Islamic Bank Berhad</i>	46	56.10	8	19.51	
7	<i>Hong Leong Islamic Bank Berhad</i>	57	69.51	9	21.95	
8	<i>Maybank Islamic Bank Berhad</i>	43	52.44	14	34.15	
9	<i>Public Islamic Bank Berhad</i>	54	65.85	12	29.27	
10	<i>RHB Islamic Bank Berhad</i>	70	85.37	14	34.15	
	Overall mean (N=10)		68.10		27.07	0.005***
Foreign owned banks						
11	<i>Al Rajhi banking & Investment Corporation (Malaysia) Berhad</i>	53	64.63	10	24.39	
12	<i>Asian Finance Bank Berhad</i>	59	71.95	12	29.27	
13	<i>HSBC Amanah Malaysia Berhad</i>	55	67.07	12	29.27	
14	<i>Kuwait Finance House (Malaysia) Berhad</i>	45	54.88	9	21.95	
15	<i>OCBC Al-Amin Bank Berhad</i>	43	52.44	9	21.95	
16	<i>Standard Chartered Saadiq Berhad</i>	42	51.22	10	24.39	
	Overall mean (N=6)		60.37		25.20	0.028**
	Total	839	1023.17	173	421.95	
	Average Score (N=16)	52.44	63.95	10.81	26.37	0.000***

(***) A significant difference at the 1 percent level (2-tailed).

(**) A significant difference at the 5 percent level (2-tailed).

loss. This constitutes a core issue of IFIs to manage the exposed risks that primarily arise because of the absence of protection for investment depositors (Erricco and Farahbaksh, 1998). Accordingly, CG in IFIs is of utmost importance. Indeed the fundamental issue addressed in this research is the extent that IFIs in Malaysia provide CG information in their annual reports. For the overall basis, the mean score achieved by IFIs was recorded at 51.42 percent. Based on the benchmark rule set by Mohd Ghazali and Weetman (2006), the CG information disclosure in IFIs in Malaysia can be considered as “good.” Additionally, the minimum disclosure score was 42.28 percent (Standard Chartered Saadiq Berhad and OCBC Al-Amin Bank Berhad) and the maximum disclosure score was 68.29 percent (RHB Islamic Bank Berhad). A possible explanation for such low scores can be attributable to the fact that all three guidelines were only issued quite recently. Thus, it may take time before IFIs actually comply with the guidelines.

Summing up, even if the intrinsic objectives that characterise the “best practices” governance are not perfectly attained yet, CG orientation in IFIs seems to converge on a pool of ethical and socially responsible issues that are wider than that in one generic industry. This can be traced back to the fourteen dimensions covered in the annual reports of IFIs. As may be recalled, D1 (board structure and functioning), D2 (nominating committee), D3 (remuneration committee), D4 (risk management committee), D5 (audit committee or Audit and governance committee), D7 (risk management), D8 (internal audit and control; (a) general-governance information and (b) specific-governance information), D9 (related parties transaction), D10 (management report), and D11(non-adherence to guidelines) were oriented towards the achievement of operational efficiency to lead to an achievement in economic objectives, while D6 (*Shariah* committee or *Shariah* supervisory board), D12 (customers/investment account holders), D13 (governance committee), and D14 (*Shariah* compliance) extended the orientation towards the realization of ethical and socially corporate values through the application of partnership-based business principles.

For the overall CG disclosure of IFIs for year 2009, eight dimensions are dominant, which, in order, are Dimension 4 (risk management committee), Dimension 2 (nominating committee), Dimension 3 (remuneration committee), Dimension 1 (board structure and functioning), Dimension 9 (related parties transactions), Dimension 5 (audit committee/Audit and governance committee) and Dimension 10 (management reports) and Dimension 6 (*Shariah* committee/*Shariah* supervisory board). The analysis goes on to test the first hypothesis concerning whether IFIs were actually disclosing more SCGi (i.e., D6, D8b, D12, D13 and D14). The expected strategy of CG structure in IFIs was that they must give due consideration to specific kinds of governance dimensions, which come together to compose the ‘best practice’ CG in the institution. The results, however, reveal that the formulated hypothesis was not supported. IFIs in Malaysia generally disclose more GCGi.

The considerations above allow this study to conclude that at the time this study was undertaken, IFIs tend to converge on general-governance related information—more related to information pertaining to risk management

committee (RMC) and nominating committee (NC). It can be interpreted that the major concern for IFIs is handling various risks and hiring persons with the credentials to lead the institutions. Of less concern to IFIs is the disclosure of general-governance information pertaining to the non-adherence to guidelines (9.38 percent) and information pertaining to the specific kind of governance information, such as the information relating to *Shariah* compliance (28.13 percent), the specific part of internal audit and control (9.38 percent), and customers/ IAHs (2.63 percent). While information on governance committee was not a concern for any of the IFIs, other information, (in order of preference) on remuneration committee, board structure and functioning, related parties transactions, audit committee/AGC, management reports, *Shariah* committee/SSB and risk management were satisfactorily disclosed by IFIs (scores more than the 50 per cent threshold). The provision of information on the general part of internal audit and control and *Shariah* compliance was minimal.

The analysis shows that IFIs seem to be in agreement about what structure should be set in the institution. The lack of SCGi disclosure may be attributable to deficiencies in the prevalent CG reporting framework and to the attitudes of IFIs management concerning the perceived costs and benefits of CG disclosure. Nevertheless, the presence of such information (however minimal) in the annual reports of the IFIs is an indication of a growing awareness of the importance of this type of governance information. The limited supply of specific-governance information in the annual report of IFIs may possibly indicate that this kind of information is uncommon in annual reports but could be disclosed through other means (i.e., websites, pamphlets, etc.).

The results, however, should be interpreted in light of certain limitations. First, the small number of IFIs considered in this study is a limitation in itself. Future studies should, therefore, attempt to include IFIs in other countries. Second is the use of cross sectional data that merely examined evidence on patterns at a particular moment as opposed to observing the changing levels of compliance over time (thus ignoring the trend of CG disclosure over time). Accordingly, a longitudinal study in the future may address this. Third, each item in the CG index in this study is assumed to have equal importance. However, this may not be necessarily so. Thus, the application of a weighted approach for the items in the CGD index would greatly improve the index. Fourth, the focus on just the 3 Guidelines; BNM/ GP1-i (2007), IFSB-3 (2006) and GSIFI (2008) in developing the CGD index is another limitation of the study. Future studies may want to include recommendations from other sources such as the Malaysian Code of Corporate Governance (MCCG) and Listing requirements of the Kuala Lumpur Stock Exchange (KLSE). Finally, the use of content analysis raises a methodological limitation to the analysis. However, according to (Florou and Galarniotis, 2007), content analysis of annual reports and web pages are expected to produce less subjective governance ratings as compared to self-completed questionnaires.

The study provides insights into the CG quality in both locally owned and foreign owned IFIs in Malaysia. In both instances, there is no requirement for an IFI to adopt suggested governance guidelines and yet this study found

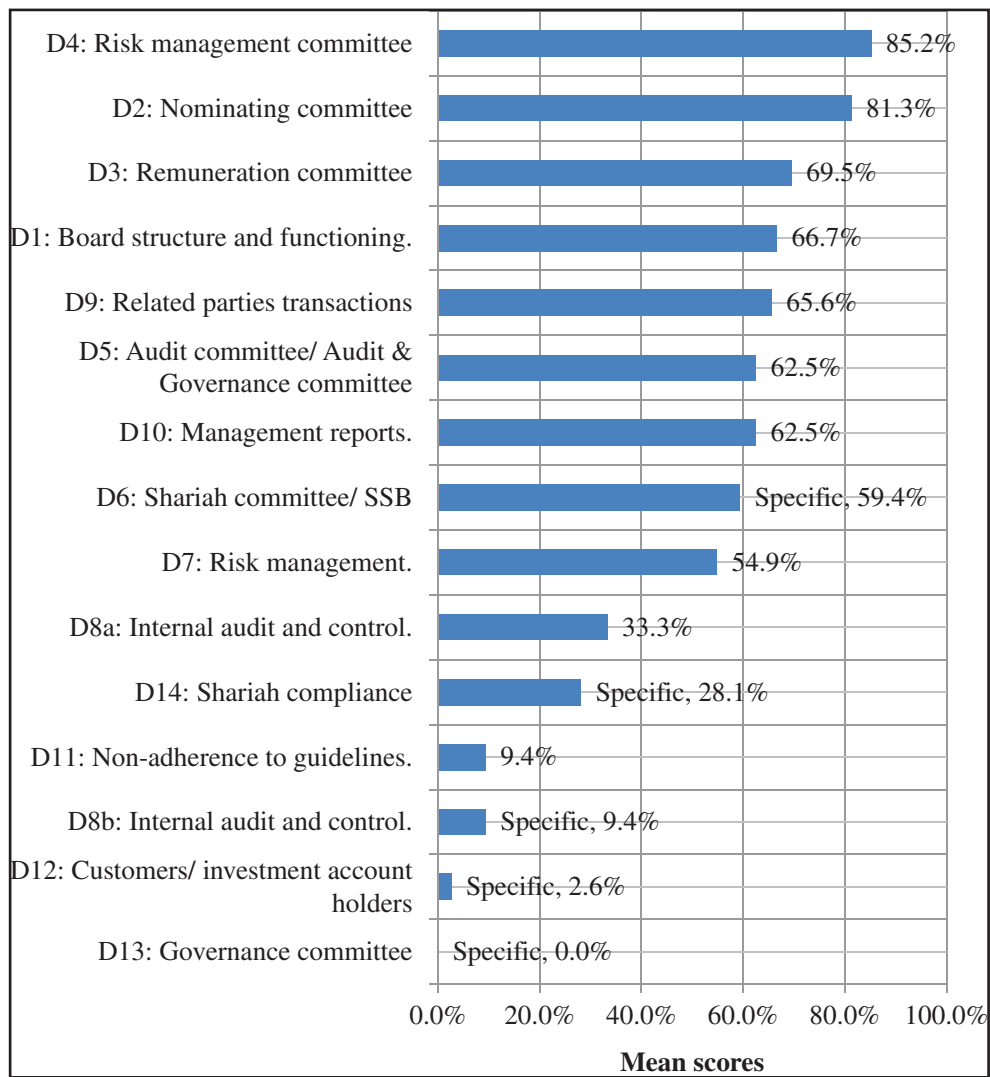
some evidence that they do so voluntarily. In addition, the overall qualities to which voluntary governance guidelines are implemented are considerably satisfactory as they met more than half of the items in the CGD index developed. Nascent development is also detected on the existence of the disclosure on the specific-governance related information.

The challenge before IFIs today is to improve all crucial aspects of CG that are unique to them as in the specific CG information that have suggested in this study. More specifically, IFIs should focus on information pertaining to the *Shariah* committee/SSB, specific matters on internal audit and control, customers/investment account holders, detailed information on governance committees and *Shariah* compliance aspects. Various banking crises over time have dramatically illustrated the catastrophic consequences flowing from the poor corporate governance of banks (Yunis, 2007). To provide a cushion against these flaws, there is a need to have a rigorous re-evaluation of CG principles of IFIs. This is important as CG may be regarded as a key factor in understanding the institution and its management. Good CG is pertinent as this will enhance investor confidence in the decision taken by the managers and board of directors of the institution (Gandia, 2008) – moreso in the case of IFIs.

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Appendix 1



Appendix 1. CG Disclosure Practices of IFIs in Malaysia.

Effect of characteristics of board of directors on corporate social responsibility disclosure by Islamic banks: Evidence from Gulf cooperation council countries

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Abstract - Corporate social activities have become major subjects because of their effects on the quality of life of citizens, in particular, and on society at large. Currently, there is an increased awareness of social responsibility due to the challenges faced by financial institutions (particularly Islamic banking) globally. This paper examines the influence of characteristics of the board of directors, that is, board size, board composition, and the separation of the roles of chief executive officer (CEO) and chairman, on corporate social responsibility (CSR) disclosure. After controlling bank size, financial performance and the relevant public, the research focuses on 53 annual reports of Islamic banks of Gulf Cooperation Council (GCC) countries. Based on the framework of legitimacy theory, the findings show that CSR disclosure has a negative and insignificant relationship with board composition. By contrast, the study found a positive association, although insignificant, between CSR disclosure and other characteristics of the board of directors (board size and separation of the roles of CEO and chairman). With regards to the controlled variables, the study indicates that bank size and financial performance have a positive and significant influence on CSR disclosure, while the relevant public has no effect. Therefore, the results indicate that the corporate governance structure of a board of directors within Islamic banks of the GCC region does not play a major role in CSR disclosure, largely due to family control. These findings suggest a need to improve best practice of corporate governance for Islamic financial institutions by imposing additional constraints on the board of directors' characteristics. The importance of this evidence is that both policy makers and investors will be more aware and will understand better the role of the board of directors in relation to CSR disclosure.

Keywords: corporate governance, board of directors' characteristics, Islamic banks, GCC countries, bank performance, legitimacy theory

1. Introduction

Corporate governance has become a vital subject during the past twenty years (Chapra and Ahmed 2002). This is because of the recent high incidence of corporate collapses, such as Enron, WorldCom, HIH Insurance, and Global Crossing, together with the increased global awareness of the need

for sound corporate governance based on stakeholder accountability and financial transparency (McLaren 2004).

Recently, Islamic financial institutions have experienced collapses similar to those of conventional banks, such as the failure in 2001 of Ihtlas Finance House (IFH) in Turkey,

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this being the most famous case for Islamic financial institutions. This collapse happened because of the weak corporate governance being practiced (Dusuki 2006). According to Grais and Pellegrini (2006a), there are many reasons behind the failure of IFH, including collusion of the board of directors with the management, audit failure, and excessive risk taking by management.

Most studies previously have examined the impact of the corporate governance mechanisms, including the board of directors, on voluntary disclosure (Akhtaruddin et al. 2009; Li et al. 2008; Haufang and Jainguo 2007; Zeghal et al. 2007; Barako et al. 2006; Gul and Leung 2004; Eng and Mak 2003; Ho and Wong 2001). Other studies have investigated the association between the board of directors' structure and CSR disclosure in non-financial industries (Abdur Rouf 2011; Said et al. 2009; Rashid and Lodh 2008; Buniamin et al. 2008; Haniffan and Cooke 2005). However, few studies have examined the influence of the board of directors' attributes on CSR disclosure in the financial sector (Barako and Brown 2008; Khan 2010). No serious attempt has yet been made to study the influence of the structure of the board of directors on CSR disclosure within the Islamic banking industry. Islamic banks claim to follow Shariah principles and rules in their activities, which influence the welfare of community. This study contributes in four ways to current knowledge of the determinants of CSR disclosure based on the board of directors' structure in the unique sector of Islamic banking:

1. It addresses the question of whether the lack of association between board size and CSR disclosure, as observed in many other industries, is apparent within the context of Islamic banking.
2. The question of whether having a greater proportion of non-executive directors on the board is positively related to CSR disclosure, as found in previous studies, is explored.
3. There is an empirical examination of whether separation of the roles of CEO and chairman has the same impact on CSR disclosure among Islamic banks as is apparent from the current literature.
4. The results of the study may prove useful to regulators for evaluating current corporate governance standards,

in terms of whether these requirements are sufficient for users of CSR information, such as investors, when making investment decisions. More important, the findings have policy implications for corporate governance mechanisms, which suggest that separation of the roles of CEO and chairman has no effect on CSR disclosure.

2. Islamic banks in GCC countries

The GCC comprises six oil-producing countries located in the Middle East: Qatar, the United Arab Emirates (UAE), Saudi Arabia, Kuwait, Bahrain, and Oman. The total population of GCC countries is around 42 million people. Currently, one of the most important strategies for achieving rapid economic growing in Islamic countries, such as those of the GCC, involves the banking sector. The banking industry in GCC countries is primarily owned by nationals due to the restrictions on foreign ownership. For instance, foreigners in Qatar are not allowed to possess more than a 49 percent share, whereas in Oman, the figure is only 35 percent ownership (Alkassim 2005).

Today, there are more than 300 Islamic financial institutions operating in 75 countries throughout the world, with the annual rate of 12–15 percent. The total assets of Islamic banks increased from US\$822 billion in 2009 to US\$1.3 trillion in 2010 (New Horizon-Islamic Banking 2010), and are expected to reach US\$3 trillion by 2016 (Eurasia Review 2011). The greatest proportion of these financial institutions is found in the GCC countries, as the Gulf region is the main source of financing for Islamic banking transactions. At the end of 2007, more than 40 percent (US\$262.6 billion) of the total Shariah-compliant financial assets (US\$640 billion) was invested in GCC countries (Wilson 2009). The strength of the banking industry in GCC countries is based on large profits and assets (see Table 1); the profitable banking sector supports stability in the financial system and, consequently, a stable local economy (Zeitun 2011).

Islamic banking provides a large range of services and products that are in conformity with Shariah principles and rules. The main principle of Islamic financing is profit-loss sharing. There are a number of principles that make

Table 1. Leading Islamic banks by asset values (US million).

Islamic ranking 2010	Institution	Country	Assets	Profits
22	Emirates Islamic Bank	UAE	6.886	35.5
23	Masraf Al Rayan	Qatar	6.627	242.0
27	Dubi Bank	UAE	4.737	-79.1
28	Investment Dar Co.	Kuwait	4.697	469.2
29	Bank AlBilad	Saudi Arabia	4.643	-66.2
30	Alima Bank	Saudi Arabia	4.615	161.4
31	Noor Islamic Bank	UAE	4.591	-302.5
33	Qatar International Islamic Bank	Qatar	4.547	140.5
34	Arcapita Bank	Bahrain	4.372	-87.9
35	Sharjah Islamic Bank	UAE	4.350	70.8
37	Amlak Finance PJSC	UAE	4.315	54.4
39	Kuwait International Bank	Kuwait	3.976	-28.6

Source: Asian Banker Research.

Islamic banks different from conventional banks (Zeitun 2011; Chong and Liu 2008; Olson and Zoubi 2008):

- The most important principle of Islamic banking is the prohibition on interest (riba).
- Investments must be in non-prohibited activities.
- All operations must be free from uncertainty (gharar) and gambling (maiser).
- Zakah must be paid by an Islamic bank or shareholders to eight kinds of people as mentioned in the Quran.
- All transactions of Islamic banks must be consistent with Shariah principles and rules.

For financial operations to be Shariah-compliant, there must be a reliable affirmation mechanism. Islamic banks in GCC countries took steps to establish boards of specialists in Islamic Commercial jurisprudence (fiqh al-muamalat) in order to give advice on the financial services and products provided. Each Islamic financial institution has its own Shariah board that provides approval for new kinds of finance services. Indeed, particularly in GCC countries, the Shariah compliance system develops the markets by offering various products and expanded customer alternatives.

3. Corporate governance in Islamic banks

Corporate governance is defined as a “set of relationships between a company’s management, its board, its shareholders and other stakeholders” (Chapra and Ahmed 2002), and aims to achieve justice to all stakeholders by increasing transparency and accountability. It also aims to monitor and control management in order to maximize company value. The main components of corporate governance include investors’ relations, as well as relationships between stakeholders, including employees, clients, and customers.

From the Islamic perspective, the framework of corporate governance is quite distinctive under Islamic banks because they must follow a unique set of principles based on the Holy Quran and the Sunnah.

According to Bhatti and Bhatti (2009), scholars of Shariah stated that the concepts of Islamic corporate governance and corporate social responsibility (CSR) were quite similar. The fundamental objective of Islamic financial institutions, such as banks, is compliance with Shariah principles, which contain principles of social justice and accountability (Farook and Lanis 2005). In the context of Islam, the ethical objectives of the community must be integrated with the objectives and policies of Islamic banks. Accordingly, Hassan and Abdul Latiff (2009) asserted that the CSR is a primary condition of Islamic banking transactions. Actually, the CSR is involved in the Corporate Governance standard of AAOIFI (Governance Standard for Islamic Financial Institutions No. 7: Corporate Social Responsibility Conduct and Disclosure for Islamic Financial Institutions). The Shariah rulings and the principles of Islamic economy and finance must be set to determine a suitable structure of corporate governance for Islamic banks. Zakah, prohibition of riba, prevention of gharar, prohibition of hoarding, and the sharing of profit and loss are the major principles of Islamic economics. All these principles influence the corporate governance structure of Islamic banks. The Islamic corporate governance structure is derived from

the structure of conventional corporate governance, but based on the ethical codes of Shariah.

The model of corporate governance for Islamic banks is supposed to be grounded on the principle of property rights in Islam; the system that is set must comply with Shariah rulings and the protection of the rights of stakeholders, who consist of shareholders, investors, creditors, employees and wider society as well (Bhatti and Bhatti 2009; Hasan 2008). According to Grais and Pellegrini (2006a), the unique attributes of Islamic banks must be clarified in order to produce a regulative structure that supports the development of their corporate governance.

In the last two decades, Islamic banks have experienced collapses similar to those of the conventional banking sector, because of the weak corporate governance being practiced within these financial institutions. According to Grais and Pellegrini (2006b), the reasons behind these failures are the collusion of the board of directors with the top management, the collapse of audit, and extreme risk-taking by management. The best examples of the collapses of Islamic financial institutions are the failure of Ihlas Finance House of Turkey in 2001 (Dusuki 2006) and, in 2003, the Patni Cooperative Society of Surat of Indian (Grais and Pellegrini 2006b).

In the light of these scandals, organizations have taken steps to strengthen their corporate governance, not only by making the board of directors more independent, but also by enhancing the firm’s transparency through the adoption higher disclosure standards (Hauswald and Marquez 2006).

Strong corporate governance of a bank is a crucial component for the improvement of the Islamic finance industry; international corporate governance standards that are compliant with the Shariah can be accepted and applied.

The Code of Best Practices for Corporate Governance in Islamic Financial institutions (Chapra and Ahmed 2002), Guiding Principles on Corporate Governance for Institutions Offering Only Islamic Financial Services (IFSB 2006), and the standards of AAOIFI have set up corporate governance devices to improve transparency and accountability. Corporate governance comprises a number of practices including a requirement regarding the size of the board, an independent directors’ board, the separation of CEO and chairman, and the independence of the chairman.

As for many other developing economies including Taiwan (Yeh et al. 2001), Thailand (Wiwattanakantang 2002), Turkey (Ararat and Ugur 2003), and South Korea (Joh 2003), banks in GCC countries are in many cases family-owned, with family members directly involved in management (Arouri et al. 2011).

Briefly, positive corporate governance is much more than a desirable concept. It supports the construction of capital, reduces capital costs, develops the climate of investment, and assists to create good markets. Therefore, the participants in the market with a vested interest in the improvement of sustainable national capital markets can also play an important role in elevating governance standards by setting the expectations of the market for what is preferable corporate behaviour.

4. Islamic social reporting in Islamic banks

The first and the major objective of reporting by Islamic financial institutions is to show that the transactions of banks are in compliance with Shariah principles and rules (Haniffa 2002; Baydoun and Willet 1997). Although considered to be the primary objective in the Western model, assessing the decision-makers in their making of economic decisions is a secondary goal for business organizations from the Islamic viewpoint (Maali et al. 2006; Mukhazir et al. 2006). For Islamic banks and financial institutions that have set by the AAOIFI, this main objective is included in the objectives of financial statement. Consequently, financial corporate reporting emphasizes the principles of full disclosure and accountability in meeting the needs of the society. The meaning of full disclosure is that Islamic banks should provide all necessary information to the society related to their transactions (Maali et al. 2006). Based on this concept, the community (ummah) has the right to know the influence of the banks' operations on the welfare of society, and to ensure that they are in compliance with the requirements of Shariah.

The truth is a very important issue in the Islamic context, and it must be disclosed as a duty for both businesses and individuals (Maali et al. 2006); Islam forbids the withholding of truth (Askary and Clarke 1997). The Quran emphasizes this duty in the following verse: "and cover not the truth with falsehood, nor conceal the truth when you know" (2:42). Six verses in the Quran refer to one meaning related to disclosure of all facts (Askary and Clarke 1997). As accountability to Allah includes an accountability to the community, the duty to disclose is owed primarily to Allah, as well as to society (Maali et al. 2006; Al-Mograbi 1996). The implication of this position for Islamic banks is that disclosure of the truth is intended to be in the public interest as the banks will know the influence of their transactions on the welfare of community. One of the primary objectives of Islamic banks is to eradicate poverty through generating jobs, and encouraging charitable activities that lead to help for the poor and needy. In the Quran Allah says: "of their goods take alms that so thou mightest purify and sanctify them" (9: 103). Furthermore, they are required to pay zakah as a religious obligation. Accordingly, Muslim investors need information related to spiritual, ethical, and other religious requirements, such as prohibition of riba (interest), payment of zakah, and the certification that banks do not engage in haram (unlawful) transactions (Mukhazir et al. 2006).

Maali et al. (2006) stated the three main objectives of Islamic social reporting:

1. Show compliance with Shariah principles through contracting fairly with various parties inside and outside business organizations, such as employees, shareholders, and government.
2. Clarify the influence the activities of Islamic businesses on the welfare of society.
3. Enable Muslims to perform their religious obligations easily.

In the context of Islamic reporting, it is expected that social issues would be a significant component of disclosure in the annual reports. Consequently, as suggested by prior studies, business organizations in Islam must be more transparent in

their disclosure practices related to social activities, which affect the welfare of community (Cho and Patten 2007; Haniffa and Cooke 2005; Hamid 2004; Patten 1992). This would lead to achievement of the main objectives of Islamic social reporting, that is, social accountability and full disclosure (Othman et al. 2009; Baydoun and Willet 2000).

5. Theoretical framework

Legitimacy theory acts as the tool to build, maintain and legitimize economic and political regulations, organizations, and ideological groups, which add to the benefits of the company. According to Guthrie and Parker (1990), disclosures have the capability to transfer the social, political and economic meanings for a pluralistic set of people or groups receiving the report. Legitimacy theory has become one of the major theories quoted in the area of social and environmental accounting (Campbell et al. 2003; Deegan 2002). According to legitimacy theory, a corporation discloses CSR information in order to establish or sustain its legitimacy by obtaining community acceptability of its actions (Deegan 2002). In other words, based on legitimacy theory, the extent of a company's CSR disclosure is a response to the pressures by the public. In fact, the majority of recent studies on CSR utilize legitimacy theory (Brown and Deegan 1998; Deegan and Rankin 1997; Patten 1992; Guthrie and Parker 1990), which explains disclosures with regard to the environmental and social behaviour of organizations (Campbell et al. 2003; Hooghiemstra 2000). Furthermore, Gray et al. (1995) argued that legitimacy theory has an advantage over other theories in providing disclosing strategies. According to Ullman (1985), while stakeholder theory states that the company and management work in conformity with the needs and pressure of its different stakeholder interests, legitimacy theory concentrates on the firm's transactions with the community as a whole. Finally, in the context of legitimacy theory, social and environmental disclosure is a way to legitimize a firm's continued existence or operations in the society (Hooghiemstra 2000; Gray et al. 1995).

In the literature of social and environmental accounting, a number of researchers agree that CSR disclosure can be used by companies to mitigate the legitimacy threat and to decrease the legitimacy gap (see, for example, Chen et al. 2008; Deegan et al. 2002; Deegan et al. 2000). Consequently, legitimacy theory suggests that the top management of organizations is responsible for meeting the legitimacy gap, practising the necessary social activities, and making provision for the different groups of stakeholders, this including accountability. Therefore, the corporate governance structure of the board of directors (board size, board composition, and the separation of the roles of CEO and chairman) is expected to play an important function in decreasing the legitimacy gap by expanding the disclosures of CSR.

6. Relevant studies and development of hypotheses

Board size

Empirical evidence in corporate governance suggests that the board size impacts the level of control, monitoring, and disclosure (Akhatruddin et al. 2009; Chaganti et al. 1985). The benefit of larger boards is an increase in the company

value, because they provide a firm with specialist members from different fields of expertise. In addition, boards with more members have the capability of better monitoring and, therefore, have the ability to practice their function effectively with respect to governance and disclosure. The most important advantage of a greater number of members is that they have a greater capacity to solve problems. Despite these benefits of larger boards, the size may have a negative impact on decision-making and the costs of this could outweigh the advantages (Lipton and Lorsh 1992). An increase the number of board members leads to problems in co-ordination (Jensen 1993), and makes them less effective in monitoring top managers (Yermack 1996).

In the context of Islamic banks, while there is no limitation in terms of the number of members of a board of directors, the perfect number comprises between five to seven members (Florackis and Ozkan 2008; Jensen and Ruback 1983). Common the number of members of a board of directors in an Islamic bank is seven or more, which is consistent with the best practice of corporate governance (Hawkamah 2011). The greater number of members in a board of directors tends to be more effective in monitoring, and makes better collective decisions, according to resource dependency theory. The larger number of directors will further control and supervise the banks' transactions to make sure of conformity with Shariah principles. This type of board could provide more transparency, moral behaviour, respect for stakeholder groups, and maximize CSR disclosure. According to Chen and Jaggi (2000), a larger board size may decrease the possibility of information asymmetry. Moreover, the greater number of board members may also reduce uncertainty and the lack of information (Birnbaum 1984). The members of a board of directors should ideally be knowledgeable in Islamic law and economics rather than being specialized in business and accounting practice (fiqh almuamalat) (AAOIFI 2005). The combination of Shariah and financial experience among the members of a board of directors brings varied resources of information, skills, and legitimacy (Hillman et al. 2000).

Board size can add to the differences of viewpoints, offering greater choices for solutions and more decision criteria, so achieving the goals of the board and objectives concerning investors' behaviour (Eisenhardt and Bourgeois 1988; Schweiger et al. 1986). In the context of Islamic banks, it is expected that the board size will not affect CSR disclosure. This is, in fact, due to the teachings of Shariah that Muslim individuals and business organizations are responsible for performing their actions in the best way. So, there should be no differences in the disclosure level between banks that have a small or a large board size.

This leads to our first hypothesis, that, based the Islamic viewpoint, board size has no impact on CSR disclosure (hypothesis 1).

Composition of board

The independent board of directors is considered to be the main corporate governance structure. It is expected that directors' independence can strengthen the board by monitoring management behaviour, and protecting investors' interests (Petra 2005), as well as reducing agency cost (Choe and Lee 2003). Because of the importance of the

function of the non-executive members of the board, UK firms tend to increase the number of independent directors (Higgs 2003; Hampel 1998). The possible reasons for this are that external board' members have good skills and experience (Kor and Misangyi 2008); they are informed and more effective at monitoring (Linck et al. 2008); and, they are willing to confront undesirable CEO decisions (Rachdi and Ben-Ameur 2011).

The main role of the board of directors is advising and counseling top management, in addition to monitoring its activities (Anderson et al. 2004). From an Islamic perspective, the members of the board of directors must have the reputation of moral integrity and be technically qualified for the banking business in order to play their role effectively. They must also have additional abilities to enable them to understand and be aware of the principles and rules of Shariah, and the Islamic teachings related to business and finance.

Haniffa and Cooke (2005) asserted that corporate social disclosure practices can be viewed as a policy that is intended to close the legitimacy gap perceived between management and shareholders through the non-executive directors. In addition, non-executive directors are likely to respond to concerns about the reputation and obligations, and would generally be more interested in satisfying the social responsibilities of a company (Zahra and Stanton 1988) that may support their status and reputation in the community. Therefore, non-executive directors may be able to put pressure on firms to provide CSR information in their annual reports.

Furthermore, it can be derived from these arguments that a greater percentage of independent directors on the board will lead to greater CSR disclosure by Islamic banks, so increasing transparency, since the independent directors will be able to motivate the management to provide more social disclosure. Many studies indicate that board composition, as measured by the proportion of independent directors on the board, has a significant impact on CSR disclosure, which is in line with the theoretical expectation (see, for example, Htay et al. 2012; Khan et al. 2012; Jo and Harjoto 2011).

Our second hypothesis is that board composition has positive influence on CSR disclosure (hypothesis 2).

Separation of roles of CEO and Chairman

Another aspect to examine in relation to the independence of the board is the "dominant personality" phenomenon (Chapra and Ahmed 2002; Ho and Wang 2001; Forker 1992). The issue refers to role duality, in which the same person undertakes both the roles of CEO and chairman. Segregation of the two roles gives the necessary checks and balances of power and authority on management behavior (Chapra and Ahmed, 2002; Blackburn 1994). From an Islamic perspective, there is an obvious separation of accountabilities in the top management of an Islamic bank through the separation of CEO and chairman, who perform two distinct functions. This leads to one of the most important constraints on the management of Islamic banks, which is that a key decision should not be made by one person (Chapra and Ahmed 2002).

On the other hand, role duality can facilitate the CEO managing the functions of the board such as meetings, agenda discussion, as well as choosing the board's members (Al-Arussi et al. 2009). Role duality also allows the CEO to regulate the company in achieving its goals and enhances the leadership in a firm (Dahya et al. 1996). From stewardship theory, there is no problem if the two functions are combined.

Forker (1992) showed that CEO duality is correlated with a lower level of voluntary disclosure, and separating the roles of CEO and chairman could help enhance the monitoring of quality and improve the disclosure quality. Consistent with this result, Huafang and Jianguo (2007) and Gul and Leung (2004) found a negative significant association between duality and disclosure. Their findings are also supported by Al-Arussi et al. (2009), who found an association between the separation of the function of chairman and CEO and voluntary financial and environmental disclosure by Malaysian firms. On the other hand, Said et al. (2009), Li et al. (2008), Barako et al. (2006), Eng and Mak (2003), and Ho and Wong (2001) found an insignificant relationship between duality and disclosure.

In the context of Islamic banks, role duality is not common, but the possible effect on disclosure is considered to be an important consideration. This is because numerous firms have combined the roles of chairman and CEO on their boards, and are working successfully, as well as having the capacity to keep the top management in check (Haniffa and Cooke 2002; Eisenhardt 1989).

Hence, it could be argued that separation of roles of the CEO and chairman has no effect on the CSR information disclosed by Islamic banks, particularly since the majority of these banks are family owned.

Therefore, our hypothesis is that separation of the roles of the CEO and chairman has no influence on CSR disclosure (hypothesis 3).

7. Research design

Sample and data gathering

The study used cross-sectional data from the annual reports of Islamic banks for the year 2008. The sample includes 53 banks operating in five GCC countries (see Table 2). The fiscal year of 2008 was chosen for this research as most of the banks had uploaded their annual reports in their websites.

Table 2. Sample distribution by country.

Country	Number of banks
Bahrain	22
Kuwait	17
Qatar	4
Saudi Arabia	4
UAE	6
Total	53

The sample size multivariate regression should preferably be one to ten (Roscoe 1975), or five (Coakes 2005; Green 1991), for each variable tested. The sample size of 53 is quite sufficient in light of the effort required for the process of data collection.

Specification of the model

The study uses regression analysis to examine the association between the structure of the board of directors and the disclosure level of CSR. In addition, it tested the assumptions of normality and multi-collinearity according to the analyses of skewness and kurtosis and the variance inflation factor (VIF). The following is the regression equation:

$$\text{CSR} = \alpha + \beta_1 \text{BOARDSIZE} + \beta_2 \text{BCOM} + \beta_3 \text{SCEO} + \beta_4 \text{BSIZE} + \beta_5 \text{BPERFOR} + \beta_6 \text{RELPUB} + \epsilon$$

where:

CSR	= corporate social responsibility disclosure index
BOARDSIZE	= size of board of directors
BCOM	= proportion of non-executive directors to total directors on the board
SCEO	= dummy variable, 1 if CEO ≠ chairman, 0 otherwise
BSIZE	= natural logarithm of total employees
BPERFOR	= return on equity (net profit divided by total assets)
RELPUB	= percentage of Muslim population to total population in a country

The characteristics of the board of directors are the size of board of directors (BOARDSIZE), board composition (BCOM), and the separation roles of CEO and chairman (SCEO). Furthermore, the study employed control variables, which have been used widely in previous studies regarding social disclosure. This study used control variables consisting of bank size (BSIZE), bank performance (BPERFOR), and relevant public (RELPUB) that will enhance the association between board of directors structures and CSR disclosure.

BOARDSIZE is the number of directors on the board. When the board size is large, the board is likely to be more effective in terms of monitoring the management and, consequently, will provide greater social and environmental information (Buniamin et al. 2008). BCOM is the proportion of non-executive directors on the board. Non-executive directors, who have no executive position in the corporation, may have more effect on environmental and social disclosure (Haniffa and Cooke 2005), and may be more interested in satisfying the company social responsibility (Zahra and Stanton 1988). SCEO refers to the separation of roles between the CEO and chairman on the board. Distinction of the function of CEO from that of chairman is more likely to be related to a higher level of CSR disclosure, since there may be a lesser degree of CEO discretion, and this may enable the CEO to practice more accountably in the stakeholders' interest (Gul and Leung 2004; Haniffa and Cooke 2002).

Larger companies are intended to provide more information (Haniffa and Cooke 2005). Bigger corporations respond to significant awareness from different stakeholder groups

in the community and, therefore, would be under strong public pressure to provide social activities to legitimize their businesses. Profitable firms provide more CSR disclosures (Haniffa and Cooke 2005). Profitability allows management the freedom and flexibility to practice, and to give additional information related to social responsibility activities to all stakeholders, particularly shareholders. Profitable corporations demonstrate their contribution to the welfare of the community, and legitimize their existence by providing social information. Companies that face more pressure from a relevant public (community) provide additional CSR information to legitimize their activities (Farook et al. 2011; Newson and Deegan 2002). This variable is used to control the political and economic differences within GCC countries.

Dependent variable—corporate social responsibility disclosure

The study employed a content analysis approach in order to gather data from the annual reports of Islamic banks. This method has been used widely in previous studies of social disclosure (Abdul Rahman et al. 2010; Menassa 2010; Guthrie et al. 2008; Maali et al. 2006; Gray et al. 1995; Zeghal and Ahmed 1990; Guthrie and Parker 1989).

This research developed a self-constructed disclosure index to measure the level of CSR disclosure. The items contained in the disclosure index are identified based on the Islamic literature review related to CSR disclosure (Haniffa and Hudiab 2007; Maali et al. 2006; Muwazir et al. 2006). Fourteen themes were identified from previous studies: vision and mission statement; top management; SSB; unlawful transactions; zakah; quard hassan; charitable and social activities; employees; late repayments and insolvent clients; environment; products and consumer; customers; poverty; and, other aspects of community involvement.

The CSR information is gathered from the reading and analysis of annual reports from Islamic banks'. Each item is coded onto coding sheets related to the theme under which the item belongs based on chosen standards. Each incidence of an item was coded according to the number of occurrences and the frequency of incidences. The disclosure nature is classified as either quantitative or qualitative, and the frequency of events (i.e., number of sentences) which are commonly observed. The study has extended to Islamic social reporting the same procedures and exercises recorded in the literature as used for corporate environmental reporting..

To increase reliability in recording and analyzing data, credible coding instruments with well-specified decision rules have been developed to reduce discrepancies and meet objectivity, or re-analyze the discrepancies that have existed and resolve the variations (Guthrie et al. 2008). By doing so, the need for the costly use of multiple coders can be reduced. The following rules covering the application of content analysis were developed:

- All CSR disclosure must be related to the Islamic bank and its operations.
- When the same sentence of CSR is disclosed more than once in the annual report, it must be recorded each time it is mentioned.

- Where a single sentence of CSR includes more than one main idea, the sentence should be recorded related to the activity most emphasized in the sentence.
- Any sponsorship activity which includes CSR has no problem in terms of how often it is advertised.

Additionally, the coder should have sufficient training to achieve reliability by reviewing a small sample of annual reports during the pilot study stage. Furthermore, sentences were chosen as the units of measurement for content analysis in order to increase reliability (Milne and Adler 1999).

This study uses the number of sentences to determine the disclosure level of CSR for several reasons. First, Ingram and Frazier (1980) chose sentences as the unit of analysis stating that “the sentence was selected as the unit of analysis for the final research since a sentence is easily identified, is less subject to inter judge variations than phrases, classes and themes, and has been evaluated as an appropriate unit in previous research”. Also, sentences are more accepted units of written English communication than individual words (Hughes and Anderson 1995), and the use of single words also has been discarded as words do not convey any meaning without sentences (Milne and Adler 1999). Compared with words and pages, a sentence is a conformist unit of speech and writing, whereas a part of the page measurement is not, and there is no need to compute for, or standardize, the number of words (Walden and Schwartz 1997; Hackston and Milne 1996). Most prior studies in the content analysis of social disclosure have used sentences as the basis for coding data, as the sentence provides perfect, reliable and meaningful data for more analysis (Oxibar and Déjean 2003; Milne and Adler 1999).

To examine the internal consistency (the reliability of measurement) of the CSR disclosure index, the Cronbach coefficient alpha was employed (Cronbach 1951). The examination is based on the average correlation within items (Nunnally and Bernstein 1994). The Cronbach coefficient alpha is used to repeat the measurement for evaluating the degree to which correlation within the measurements is narrowed to the random error (Botosan 1997). The logic behind this examination is that if the inter-correlations within the items are great, the measurement of items will be the same among the construct. Sureshchandar et al. (2002), Hair et al. (1998), and Liouville and Bayad (1998) declared that if the alpha is less than 0.60, it is considered poor, while it is acceptable at 0.70; in the meantime, if alpha is over 0.80, it is considered to be good. The Cronbach coefficient alpha is 0.697 for all themes, which exceeds the minimum acceptance level of 0.60. This finding is accepted rather than the alpha of 0.51 and 0.62 in the studies of Aribi and Gao (2010) and Gul and Leung (2004), respectively.

8. Empirical findings

Descriptive statistics

Table 3 shows the descriptive statistics for the dependent and independent variables used in the present study. The average CSR disclosure is 83.3 sentences. This average

Table 3. Descriptive statistics (N = 53).

Variables	Min	Max	Mean	Med.	Std. Dev.	Skewness	Kurtosis
CSR	20.00	166	83.30	87.5	39.22	0.276	-0.863
BOARDSIZE	4.00	13	8.30	9	1.98	0.058	-0.369
BCOMP	0.14	1	0.81	0.88	0.21	-1.540	1.933
SCEO	0.00	1	0.92	1	0.27	-3.309	9.297
BSIZE	18	8299	917.35	250	1700.41	3.374	13.652
PERFOR	-30.06	22.87	2.86	11.9	6.76	-1.432	11.897
REVPUB	76.20	97	85.97	0.75	7.89	0.303	-1.736

is more than the 25 sentences found in the study by Maali et al. (2006). The mean board size is 8.3 directors, indicating the existence of a quite a reasonable size to ensure effectiveness, as suggest by Jensen and Ruback (1983). The sample average board independence value is 0.83 percent, showing that a majority of Islamic banks have a board of directors, which is fully independent. The mean value of leadership structure (SCEO) is 0.92 percent, indicating that most banks have a separate leadership structure. This result is consistent with the best practice of corporate governance for Islamic financial institutions that requires the two occupations to be held by different persons. As for control variables, the sample banks have the mean values of 917.35 employees for BSIZE, and 2.86 percent for the financial performance (PERFOR), which are quite low values. The average value for the proportion of Muslim population to the total population (REVPUB) is 85.97 percent.

Table 4 reports the correlation matrix between the dependent and independent variables employed in the multiple regression of the study. Corporate social responsibility (CSR) disclosure is positively correlated with board size (BOARDSIZE) ($p = 0.321$), financial performance (PERFOR) ($p = 0.313$), and the separation of the roles of CEO and chairman (SCEO) ($p = 0.087$). However, CSR disclosure is negatively associated with board composition (BCOMP) ($p = -0.299$), and relevant public (REVPUB) ($p = 0.340$). Thus, it can be summarized that a larger BOARDSIZE, lower number of non-executive members on the board of directors, and separation of the roles of CEO and chairman have higher CSR information disclosure. Furthermore, BOARDSIZE is positively correlated with all independent variables except board composition (BCOMP).

Table 4. Correlation matrix (N = 53).

Variables	CSR	BOARDSIZE	BCOMP	SCEO	BSIZE	PERFOR	REVPUB
CSR	1	0.321**	-0.299**	0.087	0.327**	0.313**	-0.340**
BOARDSIZE	0.321**	1	-0.114	0.190	0.245*	0.255*	-0.078
BCOMP	-0.299**	-0.114	1	-0.069	0.041	-0.173	0.338**
SCEO	0.087	0.190	-0.069	1	-0.060	0.315**	-0.330**
BSIZE	0.327**	0.245*	0.041	-0.060	1	-0.093	0.039
PERFOR	0.313**	0.255*	-0.173	0.315**	-0.093	1	-0.322**
REVPUB	-0.340**	-0.078	0.338**	-0.330**	0.039	-0.322**	1

**/*: correlation is significant at 0.05/0.10 level, respectively.

Ordinary Least Square (OLS) regression results

Table 5 presents the empirical findings of OLS regression. It indicates that the coefficient of R^2 is 35 percent, and the adjusted R^2 is 27 percent, and shows a computation of the reasonable variance proportion. The table also shows that the p-value of the model is significant at 0.002. Because all values of tolerance exceed 0.10, there is no problem of multi-collinearity between the explanatory variables (Menard 1995). Additionally, the VIF for all independent variables is very far from 10, indicating that there is no issue of multi-collinearity between the variables (Naser et al. 2006; Haniffa and Cooke 2005; Myers 1990; Kennedy 1998).

The table reveals that the greatest values for the t statistics are 2.562 (p -value < 0.05), and -1.721 (p -value < for bank size, and relevant public, respectively, which indicates that the two variables have a significant effect on CSR disclosure at a 0.05 and 0.10 level, respectively. Expressly, these two variables are considered by Islamic banks as the foundation for making decision to disclose CSR information.

Board size has a positive and insignificant impact on CSR disclosure. This result is supports hypothesis 1, but not legitimacy theory, and is consistent with previous studies (Said et al. 2009; Matoussi and Chakroun 2007; Arcay and Vázquez 2005; Lakhali 2003). This finding may be explained by the Islamic viewpoint that there is no reason why a bank with more members on the board of directors would provide more CSR information than a bank with fewer directors, since all Islamic banks must disclose information related to CSR in their annual reports according to the Islamic principle of full disclosure. The negative and insignificant t statistics of board composition (BCOMP) highlight the

Table 5. OLS regression findings (N = 53).

Variables	Pred. Sig.	Beta	t	Sig.	Tolerance	VIF
CSR			3.027	0.004***		
BOARDSIZE	No	0.164	1.264	0.213	0.837	1.194
BCOM	+	-0.182	-1.427	0.160	0.868	1.152
SCEO	No	-0.085	-0.645	0.522	0.820	1.219
BSIZE	+	0.319	2.562	0.014**	0.907	1.103
PERFOR	+	0.220	1.652	0.105	0.791	1.264
REVPUB	+	-0.235	-1.721	0.092*	0.755	1.325
R Square	0.353					
Adjusted R Square	0.269					
F-value	4.181 (0.002***)					
Durbin-Watson	2.163					

***, ** and * Significant at the 0.01, 0.05 and 0.10 level respectively.

fact that when the proportion of non-executive directors on the board increases, the level of CSR disclosure decreases. Thus, hypothesis 2 is rejected. This result is supported by the previous studies of Barako et al. (2006) and Eng and Mak (2003). It implies that Islamic banks with boards having fewer non-executive directors would emphasize societal interests and organizational legitimacy and, therefore, would provide more CSR information. The result shows a positive and insignificant relationship between the separation of the roles of the CEO and the chairman, and the disclosure level of CSR. Expressly, it implies that the separation of the function of CEO and chairman does not affect CSR disclosure by Islamic banks and so supports hypothesis 3. This finding is consistent with previous studies (Said et al. 2009; Li et al. 2008; Barako et al. 2006; Eng and Mak 2003; Haniffa and Cooke 2002; Ho and Wong 2001). A possible explanation is that a person who is held to act as chairman and CEO of an Islamic bank at the same time is likely also to be a shareholder; hence, whether or not the two functions are separated presents no problem. This result is in line with the stewardship theory. Furthermore, the role duality allows the CEO to manage the company in achieving its objectives, and enhancing the leadership in a bank (Dahya et al. 1996).

With regards to the control variables, the results show that bank size (BSIZE) has a positive significant effect on CSR disclosure. Larger Islamic banks provide more CSR information showing their compliance with the principles of accountability and full disclosure, since they have more resources, such as human capital, and greater investments. This result is consistent with previous studies (Akhtaruddin et al. 2009; Othman et al. 2009; Haniffa and Cooke 2005; Hamid 2004), and indicates that the banks use annual reports as a channel to publicize their image and legitimize their social activities. The association between size and CSR disclosure supports the legitimacy theory (Gray et al. 2001; Patten 1991). Also, the findings reveal a positive and insignificant association between financial performance (PERFOR) and the disclosure level of CSR. The insignificance of PERFOR is consistent with previous studies (Barako 2007; Barako et al. 2006; Garcia-Ayuso and Larrinaga 2003; Hackston and Milne 1996; Cowen et al. 1987). This indicates that the decision to provide CSR information is not affected by the financial

performance level. However, the results reveal that the relevant public (REVPUB) has a negative and significant impact on CSR disclosure at the 0.10 level. This result contrasts with the findings of Farook et al. (2011). From an Islamic perspective, a possible underlying explanation is that there is no reason why a country with a great population would necessarily have banks that provide more CSR information than a country with a lower population, since all Islamic banks must comply with Shariah principles and rules.

9. Discussion and conclusion

The objective of this study is to examine the effect of characteristics of the board of directors (board size, board composition, and the separation of the roles of CEO and the chairman) on CSR disclosure by Islamic banks of GCC countries. The study found that none of these three attributes of the board of directors has any impact on CSR disclosure, this being due to the absence of some important aspects of corporate governance practices. These results are consistent with the extant literature (Said et al. 2009; Barako et al. 2006; Eng and Mak 2003). The key conclusions from the empirical results are that the decision to provide CSR disclosure is guided by bank size, and relevant public, but not by governance structure.

The insignificance of the board of directors' characteristics lies in the different legal and cultural factors that appear to affect bank governance mechanisms on CSR disclosure. Furthermore, the system of corporate governance in GCC countries is derived from major shareholders, which means that the influence of agency problems on CSR activities is small. This is due, in fact, to the larger shareholders monitoring the internal bank governance system, and being responsible for approving a bank's transactions and management policies regarding CSR activities.

The paper highlights the potential effect of the characteristics of a board of directors on the CSR disclosure for Islamic banks of GCC countries. It expands the literature regarding the influence of company-specific attributes on CSR disclosure in the banking industry by examining some of the board of directors' variables. This may help users of CSR information, such as investors in making

investment decisions. The study also shows that there may be a need to motivate the policy makers of Islamic banks to ensure that banks practise the mechanisms of corporate governance effectively. This practice should be compatible with the business environment of GCC countries, including adopting the same governance standards in order to ensure uniformity of disclosure level among the banks (Dudley 2004; Karim 2001). It is expected that employing the best practice of corporate governance characteristics will contribute to improving efficiency, effectiveness and monitoring in the Islamic banks of GCC countries; and this can only be applied by developing the regulatory and enforcement frameworks.

Future research into other important corporate governance mechanisms, such as ownership structure, audit committee attributes, and cultural factors should be considered. Further research into the effect of the board of directors' characteristics on CSR disclosure by Islamic banks of GCC countries might use larger samples over a longer timeframe, and apply a different methodology for data collection.

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Islamic corporate social responsibility in Islamic banking: Towards poverty alleviation

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Abstracts - One of the goals of Islamic banking operations is to increase the economic growth towards a better and just society. This study aims to examine the criteria and Islamic instrument of corporate social responsibility towards the creation of a sustainable economic development. Specifically, the study analyses the various approaches to improve the quality of life and alleviate poverty and the methods of applying Islamic instruments to corporate social responsibility programs in Islamic banking. Based on the review of literature and findings resulted from in depth interview with the expertises of Islamic banking in Indonesia, the study reveals that there are six (6) fundamental criteria and 34 items considered critical for corporate social responsibility to make an impact on the society. These criteria are namely: Shariah compliance, equality, responsibility in work, the guarantee of welfare, the guarantee of environmental sustainability and charity for preservation of virtue. Then application of Islamic corporate social responsibility in the society should be guided by two Islamic principles; first, the application of *maslahah* (the public good) which provides a better framework that managers can use when faced with potential conflicts arising from diverse expectations and interests of any corporation's stakeholders. Second, corporate social responsibility programs should pay more attention to the importance of social capital in the society. The corporate social responsibility practices in Islamic banking should not only be based on responsibility *al kifayah* (obligatory upon community) and get a positive corporate image but can also be deemed as a method to alleviate poverty and achieve the true economic goals of Islam.

Keywords: Islamic corporate social responsibility, Islamic banking and poverty alleviation

1. Background

The concept of corporate social responsibility (CSR)¹ is corporate responsibility for sustainable economic development in the effort to improve the quality of life and environment (Obaloha, 2008:538; Hay and Gray, 1974:9; Dusuki and Dar, 2005:390). In the last thirty years, the concept of CSR has become an issue of discussion related to the relationship between business and society. One issue discussed was the importance of harmonious relationship between the stakeholders² with the corporate institutions.

The concept of CSR began in the West in the 1970s, and discussions on the concept of CSR often focused on the view that is founded on the norms, cultures and beliefs of the West, especially Europe and America. Western perspective

of CSR has become common practice for a corporation to run CSR programs.

Nevertheless, the concept of CSR can be studied and explored critically from a different source that has been developed in the West. The concept of CSR can be studied from the culture and norms of societies like those found in the Middle East, Southeast Asia and China or across religions and belief systems like Islam, Buddhism and Hinduism. Every culture and system of norms and beliefs incorporates different philosophies and epistemologies on the form and practice of CSR.

In Indonesia the discourse about CSR has been growing significantly. After having been issued, Act No. 40 in

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2007 article 74 refers to the obligation of corporations on corporate social responsibility and society. Thus, corporates in Indonesia inevitably are obliged to enact CSR programs. If the CSR programs are not implemented, the government can impose penalties in accordance with the provision of applicable law (Article 74 paragraph 3). Adherence to conduct CSR based on the legitimate law becomes an incentive for corporations to do CSR. Therefore, CSR is undertaken for one of four reasons, first, responsibility of economy; second, the responsibility of law fulfilment; third, the responsibility of ethics, and fourth, charity (Carroll, 1999:264).

CSR for the community and increasing corporate participation in society must be interpreted as an effort to create a common good for corporations and for society. As a result, the awareness about the importance of CSR becomes a collective responsibility to create harmony and alignment with the existing range of *stakeholders*.³

Therefore, the position of Islamic Banking Institution (IBI) as one corporation of the area of finance that has been operating either nationally or internationally is obliged to be the pioneer of finance institutions in carrying out CSR programs based on Islamic values, which differ from CSR developed in the West. It is not only to fulfill the law and order or good corporate governance. Far beyond that, the implementation of CSR on IBI is based on strong foundations and the philosophy of Islam, being one of the financial institutions that can bring up prosperity for the community. CSR on IBI should be a form of accountability to Allah, humans and the environment.

In addition, the implementation of CSR in IBI must be believed and understood as a share to fulfill the commitment of Shariah compliance in the operations of IBI. CSR is not just making fame or merely to obey the obligations of law. IBI's CSR program must appropriately touch the fundamental purposes for human rights of society towards a better economy and alleviation of poverty. CSR programs should not be a mask for the pursuit more profits (The Economist, 2005) or not the desire to get law legitimatization for operation the corporate (Rizk, et al., 2008: 306).

This study aims to examine the criteria and Islamic instrument of CSR towards creation of sustainable economic development. Specifically, the study analyses the approaches to improve the quality of life and alleviate poverty and methods of applying Islamic instrument to CSR programs in IBI. The presence of IBI is to meet social responsibility; this is the differentiating favour between IBI and conventional banking institution (Sudin Haron, 2005:107). It must be admitted that the existence of Islamic banking is to fulfill social responsibility.

2. Literature review of CSR in Islamic Banking Institutions (IBI)

Researchers vary in defining CSR (Obaloha, 2008:539; Votaw and Launche, 1973; Preston and Post, 1975; Makower, 1994). For example, Bowen (1953) defines CSR as a corporate decision to give benevolence to the community. Fredrick (1960) defines CSR as a community resource, used by economic and human beings to maximize the benefits to society in addition to corporate profits and

corporate owners. Based on the theory of Elkington (1997), CSR is a concept for the corporates obligation to consider the interests of customers, employees, shareholders, communities and the environment in all aspect of their operations. This obligation applies broadly beyond the obligations stipulated by law.

Carroll (1999) mentions that CSR takes the form of economic responsibility, law, ethics and charity. According to Carroll (1999) CSR is described to be pyramid like, where economic responsibility is the key to corporate responsibility, followed by a responsibility to the laws, then ethics, and then lastly to charity (Carroll, 1999: 264). Dashrud (2004) has reviewed 37 definitions that are often used by investigators in defining CSR; he concludes that there are five dimensions that are often used in CSR; environmental dimensions, social dimensions, economic dimensions, stakeholder dimensions and charity dimensions.

From these variants of existing definitions, it can be concluded that CSR is a form of corporate commitment to continuing economic development in an effort to improve the quality of life in society and the environment. In other words, CSR is a form of corporate social responsibility towards local society based on a series of corporate activities related to economic welfare of the community for distribution to all parties.

Most studies on CSR a few decades ago have focused on the form of CSR in Western societies. CSR developments in the west are certainly influenced by ethical values, culture and beliefs of western society, particularly Europe and America. This may be found in several studies that have been done, like Bowen (1953); Carroll (1976, 1991, 1993, 2004); Davis (1960, 1973); Freeman (1984); Wattrick and Cochran (1985); Wood (1991); Donaldson and Dunfee (1994); Donaldson and Preston (1995); Smith (2000); Post, Lawrence and Weber (2002); Birch and Moon (2004). These studies found that the values and culture that flourished in the West became the standard pattern of relationship between the corporation and the community.

The concept of CSR developed in the West is not the same with the concept of CSR in Islam. CSR in Islam built on the basis of *tasawur* (world view) and epistemology of Islam, which is different from the CSR developed in the West. And the principles of Islamic CSR are based on corporate philosophy according the Qur'an and Sunnah. While CSR in the West based on the view of Western culture. Hence, the implementation of Islamic CSR needs to study of CSR's principles based on the Islamic values. It becomes a liability related to Islamic corporations that were born from the womb of Islam.

Social responsibility in Islam is a familiar subject. Social responsibility has begun to exist and has been practiced for the past 14 centuries. The discussion of social responsibility is frequently mentioned in the Qur'an. The Qur'an always links business success and economic growth, which are highly influenced by ethical entrepreneurs in their business. Allah said in the Qur'an:

"Give full measure when ye measure, and weigh with a balance that is straight: that is the most fitting and the

most advantageous in the final determination" (al Isra, 17:35)

Islam gives attention to business through the moral aspects to achieve maximum profits. This shows that Islam is concerned with the economy and morality, both of which cannot be separated. This aspect is also affirmed by the Prophet Muhammad (PBUH). The Prophet (PBUH) has said in the hadith narrated by Malik ibn Anas: "A worker/employee is entitled to at least get good food and clothing with a decent size and is not burdened with ability to work outside the limits. (Malik, 795, 2:980)

The *hadith* above concludes that minimum wages should allow a worker or employee to obtain good food and feasible clothing, reasonable amount for himself and his family, without having to work hard (Yusuf, 2008:151). Uthman ibn Affan, states:

"Do not force a woman beyond in her quest for life, because if you do that to her, she might be doing acts contrary to the moral, and not force your man with a job outside the limit of their ability, because if you do that against him, perhaps he would do the theft (Malik, 795: 2:981).

The Qur'an also considers environmental sustainability one of social responsibility. All the effort of business should ensure environmental sustainability. Responsible to environment, Allah states in al Qur'an:

And when he turns his back, His aim everywhere is to spread mischief through the Earth and destroy crops and cattle. But Allah loved not mischief" (Chapter al-Baqarah, 2:205)

This verse describes how Islam considers environmental sustainability. All the effort of business or non-business should ensure environmental sustainability. The relationship between humans and the environment is very close and cannot be separate. Islam has clearly prohibited anything that is harmful to the individual or the environment at large. Thus, it is one of the obligations for human to care for the well being of society and to guarantee environmental sustainability for the next generation.

While in social welfare, Islam encourages highly Islamic charity to those in need and less ability in work through *sadaqah*⁴ and welfare loans (*Qard hasan*)⁵. Allah says in al Qur'an:

"So fear Allah as much as ye can; listen and obey and spend in charity for the benefit of your own soul and those saved from the covetousness of their own souls, they are the ones that achieve prosperity" (Chapter al Taghabun, 64: 16)

The verse describes the responsibility of Muslims to help others through charitable contributions and donations and stinginess is abomination in Islam.⁶ The benevolent loan (*qard hasan*) described in the al Qur'an:

Who is he that will loan to Allah a beautiful loan, which Allah will double unto his credit and multiply many times? It is Allah that giveth (you) want or plenty, and to Him shall be your return (Chapter al Baqarah, 2:245).

Besides affecting social welfare, the act of benevolent loans can also bring double benefits for individuals and corporations. First, benevolent loan can be creating a positive image for individuals and corporations as well as and the second, getting a new business network formation, which may result in increasing profits.

The Prophet Muhammad (PBUH) said in a *hadith* narrated by Salman bin Amir,

"Alms for the poor is charity. And the charity to family has two advantages, namely the rewarding for Allah and strengthening brotherhood" (Narrated by Tirmidhi, 1993: Hadith No. 653).

The statement above shows that the concept of social responsibility and the concept of justice has long existed in Islam, as long as has the presence of Islam brought by the Prophet Muhammad (PBUH). Prophet Muhammad (PBUH) realised social responsibility and created justice in line with the guidance of the Qur'an. Likewise, the practice of the Prophet Muhammad (PBUH) in the application of social responsibility and justice in society becomes a source of reference for guidance to the next generation, known as al Sunnah. Both the Qur'an and the Sunnah have been very harmonious in upholding true justice.

Although the verses of Qur'an and the *hadith* do not directly refer to CSR but there are many verses in the Qur'an and *hadith*, which explain the obligations of individuals to bear the needs of others. Therefore for individuals that come together to create a corporate have the obligations to help the public and give benefits to others. The existence of corporates were viewed by jurists such as Shafi'i, Ahmad bin Hambal, Ibn Hamid al-Ghazali, Ibn al-Faraj, Ibn Al Jawzi which occupied a position as *fard kifaya*.⁷ Corporates can do what individual find hard to do, corporates can bear and take care the interests of the larger community, such as foundation (Ibn Taymiyya, 1314H).

In fact CSR corporations not only bear and care for living creatures around them, but more than that, CSR is the obligation of humans to comply with Allah's laws. Allah has commanded humans to obey Him, and a form of obedience to Allah is to ensure the survival of human kind and the natural surroundings. Allah says in the Qur'an:

I have only created Jinns and men, that they may serve Me. (Chapter al Dzaariyat, 51; 56).

Allah also says:

It is He who hath made you (His) agents, inheritors of the Earth: He hath raised you in ranks, some above others: that He may try you in the gifts He hath given you: for thy Lord is quick in punishment: yet He is indeed oft-forgiving, most merciful. (Chapter al An'am, 6: 165).

The existence of Muslims in the face of the earth has two tasks; obedient servant to Allah and the fair caliph. The relationships between the two main tasks are in line and should not be separated from one another. As a servant who worships Allah, each individual has an obligation to make all events of his life as a form of perfect devotion to Allah. In this case, the concept of worship is necessary

to be understood in a broader sense. This means that apart from the specific worship of ritual piety, each individual is required to perform other common rituals of all the activities that bring about the welfare of man and nature in compliance with certain conditions, with right intentions, and has to ensure that those actions are allowed according to the *Shariah* (Suhaila binti Abdullah, 2008: 64–68, Zahari bin Mahad Moses, 2008: 77–78, Abdullah al Mushlih and Shalah al Shawiy, 1998: 161). It also gives the meaning that human beings carrying out their duties as vicegerents on Earth cannot arbitrarily act, but must do so based on the *Shariah* rules as evidence of slavery to Allah as the creator.

As a vicegerent, humans are entrusted to manage this environment involving human relationship with other human beings and human relationships with Allah's creation, including animals, plants and the environment. Al Mawdudi interpreted meaning of the word "vicegerent" as "representative of Allah on Earth" (Abu al-A'la al Maududi, n.d.:16–23). As a representative, humans must be and act like nature, will and actions of the substitute. As the vicegerent of Allah on Earth humans do not have absolute freedom to do whatever impunity. Mankind must act within the authority delegated to him by Allah. This is as described in the Qur'an, Allah says:

O David! We did indeed make thee a vicegerent on Earth: so judge thou between men in truth (and justice): Nor follow thou the lusts (of thy heart), for they will mislead thee from the Path of Allah: for those who wander astray from the Path of Allah, is a Penalty Grievous, for that they forget the Day of Account. (Chapter Shaad, 38; 26).

Ibn Kathir explains humans purpose of ruling the Earth (*khalifah al Ard*) in verse 6; 165; is as executors for the prosperity of the Earth from time to time to be utilized by future generations (Ibn Kathir, 1996:185). This means the continuity and sustainability of the vicegerent task is not just limited to one generation, but responsible to the next generation.

Both interpretations quoted by al Maududi and Ibn Kathir regarding the meaning of vicegerent, gives a clear picture of the duty of every human being to be responsible to Allah as the giver and the representative of the human and natural on the Earth to create harmony life. Accountability requires that people take care of nature and all its contents for the salvation of man himself and the continuity of other creatures of Allah. He is also a form of trust to be guarded and escorted from the various forms of fraud. All this is proof of gratitude to Allah the creator of His servant, so that they are not classified into categories of heathen of mercy. Allah says:

He it is that has made you inheritors in the Earth: if, then, any do reject (Allah), their rejection (works) against themselves: their rejection but adds to the odium for the unbelievers in the sight of their Lord: their rejection but adds to (their own) undoing. (Chapter Fathir, 35; 39).

Precisely the position of CSR in Islam is one of the essential human tasks, which are a mandate from Allah. On one hand CSR is the obedience to Allah, on the other hand it serves as a human responsibility as the vicegerent of Allah on earth. Therefore, those who were bestowed by advantages and

higher position by Allah are obliged to help other humans in order to ease the burden on those who are not affluent and face weaknesses.

Therefore, Islamic CSR obligations are the responsibility of individuals who come together in one corporation to give a positive impression for the environment in order to empower the weak and to preserve natural surroundings. Leaving CSR activity causes the wrath of Allah and brings punishment. In contrast implementing CSR will give birth to pleasure and comfort in building cooperative relationships between the corporations and community and create intimacy within society. Allah says:

It is He who hath made you (His) agents, inheritors of the Earth: He hath raised you in ranks, some above others: that He may try you in the gifts He hath given you: for thy Lord is quick in punishment: yet He is indeed Oft-forgiving, Most Merciful. (Chapter al An'am, 6: 165)

The study of corporate social responsibility in Islam has been revealed by some researchers like Ekawati (2004), Mohammed (2007), Irwani and Dusuki (2007), Dusuki (2008), Zinkin and William (2010). There studies have been carried out to explore the concept of CSR in Islam and also to explore the values of equating Islamic CSR with CSR in the UN Global Compact.⁸

A study conducted by Ekawati (2004) was to explore the concepts *zakat*, CSR and community development. She describes community development done by the corporate community in Indonesia by using *zakat* and CSR practices. Both *Zakat* and CSR have the same ultimate goal in efforts to create the social welfare in society. She only sees *zakat* as an instrument for corporations to implement CSR. This study was limited in exploring the concept of Islam that was quite broad to create justice and social welfare of the community.

More specific studies to explore the concept of CSR in Islam have been done by Mohammed (2007). One study was conducted to explore the Islamic philosophy of corporate social responsibility in Islam. He concludes that social responsibility in Islam is built on four basic principles: unity, justice, free will and responsibility. This thesis was an early study that laid the foundations on Islamic CSR paradigm.

According to Dusuki (2008) the basic concept of CSR is based on the concepts of *khalifah* (vicegerency) and paradigms of *taqwa* (piety). The concept of vicegerency denotes that mankind is the representative of Allah on Earth and as such Allah has entrusted mankind with stewardship of Allah's possession. It means the corporate business works endowed by the power of Allah to conduct business in accordance with the laws of Allah. On the other hand, corporations are trying to make profit for shareholders, on another side it is trying to maintain and develop the economic resources of society, covering issues such as good environmental practices, safety, charitable contributions, social benefits and avoiding dangerous activities. This is done to seek the pleasure of Allah (Dusuki, 2008: 22).

Paradigm of *taqwa* (piety) means a person is imbued with a strong understanding that their role in this world is to manage and develop the world in accordance with the

Shariah. This means harmonizing and integrating material well-being with moral-spiritual values, which in turn determines their fate in this world and in the hereafter. It provides a number of values for shaping social life and clarifies the status of human beings and their position in relation to the rest of creation. Furthermore, it defines the nature of human beings' relationship with Allah, with each other and with the natural environment (Dusuki, 2008: 15–17). This will produce a godly paradigm concept of CSR practices that focus on maintaining human dignity, freedom of work, justice and recognition of individual rights, beliefs and responsibilities.

The conceptual framework of Islamic CSR introduced by Mohammed (2007) and Dusuki (2008) became the basic reference to develop further Islamic CSR models. Mohammed (2007) and Dusuki (2008) reflected a broad paradigm of Islamic business practices adherence to the principles of *Shariah*. However, the studies did not provide a framework of CSR criteria in Islamic corporate practically. Islamic CSR criteria can be used as the model for the implementation of CSR. They also did not measure how the concept of CSR was disclosed in line between concept and implementation in the field with a quantitative approach. Furthermore, Muhammed (2007) and Dusuki (2008) had given part of the Islamic CSR principles for implementing CSR.

Dusuki and Irwani (2007) reveal the effects of *maqasid Shariah* (Islamic law purposes) and *maslahah* (public interest) to the concept of CSR. Using the approach of *maqasid Shariah* and *maslahah*, CSR practices are divided into three categories; essentials (*dharuriyyah*), necessary (*hajiyyah*) and luxury (*tahsiniyyah*). Three categories of *maslahah* can be used by corporate or management to consider the facts and situation changes when implementing CSR which also provide a better framework for managers in dealing with conflicts of interest that may arise from stakeholders (Dusuki and Irwani, 2007: 1). Dusuki and Irwani (2007) also have detailed the CSR guidelines using the *maqasid Shariah* and *maslahah*. The study provides guidance to corporate managers to implement CSR according to considerations of the three categories of *maslahah*.

However, a research finding conducted by Zinkin and Williams (2010) were contrary with the findings Mohammed (2007) and Dusuki (2008). Mohammed (2007) and Dusuki (2008) concluded that there were fundamental differences between Islam and the Western concept of CSR, while Zinkin and William (2010: 17) concluded there were no fundamental difference between the Islamic concept of CSR and the UN Global Compact concept of CSR.

Zinkin and William (2010) in fact has erroneously reviewed the philosophy and foundation of Islamic CSR. The philosophy of Islamic CSR has a very different base from CSR in the UN Global Compact. These differences may cause differences in terms of CSR activities. Islam does not just look at the economic side only, but also focuses on spiritual values, which is not emphasised by Zinkin and William (2010). CSR activities in Islam have clear demarcations between permitted and forbidden which is fixed indicator from *Shariah*. CSR activities cannot change permitted (*halal*) to forbidden (*haram*) or vice versa. From another side, the accountability of hereafter arises from an

understanding of *taqwa* to produce different values in the implementation of CSR.

Islamic CSR has a philosophy from al Qur'an and al Sunnah as the guidance in the various activities of life, including CSR practices in Islamic corporates like Islamic banking. Islamic CSR must be understood as part of *Shariah* compliance. Islamic CSR is to be practiced in line with the principles of al Qur'an and al Sunnah and not just merely fulfil *al kifayah* (obligatory upon community) and giving a positive image to corporate, but also as method to reduce poverty and achieve the true economic goals in Islam.

Mohammed (2007) divides Islamic principles of CSR into four; unity of Allah, justice, free will and responsibility. Dusuki (2008) only mentions two, caliphate and *taqwa* (piety), Ekawati (2005) mentions zakat as one of CSR instruments as a form of charity in Islam, while Dusuki and Irwani (2007) describes a guide for corporate managers to implement CSR approach and the theory of *Shariah* purpose and public interest.

The Islamic principles of CSR described above are summarized in table 1.

The principles that have been discussed in the previous studies can be concluded by three principles of Islamic CSR. There are the principle of unity and justice by Mohammed (2007) and the principles of caliphate by Dusuki (2008). The zakah raised by Ekawati (2005) is one kind of instrument that can be used in the CSR practice. However zakah is not one of the CSR principles. While the concept of free will and responsibility as state by Mohammed (2007) and *taqwa* mentioned by Dusuki (2008) were the effects that arise when the principles of unity, justice and the caliphate were applied. It is not a stand-alone principle.

Principle is defined as base, initial, basic rules (Suryadi, 1980: 190). According to Juhaya (1995: 69), principles are the beginning that is the point of departure (*al-mabda*). In the terminology, principle is the universal truth that naturally exists in Islamic law and the starting point of its construction. It is a basic legal form and produces all branches (Juhaya, 1995). It can be concluded that a base or fundamental is used as the basis for the foundation of the work practices.

Consequently, the position of the implementation of Islamic CSR can be categorized into three dimensions of relationship responsibilities. Firstly, it is the relationship of responsibility to Allah. Secondly, the relationship of responsibility to human being. And the last is the relationship of responsibility towards the environment.

To realize the three links at Islamic CSR practice on IBI, require the principle that are inter-related to each other, that is the principle of unity of Allah, caliphate, justice, brotherhood, and creation *maslahah* (public benefit). The five principles of Islamic CSR practice in CSR IBI's programs may affect the interests of the very basic to fulfil the needs of all stakeholders at IBI.

The implementation of Islamic CSR principles in the IBI and responsibilities of the position of the three relationships that must be played by a Muslim can be described in the following figure:

Table 1. Principles of CSR practices in the Islamic view.

Researchers	Islamic Principles of CSR in Practices	Research objectives
Ekawati (2004)	1. Zakat as an instrument of CSR	To explore the relationship between zakat, CSR and community development at Bank Muamalat Indonesia
Mohammad (2007)	1. Unity of Allah 2. Justice 3. Free will 4. Responsible	To expose the Islamic paradigm of CSR and differences with CSR in the west. The study also looks at how the values of CSR practiced by Islamic bank using in depth interviews with managers of Islamic bank.
Dusuki (2008)	1. Caliphate 2. Taqwa (Piety)	To review and produce the concept of CSR in Islam and compare with CSR in the west.
Dusuki dan Irwani (2007)	The practice of CSR is divided into three categories: 1. Emergency (essentials) 2. Interest (necessary) 3. Luxury (embellishment)	To provide guidance for corporate managers to implement the CSR program in line <i>maqasid Shariah</i> and <i>maslahah</i> .

Source: Ekawati (2004), Mohammed (2007), Dusuki (2008), and Irwani Dusuki (2007).

Figure 1 above explains that the implementation of CSR is the manifestation of three strong relationships and intertwined among each other; relationship with Allah, human relationships and relationship with nature. To optimize these three relations in the implementation of CSR, it must be guided by the principles of unity of Allah, caliph, justice, solidarity. The four principles are aimed at realizing the end of the fifth principle which the creation of *maslahah* (public benefit) for humans and the nature. Creating *maslahah* on IBI is a key goal in implementing all the functions of

Islamic banking transactions included in the implementation of Islamic CSR. As a result, all the implementation of CSR in Islamic banking transactions should be guided by *halal* outlined by Islam and abandon any prohibition as prevented in Islam. All of these principles are practiced with the sole purpose of perfect devotion to Allah SWT.

Implementation of Islamic CSR principles in IBI based on Qur'an and Sunnah in the whole Islamic banking activities will be a vein that drives the economy of the people, not just profits

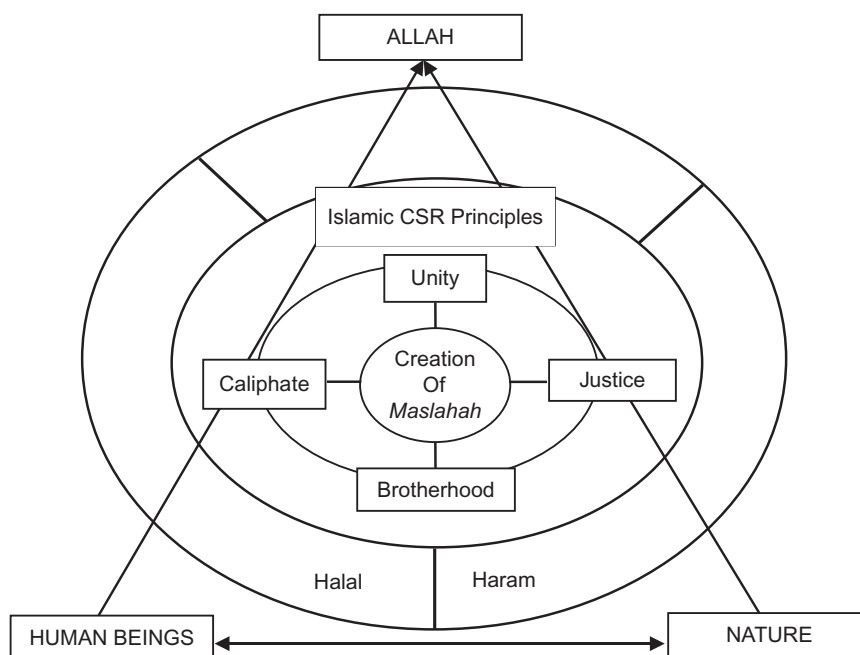


Figure 1. Conceptual implementation of Islamic csr principles of IBI and relationship responsibilities should be played by a muslim.

for shareholders alone, but affect the larger environment for economic empowerment of society through all CSR practices.

3. Criteria and instruments of CSR in Islamic Banking Institutions (IBI)

The criteria which have been studied by researchers are assembled in a conceptual framework. This conceptual framework can be used as the standard in the implementation of CSR in IBI. In general, social responsibility in Islam can be categorized into three forms of relationship responsibilities. Firstly, it is the relationship of responsibility to Allah. Secondly, the relationship of responsibility to human being. And the last is the relationship of responsibility towards the environment. To realize the three links at Islamic CSR practice on IBI, require the five principles that are inter-related to each other, that is; the principle of unity of Allah, caliph, justice, brotherhood, and creation *maslahah* (public benefit).

From the five principles produce six criteria's and 34 items for instrument to measure corporate social responsibility in the IBI. Six criteria's of CSR in IBI come out from deep reading of many literatures and understanding from Qur'an and *hadith*. Six criteria's of CSR in IBI, namely, (1) *Shariah* compliance; (2) equality, (3) responsible in work; (4) guarantee of welfare; (5) guarantee of environmental sustainability and (6) charity for preservation of virtue.

As the following criteria, there are 34 items to be an instrument for measuring these criteria are:

First, the criteria of *Shariah* compliance have five items: (1) Instruments IBI compliance with *Shariah*; (2) Financing IBI compliance with *Shariah*; (3) IBI's investment in *halal* products; (4) Avoiding profit from non-*halal*; (5) Selections of customer according to *Shariah*

Syari'ah compliance criteria and five items to measure those criteria are based on the interest to keep all IBI products and investment lawful as outlined by the Qur'an. There are many verses describing these obligations, Allah says in verses al-Mu'minun: 51; al-Baqarah: 188, 275, 278, 279, and al-Nisa': 10.

The prophet Muhammad PBUH said in *hadith*:

"Searchin the halal is obligatory on every Muslim."
(Narrated by Ibnu Mas'ud).

In banking and finance, all forms of transactions are possible, unless there is any clear evidence or injunction banning a transaction. Therefore each transaction in IBI must be based on *Shariah* in instruments, financing schemes, investment and customer selection.

Second, the criteria of equality has four items; (1) The existence values of brotherhood; (2) Services excellent; (3) Avoid discrimination and (4) Have the same opportunity.

Equality in life has been described in the Qur'an, in chapter Ali 'Imran, 3: 103, al-Anfal: 62-63, al Mukminun; 23:8, al Hujurat; 49:13. The verses explain that the people living in various communities have the duty to respect and cultivate the values of brotherhood with human being in various activities.

The prophet Muhammad (PBUH) said in varieous *hadith*:

"The glory of a believer is because religion, dignity is at the intellect and position is dependent on ethic" (Narrated Baihaqi).

"Allah loves when you do a job to work correctly and properly" (Narrated by Baihaqi).

Third, the criteria of responsible in work has eight items; (1) Trust, (2) Working accordance with the limitations and responsibilities, (3) Fulfill every contract demand; (4) Transparency; (5) Optimal for using time and expertise; (6) Reducing the adverse impact of the investment; (7) Integrity in the work; (8) Fair competition and (9) Accountability.

Responsible in work is something very important in Muslim life. Every employee must be responsible not only to his employer but more than that to Allah also. He will be asked in the Hereafter of what he had done in the world. Obligation to be responsible in their jobs have described at numerous verses in the Holy Qur'an in Surah al Maidah, 5:2, al Munafikun, 63:9, Al Baqarah, 2: 237, Al Baqarah, 2: 195, al Qashash: 77, al Nahl, 16:97. While in sunnah, Muhammad (PBUH) said;

"Muslim traders who are true and trusted in trading are with the martyrs on the Day of Judgment" (Narrated by Ibnu Majah dan Tirmizi).

"Jabir bin Abdullah said that the Rasulullah PBUH said; Allah loves to his servants who acts politely and considerately when selling, buying or reclaiming debts."
(Narrated by Ibnu Majah)

Fourth, the criteria of guarante of welfare has six items; (1) place of work safe and comfortable, (2) Free will, (3) Eligible of Wages; (4) Training and Education; (5) Work does not exceed the limits and time; (6) Profit and loss sharing; (7) Insurance for employee.

Islam is very concerned in giving guarantee of welfare for the people who are involved in every jobs. The relationship between employers and workers, staff and manager must have regulation with the norms of compulsory specific guidelines for creating both sides fairly and qualified. This is the order of Allah in the Qur'an, as mentioned in Surah al-Nahl 16: 90. The Prophet Muhammad (PBUH) also said:

"A worker/employee is entitled to at least get food, proper clothes and not be burdened with the job beyond his ability"
(Narrated by Malik, n.d: 2:980).

"It is not a Muslim who was sleeping in a gorged while his neighbour is in conditions of hunger" (Narrated by Bukhari).

Fifth, the criteria of guarantee of environmental sustainability has four items: (1) To ensure that investment does not harm the environment, (2) Involve an active in protecting the environment, (3) Educating employees to care for and treat the environment and (4) The used of recycled materials to fulfill needs of the IBIs.

The relationship between humans with nature is very close and cannot be separated. Interaction with nature is part of evidencing the greatness of Allah for making the universe to support human being. Allah describes this at the Qur'an in chapter Rum, 30: 41. al Baqarah, 2: 204–206 and al-A`raf 7: 56.

Sixth, the criteria of charity for preservation of virtue has five items; (1) The selection of investors to support the activities for social welfare, (2) Alleviate social problems (such as opening the welfare funds and donations) (3) Support and help fund welfare (such as helping to fund education, social donations, and ease the life of orphan) (4) Playing the role of welfare without looking solely for profitability, and (5) The empowerment of communities through IBIs products (such as Qard hasan, financing micro-economics to poor families and small businesses).

Islam highly asks humans to give welfare assistance to anyone in need and who does not have ability to work. The Qur'an explains a lot about this. Among them are found in chapter al Nahl, 16:71 and 75, al Maidah, 5; 2, Al Taubah, 9; 71. In addition, Prophet Muhammad (PBUH) said:

“Anyone who doesn't love mankind, it's not loved by Allah” (Narrated by Bukhari, Muslim).

“Abu Huraira said, Rasulullah has said: Those who seek to help widows and the poor are similar in rank to those who fight in Allah, pray at night and fasting during the day” (Narrated by Bukhari).

Islamic criteria of CSR in IBI can be related with stakeholders and CSR principles of Islam can be shown in table 2 below:

Table 2. Criteria, item and relationship with stakeholder and principle of Islamic CSR.

Criteria	Item	Islamic banking stakeholders	Islamic CSR principle
1. <i>Shariah</i> compliance	1. Instruments IBI compliance with <i>Shariah</i>	Worker and shareholder	Unity
	2. Financing IBI compliance with <i>Shariah</i>	Shareholder, worker and customer	Unity, caliphate and justice
	3. IBI's investment in halal products	Shareholder, worker and customer	Unity, caliphate and justice
	4. Avoiding profit from non-halal	Worker and Shareholder	Unity and caliphate
	5. Selection of customer according to <i>Shariah</i>	Shareholder, worker and customer	Unity, caliphate and justice
2. Equality	1. The existence values of brotherhood	Shareholder, worker, community, customer	Brotherhood, justice
	2. Services excellent	Shareholder, worker, community, customer	Brotherhood, justice
	3. Avoid discrimination	Shareholder, worker, community, customer	Justice
	4. Have the same opportunity	Shareholder, worker, community, customer	Justice, brotherhood and creation of <i>maslahah</i>
3. Responsible in work	1. Trust	Worker, customer	Unity
	2. Working accordance with the limitations and responsibilities	Worker	Justice
	3. Fulfill every contract demand	Worker and customer	Justice
	4. Transparency	Worker, customer and shareholder	Unity
	5. Optimal for using time and expertise	Worker	Justice
	6. Reducing the adverse impact of the investment	Worker and customer	Unity, creation of <i>maslahah</i>
	7. Integrity in the work	Worker, customer, and community	Unity and justice
	8. Fair competition	Worker, customer and shareholder	Justice, creation of <i>maslahah</i> and brotherhood
	9. Accountability	Worker, customer, shareholder and community	Justice, creation of <i>maslahah</i> and brotherhood

(Continued)

Table 2. Continued.

Criteria	Item	Islamic banking stakeholders	Islamic CSR principle
4. Guarantee of welfare	1. Place of work safe and comfortable	Shareholder and worker	Unity, caliphate and brotherhood
	2. Free will	Worker, shareholder and customer	Caliphate
	3. Eligible of Wages	Worker	Justice and brotherhood
	4. Training and Education	Worker, customer and community	Caliphate
	5. Work does not exceed the limits and time	Worker	Justice and creation of <i>maslahah</i>
	6. Profit and loss sharing	Shareholder, customer and community	Justice and brotherhood
	7. Insurance for employee	Shareholder and worker	Justice, Caliphate and brotherhood
5. Guarantee of environmental sustainability	1. To ensure that investment does not harm the environment	Worker, customer and nature	Unity and caliphate
	2. Involve an active in protecting the environment	Worker, Shareholder and community	Unity and caliphate
	3. Educating employees to care for and treat the environment	Shareholder, worker	Unity and caliphate
	4. The used of recycled materials to fulfill needs of the IBIs	Worker, Shareholder	Unity, caliphate and creation of <i>maslahah</i>
6. Charity for preservation of virtue	1. The selection of investors to support the activities for social welfare	Worker, Shareholder	Unity, caliphate and creation of <i>maslahah</i>
	2. Alleviate social problems (such as opening the welfare funds and donations)	Shareholder, worker and community	Brotherhood, creation of <i>maslahah</i>
	3. Support and help fund welfare (such as helping to fund education, social donations, and ease the life of orphan)	Shareholder, worker and community	Brotherhood, creation of <i>maslahah</i>
	4. Playing the role of welfare without looking profitability	Shareholder, worker and community	Brotherhood, creation of <i>maslahah</i>
	5. The empowerment of communities through IBIs products	Worker and community	Brotherhood, creation of <i>maslahah</i>

Table 2 above, reflects the relationship between the criteria of CSR, stakeholders IBIs with Islamic principles of CSR. It is a network that can not be separated from one another. Each criteria has an impact on the stakeholders; and each criteria is based on the principles derived from al Qur'an and al Sunnah.

The description on the criteria and items to be included Islamic CSR instruments can be used as the conceptual framework for the implementation of CSR in IBI (see Figure 2). It can be described as a series of IBI activities in performing all banking transactions with appropriate responsibility to Allah, human being and in ensuring environment sustainability. Three dimensions of responsibility is to be implemented with the fourth

principles which are unity, caliphate, justice and brotherhood. And fourth principle is intended to create the fifth principle which is the creation of *maslahah* to human and the environment.

Creation of *maslahah* is the main purpose of the IBI in performing of all the functions of banking transactions. Six criteria for CSR at IBI is to ensure that operational IBI occupies the terms and implement *syari'ah* correctly. Thus, the objective of IBI to provide for greater social impact within the environment can be achieved (IAIB 1990, Wahbah Zuhaili, 2003, Sudin Haron, 2005).

The conceptual framework in the implementation Islamic CSR in IBI described above can be seen in figure 2.

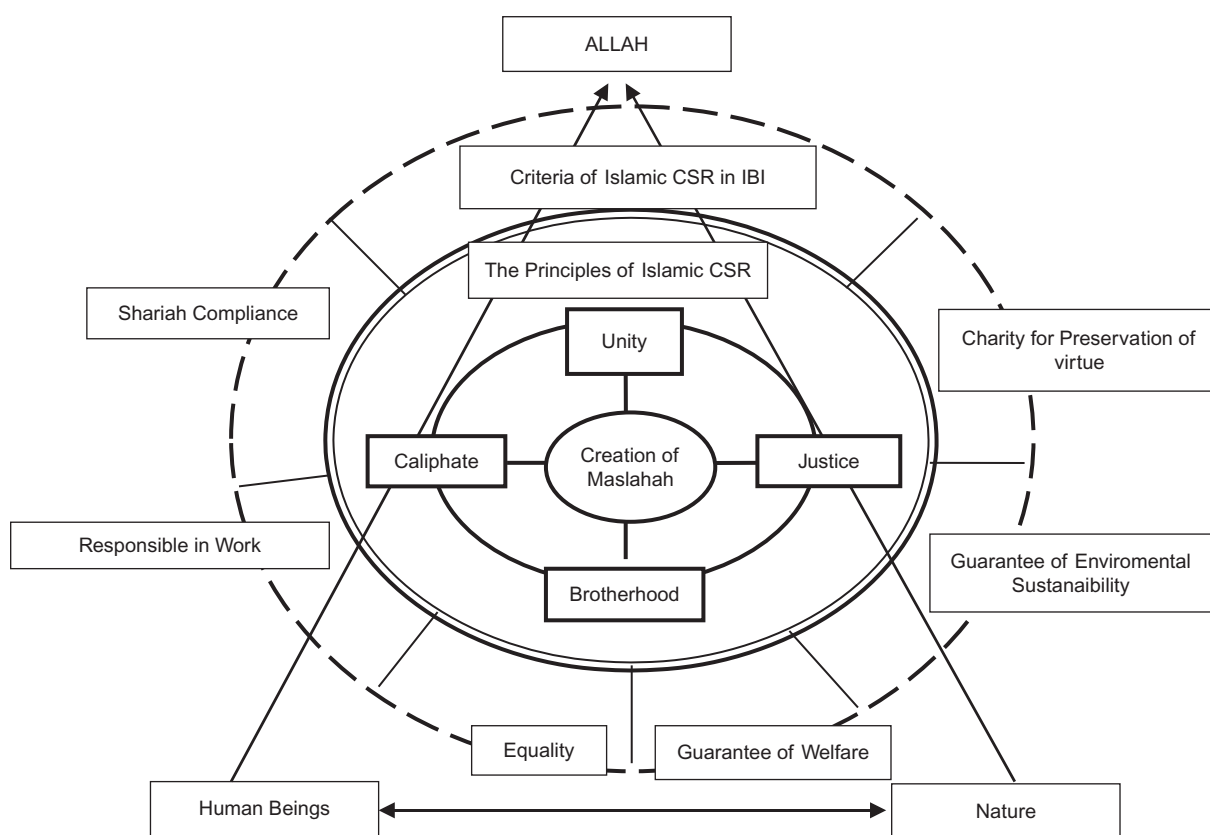


Figure 2. The criteria's and instruments Islamic CSR: Result of an empirical survey in Indonesia.

4. Background of research participants

The purpose of acquiring this information is to ascertain the research participants' authority to discuss Islamic criteria's of CSR. Each of the respondents was asked to give and confirm to the criteria of CSR in Islamic banking. Every feedback from the respondents directed to the removal, addition and modification of each banking CSR criteria established by researcher.

To ensure that the admissions made coincide with the actual purpose of the study, respondents are selected based on two conditions; first, have experience in the field of Shariah, Islamic banking and finance and second, are directly involved as policy makers in the Islamic financial institutions or have been appointed to be Shariah Advisory Board of Islamic banking. The sampling method used is purposive sampling, by selecting all the experts interviewed as participants representing four categories; academics, members of the Shariah Advisory Board of Islamic banking, director of Islamic banking and regulator of Islamic banking. The selection method is used to obtain information, views and in depth opinions from authority in Islamic banking on the phenomenon being studied.

Combinations of respondent in four categories were found to obtain more comprehensive view of CSR criteria in Islamic banking. It does not just examine purely from the theoretical aspects but also the practical aspects of the parallel existence of Islamic banking. Information of all respondents are shown in table 3 below:

Table 3. Information of research participants' based on agencies.

Category	Respondent
Academic	<ul style="list-style-type: none"> Prof. Dr. Alyasa' Abubakar, MA Director of Post Graduate State of Islamic Studies Institute Ar Raniry, Banda Aceh, Indonesia. A Former Head of Official Syariah Islam in Aceh 2004–2009
Shariah Advisory Board of Islamic Banking	<ul style="list-style-type: none"> Prof. Dr. Muslim Ibrahim, MA Head of Consultative Council of Aceh "Ulama. Head of Shariah Advisory Board Islamic Bank of Aceh Shariah
Director of Islamic Bank	<ul style="list-style-type: none"> Isnaini Mufti Aziz CEO of Baity Maal Muamalat. Bank Muamalat Indonesia (BMI) Hizir Ismail Director of Islamic Bank of Aceh Syariah
Central Bank of Indonesia (Bank Indonesia)	<ul style="list-style-type: none"> Ali Sakti Bank Researcher Islamic Banking Research and Development Team, Directorate of Islamic Banking

The background of the participants, who were well experienced, experts and professional, give opinions and endorsement for the criteria of CSR in Islamic banking. The academic and members of the Shariah Advisory Board of Islamic banking with expertise in Islamic jurisprudence were authorized to enlighten the practice of Islamic banks in accordance with the Shariah principles. The director of Islamic banking and regulator of Islamic banking related their experience and how CSR was implemented.

5. Result of survey criteria of CSR in Islamic banking

Six criteria's of CSR and 34 items of the instrument to measure CSR in the IBI were collected to the experts using a semi-structure questionnaire. Every respondent validates between the scales of 1 to 10 and gives reasons for their agreement to these criteria. Six criteria of corporate social responsibility in the Islamic bank are: (1) Shariah compliance; (2) Equality, (3) Responsible in work; (4) Guarantee of welfare; (5) Guarantee of environmental sustainability and (6) Charity for preservation of virtue.

The result of the confirmation was given by experts to criteria's of CSR applying in Islamic bank are:

Criteria of Shariah compliance

In general, all respondents agree with the criteria of Shariah compliance and all items in Shariah compliance item's to measure implementation of CSR at the IBI, because IBI have to be social responsible due to their operation in adherence to Shariah naturally (table 4).

The above matrix imply CSR in IBI have to adhere with Shariah compliance. All respondents agree and give high grade of each item to measure Shariah compliance. One of them pointed out:

...Islamic Bank as a institution based on Shariah, it must be based on the Shariah itself. Every instrument in Islamic bank must adhere with Shariah compliant, as well as financing and investment too.

Another respondent said:

I agree with all of these items in the first criteria, because basic concept of Islamic banking must appropriate with Shariah. We cannot leave the concept of Shariah in Islamic banking.

However, have misperceptions about two respondents reminded about the fifth "Selection of customer according Shariah" under the first criteria. One of them said:

But item fifth should be clear, Islamic banking also has partner with users outside of Islam, Islamic banking as rahmatal lil alamin (mercy for the universe). So anyone can interact with Islamic bank, whether Muslim or not Muslim. Customer IBIs as conventional banks are not differentiated, so that it occurs universally. We cannot select or prioritize only Muslim consumers; the most important thing is instruments and financing products that must be considered properly in line with Shariah.

Other respondent said:

I think item fifth may be misperception most people. The reason, if customer Islamic bank came from among all non-Muslim, such as Chinese, maybe people will think not possible in Islamic bank, but actually anyone can involve in Islamic bank. This item make people to think that the customer Islamic bank just come from Muslim only, however in Shariah, anyone can relate to the bank even though it is not a Muslim. It means, if non-Muslim accompany Islamic bank, Islamic bank still compliance with Shariah.

Both views from respondent was approved by the researcher. Selection customer according to Shariah does not mean that the IBI customer's should be a Muslim but a non-Muslim can be a part of IBI. Selection customer means that, IBI have to ensure that the customer should not be involved with money laundering or affected as a corruptor by law. IBI should ensure that the money put in bank from a third party are lawful with Shariah and government even though it has no obligation to the bank to ask where the money come from. On the other hand, IBI cannot invest or finance customers who have business propositions that violet Islamic tenets of business transaction. For instance, Casino or Karaoke bars that serve alcohol, due to prohibition (haram) of gambling and alcohol in Islamic jurisprudence.

Criteria of equality

The criteria of equality denotes a sense of balance among various aspects of a man's life to produce the best social order. Allah has created everything with balance to maintain equality and equilibrium. As chaliphate of Allah on earth, mankind is expected to maintain equity in society through social responsibility and justice. A middle part must be maintained in all social economic affairs of the Muslim society. Adherence to this criteria, in Islamic society

Table 4. Criteria and items of Shariah compliance.

Criteria	Item	Score by experts						
		E1	E2	E3	E4	E5	Total	Average
Shariah Compliance								
1	Instruments IBI compliance with Shariah	8	10	10	10	10	48	9.6
2	Financing IBI compliance with Shariah	8	10	10	10	10	48	9.6
3	IBI's investment in <i>halal</i> products	8	8	10	10	10	46	9.2
4	Avoiding profit from non-halal	8	10	8	10	10	46	9.2
5	Selection consumer according with shariah	8	10	4	10	10	42	8.4

Table 5. Criteria and items of equality.

Criteria	Item	Score by experts						
		E1	E2	E3	E4	E5	Total	Average
Equality		E1	E2	E3	E4	E5	Total	Average
1	The existence values of brotherhood	7	10	8	10	10	45	9.0
2	Services excellent	9	10	10	10	10	49	9.8
3	Avoid discrimination	9	8	10	10	10	47	9.4
4	Have the same opportunity	9	10	10	10	10	49	9.8

or organization will ensure a harmonious society through aggregation of nature and social forces.

IBI's as Islamic organizations are expected to facilitate the criteria of equality through their practices of maintaining balance in social-economics sphere. Equitable distribution of work/job, services and no discrimination are important aspects of this criteria. The manner in which IBI implement this criteria of equity conclude is in the following items (table 5):

The average values given by all respondents indicated a very high level of their agreement to the criteria of equality for measure CSR in IBI. One of respondent said:

I agree with four items of the second criteria due to two reasons. First, Quran ask us not to discriminate regardless of race, class, position, and age. Our difference is only in taqwa. Second, in terms of business conduct, discrimination is also not allowed and we have to give best services for all customers.

Criteria of responsibility in work

The criteria of responsibility in work is a significant part of the Muslim's faith that he/she is accountable to Allah in the Hereafter for every deed on this earth. Achieving Allah's favour and blessing by adhering to the divine commandment is a significant motivation of faithful's action. Every individual is accountable and ultimately responsible for his own actions. The manner in which IBI implement this criteria of responsible in work conclude in the following items (table 6):

All respondents mentioned the criteria of responsibility in work is something very important in the Muslim life

Table 6. Criteria and items of responsibility in work.

Criteria	Item	Score by experts						
		E1	E2	E3	E4	E5	Total	Average
Responsible in work		E1	E2	E3	E4	E5	Total	Average
1	Trust	9	10	10	10	10	49	9.8
2	Working accordance with the limitations and responsibilities	9	10	8	10	10	47	9.4
3	Fulfill every contract demand	9	9	10	10	10	48	9.6
4	Transparency	8	9	9	10	10	46	9.2
5	Optimal for using time and expertise	8	10	10	10	10	48	9.6
6	Reducing the adverse impact of the investment	8	10	10	10	10	48	9.6
7	Integrity in the work	9	9	10	10	10	48	9.6
8	Fair competition	9	10	10	10	10	49	9.8
9	Accountability	9	10	10	10	10	49	9.8

and organization-collectively to be socially responsible. Similarly, the values given to the criteria responsible in work by all respondents is high grade. They agree to the criteria responsible in work and items that can be used to measure CSR in IBI. One of the respondent said:

Actually, there are ethical considerations/understood by the performer banks to safeguard the rights of consumers. Item trust and all these items are ideal. Moreover, fairness in the competition items (item 8), the Central bank of Indonesia as regulator, have made sure that the competition between bank must be healthy. I gave a value of 10 to each item.

Other respondent who give emphasis on item 6:

In general, all investment banks would be assisted by the feasibility study related to investment, but most of the feasibility study only see the feasible return and get profit, it is not a visible impact on the environment. I think reducing the adverse impact of the investment is an important item to be created. I hope IBI pay more attention to this item.

Guarantee of welfare criteria

In order to achieve its ideal of socio-economic justice, Islam imposes social rights over individual wealth such as rights of the poor relatives for financial support, rights of the needy neighbors for assistance, rights of the slaves and servants for help, rights of the wayfarers, friends and general Muslims who need financial aid. IBIs as Islamic organization have to make sure every stakeholder are guarantee to get welfare. Therefore to measure welfare guarantee to stakeholder, there are six items to fulfill the right stakeholder in Islamic banking (table 7):

Table 7. Criteria and items guarantee of welfare.

Criteria	Item	Score by experts						
		E1	E2	E3	E4	E5	Total	Average
Guarantee of Welfare		E1	E2	E3	E4	E5	Total	Average
1	Place of work safe and comfortable	8	10	10	10	10	48	9.6
2	Free will	7	10	6	10	10	43	8.6
3	Eligible of Wages	9	10	10	10	10	49	9.8
4	Training and Education	8	9	10	10	10	47	9.4
5	Work does not exceed the limits and time	8	9	4	10	10	41	8.2
6	Profit and loss sharing	9	10	10	10	10	49	9.8

There was a general consensus among all respondents that IBI contribute to the well-being of society by providing an Islamic option of dealing with wealth. The stakeholder of IBI's have freedom to choose or reject their services. Likewise the IBI's worker have work place safety and comfortable, convenient of wages and workload that do not exceed the limit and time. And for customer or shareholder, Islamic banks have to make sure every profit and every loss share together among them. IBI's contribute to the welfare and well being of society through various avenues including stakeholder. One of the research respondents illustrated this:

I agree in general with this item, because this is part of the professional demands. I mean professionals are not professionals in the Western understanding but professionals who uphold high ethical values that Islam ask to do. Good place for work, wages, education and the provision of reward and punishment should be balanced.

One of the respondent that give additional item to put in the guarantee of workers' welfare is guarantee of insurance. Insurance was considered a significant item to make sure it is convenient for worker to be good worker in IBI.

Guarantee of enviromental sustainability criteria

Islam has clearly phohibited anything that is harmful to individual or hazardous to the environment. Thus, IBI do not deal with or finance tobacco realted businesses, as it is harmful. Similarly, some IBI do not finance logging companies because they simply log and do not replant, causing harm to the ecological environment. IBI also required compliance to the pollution effect from businesses that are hazardous to the environment. Thus, it is one of obligation for IBI to care for the well being of society to guarantee enviromental sustainability for the next generation. The manner in which IBI implement criteria

of Guarantee enviromental sustainability conclude in the following items (table 8):

The average values given by all respondents indicated general consensus among all respondents that IBI must fulfill their obligation to environment by providing every invesment in IBI that do not harm environment sustainability. One of the respondents said:

Now the Central Bank of Indonesian is conducting a green bank campaign. This was done gradually from several aspects. Currently, we are providing, financing or credit and do not give to the corporate that destroy the environment, and creating hazardous industrial waste. Then we also build coordination with the ministries of the environment. In the ministry of the environment, there is a grading for each other corporate. The grading in the both ministries are supposed to match each other. The bank is healthy, quite healthy, less healthy and an unhealthy, it would be equated with the existing corporate criteria on the assessment from the ministry of the environment. Corporate has grading, namely green, yellow, red and black. When corporate is green, it means the corporate take care of the environment. If corporate is black, this means corporate is really damaging the environment. ... well if black corporate is getting finance from a bank, it will affect the soundness of the bank. Now, this idea is being rolled out in the Central Bank of Indonesian. I strongly agree with this item

Charity for preservation of virtue

Essentially, the philosophy of Islamic banking can be fully understood in the context of the overall objectives of Islamic economic system. Many prominent Islamic economists, like Chapra (1985, 2000a, 2000b), Ahmad (2000), Siddiqui (2001) and Naqvi (2003) assert that Islamic banking is a subset of the overall Islamic economic system that strives

Table 8. Criteria and items guarantee of enviromental sustainability.

Criteria	Item	Score by experts						
		E1	E2	E3	E4	E5	Total	Average
Guarantee of environmental sustainability		E1	E2	E3	E4	E5	Total	Average
1	To ensure that investment does not harm the environment	8	9	10	10	10	47	9.4
2	Involve an active in protecting the environment	8	9	10	10	10	47	9.4
3	Educating employees to care for and treat the environment	8	9	10	10	10	47	9.4
4	Use recycled materials to fulfill needs of the IBIs	8	5	10	4	10	37	7.4

for a just, fair and balanced society as envisioned and deeply inscribed in the objectives of Shariah (Dusuki, 2008: 6). Therefore, Islamic banking is much more than just refraining from charging interest and conforming to the legal technicalities and requirements on offering Islamic financial products. It is a system which aims at contributing to the fulfilment of the socio-economic objectives and the creation of a just society.

The duty of Islamic banks towards the society in which they operate by providing a clear expression outlined in the public statement of the International Association of Islamic Banks (IAIB):

“The Islamic Banking system involves a social implication which is necessarily connected with the Islamic order itself, and represents a special characteristic that distinguishes Islamic banks from other banks based on other philosophies. In exercising all its banking or development activities, the Islamic bank takes into prime consideration the social implications that may be brought about any decision or action taken by the bank. Profitability – despite its importance and priority – is not therefore the sole criterion or the prime element in evaluating the performance of Islamic banks, since they have to match both between the material and the social objectives that would serve the interests of the community as a whole and help achieve their role in the sphere of social mutual guarantee. Social goals are understood to form an inseparable element of the Islamic banking system that cannot be dispensed with or neglected.” (p. 27)

This statement represents the core of what the advocates of Islamic banking expect to do in terms of social obligations. The form of social obligation or social objectives from IBI to community can be charity for preservation of virtue. The manner in which IBI implement this criteria conclude in following items (table 9):

Items of charity for preservation of virtue above indicated the banking industry generally cater to segment community, it must care for the less fortunate in society to maintain equilibrium and social justice. The extent to which IBI's implement this criteria of caring for the less fortunate in practice is explored in the following responses of research respondents.

I agree with five items criteria of charity for preservation of virtue, but my advice, for item 1 (the selection of investor...) should replace with the priority of investors

because it is difficult for banks to choose investors who support the activities of social virtue, if not profitable, but if this priority, I think more better.

Other respondent said:

I agree with all the items, I hope Islamic banks can be a bank that empowers people, Islamic banks do not rely on any profit (profit-oriented). So we should also focus on empowering a good people in the finance.

But one respondent said:

I do not agree if Islamic banks come to a social bank for the poor, because on other side Islamic banks must also provide benefits to shareholders. Moreover, Islamic banks do not pursuit for profit alone. Islam strives for a balance between profit and social in every work that we do.

However it is ill-conceived for anyone to believe that Islamic banks are charitable or welfare organisations which only have concern for the unprivileged or to provide monetary assistance as requested (Rosly and Bakar, 2003). Similarly, it is inappropriate for the management of Islamic banks to emphasise on the profit maximisation policies alone, while neglecting other social obligations (Haron, 1995). Instead, Islam strives for a balance between profit and social objectives. It is considered unjust for Islamic banks if they are unable to provide sufficient returns to depositors and shareholders who have entrusted them with their money. At the same time, Islamic banks are not supposed to make excessive profits at the expense of their customers or undermining and neglecting their social responsibility and commitments to their various stakeholders (Chapra, 1985; Ahmad, 2000: Dusuki, 2008; 7).

The empirical survey results reveal that the criteria of Islamic CSR to measure CSR in IBI have systematized framework came out from Islamic paradigm from the Qur'an and Sunnah. IBI quite extensively are implemented principles and criteria's Islamic CSR when practicing in IBI.

One of the goals of Islamic banking operations is to increase the economic growth towards a better and just society. Hopefully, the criteria and Islamic instrument of CSR in IBI can create a sustainable economic development. Specifically, improve the quality of life and alleviate poverty.

Table 9. Criteria and items of charity for preservation of virtue.

Criteria	Item	Score by Experts						
		E1	E2	E3	E4	E5	Total	Average
Charity for preservation of virtue								
1	The selection of investors to support the activities for social welfare	8	10	8	5	5	36	7.2
2	Alleviate social problems (such as opening the welfare funds and donations)	9	10	8	10	10	47	9.4
3	Support and help fund welfare (such as helping to fund education, social donations, and ease the life of orphan)	9	10	8	10	10	47	9.4
4	Playing the role of welfare without looking profitability	9	10	8	10	10	47	9.4
5	The empowerment of communities through IBIs products	9	10	10	10	10	49	9.8

6. How to implement Islamic CSR IBI's in society?

Implementation of Islamic CSR in the society should be guided by two Islamic principles, first, the application of *maslahah* (the public good) which provides a better framework that managers can use when faced with potential conflicts arising from diverse expectations and interests of any corporation's stakeholders. Secondly, CSR program should pay more attention to the importance of social capital in the society

First, the application of *maslahah*. *Maslahah* means something of benefit, opposite the word of *mafsadat*, which means damage or destruction. *Maslahah* means something to raise the benefits and profits (Macluf, 1976: 432). *Maslahah* consists of considerations which secure a benefit or prevent harm. Protection of life, religion, intellect, lineage and property is *maslahah*.

According to al Ghazali (1322: 286) the objective of the Shari`ah is to promote the well-being of all mankind, which lies in safeguarding their faith (*al din*), their human self (*al nafs*), their intellect (*al `aql*), their posterity (*al nasl*) and their wealth (*al mal*). Whatever ensures the safeguard of these five serves public interest and is desirable.

Al Syatibi described the objective of the Shari`ah is to promote the well-being of all mankind not all at one level. Al Syatibi and al-Ghazali divides *maslahah* in *Shariah* to be achieved in three levels (al Syatibi, t.th: 4, al-Ghazali, 1322: 1: 286). First, *al Dharuriyyah* (the essential); second, *al hajiyyah* (the necessary); and third, *al tahsiniyyah* (the luxury).

Al Dharuriyyah: The essentials are the self-interests upon which people essentially depend, such as faith, life, intellect, posterity, and wealth, if neglected, would lead to hardship and appear total disruption of life's normal order. *Al Hajiyyah*: The complementary interests supplement the essentials and refer to those interests that, if neglected, would lead to hardship but not to the total disruption of life's normal order. In other words, they are needed to alleviate hardship so that life may be free from distress and predicament. *Al Tahsiniyyah*: The embellishments refer to those interests that, if realized, would lead to refinement and perfection in the customs and conduct of people at all levels of achievement (al Syatibi, t.th: 4, al Ghazali, 1322: 1: 286, Dusuki and Irwani, 2007:32).

In the case of priority to achieve between three levels *al dharuriyyah* (essential), *al hajiyyah* (necessary), *al tahsiniyyah* (luxury), the Islamic scholars have agreed that level *al tahsiniyyah* and *al hajiyyah* have different levels, as well as *al daruriyyah*. Level *al daruriyyah* most necessary than level *al hajiyyah* and *al tahsiniyyah*. Therefore, if there is conflict between the benefit of *al tahsiniyyah* with *al hajiyyah*, *al hajiyyah* is preferred then *al tahsiniyyah*. Likewise, if benefits of *al hajiyyah* or *al tahsiniyyah* compete with *al dharuriyyah*, *al dharuriyyah* is preferred (Qarraf, 1925, 3: 94).

Hence, Qarraf asserts that the above classification is related to and deeply rooted in the Shari`ah's objectives to ensure that society's interests are preserved in the best fashion both in this world and in the Hereafter.

According to his views, such a classification implies how a *maslahah*-based methodology could be used to derive new rulings from the Shari`ah, meet society's changing needs, and solve contemporary problems related to socio economic endeavours. Thus, these principles can help establish guidelines for moral judgments and balancing the individual's self-interests with social interests. Especially in conditions where the Qur'an and al-Sunnah are not explicitly explain in detail. This framework could be basis reference for implementing CSR in IBI.

There are two ways for using *maslahah* which can be made by IBI to implement CSR. First, the positive side by performing CSR activities are for maintaining and ensuring the creation of *maslahah* for stakeholders. And the second, negative side by refusing and avoiding all the possible of *mafsadah* happened or will happen in the IBI's.

The implementation of Islamic CSR based on principle of *maslahah*, IBI can create many programs of CSR for arising welfare society. This principle, by implication, reflects how Islam stresses the importance of considering public interests rather than merely individual interests. It provides a framework for making decisions and a mechanism for adapting to change. Perhaps this principle can further contribute to delineating the role of IBI in terms of their CSR. It also offers guidelines for moral judgment on the part of managers and other stakeholders, particularly in solving conflicts that may arise when pursuing CSR.

According to Dasuki and Irwani (2007: 35–37) applying the *maslahah* to CSR can be described to look like a pyramid form (figure 3) below:

Dusuki dan Irwani (2007: 37) elaborate on the first level (the essentials), managers are expected to strive to preserve and protect their stakeholders' essential needs (viz., religion, life, intellect, posterity, and property) and the public good in general. For example, under the CSR precept, they must protect their employees' welfare or basic needs by providing adequate prayer rooms and protecting the employees' safety and health in the workplace, thereby reflecting their responsibility to safeguard, respectively, the faith and values of life. Moreover, they must confine their operations to those that safeguard the above-mentioned

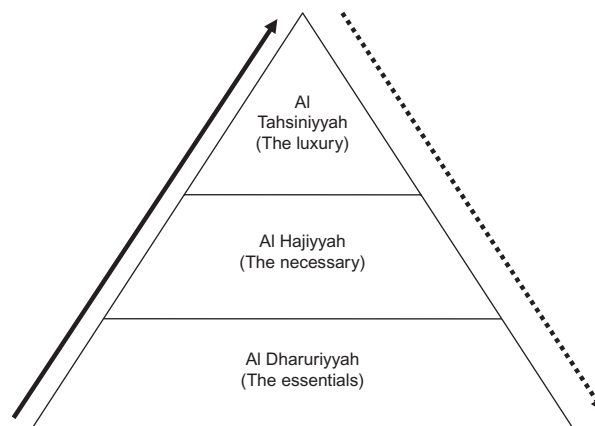


Figure 3. The *Maslahah* pyramid.

essential values. Accordingly, corporations have a moral and social responsibility to avoid any activities that may cause disruption and chaos in people's lives, even though pursuing them may engender higher profits. Such examples include business activities that can endanger people's lives and disrupt their intellects as a result of environmental degradation and manufacturing illicit drugs for public consumption.

As soon as this level's responsibilities have been fulfilled, the corporations may strive for the second level: the necessary. Here, it is deemed beneficial to remove difficulties that may not pose a threat to the normal order's survival. For example, these managers may want to extend their social responsibility commitment by extending the employees' essential needs, such as fair pay and a safe workplace, to include continuous training and enhanced human quality programs. The latter is not really essential, for neglecting it does not threaten the employees' continued existence. However, assuming such a responsibility fulfills the complementary interest of advancing the workers' intellectual well-being (knowledge and skills). In some cases, such an effort can be considered one of the essentials. For example, IBI needs to provide adequate Shari'ah training to their employees concerning the offered Islamic financial instruments in order to protect the interests of the faith.

At the highest level, the luxury, corporations are expected to discharge their social responsibilities by engaging in activities or programs that may lead to improving and attaining the perfections of public life. Giving charity or donating to the poor and the needy, as well as offering scholarships to poor students and providing sufficient, correct, and clear information or advertisement regarding all products, are some of the examples of CSR commitment with respect to realizing this level's goal for society.

The pyramid's three levels are not mutually exclusive; rather, all levels are inter-related and mutually dependent. The arrows pointing upward and downward reveal the flexibility and mechanism of change in the decision-making process, in the sense that any element comprising one level of *maslahah* may be elevated upward or pushed downward, depending on the different circumstances concerning the public at large. However, it should be noted that such flexibility is confined within the Shari'ah's framework, and not vice versa.

This reflects the pyramid's dynamism in assisting the decision-making process within each different context, time, and space. For instance, if circumstances change and corporations are encouraged to respond and, as a result, reconsider their roles within society, this will necessitate a realignment of their business institutions (e.g., mission, vision, policy deployment, decision making, reporting, and corporate affairs) to the new *maslahah*, so long as it does not contradict the Shari'ah's principles (Dusuki and Irwani, 2007: 39).

The *maslahah* pyramid above can be used as frame of reference for CSR managers in IBI's products of CSR for IBI's stakeholders. CSR which refers to *maslahah* based on three levels of urgency that must be achieved. *Maslahah* reflects the urgency level of importance that should be achieved in the implementation of CSR. Lowest level is *al dharuriyyah*,

which is the first and most major accomplishment to be achieved in the implementation of CSR. The second level *al hajjiyyah* achieved when the first level *al dharuriyyah* have been fulfilled completely, as well as the third level *al tahsiniyyah* accomplishment after the first and second levels have been done (Qarrafi, 1925).

The *maslahah* pyramid, which functions as a framework and a general guideline to an ethical filter mechanism, provides managers with three levels of judgment to resolve the ethical conflicts that inadvertently emerge while applying CSR programs and initiatives. The levels also reflect the different degrees of importance in terms of responsibility fulfillment. The bottom level, the essentials, constitutes the most fundamental responsibility to be fulfilled, as compared to the complementary and the embellishments categories.

Secondly, CSR program should pay more attention to the importance of social capital in the society.

Since in the beginning of 1990s where some influential works emerged (Coleman 1990, Putnam 1993, Fukuyama 1995), in the various field of social sciences, analysis of social capital has grown with the perceived importance of their impact on socio-economic outcomes (Yamamura, 2008). I will consider the role played by social capital in implementing Islamic CSR for IBI mainly from the standpoint of economics welfare.

Social capital is defined as features of social organization, such as trust, norms and networks that can improve the efficiency of society by facilitating coordinated action (Putnam 1993; 167). Social capital thus seems to play a critical role in preventing agents from taking opportunistic behavior, raising efficiency and so promoting the economic development (Hayami 2001).

Ostrom (1993) states the development utilizes social capital for the community's to show better result. Social capital is one of the prerequisites for the success of development programs in community. Ostrom view's have relevant with the research was conducted by Ohama (2001), Fukuyama (2000), Badaruddin (2006, 2008) and Ibrahim (2006). Therefore, implementation of Islamic CSR in IBI through micro-finance by utilizing the potential of social culture for local communities will provide high benefit impact to fulfill the basic needs of the community.

7. Conclusion

The aim of this study is to examine the criteria and Islamic instrument of CSR towards the creation of a sustainable economic development. Specifically, the study analyse the various approaches to improve the quality of life and alleviate poverty, and the methods of applying Islamic instruments to CSR programs in Islamic banking. Based on the review of literature and findings from in depth interview with the experts from the Indonesian Islamic banking, the study reveals that there are six (6) fundamental criteria and 34 items considered as critical for CSR to make an impact on the society.

Implementation of Islamic CSR principles in IBI based on Qur'an and Sunnah in the whole Islamic banking activities will be a vein that drives the economy of the people, not

just profits for shareholders alone, but affect the larger environment for economic empowerment of society through all CSR practices.

Therefore, Then application of Islamic CSR in the society should be guided by two Islamic principles, first, the application of *maslahah* (the public good) which provides a better framework that managers can use when faced with potential conflicts arising from diverse expectations and interests of any corporation's stakeholders. Secondly, CSR program should pay more attention to the importance of social capital in the society.

Notes

1. Emerging deals of CSR began from the United States in the 1970s. Corporations in America receive criticism from the community because they are powerful and that is considered anti-social. The spirit of corporations is to eliminate competitiveness in business and refuse the role of law and sometimes corporations can affect the law for their interest. Hence some corporations recognize the impact of criticism from the community. They advice to businessmen and corporations is to use their power to achieve social goals and work not only for profit. This approach produces new entrepreneurs in the business world. This idea is known as CSR (Frederick, et.al., 1988:28).
2. The stakeholders are the parties interested in and responsible for the existence of the corporation and have an influence on the decisions made. These include employees, suppliers, consumers; governments act as the makers (regulators), community and corporate owners (Frederick, et. al., 1988:77).
3. According to Clarkson, corporate stakeholders can be divided into two groups; namely, primary stakeholders and secondary stakeholders. The primary stakeholders are the parties who have an interest in economics to the corporate and bear the risk of losses as investors, creditors, workers and communities. The government also included in the primary stakeholder groups, although not directly, have economic ties, but relations between them are more transactional. The second form is secondary stakeholders, namely the nature of their relationship is not determined by this group of stakeholders. Examples of secondary stakeholders are the media and interest groups such as community social and unions (Clarkson, 1995:92–117).
4. In Islam, the word has two meanings *sadaqah*. *Sadaqah* first significant donation to charity, and required that both voluntary donations as charitable contributions.
5. *Qard Hasan* is good credit who do not take advantage. Total amount of loan repayments in accordance with the loaned property.
6. In the Al Qu'ran, Allah mentions in at least 64 section, which describes an important donation to charity. As of 2:43, 83, 110, 177, 215, 263, 264, 270, 271, 273, 274, 276, 277, 280, 4:77, 114, 162, 5:12, 45, 55, 7: 156, and others.
7. Fard kifayah mean anythings societies are obliged to possess, though the task of acquiring them may be left to certain individuals or groups. Implicit in the meaning of this category of knowledge or obligation is that without it a society would lack something that is important to its well-being.
8. Consists of 10 principles and four categories (human right, labor, environment and anti-corruption).

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Social responsibility dimension in Islamic investment: A survey of investors' perspective in Malaysia

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Abstract - This paper seeks to explore the level of support investors attach to the social responsibility dimension in Islamic investment. The call to address this 'neglected' dimension as observed in the practice of Islamic finance is emphasized in the face of the rapidly growing Socially Responsible Investment (SRI) industry in the West and other developed markets, where various social, ethical, and environmental considerations are central to the investment decision. The empirical analysis of the paper is based on a survey conducted on Malaysian investors of Islamic funds from three leading fund management companies. The overall result reveals that the investors in general place a hierarchy in the elements they considered important; the observance of *fiqh* injunctions is ranked as the most important consideration, followed by economic and social responsibility dimensions. The findings are based on both the descriptive analysis and the composite scales constructed as a result of an exploratory factor analysis, which provide statistical evidence on the nature of social responsibility dimensions being acknowledged by the respondents as part of an important underlying factor in their investment decision. Despite being overpowered by the economic aspect, the findings suggest that social responsibility criteria in investment are perceived as important by a majority of the investors, and substantial proportion of the respondents consider the dimension to be as equally or more important than the economic dimension. Further analysis reveals that the level of importance investors attached to the social responsibility dimension is determined by ethnicity, religion, level of commitment to *Shariah* principles in investment, income, age, level of SRI awareness, as well as gender, marital status and participation in pro-social activities. The favorable attitude of the respondents on the importance of social responsibility issues can be an encouraging precursor to the incorporation of these concerns into Islamic investment practices.

Keywords: social responsibility; ethical and Islamic investment; Islamic economics and finance

1. Introduction

Recent debates on the development and practice of Islamic finance have highlighted the increasing divergence between the economics literature on Islamic finance and the actual practice of the industry players. Despite the progress made and the growing maturity of the industry, critics argue that the pursuit of profit maximisation and commercial orientation of Islamic financial institutions (IFIs) often override the supposed faith-based ethical principles which had formed its underlying foundation. Moreover, while *Shariah* encompasses a holistic outlook of the system of life in Islam, many have expressed that the operation of Islamic financial services have been pre-dominantly shaped by a 'legalistic' outlook and have been considered by some as a 'prohibition driven' industry. This has led to the call

for Islamic finance to address broader social responsibility outlook beyond the traditional legal compliance, in line with the normative goals of Islamic moral economy and the *Maqasid as-Shariah* (the higher objectives of the *Shariah*).

This paper attempts to explore such discussion, within the context of Islamic investment, which has gained tremendous growth and developed into a strong and viable area in the Islamic financial services industry. The call to address social responsibility concerns especially in the field of Islamic investment is further emphasized in the face of the rapidly growing Socially Responsible Investment Industry (SRI) in the West and other developed markets, which use various social, ethical, and environmental issues in their investment criteria in effort to promote socially responsible and

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sustainable behavior among corporations. Although Islamic investment is founded by a totally different worldview and ethical foundation, Islam strongly shares the concerns towards social, ethical and environmental issues, and the incorporation of such concerns in Islamic investment will bring the industry to a new height and move it closer to the idealized aspiration of Islamic economics. Nevertheless, the viability of such an investment approach will ultimately depend on the favorable acceptance of the idea among investors. Therefore, the main objective of this paper is to investigate the perceptions in terms of the importance investors attached to the social responsibility dimension in *Islamic* investment and to explore the factors that influence this. The article starts by reviewing the Islamic investment industry, the prevalent nature of complying with the *fiqh* injunctions (as compared to its spirit and objective), and the prospect of incorporating broader aspects of social responsibility in the investment process in line with the experience of SRI. The paper continues with the description of the research methods, followed by a detailed analysis of a questionnaire survey on the issue conducted in 2009 on Malaysian investors of Islamic funds. The last section highlights the main findings and concludes the paper.

2. Literature review

The defining feature of Islamic investment practices, which are also applicable in all of the sub-sectors of Islamic finance, is based on the ethical principles embodied in the *Shariah* (Islamic legal and ethical system), where its underlying objective are generally aimed at realizing overall human wellbeing and social justice. Some of the salient *Shariah* injunctions strictly observed in Islamic investment practices include the prohibition in all activities and transactions involving the elements of *riba'* (interest), *gharar* (excessive uncertainty), *maysir* (gambling) and all other types of activities and transactions which are considered unethical or harmful as deemed by the *Shariah*. Such prohibitions necessarily remove sectors like conventional banking and insurance, gaming, alcohol, non-*halal* meat production, tobacco, entertainment, weapon and genetic biotechnology from the *Shariah*-approved investable universe. Similarly, conventionally structured financial products such as bonds, derivatives as well as excessively speculative transactions are also considered as *Shariah* repugnant (Wilson, 2004; Derigs and Marzban, 2008).

The desirability features of equity participation, where risks and returns are shared among different parties in a productive venture, naturally render common shares of companies in the capital market as readily legitimate forms of investment instruments. While it is almost unanimous among the contemporary *Shariah* experts that the equities of companies where all of its transactions are in full conformity with *Shariah* (including that the company neither borrows money on interest nor keeps its surplus in an interest bearing account) can be purchased, held and sold without any hindrance, the contention among the *Shariah* scholars focuses on the status of companies with lawful core business activities, but mixed with some impure sources of income or financing (Usmani, 1998). In a comprehensive review of the major resolutions and scholarly opinions on the issue, Yaquby (2000) concluded that the opinion of those arguing for permissibility is "closer to the truth." His observation is based on the "strength of the

sources they have cited from jurisprudence (*fiqh*) provisions and legal principles," as well as the wider acceptance of its permissibility among the *Shariah* scholars, including those who had previously argued against it (Yaquby, 2000). Other justifications being cited include serving the common interest of the public as well as the Islamic financial institutions to participate in such a vital economic activity, as well as having the benefit of propagating the message and ethical principles of Islam globally.

Such acceptance however, comes with a number of *Shariah* parameters, which need to be strictly observed in the investment process. These parameters address some issues of concern from the *Shariah* point of view, particularly on the sources of income from unacceptable business activities, including incidental interest income from cash or cash-equivalent assets of the companies; the prohibition against the interest-based financing of the business activities; and the prohibition of the sale of debt to a third party and the exchange of cash-like assets at values different from its par value. These criteria provide the threshold in which equities within the tolerable limit of the parameters are identified as *Shariah*-compliant securities. In order to ensure that returns from such investment are pure and legitimate, a process of "cleansing" or "purification" must be done to remove the elements of mixed sources of income, which are tolerated earlier. Therefore, despite some leniency on the permissibility status of companies with mixed business activities and income for investment, particularly in facilitating the common interest of the public and Islamic financial institutions to participate in such economic activity, the *Shariah* is very clear that Muslim investors must not benefit in any way from activities or transactions repugnant to the *Shariah*. Thus, if there exists some income from unacceptable business activities or interest-bearing accounts, the proportion of such income must be "cleansed" or "purified" usually through the channeling of such portion from the dividend received from the shares holding of the company, to charitable organizations or purposes.

These *Shariah* parameters and processes have been widely adopted and practiced by various institutions and index providers, including the Dow Jones Islamic Market Index (DJIMI) and FTSE Global Islamic Index Series. This development provides the industry standard in the methodology and processes for *Shariah* screening of equities. In general, these screening norms are known as sector (qualitative) and financial (quantitative) filters. Table 1 summarizes the salient features of such filters and the *Shariah* issues of concern addressed by such criteria.

While *Shariah* encompasses a holistic outlook of the system of life in Islam, it is apparent that the screening norms practiced by the industry emphasizes the "normative validity" of Islamic law, distinct from the notion of ethics and morality (Cattelan, 2010). Apart from the criteria related to weapon and genetic bio-technology adopted by some institutions, other sector screens focus on the "sin" activities considered as major prohibitions in Islam. All the three financial filters in one way or another, address the strict prohibition on the various forms of exposure to *riba* in the investment process. While such a legalistic and exclusionary approach is a necessary step, many scholars and commentators of Islamic finance have argued that it is insufficient in realizing the underlying objective of the

Table 1. Screening norms of *Shariah*-based investment.

Filter	<i>Shariah</i> Issues of Concern	Industry Norms ¹
Sector: Main business activities	–Business activities and transactions involving <i>riba'</i> , <i>gharar</i> , <i>maysir</i> , excessive speculation, and other activities or transactions repugnant to the <i>Shariah</i> are strictly prohibited.	–All securities with unlawful core business activities are excluded from the list of permissible securities; conventional financial services and products, insurance, gambling, liquor, production/ distribution of non- <i>halal</i> meat, hotels, entertainment services unacceptable in <i>Shariah</i> , tobacco, and some weapons and genetic bio-technology.
Sector: Mixed business activities	Lawful core business activities but mixed with some impermissible activities; discussions have been contentious among the <i>Shariah</i> scholars on the issue; many have accepted its permissibility (with relevant parameters) based on legal juristic opinion and present circumstances of the market and the industry.	Tolerable threshold of mixed income from impermissible activities were adopted to limit the exposure to such elements; e.g. total impure income must not exceed 5% from the total revenue.
Financial: Interest ratio	Receiving interest income is unlawful, even if such income is not generated from its main business activity.	Interest income must be very negligible; both the combined unlawful income from mixed activities and interest income must not exceed 5% of total revenue; alternatively, ratio of liquid assets (e.g. cash, receivables and short-term investment) that can generate interest income over total assets/market capitalization is also used, e.g. must not exceed 33%.
Financial: Liquidity ratio	Concerns with the presence of substantial elements of liquid assets, e.g. accounts receivables, cash or cash equivalent, and short-term investment of the company; the prohibition of the sale of debt to a third party; money can only be exchange at par value; real assets must constitute a substantial component of the total assets.	The accepted level of liquid assets to total assets/market capitalization of a company varies between institutions and index providers; ranges from 33% to 80%.
Financial: Debt ratio	Payment of interest is also unlawful; financing business activities using interest-based transactions is problematic; any involvement in such financing activities must be kept minimal.	The sum of total debt of a company must not represent more than 33% of the total asset/market capitalization.

Source: Summarised from Usmani (1998), Yaquby (2000), and Derigs and Marzban (2008).

Shariah and the normative goals of Islamic economics (Siddiqi, 1999, 2004; El-Gamel, 2006; Wilson, 2004; Lewis, 2010). Despite the fact that there were some recommendations to prohibit investing in companies with harmful policies, such as unfair treatment of workers and detrimental environmental actions (Yaquby, 2000), concerns have yet to make their way into mainstream Islamic investment practices.

It is interesting to note that the Western ethical and socially responsible investment (SRI) industry, originates from

almost similar exclusionary screening of “sin” activities and evolves towards integrating broader social and environmental issues. In line with the holistic nature of *Shariah*, and its underlying objectives, it is imperative that the Islamic investment practices move to a new phase of development, where ethical and social responsibility issues are incorporated in the decision making process. The mainstreaming of SRI and the growing concern towards social responsibility issues globally has made it even more imperative for Islamic investment to incorporate such concerns. In the face of the increasing criticisms levelled

against the practice of Islamic finance, the move towards incorporating broader principles of Islamic ethics in the investment process seems to be a promising answer to this predicament (El-Gamel, 2006), and perhaps opening the way towards breaking the so-called “formalist deadlock” of Islamic finance (Bazl, 2010). Recent development shows encouraging gestures by the industry’s leading players in this respect. In the recent 11th International Islamic Finance Forum in Dubai, one of the largest gatherings of world’s leaders in Islamic finance, the issue of linking Islamic finance with microfinance and poverty eradication programs has been the highlight. Prior to that, in 2006, the same forum had emphasized the need for the Islamic investment industry to incorporate moral and social dimensions into its investment criteria in addition to other rules (Zawya.com, 2006). In other words, despite its compliance with *Shariah* principles, which mainly shun certain impermissible activities, the Islamic finance sector, including Islamic investment, should do more to encourage and promote socially responsible practices.

One important example of such an initiative in the context of Islamic investment is the launch of Dow Jones Islamic Market Sustainability Index. The criteria used for the index incorporate both the *Shariah* compliant principles and sustainability criteria, where the constituents of the index are required to pass both the screening process of the Dow Jones Islamic Market and the Dow Jones Sustainability Index respectively. As described by the index provider, this is mainly a response to the repeated inquiries from asset managers who wish to integrate Islamic investment principles with the social, ethical and environmental criteria (Dow Jones and SAM Group, 2006). While this initiative can be considered to be an important milestone in this respect, the consideration for broader SEE issues are still lacking among Islamic financial institutions, and investment products that incorporate such concerns are still very rare in the market of Muslim countries. As the SRI industry is said to be a consumer driven phenomenon (Schueth, 2003), the support of investors on the issues is the key to the success of such investment products.

3. Data and research method

3.1 Instrument

In the light of the previous discussions, it is pertinent to obtain the perceptions and opinion of investors on the scope and the notion of *Shariah* principles subscribed in Islamic investment. The recognition of the importance of social responsibility commitment among the investors as part and parcel of the principles of the *Shariah* would therefore increase the support for social responsibility issues to be applied in the investment decision of Islamic investment products. For this purpose, respondents were surveyed on the elements that they perceive as important to be considered when investing based on *Shariah* principles. When commenting on the scope of *Shariah* supervision of Islamic funds, DeLorenzo (2004:16) highlights three different classes of rewards expected of Islamic investing: spiritual, financial and social. While the spiritual reward of the investors is frequently associated with the acknowledgement of the *Shariah* imperative and its compliance in the investment process, such compliance has been pre-dominantly focussed on the *fiqh* injunctions

and the negative screening strategy. The social aspect of Islamic investing, however, would address broader ethical and environmental concerns and require not only exclusionary, but also positive screening, advocacy and engagement strategies with companies (DeLorenzo, 2004; Wilson, 2004), and the rewards will be experience as a result of the positive contribution and policies of such companies to the society. On the other hand, pecuniary returns from investment should not be limited to financial reward alone, as broader economic benefits can be realized when investment is efficiently used and allocated.

Based on the above, the three concerns – i.e., *fiqh* injunctions, economic, and social responsibility – are believed to be an appropriate characterisation of what is expected of a holistic approach in the practice of Islamic investment. For this purpose, a total of ten criteria were identified and selected that constitute various *Shariah* prohibitions normally used in investment screening criteria, aspects of risks-returns and efficient use of resources (as normally the concerns in any investment), as well as social responsibility issues often promoted in the literature of Islamic economics such as poverty eradication, social welfare and care about the environment. The items were measured on a five-point Likert scale ranging from 1 = not important at all, to 5 = very important.

The questionnaire also gathers other important data of the respondents such as their socio-demographic information, commitment to *Shariah* principles in investment, pro-social behaviors that they consistently participated in, and some investment related characteristics, such as their main investment objective, risk-return attitude and their level of SRI awareness. This information will then be used as potential explanatory variables to understand the respondents’ perceptions about the level of importance of social responsibility dimension in Islamic investment.

3.2 Respondents

The study involved a survey of investors in Islamic funds using a purposive sampling method from 3 fund management companies in Malaysia: Public Mutual Berhad (215 respondents), CIMB-Principal Asset Management Berhad (141 respondents) and Prudential Fund Management Berhad (95 respondents), with a total of 451 respondents. The three fund management companies represent different company sizes operating in the Malaysian unit trust industry. The survey was conducted between January and March 2009, through a network of agents and agency branches of the three fund management companies located in different areas of Kuala Lumpur, the financial center of Malaysia. In general, the sample reflects a wide representation of various groups in terms of its socio-demographic variables such as gender, ethnicity, religion, age, marital status, income, educational level and occupation. Male respondents constitute 58.1 percent of the total sample, while female respondents are 41.9 per cent. Apart from the responses received from the Malay ethnic group, which constitutes about 80 percent of the total respondents, the survey also included a total of 73 (16.2%) respondents from the Chinese ethnic group, and 17 (3.8%) from the Indian ethnic group. In terms of religion, a total of 363 (80.7%) respondents were Muslims, 43 (9.6%) were Buddhist, 29 (6.4%) were Christians, and

11 (2.4%) were Hindus. A cross tabulation of ethnicity by religion shows that all Malay respondents were Muslim, while another 3 Muslim respondents came from the Indian ethnicity. As the distribution of investors in Islamic funds across ethnicities and religions in the Malaysian market is not known, a direct comparison between the sample and the population could not be made. Nevertheless, the participation of investors from other faiths contributes to a comprehensive outlook by the study and is representative of the actual population. On another note, it appears that Islamic investment products are also marketable and consumed by fellow Malaysians from other faiths. The bulk of the respondents were also from middle-aged groups, middle and high income earners, and educated individuals, which is consistent with the segment of the market for such financial products.

Another important piece of information collected from the survey is related to the proportion of funds the respondents invested in Islamic funds in comparison to the overall unit trust investment. In the context of Muslim investors, this will reflect their commitment in observing *Shariah* principles in their investment decision. As seen in past SRI studies, it is common for SRI investors to have SRI based investments and at the same time holding in other non-SRI related investment (Nilsson, 2008; Lewis & Mackenzie, 2000). Some considered this behavior as an attempt to balance two conflicting motives; to avoid the feeling of guilt if not acting in a way that is in line with their ethical conviction while at the same time not wishing to substantially sacrifice financial returns on investment. In other words, such pragmatic behavior is consistent with the principle of "not putting all the eggs in one basket," even if this involved matter of conviction or principles (Lewis, 2001). For this purpose, the respondents are categorized into three categories, with the non-Muslim investors constituting the first group, while the Muslim investors are divided between "pragmatic" and "committed" investors, based on their commitment to comply with *Shariah* principles in their choice of investment.

As seen in Table 2, from a total of 413 respondents who provide information on the pattern of their investment between Islamic and conventional funds, a total of 202 (48.9%) investors, including 3 non-Muslim investors invest all their unit trust investment in Islamic funds. The remaining investors have varying percentages of their overall investment held between Islamic and conventional funds, including a total of 131 (31.7%) Muslim investors. This suggests that while religion (Islam) may be a strong factor in guiding the investment decision for some Muslim investors (i.e., the committed investors), it does not provide sufficient influence over others (i.e., the pragmatic investors) in complying with the *Shariah* principles in their investment decision.

4. Analysis and findings

4.1 Criteria perceived as important in Islamic investment

The analysis starts by presenting the descriptive results on the level of perceived importance of the ten criteria included in the questionnaire among the respondents. Table 3 shows the frequencies, mean and standard deviation of the criteria ranked according to their level of importance perceived by the investors using the mean scores of each item. It is quite apparent that the top three criteria are dominated by the *fiqh* injunction on the prohibitions of elements repugnant to *Shariah*, namely "not be involved in the production or sales of *haram* products," "not be involved in gambling related activities," and "not be involved in entertainment activities that are not acceptable in *Shariah*" with a mean score of 4.572, 4.533, and 4.390, respectively. This is then followed by three economically-driven criteria, which include "manage risk prudently" (4.359), "maximize returns on investment" (4.340), and "use resources efficiently" (4.219). However, despite the fact that the trademark of Islamic finance is the interest-free system, the criterion of "not be involved in conventional financial services" only came seventh in the ranking with a mean of 4.171. The last three

Table 2. Commitment to *Shariah* principles based on the percentage invested in Islamic funds in comparison to overall investment.

		Commitment to <i>Shariah</i> Principles in Investment			
		Non-Muslim investors	Pragmatic investors	Committed investors	Total
Percentage invested in Islamic funds	Less than 20%	13 (35.1%)	24 (64.9%)	0 (.0%)	37 (9.0%)
	20–39%	17 (34.0%)	33 (66.0%)	0 (.0%)	50 (12.1%)
	40–59%	27 (57.4%)	20 (42.6%)	0 (.0%)	47 (11.4%)
	60–79%	19 (38.8%)	30 (61.2%)	0 (.0%)	49 (11.9%)
	80–99%	4 (14.3%)	24 (85.7%)	0 (.0%)	28 (6.8%)
	100%	3 (1.5%)	0 (.0%)	199 (98.5%)	202 (48.9%)
Total		83 (20.1%)	131 (31.7%)	199 (48.2%)	413 (100.0%)

items in the mean rank constitute those criteria related to the social responsibility aspect of investment. These include “contribute to poverty eradication” (4.164), “contribute positively to the development of the society” (4.118), and “care about the impact to environment” (3.991).

The overall results as shown in Table 3 reveal several interesting patterns with respect to the ranking of the items. Except for “not be involved in conventional financial services,” all the other three items representing the major prohibitions in *Shariah* were ranked highly. Looking at the values of the standard deviation, it is quite apparent that among the four items representing the *fiqh* injunctions of the *Shariah*, “not be involved in conventional financial services” recorded the highest value of 0.9798. In fact, this value is the highest standard deviation measure for the whole ten items. This suggests that the perceived importance of the prohibition of interest-based transactions in Islamic investment registers greater variation in the responses. Perhaps such phenomenon can be explained on several grounds. First, unlike issues related to the production or consumption of “*haram*” products (liquor, pork, etc.), gambling and unacceptable entertainment (pornography, pubs, etc.), which are traditionally and culturally recognized as major sins in Islam (for both Muslims and Non-Muslims), the banning of interest is less comprehensible in terms of its unethical nature and harmful outcome. In fact, there is the practice of some government funds that claimed to invest ethically by excluding industries like gambling, liquor, pornography and some other related criteria, but still invest in companies related to conventional financial services (Pitluck, 2008). Secondly, while the Islamic financial products and services have been offered in the market for

quite some time, and has experienced tremendous growth, the market share of interest-free products in the Malaysian market is still relatively small as compared to its interest-based counterpart. The fact is Malaysia is practicing a dual system where conventional interest-based and Islamic banking systems operate in parallel and the pre-dominant nature of the former on the latter has perhaps made such practices common place in the financial dealings among the masses and has neutralized their perception on the strict prohibition of Islam against all forms of interest. In addition, note that the respondents involved in the study include investors from other faiths; and even among the Muslim investors, sizeable numbers held different proportions of their total investment in conventional funds. If such practice is also prevalent in other aspects of finance such as in banking and insurance, it is likely that these types of investors may also have use interest-based conventional financial service, and therefore be further desensitizing their attitude towards the importance of such prohibition. Whether or not the importance of the criterion of “not be involved in conventional financial services” is considered as distinct from the other type of prohibitions will be examined in later in the analysis.

Another interesting pattern emerging from the mean scores of the ten items is the fact that the criteria related to economic aspect were consistently rank higher from the three criteria representing the social responsibility dimension. This would imply that after complying with the *fiqh* injunctions, the next most important criteria as perceived by the investors would be related to economic consideration, such as prudent risk management, maximization of returns, and efficient use of resources.

Table 3. Level of importance attached to criteria related to Islamic investment.

Items	Not important at all	Not important	Neutral	Important	Very important	Mean	Std. deviation	N
Not be involved in the manufacture or sale of prohibited products	6	9	31	80	323	4.570	0.8156	449
Not be involved in gambling related activities	6	9	36	74	295	4.531	0.8498	420
Not be involved in entertainment activities which are not permissible in <i>Shariah</i>	6	13	46	118	266	4.392	0.8826	449
Manage risks prudently	0	7	43	180	219	4.361	0.7189	449
Maximise returns from investment	1	6	40	195	206	4.337	0.7144	448
Use resources efficiently	0	17	55	190	188	4.220	0.8026	450
Not be involved in conventional financial services	7	24	69	134	214	4.170	0.9798	448
Contribute to poverty eradication	1	13	70	194	172	4.162	0.8053	450
Contribute positively to the development of the society	2	21	75	176	175	4.116	0.8788	449
Care about the impact to the environment	3	21	98	181	147	3.996	0.8904	450

On the other hand, among the three items representing the social responsibility dimension, "contribute to poverty eradication" is rank the highest, followed by "contribute positively to the development of the society" and "care about the impact to the environment." This is in line with the literature in Islamic economics, where issues related to poverty eradication received paramount attention and urgency.

Despite being at the lower end of the ranking, the mean score of the three criteria representing the social responsibility dimension, in its absolute terms, are within the range of "important" and "very important." In fact, if based on the frequencies as presented in Table 3, the percentage of investors who consider the criteria either as important or very important is around 81 percent for "contribute to poverty eradication," 78 percent for "contribute positively to the development of the society," and 73 percent for "care about the impact to the environment." Therefore, it can be safely said that despite the lower ranking of the items, these social responsibility criteria are still perceived as part of an important element in Islamic investment by a significant majority of the respondents.

4.2 Validating the underlying dimensions

The analysis on the perceived importance of social responsibility dimension in Islamic investment proceeds with an exploratory factor analysis on the ten items as presented in Table 2. In this context, the analysis would reveal whether the social responsibility dimension is recognized by the respondents as one of the distinctive factors in Islamic investment criteria. Subsequently, the

results can then be used to investigate the importance of the social responsibility dimension in comparison to other dimensions and whether there is any significant difference in the perceived importance of social responsibility dimension among various investor groups. Analysis enables the use of the underlying factor as a composite measure (as opposed of using the individual items), therefore rendering subsequent analysis more parsimonious (Hair et al., 1998).

Before running the exploratory factor analysis, statistical tests were employed to determine the appropriateness of the data in terms of its sample adequacy and the strength of inter-correlation. The KMO measure shows a value of .891, which indicates a "meritorious" sample adequacy according to the Kaiser (1974) scale, and hence is deemed appropriate for factor analysis. The Bartlett's Test of Sphericity also reaches statistical significance (0.000), supporting the factorability of the correlation matrix. Subsequent to this, an exploratory factor analysis was employed to the ten items as previously presented in Table 3. Given the nature of the data and the variables, principle axis factoring was employed for the extraction, and direct oblimin was chosen as the rotation technique as recommended by Costello & Osborne (2005).

As shown in Table 4, the rotated factor solution reveals three strong factor models with all the ten items exhibiting large factor loadings (above 0.3). Variables with factor loadings smaller than ± 0.3 are normally considered not significant and therefore were suppressed in the table for easy interpretation. In brief, the exploratory factor analysis employed above verifies the existence of three underlying

Table 4. Factor analysis-pattern matrix and communalities.

Variable	Factor			Communality of Each Variable
	1 (Social Responsibility)	2 (Fiqh Injunctions)	3 (Economic)	
Contribute positively to the development of the society	.918			.813
Care about the impact to the environment	.781			.719
Contribute to poverty eradication	.556			.657
Not be involved in gambling related activities		-.948		.833
Not be involved in the manufacture or sale of prohibited products		-.889		.791
Not be involved in entertainment activities which are not permissible in <i>Shariah</i>		-.823		.729
Not be involved in conventional financial services		-.550		.482
Manage risks prudently			.880	.723
Use resources efficiently			.633	.690
Maximise returns from investment			.552	.510
Average Commonalities				
Post Rotation Eigenvalue	3.965	4.244	4.137	
Cumulative% of Variance Explained				69.459

dimensions, which “drive or control” the values of the variables that are being measured. All of the items load heavily to their respective factors as anticipated (based on the a priori factor structure), and are therefore named accordingly as “social responsibility,” “*fiqh* injunctions,” and “economic factor,” respectively.

The result of the factor analysis has also provided the statistical evidence on the nature of the criterion of “not be involved in conventional financial services” in relation to other criteria related to the *fiqh* injunctions. Note that the initial descriptive analysis (Table 3) has shown that the item was not perceived as important as the other criteria of *Shariah* prohibitions by the respondents and therefore might be perceived as representing a distinctly different underlying factor. However, the factor analysis has shown that not only are the items clustered together with the three other *fiqh* injunctions, but the criterion also show strong loading to the factor (.550). Therefore, despite having a relatively lower mean score, the factor analysis confirms the unidimensionality of the four items, suggesting that the respondents perceived these criteria as constituting the same construct.

4.3 Comparing the perceived importance of social responsibility dimension with other dimensions

4.3.1 Overall comparison

Given that the unidimensionality of each dimension has been established, it is possible now to construct a reliable scale that represents each of the dimensions. For additional confirmation, reliability tests using Cronbach’s Alpha are also conducted for all the three factors. Based on the above, three separate scales were constructed by computing the average of the individual scores of the constituent items for each of the three factors. The mean scores and other statistics for the three scales, which represent the three dimensions, is shown in Table 5 for the purpose of comparison.

The overall results show that the consideration of the *fiqh* injunctions is regarded as the most important dimension, with an overall mean of 4.416. This is followed by the economic and social responsibility dimensions with a mean

of 4.306 and 4.093, respectively. This pattern of importance can also be seen from the values of the median and quartiles of the three dimensions, and is consistent with the earlier analysis based on the ten individual items (section 4.1). The hierarchy of importance between the three dimensions is further examined using the Friedman test. As can be seen from Table 5, the statistical result is highly significant, confirming the ordered ranking between the *fiqh* injunctions, economic and social responsibility dimensions.

4.3.2 Perceived importance of social responsibility dimension vis-a-vis economic dimension

Literature in the SRI industry has emphasised the presence of interaction between pecuniary and non-pecuniary returns faced by SRI investors in their investment decision. Therefore, it will be interesting to compare the degree of importance investors attach to social responsibility dimension vis-à-vis the economic dimension in the context of Islamic investment. In doing so, a new variable is computed by subtracting the economic scale from the social responsibility scale. This new variable will provide additional information in terms of the measurement of the importance of the social responsibility dimension in relation to the economic dimension.

Table 6 shows the frequency of this variable. For the sake of simplicity, this newly computed variable is known as “SR-Econ” scale. It ranges from 1.33 to –4.00 with a mean of –0.209 and a standard deviation of 0.549. Positive values indicate that the scores for the social responsibility scale are greater than the scores for the economic scale, and negative values imply that the scores for economic scale are greater than the social responsibility scale. It also means that a higher score of the “SR-Econ” scale indicates that the investors attach greater relative importance to the social responsibility factor as compared with the economic factor, and vice versa.

As can be seen from Table 6, around 38 percent of the respondents rate economic scale higher than the social responsibility scale, and this reflects their priority on the perceived importance of economic aspects over social responsibility concerns. On the other hand, around

Table 5. Descriptive statistics, cronbach’s alpha and friedman test statistic for the three dimensions.

	<i>Fiqh</i> injunctions scale	Economic scale	Social responsibility scale
Mean	4.416	4.306	4.093
Median	4.75	4.33	4.00
Mode	5.00	5.00	5.00
Std. Deviation	0.7651	0.6411	0.7693
Percentiles			
25	4.00	4.00	3.67
50	4.75	4.33	4.00
75	5.00	5.00	5.00
Cronbach’s Alpha	.891	.820	.877
Friedman Test			
Mean Rank		N	415
<i>Fiqh</i> injunctions	2.26	Chi-Square	90.373
Economic	2.01	Df	2
Social Responsibility	1.73	Asymp. Sig.	.000

Table 6. Descriptive statistics of SR-Econ scale.

Scores	Frequency	Per cent	Cumulative per cent
1.33	2	0.45	0.45
1.00	1	0.22	0.67
0.67	15	3.36	4.04
0.33	49	10.99	15.02
0.00	210	47.09	62.11
-0.33	76	17.04	79.15
-0.67	37	8.30	87.44
-1.00	27	6.05	93.50
-1.33	22	4.93	98.43
-1.67	2	0.45	98.88
-2.00	2	0.45	99.33
-2.33	1	0.22	99.55
-3.33	1	0.22	99.78
-4.00	1	0.22	100.00
Total	446	100.00	
Mean			-0.209
Standard Deviation			0.549

15 percent of the respondents scored social responsibility scale higher than the economic scale, implying that they prioritize social responsibility concerns over economic aspects. Interestingly, almost half of the respondents (47%) scored equally for the social responsibility and economic scale. Therefore, a total of 62 percent of the respondents perceive social responsibility issues as more or equally important to economic aspects within Islamic investment.

4.4 Factors influencing the perceived importance of social responsibility dimension in Islamic investment

As highlighted earlier, one of the objectives of this paper is to explore the factors that influence the level of perceived importance of the social responsibility dimension in Islamic investment among the respondents. Based on the measure of the perceived importance of social responsibility developed earlier, the analysis proceeds by examining whether there are any statistically significant differences between different sub-groups of investors, in the scores of importance they attached to the social responsibility scale and the SR-Econ scale. As highlighted in section 3.1, sub-groupings of the respondents that are used here as potential explanatory variables include socio-demographic profile, commitment to *Shariah* principles in investment, pro-social behaviours, and investment related characteristics. Mann-Whitney U tests are employed for variables with only two sub-groups ($df = 1$), while Kruskal-Wallis test are performed on variables with more than two sub-groups ($df > 1$).

4.4.1 Comparing social responsibility scale between sub-groups of respondents

Table 7 presents the statistical results and the summary of the mean ranks for the social responsibility scale for different sub-groups included in the study. Looking at the findings for the socio-demographic variables, statistically

significant difference at 0.05 level were not found among different sub-groups of gender, marital status, education and types of occupation.

Differences in opinions were more pronounced between respondents of different ethnicity, religion, age and income group with all of these socio-demographic variables reaching statistical significance at the 0.05 level. From Table 6, Malay-Muslim respondents register the highest mean rank statistics as compared to respondents from other ethnics and faiths. The perceived importance attached by the lower income groups to the social responsibility dimension of Islamic investment is also higher than those in higher income groups. This suggests that lower income earners are more receptive to the idea of having social responsibility criteria incorporated into the Islamic investment process. Perhaps this can be explained by the fact that criteria such as poverty eradication and societal development are issues that affect them directly. On the contrary, the higher income earners, who would likely have more funds under investment, and therefore have more at stake, would understandably be more reserved towards social responsibility concerns related to investment, especially if they perceive such non-economic consideration could compromise financial returns.

On the other hand, it appears that the perceived importance of the social responsibility dimension in Islamic investment takes a somewhat curvilinear relationship with respect to age. As shown in Table 6, higher mean ranks are observed among younger respondents (below 30) and the elderly (above 50), while those in the middle-age groups (31–40 and 41–50) register lower values. The higher mean rank for the younger group of investors is consistent with some other studies on SRI that may be explained by the increasing awareness of the younger generation on social responsibility issues.

Differences in the social responsibility scale are not only prevalent between Malay-Muslim investors and investors from other ethnicity and religion, but also between different types of Muslim investors. As previously highlighted, the investors had been segmented into three groups, and the result shows that the mean rank for the committed investors is much higher as compared to the pragmatic and the non-Muslim investors. It also appears that there is a statistically significant difference in the scores of social responsibility scale between different level of participation in pro-social activities, with the respondents who have greater participation in socially responsible behaviors at the individual level responding with higher levels of perceived importance around the social responsibility dimension in Islamic investment as compared to other respondents. Another important grouping factor that contributes significantly to the variation in the social responsibility scale is the level of awareness of SRI. As shown in Table 7, higher mean ranks can be found in the group of investors with higher levels of SRI awareness. Other characteristics of the investors, such as their risk appetite and main investment objectives, are not statistically significant.

4.4.2 Comparing SR-Econ scale between sub-groups of respondents

As the present analysis is an extension to the earlier analysis in section 4.4.1, it is useful to compare the results

Table 7. Comparing scores of social responsibility scale between different sub-groups of respondents.

Variable	Chi-square (Z-score)	Df	Sig.	Results of Mean Rank Statistics
Gender	(-1.040)	1	0.299	
Marital status	(-0.155)	1	0.877	
Ethnicity	93.452	2	0.000	Malays have higher mean rank as compared to those from other ethnicities.
Religion	95.148	3	0.000	Muslims have higher mean rank as compared to those from other faiths.
Age	10.796	3	0.013	Young and elderly respondents have higher mean ranks as compared those in their middle-age.
Highest education	2.869	3	0.412	
Income	30.141	5	0.000	Lower income earners have higher mean rank as compared to those having higher income.
Type of occupation	(-0.486)	1	0.627	
Type of investor	118.949	2	0.000	Committed investors have higher mean rank as compared to the pragmatic and non-Muslim investors.
Individual pro-social behaviour	10.553	2	0.005	Those with higher pro-social participation have higher mean rank.
Collective pro-social behaviour	3.936	2	0.140	
Main investment objective	(-0.185)	1	0.853	
Risk-return attitude	2.232	2	0.328	
SRI awareness	14.714	4	0.005	Those having higher SRI awareness have higher mean rank.

in Table 8 for the SR-Econ scale with the one shown in Table 7. Some of the results in Table 8 are consistent with the previous analysis and therefore strengthen the earlier findings based on the social responsibility scale. For instance, the Malay-Muslim respondents are associated with higher mean ranks for the SR-Econ scale as compared to the other respondents. The lower mean ranks among the respondents from other ethnicities and religions also indicate that the importances of economic factor over social responsibility are much greater among these groups. Another similar finding is with respect to income of the respondents, with lower income groups are associated with higher mean ranks for the SR-Econ scale. While differences between the sub-groups of age remain significant in this analysis, interestingly, the somewhat curvilinear relationship between social responsibility scale with age has change to a linear relationship in the context of the SR-Econ scale, with younger respondents register higher scores for the SR-Econ scale.

Turning to other characteristics of the investors, Table 8 shows that significant differences between sub-groups

on the SR-Econ scale can only be found among the types of investors based on their commitment to *Shariah* principles in investment and the level of SRI awareness. Similar to the findings in the previous analysis (Table 7), the pragmatic and the non-Muslim investors seemed to attach greater importance of economic consideration over social responsibility factor as compared to the committed investors. The insignificant values for other characteristics of the respondents such as pro-social behavior, risk-return appetite and main investment objective suggest that there were no significant differences among the sub-groups in the way they perceived the importance of social responsibility factors in relation to economic factors in Islamic investment.

Contrary to the findings based on the social responsibility scale, the analysis with the SR-Econ scale has shown that there exist statistically significant differences at the 0.05 level for gender and marital status. In this context, compared to female and single respondents, male and married investors put greater importance of economic consideration over social responsibility concern as compared to female and single respondents.

Table 8. Comparing scores of SR-Econ scale between different sub-groups of respondents.

Variable	Chi-square Z-score	Df	Sig.	Results of Mean Rank Statistics
Gender	(-2.680)	1	0.007	Female respondents have higher mean rank
Marital Status	(-3.322)	1	0.001	Single respondents have higher mean rank
Ethnicity	21.406	2	0.000	Malays have higher mean rank as compared to those from other ethnicities
Religion	21.466	3	0.000	Muslims have higher mean rank as compared to those from other faiths
Age	16.626	3	0.001	Mean rank increases with younger respondents
Highest Education	7.631	3	0.054	
Income	35.091	5	0.000	Lower income earners have higher mean rank as compared to those having higher income
Type of Occupation	(-0.855)	1	0.393	
Type of Investor	19.612	2	0.000	Committed investors have higher mean rank as compared to the pragmatic and non-Muslim investors
Individual pro-social behaviour	1.307	2	0.520	
Collective pro-social behaviour	2.836	2	0.242	
Main Investment Objective	(-0.132)	1	0.895	
Risk-return Attitude	5.571	2	0.062	
SRI Awareness	29.215	4	0.000	Those having higher SRI awareness have higher mean rank

5. Conclusion

The overall result reveals that investors on whole place into a hierarchy the elements they considered important for investment, which is based on *Shariah* principles – with the observance of *fiqh* injunctions ranked as the most important consideration, followed by economic and social responsibility dimensions. Such findings are based on both the descriptive analysis of the individual items as well as the composite scale constructed as a result of an exploratory factor analysis, which among others, provide statistical evidence on the nature of social responsibility dimensions being acknowledged by the respondents as part of an important underlying factor in Islamic investment criteria. Despite being consistently overpowered by the economic concerns, descriptive analysis on the questionnaire responses (Table 2) suggest that social responsibility criteria are still perceived as important by the majority of the investors, and based on the SR-Econ scale, 62 percent of the respondents consider social responsibility more or equally as important as the economic dimension. These results provide the empirical evidence that the social responsibility dimension is recognized by investors as part of an important component in *Shariah*-based investment.

The analysis has also explored various potential factors that can influence the level of importance investors attach to the social responsibility dimension. In this respect, two scales were constructed for such measurement, namely the social responsibility scale and the SR-Econ scale. The findings for both scales show that ethnicity/religion are among the important factors related to the level of perceived importance of social responsibility, with Malay/Muslim investors exhibiting higher scores as compared

to other groups. Nevertheless, not all Malay-Muslim respondents showed strong commitment to the *Shariah* principles in their investment decision. As has been shown earlier, sizeable numbers of Muslim respondents in this study have a different proportion of their investments allocated between Islamic and conventional funds. The findings of this study have shown that those who strictly comply to *Shariah* principles in their investment, labelled as the committed investors, placed a greater importance on social responsibility in Islamic investment as compared to the 'pragmatic' investors and the non-Muslim investors.

Like many other studies in the field of socially and environmentally desirable behaviors, demographic profiling has been one of the important areas of interest. In this context, income and age have been found to be an important factor with lower income earners and younger investors having a more favorable attitude in terms of the level of importance of social responsibility in both of the scales used in the analysis. Other variables, such as pro-social behavior, gender, and marital status, were also found to be important factors based on one of the scales. As shown earlier, those who have higher participation in the individually oriented pro-social behavior tend to have higher scores for the "social responsibility" scale, while being female and single are linked with higher scores for the "SR-Econ" scale. Nevertheless, one factor that has consistently emerged as a strong and important variable in all the analyses is the level of SRI awareness. This result can prove to be promising as such an awareness may well increase over time, and the favorable attitude among investors towards the importance of social responsibility concerns in investment will likely to be stronger in the future.

The above findings offer important insights on the perceived importance of social responsibility dimension and the main factors underlying the support for such concerns in Islamic investment. While the incorporation of social responsibility criteria in Islamic investment provides new opportunities for product development and global convergence with the SRI movement, it will be a challenge for fund managers to balance economic consideration with the social responsibility concerns. Nevertheless, the continuous growth of the SRI industry and the empirical evidence on the performance of SRI funds globally provides reassurance that such an investment approach is viable, and certainly more sustainable in the long run. The realization of such an investment approach in the Islamic investment industry will necessarily bring the sector to a greater height, in line with the normative goals of Islamic economics and the higher objective of *Shariah (maqasid as-Shariah)*.

Note

1. For details of the screening norms practiced by various institutions and index providers, see Siddiqui (2004), Derigs and Marzban (2008) and Rahman et al. (2010).

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The corporate social performance indicators for Islamic banks: The manager's perception

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Abstract - Social performance is incumbent as one of the maqasid Shariah of Islamic banks. A perception study involving questionnaire surveys was conducted of 152 Islamic bank managers in Malaysia as a means of searching for empirical evidence of what constitutes Corporate Social Performance (CSP) indicators for Islamic banks. Using 50 indicators as a CSP construct, the study found that there are forty-seven important indicators for CSP in Islamic banks. The Shariah compliance activities such as annual payment of akat, transparent measurement of zakat, avoidance of unlawful transactions, and disclosure on the nature and extent of the unlawful transactions are among the most important indicators. However, in the dual Islamic banking framework in Malaysia, managers have a significant difference in perception of the importance of qard hasan financing, number of branches and vicinity, availability of e-banking services, and third party verification for customer services as representative of Islamic banks' social performance indicators. Remarkably, environmental protection and enhancement activities are considerably important CSP indicators even though the environment does not directly affect or effect Islamic banking activities. This study contributes to the development of social performance indicators specifically for a faith-based business institution from the practitioner perspective. The indicators may be used to assess the incorporation of social function in Islamic banks towards fulfilling the maqasid Shariah and meeting the need of various stakeholders.

Keywords: Islamic bank, Maqasid Shariah, Corporate Social Performance Indicators, Stakeholders, Zakat, Qard Hasan, Investment Account Holders

1. Introduction

Islamic banking and finance is a fast-growing industry worldwide. Internationally, the industry operates in 75 countries with over 500 Islamic financial institutions (IFIs) and total assets of nearly US\$1 trillion, and is expected to capture half of the savings of the Muslim world (Austay 2010). In Malaysia the industry has also shown a tremendous growth over the last five year period. Total assets in the system increased from RM156, 810.8 million in 2007 to RM334, 982.6 million in 2011 (BNM Monthly Statistical Bulletin 2012). The industry has contributed significantly to the national economic system or Gross Domestic Product (GDP) of 9.2% in 2000, 11% in 2008, and 17% in 2011 (BNM 2009; 2012).

In Islamic faith-based commercial business organizations, banks are required to operate according to Shariah (Islamic law) with the aim of achieving maqasid Shariah (Shariah goal). The stress on achieving maqasid Shariah in Islamic banks is to ensure social fairness and justice in the protection of Islam as a religion (al din), the life of human self (nafs) or the individual person, the intellect (faculty of reasoning) (aql), the progeny or offspring (nasl), and the material wealth (mal) of the various stakeholders who are affected by and effect the Islamic banks' earning process. In this case the stakeholders of Islamic banks are employees, the community, depositors, creditors, zakat receivers, investment account holders, the environment surrounding the banks, and the regulators (government).

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In this context, the goal of property management in Islamic banks is not purely for profit (economic objective) that satisfies the interest of the shareholders but also to ensure social responsibility to various stakeholders.

Many researchers argue that corporate social responsibilities function as accountability to various stakeholders following stakeholder theory. The theory holds that an organization has a responsibility to various parties affected or effecting the business operation in meeting its goal (Freeman, Wicks and Parmar, 2004) through optimizing their corporate system so that it can maximize the bank performance over a long term (Iqbal and Mirakhor, 2004; Hasan, 2008; Hasan and Harahap, 2010). The theory provides that the bank's corporate governance has the authority and accountability to manage the business property for the benefit of shareholders without neglecting the interest of other parties who have an implicit and explicit contract with the bank. In this regard, the bank's managers are entrusted to mobilize their wealth (money deposited by depositors, and capital contributed by the investors, as well as investments made by the investment account holders) according to rules, regulations and policies issued by various regulating bodies with the aim of generating revenue.

The Islamic banks (the wealthy) are also required by Islamic law to promote social benevolence to various stakeholders (Chapra, 1985; Chapra and Khan, 2000; Munawar, Iqbal and Llywellyn, 2002) such as such as employees, communities, zakat recipients and the environment surrounding the banking business. The banks are also required to consider the property rights of various stakeholders through social and humanitarian works (Kahf, 2004). Consistent with Shariah emphasis, CSP undertaking needs to be carried out towards various stakeholders to ensure fair and just business dealings and maximization of their welfare, regardless of equity holding (Bhatti Ishaq and Bhatti Maria, 2011; Iqbal and Mirakhor, 2004; Sulaiman, 2000; Abdul Rahman and Al Bureay, 1992).

In recent years, CSP has become a trend in the business market as companies with a good track of CSP are believed to have positive influence on corporate reputation. In Islamic banks, CSP to various stakeholders allows them to fulfill the social objective part of the maqasid Shariah. It also qualifies the banks for deductible expenses in the bank's corporate tax. It benefits various stakeholders when CSP meets their various needs and expectations and, in return, the bank will get greater stakeholder support and loyalty which will enhance business profitability and legitimacy among the stakeholders, such as employees, community, zakat recipients and the environment surrounding them.

Though social fairness and justice is one of the maqasid Shariah of the banks, little is known about the banks' social performance towards various stakeholders. This is particularly true in Malaysia because CSP has not been made mandatory in practice as well as in reporting. Banks may report the CSP on a voluntary basis in their mediums of communication such as the annual report, bulletin and through advertisement. Although it is reported, the information is not accessible to all stakeholders, resulting in a problem of information asymmetry to stakeholders. They are unable to evaluate how bank managers account for their stakeholder's interest in the bank's earning process, or what constitutes the expected social performances. Inconsistency

of reporting coupled with the voluntary nature of disclosure will hinder the assessment of Islamic banks' accountability to multi-stakeholders. Consequently, the true reflection of their actual social performance may be judged wrongly and a bank may be considered to have very low CSP as compared to the actual situation, or vice versa. The difficulty in assessing CSP is also felt in the absence of specific CSP indicators to various stakeholders for Islamic banks.

Several past studies have gauged the social function of Islamic banks through CSR disclosure such as those by Hanifa and Hudaib (2007); Aribi (2009); Hassan and Harahap (2010); and Hasan (2012). However, these studies mainly evaluated the social function or responsibility using indicators developed from Islamic values or ethical perspectives and measured the variation on the basis of information reported by Islamic banks. There is very limited research that has developed CSP indicators from a practitioner's perspective especially in a country where Islamic banking is operated in a fully-fledged system ("fully-fledged Islamic banking" – FFIB) as well as in subsidiary banks where the holding companies are conventional banks (investment savings banks – ISB). Hence, this study aims to identify what counts as important CSP indicators for Islamic banks from the managers' perspective and to compare any differences in perception between FFIB and ISB managers on what they consider as important CSP indicators.

Findings in this study will add to the limited insight of what are considered to be CSP indicators of Islamic banks from a practitioner's perspective using stakeholders' theory towards fulfilling the maqasid Shariah.

2. Literature review: CSP indicators for Islamic banks

Acknowledging that social welfare underpins the responsibility or accountability of Islamic banks towards various stakeholders (Iqbal and Mirakhor, 2004; Hasan, 2008; Hasan and Harahap, 2010), the terms corporate social responsibilities (CSR) and corporate social performance (CSP) are used interchangeably in this study to denote social or benevolent activities.

This study adopts Wood's (1991) definition of CSP as the assessment of principles of social responsibility (CSR1), which motivate the company's action, how determined it is to make use of social responsiveness processes (CSR2), the existence and nature of policies and programs designed to manage societal relationships, and the social impact (observable outcomes) of the firm's actions, programs and policies. Based on this definition, CSP undertakings constitute the organizational entity, the environment, the individual executive manager, and the employees' ethical and personal values towards the business society at large. The performance includes setting up favorable conditions for decision-making, designing activity (searching, discovering and analyzing possible decisions), and selecting and implementing particular choices of action. The ultimate value of this process is in term of economics (efficient output), power and integrated relationships between organizations and their environment (Swansons, 1995).

From the Islamic perspective, CSP involves keeping up trusts, promises and adherence to fulfill the contract with various

stakeholders in applying the essence of verses in the Quran (5:1; 23:8). This study looks at eight stakeholder groups for whom the contract is considered as specified in the Code of Corporate Governance for Islamic Banks in Malaysia (2007): shareholders and investment account holders; employees; the community; depositors; borrowers; zakat recipients; the environment; and regulators. The groups can be categorized further into explicit and implicit stakeholders. The explicit stakeholders are those who are affected by or are affecting certain contracts which provide rights and protection to the contracting parties. The examples of explicit stakeholders arise from a specific contract signed between them as seller and buyer, customer and banker, and advocate and solicitor (Iqbal and Molyneux, 2005). The implicit stakeholders are those who are indirectly affected by the contracts carried out by the business operation, for example, the environment and zakat recipients.

Based on the eight stakeholders group mentioned above, the CSP indicators for various stakeholder groups are discussed with reference to Shariah and the current literature.

3. CSP indicators for shareholders and investment account holders

Islamic banks have a contract or obligation to shareholders and investment account holders (IAH) on the capital invested by them. It is the bank's obligation to protect the wealth invested and to ensure the right to return on the capital invested.

A socially-responsible Islamic bank is required to provide transparent information about the investment policy to shareholders as well as to investment account holders in fulfilling their fiduciary responsibility and accountability to manage the account within the parameters of the given mandate (CCRG IIFS). Since the encouraged form of financing and investment activities in Islamic banks is through a partnership based on a profit loss sharing (PLS) arrangement (Mirakhor and Zaidi, 2007) the extent of investment using mudharabah and musyarakah will be an indicator of the CSP of an Islamic bank.

To fulfill the IAH's right to monitor their investment performance, it is socially responsible for Islamic banks to indicate their internal guidelines on the eligibility of the employees in managing the IAH, the protection of IAH investments, the disclosure of relevant and material information to the IAH, and a proper and disclosed basis for profit allocation and investment policies based on the risk expectation of the IAH.

Islamic banks are also socially responsible for providing at least the normally available information on collective investment schemes (CIS), information on the PLS for the mudharabah investment account when the account is opened, consideration of the risk and return expectations of the IAH through knowing about customer mechanisms, employing qualified investment managers, and keeping the GC fully informed of the investment strategy adopted. Similarly, it means that IIFS shall inform the IAH about the practices of smoothing over returns by means of building up and drawing on reserves such as PER. The GC shall be mandated to scrutinize the utilization of PER and make recommendations to the board of directors (BOD), IIFS shall

clearly distinguish the distribution rate and if the investment risk reserve (IRR) is used as a cushion, it shall be placed under the scrutiny and recommendation of CG (Yunus, 2007).

Another CSP indicator specified in AAOIFI (2001) is the capability of the Islamic bank to make disclosure of earnings or expenditures prohibited by Shariah, such as the amount and nature of earnings, the amount of the expenditure for those sources, and the policy regarding the disposal of these prohibited sources (FAS No1 AAOIFI paragraph 15).

4. CSP indicators for depositors or customers

Another party with whom Islamic banks have contracts is the depositors. Depositors may deposit their money as current account deposits, or unrestricted investment deposits (in savings and mudarabah accounts), or off-balance sheet deposits (in investment and special or restricted investment accounts) (Kahf, 2004).

Irrespective of the types of deposit, the social responsibility of Islamic banks is to provide the details of the contract they have entered into even though the contractual agreement between depositors and Islamic banks is not based on predetermined rates of return.

In turn, Islamic banks are contracted to maintain the trust of keeping the depositors money safely and not to use it in operations for deposits (safekeeping) under amanah. In safekeeping under the principle of Al-Wadiah (also known as a non-interest loan from depositors to Islamic banks), the bank has the right to use the current account to invest but with no promise of any return except for a guarantee for the entire deposit. Islamic banks may perform social services to these depositors through reward with a gift (hibah) with no specific or permanent amount or customary payment on the current account used for investment.

5. CSP indicators for borrowers

The social responsibility of Islamic banks to borrowers arises from financing facilities (from households and individuals, to small and medium size businesses, large business entities, as well as government and public sector organizations) that are to provide financing activities which are free from riba and grant them a suitable period based on the benevolent principle, as mentioned in the Quran (2: 280). The relevant verse does not, however, mean that debtors are encouraged to delay payment, or not to pay at all. This is because the Prophet (peace be upon him) said that "The rich person who delays in paying back a loan is a wrongdoer" (Sahih Al Bukhari Vol. 3. Book 34. No 291). As such, if the tradition is applied to financing activities this means that both Islamic banks and debtors are accountable and socially responsible for fulfilling the contract of financing given.

Another general social responsibility that Islamic banks need to fulfill is to provide transparent information on the types and features of the financial services offered. They are not supposed to attract customers through false advertisements (Beekun, 1996). This is because such practices will deceive customers from actual or true information about the services or product defects and representation. It will create a false impression with which to induce customers

to choose services provided by the company. It is also an Islamic bank's social responsibility not to hoard or undertake profiteering. Islamic ethics do not allow storing essential stocks secretly in order to exploit the price and emphasis on profit maximization during a period of scarcity, as it will create false scarcity and invite public disorder.

Moreover, services or products provided to customers must be able to reach various target groups so as to ensure that Islamic banking reaches not only established organizations and the rich, but also the needy. The needy are not to be neglected, but banks need to put in place careful selection procedures to ensure that they are financially able to repay the amount owed, thus meeting the commercial objective of Islamic banks. As such, financing may also include financing for the disabled and aged customers, customers who are difficult to reach (for, example, microfinance), small and medium industries, and to introduce qard hasan financing (interest-free financing) to the identified groups (Farooq, 2007). With regard to providing sales of commodities and service, the Quran (17: 35) states clearly the social responsibility to adhere to accurate measurements and weights. Any weighing of commodities less than the actual measurement will be considered as exploitation. It is also the social responsibility of businesses to prohibit riba in all business transactions as it involves interest. Ethically, the transaction must be free from interest which burdens society greatly as stated in the Quran (2: 275).

Last, but not least, it is the accountability and social responsibility of Islamic banks not to undertake business which includes unlawful business activities to customers such as gambling, selling liquor, non-prescribed drugs and tobacco as this is considered a waste and will bring further ruination to society as mentioned in the Quran (2:219) which states: "They ask thee concerning wine and gambling. Say: 'In them is great sin, and some profit, for men; but the sin is greater than the profit.' They ask thee how much they are to spend; Say: 'What is beyond your needs.' Thus doth Allah Make clear to you His Signs: In order that ye may consider". Thus, Islamic banks are socially responsible for ensuring that services and products offered are free from any elements of riba (interest) and gambling in compliance with the requirements of Shariah.

6. CSP indicators for employees

Employees' labor efforts collectively are the catalyst for the fulfillment of business objectives by business organizations. Workers are supposed to be treated fairly according what they deserve and their salary needs to be paid when due according to the following rules as narrated by Abdullah ibn Umar: "Give the labourer wages before his perspiration be dry" (Tirmidhi Hadith: 2987 and Ibn. Majah) and based on the commandment narrated by Abu Huraira that the Prophet said "Allah said that I will be an opponent, on the Day of Judgment, against the person who engages someone on work and takes full work from him but does not give him (full) wages" (Sahih Bukhari No. 470).

A fair recruitment practice prescribed in the Shariah is that in order to employ new workers and give due promotion the employer should not practice discrimination due to race, religion, corruption nor nepotism. The selection needs to be based on trust and should be offered to the deserving

person and responsibility should be given to the person who is able to bear and has the ability to do justice when the trust is given to him (Abul Quasem, 1975).

To improve employee knowledge, skills and commitment, Islamic banks need to send employees for training and state a clear policy on recruitment, retrenchment and profit-sharing programs to employees. Islamic banks also need to maintain a healthy, safe and conducive working environment for employees. A conducive and healthy working environment will allow improvement of work performance and will inculcate harmony and respect of others' beliefs among workers even though they may be of different race or religion.

7. CSP indicators for the community

Besides employees and competitors, the implicit accountability and social responsibility of Islamic banks is also due to the community. Responsibility to the community is based on the relationship of businesses with fellow servants, or collective humanity (hablumminnan nas). Economic managers and entrepreneurs are individuals who administer the business organization in producing or trading in goods and are also considered to be "individual-in-community" and bear a responsibility to fulfill the pursuit of their economic activities in the advancement of fortune (Hasan, 2007).

According to Abul Quasem (1975) in Al-Ghazali ethics, the individual-in-community is subject to two kinds of binding constraints, that is, the individual must sacrifice part of his income for charity to acquire virtue and he must internalize community preference as a responsible member of society and avoid conspicuous consumption (For example, luxury and extravagance). This means that the responsibilities of Islamic banks to the community are in the form of welfare and charity because, as a financial intermediary which consists of individual-in-community, they have the same responsibility to produce community-approved good and to avoid profiteering and other unfair trade practices (Hasan, 2007).

The obligatory corporate social responsibility of Islamic banks to the community in Islam is through payment of zakat, which literally means both purification and growth (Gambling and Karim, 1986). It embodies social identity and justice, and is the best substitute for interest because business zakat is a form of business wealth distribution (regular charity of wealth) from the property of the rich to the poor (Hassan, 2007); this purifies the heart of zakat payers from greed and removes the poverty of the needy (Al Islahi, 1988). It will be distributed to the needy as specified in the Quran (At-Taubah verse 60), namely the poor, the deprived, zakat collectors, new Muslim converters, to free the slaves, those who are unable to pay their debts, destitute travelers, and those in the path of Allah. Business zakat is levied both on the net worth (capital+reserve-assets) and on the net profit at the rate of 2.5%. Some religious scholars have justified the spending of Zakat on health and education as well as other services but do not include the salaries and wages of those working in these sectors (Gambling and Karim, 1986).

Gambling and Karim (1986) suggest that a firm with real commitment to social justice might consider setting up its own zakat fund or an equivalent to cover social costs

not currently being met out of the state fund; thus, it is the management's duty to give full attention to relieve the difficulties and complaints of its customers, suppliers, workers, neighbors, and to alleviate the effect of pollution from the internal zakat fund.

Besides zakat on wealth, other examples of social responsibility in corporate organization are sadaqah (a non-obligatory social responsibility) (Hassan, 2007) and charitable activities (Farooq, 2007). Sadaqah is considered as spontaneous voluntary charity (Hassan 2007) with the purpose to "remove from you some of your (stains of) evil.." (Quran 2:271). There are two form of sadaqah: one-off and continuous. Waqf is a continuous sadaqah in which the voluntary charity is given in the form of assets in perpetuity or on a permanent basis (Ahmed, 2007). The benefits of waqf will flow continuously to the giver after his or her death (Ahmed, 2007). Examples of waqf are building up mosques, educational institutions, roads and other publicly owned premises and facilities, as well as supporting orphanages (Sadeq, 2007). Due to its voluntary nature, there are no limits to the amount and no specific guidelines except that it can be disclosed as well as concealed and it is best if given to the needy.

As a part of social responsibility financing, AAOIFI Governance Standard No 7 requires Islamic banks to provide qard al hasan (zero-interest financing) to the needy. The product arrangement requires the borrower to pay back the principal amount of the loan on maturity without any increment from the amount borrowed or interest (Anas and Mourina, 2009). It is based on a social welfare contract involving individuals and society to promote the well-being and welfare of the less privileged (Iqbal and Mirakhor, 2007; Adnan and Noraini, 2009) and the bank will only charge administration costs of handling the loan and it is not based on the duration and the amount of the loan (Adnan and Noraini, 2009). This contract will enable the poor to create new job markets and business ventures using their merits, skills and expertise and thus eradicate the unemployment problem from society (Anas and Mourina, 2009). However, Adnan and Noraini (2009) argue that expenditure on other product such as rahn, credit card and charge card under this facility is contradictory to the aim as these products are involved in profit motivation rather than benevolent activities.

8. CSP indicators for the environment

Apart from the responsibility to society, business also has a social responsibility to the universe. Islamic banks will be considered as socially responsible to the environment when they are able to utilize and manage the element of nature or universe in an orderly manner as an act of natural submission to Allah (Quran 7:54, 22:18, 24:41), and in discharging responsibility as a khalifah and cabd (Quran 2:60; 6:95–103; 15:16–23; 16:3–21).

Businesses also need to protect the environment (Haniffa, 2002; Othman and Azlan, 2010; Maali, Casson and Napier, 2003 & 2006; Dusuki, 2005). In using resources/bounties of Allah in this world, mankind is required to utilize them in the best way possible (Faroq and Lanis, 2005). Nature is not to be conquered nor must it be overcome in man's pursuit for development of the world (Mohd Haneef, 1997). The responsibility to take care of the natural environment is

emphasized in the Quran (2:30). In addition, the Quran (16: 18:81) points to how nature needs to be protected and not to be harmed as it will create inconvenience to mankind at large. As such, an investment must be selected to be one that will not have an adverse impact on the environment and priority needs to be given to investments on social development and the environment, according to quotas (Farooq, 2007).

9. CSP indicators for regulators

Last, but not least, Islamic banks have accountability and social responsibility to the banks' regulator (the external mechanism that sets rules and regulations), which will influence Islamic banks' operations. The intensity of government rules and regulation may influence the social responsibility to be carried by Islamic banks. The government has the power to set and enforce regulations and to impose penalties on those that do not abide by these regulations. The government may forward social responsibility programs to the nation through banks while in return banks need to attend to the scheme in support of the programs. For example, in Malaysia, the government introduced its social responsibility through Skim Pemilikan Perumahan Kebangsaan (national house ownership scheme) with lower loan rates but the allocation is provided through banks. Thus, it is the banks' social responsibility to be committed in supporting such scheme and in offering it to prospective customers. Pfeffer and Salancik (1978) argued that, "organizations must attend to the demands of those in its environment that provide resources necessary and important for its continued survival" (Pfeffer, 1982).

A socially responsible bank will always be committed to ensure Shariah compliance. The indicator in doing so is through the setting up of a Shariah committee to oversee and monitor compliance to Shariah in its business (Banking and Financial Institution Act (BAFIA) 1996, Section 124(3); Archer et al., 1998; Maali, Casson and Napier, 2003; Farooq and Lanis, 2005; Hanifa and Hudaib, 2007).

Table 1 summarizes the CSP indicators that have been utilized for Islamic banks in prior studies.

The majority of researchers in the past concluded that CSR disclosure in IFIs is still very low leading to an opinion that CSR practices in IFI are still weak (Hanifa and Hudaib, 2007; Aribi, 2009; Hassan and Harahap, 2010; Hasan, 2012). However the researchers evaluated CSR using mainly their perspective. Even though the indicators are generally based on the benchmark of Islamic values and ethics there is no consensus as to what constitutes the indicators, nor the theme of Islamic banks' social obligations from the practitioner's perspective. Thus, this study is aimed at identifying what will constitute CSP indicators from Islamic bank managers' perspective. It is hoped that it will lead to further understanding of management considerations concerning the most and least important CSP indicators in a controlled environment and with cultural differences (in Malaysia only).

10. Hypothesis development

Despite the vast commentary in the literature on the ideal of CSP indicators for various stakeholders, there is no common

Table 1. Summary list of CSP indicators utilized in prior studies.

No.	Author	No. of items	Name of categories*
1	Dusuki (2005)	16	Workers health and safety (1) Workers education and training (1) Fair treatment to workers and applicants (1) Energy and water conservation (1) Waste recycling policies (1) Financing companies not harming environment (1) Financing companies not violating human right (1) Financing SMEs (1) Providing affordable service to deprived areas (1) Supporting charities and community projects (1) Paying zakat and giving sadaqah consistently (1) Fostering Islamic values upon staffs (1) Solving social problems (1) Listening to public view and concern (1) Granting interest free loan (qard hasan) (1)
2	Faroq and Lanis (2005)	32	Using Maali et al. Shariah opinion unlawful (haram) transaction (6) Zakah (tithe)(for banks required to pay (3) Zakah(for bank not required to pay)(2) Qard hassan (benevolent loans) (5) Charitable and social activities (3) Employees (4) Late repayment and insolvent client(3) Environment(2) Other aspects of community involvement (4)
3	Haniffa and Hudaib (2004)		Mission statement and corporate objectives, Top management Shariah Supervisory Board Audit process Products Employees Community Islamic values
4	Maali, Casson and Napier (2003; 2006)	32	Shariah Supervisory Board opinion(4) Disclosure of unlawful transactions(2) Information of sources and distributions of zakat fund(5) Information of sources and distributions of qard al hasan (5) Disclosure of charity and other social responsibility(3) Disclosure of employee relationship(4) Disclosure of the treatment of the late payment and insolvent clients (3) Disclosure of environmental responsibility(2) Other community involvement aspects which regard to the development of ummah (4)
5	Hanifa and Hudaib (2007)	78	Themes Underlying philosophy and values (22) Provision of interest free products and service(10) Focus on development and social goals (35) Subjection to additional reviews by SSB(11) Values Vision and mission statement (9) BOD and top management(13) Product(10) Zakah, charity and benevolent loans(15) Employees (9) Debtors(4) Community(7) Shariah Supervisory board(11)

(Continued)

Table 1. Continued.

No.	Author	No. of items	Name of categories*
6	Othman and Md Thani (2010)	43	Finance and Investment(6) Product(4) Employees(10) Society(11) Environment(7) CG(5)
7	Dinar Standard and Dar Al Istithmar (2010)	13	AAOIFI Governance Standard No 7 Screening client for Shariah compliance Responsible dealing with clients Earning and expenditure prohibited by Sharia Employee Welfare Zakah(3) Qard hasan(2) Reduction of adverse impact on environment(8) Social, development and environment based investment quotas(4) Customer service Macro, small business and social saving and investments Charitable activities Waqf management Other miscellaneous activities not covered

*Number of items in each category is indicated in parentheses.

understanding as to what the social responsibilities are that need to be carried out by Islamic banks, and to whom the responsibilities are owed.

There are two models that emphasise differently the social responsibility of Islamic bank. Ismail's model (1986), for example, considers that social responsibility is implicit in nature and specifies that banks already achieved their social objective if they continuously make a profit, and are viable and sustainable. The social responsibility is considered discharged when banks pay zakat or tax and the government will be solely responsible for undertaking social responsibility activities and actions to various stakeholders. On the other hand, Chapra's model holds the view that Islamic banks have a social responsibility to various stakeholders, both implicit and explicit, in the course of achieving profits. According to Lewis and Algaoud (2001) the differences pertaining to social responsibility in these Islamic banking models are probably due to differences in the mode of operations in the alternative banking systems.

In Malaysia, although Islamic banks have legal reforms, distinct licenses and a market that encourages the development of Shariah-compliant products and services, generally the Islamic banking services are offered by fully-fledged Islamic banks alongside the conventional banks through a subsidiary, termed "Islamic subsidiary" (ISB) in this study. The ISB set-up may be the previous Islamic banking windows of conventional banks, or the newly incorporated subsidiary offering Islamic banking services under the auspices of conventional banks. The two distinct banking systems (FFIB and ISB) require two-fold the regulatory framework (Aziz, 2002). FFIBs are allowed to utilize their capital for Shariah transactions only. On the other hand, ISBs are required to comply with the regulation of having separate

capital, Shariah-compliant and Shariah-non-compliant income, as well as funds providing for withdrawals.

As a result of these differences it is probable that managers' choices in CSP decision-making will be different also. The manner in which a particular stakeholders' group will be given priority in CSP is expected to be different in FFIB compared to ISB. It is expected that bank managers in FFIB will adhere strictly to the rule of Shariah because their bank's economic and social aims will have been clearly identified since incorporation and will already be absorbed with due compliance. The other system (ISB), having migrated from a western setting to a banking system based on Islamic values will not be able to foster a total change in a manager's mindset to incorporate the social objective of Islamic banking. The influence of western culture which already permeates their conventional system would cause them to have different sources of authority and a basis of accountability different from the Islamic viewpoint (Haniffa and Hudaib, 2007); this will lead them to have differences in determining what they consider to be important CSP indicators for Islamic banks. In addition, a self-interested culture (according to agency theory) which is deeply rooted in the basic belief and values of western corporate culture (Iqbal and Lewis, 2009) is expected to widen the gap between the two groups.

Based on these arguments, it may be hypothesized that there are significant differences between managers in FFIB and ISB in Malaysia in terms of the importance attached to each CSP indicator (hypothesis 1).

11. Research methodology

This study used questionnaires to discover what constituted CSP indicators for Islamic banks from a practitioner's

Table 2. Population sample and questionnaire distribution.

No	Bank name	Ownership	Population sample	Questionnaires distributed
1	Affin Bank Malaysia Berhad	Local-ISB	8	8
2	Alliance Islamic Bank Berhad	Local-ISB	7	7
3	AmIslamic Bank Berhad	Local-ISB	9	9
4	Bank Islam Malaysia Berhad	Local-FFIB	19	19
5	Bank Muamalat Malaysia Berhad	Local-FFIB	14	14
6	CIMB Islamic Bank Berhad	Local-ISB	13	13
7	EONCAP Islamic Bank Berhad	Local-ISB	6	6
8	Hong Leong Islamic Bank	Local-ISB	6	6
9	Maybank Islamic Berhad	Local-ISB	17	17
10	Public Islamic Bank Berhad	Local-ISB	5	5
11	RHB Islamic Berhad	Local-ISB	10	10
12	Kuwait Finance House (M) Berhad	Foreign-FFIB	20	20
13	Asian Finance (M) Berhad	Foreign-ISB	10	10
14	AlRajhi Banking & Investment Corp.(M) Berhad	Foreign-FFIB	8	8
15	OCBC Al Amin Bank Berhad	Foreign-ISB	N/A	Drop
16	HSBC Amanah Malaysia Berhad	Foreign-ISB	N/A	Drop
17	Standard Chartered Saadiq Berhad	Foreign-ISB	N/A	Drop
	Total		152	152

perspective. The indicators were self-constructed based on reviews of CSR AAOIFI standards, CSR in Malaysia (Bursa Malaysia CSR framework) and the code of corporate governance for Islamic banks (2007), and prior studies on CSR disclosure for Islamic banks in the earlier literature. A five point likert scale is used to sort out how relevant each indicator is to CSP. Based on these reviews, eight stakeholder groups were identified as relevant in the context of Islamic banks in Malaysia, namely, employee, community, customers, borrowers, environment, zakat, investment account holders, and government or regulators.

The targeted respondents for this study were IBs managers. Bank managers were chosen based on a purposive sampling technique. The selected unit analysis of the survey was a top management team committee of IBs. This was to ensure that the selected individuals had knowledge of CSP issues from the Islamic perspective and had an influence on allocating resources to social issues. For FFIB banks the term “managers” refers to the heads of the departments and, in the case of ISB, the targeted respondents are the management team committees of the ISB. They were chosen as the BOD delegates in business decision-making and deal with both internal and external stakeholders in daily banking operations (Chapra and Ahmed, 2002; Lewis, 2005). Thus, they are expected to be among those who have decision-making power in terms of the corporate social responsibility of the bank.

The sample respondents for this study were drawn from seventeen licensed Islamic banks in Malaysia; however, due to the difficulty in identifying who were in the management team in the last four banks (no information was available either from the bank financial statement or websites), they were dropped from the list of potential respondents. Consequently, the sample respondents were drawn from only fourteen Islamic banks in Malaysia. Table 2 shows the distribution of questionnaires.

Researchers embarked on distribution of the questionnaires to the identified managers once permission to carry out the survey was granted by the chief executive officer (CEO) or the corporate communication manager. Each member of the management team had an equal chance of receiving a questionnaire and a researcher’s self-addressed envelope to return completed questionnaires. In total, questionnaires were distributed to 152 managers from fourteen sample banks.

The reliability and validity of the CSP indicators construct and stakeholder grouping were tested in a pilot test involving thirty-eight students studying for Masters degrees in either Management or Islamic Finance at the International Islamic University, Malaysia. The important CSP indicators were analyzed using descriptive analysis (frequency and mean) while comparison of the perception of the FFIB managers with that of the ISB managers was analyzed using a simple t – test.

12. Analysis and results

Descriptive statistics

Response rate

The questionnaires yielded a response rate of 44%, a total of 67 respondents returning the completed questionnaires. The rate was considered high because two-thirds of the respondents held managerial posts in the respective banks, such as head of department, manager, CEO, and others.

Table 3. Responses according to IB type.

Bank type	FFIB	ISB	Total
Sample	71	81	152
Percentage of total sample %	46.71	53.28	100
No of responses	24	43	67
Response rate%	33.80	53.08	44.08

The response rate was considered acceptable as mail surveys normally result in a low response rate (Sekaran, 2003). The rate was higher compared with the standard response rate for mail surveys in Malaysia, which is 20% (Samat, Ramayah and Mat Saat, 2006). In addition, the sample size and response rate was also comparable to previous studies on stakeholders relevant for CSP (Gago and Antoline, 2004; Mishra and Suar, 2010; Jamali, 2008).

13. CSP indicators

In order to establish what are considered from managers' perspective to be important CSP indicators for Islamic banks, the mean average of responses for each CSP indicator were analyzed. The findings are illustrated in Table 4. In aggregate, seventeen indicators are classified as important indicators (above 4), three are categorized as fairly unimportant indicators (mean above 3, but less than 3.49)

and the thirty remaining indicators are regarded as fairly important indicators (mean average between 3.5 and 3.99).

In total, forty-seven of 50 indicators (94%) used in the questionnaires were perceived as important CSP indicators, these having an average mean score of 3.5 and above. Only three indicators were perceived as unimportant (mean score of less than 3.5), namely, third party verification of environmental performance, qard hasan financing (interest-free loans), and financial products for elderly and disabled customers.

These results illustrate that more than 80% of respondents perceived that the indicators mentioned are important CSP indicators for Islamic banks. It shows that managers in Islamic banks generally subscribe to the model that the objective of being an Islamic bank encompasses profit and also social objectives.

Table 4. Mean of CSP indicators.

Important CSP indicators	N	Mean	Stakeholder
Payment of zakat annually	67	4.64	Zakat
Availability of training	67	4.45	Employee
Bank's commitment to Shariah compliance	67	4.36	Regulator
Transparent in the calculation of zakat	67	4.34	Zakat
Clear health and safety standards	67	4.33	Employee
Avoidance of unlawful transactions and disclosure of nature and extent	67	4.33	Employee
Provision of housing or financing to employees	67	4.31	Employee
Employee appreciation	67	4.30	Employee
Transparent information on financial services types and features	67	4.25	Customer
Clear policy on recruitment	67	4.18	Employee
Actions handling customers complaints	67	4.15	Customers
Retirement, health and education benefit	67	4.13	Employee
Value added statements	67	4.12	Zakat
Continuous enhancement of new product features	67	4.06	Customer
Payment of tax and employee's social security	67	4.03	Community
Policy of lender, depositors, suppliers and retail banking	67	4.01	Customer
Availability of E-banking services	67	4.00	Customer
Fairly important CSP indicators	N	Mean	Stakeholder
Consistent donations or sadaqah	67	3.99	Community
Supporting charities	67	3.94	Community
Statement of P&L for investment account holders	67	3.93	IAH
Involvement in charitable programs	67	3.90	Community
Commitment to quality products and services (ISO)	67	3.90	Customer
Current or previous affiliation to charitable foundations	67	3.87	Community
Providing job training to fresh graduates	67	3.84	Community
Social and ethical criteria to asset management and investment	67	3.84	IAH
Accessibility of international frontiers	67	3.84	Customer
Fund allocation to investment account holders	67	3.82	IAH
BOD statement on bank commitment in offering Islamic investment & services	67	3.81	Regulators
Number of branches and vicinity	67	3.79	Customers
Financing small and medium industries	67	3.78	Borrowers
Equal employee opportunity	67	3.76	Employee
Policy on insolvent clients, charges and utilization of penalties	67	3.76	Borrowers
Announcement of material changes on profit, investment and earning for IAH	67	3.73	IAH
Third party verification of product innovation	67	3.72	Customers
Involvement in activities of public and private partnership	67	3.69	Community

(Continued)

Table 4. Mean of CSP indicators. (Continued)

Important CSP indicators	N	Mean	Stakeholder
Involvement in social sponsorships	67	3.69	Community
Third party verification for customer services	67	3.67	Customer
Availability of stakeholder dialogue and involvement procedures	67	3.66	Customer
Employee information changes and retrenchment	67	3.64	Employee
Products for difficult to reach customers	67	3.63	Customers
Mudharabah and musyarakah to be substantial financing	67	3.61	IAH
Policy of Profit Equalization Reserve (PER)	67	3.60	IAH
Lending profile (customer, industry, concept and social benefits)	67	3.58	Borrower
Involvement in environmental protection activities	67	3.57	Environment
Enhancement on environmental performance	67	3.55	Environment
Involvement in government social activities and programs	67	3.54	Community
Clear environmental management system or policy	67	3.54	Environment
Unimportant CSP indicators	N	Mean	Stakeholder
Financial product for disables and elderly customer	67	3.49	Customer
Qard hasan financing	67	3.24	Borrower
Third party verification of environmental performance	67	3.16	Environment
Valid N (list wise)/Average	67	3.881	NA

The five most important CSP indicators for Islamic banks are:

1. Paying zakat annually.
2. Providing training to employees.
3. Commitment to Shariah compliance.
4. Transparency in the calculation of zakat.
5. Avoiding unlawful transactions and disclosing the nature and extent of the unlawful transactions.

Although the majority stated that zakat is an important CSP indicator, one anomaly was identified. This may be have been due to the respondent thought that business zakat is to be paid by the investors themselves, rather than being the institution's responsibility.

With regard to the five least important CSP indicators in Islamic banks, surprisingly, qard hasan was among them. This is in contradiction to the required disclosure according to the AAOFI standards on CSR. Even though Islamic teaching encourages enhancement of social responsibility through providing non-commercial financing (free of interest and without additional finance charge or margin) (Mohd, Ariffin and Adnan, 2009), the Islamic bank managers did not perceived it to be an important CSP indicator in a commercial bank setting. This may be due to the fact that managers have a lack of knowledge on what constitutes qard hasan financing since it is not a widely-available financial service in Islamic banks in Malaysia (Mohd, Ariffin and Adnan, 2009). This may also suggest that, in commercial Islamic banks, CSP indicators in the manager's perception are still tied to profit. The fact that qard hasan financing is a non-profitable product that has no commercial value (without profit, banks will be unable to cover the financing but it involves high levels of administrative work, high transaction cost, and risk of financing) meant that it received no support from top management as an important CSP indicator to be offered to

various stakeholders. Financial products for disabled and elderly customers, and involvement in government social activities and programs may share the same reasoning as for qard hasan in being regarded as the least important CSP indicators.

Other items which fall under the category of least important CSP indicators are third party verification of environmental performance, and a clear environmental management system or policy. Though environment indicators fall under the least important factors because neither improvement in the environment nor destruction of the environment will affect the banking operation directly, in managers' perception, involvement in environmental protection activities and enhancement of environmental performance and clear environmental management and policies are still important to Islamic banks (mean above 3.5). The importance of environmentally-related issues apparent from this perception study is similar to managers' actual practice in the Dinar Standard and Dar Al Istithmar study (2010), in which managers claimed that 38% of their investments were focused on environmentally-related investment. It can be inferred that the commitment of top management to environmental management is similar to the manager's perceptions of the company's environmental related issues.

Further analysis found that employees were perceived to be the most important stakeholder groups in terms of CSP (almost half of the important CSP indicators are related to this group). Next in the ranking was the customer group, followed by zakat.

As shown in Table 5, by further classifying indicators according to stakeholder groups, it was found that the most important CSP for zakat stakeholders was capability to pay zakat annually. For the employee stakeholder group, the essential factor was the opportunity to attend

Table 5. Most important CSP indicator for stakeholder groups.

Stakeholder	Most important indicator	Mean
Zakat	Pay zakat annually	4.64
Employee	Availability of training	4.45
Community	Payment of tax and employee's social security	4.03
Investment account holders	Statement of profit and loss for investment account holders	3.93
Customers/depositors	Commitment to quality products and services (ISO)	3.90
Regulators/government	BOD statement on bank commitment in offering Islamic investment and services	3.81
Borrowers	Financing small and medium industries	3.78
Environment	Involvement in environmental protection activities	3.57
Average Mean		4.01

training. For the community stakeholder group, the vital factor was the bank's action in paying tax and employee's social security. For the customer stakeholder group, the prominent indicator was the commitment to provide quality products and services (ISO). For the regulator stakeholder groups, the notable indicator was the bank's commitment to offering Islamic investment and services. For borrowers, the key indicator was providing financing for small and medium industry, and, for the environment, the significant CSP indicator was the bank's involvement in environmental activities.

In conclusion, the average mean result of 3.88 for 50 indicators suggested that, in general, Islamic bank managers perceived that all indicators used in the study were important indicators of the prevailing state of the corporate social performance of Islamic banks. It is also suggested that the indicators chosen here were reliable in measuring the CSP construct within the Islamic bank setting. A value of 4.01 as the mean average for the most important CSP indicators for each stakeholder group indicates that all eight stakeholder groups are important in the consideration of CSP in Islamic banks.

14. Independent sample t-test

An independent sample t-test (a test of mean differences between two different groups) was carried out establish whether there were any significant differences in terms of the

importance of each of the CSP indicators between managers in FFIB and ISB. The results, which are shown in Table 6, illustrated that there were significant mean differences in perception between FFIB managers and ISB managers for four CSP indicators at 95% confidence intervals:

1. Qard hasan financing.
2. Number of branches at the vicinity.
3. Availability of e-banking services.
4. Third party verification for customers..

A low significance value for the t-test (typically less than 0.05) indicates that there is a significant difference between the means of the two groups (Coakes, 2005). There is significant difference in the mean for FFIB and ISB managers in stating that qard hasan is an important CSP indicator. FFIB managers largely consider it as relevant (FFIB mean = 3.70) but ISB managers generally consider it as partly relevant (ISB mean = 3.00). This suggests that FFIB managers are more familiar with qard hasan financial services due to the fact that they have been exposed to such a facility since FFIB provide such financial services (for example, Al-Rajhi Banking & Investment Corporation (M) Berhad, BMMB and Kuwait Finance House (M) Berhad) in Malaysia (Adnan and Mohd Ariffin 2009). This reasoning is also consistent with disclosure made in annual reports, BMMB being the only local Islamic bank that continuously carries out financing classified as qard hasan according to their annual reports for 2003 to 2008.

Table 6. Independent sample t-test on CSP indicators.

CSP indicators	Levene's test		t-test for equality of means						
	F	Sig.	F (N = 24)	SD	t	df	Sig.	Mean dif	SE dif
Qard hasan financing	3.910	0.05	F = 3.70 I = 3.00	F = 0.974 I = 1.381	2.149	65	0.035	0.696	0.324
Number of branches and vicinity	2.628	0.11	F = 3.43 I = 3.98	F = 1.080 I = 0.876	-2.220	65	0.030	-0.542	0.244
Availability of E-banking services	0.818	0.37	F = 3.61 I = 4.20	F = 1.033 I = 0.878	-2.481	65	0.016	-0.596	0.240
Third party verification for customer services	1.319	0.25	F = 3.30 I = 3.86	F = 0.974 I = 0.852	-2.429	65	0.018	-0.559	0.230

F = FFIB I = ISB

Managers in FFIB and ISB also exhibit significant differences in perception as to whether the number of branches in the vicinity represents an important CSP indicator. The FFIB managers' perception was more towards partly relevant indicators (mean = 3.43) while generally ISB considered it as a relevant indicator (mean = 3.98). This finding bears a considerable link to the existing set-up of Islamic banks in Malaysia. In FFIB, Islamic banking services are offered throughout all branches but many ISBs still operate their Islamic banking activities in collaboration with their conventional banks. Thus, the number of Islamic bank branches is still far below that of FFIB, their separation from conventional banking being still in its infancy. As an example, a comparison was made between Maybank and BIMB for the year ended 2008. Due to its early stage of operation, Maybank has only thirteen branches of Islamic banks compared with ninety branches of BIMB. Despite the fact that Maybank had 14% of the total number of BIMB branches, its total distributable income from business operations was about half of the total distributable income of BIMB (RM 642,853,000 for Maybank and RM 1,168,837,000 for BIMB). In any case, Maybank managers may have perceived that the number of branches was a relevant CSP indicator for the expansion of their IB business operation, while for an established Islamic banking institution, the additional number of branches will bear only partial relevance to the CSP.

The third significant difference arises in the availability of e-banking as an indicator to CSP. ISB managers perceived this as very important (mean 4.20) while FFIB managers perceived it as partly important (mean 3.60, $p = 0.016$). Scrutinizing the degree of relevance of this indicator further, Table 6 indicates that ISB has double the number of FFIB managers (in percentage terms) who state that e-banking is a very relevant CSP indicator (45% compared with 21%). This may be due to the fact that the introduction of e-banking was already realized by ISB managers unlike FFIB managers, as the holding entity of ISB introduced e-banking much earlier than FFIB. This is consistent with the analysis of bank annual reports which showed that ISB introduced e-banking from the year 2000, whereas FFIB has made a quiet move into it quite recently.

The final indicator with vast significant differences is third party verification for customer services (mean FFIB = 3.30; ISB = 3.80). FFIB managers perceived this not to be an important CSP indicator while the ISB managers held the contrary opinion. This may also be a hint that third party verification is a more important CSP indicator in an ISB manager's perception compared with an FFIB manager's. It can also be interpreted to mean that for FFIB verification must come from their customer who already subscribes to services provided by the bank, rather than through verification by the third party.

These findings substantiate the position that significant differences exist between managers in FFIB and ISB in terms of their perception of how important the four indicators are in representing CSP to Islamic banks. In other words, these results also suggest that, even though managers are from two different settings of Islamic banks in Malaysia, their perception on the degree of importance of the forty-six CSP indicators used in this study are the same except for just these four indicators. Thus, hypothesis 1 – that there are significant differences between managers in FFIB and ISB

in terms of the importance attached to each CSP indicator – is partly supported by the four indicators discussed.

15. Conclusions and limitations

This study examines the CSP indicators for Islamic banks from a practitioner's perspective. The results revealed that Islamic bank managers of FFIB and ISB in Malaysia perceived that social performance towards various stakeholders is an important objective of Islamic banks in line with the maqasid Shariah to ensure social fairness and justice in the preservation and management of bank properties. These results also suggest that Islamic bank managers in FFIB and ISB are proactive in considering CSP activities that meet the need of various stakeholders affecting and affected by bank operations. The Islamic bank manager's considerations for CSP were not dominated by the status of whether they have a contract either explicitly or implicitly with stakeholders. As such, CSP undertaken by Islamic banks will help them in meeting the philosophical, economic, ethical and social foundation in administering a faith-based commercial business institution.

The findings also indicate that the majority of Islamic bank managers are in support of Chapra's model of social responsibility which proposes that the CSP of Islamic banks includes explicit responsibility to various stakeholders in the course of achieving profits. They generally perceive that Islamic banks fulfill their social function if they consider the interests of employees, customers, zakat recipients, regulators, and community.

Furthermore, the contradictory finding of Malaysian Islamic bank managers' perception compared to the AAIOFI standards on qard hasan financing as a highly recommended social responsibility shows that the product has not been given due attention in practice. If the product is universally acclaimed as the Islamic bank's social function, the industry needs to give more significance to it so that it distinguishes the bank function from that of conventional banks.

Lastly, environmental issues and management will be a potential area of CSP for Islamic banks because their importance has attracted managers' attention in this study, despite the fact that they are affecting or affected by the banking business.

The importance of CSP indicators in this study is limited to the perception of the Islamic bank managers only and excludes indicators pertaining to Tawhid or philosophical foundation, due to its subjectivity. In order to have a holistic view on what comprises CSP indicators for Islamic banks, future studies may also consider multi-stakeholders' perceptions such as customers, borrowers, investors, board of directors and Shariah committee members. Future studies may also consider using constructed indicators in assessing the extent of CSP in Islamic banks in order to gain an insight into the status quo of each Islamic bank in upholding their social functions.

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The continuing influence of common law judges and advocates in the adjudication of Islamic finance disputes in Nigeria

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Abstract - The growth and development of an Islamic capital market and finance depends on the institutions in which its dispute resolutions are anchored. The institution for Islamic finance dispute resolution and its practitioners must be knowledgeable and versed in Islamic finance. Despite this, those who are trained in common law, either as judges or advocates, continue to weigh a considerable influence in matters that border on Islamic finance dispute resolution. This problem is further compounded by the constitutional backing given to these judges and advocates. This has serious effects on the adjudication of Islamic finance disputes in Nigeria. Based on this premise, this paper analyzes how the common law trained judges and advocates have and may have considerable influence in the resolution of Islamic finance disputes in Nigeria. This more so emphasizes that dispute is inevitable in any human endeavors. It makes far-reaching recommendations, which if considered and applied will assist the growth and development of the dispute resolution sector of Islamic finance in Nigeria, being a member of OIC. Content analysis of legal issues is used to enrich the study.

Keywords: Islamic finance, dispute resolution, common law judges and advocates

1. Introduction

Nigeria, with not less than 70 million Muslims, cannot afford to be left behind in an effort to benefit from the growing popularity of one of the world's fastest-growing financial sectors – Islamic finance. Studies show that 30 percent of the Muslim population typically is interested in Islamic finance transactions (CNN, September 7, 2011). Also, 50–60 percent will use Islamic finance products if the prices are fair enough (ibid). This shows that disputes in the course of this transaction, as would be the case with any other human endeavors, are inevitable (Sambo & Akanbi 2012; Kadouf & Sambo 2012). Yet, people who are not trained in the act of dispute relation in this sector play significant roles in the act of resolving disputes emanating from Islamic finance transactions. This is based on the influence that existing legal frameworks in Nigeria have bestowed on these categories of people in matters relating to Islamic finance.

The growth and sustainability of Islamic finance in Nigeria, like any institution, depends largely on how it nurtures and protects the institutions where disputes are finally

resolved. In other words, the ability to settle Islamic finance disputes depends on knowledgeable practitioners and sound institutions for dispute resolution. Where this is not put in place, a lot would have been done in vein. Those who have their say in matters of Islamic finance ought to be people who are familiar with its rules and principles. This is more so that Islamic finance has received very stiff oppositions from those who lack the knowledge of what it is all about. To this extent, judges who are to decide matters on Islamic finance, and advocates of Islamic Finance, need some considerable knowledge in this respect.

The influence of those who do not have sufficient knowledge about Islamic finance but are allowed by law to decide such matters may cause miscarriages of justice. The ignorance may be expressed in a way that will result in injury of parties, thereby retarding the growth and development of the sector. For instance, the recent decision of the Federal High Court sitting in Abuja by Justice Gabriel Kolawole shows that civil courts, such as the Federal High Court or a High Court, should not decide matters relating to Islamic finance

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in Nigeria (The Guardian, June 16, 2012). This is because, since there is non-recognition of Islamic law as a distinct legal jurisprudence (Haji & Sambo 2012), Islamic finance may be resolved based on sentiments of a particular judge (non-Muslim). This is clear in the decision recently handed down by the Federal High Court. It is elementary that the judge decided that the plaintiff lacked requisite *locus standi* to present the case, and it ought not to have gone into the merit of the matter. The reason is that the effect of lack of *locus standi* is to deny judicial assistance to the plaintiff by not looking at the merit of the case (Sambo, 2009). However, the court went ahead to pronounce diplomatically that the license issued by the Central Bank of Nigeria (CBN) to an Islamic bank (Jaiz International Bank PLC) is illegal. In the words of the Court: "If not that the plaintiff has no *locus standi* to maintain this action, I would have nullified the illegal license issued to the Jaiz International Bank PLC by the CBN to operate non-interest banking under the principles of Islamic jurisprudence." The Judge could not hide his hatred for or sentiment against Islamic bank when he further observed: "The so-called non-interest bank under the guise of Islamic banking has to come by Act of the National Assembly." There is no doubt that the court has misdirected itself by making an unwarranted statement that Islamic banking is illegal and unconstitutional.

Against the above backdrop, this paper analyzes how the common law-trained judges and advocates have considerable influence in the resolution of Islamic finance disputes in Nigeria. It discusses the influence at various levels of the adjudication processes of Islamic finance, where matters are brought to court for its intervention.

2. Nature of Islamic finance in disputes

As part of the activities of Islamic finance, the account/finance of the institution includes deferred payment sale; short-term deposit; retail current account; simple account; current account, and retail savings account. Generally, the Islamic finance product types are the classical contracts in Islamic finance—*Murabaha*, *Ijarah*, *Mudaraba*, *Musharak*, Islamic bonds (*Sukuk*) and *Ijara* (Lease) (Abdul Rahman 2010). Similarly, the solutions offered by Islamic finance allow access to funds, including non-interest banking, *Takaful* (Islamic Insurance), Islamic microfinance, *Sukuk* (Islamic Bonds), Islamic Asset Management.

Islamic finance is profit-oriented (Sanusi, 2011). However, its system is based on moral and ethical values that are based on the *Shariah*. It has proven to be the most developed form of profit and loss sharing banking, which is based on non-interest principles, mainly because of its international recognition. Despite its religiosity in origin, its products are useful to all who are willing to be fair and just in their economic endeavors. It is strictly based on no-interest rule as no interest can be paid or earned from a loan.

In the same vein, there are four key philosophies of Islamic finance, namely:

1. Existence of some risk, whether funds are used in commercial or productive venture
2. Funds are required to preferably finance ethically and socially productive activities

3. The requirement that financial risk should lie solely with the lender of the capital and not with the manager or agent working with the capital
4. Interest is prohibited as it is a predetermined, fixed sum owed to the lender irrespective of the outcome (success or failure) of the business venture in which the fund is invested

Also, Islamic finance prohibits all forms of transactions or conditions connected with the execution of business contract involving elements of *Gharar* (uncertainty), deceit, gambling, speculation, and so on. The objective is mainly to create the financial system, which serves as an efficient medium for intermediation between savers and investors. *Gharar* is prohibited, for instance, in order to prohibit risk or to prohibit derivative instruments in today's financial markets, which are designed to transfer risks from one party to the other.

Also, transactions in Islamic finance are based on sound Islamic morality and legality. So, the need to scrutinize transactions in order to see their compliance with moral standards and Islamic finance principles become inevitable. Therefore, legal instruments, contracts and transactions, which involve dealings in pork, gambling, pornography, ammunition, alcohol, are not legally permissible because of their non-*Sharī'ah* compliance. The principles of Islamic finance are strictly aimed at avoiding interest; uncertainty or ambiguity relating to a subject matter; disproportionate speculation; unjust enrichment or unfair exploitation, and greed. Thus, financial products, services, transactions and contracts are structured to be in compliance with Islamic finance principles. Also, financial transactions are required to be asset-based or linked to real economic activities in order to create returns. Finance can only be extended for projects, trade and commercial transactions, as they are activities in the real sector which generate income and wealth.

It is observed that the Central Bank of Nigeria (CBN) over the years granted licenses for the operation of Islamic finance in Nigeria. For instance, in the year 1992, the Habib Nigerian Bank limited (former Bank PHB Plc. now Keystone Bank Plc.) was granted license by the CBN to operate non-interest banking services on a "window basis." Similarly, in the year 2004, Lotus Capital limited, which is a *halal* fund (an ethical investment fund), started operation as an Islamic finance company dealing in *Shariah* compliant fund management and investment activities. Also, the first full-blown Islamic microfinance bank, Al-Barakah microfinance, began operations in April, 2010, in Lagos. Recently, the first complete non-interest bank, Jaiz Bank Plc., began operations as a regional bank in January, 2012, with branches covering Abuja, Kano State and Kaduna State of Nigeria.

In fact, Nigeria cannot afford to fail in providing effective and efficient legal frameworks for dispute resolution in the Islamic finance industry. This is based on the marvelous prospects for states and institutional cooperation and assistance across the continent. This is more so that Nigeria is a full member of Islamic Development Bank (IDB) and the International Financial Services Board (IFSB), international organizations that set standard for the Islamic finance industry.

The above shows the nature of Islamic finance and the products it offers to the public. Consequently, disputes become unavoidable just like any human interaction as earlier stated. Here, the disputes could be, for instance, in relation to Islamic Capital Markets (ICM). In this area, there could be disputes among capital market services licenses holders who deal in securities or conducting trade in future contracts; disputes among some organizations involved and a stock exchange; disputes between an approved clearing house and an affiliate; disputes among those who participate in capital market transactions; disputes between the clients and capital market services licenses holders. Disputes of this nature seem to be emerging in some jurisdictions like Malaysia. Apart from this, since Islamic finance deals in certain products like *waqf* and inheritance, handling of Islamic wealth management, and cash *waqf*, disputes regarding these transactions are inevitable. In all these disputes, the principle issue among other things that the courts would need to determine is whether the transactions are *Shariah* compliant. This is because Islamic finance cannot derogate from the established principles of the *Shariah*.

It is also interesting to note here that issues like *waqf* and inheritance are within the jurisdiction of the *Shariah* court of appeal. However, in a situation where the transaction has to do with Islamic banking and finance, it is highly doubtful that the court has jurisdiction in this regard. This is because, as it will be seen later, the disputes will concern banking matters, which clearly fall within the jurisdiction of the Federal High Court or High Court (being banker/customer relation, section 251(1) (d) CFRN 1999). Thus, the nature of Islamic finance and the nature of its products together with disputes emanating therefrom show that they go beyond what can be heard and determined by the Federal High Court or a State High Court. Yet, these courts have influence in the adjudication of such matters. The nature of influence is discussed in the next section of the paper.

3. Influence of common law judges at the high court

The High Court, especially the Federal High Court of Nigeria, is a creation of the Constitution (section 249(1) of the Constitution of the Federal Republic of Nigeria, 1999 as altered (CFRN, 1999)). The appointment as a judicial officer in the court is made by the president on the recommendation of National Judicial Council, subject to the confirmation by the Senate (section 250(2) of the CFRN, 1999). The qualification for appointment into such office is that a person must be qualified to practice as a legal practitioner in Nigeria and must have been so for a period not less than ten years (section 250(3) of the CFRN, 1999). Apart from this qualification, there is no requirement as to whether the person needs to be trained or knowledgeable in Islamic finance. Well, this is not expected because the reason for the creation of the Federal High Court is not to decide matters relating or connected with Islamic finance. So it would be unexpected that judges be appointed based on the criteria of having sound knowledge of Islamic finance or of the *Shariah*. However, the problem seems to be evident from the way and manner in which the jurisdiction of the Federal High Court is stated.

The jurisdiction of the Federal High Court today covers matters that relate to Islamic finance. This is despite the

fact that, as earlier stated, judges of the court need not be knowledgeable in matters relating to Islamic finance (there is no requirement for being knowledgeable in Islamic finance or the *Shariah* as part of its qualification (see section 250 (3) of the CFRN, 1999). Section 251 of the constitution provides that “notwithstanding anything to the contrary contained in this constitution and in addition to such other jurisdiction as may be conferred upon it by an Act of the National Assembly, the Federal High Court shall have and exercise jurisdiction to the exclusion of any other courts in civil cases and matters- (d) connected with or pertaining to banking, banks, other financial institutions, including any action between one bank and another, any action by or against the Central Bank of Nigeria arising from banking, foreign exchange, coinage, legal tender, bills of exchange, letters of credit, promissory notes and other fiscal measures, provided that this paragraph shall not apply to any dispute between an individual customer and his bank in respect of transactions between individual customer and the bank...” (section 251(1) (d) of the CFRN, 1999). This shows that disputes in matters relating to Islamic finance fall squarely within the jurisdiction of the Federal Court.

It should also be mentioned that where the matter relates to banker/customer relationship, the matter Federal High Court does not have exclusive jurisdiction (*ibid*). In other words, the plaintiff is at liberty to institute the action in either the Federal High Court or a state High Court. A state High Court is also a creation of the Constitution (section 255(1) and 270(1) of the CFRN, 1999). The appointment of judges into this court is made by the Governor (or President in the case of Federal Capital Territory, (F.C.T.) Abuja) on the recommendation of National Judicial Council subject to the ratification of the State House of Assembly (or the Senate in the case of the F.C.T) (section 256(1) and 271(1) of the CFRN, 1999). The qualification of persons into the office of a judge of the High Court is that such persons must be qualified to practice as legal practitioners in Nigeria and must have been so qualified for a period of not less than ten years (section 256(3) and 271(3) of the CFRN, 1999). There is no requirement that such persons must be learned in *Shariah* or in principles of Islamic finance. This is unexpected actually in view of the fact that the court was not meant to determine such kinds of disputes. The problem seems to lie in the perspective on matters which border on Islamic finance.

The discussion above shows clearly that disputes relating to the affairs of Islamic banking and finance will be resolved by the Federal High Court or a State High Court. This is even to the exclusion of any other courts of law in Nigeria. The issue here is whether the judges of the Federal High Court or a State High Court are reasonably and justifiably competent enough to decide matters that relate to Islamic finance. This is based on the fact that – looking at the nature of disputes that may arise in Islamic finance and having regard to the qualification and backgrounds of the judges occupying the court – the court may not be competent to decide such matters.

It is well known that the main duty of the law courts is to interpret the law and to decide the claims/objections by the parties. But a question may be raised: given the nature of the cases, which are based on *Shariah*, are the courts concerned

(Federal High Court or a State High Court) competent to construe the legal issues and decide the cases? The answer is definitely “no.” The reason is that judges in these courts are not trained in this respect. Also, the legality to be determined relates mainly to the extent of *Shariah* compliance of the transaction. In other words, the main focus of the court is to see whether the transaction between the parties strictly complies with the *Shariah* and the principles of Islamic finance. This is beyond the competence of the Federal High Court or a State High Court. The reason is that judges in these courts are not trained in this respect. These disputes are based on different legal jurisprudence from the civil law in which the judges are trained. Also, matters of contracts signed by the parties are not related to the common law types of contracts. Although it has some similarities, it is fundamentally different in principles thereby making the construction or interpretation a totally different thing. One area of difference in the interpretation relates to the sources of law to be used by the judges. While the judges will simply rely on the law of contracts as applicable in Nigeria for the purpose of determining the contract, the primary sources of such interpretation under Islamic law are the Qur’an, *Sunnah*, *Ijma* and *Qiyas*. Also, while charging of interests does not render invalid contracts under the common law, which the judges may seek to apply, the hallmark of the principles of Islamic finance is to avoid interest-based transactions having been prohibited in strong terms by Allah (s.w.t.) (Sanusi 2011; Sambo & Abdulkadir 2012). All these may occasion miscarriage or misplacement of justice in the courts.

Again, the jurisdiction conferred on the Sharia Court of Appeal does not solve the problem. As it is now, the Sharia Court does not have more than mere jurisdiction in Islamic personal law. Islamic finance is not covered by the definition of Islamic personal law in the Constitution. Although the Constitution does not define Islamic personal law, ingredients of Islamic personal law as envisaged by the Constitution were stated as: a) any question of Islamic law regarding marriage concluded in accordance with that law, including a question relating to the validity or dissolution of such a marriage or a question that depends on such a marriage and relating to family relationship or guardianship of an infant; b) where all the parties to the proceedings are Muslims, any question of Islamic personal law regarding a marriage, including the dissolution and validity of that marriage, or regarding family relationship, a foundling or guardianship of an infant; c) any question of Islamic personal law regarding *waqf*, gift, will or succession where the endower, donor, testator or deceased person is a Muslim; d) any question of Islamic personal law regarding an infant, prodigal or person of unsound mind who is a Muslim or the maintenance or guardianship of a Muslim who is physically or mentally infirm; and e) where all the parties to the proceedings being Muslims, have requested the court that heard the case in the first instance to determine the case in accordance with Islamic personal law, any other question (section 277 (1) and (2) of the CFRN, 1999). This shows that Islamic finance is not envisaged as Islamic personal law so as to confer jurisdiction on the Shariah Court.

The issue here is whether any House of Assembly can validly expand the jurisdiction of the Sharia Court of Appeal. In other words, although the State House of Assembly has the power to extend the jurisdiction of the Sharia Court of Appeal through legislation, this cannot validly extend to matters

on Islamic banking and finance. This is because issues or matters relating to banking and other financial institutions are within the exclusive jurisdiction of the Federal High Court (see section 251 which starts with the expression “notwithstanding” anything contained in the Constitution.). Even where the matter has to do with banker/customer relationship, it is either the Federal High Court or the State High Court that has jurisdiction and not the Sharia Court of Appeal (proviso to section 251(1) (d) of the CFRN, 1999). An attempt by any state House of Assembly to confer such jurisdiction on the Sharia Court of Appeal may be regarded as an indirect way of amending the Constitution, which is beyond its competence. The effect of this, as earlier stated, is that, notwithstanding the fact that the matter has to do with an Islamic bank and its customer; an Islamic bank and its staff; an Islamic bank and other similar financial institutions; Islamic capital market and Islamic finance, the Sharia Court of Appeal will ultimately lack jurisdiction.

4. Influence of justices at the court of appeal

The justices of Court of Appeal have considerable influence in matters relating to Islamic finance. This is based on the fact that appeals from the Federal High Court or a State High Court, involving matters of Islamic finance, will be heard by the justices of the court (section 240 of the CFRN, 1999). The Court of Appeal is a creation of the Constitution (section 237 of the CFRN, 1999), and the justices are appointed by the President of Nigeria on the recommendation of the National Judicial Council, subject to the recommendation by the Senate (section 238(1) of the CFRN, 1999). The issue here has to do with the qualifications of justices at the Court of Appeal, who may sit on matters relating to Islamic finance. The qualification required of the justices of the Court of Appeal is that they must be qualified to practice as legal practitioners and must have been so qualified for a period not less than twelve years (section 238(3) of the CFRN, 1999). For the purpose of sitting on matters, which relate to Islamic personal law, those justices hearing the case are required to be learned in Islamic personal law (section 247(1) (a) of the CFRN, 1999).

The problem with the above arrangement is that the Constitution does not categorize matters relating to Islamic finance as falling under Islamic personal law. In other words, the Constitution does not regard Islamic finance as personal law, which may justify the sitting of those learned in Islamic personal law on the matter. So, any justice of the Court, depending on the discretion of the president of the Court of Appeal, may be assigned to sit on matters of Islamic finance, which may include deciding whether the action of an Islamic bank is *Shariah* compliant. It is submitted that this is obviously a difficult task for any judge that does not have the background of Islamic law and considerable knowledge of Islamic finance. The end result is either a misplacement of justice or miscarriage of justice at appellate levels occasioned as a result of influence of a judge who does not have sufficient knowledge or background of a legal jurisprudence.

5. Influence of common law judges at the supreme court

The justices of the Supreme Court also have some influence in the adjudication of matters relating to Islamic finance.

This is based on appeals being brought before the Court from the decisions of the Court of Appeal in matters relating to Islamic finance. It should be noted that the Supreme Court of Nigeria, like other courts mentioned above, is a creation of the Constitution (section 230(1) of the CFRN, 1999). The appointments of the justices are made by the President on the recommendation of the National Judicial Council, subject to the confirmation of such appointment by the Senate (section 231(1) of the CFRN, 1999). A person is not also qualified to be a justice of the Supreme Court unless he is qualified to practice as a legal practitioner in Nigeria and has been so qualified for a period not less than fifteen years (see section 231(3) of the CFRN, 1999). There is no other requirement for qualification for such appointment (ibid). In other words, a person or certain number of persons, is not required to have knowledge of Islamic law or Islamic finance to be appointed to that position. This is unlike the position in the Court of Appeal, where some of the justices are required to be learned in Islamic personal law. Even for the purpose of hearing matters, which border on or pertain to Islamic finance, no special qualification exists.

The problem with the above arrangement is that justices who do not have a background of Islamic finance or at least Islamic personal law will end up becoming final judges (decision makers) in matters that pertain to Islamic finance. It must be said that even if a justice of the Court perchance has sufficient knowledge of Islamic finance or Islamic law, it is submitted that this does not solve the problem. The reason is that majority rule in decision making applies at the Supreme Court. So, where one of the justices has knowledge of the principles of Islamic finance or Islamic law and others do not, the day may be carried by other justices with little or no knowledge of Islamic finance. While one of the justices may be satisfied in declaring a riba-based transaction illegal for not being *Shariah*-compliant, for instance, others may not be favorably disposed to doing so. The end result is miscarriage of justice occasioned by ignorance or injustice at the highest bench of dispute resolution. This may affect the growth and development of dispute resolution aspects of Islamic finance knowing fully well that disputes in the course of such interaction, like any other human endeavors, are inevitable.

6. Influence of common law advocates at the various levels of adjudication

Advocates have influence in matters relating to Islamic finance at various levels of adjudication. By advocates, we are referring to those who are qualified to practice as legal practitioners under the Legal Practitioners Act (section 2). The influence is witnessed at the High Court, Court of Appeal and the Supreme Court. The reason is that they represent litigants in any court of law in Nigeria. Once a person is called to the Nigerian bar, he has the right of audience in any court of law or judicial tribunal established by law in Nigeria including the *Shariah* Court of Appeal. More so, since the Constitution, as earlier stated, has conferred jurisdiction on banking matters including Islamic finance, on the Federal High Court or a State High Court as the case may be, legal practitioners' right of audiences in these courts appear settled and beyond argument. Some of the advocates may not have knowledge, owing to their training, in Islamic law, let alone Islamic finance.

In view of the fact that the role of an advocate is to assist the court to reach a just conclusion, we wonder how significant is the role of an advocate who is not trained (owing to his educational background) nor endowed with the knowledge of Islamic finance in matters that pertain to adjudication of Islamic finance. It should not be forgotten that the principal question that the court may be asked to determine may border on the extent of a transaction's compliance with the *Shariah*. This is coupled with the fact that the court, as earlier mentioned, which seeks to determine the matter in controversy, is one without sufficient knowledge of the basic principles of Islamic finance. Thus, the role of such practitioners will be nothing but playing of technicalities, increased costs and a delay in court proceedings as a result of asking for unnecessary adjournment thereby leading to the ultimate miscarriage of justice.

7. Conclusion

From the foregoing discussion, common law judges and advocates have and may continue to have considerable influence in the adjudication of Islamic finance matters in Nigeria. This is mainly because the legal framework has conferred jurisdiction on the Federal High Court or a State High Court, in matters that border on hearing and determination of Islamic finance. Yet, the appointments and qualification of judges in these courts do not qualify them to hear and determine matters on Islamic finance. Also, advocates are allowed by law to have right of audience in these courts despite the facts that the matters may have to do with Islamic finance. Thus, it is submitted, that most advocates in Nigeria are not trained in this regard, except for the few who studied Common and Islamic law. The effect of this is miscarriage or misplacement of justice occasioned as a result of ignorance or lack of sufficient knowledge on the part of those (judges and advocates) charged with the duty of dispute resolution in Islamic finance. More so, sound decisions of courts require sound knowledge on the part of judges and advocates, and this should be more pronounced in matters of Islamic finance. The industry is still at its nascent stage in Nigeria, and its growth and development largely depends on the institutions in which its dispute resolution is anchored.

Thus, to ensure the growth and development of Islamic finance in Nigeria, there is the need for suitable legal and institutional frameworks in which the system is to operate. To start with, there should be constitutional amendment to remove matters on Islamic finance from the control (jurisdiction) of the Federal or State High Court. This is more so that a judge, as noted above, has expressed his displeasure with Islamic finance. One can argue that the *Shariah* Court of Appeal may be conferred with such jurisdiction. The reason is that the Court is also a superior court of record in Nigeria with coordinate jurisdiction with the Federal High Court or a State High Court. The judges or *Khadi* of the *Shariah* Court are trained in matters of Islamic law including Islamic finance but they may be required to do a little more training in Islamic finance. However, the problem with this arrangement is that matters may still go on appeal to the Court of Appeal or the Supreme Court, where the justices do not have sufficient knowledge (having regard to their background) in matters that border on the principles of Islamic finance. To solve this problem, it is suggested that more people who are learned in Islamic

finance and Shariah should be appointed to appellate courts to decide matters bearing on Islamic finance. Alternatively, the creation of the Shariah Supreme Court, separate from traditional Supreme Court, through constitutional amendment is suggested.

Again, in the meantime, the legal framework can be improved upon by permitting the appointment of a *Shariah* Advisory Board annexed to all Federal High Court and State High Courts, especially in northern Nigeria, where Islamic finance may flourish more or for any states of the Federation that desire such boards in their courts. This board will play a very important role in assisting the courts in adjudicating disputes on Islamic finance. The opinion of the board in matters relating to the transactions' compliance with the *Shariah* or the rights and duties of the parties based on the principles of Islamic finance should be binding on the courts. This will reduce the influences of judges and advocates who are not trained in Islamic finance in the adjudication of disputes in matters of Islamic finance. It will also lead to high quality of courts' decisions in matters of Islamic finance and ensure the justice of the matter. Finally, if these suggestions are considered and applied, it will lead to the growth and development of the Islamic finance industry, especially in the area of dispute resolution in Nigeria, being a member of OIC and other similar jurisdictions.

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Dispute resolution in Islamic finance: A case analysis of Malaysia

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Abstract - The paper's purpose is to contribute to the existing body of work in the area of Islamic finance through the discovery of the feasibility of effective dispute resolution mechanisms for the resolution of disputes for Islamic banks and institutions offering Islamic financial services. This is investigated to determine whether the Shariah framework for the enforcement of financial contracts and dispute resolution is a legal risk or appropriate alternative mechanism to the world on whole, individual countries, the business environment, organisations and individuals. The research methodology employed in this study is an amalgamation of direct observation from legal and regulatory perspectives and case analysis of some landmark cases of the English and Malaysian courts. However, the Islamic legal framework remains the only hypothetical basis of the study. Through examining the above, the paper proposes to complement the civil court scheme with a hybrid feature of expert determination whereby the court would refer all issues pertaining to Islamic law to a recognized body of Shariah experts for an opinion that would bind the court. Such a body should be an independent arbitral tribunal, which may or may not be court-annexed, composed of Islamic finance experts whose decision is final. This will complement the work of the Financial Mediation Bureau, which has been handling small claims in banker-customer relationship. The paper concentrates on exploratory study of the viability of dispute resolution mechanisms for the resolution of Islamic finance disputes. The investigation has been supplemented by case analysis of some English and Malaysian courts.

Keywords: dispute resolution, Islamic finance, Shariah advisory council, Malaysian court, ADR

1. Introduction

The overwhelming growth and continuous expansion of the Islamic finance industry in the world during the last decade has been unparalleled. The faith-based finance, which spurns activities outlawed by Islam, is a viable ethical alternative to conventional financing. In addition to being legal under civil laws and tax, as well as cost efficient, Islamic finance is also Shariah compliant. The dispute resolution framework in Islamic finance as practiced in most countries has proven to be inadequate, particularly in its application and interpretation of the Shariah. Islamic law in Malaysia, which has a predominantly Muslim population that constitutes much of the Islamic economic sphere, is one of the major sources of law in the country. Islamic law is only applicable to Muslims and deals with property matters, matrimony, and religious offences. The law of commerce and business is still either determined by statute law or English law. Shariah courts only have

jurisdiction over matters falling under the state list in the Federal Constitution. Islamic law is not applicable in the conventional Malaysian Judiciary, as it is administered separately in the Shariah courts. Consequently, Shariah compatibility in enforcement of financial contracts and dispute resolution becomes a legal risk.

Given the above mentioned legal complexity that Islamic finance casts over the law of the land, the study recommends to complement the civil court scheme with a hybrid feature of expert determination through mediation and arbitration whereby the court would refer all issues pertaining to Islamic law to a recognised body of Shariah experts for a binding decision that is enforceable in the court. This will facilitate the smooth running and operation of the Islamic financial system in the country. The study therefore explores the feasibility of alternative dispute resolution mechanisms as a form of resolving Islamic finance disputes.

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This paper is divided into two broad areas. The first is based on the mechanisms used to serve the resolution of disputes between parties involved in the Islamic banking and finance industry, as the study focuses on legal and regulatory perspectives on the problem. The second is the current legal and institutional framework for the resolution of Islamic finance disputes in Malaysia. This is investigated to determine whether Shariah compatibility in enforcement of financial contracts and dispute resolution is a legal risk to the Islamic finance industry.

The first section gives an insight into the modern history of Alternative Dispute Resolution (ADR) and the events that culminate into the paradigm shift to these forms of informal justice. The second section thereafter gives a brief overview of effective dispute resolution in Islamic law and the relevance of the ADR processes in Islamic law in modern Islamic finance disputes. The third section dilates on the dispute resolution framework in the Islamic finance industry in Malaysia through an examination of the institutional frameworks for the resolution of Islamic finance disputes. The recent trends in the resolution of Islamic finance disputes are also examined. The fourth section gives the conclusion, recommendations and potential areas for further research.

2. An insight into the history of alternative dispute resolution

Definition of alternative dispute resolution

Since time immemorial, dispute resolution has been practiced because disputes are inevitable in human relationships. ADR is a range of processes for amicable resolution of disputes outside the formal court procedure or litigation, where a third neutral party neutral intercedes to resolve the dispute. Though its definition seems to be simple, there is an ongoing controversy on the actual meaning of ADR, the acronym often used for Alternative Dispute Resolution (Brown and Marriott 1999). The alternative processes give the idea of alternative to court litigation. However, some have referred to ADR as amicable dispute resolution while others prefer to merely call it. Whatever the case, ADR is an alternative to formal court litigation. When disputes are channelled through the formal court system, the parties tend to be farther from each other after the judgment because the judgment of the court leads to a win-lose situation where one of the parties rejoices with pomp while the other party wallows in anguish. In order to avoid a winner-takes-all syndrome as generally occasioned in litigation, effective alternatives were created that satisfy the needs of many litigants. The dramatic turn of events now shows the complementary nature of ADR in litigation. ADR facilitates the administration of justice and ensures speedy litigation without compromising the rights and liabilities of the parties. In essence, ADR leads to a win-win settlement where the parties resolve the ensuing dispute amicably and secure the ongoing relationship.

3. Recent history of alternative dispute resolution

The recent history of ADR can be traced to the bold attempt by Roscoe Pound to redress the popular disaffection in the administration of justice in the US at the annual meeting

of the American Bar Association in August of 1906. In his seminal speech, he highlighted the causes of general disaffection in the system and proposed a way forward (Pound 1912-1913). Despite the fact that some of the recommendations he made were not taken seriously at the initial stage, the decades that followed his proposed reforms saw significant changes in the administration of justice in America. The remarkable development spurred further developments in other jurisdictions across the world. Though there was that latent conception and practice of amicable resolution of disputes in other jurisdictions, the remarkable speech ushered in a regime of formalised ADR systems throughout the modern world. The formalized court system began to appreciate their unutilised role of case management. Case management generally requires the court to facilitate amicable resolution of the dispute with some level of contribution by the parties, while upholding the rights and liabilities of the parties.

As time went on, people began to discuss the importance of access to justice and the manner at which the over litigation of the society has continuously denied an underprivileged segment of the society from formal justice through exorbitant costs of litigation and the protracted time to successful litigation from filing stage to the judgment stage (Resnik 1986). These, as well as other concerns, based on Pound's seminal speech, constitute the "spark that kindled the white flame of progress" in the drive toward reforms in the administration of the justice system (Wigmore 1937). Despite the fact that there were pockets of reforms across the world among different civilisations where amicable means of resolving disputes have been in place for some centuries, there were no formal systems of ADR as proposed by Pound. In the developed world, little or no attention was given to Pound's recommendations for the improvement of the administration of justice through meaningful reforms. However, the accumulated backlog of cases in the United States signalled a new direction toward reforms in the 1960s. The anti-litigation wave emerged in the 1970s; and by 1976, which marked seventy years after Pound made the remarkable speech, the Pound Conference was held. The need to improve the judicial system was highlighted during the conference (Kovach 2007: 1004). Frank E. A. Sanders of Harvard Law School proposed what is known as Multi-Door Courthouse, where parties to a dispute are at liberty to choose from a variety of processes that are most suited for amicable resolution of the dispute. This significant conference ushered in a new era of court-annexed ADR that is now widely practiced across the world (Resnik, Many Doors? Closing Doors? Alternative Dispute Resolution and Adjudication 1995).

Remarkable reforms were experienced in the succeeding decades. In 1998, the Alternative Dispute Resolution Act¹ was introduced in the United States. This was specifically introduced to reduce the increasing backlog of cases in the Federal courts through mandatory court-annexed ADR programmes. These mandatory court-referrals must be made as a preliminary step to court litigation. The court keeps a list of neutrals from which the parties may choose after the court has ascertained the most suitable ADR process for the dispute. Section 3(a) of the ADR Act 1998 defines ADR as follows: "For purposes of this chapter, an alternative dispute resolution process includes any process or procedure, other than adjudication by a presiding judge,

in which a neutral third party participates to assist in the resolution of issues in controversy, through processes such as early neutral evaluation, mediation, minitrial, and arbitration.” There is no doubt in the fact that this mandatory ADR program has tremendously reduced the backlog of cases in the Federal courts.

Earlier on, there had been series of efforts to introduce reforms into the civil justice system in the United Kingdom. “Since 1851, there have been some 60 Reports on aspects of civil procedure and organization of civil and criminal courts in England and Wales itself” (Rashid 2002). The difficulties attending the adjudication of disputes in the courts brought about the most recent report, popularly called *Lord Woolf’s Report on Access to Justice*. This Report, which was submitted in 1996, significantly introduced far-reaching reforms in the civil justice system through the recommendation of court-annexed ADR as part of the case management role of the judge (Woolf 1996).

These reforms were meant to tackle head-on the negative aspects of litigation. Lord Woolf’s Report identified a number of the negative aspects of litigation apart from excessive cost. These aspects relate to excessive delay. The following five main areas of delay in litigation are summarised thus:

- a. *Delay in progressing the case from issue to trial*: In London, High Court cases on an average took 163 weeks; elsewhere 189 weeks
- b. *Delay in reaching settlement*: Majority of the cases took four and six years to settle; late settlements involve the parties in substantial costs
- c. *Delay in obtaining a hearing date*
- d. *Delay due to time taken by the hearing*: No one knows for sure how long a hearing might last; frequent adjournments and long submissions by the lawyers are mainly responsible for this, and no remedy appears to be available
- e. *Low priority is given to civil cases*, because in criminal cases there is a prisoner in detention awaiting trial, so civil cases come for hearing after the judge finished the criminal business—as the number of criminal cases is usually larger than the civil cases, they consume much of court’s time, and in recent times courts give more time to family cases than cases relating to business or contractual disputes (Woolf 1996; Rashid 2002: 5)

The recommendations contained in Lord Woolf’s Report were introduced in the amended Civil Procedure Rules (CPR) in May 2000.² Court referrals found their way, for the first time, into the CPR. As Mistelis rightly put it, “[t]he driving force behind the reforms was a combination of the lawyers involved in commercial litigation, a handful of academics, and the courts” (Mistelis 2003: 1). Rule 1.4 provides *inter alia*:

1. The court must further the overriding objective by actively managing cases
2. Active case management includes —
 - e. encouraging the parties to use an alternative dispute resolution procedure if the court considers that appropriate and facilitating the use of such procedure
 - ...

- f. helping the parties to settle the whole or part of the case³

This provision obliges the judge, as part of the case management role, to encourage the parties in a dispute to consider the use of an ADR process, and the court should facilitate the use of such a procedure (Nesic 2001). Rule 26.4 CPR also enables the judge, either of its own initiative or with the agreement of both parties, to stay proceedings where they consider the dispute to be better suited to solution by alternative dispute resolution or other means. It is therefore the duty of the claimant to inform the court when a settlement is reached.⁴ With this, ADR has been inducted into the courts in England as a procedural rule, allowing the court to order parties to mediation (Trent 1999).

Islamic finance disputes cannot afford to suffer such protracted delays in the administration of justice system. The disputes emanating from the Islamic finance industry are *sui generis* that requires speedy and efficient frameworks for amicable resolution considering the need to secure ongoing business relationship and the recent fluctuations experienced in the financial markets across the world (Oseni and Hassan 2011).

4. Alternative dispute resolution in Malaysia

Amicable dispute resolution in Malaysia is as old as the culture of the people of Malaysia. There are recorded historical facts that reveal elements of dispute resolution in the cultures of the predominant tribes in Malaysia—namely Malays (Muhammad 2008), Chinese (Shijan MO 1999), and Hindus (Lahoti 1999). The customary values of these major races in Malaysia primarily provide for amicable settlement of disputes (Oseni 2010b). So, the formalised ADR introduced in the twilight of the 19th century was not new to Malaysia as a country. However, the models adopted by the court were based on best practices in Australia, United Kingdom and the United States. The court-annexed mediation programme is new to Malaysia as differentiated from the customary mediation practices common in the cultural heritages of the predominant cultures in the country. In 2000, the pilot project of court-annexed mediation was introduced in Penang. This project was a success but there was a need to amend the Rules of the High Court 1980 to allow for court referrals (Yiam 2009). For 10 years, there has been series of calls for reforms in the civil justice system to scale up the adjudication process in line with the advances experienced in other common law jurisdictions such as England, Canada, Australia and New Zealand.

As a welcome development in the civil justice system in Malaysia, the Chief Justice of Malaysia issued Practice Direction No. 5 of 2010 on 16 August, 2010. This is the Practice Direction on Mediation (Mohamed 2010). So, for the first time, the civil courts are given a suitable framework to explore every amicable process of dispute resolution before proceeding for court adjudication. For the Shariah Courts, each state has its enactment on court referrals to *tahkim* (arbitration), popularly known as *hakam*, which was introduced in 1984. The Islamic Family Law (Federal Territories) Act 1984 (“IFLA 1984”)⁵ introduced the framework for *lakam* and the conciliatory committee. This

court referral programme is purposefully meant for Islamic family disputes. Similarly, *sulh* (mediation) was introduced in the 1990s in the Malaysian Shariah Courts, but the practice was consolidated in the next decade of 2000, where a series of enabling enactments were made. Both the *sulh* and *hakam* programmes were meant for Islamic family disputes that fall within the jurisdiction of the Shariah Court (Abdul Hak 2006).

It should be borne in mind that despite the fact that Islamic law matters are state issues according to Federal Constitution⁶, Islamic finance disputes are classified under the jurisdiction of the High Court (Mohamed Shariff 2005). Therefore, for this purpose, a Muamalat Bench was introduced at the Kuala Lumpur High Court in order to encourage a sort of expert determination of Islamic finance disputes, albeit through adjudication. This Bench at the Commercial Division of the Court only hears and determines Islamic banking and finance cases.⁷ Despite the laudable efforts of this Bench as well as significant progress recorded over the years, certain problems have been highlighted. There is the problem of inadequate manpower to handle the increasing number of cases. This has led to a situation where other judges in the commercial division of the High Court who are not learned in Islamic finance hear and determine such cases. Judges who are ordinarily required to hear and determine conventional banking and finance cases now handle Islamic finance disputes. This has resulted in some untoward judgments that have attracted a lot of criticisms from Islamic finance practitioners. One aspect of the new Practice Direction on Mediation that would have been very useful to the amicable resolution of Islamic finance disputes is court-referrals. In order to encourage expert determination of Islamic finance disputes through amicable means, this Practice Direction on Mediation will play a significant role. But time will tell whether the judges in the Muamalat Bench practically consider the use of this Practice Direction.

5. Dispute resolution in Islamic law

Muslim scholars have continuously argued that ADR has its source in the prime sources of Islamic law since it is a practice encouraged in Islam. Therefore, dispute resolution in Islamic law is a wide area of study that, though similar to the conventional practice of ADR, has its unique principles and concepts. The varieties of dispute resolution processes have been practiced at different momentum since the advent of Islam about 14 centuries ago. These processes are worth exploring and formalizing to suit the modern needs of Muslims across the world in their various endeavours.

6. Definition of dispute resolution in Islamic law

There is no use of the term 'Alternative Dispute Resolution' in the Islamic sources but there are numerous references to amicable resolution of disputes. This has led modern Muslim thinkers to equate ADR to the Islamic ideals of dispute resolution encouraged in the Qur'an and Sunnah. For the purpose of this paper, the term "dispute resolution" is used for the Islamic law paradigm. The definition of dispute resolution in Islamic law is in no way different from the earlier definition of ADR given above. However, one

thing that is added is the underlying principle of all Islamic transactions, whether contractual or otherwise. This is the concept of *halal* (permissible terms) and *haram* (prohibited terms) in concluding a contract. As the dispute resolution clause is considered a binding contract between the parties, such must not involve the permissibility of what is prohibited under the law or the prohibition of what is expressly permissible under the law. All types of compromises or amicable settlement of disputes among disputing parties is permissible except settlements, which make forbidden anything that is originally permissible in the eyes of the law and permit a thing that has been declared prohibited under the law (Zaidan 2007/1427).⁸

From the foregoing, dispute resolution in Islamic law can be defined as a range of processes for amicable resolution of disputes, either as court-annexed processes or outside-court-settlement by a third party neutral based on the Islamic worldview without compromising the fundamentals of Islamic law. This is where another problem being faced in the Islamic finance industry lies. In a bid to adopt ADR, conventional arbitration tribunals that specialize in banking and finance are now handling Islamic finance disputes. This is a counter-productive approach toward solving the challenges posed by litigation of Islamic finance disputes. A step toward the introduction of a new framework for the resolution of Islamic finance disputes has led to the emergence of another problem (Oseni 2010a). As will be seen below, Islamic law has its unique standards and requirements for arbitration. If a proper Islamic framework is not introduced for the arbitration of Islamic finance disputes, the repercussion of arbitrating such disputes under conventional arbitration rules may be devastating in the long run.

7. Processes of dispute resolution in Islamic law

The dispute resolution processes in Islamic law are meant for different types of disputes and some are relevant at various stages of a dispute. The Islamic concept of dispute resolution is a continuum of not less than nine processes of dispute resolution. The common processes of dispute resolution in Islamic law are (Rashid 2004):

- *Nasihah* (Counselling)
- *Sulh* (Negotiation, mediation, conciliation, compromise of action)
- *Tahkim* (Arbitration)
- Med-Arb (A process that begins with mediation and ends in arbitration);
- *Muhtasib* (Ombudsman)
- *Wali al-Mazalim* (Chancellor or Ombudsman Judge)
- *Fatwa of Mufti* (Expert Determination)
- Med-Ex (A combination of mediation and expert determination)
- *Qada* (adjudication)

The treasure trove contained in these processes has not been fully explored in the modern practice of ADR (Oseni, 2011; Yaacob, 2009; Oseni, 2009; Othman, 2007; Zahraa and Abdul Hak, 2006; Othman, 2005; Rashid, 2004; Masud, Messick and Powers, 1996; Al-Mawardi, 1983; Khalil, 1976). In fact, Muslim countries tend to adopt the conventional practices rather than looking inward to formalize some of these processes that have been practiced

for centuries. Though most of these dispute resolution processes are relevant to most contractual disputes, not all are relevant to Islamic finance disputes. We shall shed some light on the most relevant processes in the next subsection. The mostly used processes in Malaysia are *sulh* and *tahkim* for the resolution of family disputes in the Shariah court. Meanwhile, expert determination is used in most cases inadvertently for the purpose of dispute avoidance. The Shariah Advisory Council of the Central Bank of Malaysia plays this important role, which has helped in the avoidance of foreseeable disputes in the Islamic finance industry in Malaysia.

8. Relevance of alternative dispute resolution in Islamic finance disputes

The repeated instances of Islamic finance litigation in the civil courts call for the need to have an Islamic framework for the resolution of Islamic finance disputes. There is no doubt in the fact that Islamic finance disputes can be best resolved through Islamic processes of dispute resolution and not otherwise. As earlier observed, Islamic finance disputes require speedy and efficient processes owing to the nature of business disputes and the need to secure ongoing business relationship and avoid unnecessary public attention, which may affect the credibility of the financial outfit. We must decide which way to follow: whether to adopt the conventional ADR processes or look inward to evolve relevant processes for Islamic finance disputes.

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), a body that issues global standards on different aspects of Islamic finance, has issued the standard on arbitration. This is yet to be fully utilised by the Islamic banks and financial institutions including those in Malaysia. The AAOIFI standard on Arbitration is a welcome development, which mirrors the unique features of Islamic arbitration (Oseni, 2010a). Unfortunately, the Islamic banks and financial institutions in Malaysia and elsewhere only adopt other standards, which they feel affect their daily transactions while neglecting the aspect of arbitration. In cases of default, it is common for Islamic banks to head for the court rather than giving effect to the AAOIFI standard on arbitration. It is appalling to observe that many Islamic finance practitioners have continued to neglect dispute resolution in Islamic finance in their policies and practices. Rather, they have focused on other areas that directly affect the profit and risk involved in financial transactions. It must be mentioned here that if care is not taken, the courts will eventually restructure all Islamic finance transactions in line with their limited understanding of the dynamics of most transactions (Oseni 2011).

As one of the countries with the most successful experiments of Islamic finance in the modern world, Malaysia is also leading in the increasing number of Islamic finance disputes. The number of cases has continued to rise over every passing day. The only judge in the Mu`amalat bench of the commercial division of the High Court in Kuala Lumpur is Dato' Rohana Yusuf, who has considerable experience and expertise in Islamic finance. But a judge may not be enough for the current backlog of cases in the court. If the status quo is to be maintained, the Mu`amalat bench has no choice other than to embrace ADR or implement the instructions

in the Practice Direction on Mediation. This will enable the learned judge to be able to make requisite court referrals to expert arbitral panels or tribunals. Another option is to refer the parties to the Financial Mediation Bureau for mediation. Once a settlement is reached, the court may adopt such terms of settlement as consent judgment. The complexities involved in Islamic finance transactions require expert determination, and there is a framework for court referrals to such in the current arrangement.

The Practice Direction on Mediation, if properly utilised, would be a veritable tool for the quick dispensation of justice through expert determination. According to the Practice Direction, all judges are required to "give such directions that the parties facilitate the settlement of a matter before the court by way of mediation." This is to encourage the parties to amicably arrive at an early settlement without necessarily going through the rigors of a complete trial in the court. The advantages of settling the dispute in line with the Practice Direction include: parties are able to explore all options available; underlying issues and common grounds may be identified; good relationships are restored and maintained; terms agreed upon would be acceptable to both parties; settlement is expeditious; no delays in court hearings, and terms of settlement are final. This court-annexed mediation is in line with *sulh*, but one thing that must be emphasized is the need to make court referrals to experts in Islamic finance and not just mediators on the court's list of neutrals.

There are two modes of referrals to mediation in the Practice Direction. The parties are given the option to choose based on the principle of party autonomy. Option A provides for judge-led mediation while Option B provides for the appointment of a mediator agreeable to the parties. The explanation given for these two options as contained in the Practice Direction is reproduced below.

Option A: Judge-Led Mediation

1. Unless agreed to by the parties, the judge hearing the case should not be the mediating judge; he should pass the case to another judge—if the mediation fails then it will revert to the original judge to hear and complete the case
2. The procedure shall be in the manner acceptable to both parties
3. Unless agreed to by the parties the judge will not see the parties without their lawyers' presence except in cases where the parties are not represented
4. If the mediation is successful, the judge mediating shall record a consent judgment on the terms as agreed to by the parties

Option B: Court-referred Mediation

1. Mediator

- 1.1 A mediator may be chosen by the parties from the list of certified mediators furnished by the Malaysian Mediation Centre ("MMC") set up under the auspices of the Bar Council, or any other mediator chosen by the parties.
- 1.2 Such a mediator shall facilitate negotiation between the parties in the dispute and steer the direction of the mediation session with the aim of finding a mutually acceptable solution to the dispute.

- 1.3 If the parties so desire, they may appoint more than one (1) mediator to resolve their dispute.
- 1.4 Any mediator so chosen by the parties may agree to be bound by the MMC Code of Conduct and the MMC Mediation Rules, or not at all.

2. Procedure

- 2.1 If the parties agree that they be bound by the MMC Mediation Rules, upon direction of the Court, the Plaintiff's solicitor shall, within (7) calendar days notify in writing the MMC; upon receiving such notification, MMC shall then proceed with the mediation process as provided under the MMC's Mediation Rules.

3. Settlement Agreement

- 3.1 Any agreement consequent upon a successful mediation may be reduced into writing in a Settlement Agreement signed by the parties but in any case the parties shall record the terms of the settlement as a consent judgment.

This is a commendable effort on the part of the Malaysian judiciary, but there is still further room for improvement. Expert mediators in Islamic finance should be identified and appropriately utilised in the Muamalat Bench of the High Court of Malaya. The MMC may assist the court in identifying leading experts in the field of Islamic finance who will exclusively sit to mediate disputes involving Islamic financial transactions.

9. Dispute resolution in the Islamic finance industry in Malaysia

The dispute resolution framework for the resolution of Islamic finance disputes in Malaysia has assumed an advance stage in the modern world. The prime stage of this aspect of the Islamic finance industry in Malaysia and the recurrent regulatory and legal reforms being introduced to improve the delivery of Islamic financial services is enviable considering the diverse rate of development of the industry across different jurisdictions in the world. The current institutional framework for the resolution of Islamic finance disputes is encouraging but to what extent the Islamic finance practitioners and financial institutions have utilised the frameworks necessities further analysis. The dynamics of the growing case law on Islamic finance have been studied and are worth further exposition to streamline the process of dispute resolution in the industry (Yaacob 2011).

10. Institutional framework for dispute resolution in Malaysia's Islamic finance industry

There are several institutions in Malaysia that undertake the services of resolving Islamic finance disputes through mediation, arbitration or any other process. Though these bodies are setup under different auspices, they tend to achieve a common goal. A quick overview of the institutional framework for ADR for Islamic finance cases includes the following bodies:

- i. Kuala Lumpur Regional Centre for Arbitration
- ii. Financial Mediation Bureau

- iii. Shari'ah Advisory Council of the Central Bank of Malaysia
- iv. Malaysian Mediation Centre

i. Kuala Lumpur regional centre for arbitration

The Kuala Lumpur Regional Centre for Arbitration (KLRCA) is a dispute resolution body established under the auspices of the Asian-African Legal Consultative Organisation (AALCO) in 1978 (Lau 2009). It provides institutional support as well as a convenient venue for domestic and international arbitrations. It introduced the Rules for Arbitration of Kuala Lumpur Regional Centre for Arbitration (Islamic Banking and Financial Services) in 2007 to encourage the use of arbitration for disputes emanating from Islamic financial services. According to Rule 1, para 3, "These Rules shall be applicable for the purposes of arbitrating any commercial contract, business arrangement or transaction which is based on *Shariah Shariah* h principles." Though the Rules have been criticized as being a complete replica of the UNCITRAL Arbitration Rules of 1976 with some modifications to suit the specific needs of parties in Islamic financial transactions (Oseni 2009), it represents a significant innovation in the drive towards introducing better ways of resolving disputes in the industry. At present, there are 23 panelists for Islamic banking arbitration, one of whom is from Singapore.⁹ During an informal discussion with one of the arbitrators, she revealed that not more than two cases have been arbitrated under the KLRCA Rules since 2007. This is discouraging, as many of the Islamic banks and financial institutions prefer to head to the court to get their money in cases of default rather than arbitration. As earlier observed, many of the Islamic banks and financial institutions prefer to adopt other standards of AAOIFI that regulate their transactions rather than implementing the AAOIFI Standard on Arbitration. This situation is appalling and calls for concern from all the stakeholders in the industry.

ii. Financial mediation bureau

The Financial Mediation Bureau (FMB) is an amalgam of the erstwhile Banking Mediation Bureau and Insurance Mediation Bureau. The two earlier bodies were independent initiatives by Islamic banks and financial institutions closely supported by the Central Bank of Malaysia. While the Banking Mediation Bureau handled Islamic banking issues between customers and banks who are its members, the Insurance Mediation Bureau provides a simple process for the resolution of insurance disputes. The whole process is simple, efficient and without costs on the part of the customers or the financial institution. The two bodies were merged in January 2005, and the FMB was established (Segara 2009). The FMB provides dispute resolution services to customers and their financial services provider. As an alternative to the court system, FMB provides free, fast, and efficient service to customers and their financial services providers who are members. The body is under the close supervision of the Central Bank of Malaysia. A number of banks and financial institutions in Malaysia are members of FMB, including about 16 Islamic banks and financial institutions. Unlike the KLRCA, the FMB is very active in its service delivery in the Islamic finance industry because it is cost-effective and fast. From the case review released by FMB, most of the cases are petty disputes involving banker-

customer relationships, such as loss of deposits over the counter and unauthorized ATM withdrawal. This is due to the limited jurisdiction. The FMB can only handle disputes, claims or complaints involving financial loss of which the amount claimed does not exceed RM100,000 for banking and financial related matters. The exceptions to this are fraud cases involving payment instruments, credit cards, charge cards, ATM cards and cheques, whose maximum limit is set at RM 25,000. On the other hand, the maximum claim in disputes, claims or complaints involving insurance or *takaful* must not exceed RM200,000 in motor and fire insurance/*takaful* and RM100,000 for others. Since it is the parties who head to FMB for the amicable resolution of a case with their financial service provider, the FMB handles a lot of cases unlike instances where the bank seeks to recover its money from defaulting customers through litigation.

iii. Shariah advisory council of Central Bank of Malaysia

People, including many Islamic finance practitioners, tend to believe the Shariah Advisory Council (SAC) of Central Bank of Malaysia is only an advisory body saddled with the responsibility of performing its statutory functions. There is more to its functions, which is not expressly mentioned in section 51 of the Central Bank of Malaysia Act 2009 (CBM Act).¹⁰ As the principal advisory body on Islamic financial services at the apex bank, SAC occupies a key position with respect to dispute resolution and dispute avoidance in Islamic law. Before unravelling the key role being played by SAC and the far-reaching effect in dispute avoidance in the Islamic finance industry, it may be necessary to enumerate the provisions of section 51 of the CBM Act on the functions of SAC.

The Shariah Advisory Council shall have the following functions:

- a. to ascertain the Islamic law on any financial matter and issue a ruling upon reference made to it in accordance with this part
- b. to advise the Bank on any Shariah issue relating to Islamic financial business, and the activities or transactions of the bank;
- c. to provide advice to any Islamic financial institution or any other person as may be provided under any written law
- d. other functions as may be determined by the bank

These functions serve two important purposes in ADR; dispute resolution and dispute avoidance. But the kernel of the functions is more of dispute avoidance. In simple terms, when there is a reference of a Shariah issue from the court or arbitral tribunal, SAC ascertains the Islamic law on such a matter and issue a ruling, which is considered in the final judgment or award of the court or arbitral tribunal respectively. Section 57 of the CBM Act provides that any ruling made by SAC pursuant to a reference made by either a court or arbitral tribunal shall be binding on such body. This helps in resolving the dispute expediently, effectively and promptly. The ruling of SAC at such instances of referrals serves as a catalyst that facilitates the quick disposal of the dispute. However, section 56 (1) of the Act provides for instances where the published rulings of SAC

may serve as dispute avoidance mechanism. Any published ruling of SAC must be taken into consideration by the court or arbitral tribunal in any proceedings relating to Islamic financial business, where any question arises concerning a Shariah matter. The published rulings are also reviewed and considered by the Shariah Advisory Committees of Islamic banks and financial institutions in Malaysia, where reasonable steps are taken to streamline all contracts and financial dealings to avoid unforeseeable disputes with customers. The ultimate reference of the Shariah Advisory Committees is the ruling of SAC on any transaction in question. The publication of the rulings and guidelines of SAC allows potential investors, customers and the financial institutions to understand their rights and liabilities with regard to certain contracts in question. Therefore, SAC is more than a mere financial advisory body but may also be considered as a dispute resolution and dispute avoidance body.

iv. Malaysian mediation council

The Bar Council of Malaysia established the Malaysian Mediation Council (MMC) as a foremost body for both institutional and ad hoc mediation on 5th of November 1999. This was the end result of the recommendations of the Alternative Dispute Resolution Committee set up by the Bar Council in 1995 to look into the possibility of establishing a world class Mediation Centre in Malaysia. The services of the MMC include mediation services, assistance and advice on how to get the other side to agree to mediation if one party has shown interest, and provision of mediation training for those interested in becoming mediators. It also accredits trained mediators and maintains a panel of mediators. Over the years, there have been concerted efforts to form a formidable synergy with the judiciary by encouraging the parties to a dispute to explore ADR processes as part of the pre-trial procedures (Bukhari n.d.). These efforts by the Bar Council were consolidated with the issuance of the Practice Direction on Mediation in August 2010. As cited above, the Practice Direction expressly provides for the use of MMC Code of Conduct and Mediation Rules. Except otherwise provided by the parties, all court referrals are made to a mediator appointed from the list of neutrals furnished by the MMC. The Muamalat Bench of the Commercial Division of the High Court of Malaya will also have course to refer Islamic finance disputes to qualified mediators. Such mediators who have requisite expertise in the practice of Islamic finance with many years of experience should be exclusively considered for this purpose.

11. Current trends in Islamic finance litigation in Malaysia

The litigation of Islamic banking and finance disputes in Malaysia dates back to 1985. Once the Islamic Banking Act of 1986 came into force with the proliferation of Islamic finance products in the country, the High Court began to hear related cases.¹¹ Though it is beyond the scope of this paper to review all the cases, it is important to briefly review some cases and suggest a better framework for the resolution of such litigated cases using appropriate ADR processes.¹² The advantages of using ADR processes over litigation are obvious considering the legal complexities and procedural bottlenecks involved in Islamic finance litigation that may pose a threat to the future of the Islamic

finance industry.¹³ In fact, the Court of Appeal held in *Bank Kerjasama Rakyat Malaysia Bhd v. Emcee Corporation*,¹⁴ that the law applicable to Islamic banking disputes is the same as that applicable to the conventional banking. Therefore, despite the fact that the case involved an Islamic facility, the court held that the procedure and principles applicable to conventional banking are also applicable in the case. This position is similar to the rulings of the English Courts in *Beximco Pharmaceuticals Ltd v Shamil Bank of Bahrain E.C.*¹⁵ where the court refused to apply the principles of Shariah as the governing law of the contract in a *murabahah* case.

The trends in Islamic finance litigation since 1986 have been classified into three phases: Phase One (1994-2002); Phase Two: (2003-2007); Phase Three: (2008 onwards) (Markom, et al. 2011), but we have modified the classification to reflect current trends. Phase One should be the period between 1986 and 2002, Phase Two (2003-2007), Phase Three (2003-2009), and Phase Four (2010 onwards). The reason for this additional phase is the affirmation of the value of the rulings of SAC in the new CBM Act 2009, which emphasises the binding nature of the rulings. Before this period, some judges were still sceptical about the weight to be attached to the rulings of SAC when cases are referred to it for its opinion. In *Affin Bank Berhad v. Zulkifli Abdullah*¹⁶ Abdul Wahab Patail J. was reluctant in making referral to SAC. Similarly, Rohana Yusuf J. in *Tan Sri Abdul Khalid bin Ibrahim v Bank Islam Malaysia Bhd and another suit*¹⁷ expressly stated her views regarding the relevant provision of the law which requires the court to make referrals to SAC. Though she accepted the opinion of SAC, she however re-echoed the position of the law where she observed: "Having examined the SAC, its role and functions in the area of Islamic banking, I do not see the need for me to refer this issue elsewhere though I am mindful that under s 16B (7) I am not bound by its decision."¹⁸ The CBM Act 2009 expressly provides that the Shariah ruling of SAC is binding on the court or arbitrator. Therefore, this ushers in a new phase, which has been further complemented by the Practice Direction of 2010. This argument justifies the reason why the fourth phase should be introduced in the history of Islamic finance litigation in Malaysia.

12. Judicial precedents and legal risks in the Islamic finance industry

The negative effect of judicial precedents applicable in common law jurisdictions such as Malaysia is now being felt in the Islamic finance industry. The principle of *stare decisis* provides that the judgments of superior courts are binding on the lower courts. The lower courts must take into consideration previous decisions of superior courts of records in arriving at a decision. This has negative effects in the Islamic finance industry because even if the single judge of the Mu`amalat Bench at the High Court is learned in Islamic finance, what is the probability that the judges who will be sitting to hear the appeal at the Court of Appeal and ultimately at the Federal Court are similarly learned in Islamic finance? With due respect to the expertise of the judges of superior courts of record, there are very complex issues and terminologies involved in Islamic financial transactions that may not be known to the learned judges. If the judges at the appellate court are allowed to hear and determine an appeal from the Mu`amalat Bench without necessary guidance

from experts, the decisions handed down by such appellate courts will be binding in subsequent cases in the lower courts. This constitutes a legal risk for Islamic financial transactions since the courts may restructure the generally known Islamic finance products by their judgements. There is a mandatory requirement for Shariah compatibility in the enforcement of financial contracts in Islamic finance. If judicial precedents supersede the mandatory Shariah requirements in financial contracts, the Islamic finance industry will be facing legal risks because there are situations where the superior court will overrule the decision of a lower court as in the case of *Bank Islam Malaysia Bhd v Lim Kok Hoe & Anor and other appeals*.¹⁹ In this case, the Court of Appeal overruled the decision of the High Court, which likened *Bai Bithaman Ajil* (BBA) contract to conventional loan agreement. Without going into the validity of BBA contract, it suffices to observe that if the superior court's decision is not in line with Islamic commercial law, then a binding precedent would have been created in the Islamic finance industry which would make such a decision binding on all subsequent similar cases until it is overruled by either another superior court or by itself.

13. Conclusion

The dynamics of dispute resolution in the Islamic finance industry seems to be complex, particularly in the aspect of Islamic finance litigation. In order to mitigate legal and regulatory risks in the dispute resolution aspect of Islamic finance in Malaysia, the existing ADR institutions and bodies should be strengthened to reflect the modern drift towards amicable resolution of disputes, which incidentally is the underlying spirit of Islamic contracts. Rather than duplicating efforts in the establishment of more ADR bodies that would help in handling Islamic finance disputes, the existing bodies should be consolidated and a formidable court-annexed programme put in place where experts will have the opportunity to mediate Islamic finance disputes while ensuring enforceability of such settlement. This is why Med-Ex—a combination of mediation and expert determination—may be the best bet for the existing court-annexed mediation in the High Court of Malaysia introduced through the Practice Direction on Mediation. The members of the Shariah Advisory Council of the Central Bank of Malaysia may be enlisted as neutrals for the purpose of court-annexed mediation at the Mu`amalat Bench. These recommendations will drastically reduce the existing tension in the Islamic finance industry, which is occasioned by the increasing number of cases in the court. Other potentially relevant areas of research include the practitioners' perspectives on Islamic finance litigation and efforts towards the reutilization of in-built mechanisms of dispute avoidance in Islamic finance contracts (Oseni 2011). The future of ADR in Islamic finance is dispute avoidance, which should be vigorously pursued by all (Rashid 2002).

Notes

1. Alternative Dispute Resolution Act, 1998 (HR 3528). President Bill Clinton signed it into law on October 30, 1998.
2. Civil Procedure (Amendment) Rules 2000 (SI 221 of 2000). It should be observed that the Civil Procedure Rules are the rules of civil procedure used by the Court of Appeal, High Court of Justice, and County Courts in civil cases in the whole of England and Wales. The

new rules came into force on 26 April 1999. The Rules were actually made in 1998. So, reference to the rules may sometimes read “Civil Procedure Rules 1998 (L17 No. 3132 of 1998). Some amendments were incorporated into it in 2000.

3. Rule 1.4(1) and (2) (e) - (f) CPR.
4. See Rule 26.4 (1)-(4) CPR.
5. There are corresponding Islamic Family Law Enactments across the States in Malaysia and they were modelled after the IFLA 1984 (Act 303). These enactments include Islamic Family Law Enactment 1990 (Johor) (No. 5 of 1990); Islamic Family Law Enactment 2002 (Kelantan) (No. 6 of 2002); Islamic Family Law (State of Malacca) Enactment 2002 (No. 12 of 2002); Islamic Family Law (Negeri Sembilan) Enactment 2003 (No. 11 of 2003); Islamic Family Law Enactment 1987 (Pahang) (No. 3 of 1987); Islamic Family Law (State of Penang) Enactment 2004 (No. 5 of 2004); Islamic Family Law (Perak) Enactment 2004 (No. 6 of 2004); Islamic Family Law Enactment 1992 (Perlis) (No. 4 of 1992); Islamic Family Law Enactment 1992 (Sabah) (No. 15 of 1992); Islamic Family Law Ordinance 2001 (Sarawak) (Cap 43); Islamic Family Law (State of Selangor) Enactment 2003 (No. 2 of 2003); Administration of Islamic Family Law Enactment 1985 (Terengganu) (No. 12 of 1985).
6. Article 74, Federal Constitution and section 1, Second List, Ninth Schedule to the Federal Constitution. Section 1 of the Second List in the Ninth Schedule provides in relation to the exclusive powers of State Legislature: “Except with respect to the Federal Territories of Kuala Lumpur and Labuan, Islamic law and personal and family law of persons professing the religion of Islam, including the Islamic law relating to succession, testate and intestate, betrothal, marriage, divorce, dower, maintenance, adoption, legitimacy guardianship, gifts, partitions and non-charitable trusts; Wakafs and the definition and regulation of charitable and religious endowments, institutions, trusts, charities and charitable institutions operating wholly within the State; Malay customs. Zakat, Fitrah and Baitulmal or similar Islamic religious revenue, mosques or any Islamic public places of worship, creation and punishment of offences by persons professing the religion of Islam against precepts of that religion, except in regard to matters included in the Federal List; the constitution, organisation and procedure of Syariah courts, which shall have jurisdiction only over person professing the religion of Islam and in respect only of any of the matters included in this paragraph, but shall not have jurisdiction in respect of offences except in so far as conferred by federal law, the control of propagating doctrines and beliefs among persons professing the religion of Islam; the determination of matters of Islamic law and doctrine Malay custom.” Also see the Malaysian Supreme Court decision in *Mamat bin Daud v. Government of Malaysia* [1988] 1 MLJ 119 (SC) where the apex court held in its majority decision that only the State Legislature will have the exclusive powers to enact laws on Islamic matters.
7. See paragraph 2 of the Practice Direction No. 1/2003.
8. This is a popular hadith which was reechoed in the principles enumerated in Caliph Umar’s letter to Abu Musa Al-Ash’ari on the latter’s appointment as a judge. An aspect of this letter which deals with mediation as part of the case management apparatus of the court is the text of the hadith narrated by Amr bin Auf who narrated that the Prophet Muhammad (S.A.W.) said: “Conciliation is permissible among Muslims except the one which makes permissible what has been forbidden or forbids what has been permitted.” This hadith was related by al-Tirmidhi, Abu Dawud, Ahmad and Ibn Majah.
9. For a complete list of the panelists, their affiliations, expertise and addresses, see Islamic Banking Arbitrators, Kuala Lumpur Regional Centre for Arbitration at [http://www.klrca.org.my/KLRCA's_Panellists-@-Islamic_Banking_Arbitrators.aspx]
10. Act 701 of 2009.
11. The first reported case is *Tinta Press v. Bank Islam Malaysia Berhad* [1986] 1 MLJ 474.
12. Example of cases heard and decided by the civil courts in Malaysia include: *Tinta Press v. Bank Islam Malaysia Bhd* [1986] 1 MLJ 474; *Bank Islam Malaysia Bhd v Adnan bin Omar* [1994] 3 CLJ 735; and *Dato Hj Nik Mahmud bin Daud v Bank Islam Malaysia Bhd* [1996] 4 MLJ 295 (High Court); [1998] 3 MLJ 396 (Supreme Court).
13. Hakimah Yaacob, “Alternative Dispute Resolution in Islamic Finance...”, 135.
14. [2003] 1CLJ 625.
15. [2004] EWCA Civ 19. Also see the decision of the English Court in the earlier case of *Islamic Investment Company of the Gulf (Bahamas) Ltd v Symphony Gems N.V. and others* [2002] All ER (D) 171.
16. [2006] 1 CLJ 438 HC.
17. [2009] 6 MLJ 416.
18. *Ibid*, pp. 426-427.
19. [2009] 6 MLJ 839; [2009] 6 CLJ 22.

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Regulatory and financial implications of Sukuk's legal challenges for sustainable Sukuk development in Islamic capital market

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This research paper does not represent the views of Maybank Syariah Indonesia towards the subject matter of this research.

Abstract - This discursive research paper is appraising issues pertaining to legal compatibility of sukuk, which is at the heart of Islamic finance. Sukuk serve a powerful tool for Islamic financial institutions to mobilise funds from the Islamic capital market, and to extend financing through Islamic capital market operations. In Shariah values, sukuk has to represent the ownership of either underlying assets or usufructs or services of the business entity based on asset securitisation concepts, where the return is justified by risk taking coupled with risk mitigation principles. Nevertheless, the present state of sukuk practises is detached from ideal values because, to some extent, a western legal framework is not supportive enough for sukuk operations in the Islamic capital market to comply with Shariah values. As a result, the structure of sukuk is heavily influenced by conventional bonds practises governed by the western legal framework. Due to that fact, in this research, sukuk structures are scrutinised to examine legal impediments inherent in sukuk contracts. This research portrays that the western legal system is not supportive enough for sukuk to protect the rights of sukuk holders in the event of sukuk defaults. Regulatory and financial implications are suggested as anticipations to any future sukuk defaults. The objective of this research paper is to sustain sukuk development in the Islamic capital market, where Shariah and western legal frameworks can be in harmony to govern sukuk operations.

Keywords: sukuk, Islamic capital market, legal challenges, Sharia, western legal framework

1. Introduction

Research background

The development of the Islamic capital market ('ICM') is crucial for the sustainable development of Islamic finance. ICM has a long-term objective to mobilise and allocate resources in an effective and efficient manner. This long-term objective can be achieved through real sector development financing. In another dimension, ICM is the avenue for liquidity management of the Islamic financial industry through Islamic money market operations. Liquidity management is a pivotal aspect for ICM in the short run because it is one of parameters for ensuring the long-run survival of Islamic financial institutions ('IFIs') in the financial market arena. Thus, the development of innovative, Shariah compliant ICM products is urgently needed for realising the existence of vibrant and efficient ICM. In this regard, *sukuk*, which is a term describing Islamic debt instruments in ICM, plays an important role for smoothing liquidity and resource mobilisation in ICM.

Besides, *sukuk* are potential financing instruments for contributing to a country's economic growth through real sector development initiatives. *Sukuk* plural; singular *sak* are defined by the Accounting and Auditing Organisation for Islamic Financial Institutions ('AAOIFI') as "certificates of equal value representing undivided shares (in ownership of) tangible assets, usufruct, and services or (in the ownership of) the assets of particular projects or special investment activity" (AAOIFI 2008, p. 307).

Sukuk are indeed promising as a Shariah compliant financing instrument. Total *sukuk* issuance amounts to US\$ 236.75 billion as per June 2011 with Malaysia still champions the *sukuk* issuance¹. This big number of *sukuk* issuance can be supported by the fact that western countries such as the United Kingdom and United States have jumped on the bandwagon for issuing *sukuk* as indicated by the UK's consideration of *sukuk* for government financing, and the issuance of *sukuk* by General Electric and East Cameron Gas in the US.

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Based on Islamic Finance Information Services ('IIFS') statistic database of *sukuk*, *sukuk* issuance experienced an impressive growth from 2005 to 2006, increasing by 134% with the total *sukuk* issuance amounting US\$ 26 million. *Sukuk* issuance peaked at US\$46 million in 2007 but substantially declined by 64% to US\$17 million in 2008. There are several factors that can explain the substantial decline of *sukuk* issuance, including global financial crisis, dry liquidity, widening credit spreads, and investor's wait-and-see attitude (Damak *et al.*, 2009). Although *sukuk* were badly hit in 2008, they are indeed a promising ICM's instrument (IFIS, 2009). One reflection of this is the *sukuk* rebound throughout 2009 brought mainly by sovereign and quasi-sovereign *sukuk* issuances. These included the US\$1.4 billion *sukuk* issuance of Terengganu Investment Authority in Malaysia, US\$487.2 million retail *sukuk* issuance of government of Indonesia, plus *sukuk* from the Dubai government, the Islamic Development Bank (IDB), and so forth (Zawya *Sukuk* Intelligence, 2010).

Sukuk declined by 15% in 2010, which indicates that there was low confidence in *sukuk* market. This can be explained that there have been 21 *sukuk* defaults recently in Islamic capital market space as reported by Khnifer (2010), with Nakheel *sukuk* and East Cameron Gas *sukuk* are the most controversial one. These *sukuk* defaults pose severe legal risks of *sukuk* inherent in the *sukuk* contract. Specifically, the risk emanating from *sukuk* contract's enforceability whereby whether or not the *sukuk* can be enforced in order to protect the rights of *sukuk* holders in the event of *sukuk* defaults. As a matter of fact, legal conflicts are persistently occurring in the court due to *sukuk* defaults cases with the adverse impacts on legal rights, and even financial rights of the *sukuk* holders. Therefore, in this article, the issues surrounding enforceability of *sukuk* contract are discussed as an attempt to give possible legal and financial mitigations as solutions to the problem of *sukuk*'s legal challenges in Islamic capital market. At the end, it is expected that legal and financial rights of the *sukuk* holders can be fully protected.

Research objectives & questions

This research has four main objectives, which are as follows:

1. Appraising legal issues at stake in present *sukuk* structures,
2. As precautionary measures for Islamic finance key players regarding the importance of legal protection for *sukuk* structuring,
3. Presenting regulatory and financial implications for the ideal *sukuk* development in the ICM given the legal issues of present state of *sukuk* structures, and
4. As a way to obtain holistic approaches from academia and practitioners point of views to tackle unresolved legal challenges of *sukuk*.

In order to achieve the stated research objectives, there are three important questions that need to be answered in this research, which are as follows:

1. What is the present state of *sukuk* structures?
2. What are the salient legal issues that come to bear on *sukuk* structures?
3. What are the regulatory and financial implications for ideal future *sukuk* development in the ICM?

Significance and scope of research

There have not been much discussions going on to appraise legal aspects of *sukuk* with the fact that there are *sukuk* legal default cases in ICM. So far, the legal aspect of *sukuk*, which are heavily discussed in literatures and conferences, only pertains to *Shariah* compatibility of *sukuk* structures, but not taking consideration into *sukuk*'s legal issues. Amongst others, the research that discusses *Shariah* compatibility of *sukuk* structure are Rosly and Sanusi (1999) with critical evaluation of the application of *bay al-inah* and *bay al-dayn* contracts for *sukuk* issuance in Malaysia, Al-Amine (2001) with critics for the interest rate benchmarking and guarantee features in *sukuk* operation, and Usmani (2008) with critics over current *sukuk* mechanism on asset ownership, guarantee, and *sukuk*'s pricing benchmarks. For the recent research, Dusuki & Mokhtar (2010) criticise asset ownership in current *sukuk* mechanisms, and Al-Jarhi & Abozaid (2010) discuss *Shariah* issues of current *sukuk* structure in a paper presented this year to the OIC *fiqh* academy conference.

However, in light of *sukuk* legal defaults occurring in ICM, so far there has been only one research paper discussed by Salah (2010) in reference to Nakheel's *sukuk* defaults. But, still more research paper is needed to find out solutions for *sukuk*'s legal challenges since legal aspect is one of important ingredients in *sukuk* issuance packaging that makes *sukuk* attractive to the investors. Hence, this research paper will contribute by scrutinising legal problems inherent in current *sukuk* structures with the expectation that there will be significant efforts in improving the status quo of western legal systems to cater the needs of *sukuk* operations in ICM.

The scope of this research is limited to theoretical research with secondary source data from relevant literatures or journals. Field work research to collect primary data, such as interviews, or questionnaires, cannot be conducted for this research due to time and resources constraints.

Research outline

This research study is organised in a following manner. In the next section, the present state of *sukuk* will be scrutinised in light of recent debates and innovation of current *sukuk* structure. Section 3 is appraisal of the legal issues of *sukuk*. After appraising legal problems of *sukuk*, chapter 4 discusses regulatory and financial implications in the ICM arising from those legal issues. Finally, chapter 5 ends up this research paper with a conclusion.

2. *Sukuk* practises in Islamic capital market

Sukuk structures have evolved from their basic structures through attempts to innovate on *sukuk* so as to gain popularity in financial markets. Nevertheless, not all *sukuk* innovation is positive, as signified by the failure of *sukuk* to become a *Shariah* compliant financing instrument and alternative to conventional bonds after being tested by the Islamic financial industry.

Types of *sukuk*

Since *sukuk* can be structured in numerous ways, proper classification of *sukuk* is crucially important for issuers to determine the aim of *sukuk* structures, as well as the nature of *sukuk* structures. AAOIFI (2008) has classified

sukuk investments in its *Shariah* standards, which are *ijarah* certificates (leased assets), *ijarah* certificates (ownership of usufructs of existing assets, described future assets, specified party, and described future services), *salam* (purchasing goods to be delivered in the future) certificates, *istisna'* (manufacturing/production of goods) certificates, *murabaha* (purchasing goods) certificates, *musharakah* certificates (participation, *mudharaba*, and investment agency *sukuk*), *muzara'a* (sharecropping) certificates, *musaqa* (irrigation) certificates, and *mugharasa* (agricultural) certificates. *Ijarah* and *musharakah* *sukuk* are predominant *sukuk* structures prevalent in the Islamic capital market. Other than the *sukuk* classified by AAOIFI, Tariq & Dar (2007) have a list of the modified types of *sukuk*, which is as follows:

i. Hybrid/pooled certificates

These are certificates based on an underlying pool of assets, including *istisna'*, *murabahah* receivables, and *ijarah* with the condition that at least 51 percent of the pool comprises *ijarah* assets. The return on these certificates can only be a pre-determined fixed return.

ii. Variable rate redeemable certificate

This type of *sukuk* can be called alternative *sukuk* due to its seniority to issuer's equity, their redeeming nature and their relative stable rate as compared to dividend payouts. The return on these *sukuk* is benchmarked to market references, such as LIBOR.

iii. Fixed-rate-zero-coupon certificate

These certificates are non-tradable certificates based on an underlying pool of assets, primarily *istisna'* or *salam* that would create debt obligations.

Sukuk versus conventional bonds

It is imperative to differentiate between the basic tenets of bond and *sukuk* operations. Bonds are financial obligations, in form of certificates, issued by borrowers to creditors. Bonds have guarantee features in which creditors guarantee capital repayment with capital charge to the borrowers. The prime objective of bonds is to gear up the issuer's leverage through a loan relationship. That loan relationship implies a contract with the characteristic of earning money on money, which is the practise known as *riba* and prohibited in Islam (Adam & Thomas, 2004). Bonds are very liquid in nature, as they can be easily traded in secondary markets in case the bondholders need liquidity. Bond's risks are highly concentrated on credit risk of the issuer.

In contrast, *sukuk* represents asset ownership passed from the issuer to *sukuk* holders in form of *Shariah* compliant contracts such as lease, partnership, or sale contract, which originate from trade and business activities. The return can be either derived from profits of real underlying assets attached to *sukuk* or from sales, lease or partnership of business ventures, which characterises *sukuk* as an asset-backed financing instrument. It is important to note that *sukuk* are not always debt instruments, but sometimes equity instruments, depending on how they are structured. The risks of *sukuk* are broader than conventional fixed income instruments in that they involve not only credit risk, but also market risk, asset-quality risk, regulatory risk, and so forth (Zaidi, 2009).

Under current practises, *sukuk* are aimed at having structure similar to conventional bonds in spite of different characteristics and *modus operandi* between *sukuk* and conventional bonds. According to Miller *et al* (2007), *sukuk* ensure returns similar to conventional bonds, while the difference is that the return of *sukuk* is generated from the underlying real asset ownership, not interest payments obligation as found in conventional bonds. This is similar to Wilson's (2008) argument that replicating *sukuk* to be identical to conventional bonds has been attempted by financiers because the financiers' aim is simplifying risk assessment for this new asset class of investments.

In the Malaysian experience, asset-backed *sukuk* have been structured in such a way that the receivables attached in the *sukuk's* underlying assets can be traded in the market, as with the Time Engineering *musharakah* asset-backed *sukuk*. In that case, *sukuk* is structured to acquire the receivables generated by Time System Integrator (Mokhtar & Thomas, 2009). Furthermore, the rating proxies' treatment of *sukuk* is exactly the same as conventional bonds as shown by the research conducted by Siswantoro (2006). He finds that revenue income of the coupon payments stream is attached to the whole company (obligor), not the specific project undertaken by the company. Hence, those facts indicate that the current structure of *sukuk* show indifference of economic outcomes of conventional bonds and adjusts well to modern western capital market technique, which characterises asset-based *sukuk*.

Asset backed sukuk versus asset based sukuk

According to IFSB guidelines (2005) No. 2, *sukuk* are ideally categorised as asset-based and equity-based instruments whereby the former offers fair and predictable return, such as in the case of *salam*, *istisna'*, and *ijarah* whilst the latter the return is derived from profit-loss sharing of joint venture business, which offers unpredictable return, based on *musharakah* or *mudharabah* contracts. Since there are deviations in the actual implementations of *sukuk* from ideal theoretical ground of *sukuk*, there has been a concern to categorise *sukuk* in order to differentiate genuine and non-genuine ones, particularly risk factors and sale execution. In this regard, the guidelines of IFSB 7-Capital Adequacy Requirement for *sukuk*, Securitisations, and Real Estate Investments (2009) distinguish three types of *sukuk* structures: Asset-Backed *sukuk* ('ABS') and two non-ABS structures, which are pay-through and pass-through structures.

According to these particular guidelines, ABS are "structures that meet the requirement for being an asset-backed structure as assessed by a recognised external credit assessment institution (i.e. rating bodies)" (p.3). Based on this guideline, there are two factors that constitute ABS. Firstly, in the case of any impairment of the *sukuk's* assets, the *sukuk* holders have to face the loss. Secondly, the risk factor of ABS is the underlying assets of *sukuk*. Therefore, *sukuk* holders derive the risk and return from the cash flows of the *sukuk's* underlying asset as well as have recourse to the *sukuk* asset, not the issuer, in case of default of *sukuk* issuer. True sale execution is another dimension of ABS in which there is a real transfer of assets from the originators to *sukuk* holders with the effect of releasing assets from the issuer's balance sheet to investors (Ahmed, 2010). Therefore, ABS issuance must be backed by real assets that

represent the *sukuk*'s ownership as well as risks attached to the assets.

In contrast, with asset-based *sukuk*, there is no true sale transaction taking place, rather one sees just transfer of financial rights to the asset and the income is derived from the financial rights to obligations attached to the debt (Aziz & Gintzburger, 2010, p.276). True sale transaction is absent since the *sukuk* holders have recourse to the originator instead of the underlying assets in the event of defaults. This is based on pay-through and pass-through as defined in IFSB-7 (2009) guidelines, in which the former constitutes recourse to the originator via purchase undertaking whilst the latter constitutes recourse to the issuer via guarantee. Therefore, the risk and return of asset-based *sukuk* are derived from the obligor instead of the *sukuk*'s underlying assets, so that in case of defaults, investors have recourse to the obligor and secured creditors cannot recourse the asset. The risks are measured solely on the issuer or obligor's creditworthiness to pay back the capital. Thus, it is not surprising that investors are mainly focused on sovereign/corporate credit quality and less concerned on the actual underlying asset performance when they buy sovereign *sukuk* (Hales, 2005). In this regard, *sukuk* holders are guaranteed to get the capital back in the event of bankruptcy. Furthermore, in asset-based *sukuk*, the structures are merely fulfilling the form of a contract with much more complexity, which ultimately leads to Islamic equivalent of unsecured conventional bond (Howladar, 2009). Hence, *sukuk* holders would only be able to dispose of the assets to the lessee and be treated as unsecured creditors or ranked *pari passu* with other unsecured creditors (Haneef, 2009).

Islamic securitisation vis-à-vis asset backed sukuk

In a conventional framework, asset securitisation refers to "the process and the result of issuing certificates of ownership as a pledge against cash flow streams of diversified pool of assets (assets portfolio) to investors" (Jobst, 2007, p.14). This asset securitisation proposes an alternative for capital market-based refinancing mechanism to diversify external sources of asset funding instead of intermediated debt finance based with a special emphasis on the risk assessment of securitised assets (Jobst, 2006). True sale, bankruptcy remoteness, and enforceability of assets are essential prerequisites for asset securitisation. Effective risk management and capital enhancement are great advantages of asset securitisation, since there are lower costs and risks emanating from asset securitisation than contractual loan relationships (Shaenker & Colletta, 1991; Dvorak, 2002). Asset securitisation is highly exposed towards interest rate risks, since receivables associated to securitised assets are valued by interest rate discounting. Mortgage Backed Securities ('MBS') is one of examples of asset backed security, in which a pool of receivables of home buyers is securitised through intermediary institutions, such as Fannie Mae or Freddy Mac in US, and Cagamas in Malaysia. The risks of asset securitisation can be commoditised in a way that the risks can be detached from the assets to trade the risks in the market through irresponsible derivatives instruments, such as Credit Default Swaps ('CDS') instrument. CDS transfers the risk of default from the fixed income security holder to the swap seller.

To a certain extent, conventional asset securitisation is in line with Islamic securitisation. Both of these types of securitisation have similar prerequisites, processes, and advantages. Nevertheless, due to *Shariah* restrictions, Islamic securitisation has distinctive features that distinguish it from asset securitisation. Following the spirit of *Shariah*, Islamic securitisation must be free from three prohibited practises, which are *riba*, *gharar*, and *maysir*. Thus, anything leading to these practises is not tolerated such as debt and financial assets trading (*bai al-dayn*), *haram* activities, interest bearing collateral, and so forth. Furthermore, Islamic securitisation must involve the funding or the production of real assets rather than financial securities, which causes irresponsible leverage as well as speculation, through derivatives lending (Wilson, 2004). Jobst (2007) points out four important conditions for Islamic securitisation to take, which are as follows:

1. Investor's asset ownership conferment through direct business participation,
2. Real purpose for securitisation through identification of productive securitised assets,
3. Unconditional and unsecured payment obligation (non-guarantee promissory notes),
4. Risk-pooling spirit whereby the risks and rewards are shared among market participants in the Islamic financial market

Thus, based on those four conditions, Islamic securitisation has the risk-reward sharing spirit and places a paramount importance on the real economy through undertaking real project activities.

Islamic securitisation is in line with asset-backed *sukuk* structures whereby the true sale transaction is taking place between the *sukuk* holders and the *sukuk* issuer. Besides, the return of securitised assets is derived from real activities, and the *sukuk* holders can legally enforce the securitised assets in the event of defaults. But, under current practises the *sukuk* structures, as asset-based *sukuk* is dominant structures in the ICM, unfortunately there is no such an Islamic securitisation in *sukuk* structuring. Thus, this poses major legal problems in the event of *sukuk*'s legal defaults where the *sukuk* holders cannot recourse to the securitised assets.

3. Legal challenges of Sukuk development in Islamic capital market

Legal infrastructure of Sukuk in various jurisdictions

Sukuk legal development is varied across countries operating Islamic finance, but the status of development is a major determinant of the success of *sukuk*. From an Indonesian perspective, the legal basis for *sukuk* development is not sufficient, because the legal basis for Islamic financial development as a whole still relies on conventional banking laws and regulations. With regard to *sukuk* development, the existence of the asset securitisation law in Indonesia is not in line with *Shariah* dictates, wherein the draft of the asset securitisation law clearly states that securitisation can only be structured through debt (Djojosingito, 2007). Meanwhile, in Malaysia, which is the most active Islamic capital market, has robust regulatory standards as framed by their Securities Commission ('SC').

From a British legal perspective, *sukuk* instruments apparently fall under the definition of a Collective Investment Scheme ("CIS") as pursuant to the Financial Services and Markets Act (FSMA 2000). If *sukuk* were treated in the same way as CIS, *sukuk* issuers would be subject to a wider range of controls, and may need to be authorised. Such authorisation would entail limits on the range of assets eligible for investments, gearing and marketing purposes. Hence, this would arguably put *sukuk* issuers at a disadvantage compared to issuers of conventional debt securities.

The legal perspective of the US, however, is very helpful for facilitating *sukuk* issuance by upholding its true value as project financing for real activities. *Sukuk* are regulated in such a way that *sukuk* are structured through U.S traditional private-placement.² The Securities Act, Section 4 (2) exempts "transactions by an issuer not involving any public offering," which indicates that the investors in the private placement market are not typical investors who need the protection of the registration provisions of the Securities Act, since the investors have the ability to make an informed decision and bear the economic risk of the specified investment (Khaleq & Young, 2007). This Securities Act is supported by Rule 144 A in which full due-diligence over the issuer must be conducted and receive disclosure on the prospectus from the US Securities Council within US disclosure standards and Management's Discussion and Analysis, Financial Condition Results of Operation ('MD&A').

Furthermore, Regulation S and Regulation D are interrelated to facilitate international secured financing through private placement in US (Shenker & Colletta, 1991). This can be seen in the *sukuk* issued by East Cameron Gas in the US through private placement, whereby there was a proper due-diligence conducted over the project – oil drilling – along with risk management mechanisms for project's anticipated risks. Hence, US federal securities law provides an impetus for *sukuk* development towards the true value, even though US federal securities law treats *sukuk* in similar fashion with conventional bonds.

Enforceability of Sukuk contracts

Dispute between Western law and Shariah

Before assessing issues surrounding the enforceability of *sukuk*, it is imperative to portray the kind of conflicts happening in the sphere of Islamic finance due to dual law system that governs transactions.

English common law and civil law each present distinctive problems when they collide with *Shariah*. The problem in using *Shariah* finance under common law jurisdiction is the conflict that emerges between *Shariah* law and common law; the national law/common law always prevails over *Shariah* law when there are disputes. As a consequence, the contract is interpreted solely based on what is written in the contract in respect to *Shariah* regulations. This can be seen in the case of Shamil Islamic Bank of Bahrain VS Pharmaceutical Company, as explained by Potter (2004). In that case, the defendant was not able to make payment for his financing to the bank, and the court judged based on English law instead of Islamic law. The defendants argued that the contract was so worded with *Shariah* principles

as not to clash with English law. However, the judge ruled that there cannot be two separate law systems governing a contract, and that the national system is the valid law to govern the contract based on Roman conventions which have force in the British law system. The conflict between common law and *Shariah* leads to idiosyncrasies, such as that verdict which was decided based on sale contract law, while the substance of the contract was actually a conventional debt contract. Therefore, confusion emerged as to the legal basis of the verdict.

On the side of civil law, one sees a lack of predictability, transparency, and consistency. Full codification of law, which is needed for predictability, is not implemented in the countries under civil law regimes. The problems posed by civil law can be witnessed in the recent *Nakheel Sukuk* case, in which there was confusion over which law should be adopted when *Nakheel* declared itself in a state of default. Because the *Nakheel* offering circular was governed with English common law while the *sukuk* transactions took place in a civil law jurisdiction, there was a conflict when the investors sued *Nakheel* for capital repayment in Dubai's civil court. The investors could sue in English courts as well as in the United Arab Emirates, the seven-member federation that includes Dubai. Nevertheless, even if they win and the court orders seizure of the assets, the foreign law ownership as well as *sukuk* agreement cast doubts over whether the law is enforceable in the UAE (Kasolowsky & Abocar, December 2009). Consequently, the investors' rights are restricted from what was promised in the offering circular. Therefore, this indicates that civil law is not yet predictable and flexible enough to be enforced in governing jurisdiction.

With respect to *sukuk* structures in jurisdictions where *Shariah* concepts are followed, this is, to a certain degree, more straightforward from a legal perspective, although the process does compose more layers since it requires compliance with *Shariah* as well as local law (Khaleq & Richardson, 2007). Realising that in most of *sukuk* issuances that there are cross-border transactions, there is a problem with which law would be enforced. This enforceability issue causes legal impediments due to the inability to obtain satisfactory legal opinions, which emanate from the sales of assets between the originator and investors through the SPV, and also due to various bankruptcy law matters (McMillen, 2007). Hence, there is a confusion about which law can be enforced and to what extent that law can be enforced in *sukuk* issuance.

True sale execution

Executing a true sale is a crucial element in *sukuk* operation, as it constitutes a real transfer of ownership from the originator to the *sukuk* holders via the SPV. Nevertheless, some *sukuk* issuances do not execute a true sale, as with asset-based *sukuk* issuance, due to the absence of property law and bankruptcy law under civil law regimes. This again was reflected in the *Nakheel Sukuk* case wherein leasehold interests were not viewed as real rights or property rights under the relevant laws of the UAE as applicable in the Emirate of Dubai (Salah, 2010, p.10). Instead, the rights were viewed as unregistered personal contractual rights binding the parties as opposed to rights to the land in question (Silkenet *et al.*, 2009). Similarly, in Indonesia, the concept of beneficiary rights has not been recognised

for sovereign *sukuk* issuance, as state assets needed for government operational activities cannot be transferred to third parties and must be subject to the approval of a government body (Guritno & Oktavinanda, August, 2008). This indicates that the civil law indeed impedes the undertaking of true sales that would be enforceable in *sukuk* issuance.

Bankruptcy

Bankruptcy law is crucial for facilitating true sale transactions in which investors are protected and will receive payment on asset-backed securities, even in cases of the originator's bankruptcy (Schwartz, 1995, p.151). So far in some countries under civil law regime, especially Middle East region, there has not yet emerged a proper bankruptcy law to protect *sukuk* holders from bankruptcy on the part of the *sukuk* originator. Taking example of the bankruptcy law of UAE, bankruptcy governed in Commercial Companies Law, Federal Law No.8 of 1994 does not have a specific definition of bankruptcy. The Law only shows the situation where a 'Trader' will be regarded as a bankrupt in the event of insolvency, as governed in Article 645 of the Law. In pursuant to Article 4 of the Law a trader is defined as being an individual or company that carries out commercial activities. The Law unfortunately does not have specific recognition of the term that describes the situation where shareholders have limited liability, as in the case of common law jurisdiction (Gulf News Report, January 2009). On the side of common law jurisdiction and some countries under civil law jurisdiction such as Indonesia and Netherlands, the bankruptcy law is codified in the specific law. Besides, the law has clearer administrative procedures to deal with bankruptcy entity.

Due to lack of codification of bankruptcy law under civil law regime in Middle East region, the transaction is not a true sale, but a secured disguised loan in a true sale. This originates from the suspicious type of financing occurring persistently between the originator and the trustee. Thus, in case of bankruptcy, the court follows the legal precedent that the financing is a transfer of collateral because of the presence of recourse to the originator (Lupica, 1998). Nakheel *sukuk* default is precisely the example of legal uncertainties in UAE where the *sukuk* holders' rights to claw back the assets are not protected when Nakheel declared its bankruptcy. Due to that fact, this is a warning for asset-based *sukuk* issuance in which the *sukuk* are issued in reflection of a secured collateralised loan. Hence, this means that the enforceability of the law in the court will be exactly the same between *sukuk* and secured collateralised loan.

SPV

An SPV is a bankruptcy remote firm, which is independent from the obligor. The SPV is established based on the trust law in which the *sukuk*'s originator as the transferor transfers the assets to the *sukuk* holders as beneficiaries via the SPV as a trustee with a good faith. Therefore, trust law plays an important role in governing the SPV's establishment. Trust law has been well incorporated into both common and civil law jurisdictions; Dubai and Bahrain have already incorporated trust law in their legal systems. This trust law recognises the equity for remedies and rights in which beneficiaries are provided with equitable treatment remedies against unfaithful acts.

Within common law treatment, the legal rights of the trustee are bounded by the legal rights of beneficiaries. In contrast, under civil law treatment, the beneficiaries have no rights or control towards the assets managed by trustee (Hansmann & Mattei, 1998). Hence, civil law treatment entails a problem for *sukuk* issuance that originates from civil law jurisdiction countries. In those cases, in the event of default, the *sukuk* holders do not have recourse to the asset due to civil law restrictions, and therefore those *sukuk* are characterised as asset-based *sukuk*.

In *sukuk* issuance, usually the issuers do a cross-border securitisation in which the SPV is located outside the originator's country due to the absence of specific legislation on certain issues (e.g. tax law, securitisation law, etc.). This can be seen in the *Tamweel sukuk* issuance in which the SPV was located in the Cayman Islands – far from Dubai, the originator's country. However, this typical offshore SPV leads to a problem whereby there is no uniform law, insofar as the off-shore jurisdiction is very lax on specific law enforcement with the consequence of a fragmented legal governing process in order to accommodate the parties' needs (Frankell, 1998). Indeed, there is a significant legal unpredictability governing *sukuk* transactions if they are issued through an offshore SPV. Furthermore, even if legal judgments are obtained in the Cayman Islands or the United Kingdom, there can be additional impediments arising from those foreign judgements' enforceability in those foreign jurisdictions where there is an absence of bilateral treaties for reciprocal enforcement of judgments (Ryan & Elmalki, January, 2010). Therefore, this issue leads to weakness on the part of the local court or legislation as well as legal confusion with respect to certain laws' enforceability in case the issuer defaults.

4. Regulatory and financial implications of *Sukuk*'s legal challenges

Regulatory implications

Role of rating agency

It is an inevitable fact that when investors purchase *sukuk*, they are interested in the risk related to the issuer instead of the underlying assets or project undertaken due to prevalence of asset-based *sukuk*. This is happening because the methodology used by rating agencies for *sukuk* rating is similar with conventional bond ratings, since no independent *sukuk* rating agency has yet formed. In this regard, since the very essence of *sukuk* is project financing backed by real assets, rating agencies should shift the paradigm of *sukuk* rating whereby the risk's proxy is based on the feasibility and prudential evaluation of the assets instead of the originator's risks. Furthermore, compliance with *Shariah* as well as legal uncertainties are important proxies to be incorporated in *sukuk* rating methodology, particularly regarding how the *sukuk* issuance can protect the investors and also resolve the legal conflicts in the event of bankruptcy. It is important also for rating agencies to give assurances to investors through information notification regarding the underlying asset's quality, so that they can make informed decisions (Zaidi, 2009).

Standardisation of *Sukuk*

Since there are legal uncertainties and conflicts arising from *sukuk* transactions as well as *Shariah* divergences, *sukuk*

need to be standardised and streamlined in terms of legal documentation and *Shariah* standards. AAOIFI *Shariah* standards for *sukuk* have been set properly, but the problem is that the standards are not binding among key players in the Islamic financial industry. Therefore, enforcement of the standards is critical at the moment for having *Shariah* compliant *sukuk* in the market. Besides, there should be uniformity of law for offshore jurisdiction as well as the methods to resolve the conflict of legal systems that applies to all *sukuk* issuance across all jurisdictions. The goal would be that, in a case of default, the case could be resolved in pursuant to a standardised legal documentation. Hence, there would be predictability, certainties and *Shariah* convergence through *sukuk* standardisation.

Financial implications

Sukuk feasibility analysis

Since one must undertake a true sale undertaking as well as have full ownership of the assets, usufructs, or projects in a *sukuk* transaction, it is important that *sukuk* are structured in a manner backed by an identified portfolio of high quality assets, which is in line with asset securitisation, and prospective projects (Dusuki & Mokhtar, 2010). Hence, the value of the identified portfolio of assets and project must represent the market value of the *sukuk* issuance in order to ensure that there are genuine interests over the portfolio of assets or a project. In this regard, at the initial *sukuk* structuring stage, it is vital for the *sukuk*'s lead arrangers, which are Islamic investment banks in most cases of *sukuk* issuance, to exercise careful due diligence over identified assets through scenario analysis (both best and worst scenarios), as well as stress-testing analysis where the asset performances in different financial situations over the *sukuk*'s tenure are evaluated. In addition, an on-site visit is required to look over the identified portfolio of assets and whether or not the assets are in existence and productive enough to generate positive cash flows. If, after thorough due diligence analysis over asset and an on-site visit, the identified portfolio of assets are deemed to be high quality and productive assets, then the *sukuk* issuance can proceed. Consequently, positive cash flows are ensured for the investors along with the risks arising from a portfolio of underlying assets.

With regard to project identification, *sukuk* must be structured in a way that *sukuk* structures provide linkage of the identified project's risks to the *sukuk* holders. This can be seen in *Tamweel Sukuk* where there were risks borne by the *sukuk* holders over the property development project since the periodic rental payment is from a third party lessee. There must be a proper feasibility analysis over the investment project's plan, wherein the location of the project is identified. A scale model of project is also needed for conducting feasibility analysis. Realising that there are different sectors of industry, such as oil and gas, property development, pharmaceuticals, and so forth, industry analysis over the investment project plan is also required to assess the position of the sector in comparison with other sectors as well as the industry's risk assessment within current and projected economic conditions. If the project is deemed to have bright prospects in which the project would generate positive returns in the future, then the investment project should be undertaken. This project *sukuk* financing is actually a long-term investment asset class. Therefore,

the investors are no longer interested in the issuers' risks rather than the asset's risks, with the consequence of no guarantee and the investors easily have recourse over the assets in the event of default since the investors have legal ownership. There must be a proper and simple disclosure of the risk assessment and the nature of assets and project risk profile to the investors at the first *sukuk* offering, so that investors can make an informed investment decision based on the underlying risks in the *sukuk* issuance.

This actually has a good implication for looking at alternatives for *sukuk* pricing, as *sukuk* are currently priced at LIBOR. Due to the fact that the *sukuk* holders bear the risks of the identified portfolio of assets and the projects, the periodic payment of *sukuk* to the *sukuk* holders is positive cash flow derived from the underlying assets in proportion with the number of *sukuk* holders. So, for *sukuk ijarah*, the cash flows are derived from rental payment of underlying assets leased to the third party lessee. For the project financing, the payment is from rental proceeds once the project is developed in a case of *sukuk ijarah mausuf bi al-zimmah*. Hence, the ideal pricing for a given *sukuk* is derived from the real underlying assets or projects rather than current interest rates, and this pricing mechanism is actually in line with Islamic economic objectives.

Shariah compliant financial innovations of Sukuk

Possible *Shariah* compliant financial innovations can be suggested in order to give the financial protection to the *sukuk* holders from the legal uncertainties. As suggested by Khnifer (2010), there are three ways for suggesting so. Firstly, *sukuk* maturity extension whereby the *sukuk* contract is extended until the issuer's legal dispute is resolved by imposing legal compensations in *sukuk* documentation, which can be reflected in higher rental payments to the *sukuk* holders in the case of *ijarah sukuk*, and higher agreed profit sharing ratio in the case of *musharakah sukuk*. Secondly, *sukuk* refinancing in which *sukuk* are refinanced with another *sukuk*, which have lower financing costs, in order to settle the *sukuk* holders' residual payments. These two suggestions can be done only if the *sukuk* position had a strong financial position. Lastly, convertible equity *sukuk* in which *sukuk*'s assets values are converted into the issuer's equity value based on pre-determined formula in the event of defaults. These innovations are expected to give assurances to the *sukuk* holders before the purchase undertaking is executed, and hence their financial rights are fully protected from legal uncertainties.

5. Conclusion

In this discursive research paper, current *sukuk* practises and legal compatibility issues of *sukuk* have been extensively discussed in the wake of *sukuk* defaults occurring in Islamic financing space. Regulatory treatments and also practical *Shariah* compliant financing innovations have been suggested to mitigate future *sukuk* defaults.

With the current structure of *sukuk*, the problems still revolve around form over substance of the *sukuk* structures whereby asset based *sukuk* structures are prevalent in the Islamic capital market. In line with Islamic securitisation concepts, asset-based *sukuk* do not fall under Islamic securitisation concepts because of the absence of a true sale in the operation, whilst asset-backed *sukuk* falls under

Islamic securitisation due to the presence of a true sale. The absence of true sales in current *sukuk* operations poses legal uncertainties to all *sukuk* parties, especially the *sukuk* holders. Based on an analysis of the legal issues discussed in this research, the legal infrastructure under various jurisdictions is not supportive enough for *sukuk* operations taking place. Each legal system entails different problems in governing *sukuk* operations as a true *Shariah* compliant financing. Due to that reason, at the bottom line, current *sukuk* structure fails to protect the legal rights of *sukuk* holders to the securitised assets. For the way forward, closer engagement between key players, regulators, *Shariah* advisers, and scholars in the industry are urgently needed to discuss and improve the feasibility of these regulatory and financial implications as discussed in this research paper.

This research paper only covers salient features of legal issues facing *sukuk* development. There are still rooms for improvements and more detailed analysis of this research topic, such as detailed legal analysis of trust law and bankruptcy law vis-à-vis SPVs, the regulatory issues pertaining to law development for *sukuk* issuance – just to name a few. It is expected that more works on this research topic will create awareness among regulators and key players in the Islamic financial industry, particularly the lawyers who do *sukuk* legal documentation. This is to ensure that *sukuk* can further progress through eliminating legal challenges with a step-by-step approach, which indeed requires concerted and synergised efforts from all key players in the Islamic financial industry.

Notes

1. The data is retrieved from combination 2 databases: Islamic Finance Information Services (IIFS) and Zawya Sukuk Monitor.
2. Private placement refers to secured long-term financing provided directly by a limited number of big investors such as big investment banks, insurance companies, and mutual funds (Ross et al., 2008).

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Overcoming the divergence gap between applicable state law and Shariah principles: Enhancing clarity, predictability and enforceability in Islamic finance transactions within secular jurisdictions

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Abstract - With the emergence of Islamic finance, legal precepts of Islam gained momentum through voluntary adherence by market participants. Transactions are not governed by Islamic law as such. Rather they are structured within the framework of freedom of contract in a way that is coherent with Shariah principles. In absence of an authoritative judicial institution deciding on the Shariah conformity of a commercial transaction, individual Shariah scholars fill this gap. They interpret Islamic legal principles and exercise oversight of the products and operations of the Islamic finance industry. In Islamic finance transactions, there is frequently a dichotomy and tension between Shariah principles and perceptions underlying contractual agreements and their de jure qualification and treatment in secular jurisdictions. This paper investigates the divergence gap between Shariah precepts and the contractual design of Sukuk transactions as well as transparency issues under the German legal regime. Sukuk is taken pars pro toto for Islamic finance products. German law is chosen as case example within the circle of European civil law systems. One of the problematic issues is ownership status of Sukuk holders in sale-and-lease-back based Sukuk. Although, asset linkage is a major characteristic that distinguishes Sukuk from conventional bonds, the transfer of ownership in some sale-based Sukuk structures is highly controversial not only from a Shariah perspective but also from a legal perspective. This is particularly the case when Sukuk transactions are structured in civil law legal systems where the common law concepts of trust and beneficial ownership are not recognized. The disengagement of Sukuk transactions from their underlying originating assets can be problematic for Sukuk holders in the event of a bankruptcy of the obligor. The asymmetrical risk allocation between Sukuk issuer/obligor on the one side and the investor on the other may not only be problematic from an inner-Islamic point of view. In some cases this situation may also cause legal liability issues. Besides the issue of ownership status, some other terms and conditions of widespread Sukuk issues appear to be problematic with respect to legal transparency requirements on national and EU level. This paper suggests solutions to bridge the gap.

Keywords: Sukuk, ownership issues, trust, insolvency, transparency, legal enforcement, conflict of laws

1. Introduction and overview of the issues

While Islamic law is applicable in most jurisdictions of the Arab world in the field of “statut personnel” (*akhwal al-shakhsiyya*) such as family law, it is generally not applied in commercial matters which are instead governed by

codified civil law, even though many Arab constitutions declare Islamic Shariah to be a “main source of legislation”. Similarly, civil codes of Arab jurisdictions refer to Islamic Shariah as interpretative rule (e.g., Art. 1(2) Qatari Civil Code 2004; Ballantyne, 1985, pp. 245–264; Al-Muhairi,

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1996, pp. 219–244). Islamic finance and banking is characterized by voluntary adherence to Islamic commercial principles such as the prohibition of interest (*riba*), gambling (*maisir*) and speculation (*gharar*) as well as the principle of profit-and-loss-participation. Despite the absence of an all-binding “Islamic *lex mercatoria*” and differences between the different schools of law on the admissibility of certain Islamic finance products, there is a high degree of consistency and consensus among Shariah scholars as to the core principles governing Islamic financial transactions. Moreover, standard setting organizations such as the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) have formulated principles pertaining to major Islamic finance transactions aiming inter alia to standardise rules and to avoid ambiguities. In recent legal disputes between parties to an Islamic finance transaction within a secular jurisdiction it had to be tested whether Islamic law is merely non-binding soft law or a set of rules that is also applicable and enforceable before secular state courts. The prevailing view in “Western” jurisprudence is that Shariah is “insufficiently determinate to be a governing law of a contract” (*Shamil Bank of Bahrain EC v Beximco Pharmaceuticals Ltd*, 1 WLR (CA 2004) (UK)).

Notwithstanding this finding, the parties to a Shariah compliant financial contract do have the freedom to “dress” their contracts in accordance with their belief. This can be achieved by formulating the principles of Islamic law in the form of contractual clauses.

This paper will consider contracts that *prima facie* seem to mirror and satisfy Shariah requirements but do not always stand up to further scrutiny. This problematic issue became apparent in some asset-based or “asset-light” Sukuk structures where doubts were voiced about their representation of ownership. These doubts do not only stem from Shariah law considerations (e.g., Dusuki and Mokhtar, 2010; Haneef, 2009; Usmani 2007). With regard to current market practices, the validity of ownership transfers from the transferring obligor/originator to the SPV who is the *alter ego* of Sukuk holders and is also contentious under applicable laws. This further provokes the question if there is a potential risk of a prospective “claw back” of the Sukuk assets by an insolvency practitioner in the event of the obligor’s insolvency or the transfer’s re-characterization as a loan (see also Thomas, 2009). These problematic issues emerge predominantly in civil law jurisdictions such as Germany or the UAE, which do not provide for the concept of trust or beneficial ownership, two of the main characteristics which mark the difference between common law legal systems and civil law jurisdictions.

Unlike in asset-backed structures, Sukuk holders generally do not have any security interest over assets underlying an asset-based Sukuk. The contractual agreements are designed in a way that ownership is reduced to a symbolic rather than enforceable status. This is because the perception under Shariah has generally no legal effect unless it is substantiated in the contract not by mere reference to Shariah but by virtue of material inclusion. However, Shariah positions may be taken into consideration in examining the will of the parties.

It must be remembered that asset-based structures were created due to market pressure and competition as well

as legal constraints (Haneef, 2009, pp.108-110) such as the inalienability of property to foreigners in most Gulf jurisdictions. Asset-based Sukuk are a viable financing solution for corporations and banks who are unwilling to dispose of their physical assets by way of true sale to an SPV, inter alia due to risk management considerations. From an investor’s perspective, asset-based Sukuk is a Shariah compliant alternative to bonds. The Sukuk holder generally has no asset risk but credit risk.

Besides the issue of ownership status of Sukuk holders, some other terms and conditions of widespread Sukuk issues appear to be problematic with respect to legal transparency requirements on national and EU level.

As will be discussed in this paper, Shariah issues (“*lex internum*”) can strike through to the level of applicable state law (“*lex externum*”) in various ways. Examining this scenario under (German and UAE) civil law, the paper will discuss the consequences of this divergence. It will then examine to what extent this “conflict of laws” can be resolved and the divergence gap be bridged.

2. The issue of transfer of ownership to the SPV

Basic characteristics of Ijara-Sukuk

The AAOIFI, in its Shariah Standard 17 (2), defines investment Sukuk as “*certificates of equal value representing undivided shares in the ownership of tangible assets, usufructs and services or (in the ownership of) the assets of particular projects or special investment activity*” (AAOIFI, 2008). Accordingly, asset linkage is a major characteristic that distinguishes Sukuk from conventional bonds and is required from a Shariah perspective. Asset ownership is also a condition for the tradability of Sukuk securities on secondary markets because the trading of debt (*bai al-dayn*) is not permitted (e.g., Ayub, 2007, p.146-147). Sukuk are based on a common Shariah contract such as *Murabaha*, *Salam*, *Istisna*, *Ijara*, *Mudaraba*, *Musharaka* and *Wakala* (for an overview of Sukuk see Ali, 2011; Adam/Thomas, 2004; Thomas, 2009; Sacarcelik, 2011). One of the most frequent types of Sukuk is the Ijara Sukuk. In a nutshell, in a typical Ijara-Sukuk transaction a capital seeking sovereign or corporate entity (obligor) incorporates a special purpose vehicle (SPV)—often in a tax efficient off-shore jurisdiction. The obligor sells and transfers (the beneficial ownership of) an asset or a class of assets to the SPV whose sole purpose is to participate in that specific Sukuk transaction. The SPV issues certificates (Sukuk) to the Sukuk holders (investors) to finance the purchase of the asset. In its capacity as trustee, the SPV holds the assets in trust for the Sukuk holders. The SPV then leases the asset back to the obligor for a period that corresponds with the term of the Sukuk certificates. According to prevailing definitions, the Sukuk certificates represent pro rata ownership in the asset. Hence, Sukuk holders are seen as (beneficial) owners of the asset. Often purchase undertakings, third party guarantees, liquidity facilities, profit reserve accounts as well as covenants ensure that the cash flow to the investors is maintained and the principal returned at term end or at the occurrence of a dissolution event (e.g., default on payments). Other important elements of the Ijara Sukuk are the initial purchase and sale undertakings. The obligor undertakes

to purchase the underlying asset back from the SPV at face value on the maturity date (scheduled dissolution) or in case of a dissolution event. At the same time, the SPV undertakes to sell the asset back (sale undertaking) to the issuer. It is important to note for the present analysis that the SPV in its capacity as the trustee does not have the power to retain or sell the assets to any third party other than the obligor. The sale and purchase undertakings do not constitute offer and acceptance but a unilateral promise (*wa'd*) from both a classical Islamic legal and German civil law perspective. Whereas *wa'd* is not binding according to the majority view in classical Islamic legal literature and creates only a moral obligation, contemporary scholars declare it to be a binding promise if the promisee incurs liabilities and expenses on the basis of such a promise (e.g., Islamic Development Bank, 2000; for a discussion on the legal nature of *wa'd* and its application in Islamic financial transactions, Al-Masri, 2002; Mokhtar, 2011; Usmani, 2008, pp. 120). This is for example the case in *murabaha* financing and the repurchase agreement in Ijara-Sukuk structured as a sale-and-lease-back transaction. Accordingly, at the end of the lease term, the obligor (re-)purchases the underlying asset (e.g., real estate) from the SPV. The redemption price payable by the obligor equals the nominal amount of the outstanding certificates and is distributed to the investors through the SPV.

Ownership rights of Sukuk holders?

Common law trust and beneficial ownership

The vast majority of Sukuk issues are governed by English law. Legal certainty and familiarity demanded by investors explains the predominant use of English law. Another reason for this choice is that ownership rights can be split into legal and equitable or beneficial ownership in English law. This dualism of ownership is the fundamental component in the concept of trust (Hayton, 2003) which is used both in conventional securitizations and Sukuk transactions. The obligor in a Sukuk transaction does not transfer legal title to the SPV but only the beneficial interest in the underlying assets (Thomas, 2009, pp. 95). Pursuant to a declaration of trust, the SPV acts as trustee and holds the (beneficial interest in the) assets upon trust in favor of the Sukuk holders who obtain (derivative) beneficial ownership. Among other qualities of a trust is that the assets do not form part of the estate of a trustee. The trustee can only act within the powers given to it by the trust deed or the statutes. As such it is not at liberty to sell on the sukuk assets or to keep the proceeds.

The concept of beneficial ownership as used in asset-based Sukuk is deemed sufficient by Shariah scholars (Thomas, Sukuk, pp. 97) to meet the requirements of Islamic property law (Habachy, 1962; Wohidul Islam, 1999; Ziadeh, 1993). And in fact, the legal position of a beneficial owner is similar to that of a legal owner in many respects. For example, the beneficial owners can enforce their right to the asset. They are also entitled to transfer their beneficial interest to third parties. Beneficial ownership can be obtained through inheritance. However, the protection against the legal owner who transfers the asset to a bona fide third person is weaker (Baur and Stürner, 2009; § 64 mn. 31). In contrast to the transfer of legal title in real property (sec. 27(1), 3(a) Land Registration Act, 2002), the transfer of beneficial interest in real property does not require formal registration in English law. The concept of trust and the

split of ownership facilitate the transfer of an asset without incurring tax or registration burdens.

The main structural weakness of beneficial ownership vis-à-vis full legal title, however, most notably comes up in the insolvency scenario under a legal regime (*lex concursus*) that does not recognize the concept of split ownership.

Despite the fact that, for example, English law is chosen as governing law in the Sukuk documentation (e.g., offering circular), according to the conflict of laws doctrine of *lex rei sitae* (e.g., sec. 43 German Introductory Law to the Civil Code (EGBGB)), the law governing the transfer of title to property is dependent upon, and varies with, “the law where the property is situated”. Choice of law is not permitted in Germany for legal transactions involving property. The same applies most likely in UAE law which is far more protective when it comes to property ownership. This can be seen for instance in the ownership restrictions for Non-UAE and Non-GCC nationals in the Emirate of Dubai (Article 4 (1) of the Dubai Real Property Registration Law).

Conclusively, it is debatable whether ownership is effectively transferred to the SPV when real property underlying an Ijara-Sukuk or similar sale-based structures is situated for example in Germany or the UAE. This might also have an effect on the validity of the English law trust structure itself because one of the required certainties of a trust is the trust property.

Doubts about ownership transfer

In his recent criticism of some widespread asset-based Sukuk structures, *Sheikh Taqi Usmani* raised doubts about the transfer of ownership to Sukuk. His famous paper “Sukuk and Their Contemporary Application,” which was circulated towards the end of 2007, caused quite a stir and led to turmoil in the Sukuk market during the global financial crisis. As a result of the controversies, the AAOIFI issued a Shariah resolution on Sukuk in 2008 to clarify the situation and restore calm. *Usmani's* main criticism centered on the purchase undertaking in equity based Sukuk where the issuer undertakes to buy back the underlying assets from the issuer at face value and not prevailing market value or fair value on the expiry date of the Sukuk or in the event of a default. In fact, this stipulation moves Sukuk very close to a conventional debt security in terms of risk characteristics and performance. The risk is related to the credit worthiness of the provider of the purchase undertaking (obligor) and not the assets underlying the Sukuk. Whether recourse to the issuer or the asset (or a combination of both) is allowed, also affects the rating of a Sukuk, since rating agencies may evaluate a Sukuk either in terms of cash flow stability or default probability.

In his paper, however, *Usmani* did not deal with the issue of ownership directly or to any great depth (see already: *Usmani*, 2008, p.178), saying “generally, Sukuk represent ownership shares in assets that bring profits or revenues, like leased assets, or commercial or industrial enterprises, or investment vehicles that may include a number of projects. This is the one characteristic that distinguishes Sukuk from conventional bonds. However, quite recently, the market has witnessed a number of Sukuk in which there is doubt regarding their representation of ownership” (*Usmani*, 2007).

Acquisition of ownership under German law

As previously mentioned, the issue of ownership of assets underlying Sukuk becomes indeed apparent in Sukuk default scenarios where risk mitigating mechanisms cease to operate and both the distressed issuer and the obligor fail to fulfill their payment obligations. As a last resort, Sukuk holders seek recourse to the assets.

Protecting Sukuk holders from any prospective “claw back” of the assets by creditors of the obligor the SPV or the transfer’s recharacterization as a loan requires that:

1. the SPV is insolvency remote
2. the transfer of ownership is valid and legally binding (“true sale” or off-balance sheet treatment)

Hence, in an insolvency of the obligor, it is decisive to identify the status of the SPV: Is it the owner of the Sukuk assets, a secured creditor or an unsecured creditor? This is crucial because according to s. 47 of the German Insolvency Code (*Insolvenzordnung*), for example, third party property does not belong to the debtor’s bankruptcy estate. Owners have a right to segregate their property (*Aussonderungsrecht*) and enjoy a priority status over other creditors and equity holders who will only receive distributions after the higher priority claims are satisfied. Because of the disputed and unclear situation, the issue of proprietary rights and of Sukuk holders needs further examination from a civil law perspective.

Legal conditions for the transfer of moveable and immovable property

In Sukuk transactions, the obligor and the SPV formally agree to conclude a contract of sale. The initial purchase agreement is also mentioned in the prospectus. Pursuant to this agreement, the Sukuk assets are sold to the SPV and leased to the obligor according to a lease agreement. The obligor undertakes to purchase the asset back on the maturity date or a dissolution event. The SPV is obliged to sell the assets back to the obligor and it is not at liberty to dispose of the assets. This arrangement shows structural similarities to the “Sicherungsübereignung” in German law where ownership in a *res* is transferred to a creditor for the security of a debt that is owed to them by the owner of the transferred *res*, or by another debtor. However, while the “Sicherungsübereignung” which resembles chattel mortgage is used for security purposes and is comparable to a lien on property, the agreements in a Sukuk transactions aim to ensure Shariah compliance.

Regardless of the purpose of the ownership transfer, the transfer is only valid if certain conditions are met.

In contrast to common law systems, in civil law systems, and particularly in the German one, there is a much greater differentiation between the “contract” (e.g., a contract of sale) (*Verpflichtungsgeschäft*), which creates the obligation to transfer, and the “conveyance” (*Verfügungsgeschäft*), the actual transfer of a proprietary right (especially ownership) in a *res* which effects the alienation of that *res*, i.e., the passing of the real right from transferor to transferee. The contract of sale does not effectuate the transfer of ownership *ipso iure*. Rather, the transfer of ownership in a *res* is a twofold process that requires first an agreement by the parties that ownership shall pass in respect of a specific *res*, and

second the handing over of the *res* (delivery) as a factual act. If the *res* is immovable property, the conveyance must be approved by a notary (§ 311b German Civil Code) and the agreement on the transfer of ownership must be in the presence of a notary (§ 925 German Civil Code). Moreover, the transfer of ownership requires registration with the land registry (§ 873 German Civil Code). Similarly, in Dubai, it is compulsory to register real estate with the Dubai Land Department (Article 1277 UAE Federal Law No. 5 of 1985 (Civil Code) and Articles 6, 7 of the Dubai Real Property Registration Law – Federal Law No. 7 of 2006).

Despite the use of terms such as “sale” or “ownership” in the transaction documents, the initial transfer of ownership is often not perfected in asset-based Sukuk.

Characterisation of the transfer as a loan?

Because German law does not recognize the concept of trust or beneficial owner, the transfer of ownership in real property forming the underlying of a Sukuk and situated in Germany requires registration. It is expressly stated in the transaction documents of some Sukuk offerings that transfer of the ownership will not be perfected (see e.g., ADIB Sukuk, Offering Circular, Risk Factors, pp. 9–10). This provokes the question if this statement is merely of declaratory nature clarifying that the factual act of transfer, e.g., registration of real property did not take place. Assuming this is the will of the parties, one could argue that the registration of the property to perfect the transfer of the legal title could be made good at a later point in time, e.g., when investors fear the near default of the obligor. A counter-argument against this view could be that there is no convincing reason as to why the SPV representing the Sukuk holders should be given the right to pursue property registration although both parties willingly and knowingly did not act in conformity with their contractual sales agreement just until a critical stage is reached, i.e., payment problems of the obligor evolved. Sukuk holders who set themselves in contradiction to their previous conduct might forfeit their right to obtain ownership (*venire contra factum proprium*). However, this rigid sanction cannot be justified if there is a valid claim and only a relatively short of time elapsed after the conclusion of the contract of sale.

Taking into consideration that the intention of the parties of an asset-based Sukuk is to structure an instrument that replicates the economic features of an unsecured bond, one could also take the view that the obligor at no time intended to fulfill its obligation to transfer the assets to the SPV. One has to bear in mind that asset based Sukuk were created due to market pressure and competition (Haneef, 2009, pp. 108–110) as well as legal constraints such as the impossibility of true sales due to the inalienability of real property to foreigners in Gulf jurisdictions. Moreover, the SPV is not more than an “orphan shell company”.

The assumption that the Sukuk holders generally are not quite interested in the underlying assets or structure of a Sukuk but rather the cash flow generated by them is supported by the fact that no asset due diligence or valuation is performed by a neutral third-party expert. This aspect is clearly indicated in certain prospectus: “No investigation or enquiry will be made and no due diligence will be conducted in respect of any Sukuk assets. Only limited representations will be obtained from IDB in respect of the

Sukuk assets of any series of trust certificates. In particular, the precise terms of the Sukuk assets or the nature of the assets leased or sold will not be known (including whether there are any restrictions on transfer or any further obligations required to be performed by IDB to give effect to the transfer of the relevant Sukuk assets). No steps will be taken to perfect any transfer of the relevant Sukuk Assets or otherwise give notice of the transfer to any lessee or obligor in respect thereof. Obligors and lessees may have rights of set off or counterclaim against IDB in respect of such Sukuk assets” (IDB Sukuk 2005 Offering Circular, Risk Factors, pp. 69–70). Thus, in most cases it will also not be possible to assess whether the face value of the Sukuk certificates truly reflects the real market value of the underlying assets. Similar to the “disclaimer” mentioned above, one can also find the clarification in some prospectuses that Sukuk holders will not have interest in the assets from a legal perspective. This is indicated for example in the DP World offering circular: “Each of the Mudaraba Agreement, the Purchase Undertaking and the Sale Undertaking are governed by English law under which the interest under Shariah in the Mudaraba Assets of either the Issuer and/or the Trustee may not be recognized. Neither the Issuer nor the Trustee has any interest in the Mudaraba assets under English law” (DP World Offering Circular, Risk Factors, p. 22).

The lack of interest of Sukuk holders in the assets—at least so long they receive payments—may not be a sufficient evidence to negate ownership. Similarly, the (fiduciary) restrictions on the transferability of the assets to third parties by the SPV is legally permissible in German civil law (sec. 137 German Civil Code) and serves the interests of the Sukuk holders. However, the fact that payment obligations of the issuer rank *pari passu* with the claims of all its other unsecured and unsubordinated creditors possibly can be taken as an argument against ownership of Sukuk holders.

On the basis of the statements in the sales contract or the prospectus stating that “no steps will be taken to perfect any transfer of the relevant Sukuk assets” one could argue that the claim of the SPV for procurement or transfer of the assets as promulgated in sec. 433 subsec. 1 German Civil Code is waived. In view of these circumstances, one would perhaps not go to the length of holding the transfer of property or the sales contract as fictitious and thus null and void (e.g., sec. 117 German Civil Code). If, however, the sales contract is “deformed” to such a degree that the most fundamental obligation of a sales transaction, i.e., the transfer of the subject matter, is excluded bilaterally on the basis of a (side) agreement, one will usually tend to take a substance over form approach and classify the transaction as sale and not a loan—irrespective of the designation by the contracting parties. The financing character of the described structures dominates the transactions. Thus, there is little room to classify the transaction as a contract of sale. Rather, the contract would be classified as a loan according to sec. 488 German Civil Code.

In recent judgments in the UAE or Saudi Arabia, courts took a substance over form approach when they had to consider Islamic finance transactions. In a decision dated 24 March 2010, the Dubai Court qualified an Ijara Contract as a sales contract taking a substance over form approach (personal communication). The Saudi Board of Grievances declared that “the circuit is concerned about the substance, not the

title” (Khalid Bin Abdulaziz Alanzan v. Saudi American Bank (Samba Financial Group), 17.1.1429 A.H./26 January 2008, Personal communication). Accordingly, taking a substance over form approach, the courts in the GCC could declare the Sukuk construction with the aforementioned features to be a disguised form of an interest bearing bond.

Similarly, in the recent case *Blom Development Bank vs. The Investment Dar Company* ([2009] EWHC 3545 (Ch)), the English High Court moved away from the previous view taken in *Shamil Bank of Bahrain vs. Beximco* ([2004] EWCA Civ. 99) and held that TID’s legal counsel had made an arguable case that a *Wakala* agreement entered into between TID and Blom was not compliant with Shariah and, therefore, that the agreement was beyond the corporate powers of TID and void.

The classification of the underlying contract not as a sales transaction but a loan could also trigger unpredictable international enforceability issues (e.g., Salah, 2010). If, for example the Sukuk transaction is structured under German law but the assets are in Doha or Dubai, the local court could accept the German judicial assessment and commence with the enforcement procedure. In this case the court could ignore the limited recourse or insolvency remote structure of the Sukuk transaction, pierce through this veil and realise the assets of the obligor. However, the local court might also revisit the merits of the case and could make Shariah considerations fully or partially effective. Hence, the court could give effect to the sale contract and acknowledge the proprietary rights of Sukuk holders. It would first urge the parties to register the underlying real estate with the Land Department. In this scenario, Sukuk holders would only have recourse to the assets taking the risk that the asset value is not sufficient to cover the invested capital.

One possible way to avoid these problems would be to use the concept of German “custody” or “fiduciary agency” (*Treuhand*) which is very close to the Common Law Trust. Whereas the opinions in legal literature are “liberal” as to the conditions of an insolvency remote *Treuhand*, the German Federal Court (Bundesgerichtshof) requires an immediate transfer of the *Treuhand* asset from the Beneficiary (*Treugeber*, here: SPV) to the Trustee (*Treuhänder*, here: Obligor). According to this restrictive view, a declaration by the Obligor that it holds the assets on trust for the SPV is not sufficient. Furthermore, in case the *Treuhand* asset is a real estate, the Federal Court takes the view that the registration of a priority notice (*Vormerkung*, sec. 883 German Civil Code) is compulsory. In light of this judicature it is recommendable to register the real estate with the land registry in order to grant Sukuk holders recourse to the assets in case of insolvency of the Obligor and to avoid a “claw back” by an insolvency practitioner.

Legal consequences of deficient transparency in sukuk documents

Sukuk structures, as described above, may be particularly problematic if they are publicly offered to retail customers. Despite the disclaimers and statements in the prospectuses, confusions on the side of average retail customers about the *de facto* characteristics of an asset based Sukuk cannot be entirely dispersed. Especially the terms “sale”, “lease”,

or “repurchase” used in Sukuk prospectuses may be misleading. Market participants who, without access to (or interest in) the legal detail, could sincerely believe there is asset security and that the investment/financing provided is collateralized (see Moody’s, 2009, p. 5).

Poor transparency in the terms and condition of Sukuk offerings can violate the transparency requirement promulgated in sec. 3 Bond Act (Schuldverschreibungsgesetz) or the unfair terms provisions, most notably sec. 307 of the German Civil Code, rendering the relevant clause void. Moreover, prospectus liability may arise, e.g. when the formulations in the prospectus are misleading. Prospectus liability can be triggered also in case of explicit violation of fundamental Shariah rules (Casper, 2011; Sacarcelik, 2010).

3. Shifting ownership risks to the lessee

Another major concern in Ijara Sukuk is that Sukuk holders who are owners (i.e., lessors) from the Shariah point of view are responsible for major maintenance or insurance expenses of the subject matter of the sale and lease agreement. In practice, the obligor is frequently appointed as servicing agent for the asset. In this capacity, the lessee manages the maintenance on behalf of the Sukuk holders. The lessee usually receives a servicing fee and can claim reimbursement if any additional expenses incurred. However, the ownership responsibilities and costs are passed on to the lessee through charging a supplemental rental in the amount equal to the expenses claimed by the lessee. The lessee’s obligation to pay supplemental rent is then set off against the lessor’s (SPV/Sukuk holders) obligation to reimburse expenses. Passing on maintenance responsibilities can be agreed under German law between the lessor and the lessee within certain statutory limits. In conventional finance lease contracts, the lessee usually bears this responsibility. Since Sukuk holders economically benefit from this arrangement there is generally no legal objection; e.g., with respect to unfair terms rules. However, this risk shifting might be problematic from a Shariah perspective because it disburdens Sukuk holders from genuine ownership obligations. Moreover, German tenancy law sets limits to the rent increase both for residential and commercial real estate. Consequently, charging supplemental rent to absorb expensive maintenance costs might be barred when it exceeds a certain level.

4. Conclusion

This article has shown that Shariah considerations underlying Islamic finance transactions and legal structuring can fall apart and create a gap. This divergence gap can be seen, for example, when it comes to ownership issues in asset-based Sukuk. The complexity of the issues increase due to the international scope of these transactions involving different jurisdictions. The disengagement of Sukuk transactions from their underlying assets leads to a risk structure that is not always reflecting the stipulations of Shariah compliant finance.

This paper suggests that in absence of the trust structure in German law or comparable civil law legal systems, a true sale has to be effectuated to grant Sukuk holders ownership rights. Formal registration is mandatory where

the underlying asset of a Sukuk is immovable property. The valid transfer of the assets can eliminate the risk of a “claw back” of the assets or the characterization of the transfer as loan. Alternatively, the concept of Treuhand can be used to approximate the relevant Sukuk under German law to transactions utilizing an English law trust.

Legal issues in Sukuk transactions structured in civil law jurisdictions are not limited to Ijara Sukuk. Equity-based Sukuk such as Mudaraba and Musharaka also show features that might conflict with existing legal provisions of German law. Moreover, the Mudaraba or Musharaka arrangement could qualify as civil or commercial company. However, complying with Shariah requirements usually does not cause legal frictions as long as the relevant statutory rules are observed. Despite challenges and some problematic issues regarding current Sukuk market practices, German law provides a liberal and secure legal environment for Islamic finance transactions including Sukuk. This has been already proven by various Islamic funds, certificates and the prominent Saxony Anhalt Sukuk being the only “European” Sukuk to date.

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