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Appraising shariah committee operations in microfinance firms: PLS approach

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Abstract

Increased attention towards the role of the *Shariah* committee makes demands on processes in the boardroom. In Malaysia, even Islamic microfinance firms are experiencing the challenges of creating well functioning *Shariah* boards. This paper examines the importance of structures and processes in the *Sharia* committee boardroom of selected microfinance firms in Malaysia through survey perception of 63 participants. The objective is to determine the engagement and processes affecting the operations of *Shariah* committee in governing and promoting Islamic microfinance. The contribution of the paper explores the relationship between appraisal processes in the board and board performance. It also examines board policy structures that exist to maximize the *Shariah* board's monitoring performance. The analysis in the paper found that the current governance mechanisms as nurtured in the roles of *Shariah* committees for microfinance providers is modestly rated well as potentially effective. However, the *Shariah* committee is perceived by relevant stakeholders as lacking in combining Islamic knowledge with strategic demands facing IMF. There is also the need to evaluate information sources, and exercise power towards ensuring management accepts and implements its *Shariah* decisions. Hence, appraisal, policy change, monitoring of board processes and *Shariah* values are required in the governance mechanism.

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Keywords: Islamic governance, Monitoring, Microfinance, Shariah committee, Shariah values

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1. Introduction

Companies periodically review the performance of their key stakeholders – whether individual staff, business units, senior managers, credit customers or suppliers. But corporate boards usually escape such review. The Shariah boards of Islamic financial institutions are no exceptions in this circumstance. It is most likely that in a competitive market, a very important reason that necessitate periodic appraisal of board is that investors, donors and creditors will demand for quality board as an evaluation criterion for their continuous patronage. Therefore, appraising a company's board performance can clarify the individual and collective roles and responsibilities of its directors, and better knowledge of what is expected of them can help board become more effective (Conger, Finegold & Lawler, 1998). It is usually expected that after directors initiate board evaluation, their meetings went more smoothly by getting better information, acquiring greater influence, and get more attention to long-term corporate strategy.

If it is done properly, board appraisals may also improve the working relationship between a company's board and its management (Conger, Finegold & Lawler, 1998). This means that formal appraisals of the board as a whole, and in this case appraising shariah committee as an individual constituent board member, can help ensure a healthy balance of power between the board and the shariah committee. The changing roles and rewards for shariah committee create another compelling reason to review board monitoring performance regularly. Investors and other key participants understandably may want to know what they are getting for the cash rewards their microfinance firms are paying to the shariah committee.

It is important to note that in the governance structure of Islamic microfinance institutions, Shariah committee carries the responsibility of assuring partners that all products and services offered are within the permissibility of Islamic Shariah law. The committee achieves its functions through reviewing and overseeing all potential new product offerings, and making judgments on whether customer business requests are acceptable to the Islamic financial institution.

The need for Shariah compliance calls for a paradigm shift for integrated governance system with dual worldview. There is the need to explore on governance mechanism that directs and controls rights of all stakeholders on one hand, and one that places emphasis on moral values. Advocates perceive that value-free rules, standards, and policies have not yielded the desired outcomes. However, despite considerable interests and efforts on corporate governance by Islamic organizations, little is written on Islamic corporate governance structures (Ahmad, 2000; & AAOIFI, 2003). And, there is yet a unified terminology in Arabic language to represent the term corporate governance (Sourial, 2004). However, for both conventional and Islamic, to comprehend the meaning to a larger outreach of usage, Rashidah and Mohammad (2010) opine that corporate governance is about achieving business prosperity and ensuring accountability not only to shareholders but also to a larger group of stakeholders.

On the wave of these interests therefore, the major objective of this paper is to examine the covenants and processes affecting the operations of Shariah committees in promoting Islamic microfinance, based on Shariah values using survey questionnaire approach. The pertinent questions are: is Shariah committee a desired component of an Islamic governance system? How does board appraisal influence Shariah board monitoring performance? How does board policy change enhance the operations and effectiveness of the monitoring performance of Shariah committee?

2. Need for theory of Islamic governance

Until today, Muslim intellectuals have been unable to formalize an Islamic theory of governance or leadership (Saleh, 2011). The attempts made so far have been to prove that Islam had sufficient resources to formulate such a theory, and the weak complex of claiming that some of the Western achievements had been rooted in Islamic principles. To build up, Muslims have to present the features of an Islamic theory in which values and morals are the basis by aligning Islamic scholars' efforts to contemporary economic variables, material incentives (within Shari'ah limits), social philosophy of the Muslim society, its ethics and values (Saleh, 2011). Hence, the need to extend approach by integrating what is currently available with what is desirable. This can be achieved through discussions with practitioners and regulators, with emphasis on value-laden governance mechanism.

It is on the notion of the fear of Allah that corporate governance in Islamic perspective is to develop, with full recourse to Shariah moral values. Therefore, to be successful in a system of public or private governance, Alhabshi (2011) affirms that more than 1,400 years ago, Islam teaches us that we do not need only an effective leadership (president, boards, top executives, managers), but we also need a very co-operative set of followers (employees, equity holders, fund-beneficiaries, investors, clients, citizens). In other words, Islam is a package that requires dedicated commitment of all stakeholders. Hence, the need for governance reforms that can suit current practice for Islamic microfinance institutions. On the other hand the invocation of Shari'ah and the reflection of the taqwa-paradigm in business imply that the Islamic micro-firm business is no longer driven only by the principle of profit maximization, but also by the pursuit of the ultimate happiness in this life and the Hereafter, whereby he acknowledges his social and moral responsibility for the wellbeing of his fellow-men (e.g. consumers, employees, shareholders and local communities). It is therefore proposed that:

H1 Shariah committee appraisal factors - knowledge; spiritual values; experience; information; power; motivation and time significantly relate to board performance

H2 Board policy change on Shariah committee significantly relate to board performance

3. Methodology

3.1 Instrumentation and measurements

The survey questionnaire items for the construct had been adapted and in some instances developed. Though we have not seen any previous efforts that attempted to test similar Shariah constructs, based on the discussions, the content validity was deemed adequate. As a pre-test and piloting process, the research instrument was initially evaluated and discussed, which provide assessment of the content (face) validity of each item, as suggested by Rea and Parker (2005). Their suggestions during the questionnaire design and revision process helped ensure a close match between the pre-test and final version of the instrument. All the participants in the questionnaire pre-test were sufficiently knowledgeable about issues of relevance to the field of microfinance in Malaysia.

The questionnaire contained 18 sets of statements, and 10 for board monitoring performance, in addition to 4 demographic questions. Apart from the demographic questions, each of these sets of questions required a single response (tick as appropriate in the answer options 1-5) for each of a range of items. Each statement was rated by respondents on a range of measures scaled from 1 “strongly disagree” to 5 “strongly agree”. Greater scores mean higher level of constructs.

Despite the difficulty of accessing board members, this study was able to get responses with the help of committed insiders. Ideally, questions on board effectiveness should better be responded by the board themselves (Ingley & van der Walt, 2005). The participants (N = 63) as shown in Table 1 were few board members, and many top managers that proxy for boards of Ambank Islamic (19); TEKUN (29); Maybank Islamic (11); and Amanah Ikhtiar Malaysia (4). It is not surprising that 46% of the participants were from TEKUN because they are full Islamic microfinance institution with 194 branches compared to AIM’s 86, and they provide financial capital to poor and not-so-poor compared to the AIM’s poor and hard-core poor (Mokhtar, 2011). They are both largely sustained by Malaysian government.

Table 1. Organizational distribution.

		Frequency	%	Valid %	Cumulative %
Valid	AmbankIslamic	19	30.2	30.2	30.2
	TEKUN	29	46.0	46.0	76.2
	MaybankIslamic	11	17.5	17.5	93.7
	AIM	4	6.3	6.3	100
	Total	63	100	100	

In addition, of the 63 participants, 34 were female and 29 male. In the designated position of the participants, 2 CEOs; 20 Executive Directors; 6 Shariah board members and 35 “Others” responded. The “Others” could be

Independent directors, Non-Executive directors, and high-level managers (see Table 2). All the respondents rated themselves using 5-point Likert-Scale anchored by: 1 = strongly disagree, 2 = disagree, 3 = Indisposed, 4 = agree and 5 = strongly agree. The field operation of these variables is discussed below.

Table 2. Position.

		Frequency	%	Valid %	Cumulative %
Valid	CEO	2	3.2	3.2	3.2
	Executive Director	20	31.7	31.7	34.9
	Shariah Board Member	6	9.5	9.5	44.4
	Others	35	55.6	55.6	100
	Total	63	100	100	

4. Results and analysis

4.1 Measurement model

For the questionnaire survey data, the statistical multivariate analysis used for this paper is the Smart PLS-SEM because it presents a wide range of extensions that provide more nuanced composite analyses in multi group analysis technique, specific segment approaches and methods to empirically test the mode of the measurement models (Sarstedt & Ringle, 2010). First, we assessed the convergent validity and the reliability of the constructs as shown in Table 3 and Table 4 respectively. As a threshold, Tabachnick and Fidell (2001) cite 0.32 as a good rule of thumb for the minimum loading of an item, which equates to approximately 10% overlapping variance with the other items in that factor. A cross-loading item is an item that loads at 0.32 or higher on two or more factors. The researcher needs to decide whether a cross-loading item should be dropped from the analysis, which may be a good choice if there are several adequate to strong loaders (0.50 or better) on each factor. If there are several cross-loaders, the items may be poorly written or the a priori factor structure could be flawed (Costello & Osborne, 2005). A factor with fewer than three items is generally weak and unstable; five or more strongly loading items (0.50 or better) are desirable and indicate a solid factor. In this study, table 3 shows that all the cross-loading items (in bold) load at the range of 0.726 – 0.893 for board change policy; 0.704 – 0.900 for board appraisal; and 0.9382 – 0.9384 for board monitoring performance. In addition, other reports affirm that as a rule of thumb, construct validity are ascertained if the loadings are greater than 0.7; if composite reliability co-efficient is greater than 0.7; if average variance extracted is greater than 0.5; and if Cronbach alpha co-efficient exceeded the cut-off point of 0.7 (Hair et al., 2012).

Table 3. Cross-loadings.

	Cpolicy	Mont	appr
BCPInternalCntrl	**0.876339**	0.270774	-0.007882
BCPRegCompl	**0.893877**	0.423987	0.117546
BCPReputation	**0.726683**	0.268565	-0.349325
BCPShariaComp	**0.845788**	0.33152	0.095312
BChangSEIncent	**0.790193**	0.473637	-0.193394
BMontPerf1	0.520522	**0.98342**	-0.393131
BMontPerf2	0.363747	**0.983273**	-0.537222
Bappraisal10	-0.232148	-0.454497	**0.900304**
Bappraisal11	0.023919	-0.14272	**0.857063**
Bappraisal15	0.103518	-0.291316	**0.717046**
Bappraisal4	0.024729	-0.251748	**0.839928**
Bappraisal5	-0.028829	-0.235393	**0.853876**
Bappraisal6	0.08052	-0.166102	**0.876103**
Bappraisal7	-0.021453	-0.168394	**0.879716**
Bappraisal8	-0.116423	-0.641168	**0.704426**

Note: estimates in bold of each construct represent loads of cross-loading items

Factor loadings, variance extracted, average variance extracted (AVE) and construct reliability are some of the available ways to estimate the relative amount of convergent validity. In general, researches report at least one of the three models-based estimates of reliability: construct reliability, SMC or variance extracted (Bollen, 1989). In this paper, the results in table 4 indicated that the average variance extracted ratios for all the three latent constructs were all above the suggested 0.50, ranging from 0.686 to 0.966. In addition, table 4 shows detailed composite reliabilities for all the latent constructs. Interestingly, all the constructs generally exhibited high values that ranged from 0.916 to 0.9983. These results are greater than the acceptable threshold of 0.70, and also above the Cronbach's alpha correlation reliability estimates ranging from 0.886 to 0.965, which further confirmed the assertion that coefficient alpha understate reliability, as stated by Hair et al. (2010). These results statistically confirm that the validity for all the latent constructs were all high.

Table 4. Reliability and Validity of Constructs.

	AVE	Composite Reliability	R Square (R^2)	Cronbachs Alpha	Communality	Redundancy
Cpolicy	0.686963	0.916057		0.886144	0.686963	
Mont	0.96697	0.983208	0.397236	0.965842	0.96697	0.194506
Appr	0.69144	0.946806		0.945305	0.691438	

Note: R^2 = 0.397

Table 5. PLS Quality Criteria Latent Variable Correlations (Discriminant Validity).

	Cpolicy	Mont	appr
Cpolicy	**0.83**		
Mont	0.45	**0.98**	
appr	-0.07	-0.47	**0.83**

Note: Diagonals (in bold) represent the square roots of the average variance extracted while the other estimates represent the correlation

Secondly, in line with Fornell and Lacker (1981) recommendation, the study performed a discriminant validity of the construct, which suggest that the average variance shared between each construct and its measures should exceed the variance shared between the construct and other constructs (Fornell & Lacker, 1981). In this paper, as shown in table 5 above, the correlations for each construct is less than the square root of the average variance extracted suggesting adequate discriminant validity estimate of the construct (Hair et al., 2010).

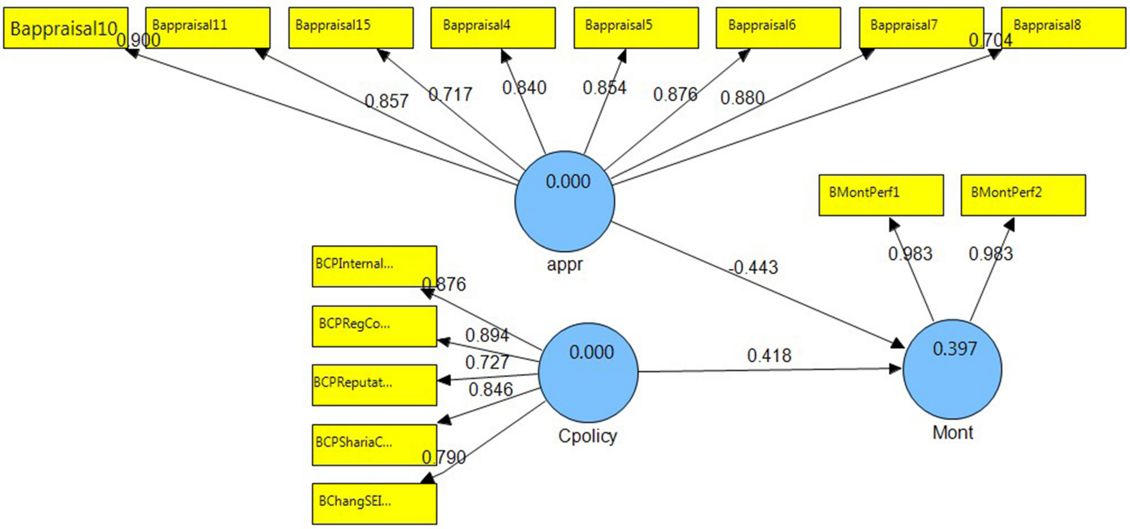

Fig. 1. Results of the structural model analysis.

The results of the structural model are presented in Table 6 and Figure 1. The R-square (R^2) value was 0.397, which suggests that the modeled variable can explain approximately 40% of the variance of board appraisal performance and board policy change (for example shariah compliance). In other words, within the overall model, the estimates of the structural coefficients provide the basis for testing the proposed hypothesis. As expected, board change shariah policy and shariah board appraisal factors are significantly related to shariah board monitoring performance, thus supporting the proposed hypothesis. In other words, the regression weights for the two independent variables in the prediction of shariah board monitoring performance is significantly different from zero at 1% level as shown in table 6 above (0.397). In other words, both relationships show strong path (0.417 and 0.442), and T statistics of 3.955 and 3.067 respectively. Hence, statistically significant, and the hypothesis is supported. In addition, the table confirms the statistical significance of all the 15 measures of the stakeholder model.

Table 6. Path Coefficients (Mean, STDEV, T-Values, and P-Values).

Relations	Beta Original Sample (O)	Standard Error (STERR)	T Statistics (|O/STERR|)	P-Value	Findings
Cpolicy -> Mont	0.417758	0.105625	3.95509**	0.000199	Supported
appr -> Mont	-0.442658	0.144995	3.052908**	0.003336	Supported

Note: **p < 0.01

5. Discussion and conclusions

This quantitative survey perception study investigates the influence of Shariah board appraisal and board policy change on Shariah board monitoring performance in Malaysian Islamic microfinance institutions. In effect, the paper has described the covenants and processes affecting the operations of Shariah committees in promoting Islamic microfinance, based on Shariah values. The results of the study provided empirical support for the influence of Shariah board appraisal and Shariah board monitoring performance shows that Shariah committee improves organizational governance of Islamic microfinance institutions in Malaysia. Hence, the committee is an important and indispensable component of an Islamic governance system. The study empirically describes governance mechanisms being practiced by microfinance providers and the impact Shariah committees have had in the Malaysian micro-enterprise market. The roles of the Shariah committees have been partially assessed. The current operations were then examined by obtaining evidence of the Shariah committees' impact on microfinance providers and the relevant stakeholders' perceptions of the effectiveness of the governance mechanisms were ascertained. Based on the study findings, it is obvious that the relationship between the potential effectiveness of the Shariah committee and the extent to which the Shariah committee positively impacts upon the microfinance providers in Malaysia, in terms of periodic appraisal of the committee as reported by relevant market participant stakeholders is now considered.

From one extreme limit to the other, this study primarily suggests there is partial comparison between the potential effectiveness of the governance structure as nurtured by the Shariah committees and its effectiveness, as perceived by the respondents. The governance structure and Shariah committees' composition and activities comply with the regulator's (Bank Negara) guidelines on microfinance to a very large extent (for example regarding qualification, size, fatwas, meetings and scope of operations).

Therefore, when considering the perceptions of the stakeholders, the reported criticism of the Shariah committee reflects lack of independence due to the financial remuneration benefits on one hand and lack of sufficient knowledge to pass fatwa on contemporary business muamalat on the other. This could be strong factors limiting the effectiveness of the Shariah committees and by extension the overall governance mechanisms of Islamic microfinance providers. These parallels suggest that thorough Islamic regulations that establish the ancient classical shura committee (currently referred as Shariah committee) and their activities in compliance with the recommendations of Imam Abu Yusuf, Qardawi and other renowned scholars may well be addressed the perceived weaknesses within current Shariah committees' operations.

Though very scarce in the market, but Sharia scholars with expertise in both religious and conventional law are undoubtedly key to this growth. Muslim investors may not buy instruments without believing they are religiously acceptable, so most wholly Islamic financial firms have their own board of Sharia scholars which certifies products and monitors the firm's business. The 'independent' Sharia boards that exist, offering their services to financial firms for a price could be caught up in conflicts of interests. According to a report of Islamic finance center (2012), there are over 400 Sharia scholars worldwide but only around 15 to 20 prominent and experienced ones, which create demand for scholars to sit on multiple boards. The top 20 scholars hold 14 to 85 positions each, occupying a total of around 620 board positions or 55 per cent of the industry.

The shortage of scholars is a capacity constraint for the industry, said Sheikh Muddassir Siddiqui, a Sharia scholar and Harvard-trained attorney at law firm SNR Denton. He is a member of the Sharia standards committee of (AAOIFI). The capacity problem is worsened by the fact there is no single, universally accepted interpretation of religious principles. So firms seek out the scholars who they think will carry the most weight with investors; in effect, a scholar's reputation becomes a currency used in completing a deal.

"The reason the Islamic finance industry is still emerging is that governance standards are not as well established as in other industries," said Murat Ünal, CEO of Funds@Work. If you have a prominent scholar on board, this increases trust and makes up for the lack of governance standards. Institutions sell their products via the reputation of the scholars, so Islamic institutions make sure they have accepted scholars on board." Sheikh Hussein and other scholars strongly reject the idea that there is anything improper in the fee system. "We're just like auditors, lawyers. Each one of us has years and years of experience in Sharia law. We do our job and get paid for it. Nobody is allowed to question our honor, integrity and truthfulness." Nevertheless, the system is open to accusations of conflict of interest because scholars head or sit on the boards of the industry's standard-setting bodies, such as AAOIFI, at the same time as they are being paid handsomely by the firms which are being regulated.

As a complete way of life, Islam emphasizes on transparency and fairness in muamalat. Good moral values lead towards participatory discipline through excellent leadership. The motivation to provide only Shariah approved sources of financing is great incentive to guide Islamic finance towards success, and this is fundamental for governance. As Muslims, moral values to govern financial institutions should be sacred. So many things are involved in moral values. Interestingly, even conventional banks insist on ethical values. Definitely, any organization needs good governance to succeed. Therefore, it is in the interests of market participants and non-contractual stakeholders to have in place mechanism that will achieve good governance based on spiritual ethical values. However, it is not easy to know if one has good morals or not. There are lots of reservations on the sincerity and even competence of the so-called Shariah advisory committee. "You cannot give what you don't have". If Islamic firms can truly be governed by spiritual values, then good outcome will be expected. However, it is difficult to determine who possess strong Taqwa (faith) because this complements the hadith reported by Caliph Umar, that the prophet said "Attaqwa Haahuna" (faith is in the heart).

As an exploratory study, generalization of these findings may be debatable because the evidence reported is specific only to the perceptions of few stakeholders. Lack of access to all of the Shariah committees' stakeholders and board members lead to our inability to explore the issues in greater depth and our findings are unlikely to be as comprehensive as they could have been if we had surveyed all Shariah committee members and other top board members. Hence, wider coverage of top board and Shariah committee members would have allowed for generalization and more beneficial in establishing the actual effectiveness of the Shariah committee using internal processes. Moreover, assessments of effectiveness are inherently subjective especially using regulator's guidelines and IMFIs' own trust deeds. Further studies may attempt to reconcile what relative weightings might be given to individual criteria when appraising and assessing overall governance and Shariah effectiveness.

Finally, longitudinal studies could help provide additional evidence about how historical events may shape Shariah committee and governance operations more as Qardul-Hasan than micro-credit. Another limitation is, although the study claims using an ideal classical governance framework of the Islamic caliphates and current guidelines as benchmarks, in-depth provision of the framework needs to be provided. Future researchers with better Arabic background could read through the literature and explain in details the best way to appraise sharia committee. As a first attempt, no conclusion can be reached.

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