

Islamic Finance and Corporate Governance

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Islamic Finance and Corporate Governance: Synergies for Sustainable Growth

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INVESTOR IN PEOPLE

To our dear families, whose steadfast support, endless encouragement, and unwavering belief have been the foundation upon which this work is built. Your love and guidance have been a constant source of inspiration, and it is with deep appreciation that we honour you in these pages. Thank you for being the cornerstone of our journey and for enriching our lives in countless ways.

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Foreword

As CEO of Faysal Bank – the largest bank in the world to have successfully transitioned from a conventional institution to a fully-fledged Islamic bank – I am pleased to introduce this book, which offers a detailed look into the evolving synergistic relationship between Islamic finance, corporate governance, and sustainable growth.

The book addresses key topics such as the integration of ESG principles in Islamic investments, the role of strong governance in Islamic banks, and the growing influence of fintech on the industry. These discussions provide practical insights alongside well-founded theories, offering a balanced view of both current practices and future possibilities.

There is also a focus on important areas like Sukuk and Takaful, highlighting their role in maintaining financial stability. Concepts such as Musharakah Mutanaqisah for elderly care and Zakat management are explored, showing how Islamic finance can be applied to address contemporary social challenges.

With the increasing focus on ethical and responsible finance, the themes explored in this book have become highly relevant. The in-depth research presented here will appeal to professionals, policymakers, and academics in the Islamic finance industry by providing clear insights into how responsible governance and finance can contribute to sustainable growth.

Regards,
Yousaf Hussain
Chief Executive Officer
Faysal Bank Ltd

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Preface

*Muhammad Ali, Syed Ali Raza, Nor Shaipah Abdul Wahab,
Chin-Hong Puah, Hanudin Amin, and Abadullah*

This book explores the various topics that create the intersection between three key areas of Islamic finance, corporate governance, and sustainable growth. The intersection between these areas develops a useful understanding of how Islamic finance and corporate governance is an essential aspect of sustainable growth. The book sheds light on the role of ethical investment such as environmental, social, and governance (ESG) in promoting sustainable goals. This book includes the debate on how social responsibility can be integrated into the Islamic banking framework for modern practices and ethical foundations. It also explores the governance mechanism in microfinance and Islamic banking institutions. Similarly, this book presents the governance framework, opportunities, and challenges related to Islamic fintech. The inclusion of Sukuk and Takaful governance frameworks in Islamic financial institutions is also included in the book. These areas are essential for the sustainable performance of Islamic finance. Additionally, the book also introduces a new direction within Islamic banking and corporate governance through Musharakah Mutanaqisah for elderly care, integrating financial literacy to ensure sustainable retirement. This topic can be a useful way to expand the boundaries of Islamic banking and corporate governance for sustainable performance. Lastly, it addresses strategic Zakat management to amplify social impact within corporate social responsibility, underscoring the importance of ethical and socially responsible practices in Islamic finance. Overall, this book provides a useful guide and innovative approaches for policymakers and managers to enhance their knowledge on various key topics of Islamic finance and corporate governance.

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We extend our sincere gratitude to the gifted writers who shaped the story of this book with their commitment, knowledge, and teamwork. They are the real designers of this project, and each chapter has benefited from their contributions, which have given it more depth and richness.

We would also like to thank our families for being our steadfast source of support and for giving us the time and space we needed to learn about the intricacies of contemporary finance.

We express our gratitude to the hardworking staff of the Emerald publishing team. The dedicated staff of Emerald publishing has played an essential role in transforming concepts into the concrete information that is contained on these pages. We received wonderful support from team Emerald throughout the publishing process.

Finally, we would like to thank all of you, the readers. We are inspired by your dedication to overcoming the obstacles of contemporary finance and your quest for knowledge. We all contributed to this book, and we genuinely hope it will be a useful tool for you as you pursue your managerial goals.

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Chapter 1

Islamic Corporate Governance and Sustainable Financial Growth

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Abstract

The former financial fiascos from Enron to slumps of capital markets during covid-19 pandemic are also measured as a failure of corporate governance systems. However, the circumstances are different for Islamic financial institutes as they competently handle the rising risk and prove beneficial for their nominees during financial disasters. This highlights the Islamic finance offered services and products around the globe which are considered and proven themselves for delivering sustainable financial growth. The Islamic finance regulatory bodies such as the financial services board (IFSB) and the accounting auditing organization for islamic financial institutions (AAOIFI) established several governance standards (GSs) that open the way for Islamic finance institutions to develop vigorous Islamic corporate governance procedures. The AAOIFI and IFSB frameworks for Islamic corporate governance clarify that there must be a central Shariah board, supervisory council, internal compliance, internal audit, and external independent audit to ensure the Shariah obedience of Islamic finance institutions. The AAOIFI and IFSB familiarized GSs support the establishing of Islamic corporate governance procedures that are rooted in Islamic principles, thus, when executed they deliver sustainable financial growth. Besides, Islamic corporate governance guarantees risk sharing, ethical business practices, social responsibility, and

environmental goals that are aligned with Shariah philosophies. The integration of Islamic finance governance procedures with corporate, social, responsibilities (CSR), sustainable development goals (SDGs), and environmental, social, and governance (ESG) creates a comprehensive approach that offers sustainable financial growth. Thus, the amalgamation of Islamic finance ideologies with vigorous corporate governance procedures guarantees social and environmental development and offers the utmost sustainable growth.

Keywords: Islamic finance; Islamic corporate governance; AAOIFI; IFSB; sustainability

1. Introduction

Islamic finance refers to all those financial practices, assets, and products that are offered and function by following Islamic laws (Hanif et al., 2024). Typically, some of the key principles on which Islamic finance stresses are forbidding of interest, that is, *riba*, the avoidance of speculation, that is, *maisir*, ethical investments, risk sharing, asset-backing, and not investing in several businesses prohibited in Islam like gambling, alcohol, etc. Likewise, the key products of Islamic finance are *Sukuk*, that is, Islamic bonds; *Murabaha*, that is, cost-plus financing; *Ijara*, that is, leasing; *Mudarabah*, that is, profit-sharing; and *Musharakah*, that is, joint venture (Siregar & Irmayuliana, 2024). Visibly, Islamic finance boosts sustainability by accentuating social responsibilities, ethical investments, and aligning financial performance with social and environmental goals. Islamic finance emphasizes Islamic principles to boost social justice, financial inclusion, and sustainable financial growth. Remarkably, the after-effects of prior financial crises, that is, from Enron to slumps of capital markets during covid-19 pandemic, forced financial concerns and stakeholders to reevaluate the conventional modes which they approached for the allocation of their investments. This rapidly highlighted Islamic finance and its presented services and products which are measured best to handle all sorts of financial fiascos and dissimilar inflation regimes (Alkassim Farid, 2019). Accordingly, Islamic finance which is also discussed as a shift from a conventional finance encompasses distinctive attributes that spin around risk sharing, participatory measures, and adherence to Islamic rules (Asif, 2022; Saeed, 2016). Evidently, during former financial messes, the circumstances were different for Islamic financial institutes as they competently handled the rising risk and proved beneficial for their nominees (Wahyono, 2022). For instance, during the covid-19 pandemic, when the slipping of inflation resulted in the dwindling of the global conventional financial markets, Islamic finance presented an alternative (see Table 1.1) and utmost sustainable risk-adjusted growth (Dharani et al., 2022).

Table 1.1 demonstrates the financial performance of Islamic and conventional indexes during the first quarter (Q1) of 2020, that is, the beginning period of covid-19 pandemic. Visibly, during the first quarter (Q1) of 2020, the conventional S&P global broad market index (BMI) dropped to -22% , whereas, the

Table 1.1. Comparative Returns (Islamic vs. Conventional Indexes).

S#	Benchmark	Shariah Indexes (%)	Conventional Indexes (%)	Variance
1	S&P BMI (global)	-17.2	-22.3	5.1
2	S&P (Pan-Arab composite)	-20.6	-23.4	2.8
3	DJIM (world)	-16.6	-22	5.4
4	DJIM (Asia)	-14.3	-19.8	5.5
5	DJIM (Europe)	-16.8	-24.8	8
6	DJIM (emerging markets)	-15.9	-24.4	8.5
7	DJIM (developed markets)	-16.7	-21.6	4.9

Source: [Sherif \(2020\)](#).

Shariah-based S&P BMI dropped only -17%. This drive of Shariah indexes is consistently spotted across numerous regions, as Dow Jones Islamic indexes for Europe and emerging markets outperformed 8% more than their traditional peers ([Sherif, 2020](#)). Likewise, in the first quarter of 2021, the Shariah indexes presented higher returns than conventional funds. Hence, the sustainable return and growth of Islamic finance during the periods of financial disasters are the core reasons that lead to a surge in Islamic finance’s global worth and acceptance. Currently, due to its ethical principles, resilience, and increasing global demand for Islamic-compliant financial services, Islamic finance experienced significant growth. Resultantly, it has increased its exploration and integration with recent technologies such as blockchain, metaverse, and artificial intelligence to boost its operations and grow in international finance ([AL-Hawamleh et al., 2024](#)). In the same vein, Islamic finance lines up with ESG measures for promoting ethics-based investments, environmental stewardship, and social fairness via Sahirah-based rules and principles. Remarkably, core fiascos of the financial world are not only considered a failure of conventional finance, but it has also been measured as letdowns of corporate governance ([Haron & Siraj, 2024](#); [Tahir and Sohail, 2012](#)).

The corporate governance is a mechanism that is made by a business such as processes and a set of rules by which it is directed and controlled. The key corporate governance elements are accountability, control, stakeholders’ rights, equitable treatment, transparency, and board structure ([Drew et al., 2006](#)). Technically, in the absence of corporate governance, the agency problem, that is, conflict between owners and managers arises ([Gwala & Mashau, 2023](#)). The corporate governance in Islamic finance formulates business governance principles by considering Islamic laws for transparent, ethical, and responsible management. At first glance, Islamic finance and corporate governance seem to be poles apart. Later, it becomes clear that there is a substantial synergy between them. However, the Islamic finance industry must follow all set of procedures known as Islamic laws and regulations to exercise corporate governance measures. The Islamic finance regulatory bodies such as the IFSB and the AAOIFI proposed several GSs that provide guidelines for the Islamic finance institutions.

The Sharia supervisory councils ensure that executed corporate governance policies comply with Islamic rules and regulations. For that, Shariah councils added several layers of oversight and moral scrutiny and strictly monitor all those corporate sectors that are tagged with Shariah businesses. This is to create a stable, ethical, and socially responsible financial system that operates by following Islamic laws. Thus, the integration of Islamic finance and corporate governance which share several common philosophies and values offers sustainable finance that promotes financial inclusion, environmental stewardship, and social equity (Yusuf et al., 2024). The integration of Islamic finance and corporate governance offers sustainable growth by adding ethical morals, plainness, and accountability to business operations (Dai, 2024). Islamic finance is sturdily associated with the governance conceptions of fairness and justice as it is directed by Islamic rules and regulations that encourage risk-sharing and ethical investments. For instance, the interest is prohibited in Islamic finance and the debt-based transactions are backed by asset tangibility. Hence, the connection between Islamic finance and corporate governance builds up trust among shareholders, boosts long-term investment perceptions, and promotes financial stability. Typically, the developed corporate governance frameworks in the Islamic finance systems are in line with Islamic laws. The Shariah councils and boards ensure that the corporate governance procedures of Islamic-tagged businesses are consistent with Islamic rules. Therefore, this integration of corporate governance and Islamic finance not only attracts ethical investors but also develops a resilient economic system that eventually fosters sustainable financial growth (Setiawan, 2023). Visibly, the implementation of corporate governance procedures by considering Islamic rules and regulations offers sustainable financial growth for the Islamic finance industry in the last decade (see Table 1.2).

Table 1.2. Market Growth of Islamic Finance Assets (USD Billion, 2014–2022).

S#	Country	Islamic Finance Assets *CAGR % (2014–2019)	Islamic Banking Assets Shares % (2020)	Islamic Banks Net Profit % (2021)	Islamic Banks Net Profit % (2022)
1	Malaysia	6.50%	11.10%	40.60%	44.70%
2	Saudi Arabia	8.80%	24.90%	53.80%	72.10%
3	The UAE	7.70%	8.70%	35.10%	42.10%
4	Qatar	10.70%	6.10%	40.10%	32.40%
5	Kuwait	6.30%	6.30%	33.80%	51.50%
6	Indonesia	19.70%	2.00%	24.90%	31.80%
7	Bahrain	5.60%	1.80%	29.90%	36.80%
8	Turkey	3.10%	2.60%	27.40%	48.20%
9	Bangladesh	14.20%	2.10%	36.00%	37.80%

Source: Compiled by authors based on IFSB (2023), Alpen Capital (2021), and Musaffa (2020).

Table 1.2 displays the year over year (YOY) swiftly mounting Islamic finance industry's financial growth. Noticeably, the Islamic finance overall assets have increased its total size in the last decade, specifically, during the financial years 2014–2022 mainly in all key Islamic countries. Remarkably, the Shariah Councils operating in these countries ensure that the implemented corporate governance structures for Islamic-tagged businesses are in line with Islamic rules and regulations to sustain the landscape and obtain utmost sustainable growth (Capital and Advisors, 2021).

2. The Corporate Governance Structure of Islamic Finance Institutions

Islamic corporate governance is a set of directorial measures through which Islamic financial institutions oversight and ensure the board of directors' accountability, responsibility, and management of Shariah-based committees (Abdulrahman et al., 2023). Fundamentally, Shariah-based governance plays a key role to confirm the integrity of the Islamic corporate governance system. Typically, the governance of Islamic financial institutions is different than its counterpart system as Islamic financial system is based on Shariah rules and regulations. Also, with investors and stakeholders, several regulatory bodies and Islamic communities are involved in the Islamic finance governance structure. The framework of Islamic corporate governance is a mechanism that is developed by Shariah regulatory bodies to ensure compliance with Islamic rules and to mitigate several upsurging non-compliance risks (Haqqi, 2014). The global Islamic finance standard-setting bodies such as the IFSB and AAOIFI have proposed several procedures and standards of Islamic governance to operate Islamic financial institutions (see AAOIFI, 2015; Hilmy & Hassan, 2019; IFSB, 2006). Thus, to satisfy the investors and to ensure vigorous practices of Shariah compliance, Islamic financial institutions must follow all the set measures by IFSB and AAOIFI. The IFSB-10 explained the Islamic governance system by considering the background of the Islamic financial institutions:

It is an institutional and organizational framework by which Islamic financial institutes ensure the existence of an efficient and independent supervision that oversight the adherence of all shariah laws and regulations for the issuance of shariah relevant pronouncements, review of all shariah compliance and for the dissemination of all appropriate shariah linked material (IFSB, 2009).

The above-given clarification for the Islamic governance system by the IFSB-10 is clear that the Islamic governance system contains three dissimilar features and main functions which are governance, control, and compliance to ensure the implementation of Shariah-based governance in the Islamic financial institutes. Notably, these three key functions also distinguish (see Table 1.3) the corporate structure of conventional financial Institutions from the Islamic institutions financial systems.

Table 1.3. Islamic and Conventional Governance Structure Features.

Main Functions	Shariah Governance Structure	Conventional Governance Structure
Governance, control, and compliance	Shariah supervisory board, Shariah review (internal and external), internal Shariah- based compliance unit	Board of directors, auditors (internal and external), financial compliance unit, officers, departments

Source: Authors' own elaboration.

Table 1.3 clarifies the process and structure of the Islamic financial governance structure that contains a Shariah supervisory board, internal and external Shariah review committee, and internal Shariah-based compliance unit. Additionally, it also displays the dissimilarities in the core functions of Islamic and conventional financial systems. Technically, Islamic corporate governance is functioning by following the GSs issued by two dissimilar international Shariah standard-setting bodies that are the IFSB and the AAOIFI. The IFSB and AAOIFI-issued standards (see Table 1.4) suggest how the Islamic corporate governance structure operates in the Islamic financial institutes.

Table 1.4 presents the AAOIFI and IFSB-issued GSs for Islamic financial institutes. The AAOIFI declared 13 dissimilar GSs that explain the Islamic corporate governance framework for Islamic financial institutes.

The AAOIFI developed GS 1 to construct standards and provide guidelines on the reporting, composition, appointment, and description of the Shariah supervisory board. Likewise, GS 2, that is, Shariah review is developed to create guidelines, establish standards, and assist the Shariah supervisory board in ensuring that all regulations, fatwas, that is, clarification and guidelines are consistent with the Shariah principles. The GS 3 is for the internal Shariah assessment in all those financial institutions that are tagged with Shariah. In the same vein, the GS 4 explains the role and responsibilities of the audit governance committee (AGC) and audit firms for Islamic financial organizations. The AAOIFI developed GS5 which is set for the governance principles to develop the Shariah governance practices in the Islamic financial institutions. Notably, the GS5 also assists AAOIFI with standards setting. Afterward, GS7 is introduced that is for the formation and measures of the corporate social responsibilities for Islamic financial institutions. The GS8 is to guide the central Shariah board on its definition, appointment, independence, responsibilities, and other related matters. Subsequently, the GS9, that is, for the Shariah compliance function is set to be in line with and harmonize the Shariah principles for Islamic financial institutions to standardize the procedures and principles as per the worldwide practices. The GS10 is used to set and construct procedures for all rating agencies that apply for Shariah compliance and rating of Islamic financial institutions. Besides, the GS11 is built on former standards to improve the management of internal Shariah audit operations and functions in

Table 1.4. AAOIFI GSs for Islamic Finance Institutions.

S#	AAOIFI GSs	IFSB GSs
GS* No. 1	Shariah supervisory board appointment, composition, and report	Guiding principles for corporate governance of Islamic financial institutions
GS No. 2	Shariah review	Guiding principles on governance of Islamic collective investment schemes
GS No. 3	Internal Shariah review	Guiding principles on governance of Takaful undertakings
GS No. 4	Audit and governance committee for Islamic financial institutions	Guiding principles Shariah governance systems for Islamic financial institutions
GS No. 5	Independence of Shariah board (SSB)	Guidance note on the practice of smoothing the profits payout to investment account holder
GS No. 6	Statement of governance principles for Islamic financial institutions	
GS No. 7	Corporate social responsibility: conduct and disclosure of Islamic financial institutions	
GS No. 8	Central Shariah board	
GS No. 9	Shariah compliance function	
GS No. 10	Shariah compliance and fiduciary ratings	
GS No. 11	Internal Shariah audit	
GS No. 12	Sukuk governance	
GS No. 13	Waqf governance	

Note: GS, governance structure.

Source: Compiled by authors based on [AAOIFI \(2015\)](#) and IFSB-10.

Islamic financial institutions with the consistency of Shariah rules and regulations. GS12 and GS13 are built for the governance of Sukuk, that is, Islamic bond and waqf. The GS12 is built to provide guidelines for dissimilar stages of Sukuk such as its issuance procedure, management, termination, or restricting phases. Moreover, the GS13, that is, for the waqf governance ensures to meet all waqf-related activities objectives.

Additionally, like AAOIFI, the IFSB declared five different governance principles for Islamic finance institutions. The IFSB GS1 is for guiding key principles to Islamic financial institutions. Then, the IFSB GS2 is to provide a guideline on governance such as issuance, restructuring, etc., of Shariah-based investment schemes and GS3 is for Takaful governance and its related activities. The GS4 guide about the principles, rules, and regulations for Islamic financial institutions. The last GS5 of IFSB is to offer guidance notes to make smooth procedures for profit disbursement to investment scheme account holders.

Fig. 1.1 explains the AAOIFI corporate governance framework for Islamic financial institutes. The AAOIFI Islamic governance framework clarifies that there must be a central Shariah board, Shariah supervisory board, internal Shariah compliance, internal Shariah audit, and external independent Shariah audit to ensure the Shariah compliance of Islamic finance institutions (Ginena & Hamid, 2015). Functionally, the internal Shariah review is conducted by Islamic financial institutions. The Shariah review is handled by the Shariah supervisory board that scrutinizes the Shariah compliance for Islamic finance services, products, business-related transactions, and activities. After that, another Shariah review testing is conducted by internal and independent Shariah audit, that is, measured as an internal exercise of audit for the Islamic financial institutions. The second external independent Shariah audit is to analyze the Islamic financial institutes' compliance by following the Shariah guidelines, rules, and instructions that are imposed by the Shariah advisory council and Shariah supervisory board. The AAOIFI explained this procedure as an internal and external Shariah audit, respectively (Hasan, 2011). The developed Islamic Corporate Governance structure by Shariah regulatory bodies such as AAOIFI and IFSB ensures that Islamic-tagged firms are not involved in all those activities that are forbidden in Islam and also offer risk-adjusted sustainable financial growth. Hence, the developed framework and procedures for Islamic corporate governance by AAOIFI and IFSB governance promote sustainable growth by ensuring ethical business practices, risk management, and social responsibility, aligned with Sharia principles.

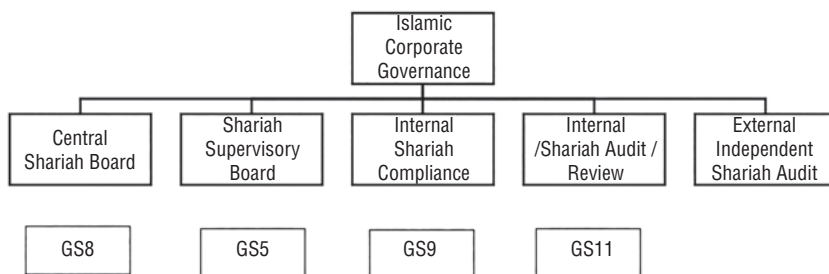


Fig. 1.1. AAOIFI Islamic Corporate Governance Framework. Source: Compiled by authors based on Hilmy and Hassan (2019) and AAOIFI (2015).