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Monitoring non-compliance risks in Islamic venture capital

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ABSTRACT

Islamic venture capital firms are not in a position to pay high interest rates as in bank loans. They participate in the risk as well as the profit (the profit and loss sharing arrangements) of the new businesses they fund. The establishment of Islamic venture capital firms is based on the objective to comply with shariah principles in all aspect of business activities. A common feature of IVC firms is their unique structure of assets and liabilities and this exposed to additional types of risk, known as shariah non-compliance risk. This shariah non-compliance risk must be prudently managed to ensure the survival of these firms. Thus, good shariah governance mechanism is very important in ensuring their activities are in compliant to shariah. The paper suggests that the roles of shariah committee and shariah audit are important to observe the Islamic venture capitalists' involvement is shariah compliant in every aspect of business transaction. The shariah committee is responsible to advise the IVCs on shariah aspect while, Shariah audit acts as a monitoring mechanism to validate the compliance with shariah. Thus, shariah committee and shariah audit are assumed to play significant roles to ensure the shariah-compliant agenda is achieved which is the backbone of the establishment of Islamic organizations be it venture capital firms or Islamic financial institutions.

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INTRODUCTION

Islamic venture capital is at the threshold of entering into one of the best markets for investing in emerging markets. However, being an Islamic organization, IVC firm must always maintain spiritual image towards the public, which is needed so that a differentiation between Islamic venture capitalist and the conventional practice can be recognized (Hidayat 2012). The core principle of profit and loss sharing is the foundation of Islamic venture capital firms. If these firms cannot portray that the PLS is the outcome of the Shariah-compliant activities, then the IVC is no different than the conventional one. Consequences could be very fatal, and would at least undermine the reputation of the said IVC. Therefore, IVCs not only have to maintain their professional image as an Islamic institution but also the spiritual one. A negative perception not only affects the image of players involved in IVCs, but also their corporate image leading to a tarnished reputation for the entire Islamic finance industry.

Islamic finance is a risky business and several risk factors such as credit, liquidity, operational and market risks have been identified as critical to ensure that the industry remain intact in the extreme competition globally (Noraini & Salina, 2011). The survival and success of an organization critically depends on the efficiency in managing these risks (Khan & Ahmed, 2001). Islamic institutions face the same risks as conventional ones and in fact, they are confronted with "new and unique risks as a result of their unique asset and liability structures" (Kahf, 2006).

The significant risk in Islamic venture capital firms is operational risk which arises as an immediate outcome of their compliance with the Shariah requirement (Islamic law) because the PLS concept adopted is based on interest free transactions, which prohibits interest on all types of financings. Thus, operational risks in Islamic finance are perceived to be significantly higher than conventional ones (Izhara & Asutayb, 2010). In fact, the study by Khan & Ahmed (2001) shows that operational risk is relatively higher and serious than credit risk and market risk for Islamic finance transactions.

According to Archer & Karim (2007), appropriate systems, processes and products are all latest developments in the context of Islamic financial services industry. This however, poses a continual challenge in areas of development, and the failure in managing these areas would bring negative consequences. The most key challenge is to deal with the Shariah compliance requirement. Furthermore, Archer & Karim (2007)

also reiterated that Shariah compliance is critical to an Islamic finance operation, and such compliance requirements must cover throughout the organization and its products and activities.

Apart from complying with shariah rules, maintaining good reputation is also crucial for Islamic finance (Hamidi, 2006) since failure to do so could trigger withdrawal of funds invested which would result in liquidity crisis, which eventually result in the failure of the venture agreement.

Events that can bring reputational risks to an Islamic institution are bad service, high financing rates, inappropriately dressed employees, insufficient knowledge by employees about Shariah agreements, and others (Hidayat, 2012). The most severe one is if the reputational risk arises because of a breach of Shariah compliance. Therefore, in order to keep a good reputation, it is suggested that Islamic institutions ensure that their financial products are shariah compliant (Greuning & Iqbal, 2008). This is proved by studies of Subhani, Hasan, Rafiq, Nayaz & Osman (2012); Rehman (2012); Lee & Ullah (2011); and Asyraf Wajdi & Nurdianawati Irwani (2007) which found among the reasons why customers patronised Islamic banking sector are because of Shariah compliant product and reputation of the Islamic financial institution.

Thus, Islamic venture capital firms need to focus on shariah non-compliance risk as it is a critical aspect in the Islamic financial industry. The failure in managing these risks will result in voiding of contracts, loss of income, withdrawals of the venture relationships, diminished reputation and reduction in business. Therefore, it is important to manage this non-compliance through a good shariah governance in placed. As suggested by the Central Bank of Malaysia in its Shariah Governance Framework (2010), in order to ensure Islamic Financial Institutions operate within the shariah principles, it must have shariah committee whose primary duty is to oversee shariah matters. Furthermore, Islamic Financial Institutions also need to conduct internal shariah audit aiming to ensure effective internal control system is in place for shariah compliance. This is also relevant and applicable to venture capitalists which operate within the jurisdiction of the requirements for Islamic capital markets.

1. LITERATURE REVIEW

Islamic finance can be defined as a system offering financial services that are compliant with Shariah (Islamic law) (ElGindi et al. 2009). It is based on Islamic principles and the activities of Islamic financial institutions (IFIs) must be compliant with Shariah

principles in all aspect. Shariah shall govern all IFIs's activities which adds additional values to the existing corporate governance structure (Grasa 2013).

In Malaysia, the Islamic finance is regarded as more progressive and robust as opposed to other Muslim countries (PWC, 2011). The legal basis is subject to regulations such as under the Banking and Financial Institutions Act 1989, Securities Commission Act 1993, Capital Markets and Services Act 2007, Companies Act 1967 and Islamic Financial Service Act 2013.

The Central Bank of Malaysia (BNM) has issued several guidelines to IFIs which relates to their management and reporting. In 2010, the Bank issued a guideline concerning the governance of Islamic Financial Institutions called the Shariah Governance Framework (2010) with an objective to develop a Shariah-based operating environment. The main areas of Shariah Governance Framework (2010) are as follows:

- Shariah governance structure which focuses on structure, processes and arrangements to make sure all operations and business activities are in accordance with Shariah
- Shariah governance attributes which provides guidance to board, Shariah committee and management in discharging their duties related to Shariah.
- Shariah compliance and research which mainly related to Shariah review, Shariah audit, Shariah risk management and Shariah research.

  (Shariah Governance Framework, 2010, Principle 2.1, 2.8 and 2.9, pp.11)

The key focus of the Shariah Governance Framework (2010) is on the compliant to the Shariah requirement. Similarly, venture capitalists involved in Islamic transactions are no different from this requirement. Therefore, it is vital for all operations related to Islamic finance to focus their emphasis on Shariah non-compliance risk as it is embedded in their daily operations. Shariah non-compliance risk is defined as the risk arising from the failure to comply with the Shariah rules and principles. This is determined by the Shariah Board or the relevant body in the jurisdiction in which the parties involved in Islamic operations operate. The non-compliance will affect the customer faith and confidence towards the them which will give rise to reputational risk. This risk takes place when an Islamic institution fails to meet its business strategy; shows weakness in corporate governance and business operations; or lack of

performance in the Shariah department which regulates the validity of operations in the Islamic institution.

2. SHARIAH GOVERNANCE

Corporate governance refers to the way the corporation being is directed, administered and controlled. It is designed to reduce the inefficiency due to moral hazard and adverse selection. Corporate governance also viewed as the process of monitoring performance and dealing with transparency, integrity and accountability specifically to the shareholder on monitoring of management decisions. This is important due to the fact that the ultimate goals of a shareholder might not be matched with the management's due to a conflict of interest which can be explained in via the agency theory.

Corporate governance in an Islamic environment is not a new exploration. Principally, corporate governance in the Islamic perspective is stressing on the accountability, transparency and trustworthiness. Shahul Hameed (2000) defines accountability in Islam as a dual accountability specifically referring to accountability not only in this world but also the accountability in the hereafter. This is referring to man as a *Khalifah* (trustee) of Allah's (s.w.t) resources (accountable for all his/her actions in the hereafter for carrying out the trust to ensure benefits for the *ummah* as a whole); and accountability due to contract between an owner or an investor and a manager (accountability in this world). In primary, accountability in Islam does not segregate business matters from religion.

In essence, corporate governance according to Islam is a unique characteristic where it is concerned with business conducts without neglecting the religious aspects and values such as *Adl* (fairness) and *Ehsan* (benevolence) (Zulkifli, 2010). According to Nahar & Yaacob (2011) shariah governance in Islamc organizations means a formal system of accountability by the top management to their stakeholders and also to the Allah i.e. dual accountability. Whilst IFSB, Standards 10 (2009) has given the definition of shariah governance as:

"Shariah governance system refers to the set of institutional and organizational arrangements through which an institution ensures that there is effective independent oversight of Shariah compliance".

Basically, Shariah governance relates to a system driven by the Shariah principles and controlled by an effective religious board (Grasa, 2013) to convince that the activities

of the Islamic organization which include the systems, policies and procedures, are in accordance with the Shariah principles and conducts (Aziz, 2007)). The shariah governance is vital in the Islamic environment as it involved the protection of stakeholders' interest and right from the management actions and decisions by taking into account the *Maqasid al-Shariah* (the objectives of the Islamic law) (Zulkifli, 2009). Furthermore, the compliance towards shariah in all aspects of its operations and management may have direct impact to the *maslahah of ummah* (benefit of people) (Nawal, Shahul Hameed & Maliah, 2009) on the corporate practices and policies especially on zakat and on the prohibition of *riba'* (interest).

In order to achieve the ultimate goal in the development of Islamic finance or in specific for this paper Islamic venture capital, shariah governance should be centred to the aspects of shariah assurance that measures and protects the interest of parties involved as well as the stakeholders. Realising the importance of the shariah compliance, it is timely that the BNM has imposed the two-tier Shariah governance arrangement comprising two vital components of shariah assurance i.e. internal and external measures, which are a centralised Shariah advisory body at national level and an internal Shariah Supervisory Board or Shariah Committee formed in each respective Islamic institution. Islamic capital market where venture capitalists operate should be able to follow this requirement. Further, comprehensive and strong shariah governance can be achieved through monitoring specially by conducting shariah review, shariah audit and shariah risk management assessment.

2.1. National Shariah Advisory Council (SAC)

National Shariah Advisory Council (SAC) is the highest authority which acts as the sole authoritative body to advice BNM for Islamic banking and Takaful operations (Abdul Rahim, 2008). SAC can issue rulings on Islamic banking products and services. The establishment of SAC is under section 51 of BNM Act 2009. SAC also has the power to issue fatwa and these fatwa resolutions are binding on all financial institutions in the country. According to Abdul Rahim (2008) among other function of SAC is to study and consider the shariah opinions of the shariah committee of Islamic banks and financial institutions. The SAC is also responsible to supervise the IFI's operations to ensure compliance with shariah rules and guideline. Other functions may include

advising Islamic banks and financial institutions on shariah issues related to operations and financial dealings. The SAC also has authority to examine laws, by-laws and circulars governing the financial institutions activities.

2.2. Shariah Committee

At the institutional level, internal Shariah Committee is available to advise the Islamic Financial Institutions in relation to shariah matters. Section 30 (1) of the Islamic Financial Service Act (2013) stated that shariah committee is responsible “for purposes of advising the licensed person in ensuring its business, affairs and activities comply with Shariah” (IFSA, 2013, pp. 42).
Thus, the main objective of the establishment of shariah committee is basically to advise the Islamic Financial Institutions on shariah matters and to ensure compliance with the shariah principles and requirement in operation (Zulkifli 2006). Thus an effective shariah committee will ensure that all products and processes in IFIs are in accordance with shariah requirement. The Shariah Governance Framework (2010) clearly spell out the responsibilities of shariah committee in relation to shariah compliance under paragraph 2.7, 2.8 and 2.9 (SGF, 2010, pp.11):

- The Shariah Committee shall be responsible and accountable for all its decisions, views and opinions related to Shariah matters. As the Shariah decisions, views and opinions bind the operations of the IFI, the Shariah Committee is expected to rigorously deliberate the issues at hand before arriving at any decisions.
- The Shariah Committee is expected to perform an oversight role on Shariah matters related to the institution’s business operations and activities. This shall be achieved through the Shariah review and the Shariah audit functions. Regular Shariah review reports and the Shariah audit observations should enable the Shariah Committee to identify issues that require its attention and where appropriate, to propose corrective measures.
- In discharging its duties, the Shariah Committee is expected to disclose sufficient information in the IFI’s annual financial report on the state of compliance of the IFI as per the requirements under the Guidelines on Financial

Reporting for Licensed Islamic Banks (GP8-i) and Guidelines on Financial Statements for Takaful Operators (GPT6).

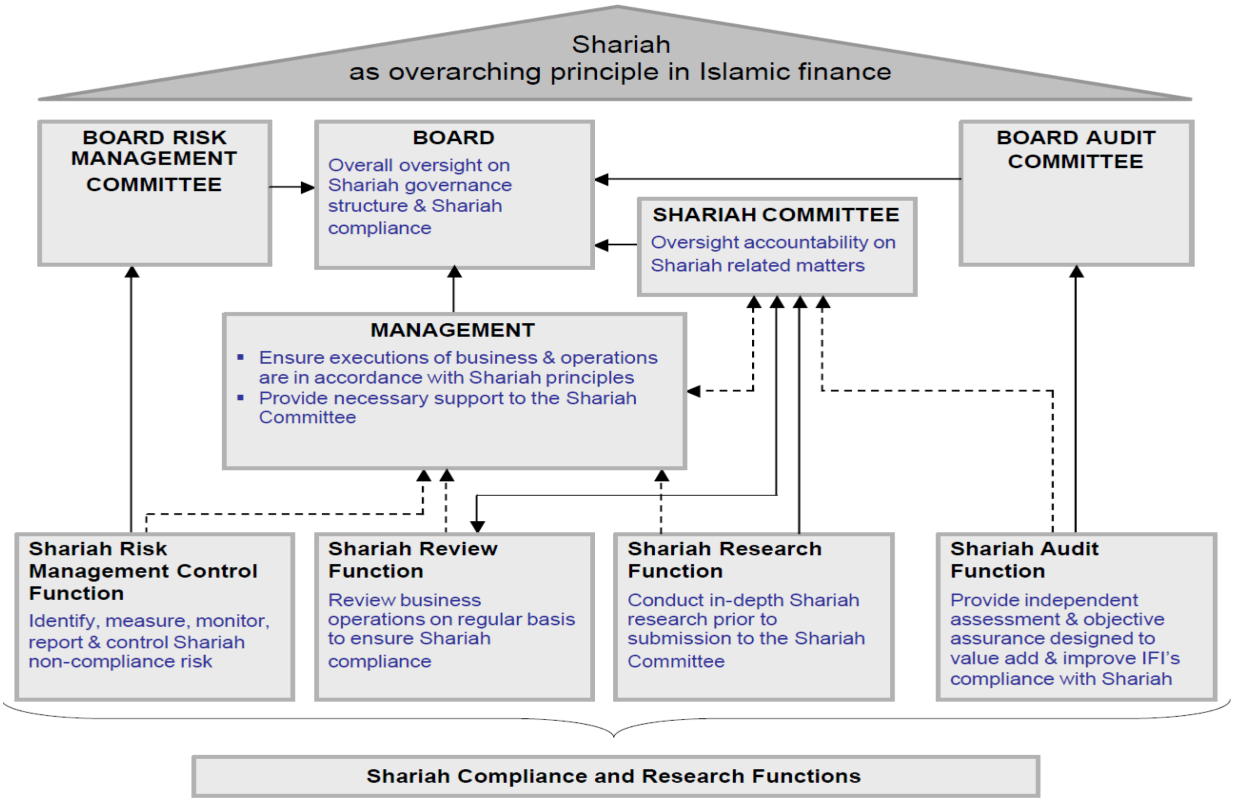

Figure 1: Shariah Governance Framework Model for Islamic Financial Institutions (SGF, 2010 p.8)

2.3. The role of Shariah committee in reducing the non-compliance risk

The Shariah committee has become the most important element of the Shariah governance system which directly involved in the day-to-day practice of Islamic finance in IFIs (Zulkifli, 2010). Grais & Pellegrini (2006) stated that by having Shariah committee in the IFIs level, it provides assure to the stakeholders that the IFIs operates their business in accordance with Shariah. Thus, the structure of the internal governance in IFIs able to improves the credibility of the institutions in the eyes of its customers, shareholders, stakeholders and strengthening their Islamic credentials (Rammal, 2006). The introduction of Shariah Governance Framework (2010) is seem to enhance the corporate governance in IFIs. This evidenced in Zurina et al. (2013) study which conclude that Shariah Governance Framework (2010) has enhanced the role of Shariah committee which they found that Shariah committee getting involved in the whole

proses of Shariah compliance matters including risk management, financial management, information system and other areas.

Furthermore, during Shariah audit, the recommended good internal control being identify by Shariah auditor to Shariah committee in order to mitigate Shariah compliance risks (Zurina et al. 2013). According to Abdul Rahim (2008) Shariah committee should work closely with internal and external auditor to help in understanding the processes in Shariah assurance within the organization. The audit committee is responsible to communicate with Shariah auditor on the state of Shariah compliance (Zurina et al. 2013), to conduct audit and achieved good quality of audit practices.

As for current practice, the responsibility to ensure Shariah compliance depend principally on internal corporate structure in particular Shariah committee. Furthermore, the final output of the Shariah committee declaration will be presented as part of the annual reports of Islamic banks (Abdul Rahim 2008). Thus, it is argue that Shariah committee will ensure that the Shariah audit practices being conducted effectively, as the statement of assurance issued concerning the results of audit being the their responsibility. Moreover, Islamic Financial Service Act (2013) also enforce the penalty clause under section 29 which stated that the management including directors of the financial institutions, the chief executive officer, senior officers and members of the Shariah Committee of the financial institutions is liable for failure to comply with any standards specified.

3. SHARIAH AUDIT

The main objective of the conventional audit is to enhance the degree of confidence users of the financial statements as to whether the financial statements are prepared in accordance with the relevant financial reporting framework and standards. Following the development and significant growth of Islamic Financial Institutions in recent years, the scope of conventional audit is insufficient in Islamic environment (Nawal & Zuraidah, 2013). Haniffa (2010) stated that "the conventional financial audit is inadequate to fulfil the needs of the stakeholders of IFIs". Thus, auditing from Islamic perspective or Shariah audit is more suitable and it is really needed in Islamic financial service to fulfil the requirement by stakeholders.

There are two independent standards setting organizations involved in the Islamic finance industry namely, Islamic Financial Services Board (IFSB) and the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). Both bodies have issued standards for accounting and reporting and also auditing as well as on corporate governance. AAOIFI's Governance standard No.2 (GSIFI) provides the description of what Shariah Audit is as:

"an examination includes contracts, agreements, policies, products, transactions, memorandum and articles of association, financial statements, reports especially internal and central bank inspection, circulars, and etc" (Para 3, GSIFI 2, AAOIFI Standards)

In Malaysia, BNM is the responsible regulatory body that govern the operation of Islamic Financial Institutions. BNM has described that Shariah audit in Shariah Governance Framework (SGF, 2010, Principle 7.7, p.23) as:

"periodical assessment conducted from time to time, to provide an independent assessment and objective assurance designed to add value and improve the degree of compliance in relation to the IFI's business operations, with the main objective of ensuring a sound and effective internal control system for Shariah compliance."

3.1. The role of Shariah audit in reducing the non-compliance risk

The importance of Shariah audit is to ensure the effective internal control is in place for Shariah compliance (SGF, 2010). As stated by Syed Alwi (2007), the Shariah audit is an investigation of IFIs compliance with the Shariah, in all its activity particularly the financial statements and other operational mechanisms. This includes the risk of compliance in products, the technology supporting the operations, operational processes, the people involved in the main risky areas, documentations and contracts, policies and procedures, and other activities that requires adherence to Shariah principles. Shariah audit is necessary to ensure that every institution should contribute towards achieving the objectives of the maqasid al-Shariah (Shahul Hameed & Rizal, 2005) as majority of the fund providers used Shariah-compliant banking services as a matter of principle. Thus, their perception regarding the Islamic bank's compliance with Shariah rules and principles is likely to be of a great importance in maintaining their customer's loyalty (Zulkifli, 2009).

Apart from this, Shariah audit is important in order to eliminate or prevent risk that arises from the operational activities. Basically by opting for Shariah Audit, it will help IFIs to comply with the law as well as accounting regulations (Greuning & Iqbal, 2008). Furthermore, Shariah audit would certainly facilitate IFIs to gain a comprehensive corporate governance by providing the right structure of principles and enforcement. Since Shariah is the basis of Islamic financial products and services, if the customers find that the products that they have in their portfolio are not Shariah compliant, this would seriously undermine the confidence in the Islamic financial services industry as a whole. Thus, Shariah non-compliance risk is clearly a major challenge for regulators (Khan & Ahmed 2001). According to Zurina et al. (2010) the main objectives of the audit is to manage the operational risks in IFIs. The operational risks includes among others is Shariah risk management which is very crucial in IFIs as the establishment of IFIs were based on the principles of Shariah law.

Thus, IFIs should have in place, guidelines or internal control which can give direction to IFIs in meeting the Shariah requirement. Basically by opting for Shariah audit, it will help IFIs to comply with the Shariah law as well as accounting regulations (Greuning & Iqbal, 2008). Furthermore, Shariah audit would certainly enable IFIs to gain a sound Corporate Governance by providing the right formulation of principles and enforcement.

CONCLUSION

The main difference between an Islamic organization from its conventional counterparty is the requirement to comply with the Shariah law. This is what business is all about for the Islamic business operations be it financial institution or venture capital firms. However, they are similar in terms of the risk exposure specifically on handling deposits and providing financings. Nevertheless, an Islamic organization will face an additional risk which arises as a result of having Shariah-compliant operations and activities. Therefore it will be exposed to Shariah non-compliance risk (Kahf, 2006).

In order to reduce the possible non-compliance risks, it is important to have a good Shariah governance to ensure that Islamic business operations and activities uphold the rules of Shariah (Hidayat, 2012). Shariah governance mechanism refers to oversight roles of board, Shariah committee and management, while the monitoring aspect focus

on internal Shariah review, Shariah audit, Shariah risk management and Shariah research. Having the governance and monitoring functions both hand-in-hand, the paper suggests that the Shariah committee and the Shariah audit should be the backbones in reducing the exposure to non-compliance risk. The Shariah committee is responsible to advise on all aspects of Shariah matters while Shariah audit is a function of monitoring in nature needed to verify the compliance with Shariah. It is the function of Shariah audit to be a mechanism of check and balance on all business operations and activities, be it financially or non-financial. Thus, Shariah committee and Shariah audit are expected to play significant roles to ensure the non-existent of the non-Shariah compliance risks.

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