

CRITICAL REVIEW WITH META-ANALYSIS

## Strengthening Corporate Governance Regime for Islamic Banks in Pakistan: Focusing on the Principles of *Amāna* and *Mas'ūliyah*

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**Abstract.** The debate on the topic of Corporate Governance (CG) witnessed a substantial boost in the wake of the unprecedented financial crisis of 2008, and previously, the collapses of big corporations and banks in 1990s. The governance failure has been found as the key factor behind this debacle. The CG in Islamic perspective got attention from the scholars and researchers soon after the Islamic Banking Institutions (IBIs) emerged. Nevertheless, Islamic CG faced some issues such as incompetency of the board of directors, absence of effective risk management policies, moral hazards, and non-compliance of Sharī'ah principles. The goal of compliance with Islamic law has also been added to the CG and the State Bank of Pakistan (SBP), as regulator, issued a Sharī'ah Governance Framework (SGF) in this respect. However, a separate statutory law for the governance of IBIs is non-existent. Hence, the IBIs follow conventional regime, which failed to cater the specific requirements of IBIs. The research adopts qualitative inquiry method for deeper analysis. The governance of the IBIs should be in the hands of such competent CG players, who comply with the principles of *amānah* (trusteeship) and *mas'ūliyah* (accountability) in addition to other capabilities. There are certain provisions in the existing CG regime, compatible with these principles, but the same do not ensure good governance. Further, to the best of our knowledge, no CG player is punished for non-compliance with the provisions of the SGF. We suggest proper punitive actions for the Sharī'ah non-compliances. Various scholars have discussed CG principles, but they did not check any legal regime to verify the degree of compatibility of its provisions with those principles. This study is an effort to fill the gap by assessing the compatibility of the provisions of the existing SGF with the Islamic principles of *Amānah* and *Mas'ūliyah* with respect to IBIs in Pakistan.

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## INTRODUCTION

Since the time of Smith (1776)<sup>1</sup> Berle and Means (1932)<sup>2</sup>, the issue of CG has been a point of concern, but in the modern era, in the wake of fast developments and corporatization, the scenario has changed altogether. The topic received fresh attention after the failures of huge financial corporations<sup>3</sup> and banks<sup>4</sup> in the 1990s and the recent financial crisis of 2008. The governance failure by the corporate managers themselves has been found as the most important factor behind these crises. As Ketz (2003) notes, the failure of WorldCom, Enron, and other companies has raised objections on the value of CG, which fails to control the hazardous behavior of the companies' managers or directors<sup>5</sup>. Minhas (2013) pointed out reasons behind the closures of the Non-banking Islamic Financial Institutions (NBIFIs) in Pakistan, such as the incompetency of the board of directors and top management; weak internal system of control; absence of risk management policy, greed, regulatory failures, and non-observance of Sharī'ah principles. It is obvious that NBIFIs were involved in unethical as well as un-Islamic business practices, which led to their failure.

The analysis of Strebel (2010) identifying the lessons learnt from the unprecedented financial crisis of 2008 is important. He pointed out that the hubris and a lack of sincerity on the part of a chairman or CEO destroy the organization, while poor risk management and too much financial leverage have also damaged the performance of the institutions. These factors were the major contributors behind the financial crisis in 2008. From this analysis, it is reflected that strict CG, in terms of fairness, transparency, and accountability, is a pre-condition to avoid such crisis in future.

With the emergence of Islamic banks, the goal of compliance with the Islamic law has also been added to the conventional CG. Therefore, in Pakistan, the central bank SBP issued Sharī'ah governance guideline in 2008 and the SGF in 2015. However, in the absence of separate statutory law for Islamic banks in Pakistan, the players of the IBIs get their powers from the existing legal regime relating to conventional banks, which includes The Companies' Ordinance (1984), The Banking Companies Ordinance (1962), and the Securities and Exchange Commission of Pakistan (2012), in addition to the SGF, 2015. Major problem is that such laws have been promulgated without keeping in view the peculiarities in the transactions of Islamic banks, necessary eligibility criteria, educational qualification and experience of CG players associated with Islamic banks. Thus, the provisions of the existing CG regime do not ensure good governance inside Islamic banks.

Although, with respect to Islamic banks, the scholars, such as, Dusuki (2008), Iqbal and Mirakhor (2004), Lewis (2005), and Malekian and Daryaei (2010) have discussed Islamic

<sup>1</sup>In his book titled *Wealth of Nation* Adam Smith discussed the natural self-maximization behavior of management (as humans) of firms.

<sup>2</sup>Berle and Means (1932) discussed the agency problem that arises between shareholders and managers of firms.

<sup>3</sup>Like Maxwell in the UK and WorldCom in the US.

<sup>4</sup>Such as Baring Bank in Singapore.

<sup>5</sup>For instance, Asil Nadir (a top Corporate Player) of the Poly Peck was practicing hazardous activities. Likewise, directors of the WorldCom applied methods based on fraud, to inflate stocks prices. Similarly, the large-scale losses in the Enron's projects as a result of mismanagement were concealed by the company's directors.

CG principles but they did not test legal provisions of the SG system to verify the degree of compatibility of the provisions with those principles. This is an obvious gap in the existing literature. Therefore, the current study tries to fill the existing gap with respect to Pakistani Islamic banks.

### Objectives

This study plans to the analysis of the CG regime for Islamic banks in Pakistan in the light of the Islamic CG principles of *amānah* and *mas'ūliyah*. It has three objectives; (1) to explore whether the Pakistani CG regime ensures competency of the CG players before they are entrusted with the *amānah* (trusteeship) of their respective authorities; (2) to investigate whether the CG players are held accountable in instances of their non-performance of *amānah*, especially for non-performance of their *amānah* with respect to Sharī'ah compliance; and (3) to suggest measures in order to strengthen the CG system for Islamic banks in Pakistan.

### Methodology

This study uses the qualitative method of inquiry for exploring deeper into the matter to understand the issue in a comprehensive manner. Tewksbury (2013) endorses the qualitative method of inquiry on the basis that it enables the researcher to have an in-depth understanding as compared to the quantitative method. Creswell (1994) finds the qualitative method more appropriate if topic needs a deeper investigation, and relevant theories are not there. Straus and Corbin (1998) suggest this method of research as it helps the researcher to produce the findings which are not possible to find out through statistical tools. Thus, being one of the effective methods in social sciences, the qualitative research technique has been adopted and the content analysis of the available primary data exhaustively made.

Moreover, before the application of the above technique, Islamic CG principles of *amānah* and *mas'ūliyah* (accountability) have been analyzed and their implications have been highlighted in the primary sources, whereas the principles are explored in the primary sources of Islamic law namely the Qur'ān and Sunnah. A substantial use of primary data, obtained from the treatise of the Ḥanafī Jurists, Pakistani statues, and the official websites of the SBP, Securities and Exchange Commission of Pakistan (SECP), and Pakistan Law Site, has been made.

## LITERATURE REVIEW

With the emergence of Islamic financial institutions, the issue of Islamic CG got attention among scholars such as Choudhury and Hoque (2006), Dusuki (2008), Hasan (2012), and Iqbal and Mirakhor (2004). These scholars have discussed the concept, model, and foundational principles of Islamic CG system. They also have compared the Islamic CG with the Western counterpart. On the other hand, in classical Islamic literature, the CG can be traced in the studies of Al-Kāsāni (2000), Al-Sarakhsi (1978), and Al-Marghenani (n.d.), who discussed the foundational principles, which are related to CG. Al-Sarakhsi (1978) has discussed about the principle of *amānah* under the chapter *al-wadī'ah* (trust). Refer-

ring to the fourth Caliph, *Hadrat* Ali (RA), Al-Sarakhsi (1978) says that the trustee and the supervisor are not held liable except in the case of negligence or misconduct on their part. Similarly, Al-Kāsāni (2000) has discussed the principles of trust and liability under the chapter *al-wadī'ah*. According to him, a trustee is held liable for his acts of negligence and misconduct.

Al-Zuhaili (1989) has written a treatise in which he has combined the views of all the four major Sunni schools of thought. In his view, the possessor (holder as *amīn*) of things is held liable for the loss of the things only when he acts negligently or commits misconduct with respect to that thing. Ahmad (1987) argued that even if the owner of the thing agrees with the trustee that he shall not be liable for any loss to the thing, still the trustee shall be liable and such condition shall be treated as void.

One of the modern scholars, Kasri (2009) argued that the key difference between both the conventional and the Islamic CG systems is in the philosophical aspects. This difference is rooted in the fact that Islam considers the practices of CG as an obligation of Muslims to Allah, leading to the presence of 'implied' contract with the God and 'express' covenant with human beings. Hasan (2012) has conducted comparative research on CG from Islamic and Western perspective, focusing on the elements of definition, objective, structure, and implementation of CG. According to him, Islamic CG has its own distinctive features of *tawḥīd* (oneness of God) as episteme, *shūrā* (mutual consultation), and individuals' and public interests' protection. Abu-Tapanjeh (2009) has compared Islamic principles with the OECD's principles relating to CG. He argued that Islamic principles of business ethics, *shūrā*, *ḥisbah* (an expression used for the duty of enjoining the good and forbidding the evil), accountability, book keeping, and final account are the foundational stones of CG.

According to Gitau (2015), accountability, transparency, and fairness are the pillars of the CG. Iqbal and Mirakhor (2004) have argued that the Islamic principles of property rights and commitment to explicit as well as implied contracts offer strong foundation for Islamic CG. From Islamic perspective, a company can be considered as 'nexus-of-contract', in which case, its goal will be minimization of cost of transaction and maximization of investors' profits, without violating the property rights of any party, no matter the party makes direct or indirect interactions with the company. Amer, Anees, and Sajjad, (2014) discussed the contract of *mudārabah* in the system of CG. They argue that shareholders entrust the control on their wealth into the hands of managers. Therefore, a good monitoring atmosphere is necessary to ensure their participation in making significant decisions and policies. In their view, the business entity must resolve the problems relating to CG that may arise from the limited liability and division of ownership. This way, the rights of all the stakeholders could be protected.

According to Hafeez (2013), Islamic CG principles settle on three aspects of decision-making, i.e., by whom: Through mutual consultation, for whom: to achieve God's grace, and being His trustees to safeguard the interests of His slaves, and with whom, and to whom: through active religious supervision to ensure the Sharī'ah-compliant operations. He argued that the institution of *ḥisbah* ensures Sharī'ah-compliant business and corporate affairs. He also argues that the *amīr* (leader) provides base for group members to comply with the direc-

tions of team leader (like CEO or Chairman of the board). He further explains that the life of Prophet Muhammad (PBUH) in both war and peace-time suggests the idea of *al-takhṭīṭ* (planning and strategy), which is accepted as the foundation for corporate strategy. Lewis (2005) states that *shūrā*, *ḥisbah*, the Sharī‘ah supervision, and religious audit are the bases of Islamic CG. The *shūrā* is the foundation for making corporate strategies. While deciding matters through *shūrā*, directors and top executives would duly consider the opinions of other managers. The *ḥisbah* offers base to encourage morals in the companies.

The above literature indicates that the scholars have discussed Islamic principles relating to CG that cover various aspects, but no one studied the provisions of any legal regime relating to CG practices in IBIs, with reference to these principles. Likewise, none of them has reviewed the Pakistani CG regime for IBIs in Pakistan. In order to fill the gap, in the present study, the two important principles of CG namely *amānah* and *mas’ūliyah* are applied to the provisions of Pakistani CG regime in order to check the degree of compatibility of the provisions with the said principles.

## ISLAMIC CG PRINCIPLES

Four commandments of Allah provide the basis for the CG system. These commandments include *khilāfah* (vicegerency), *amānah*, *mas’ūliyah*, and *shafāfiyah* (transparency). The concept of *khilāfah* in Islam is that human beings are vicegerents of Allah in this world, and they are required to obey Allah’s commands only (Maudūdī, 1949), no matter they act in any capacity such as doctor, engineer, director or CEO of an Islamic bank. It means that they shall observe and implement the principles of Sharī‘ah in all aspects of their lives. Similarly, *shafāfiyah* means that actions of all human beings<sup>6</sup> shall be visible to all. This *shafāfiyah* in the actions of human beings is the main factor in holding them accountable for their actions. The other two principles, which are *amānah* and *mas’ūliyah*, are discussed below in detail because the scope of the current study is limited to these principles only.

### The Principle of *Amānah*

The term *amānah* is from an Arabic word *amn*, which means security, protection, peace, safety, and shelter (Samsudin & Islam, 2015). It is opposite of *khiyānah* (disloyalty) (Ansari, 1993). In Islamic jurisprudence, the word is used in two senses. Firstly, it is used in the perspective of “thing” (Ministry of Awqāf and Islamic Affairs, 2006). Secondly, the word is used in the sense of feature or characteristic, such as the nature of *mudārabah* contract and public authority is *amānah* (Ministry of Awqāf and Islamic Affairs, 2006). The rule for *amānah* is that if a person is performing his *amānah* with due care, he is not responsible for any loss incurred to the thing kept as *amānah*, but if he commits any negligence or misconduct, then the person is held liable for all the losses incurred (Marghenani, n.d.; Mansoori,

<sup>6</sup>This principle is inferred from the following texts of Sunnah of the Prophet Muhammad (PBUH): “When we appoint someone to an administrative post and provide him with an allowance, anything he takes beyond that is unfaithful dealing” (Abu Dawud, 2943); “Whosoever from you is appointed by us to a position of authority and he conceals from us a needle or something smaller than that, it would be misappropriation (of public funds) and will (have to) produce it on the Day of Judgment” (Al-Naysaburi, 2007).

2007). In this case, any condition agreed upon by both the parties, exempting the liability of the *amīn*, shall be considered void (Ahmad, 1987). Further, on the basis of two *aḥādīth* of the Prophet Mohammad (PBUH) as narrated by Abu Dhar<sup>7</sup>, the authority<sup>8</sup> is also *amānah* and it shall be handed over to competent persons. So, any office-bearer (public or private) is *amīn* in the capacity of such position-holder. By applying the rule of *amānah* to the office-holders, it can be argued that they shall be liable for all their misconducts and negligent actions with respect to their powers and duties. On the same basis, the CG players like CEOs and directors are also trustees of their authorities, who shall be held liable for any misconduct or negligence during the course of exercise of their powers.

Based on the two *aḥādīth* referred above, a person having the authority to appoint others to some positions is also *amīn*<sup>9</sup> for such appointments. So, he shall be held liable for any misuse of his powers. He shall be held liable for nepotism and favoritism<sup>10</sup> in the course of appointments. On the basis of the foregoing discussion, it is summarized that the CG players of Islamic banks, are trustees, being authority holders. Therefore, they need to be competent enough to be entrusted with the *amānah* of their respective authorities. For this purpose, some minimum criteria in terms of degree qualification and experience are necessary to be set for the CG players. If any player does not fulfill such criteria, he shall not be handed over the affairs of the IBIs. Similarly, if any of the players commits any misconduct or negligence during the course of one's performance of duties and powers as *amānah*, he shall be held liable.

### **The Principle of *Mas'ūliyah* (Accountability)**

*Mas'ūliyah* is also a vital principle of Islamic system of CG. According to Ali (2015), accountability is "the process through which a person or group can be held to account for their conducts". It means that all humans shall be asked for their actions. In the perspective of CG, it suggests that CG players are accountable for their acts. It is one of the important elements of good governance (Fernando, 2009). The Prophet (PBUH) says: "Each one of you

<sup>7</sup>It is reported on the authority of Abu Dhar who said: "I said to the Prophet (PBUH): Messenger of Allah, will you not appoint me to a public office? He stroke my shoulder with his hand and said: Abu Dhar, thou art weak and authority is a trust. And on the Day of Judgment, it is a cause of humiliation and repentance, except for one who fulfills its obligations and (properly) discharges the duties attendant thereon" (Al-Naysaburi, 2007). In this *ḥadīth*, it is explicitly mentioned that responsibility is *amānah*, and it should not be handed over to weak people or those who betray, rather, to those who are trustworthy.

It is also reported by Abu Dhar that Allah's Prophet said: "Abu Dhar, I find that thou art weak and I like for thee what I like for myself. Do not rule over (even) two persons and do not manage the property of orphan". (Al-Naysaburi, 2007).

It is concluded from these *aḥādīth* that the authority, being *amānah*, should not be handed over to incompetent or weak persons.

<sup>8</sup>Here, the authority includes all types of responsibilities, duties, and powers.

<sup>9</sup>He is *amīn* on the basis of the above-mentioned two *aḥādīth* of the Prophet Mohammad (PBUH), because the word "authority" used therein is absolute, which includes all roles, responsibilities, duties, and powers, including the power to appoint others on some posts.

<sup>10</sup>It is narrated from Ibn Abbas on the authority of al-Hakim that the Messenger (PBUH) said: "whosoever employs a person out of favoritism, when there is someone who is better than him, has committed a breach of trust with God, His Prophet (PBUH) and all Muslims" (Al-Naysaburi, 2007, p. 175).

is a guardian and each guardian is accountable to everything under his care.” This *ḥadīth* shows that everyone is answerable, whatever position he holds.

Accountability in Islam is dual; human beings shall be accounted for their actions in this life as well as in the world hereafter<sup>11</sup>. In the Islamic legal system, human beings are held accountable in this life in three ways: Firstly, they are liable to *ḥudūd*<sup>12</sup> secondly to *qiṣāṣ*<sup>13</sup>; and thirdly to *ta‘zīr*<sup>14</sup>. *Ta‘zīr* punishments are applied in instances where *ḥudūd* and *qiṣāṣ* are not applicable. For example, a caretaker of *waqf* (endowment) is accountable for the *waqf* property (Hanafī, 1992, p. 448), the collector of *zakāh* is accountable to the ruler (Ministry of Awqāf and Islamic Affairs, 2006, p. 178), and the trustee is accountable for his trust (Al-Samnānī, 1984). In case the society’s rights (money of general public, for instance) are involved, then people are entitled to ask the authority-holders, who are bound to give accounts for their acts. The practice of accountability in early Islamic life could also be found during the era of the righteous Caliphs. *Abu Bakr al-Siddiq* (RA) emphasized the significance of accountability in his very first address to the Muslims after being chosen as the Caliph (ruler) in the following words:

“I have been given authority over you but I am not the best of you. If I do well, help me, and if I do ill, then put me right....The weak among you shall be strong in my eyes until I secure his right if God wills; and the strong among you shall be weak in my eyes until I wrest the right from him...Obey me as long as I obey God and His apostle, and if I disobey them, you owe me no obedience” (Guillaume, 2006).

The same was the position of Umar ibn al-Khattab (RA). In his first address as Caliph, he emphasized the need for accountability in his administration, and the rights of every citizen including minorities. During his era, once a man asked the righteous Caliph Umar (RA) to give account for extra cloth than the normal share of every companion, then Umar explained

<sup>11</sup>Individuals’ accountability for their acts in the world hereafter is obvious from these texts of the Qur’ān and the *aḥādīth*: “To Allah belongs whatever is in the heavens and whatever is in the earth. Whether you show what is within yourselves or conceal it, Allah will bring you to account for it” (Qur’ān, 2: 284); “And fear a Day when you will be returned to Allah. Then every soul will be compensated for what it earned. And they will not be treated unjustly” (Qur’ān, 2: 281); also see the verses: 3: 30; 36: 17; 101; 1-11 and 102: 8.

<sup>12</sup>*Ḥudūd* are the specific types of crimes and punishments thereof (Al-Zuhaili, 1989).

<sup>13</sup>It means just retaliation by the Ruler-to treat the accused in the manner he treated the victim like kill A for killing B. (Al-Zuhaili, 1989).

<sup>14</sup>These are the punishments other than *qiṣāṣ* and *ḥudūd*, which are on the discretion of the ruler to be fixed (Al-Zuhaili, 1989).

properly.<sup>15</sup>

Hence, every authority holder is accountable for his/her actions. Based on this rule, the CG players such as directors and managers of Islamic banks are also accountable for their actions and if any one does not perform the role properly, appropriate action needs to be taken against him. So, it is inferred that before entrusting the duty of directorship, CEOship, auditor-ship, and Sharī'ah board's membership, it shall be ensured that the persons are competent for their respective posts. After, they have been so entrusted, they need to exercise due care and to commit no misconduct or negligence in the course of performing their duties. If any person makes any violation, it becomes necessary that appropriate actions are taken against him.

### APPLICATION OF THE PRINCIPLE OF *AMĀNAH*

In this part, we review the Pakistani legal and regulatory regime to verify whether it ensures competency of the CG players before entrusting them with their respective authorities. The relevant provisions of the regime are discussed below:

#### Directors and the Board of Directors

Directors are the persons usually appointed by shareholders, who provide central leadership to the companies (Securities and Exchange Commission of Pakistan, 2002). They have unlimited powers with respect to the business of companies (Bloomfield, 2013). The job of the board is policy-making and monitoring to make sure that the policy is implemented (Chapra & Ahmad, 2002). The BODs holds central position in any organization. It acts as a mind of the firms (Nyazee, 2007, p. 149).

Under the State Bank's SGF 2015, the BODs of Islamic banks is ultimately accountable for ensuring Sharī'ah compliance. Being key position-holders, the directors are trustees of their authority under Islamic principle of *amānah*. Under this principle, the authority of trust shall be entrusted into those persons being competent to properly perform the trusts.

For making sure that the directors are competent, the SECP requires that the persons shall have at least five (5)<sup>16</sup> to seven (7)<sup>17</sup> years of experience to become eligible for the post of directorship, in addition to minimum qualification of graduation (State Bank of Pakistan,

<sup>15</sup>It is narrated that 'Umar (RA) received sheets of cloth from Yemen. By distributing it among people, each one got one length as his share. The share of 'Umar (RA) was as more as twice of one Muslim's share. After he wore it, the next day he came to give commands to the people for *jihād*'s preparation. A person stated by standing, "We neither listen to you nor obey you." "Why so?" The 'Umar asked. The man replied, "Because you have preferred yourself to us." 'Umar questioned him again, "In what way I have done so?" He answered, "When you distributed the Yemen lengths of cloth, each one received one and so you too. But one length would not make you a garment; we see you have tailored it into a whole shirt and you are a tall man too. If you had not taken more, you could not have made a shirt of it." By turning to his son Abdallah, 'Umar (RA) asked him, "Abdallah! Reply him." He replied while standing, "When the commander of the faithful 'Umar wished to tailor this length of cloth, it was not sufficient, so I gave him enough of my length to complete it for him." The man said, "Now we listen and obey you" (Ibn Ṭabāṭabā, 1947).

<sup>16</sup>When the person has experience in business or management.

<sup>17</sup>When the person is a lawyer.

2011). The minimum qualification of graduation with five years of managerial or seven years of legal experience is enough to ensure the competency of a person to be entrusted with the affairs of banks in the capacity of directorship.

To further enhance the integrity and reputation of the directors, the State Bank of Pakistan (2011) has issued Fit and Proper Test (FPT).<sup>18</sup> The FPT checks integrity of persons on the basis of their involvement in or conviction for fraud, forgery or crime (State Bank of Pakistan, 2011). Any person who is involved in, or has been convicted for, any fraud, forgery or crime, proves his bad character and dishonesty, who cannot be trusted, because the rule of *amānah* is that it shall be handed over to trustworthy people.

Similarly, Section 1 (iii) of the FPT weighs the integrity of a person on the basis whether he has contravened any requirement/standard of the SBP or other regulatory or professional body (State Bank of Pakistan, 2011). If the person has made such contravention, he is considered ineligible for appointment to the post of CG player. The requirements of regulators<sup>19</sup> and professional bodies<sup>20</sup> are necessary for ensuring smooth running and maintaining standard of organizations like banks. The persons involved in violations of the rules shall not be entrusted with the affairs of sensitive institutions like banks<sup>21</sup>, especially Islamic banks.<sup>22</sup>

Further, the FPT considers an individual ineligible for the director's post if he is not solvent or lacks integrity, which is checked on the basis of his: i) connection with illegal activity relating to business of banking; and ii) default in payments to be made to a financial institution, or taxes to be paid to a government body (State Bank of Pakistan, 2011).

The ineligibility of any person on the basis of default in payment also conforms to the Islamic principle of *amānah* since, like every other *amānah*, repayment of loan is also an *amānah*.<sup>23</sup> He, who does not repay his debts, cannot be trusted and thus, cannot be entrusted with *amānah* of authority.

According to Section 2 (i) and (ii) of the FPT, a person is eligible to be appointed as a director only that he has been a person of clean track record during his service in any institution. Further, he has not been demoted or fired from his position by his institution, any government or regulatory body (State Bank of Pakistan, 2011). It means that the person has to prove himself as a man of integrity and reputation and only such person can be trusted to be entrusted with the *amānah* of authority.

The provision of handing over the authority to the upright people with a good track record demonstrates that it conforms to the principle of *amānah*. Further, the BODs of Islamic banks are ultimately accountable for ensuring overall Sharī'ah-compliant environment inside the Islamic banks (State Bank of Pakistan, 2015). Therefore, to perform this *amānah*,

<sup>18</sup>The FPT includes important elements: (a) integrity, honesty, and reputation, (b) solvency and financial integrity, and (c) track record, which are applicable to directors, CEOs and other top managers (State Bank of Pakistan, 2011).

<sup>19</sup>Like SBP in Pakistan and BNM in Malaysia.

<sup>20</sup>Such as Institute of Chartered Accountants of Pakistan (ICAP).

<sup>21</sup>Banks are sensitive institutions because public monies are lying in their custody as trust (like deposits of investment account-holders), and they are subjected to stricter rules.

<sup>22</sup>Islamic banks are more sensitive because of their additional objective of Sharī'ah compliance.

<sup>23</sup>Each and every act, which a man is required to do or to abstain from its doing, is *amānah* with him (Ibn Kathīr, 2016, p. 711).

they need to have additional competency to ensure such environment. For this purpose, the State Bank of Pakistan (2015), under its Section 2(iv), requires the management to arrange proper trainings and orientation programs for the members of the board to educate them on the Islamic banking and finance transactions. Although with the help of such trainings, the members of the board can be familiarized with the Islamic banking and finance concepts, yet they cannot be expected to be competent enough to be aware of all the Sharī'ah non-compliance risks.

### Management

Implementation of decisions taken and policies made by the directors is the responsibility of the management. They are responsible to manage business of the companies (Kaen, 2008). The management includes the Chief Executive Officer (CEO) and other senior officers<sup>24</sup>, who have the responsibility of day-to-day management of the business (Chapra & Ahmad, 2002). The post of CEO-ship, being the most important position on the management side, needs to be handed over to sufficiently qualified and competent persons because it is the requirement of Islamic CG principle of *amānah*. For ensuring competency of CEO, the FPT fixes some qualification criteria. Under its Section 4(ii), the minimum requirement in terms of degree is graduation in banking, finance, economic, business, along with minimum of 5 years of senior level experience (State Bank of Pakistan, 2011).

In addition to the other provisions of the PFT<sup>25</sup> the minimum requirement of five years of management experience is sufficient for efficient handling of management affairs of conventional banks. But the BODs of IBs have additional responsibility of getting trainings on Sharī'ah for proper implementation of decisions and opinions of Sharī'ah Board (State Bank of Pakistan, 2015). The management cannot be expected to perform these responsibilities effectively unless they have proper Sharī'ah knowledge and trainings of Islamic banking and finance transactions. For this purpose, the SGF under Section 2(v) requires banks to arrange proper trainings about Islamic finance for the senior management to enable them to be competent enough to effectively implement the decisions of the Sharī'ah board. It means that the SGF ensures that the *amānah* of the management of Islamic banks is handed over to competent managers who have the knowledge of Islamic finance.

### Auditors

Auditors conduct official examination of the accounts (or accounting systems) of an entity (The Institute of Chartered Accountants of Pakistan, 2015). The objective of an audit is to assess whether annual accounts are made in conformity with the applicable law of a particular country or not. They also examine whether the accounts represent 'true and fair' value of the state of the companies' activities (The Companies Ordinance, 1984). Therefore, the post of auditor-ship needs to be necessarily handed over to competent and independent persons. The eligibility criteria for the auditors are, therefore, threefold: first, the auditors must

<sup>24</sup>Knowledge about Sharī'ah.

<sup>25</sup>Such as CFO, COO, and other heads of each department like internal audit and compliance.

have a proper degree of chartered accountancy<sup>26</sup> second, only those auditors are eligible to conduct audit whose names are on the panel of auditors<sup>27</sup>; second, only those auditors are eligible to conduct audit whose names are on the panel of auditors<sup>28</sup>; and third, they must comply with the minimum ‘quality control review program’ of the ICAP.<sup>29</sup>

But the above eligibility criteria are enough for the audit of conventional banks only, and the auditors of IBs have to conduct additional audit for Sharī‘ah compliance, in which case, this qualification falls short. Therefore, in order to ensure competency of the CG players for the conduct of Sharī‘ah audit of IBs, the SGF puts additional conditions for the officers conducting Sharī‘ah audit. The provisions are discussed below:

### **Internal and External Sharī‘ah Auditors**

Sharī‘ah audit<sup>30</sup> is a distinctive characteristic of IFI’s for assessing Sharī‘ah-compliant affairs of the IFIs. In Pakistani IBs, both the Internal and external Sharī‘ah audit functions are working. Internal Sharī‘ah Audit (ISA) is conducted by IBs’ Internal Sharī‘ah Audit Unit, which is either a part of Internal Audit Department (IAD) or an Independent Unit. The staff of ISA has to be suitably qualified and trained. Similarly, External Sharī‘ah Audit (ESA) is conducted by external auditors, who are required to have appropriate human resource and methodology (State Bank of Pakistan, 2015).

The existence of ISA and ESA for Islamic banks will help ensure Sharī‘ah compliance environment inside the IBs. But, the SGF does not define any qualification criteria for the Sharī‘ah auditors, which puts a question mark on the competency of the auditors in conducting Sharī‘ah audit. Speaking from Sharī‘ah perspective, the untrained auditors cannot be expected to make correct assessments of the transactions. So, according to the principle of *amānah*, they cannot be entrusted with the job of conducting Sharī‘ah audit. In both the cases, whether the Sharī‘ah audit is performed by the conventional auditors or the specialized Sharī‘ah auditors, they need to have proper qualification. In this regard, the authors suggest that the courses of *fiqh al-mu‘āmalāt* (Islamic law of contracts and business transactions) need to be included in the basic qualification<sup>31</sup> degree of auditors. The universities

<sup>26</sup>As the provisions of the FPT relating to reputation, financial integrity, and faultless track record (as discussed in the directors’ part) are also applicable to management. Therefore, there is no need to reproduce them once again. (Please, see pages 7-8 of this research paper).

<sup>27</sup>Under section 254(1) of the CO and 35(1) of BCO, auditor is required to be a Chartered Accountant under Chartered Accountants Ordinance, 1961.

<sup>28</sup>Under its BSD Circular No. 03 of 2003, the SBP has categorized the panel into three categories namely Category A, B and C, being eligible to conduct audit of all Banks/DFIs, of those having total assets up-to Rs. 50 billion or no. of branches up to 99, of those having total assets below Rs. 5 billion or no. of branches below 10, respectively.

<sup>29</sup>The ICAP has put ‘quality control review program’ for auditors to be eligible for conducting the audit of listed companies. Hence according to clause xxxiii of the Securities and Exchange Commission of Pakistan (2012), an auditor is eligible to conduct an audit only if he has a satisfactory rating under such program.

<sup>30</sup>“Sharī‘ah audit refers to the periodical assessment conducted from time to time to provide an independent assessment and objective assurance designed to add value and improve the degree of compliance in relation to the Islamic Financial Institutions (IFIs) business operations, with the main objective of ensuring a sound and effective internal control system for Sharī‘ah compliance” (Bank Negara Malaysia, 2011).

<sup>31</sup>The qualification of Chartered Accountancy under Chartered Accountants, 1961.

and other training institutes like National Institute of Banking and Finance (NIBAF) should start specialized Sharī'ah audit certificate/courses. It is also suggested that proper degree in *fiqh al-mu'āmalāt* is required for some members of the audit firms to become eligible for the Sharī'ah audit.

### Sharī'ah Board

The most important organ of Sharī'ah governance structure of banks is the Sharī'ah Board. The Section 3(A)(i) of the SGF obliges every IBI to establish a SB. On the basis of Islamic principle of *amānah*, the membership of the SB needs to be given to competent Sharī'ah advisors. For this purpose, the SGF suggests minimum qualification and experience criteria. The Sharī'ah Board members need to hold degree of *Shahādat al-'ālamīyyah (dars-e-nizāmī)* from a recognized board of *madāris*, and Bachelor's degree from a modern educational institution, to become eligible for appointment on the SB. But, if one holds a degree from a modern education system, the minimum degree required is postgraduate in *Uṣūl al-dīn* (Islamic studies), or LLM in Sharī'ah or Islamic Jurisprudence (State Bank of Pakistan, 2015).

But the above qualification criteria are not enough to ensure Sharī'ah good governance. First, *madāris* graduates might not be generally expert in modern *fiqh al-mu'āmalāt* (Islamic law of contracts and business transactions). Second, they might not be able to practically apply Sharī'ah knowledge to modern Islamic finance. Similarly, a mere degree-holder in Islamic jurisprudence is also not a suitable candidate for the post of Sharī'ah scholar member of the Sharī'ah Board. Islamic jurisprudence is the science of principles and comprehensive<sup>32</sup> evidences, on the basis of which *ahkām* (rules) are derived (Zedān, 1976, p. 11). Therefore, the degree-holder shall be well-aware of the rules for the derivation of the legal rules, but shall not necessarily be an expert in the application of these rules to the modern finance transactions. Likewise, post-graduate degree in *Uṣūl al-dīn* also does not enable a candidate to be competent enough to act as efficient Sharī'ah scholars to become SB members. The authors acknowledge that the requirement of *Shahādat al-'ālamīyyah* or postgraduate degree in *Uṣūl al-dīn* or Islamic Jurisprudence is compatible with the principle of *amānah*, but any person to become a SB member must have sound knowledge of modern business and finance.

The minimum experience of five years as Sharī'ah advisor for the post of chairmanship of the SB is enough for its smooth functioning. Similarly, the minimum experience of three years required from other members of the SB is also enough for the better Sharī'ah-complaint decision-making process. So, it is concluded that this provision is compatible with the Islamic principle of *amānah*.

<sup>32</sup>For example, Qur'ān and Sunnah, as a whole, are comprehensive evidences. They are different from detailed (individual) evidences (for example, the verse of Qur'ān dealing with cutting of hands of a thief, is a detailed evidence).

## APPLICATION OF THE PRINCIPLES OF *AMĀNAH* AND *MAS'ŪLĪYAH*

In this part of the research paper, we apply the principles of *amānah* and *mas'ūlīyah* simultaneously because the test for the verification of *amānah* principle lies in ensuring accountability of CG players, which is also a feature of the principle of *mas'ūlīyah*. So, the basic rule has to be that the CG players are held liable for their non-compliances. By examining the Pakistani legal and regulatory regime, we find a number of provisions which evidence that the CG players are accounted for their acts, which are non-compliant with the provisions of the regime. For example, a director is held liable for non-performance of any of his responsibilities as given under S. 219(6) of the The Companies Ordinance (1984), non-disclosure of his interests in the transactions made by the company, contravention of his restriction from voting and participating in the meeting in which those transactions are discussed in which the director has interests or non-entering into the register, the particulars of these contracts, and arrangements.

From the perspective of Islamic principle of *amānah*, in all the above cases, a director is *amīn* (under trusteeship) to do what is required from him to do and to omit what is required from him not to commit. If he does not perform these responsibilities, he shall be accounted for it. Similarly, the director has the *amānah* to disclose his interests in the transactions made by the company and also to enter all particulars of these transactions into register, so that one is stopped from taking undue personal benefits from the transactions of the company. The directors are further forbidden from voting and participation in the meeting in which those transactions are discussed. Declaring the directors liable in all the above cases shows that the principle of *amānah* is complied with in these provisions.

Similarly, any CG player making default in director's report, statutory report, and Annual General Meeting (AGM), shall be held liable. The directors' report is prepared by directors and it deals with the state of activities of the companies at the year's end (The Companies Ordinance, 1984). After the auditor's report, the directors' report has very much significance because if the auditor's report does not verify that the financial statements represent true and fair value of the companies' affairs, it will certainly create a panic among the stakeholders (especially, shareholders and investment account-holders of IBs). Under the principle of *amānah*, the report needs to be prepared with due care, and any person making default in its preparation needs to be accounted. As the above provisions hold them accountable, hence, they are compatible with the principle of *amānah*.

Further, full information disclosure and explanation in this regard is the responsibility of the BODs, for which it is *amīn*. If any person makes default with respect to such a significant report, he must be punished. Similarly, the statutory report is prepared by directors within six months from the commencement of business of the company. Any default in its preparation shall expose the culprit to punishment, because the preparation of the report and putting the significant information therein is the *amānah* with the CG players.

Furthermore, the AGM is an important meeting held every year. Annual accounts are discussed in the AGM; directors are elected in it; and most of the decisions of the company are made in the meeting. With respect to the AGM, the CG players are *amīn* to perform

their respective responsibilities as *amānah*, for which they shall be accountable in case of their misconduct or negligence in the performance of the *amānah*.

Likewise, the CG players are accountable for their involvement in political contributions or distribution of gifts to the members of the company-bank (The Companies Ordinance, 1984). Actually, politicians are the potential law-makers. It is necessary for their independent law-making that companies are prohibited from political contributions. The capital of the company is *amānah* with the CG players, who are not allowed to misuse it, because this is against the Islamic principle of *amānah*. Further, gifts to the members of corporations are prohibited because these are paid at the cost of the shareholders.

As the power of handing over *amānah* is also *amānah*<sup>33</sup>, therefore, a person making negligence or misconduct in the appointment, terms of appointment, and removal of the CEO, means that he is violating his *amānah*, for which he needs to be accounted under the principle of *amānah*.<sup>34</sup>

The Board members and the officials involved in CG are restricted from entering into direct or indirect transactions with the companies to avoid conflict of interest situation. Because, on one hand, the officers are the employees of the company whereas on the other hand, they are party interested in the transaction, in which case they can compromise the interests of the company (for which they are *amīn*) over their personal interests. This compromising behavior of the officers will tantamount to betrayal in the *amānah*. Therefore, they are restricted from entering into such transaction to maintain their trust. If they are still interested, they have to disclose their interests to the BODs for approval. Default in disclosure of their interests (being their *amānah*) exposes them to punishment, which means that the provision is conforming to the principle of *amānah*.

On the basis of the foregoing arguments, it is opined that accounting the CG players in banking companies in Pakistan for their non-compliant acts suggests that the provisions are conforming to the principle of *amānah*. The accountability of the players for their actions verifies another Islamic principle, i.e., *mas'ūliyah*. However, such CG provisions are not found in the SGF with respect to non-Sharī'ah compliance, which means that no CG player is held liable and punished for non-compliance with the provisions of the SGF. This is a big flaw which has been discussed below in detail.

<sup>33</sup>The authors hold such view on the basis of the *ḥadīth* of the Holy Prophet Muhammad (PBUH), which is narrated from Ibn Abbas on the authority of al-Hakim that the Messenger (PBUH) said: "whosoever employs a person out of favoritism, when there is someone who is better than him, has committed a breach of trust with God, His Prophet (PBUH), and all Muslims" (Mundharī, 1986, p. 175).

<sup>34</sup>He who makes default in his *amānah* to appoint competent persons are held liable on the basis of the *ḥadīth* narrated from Abu Bakr al-Siddiq on the authority of al-Hakim that the Messenger (PBUH) said: "whosoever has been invested with the authority on any affairs of Muslims, but appoints over them someone out of favoritism, faces the curse of God. God will not accept him any ransom or compensation and will send him to hell" (Mundharī, 1986, p. 175).

## THE CHALLENGE OF ACCOUNTABILITY OF CG PLAYERS FOR SHARĪ‘AH NON-COMPLIANCE

The goal of good CG cannot be achieved without the accountability of the CG players. Being emerged as an alternative to conventional banks, the Islamic banks need to do businesses in conformity with the ethos of Islam (Ayub, 2007, p. 73). The SBP has issued the Sharī‘ah Governance Framework for the IBIs, but the problem with the framework is that it does not hold any CG player accountable for non-compliance of the provisions of the SGF. The State Bank of Pakistan (2015) only states that the board of directors shall be ultimately accountable for the Sharī‘ah non-compliance. But does not tell us to whom they are responsible, and to what extent. Whether they shall be removed, fined or imprisoned for any Sharī‘ah non-compliant actions or not is also a concern? Penalty can be imposed on the banking company in case of managerial-type non-compliance like not holding two joint meetings of the BODs and the Sharī‘ah Board, but the management is not accountable for Sharī‘ah non-compliance of transactions/banking business.

Similarly, the members of the SB are held accountable to some extent and removed from their offices, but the reason for their removal is not Sharī‘ah non-compliance or giving faulty Sharī‘ah opinions. Rather, they are removed under Section 3(ix) of the SGF for their non-compliance with the requirements of paragraph 3-to-6 of the FPT as annexed A to the SGF.

Likewise, each group head in the IBIs is held responsible to take necessary actions against those managers who do not comply with Sharī‘ah in his respective area. “Instances of Sharī‘ah non-compliance shall also have a strong bearing on their performance appraisals, promotions, increments, bonuses, etc.” The SGF provides Section 2(ii). But this check is not useful for two reasons: first, the group head himself does not generally have enough knowledge of Sharī‘ah to make analysis, whether the action of any employee working under his authority is in violation of any Islamic principle. And second, even if the group head comes to know about any particular action of the employee that is Sharī‘ah non-compliant, it is not clear that what appropriate action can be taken against the employee. So, in view of the authors, the issue of accountability for Sharī‘ah non-compliant actions needs to be taken more seriously, for which purpose it is suggested to frame strict rules for Sharī‘ah compliance ensuring proper punishments to those who cause non-compliances.

### CONCLUSION

For Islamic banks, the goal of Sharī‘ah compliance has been added to the conventional CG system. Without Sharī‘ah compliance, there is no rationale for the creation of IBs and it would be like “old wine in new bottles”. Therefore, in our opinion, if Islamic banks do not adhere to Islamic law, their existence as a separate entity would not be justified. Furthermore, the goal of Sharī‘ah compliance cannot be accomplished without appropriate governance system.

The authors conclude that the CG regime for Islamic banks in Pakistan includes such provisions which are related to ensuring competency of the CG players. So, these provisions conform to the *amānah* principle. However, there are certain issues. For example, Section 6

(ii) of the SGF requires that staff of the Internal Sharī'ah Audit needs to be adequately qualified and trained, but the Sharī'ah Governance Framework does not mention any eligibility criteria for these auditors.

Further, Section 7 of the SGF requires that the External Sharī'ah auditors need to have human resource and methodology for conducting external Sharī'ah audit, but it fails to give any qualification criteria for the external auditors, which is, in fact, a big concern as it can seriously undermine the IBs' performance. In this regard, the authors suggest that courses of *fiqh al-mu'āmalāt* in the perspective of modern nature of businesses need to be included in the basic qualification like CA/ICMA. The universities and training institutions like NIBAF also need to start specialized Sharī'ah audit degrees/certificate/courses. It is also suggested that proper degree in *fiqh al-mu'āmalāt* is required from some members of the audit firms to become eligible for the Sharī'ah audit.

Although the authors acknowledge that the SGF provides eligibility criteria for the members of the Sharī'ah Board like *Shahādat al-'ālamīyyah* from recognized board of *madāris*, or postgraduate degree in *Uṣūl al-dīn* or Islamic Jurisprudence from university, but holding a degree from *madāris* or even from universities is not ideal in the view of the authors because of two reasons. The scholar and the graduates will not be an expert in modern *fiqh al-mu'āmalāt* and its practical application. Similarly, degree-holder in Islamic jurisprudence is also not a suitable candidate for the post of Sharī'ah scholar because the Islamic jurisprudence is the field which does not directly deal with modern commercial transactions in Islamic perspective.

Alternatively, the authors suggest a mixed Sharī'ah Board having members from different backgrounds. For example, it is suggested that one-third (1/3) members of the Sharī'ah Board should be Ph.D. degree-holders with practical knowledge of conventional and Islamic banking and finance, whereas the other two-third (2/3) should hold *Shahādat al-'ālamīyyah* and LL.M. in Islamic Commercial Law, also having sound knowledge of modern finance, preferably with the proportion of 1/3 each.

The CG regime in Pakistan provides some provisions which hold the CG players liable and accountable for their non-compliances with the provisions of the Sharī'ah Governance Framework. For instance, directors are responsible for non-performance of their responsibilities and non-disclosure of their interests in the transactions of the banks. It implies that the principles of *amānah* and *mas'ūliyyah* are verified in these provisions of the regime. However, there are two problems. The first problem is that these are only few categories like disclosure in which the CG players are held liable, and other categories of non-compliance are not covered. The second problem is that no CG player is held liable for non-compliance with Sharī'ah. The BODs is ultimately held responsible and accountable for ensuring overall Sharī'ah-compliant environment inside Islamic banks, but their extent of accountability is not clear. Further, no provision has been made that any of the members of the BODs has sufficient knowledge of Islamic law of contracts. How can one be expected to ensure Sharī'ah compliance, while he/she does not have the knowledge of Sharī'ah? Therefore, the authors suggest that a provision may be added to include at least one member having dual experience and knowledge of finance and Islamic law of contracts in the board of directors

of the IBIs, who may be treated as independent Sharī‘ah director. In this way, the BODs shall be more effective in ensuring Sharī‘ah-compliant environment in the Islamic banks. The SGF, under its Section 2(iv), requires the management to arrange proper trainings for the BODs’ members. But it is not enough to fill the existing skill gap fully. It is hoped that the incorporation of recommendations of this paper would further strengthen the CG practices in Islamic banks.

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