



Governance for Takaful Operators (Islamic Insurance Companies)

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Abstract: The article reviews past literature on the governance aspect of takaful operators. This aspect has been given limited attention in literature on Islamic finance compared to other components such as Islamic banking and Islamic capital market. Therefore, major articles concerning governance issues of takaful operators are discussed and special consideration has been given to the UK Stewardship Code and the Malaysian Rating Corporation (MARC) guidelines for Islamic financial institutions. Interestingly, this article suggests that the Malaysian Rating Corporation (MARC) guidelines for Islamic financial institutions and the UK Stewardship Code should be used as references in order to develop dedicated stewardship guideline for Islamic financial institutions like takaful operators. The stewardship theory is compatible with the Islamic notion of al-falah. Therefore, by having specific stewardship guidelines for the takaful operators it can further encourage policyholders' engagement with the takaful operators' management. Last but not least, this article contributes to discussion in this area especially on the possibility of having a set of stewardship guidelines for the Islamic financial institutions (IFIs) such as takaful operators.

Keywords: Takaful, Corporate governance, Stewardship, Islamic insurance, Takaful governance

JEL Classification: G1, G2, P4

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© Research Center for Islamic Economics
DOI: 10.26414/A094
TUJISE, 8(1), 2021, 35-58
tujise.org



Submitted: 12.06.2019
Revised: 14.04.2020
Accepted: 28.05.2020
Online First: 30.08.2020



Introduction

The governance structure of *takaful* operators is unique due to the presence of two principals which are; the shareholders and the *takaful* participants. Therefore, this begets a suitable governance structure that can accommodate these two important groups. Nevertheless, limited discussion is directed towards this topic especially with regards to *takaful* operators. This is not surprising due to the nature of the industry which is seen by many as a saturated sector and less interesting compared to the other sectors in the Islamic financial system such as Islamic banking and Islamic capital market. Accordingly, this paper gathers and discusses the relevant articles from various scholars on the governance structure of *takaful* operators for reference and critical analysis.

The paper starts with reviewing different forms of governance for *takaful* operators based on the governance theories and models which influence the *takaful* operators, followed by a review on the governance components of Islamic financial institutions (IFIs) such as *takaful* operators and a discussion on the Stewardship Code of the United Kingdom with special reference to *takaful* situation. Next, the importance of appropriate governance structure capable to influence the company's social performance is presented followed by conclusion.

Governance Models for *Takaful* Operators

Tricker (2012) argues that beginning in the 19th century, most of the corporations, particularly in England and other European countries were formed either as sole proprietorships, partnerships or unincorporated bodies (with the presence of sleeping partners) apart from corporations formed by the monarch or the state. During the same period, the corporations in the Muslim world, notably in the Ottoman Empire, were mostly in the forms of sole proprietorships and partnerships – the difference is in terms of the number of partners. The former pooled resources from partners, as many as or more than 100 (Kuran, 2012; Tricker, 2012), while the latter was predominantly between two partners, although in some cases had up to 21 people (Kuran, 2012). Thus, it is not strange that the development of corporations in Europe paved the way for modern corporation models and governance standards. This innovation contributed to rapid economic development since businesses were thriving because of easier access to capital than before. However, it has raised debates on the way corporations should be managed prudently. Several theories have influenced the development of corporate governance standards and practices from then until now.

Agency Theory (AT)

The earliest theory on governance was agency theory (AT) which is also known as principal-agent theory. The agency theory invokes the principle that a corporation is characterized by the relationship between the owner of the firm or principal, and the director or agent. The interests of these parties converge as set out in a contract signed between them. The AT emphasises the ownership structure of the firm and the implications of such structure on the relationship between the principal and agent (Jensen & Meckling, 1976). In other words, it views the interaction between principal and agent from the lens of conflict as a result of the mismatch of expectations between the two parties due to the potential for self-interest maximization on the part of the agent. This potential problem had been postulated earlier by Adam Smith, in his *Wealth of Nations* (cited in Tricker, 2012); “the directors of companies, being managers of other people’s money, cannot be expected to watch it over with the same vigilance with which they watch over their own”.

Therefore, in order to control such conflict, attractive compensation schemes and governance tools in the forms of board of directors and audit processes are in place in most modern corporations (Fama, 1980; Fama & Jensen, 1983). Arguably, AT may be criticized on several fronts. Demb and Neubauer (1992) and, Haniffa and Cooke (2002) mention that the agent’s behaviour is beyond the contractual relationship as it encompasses interpersonal behaviour, group dynamics and is subject to local government’s queries. From another perspective, Muth and Donaldson (1998) explain that a firm’s performance does not necessarily improve with increased compliance and conformance towards additional rigorous governance standards, but on the contrary, it can produce negative outcomes. Furthermore, Tricker (2012) argues that in a modern economy as reflected in the financial sector, the chain of agents becomes long due to the multiple layers of investment and business ventures which make the monitoring process challenging. Moreover, he also questions the AT premise which assumes people to be self-interested and self-centred without having any altruistic traits.

Stakeholder Theory (StT)

Stakeholder theory (StT) attempts to provide an alternative perspective to agency theory in determining the relationships between parties in an organization as proposed in the StT, and the parties outside the organization. Donaldson and Davis (1991) propose that any party which influences or has been influenced by the accomplishment of a firm’s objectives should be included as a stakeholder – a foundational axiom of StT. The broad stakeholders’ definition by Donaldson and Davis

(1991), has been narrowed down and focuses on three important traits, before any party can be considered as relevant stakeholder. The party should have these qualifications: legitimacy, power, and urgency as perceived by managers as capable of influencing a firm's operation.

One of the main differences between this theory and self-centred agency theory is that it includes a societal purpose as well. This altruistic trait of StT is noticeable in the form of the community as one of the firm's main stakeholders. In other words, the theory promotes corporate social responsibility which is given proper consideration whenever the firm develops and executes its strategic business plan.

Nevertheless, this theory has also received substantial criticism. One of the criticisms which this theory still struggles to explain is who is/are the stakeholders and how to treat every stakeholder equally, without having conflicts of interest (Freeman, 1994; Mitchell, Agle & Wood, 1997). The debate still continues in spite of proposals by researchers such as those by Mitchell, Agle and Wood (1997) about the nature of stakeholders. Moreover, in reality, selective decisions by firms when managing its range of stakeholders are common and the tendency is to respond to the needs of immediate stakeholders.

To put it differently, management approaches are likely to benefit a limited set of stakeholders only (Phillips, Freeman & Wicks, 2003; Barkemeyer, 2009), who are closer to management and capable of influencing the firm's business operations (Mitchell, Agle & Wood, 1997). As a strong advocate of StT, Freeman (1994) even suggested some areas which were due for consideration when reforming corporate laws, and by doing so, stakeholder's interest would be protected. Chapra and Ahmed (2002), and Hasan (2009) argue that StT requires a well-functioning competitive market and proper legal framework to ensure that every stakeholder is covered.

Stewardship Theory (ST)

Stewardship theory (ST) emphasises the fiduciary duty of directors to act in the best interests of principals (Donaldson & Davis, 1991). Tricker (2012) argues that ST's main principle is actually to reaffirm the role of directors as prescribed in classical corporate governance – accountability to shareholders and not themselves.

ST recognizes the capability of directors as agents to act responsibly towards their principals and not be motivated by their own interests and desires. Moreover, the case of a collusion of interests between the two parties, being stewards to the company makes the directors able to put the principals' interest at priority

compared to their own, for the reason that the organization's success will benefit everybody associated with the firm – including them (Davis, Schoorman & Donaldson, 1997).

Interestingly, ST accentuates the financial and societal objectives which the firm needs to strive for (McCuddy & Pirie, 2007). These may be termed as secular and spiritual missions which resonate with the *takaful* operators' *raison d'être* – an alternative insurance system for the Muslims based on Islam's religious tenets. Karns (2011) suggests that profit generated from the business operation is compatible with the classical business objective of maximizing shareholders' wealth. The profit is important for the firm's business survival and to enable the firm to continue serving the community.

Criticism towards ST is mainly based on the incapability of the theory to explain how it can enhance the progress of a business and deal with problems of scale such as the intricacies arising as a result of remote shareholders and the presence of corporate laws to protect these parties' interests (Tricker, 2012). Repeated corporate scandals all over the world are reflective of the inability of the directors in being responsible stewards to firms. Thus, these issues signify that ST precepts, mostly normative, are unable to predict specific business behaviour and corporate performance, although some scholars have rebuffed this claim by invoking empirical findings on corporate performance and stewardship attributes such as Donaldson and Davis (1991); Pirie and McCuddy (2007); and McCuddy and Pirie (2009), amongst others.

The Financial Reporting Council (FRC) of the United Kingdom recognizes this aspect of business with the formulation of a UK Stewardship Code. It espouses active participation of the principals in the firms' operations and further strengthens management's focus by placing principals' interests over their own. In the next section, further discussion about the compatibility of stewardship precepts with the Islamic concept of good governance is presented.

An outline of the three dominant corporate governance theories has been given, and clearly, each theory is built upon its own axioms, and views the firms' practices from various perspectives. Davis, Schoorman and Donaldson (1997) have suggested a reconciliation of each theory with the others in order to derive best practices from it. McCuddy and Pirie (2009) propose an amalgamation of the governance models which exhibit features of the theories discussed above for catering the firms' financial and societal needs.

The discussed corporate governance theories are essential for assessing two main corporate governance models, the Continental European and Anglo-Saxon

models. These two governance models along with the corporate governance theories provide the necessary elements which blend together in order to derive the Islamic governance model. This religio-secular governance model is pertinent as it dictates IFIs behaviours such as those of takaful operators.

Governance Models

Continental European Two-tier Governance Model

This model is also referred to as a stakeholder governance model due to the high involvement of external parties recognized as stakeholders in the firm's operations (Lewis, 2005; Hasan, 2009; Tricker, 2009; 2012). As the name implies, it reflects the strong influence of stakeholder theory in terms of the relationship between the constituents in the firms' governance aspect. The company's survival is seen as more important than the returns from the business operation. It also encompasses the survivability of the company which is a consideration for all stakeholders and not exclusive to the management and principal of the company alone (Schneider-Lenné, 1993; Lewis, 2005).

It is interesting to note that Tricker (2009) emphasises the placement of the social component in this governance model, which Lewis (2005) further describes as a "triple bottom line agenda" – social obligations in the forms of economic, social and environmental dimensions. In addition, Hasan (2009) and Tricker (2012) characterize another important trait in this governance model, which is the influence of banks in corporate affairs due to the heavy use of bank loans to finance the companies, thus making them one of the most important stakeholders. This active participation by banks is noticeable particularly in Germany, where Schneider-Lenné (1993) describes it as long-term ownership holding in the firms by the banks.

The two-tier supervisory boards as adopted in this model enable mutual cross-examination. One executive board is responsible for a firm's business operations while the other supervisory board, whose members are non-executive directors, is responsible for, amongst other things: selecting and appointing members for the executive board; determining executive board remuneration; and reviewing major business decisions.

The Anglo-Saxon Governance Model

This model takes most of the principles from agency theory. Tricker (2012) explains that throughout Commonwealth countries, the underlying precepts for this model are similar, albeit with some differences due to the local contexts. The precepts are

exemplified by the presence of independent non-executive directors, audit process, remuneration and nomination committees, and the separation of roles between the CEO and chairman. It depends more on the self-evaluation by the companies against the prescribed governance standards which will enable stakeholders to assess the audit information. Inability to meet the standards will cause a setback to a company's corporate image, loss of current and potential customers and investors, and for listed companies a consequence will be fines and delisting from the bourse.

The difference between governance style in the UK and US is that the former is influenced by a base of principles while the latter influenced by a base of rules. The difference is reflected by the fact that more litigation cases are filed in the US compared to the UK due to stringent US governance requirements in the form of statutes (Tricker, 2012; Vakkur & Herrera, 2013). CSR in this governance model is seen as a voluntary aspect for the companies, although over the years it has gained more attention from the management.

Governance Models under Islam

Much has been discussed about suitable governance models which are compatible with the Islamic tenets parallel with the rapid development of the Islamic financial sector worldwide. Islamic financial institutions (IFIs) are required to observe governance models which are not only transparent and capable of safeguarding the stakeholders' interests but also promote the religious tenets relevant to their commercial activities.

The Islamic governance model derives its precepts from the primary and secondary sources of *shariah* like any Islamic views on human activities. Lewis (2005) indicates that certain religious texts provide or become guidelines for the IFIs governance standards but some of the religious injunctions also have a practical impact on IFIs' business operations such as the requirement for zakat and the prohibition of *riba*. Karbhari, Muye, Hassan, and Elnahass (2018) describe that adhering to the conventional (Anglo-Saxon) governance standard is already challenging due to the potential of agency problems; however, governance in the context of IFIs is more challenging since the firms need to strike a balance between the dual governance layers (conventional governance standards as well as *shariah* governance framework). The Islamic governance model is, in reality, influenced by the three dominant governance theories which have been discussed earlier: agency; stakeholder and stewardship theories – with special reference to *shariah* requirements. The Anglo-Saxon governance model, whose principles are influenced mostly by agency theory, is seen as incompatible, to some extent, with the IFIs, as described

by Choudhury and Hoque (2006) and Safieddine (2009), due to the nature of IFIs' business operations which have to comply with the religious tenets and the laws of the countries they operate in. In addition, there are expectations bestowed on the management of IFIs to maximize returns in terms of monetary gain and to strive to achieve the objectives of *shariah*.

Stakeholder theory is the western model considered by many Islamic finance scholars as the model most able to meet the *shariah* objectives, subject to some refinements to reflect *shariah* precepts. The inclusive orientation as propagated in the stakeholder model is seen as covering the whole spectrum of needs which Lewis (2005) regards as a "triple bottom line agenda" i.e. social obligations with economic, social and environmental dimensions.

Nevertheless, proponents suggest that this theory argues for equal consideration of every party deemed as a stakeholder in the firm, rather than focusing solely on shareholders' needs. Ironically, as pointed by Chapra and Ahmed (2002), and Hasan (2009), the stakeholder framework is difficult to implement since it requires the availability of a well-functioning competitive market and a proper legal framework to ensure stakeholders' protection.

Moreover, these researchers suggest that there is difficulty in implementing such a governance style in Muslim minority countries, as it requires further clarification of certain important details, such as the appropriate governance structure, and importantly, a proper definition of Islamic government. The need for an Islamic government issue is seen as a top-level pre-requisite as some regulatory and legal requirements preclude the realization of this framework.

Nevertheless, agency theory is in reality practiced by most of IFIs in the Islamic countries as opposed to the stakeholder or European model, although theoretically agency theory (as in the classical views on agency theory) exhibits more antagonistic ideas towards Islamic precepts by being self-serving and profit orientated rather than being collective as a team with social consideration. This peculiar contradiction has appeared as a result of the post-colonial heritage of the British system in the Muslim countries which are now part of the Commonwealth pact (Kamla & Rammal, 2013).

In spite of being theoretically less 'Islamic' compared to the stakeholder model, the Anglo-Saxon governance model epitomises the Islamic spirit of transparency and accountability through the establishment of certain governance tools: an audit process, and remuneration and nomination committees, amongst other things. On the other hand, as discussed earlier, variation occurs between the conventional

financial institutions and IFIs since the latter need to accommodate whatever differences are reflected in the adopted governance model.

Considering the features of governance theories above, this study posits that incorporating stewardship theory and linking it to the other two governance theories (agency and stakeholder theories) will make explicit a call for the realization of objectives (*maqasid*) of *shariah*. Furthermore, a reconciliation of models will extend some way towards the need to ensure sustainable development for future generations, as suggested by the inter-temporal stewardship precept.

An IFI's success is measured from a secular angle in the form of profit, and from a spiritual aspect in the form of its CSR works for the community, as inspired in the Islamic *al-falah* connotation – success in the world and hereafter (Asutay, 2007; Haniffa & Hudaib, 2007). *Al-falah* epitomises continuity of success (worldly and afterlife) which resembles the sustainability of success. This signifies the importance and relevance of sustainability for IFIs which parallels the inter-temporal stewardship concept (an extended version of stewardship theory). Inter-temporal stewardship theory propagates the idea of sustainable development which caters for current and future needs, and in order to achieve this, the spirituality element is needed (McCuddy & Pirie, 2007).

This is in harmony with the Islamic view about the role of humans as vicegerents on this earth (as stated earlier), which requires execution of the stewardship role when managing and using the resources of this world so that the sustainability is in place. The idea is that prudent management of resources will ensure everlasting benefits from these resources for current and future generations.

The use of wealth in Islam is seen from two perspectives: private and public ownership. These must be balanced between community and personal needs. Accordingly, community needs shall prevail over personal needs (Iqbal & Mirakhor, 2004; Hasan, 2009). Beekun and Badawi (2005) and Hasan (2009) explain that the *tawhid* principle leads to important concepts which are *khilafah* (vicegerency) and *al-adl wal Ihsan* (equilibrium). Moreover, the *al-adl wal Ihsan*¹ encompasses the conventional precept on stakeholder theory as proposed by Donaldson and Preston (1995), that every party in the firm has an equal relationship with none having preference over the other.

1 Naqvi (1994) defines *al-adl wal Ihsan* as a state of equilibrium. The principle of social equilibrium in the context of economy provides a best configuration of the production, consumption and distribution activities where the needs of all members in the society constitute the first priority over the individual (cited in Hassan Z, 2009).

McCuddy and Pirie (2007) denote that stewardship has both secular and spiritual implications which are compatible with the missions of IFIs: to attain profit and at the same time to fulfil their societal roles. Karns explains that under the stewardship paradigm, profit is “a necessary instrumentality, a vitally important internally generated funding source that provides for a firm’s continuing and expanding ability to serve humanity (2011, p. 341).”

Furthermore, this is very much relevant with regard to the *takaful* operators’ situation, with the existence of two principals: shareholders and *takaful* contributors. The stewardship theory is appropriate in many ways to support this idea, as it places the importance of aligning the agent’s interest with that of the principal’s (Majid, Sulaiman & Ariffin, 2011). This requires the agent to consistently serve the principals without bias, while at the same time neither party can afford to neglect social obligations.

Pirie and McCuddy (2007) have empirically proven that the firm’s success is derived from its financial and stewardship performance together, rather than from each in isolation. They derived these findings from Fortune’s Global Most Admired Companies 2002, by segregating them into categories of success and then matching the financial and stewardship considerations against the companies’ missions.

Recent development in the area of stewardship has witnessed the institutionalisation of stewardship practices as exhibited in the UK. Adherence to the stewardship principles is compulsory for public limited companies in the country, although to some extent it also accommodates difficulties faced by the companies. Flexibility is given in terms of implementation of the principles by allowing the companies to disclose the reasons which have impeded the involvement of stakeholders as espoused in the UK Stewardship Code, based on the “comply and explain” concept.

Retrospectively, the early practices of stewardship concepts which primarily relied on self-imposed stewardship traits can be described as normative, in most of their aspects. Therefore, the regulated stewardship procedures as implemented in the UK reinforced the normative (most of the time) aspect of stewardship in order to be implementable and proven viable by simultaneously ensuring that the principal’s interests are given priority through the principals’ active involvement and easy access to information as suggested in the report.

This reinforced concept of stewardship seems compatible with Islam since it ensures fair treatment of every stakeholder and fulfils the call for good governance. In the *takaful* context, as highlighted by Hourani (2007) on Islam’s views on fairness (*adl*) and injustice (*zulm*); fairness for stakeholders does not signify an equal

stake for everybody in the business. In fact, it emphasises the rights of the stakeholders, particularly the takaful contributors, a status which they expect to have based on the contributions they give to the *takaful* operators. Nevertheless, this study views such rights as lacking in the current *takaful* operations, a deficiency which is debated in the following discussions.

In addition, from another angle, such an active involvement of stakeholders may influence the business model of the company. The *mudharabah* (partnership-profit sharing) model invoked the principle that in this partnership model, the principal will contribute capital while the business will be run by the entrepreneur (either individual or company). Furthermore, administration of the business will be managed by the entrepreneur while the principal will get a return in terms of business profit based on a ratio as agreed in advance. In case of business failure, monetary losses will be borne by the capital provider while the entrepreneur will bear loss in terms of time and effort put into the business.

In addition, the capital provider will not interfere in the management of the business. Thus, from the Islamic *muamalat* (business) point of view, such active involvement on the part of the principal as suggested in the UK Stewardship Code will possibly change the business model from *mudharabah* to *musharakah* (partnership-profit and loss sharing). In the latter model, the active involvement of the partners is expected in terms of capital, expertise, and networking.

Furthermore, the *wakalah* (agency) model also will be changed to *musharakah* based on similar reasoning. Nevertheless, such discrepancies only exist as concepts unless the legal aspect is properly sorted out since every model begets different responsibilities. This can be categorized as primarily a micro issue.

From a macro perspective, such discrepancies do not affect legality in term of permissibility (being *halal*) as a result of the active involvement of stakeholders. Notably, the *Quran* and *sunnah* only necessitate fairness in business dealings however there is no explicitly prescribed business model in Islam. The categorization of Islamic business models is made by Islamic jurists for public understanding by deducing from the previous practices of the Prophet and his companions through the process known as *usul fiqh* or Islamic jurisprudence. This implies that regulated stewardship practices are attuned with Islam.

All considered, an Islamic governance model is expected to demonstrate fair treatment to every party in the firm as proposed by the stakeholder theory, with emphasis on the financial and societal objectives as propagated in the stewardship theory, and that these constraints will be applied within the framework of an An-

glo-Saxon governance model with special reference to *shariah* requirements. Thus, these essential features which are embedded in the conventional governance theories are then linked to the Islamic precepts on governance.

The main pillar in every Islamic-based environment whether in management, economics and finance or in any other field is *tawhid*. This *tawhidic* approach emphasises total submission to the oneness of Allah, which must be reflected in daily action by being consistent with His commandments. The resources on this earth belong to Him, while human beings as His vicegerents are expected to honour the pledge by managing the resources wisely (Choudhury & Malik, 1992; Presley & Sessions, 1994; Asutay, 2007).

This resonates with the stewardship theory as mentioned earlier. Thus, agents as stewards of the companies will be spiritually rewarded by Allah if they manage the companies well by fulfilling the principals' interests with an intention to earn their living in a rightful way, as propagated by the *tawhidic* concept. Furthermore, other stakeholders' interests also need to be in line with the Islamic teachings on fairness and justice.

Another important component of Islamic governance is the concept of *shura* or consultation (Chapra & Ahmed, 2002; Lewis, 2005; Hasan, 2009). Chapra (1992) describes *shura* as a compulsory process and not merely an option since it provides an avenue for consultation amongst the stakeholders in a wider perspective, rather than being limited to specific stakeholders.

This is enunciated in one of the verses in the Qur'an, *Al-Shura* (38);

"And those who respond to their Lord and keep up prayer, and whose affairs are (decided) by counsel among themselves, and who spend out of what We have given them".

In the context of the corporation, this verse can be interpreted as encouraging the companies to have specific platforms to discuss and decide companies' affairs which are contemporarily represented by the board of directors. In order to ensure that such processes are in place, compliance towards the procedures and standards is necessary which requires a monitoring process that Lewis (2005) refers to as, an institution as *hisba*, another important component in Islamic governance. He explains that such an institution was part of the long tradition in Islamic institutions which adhered to an Islamic notion i.e. enjoining good and forbidding evil – a role normally given to the state.

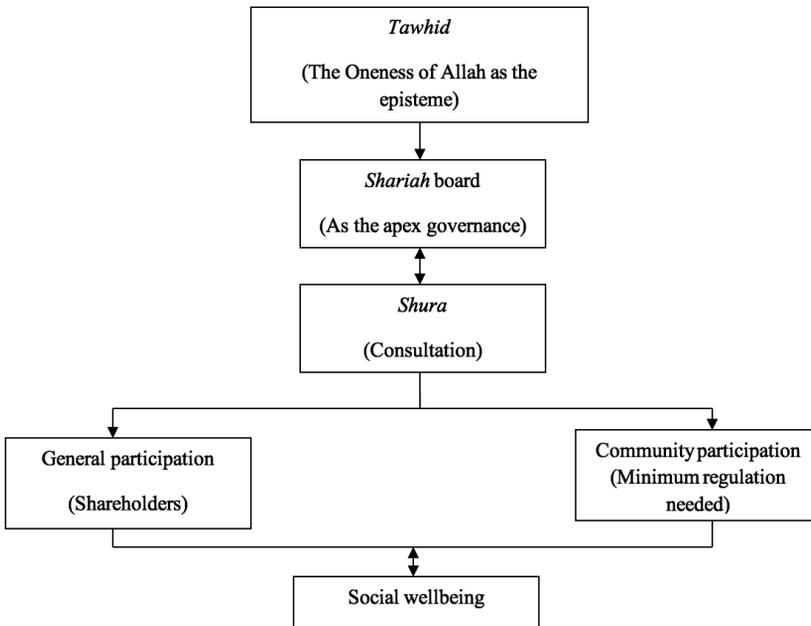
Nevertheless, the spectrum of *hisba* can be broadened to include the internal auditor and *Shariah* Advisory Committee (SAC) under a firm's initiative to ensure

that the company’s operations align well with the firm’s governance standards and act as part and parcel of the *takaful* companies’ governance functions. From another perspective, this initiative is compatible with the concepts of Anglo-Saxon governance tools such as audit processes, separation of roles between CEO and chairman, establishment of various committees for nomination and remuneration, and so on.

Therefore, based on this foundation, the suggested Islamic governance model is illustrated in the Figure 1.

Figure 1

Islamic Governance Model, As Proposed and Adapted From Choudhury, M.A. and Hoque (2006).



Takaful Governance in Malaysia

Discussions in the early sections have covered various aspects which influence the governance of *takaful* operators, however this section focuses on Malaysia in particular (as a reference case due to promising outlook of the sector in the country). Hence, this section will deliberate on the structure of *takaful* operators and how the previous components interact within the firms’ governance framework.

Takaful operators, like the Islamic banks, are made up of two important parties: the shareholders and *takaful* contributors, or in the case of Islamic banks, the depositors. These two groups become the principals towards which firms which are managed by the appointed directors are aligned. Amongst the central governance issues which affect *takaful* operators apart from the relevant governance model that suits them, is how the management handles the interests of the two principals in the firms.

All over the world *takaful* operators can be established as either stock or mutual form of *takaful* companies while the former form is widely practiced in most countries. In the Malaysian context, the stock type of *takaful* form is adopted by every *takaful* operator in the country in forms of consortiums between several big banks, conventional insurers or cooperatives through local and foreign ownerships – they are the shareholders.

Archer, Karim and Nienhaus (2009) suggest that shareholders' involvement in *takaful* business can be regarded as 'compulsory'. This can be viewed from two perspectives: either mandatorily imposed or situationally influenced. The former condition is facilitated by the legal requirements enforced on the industry by the regulator which shows less preference for the establishment of mutual *takaful* operators. This can be compared to the situation in Bahrain where the law requires *takaful* operators to be established under the *wakalah* (agency) model only (Gönülal, 2012).

It is noticeable that the most widely practiced *takaful* model is *wakalah*, either pure *wakalah*, modified *wakalah*, or the hybrid version of a *takaful* model (with *wakalah* feature in its components). The adoption of the *wakalah* model implies the hiring process of an external party to run the business on behalf of the *takaful* contributors.

From the Malaysian perspective, the *wakalah* model has been adopted by every *takaful* operator in the country, possibly because it is seen as compatible with the *takaful* operators' structure. In spite of the governance features in *takaful* companies, the issues arising from agency problems still exist, as a result of the hybrid form of *takaful*, which has been discussed before. Governance is further strengthened by the Islamic Financial Services Board (IFSB) which defines each *takaful* operation as a hybrid component of social and commercial undertakings (Islamic Financial Services Board, 2009) comparable to the Malaysian Islamic Financial Services Act 2013.

Therefore, it is clear that the *raison d'être* of *takaful* operators' existence is the availability of *takaful* contributors who agree to pool money to compensate themselves against unfortunate future events; while shareholders existence is needed

to shape directions of the companies in a competitive commercial environment, apart from the regulatory issues such as providing *qard hassan* (risk capital) in case of deficit, as discussed above.

It is noteworthy that even if takaful operators are managed under the pure co-operative (*ta'awuni*) model, agency issues will still occur as long as there is another party that is hired to oversee the business. However, the condition will be more noticeable in the stock form *takaful* (as characterized in *wakalah*, *mudharabah* and the hybrid model) compared to the cooperative (*ta'awuni*) model.

Archer, Karim and Nienhaus (2009) explain that there is a tendency for management to prioritize shareholders over *takaful* contributors, since the former have the privilege to appoint the board of directors. They can make crucial decisions regarding the investment, business strategies and matters concerning the method of distribution of underwriting surplus. The inclination towards the interests of major shareholders is pertinent in Malaysian *takaful* companies since only one *takaful* operator has its shares traded publicly, while others are owned by consortiums of banks, foreign insurance companies and government linked companies.

Treatment towards *Takaful* Contributors in the *Takaful* Operators' Governance

Several pertinent governance issues which affect *takaful* contributors have been touched upon earlier. Nevertheless, it is worthwhile to focus on this group – *takaful* contributors – as they are related to the investment activities of *takaful* operators.

While this study focuses on *takaful* contributors, it does not mean to sideline the importance of shareholders' rights and their legitimacy in *takaful* operations. As discussed earlier, shareholders' involvement in *takaful* operators and their rights are recognized by law. Moreover, *takaful* operators' commercial needs suggest that the shareholders have essential roles to play in the companies.

Nevertheless, *takaful* contributors should be seen at the level of principal's principal. In other words, priority should be given to the *takaful* contributors over the shareholders. It is not the same as the classical analogy between eggs and chicken – deciding which one comes first. Rather it is a straightforward conclusion based on the historical or classical origin which triggered the formation of *takaful* – the contributors.

Takaful resembles a self-insurance scheme by the contributors, and shareholders partly own the business through shouldering together the business risks with *takaful* contributors, and at the same time provide facilities in the forms of offices,

management and staff to run the business. The “insurance business” which is the core activity of *takaful* operators has evolved over time to include investment and savings as part of its services. This service can be realized by investing part of the contributions (premium) received. Thus, the *takaful* operators are expected to wisely invest their scarce resources.

At this point in time, it is not appropriate to impose the opinion of *takaful* contributors upon *takaful* operators cum the management because most of the old literature focuses on assessing the *takaful* contributors’ satisfaction with *takaful* products or policies, or awareness of *takaful* services.

Nevertheless, it would be a tremendous improvement if *takaful* contributors were empowered with the opportunity of greater involvement in *takaful* operators’ business decisions and better communication with them, especially on investment activities. This is consistent with the call for higher involvement of principals in the business by not totally delegating away the responsibilities to the agents in order to ensure prudent management (Myners, 2009; Green Paper, 2011; Arsalidou, 2012). Moreover, this would realize the Islamic notion of “checks and balances” by having a group which calls for good and forbids evil as stated in the Quran, verse 3:104.

Involvement in *takaful* operators’ corporate decisions could possibly happen through the establishment of an annual general meeting (AGM) of *takaful* contributors for selecting and appointing their representatives to the board of directors (BoD). This procedure is practiced by *takaful* operators in Sudan. It is noticeable that the *takaful* models are adopted differently in Malaysia and Sudan.

Nevertheless, such cross-adoption of best practice is not uncommon, and potentially contributes to better governance on the former’s part. Evidently, there is no pressing issue for *takaful* operators in Malaysia to adopt such a style in their operations and there is no demand from the *takaful* contributors, nor is there a direction from the central bank to do so. Nonetheless, as the community gains more familiarity with *takaful* operations and more members of the society become educated, such demands would possibly arise in due time.

Perhaps, the appointment of *takaful* contributors’ representatives would bring diverse representation in the board rooms, which in the context of *takaful* operators in Malaysia, were formed by consortiums of large banks, insurance companies and cooperatives from the country and overseas. It is understood that the role of independent non-executive directors, and even the collective role of the BoD is to ensure that proper governance remains in place. This would also mean that *takaful* contributors’ interests are taken care of. Previous studies of this proposition about contributor participation have indicated various findings in the boardroom

context, so action remains uncertain. It is proposed here that the appointment of *takaful* contributors' representatives might bring positive outcome for the companies as well as for the *takaful* contributors.

In the current practice, *takaful* contributors do not have a significant platform to raise their grievances except through the customer service offices of the *takaful* operators. Existing points of contact might work for settling issues with regards to the products and services but are not a suitable avenue for questioning or suggesting ideas with regards to the companies' policies and decisions. The only way for contributors to show their dissatisfaction, as Archer, Karim and Nienhaus (2009) describe it, is through 'voting with their feet', by terminating their contractual arrangements with the *takaful* contributors and switching to other service providers. This obviously does not help in solving the current problem since the grievance is still there.

On another aspect, better communication with the *takaful* contributors, specifically on investment activities is argued for several reasons. Reiterating from previous discussions, *takaful* contributors will bear the investment risk and such information regarding the activities would be beneficial for them, which resonates with IFSB-8, point number 71 – the urgent need to supply sufficient investment information since *takaful* contributors are the risk bearers.

Current practises indicate that information in forms of an annual report and fund fact sheet (for investment linked products) is provided. However, they do not cover the whole spectrum of investment activities because the other investment streams in forms of annuity, endowments, real estates and money markets are not stated in detail. There is also a lack of data on historical performance of investment assets. Switching of funds from one fund to another should be permitted without constraints on the basis of personal choice and investment strategy on the *takaful* contributors' part.

Another aspect which validates the notion of *takaful* contributors as the principal's principal is the treatment of excess funds (Archer, Karim & Nienhaus, 2009). The Islamic Financial Services Board (IFSB) outlines the institution's recommendations for best practices for *takaful* operators to observe. IFSB-8, point number 42, again, emphasises the need to establish a platform for *takaful* contributors to raise their concerns and engage actively in the *takaful* operators' major business decisions. This is to substantiate that *takaful* contributors are the economic beneficiaries of *takaful* business, and not the other way around, which is further stressed in IFSB-8, point number 44 – *takaful* funds belong to *takaful* contributors. Thus, the IFSB's recommendations, again resonate with the previous argument that pri-

ority should be given to the *takaful* contributors since the foundation of *takaful* is self-insurance amongst the participants.

Guidelines from the central bank of Malaysia, BNM/RH/GL 004-22, indicate that amongst the minimum requirements which *takaful* operators have to adhere to with regard to investment is providing information about the investment strategy and method used for calculation of the investment profit for PA, participant account or PIF, and participant investment fund (Bank Negara Malaysia n.d.). Clearly, such guidelines are not followed by most of the *takaful* operators since it is just a recommendation, except in the case of dedicated investment-linked products (ILP). Investment strategy is presented in the ILP's fund fact sheet but not provided for investment activities in endowment, annuity, and other products.

Linking MARC Governance Qualities with the UK Stewardship Code

Malaysia Rating Corporation, MARC has formulated a set of guidelines which have been customized to reflect the nature of IFIs – adherence to rigorous governance standards and steadfastness in meeting *shariah* requirements. MARC emphasizes that the guidelines are formulated from the recommendations and available policies of sound corporate governance suggested by various international standard-setting bodies, regulators, and agencies that specifically work on good corporate governance for companies with regards to *shariah* precepts.

MARC's governance qualities are based on seven key areas: governance structure (GS); ownership structure and external influences (OSEI); management and processes (MP); internal control and compliance framework (ICCF); equitability and treatment of stakeholders (ETS); financial reporting and disclosure (FRD); and corporate social responsibility (CSR). On the other end of the spectrum, the UK Stewardship Code is regarded as the first Code in the world which comprised a set of guidelines based on the stewardship precepts regulated by the Financial Reporting Council (FRC) of UK, framed for institutional investors and investment managers of public listed companies based on the “comply or explain” model. This Code is postulated as capable of enhancing the shareholders' surveillance over the invested companies (Arsalidou, 2012).

This non-mandatory Code promotes transparency and encourages owners – the shareholders – to be actively involved in the major decisions of their invested companies. The targeted shareholders are the institutional investors who are perceived by many as having the capabilities to influence and protect their rights, which also eventually safeguard other minority shareholders' rights from being ‘hijacked’ by

companies' top managements. Arsalidou (2012) argues that such protection was established as a result of the collective voting power used by the institutional investors when deciding on business proposals, especially the major ones.

A "head to head" comparison between the two guidelines is not appropriate considering the different foundations of each guideline when they were formulated. MARC is heavily emphasised on governance procedures while the UK Stewardship Code has been derived from stewardship precepts. With that in mind, this section reconciles the stewardship aspect in the two guidelines by using the UK's Stewardship Code as the benchmark against the MARC's ETS and CSR dimensions.

In contextualizing the stewardship aspect with regards to *takaful* operators, the stewardship initiatives as proposed in ETS and CSR are solely the responsibility of the *takaful* operators; and not a cooperation between *takaful* operators and the *takaful* contributors. This is the "missing element" in the MARC's governance qualities guidelines as against the UK Stewardship Code.

While the UK Stewardship Code is targeted for institutional investors and fund managers, such a process can be amended to suit the *takaful* sector by placing such onus on the major *takaful* contributors. Criteria for who constitute major *takaful* contributors can be ascertained either from the value of *takaful* certificates or the number of policies issued by the *takaful* operators.

For instance, in family *takaful*, there are a number of cooperatives and companies that offer *takaful* coverage schemes to their members and employees. In the case of general *takaful*, there are car dealers, bus operators, companies and other institutions which engage with various *takaful* operators for their general *takaful* protection, such as for their fleet of buses or lorries, cars which have been sold, fire protection and so on. These parties have a potential to play the role of institutional investors in the context of *takaful*, subject to adjustments.

To date, we cannot conveniently say that *takaful* contributors' rights are well-protected and considered because there is no party who represents them, although the central bank has prescribed that one of the duties of *takaful* operators is to ensure *takaful* contributors' rights are protected through the role played by the boards. To put it differently, at this present moment, *takaful* contributors do not have any avenue to nominate or elect members of the board to represent them. Likewise, Ismail and Aziz (2017) write that in the Malaysian central bank's quarterly bulletin that the regulator is continuously empowering the boards of the financial institutions, so that the top-down instructions will bring positive effect to the financial institutions. Perhaps, more needs to be done in this area. There

are several ways to enable *takaful* contributors to be active in the management of *takaful*, either through dialogue as mentioned earlier, the conduct annual general meeting (AGM) for *takaful* contributors (Green Paper, 2011), or by developing dedicated websites to enable the *takaful* contributors to express their suggestions or concerns (Arsalidou, 2012).

Furthermore, this would provide a platform to *takaful* contributors to voice their opinions and concerns through an official channel which would be listened by the top management, rather than expressing grievances to customer service, which is suitable for products and services related experience but not for matters concerning policies and strategies of the firms.

In terms of CSR, by having stakeholder involvement in this aspect, it provides an opportunity for the stakeholders, especially the *takaful* contributors, to give ideas on the community projects to be organized by the *takaful* operators. In addition, this process can make them aware of the CSR initiatives taken by the firms where previously not much information was available for the public.

It is postulated that with the adoption of the UK Stewardship's "spirit" by MARC in its guidelines, the ETS and CSR dimensions would be enhanced, as it would capture wider aspects by extending responsibility to both, stakeholders and also *takaful* operators, in terms of ensuring equitable treatment for stakeholders and deciding on the types of community projects to be implemented by the firms.

The remaining issue what might be entailed by owners' active involvement is the management of *takaful* operations. Allowing *takaful* contributors to participate actively in the management of *takaful* operations would affect the contractual arrangement between the *takaful* contributors and *takaful* operators. From a religious point of view, there is nothing that hinders such active involvement. In fact, it harmonizes with Islam's call for transparency and fairness.

Nevertheless, from a legal point of view, amendments have to be made in the *takaful* certificates (policies) between *takaful* contributors and *takaful* operators. In the context of this research, which focuses on investment management of *takaful* funds, the active involvement of *takaful* contributors would bring transparency to matters which previously were privy only for boards and management of *takaful* operators, or on some occasions, to the public domain, especially for matters concerning investment. Confidential as it can be, nevertheless, there is certain information which can be shared with the *takaful* contributors, since they are the ultimate risk bearers for the investment of *takaful* funds. Ali and Ahmad (2012) suggest *takaful* operators disclose matters concerning market movement, potential risks and types of assets invested.

Thus, with regards to this, it would be challenging to find *takaful* contributors who are able to participate actively in this complex business and are interested enough to devote time to it. However, this challenge should not be an excuse for not empowering the stewardship rights to *takaful* contributors. Karbhari et al. (2018) in their research have elucidated interesting findings on the list of *takaful* operators' governance structures that produce significant influence on the scale efficiency of *takaful* operators: non-executive directors, shariah board, product diversification and institutional ownership. They emphasised that *takaful* operator that has a bigger size of board of directors produces technical and scale efficiencies for the firm. Their findings resonate well with the previous discussion in this paper – this paper has highlighted on the importance of *takaful* operators (as well as the IFIs) to execute the stewardship's recommendation as in the Stewardship Code of UK by bringing in major *takaful* operators' clients (companies which are the business clients) on the board. These companies have resources in terms of experienced and knowledgeable staff, in-depth networking, well-known reputation and motivation that can become added value to the *takaful* operators.

Moreover, the number of youngsters who enter tertiary institutions is rising from year to year and this reflects a rising literacy rate and educational level of the population (Muhamat, Jaafar & Ali Azizan, 2011). Hence, sooner or later, the *takaful* operators will have a range of qualified and interested *takaful* contributors to engage with them, especially when the major contributors are from companies or cooperatives which have the capacity to place reliable representatives.

Nevertheless, for *takaful* operators, any reservations should also be considered if the stewardship code of *takaful* operators is planned to be devised and introduced in the future. Although in this research the backdrop of arguments is based on the UK's Stewardship Code and Malaysia's MARC Rating Guidelines for IFIs; these two guidelines can be important reference for IFIs including *takaful* operators.

Conclusion

Takaful operators' governance is a delicate issue with the presence of two principals in the companies, apart from their two roles which must be fulfilled in terms of profitability and social responsibilities. Mansour and Bhatti (2018) elaborate on the need for Islamic financial institutions to embark on the new paradigm for Islamic corporate governance. Their findings summarize that corporate governance in IFIs is no longer on the "check and balance" approach and is rather on the proactive platform – as initiator. They pointed out that there is lack of treatment of the depositors who are important stakeholders for the Islamic banks. Similarly, this

study equates *takaful* participants as the critical stakeholders in the *takaful* operation who face the same problem.

The incorporation of a stewardship model proves to be essential for the *takaful* operators in order to realize their societal role since a stewardship model not only emphasises the social requirements, but also highlights the need for companies to achieve profit. Le Breton-Miller and Miller (2018) suggest that the stewardship precepts are much concerning on the personal characteristics such as honesty, discipline, generosity and sacrifice which produce dedicated and self-restrained stewards who will put the company's cause at priority instead of their own. Le Breton-Miller and Miller (2018) regard these values as predominantly propagated in the religion. Therefore, stewardship is more compatible for the IFIs (such as *takaful* operators) because they are financial institutions that were established to fulfil the social and commercial objectives of the society shaped by the *shariah* requirements. This is crucial for business sustainability and social objectives can be achieved through activities financed from the profit. In other words, it focuses both secular and moral aspects of companies which are compatible with *takaful* operators being a socio-religio driven business.

As foreshadowed in previous discussions, this article has compared the Malaysian Rating Corporation's (MARC) governance quality guidelines with the UK Stewardship Code. It is suggested that the MARC's guidelines capture some aspects of the UK Stewardship code however the latter is more comprehensive. In view of the stewardship theory as the most compatible governance paradigm for IFIs as in the context of *al-falah*, it would be a breakthrough for Islamic finance industry if specific stewardship guideline could be developed.

Acknowledgement: I would like to express my appreciation to UiTM Selangor for the DUCS grant, 600-UITMSEL (PI. 5/4) (039/2018) for this study. Also, I would like to extend gratitude to Faculty of Business and Management UiTM for the FBM grant, 600-IRMI 5/3/DDF (FPP) (006/2019).

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