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Special Future: Malaysian Practice of the Islamic Economy at a Crossroads: Issues and Challenges

Editors' Preface

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This special issue is a volume that features conceptual and empirical studies on the Islamic economy, an economic system that promotes sustainable and inclusive approach for growth and development based on principles of Islam. The Southeast Asian practice of the Islamic economy has been key to the rapid growth of the industries such an Islamic finance and *halal* products in the first decade of the twenty-first century. Malaysia, in particular, has established itself as a global hub for the Islamic economy. Therefore, Malaysia is widely seen as a symbol of the development of the Islamic economy. This special focuses on the Malaysian practice of the Islamic economy, and tries to clarify what the practice has achieved and what is to be solved for the universalization of the Islamic economy. For Muslim researchers, studying Islamic economics and finance applications is seems like a natural option, which is seen as an avenue for the contribution to the advancement of the society. While, researchers examining the Islamic economic issues and application in non-Muslim majority community may go extra miles to get the research findings instigated in the community. Thus, a conscious effort is due for the discussions and applications on the Islamic economy to be identified and promoted as a universal solution to humanity. The values are founded on the basic tenets that economics undertakings are the manifestation of a belief system that is applies the universality of noble values founded on the unity of the creator. The system promotes sustainable and inclusive approach for growth and development; the qualities could be extended for common good, not limiting to applications by Muslims. Islamic economics, finance and banking practices in Malaysia have been adopted within the conventional and Islamic finance system that runs in parallel. Islamic economists in Malaysia, thus has always studied the Islamic economy with considering such a universal perspective.

Kosugi (2015), on this front has been promoting the universalization of the Islamic economic applications to the community as an alternative to the western's capitalism. In his keynote address in 6th International Symposium on Islam, Civilization, and Science (ISICAS) 2015, he talked about embracing *halal* life movement, as western civilization model has not worked well, which has created a long lists of negative externalities; global warming, ecological destruction, unequal wealth distribution, excessive expansion of uncontrolled financial markets

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far larger than the real economy, displacement of local businesses, among others.

In order to conceptualize and provide avenue for inspiration and stimulations, conceptual and empirical examinations in the Islamic economy are presented in this issue based on several case studies in Malaysia. The papers in this issue are categorized into several themes, namely: Islamic social finance, Islamic banking and *takaful* and Islamic capital market.

A few aspects on Islamic social finance were examined. Rose Ruziana Samad and Zurina Shafii discussed the underpinning theories for Islamic good governance in cooperatives, in order to build a case for the importance of the development of an alternative sharing economy, centered on the spirit of cooperation of the members in the established socio-economic establishment. This conceptual paper discusses Islamic good governance aspects. To cater for the unique governance needs of *Shari'a*-compliant cooperatives, the authors proposes that Islamic good governance model for cooperatives to feature the western theories discussed, namely agency theory, stewardship theory, stakeholder theory and institutional theory, integrated with Islamic principles of *tawhid*, *ta'awun* and *shura*.

Cooperatives are built on the spirit of co-operators as being responsible to manage the responsibilities as a vicegerent to Allah. This calls for co-operators to discharge their responsibilities in the most effective manner as vicegerent to Allah SWT, they are the believer that accountability is answerable in the world as well as in the hereafter. Internalized values brought by the element of *tawhid* serve as a check and balance mechanism to making sure that co-operators are performing *amana* in the most observant manner.

The authors too highlight that consultative governance, is being adopted in the governance of institutions by the Board members collectively make decisions upon hearing out the needs of the management of cooperatives. *Shura*, or Islamic consultative concept extends the concept of collective decision making to reflect divine guidance brought about by *Shari'a*. Board members and *Shari'a* advisors are deliberating amongst them on issues taking into account *Shari'a* requirements. *Ta'awun* or mutual assistance forms the foundation for Islamic cooperatives as cooperatives operate on the basis of mutually assisting the members of the cooperative in question to focus on equality, equity via members economic participation, solidarity and self-responsibility. The paper proposes an Islamic good governance framework as a takeaway for policymakers and practitioners to manage this alternative model of economic system that thrives on community based resources sharing, rather than focusing on shareholders' interest maximization.

Nurul Aini Muhamed and her co-authors work on the framework for Islamic social enterprise (ISE), by conducting qualitative research to explore three aspects of ISEs management practices; governance, financial management, and distribution of income. Their study is driven by the potential of Islamic social enterprises to contribute to the economic growth. They argue that the roles of the third economic sector are important to reduce the gap between the poor and the rich, and to support government initiatives to provide extensive facilities to the community. It is reported that 40 percent of Organisation of Islamic Cooperation (OIC) countries' population earn under the poverty line (SESRIC 2012). The third economic sector can increase the opportunity for the poor to access education and skills, consumption, property ownership, and self-mobilization (Obaidullah and Muhamed, 2016).

With a limited number of ISEs in comparison with other Islamic charitable institutions and social enterprise (SE), not much is known about the governance, financial, and income distribution of ISE. Due to ISEs different features and the reasons for the establishment, not much is known on the existing models of ISE's operations worldwide that can sustain their existence. This paper aims to explore the operation of ISE in Malaysia in three aspects; governance, financial management, and distribution of income.

Their study adopts case study methodology on ISE's monitoring and management on two ISEs; an international-based non-profit organization and an ISE owned by local-based non-profit organization. Semi-structure interviews are conducted with the manager and head director of the ISEs. The result of the study found that, it was found that both ISEs operations are in an organized system with some differences in the aspect of governance, financial management and distribution of revenues. In terms of governance, the two ISEs viewed governance as an important mechanism in ensuring the organizations do not divert from their objectives. In addition, both institutions placed importance on financial management to ensure the financial sustainability of the ISE. Distribution of income for both ISEs depends on the ISE's objectives of establishment; however, the ultimate aims of ISE establishment are to fulfill the society's needs. The study too, provides indication that *maqasid Shari'a* as well as the stakeholders' assentation are in line with ISE's practices. This paper suggests that the management to provide some room to ISE to perform their task independently in order for them to grow.

Studies on Islamic banking and *takaful* features works on *Shari'a* governance and assurance. Nurazalia Zakaria and co-authors investigates the concept of internal *Shari'a* audit effectiveness (ISAE) and its possible determinants by reviewing regulations (i.e. internal auditing framework and the *Shari'a* governance framework, SGF) and past literature in internal audit effectiveness (IAE) and ISA in Islamic financial institutions (IFIs). According to the authors, the series of failures of governance and audit in IFIs at the global scale calls for an examination on the factors that contribute to the effectiveness of *Shari'a* audit as the independent lines of defense that ensures *Shari'a* compliance.

Internal *Shari'a* Audit (ISA) practice assist the *Shari'a* Committee providing an independent assurance that operations of IFIs are *Shari'a* compliant. Such a requirement is timely as the Islamic banking assets and *takaful* operators' net contribution has shown tremendous increase over the past couple of years. For instance, in year 2013, the Islamic banking assets in Malaysia amounted to USD140 billion and it is expected to increase to more than USD392 billion by year 2018 with compounded annual growth rate of 21 percent (Ernst & Young, 2013).

They highlighted a set of determinants for the effectiveness of ISA. The determinants include top management support, organizational independence and objectivity and performance of ISA process and activities as per Bank Negara Malaysia (BNM)'s SGF and IIA (Institute of Internal Auditors Malaysia) standards. These determinants and ISAE are interrelated in a value chain. ISAE can only be achieved by IFIs instituting an organizational structure that support independent ISA departments/units, providing adequate resources in terms of funds and capable manpower for effective performance of ISA. As a consequent of sufficient funds for its operation, internal *Shari'a* auditors would be able to perform effective audit based on *Shari'a*-related knowledge and skills to perform *Shari'a* risk-based audit.

Noor Aimi Mohamad Puad and co-authors, on the other hand, explores how *takaful* operators' undergo the *Shari'a* audit planning process, by conducting series of interviews with auditors in three *takaful* institutions. The general questions focused on how the auditor conducted the planning process and the challenges faced by the auditors.

They are motivated to dig deeper on *Shari'a* audit planning process as audit planning has become a major activity performed by auditors in order to achieve the effectiveness of the audit report, gain audit performance, and enhance audit success. The audit planning is designed to allow the auditor to conduct and evaluate business risks and develop a specific audit program and scope to test in the audit process. The auditors with greater audit planning are likely to generate more efficient audits that encourage them to maintain the competitive audit planning that could be significant to ensure the audit's efficiency, excellence and effectiveness (Ratanasongtham and Ussahawanitchakit, 2015).

Shari'a audit would be effective with proper planning. *Shari'a* audit planning is necessary to ensure that the audit will be performed in an effective manner, while helping them to keep the audit cost-reasonable. Audit planning serves as terms of reference amongst the parties in the audit exercise and will be referred in cases of misunderstanding with the clients (Shafii *et al.*, 2015).

Their study found that the *Shari'a* auditing process was conducted by replicating the conventional framework due to the unavailability of a specific *Shari'a* audit model. Hence, the *takaful* operators tend to have a restrictive focus on the financial audit whereas *Shari'a* audit should have a wider scope to cover. Most of the *takaful* operators in Malaysia are currently practicing combined audit. As the consequences, *Shari'a* audit is not done thoroughly as the audit focuses on operational issues and the *Shari'a* scope is performed only when *Shari'a* issues arise, and not comprehensively on measures of internal control within the *takaful* institutions. Another significant finding is the lack of communication between

Shari'a committee members and *Shari'a* auditors. They found that most of the auditors table their annual *Shari'a* audit planning to the Board of audit committee and then only the auditor will notify the plan to the *Shari'a* committee. When this happens, the *Shari'a* committee members has limited role to deliberate on the plan as it has been approved by the board of audit committee.

They also learned that the issue of competency of *Shari'a* auditor is a challenge faced by the industry. In order to have a competent *Shari'a* auditor, the auditor must have an integrated background between *Shari'a* knowledge and accounting/finance knowledge. *Shari'a* auditors without the *Shari'a* background will face the problem of finding *Shari'a*-related risk issues when performing the audit and thus leading to the possibility of understating the identification and analysis of *Shari'a* non-compliant risk. On the other hand, an auditor without accounting/finance background might not be able to perform the duty diligently as they do not have the skills of auditing. The best solution is to have an auditor with an integrated background or the team of auditor with an integrated background.

The analysis of the study is important in enhancing the current planning process and the *Shari'a* audit process as a whole. This study emphasizes the planning process and covers only the *takaful* industry. Future researches could seek to examine the whole *Shari'a* auditing process starting from the planning stage until the reporting stage and select different case studies with different characteristics. Future research could also evaluate the effectiveness of audit practice in the finance industry especially the insurance industry.

Sabri Embi and Zurina Shafii focused their study on risk management, another essential *Shari'a* governance function. Specifically, the study aims to investigate the level of the variables of understanding risk and risk management (URRM), risk identification (RI), risk assessment and analysis (RAA), risk monitoring (RM), credit risk analysis (CRA), and the risk management practices (RMPs).

The universe of the study consists of 16 full-fledged commercial Islamic banks situated in Kuala Lumpur, Malaysia. The target population includes all the officers in the head office of the banks. The samples comprise the officers from the first-line, second-line, and third-line of defenses such as the operation officers, risk officers, *Shari'a* officers, compliance officers, legal officers, internal auditors, and members of the various committees related to risk management. A total of 450 survey self-administered questionnaires were distributed to the targeted respondents through delivery and collection method.

The results of the study indicate that Islamic banks in Malaysia are perceived to have high levels of RMPs, URRM, RI, RAA, RM, and CRA. Overall, the banks are effective in their risk management practices. Thus, research objective one is answered. In addition, they found that URRM, RI, RAA, RM, and CRA as a group significantly impact the RMPs of the banks. Further, they established that URRM, RI, RAA, RM, and CRA individually have a significant influence on the RMPs of the banks. Finally, they found that RM emerges as the most influential variable that affects the RMPs of the banks, followed by RAA, RI, CRA, and URRM.

Their study proposes several theoretical contributions in expanding the body of knowledge in the area of risk management in Islamic banking field by providing a substantive understanding of the level of various variables and also the relationships between the variables in the context of Malaysia. Specifically, the theoretical contribution includes establishing the effect of URRM, RI, RAA, RM, and CRA on the risk management practices (RMPs) and in providing the empirical evidence of the importance of the various variables. They authors highlighted that the Islamic banking practitioners should place the most attention on the risk monitoring as this is the most influential variable that affects the risk management practices of the banks, followed by risk assessment and analysis, risk identification, credit risk analysis, and understanding risk and risk management. Understanding the unique types of risk facing the Islamic banks should lead to the development of special risk management techniques and monitoring procedures that are suitable for those risks.

For Islamic capital market, Ahmad Zainal Abidin and co-authors examines the *Shari'a* assurance for the industry. They discussed that laws in Malaysia do not require the Islamic capital market (ICM) to establish the *Shari'a* governance and compliance functions. The *Shari'a* compliance status of listed securities in Bursa Malaysia is screened by the regulator using its qualitative and quantitative screening. However, it is deemed that every company in ICM should carry out their activities in accordance with the principles of *Shari'a*, at all times. Thus, it is imperative to have a proper *Shari'a* audit function. They argued that it is essential to have a comprehensive, robust and well-functioning *Shari'a* control system to ensure that *Shari'a* is upheld at all times. It implies that there is a need to study external and internal control mechanisms practiced by the regulator and the companies with *Shari'a* compliant securities to ensure its *Shari'a* compliant status.

For that, they proposed the external-internal control framework to strengthen the governance and audit for the market. This study provides preliminary information on the area to be explored, especially within the empirical sphere, towards the evaluation of the current internal control practices of the companies with *Shari'a* compliant securities to ensure compliance with *Shari'a*.

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