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***SHARĪ'AH GOVERNANCE IN ISLAMIC FINANCIAL
INSTITUTIONS IN MALAYSIA, GCC COUNTRIES AND THE UK***

**BY
ZULKIFLI HASAN**

**Thesis submitted in Fulfilment of the Requirements for the Degree of
Doctor of Philosophy at Durham University**

**School of Government and International Affairs
Durham University**

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Abstract

ABSTRACT

Shari'ah governance is peculiarly exclusive and unique to Islamic systems of financial management. While affirming the need for sound and efficient *Shari'ah* governance as a crucial part of corporate governance in Islamic financial institutions (IFIs), it has nevertheless been found that little has been written on the subject. In view of the scarcity of literature and specific studies in this area, this study aims to explore the state of *Shari'ah* governance practices in IFIs, particularly in Malaysia, GCC countries (Kuwait, Bahrain, United Arab Emirates, Qatar and Saudi Arabia) and the UK, as these countries present distinctive models and approaches towards *Shari'ah* governance in diverse legal environments. This study explores and analyses the extent of *Shari'ah* governance practices by highlighting seven main areas of *Shari'ah* governance: (i) *Shari'ah* governance approaches; (ii) regulatory frameworks and by-laws; (iii) roles of *Shari'ah* boards; (iv) attributes of *Shari'ah* boards in terms of independence, competence, transparency and confidentiality; (v) operational procedures; (vi) *Shari'ah* board assessment; and (vii) disclosure practice.

Since the availability of data and information on *Shari'ah* governance practices is very limited, a detailed questionnaire was generated for the sourcing of primary data from IFIs. As part of the qualitative research strategy, semi-structured interviews were conducted with *Shari'ah* scholars, specifically to explore their perceptions on selected *Shari'ah* governance issues. In addition, the content analysis approach was used in extracting and analysing the data and factual input derived from information and resources on IFIs' websites, exchange websites, annual reports and financial statements. The findings in this study interestingly reveal that there are shortcomings and weaknesses in the present practice of *Shari'ah* governance in all seven core areas mentioned above. Based on the empirical analysis extracted from the research findings, the study finally offers and formulates some policy recommendations for the purpose of enhancing and improving the present *Shari'ah* governance system.

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LIST OF ACRONYMS

AAOIFI	Accounting and Auditing Organisation for Islamic Financial Institutions
AASB	Accounting and Auditing Standard Board
AFB	Asian Finance Berhad
AGC	Audit and Governance Committee
AGM	Annual General Assembly
AIB	Affin Islamic Bank
BAFIA	Banking and Financial Institutions Act 1989
BBA	<i>Bay‘ Bithaman Ājil</i>
BCBS	Basel Committee on Banking Supervision
BIB	Bahrain Islamic Bank
BMBI	BMB Islamic
BMMB	Bank Muamalat Malaysia Berhad
BNM	Bank Negara Malaysia (Central Bank of Malaysia)
BOD	Board of Directors
BSN	Bank Simpanan Nasional
CBA	Central Bank of Malaysia Act 2009
CBB	Central Bank of Bahrain
CBK	Central Bank of Kuwait
CEO	Chief Executive Officer
CIBAFI	General Council for Islamic Banks and Financial Institutions
CIMB	CIMB Islamic Bank Berhad
CSAA	Certified <i>Shari‘ah</i> Adviser and Auditor

List of Acronyms

DIB	Dubai Islamic Bank
DIFC	Dubai International Financial Centre
DFSA	Dubai Financial Services Authority
DIJM	Dow Jones Islamic Market Indexes
FI	Failaka International
FSA	Financial Services Authority
GCC	Gulf Cooperation Council
HLIB	Hong Leong Islamic Bank
HSBC (M)	HSBC Amanah Malaysia Berhad
IAH	Investment Account Holders
IAIB	International Association of Islamic banks
IB	Instructions to Banks
IBB	Islamic Bank of Britain
IBFIM	Islamic Banking and Finance Institute of Malaysia
IIBI	Institute of Islamic Banking And Insurance
IIIF	International Institute of Islamic Finance
IFSB	International Financial Services Board
IFIIs	Islamic Financial Institutions
IIFM	International Islamic Financial Market
IIRA	International Islamic Rating Agency
IICRCA	International Islamic Centre for Reconciliation and Commercial Arbitration
IDB	Islamic Development Bank
IOSCO	International Organization of Securities Commission

List of Acronyms

ISFI	Islamic Finance Rule Book of Qatar
ISRA	International <i>Shari'ah</i> Research Academy
KFH (M)	Kuwait Finance House Malaysia Berhad
KIB	Kuwait International Bank
MEED	Middle East Business Intelligence
MFSA	Minhaj <i>Shari'ah</i> Financial Advisory
MIB	Maybank Islamic Bank Berhad
MIFC	Malaysian International Financial Centre
OECD	Organization for Economic Co-operation and Development
OIC	Organization of the Islamic Conference
RHB	RHB Islamic Bank Berhad
QCB	Qatar Central Bank
QFC	Qatar Financial Centre
QFMA	Qatar Financial Markets Authority
SAC	<i>Shari'ah</i> Advisory Council
SAMA	Saudi Authority Monetary Agency
SC	Securities Commission
SBP	State Bank of Pakistan
SHC	<i>Shari'ah</i> Committee
SII	Securities and Investment Institute
TA	<i>Takaful</i> Act 1984
UKTI	UK Trade & Investment
YL	Yasaar Limited

TRANSLITERATION OF ARABIC WORDS

Name of the Letters	Form	Transcription
Alif	ا	a
Bā'	ب	b
Tā'	ت	t
Thā'	ث	th
Jim	ج	j
Hā'	ه	h
Khā'	خ	kh
Dāl	د	d
Dhāl	ذ	dh
Rā'	ر	r
Zay	ز	z
Sīn	س	s
Shīn	ش	sh
Sād	ص	ṣ
Dād	ض	ḍ
Tā'	ط	ṭ
Zā'	ظ	ẓ
Ayn	ع	'
Ghayn	غ	gh
Fā'	ف	f
Qāf	ق	q
Kāf	ك	k
Lām	ل	l
Mīm	م	m
Nūn	ن	n
Hā	ه	h
Wāw	و	w
Yā	ي	y
Hamzah	ء	'

Notes:

- i. Short vowels are transliterated as [a], [i] and [u];
- ii. Long vowels are transliterated as [ā], [ī] and [ū]; and
- iii. There are two diphthongs in Arabic which are transliterated as [aw] and [ay].

Declaration

DECLARATION

I hereby declare that no portion of the work that appears in this study has been used in support of an application of another degree or qualification to this or any other university or institution of learning.

Statement of Copyright

STATEMENT OF COPYRIGHT

The copyright of this thesis rests with the author. No quotation from it should be published in any format, including electronic and the internet, without the author's prior written consent. All information derived from this thesis must be acknowledged appropriately.

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I owe you a great debt of appreciation.

Dedication

DEDICATION

To my dear parents:

***Haji Hasan Yeen
&
Hajjah Rabeah Khalid***

To my beloved wife:

Hanani Harun

To My Dearest Children:

***Muhammad Al Ameen
Iffah Madiehah
Izzah Maisarah***

CHAPTER 1

INTRODUCTION

1.0 Background

In recent years, corporate governance has received considerable attention in Islamic finance. The extensive development of corporate governance in conventional finance raises the issue of how Islamic corporate governance should be designed. Does it need its own theoretical model or is it sufficient to modify conventional corporate governance structures? This question has prompted scholarly research to identify and define the foundational dimensions and characteristics of Islamic corporate governance.

An aspect of particular importance to formulate a theoretical foundation of Islamic corporate governance is to search for its epistemological orientation and to identify the theories associated with the existing corporate governance model. The main theories that have affected the development of corporate governance are agency theory, which is primarily concerned with the relationship between managers and shareholders, and stakeholder theory that takes account of a wider group of constituents (Mallin, 2007: 16). These theories generate the two most dominant corporate governance models known as the shareholder value system and stakeholder value orientation.

The theoretical framework of both the shareholder value system and stakeholder value orientation is very important for the purpose of enlightening the theory of corporate governance from Islamic perspective. Despite the fact that these two models of corporate governance are human constructs and have different characteristics, they actually share certain similarities in term of values and principles with the Islamic model of corporate governance, particularly stakeholder value orientation. Having analysed the core features of both models, corporate governance in IFIs seems better suited to operate within the stakeholder value framework rather than shareholder system, emphasizing the interest of a diverse group of constituents such as employees, customers, suppliers and the local community.

Another dimension of corporate governance in Islam which is different from the western concept refers to its epistemological orientation. The fundamental principles of *Tawhīd*,

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shura, property rights and commitment to contractual obligation that govern the economic and social behaviour require IFIs to comply with the *Shari‘ah* rules and principles (Choudury, 2004 and 2006 and Iqbal and Mirakh, 2004). At this juncture, corporate governance structure in IFIs need additional measures of governance for the purpose of *Shari‘ah* compliance, known as *Shari‘ah* governance. As part of the corporate governance framework in IFIs, *Shari‘ah* governance is the very essence of Islamic finance practice in building and maintaining the confidence of the shareholders and other stakeholders and assuring them that all transactions, practices and activities are in compliance with the *Shari‘ah* principles.

Shari‘ah governance is now becoming more diverse and advanced, in parallel with the development of Islamic finance industry worldwide. In view of the impressive growth and increasing sophistication of the Islamic finance sector, *Shari‘ah* governance of this rapidly evolving industry has proved challenging. As a consequence each jurisdiction has adopted different approaches to developing and nurturing its *Shari‘ah* governance framework. At this point, it is very important to understand and appreciate the pluralistic approaches of *Shari‘ah* governance across jurisdictions, so as to identify and highlight best practice. It should be noted that, from a regulatory point of view, Malaysia represents the most regulated *Shari‘ah* governance model, followed by Brunei, Pakistan and Sudan respectively, whilst GCC countries and the UK prefer less regulatory interference.

Malaysia has developed its *Shari‘ah* governance infrastructure and architecture in both regulatory and non-regulatory aspects. In fact, a special endowment fund of USD60 million has been allocated by the government of Malaysia to promote the development of *Shari‘ah* compliance and governance in the Islamic financial services sector. With regard to the development of *Shari‘ah* governance at the macro level, Bank Negara Malaysia (BNM) has established the National *Shari‘ah* Advisory Council (SAC) as the highest *Shari‘ah* authority in Islamic banking and finance. The SAC works closely with the *Shari‘ah* board of IFIs as well as the Securities Commission (SC) and also acts as a reference point for advice from the judiciary. The Malaysian regulators have gone even further to enhance the quality of *Shari‘ah* governance in the Islamic financial services sector by issuing, in 2004, *Guidelines on the Governance of Shari‘ah Committee for the*

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Islamic Banks, known as BNM/GPS1, and are introducing in 2010, a Concept Paper on *Shari‘ah* Governance Framework for IFIs.

IFIs in GCC countries , namely countries in the Arabian Gulf, including Saudi Arabia, Kuwait, Bahrain, Qatar and the UAE (except for the Sultanate of Oman), have their own framework of *Shari‘ah* governance which is different from that of Malaysia. Saudi Arabia treats IFIs as equal to their conventional counterparts and therefore allows the market to develop its own *Shari‘ah* governance system. On the other hand, Kuwait, Bahrain, Qatar and the UAE allow slight regulatory intervention in their *Shari‘ah* governance framework by issuing several directives in the form of rulebooks, as well as adopting the AAOIFI governance standards.

The *Shari‘ah* governance framework in the UK is aligned with that of the Financial Services Authority (FSA), and is unregulated through specific legislation. The establishment of a *Shari‘ah* board of the Islamic Bank of Britain, for instance, is due to the market factors and not because of regulatory requirements in the UK. It should be noted that the practices and frameworks of *Shari‘ah* governance are developed and nurtured by the respective IFIs in the UK and that there is no formal monitoring or coordination as in the case of Malaysia. The IFIs are allowed to adopt their own *Shari‘ah* governance approaches without being subject to any national or higher level *Shari‘ah* boards.

The discussion so far indicates that a study on the *Shari‘ah* governance system in IFIs is viable, indispensable and, in fact, beneficial, especially if it is explored theoretically as well as empirically. Indeed, this brings into focus the measures, analysis and empirical study that needs to be carried out to enhance and find the best practice of *Shari‘ah* governance in IFIs. In this regard, the study aims to provide, in the light of the research findings, useful guidelines and policy recommendations for sound *Shari‘ah* governance systems.

1.1 Statement of Problem

IFIs have taken the form of commercial banks, investment banks, investment and finance companies, asset management companies and financial services companies. There are

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diverse banking models practised in different jurisdictions, namely dual banking models, fully fledged Islamic institutions, Islamic subsidiaries of conventional banks and Islamic windows. Basically, the implementation of Islamic finance, and the way it is nurtured, greatly depends on the local legal environment and market factors.

In Malaysia, the establishment of a *Shari‘ah* board is a statutory requirement for all banks offering Islamic banking products pursuant to section 3 (5) (b) of the Islamic Banking Act 1983 (IBA 1983) for Islamic banks, section 124 (7) of the Banking and Financial Institutions Act 1989 (BAFIA 1989) for Islamic banking scheme banks, and section 51 of the Central Bank of Malaysia Act 2009 (CBA) for the BNM. The main objective of the establishment of the *Shari‘ah* board is to advise Islamic banks on any *Shari‘ah* matters and also to ensure compliance with the *Shari‘ah* tenets and requirements in their operations. Even though these legislation provide regulatory frameworks for the establishment of *Shari‘ah* boards, their legal ambit is not clear. The existing provisions in these legislation are inadequate and the frameworks are slightly ambiguous.

In the UK and GCC countries, the absence of a comprehensive set of regulatory framework on *Shari‘ah* governance may impede the development of Islamic finance. This position may create regulatory gaps and confusion to the players and the public with regard to the legal and *Shari‘ah* compliance of IFIs. Significant *Shari‘ah* governance issues, such as rejection of *fatwa*, differences in *Shari‘ah* pronouncements and *Shari‘ah* non-compliance risks, have the potential to affect the credibility and image of Islamic finance as well to create huge financial liabilities.

In view of the diverse and distinct frameworks of *Shari‘ah* governance, this study attempts to explore the actual practices of *Shari‘ah* governance in Malaysia, GCC countries and the UK. It is expected that the empirical findings of such an extensive study on this subject will be able to identify issues, gaps and problems, and at the same time propose policy recommendations pertinent to *Shari‘ah* governance systems in IFIs for further development of the industry.

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1.2 Research Aim and Objectives

The aim of this research is to analytically explore the extent of *Shari‘ah* governance practices in IFIs by analysing the practices and implementation of *Shari‘ah* governance in Malaysia, GCC countries and the UK through the perceptions and opinions of participants and available documents. This study explores, *inter alia*, whether the existing *Shari‘ah* governance framework provided in the mentioned case countries is adequate and efficient or whether it needs further enhancement. The study, thus, attempts to formulate a good and sound *Shari‘ah* governance framework based on the empirical analysis extracted from the research findings.

There are a number of objectives through which the aim of this study will be fulfilled, which are as follows:

- (i) To investigate the different approaches of IFIs to *Shari‘ah* governance;
- (ii) To study the regulatory framework and internal policies of *Shari‘ah* governance in IFIs;
- (iii) To examine the roles and functions of the *Shari‘ah* board in IFIs;
- (iv) To examine the attributes of *Shari‘ah* board members on independence, competence and transparency, and confidentiality;
- (v) To examine the operational procedures of *Shari‘ah* governance in IFIs;
- (vi) To investigate the perception of IFIs of their *Shari‘ah* board’s performance;
- (vii) To ascertain the extent of disclosure of *Shari‘ah* governance practices in IFIs;
- (viii) To provide, in light of the empirical results of the research, certain essential guidelines and policy recommendations that can be considered to enhance and improve the *Shari‘ah* governance system.

1.3 Research Questions

The study aims to respond and answer the following formulated research questions, which are derived from the aim and objectives of the study:

- (i) What is the *Shari‘ah* governance system?
- (ii) What are the different approaches of IFIs towards *Shari‘ah* governance?

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- (iii) How different are the regulatory and internal frameworks of *Shari‘ah* governance in IFIs?
- (iv) How do the roles and functions of *Shari‘ah* boards differ between IFIs?
- (v) Are there any standard operational procedures for *Shari‘ah* governance processes?
- (vi) What mechanisms are in place that would ensure independence, competence, transparency and confidentiality in *Shari‘ah* governance?
- (vii) To what extent has the *Shari‘ah* board demonstrated its roles and functions?
- (viii) What is the extent of disclosure practices of *Shari‘ah* governance in IFIs?

Analytical responses to each of these questions are provided through qualitative and quantitative analysis in the following chapters in an empirical manner.

1.4 Hypotheses

In the light of the research aim and objectives, as well as the research questions, seven hypotheses have been formulated in order to give direction to the research. They are as follows:

- (i) There are differences in the approaches of various IFIs to *Shari‘ah* governance;
- (ii) There are differences in the regulatory and internal frameworks of *Shari‘ah* governance in IFIs;
- (iii) There are differences in the roles and functions of *Shari‘ah* boards;
- (iv) There are differences in the attributes of *Shari‘ah* board members in terms of competence, independence, transparency and confidentiality;
- (v) There are differences in the operational procedures of *Shari‘ah* governance practices;
- (vi) The IFIs are satisfied with the performance and contribution of the *Shari‘ah* boards;
- (vii) There are differences in the extent of disclosure of *Shari‘ah* governance practices.

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1.5 Thesis Statement

This research is a theoretical and empirical study on the *Shari‘ah* governance practices of IFIs in Malaysia, GCC countries and the UK. The findings indicate that there are some common elements underlying and promoting good governance and best practices. If these are more widely disseminated they will create a better environment for the *Shari‘ah* governance which in turn is important for the consolidation and sustainability of the global Islamic finance industry.

1.6 Significance of Research

In view of the lack of intensive and in-depth research in the area of *Shari‘ah* governance, the researcher undertakes to conduct a comprehensive study of the extent of *Shari‘ah* governance practices, in the hope that its findings may provide certain guiding frameworks, principles and best practices for *Shari‘ah* governance system in IFIs. The findings of this study will provide useful information on the frameworks and practices of *Shari‘ah* governance of IFIs in Malaysia, GCC countries and the UK by emphasizing the following aspects:

- (i) The design and implementation of the *Shari‘ah* governance strategy in Malaysia, GCC countries and the UK;
- (ii) The need for a comprehensive *Shari‘ah* governance framework at the institutional, national and international levels;
- (iii) The need to strengthen the existing *Shari‘ah* governance framework through a comparative study of the practices in Malaysia, GCC countries and the UK;
- (iv) The role of the regulatory authority in improving the standards and best practices in order to ensure sound and effective *Shari‘ah* governance;
- (v) The role of *Shari‘ah* board practices in Malaysia, GCC countries and the UK and best practices for policy adaptation.

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1.7 Scope of Research

The scope of this study is limited to *Shari‘ah* governance of IFIs or institutions that offering Islamic financial products and services in Malaysia, GCC countries (Kuwait, Bahrain, Qatar, Saudi Arabia and the UAE) and the UK. The study excludes Oman as one of the case countries in the GCC region, since the government of Oman has resisted implementing *Shari‘ah*-compliant banking for political reasons. This research focuses on the framework of *Shari‘ah* governance of these three different territories, as they provide three distinctive models and approaches. The research attempts to explore the extent of *Shari‘ah* governance practices by systematically analysing the empirical results of the research; its findings may provide certain essential guidelines for a strong and effective *Shari‘ah* governance system.

1.8 Outline of Research

Corporate governance is one of the vital parts of any corporation's development, as it plays a role in designing and promoting principles of fairness, accountability and transparency. It seems that the Western concept and principles of corporate governance are very similar to Islamic perspectives and are in fact highly commendable in Islam, despite the fact that they stem from two different epistemological orientations. In the context of IFIs, the concept of corporate governance plays a crucial part in ensuring its development and, more importantly, fulfilling the objectives of the firm within the ambit of *maqāsid Shari‘ah*. In this regard, corporate governance in IFIs needs another layer of governance, namely *Shari‘ah* governance, to address the issue of *Shari‘ah* compliance.

The literature seems to suggest that the existing *Shari‘ah* governance framework needs further enhancement and improvement in order to reinforce the development and growth of IFIs. This brings into focus the measures and efforts that need to be taken to strengthen the credibility of IFIs through enhancing the *Shari‘ah* governance framework. This research attempts to study the framework of the *Shari‘ah* governance system in IFIs and its actual practices in Malaysia, GCC countries and the UK. The research consists of ten chapters which are divided into four parts as follows. Part 1: Theoretical Concept of Corporate Governance; Part 2: Theoretical Concept of *Shari‘ah* Governance; Part 3:

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Empirical Results of the Research; and Part 4: Discussion, Recommendations and Conclusion.

Part 1 of the study comprises three chapters. Chapter 1 mainly presents an overview of the study, objectives, scope, significance, research questions, research methodology and statement of problems of the research. It outlines the whole research direction and the essence of the study in the area of *Shari‘ah* governance. Chapter 2 discusses a conceptual framework of corporate governance from a Western perspective. This includes conceptual definition, roles, models and institutions of corporate governance, particularly within the context of the financial services sector. References are made to famous Western academic concepts of corporate governance, namely ‘shareholder value’ and ‘stakeholder value’ models. Chapter 3 provides a comprehensive analysis of the concept and theoretical context of corporate governance from Islamic perspectives. This chapter briefly analyses a few models of corporate governance in Islam and explains its fundamental principles in the context of the financial services industry.

The discussion on the conceptual definition and theoretical framework, as well as the comparative overview of corporate governance from both conventional and Islamic perspectives, in Chapters 2 and 3 is very important for the purpose of enlightening the relevancy of *Shari‘ah* governance as part of the corporate governance in IFIs. The faith-based epistemology of corporate governance in Islam, which is inclined towards a stakeholder-oriented system, means that IFIs require additional measures to address specific issues pertaining to Islamic rules and principles in the form of *Shari‘ah* governance.

There are two chapters in Part 2. Chapter 4 constructs a theoretical concept of *Shari‘ah* governance. It discusses the conceptual definition of *Shari‘ah* governance, roles and models of the *Shari‘ah* board, the development of the *Shari‘ah* governance system, and its process and guidelines. The research also highlights issues and challenges pertinent to the *Shari‘ah* governance system, as practised by IFIs in cross-border jurisdictions. Chapter 5 focuses on the regulatory frameworks of the *Shari‘ah* governance system in

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Malaysia, GCC countries and the UK. The study identifies five *Shari‘ah* governance models in the context of regulatory perspectives.

Part 3 presents empirical results of the study and consists of four chapters. Chapter 6 explains the research methodology used and how the study is conducted and the findings are derived. The study employed a mixed-method approach as a research strategy, namely a combination of quantitative and qualitative research methods. Primary data was collected through interviews and questionnaires and secondary data was generated through the literature review and unobtrusive research methods. Descriptive, interpretative and content analysis method of analysis are used to analyse the data and sources available. Chapters 7, 8 and 9 distinctively impart the empirical results of the study: Chapter 7 provides an analysis of the questionnaires; Chapter 8 presents the empirical results of the semi-structured interviews and Chapter 9 elucidates the extent of disclosure of *Shari‘ah* governance practices via analysis of annual reports, financial statements and websites.

Part 4 provides the overall findings, policy recommendations and conclusions. Based on the research findings derived from the empirical study, Chapter 10 offers details of specific policy recommendations derived from the overall research findings for the purpose of enhancement and improvement of *Shari‘ah* governance. This chapter concludes the study by summarizing the entire research findings and the extent of the study’s contribution, and highlighting research limitations.

1.9 Conclusion

The aim of this research is to conduct a theoretical and empirical study into *Shari‘ah* governance practices of IFIs in Malaysia, GCC countries and the UK. The study emphasizes the regulatory and non-regulatory aspects of *Shari‘ah* governance and these include *Shari‘ah* governance approaches, regulatory and internal frameworks, roles of the *Shari‘ah* board, attributes of the *Shari‘ah* board with respect to independence, competence, transparency and confidentiality, operational procedures, and assessment of the *Shari‘ah* board. With significant numbers of *Shari‘ah* boards in numerous IFIs in Malaysia, GCC countries and the UK, it is undeniable that there are distinctive models

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and practices of *Shari‘ah* governance. This diversity actually reflects the beauty and blessing of Islam because it provides an opportunity to study comparatively the *Shari‘ah* governance practices with the purpose of identifying gaps, shortcomings and weaknesses, and highlighting the best practices for possible recommendations.

It is important that some common elements underlying and promoting good governance and best practices are fundamentally to be drawn together to facilitate the creation and optimization of a healthy and viable environment for *Shari‘ah* governance without impeding further growth of the industry. Effective *Shari‘ah* governance is essentially that which adheres to its essential elements of being participatory, transparent and accountable. These elements are embedded in Islam and therefore become an integral part of corporate governance framework in IFIs. Consequentially, a sound *Shari‘ah* governance framework requires the involvement of all stakeholders, the government, the industry associations, the shareholders, the directors, the management and other persons relevant to the business. This research argues that the findings, solutions and recommendations from an in-depth study into this area will contribute something significant towards developing a good and effective *Shari‘ah* governance system. Constant enhancement of the framework is necessary to ensure optimal *Shari‘ah* governance in IFIs.

CHAPTER 2

CORPORATE GOVERNANCE: A CONVENTIONAL PERSPECTIVE

2.0 Introduction

Corporate governance is one of the vital elements in any corporation. There has been much debate and discourse on the issue of corporate governance for many years. The concept of corporate governance is becoming much more popular since there have been more corporate failures due to ineffective governance.¹ Basically, there is no consensus on the definition and concept of corporate governance. This is due to the different understandings of the goals of corporations with respect to different models of corporate governance, as well as a large number of distinct economic systems. As a result, there are various definitions and concepts of corporate governance propounded by different parties that basically reflect their special interest in the field.

Iqbal and Mirakhor (2004: 43–44) argue that the increased attention on the issue of corporate governance is due to the growth of institutional investors, the weaknesses and defects of a ‘shareholder model’ of corporate governance, a shift away from the traditional shareholder value system to a stakeholder model, and impact of the globalization of the financial market. Recognizing all these aspects, this chapter explores the theoretical foundation of corporate governance from a conventional perspective in general and tries to conceptualize its framework in the context of the financial services sector. The discussion involves an overview of the corporate governance system, its conceptual definition, models, mechanisms and institutions. The aim of this chapter is to build a basic understanding of corporate governance in conventional literature so as to enable the study to construct and develop the concept of corporate governance within the Islamic paradigm that will be discussed in Chapter 3.

¹ There have been numerous scandals and corporate failures during the last two decades that have affected regional and global economic stability, such as the BCCI in 1991, Barings Bank in 1995, Credit Lyonnais in 1998, Enron, Arthur Anderson and WorldCom in 2002, Northern Rock in 2007, and Madoff Securities and Lehman Brothers in 2008.

2.1 Conceptual Definition

The discourse on corporate governance as a discipline in its own right is relatively new as it has evolved over centuries (Cadbury, 1999: 3). There are various definitions of corporate governance and the absence of any real consensus on its actual meaning leads to various interpretations. Sections 2.1 and 2.2 briefly provide a conceptual definition of corporate governance in conventional literature by defining corporations, governance, corporate governance, and corporate governance in financial services.

Literally, the word ‘corporation’, as defined in the Oxford English Dictionary (1989), is derived from the Latin word *corpus* which means “a group of people authorized to act as an individual and recognized in law as a single entity”. A similar definition can be found in the American Heritage Dictionary (2007), where a corporation is referred to as “a body that is granted a charter recognizing it as a separate entity having its own rights, privileges, and liabilities distinct from those of its members”. In terms of legal definition, Blacks’ Law Dictionary (2009) legally defines a corporation as “an artificial person or legal entity created by, or under the authority of, the laws of a state”. In short, these three different definitions lead to a similar conclusion that a corporation can be defined as a form of organization that represents a group of people as a single entity for certain purposes.

The term ‘governance’ originates from a Latin word, *gubernare*, which means to steer or to govern (Cadbury, 2002: 1). Lewis (2005: 5) also mentions that the word governance comes from the Greek word *kybernan* which means to steer, to guide or to govern.² The Oxford English Dictionary (1989) provides a wide meaning of governance as to include any “act or manner of governing”. All of these definitions present a very wide meaning of governance as the term may cover areas of politics, economics, social justice and public administration. In other words, the term governance in a general sense means the style or way an organization, institution or corporation is guided, steered and controlled.

² *The Macquarie Encyclopedic Dictionary* (1990), states that the etymological root of governance is from the Greek to the Latin *gubernare* and to the Old French *gouverner* (Lewis, 2005: 25).

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From the above definitions of corporation and governance, the meaning of corporate governance can be categorized into two senses, namely a narrower sense and an expansive term. The former considers it a formal system of accountability between the shareholders and their agent such as BOD and senior management and the latter refers to it as the entire network of formal and informal relations involving large group of stakeholders in the firm, such as shareholders, management, employees, the community and the environment.

2.2 Defining Corporate Governance in the Financial Services Sector

A concept of corporate governance in the context of the financial services sector presents its own distinct characteristics and features. Basically, it requires additional measures and greater concerns as compared to the firms in other sectors as it involves a larger group of stakeholders. The OECD (2004: 11) provides a general definition of corporate governance as “a set of relationships between a company’s management, its board, its shareholders, and other stakeholders”. This definition nevertheless does not specifically differentiate the nature of corporate governance in the financial services sector.

The Basel Committee for Banking Supervision (BCBS), on ‘Enhancing Corporate Governance for Banking Organizations’, specifically explains the corporate governance from a banking industry perspective, which involves “the manner in which the business and affairs of individual institutions are governed by their BOD and senior management affecting how a bank sets its corporate objective, daily business, interest of the stakeholder, to align corporate activities operate in a safe and sound manner and to comply with laws and regulations, and to protect the interest of depositors” (BCBS, 1999: 3). At this point, the BCBS expands the term ‘stakeholders’ to include employees, customers, depositors, suppliers, supervisors, government and the community. In explaining corporate governance in the context of the financial services sector, Arun and Turner (2003: 6) specifically mention the importance of ensuring capital and investment return and protecting depositors as well as shareholders. On the whole, corporate governance in financial institutions to certain extent is different to that in other types of business organization, as it involves a larger group of stakeholders. With this position, financial institutions are much more regulated as compared to other commercial entities.

2.3 Role of Corporate Governance

If we refer to early academic discussion on corporate governance in the case of the United States, it is found that the main function of corporate governance is to reduce agency costs due to conglomerate mergers and hostile takeovers; it then evolves into other areas, including the role of institutional investors as corporate monitors to control managerial shirking and to maximize shareholder value (Macey, 2004: 580). This is affirmed by Scott (2003:527), who explains the objective function of a corporate governance system as a set of legal rules, incentives and behaviours that support the reliance by investors in order to maximize the economic efficiency of the firm. Studies by Selvaggi and Upton (2008), Black (2001) and Black et al. (2006), for instance, strongly affirm the positive correlation between corporate governance behaviour and firms' performance.³

In the context of the financial services sector, Claessens (2003: 14) considers that corporate governance is very important, particularly in determining a firm's performance in terms of ability to facilitate access to external finance, to lower cost of capital, to improve operational performance, to mitigate the operational risk, and to achieve better relationships amongst the stakeholders. In this aspect, a clear and precise corporate governance framework will stimulate the bank's efficiency which may contribute towards better performance, avoid unnecessary agency cost, and resolve the agency problem (Hart, 1995: 678).⁴

Another key function of corporate governance refers to the promotion of corporate fairness, transparency and accountability (Wolfensohn, 1999). Corporate governance requires financial institutions to be more transparent and to ensure fairness not only to shareholders but also to other stakeholders. Having greater transparency and more

³ In the UK, companies with good governance posted 18% higher returns than those with poor governance, while in Russia it is predicted that it may significantly increase the firm's value and in Korea firms with good governance have been found to trade at a premium of 160% to poorly governed corporations (IFC and Hawkamah, 2008: 12).

⁴ In the absence of agency problems, all members of the organization can be instructed to maximize profit or to minimize cost and they will be prepared to carry out the instructions. Effort and other kind of costs can be reimbursed directly and incentives are not required to motivate and therefore no governance structure is required to resolve disagreement. The issue of the corporate governance model is not relevant in the absence of this agency problem (Hart, 1995: 678).

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accountability as an element of best corporate governance practice will positively affect growth as well as improve the firm's stability, efficiency and trustworthiness (Grais and Pellegrini, 2006b: 5).

To sum up, corporate governance plays an essential role in meeting the specific goals and objectives of a corporation. The distinct function of corporate governance in the financial services sector is mainly focused on the determination of policies, a set of legal rules and managerial behaviours amongst the shareholders, the managers, the BOD, the depositors and other stakeholders. The complication and sophistication of the financial services sector with a larger group of stakeholders affects the scope and framework of the corporate governance system in financial institutions. These factors also lead to the needs for a distinctive codes and guidelines to promote best practice of corporate governance in financial services sector.

2.4 Corporate Governance Systems

It is imperative to conduct a survey on the international corporate governance system in the world and how it has been practised. Shleifer and Vishny (1997) provide a comprehensive survey of corporate governance, centring on the essence of legal protection of investors and ownership concentration in the governance system. The underlying problem of corporate governance, as recognized by a long tradition of scholars, such as Berle and Means (1932), Marshall (1920) and Smith (1993), lies with the issue of separation of beneficial ownership and executive decision-making (Keasey et al., 1997: 528).

Corporate governance has emerged for several reasons including corporate fraud and corporate collapse, such as the cases of web fraud and deception involving Bank of Credit and Commerce International, the collapse of Barings and Polly Peck, and the Enron scandal in the United States (Kay and Silberston, 1995: 84). All these events have led to corporate governance reforms in the form of governance codes, rules and guidelines as to how companies can be best managed and controlled.

Becht and Barca (2001) provide a literature review of a number of quantitative corporate governance models as a possible means to resolve the issue of the collective action problem among dispersed shareholders. These models consist of: the takeover model; block holder model; delegated monitoring and large creditors; board models; executive compensation models; and multi-constituency models. Another interesting examination can be found in Lewis (1999: 33–66), where he examines six different models of corporate governance, namely the Anglo-Saxon model, the Germanic model, the Japanese model, the Latin model, the Confucian model and the Islamic model. This study chooses this classification by Lewis (1999) to explain the differences of corporate governance models by focusing on the main two dominant systems, i.e. the Anglo-Saxon and the European models, and by briefly mentioning some other models of corporate governance in Japan,⁵ China,⁶ and Italy.⁷

2.4.1 The Anglo-Saxon Model

The Anglo-Saxon model is also known as a market-based, shareholder value or principle-agent system and is considered the most dominant theory of corporate governance. This is demonstrated by the practice of numerous corporations all over the world, such as in the United States⁸ and the UK.⁹ This corporate governance system is relatively important

⁵ The basic model of Japanese corporate governance system is known as a bank-led or bank-based model. The bank-based model not only refers to the bank as a shareholder per se but another essential element is powerful state supervision and intervention (Okumura, 2004: 3–4). In Japanese corporations, there are normally two groups of shareholders, namely corporate shareholders, known as market investors, and bank shareholders, known as stable investors. This structure affects the corporate governance objective as it is not only to maximize the investment return for corporate shareholders but also to protect the quality of its loan portfolio for bank shareholders (Yoshikawa and Phillip, 2005: 304).

⁶ The Chinese government has mandated the corporate governance structure for Chinese corporations to be modelled based on the Anglo-Saxon or market-based model (On Kit Tam, 2000: 52). In 1996, China decided to begin implementing its own version of a corporate governance system known as ‘Zhuban Yinhang’ or ‘Main Bank’, a combination of the Japanese and European models, as a means to reform state-owned corporations (On Kit Tam, 2000: 52).

⁷ The Latin model is classified as an insider model of corporate governance, where the concentration of shareholding is owned by cross shareholdings, financial shareholdings, a residue state ownership and family-based control (Lewis, 1999: 44).

⁸ Grant, (2003: 923–934) interestingly examines the impact of corporate governance evolution and development in modern corporate America and concludes that corporate governance remains the core issue to align the interest of different stakeholders.

⁹ The concept of enlightened shareholder value is clearly enshrined in section 172 (1) of the Companies Act 2006. With the recommendation of the Law Review Committee Steering Group, section 172 (1) provides that “directors owe their fiduciary duty only to the shareholders generally, rather than a range of interest groups, but seeks to provide a broader context for fulfilling that duty” (Andrew, 2007: 579). .

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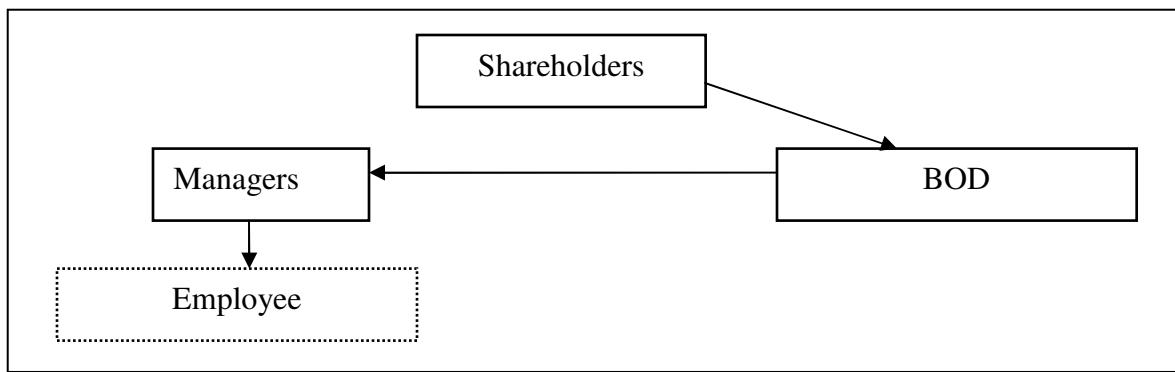
for corporations in these jurisdictions as it sets a clear and very objective corporate goal of maximizing shareholders' profit¹⁰.

Although the corporate governance theory has been discussed for centuries, there is no formal or serious discussion on the approach or model of corporate governance. The extensive discourse on corporate governance began in the 1970s when a group of American financial economists developed the agency theory as a basis of a corporate governance system (Lazonick and O'Sullivan, 2000: 14–17). This agency theory was formulated with sole motivation of maximizing shareholder value and there are legal rules and policies to be imposed on BOD and executive officers which require them to act in the best interest of the shareholders.

Mallin, (2007: 12) states that one of the advantages of the agency theory is it “identifies the relationship where one party, the principal, delegates work to another party, the agent”. At this point, she mentions that BOD plays a role as an essential monitoring device to minimize any principal-agent relationship problems (Mallin, 2007: 13). In addition, Hart (1995: 678) considers that corporate governance is very important to resolve the agency problem either in the form of cost of business or conflict of interest. At this point, the agency theory influences the corporate governance structure in the Anglo-Saxon model of corporation where BOD and senior managers act as agents to protect the interest and rights of investors or shareholders. Cernat (2004: 3) briefly illustrates this structure in Figure 2.1.

¹⁰ Although the UK and the United States corporate governance models share many similarities, there are several differences on their actual practices such as the board structure and the roles of Chairman, CEO and executive directors. It is reported that the Chairman and the CEO of 75 percent of the S&P500 in the United States are the same person while in the UK the roles are separated (Keenan, 2002: 173). In addition, unlike in the UK, it is a rare practice in the United States to appoint additional executive directors on top of the Chairman, CEO and Chief Financial Officer (Keenan, 2002: 173).

Figure 2.1: The Anglo-Saxon Model of Corporate Governance



Source: Cernat (2004: 153).

Figure 2.1 appears to show that the Anglo-Saxon model is based on the corporate concept of a fiduciary relationship between the shareholders and the managers motivated by profit-oriented behaviour. The central motivation of corporate governance in the shareholder value orientation system is to protect the interests and rights of the shareholders. In this regard, Miller (2004: 2) considers that corporate governance is concerned with shareholder value, in which the individual is sovereign, and not the government, the producers or the merchants. The connection between customer sovereignty and corporate governance does not just lie in the benefit the customer derives from the corporation's output, but the shareholders, investors and owners are also customers and that is what drives the shareholder value principle.

2.4.2 The European Model

Since the publication of Berle and Means (1932), many have believed that there are significant problems with the shareholder value system of corporate governance. This model is viewed as inferior by some scholars because it does not effectively address the agency problems (Macey and Miller, 2004: 552). This modern tendency has led to a formulation of another corporate governance system known as stakeholder theory.¹¹

A different perception of corporation in the European countries results in another approach to corporate governance which is based on the stakeholder-oriented model.

¹¹ Some authors use different terminology for the European model of corporate governance, such as stakeholder model or theory, stakeholder management, stakeholder value orientation, Franco-German model and stakeholder society.

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Initial studies on the stakeholder theory of corporate governance has been conducted by Clarkson (1995) and Donaldson and Preston (1995), who claim that the interests of all the stakeholders have intrinsic value and that one set of interests is not supposed to dominate the others (Yamak and Suer, 2005: 113). The efficiency of this model is proven by referring to the successful corporations and industrial societies that has developed a reputation for the ethical treatment of suppliers, clients and employees and that are able to build up trusting relationships, which support profitable investments and mutually beneficial exchanges (Jones, 1995: 404).

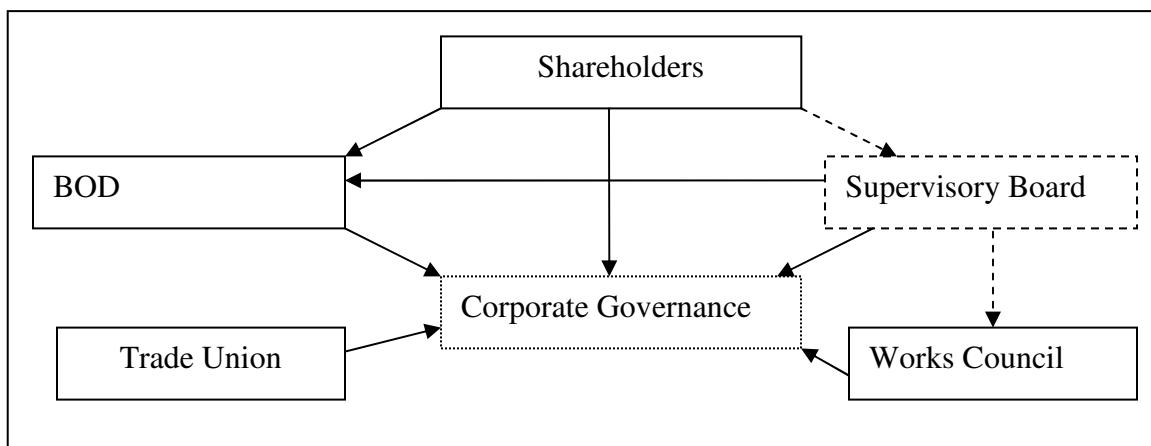
As a basic premise, the stakeholder theory rejects propositions of the shareholder value model and enhances the corporate governance framework by which stakeholders have a governance right to participate in corporate decisions, it is the manager's fiduciary duty to protect the interests of all stakeholders and the corporation's objective to promote the interest of all stakeholders and not only the shareholders (Iqbal and Mirakh, 2004: 46). Mallin, (2007: 16) states that "stakeholder theory takes into account of a wider group of constituents rather than focusing on shareholder". In explaining the term stakeholders, Freeman (1984: 46) defines it as a group of constituents who have a legitimate claim on the corporation or a person who contributes directly or indirectly to the firm. In addition, Lepineu classifies the stakeholders into shareholders, internal stakeholders (employees and labour unions), operational partners (customers, suppliers, creditors and contractors), and the social community (state authorities, trade union, non-governmental organizations and civil society) (Yvon Pesqueux and Salma, 2005: 7).

In terms of corporate governance structure, the special attribute of the European model of corporate governance system refers to the practice of the two-tier system, comprising a supervisory board of outside directors and a separate management board of executive directors, in which structure the two boards meet separately (Dignam and Galanis, 2009: 269-274). Basically, there is much literature examining and discussing the role of the firms, which is contrary to the understanding of the Anglo-Saxon corporate governance model, particularly in Germany. The concept of corporate personality or '*Verbands Personlichkeit*' affects the German view about a corporation as it constitutes part of the social and economic structure within the community and has its own function towards

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society at large (Kay and Silberston, 1995: 88). At this point, Mallin, (2007: 162) states that the philosophy of the German approach to corporate governance emphasizes on a wider set of stakeholder interest and this includes the employees and customers. Figure 2.2 illustrates the corporate governance structure of the European model.

Figure 2.2: Corporate Governance Structure of the European Model



Source: Cernat (2004: 153).

Figure 2.2 illustrates that the European model of corporate governance operates on the two-tier boards system, i.e. supervisory and management board system. The supervisory board is elected by the shareholders and the employees and has the authority to elect the management board (Schilling, 2001: 148). Members of the supervisory board normally consist of shareholders, trade union members and work council representatives (Dignam and Galanis, 2009: 271). The management board has a fiduciary duty to manage the business of the company by not only taking into consideration the rights and interests of shareholders but also of other stakeholders, while the supervisory board plays the role of supervising and monitoring the management board (Schilling, 2001: 148).

2.4.3 The Differences between the Anglo-Saxon and the European Models

The main difference between the Anglo-Saxon and the European models of corporate governance refers to the ownership and control of corporations. The former presents the feature of maximization of the shareholders return and the latter displays the characteristic that decisions are traditionally made under the assumption that employee's

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interests will be safeguarded (Franks and Mayer, 2004: 535).¹² Table 2.1 summarizes the diversity of the Anglo-Saxon and the European models of corporate governance:¹³

Table 2.1: The Diversity of the Anglo-Saxon and the European Models of Corporate Governance

Aspects	The Anglo-Saxon Model	The European Model
Objective		
Rights and interests	To protect the interests and rights of the shareholders	To include the rights of other stakeholders
Corporate goal	Shareholders controlling managers for purpose of shareholder profit	Society controlling corporation for purpose of social welfare
Nature of management	Management dominated	Controlling shareholder dominated
Labour-related		
Cooperation between social partners	Conflictual or minimal contact	Extensive at national level
Labour organizations	Fragmented and weak	Strong, centralized unions
Labour market flexibility	Poor internal flexibility; high external flexibility	High internal flexibility; lower external flexibility
Employee influence	Limited	Extensive through works councils and codetermination
Capital-related		
Ownership structure	Widely dispersed ownership; dividends prioritized	Banks and other corporations are major shareholders; dividends less prioritized
Role of banks	Minimal role in corporate ownership	Significant role in corporate ownership control
Family-controlled firms	General separation of equity holding and management	Family ownership important only for small and medium sized enterprises
Management boards	One-tier board	Two-tier boards; executive and supervisory responsibility separate
Market for corporate control	Hostile takeovers are allowed and considered as a ‘correction mechanism’ for management failure	Takeovers restricted
Role of stock exchange	Strong role in corporate finance	Reduced role in corporate finance

¹² Due to these inherent characteristics of the Anglo-Saxon and the European models, Iqbal and Lewis (2009: 268) classify the former as within the ‘managed corporation’ paradigm and the latter as a ‘socially responsive’ corporation.

¹³ It is worth mentioning that the following comparison is based on the general characteristics of the Anglo-Saxon and the European models. Undeniably, both models evolve and their features may change and transmit into another form or even converge.

Source: Rhodes and Van Apeldoorn (1997: 174–5) as cited in Cernat (2004: 150): modified.

Although the corporate governance models have their own characteristics and distinctive features, it is hard to provide grounds for the sharp distinction of all these governance systems in actual practice. Commentators have argued that the market-based system and bank-based system are converging because it is difficult to differentiate the actual application of both systems. At this point, Hansmann and Kraakman, (2001: 439) considers that there is a substantial convergence in the practices of corporate governance. In fact, Articles I, II and III of the OECD (2004) appear to promote the convergence of the shareholder and stakeholder models by providing that corporate governance should protect shareholders' rights, ensure the equitable treatment of all shareholders and guarantee the rights of stakeholders as established by law.

Macey and O'Hara (2001: 91) seem to agree with the notion of convergence of these two corporate governance systems; they argue that the BOD and managers must not only manage the business of the company for the sake of shareholders alone but must also take into consideration other stakeholders' interests. The notion of convergence of the corporate governance system has already happened all over the world at least in the aspect of laws on corporate governance particularly rules on shareholder protection, diverged in worker protection and evened out in creditor protection (Siem, 2010: 756). The corporate governance system in Japan has evolved with a combination of the stakeholder, shareholder, and bank-based models, and the firms in the European model countries have emerged to accept and practise a few aspects and characteristics of the Anglo-Saxon model (Jacoby, 2000: 14). In fact, the corporations in the Anglo-Saxon countries have also shown interest and inclination towards adopting and importing values and approaches of the European model. Therefore, the hypothesis of the convergence of the stakeholder and shareholder systems appears to be affirmative.

2.5 Corporate Governance Code

With a number of high-profile corporate collapse because of lack of effective corporate governance, the corporate governance codes and guidelines have been issued by a variety

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of bodies all over the world. The earlier corporate governance code was introduced in the United States in 1970s, a period in which the corporate sector experienced numerous mergers and hostile takeovers. In 1978, a report was published by the Business Round Table entitled “The role and composition of the BOD of the large publicly owned corporation”; it was a guideline to prevent corporate criminal behaviour and to provide a set of laws on corporate governance (Hermes et al., 2006: 280). In 2002, the United States government introduced the Sarbanes Oxley Act 2002 with the purpose of strengthening the corporate governance framework by emphasizing the importance of corporate disclosure and strengthening auditor independence and company’s audit committee (Walsh, 2007: 770).

The first corporate governance code in the UK was instituted by the Bank of England and the London Stock Exchange in 1992. The report of the Committee on the Financial Aspect of Corporate Governance with its Code of Best Practice was published in December 1992 (Cadbury, 2002: 15). This code provides recommendations of best practice of corporate governance. In May 1995, another committee known as the Greenbury Committee was set up to specifically study the director’s remunerations, as a response to public and shareholder concern over executive pay (Mallin, 2007: 24). In view of several shortcomings and weaknesses of the previous corporate governance codes, the Hampel Committee was established in November 1995 to review the previous governance recommendations and issued its full report in January 1998 (Sheridan et al., 2006: 499). Finally, all of the previous corporate governance codes were superseded by the Principles of Good Governance and Code of Best Practice issued by the London Stock Exchange (Cadbury, 2002:16).¹⁴

Since the emergence of corporate governance as a discipline of its own, there have been numerous reports produced all over the world with different approaches and features. In France, the Marini report of 1996 led to the issuance of a specific law on corporate governance known as the Law on New Economic Regulation 2001 (Mesnooh, 2002: 9). Other significance corporate governance codes are the Cromme Code 2003 of Germany,

¹⁴ There are other two reports on corporate governance in the UK, namely the Higgs Report and Smith Report in 2003; the former emphasized the roles of non-executive directors and the latter was a specific response to the Enron corporate scandal. For further reading on the development of corporate governance code in the UK, see Mallin, (2007: 21-29)

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the Aldama Report 2003 of Spain, the Swedish Code of Corporate Governance 2004, the Dutch Corporate Governance Code 2003, the Belgian Corporate Governance Code 2004, and the Report on Corporate Governance 2003 in Denmark (Hermes, et al., 2006: 281). By 2004, a total of twenty-two European countries had established their own corporate governance code (Hermes, et al., 2006: 281). In 2003, the European Commission released Communication 284, a specific code of corporate governance for the European Commission countries entitled “Modernizing Company Law and Enhancing Corporate Governance in the European Union – A Plan to Move Forward” that consists of rules and guidelines to enhance corporate governance disclosure, strengthen shareholders’ rights and modernize the BOD (Hermes, et al., 2006: 282). These corporate governance codes, however, are classified as voluntary in nature and have no statutory force as in the case of the Sarbanes Oxley Act 2002.

The first effort to offer a universal code of corporate governance principles was carried out by the OECD. The OECD Principles of Corporate Governance was issued in May 1999¹⁵ and further revised in 2004 (Mallin, 2007: 31-33). The OECD (1999 and 2004) provide guidelines and recommendations on corporate governance, particularly with respect to the rights of shareholders, equitable treatment of shareholders, roles of stakeholders, disclosure and transparency, and the responsibilities of the board. Interestingly, the OECD principles enhance the scope of corporate governance by recognizing the rights of stakeholders instead of shareholders alone. The OECD principles nevertheless have no binding force upon the member countries and it is reported that none of the fifteen countries assessed by Fremond and Capaul, 2002: 2) comply with it.

On the whole, the United States is the pioneer for the issuance of corporate governance codes, followed by the UK, the European countries, and the rest of the world. The universal code of corporate governance then was initiated by the OECD with its Principles of Corporate Governance and supported by the International Corporate Governance Network and the Communication 284 at the European Commission level. On top of this, a number of influential organizations have also issued corporate governance

¹⁵ Twenty-nine governments of the OECD voted unanimously to endorse the OECD Principles of Corporate Governance (OECD, 1999).

guidelines such as the World Bank, the Global Corporate Governance Forum, the Commonwealth Association of Corporate Governance (Mallin, 2007: 43). It is reported that by January 2002 more than forty-three countries all over the world had developed their own corporate governance codes (Freemond and Capaul, 2002: 2). The emergence of all of these codes demonstrates the essence of best practice and the value of corporate governance.

2.6 Corporate Governance in the Financial Services Sector

Corporate governance is crucial in the financial services sector. History has witnessed the corporate collapse and malpractice of several financial institutions because of weak corporate governance frameworks such as the cases of BCCI, Barings, Equitable Life mortgage endowment mis-selling, split-cap investment trust opacity and a spate of money laundering failures¹⁶ (Schachler et al., 2007: 628). There are various significant issues of corporate governance in the financial services sector that affect its structure and approach, such as the opaqueness of the banks, heavily regulated and impeded natural corporate governance mechanisms and government ownership, which alter the corporate governance equation (Caprio and Levine, 2002: 11–18).¹⁷

Financial institutions are more opaque than other sectors of the economy. In this regard, the government or regulatory authority normally imposes certain regulatory requirements upon banks, such as restrictions on shareholders, rules on deposit insurance and restrictions on certain activities.¹⁸ In addition, there are differences in some key corporate governance variables in the financial services sector, particularly in terms of board size and composition, board activity, CEO compensation, and ownership and block share

¹⁶ See Komert (2003) and Dale (2001). Both articles analyse the failure of financial institutions that led to the establishment of the Financial Services Authority in 1998 with a purpose to take over responsibility for banking supervision.

¹⁷ Another corporate governance issue in financial institutions refers to the intervention of bureaucrats, especially in the case of governments as shareholders of the banks (Caprio and Levine, 2002: 18). As reported by La Porta, Lopez de Silanes and Shleifer (2000: 12, as cited in Caprio and Levine, 2002: 18), it is estimated that about 40% of the total assets in the banking system are majority-owned government banks.

¹⁸ For instance, in the UK, the Financial Services and Markets Act of 2000 grants power to the Financial Services Authority to regulate and enforce rules and regulations related to the financial services sector. The FSA Handbook of Rules and Guidance of 2005 further provides general guidelines for corporate governance, particularly in relation to the responsibilities of the BOD, senior management and maintaining proper mechanisms of control (Dewing and Russel, 2004).

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ownership. These unique characteristics imply the need for distinctive and effective corporate governance measures for financial institutions. This is affirmed by Macey and O'Hara (2003) who conducted a study on corporate governance for the Federal Reserve Bank of New York¹⁹ and highlighted the need for additional measures on corporate governance in the financial services sector.

In view of the unique features of corporate governance in the financial services sector, the Basel Committee on Banking Supervision (BCBS) has taken the initiative to issue guidelines on Enhancing Corporate Governance for Banking Organizations in order to foster safe and sound banking practices. Unlike the OECD Principles of Corporate Governance, which are more general and applicable to any type of corporate entity, the BCBS guideline addresses specific corporate governance issues exclusive to financial institutions. The BCBS (1999 and 2004) stresses the importance of an environment supportive of sound corporate governance, the role of supervisors and the significance of other stakeholders.

The above corporate governance studies imply that the multiple approaches to corporate governance models is necessary within the context of the financial sector. The diversity in the financial sector as compared to other types of corporate entity stems mainly from the presence of various stakeholders, such as shareholders, investors, depositors and regulators (Yamak and Suer, 2005: 112). This condition entails that the BOD and managers are assumed to have a duty to all stakeholders and it needs a distinctive corporate governance system as a mechanism of control. Yamak and Suer (2005: 114–115) identify and classify major stakeholders in financial institutions into the owners, the managers, the depositors, the borrowers and the regulators. The shareholders and the owners expect profit maximization, the managers assume they will obtain monetary and non-monetary compensation as stipulated in their contracts, the depositors expect a return on their deposits, the borrowers are concerned with fair and non-discriminatory treatment by the banks, and the regulators are interested in the compliance to the laws and

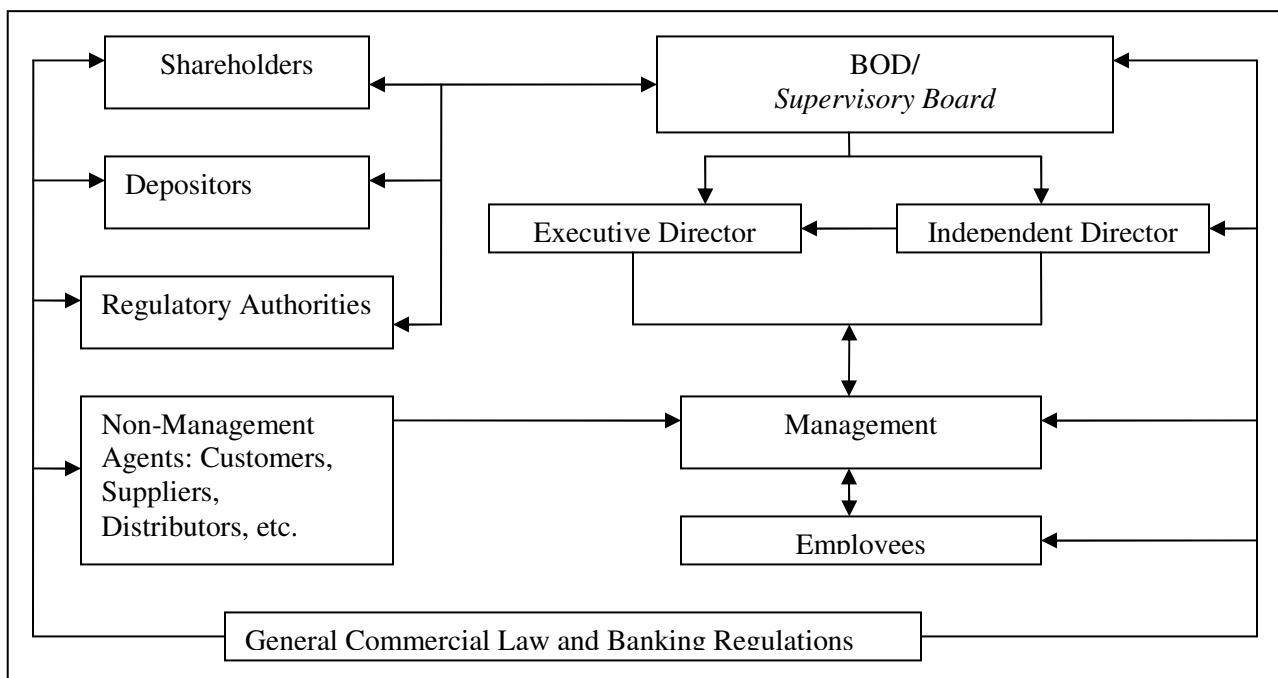
¹⁹ Mortlock (2003) discusses the corporate governance of the Reserve Bank of New Zealand, which emphasizes the need for appropriate banking supervisory arrangements and specific financial disclosure and external auditing arrangements. He argues that corporate governance in banking is a crucial factor to determine financial stability.

regulations by all the stakeholders. Recognizing all the stakeholders' interests and rights, the corporate governance model in the financial services sector seems to be more complicated than in other types of corporation and it implies the need for a specific and distinctive model.

2.7 Key Participants in Corporate Governance in Financial Services

The corporate governance key participants in the financial services sector can be divided into internal and external. There are four internal key participants: the BOD or supervisory board, the managers, the shareholders and the depositors. External key participants refer to government regulatory agencies, stock markets and the court that enforces the remedies for violation of governance rules (Salacuse, 2003: 52). All these institutions play their own roles in the corporation, with the specific goal of protecting the interests and rights of the shareholders and the stakeholders as a whole. Figure 2.3 summarizes the corporate governance structure and style in the financial services sector. This figure combines both the Anglo-Saxon and the European models and the only differences between these two are the supervisory board and the goals of the corporation.

Figure 2.3: Corporate Governance Structure in Conventional Financial Institutions



Source: Choudhury and Hoque (2004: 86) and Nienhaus (2007: 129): Modified

2.7.1 Internal Key Participants

2.7.1.1 Board of Directors (BOD)

One of the major debatable issues in corporate governance has focused on the role of the BOD. In general, the main functions of the BOD are to define the firm's purpose, to agree strategies, to plan for that purpose, to establish the firm's policies, to appoint the management, particularly the CEO, to monitor and assess the performance of the management team and to assess their own performance (Cadbury, 2002: 33–47). Nathan and Ribiere (2007: 475–476) divide the BOD's role into five main functions: an active role as independent thinkers in shaping the strategic directions of their organization; responsible for monitoring and influencing the strategy rather than implementing the strategic decisions; leans towards guiding the top management rather than setting up the actual strategy; a strategizing role in advising the management team and providing strategic alternatives; and establishing standards, advising the CEO and monitoring strategy implementation.²⁰

In banking sectors, the BOD acts as internal control mechanism in protecting the shareholder and stakeholders interest. The BOD has a strong role to play in corporate governance and that is why the board members must be technically qualified and possess high moral integration. The BOD has certain specific duties, such as monitoring and supervising the firm's performance, setting the business objectives and framing the policy. The board's main function is to set the firm's aims and objectives and to ensure that all of them are achieved. It is therefore for them to devise plans and policies to achieve those aims and to appoint and monitor the management to meet those objectives.

2.7.1.2 Supervisory Board

While the Anglo-Saxon model provides a single model BOD, certain European countries that promote the stakeholder system require corporations of a certain size to have a two-tiered system. A two-tiered system consists of a management board and a supervisory board; the former is composed of members of the corporation and the latter is composed

²⁰ See also Davis and Thompson (1994), Forbes and Milliken (1999), Ingleby and Van der Walt (2001: 176), Zahra and Pearce (1989) and Helmer (1996).

of non-executives elected by shareholders or employees. The supervisory board has the power to elect the management board and ensure their accountability to corporate aims and governance regulations. This two-tier system encompasses a clearer formal separation between the supervisory board and those being supervised and monitored (Weil and Manges, 2002: 43).

2.7.1.3 Managers

The management team refers to the CEO and other members of staff who perform management functions. The management team is responsible and accountable before the BOD. The BOD appoints the CEO and his management team. Since the quality of decision-making is dependent on the volume, relevance and quality of collected information, the CEO and executive members should be responsible for making information available to the BOD. The stakeholder's model of corporate governance considers the managers as having fiduciary duties not only to the shareholders but to all parties related with the corporation, including the community and the public at large.

2.7.1.4 Shareholders and Depositors

In both the Anglo-Saxon and the European models of corporate governance, the direct participation of shareholders is limited: in the former, to electing directors; and in the latter, to electing directors and the supervisory board. Shareholders are also limited in their ability to approve certain items that should ideally require their approval, such as decisions on mergers and acquisitions (Salacuse, 2003: 57). The European model of corporate governance particularly in Germany emphasizes on a wider set stakeholder interest and views companies as more of partnership between employers and employees as well as between shareholders (Dignam and Galanis, 2009: 269). In this regard, employees have the right to elect some members of the board as their representative. By contrast, in the case of the Anglo-Saxon model of corporate governance, the board members are elected by the shareholders and the emphasis is on the relationship between shareholders and the directors (Mallin, 2007: 57). The Anglo-Saxon model seems to protect the minority shareholders through strong legal protection more in comparison with the European model.

In the conventional financial sector, the depositors are not of the essence institutions of corporate governance. Depositors whose interest is also at stake do not get much attention in either the Anglo-Saxon or European model. The reason for this is that the depositors are insured with a certain positive rate of return and it is in fact guaranteed in the hope of reducing the risk of systemic failure and to stabilise the financial system (Cull et al. (2005: 44) Therefore, it is not necessary for the conventional models of corporate governance in the financial sector to deal with depositors in depth, as their primary concern is to protect the shareholders' interests, who have invested their wealth in the corporation, and not the depositors who have been guaranteed their returns (Chapra and Ahmed, 2002: 14–15, 43–44).

2.7.2 External Key Participants

The external key participants refer to external institutions that facilitate and support the implementation of corporate governance and these include government agencies, the judiciary and regulatory authorities. The government plays a key role in corporate governance by defining the regulatory and legal environment and may influence managerial decisions (Caprio and Levine, 2002: 8). The regulatory authorities, as part of a corporate governance institution, provide sound guidelines for the financial system and develop internal control, risk management procedures, standards of transparency and monitor overall banking operations. In terms of laws and regulations, all institutions of corporate governance must follow and comply with the rules promulgated by either the legislative or regulatory agencies, while the court is the institution that enforces the remedies for violation of corporate rules.²¹

²¹ See *Re Bank of Credit and Commerce International SA* (No 10) [1995] 1 BCLC 362, *Barings plc (in liq) and another v Coopers & Lybrand (a firm) and others* (No 1); *Barings Futures (Singapore) Pte Ltd (in liq) v Mattar and others* (No 1) [2002] 2 BCLC 364, *Barings plc (in liquidation) v Coopers & Lybrand and others* [2000] 3 All ER 910 and *Re Equitable Life Assurance Society* [2002] 2 BCLC 510.

2.8 Conclusion

This chapter has attempted to explore the conceptual dimension and theoretical framework of corporate governance from conventional perspectives by referring to the two main dominant corporate governance systems of the Anglo-Saxon and the European models. The Anglo-Saxon model, which is formulated on the basis of agency theory, represents the shareholder value system, while the European model, which is constructed on the basis of stakeholder theory, seems to offer remedies for the defects of the shareholder model by promoting the stakeholder value orientation system. In the context of financial services, the OECD Principles of Corporate Governance and the BCBS on Enhancing Corporate Governance for Banking Organizations seem to bridge the gap between these two models by acknowledging the essence of the shareholders' value and at the same time recognizing the large stakeholders' interest. In this regard, the BOD, the supervisory board, the managers, the shareholders, the depositors and the regulatory authorities are the key participants in corporate governance in the conventional financial services sector. The literature further proves that there is a tendency and trend for convergence of these two corporate governance systems and the determination of either the 'shareholder' or the 'stakeholder' system nevertheless is preoccupied by five main factors, these are: the origins of national diversity, the nature of the legal framework, the political background, social norms or culture, and the economic conception (Jacoby, 2000: 7–14).

In conclusion, therefore, this chapter provides an extensive literature survey and overview of corporate governance from conventional perspectives, particularly in relation to financial institutions. The understanding of the conceptual and theoretical framework of corporate governance is imperative in this study since it will enlighten further discussion of corporate governance from an Islamic perspective. The model of corporate governance system from a conventional perspective raises an issue of the design of an efficient corporate governance structure of IFIs within an Islamic paradigm. It is very important to identify characteristics, values, norms and behaviour of corporate governance from an Islamic perspective. As an observation, the initial study finds that the corporate governance model in Islam is inclined towards the stakeholder value

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orientation, where its governance style aims at protecting the wider group of stakeholders. The study further explores the conceptual and foundational dimensions of corporate governance in Islamic literature and further highlights its differences and diversities in Chapter 3.

CHAPTER 3
CORPORATE GOVERNANCE: IN SEARCH OF AN ISLAMIC PERSPECTIVE²²

3.0 Introduction

Corporate governance in banking has been analysed extensively in the context of conventional banking. The Western concept of corporate governance, either the Anglo-Saxon model that promotes a shareholder value system or the European model that upholds the stakeholder value orientation, has been subject of continuing debate for many years. By contrast, little is written on corporate governance from an Islamic perspective, particularly in the context of Islamic finance, despite its rapid growth since the mid-1970s and its increasing presence in the world's financial markets (Yunis, 2007: 308).

This study classifies the existing literature on corporate governance in IFIs into three main phases, namely the first phase (pre-1980s), the second phase (1980s–1990s) and the third phase (post-2000s). The first phase shows an absence of studies on corporate governance and the subject has not been given due concern in mainstream research. This is affirmed by the surveys of Siddiqi (1981), Mannan (1984) and Haneef (1995) on the contemporary literature on Islamic economics. Specific studies on the issue of corporate governance of IFIs began in the second phase (1980s-1990s). For example Abomouamer (1989) conducted a survey on the role and function of *Shari‘ah* control in Islamic banks and Banaga et al. (1994) carried out research on external audit and corporate governance in Islamic banks. Both studies nevertheless were carried out by individual and only addressed the issues of *Shari‘ah* control and audit. In view of the several corporate failures of IFIs in the 1990s and 2000s, as in the cases of the closures of Ihlas Finance House in Turkey, the Islamic Bank of South Africa and Islamic Investment Companies of Egypt, a significant number of studies on corporate governance were then carried out by different individuals, organizations and institutions in the third phase (post-2000s). One of the most significant studies on corporate governance in IFIs was carried out by Chapra

²² Some parts of Chapter 3 were presented during the Annual London Conference on Money, Economy and Management at Imperial College, London on 3rd–4th July 2008 and published in the Journal of International Review of Business Research, 5 (1), 2009, 277–293.

and Ahmed (2002), who discussed the issue of the roles and functions of the *Shari‘ah* board, auditing, accounting and the general framework of corporate governance in IFIs. Other studies were conducted by Al-Baluchi (2006), on corporate disclosure practices of IFIs, and Al-Sadah (2007), on the corporate governance of Islamic banks, its characteristics, its effect on stakeholders and the role of Islamic bank supervisors. In 2008, the IFSB published a survey on *Shari‘ah* Boards of Institutions Offering Islamic Financial Services across Jurisdictions (IFSB, 2008) and this was followed by Faizullah (2009), who discussed issues of governance, transparency and standardization of Islamic banks.

Despite all of the above research, it is nevertheless found that there is a lack of studies that attempt to deconstruct and establish the theoretical foundation of corporate governance from an Islamic perspective. At this point, Choudhury and Hoque (2004) and Iqbal and Mirakhori (2004) deconstruct the theoretical framework of Islamic corporate governance; the former demonstrates the theory of corporate governance founded on the epistemology of *Tawhīd* (Oneness of God), while the latter recommends the stakeholder-oriented value system based on the principle of property rights and contractual obligation. Safieddine (2009) extends the existing literature by highlighting variations of agency theory in the unique and complex context of Islamic banks. Until now, corporate governance has been major concern of IFIs, regulators, supervisors and international standard-setting agencies.

Based on the above development, undeniably corporate governance is one of the vital components in IFIs as it plays a role in designing and promoting principles of fairness, accountability and transparency. In fact, it is an even bigger challenge to IFIs due to their additional risk as compared to the conventional banking system.²³ Therefore, it is strongly indicated that any Islamic corporation, particularly an IFI, needs to have a sound governance system and appropriate strategies that will promote the adoption of strong and effective corporate governance within the Islamic paradigm. This chapter attempts to provide an overview of the foundational dimension of corporate governance from an

²³ For instance, depositors become exposed to various kinds of risk when Islamic banks start moving into the risk-sharing modes, i.e. *mudhārabah* and *mushārakah* (Chapra, 2007: 338).

Islamic perspective, with special emphasis on the governance framework of IFIs. It also aims at constructing the basic understanding of corporate governance in Islam and to clarify any issues involved so as to differentiate its value and features from its Western counterpart. The initial study submits that Islam presents distinctive values and special characteristics of corporate governance with aim to uphold and maintain the principle of social justice not only to the shareholders of the firm but to all stakeholders.

3.1 Conceptual Framework of Corporate Governance from an Islamic Perspective

Basically, the concept of corporate governance from an Islamic perspective does not differ much from the conventional definition as it refers to a system by which companies are managed, directed and controlled with the purpose of meeting the corporation's objective by protecting all the stakeholders' interests and rights. Uniquely, the context of corporate governance within the Islamic paradigm presents certain exceptional characteristics and features in comparison with the Western theories.

Choudhury and Hoque (2006) discuss the faith-based theoretical framework of corporate governance in Islam and they consider it as a theory pertaining to decision-making processes that employ the premise of the Islamic socio-scientific epistemology of *Tawhīd*. The practical implications of the Islamic idea of corporate governance are immense, especially when they are related with transaction cost minimization in decision-making environments and achieving the aims and objectives of the corporation within the boundary of *Shari‘ah* rules and principles (Choudhury and Hoque, 2006). In this regard, it is essential to understand and refine the conceptual definition of corporate governance from an Islamic point of view in order to enlighten any further discussion on the subject of *Shari‘ah* governance.

3.1.1 Defining ‘Corporation’

Although the concept of partnership in the form of *mushārakah* or *mudhārabah* has been well known since the early period of Islam, it is found that there is less discussion on a concept akin to ‘corporation’. At this point, Vogel and Hayes (2006: 133–134) mention that classical Islamic law only discusses a concept of partnership and not modern

companies with an artificial personality.²⁴ In other words, the corporate form of business organization with a separate legal entity does not appear directly in the classical *fiqh* discussions by Muslim jurists.²⁵ This is supported by a group of eminent scholars in Pakistan who argue that the concept of juristic person and limited liability are alien to *Shari'ah* and exploitative in nature (Rahman, 2010: 77).

Despite the above connotation on the concepts of legal personality and limited liability²⁶, they are nevertheless generally accepted almost without question. Most of contemporary Muslim scholars such as Abdul Qadir Audah, Mustafa Zarqa and Hasanuzzaman have accepted this concept²⁷ known as *shahsiyyah i'tibāriyyah* (juristic person) based on principles of *qiyās* (analogy), *istihsān* (equity), *maṣalih mursalah* (public interest) and *dhimma*.²⁸ In addition, the Islamic Fiqh Academy and the AAOIFI *Shari'ah* Council affirm the acceptability and recognition of the concept of limited liability, where the former states “there is no objection in *Shari'ah* to setting up a company whose liability is limited to its capital” (IFA and IRTI, 2000: 130) and the latter mentions in the AAOIFI *Shari'ah* Standards No. 12, which accepts its practice through incorporation by law (AAOIFI, 2003: 208).

Since this subsection focuses on the conceptual framework of corporate governance, the research does not intend to discuss in depth the debates on the concept of corporation in Islam. It is submitted that the concept of artificial personality or a corpus with a separate

²⁴ Foster, (2010a: 279-291) interestingly discusses the arguments put forth by Muslim jurists on the concept of legal personality and limited liability from both *Shari'ah* and Western-style law business organization. He critically analyses the arguments and concludes that the concept of corporation is absence in classical *Shari'ah*. See also Foster, (2010: 3-34).

²⁵ Schacht, (1964: 125–126) argues that Islamic law does not recognize the concept of a juristic person or artificial legal entity. He nevertheless indirectly indicates that the legal personality did exist in an undeveloped form as contained in the principle of *aqila* (Nyazee, 1998: 80). *Aqila* means blood money that has to be paid by the tribe or clan in the case of homicide committed by one of its members.

²⁶ Nyazee (1998: 81–85) classifies the scholars’ views on the legality of a juristic person into three: scholars who opine that there is no textual legal evidence on its validity, scholars who suggest that the concept of juristic person could be extracted from the concept of *bayt al-māl*, *waqf* and *aqila* and finally scholars who called for *ijtihād* on the basis of necessity.

²⁷ See Chapra, (2008: 49), Ghazali, (2005: 456), Zahraa, (1995: 204) and Usmani, (2007: 221) and Hasanuzzaman, (1989: 353).

²⁸ The concept of *dhimma* refers to “a presumed or imaginary repository that contains all the rights and obligations relating to a person in the present and future”. Contemporary Muslim jurists have extended the concept of *dhimma* to other than human beings and these include *waqf*, *bayt al-māl*, schools, orphanages, hospitals, mosques and commercial companies (Zahraa, 1995: 204).

legal entity is clearly acceptable in Islam. The concept of corporation in business organizations is essential as it provides certain distinct core characteristics, namely separate legal personality, limited liability of the shareholders, divisibility, transferability of ownership, centralized management under a board structure, the absence of *delectus personae* amongst the shareholders and shared ownership by holders of capital²⁹ (Kraakman et al., 2004).³⁰

The recognition and acceptability of the concept of corporation in Islam raises another issue as to its conceptual definition. At this point, the existing literature attempts to define an Islamic corporation by specifying its distinct characteristics. Choudhury and Hoque (2006: 127) define an Islamic corporation as “a legal entity of shareholders with principal and proportionate ownership of assets according to individual group equity and profit-sharing capabilities”.³¹ They further state additional social and commercial criteria of corporation as a market-driven and profit-oriented legal entity within a social and responsible cooperative milieu. Another definition also characterizes an Islamic corporation as a business organization with the objective of maximizing profit without violating property rights or infringing the interests of any group of stakeholders (Iqbal and Mirakh, 2004: 48). From these definitions, it is concluded that a corporation in Islam is characterized by at least three core features, namely: (i) a legal entity with limited liability; (ii) a profit-motivated and market-driven objective; and (iii) being within the boundary of Islamic social justice. Within these frameworks, *Shari‘ah* rules and principles play an important role in defining and determining the scope of Islamic social justice as well as the extent of permissible and non-permissible activities.

²⁹ If we refer to the definition of a corporation in conventional literature such as Monks and Minow (2004: 8), who define it as an artificial being, invisible, intangible and existing only in the contemplation of law, it does not present itself as being much different to the concept of corporation in Islam.

³⁰ Lewis (2005: 6–9) distinguishes the characteristics of a corporation from partnership into three areas. From a legal perspective, it concerns a distinct legal personality by the law, while the economic point of view considers it as a mechanism to reduce the transaction and cost of negotiating the individual transaction. The accounting view of the corporation contemplates the ability of the firm as a collection of resources of business activities and information on those assets is kept, maintained, documented and reported for the benefit of the stakeholders.

³¹ They also view that *mudhārabah* and *mushārakah* contracts establish the legal validity of the corporation (Choudhury and Hoque, 2006: 127).

3.1.2 Defining ‘Governance’

There is no standard translation for the term ‘governance’ in Arabic. At this point, Boutros-Ghali (2001) states that the concept of corporate governance is not yet clearly understood in the Arab world. This statement is not really accurate as the term governance is synonymous with the word *wilaya* or *hawkamah*. For example, a number of Muslim jurists seem to have employed the principle of governance of the scholars as *wilayat al-‘ulama’* (Khir, 2007: 79). The term *wilaya* is derived from the root *waly*, which means “to be near, adjacent, contiguous to” someone or something. In other words it denotes “the exercise of authority” or representation, which signifies the power of an individual to personally initiate an action (Dien, 2008).

Another terminology used for governance is *hawkamah*.³² In Egypt an official translation of governance in Arabic is known as *hawkamah* and this term has been accredited by the Egyptian Linguistic Department (Lewis, 2005: 25). The word *hawkamah* has been used extensively, particularly in reference to corporate governance. The meaning of these two terminologies concludes that the word governance indicates the authority of individual or legal personnel to initiate an action to govern, direct and steer someone or something, and this includes how a corporation is controlled, managed, directed and monitored.

3.1.3 Defining Corporate Governance in IFIs

The understanding of the terms corporation and governance from an Islamic perspective enables the study to come up with an appropriate definition of corporate governance. The researcher simplifies the definition of corporate governance as: a set of organizational arrangements as to how a corporation is directed, managed, governed and controlled, which provides the governance structure through which all stakeholders’ interests are protected, the company’s objective is achieved, social responsibility is upheld and the principles of *Shari‘ah*³³ are complied with.

³² The Institute for Corporate Governance of Dubai International Financial Centre uses the term *hawkamah* as a reference to corporate governance (Hawkamah, 2008).

³³ *Shari‘ah* is derived from word *shara‘a* (شَرِعَة) and the word *Shari‘ah* and its derivatives relate to watering animals at a permanent waterhole (Calder, 2008). Technically *Shari‘ah* designates the rules and regulations which are derived from *al-Qur’an* and *al-Sunnah*. In explaining *Shari‘ah*, Hallaq (2002: 235) mentions that

In the context of IFIs, the definition of corporate governance can be referred to in the IFSB-3, Guiding Principles on Corporate Governance for Institutions Offering Only Islamic Financial Services (Excluding Islamic Insurance (*Takāful*) Institutions and Islamic Mutual Funds).³⁴ The IFSB-3 defines corporate governance “as a set of relationships between a company’s management, its BOD, its shareholders, and other stakeholders which provides the structure through which the objectives of the company are set; and the means of attaining those objectives and monitoring performance are determined.” It further explains corporate governance in IFIs to encompass “a set of organizational arrangements whereby the actions of the management of IIFS are aligned, as far as possible, with the interests of its stakeholders; provision of proper incentives for the organs of governance such as the BOD, *Shari‘ah* board, and management to pursue objectives that are in the interests of the stakeholders and facilitate effective monitoring, thereby encouraging IFIs to use resources more efficiently; and compliance with Islamic *Shari‘ah* rules and principles” (IFSB, 2006: 33).

The IFSB-3’s definition provides a clear explanation as to the actual meaning and framework of corporate governance in IFIs. The definition consists of all elements of corporate governance framework with an additional feature of *Shari‘ah* requirement. The first limb of the definition explains the general functional objective of corporate governance as a set of relationships between the stakeholders.³⁵ The second limb of the definition then incorporates the requirement of compliance with the *Shari‘ah* rules and principles, which clarify the actual conceptual framework of corporate governance in IFIs. Referring back to the definition of *Shari‘ah* and its framework in business organizations, particularly IFIs, it is observed that the majority of *Shari‘ah* issues involved in the context of corporate governance fall under the purview of *fiqh al-muāmalāt*.

the *Shari‘ah* is nothing but a way or a method of conducts that expresses belief in God. See Hallaq (2002 and 2005).

³⁴ See also IFSB-6, Guiding Principles on Governance for Collective Investment Schemes (IFSB, 2009a) and IFSB-8, Guiding Principles on Governance for *Takāful* (Islamic Insurance) Undertakings (IFSB, 2009b).

³⁵ This is more or less similar to the definition in the OECD Principles of Corporate Governance.

3.2 Role of Corporate Governance in IFIs

With several corporate failures and difficulties of IFIs, such as the closures of Ihlas Finance House in Turkey,³⁶ the Islamic Bank of South Africa³⁷ and the Islamic Investment Companies of Egypt,³⁸ and corporate difficulties, as in the case of the Dubai Islamic Bank,³⁹ and Bank Islam Malaysia Berhad⁴⁰, the need for a good and efficient governance system is considered as a crucial part of corporate governance. All these cases indicate that IFIs are not immune from crisis and failures due to governance issues and conundrums.

The role of corporate governance in IFIs is more or less similar to the general concept of corporate governance in any other type of corporation. The best explanation of the corporate governance objective can be simplified as being about promoting corporate fairness, transparency and accountability. Good corporate governance is crucial in order to protect the rights and interests of all stakeholders. This is the main reason why there has been a growing interest in the topic of corporate governance, particularly in financial institutions (Macey and O'Hara, 2003).⁴¹ In the context of corporate governance in IFIs, its framework goes beyond the relationship between the shareholders, BOD, management and stakeholders, since it also includes how maintain the relationship with God. In this

³⁶ Ihlas Finance in Turkey was closed in February 2001 due to financial distress and weak corporate governance. Ali (2007: 1–52) reports that the closure of Ihlas Finance was mainly due to the failure of corporate governance and internal checks and balances; it was found that the bank was run without proper systems of internal control, the management was not preparing for any changing circumstances and the scope of regulations was unclear. See also Martha and Rasim (2005).

³⁷ The Islamic Bank of South Africa was closed in November 1997 due to lack of supervision from regulatory authority, bad management, weak risk management and numerous loans to insiders (Okeahalam, 1998: 29–48).

³⁸ The closure of the Islamic Investment Companies of Egypt in 1988 was due to weak corporate governance, irresponsible management, improper regulatory frameworks and engagement in *Shari'ah* non-compliant activities (Zuhaida, 1990: 152–161).

³⁹ This refers to the fraud case in the Dubai Islamic Bank involving USD501 million. Seven individuals were charged, including two Dubai Islamic Bank former executives (Morris, 2009). In this case the two DIB personnel collaborated with five businessmen and fabricated documents and bogus transactions to obtain huge amount of financing (Za'za, 2009).

⁴⁰ The BIMB declared losses totalling RM457 million in 2005, mainly due to the provision of RM774 million as a result of bad financing and investments incurred by its Labuan branch (Parker, 2005). The composition of the board was not appropriate as there were no board members who were familiar with banking sectors as well as no sound and proper credit and debt collection (Parker, 2005).

⁴¹ Corporate governance in financial institutions is extremely important for the development of an economy as the banks play a role in utilizing funds, which may lead to a stable market, reduce the cost of capital and stimulate economic growth (Yunis, 2007: 296).

aspect, IFIs require the additional framework of *Shari‘ah* to safeguard and maintain not only the relationship with God but to include other human beings and the environment.

Grais and Pellegrini (2006a: 2) state that there are two broad corporate governance roles that are exclusive to IFIs. Firstly, there is a need to reassure stakeholders⁴² that their activities are fully compliant with *Shari‘ah* principles. Secondly, the stakeholders also need to be assured that IFIs aim to maintain and improve growth and are able to prove their efficiency, stability and trustworthiness. Corporate governance hence plays a role to basically harmonize these two functions so as to meet the requirement of *Shari‘ah* and to satisfy the natural aim of corporation of maximizing profit without violating stakeholders’ rights and interests.

Corporate governance in IFIs is also crucial as a means to address numerous types of risk and this includes governance risk. Iqbal and Mirakhор (2007: 227–250) define governance risk as “the risk arising from failure to govern the institution, negligence in conducting business and meeting contractual obligations and from a weak internal and external environment”. They further classify the governance risk into operational risk, fiduciary risk, transparency risk, *Shari‘ah* risk and reputation risk (Iqbal and Mirakhор, 2007: 242–246). With the complexity and some exclusive characteristics of risks in IFIs, unlike its conventional counterparts, a sound and efficient corporate governance system must be in place in order to mitigate those kinds of risks.⁴³

The special characteristic of IFIs needing to comply with *Shari‘ah* rules and principles in all their activities requires for a specific kind of governance. As Islamic corporations, IFIs should avoid any involvement with all kinds of *Shari‘ah* prohibitions, such as *riba* (interest), *gharar* (uncertainty), speculation and *maysir* (gambling), to stay away from investing in any unlawful activities, and to observe the principles of Islamic morality or the Islamic ethical code. In this respect, corporate governance in Islam is a necessity to

⁴² Stakeholders include shareholders, employees, customers, depositors, regulators, governments, communities and environments (IFSB, 2006a: 27). Unlike conventional banking organizations, corporate governance in IFIs also concerns another kind of stakeholders, namely investment account holders.

⁴³ For further reading on the specific risk exclusive to IFIs, see Greuning and Iqbal (2008).

IFIs not only to foster and gain the confidence of the stakeholders but also to the general public that all products, operations and activities adhere to *Shari'ah* rules and principles.

3.3 The Development of Corporate Governance in IFIs

This section briefly discusses the development of corporate governance in IFIs by revisiting the historical development of financial institutions from the early stages of Islam until today. This study classifies the development of corporate governance in IFIs into two main phases, namely: (i) pre-20th century and (ii) post-20th century. The study further divides the second phase into two different stages: the first stage (pre-1970s) and the second stage (post-1970s).

Phase I (Pre-20th Century): Absence of Corporate Governance in Traditional IFIs

The term ‘bank’⁴⁴ is alien to the early Muslim period where the term *bayt al-māl* is extensively used⁴⁵. In the 8th and 9th centuries, financiers were known as *sarrāf*⁴⁶ and *jahbadh* and functioned as modern bankers in pre-modern Islam. *Sarrāf* provided financing facilities primarily on the basis of *mudhārabah* and *mushārakah*, negotiable instruments and trade facilities by cashing cheques, and issued promissory notes and letter of credits⁴⁷ (Chapra and Ahmed, 2002: 3). They also provided banking facilities to the public as well as the private sector, while *jahbadh* served mainly the public sector.⁴⁸

⁴⁴ The term bank originates from the Italian word *banco*, which means ‘table’ as in the past moneychangers from Lombardy used to place money on a table (Baldwin, 1988: 178). The first modern bank was started in Venice in 979H or 1584CE and was known as *Banco di Rialto* (Imamuddin, 1997a: 153).

⁴⁵ *Bayt al-māl* could be considered as a state-owned bank; it played the role of an agricultural credit bank, commercial bank and clearing house for merchants to facilitate commercial activities from the time of Umayyad (Imamuddin, 1997: 132).

⁴⁶ In the Ottoman Empire, *sarrāf* were moneylenders, brokers and pawnbrokers; many *sarrāf* became large financiers with well-recognized international connections and played a significant role in the economy and politics of the Ottoman Empire (Saeed, 2002). *Sarrāf* also functioned as moneychangers to provide facilities of currency exchange (Imamuddin, 1997: 134) and played a role in determining the relative value of coins (Cohen, 1981: 315–333).

⁴⁷ In 313H or 924CE, the caliph Al-Muqtadir received a *sufṭajah* (bill of exchange) of 147,000 dinars, sent by the Governor of Egypt and Syria. *Sufṭajah* as one of the financial instruments was commonly used by Abbasid Empire and the Fatimid State in commercial, government and private transactions (Imamuddin, 1997: 137). These financial instruments enabled the Muslims to mobilize their financial resources and further provided a great boost to trade not only in the Middle East but to Europe in the West, China in the East, Central Asia in the North and Africa in the South (Chapra, 2007: 328).

⁴⁸ *Djahbadh* played its function as an administrator of deposits and as a remitter of funds from place to place through the medium of the *ṣakk* and especially of the *sufṭajah* (Fischell, 2002). Chachi (2005: 3–25) and Heck (2006) view that the Islamic bank of today is a transformation of *Jahbadh* in a modern form where it has some characteristics of a full-fledged banker as well as merchant banker.

Sarrāf as financiers were owned by the individual, family⁴⁹ or tribe, whereas *jahbadh* were owned by the state. Neither institution, however, was a bank, as they did not receive deposits or issue cheques as normal modern banks do; therefore Udovitch prefers the term *sarrāf* to mean bankers without a bank rather than the bank as financial intermediary⁵⁰ (Chapra, 2007: 328).

Corporate governance was not an issue at all in *sarrāf* or *jahbadh*, since neither institution was classified as a corporate legal entity. Interestingly, even without any sort of corporate governance framework, the so-called banking institutions during that time, in the form of *sarrāf* and *jahbadh*, were able to effectively facilitate economic activities both locally and internationally.⁵¹ Although there is no appropriate data available to prove the efficiency of such a financial system, historical evidence in many works of literature provides its clear indication.⁵²

⁴⁹ The *sarrāf* families included the Baltazzis, the Rallis, Zarafis, the Rodoconachis and Duzuoglus. These families played big roles in most of the major private and public banks that were established in the second half of the 19th century, starting with the Istanbul Bankası (Bank of Istanbul) in 1845 (Saeed, 2002).

⁵⁰ Udovitch (1970) provides a comprehensive commercial law and economic history, particularly on the practice of partnership and profit in medieval Islam.

⁵¹ Chapra (2007: 329–330) mentions that there are several factors contributing to this phenomenon and these include common practice of Islamic values, nature of communities, economic environment, absence of agency problems, extensive legal instrument for trade and independence of judiciary. In fact, *sarrāf* and *Jahbadh* operated in communities which were far smaller than those the modern banks operate in. The parties involved, such as the providers, users of funds and *sarrāf* personnel, were known to each other as the participants normally consisted of individuals in tribes, guilds and fraternities. The economic environment during that period was also less complex and the nature of *sarrāf* and *Jahbadh* meant there was no agency problem, such as the issue of separation of ownership and control as experienced by the modern financial institutions. In addition, the economic activities were controlled and supported by the strength and independence of the judiciary which led to economic stability (Chapra, 2007: 329–330).

⁵² Udovitch writes that the Islamic modes of equity financing were able to mobilize the resources of the Islamic world for financing of agriculture, crafts, manufacturing and international trade (Chapra, 2007: 328). Cohen (1981: 315–333) illustrates the the monetary system in Egypt at the time of the Crusades and the reform of *Al-Kamil* and mentions that there was a sophisticated system of exchange during that time. In fact, early Muslim jurists have already discussed the concept of economy in general. This is affirmed by Chachi (2005: 3–25), who refers to the historical writings of numerous Muslims scholars such as al-Qalqashandi and al-Djahshiyari.

Phase II (Post-20th Century): The Emergence of Corporate Governance in Modern IFIs

Stage I: Pre-1970s

At the end of the 19th century, the Muslim role in *sarraf* business was radically reduced by the increase in non-Muslim *sarraf* families and the emergence of modern banks, established largely by Europeans and by Armenian and Greek *sarrāf*⁵³ (Saeed, 2002). The colonization of the majority of Muslim countries further affected the existing Islamic financial system and hence it was replaced with Western modern banking, an interest-based financial system. Not until the 1950s were there efforts to establish IFIs, such as in Pakistan, on the notion of inserting a clause to ban interest in the constitution and the establishment of a local Islamic bank that provided financing mainly for the poor.⁵⁴ This is followed with the opening of the Mitr Ghams Savings Bank on 23rd July 1963 and the Nasser Social Bank in 1972 (Haron, 1997: 3). The establishment of the Mitr Ghams Savings Bank and the Nasser Social Bank in Egypt demonstrates the potential of the Islamic financial system in the modern economic infrastructure.

The success of the earlier Islamic banks, although a partial breakthrough, was discussed extensively by many scholars, particularly the aspects of operations, procedures, activities, performance, nature of financing facilities and socio-legal matters. Corporate governance nevertheless was not given due concern and there is no specific discourse or initiatives on it. This is because all of those Islamic banks were incorporated in the form of either cooperative societies or social banks. In fact, the modes of financing activities were also very limited and only attempted to redress social and small community needs. In this regard, corporate governance is less relevant to this kind of business organization.

⁵³ There were many European banks established in the Ottoman Empire such as the Deutsche Orient Bank, the Deutsche Bank, the Credit Lyonnais and the Banque Ottomane and all of these big banks were controlled by foreign entities (El-Ashker, A.A.F, 1987: 26).

⁵⁴ The experiment was, however, unsuccessful; it faced a lot of operational problems, was short of funds and had weak governance (Wilson, 1984: 33).

Stage II: Post-1970s

The period between 1975 and 1990 was the most crucial period in the development of the Islamic financial sector. The establishment of several Islamic banks, in the form of corporations such as the Dubai Islamic Bank, Faisal Islamic Bank and the Kuwait Finance House including the Islamic Development Bank in Jeddah, triggered the need for a specific corporate governance system.⁵⁵ In fact, due to several corporate failures and difficulties of IFIs in the 1990s and 2000s, a few international infrastructure institutions were established with the purpose of supporting the Islamic financial sector to enhance and strengthen their corporate governance framework; these include the Accounting and Auditing Organization for IFIs (AAOIFI), the International Islamic Financial Market (IIFM), the International Islamic Rating Agency (IIRA) in Bahrain, the General Council of Islamic Banks and Financial Institutions (CIBAFI)⁵⁶ and the Islamic Financial Services Board (IFSB) in Malaysia.⁵⁷ The AAOIFI and the IFSB were established *inter alia* to address issues pertaining to corporate governance in IFIs by issuing governance standards and guidelines of best practice while the rest of the institutions provide infrastructure support to the implementation of Islamic finance. In addition, the Hawkamah, the Institute for Corporate Governance based in Dubai, also used its own initiative by setting up a specific task force and working committee on corporate governance for Islamic banks and financial institutions with the purpose of studying and developing best practice for corporate governance in the regions of the Middle East and North Africa.

⁵⁵ The numbers of financial institutions offering Islamic financial products and services has risen, including the conventional banks that have opened Islamic windows and branches. In 2002, there were twenty-two Islamic banks in South East Asia, representing 13.5% of the total assets of Islamic banks, twenty-six in Gulf Cooperation Council countries (77.7%), fifteen in other Middle Eastern countries (8.6%), four in Africa and two in the rest of the world (0.2%) (Iqbal and Molyneux, 2005: 47). The average growth since the mid-1970s is around 10–15% per annum and in 2001 it achieved almost 23.5%. In terms of worldwide consolidated assets it stands at over USD260 billion and in 2005 the total number of Islamic banks was 267 (Baba, 2007: 384).

⁵⁶ Bahrain has become the pre-eminent financial centre in the Middle East and hosts 52 offshore banks, 357 financial institutions, 24 full commercial bank, 35 investment banks and 157 insurance companies (Bahrain Monetary Agency, 2005).

⁵⁷ The IFSB was established in Kuala Lumpur, Malaysia on 3rd November 2002 with the purpose of serving as an international standard-setting institution responsible for providing prudent and substantial guidelines in order to ensure the stability of the Islamic financial services industry (IFSB, 2010).

To date, the AAOIFI has issued seven governance standards, namely the standard on *Shari‘ah* Supervisory Board: Appointment, Composition and Report; the *Shari‘ah* Review; Internal *Shari‘ah* Review; Audit and Governance Committee for IFIs; Independence of *Shari‘ah* Supervisory Board; Statement on Governance Principles for IFIs; and Corporate Social Responsibility. Similarly, the IFSB has issued seven guidelines on governance, disclosure and supervisory review processes for IFIs, namely the Guiding Principles on Governance for Islamic Collective Investment Schemes; the Guidance Note In Connection with the Capital Adequacy Standard: Recognition of Ratings by External Credit Assessment Institutions (ECAIs) on *Shari‘ah*-Compliant Financial Instruments; the Guidance on Key Elements in the Supervisory Review Process of Institutions offering Islamic Financial Services (excluding Islamic Insurance (*Takāful*) Institutions and Islamic Mutual Funds); the Disclosures to Promote Transparency and Market Discipline for Institutions offering Islamic Financial Services (excluding Islamic Insurance (*Takāful*) Institutions and Islamic Mutual Funds); the Guiding Principles on Corporate Governance for Institutions Offering Only Islamic Financial Services (Excluding Islamic Insurance (*Takāful*) Institutions and Islamic Mutual Funds); the Guiding Principles on Conduct of Business for Institutions offering Islamic Financial Services; the Guiding Principles on Governance for *Takāful* Operations; and the Guiding Principles on *Shari‘ah* Governance System for Institutions offering Islamic Financial Services.

3.4 Foundational Dimension of Corporate Governance

In view of the distinctiveness of the underlying principles and paradigm of the corporate governance in Islam compared with the Western model, there are several studies that attempt to construct an Islamic model of corporate governance.⁵⁸ Unlike the Western concept of corporate governance, which is based on the Western business morality that derives from ‘secular humanism’, the study discovers that Islamic corporate governance is founded on the epistemological aspect of *Tawhīd* and the embedded *Shari‘ah* rules and

⁵⁸ There are at least three different underlying ethical principles of Western corporate governance that are inappropriate to Islam. Firstly, the Western concept of corporate governance is derived from a secular humanist perspective. Secondly, the Western concept remains rooted in a self-interest paradigm. Thirdly, the theoretical model of Western corporate governance is based on the agency theory rather than stewardship theory (Iqbal and Lewis, 2009: 272).

principles where the former refers to the principle of consultation in which all stakeholders share the same goal of *Tawhīd* or the oneness of Allah (Choudhury, 2004 and 2006) and the latter concerns an adoption of the stakeholder-oriented value system (Iqbal and Mirakhor, 2004 and Chapra and Ahmed, 2002). At this point it is worth discussing the foundational dimension and the main arguments of the Islamic corporate governance model, as identified in the literature, which are based on the four fundamental principles of *Tawhīd*, *shura*, property rights and commitment to contractual obligation that govern the economic and social behaviour of individuals, organizations, society and state.

3.4.1 *Tawhīdi Epistemology and Shuratic Process*

Although there is consensus amongst Islamic economists and Muslim jurists on the concept of *Tawhīd* as one of the philosophical pillars of Islamic economics,⁵⁹ it is observed that little is written on the *Tawhīd* epistemological aspect of the issue of corporate governance. Fortunately, Choudhury and Hoque (2004 and 2006) lay down the fundamental Islamic epistemology of *Tawhīd* in Islamic corporate governance.⁶⁰

As the foundation of Islamic faith is *Tawhīd* (Al-Faruqi, 1982), the basis for corporate governance framework also emanates from this concept. Allah says in *al-Qur'an* “*Men who celebrate the praises of Allah, standing, sitting, and lying down on their sides, and contemplate the (wonders of) creation in the heavens and the earth, (with the thought): ‘Our Lord! Not for naught Hast thou created (all) this! Glory to Thee! Give us salvation from the Penalty of the the Fire*” (3: 191).⁶¹ The praise by Allah upon the believers that remember Him standing, sitting, lying down, and contemplate the wonders of creation indicates the *Tawhīd* paradigm. Another verse of *al-Qur'an* (51: 56) further points out the *Tawhīd* dimension in Islam as Allah says “*I have only created Jinns and men, that may serve Me*”. Both these verses indirectly provide the fundamental principles of

⁵⁹ See Mannan (1970), Siddiqi (1978), Kahf (1978), Ahmad (1980), Naqvi (1981), Taleghani (1982), Al-Sadr (1982) and Choudhury and Malik (1992).

⁶⁰ Choudhury and Malik (1992) discuss the principle of *Tawhīd* as the episteme of corporate governance and human solidarity in Islamic political economy. Episteme means “the total set of relations that unite at a given period, the discursive practices that give rise to epistemological figures, science and possibly formalized system” (Dreyfuss and Rabinow, 1983: 18).

⁶¹ Translations of *Qura'nic* verses throughout this thesis are from Abdullah Yusuf Ali (2004) *The Meaning of the Holy Qur'an*. Maryland, USA: Amana Publication. For ease of typography and reading, the full transliteration used in the quotations has not been retained.

governance, where everything created by Allah has a purpose and a human being is created to be the vicegerent of God on earth towards the Unity of God. By putting His trust in mankind as a vicegerent, Allah plays an active role in monitoring and being involved in every affairs of human beings and He is omnipresent and a knower of everything (Chapra, 1992: 202). Allah states in *al-Qur'an* (31: 16) "*O my son! (said Luqman), if there be (but) the weight of a mustard seed and it were (hidden) in a rock, or (anywhere) in the heavens or on the earth, Allah will bring it forth: for Allah understands the finer mysteries, (and) is well acquainted (with them)*".⁶² As Allah knows everything and all mankind is accountable and answerable to Him, the *Tawhīd* paradigm therefore enhances the scope of firm's obligation and objectives to include a large group of stakeholders rather than the shareholders alone. Furthermore, it also denotes the concept of accountability, or *taklīf*, indicating that everyone is accountable to God for his own deeds. As such, the principle of *taklīf* that is derived from the supreme concept of *Tawhīd* should be the foundation of corporate governance in Islam.

Inspired by the paradigm of *Tawhīd*, which acknowledges the stakeholders as vicegerent, firms and corporate organizations have a fiduciary duty to uphold the principle of distributive justice⁶³ via the *shuratic* process. There are numerous references in both *al-Qur'an* and *al-Sunnah* that oblige every single human being to practice the principle of *shura* in every aspect of their life. Allah says in *al-Qur'an* (3: 159) "*So pass over (their faults), and ask for (Allah's) forgiveness; for them; and consult them in affairs (of moment). Then, when thou hast taken decision, put thy trust in Allah. For Allah, loves those who put their trust (in Him).*" Based on this verse, in explaining as to how important the concept of *shura* is, Chapra (1992: 234) mentions that the practice of *shura* is not an option but rather an obligation.

⁶² See *al-Qur'an* 99: 7-8: "*So, whosoever does good equal to the weight of a speck of dust shall see it. And whosoever does evil equal to the weight of a speck of dust shall see it.*" The verse reminds the human being that Allah knows everything and this invokes the principle of accountability in which all groups of stakeholders are answerable to God.

⁶³ Islam clearly emphasizes the principle of distributive justice, where Allah says "*We sent Our Messengers with clear signs and sent down with them the Book and the Measure in order to establish justice among the people*" (57:25). See also 16:90 and 5:8.

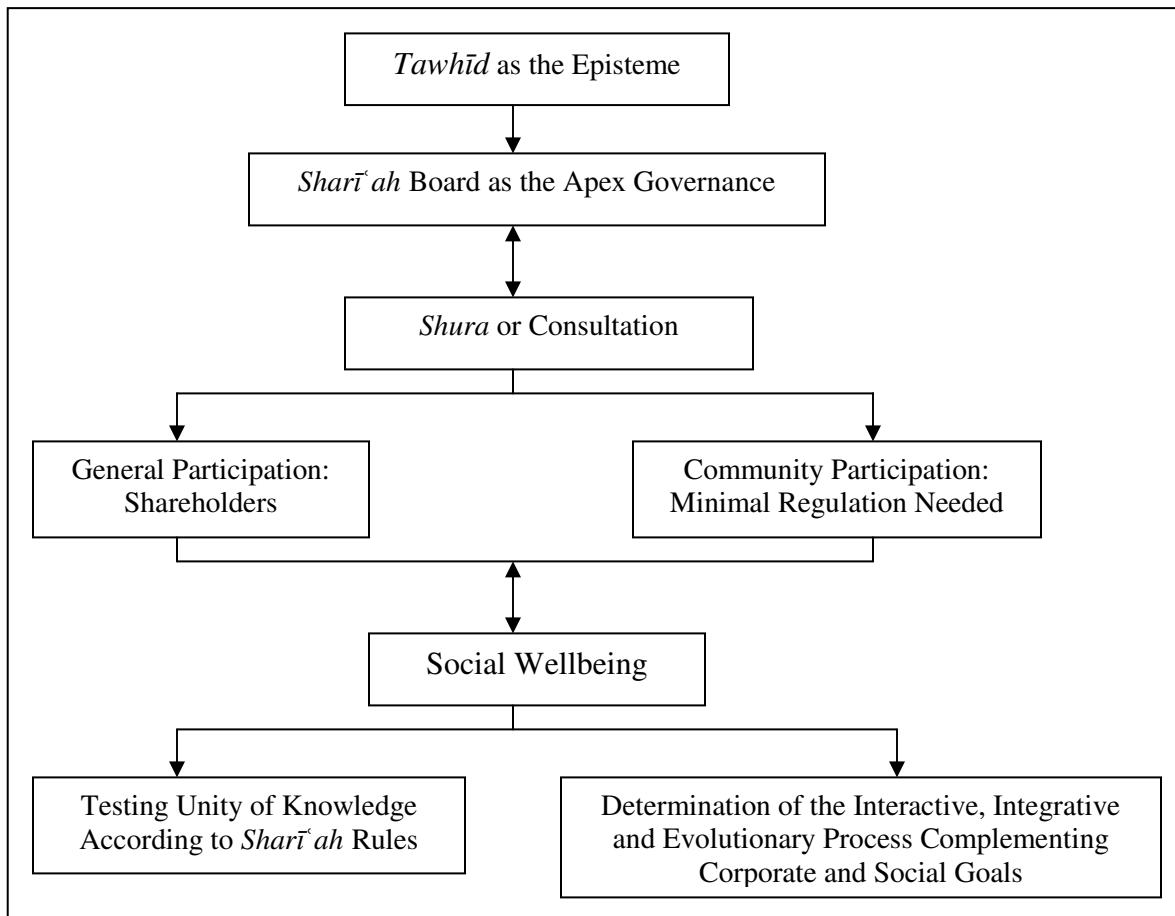
In the context of corporate governance, the constituent of *shura* provides the widest possible participation of the stakeholders in the affairs of the corporation either directly or via representatives. The constituent of *shura*'s group of participants, namely the shareholders, the management, the BOD, the employees and the communities, plays a crucial role to ensure that all corporation activities not only meet all the firm's objectives but are also in line with the *Shari'ah* principles. In this aspect, each organ of governance structure has its own unique function. For instance, the management and the BOD act as active participants and conscious stakeholders in the process of decision-making and policy framework. The decisions are made by considering the interests of all direct and indirect stakeholders, rather than maximizing shareholders' profit alone. The other stakeholders, such as the community, on the other hand, play their roles of providing mutual cooperation and stimulating the social wellbeing function of the corporation.

In deconstructing the foundational paradigm of corporate governance in Islam, Choudhury and Hoque (2004) summarize their model of *Tawhīd* and the *shuratic* process by referring to four principles and instruments governing Islamic corporate governance, i.e. unity of knowledge, the principle of justice, the principle of productive engagement of resources in social, and the principle of economic activities and recursive intention. All of these principles are the main premises of the Islamic corporate governance, in which *Shari'ah* rules embedded in *al-Qur'an* and *al-Sunnah* make the Islamic corporation market-driven and at the same time uphold the principles of social justice (Choudury, 2004: 57–83). Lewis (2005: 16–18) seems to support this approach by mentioning the essence of *Tawhīd* and the institution of a *shuratic* decision-making process and explaining how decision-making in business and other activities can meet Islamic moral values.⁶⁴ He mentions that all resources are from Allah, ownership of wealth belongs to Allah and the individual is only a trustee who is accountable and answerable to Allah. The ultimate ends of business and economic activities, including the aims of the business organization, shall be in the direction of upholding the principle of *Tawhīd*. The concept

⁶⁴ Lewis (2005: 16) states that, on the basis of *Shari'ah*, all stakeholders shall participate in decision-making or at least to contribute knowledge to the formulation and implementation of the organizational vision and consultative procedures.

of corporate governance from an Islamic perspective is summarized by Choudhury and Hoque (2004: 86), shown in Figure 3.1.

Figure 3.1: *Tawhīd* and *Shura*-Based Corporate Governance Structure



Source: Choudhury and Hoque (2004: 86).

Figure 3.1 illustrates that the Islamic corporate governance approach is premised on the *Tawhīd* epistemological model, in which the functional roles of the corporation are working via the *Shari'ah* rules. The principle of *Tawhīd* leads to the important concepts of vicegerency (*khilāfah*) and justice or equilibrium (*al-adl wal ihsān*⁶⁵). The stakeholders, as vicegerents of Allah, have a fiduciary duty to uphold the principles of distributive justice via the *shuratic* process. Chapra (1992: 234) highlights that the

⁶⁵ Naqvi (1994: 27–28) defines *al-adl wal ihsān* as a state of social equilibrium, which means the 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.

practice of *shura* is an obligation in any decision-making process and the constituent of *shura* denotes the widest participation of the stakeholders.

There are two main institutions involved in Islamic model of corporate governance, namely the *Shari‘ah* board and the constituent of the *shura*'s groups of participants. In determining the scope of *Shari‘ah*, the institution of the *Shari‘ah* board comes into the picture and plays crucial role to ensure that all corporation activities are in line with the *Shari‘ah* rules and principles. In addition, the shareholders also have a responsibility as active participants and conscious stakeholders in the process of decision-making and policy framework by considering the interests of all direct and indirect stakeholders rather than maximize their profit alone. The other stakeholders, including the community, should also play their roles to provide mutual cooperation to protect the interests of all stakeholders and to stimulate the social wellbeing function for social welfare. All of these processes are centred on fulfilling the ultimate objective of Islamic corporate governance of complementing the private and social goals via upholding the principle distributive justice (Choudury, 2004: 85–88).

The *Tawhīd* and *shura*-based approach provides the epistemological foundation of corporate governance. This approach, however, seems to be unclear and ambiguous as to how it could be adopted and implemented in the current corporate governance system. Moreover, the practice shows that major corporations, including IFIs, tend to adopt the existing corporate governance model, which is founded on the episteme of rationalism and rationality. This triggers the need for further research and empirical rather than theoretical studies to examine the operational aspects of this *Tawhīd* and *shura*-based approach.

3.4.2 Stakeholder-Oriented Approach

Chapra and Ahmed (2002: 14) emphasize the notion of equitably protecting the rights of all stakeholders irrespective of whether they hold equity or not. This seems to support the model proposed by Iqbal and Mirakhori (2004), who argue that the corporate governance model in the Islamic economic system is a stakeholder-centred model in which the

governance style and structures protect the interests and rights of all stakeholders rather than the shareholders per se⁶⁶ (Iqbal and Mirakhori, 2004: 43, 48 and Iqbal, 2007: 273–294). Iqbal and Mirakhori's main arguments are based on two fundamental concepts of Islamic law, namely the principle of property rights and the commitment to explicit and implicit contractual obligations that govern the economic and social behaviour of individuals, institutions, corporations, societies and states. These two principles provide strong justification for the notion of classifying Islamic corporate governance as a stakeholder-oriented model.⁶⁷ In addition, Nienhaus (2006: 290) states that Islamic corporate governance should promote the principle of fairness and justice with respect to all stakeholders.⁶⁸

The principle of property rights in Islam formulates a framework as to how to identify and then protect the interests and rights of all stakeholders⁶⁹. The majority of jurists agreed that usufructs (*manafi'*) and rights (*huquq*) are considered as property⁷⁰ and they must be protected and safeguarded. At this point, Islam guarantees the protection of property rights, be it in the form of *manafi'* or *huquq*, and these include right of

⁶⁶ Archer (2007) implies that corporate governance of IFIs is inclined toward the stakeholder value model. This is because the nature of corporations, particularly of the directors and the management, owe fiduciary duties of care and loyalty to the shareholders and also other stakeholders, including and especially the investment account holders. Grais (2006) states that corporate governance of the Islamic financial sector is concerned with the issue of protecting the stakeholders' financial interests via internal and external arrangements. Dusuki (2008: 391–413) further supports the notion of the stakeholder-oriented model in IFIs and provides the pyramid of *maslahah* as a device or mechanism to protect rights and interests of various stakeholders.

⁶⁷ The stakeholders' model of Islamic corporate governance seems to be against the traditional shareholder-oriented corporate governance doctrine as reflected by Friedman (1970), who indicates that the social responsibility of any business organization is to generate profits. Friedman's doctrine not only contradicts the Islamic model of corporate governance but it has been criticized by Western scholars as well. Mulligan (1986), for instance, criticizes that Friedman fails to prove that the exercise of social responsibility in business is by nature an unfair and socialist practice. He considers Friedman's contention is based on a questionable paradigm, a false key premise and that it lacks logical cogency.

⁶⁸ Interestingly, Nienhaus (2006: 298–301) discusses whether the depositors of Islamic banks have a need for representative in boards for more efficient corporate governance supervision, as in some corporations in Germany. He concludes, however, that the said notion will not be effective in the case of Islamic banks that are exposed to competition. This strongly implies that the corporate governance of IFIs is more toward the stakeholder value model.

⁶⁹ Bashir, (2000) interestingly analyse the concept of property rights in Islam. While Islam acknowledges the right of individual property, this right must be exercised with due caution by maintaining the interest of large group of stakeholders including the society at large.

⁷⁰ *Manafi'* refers to the ostensible benefits taken out of material things by way of their utilization, such as rental payment from a leasing contract, and *huquq* means something that can be justly claimed such as right of ownership, right of easement and right of acquisition (Islam, 1999: 361–368).

ownership, acquisition, usage and disposition. In terms of right of ownership, Islam declares that Allah is the sole owner of property⁷¹ and a human being is just a trustee and custodian in whom it implies the recognition to use and manage the properties in accordance with *Shari‘ah*, as property is given as *amanah* (trust) to individuals. There are numerous verses of *al-Qu’ran* referring to the principle of property rights such as “*Believe in Allah and His Messenger and spend (in charity) out of the (substance) whereof He has made you Heirs. For those of you who believe and spend (in charity) for them is a great reward*” (*Al-Qur’an*, 57: 7) and “*It is He who hath created for you all things that are on earth, then he turned to the heaven and made them into seven firmaments and all of things he hath perfect knowledge*” (*Al-Qur’an*, 2: 29). The implied meaning of these verses lays down the foundational principle and the effect of property ownership where mankind is only regarded as a trustee of God.

Azid et al. (2007: 7) considers that property rights in Islam guarantee individuals as well as corporations “the right to own private property and economic resources, to make a profit, to expand jobs, to boost investment and to increase prosperity”. This implies the recognition of individual ownership in corporation. While acknowledging the right to property of an individual or firm, Islam at the same time provides guidelines on how to deal with the property ownership via the *Shari‘ah* principles. The *Shari‘ah* then requires the enjoyment of rights to property by either individuals or corporations to be balanced with the rights of the community at large. This property rights principle is a vivid recognition of Islam that the corporation should not concentrate on protecting the interests of certain organs of governance in the corporation, particularly shareholders, but should include other stakeholders. In summary, the concept of property rights in Islam is based on three fundamental principles: the right to property is subjected to *Shari‘ah*; the enjoyment of the right to property is balanced with the rights of society and the state; and individuals, society and the state are stakeholders and the rights of stakeholders are recognized by Islamic law (Iqbal and Mirakhori, 2004: 54).

⁷¹ The consensus view of Islamic economists is that the ownership of property belongs to Allah (Siddiqi, 1981: 7).

The contractual framework is also unique in Islam. In *al-Qur'an, surah 5:1*, Allah clearly reminds the Muslims of the principle of fulfilling each of their contractual obligations where He says: "*O you who believe! Fulfil (all) obligations*". This verse presents a basic foundation for the principle of contract that every individual, society, corporation and the state are bound by their contracts. In relation to the issue of corporate governance, each stakeholder has a duty to perform his contractual obligations in accordance with the terms stipulated in the contract. While Islam guarantees the freedom of contract within the *Shari'ah* parameters, the parties to any transactions are bound to fulfil their contractual obligations⁷².

This contractual framework enhances the scope of the firm's stakeholders, as it is not necessary to refer to the shareholders alone but it also involves those who have active and non-active participation in the firm. At this point, Iqbal and Mirakhori (2004: 58) formulate two tests to determine whether any individual qualifies as a stakeholder: firstly, whether the individual or group has any explicit and implicit contractual obligations; and, secondly, whether they are someone whose property rights are at risk due to business exposure of the corporation.⁷³ As such, all parties who are directly or indirectly affected by the firm's business are considered as the rightful stakeholders. In this regard, each stakeholder has its own function, the shareholders have a duty to provide business capital, the management to manage and run the business, the employees to perform their respective duties and the regulators to ensure enforceability of the contracts. All these duties arise through the contractual framework and provide vivid evidence that the Islamic corporate governance model is inclined towards the stakeholder-oriented approach.

Corporate governance based on the stakeholder value orientation is preoccupied by the two fundamental concepts of *Shari'ah* principles of property rights and contractual obligation. The governance of any corporation in Islam is ruled by *Shari'ah*. It

⁷² For further analysis on the theory of contracts in Islamic law, see Rayner, (1991) and Vogel, (2006). Both of them discuss in details the position of Islamic law of contract and its modern application particularly in the Arab Middle East.

⁷³ This is in line with the saying of Prophet: "A Muslim is the one from whose hand others are safe" (Sahih Bukhari, Volume 1, Book 2, Number 10).

emphasizes the notion of protecting the rights and interests of all the stakeholders. Interestingly, the stakeholder-based governance structure considers a *Shari‘ah* board as a unique institutional arrangement in corporate governance, which plays a role of overseeing and supervising the *Shari‘ah* aspects of Islamic corporation. The BOD, on the other hand, acting on behalf of the shareholders, has a duty to monitor and oversee overall business activities while the managers have a fiduciary duty to manage the firm. The other stakeholders, such as employees, depositors and customers have a duty to perform all of their contractual obligations. The regulatory and supervisory authorities, as external stakeholders, play a role in promulgating rules and laws and providing an appropriate regulatory environment.

Having analysed the stakeholder-based model approach, it is important to highlight a few issues on the arguments put forward by Iqbal and Mirakhori (2004); Chapra (2004: 65), in his critical review on Iqbal and Mirakhori’s arguments, commented that while most of the arguments positively supported the stakeholder model and acknowledged the stakeholders’ rights, they failed to demonstrate how these rights would be protected. The argument that the observance of rules of behaviour guarantees internalization of stakeholder rights seems difficult to be materialized. Chapra (2004: 65–66) argues that Islamic norms had become internalized in the Muslim society during the classical period but this does not work in today’s society. There are a few factors that contributed to the phenomenon of internalization of the stakeholders’ rights and they include common practice of Islamic values, nature of communities and economic environment (Chapra, 2007: 329–330). In this respect, he considers that there are other factors need for the internalization of stakeholder rights, such as well-functioning competitive markets and a proper legal framework for the protection of stakeholders (Chapra, 2004: 67).

Another debatable argument refers to the task of designing a corporate governance system to be solely the prerogative of Islamic government. It is the duty of Islamic government to regulate the rules and legislation to specify the appropriate corporate governance structure. This argument raises a few issues, such as a proper definition of Islamic government and the corporate governance structure of Islamic corporations in the countries where Muslims are a minority.

The overall arguments on stakeholder value orientation as the ideal model of corporate governance in the Islamic economic system indicate that the corporate goal of Islamic firms is balanced with the aim of maximizing profit and duty to observe social justice by protecting the rights, interests and welfare of all stakeholders. It is observed nevertheless that, contrary to its ideal framework, the main objective of many corporations, including the so-called Islamic corporations, is to maximize the shareholders' profit. This implies that, in actual practice, many Islamic corporations adopt the shareholder model of corporate governance rather than the stakeholder value orientation.⁷⁴ Therefore, the issue before researchers and scholars is to come up not only with the theoretical foundations of Islamic corporate governance but to support it with empirical evidence and appropriate case studies as to the actual corporate governance practice and possible transformation.

3.5 Corporate Governance Framework in IFIs

This section briefly explains the corporate governance framework from an Islamic perspective in the context of IFIs by describing the roles, functions and relationships of the institutions of the BOD, the management, the shareholders, the depositors and, more importantly, the *Shari‘ah* board, which represents the fundamental component of the study. As a basis of the discussion, the study refers to the IFSB-3⁷⁵. In addition, the study also makes reference to the OECD Principles of Corporate Governance as well as the BCBS guidelines, as both documents are very relevant in discussing the key elements of corporate governance best practice, such as separation of ownership and control,

⁷⁴ The World Bank Note on Risk Analysis for IFIs states that the existing corporate governance in IFIs is modelled along the lines of shareholder value orientation (Greuning and Iqbal, 2008: 185). This is affirmed by a study conducted by Lim (2007: 737–738) on corporate governance reform in Malaysia, which found the majority of companies prefer to adopt the Anglo-Saxon model of corporate governance as a benchmark rather than the stakeholder value model.

⁷⁵ The IFSB-3 sets out seven guiding principles of prudential requirements in the area of corporate governance for IFIs. It is divided into four parts, namely: general governance approach, rights of investment account holders, compliance with Islamic *Shari‘ah* rules and principles, and transparency of financial reporting in respect of investment accounts. Section 10 of principle 1.1 specifically mentions the need to establish a policy framework for the purpose of *Shari‘ah* governance by setting out a *Shari‘ah* supervisory board (IFSB, 2006a: 3).

transparency and market discipline, balancing the stakeholders' interest, and information asymmetries.⁷⁶

One of the versions of Islamic corporate governance framework is illustrated by Abdul Rahim (1998: 55–70), who presents the framework that integrates *Shari‘ah*⁷⁷ and Islamic moral precepts and emphasizes the institutions of *shura*, *hisbah*, and religious audit as the major components of the corporate governance framework. The institution of *shura*, which consists of management, BOD, shareholders, employees, customers and other interested parties, may ensure the effectiveness of any corporate decision-making that may possibly affect the corporation. The institution of *hisbah*⁷⁸ and the religious auditor play a role in monitoring the corporate activities with regard both regulatory and moral aspects, while *Shari‘ah* boards are concerned with issuing legal rulings and providing *Shari‘ah* advisory and supervisory services.

A more comprehensive framework of Islamic corporate governance is illustrated by Choudhury and Hoque (2004: 86). They clearly locate the governance structure and the appropriate level of each institution, its roles and functions, aims and objectives, and governing laws of the corporation based on the epistemology of *Tawhīd* and *shura*. Nienhaus (2007: 129) also offers another illustration of Islamic corporate governance framework by insisting on the aspects of regulatory framework of Islamic law as well as

⁷⁶ Bhatti and Bhatti (2010: 34–35) assert that the concept of corporate governance in Islam is consistent with all of the six OECD Principles of Corporate Governance, namely: ensuring the basis for an effective corporate governance framework through rule of law and market transparency; protection of shareholders' rights; equitable treatment of shareholders; role of stakeholders to create wealth and jobs; disclosure and transparency; and ensuring the strategic guidance of the company through effective monitoring and supervision. All of these principles are consistent and in fact commendable from an Islamic point of view.

⁷⁷ Bearing in mind that people are sometimes confused with the terminology of *Shari‘ah* and *fiqh*, it is worth noting a distinction between these two. *Shari‘ah* is the perfect and immutable divine law as revealed in *al-Qur‘an* and *al-Sunnah* and *fiqh* refers to the sum of human efforts to understand and interpret the law derived from these sources, in other words, the valid means to know *Shari‘ah* by utilizing its proper methodology of *usul al-fiqh* (Islamic jurisprudence) (Vogel and Hayes, 2006: 23–24).

⁷⁸ During the early Abbasids (750 CE), the institution of *hisbah* or an office of local administration was established to ensure compliance with the requirements of *Shari‘ah*. The very basic functions of *muhtasib* or the officeholder of *hisbah* were to promote good and discourage evil and these include duties to inspect correct weights and measures in business dealings, ensure fair trading transactions, check business frauds and irregularities, audit illegal contracts, keep the market free and prevent hoarding of necessities (Abdul Rahim, 1998: 63–64). Klein (2006) provides a comprehensive examination of theoretical and manual *hisbah* literature. The literature mentions several *hisbah* duties and they include music-related offences, public display of wine offences, offences inside the home, overseeing cemeteries and wailing practices, instruction of children and mosque-related tasks. See also Schacht (1964).

general banking law and regulations. Banaga et al. (1994: 168–196) conceptualizes an integrated framework incorporating a corporate culture and control mechanism within an Islamic setting.⁷⁹ On the whole, Choudhury and Hoque (2004), Nienhaus (2007), Banaga et al. (1994) and Abdul Rahim (1998) tend to conclude that a conceptual framework of Islamic corporate governance must take into account the element of the epistemology of *Tawhīd*, the *shuratic* process, the concept of vicegerency (*khilafah*), social justice (*al-adl wal ihsān*), accountability (*taklīf*), regulatory aspects of Islamic law, general banking law and regulations, and the principles of Islamic morality. Despite having this solid conceptual framework, there is a big challenge as to how to address the problems in operationalizing such framework, to integrate all of the said principles and to internalize the Islamic norms in the corporation. In fact, Banaga et al. (1994: 177–178) mentions that the implementation of *Shari‘ah*, moral and ethical standards in an Islamic business organization will not necessarily be followed with excellent economic performance.

With respect to the above, corporate governance in IFIs requires additional measures of governance as compared to its conventional counterpart as a tool to integrate each component of the corporate governance framework. In this regard, the IFSB-3 attempts to provide guidelines and key principles to facilitate IFIs with appropriate governance structures and processes with the stakeholder-oriented approach as a model basis. Part 1 and part 3 of the IFSB-3 recommend the integrated approach of corporate governance by insisting on ethics and compliance with *Shari‘ah* rules and principles (IFSB, 2006a).

In order to understand and appreciate the corporate governance framework in IFIs, it is essential to examine roles and duties of several of its key participants, i.e. the shareholders and depositors, the BOD, the management,⁸⁰ and the *Shari‘ah* board. Unlike their conventional counterparts, the *Shari‘ah* board, religious auditors and depositors, particularly investment account holders (IAHs), are additional key participants for

⁷⁹ Corporate culture refers to core values, common behaviour, codes of conduct, self-regulation and control mechanism concerns of executive management, goals and strategies, and leadership (Banaga, 1994: 180).

⁸⁰ Chapra (2002: 31–48) considers the BOD, the senior management, the shareholders and the depositors as the most significant mechanisms of corporate governance in IFIs.

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corporate governance in IFIs. Table 3.1 illustrates the key participants in corporate governance in IFIs and briefly mentions their functional roles.

Table 3.1: Key Participants in Corporate Governance in IFIs

Key Participants	Interest	Functional Roles
Regulatory Authority	Economic stability	Set regulatory framework for sound and proper corporate governance
Supervisory Authority	Compliance with the laws and regulations	To supervise and monitor the effectiveness of corporate governance and to check compliance with regulations
Shareholders	Profit maximization; satisfactory earnings per share; dividends; above average return on investment; and excellent continuous growth	Appoint fit and proper boards, management auditors and <i>Shari'ah</i> board
IAHs	Repayment of deposits at maturity on the agreed terms; protection of their interests and profit	To monitor the investment performance
<i>Shari'ah</i> Board	Compliance with <i>Shari'ah</i> and fulfilling <i>maqāsid Shari'ah</i>	To ensure <i>Shari'ah</i> compliance and protect the rights and interests of depositors and other stakeholders
BOD	Monetary and non-monetary compensation; manage the company efficiently, effectively and with high integrity; and outstanding corporate reputation and brand	To set the IFI's direction and policies
Management	Monetary and non-monetary compensation; and commitment to claims of the contract	To implement policies set by the BOD

The regulatory authority, as an external organ of governance, plays a key role in corporate governance by defining the regulatory and legal environment to facilitate a sound corporate governance framework. It also has responsibilities to provide appropriate guidelines for IFIs, to develop internal control, risk management procedures and standard of transparency, and to monitor the IFI's overall operation. To complement this function,

the supervisory authority has a duty to supervise and monitor the effectiveness of the corporate governance system and to check compliance with such regulations.

With regard to the internal institution of governance, shareholders have responsibilities to appoint fit and proper BOD, management auditors as well as a *Shari‘ah* board. Unlike conventional banks, the functions of shareholders in IFIs are extended to include the duty to appoint a *Shari‘ah* board. This is affirmed by the AAOIFI Governance Standards, which require that the appointment of the *Shari‘ah* board shall be made by the shareholders in the general assembly. This demonstrates the uniqueness of IFIs, where the shareholders play a role in electing and appointing the *Shari‘ah* board members. This position is essential to indicate that *Shari‘ah* board is independent from the BOD so as to enable them to provide advisory and supervisory functions without fear or favour.

The scope of corporate governance has been enlarged for IFIs to include not only protection of the shareholders but also the depositors, particularly IAHs. This is because the depositors in IFIs are exposed to a much higher risk than in conventional banks. The modus operandi of a deposit in an Islamic bank, especially an investment account, implies participation in the financial results of the employment of funds (Nienhaus, 2007: 128). This indicates that corporate governance in IFIs must take into consideration the interest of the depositors as one of the main stakeholders.

The IAHs in IFIs participate in the profit and loss, since their investments are not explicitly or implicitly insured or guaranteed as in the case of conventional financial institutions. In actual context of IFIs, the IAHs nevertheless are not directly exposed to the risks of Islamic banking business as they are not involved in the management and have no voting rights in the shareholders’ meetings.⁸¹ The depositors are exposed

⁸¹ Although known as quasi-shareholders, the IAHs do not have shareholders’ governance rights such as the power of appointment or dismissal of the BOD and the external auditors, the right to receive annual reports, the right to vote in annual general meetings and general assemblies and the right to appoint the *Shari‘ah* board (Archer and Karim, 2006: 137). The IFSB-3 recommends several key principles with respect to protecting the rights and interests of the investment account holders (IAHs). For instance, principle 2.1 requires IFIs to acknowledge IAHs’ rights to monitor the performance of their investments and associated risks, while principle 2.2 encourages them to adopt a sound and transparent investment strategy (IFSB, 2006a: 6–10). In the absence of the right to participate in governance, even though recognized as quasi-

indirectly to the risks incurred in two situations, namely the deposit insurance system does not insure demand deposit beyond a certain limit and the losses suffered by the banks on their profit and loss sharing advances may be substantial and the capital and reserves plus investment deposit may not be sufficient to cover them (Chapra and Ahmed, 2002: 42–47). This position raises several issues pertaining to the rights and interests of the IAHs and demands extra precautions in terms of good governance in order to gain the confidence of the depositors and at the same time protect the rights and interests of the main shareholders.⁸²

The BOD plays a strong role in specifying the strategic objectives, guiding principles, code of conduct and standard of appropriate behaviour of the employees (Chapra and Ahmed, 2002: 31–32). Corporate governance requires the BOD to be not only professionally competent in the aspect of risks, business strategies and banking business, but also to have the additional qualifications to understand and appreciate *maqāsid Sharī‘ah*,⁸³ as well as having at least a basic understanding of *Sharī‘ah* rules and principles. The motivation of managing the corporation is not solely for the purpose of maximization of the shareholders’ profit but rather to promote the welfare of all stakeholders. At this point, principles 13–17 of the IFSB-3 state that the BOD shall be responsible for steering the establishment of a governance policy framework (IFSB, 2006a: 3–4). These principles require the BOD to not only concern themselves with the profit-driven business strategy of the firm but also to consider the interests and rights of all stakeholders, such as depositors, employees and consumers.

Unlike the BOD, the management has a fiduciary duty to implement the policies and strategies set by the BOD. The management is an agent or *wakil* to the BOD and acts as a trustee not only to the BOD but to the shareholders and other stakeholders. It is therefore important to the management to be honest and frugal at all times and in all matters. It is

equity holders, the *Sharī‘ah* board and the regulatory and supervisory authorities are expected to protect their rights and interests (Greuning and Iqbal, 2008: 194).

⁸² In this circumstance, the *Sharī‘ah* board and regulatory authorities are responsible for protecting the interests and rights of the IAHs by ensuring adequate and efficient monitoring mechanisms are in place (El Hawary, Grais and Iqbal, 2004: 16).

⁸³ *Maqāsid Sharī‘ah* means protection of the welfare of the people, which lies in safeguarding their faith, life, intellect, posterity and wealth (Al-Ghazali, 1937: 139–140).

also essential for the management to be truly aware of the principle of *maqāsid Sharī‘ah* and other Islamic principles so as to ensure that all stakeholders' interests are protected while performing their duties. The IFSB-3 considers the management as a crucial entity to ensure the direction and all business transactions meet the *Sharī‘ah* requirements and are aligned with the interests of all stakeholders because it involves the day-to-day activities of IFIs (IFSB, 2006a: 16).

One of the most essential key participants of Islamic corporate governance is the *Sharī‘ah* board. The *Sharī‘ah* board is an institution that can only be found in the organizational structure of Islamic corporations. Principle 13 of the IFSB-3 requires each IFI to set up a *Sharī‘ah* board comprising at least three members to oversee and monitor the implementation of the governance policy framework by working together with the management and the audit committee (IFSB, 2006a: 3). The *Sharī‘ah* board is considered as part of the corporate governance limbs that play essential roles in *Sharī‘ah* supervision. Basically, the functions of the *Sharī‘ah* board are twofold, i.e. advisory and supervisory, and these include advising IFIs in their operation, to analyse and evaluate *Sharī‘ah* aspects of any banking and financing activities, and to monitor and supervise the extent of *Sharī‘ah* compliance.

To sum up, corporate governance in Islam adds additional value to the existing governance structure as it emphasizes the elements of faith, ethics and *Sharī‘ah* principles. A unique feature of the Islamic corporate governance model requires another layer of governance structure in order to accomplish all of those elements. In this regard, IFIs need a specific organizational arrangement as part of their corporate governance framework for the purpose of *Sharī‘ah* compliance and to ensure an effective independent oversight over *Sharī‘ah*-related matters.

3.6 Conclusion

It is worth mentioning that this chapter does not intend to discuss in detail every single issue of corporate governance as it only aims at providing its conceptual framework and theoretical foundation. The foundational paradigm of corporate governance from an

Islamic perspective, then, would be able to enlighten the concept of *Shari‘ah* governance in IFIs. In summary, the design of the corporate governance system in Islam has its own unique features and presents distinctive characteristics. The study summarizes the diversities of the Western models of corporate governance and classifies them into six aspects, namely: the episteme, the rights and interests, the corporate goal, the nature of management, the management board, and the capital-related ownership structure.

Table 3.2: The Diversities of the Anglo-Saxon, the European⁸⁴ and the Islamic Models of Corporate Governance

Aspects	The Anglo-Saxon Model	The European Model	The Islamic Model
Episteme	Rationalism and rationality.	Rationalism and rationality.	Faith-based rationalism with <i>Tawhīd</i> as a basis.
Rights and Interests	To protect the interests and rights of the shareholders.	The rights of the community in relation to the corporation.	To protect the interests and rights of all stakeholders but subject to the rules of <i>Shari‘ah</i> .
Corporate Goal	Shareholders controlling managers for purpose of shareholders’ profit.	Society controlling corporation for purpose of social welfare.	Corporate objective is balanced with the <i>maqāsid Shari‘ah</i> .
Nature of Management	Management dominated.	Controlling shareholder dominated.	Concept of vicegerency and <i>Shura</i> .
Management Boards	One-tier board.	Two-tier boards; executive and supervisory responsibility separate.	<i>Shari‘ah</i> board as part of the governance structure.
Capital-related and Ownership Structure	Widely dispersed ownership; dividends prioritized.	Banks and other corporations are major shareholders; dividends less prioritized.	Shareholders and depositors or IAHs.

Source: Rhodes and Van Apeldoorn (1997: 174–5) as cited in Cernat (2004: 150): modified.

⁸⁴ It is worth mentioning that the following comparison is based on the general characteristics of the Anglo-Saxon and the European models of corporate governance. Undeniably, both models evolve and their features may change and transmit into another form or even converge.

The above simplified version of the differences of Islamic and Western concepts of corporate governance provides an overview of the diverse approaches of corporate governance style and structure. With respect to epistemological method, Islam rejects rationality and rationalism as the sole episteme of corporate governance and replaces it with the episteme of *Tawhīd*. While the shareholder model prioritizes the shareholders' value alone and the stakeholder value orientation protects all the stakeholders' interest and rights, the corporate governance objective in Islam balances the corporate goal of maximizing the profit with the duty to uphold the principle of social justice and *maqāsid Sharī‘ah* and this entails the notion of protecting the interests and rights of all stakeholders within the *Sharī‘ah* rules.

The nature of management of the corporate governance model is premised by the fundamental principles of *shura*, with the *Sharī‘ah* board playing a significant role in supervising and overseeing the overall corporate activities so as to ensure they comply with the *Sharī‘ah* principles. In contrast to the Western concept, the nature of ownership structure in corporate governance considers the shareholders and the IAHs as the rightful owners, rather than the shareholders alone. The distinct features and characteristics of corporate governance combine the element of *Tawhīd*, *shura*, *Sharī‘ah* rules and Islamic morality to maintain the private goal without ignoring the duty of social welfare.

On the whole, unlike the Western model of corporate governance, the foundational dimension of Islamic corporate governance is rooted in the fundamental principles of *Tawhīd*, the *shuratic* process, property rights and contractual obligation. Based on this aspirational foundation, key participants in corporate governance in Islamic corporation, particularly IFIs, such as the BOD, the shareholders, the depositors, the managers and particularly the *Sharī‘ah* board, play significant roles in ensuring the *Sharī‘ah* objectives and the firm's goal are both realized within the parameters of *Sharī‘ah* and Islamic values and ethics. As a matter of fact, the spread of Islamic banking business and strong growth of the Islamic finance sector, along with the increasing numbers of IFIs, require a specific organizational arrangement in the form of '***Sharī‘ah* governance**' as part of an Islamic corporate governance framework.

CHAPTER 4

THE SHARI‘AH GOVERNANCE SYSTEM IN ISLAMIC FINANCIAL INSTITUTIONS

4.0 Introduction

The philosophical foundation of corporate governance in Islam requires an additional layer of governance for the purpose of *Shari‘ah* compliance. With this aspiration, corporate governance in IFIs needs a set of institutional arrangements to oversee the *Shari‘ah*-compliant aspects of their business and operations. In the absence of any model of corporate governance in Islamic literature, IFIs have innovatively introduced the *Shari‘ah* governance system as part of their corporate governance framework, which is peculiarly exclusive to its corporate governance framework.

With the lessons from the failure and financial scandal of several IFIs and the huge potential implications of *Shari‘ah* non-compliance risks, the need for a good and efficient *Shari‘ah* governance system is considered as part of the crucial portion of corporate governance. As one of the essential key participants of corporate governance in IFIs, the institution of the *Shari‘ah* board plays an essential role in the aspect of *Shari‘ah* supervision, monitoring, auditing and issuing legal rulings. The *Shari‘ah* board has become the central part of the *Shari‘ah* governance system that has a profound influence on the day-to-day practice of finance in providing advisory and consultative services to IFIs.

In parallel with the tremendous growth of the Islamic finance sector worldwide and the complexity of Islamic financial products and services, it is strongly indicated that there must be a sound and proper *Shari‘ah* governance system. With the aim of providing an overview of the *Shari‘ah* governance system and its related issues, this chapter is organized into ten sections, comprising of an introduction, conceptual framework, historical development, objective of *Shari‘ah* governance system, roles of *Shari‘ah* board, models of *Shari‘ah* board, international standard-setting agency, *Shari‘ah* governance process, issues and challenges, and a conclusion.

4.1 Conceptual Framework of *Shari‘ah* Governance Systems

Until the issuance of the IFSB Guiding Principles on *Shari‘ah* Governance Systems in Institutions Offering Islamic Financial Services (IFSB-10), there is no formal or proper definition of a *Shari‘ah* governance system. The AAOIFI Governance Standard No. 1-5 is also silent on its actual definition. In fact, the existing literature, as discussed in Chapter 3, seems to provide definitions of corporate governance rather than *Shari‘ah* governance in particular. Furthermore, neither the AAOIFI nor the IFSB have provided a proper definition of the existing governance standards. This leads to uncertainty and different understandings as to what is meant by a *Shari‘ah* governance system. Because of this, it is very important to clarify the term ‘*Shari‘ah* governance system’ and to have a sound understanding of its actual concept and meaning.

Perhaps, the best definition of *Shari‘ah* governance can be found in the IFSB-10.⁸⁵ The IFSB-10 defines the *Shari‘ah* governance system as “a set of institutional and organizational arrangements through which IFIs ensure that there is effective independent oversight of *Shari‘ah* compliance over the issuance of relevant *Shari‘ah* pronouncements, dissemination of information and an internal *Shari‘ah* compliance review” (IFSB, 2009a: 2). To understand further, this definition can be divided into three essential components:

- (i) The set of institutional and organizational arrangements: This refers to the *Shari‘ah* board and its related institutions, such as an internal audit department and *Shari‘ah* division.
- (ii) Effective independent oversight of *Shari‘ah* compliance: This indicates the aims and objectives of the *Shari‘ah* governance system to provide efficient mechanisms for the purpose of *Shari‘ah* compliance.

⁸⁵ Sheikh Mohammad Ali El Gari, a prominent Saudi *Shari‘ah* scholar, defines *Shari‘ah* governance as “the set of procedures, institutions and organizational arrangements through which the *Shari‘ah* position on contemporary issues is revealed and *Shari‘ah* compliance ensured” (Parker, 2010). This definition nevertheless provides a narrow interpretation of the concept of *Shari‘ah* governance as it mainly refers to *fatwa* issuing and the process of *Shari‘ah* compliance.

- (iii) *Shari‘ah* pronouncements, dissemination of information and an internal *Shari‘ah* compliance review: This involves the overall *Shari‘ah* governance processes that cover both *ex ante* and *ex post* aspects of the *Shari‘ah* compliance framework.

This definition implies that the institution of the *Shari‘ah* board is crucial to the *Shari‘ah* governance system as an authoritative body to ensure *Shari‘ah* compliance in IFIs. The AAOIFI Governance Standard No.1 defines a *Shari‘ah* board as “an independent body entrusted with the duty of directing, reviewing and supervising the activities of IFIs for the purpose of *Shari‘ah* compliance and issuing legal rulings pertaining to Islamic banking and finance” (AAOIFI, 2005: 4). A similar definition is given by the IFSB-10, which refers to “a body comprised of a panel of *Shari‘ah* scholars who provide *Shari‘ah* expertise and act as special advisers to the institutions” (IFSB, 2009c: 1). In carrying out this duty, the *Shari‘ah* board needs a clear framework and structure to ensure its effectiveness, particularly with respect to its independence, the binding force of its rulings, its objectivity and its full mandate. On this basis, any formal or informal arrangement as to how the *Shari‘ah* board is directed, managed, governed and controlled for the purpose of *Shari‘ah* compliance is also part of the *Shari‘ah* governance system.

Shari‘ah governance is a unique kind of governance in financial architecture as it is concerned with the religious aspects of the overall activities of IFIs. To illustrate the rationale of the *Shari‘ah* governance system in the existing corporate governance framework, Table 4.1 provides an illustration as to how *Shari‘ah* governance complements the existing corporate governance framework in IFIs.

Table 4.1: Institutional Arrangement in the Sharī'ah Governance System

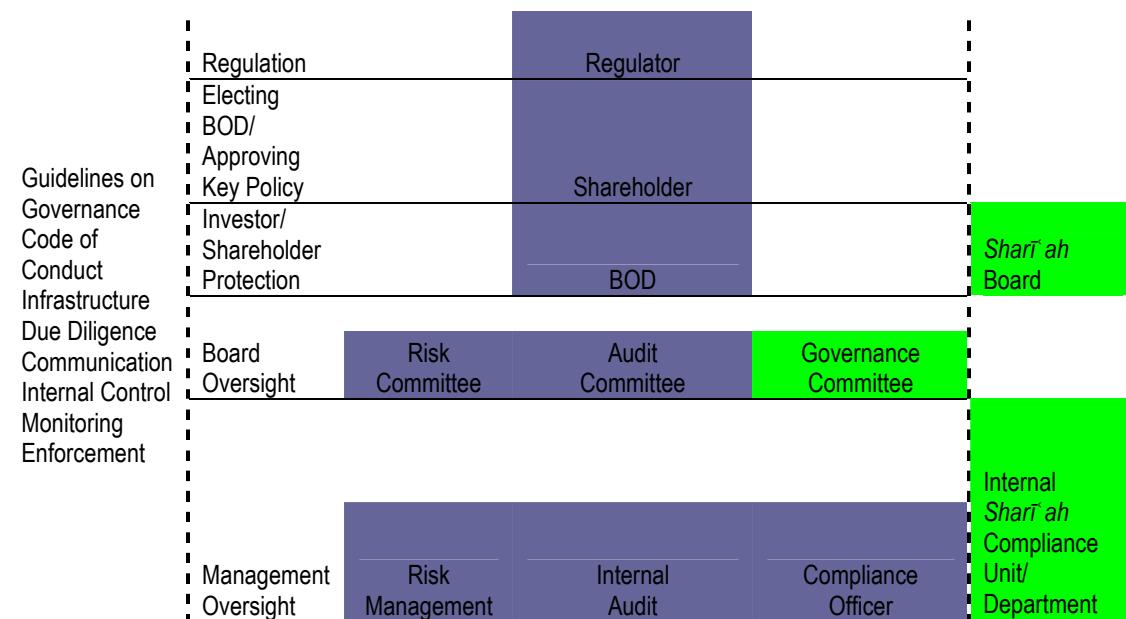
Functions	Typical Financial Institutions	Exclusive to IFIs
Governance	BOD	<i>Sharī'ah</i> Board
Control	Internal Auditor/External Auditor	Internal <i>Sharī'ah</i> Review Unit/External <i>Sharī'ah</i> Review
Compliance	Regulatory and Financial Compliance Officers/Unit/Department	Internal <i>Sharī'ah</i> Compliance Unit

Source: IFSB (2009c: 4).

Table 4.1 initially indicates that IFIs and typical financial institutions share common institutional arrangements for their corporate governance framework, particularly in the aspects of governance, control and compliance. The only element that differentiates corporate governance in IFIs is the institutional arrangement for their *Sharī'ah* governance mechanism. IFIs require another set of organizational arrangements in the form of a *Sharī'ah* board, an internal or external *Sharī'ah* review and an internal *Sharī'ah* compliance unit to meet the religious requirement of *Sharī'ah* compliance in all aspects of their business transactions and operations.

In terms of governance structure, the *Sharī'ah* governance system adds an additional layer of governance to the existing corporate governance structure. Figure 4.1 simply demonstrates the unique corporate governance structure in typical IFIs, in which the *Sharī'ah* board and internal or external *Sharī'ah* review are the additional institutions that oversee the *Sharī'ah* compliance aspects. This is actually based on the AAOIFI governance standards, which put the *Sharī'ah* board on a par with the BOD in the corporate governance structure and therefore it is subject directly to the shareholders. The IFSB-10 approach, on the other hand, places the *Sharī'ah* board either as parallel or subordinate to the BOD. Both the AAOIFI and IFSB guidelines nevertheless agree that the *Sharī'ah* board must be independent of the BOD and be accountable not only to shareholders but to all stakeholders.

Figure 4.1: Corporate Governance Structure in IFIs.

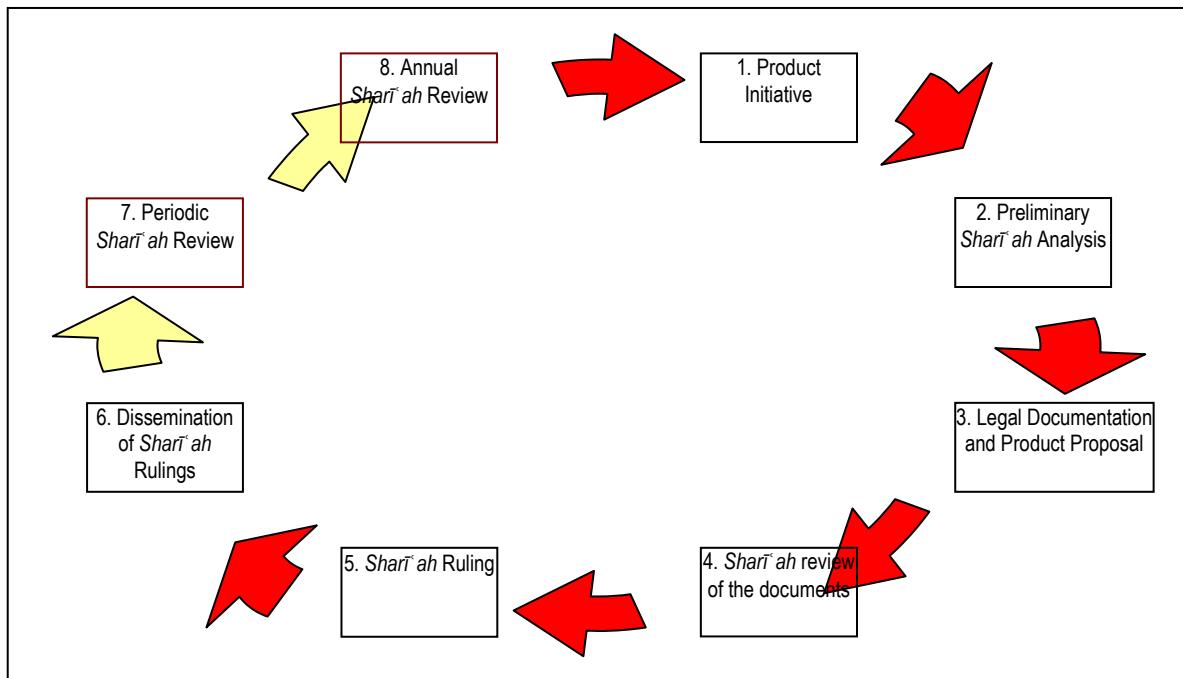


Source: Stanley (2008): modified.

With regard to scope of the *Shari'ah* governance framework, it covers *ex ante* and *ex post* aspects of *Shari'ah* compliance, of which the former refers to issuance of *Shari'ah* rulings and dissemination of *Shari'ah* -related information and the latter to the periodic and annual internal *Shari'ah* review process. Figure 4.2 illustrates the scope of the *Shari'ah* governance system in the two phases, i.e. *ex ante* and *ex post*. It is worth noting that the process outlined here only illustrates the generic process for the approval of Islamic financial products and this process can differ from one IFI to another. Figure 4.2 only attempts to provide a general idea of the *Shari'ah* governance process and its framework in typical IFIs.

The *Shari'ah* Governance System in Islamic Financial Institutions

Figure 4.2: Scope of the *Shari'ah* Governance Framework



Source: Dar (2009): modified.

Figure 4.2 illustrates the scope of the *Shari'ah* governance framework in IFIs. It involves a systematic process and requires involvement of numerous organs of governance. In phase 1, processes 1–6, the diagram illustrates *ex ante* *Shari'ah* compliance aspects, which include a product proposal, legal documentation, *Shari'ah* review, and procuring and dissemination of *Shari'ah* rulings. In phase 2, processes 7–8, the diagram demonstrates the *ex post* processes, which involve the periodic and annual *Shari'ah* reviews. The *Shari'ah* board plays a central role in ensuring the legitimacy of the products and services and this can only be achieved by having sound *Shari'ah* coordination and an efficient internal *Shari'ah* review unit. The *Shari'ah* coordinator acts as a liaison officer or coordinator to the *Shari'ah* governance process from product initiation to annual *Shari'ah* review.

This section attempts to provide the conceptual framework of *Shari'ah* governance in IFIs in three main aspects, namely its definition, institutional arrangement and scope of *Shari'ah* governance system. In summary, the *Shari'ah* governance system refers to a set

of institutional arrangements for the purpose of *Shari'ah* compliance and this involves *ex ante* and *ex post* *Shari'ah*-compliant processes, such as *Shari'ah* pronouncements, dissemination of information and an internal *Shari'ah* compliance review. The institutional arrangement in *Shari'ah* governance places the *Shari'ah* board as the backbone of the system. The formation of the *Shari'ah* board has become an integral part of the *Shari'ah* governance system in IFIs. In light of this conceptual framework, this research attempts to explore various practices of *Shari'ah* governance in IFIs with the *Shari'ah* board as the focus point.⁸⁶ The study highlights the different governance structures and processes across jurisdictions, including issues and challenges, with an objective of identifying and promoting best practices of *Shari'ah* governance.

4.2 Objectives of the *Shari'ah* Governance System

The objectives of the *Shari'ah* governance system lie in the very reason for its existence, i.e. for the sake of *Shari'ah* compliance as inspired by its philosophical foundation. It involves numerous processes and procedures which incur cost and involvement of various organs of governance in IFIs. Despite the extra cost, time and effort, IFIs still favour having *Shari'ah* governance, at least with the establishment of the *Shari'ah* board. This raises another very significant issue as to what extent the essence of *Shari'ah* governance system for IFIs? To address this issue, it would be better to understand the objectives and instrumental functions of *Shari'ah* governance in IFIs and these include legitimacy of the product, promotion of moderation and justice in financial transactions, confidence and trust of stakeholders, and as part of the risk management tools exclusive to IFIs.

⁸⁶ Bearing in mind that there are other *fatwa* institutions which issue rulings pertaining to Islamic banking and finance, such as the Council of Islamic *Fiqh* Academy, the Egyptian Office of the *Mufti*, the Council of Islamic Studies, Al-Azhar, Cairo, Egypt, the Council of Islamic *Fiqh*, Muslim World League, the General's Presidency of *Ifta'* in Saudi Arabia and others, the scope of the research nevertheless is only confined to *Shari'ah* governance system in IFIs. In this regard, it is important to note that such *fatwa* institutions are excluded from the definition of *Shari'ah* governance in this research. Meanwhile, although the term *Shari'ah* board has been used interchangeably with other names such as *Shari'ah* committee, *Shari'ah* advisory body, *Shari'ah* advisory council, *Shari'ah* control board, *Shari'ah* advisor, *Shari'ah* control committee, *Shari'ah* controller, *Shari'ah* council and religious committee, this research prefers to use the term *Shari'ah* board.

The *Shari‘ah* Governance System in Islamic Financial Institutions

Islamic financial products must be genuinely legitimate and comply with the *Shari‘ah* principles. In this respect, IFIs are in need of specialized body who are expert in *Shari‘ah*, particularly *fiqh al muāmalāt* and *usul al fiqh*, to assist them in determining the legitimacy of certain Islamic financial products. In view of the numerous issues involved in this process, such as the independence, qualifications, reporting structure, accountability and transparency of the *Shari‘ah* board, the *Shari‘ah* governance system is very important to maintain the credibility of the *Shari‘ah* board as well as to ensure the legitimacy of the products.

The *Shari‘ah* governance system is also important in promoting moderation and justice in financial transactions (Wilson, 2009a: 61) and therefore enhancing the public confidence in IFIs on the aspect of compliance in its application of *Shari‘ah* principles. The objective of IFIs is not to satisfy the shareholders’ alone but to inculcate the confidence and trust of the public and community, who rely on the services provided by them. In the absence of any control mechanism or governance system, the public confidence in the legitimacy and legality of the products may be impaired.⁸⁷ The *Shari‘ah* governance system, which consists of *ex ante* and *ex post* *Shari‘ah* compliance processes, would enhance the credibility of IFIs.

The *Shari‘ah* governance system is meant to address a specific type of risk exclusive to IFIs, known as *Shari‘ah* non-compliance risk. The IFSB-3 defines *Shari‘ah* non-compliance risk as “the risk that arises from IFIs’ failure to comply with the *Shari‘ah* rules and principles determined by the *Shari‘ah* board or the relevant body in the jurisdiction in which the IFIs operate” (IFSB, 2006a: 26). In this aspect, Delorenzo (2007: 398–407) illustrates *Shari‘ah* non-compliance risk by referring to the risk of *fatwa* rejection and differences as a form of operational and regulatory risk. In addition, Iqbal and Mirakhor (2007: 245) classify *Shari‘ah* risk into two types, namely the risk due to

⁸⁷ It is reported that 81.4% of the total number of 468 depositors from Bahrain, Bangladesh and Sudan will transfer their funds to other banks due to non-compliance to *Shari‘ah* principles and 70% of depositors will also move their funds if they know that the bank’s income is derived from interest-based earnings (Chapra and Ahmed, 2002: 118–120).

non-standard practices of Islamic financial products and the risk due to non-compliance with the *Sharī‘ah*.

The significance of *Sharī‘ah* non-compliance risk to the Islamic finance industry can be illustrated in the case of falling *sukuk* issuance due to a statement made by the chairman of the AAOIFI *Sharī‘ah* board, the OIC Fiqh Academy declaration on the impermissibility of *tawarruq*,⁸⁸ the Malaysian High Court judgment on the issue of BBA,⁸⁹ and the dispute in the case of *The Investment Dar Company KSCC v Blom Developments Bank Sal* (2009) EWHC 3545 (Ch).⁹⁰ Despite other factors that affect *sukuk* issuance worldwide, undeniably, the statement of 85% of potential *Sharī‘ah* non-compliance *sukuk* in the Gulf by Sheikh Muhammad Taqi Usmani has negated in some way public confidence on the legitimacy and Islamicity of the *sukuk*.⁹¹ Besides, the declaration of the impermissibility of *tawarruq* has potentially huge implications for IFIs, since the *tawarruq* financial instrument is widely offered in the market. Similarly, in the case of BBA in the Malaysian High Court, the learned judge declared that the profit portion derived from the BBA facility was illegitimate. This nearly caused panic to IFIs as more than 80% of Islamic financing facilities in Malaysia are based on the BBA concept.

All of these major cases indicate the significance of the *Sharī‘ah* governance system as a risk management tool to mitigate the *Sharī‘ah* non-compliance risk. If other kinds of risks, such as credit, equity investment, market, liquidity and rate of return risks, are

⁸⁸ The Islamic Fiqh Academy of the OIC issued the final resolution on *tawarruq* at the 19th meeting in Sharjah, United Arab Emirates on 26–30th April 2009 which confirmed its impermissibility.

⁸⁹ *Arab Malaysian Finance Bhd v Taman Ihsan Jaya Sdn Bhd & Ors (Koperasi Seri Kota Bukit Cheraka Bhd, third party)* [2008] 5 MLJ 631

⁹⁰ This case was an appeal from a summary judgment granted to the claimant on part of its claim in the amount of USD10,733, 292.55. In this case the Investment Dar refused to pay the expected profit and to return the principal amount of *wakala*-based deposit. The Investment Dar claimed that the *wakala*-based deposit did not comply with the *Sharī‘ah* and therefore should be considered void. On the other hand, the Blom argued that the claim was nonsense as the *wakala*-based deposit had already been authorized by the Investment Dar’s *Sharī‘ah* board. The court allowed the appeal and held that there was a triable issue on both claims. This case is a timely reminder to IFIs about the essence of the *Sharī‘ah* compliance of products via the mechanism of *Sharī‘ah* governance.

⁹¹ Sales of *sukuk* dropped 50% in 2008 and prices fell at an average of 1.51% (Kettel, 2008: 38). According to Bloomberg, sales of global *sukuk* had dropped to USD856 million in 2008 (Sobri, 2008: 16).

quantifiable, the *Sharī‘ah* risk on the other hand is difficult to manage. Furthermore, there is no specific risk management model to address the *Sharī‘ah* non-compliance risk which is unique to IFIs. The IFSB Guiding Principles on Risk Management (IFSB-1) specifically classify the *Sharī‘ah* risk as part of the operational risks which can be managed through a sound and proper *Sharī‘ah* governance system. The *Sharī‘ah* governance system would help IFIs to mitigate the *Sharī‘ah* non-compliance risk that may incur unimaginable loss and negate IFIs' credibility.

4.3 Institutionalization of the *Sharī‘ah* Board

Although *Sharī‘ah* governance is relatively new to any discourse on *fiqh al muāmalāt*, the notion of market regulation and enforcement through the institutionalization approach has already been implemented since pre-modern Muslim societies and is known as the institution of *hisbah*.⁹² The *hisbah* was instituted for the purpose of supervising public morals, where markets were regulated and monitored by its executor or the *muhtasib*.⁹³ Traditionally, the functions of *hisbah* include duties related to transgressing physical boundaries such as music-related offences and the public display of wine (Klein, 2006: 46–50). On top of that, the jurisdiction of *hisbah* also covered matters inside the private domain such as offences inside homes, cemeteries and wailing practices, the instruction of children, and proper functioning of the mosque (Klein, 2006: 50–58). The most important function of *hisbah* in the context of the economic welfare of the people was supervision of market affairs and this included control of scale and prices, protection of measures and standards of weight, accurate valuation of coins used in the market and prevention of fraud (Wittmann, 2006: 115–122).

⁹² The literature on *hisbah* can be divided into theoretical, such as *Public Duties in Islam: The Institutions of the hisbah* by Ibnu Taymiya and *Al Ahkam Al Sultaniya* by Al Mawardi, and prescriptive-legal literature (*hisbah* manuals), such as the manuals of Ibnu Bassam and Ibnu Ukuwa (Klein, 2006: 42–43). Ibnu Taymiya discusses in great detail the institution of *hisbah*, pertaining to its duties, rights and obligations upon specific socio-economic activities as well as market regulation (see Ibnu Taymiya, 1985).

⁹³ The *muhtasib* is the executor who discharged the principles of religious obligation of the individual believer “to command right, when its omission becomes apparent and to forbid wrong, when its realization becomes imminent” (Wittmann, 2006: 109).

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In view of some similarities of the institution of *hisbah* with *Shari‘ah* governance, particularly to their objectives and functions, the institutionalization of the *Shari‘ah* board can be considered as a new concept of the *muhtasib* in modern Muslim societies. The adoption of this modified *hisbah* model is very important to ensure all activities, transactions and operations of IFIs meet the principles of *Shari‘ah* and Islamic morals. At this point, the *Shari‘ah* board particularly at the national or regulatory level is the ideal institution that would be able to play some function of the *muhtasib* as the institution of *hisbah* within the context of IFIs. As with the notion of the *hisbah* institution during the pre-modern Muslim societies commanding right and forbidding wrong, the spread of Islamic banking business and the strong growth of the Islamic finance sector require a specific organizational arrangement to provide a standard of appropriate behaviour, guidelines and code of conduct for IFIs. At this juncture, it is worth briefly exploring the historical development of the institution of the *Shari‘ah* board and the *Shari‘ah* governance system in IFIs.

The establishment of the *Shari‘ah* board in IFIs is relatively new. The idea of setting up the *Shari‘ah* board as part of the governance structure of IFIs is considered to be the initiative of Sheikh Saleh Kamel when he founded the Dallah Al Baraka Group (Abdul-Rahman, 2010: 76). In 1976 the first formal *Shari‘ah* board was instituted by the Faisal Islamic Bank of Egypt (Kahf, 2004: 17–36). In the early period of Islamic finance practice there was no special body responsible for advising Islamic banks on *Shari‘ah* matters. The formations of the Mitr Ghams Savings Bank on 23rd July 1963, the Nasser Social Bank in Egypt in 1972 and the Dubai Islamic Bank in 1975 were made without setting up any *Shari‘ah* body as part of their governance structures. Although without such *Shari‘ah* supervisory boards, it is observed that the activities of IFIs did conform to the spirit of *Shari‘ah*.

The setting up of the institution of the *Shari‘ah* board began in 1976 when the Faisal Islamic Bank of Egypt was established. It was the first to have a formal *Shari‘ah* board consisting of selected *Shari‘ah* scholars in Egypt (Kahf, 2004). This practice was then

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followed by the Jordan Islamic Bank⁹⁴ and the Faisal Islamic Bank of Sudan in 1978, the Kuwait Finance House in 1979, the Bank Islam Malaysia Berhad in 1983, and the Dubai Islamic Bank in 1999.⁹⁵ The Islamic Development Bank (IDB) had no formal *Shari‘ah* supervisory board or an appointed *Shari‘ah* council during its early establishment but it has started establishing relationships with several *Shari‘ah* scholars by inviting them for consultation, seeking *fatwa* on *muamalāt* issues (Kahf, 2004: 17–36). The IDB also then established its own internal *Shari‘ah* board which was appointed by the IDB Board of Executive Directors.⁹⁶

Besides this, the International Association of Islamic Banks (IAIB) also set up its own *Shari‘ah* board.⁹⁷ The IAIB, however, was replaced with the CIBAFI in 1999.⁹⁸ In the meantime, the Organization of the Islamic Conference (OIC) countries acknowledge the Council of the Islamic *Fiqh* Academy based in Jeddah as having the authority to issue *fatwa* rulings including matters related to Islamic banking and finance.⁹⁹ To date, the majority of IFIs, including some of the well-respected central banks, have established their own *Shari‘ah* boards.

There are a few independent international entities established to support the Islamic finance sector on the aspect of governance, such as the AAOIFI and the IFSB. The AAOIFI has developed seven governance standards, of which five relate specifically to *Shari‘ah* governance. Similarly, the IFSB has issued seven guidelines on governance, disclosure and the supervisory review process and the IFSB-10 specifically addresses

⁹⁴ The Jordan Islamic Bank was established on 1st April 1978 and in the same year it set up a *Shari‘ah* board known as the *Shari‘ah* supervision authority. Sheikh Abdul Hamid Al Sayeh was the first *Shari‘ah* advisor to the Jordan Islamic Bank (Shallah, 1989: 230–231).

⁹⁵ Interestingly, the Japan Bank for International Cooperation also set up its own *Shari‘ah* board in May 2006 (JBIC, 2007: 5).

⁹⁶ The IDB established its own *Shari‘ah* board in 2002. Before this, the IDB referred any of its *Shari‘ah* matters to the Islamic Academy of *Fiqh* for deliberation (Bakar, 2002: 79).

⁹⁷ This institution, based in Cairo, Egypt, was established in 1977 and it has the official support of the IDB, the OIC, the central banks and monetary agencies of Muslim countries. The IAIB is active in providing a forum of cooperation amongst IFIs, promoting the concept of Islamic banking and finance, provide research, consultancy and training (Wilson, 1997: 83–93).

⁹⁸ The CIBAFI was incorporated in Bahrain on 16th May 2001 as an international autonomous non-profit corporate body that represents IFIs globally.

⁹⁹ The Council of Islamic *Fiqh* Academy is a subsidiary body of the OIC, created by the Third Islamic Summit Conference held in Makkah al-Mukarramah in January 1981 (IFA, 2010).

issues to promote best practice for the *Shari‘ah* governance system. At the national level, the BNM issued the BNM/GPS1 in December 2004 and *Shari‘ah* Governance Framework for IFIs in April 2010,¹⁰⁰ as well as the State Bank of Pakistan issuing the Instruction and Guidelines for *Shari‘ah* Compliance in Islamic Banking Institutions in 2008 (SBP, 2008). In addition, Bahrain formally acknowledged the adoption of the AAOIFI governance standards, the Dubai International Financial Centre and the Qatar Financial Centre have each issued a Rulebook on Islamic Financial Business Module, which specifies, among others, the requirements of *Shari‘ah* governance.

Regardless of the positive development of *Shari‘ah* governance in IFIs, it is observed that there are a few significant issues involved, particularly with respect to the *Shari‘ah* governance process, such as the *Shari‘ah* board’s independence, competence, conflict of interest, confidentiality, transparency, disclosure, issue of *Shari‘ah*-compliance and *Shari‘ah*-based products, and the remit of the *Shari‘ah* boards. With the diversity of *Shari‘ah* governance approaches in IFIs, a high standard of *Shari‘ah* governance practice should be implemented to ensure that the institution of the *Shari‘ah* board can play its role effectively.

4.4 Role of the *Shari‘ah* Board

The role of the *Shari‘ah* board varies from one board to another and it depends upon the nature, extent and degree of *Shari‘ah* compliance. Inspired by its foundational dimension and stakeholder value orientation, the *Shari‘ah* board has fiduciary duties towards all stakeholders of the IFIs.¹⁰¹ Moreover, the integrity of IFIs is greatly dependant on the status of *Shari‘ah* compliance, the impact of products, professional competence and behaviour towards observance of *Shari‘ah* norms (Ayub, 2007: 467). In this aspect, the

¹⁰⁰ The *Shari‘ah* Governance Framework for IFIs will replace the BNM/GPS1 and become officially effective in 2011.

¹⁰¹ It is also contended that the duty to protect the rights and interests of the account holders especially IAHs are at the mercy of the *Shari‘ah* board since they do not have governance rights or rights of participation in IFIs.

Shari'ah board plays a fundamental role in ensuring and enhancing the credibility of IFIs¹⁰² as well as having the authority to issue *fatwa* via collective *ijtihād*.¹⁰³

As a general observation, the *Shari'ah* board plays a role as a control mechanism to monitor the IFI's activities and operations for the purpose of *Shari'ah* compliance including assuring *zakah* obligation (Briston and El-Ashker, 1986). This is affirmed by Dawud (1996), who mentions that the *Shari'ah* board's objective is to guide IFIs in the setting of policies and regulations according to *Shari'ah h* in approving their financial transactions from the legal side and in preparing their contracts for future transactions according to Islamic law. In addition, AbuMouamer (1989) describes the role of the *Shari'ah* board as being proactive rather than reactive and mentions that the *Shari'ah* board has fiduciary duties to force the management of IFIs to disclose and dispense revenue from any unlawful transaction to charity as well as to conduct audits on *zakah* funds. Abdallah (1994) seems to agree with the contention that the *Shari'ah* board must be proactive rather than reactive. At this point he suggests that the *Shari'ah* board should set up accounting policies to assure that the formula used in allocating profit between shareholders and account holders is fair and that all revenues are generated from lawful transactions, to ensure *zakah* funds are properly calculated and to influence the IFIs to perform their social responsibilities towards the community and other stakeholders (Abdallah, 1994).

Banaga et al. (1994), on the other hand, details the *Shari'ah* board's responsibilities from an auditor's perspective as including answering enquiries, issuing legal opinions, and reviewing and revising all business transactions and operations to ensure they are in compliance with *Shari'ah* principles. This is affirmed by Grais and Pellegrini (2006: 4), who summarize the functions of the *Shari'ah* board into five main areas, namely *ex ante*

¹⁰² Iqbal (2002: 47) mentions that one of the factors of the failure of Kleinwort Benson, the first investment bank to introduce an Islamic unit trust in 1986, was due to investors' reservations about the absence of a *Shari'ah* board. This indicates how important the establishment of *Shari'ah* boards in IFIs is for the sake of gaining confidence from investors and the general public as well as to ensure *Shari'ah* compliance.

¹⁰³ A concept of a group *ijtihād* in the form of a *Shari'ah* board is important, especially within the individual IFIs, and its establishment is really necessary to facilitate research, enhance credibility and to promote standard practice in the industry (Vogel and Hayes, 2006: 47–50).

audit, *ex post* audit, calculation and distribution of *zakah*, disposing of non-*Shari‘ah*-compliant earnings, and advising on the distribution of income and expenses.

Unlike AbuMouamer (1989), Dawud (1996), Banaga et al. (1994), Abdallah (1994), Briston and El-Ashker (1986) and Grais and Pellegrini (2006), who are not *Shari‘ah* scholars, it is worth referring to a *Shari‘ah* scholar’s views on the functions of the *Shari‘ah* board. Sheikh Yusuf Talal De Lorenzo, a prominent *Shari‘ah* advisor, describes the functions of the *Shari‘ah* board in IFIs; these include assisting IFIs in the product pre-certification stage, such as product development and structuring, certifying products by means of *fatwa*, and ensuring *Shari‘ah* compliance throughout the financial product’s life cycle (Delorenzo, 2007: 399–400). In another paper, Delorenzo (2006: 3–11) further explains the functions of the *Shari‘ah* board in the context of the Islamic mutual fund and these include consumer advocacy, fiscal and moral portfolio purification, portfolio purification with regard to screening stocks, portfolio monitoring of management, fees, funds, documentation, industry, product development and *zakah*. Based on all these descriptions from various works of literature, the ideal functions of the *Shari‘ah* board can be summarized as overseeing the *ex ante* and *ex post* aspects of the business transactions, activities and operations of IFIs for the purpose of *Shari‘ah* compliance and these include advisory, approval and audit roles.

Despite numerous descriptions of the roles of the *Shari‘ah* board in the existing literature, they fail to differentiate the diverse functions of various models of *Shari‘ah* advisory services. Even though the majority of the *Shari‘ah* boards share common objectives and responsibilities, it is very important to identify and understand their different functions. For this reason, the roles of the *Shari‘ah* board can be divided into three different levels, namely international, macro and micro levels.

(i) The *Shari‘ah* Board at the International Level

At the international level institution, we may refer to the roles play by the *Shari‘ah* boards of the AAOIFI and the IDB. The AAOIFI has laid down the objectives of its *Shari‘ah* board and these include duties in realizing harmonization and convergence in

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the concepts and application amongst the *Shari'ah* supervisory boards of IFIs so as to avoid contradiction or inconsistency between the *fatwa*. The AAOIFI *Shari'ah* board is also involved in the development of *Shari'ah* approved instruments, examining any inquiries they receive, and reviewing the standards the AAOIFI issues in accounting, auditing and code of ethics and related statements to ensure that these issues are in compliance with the rules and principles of *Shari'ah* (AAOIFI, 2008a). The AAOIFI *Shari'ah* board mainly functions as a body to harmonize *fatwa* and to develop, examine and review the *Shari'ah* standards. It does not have power to enforce its rulings or decisions upon any IFIs. The IDB *Shari'ah* board acts as an advisory body to the IDB by issuing *Shari'ah* opinions and it is also involved in developing the governance standards of IFIs together with the IFSB.¹⁰⁴

(ii) The *Shari'ah* Board at the Macro Level

To date, there are five jurisdictions that have established *Shari'ah* boards at the central bank or regulatory authority level, namely Malaysia, Indonesia, Brunei, Pakistan and Sudan. Basically, a national *Shari'ah* board plays a role as the authority to establish a *Shari'ah* governance framework and to formulate national policy and rulings for the industry. This is affirmed by the IFSB survey on the practice of *Shari'ah* governance in 69 IFIs from 11 countries, namely Bahrain, Brunei, Indonesia, Iran, Jordan, Malaysia, Pakistan, Qatar, Sudan, the UAE and Bangladesh, which indicates that the primary role of a national *Shari'ah* authority is to establish the *Shari'ah* governance framework and not as a body for specific rulings for IFIs (IFSB, 2008b: 17). Despite the above findings, *Shari'ah* boards at the macro level also play a significant role in respect of harmonization and standardization of *fatwa*, and acts as the highest authority for IFIs.¹⁰⁵

¹⁰⁴ The *Shari'ah* board of the IDB consists of Sheikh Mohamed Mokhtar Sellami as Chairman, Sheikh Saleh bin AbdulRahman bin Abdul Aziz Al Husayn as Deputy Chairman, and Sheikh Abdul Sattar Abu Ghodda, Sheikh Hussein Hamed Hassan, Sheikh Mohammad Ali Taskhiri and Sheikh Mohamed Hashim Bin Yahaya as members (IFSB, 2006: ii).

¹⁰⁵ For instance, the SAC is the highest authority for the ascertainment of Islamic law pertaining to banking and finance in Malaysia. The decision made by the SAC is binding and statutorily enforceable to all IFIs in Malaysia.

(iii) The Sharī‘ah board at the Micro Level

The AAOIFI governance standard provides universal guidelines as to the roles and functions of the *Sharī‘ah* board to advise, monitor and supervise the activities of IFIs so as to ensure that they are in compliance with the *Sharī‘ah* principles (AAOIFI, 2005). Basically, the *Sharī‘ah* board at the micro level performs a range of responsibilities and these include participation in product development and structuring activities, reviewing and approving matters related with *Sharī‘ah*, issuance of *fatwa*, *Sharī‘ah* auditing, issuance of an annual certification of *Sharī‘ah* compliance (McMillen, 2006: 141), to ensure the *Sharī‘ah* compliance of IFIs' investment in shares, equities, *sukuk* and other business avenues (Ayub, 2007: 363), and computation of *zakah*. Provisions on the duties and objectives of the *Sharī‘ah* board in individual IFIs can be found in the article of association, the AAOIFI governance standards and the IFSB guidelines. For instance, clause 2.4 of the Islamic Bank of Britain's article of association specifies its *Sharī‘ah* board's function at ascertaining the bank's activities to be in conformity with the *Sharī‘ah* principles (IBB, 2008).

To sum up, the *Sharī‘ah* board is normally involved in three main areas of *Sharī‘ah* governance, i.e. the issuance of *fatwa* via collective *ijtihād*, supervision (*raqabah*) and review (*mutābaah*). The *Sharī‘ah* board at the micro level has a key function in advising *Sharī‘ah* matters, to ensure that the operations comply with *Sharī‘ah* principles, endorsing and validating relevant documentations pertaining to the products and services, as well as the internal policies, manuals, and marketing advertisements, and ensuring all its decisions are properly implemented. The *Sharī‘ah* board at the national (macro) level acts as the highest *Sharī‘ah* authority and has ability to establish a *Sharī‘ah* governance framework and to formulate national policy and rulings for the industry. Meanwhile, a *Sharī‘ah* board at the international level, such as the AAOIFI, is engaged mostly in the aspects of harmonization and development of *Sharī‘ah* standards.

4.5 Models of *Shari'ah* Boards

Banaga and Tomkins (1994: 10) describe three main types of *Shari'ah* board, namely that which is composed of *Shari'ah* scholars, the judicial advisors who are authorized to deal with *Shari'ah* issues, an in-house *Shari'ah* department staffed with *Shari'ah* experts, who provide professional services in relation to *Shari'ah* matters, and the third form of *Shari'ah* board allows individuals other than *Shari'ah* scholars to be appointed as its members, as in the case of the SBP and BNM. The researcher offers a further classification of the *Shari'ah* board into internal and external *Shari'ah* boards, where the former refers to the in-house *Shari'ah* board of IFIs and the latter to the *Shari'ah* boards at national and international levels, *Shari'ah* advisory firms and individuals undertaking *Shari'ah* advisory services. In addition, there are standard-setting agencies that do not issue *fatwa* but play a role in developing *Shari'ah* standards and issuing guidelines on *Shari'ah* governance, namely the AAOIFI and the IFSB.

4.5.1 Internal *Shari'ah* Boards

(i) *Shari'ah* Boards at Individual IFI Level

This model is the most prevalent practice of IFIs. Generally, an IFI is required to establish its *Shari'ah* board as stipulated in the article of association.¹⁰⁶ The internal *Shari'ah* board structure may vary from one board to another. The objective of the establishment of the *Shari'ah* board, as stated in the article of association, determines the nature of its governance structure. This model lets an individual IFI establish its own *Shari'ah* board, regardless of its parent or group companies. For instance, HSBC Amanah has a different *Shari'ah* board in each of its subsidiaries to suit the legal environment of the local market.¹⁰⁷

¹⁰⁶ Some of IFIs do not have a *Shari'ah* board, such as Iskan Finance of Australia, but refer to the existing various *fatwa* issued by leading Islamic scholars and seek the opinion of Al-Azhar University, Egypt. The establishment of the *Shari'ah* board in Islamic banks, however, was determined as a prerequisite for admission into the IAIB (Rammal, 2006: 205).

¹⁰⁷ HSBC Amanah has established a Global *Shari'ah* Advisory Board, with the purpose of promoting the harmonization of *Shari'ah* standards and practices of the Islamic finance industry, a Central *Shari'ah*

(ii) Central Sharī‘ah Board for the Whole Group

Unlike the former model, this model centralizes the *Sharī‘ah* board for a whole group of companies. Although IFIs of this model are involved in cross border transactions, there is one central *Sharī‘ah* board that undertakes responsibility for matters pertaining to *Sharī‘ah* compliance. This model is practised by the Dallah al-Baraka Group. This model nevertheless seems to be inefficient in most jurisdictions, since a single *Sharī‘ah* board is incapable of handling numerous *Sharī‘ah* issues from various jurisdictions at one particular time.

4.5.2 External Sharī‘ah Boards

External *Sharī‘ah* boards can be further classified into national *Sharī‘ah* boards, *Sharī‘ah* boards at international level, *Sharī‘ah* advisory firms and individuals undertaking *Sharī‘ah* advisory services.

(i) National Sharī‘ah Boards

There are a few *Sharī‘ah* boards established by governments, particularly at the national level, either by the central bank or securities commission, such as in Malaysia, Indonesia, Brunei, Pakistan and Sudan, or by other government agencies such as the Ministry of *Awqaf* in the case of Kuwait. Another form of national *Sharī‘ah* board refers to the practice in Iran by which the Council of Guardians plays a role as the only institution that deals with Islamic banking and finance matters (Dar and Azami, 2010: 184). Unlike the model in Malaysia, Brunei, Pakistan and Sudan, which also allows the establishment of *Sharī‘ah* boards at the institution level, the practice in Iran recognizes the Council of Guardians as the sole *Sharī‘ah* authority for IFIs. All these national *Sharī‘ah* boards nevertheless have common functions as the highest *fatwa* authority for IFIs and aim at harmonizing and standardizing *Sharī‘ah* practices and all its decisions are final and binding.

Committee to supervise businesses and operations in seven regions (UAE, Qatar, Bahrain, Bangladesh, Mauritius, the United States and the UK) and a Regional *Sharī‘ah* Committee to oversee *Sharī‘ah* compliance matters in respective markets (HSBC, 2009).

(ii) *Shari‘ah* Boards at International Level

A *Shari‘ah* board at international level normally refers to an independent *Shari‘ah* body established by the mutual cooperation of several Muslim countries, such as the AAOIFI and the IDB. The AAOIFI *Shari‘ah* board has different functions from the internal and national *Shari‘ah* boards as it plays a role in developing *Shari‘ah* standards and promoting uniformity of *Shari‘ah* governance practice (AAOIFI, 2008a). The IDB *Shari‘ah* board provides internal *Shari‘ah* advisory services to the IDB as well as being involved in developing the governance standard of IFIs. Usually, the composition of the AAOIFI and the IDB is comprised of the eminent *Shari‘ah* scholars in the world from diverse backgrounds. All of these scholars are considered as the leading experts in *fiqh al-muāmalāt* and enjoy high authority in the *Shari‘ah* aspect of Islamic finance.

(iii) *Shari‘ah* Advisory Firms

A *Shari‘ah* advisory firm is an organization which offers *Shari‘ah* services, either as a supervisory or consultative function, such as the Institute of Islamic Banking and Insurance (IIBI), the International Institute of Islamic Finance Incorporated (IIIF), the Islamic Banking and Finance Institute of Malaysia (IBFIM), Yasaar Limited (YL), the Minhaj *Shari‘ah* Financial Advisory (MSFA), Failaka International (FI), BMB Islamic (BMBI) and Taqwaa Advisory and *Shari‘ah* Investment Solutions (TASIS).¹⁰⁸ These organizations are business entities and not part of any IFIs as they provide consultative and supervisory services for various aspects of banking and finance including matters related with *Shari‘ah*. In terms of ownership, the current practice shows that *Shari‘ah* advisory firms are either owned by independent parties (e.g. IIBI), IFIs (e.g. BMBI and IBFIM), legal firms or even by *Shari‘ah* scholars themselves (e.g. FI, YL, IIIF and MSFA).

All of the above entities provide various *Shari‘ah* consultancy services such as *Shari‘ah* reviews, auditing and product endorsement. The nature of these *Shari‘ah* advisory firms'

¹⁰⁸ The initial study found that more than seventeen *Shari‘ah* advisory firms are available in the market and this figure is expected to increase in line with market demand for *Shari‘ah* advisory services from various entities.

roles and responsibilities is more towards providing *Shari'ah* compliance and consultancy services. The IFIs that seek their services have to pay consultancy and other related fees based on the degree and extent of the services rendered. The decisions or rulings made by the *Shari'ah* advisory firms nevertheless are not binding upon the IFIs since their roles are merely advisory.

(iv) Individuals Undertaking *Shari'ah* Advisory Roles

This form of *Shari'ah* advisory services is rarely utilized by IFIs. In the absence of an internal *Shari'ah* board, instead of hiring a *Shari'ah* advisory firm, IFIs may seek *Shari'ah* advisory services from individual *Shari'ah* experts. This model is more prevalent in the case of Islamic windows, IFIs in non-Muslim countries or small scale companies.¹⁰⁹

4.6 International Standard-Setting Agencies

The existing standard-setting agencies, such as the OECD, the International Organization of Securities Commission (IOSCO) and the BCBS, have issued numerous guidelines on governance and risk management for financial institutions. The OECD has issued Guidelines on Corporate Governance, the IOSCO on Capital Market and the BCBS on Basel Committee I, II and possibly III in the future. Nevertheless, these standard guidelines have failed to address specific issues of Islamic finance. As the nature and financing model of Islamic finance are different those in its conventional counterparts, the need for an independent standard-setting agency specifically for Islamic finance is really crucial. Hence, with the initiative of several IFIs and regulatory authorities, the AAOIFI and the IFSB were established in 2002 and 2004 respectively. The difference between the two is that the IFSB is more concerned with regulators while the AAOIFI focuses on the individual IFI level. Although the guidelines and governance standards of the AAOIFI and the IFSB are not officially binding, the principles embedded in those documents are certainly taken into consideration by policy makers and practitioners.

¹⁰⁹ Islamic Financial Securities and Co of Qatar (IFSC) appoints Sheikh Walid bin Hadi as the only *Shari'ah* expert for *Shari'ah* advisory and consultancy services (IFSC, 2009).

4.6.1 The AAOIFI Governance Standards

The AAOIFI has issued 81 standards and guidelines, including 25 accounting standards, 6 auditing standards, 7 governance standards, 41 *Shari‘ah* standards and 2 codes of ethics (IFSB, 2010). In the absence of any corporate governance framework for IFIs in the late 1990s, the AAOIFI took the initiative to provide basic guidelines for *Shari‘ah* governance in its governance standards Nos. 1–5. It is important to note that these five standards must not be read in isolation as they complement each other.

(i) Governance Standard for IFIs No. 1: *Shari‘ah* Supervisory Board: Appointment, Composition and Report

Governance Standard No.1 was adopted by the Accounting and Auditing Standard Board (AASB) in its meeting No. 13 held on 15–16th June 1997 (AAOIFI, 2005). It consists of eight parts, namely introduction, definition, appointment, composition, selection and dismissal, basic elements of report, publication of the report, publication of *Shari‘ah* rulings and guidelines, and the effective date. Section 2 represents the most important provision in Governance Standard No.1. It has three elements which define the term ‘*Shari‘ah* board’. Firstly, a *Shari‘ah* board is an independent body of specialized jurists in *fiqh al muāmalāt*. This section allows the appointment of *Shari‘ah* board members who are not specialized in *fiqh al muāmalāt* but who are expert in the field of Islamic finance. Secondly, it elaborates the role of the *Shari‘ah* board to ensure compliance with *Shari‘ah* principles by having the authority to direct, review and supervise the activities of IFIs. Thirdly, it indicates the binding authority of the *Shari‘ah* board upon the IFIs.

Sections 3–6 mention the process of appointment and remuneration of the *Shari‘ah* board. With the motive of ensuring the independence of the *Shari‘ah* board, the AAOIFI prefers appointments as well as dismissals to be made by the shareholders in the AGM upon recommendation of the BOD. In view of the practicalities in actual market practice, the appointment of the *Shari‘ah* board as recommended by the AAOIFI may not always be appropriate. The researcher considers that the appointment of board members may also be made by the BOD with the consideration that there are other mechanisms to

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ensure independence and to manage any potential conflict of interest, such as appointment and termination being subject to the approval of the regulatory authorities. The terms of the appointment must be agreed by the *Shari‘ah* board and need to be recorded. In terms of remuneration, the BOD, with the authorization of the shareholders, has the authority to fix appropriate remuneration for the *Shari‘ah* board. The AAOIFI requires the composition of a *Shari‘ah* board to be a minimum of three members. The directors or significant shareholders of the IFIs cannot be appointed as *Shari‘ah* board members, even if they are qualified. Sections 9–26 specify the format of the *Shari‘ah* report, which must be published in the annual report of the IFI.

(ii) Governance Standard for IFIs No. 2: *Shari‘ah* Review

Governance Standard No.2 was adopted by the AASB in its meeting No. 15 held on 21st–22nd June 1998 (AAOIFI, 2005a). It consists of eight parts with eighteen sections. Section 3 explains the *Shari‘ah* review as an examination of the extent of the IFIs’ *Shari‘ah* compliance. While this section further confirms the *Shari‘ah* board’s authority to access all necessary information for the *Shari‘ah* review, section 5 on the other hand puts the responsibility for compliance upon the management. The *Shari‘ah* board is only responsible for forming and expressing opinions on the extent of *Shari‘ah* compliance. Sections 7–13 detail the *Shari‘ah* review procedures, which involve planning, designing, executing, preparing and reviewing. The *Shari‘ah* review report should be submitted to the AGM.

(iii) Governance Standard for IFIs No. 3: Internal *Shari‘ah* Review

Governance Standard No. 3 was adopted by the AASB in its meeting No. 17 held on 13–14th June 1999 (AAOIFI, 2005b). It consists of eleven parts and thirty sections which complement Governance Standard No. 2. Standard No. 3 aims at establishing standards and guidance on the internal *Shari‘ah* review. As the management of IFIs is responsible for the extent of *Shari‘ah* compliance, it is incumbent upon them to have a proper mechanism of internal *Shari‘ah* review. While the AAOIFI requires IFIs to carry out an

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internal *Shari‘ah* review, it does not specify the requirement of establishing a separate internal *Shari‘ah* audit department. The internal *Shari‘ah* review can be carried out by either an independent department or part of the internal audit division.

The AAOIFI insists that the internal *Shari‘ah* review must be conducted independently and comply with the Code of Ethics for Accountants and Auditors of IFIs. The management and the BOD must give full and continuous support to the internal *Shari‘ah* reviewers. In this aspect, the head of the internal *Shari‘ah* reviewers is accountable to the BOD. Since the nature of the internal *Shari‘ah* review is different to the normal auditing process, the internal *Shari‘ah* reviewer must be proficient and have the appropriate academic background and necessary training relevant to *Shari‘ah* review, particularly proficiency in *Shari‘ah* and *fiqh al muāmalāt*. The reporting structure requires the head of the internal *Shari‘ah* review to discuss the findings with the management and the final report must be addressed to the BOD and copied to the *Shari‘ah* board and management. Any disputes between management and internal *Shari‘ah* reviewers should be referred to the *Shari‘ah* board for determination.

(iv) Governance Standard for IFIs No. 4: Audit and Governance Committee

Governance Standard No. 4 was adopted by the AASB in its meeting No. 21 held in May 2001 (AAOIFI, 2005c). To complement the corporate governance framework for IFIs, the AAOIFI strongly recommends the establishment of an Audit and Governance Committee (AGC) at the board level. The AGC should consist of a minimum of three members, appointed by the BOD from its non-executive and independent board members, who are knowledgeable about the affairs of the institution and applicable regulations and laws, including *Shari‘ah* rules and principles.

On top of the *Shari‘ah* board and the BOD, the AGC has the specific function of preserving the integrity of financial reporting, processes, safeguarding the interest of stakeholders, providing additional assurance on the reliability of information and acting as an independent link between the management and other stakeholders. It is incumbent

upon the AGC to conduct reviews of internal controls, accounting practices and audit plans, interim and annual accounts, financial reports, compliance with *Shari‘ah* principles, and the use of restricted investment accounts' funds in accordance with the AAOIFI's Code of Ethics for Accountants and Auditors of IFIs. The AGC report should then be submitted to the BOD and copied to the CEO.

(v) Governance Standard for IFIs No. 5: Independence of *Shari‘ah* Board

Governance Standard No. 5 was adopted by the AASB in its meeting No. 29 held on 7–8th June 2005 and is aimed at providing guidelines for its independence and mechanisms to resolve issues of independence (AAOIFI, 2005d). There are nine sections with an appendix of an example of a possible issue of independence impairment. The state of independence of the *Shari‘ah* board is of the essence in enhancing public confidence on the aspect of *Shari‘ah* compliance. Section 3 restricts the *Shari‘ah* board to subordinating their judgment on *Shari‘ah* supervision to third parties. The *Shari‘ah* board is not recommended to consist of employees of the same IFIs or be involved in managerial decisions and operational responsibilities. The *Shari‘ah* board is required to conduct continuous assessment of the IFIs and do anything necessary to resolve any issues of independence impairment.¹¹⁰

4.6.2 The IFSB Guiding Principles

The IFSB is another standard-setting agency with the exclusive aim of supporting the Islamic finance industry in terms of regulations, guidelines, training, research, databases and standard practices, and promoting greater uniformity. The IFSB does not have its own *Shari‘ah* board as it plays a different role to internal and external *Shari‘ah* boards and it does not issue any *fatwa* or rulings pertaining to Islamic banking and finance. The objectives of the IFSB include establishing various standards and recommending them for adoption, providing supervisory and regulatory guidelines, encouraging cooperation

¹¹⁰ Appendix A of the AAOIFI Governance Standard No. 5 illustrates the example of independence impairment as financial involvement with clients, personal and family relationships, fees, contingency fees, performance-related bonuses, goods and services, threatened litigation and long association with IFIs (AAOIFI, 2005d).

among its members, facilitating training and development, undertaking research, and establishing databases of participants in the Islamic finance industry (IFSB, 2008a).

The IFSB has issued ten guiding principles for IFIs: two for capital adequacy requirements,¹¹¹ one for risk management,¹¹² and seven for governance, disclosure and supervisory review processes.¹¹³ The need for a *Shari‘ah* governance mechanism has already been addressed in the IFSB-1 and the IFSB-5, which both insist IFIs establish appropriate policies and institutional arrangements to manage operational risks, specifically *Shari‘ah*-compliance risks, as well as specifying the mechanism of the supervisory review process. In addition, the IFSB-3, IFSB-6 and IFSB-8 specify the governance standards for IFIs, Islamic Collective Investment Schemes and *Takāful* respectively. All of these earlier guidelines only address the general framework of corporate governance without specifying its relevance to the *Shari‘ah* governance matter exclusively. The IFSB then initiated the IFSB-10, which specifically addresses the issue of the *Shari‘ah* governance system in IFIs. The basic premise of the IFSB-10 is to promote best practice of *Shari‘ah* governance by emphasizing four key elements, which can be summarized as follows:

¹¹¹ The IFSB-2: Capital Adequacy Standard for Institutions (other than Insurance Institutions) offering only Islamic Financial Services (IFSB, 2003) and the IFSB-7: Capital Adequacy Requirements for *Sukuk*, Securitisations and Real Estate investment (IFSB, 2008).

¹¹² The IFSB-1: Guiding Principles of Risk Management for Institutions (other than Insurance Institutions) offering only Islamic Financial Services (IFSB, 2005).

¹¹³ The IFSB-6: Guiding Principles on Governance for Islamic Collective Investment Schemes, GN-1: Guidance Note In Connection with the Capital Adequacy Standard: Recognition of Ratings by External Credit Assessment Institutions (ECAIs) on *Shari‘ah*-Compliant Financial Instruments (IFSB, 2007), the IFSB-5: Guidance on Key Elements in the Supervisory Review Process of Institutions offering Islamic Financial Services (excluding Islamic Insurance (*Takāful*) Institutions and Islamic Mutual Funds) (IFSB, 2006), the IFSB-4: Disclosures to Promote Transparency and Market Discipline for Institutions offering Islamic Financial Services (excluding Islamic Insurance (*Takāful*) Institutions and Islamic Mutual Funds) (IFSB, 2007a) and the IFSB-3: Guiding Principles on Corporate Governance for Institutions Offering Only Islamic Financial Services (Excluding Islamic Insurance (*Taākful*) Institutions and Islamic Mutual Funds (IFSB, 2006a), the IFSB-8: Guiding Principles on Governance for *Taākful* Operations (IFSB, 2009b), the IFSB-9: Guiding Principles on Conduct of Business for Institutions offering Islamic Financial Services (IFSB, 2009b) and the IFSB-10: the Guiding Principles on *Shari‘ah* Governance System for Institutions offering Islamic Financial Services (IFSB, 2009c).

Table 4.2: Key Elements of *Shari‘ah* Governance in the IFSB-10

Key Element	Principle	Operational Framework
Competence	Fit and proper criteria	<i>Ex ante</i> : Screening process
	Professional training	<i>Ex post</i> : Review and assessment
	Formal assessment	
Independence	Adequate capability to exercise objective judgment	<i>Ex ante</i> : Appointment, disclosure and full mandate
	Complete, adequate and timely information	<i>Ex post</i> : Review and assessment
Confidentiality	Strictly observe the confidentiality	<i>Ex ante</i> : Undertaking secrecy <i>Ex post</i> : Review and assessment
Consistency	Fully understand the legal and regulatory framework strictly observes the said framework	There must be consistency in all <i>ex ante</i> and <i>ex post</i> <i>Shari‘ah</i> governance processes

Source: IFSB (2009): modified.

The *Shari‘ah* governance framework of the IFSB-10 tends to cover the overall aspects of *Shari‘ah* compliance processes by invoking the very important elements necessary for an effective *Shari‘ah* governance system. At this point, it is the duty of regulatory authorities to determine the adoption of the IFSB-10 as this guiding principle on the *Shari‘ah* governance system is strongly commendable. Nevertheless, there is some inconsistency between the IFSB-10 and the AAOIFI governance standards which needs to be resolved. Since some jurisdictions, such as Bahrain, the UAE and Qatar, have already adopted the AAOIFI governance standards while others have remained silent, the IFSB-10 may be irrelevant to these jurisdictions. In addition, the IFSB-10 seems to fail to provide adequate framework for a *Shari‘ah* advisory firm. With the trend for *Shari‘ah* advisory firms being likely to increase in time, it is of the utmost importance to have adequate guidelines and guiding principles for such a practice.

4.7 *Shari‘ah* Governance Process

The most important element of *Shari‘ah* governance refers to its process. The *Shari‘ah* governance process represents the instrumental functions of the *Shari‘ah* board as part of

the internal governance structure of corporate governance in IFIs. This section provides a brief explanation of the *Shari‘ah* governance process and this includes the appointment, composition and qualification of the *Shari‘ah* board, the *Shari‘ah* compliance process, *Shari‘ah* coordination, the *Shari‘ah* compliance review and the *Shari‘ah* report.

4.7.1 Appointment

In contemporary practice, the members of the *Shari‘ah* board are appointed by the shareholders in the annual general meeting (AGM) or by the BOD. The IAIB document mentions that, in order to ensure freedom and independence, the *Shari‘ah* board members must not be working as personnel in the bank and are not subject to the authority of BOD (Rammal, 2006: 205). In addition, the AAOIFI governance standard provides that the shareholders have the authority to appoint members of the *Shari‘ah* board during the AGM but the BOD does not have this authority.¹¹⁴ This is to ensure the independence of the *Shari‘ah* board because the management board does not have power to appoint or to dismiss any members of the board as the authority is vested in the shareholders. In the case of appointment made by the shareholders during the AGM with the recommendation by the BOD, the *Shari‘ah* board is allowed to attend the BOD meetings to discuss the religious aspects of their decisions (Nathan and Ribiere, 2007: 472).

In actual practice, numerous IFIs appoint members of their *Shari‘ah* board through their BOD, as in the case of Jordan, Malaysia and Pakistan.¹¹⁵ Section 27 (a) of the Jordanian Islamic Banking Law provides that the BOD will appoint a *Shari‘ah* advisor amongst the experts on *Shari‘ah* for a maximum period of five years (Bakar, 2002: 78).¹¹⁶ In Pakistan, the appointment of the *Shari‘ah* board should be approved by the BOD in the case of domestic IFIs and, in the case of foreign banks having Islamic banking subsidiaries, the appointment should be made by the management (SBP, 2008: 1). The practice is different

¹¹⁴ For instance, in the case of the *Shari‘ah* board of Al Rajhi Bank in Saudi Arabia, the appointment is made by the shareholders during the AGM with the recommendation of the BOD (Al Rajhi, 2008).

¹¹⁵ Of sixty-nine IFIs, 86% indicate that their *Shari‘ah* board members are represented in other institutions (IFSB, 2008b: 31).

¹¹⁶ This practice has been changed with the amendment of Article 58 of Law 28 of 2000 in 2003. The appointment of *Shari‘ah* board members are made by the shareholders during the AGM and the members may be dismissed only with a two-thirds majority of the BOD and if endorsed by the general assembly (Grais and Pellegrini, 2006: 31).

in the case of the appointment of *Sharī‘ah* board members at the national level where the power is vested in the government, as in the case of the *Sharī‘ah* board of the Central Bank of Sudan¹¹⁷ and Malaysia. In Malaysia, the *Sharī‘ah* board of the BNM is appointed by the Yang di-Pertuan Agong on the recommendation of the finance minister pursuant to the CBA. On this basis, it can be concluded that there are various practices of the method of appointment of the *Sharī‘ah* board across jurisdictions.

4.7.2 Composition

At present, a *Sharī‘ah* board is normally comprised of *Sharī‘ah* scholars who are experts in *fiqh al muāmalāt* and *usul al fiqh*. The composition of the *Sharī‘ah* board members varies from one IFI to another. The *Sharī‘ah* board at the international institutions and at the national level is usually comprised of leading internationalist and regional scholars, whereas *Sharī‘ah* boards of individual IFIs consist of regional and local scholars, with some of them also having so-called internationalist scholars sitting on their *Sharī‘ah* board.¹¹⁸

By and large, most IFIs appoint three to six members on their *Sharī‘ah* board. The AAOIFI *Sharī‘ah* board is composed of not more than twenty members who are appointed by the Board of Trustees for a four-year term from among *Sharī‘ah* scholars. The AAOIFI governance standard requires at least three members at IFI level and this is followed by a few countries such as Bahrain, Dubai, Jordan,¹¹⁹ Lebanon,¹²⁰ the UAE¹²¹ and Malaysia. For instance, *Sharī‘ah* governance in Indonesia puts a requirement of a minimum of two persons and maximum of not more than half the number of members of

¹¹⁷ Section 3 of the Directive Order of the Minister Directive (No. 184) 1992 lists the names of the *Sharī‘ah* board members of the Bank of Sudan.

¹¹⁸ The term ‘internationalist scholars’ refers to *Sharī‘ah* board members who most often sit on the *Sharī‘ah* boards of the investment funds and international organizations such as the AAOIFI and the IDB and have expertise and experience in sophisticated financial transactions in various jurisdictions around the world (McMillen, 2006: 140).

¹¹⁹ Article 58 of Law 28 of 2000 as amended by Law No. 46 of 2003.

¹²⁰ Law No. 575 of 2004 on the Establishment of Islamic Banks in Lebanon.

¹²¹ The Federal Law No. 6 of 1985 of the UAE.

the BOD of the IFI.¹²² The *Shari'ah* board of the SBP is comprised of two *Shari'ah* scholars and three experts in the areas of banking, accounting and law and at each individual IFI there must be at least one *Shari'ah* advisor and the *Shari'ah* board may be set up at the bank's discretion (Ayub, 2007: 473).

4.7.3 Qualification

It is contended that the ideal *Shari'ah* board members are those who are experts in *Shari'ah* and law, specifically in the area of *fiqh al muāmalāt* and *usul al fiqh*. The reason behind this is that the *Shari'ah* board mostly deals with the issues related with commercial transactions (Bakar, 2002: 74–89). The AAOIFI governance standards and the IFSB-10 allow the appointment of an inexpert person in *fiqh al muāmalāt* to be a *Shari'ah* board member¹²³ with the purpose of strengthening the ability of the *Shari'ah* board to scrutinize and understand banking business and its operations, as in the case of the SBP and BNM.

The *Shari'ah* boards of the SBP and the BNM consist of experts from various fields, including *Shari'ah* scholars, chartered accountants, lawyers, judges and central bankers. The SBP has gone even further by putting very strict conditions on its *Shari'ah* board members. In terms of educational qualification, any board member must have a minimum of a 2nd Class Bachelor Degree in Economics or a degree with *Takhassus Fil Fiqh* and sufficient understanding of banking and finance or a postgraduate degree in Islamic jurisprudence or *Usuluddin* or LL.M (*Shari'ah*) from any recognized university with exposure to banking and finance (SBP, 2007: 1). In the aspect of experience and exposure, any members must have at least three years' experience of giving *Shari'ah* rulings or at least five years' experience in research and development in Islamic banking and finance (SBP, 2007: 1). The SBP also insists on the capability of mastering or having reasonable knowledge of Arabic and English languages (SBP, 2007: 1). All of these

¹²² The Act No. 7 of 1992 of the Republic of Indonesia as amended by Act 10 of 1998, Regulation 4/1/PBI/2002 is the governing law on the aspect of *Shari'ah* governance (Grais and Pellegrini, 2006: 31). See also Ilyas, (2008).

¹²³ Those *Shari'ah* board members, however, need to have a certain degree of knowledge of Islamic commercial law. In this regard, the majority of the *Shari'ah* board members must be *Shari'ah* scholars in order to avoid the dominance of inexpert *Shari'ah* advisors in the decision-making process (Bakar, 2002:77–78).

requirements will enable the board to establish a higher standard of practice of *Shari'ah* governance in IFIs, which is extremely important.

4.7.4 The *Shari'ah* Compliance Process

Every IFI has its own procedures for its *Shari'ah* governance system. There is currently no specific standard guideline for *Shari'ah* governance as to the aspects of management, products approval, and *ex ante* and *post ante* auditing. The practice is that there is a *Shari'ah* secretariat or department to coordinate and handle *Shari'ah* matters. The officer in the *Shari'ah* department mostly handles clerical and office works pertaining to *Shari'ah* board matters, such as compiling and handling documents that need to be presented during the *Shari'ah* board meeting.

In terms of meeting, the *Shari'ah* board normally has a weekly or monthly meeting depending on the needs of the individual IFI. Research conducted by Aboumouamer (1996: 188) reveals that of forty-one *Shari'ah* boards, ten or 24.4% have a weekly meeting, three or 7.3% have a monthly meeting, twenty or 48.8% have a quarterly meeting and one or 2.4% has a biannual meeting. The meeting varies from one *Shari'ah* board to another and it may be attended by the CEO, management, bank officers, legal officers, lawyers and representatives from the IFI's branches. The range of attendees depends on the *Shari'ah* issues involved, whether they relate to operational, product, legal documentation or any other matters.

A *Shari'ah* board meeting involves discussion of various *Shari'ah* issues including the concept and structure of new and existing products, documentations, operations and investment portfolios. *Shari'ah* board members will receive all relevant documents from the IFI at least a week before the date of the meeting to give them sufficient time to read and study the documents. The meeting will be chaired by the chairman of the *Shari'ah* board and the decisions are usually made unanimously. Some *Shari'ah* boards allow decisions to be made by a simple majority and this happens mostly in the case of *sukuk* issuance by an international IFI (Ayub, 2007: 472). A certain *Shari'ah* board practice requires one of its members to be the administrative member. The administrative board

member acts as a selection committee who has the authority to exercise discretion over whether to convene discussion on specific issue or not (McMillen, 2006: 141). Another practice grants power to the *Shari'ah* officer to decide the matter. The determination of the *Shari'ah* board in the meeting will then be distributed to the relevant parties in the IFI for reference and they are bound to follow all of its decisions.

4.7.5 *Shari'ah* Coordination

Shari'ah coordination is vital to the *Shari'ah* governance system and is as important as the company secretary is to the BOD. The *Shari'ah* coordinator acts as a secretary or liaison officer that coordinates the *Shari'ah* governance process, including the interaction with the *Shari'ah* board, internal or external review, and other organs of governance. This study identifies several models of *Shari'ah* coordination which can be classified into the following: secretary of the *Shari'ah* board serving as the *Shari'ah* coordinator, internal *Shari'ah* coordinator, *Shari'ah* compliance officer, *Shari'ah* coordination department, external *Shari'ah* coordination, *Shari'ah* advisory firm as external *Shari'ah* coordinator, internal *Shari'ah* liaison officer (Dar, 2009). The most prevalent practice of *Shari'ah* coordination is having a secretary of the *Shari'ah* board or a *Shari'ah* compliance officer serving as the *Shari'ah* coordinator. In fact, some *Shari'ah* compliance officers in IFIs play many roles and not only act as *Shari'ah* coordinators but also have the responsibility of handling the *Shari'ah* review process.

4.7.6 *Shari'ah* Compliance Review

Unlike conventional banks, IFIs are required to undertake a *Shari'ah* review and internal *Shari'ah* review process for the purpose of ensuring that all transactions are in conformity with *Shari'ah* principles. In the former, the *Shari'ah* board examines the extent of *Shari'ah* compliance of the IFIs' products, activities and business transactions, whereas the latter refers to the examination of the extent of *Shari'ah* compliance by an independent internal *Shari'ah* audit or as part of the internal audit based on the *Shari'ah* rulings, guidelines and instructions issued by the *Shari'ah* board. The *Shari'ah* board is

normally assisted by this internal audit unit to review the *Shari'ah* compliance aspects in IFIs.

The chief purpose of the *Shari'ah* review exercise is to ensure compliance with the *Shari'ah* rules and principles as reflected in the rulings and instructions issued by the *Shari'ah* board. In this regard, the AAOIFI governance standards lay down several procedures for *Shari'ah* reviews and these include planning review procedures, executing review procedures, preparing and reviewing working papers as well as procedures in documenting conclusions and preparing the *Shari'ah* review report (AAOIFI, 2005a). In actual practice, there is no standard format for *Shari'ah* review procedures or the *Shari'ah* compliance report. The IFSB survey shows that more than 90% of sixty-nine IFIs undertake a *Shari'ah* compliance review (IFSB, 2008b: 27). As the main objective of the *Shari'ah* review is to ensure that the management of the IFI is discharging its responsibilities in compliance with *Shari'ah* rules and principles, the scope of a *Shari'ah* review is different from a normal auditing task as it specifically concerns the *Shari'ah* aspects and the process is guided by Islamic principles.

The *Shari'ah* review addresses the *Shari'ah* compliance matters of products offered and this process needs a sound *Shari'ah* internal control system. The *Shari'ah* review process requires an internal auditor to review every stage of the *Shari'ah* governance process and this includes the conception of a product, product design, product documentation, product testing, product implementation and product review. The *Shari'ah* review practice nevertheless indicates that the majority of IFIs are not involved in a review of their products (IFSB, 2008b: 29). In most IFIs, the *Shari'ah* review is carried out by the internal auditors either as part of the regular internal audit or as a separate part of the *Shari'ah* audit. Some IFIs prefer to use the external auditor for its *Shari'ah* review requirements.¹²⁴ The IFSB demonstrates that 41% of IFIs adopt an external review and 89% an internal review (IFSB, 2008b: 34). The *Shari'ah* compliance framework in

¹²⁴ The current practice indicates that the external review panel consists of 19% auditors, 13% *Shari'ah* board and 21% supervisory authority while the internal review comprises of 73% *Shari'ah* board, 37% internal auditors and 17% audit committee (IFSB, 2008b: 35).

Pakistan puts a mandatory requirement for an annual *Shari‘ah* review and auditors of the SBP conduct periodical *Shari‘ah* compliance inspections in every individual IFI. On top of that, the SBP has issued a manual for *Shari‘ah* reviews for IFIs to ensure a uniform review process, *Shari‘ah* compliance and to enhance the credibility of the Islamic finance system (Ayub, 2007: 474).

Basically, the *Shari‘ah* board has a responsibility to perform pre-audit, audit and post-audit functions. This is evident in Aboumouamer’s (1996: 285–288) findings, which show that 78% of the *Shari‘ah* board members perform pre-audit work, 80.5% during the audit work and 61% post-audit work. Some *Shari‘ah* boards do not engage directly in the *Shari‘ah* auditing process due to their small size and most of them are not employees of the respective IFIs and have limited time and material resources to do the job. Moreover, they are also not qualified to perform the auditing task because of lack of audit skills and required knowledge on the operational side of IFIs’ activities (Banaga et al., 1994: 65). Typically, the *Shari‘ah* board will only be involved in the *Shari‘ah* auditing process when there is dispute or issue over *Shari‘ah* matters which need its deliberation. This requires that the auditor who is responsible for undertaking the *Shari‘ah* auditing process possesses adequate religious knowledge to be able to identify *Shari‘ah* issues and give opinions on compliance with *Shari‘ah* rules.

Khan (1985: 36–38) suggests that the specific areas in which the *Shari‘ah* auditor would report to include *bakhs* (decrease in the quality of the product), *tatfif* (causing damage to the other party in weights and measures), *uqud* (contract), *ihtikār* (hoarding), *khiyānah* (embezzlements), *isrāf* (extravagance), *tanājush* (bidding up prices in auction by planting a fake bidder) and speculation. The scope of the *Shari‘ah* review proposed by Khan seems to cover a very wide area of audit which is ambiguous and complex. In actual practice, the *Shari‘ah* review contains of observations and assessments of systems and controls for *Shari‘ah* compliance, recommendations for potential improvements, corrective actions need to be taken (SBP, 2008: 2) and the audit of *zakah* funds (Aboumouamer, 1996: 79–80). In the event of disputes or conflict of opinion between management and *Shari‘ah* auditors, the matters may be referred to individual *Shari‘ah*

boards. Similarly to the normal review process, the *Shari‘ah* review report should be presented before the *Shari‘ah* board, the audit committee, the BOD and the shareholders of the IFIs.

4.7.7 *Shari‘ah* Report

Shari‘ah governance favours fair and true disclosure and transparency. The fundamental concept of governance in *Shari‘ah* is accountability and hence requires IFIs to make true disclosure and to provide accurate necessary information. This is in line with the spirit of *al-Qur‘an* where Allah says “*O ye who believe! When ye deal with each other in transactions involving future obligations in a fixed period of time, reduce them to writing and let a scribe write down faithfully as between the parties*” (*Al-Qur‘an*, 2: 282). This verse mandates and strongly encourages that any business dealing or transaction should be recorded and written down in a proper way. In the context of *Shari‘ah* governance, it refers to the duty of the *Shari‘ah* board to produce a *Shari‘ah* report either periodically or annually.¹²⁵

The *Shari‘ah* board is expected to prepare and issue a report on its activities, information on duties and services, *Shari‘ah* pronouncements and declaration of *Shari‘ah* compliance. As a general practice, the *Shari‘ah* report will be submitted to the BOD. Some IFIs submit the *Shari‘ah* report to the BOD and even further seek the endorsement of the shareholders.¹²⁶ Current practice shows that only 49% of IFIs present the *Shari‘ah* report to the shareholders for approval and 48% to the audit committee (IFSB, 2008b: 35). This position perhaps reflects the mode of appointment of the *Shari‘ah* board and whether it was made through the BOD or the shareholders.

¹²⁵ A survey conducted by Al Hajj on fourteen institutional investors, thirty-three IFIs and thirty IFI customers in 2009 revealed that the customers and the IFIs were very concerned about the *Shari‘ah* report and ranked it as very important compared to the institutional investors (Al Hajj, 2003: 228–229). Another study carried out by Sulaiman Al Mehmadi (2004: 228) revealed that 57% to 86% of 117 investors in IFIs in Saudi Arabia considered the *Shari‘ah* report as an important component for making investment decisions. These findings indicate that the IFIs as well as investors generally understand the importance of the *Shari‘ah* report. At this point, IFIs are expected to be more transparent in providing adequate and reliable information in the *Shari‘ah* report.

¹²⁶ In the case of IFIs in Pakistan, the *Shari‘ah* boards of Islamic banks should report to their BOD while the *Shari‘ah* boards of foreign banks that have Islamic banking branches should report to the CEO or country head of the bank (SBP, 2008).

The content of the annual *Shari‘ah* report is generally information as to the duties and services of the IFI, *fatwa* issuance, the *Shari‘ah* board’s activities, and a declaration on *Shari‘ah* compliance (Banaga et al., 1994:11–13). Haniffa and Hudaib (2007: 102–103) view that the *Shari‘ah* report should contain more information, including names, pictures and remuneration of the *Shari‘ah* board, number of meetings held, disclosure as to the defects in the products offered and recommendations to rectify the defects including actions taken by management, basis of examination of the documents, declaration of *Shari‘ah* compliance, and signatures of all *Shari‘ah* board members.

Practice indicates that most *Shari‘ah* reports are concerned with the aspect of product compliance rather than emphasizing the efficiency of the internal *Shari‘ah* control system (IFSB, 2008b: 48). The Instructions for *Shari‘ah* Compliance in Islamic Banking Institutions of Pakistan states specific requirements for the *Shari‘ah* report and these include examining all transactions, relevant documentation and procedures, observing whether the IFI has complied with *Shari‘ah* rules and principles, scrutinizing whether the allocation of funds, profit sharing ratios, profits and charging of losses is in accordance with *Shari‘ah*, and ensuring that any earnings that have been realized from illegitimate sources have been credited to the charity account (SBP, 2008: 4–5).

In terms of the format of the *Shari‘ah* report, the AAOIFI governance standards provide specific guidelines and a format for the *Shari‘ah* report. In actual practice, the format and content of the *Shari‘ah* report are nevertheless different and even some of the *Shari‘ah* boards do not issue an annual report. A survey conducted by Grais and Pellegrini (2006: 8) found that four out of thirteen IFIs failed to issue a *Shari‘ah* report. Other research carried out by Maali et al. (2006: 285) discovered that, from a sample of twenty-nine banks, only 72% or twenty-one banks issued a *Shari‘ah* report. The *Shari‘ah* report is very important as an endorsement of the compliance of an IFI with *Shari‘ah* principles and it is considered a crucial means by which the general public and interested parties can find information about to what extent services and products of the IFI meet the *Shari‘ah* requirements. For this reason, due to the very essence of the *Shari‘ah* report, the *Shari‘ah*

board should issue the annual *Shari‘ah* report in accordance with the specific format laid down by the AAOIFI governance standards.

4.8 Issues and Challenges

The cross-border practice of Islamic finance raises significant issues and poses great challenges to the Islamic finance industry, in particular to its *Shari‘ah* governance system. Since *Shari‘ah* compliance aspects cannot be compromised at any time, these unresolved issues and challenges must be properly addressed. This study identifies six main issues and challenges pertaining to the *Shari‘ah* governance system which are of the essence to the Islamic finance industry.¹²⁷

4.8.1 Independence of *Shari‘ah* Board

There has long been debate on the issue of the independence¹²⁸ of the *Shari‘ah* board. One of the reasons is that *Shari‘ah* board members receive remuneration from the IFIs¹²⁹ and there exists a potential of conflict of interest by which members could legitimize unlawful or dubious operations to ensure they remain in the *Shari‘ah* board (Rammal, 2006: 207). Even though such an assumption is not truly accurate, as the *Shari‘ah* board members are expected to be guided by moral beliefs and religious values,¹³⁰ it still needs a proper framework in the form of policy or regulation because the credibility of IFIs depends on the perceived independence of the *Shari‘ah* board.¹³¹ In fact, with the

¹²⁷ Grais and Pellegrini (2006b: 20) identified five major corporate governance issues, namely independence, confidentiality, competence, consistency and disclosure. This study adds other significant unresolved issues specific to the *Shari‘ah* governance system.

¹²⁸ The IFSB-10 explains the independence of the *Shari‘ah* board as the ability to exercise sound judgment after fair consideration of all relevant information and views without influence from management or inappropriate outside interests. Section 2 of the AAOIFI Governance Standard No. 5 defines independence as “an attitude of mind which does not allow the view points and conclusions of its possessor to become reliant on or subordinate to the influences and pressures of conflicting interests. It is achieved through organizational status and objectivity” (AAOIFI, 2005d).

¹²⁹ The remuneration of the *Shari‘ah* board is normally fixed by the BOD and authorized by the shareholders (Gooden, 2001: 12–15).

¹³⁰ Karim (1990: 39–40) states that the *Shari‘ah* board’s framework is guided by their moral beliefs and obligations to religious peers and community. A commitment to religious values and obligations do indeed provide strong incentives to be independent.

¹³¹ There are two types of independence, i.e. practitioner independence and professional independence; the former is important to maintain a proper attitude toward planning, performing and reporting on an audit and the latter to avoid any appearance which may reduce the perceived independence of the auditors (Mautz

tremendous growth of the Islamic finance industry, it is expected that the number of conflicting *fatwa* is likely to increase. With this in mind, it is imperative to examine the method of appointment of the *Shari‘ah* board.

According to a survey by Aboumouamer (1996: 185), it is found that most *Shari‘ah* board members, out of forty-one surveyed, felt that the *Shari‘ah* board's authority is derived from the shareholders (75%) and their relationships with the management and directors only related to coordination and advisory roles. This research finding, however, only illustrates the perception of the BOD upon the appointment of the *Shari‘ah* board and cannot be regarded as conclusive. Despite the above finding, other research carried out by the International Institute of Islamic Thought in 1996 seems to demonstrate a different scenario as it found that almost 80% of the appointments of *Shari‘ah* board were done by the BOD and only 39% were made by the shareholders (Bakar, 2002: 78). These two surveys establish that the practice of the appointment of the *Shari‘ah* board in actual fact differs amongst the IFIs and is contrary to the assumption that the board's independence can only be guaranteed if the appointment is made by the shareholders.

The notion of assuming that the independence of the *Shari‘ah* board can be assured with appointment by the shareholders is not truly convincing per se. Even if the appointment is made by the shareholders, the BOD may still influence the shareholders in the process of selecting the *Shari‘ah* board members. In lieu to this, it is worth mentioning suggestions by Grais and Pellegrini (2006: 11), in which they discuss three possible approaches to resolving the issue of the independence of the *Shari‘ah* board. The approaches seem to focus on the issues of power and authority and they are: to define clearly the responsibilities and powers of the *Shari‘ah* board in the articles of association; to grant the board sufficient powers, proper organizational status and audit responsibilities; and to provide adequate authority as enjoyed by independent directors in the audit committee.¹³²

and Sharaf, 1961). The *Shari‘ah* governance system is more concerned with professional independence as it involves public perception and stakeholders' confidence in the IFIs.

¹³² Principle 1.2 of the IFSB-10 requires that the *Shari‘ah* board must have clear terms of reference regarding its mandate and responsibility, well-defined operating procedures and lines of reporting and good understanding of, and familiarity with, professional ethics and conduct (IFSB, 2009c: 9).

4.8.2 Competence, Conflict of Interest and Confidentiality

In terms of the qualifications of *Shari‘ah* board members, a survey on Islamic banking practices shows that 76.6% of the members have training and qualifications, 8.6% are well versed in *Shari‘ah* and commercial law, and only 11.4% have expertise in *Shari‘ah*, law and economics (Bakar, 2002: 78). Another study found that from the members of forty-one *Shari‘ah* boards, only ninety-two people have Islamic law training and 60% had studied non-religious subjects (Abomouamer, 1989: 226). This result indicates that there are issues on the different criteria and qualifications of the *Shari‘ah* board.¹³³ Moreover, the education of *Shari‘ah* board members is not properly coordinated and there are no established specific curricula for them¹³⁴ (McMillen, 2006: 139). This position may affect the effectiveness of the *Shari‘ah* board’s function, particularly in providing solid and concrete *Shari‘ah* rulings, as they must have the necessary professional knowledge and training as well as expertise in *Shari‘ah*.

For many years, numerous *Shari‘ah* scholars have enjoyed the right to sit on different *Shari‘ah* boards without any sort of restriction, such as those in Saudi Arabia, Kuwait, Bahrain, the UAE and Qatar. In fact, the existing practices in many countries show that there is no restriction on the members of a *Shari‘ah* board to stop them serving in any other IFI’ boards. This situation denotes a negative perception of the *Shari‘ah* board as it raises the issue of conflict of interest as well as confidentiality. As an illustration, we may refer to the possible situation of conflict of interest and breach of confidentiality in the case of a new Islamic banking product of the IFI being brought up for approval to the *Shari‘ah* board at the central bank’s level, where the same advisors that are sitting on the central bank’s *Shari‘ah* board at the same time also serve that particular IFI. In this case,

¹³³ Sheikh Mohamad El Gari, one of the prominent *Shari‘ah* scholars pointed out his concern on the issue of the competence of the *Shari‘ah* board. He admitted that there were many mistakes in *Shari‘ah* rulings issued by *Shari‘ah* boards (Parker, 2009).

¹³⁴ The AAOIFI has initiated a four-month training programme for *Shari‘ah* scholars known as Certified *Shari‘ah* Adviser and Auditor (CSAA), which is specifically designed to equip *Shari‘ah* scholars with the requisite technical understanding of and professional skills for *Shari‘ah* compliance and review processes (AAOIFI, 2008). The IBFIM also offers a *Shari‘ah* Scholars’ Introduction Program that has been endorsed by the BNM, which is specifically designed for *Shari‘ah* officers and advisors (MIFC, 2008: 21). Another programme available is the Scholar Development Program initiated by the Islamic Finance Council and the Securities and Investment Institute, which provides *Shari‘ah* scholars with knowledge of the conventional system (HM Treasury, 2008: 26).

the *Shari‘ah* advisors who have access to proprietary information about different features of financial products in various IFIs are not supposed to represent either both or one of the *Shari‘ah* boards since they have a common interest and redundant contractual duties.

The absence of restrictions on the multiple appointments of *Shari‘ah* board members may also contribute to the issue of the shortage of *Shari‘ah* scholars. According to a survey of the *Shari‘ah* Network in GCC – A Network Analytic Perspective conducted by Funds@Work – of 94 scholars sat on the boards of 467 IFIs, only 20 of them are heavily utilized; they represent 339 board positions equalling a total of 17 board positions per scholar.¹³⁵ This position may seriously negate public confidence in the *Shari‘ah* board’s credibility and there are even allegations of *Shari‘ah* arbitrage being practised by some *Shari‘ah* scholars.¹³⁶ The fact there is a lack of a pool of expert, experienced and competent *Shari‘ah* scholars should not be an everlasting justification for employing the same scholars on numerous *Shari‘ah* boards.

In order to avoid any issues or a perception of conflict of interest, it is necessary to have a legal provision that states clearly a restriction on sitting on more than one *Shari‘ah* board at one particular time. For instance, section 19 of the BNM/GPS1 provides that IFIs are not allowed to appoint any member of a *Shari‘ah* board in another IFI in the same industry. Besides avoiding any element of conflict of interest, this requirement is also important in the aspect of guaranteeing secrecy in confidential matters and able to stimulate further *Shari‘ah* research by allowing more potential *Shari‘ah* scholars to be involved directly in the Islamic financial sector. This policy also ensures the full-time availability of the *Shari‘ah* board to guide and monitor IFIs more effectively. In parallel

¹³⁵ Shaikh Nizam Mohammed Saleh Yaaqubi from Bahrain sits on boards in 46 IFIs; Shaikh Dr. Abdul Satar Abdul Karim Abu Ghuddah and Dr Mohamed Eid El Gari from Syria sit on boards in 45 and 31 IFIs respectively; Dr Abdulaziz Khalifa Al Qassar from Kuwait and Dr Mohamad Daud Bakar from Malaysia both sit on 22 boards; Shaikh Abdulla Bin Sulaiman Al Manea from Syria in 20 IFIs; Shaikh Dr Hussein Hamid Hassan from UAE in 19 IFIs; Shaikh Dr Ali Mohi Eldinne Al Qaradaghi from Syria and Dr Essa Zaki Essa from Kuwait both sit on boards in 17 IFIs; and Shaikh Ajeel Jasim Al Nashmi from Kuwait in 15 IFIs (Unal and Ley, 2009).

¹³⁶ El Gamal (2006: 175) explains *Shari‘ah* arbitrage as an act of “identifying a captive market, with religious injunctions that forbid a given set of financial products and services, and synthesizing those products and services from variations on those pre-modern nominate contract”. The *Shari‘ah* arbitrage increases transaction costs, which justify the high related fees and excessive profit rate charged by IFIs.

with the rapid expansion of the Islamic finance industry and the increasing numbers of *Sharī‘ah* boards, the issues of competence of *Sharī‘ah* advisors and conflict of interest may be solved by having a legal framework pertaining to their qualifications and certain limitations on their practice.

4.8.3 Disclosure and Transparency

The crucial element of the *Sharī‘ah* governance system is disclosure and transparency.¹³⁷

Transparency is of the utmost importance for IFIs so as they comply with *Sharī‘ah* as *al-Qur’ān* specifically forbids concealing of evidence. As Allah says, “*If ye are on a journey, and cannot find a scribe, a pledge with possession (may serve the purpose) and if one of you deposits a thing on trust with another, let the trustee (faithfully) discharge his trust and let him fear his Lord. Conceal not evidence for whoever conceals it, his heart is tainted with sin and Allah is knoweth all that ye do*” (*Al-Qur’ān*, 2: 283).¹³⁸

According to the IFSB, IFIs must ensure that their financial and non-financial reports meet the requirements of the internationally recognized accounting codes and complies with *Sharī‘ah* principles (IFSB, 2006: 5). The various *Sharī‘ah* governance practices demonstrate that disclosure of information is currently minimal and even information on the *Sharī‘ah* resolutions are hardly available for public viewing.

In addition, surveys conducted by Grais and Pellegrini (2006: 34) and Maali et al. (2006: 285) indicate the shortcomings and weaknesses of the current disclosure of information practice, in particular the *Sharī‘ah* report. Numerous IFIs are still neglecting the requirement of the *Sharī‘ah* report, even though it is very important as an endorsement of their compliance with *Sharī‘ah* principles and it is considered a crucial means by which the general public and interested parties can find information as to what extent the

¹³⁷ The IFSB-4 defines transparency in IFIs “an environment where material and reliable information is made available in a timely and accessible manner to the market at large and to all stakeholders. Such transparency can reduce asymmetric information and uncertainty in financial markets” (IFSB, 2007a: 30). Iqbal and Mirakhор (2007: 291) refer to disclosure as “the process and methodology of providing information and making policy decisions known through timely dissemination and openness” and transparency as “the principle of creating an environment where information on existing conditions, decisions and actions is made accessible, visible and understandable by all market participants”.

¹³⁸ See also *al-Qur’ān* (3: 187), where Allah says “*You shall make it clear to people and not conceal it.*”

services and products of the IFI meets the *Shari‘ah* requirements. The ideal *Shari‘ah* governance system, then, must be able to address the issues of disclosure and transparency.

4.8.4 *Shari‘ah*-Compliant versus *Shari‘ah*-Based

Numerous criticisms of the current practices of Islamic finance has led to intensive debate, particularly on the issue of whether something is *Shari‘ah*-compliant or *Shari‘ah*-based, where the latter can be defined as adhering to the *Shari‘ah* objectives and spirit, while the former is complying with the legal aspects of *Shari‘ah* law but not necessarily the spirit of *Shari‘ah*.¹³⁹ Although there is no exact definition of *Shari‘ah*-compliant and *Shari‘ah*-based, the proponents of the *Shari‘ah*-based approach insist that Islamic financial products and services must not only be concerned about compliance with Islamic law but they should go beyond that, i.e. to fulfil the *maqāsid Shari‘ah* (Dar, 2009a: 11). Another contention refers to *Shari‘ah*-based products as Islamic financial instruments which have no origin in the conventional market (ISRA, 2009: 2). In this regard, Siddiqi (2008: 76) insists that product innovation is really crucial, especially in designing financial ways that would serve the *maqāsid Shari‘ah*.¹⁴⁰

Some scholars indicate that there is no difference between a product being *Shari‘ah*-compliant and *Shari‘ah*-based. As long as a financial product is deemed *Shari‘ah*-compliant, in that it is free from interest, uncertainty, gambling and prohibited things and it fulfils the requirement of contracts, the product is said to be *Shari‘ah*-compliant, *Shari‘ah*-based or *Shari‘ah*-tolerant (ISRA, 2009: 2). Dar (2009a: 10–12), on the other hand, refers to the *Shari‘ah*-based approach as a combination of two dimensions, namely compliance with *Shari‘ah* principles and fulfilling social responsibilities. He further

¹³⁹ Sheikh Saleh Kamel, chairman and founder of the Dallah Al Baraka Group as well as chairman of the General Council for Islamic Banks and Financial Institutions, also states his concern about the existing practice of Islamic finance, where he personally opines that most of the Islamic financial products and services that are available in the market are not Islamic (Mahdi, 2008).

¹⁴⁰ With the existing mode of financing that replicates conventional banking, Islamic finance has failed to serve the objectives of Islamic law (El-Gamal, 2006: xiii). Asutay (2007) posits that the Islamic finance industry has failed to realize the very reason for its existence in providing socio-economic development for the larger parts of the Muslim world and communities.

characterizes Islamic financial products as *Shari'ah*-tolerant, such as *tawarruq* and *bay' al inah*, *Shari'ah*-compliant, like *murābahah*-based short selling and *arぶn*-based short selling, and *Shari'ah*-based, such as *zakah*, *waqf*-based financial products, Islamic private equity and Islamic venture capital. This general classification of Islamic financial products is based on the degree of *Shari'ah* compliance.

The diverse understanding of *Shari'ah*-compliant and *Shari'ah*-based products may affect the framework of the *Shari'ah* governance system. If it is only a matter of *Shari'ah* compliance, the scope of *Shari'ah* governance will be the legal technicalities of Islamic financial products and IFIs' operations, whereas if it goes beyond that, i.e. social responsibility, public interest and *maslahah*, the framework of the *Shari'ah* governance system will be wider and more complicated.¹⁴¹ At this point the *Shari'ah*-based approach requires IFIs to not only be concerned about the *Shari'ah* compliance aspect but also to fulfil their social responsibilities.¹⁴² This may have certain implications for IFIs as it widens the scope and objective of the *Shari'ah* governance system.

4.8.5 Consistency

In view of the diversity in Islamic finance practices in different jurisdictions, the likelihood of conflicting *fatwa* or *Shari'ah* pronouncements is relatively high, which may undermine the stakeholders' confidence in the industry.¹⁴³ At this point, there must be continuous efforts to harmonize the *Shari'ah* standards for the purpose of consistency.

¹⁴¹ Interestingly, the Registration of *Shari'ah* Adviser's Guidelines issued by the SC uses the term *Shari'ah*-based rather than *Shari'ah*-compliant (SC, 2009). This indicates that IFIs in Malaysia need to address this issue specifically to Islamic capital market products to meet the *Shari'ah*-based requirement.

¹⁴² Haniffa and Hudaib (2007: 97–116) attempt to assess the strength and degree of the ethical identity by analysing annual reports of seven IFIs in the Gulf region in four different dimensions, namely: commitment to society, vision and mission; contribution and management of *zakah*; charity and benevolent loans; and information about top management. The survey results indicate that there was a serious lack of communication in IFIs on the socio-economic dimensions, which significantly failed to reflect their accountability and duty towards social justice (Haniffa and Hudaib, 2007: 111).

¹⁴³ The CIBAFI reported that, out of 6,000 *fatwa* issued by different IFIs with over 100 *Shari'ah* scholars, only 10% were not consistent across IFIs (Iqbal and Mirakhor, 2007: 290). Although this figure tends to show that the level of consistency is at an acceptable level, it is expected that greater inconsistencies are likely to happen in the future when the Islamic finance industry expands further.

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The idea of *Shari‘ah* harmonization, despite its pros and cons,¹⁴⁴ would be a good approach to achieve a certain level of consistency that is crucial to the Islamic finance industry.¹⁴⁵

Besides, the adoption of the AAOIFI *Shari‘ah* standards would help to promote consistency in Islamic finance practices across jurisdictions as well as ensuring the enforceability of transactions. The IFSB survey demonstrates different countries' perspectives on the adoption of the *Shari‘ah* standards, where IFIs from Brunei, Jordan and Qatar fully supported its adoption, Sudan and Indonesia viewed it as favourable and Pakistan, Malaysia and the UAE only indicated their fair support (IFSB, 2008b: 26). The survey further shows that 65% of IFIs (out of sixty-nine) do not recognize the importance of the AAOIFI *Shari‘ah* standards.

Despite the need for common and high standards for *Shari‘ah* governance practices, the determination to adopt any international standards is a matter of political consideration. The current practice demonstrates that political will is of the essence in determining the direction of Islamic finance. In the meantime, it is also important to consider numerous factors from various perspectives in accordance with the legal, political and economic environment of certain countries. In this respect, the IFSB's approach of no 'single model' or 'one-size-fits-all' is relevant. If internal and external factors of certain countries are against the adoption of such *Shari‘ah* standards, IFIs should at least have a set of adequate, effective and high standards of *Shari‘ah* governance that would be able to maintain their credibility as well as mitigate *Shari‘ah* non-compliance risks.

¹⁴⁴ It is contended that *Shari‘ah* harmonization may create rigidity and impede the development of Islamic finance particularly in the aspect of product innovation. The researcher is of the view that *Shari‘ah* harmonization with some flexible conditions is necessary to ensure consistency.

¹⁴⁵ Although, the idea of *Shari‘ah* harmonization is commendable, it is also important to look at another dimension on its implementation. In this regard, Peters, (2003: 92-93) critically analyse the effect of *Shari‘ah* codification. He mentions that the codification of *Shari‘ah* has actually transferred the authority to determine the *Shari‘ah* norms to the state and finally became a part of national politics. Vikor, (1998), points out similar observation where he states that the *Shari‘ah* codification is actually against the theological reason. In addition, he also mentions that historically, *Shari‘ah* is developed independently and always opposition to the power of state. In view of these arguments, any element of political interference in the process of *Shari‘ah* harmonization in Islamic finance must be avoided with appropriate measures.

4.8.6 The Remit of Various Institutions of *Shari‘ah* Boards

The establishment of *Shari‘ah* boards in numerous IFIs and at the national level may raise an issue of lack of coordination and overlapping jurisdiction. IFIs may need to get products approved by different levels of *Shari‘ah* boards. As an illustration, we may refer to the Malaysian *Shari‘ah* governance approach. As a general requirement, IFIs are expected to refer to their internal *Shari‘ah* board as well as to the national *Shari‘ah* advisory council for approval of any Islamic financial products. If it involves Islamic capital market products, IFIs are additionally required to get the approval of the *Shari‘ah* board of the SC. This long process may have certain implications to IFIs in terms of cost, time and effort, as well as potential conflicting *fatwa*.

The IFSB survey discloses that there is a lack of communication amongst the *Shari‘ah* boards that facilitate the harmonization of *Shari‘ah* matters and practices. Only 65% of *Shari‘ah* boards communicate with the *Shari‘ah* boards of other IFIs and 45% of *Shari‘ah* boards at individual IFI level communicate with the national *Shari‘ah* board (IFSB, 2008b: 40). With this shortcoming, the *Shari‘ah* governance system must then be able to address the issue of the remit of *Shari‘ah* boards by having effective *Shari‘ah* coordination at micro and macro levels.

4.9 Conclusion

Shari‘ah governance adds additional values to the existing corporate governance framework. It inculcates transparency, trust, credibility, philosophy, values, beliefs (*aqidah*), *Shari‘ah* and ethics (*akhlāq*) (Nathan and Ribieri, 2007: 477). While *Shari‘ah* governance is expected to add Islamic values, there are also criticisms of its current practice, particularly in relation to the affairs of the *Shari‘ah* board. Kahf (2004: 26) mentions that many *Shari‘ah* advisors of the IFIs are now being alleged to be “bankers’ window-dressers and overstretching the rules of *Shari‘ah* to provide easy *fatwa* for the

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new breed of bankers.”¹⁴⁶ Although this allegation has not been proven by any empirical research, this negative perception of the *Shari‘ah* board should be obliterated with the implementation of strong and good *Shari‘ah* governance.¹⁴⁷

The need to have effective *Shari‘ah* governance is crucial as it would strengthen the credibility of IFIs. Such *Shari‘ah* governance framework must be able to address various issues pertinent to the foregoing discussion. The AAOIFI governance standards and the IFSB guiding principles are very important for the purpose of improving and bringing harmonization to the *Shari‘ah* governance practices. The standards are expected to effectively resolve numerous issues with respect to *Shari‘ah* governance. In conclusion, therefore, the foregoing discussion seems to suggest that the existing *Shari‘ah* governance framework needs further enhancement and improvement in order to reinforce the development and growth of the Islamic finance industry. This position hence calls for further research to study and examine the extent of *Shari‘ah* governance practice across jurisdictions with the purpose of identifying issues and providing guidelines for best practice of *Shari‘ah* governance in IFIs.

¹⁴⁶ See also El-Gamal (2006: 26–45). He heavily criticizes the practice of *Shari‘ah* arbitrage and the failure of Islamic finance to serve *maqāsid Shari‘ah*. Kuran (2004: xi) claims that Islamic finance is not any different from conventional banking except in name. He also criticizes that behavioral norms, as inspired by the doctrine of Islamic economics which is motivated by religious incentives, are unrealistic. The practice in Islamic finance evidences that IFIs are turning away from the normative concerns of Islamic economics (Kuran, 1983: 353–374).

¹⁴⁷ Sheikh Nizam Yaqubi, a prominent *Shari‘ah* scholar strongly refutes any allegation of *fatwa* shopping in Islamic finance. He clearly mentions that such an allegation is baseless and has no justification (Hanif, 2010).

CHAPTER 5

REGULATORY FRAMEWORK OF SHARI'AH GOVERNANCE SYSTEM IN MALAYSIA, GCC COUNTRIES AND THE UK¹⁴⁸

5.0 Introduction

The *Shari'ah* governance system as defined by the IFSB-10 refers to a set of institutional and organizational arrangements to oversee *Shari'ah* compliance aspects in IFIs. In this regard, the majority of IFIs have established their own *Shari'ah* boards and some of them even have set up a dedicated internal *Shari'ah* review unit or department to support the *Shari'ah* board in performing its function. This indicates a positive development on the aspect of *Shari'ah* governance system in IFIs. Looking at the different frameworks and styles of *Shari'ah* governance in various legal environments and diverse banking models, it is worth examining the regulatory framework of *Shari'ah* governance system in different jurisdictions.

This chapter focuses on the regulatory framework of the *Shari'ah* governance system in Malaysia, GCC countries¹⁴⁹ and the UK as the case studies. Uniquely, it is a *sine qua non* for the significant differences of the *Shari'ah* governance system, in particular from the regulatory overview, as Malaysia represents a model in a mixed legal jurisdiction, GCC in an Islamic and mixed legal environment and the UK in a non-Islamic legal environment. This chapter concludes with a brief review of the legal backgrounds and some observations on the *Shari'ah* governance framework of the case countries.

¹⁴⁸ Major parts of this chapter were presented at the International Workshop on Islamic Economics, “Evaluating the Current Practice of Islamic Finance and New Horizon in Islamic Economic Studies” on 23rd–24th July 2009 in Kyoto, Japan and published in the Kyoto Bulletin of Islamic Area Studies, 3–2, 2010, 82–115. In addition, some of the legal updates on the CBA, as discussed in subsection 5.2, were published in the Journal of International Banking Law and Regulation, Issue 3, 2010, 105–108.

¹⁴⁹ The value of *Shari'ah* compliant assets for Saudi Arabia, the UAE, Qatar, Bahrain and Kuwait alone is worth over USD262.6 billion and accounts for 41% of the world's total *Shari'ah* compliant assets (Wilson, 2009: 3). This simply demonstrates the emergence of the need for a strong and robust *Shari'ah* governance framework to address the issues pertaining to *Shari'ah* matters.

5.1 The *Shari'ah* Governance Model from a Regulatory Perspective

The existing framework of Islamic finance in various jurisdictions demonstrates the diverse practices and models of the *Shari'ah* governance system. Some jurisdictions prefer greater involvement of regulatory authorities and some countries favour otherwise. Until now, it is still debatable whether the former or the latter is more prevalent and appropriate for possible adoption.¹⁵⁰ To illustrate these diverse approaches, this study identifies five *Shari'ah* governance models in the context of a regulatory perspective.

5.1.1 Reactive Approach

This model is more prevalent in non-Islamic legal environment countries such as the UK and Turkey. Although several Islamic banking licences have been issued to IFIs, the regulatory authority is silent on the *Shari'ah* governance framework. Like conventional banks, IFIs are required to comply with the existing legislation and regulations. On top of that, IFIs have a duty to make sure that all their business operations and products are *Shari'ah*-compliant. There is no specific legislation governing IFIs or any directive from regulatory authorities specifying *Shari'ah* governance requirements. At this point, the regulators will only react and intervene in *Shari'ah* governance matters if there is any significant issue involved which may affect the finance sector. For instance, the UK Financial Services Authority only sees the role played by the *Shari'ah* boards of IFIs as being advisory and supervisory and not as having executive authority as in the case of the BOD.

5.1.2 Passive Approach

This model is exclusive to the *Shari'ah* governance model in Saudi Arabia. The Saudi Authority Monetary Agency (SAMA) treats IFIs as equal to their conventional counterparts. SAMA has yet to issue legislation pertaining to Islamic finance and guidelines on a *Shari'ah* governance system. There is no national *Shari'ah* advisory

¹⁵⁰ On the other hand, El Sheikhh (2000: 43–49) prefers that IFIs should not be regulated or supervised by any authorities. The researcher nevertheless disagrees with this contention and rather considers that the regulation is a necessity for the Islamic finance industry in view of its numerous inherent risks.

board, nor are any institutions the sole authoritative body in Islamic finance. The existing *Shari‘ah* governance system, as practised by IFIs in the kingdom, is a product of self-initiative rather than a regulatory requirement or at a regulator’s direction.

5.1.3 Minimalist Approach

This model is mainly practised by GCC countries, with the exceptions of Oman and Saudi Arabia. Unlike the reactive approach, the minimalist model allows slight intervention on the part of regulatory authorities. The regulatory authorities expect IFIs to have a proper *Shari‘ah* governance system without specifying the requirements in detail. There is no restriction on multiple appointments of the *Shari‘ah* board to sit on various institutions at one particular time. Some jurisdictions in GCC countries, such as Bahrain, the UAE and Qatar, favour the adoption of the AAOIFI governance standards. The minimalist approach prefers the market to develop its own *Shari‘ah* governance system rather than have greater intervention on the part of regulators.

5.1.4 Proactive Approach

This model is favoured by the Malaysian regulatory authority. The proponents of this model have strong faith in the regulatory-based approach to strengthen the *Shari‘ah* governance framework. With this motivation, the Malaysian regulator initiates a comprehensive *Shari‘ah* governance framework from regulatory and non-regulatory aspects. There were several laws passed and amended by the parliament such as the IBA, the BAFIA, the *Takaful* Act 1984 (TA) and the Securities Commission Act 1993. The CBA confirms the status of the SAC as the sole authoritative body in Islamic finance. To complement this, the BNM issued the BNM/GPS1 in 2004 as well as *Shari‘ah* Governance Framework for IFIs in 2010, and the SC issued the Registration of *Shari‘ah* Advisers Guidelines 2009, which set the criteria for the registration of a *Shari‘ah* advisor in the capital market sector.

5.1.5 Interventionist Approach

While the passive approach is exclusive to Saudi Arabia, the interventionist model is unique to the *Shari‘ah* governance model in Pakistan. The interventionist model allows third party institutions to make decisions on *Shari‘ah* matters pertaining to Islamic finance. In the case of Pakistan, the *Shari‘ah* Federal Court is the highest authority in matters involving Islamic finance, despite the establishment of a *Shari‘ah* board at the State Bank of Pakistan level.

5.2 *Shari‘ah* Governance Systems in Malaysia, GCC Countries and the UK

5.2.1 Malaysia

(a) Regulatory Overview

Malaysia has a unique legislative framework consisting of mixed legal systems, namely common law and *Shari‘ah*. The common law principles are applied in the civil court in almost all matters of jurisdiction. Islamic law, in contrast, is practised in the *Shari‘ah* court and only pertaining to family matters and laws of inheritance. The Federal Constitution of Malaysia puts Islamic banking matters under the jurisdiction of the civil court. This is due to the fact that Islamic banking is considered as being under the item ‘finance’ in the Federal Constitution. As a matter of fact, the BNM, with the cooperation of the judicial body, has agreed to set up a special High Court in the Commercial Division known as the *muamalat* bench. According to Practice Direction No.1/2003, paragraph 2, all cases under the code 22A filed in the High Court of Malaya will be registered and heard in the High Court Commercial Division 4 and this special high court will only hear cases on Islamic banking.

The development of the Islamic banking industry in Malaysia involved two phases; the first phase was from 1983 until 1993 and the second phase began in 1994. Malaysia has liberalized its policy on the implementation of Islamic finance by allowing foreign entities to set up Islamic banks in the local market. These staggered developments are facilitated and supported by legal infrastructure through several legislation and directives.

The first *Shari'ah* board was set up in 1983 by Bank Islam Malaysia Berhad. After ten years, on 4th March 1993, the BNM introduced an interest-free banking scheme, in which conventional banks could offer Islamic banking products through its windows. With that policy, many conventional banks set up Islamic windows and at the same time appointed selected Muslim scholars to be members of the *Shari'ah* board. As part of the effort to streamline and harmonize the *Shari'ah* interpretations, the SAC was established on 1st May 1997 under the BAFIA and is considered the highest *Shari'ah* authority pertaining to Islamic banking, finance and *takāful* in Malaysia.

The terms *Shari'ah* committee, *Shari'ah* supervisory council or *Shari'ah* advisory council are used interchangeably in Malaysia. The IBA refers to the *Shari'ah* board as the *Shari'ah* supervisory council and the BAFIA as the *Shari'ah* advisory council. With the issuance of the BNM/GPS1, all *Shari'ah* boards of IFIs and *takāful* operators are recognized as *Shari'ah* Committees (SHCs) and the SAC is used as a reference to the *Shari'ah* board of the BNM. The establishment of an SHC is a statutory requirement of all banks offering Islamic banking products pursuant to section 3 (5) (b) of the IBA for Islamic banks and section 124 (7) of the BAFIA for Islamic banking scheme banks. The main objective of the establishment of an SHC is to advise IFIs on any *Shari'ah* matter and to ensure compliance with the *Shari'ah* tenets and requirements. Section 3 (5) (b) of the IBA makes the establishment of *Shari'ah* board a mandatory requirement, which must be clearly stipulated in the articles of association of the bank.

As a response to the positive demands of the conventional banks to open Islamic counters, section 124 (7) of the BAFIA was then introduced which regulated the establishment of SHCs for Islamic windows. Similar to the IBA and the BAFIA, section 8 of the TA puts two conditions on the *takāful* licence, namely that the aims and operations of the *takāful* business are in line with the *Shari'ah* principles and there is a clear statement for the establishment of the *Shari'ah* board in the articles of association. Apart from institutions under the IBA, the BAFIA and the TA, SHCs also exist in institutions under the Development Financial Institutions Act 2002 (DFIA).

(b) *Shari'ah* Governance

The BNM issued the BNM/GPS 1 that provides an appropriate governance framework for *Shari'ah* boards.¹⁵¹ The amendment to the Central Bank of Malaysia Act 1958 enhances the functions and jurisdiction of the SAC, where it will be the sole *Shari'ah* authority in Islamic finance and will be referred to by the court or arbitrator in disputes involving *Shari'ah* issues. Apart from that, the BNM has also issued the Guidelines on the Disclosure of Reports and Financial Statements of Islamic Banks known as BNM/GPS8-i. In April 2010, the BNM issued another guideline namely the *Shari'ah Governance Framework for IFIs* which will replace the BNM/GPS1 and become officially effective in 2011.

The BNM/GPS1 consists of ten parts with twenty-four sections and one appendix. Its contents consist of objectives, scope of application, establishment of the SHC, membership, restrictions, duties and responsibilities of the SHC and IFIs, reporting structure, effective date, and secretariat of the SAC. IFIs had to comply with the guideline by 1st April 2005 and the dateline was extended for development financial institutions prescribed under the DFIA that offered Islamic financial products and services as at 1st September 2005.

The objective of BNM/GPS 1 is threefold, i.e. to set out the rules, regulations and procedures in the establishment of the SC; to define the role, scope of duties and responsibilities of the SHC; and to define the relationship and working arrangement between the SHC and the SAC (section 5). IFIs licensed under the IBA, the BAFIA, the DFIA and the TA are required to comply with this guideline (section 6).

In terms of appointment of the *Shari'ah* board, section 8 mentions that the BOD of IFIs should appoint the members of the SHC and the tenure should be valid for a renewable term of two years subject to the approval of the BNM. Section 12 requires the *Shari'ah*

¹⁵¹ The Malaysian Code on Corporate Governance was first issued by the Securities Commission in 2000 and was revised in 2007. The scope of this code nevertheless has failed to address specific corporate governance issues applicable to IFIs. In this regard, the BNM has initiated specific guidelines for a *Shari'ah* governance system for IFIs as part of the efforts in strengthening corporate governance in IFIs.

board members to at least either have qualifications or possess the necessary knowledge, expertise or experience in Islamic jurisprudence or Islamic commercial law.¹⁵² To ensure that the SHC is able to function effectively, the SHC should consist of a minimum of three members and its activities and functions will be coordinated by the *Shari'ah* secretariat of the respective IFIs (section 15).

There are certain restrictions with regard to the *Shari'ah* governance practice. With the purpose of mitigating the risk of potential of conflict of interest and confidentiality issues, IFIs are not allowed to appoint any member of the SC in another IFI of the same industry (section 19). An SHC member may be disqualified if he fails to satisfy that he is fit for the position, fails to attend 75% of meetings in a year without reasonable excuse, has been declared bankrupt, or a petition under bankruptcy laws is filed against him, was found guilty for any serious criminal offence or any other offence punishable with imprisonment of one year or more, or is subject to any order of detention, supervision, restricted residence or banishment (section 16).

With regard to functions of the *Shari'ah* board, section 20 provides the clear duties and responsibilities of the SHC and these include: to advise the BOD on *Shari'ah* matters in its business operations; to endorse *Shari'ah* compliance manuals; to endorse and validate relevant documentations; to assist related parties on *Shari'ah* matters for advice upon request; to advise on matters to be referred to the SAC; to provide written *Shari'ah* opinions; and to assist the SAC on reference for advice. Besides this, the IFIs must assist the SHC as well as possible in providing sufficient relevant information and this includes: to refer all *Shari'ah* issues to the SHC; to adopt the SC's advice; to ensure that product documents are validated; to have a *Shari'ah* compliance manual; to provide access to relevant documents; to provide sufficient resources; and to remunerate the members of the SHC accordingly (section 21).

¹⁵² Paragraph 2 of the Guidelines on Islamic Private Debt Securities (1st July 2000), issued by the SC, requires that the appointment of the *Shari'ah* advisors in relation to the approval of the structure of Islamic bonds must be of good reputation and well versed in *fiqh al muāmalāt* and *usul al fiqh* and having at least three years experience in Islamic financial transactions (SC, 2000).

The SHC is legally required to produce a *Shari'ah* report expressing their observations on IFIs' compliance with *Shari'ah* principles. In this aspect, the BNM/GP8-i specifies the minimum requirements of the *Shari'ah* report. The BNM/GP8-i requires content of the *Shari'ah* report to be at least, declaration of *Shari'ah* compliance endorsed by the *Shari'ah* committee members.¹⁵³ In terms of reporting structure, the SHC will report functionally to the BOD as this reflects the status of the SHC as an independent body of the IFIs. The BOD is bound by any decision of the SHC and they have to consider their views on certain issues related to operational matters, policy or business transactions.

The amendment to the Central Bank of Malaysia Act 1958 in 2003 enhances the role of the SAC. The SAC is then accorded to be the sole authoritative body on *Shari'ah* matters pertaining to Islamic finance. The decision made by the SAC nevertheless is only binding upon the arbitration and not the court. Malaysian government took a further step in enhancing the framework of *Shari'ah* governance by passing the CBA. The CBA was passed by the parliament in July 2009, received royal assent on 19th August 2009 and was gazetted on 3rd September 2009. Unlike the earlier act, the CBA inserts a new provision in Part VII which covers matters pertaining to Islamic finance. Chapter 1 of Part VII aims at resolving issues pertinent to *Shari'ah* matters as demonstrated in several cases involving IFIs in Malaysia such as in the case of *Affin Bank Berhad vs Zulkifli Abdullah* (2006) 1 CLJ 447¹⁵⁴ and *Arab Malaysian Finance Bhd v Taman Ihsan Jaya Sdn Bhd & Ors (Koperasi Seri Kota Bukit Cheraka Bhd, third party)* [2008] 5 MLJ 631.¹⁵⁵ The Central Bank of Malaysia (Amendment) Act 2003 seems to have failed to resolve the issue since the decision made by the SAC is only binding upon the arbitration and not the

¹⁵³ The BNM/GP8-i *Shari'ah* report's format is lacking several important pieces of information compared to the format of the AAOIFI Governance Standard No.1. The AAOIFI requires additional information on the *Shari'ah* report, which should contain necessary information on *Shari'ah* compliance matters such as activities, operations and transactions carried out by IFIs (AAOIFI, 1997).

¹⁵⁴ In this case, the learned judge applied the equitable interpretation of the term 'selling price' as it referred to the sum calculated for the date when the facility was to be paid off. This is supported by the case of *Malayan Banking Berhad v Ya'kup bin Oje & Anor* [2007] 6 MLJ 398. The court applied the principle of equity to demand the plaintiff to grant substantial rebate to the defendant upon the disputed BBA facility.

¹⁵⁵ The High Court decreed that the profit derived from the BBA facility was unlawful and rendered the transaction null and void. This decision will notably affect IFIs in Malaysia since the judgment obviously declared that defaulters in the BBA facility were only liable as to the original facility amount and not the selling price.

court¹⁵⁶ Moreover, in view of the huge potential implications of *Shari‘ah* non-compliance risks, the need for clear and precise *Shari‘ah* governance framework is also crucial to the Islamic finance industry.

Realizing this, section 51-58 of the CBA clarifies and enhances *Shari‘ah* governance framework for IFIs in Malaysia in the following aspects:

- (i) It grants authority to the BNM to establish the SAC and to specify its distinctive functions as well as the secretariat to assist the SAC in carrying out its definitive roles. This vividly clarifies the roles and responsibilities of the SAC as the highest and sole authority in Islamic financial matters.
- (ii) In parallel with the status of the SAC as the highest authority in matters pertaining to Islamic banking, finance and *Takāful*, the appointment of the SAC members shall be made by the Yang di-Pertuan Agong. The SAC’s remuneration and the terms of reference shall then be determined by the BNM.
- (iii) It sets the minimum fit and proper criteria of the SAC members. The candidate must be at least knowledgeable and qualified in *Shari‘ah* or have appropriate knowledge and experience in banking, finance and law. Section 53 of the CBA also allows experts in other related disciplines, as well as judges of the civil and *Shari‘ah* courts, to be the SAC members. This provision is unique as a combination of mixed expertise amongst the SAC members would potentially contribute towards more sound and integrated *Shari‘ah* rulings.
- (iv) The repealed section 16B of the Central Bank of Malaysia (Amendment) Act 2003 merely provides that *Shari‘ah* rulings issued by the SAC are binding upon the arbitration. Section 57 of the CBA then clarifies the legal status of the *Shari‘ah* pronouncement issued by the SAC to be binding upon both the court as well as arbitration.

¹⁵⁶ The learned judge in the case of *Arab-Malaysian Finance Bhd v Taman Ihsan Jaya Sdn Bhd & Ors* [2008] 5 MLJ viewed that the court did not have to refer to the SAC for any ruling or deliberation as there was no dispute on the validity of the BBA facility since BBA was one of the products approved by the SAC.

- (v) The court or arbitrator is not obligated to refer to the SAC to resolve any *Shari‘ah* issue under the previous regulation.¹⁵⁷ Section 58 of the CBA, on the other hand, makes it mandatory for the court or arbitrator to refer to the SAC for deliberation on any *Shari‘ah* issue, as well as taking into account its existing *Shari‘ah* rulings.
- (vi) It clarifies the status of the *Shari‘ah* rulings issued by the SAC in the event that they contradict the *Shari‘ah* pronouncement of a *Shari‘ah* committee at an individual IFI. The *Shari‘ah* rulings of the SAC shall prevail and have binding force over the *Shari‘ah* resolutions of the *Shari‘ah* committees of IFIs.

Despite the recent legal development, it is worth noting that the CBA has jurisdiction only in matters that fall under the auspices of the BNM, which therefore excludes the *Shari‘ah* board in the SC. The SC has its own *Shari‘ah* board and, in August 2009, it issued the Registration of *Shari‘ah* Adviser’s Guidelines under section 377 of the Capital Markets and Services Act 2007. This guideline specifically provides rules and procedures for registration of *Shari‘ah* advisors in matters regulated and supervised by the SC (SC, 2009).

5.2.2 GCC Countries

The GCC was established on 26th May 1981 in Abu Dhabi, with the aim of fostering and furthering cooperation amongst the member states (n.a., 1987). The IFIs¹⁵⁸ in the GCC region¹⁵⁹ have their own framework of *Shari‘ah* governance system.¹⁶⁰ The monetary

¹⁵⁷ In the case of *Tan Sri Khalid Ibrahim v Bank Islam Malaysia Berhad* [2009] 6 MLJ 416, it was the first time in the history of the Malaysian court that the learned judge made reference to the SAC for *Shari‘ah* deliberation on BBA agreement.

¹⁵⁸ Previously, the establishment of IFIs in the Gulf states was done by decree from the ruler. For instance the Dubai Islamic Bank by the Decree from the Ruler of Dubai in 1975, the Kuwait Finance House by the Decree No. 72/1977 from the Emir of Kuwait, the Bahrain Islamic Bank by the Decree No. 2/1979 from the Emir of Bahrain, the Masraf Qatar al-Islami by the Decree No. 45/1982 and the Qatar International Islamic Bank by the Decree No. 52/1990 from the Emir of Qatar. The UAE was the first Gulf state that introduced a specific law to govern the establishment of IFIs in its Law No. 6 of 1985 (Al-Suwaidi, 1993: 300).

¹⁵⁹ The Central Bank of Oman has reiterated its rejection of *Shari‘ah* -compliant banking due to its policy of allowing only universal banks as there is less demand for IFIs compared to their conventional counterparts (MEED, 2007). These two sets of justifications for not having Islamic finance indicate the failure of the Oman authorities to appreciate the very reason for the existence of Islamic finance. Islamic

agencies or financial authorities are responsible for the regulation and supervision of the IFIs, including in matters of *Shari'ah* governance.

It is imperative to understand the legal background of GCC countries, particularly the application of Islamic law in their judicial system, before discussing their *Shari'ah* governance framework.¹⁶¹ With the fact that not all GCC countries' constitutions prescribe *Shari'ah* as a source of legislation, there is an issue around to what extent *Shari'ah* applies or could apply, in particular in relation to Islamic finance.¹⁶² At this point, this subsection not only discusses laws and regulations pertaining to *Shari'ah* governance in GCC countries, but also provides some basic information on their legal backgrounds. The study explores the application of *Shari'ah* and tries to relate it to the implementation of Islamic finance in GCC countries.

Generally, the *Shari'ah* governance approach in GCC countries can be classified into two types: either it is regulated via legal and supervisory requirements, as in the cases of Bahrain, Kuwait, the UAE and Qatar, or through self-regulation as in the case of Saudi Arabia. This section presents the diverse *Shari'ah* governance systems within GCC countries and therefore enables the study to highlight and identify essential issues that would be useful for further analysis.

finance is not only concerned with market demand and is not material in nature, but it is more concerned with the fundamental aspects of *Shari'ah*. Unfortunately, as of today, Oman is the only state in the GCC countries that does not permit *Shari'ah*-compliant banking activities. Perhaps the situation will be different in the future as the first company in Oman, namely Sohar Alumunium, has raised USD260 million for the first Greenfield aluminium smelter project via Citi Islamic Investment Bank in Dubai. This indicates positive interest in Islamic finance in Oman (Alam, 2006).

¹⁶⁰ There are a few corporate governance codes or regulations already in place, such as the Corporate Governance Regulations (2006) of Saudi Arabia, the Abu Dhabi Securities Market Corporate Governance Code (2006), the Emirates Securities and Commodities Authority (2007), Abu Dhabi Securities Market Corporate Governance Listing Rules (2006) of the UAE, and the Corporate Governance Code for Listed Companies of Bahrain. In the event of absence of specific corporate governance codes and regulations, the company law of the countries provides rules and guidelines for their corporate governance framework. These codes and regulations do not, however, specifically tackle the issue of *Shari'ah* governance in IFIs.

¹⁶¹ Prior to 1961, the majority of the Gulf states, except Saudi Arabia, were under the extra-territorial jurisdiction of the British Crown. After independence (Kuwait in 1961, Oman in 1971, Bahrain, the UAE and Qatar in 1971) all of them developed their own codified legal system (Al-Suwaidi, 1993: 289–301). On the other hand, Saudi Arabia has never fallen under the extra-territorial jurisdiction of the British and is therefore less influenced by the common law.

¹⁶² The constitutions of Kuwait, Bahrain and the UAE clearly state that *Shari'ah* is a source of legislation; Qatar's constitution is silent on this position and Saudi Arabia has no written constitution since it considers *al-Qur'an* and *al-Sunnah* as its only constitution.

5.2.2.1 Bahrain

(a) Regulatory Overview

Bahrain was exposed to the English system more than other GCC countries (Al-Suwaidi, 1993: 292–293). However, after independence in 1971, Bahrain developed several substantive and procedural laws and at the same time put *Shari‘ah* as a main source of legislation, as stated in Article 2 of the Constitution of Bahrain. This position created difficulties for commercial sectors, particularly financial institutions, because interest-based transactions would have been declared illegal. In view of this, Bahrain developed its own laws, such as the Law of Civil and Commercial Procedure of 1971, the Law on the Establishment of the Bahrain Monetary Agency of 1973, the Companies Registration Act of 1983, and the Commercial Law of 1987, which are based mainly on the Egyptian code. Article 76 of the Commercial Law of 1987 clearly allows interest charges in commercial loans but subject to the rate determined by the Bahrain Monetary Agency (Al-Suwaidi, 1993: 292). As such, the Civil Court of Bahrain has comprehensive jurisdiction over civil and commercial matters, except those relating to *Shari‘ah* disputes.¹⁶³

With reference to the Islamic finance industry, Bahrain is known as one of the leading players in Islamic finance. Besides initiating the establishment of the Bahrain-based Liquidity Management Centre, Bahrain also hosts two international institutions for Islamic finance, namely the AAOIFI and the International Islamic Financial Market (IIFM). The Central Bank of Bahrain (CBB) is the sole regulator of the financial sector¹⁶⁴. The CBB is responsible for regulating and supervising all financial institutions, the insurance sector and capital markets. There are five main pieces of legislation that govern the financial system of Bahrain, namely the Central Bank of Bahrain and Financial Institutions Law 2006, the Bahrain Stock Exchange Law 1987, the Commercial

¹⁶³ For further reading, it would be beneficial to refer to Radhi (2003), who presents a comprehensive legal development and judicial background of Bahrain and divides it into three stages, namely the period of Islamic law, the mixed common and Islamic law period, and the period of mixed Romano-Germanic and Islamic law.

¹⁶⁴ The CBB was established in 2006 by virtue of the Central Bank of Bahrain and Financial Institutions Law (Decree Law No. 64/2006) (Ross, 2008: 26).

Companies Law 2001, The Anti Money Laundering Law 2001, and the Financial Trust Law 2006. The legal provision for the implementation of Islamic finance in Bahrain is provided in the CBB Rule Book Volume 2, Islamic Banks.

(b) *Shari‘ah* Governance

The CBB Rule Book Volume 2, Islamic Banks, Part A, High Level Control, section 1.3.15 provides that the CBB requires all banks to establish an independent *Shari‘ah* board complying with the AAOIFI governance standards for IFIs No. 1 and No.2. This section provides a clear legal requirement for the establishment of a *Shari‘ah* board in IFIs in Bahrain and failure to do so will constitute non-compliance with the CBB’s directive.

Unlike the other GCC countries, Bahrain has established a National *Shari‘ah* Advisory Board of the CBB with the purpose of serving and verifying *Shari‘ah* compliance (Hasan, 2007). The *Shari‘ah* board of the CBB is nevertheless different to the other national *Shari‘ah* boards of Malaysia, Sudan, Indonesia, Pakistan and Brunei, as it does not have authority at institutional level. With regard to the *Shari‘ah* governance system, Bahrain follows the AAOIFI governance standards, where it requires all IFIs to establish a *Shari‘ah* board. Section 1.3.16 of the CBB Rule Book requires IFIs to adopt the AAOIFI governance standards as well as having a separate function of *Shari‘ah* review for the purpose of ensuring *Shari‘ah* compliance as stipulated in the AAOIFI Governance Standard No.3. The legal requirement for the adoption of the AAOIFI governance standards reflects the role of Bahrain as the host of the AAOIFI since its establishment in 2001.¹⁶⁵

¹⁶⁵ This position positively influences the level of compliance of IFIs in Bahrain to the AAOIFI governance standards. A study conducted by Vinnicombe (2010: 61–63) on twenty-six IFIs in Bahrain revealed that the level of compliance was very high with respect to governance standards relating to in-house supervisory boards and reporting of the Islamic *mudaraba* contract.

5.2.2.2 United Arab Emirates

(a) Regulatory Overview

On 2nd December 1970, seven emirates decided to form a federal union consisting of Abu Dhabi, Dubai, Sharjah, Ajman, Umm Al-Quwain, Al Fujairah and Ras Al-Khaima, known as the United Arab Emirates or UAE (Al Muhairi, 1996a: 119). After independence in 1971, the government passed the UAE Provisional Constitution of 1971 with the aim of preserving the internal autonomy of the seven emirates (Al-Muhairi, 1996a: 118). In the meantime, Article 7 of the UAE Constitution recognized *Shari‘ah* as a main source of legislation and the religion of the state is Islam.¹⁶⁶ In addition, Article 75 of the Federal Law No. 10/1973 provides that “the Supreme Court shall apply the provisions of the *Shari‘ah*, Federal Laws and other laws in force in the member Emirates of the Union, conforming to the Islamic *Shari‘ah*. Likewise it shall apply those rules of custom and those principles of natural and comparative laws which do not conflict with the principle of the *Shari‘ah*.” In terms of the banking and finance sectors, the Union Law No. 10 of 1980 Concerning the Central Bank, the Monetary System and Organization of Banking is the main governing law for the financial sector in the UAE. This legislation grants power to the UAE Central Bank to regulate and supervise the financial institutions.

At the beginning of the financial regulation development of the UAE, any kind of interest in respect of civil transactions is prohibited by virtue of Article 714 of Federal Law No. 5 of 1985. This provision implicates interest-based transactions to be void and unenforceable. In 1987, the Civil Transactions Law was amended by Federal Law No. 1 which excluded commercial transactions from being governed by the civil transactions law and, finally, the Federal Law No. 11 of 1992 invalidated all previous laws with respect to the interest prohibition. As a result, the charging of interest in commercial

¹⁶⁶ There are two views on the interpretation of article 7 of the UAE Constitution. Islamists tend to interpret that *Shari‘ah* shall be the supreme law above all other laws, while liberalists place *Shari‘ah* on an equal footing with other laws. The reality, however, shows a different situation, where *Shari‘ah* rules are made obligatory in criminal cases and are not strictly applicable in commercial matters, especially in relation to banking and finance disputes (Al-Muhairi, 1996b: 219–244).

transactions is now permissible in the UAE.¹⁶⁷ Federal Law No. 18 of 1993 grants the bank’s right to charge interest in respect of a commercial loan as per the agreed rate in the contract (Tamimi, 2002: 51).¹⁶⁸ This position was taken in view of the necessity or *dharuriyah* for economic stability and the needs of the people. Moreover, during this time, the implementation of Islamic finance in the UAE was still in its infancy and could not cater for the market needs.¹⁶⁹ The civil court has jurisdictions in banking matters and any financial transactions that involve issues pertaining to the legality of interest fall under its jurisdiction (Ballantyne, 1985: 14).

Despite the above, the UAE at the same time makes numerous efforts to promote the Islamic finance and Dubai is leading the way as a centre for Islamic finance. In 1985, the UAE government passed a specific law in relation to Islamic finance – Federal Law No. 6 of 1985 Regarding Islamic Banks, Financial Institutions and Investment Companies. Article 1 of this Federal Law requires the IFIs to conduct business in accordance with *Shari‘ah*, which should be stated in the articles and memorandum of associations.

Dubai presents a unique position in comparison with other parts of the UAE. The UAE authority passed a separate law with Federal Law No. 6 of 1985, known as the Dubai International Financial Centre Law No. 13 of 2004, and the Islamic Financial Business Module of the Dubai Financial Services Authority provides a legal framework for regulating Islamic financial business as well as regulation of the *Shari‘ah* board. The DIFC Law No 13 led to the establishment of the DIFC which enjoys certain privileges and economic incentives from the government.¹⁷⁰ All institutions and corporate entities

¹⁶⁷ This was affirmed by the Constitutional Division Bench of the Supreme Court in the case of No. 14, Year 9 (June 1981). The Supreme Court held that articles 61 and 62 of the Civil Procedure Law of Abu Dhabi No. 3/1970 concerning interest charges were unaffected by article 7 of the constitution since they were in existence before the application of the constitution dated 2nd December 1971 (Al-Suwaidi, 1993: 293).

¹⁶⁸ See Article 61 and 62 of the Civil Court Procedures Law of Abu Dhabi as amended by Law No. 3 and Law No. 4 of 1987. In the case of *Petroleum Development (Trucial Coasts) Ltd v Sheikh of Abu Dhabi* [1951] 18 ILR 144, the Arbitrator, Lord Asquith, rejected the application of Islamic law to regulate a modern commercial transaction. Although the arbitrator’s arguments are highly debatable, his remarks at least clarified the position of interest in commercial transactions in the UAE.

¹⁶⁹ This was confirmed by the Constitutional Department of the Federal Supreme Court of Dhabi in its interpretation Decision No. 14/9 issued on 28th June 1981 (Tamimi, 2002: 50–51).

¹⁷⁰ The DIFC is a financial-free zone established in the UAE by Federal Decree Number 35 for the year 2004. IFIs registered under the DIFC enjoy the privilege of 100% foreign ownership (normal companies in

under the jurisdiction of the DIFC are governed by the DIFC Law and are subject to the DIFC Court and the DIFC Arbitration Centre.

(b) *Shari‘ah* Governance

The *Shari‘ah* governance system in the UAE, except in Dubai, is governed by the Federal Law No. 6 of 1985. Article 5 of the Federal Law No. 6 of 1985 requires the establishment of a “Higher *Shari‘ah* Authority” under the Ministry of Justice and Islamic Affairs to supervise Islamic banks, financial institutions and investment companies and to provide *Shari‘ah* opinion on matters pertaining to Islamic banking and finance. This Article 5 clearly states the position of the Higher *Shari‘ah* Authority as binding. Besides Higher *Shari‘ah* Authority, which is a government established body, it is worth mentioning here that *Shari‘ah* scholars in the UAE have voluntarily initiated the establishment of a central committee of the *Shari‘ah* board for the purpose of harmonizing and standardizing *Shari‘ah* practice (Dar, 2009b). This voluntary arrangement is at least able to assure the consistency of *Shari‘ah* rulings.

In terms of composition of the *Shari‘ah* board, Article 6 requires all IFIs to clearly stipulate the establishment of the *Shari‘ah* board in the articles and memorandum of association. This provision further puts a condition of a minimum of three members. The articles and memorandum of association must contain the manner and governance of the *Shari‘ah* board, such as its duties, responsibilities, functions and appointment. In the aspect of appointment, members of the Higher *Shari‘ah* Authority are appointed by the government and at the individual IFI level by the BOD or the shareholders. The IFIs cannot simply appoint their *Shari‘ah* board members but are required to submit the proposed names of the *Shari‘ah* advisors to the Higher *Shari‘ah* Authority for approval.

IFIs registered under the DIFC have to comply with the DIFC law and regulations, particularly the Law Regulating Islamic Financial Business DIFC Law No.13 of 2004

the UAE must have at least 51% of the company’s shares owned by a UAE national), a 0% tax rate on income and profits, the freedom to repatriate capital and profits without restrictions (Al Tamimy & Co., 2008: 6–7). Article 3 (3) provides the establishment of three centers under the DIFC namely the DIFC Authority, the DIFC Services Authority and the DIFC Judicial Authority.

and the DIFC Services Authority (DFSA) Rulebook on Islamic Financial Business Module (ISF).¹⁷¹ As a general requirement, the DFSA requires IFIs to adopt the AAOIFI governance standards to ensure consistency and compliance with the *Shari‘ah* (Praesidium and DIFC, 2007: 40–44). With respect to *Shari‘ah* governance, section 13 of the law requires IFIs to establish a *Shari‘ah* board and the DFSA has the power to make rules prescribing its appointment, formation, conduct and operation. In this instance the ISF specify the requirements of the *Shari‘ah* governance system of the DIFC.

Section 5.1.1 of the ISF requires the composition of *Shari‘ah* board to be of at least three members who are competent to perform their functions. The ISF does not specify the appropriate body for the appointment of the *Shari‘ah* board; it only states that appointment should be made by the governing body of the IFIs. The practice indicates that some of the appointments are made by the shareholders and some by the BOD. The ISF restricts the *Shari‘ah* board members from being directors or controllers of any IFIs they serve in order to avoid any conflict of interest.

While section 5.1.1 deals the issue of appointment, composition and restrictions pertaining to the *Shari‘ah* board, section 5.1.2 addresses the issue of transparency and disclosure, in which it requires the IFIs to document its policy in relation to appointments, dismissals or changes, the process, qualification and the remuneration of the members of the *Shari‘ah* board. In this respect, the IFIs are required to maintain six years' records of their assessment of the competence of *Shari‘ah* board members and the agreed terms of reference for each of them. In dealing with the issue of conflict of interest, the IFIs must have a mechanism in the form of a policy and procedures to manage any potential conflict of interest of the *Shari‘ah* board. Besides, the IFIs shall also provide reasonable assistance to the *Shari‘ah* board in terms of access to relevant records and information and should not at any time provide misleading information or interfere with the *Shari‘ah* board's ability to perform its duties.

¹⁷¹ On top of that, the DFSA also issued Islamic finance tailored handbooks in five areas of Islamic finance: Islamic Banking, Islamic Insurance, Islamic Investment Business Other than Operating Funds, Islamic Insurance Intermediation and Management and Operation of Islamic Funds (DFSA, 2010). These handbooks are designed to create further understanding and awareness of the DFSA's rulebooks pertaining to Islamic finance.

Sections 5.2 and 5.3 of the ISF clearly stipulate the requirement to adopt the AAOIFI governance standards by which the IFIs are obligated to produce a *Shari‘ah* annual report which must be submitted to the DFSA. Section 5.3 further requires that the IFIs conduct an internal *Shari‘ah* review and must ensure that the internal *Shari‘ah* review is performed by the internal audit function or the compliance function, either as part of the existing internal audit or compliance department or the independent internal *Shari‘ah* audit department of the IFIs. The IFIs must also ensure that the internal *Shari‘ah* review is conducted by a competent and sufficiently independent body to assess compliance with *Shari‘ah*.

5.2.2.3 Kuwait

(a) Regulatory Overview

The legal system of Kuwait is based on French and Egyptian models, particularly its commercial codes, such as the Commercial Companies Law of 1980 and the Commercial Code of 1981 (Gerald, 1991: 322).¹⁷² Article 2 of the constitution of Kuwait vividly puts *Shari‘ah* as a main source of legislation and Islam as the official religion. This can be referred in Article 547 of the Civil Code Law of Kuwait of 1980, which prohibits the practice of charging interest on loans,¹⁷³ and Article 305, which declares such transactions to be void. Nevertheless, within the same year the Kuwait Authority issued specific legislation to exclude commercial transactions from the application of the code (Ballantyne, 1985: 5). As a result of the issuance of the Commercial Code of 1981, interest charges on loans by financial institutions are expressly permissible (Ballantyne, 1987: 12–28).¹⁷⁴

¹⁷² The original Commercial Code of Kuwait 1961 was drafted by Al-Sanhouri, an Egyptian jurist, and contained more principled of Western secular law than of the *Shari‘ah* (Ballantyne, 1988: 317–328).

¹⁷³ Al-Moqatei (1989: 138–148) points out that Kuwait is considered the leader among the GCC countries in the process of Islamization of the legal system due to its adoption of some Islamic laws in the form of legislation since the 1980s.

¹⁷⁴ Article 102 of the Commercial Code provides that the creditor has the right to interest in accordance with the terms of contract; in the absence of a specified contract, the interest shall not exceed 7% and if the debtor delays in payment the interest shall then be calculated on the agreed basis rate. In addition, article 115 further states that interest shall not be paid for a frozen interest.

The principal ministerial authority for enforcement of commercial laws is the Ministry of Commerce and Industry and the Central Bank is the sole regulator for monetary financial system in the State of Kuwait. The Central Bank of Kuwait Law No. 32 of 1968 (CBK Law), amended by Law 130/1977, is the governing legislation that provides the regulatory framework for currency, grant authority to the CBK to supervise the financial institutions and matters of the organization of banking business (Ross, 2008: 86). In spite of that, financial institutions including IFIs must also strictly comply with the Commercial Code and Commercial Companies Law of Kuwait (Al-Suwaidi, 1993: 291–292). The judicial system of Kuwait places the civil court as having jurisdiction over commercial matters and this includes banking and finance disputes.

With regards to Islamic finance, section 10 of the CBK Law (Article 86-100) addresses the legal provision pertaining to the rules and controls of IFIs. Article 86 states that the CBK is responsible for regulating and controlling the activities of IFIs. The definition of an Islamic bank in general can be found in Article 86 of the CBK Law, which considers an Islamic bank as a business entity that exercises activities pertaining to banking business which should comply with the *Shari‘ah* principles. This general and wide provision on the activities of Islamic banks, without a definition of every single contract or transaction in Islamic law, creates flexibility for IFIs in relation to Islamic financial services and products in Kuwait.

(b) *Shari‘ah* Governance

The *Shari‘ah* governance practice in Kuwait is regulated by virtue of Article 93 of the CBK Law, which provides a legal basis for the regulations of the *Shari‘ah* board. Article 93 requires all IFIs to establish an independent *Shari‘ah* board, which shall be appointed by the bank’s general assembly. Unlike the other *Shari‘ah* governance approaches, which allow the appointment of the *Shari‘ah* board by the BOD, this Article 93 specifically requires the appointment to be made only by the general assembly. In terms of composition of the *Shari‘ah* board, the CBL Law puts a condition of a minimum of three members; this requirement is similar to the AAOIFI governance standards as well as the *Shari‘ah* governance requirements in Bahrain and the UAE. IFIs are also required to

mention the establishment of the *Shari‘ah* board in their articles and memorandum of association and both documents must specify the powers, workings and governance of the *Shari‘ah* board.

There is no *Shari‘ah* board in the CBK to act as the highest *Shari‘ah* authority in Islamic banking and finance. This may raise an issue of dispute settlement in the case of a conflict of opinion amongst members of the *Shari‘ah* board. To address this issue the CBK Law recognizes the *Fatwa* Board in the Ministry of Awqaf and Islamic Affairs as the final authority for any *Shari‘ah* dispute involving Islamic banking and business. The BOD of IFIs has the responsibility to refer the dispute to the *Fatwa* Board. The CBK Law nevertheless is silent about the status of the decision of the *Fatwa* Board, which should be made binding to all IFIs. Interestingly, Article 100 of the CBK Law clearly provides the supremacy of Islamic law, where it states that IFIs shall be subject to the provision of the CBK Law and subject to the Islamic *Shari‘ah* principles. This is a strong legal proviso which places *Shari‘ah* as the supreme law in relation to Islamic banking and finance in Kuwait.

With regard to the reporting structure, the *Shari‘ah* board has a duty to submit a *Shari‘ah* report to the bank’s general assembly since they are also appointed by the shareholders. The CBK Law specifies that the *Shari‘ah* report must contain the *Shari‘ah* opinion on the bank’s operation in terms of *Shari‘ah* compliance, including comments and views on *Shari‘ah* issues. This *Shari‘ah* report must be included in the IFIs’ annual report.

5.2.2.4 Saudi Arabia

(a) Regulatory Overview

The history of banking system in Saudi Arabia began in the 20th century with the first commercial bank, the Dutch Commercial Company, which was established in 1926 (Hamed, 1979: 167). As a general overview, banking and finance activities in Saudi Arabia are controlled by the Saudi Arabia Monetary Agency (SAMA), established by Royal Decree M/23 of 23.05.1377 on 15th December 1957, which functions under the

Banking Control Law 1966 as amended by Decree 2/ 1391 (Pepper, 1992: 34). *Shari'ah* is a main source legislation for Saudi Arabia and the *Shari'ah* court is the highest body in the judicial system.¹⁷⁵ Commercial matters, however, are put under the jurisdiction of the commercial court, which is more like a commercial council set up by Order 32/1350 1931 (Pepper, 1992: 33).

The development of Islamic finance in Saudi Arabia is considered unique and distinctive.¹⁷⁶ The legal framework of the financial system is governed by the Banks Control System by virtue of Royal Decree No. 5 on 12th June 1966 and this law is silent on the issue of usury or interest (Sfeir, 1988: 729–759). As a result, the majority of financial institutions have been conducting business in the conventional banking manner.¹⁷⁷ For instance, Articles 8 and 9 consider money lending as perfectly legitimate.

Despite the Banks Control System 1966, the legal system of Saudi Arabia is actually based on Islamic law. Vogel, (2000: 2) clearly mentions that the paramount legal system in Saudi Arabia is *Shari'ah*. This means the IFIs in Saudi Arabia operate under a strange legal framework since the existing law of the Banks Control System 1966 is still applicable and has not been repealed or amended to regulate the establishment or existence of IFIs. This is supported by a statement made by Al Sayari (2004), who mentions that, as of 2004, no law had been passed by the Saudi authority and not a single

¹⁷⁵ Although *Shari'ah* is considered as the main source of legislation, the other sources of law such as customary law, world case law and doctrine and jurisprudence are also acceptable (Ballantyne, 1986: 13–14). In the case of *Aramco Arbitration, Saudi Arabia v Arabian American Oil Company* (1958) 27 ILR 117, the arbitrator held that the proper law of the Concession Agreement was Islamic law but it is necessary to refer to other laws in order to fill the lacunae in the existing legal frameworks.

¹⁷⁶ Unlike the other GCC countries, Saudi Arabia has deliberately avoided the usage of term ‘constitution’ as *al-Qur'an* is considered as its constitution. *Nizam Asasiy* or Basic Law of Rule of 1992 is considered as the main law or the constitution of the Kingdom (Marar, 2004: 111). The administrative structure of Saudi Arabia was established by the Organic Instructions of the Hijazi Kingdom 1926, which is supplemented by the Statute of the Council of Deputies 1932 and the Constitution of the Council of Ministers 1958 (Pepper, 1992: 33).

¹⁷⁷ Despite there being no specific regulation to penalize financial institutions involved in interest-based transactions, any claims for interest are not enforceable. Interestingly, in Saudi the religious sentiment is so strong it is reported that deposits attracting interest only reached 49% in 1988 compared to 80% in Bahrain and 85% in Kuwait in the same year. This illustrates that there is a significantly strong natural antipathy and awareness of the prohibition of interest amongst Saudi people (Reumann, 1995: 218–219). A more recent study by Ernst and Young in 2008 reported that 70–90 % of Saudi Arabian mass affluent investors prefer *Shari'ah* investment products over conventional products (Hamedanchi and Altenbach, 2009: 58–61).

Islamic banking licence had been granted from the SAMA to any companies in Saudi Arabia. Despite the Capital Market Laws of 2003, fifteen *sukuk* issuances in 2000–2008 and huge Islamic mutual funds in the kingdom, there is no single legislation specifically regulating the implementation of Islamic finance (Wilson, 2009: 10). As part of the government’s policy for legal reform, it is anticipated that several new and revised regulations will be promulgated to boost the economy and increase foreign investment such as the redraft of the companies law, settlement of the jurisdictional conflict between the Capital Market Authority and Ministry of Commerce and Industry in relation to the securities in public offering and financial sector regulation (Al-Abduljabbar and Marshal, 2010: 731). In fact, the SAMA has also consulted a group of consultants, legal and banking specialists and appointed a steering committee to study the feasibility of Islamic finance in Saudi Arabia and hence to provide the required legal framework (Al Sayari, 2004).

With regard to banking disputes, SAMA set up a specific institution in October 1987 to hear cases pertaining to banking matters, including Islamic finance, known as the Committee of Settlement for Banking Disputes (CSBD) (Reumann, 1995: 230). The establishment of the CSBD is governed by the CSBD Regulations (Marar, 2004: 114). With the purpose of giving exclusive jurisdiction to the BDC, another Resolution of the Council of Ministers No. 732/8 of 10.07.1407 (10 March 1987) was issued via a Circular of the Minister of Justice No. 12/138T of 28.07.1407 (28th March 1987), which specifically instructs the *Shari‘ah* court not to hear any more banking disputes (Reumann, 1995: 230–237). To date, the banking disputes in Saudi Arabia are heard in the CSBD and not in the *Shari‘ah* court as practised pre-1987 unless authorized by the Ministerial Council (Marar, 2004: 114).

(b) *Shari‘ah* Governance

Since there is a lacuna in the regulatory framework pertaining to Islamic finance in Saudi Arabia, the nature of the *Shari‘ah* governance system is different to other jurisdictions. The notion of having a *Shari‘ah* governance system within the IFIs is not due to any legal

and supervisory requirement but rather as a voluntary initiative and indirect influence from the market. In other words, the *Shari'ah* governance model in Saudi Arabia is much more based on a self-initiative approach.¹⁷⁸ As an illustration of the *Shari'ah* governance system in Saudi Arabia, it would be beneficial to refer to the Al Rajhi model. The 11th General Assembly of the Al Rajhi established the *Shari'ah* board and its charter (Al Rajhi, 2008). The provision of the establishment of the *Shari'ah* board was clearly stipulated in the articles of association as well as Al Rajhi internal rules and guidelines. The *Shari'ah* board of Al Rajhi is deemed to be independent of all organs of governance, such as the management and BOD, since the appointment is made by the shareholders.

The Al Rajhi *Shari'ah* board plays four major roles to ensure and promote *Shari'ah* compliance and these include monitoring the activities and implementation of *Shari'ah* rulings with the assistance of the *Shari'ah* department, assisting the bank to develop products and services, promoting and creating awareness about Islamic finance to all stakeholders, and finally ensuring proper selection of employees, particularly senior management (Al Rajhi, 2008). Unlike the other *Shari'ah* boards, interestingly Al Rajhi has granted additional authority to the *Shari'ah* board to assist the management in the process of selecting employees who have capacity and are well qualified to implement Islamic banking practice.

There are three main specific organs that support the function of the *Shari'ah* board, namely its secretariat, the *Shari'ah* Control Department and the Control and Information Unit.¹⁷⁹ The secretariat deals with the *Shari'ah* board meeting and its operational procedures. The *Shari'ah* control department assists the *Shari'ah* board in performing the

¹⁷⁸ It is worth noting that the *Shari'ah* governance system in Saudi Arabia must take into consideration the influence of other *Shari'ah* scholars who do not even sit on any *Shari'ah* boards of IFIs. For instance, if a negative *fatwa* is issued by Sheikh Al-Mani'a on a certain Islamic banking product, it would be very difficult to sell the product in the market (Selvam, 2008: 12–14).

¹⁷⁹ Another Saudi Bank, namely Bank Al Bilad, has established a *Shari'ah* board, preparatory committee and *Shari'ah* group as its institutional arrangement for *Shari'ah* compliance purposes. The *Shari'ah* board plays a role as a *fatwa* issuing body while the preparatory committee acts as a research unit that studies *Shari'ah*-related issues and enquiries before they are forwarded to the *Shari'ah* board for deliberation. Another function emanating from the *Shari'ah* board is the *Shari'ah* group, consisting of the *Shari'ah* secretariat and the *Shari'ah* audit department. The former acts as a *Shari'ah* coordinator and the latter conducts periodic *Shari'ah* reviews (Al Bilad, 2008: 13–14).

Shari'ah review while the Control and Information Unit specifically provides information and creates awareness to promote *Shari'ah* compliance (Al Rajhi, 2008). Besides that, Al Rajhi has gone even further to develop its own *Shari'ah* governance arrangement by setting up an executive committee to oversee the functions of the *Shari'ah* Control Department, to appoint *Shari'ah* controllers, and to study issues submitted to the *Shari'ah* board (Al Rajhi, 2008).¹⁸⁰

Since there is no standard guideline for *Shari'ah* governance issued by the regulatory authority, the Al Rajhi has issued its own *Shari'ah* guidelines and procedures, known as the *Shari'ah* Monitoring Guide and *Shari'ah* Control Guidelines, with the purpose of ensuring the proper monitoring and implementation system of *Shari'ah* rulings (Al Rajhi, 2008). These *Shari'ah* guidelines make it very clear that the *Shari'ah* board's rulings are considered binding. Therefore, all products or services must be approved by the *Shari'ah* board before they can be offered in the market.

5.2.2.5 Qatar

(a) Regulatory Overview

Qatar celebrated its independence in 1971 with its first Provisional Constitution on 2nd April 1970; this was replaced by the Amended Provisional Constitution of 19th April 1972 (Hamzeh, 1994: 83). Article 1 of the 1972 constitution clearly states that Islamic law is the main source of legislation and Islam is the religion of the state. Although the constitution of Qatar specifically puts *Shari'ah* as a main source of legislation, nevertheless in the aspect of commercial transactions, *Shari'ah* is acceptable as one of the main sources of legislation but not as a primary consideration.¹⁸¹ Moreover, there is a

¹⁸⁰ This committee consists of three members; two of them are *Shari'ah* board members (one of them is a committee chairman) and the third is the general secretary of the *Shari'ah* board. This executive committee will then have to submit its reports to the *Shari'ah* board (Al Rajhi, 2008).

¹⁸¹ In the case of *Ruler of Qatar v International Marine Oil Company Limited* (1953) 20 ILR 534, the arbitrator rejected the application of Islamic law as the proper law of the Concession Agreement, despite its acknowledgment of Islamic law as a source of legislation. It was decided that Islamic law is inappropriate to govern modern oil concessions. Ballantyne (1987: 16–17) claims that the true reason behind this case was not because Islamic law was inappropriate but that the concession agreement was full of irregularities that would make it invalid.

contradiction between the Qatar Civil and Commercial Codes and its constitution.¹⁸² For instance, article 4 of the Civil and Commercial Code states that *Shari‘ah* shall apply in the absence of express legislation provision or custom (Ballantyne, 1985: 9).

This position puts *Shari‘ah* as a secondary source of legislation with respect to commercial transactions, which contradicts Article 7 of the constitution. In view of the similar situations that happened in Kuwait, the UAE and Bahrain, it is presumed that the Qatar Civil and Commercial Code is excluded from the application of Article 7 and hence permits interest-based transactions in Qatar’s financial sector. In fact, Law No 7 of 1973, amended by Law No. 7 of 1975, granted power to the Qatar Monetary Agency to determine the interest rates on deposits and loans. The government of Qatar then established the Qatar Central Bank (QCB) that inherited all functions of the Qatar Monetary Agency in 2006 by Decree Law No. 33 of the Banking Law of Qatar 2006 (Ross, 2008: 134). The QCB is the regulatory body that supervises and manages the financial sector in Qatar, while the Doha Securities Market serves as the securities market regulator. The judicial system of Qatar has the civil court hearing cases pertaining to commercial, banking and finance disputes.

In early 2005, the government of Qatar established the Qatar Financial Centre (QFC), with the purpose of creating an independent regulatory body for the financial sector, and the Qatar Financial Markets Authority (QFMA) to manage the securities market (QFC, 2010a). The establishment of the QFC was regulated by the QFC Law (Law No. 7 of 2005) and the QFMA by Law No. 33, where both laws are regarded as the main legislation governing the basic construction of the QFC. The QFC Law establishes four different independent bodies, namely the QFC Authority, the QFC Regulatory Authority, the Appeals Body and the QFC Tribunal. The QFC has the power to regulate the financial sector, including Islamic financial business. As the QFC is inspired by the DIFC model

¹⁸² It is reported that, since the 1960s, the application of Islamic law in Qatar has been confined to family and personal matters, such as marriage, divorce and inheritance. Hamzeh (1994: 79–90) describes the development of the Qatar legal system in three different stages, namely tribal law, Islamic law and modern law.

that has separate judicial and federal systems, the QFC also has its own civil and commercial court and regulatory tribunal as part of its legal infrastructure.

In parallel with the expansion of Islamic banking in Qatar’s financial market, the QFC Regulatory Authority issued the Islamic Finance Rule Book 2007 (ISFI) in July 2007 (QFC, 2010b). The ISFI provides rules and regulations pertaining to Islamic financial business, such the endorsement of IFIs and Islamic windows, disclosure requirements, constitutional documents, systems and control, conduct of business standards, and *Shari‘ah* boards. With the issuance of the ISFI, all IFIs and Islamic windows must comply with the ISFI and they are subject to the supervision of the QFC Regulatory Authority.

(b) *Shari‘ah* Governance

There are two sets of frameworks of *Shari‘ah* governance system for the IFIs in Qatar, namely under the auspices of QCB and the QFC.¹⁸³ The QCB issued prudential regulations for banking supervision known as Instructions to Banks (IB) in March 2008 and Part Seven of the Banking Supervision Instructions provides the guidelines for IFIs. Meanwhile, the QFC has its own rules and regulations pertaining to the *Shari‘ah* governance system, as stipulated in the ISFI.

Chapter 1 of Banking Risk, Credit and Financing Risk of the IB requires IFIs to establish a *Shari‘ah* board. The *Shari‘ah* board must consist of not less than two qualified Muslim members appointed by the BOD and approved by the general assembly. It further states that the *Shari‘ah* board has a duty to supervise activities and to approve products and services. As such, contracts and documentations of any transactions must be ratified by the *Shari‘ah* board. In carrying out this duty, the *Shari‘ah* board shall be assisted by a *Shari‘ah* internal auditor and the *Shari‘ah* audit report shall be submitted to the *Shari‘ah*

¹⁸³ IFIs in Qatar must also comply with the regulations pertaining to corporate governance, such as the Commercial Companies Law No. 5 of 2002 (CCL). The CCL mainly provides guidelines for management and control of Qatari companies in terms of transparency and disclosure as part of its corporate governance measures (Ross, 2008: 146).

board. For purpose of standardization of practice, the IB requires the IFIs to adopt the AAOIFI governance standards.

The IB contains two unique features which differentiate its position from other *Shari‘ah* governance frameworks. Firstly, the IB restricts the *Shari‘ah* board members to receive credit facilities for commercial purposes (QFC, 2009: 160). This position raises an issue as to the reasonability of such a restriction. If the purpose of such a restriction is to ensure the independence of the *Shari‘ah* board and to avoid conflict of interest, the prohibition should include receiving credit facilities for both personal and commercial purposes. Secondly, the IFIs are required to appoint directors and senior management who are highly qualified, experienced and trained in the field of Islamic financial services (QFC, 2009: 197). This is a unique provision which cannot be found in any rules and regulations of other jurisdictions.

The ISFI specifies the *Shari‘ah* governance framework for IFIs registered with the QFC. Section 5 of the ISFI requires IFIs to establish and maintain systems and controls to ensure the *Shari‘ah* compliance of all their Islamic financial business. Section 5.2.1 (1) details this requirement to include the *Shari‘ah* compliance aspect, the *Shari‘ah* board and internal *Shari‘ah* review matters. With respect to *Shari‘ah* governance, section 6 of the ISFI provides a comprehensive provision pertaining to the *Shari‘ah* board. Section 6.1.1 places a mandatory condition on IFIs to establish their own *Shari‘ah* board. Although there is no *Shari‘ah* board at the QCB or the QFC, the government of Qatar has established the Supreme *Shari‘ah* Council attached to the Ministry of Awqaf as the highest *Shari‘ah* authority. The Supreme *Shari‘ah* Council is the final authority in cases of *Shari‘ah* disputes pertaining to Islamic finance.

With regard to the composition of the *Shari‘ah* board, the ISFI includes a condition of a minimum of three members who are appointed by the governing body of the institution. Section 3 of the Interpretation and Application Rulebook 2008 defines the governing body as the BOD, the management or other governing body of an authorized firm. In this

context, the appointment, as well as the dismissal and changes, of the *Shari'ah* board members will be made by the BOD.

In terms of qualifications, the ISFI does not specify the exact criteria for the appointment of *Shari'ah* board members. Section 6.1.1 (B) (ii) mentions that the members appointed must be competent to perform their functions as *Shari'ah* board members by considering their qualifications and previous experience. In addition, the ISFI forbids the *Shari'ah* board members to be appointed as directors or controllers of the IFIs. This restriction is perhaps intended to clarify the role of the *Shari'ah* board members, which is supervisory and advisory in nature. Section 6.1.2 requires IFIs to have a set of policies on the *Shari'ah* board with regard to method of appointment, dismissals, changes and remuneration. The ISFI also makes it compulsory for IFIs to retain records of its assessment of the *Shari'ah* board members and the agreed terms of engagement of each member for at least six years from the date on which the individual ceased to be a member of the *Shari'ah* board.¹⁸⁴

A unique position of the ISFI is that the IFIs have legal responsibilities to take reasonable steps to ensure that the members of the *Shari'ah* board are independent and not subject to any conflict of interest. This position then requires IFIs to provide the QFC Regulatory Authority with information on the qualifications, skills, experience and independence of the *Shari'ah* board. In fact, the ISFI also emphasizes the IFIs' duty to take reasonable measures, to provide assistance to the *Shari'ah* board, and to ensure their right of full access to relevant records and information for the purpose of *Shari'ah* compliance.

The ISFI clearly mentions the requirement for the adoption of the AAOIFI governance standards, particularly in the aspect of the *Shari'ah* review. Section 6.2 requires IFIs to ensure that all *Shari'ah* reviews are undertaken in accordance with the AAOIFI Standards

¹⁸⁴ Section 6.1.4 of the ISFI requires that records of the assessment of competence of *Shari'ah* Supervisory Board members must include at a minimum: (A) the factors that have been taken into account when making the assessment of competence; (B) the qualifications and experience of the *Shari'ah* Supervisory Board members; (C) the basis upon which the Authorized Firm has deemed that the proposed *Shari'ah* Supervisory Board member is suitable; and (D) details of any other *Shari'ah* supervisory boards of which the proposed *Shari'ah* Supervisory Board member is, or has been, a member.

on Governance No. 2 and to submit a *Shari'ah* report as stipulated in the AAOIFI Standards on Governance No. 1. The *Shari'ah* report must be submitted within four months of the financial year end. To complement the process of the *Shari'ah* review in accordance with the AAOIFI Governance standard No. 3, the IFIs must perform an internal *Shari'ah* review to audit the extent to which the IFIs comply with *fatwa*, rulings and guidelines issued by the *Shari'ah* board. The internal *Shari'ah* review should be conducted by the internal audit team and the individuals or departments involved in performing the review must be competent and sufficiently independent to assess compliance with *Shari'ah*.

5.2.3 United Kingdom

(a) Regulatory Overview

The attempt to introduce Islamic financial services to the UK began in the 1980s when Al Barakah Bank endeavoured to form a fully-fledged Islamic bank in 1982 but unfortunately it was forced to close in June 1993 by the Bank of England after failing to satisfy certain requirements of the regulators (Housby, 2005: 69).¹⁸⁵ In 2000, the Bank of England, with the cooperation of HM Treasury, set up a working group to study the feasibility of Islamic finance in the UK. This working group was set up by Sir Edward George, the then Governor of the Bank of England and the members comprised representatives from the Treasury, the Financial Services Authority, the Council of Mortgage Lenders, banks and Muslim organizations including the Muslim Council of Britain (Briault, 2007). Since then several legislative measures have been introduced by HM Treasury in relation to the tax and regulatory systems to enable the development of Islamic finance in the UK and, in August 2004, the first full *Shari'ah*-compliant retail Islamic bank, the Islamic Bank of Britain, was authorized.

According to a report produced by International Financial Services London, at the beginning of 2008 the UK hosted five Islamic banks, more than twenty Islamic windows, one *Takāful* operator, nine fund managers and one *Shari'ah*-compliant hedge fund

¹⁸⁵ This is one the main reasons why the UK authorities are very careful and vigilant in the implementation of Islamic finance in the UK. Despite that, Islamic retail products have been appearing in the UK market since the 1990s (HM Treasury, 2008: 12).

manager (HM Treasury, 2008). In the meantime, the UK authorities have continued to develop Islamic finance in the UK by establishing the Islamic Finance Council based in Scotland in 2005 and a special subgroup in early 2007 to study and produce a strategy for the promotion of the UK as a centre for Islamic financial services.¹⁸⁶ In April 2007, the HM Treasury and the UK Debt Management Office also undertook a feasibility study for sovereign *sukuk* issuance. This positive development further enhances the growth of the Islamic finance industry in the UK and may stimulate its expansion into other European countries.

(b) *Shari‘ah* Governance

Although Islamic banking is considered new to the UK, there is already a well-developed Islamic financial structure and governance framework. Basically, the UK authority implements equal legal treatment and framework for conventional banks and IFIs. With regard to *Shari‘ah* governance, there is no legal requirement for IFIs to establish a *Shari‘ah* board, either at individual bank or national level. The UK authorities nevertheless are concerned with the issue of *Shari‘ah* governance as the FSA mentions that it needs to clarify from financial and operational aspects the role of the *Shari‘ah* board in IFIs (Briault, 2007).

Actually, the major concern of the FSA about *Shari‘ah* governance is whether the *Shari‘ah* board has an executive or directorial role in IFIs. As long as it does not have an executive role, there will be no significant issue from the FSA’s perspective. The practices of the five existing Islamic banks in the UK show that the *Shari‘ah* governance is managed by the individual IFIs and they are free to adopt their own *Shari‘ah* governance without adhering to any national or other higher level of *Shari‘ah* board. HM Treasury clearly mentions that the UK government does not intend to follow the *Shari‘ah* governance approach of other jurisdictions, since the UK authorities are secular bodies and not religious regulators.

¹⁸⁶ This subgroup was set up by UK Trade & Investment (UKTI), through their Financial Services Advisory Board, and consists of fifteen practitioners and representatives from UKTI and HM Treasury and four private sector working groups were set up into another four specific subgroups of Banking & Insurance, Legal, Accountancy, and Education, Training and Qualifications (ETQ) (HM Treasury, 2008: 14).

With respect to the composition of the *Shari‘ah* board, current practice shows that the Islamic Bank of Britain and the European Finance House consist of three *Shari‘ah* advisors, the Bank of London and the Middle East and the European Islamic Bank with four *Shari‘ah* advisors and Gate House Capital with one *Shari‘ah* advisor. The variety of *Shari‘ah* board compositions amongst the IFIs indicates that there are no legal or policy requirements from the FSA or other UK authorities which creates flexibility for the IFIs in the UK to organize and manage their own *Shari‘ah* governance.

The FSA is also concerned about the aspect of confidentiality and the shortage of *Shari‘ah* scholars. Some of the *Shari‘ah* advisors are sitting on more than three different *Shari‘ah* boards at one particular time and this position may raise potential issues of confidentiality and conflict of interest. At the moment, the individual IFIs tackle this issue internally as there is no specific guideline for *Shari‘ah* boards. HM Treasury has, however, highlighted its concern on this aspect by recommending the standardization of products and practices of Islamic finance services. In this regard, the UK government supports the roles played by the international standard-setters, such as the AAOIFI, the IFSB and the IIFM (HM Treasury 2008: 19–25). The standardization of products and practices guarantees the further growth of the Islamic finance industry as it may reduce cost and time, improve documentation and confidence, lessen the burden on *Shari‘ah* scholars (HM Treasury, 2008: 23) and mitigate the potential of *Shari‘ah* risk. In order to address the problem of the shortage of *Shari‘ah* scholars in the UK, the Islamic Finance Council, in collaboration with the Securities and Investment Institute (SII), offers a Scholar Development Programme specifically for *Shari‘ah* advisors or potential *Shari‘ah* scholars. This programme provides a wide range of subjects with knowledge of the conventional system that *Shari‘ah* scholars need to be able to practice in the UK or elsewhere (SII, 2008).

Even though the UK authorities are silent on many aspects of *Shari‘ah* governance, the situation is different in the case of *sukuk*. HM Treasury (2008a: 39) highlights the need for the appointment of internationally recognized *Shari‘ah* scholars to ensure *Shari‘ah*

compliance of the Government Sterling *Sukuk* Issuance. Furthermore, there was a suggestion to incorporate British *Shari‘ah* scholars onto the board to approve the *sukuk* issuance (HM Treasury, 2008a: 24). This position indicates that the UK authorities have started to look into a possible framework of *Shari‘ah* governance. It is expected that the growth of the Islamic finance industry, in parallel with the sophistication of its products, may force the UK authorities to consider introducing a comprehensive *Shari‘ah* governance framework in the future, which may be a good model for countries with a non-Islamic legal environment.¹⁸⁷

5.3 Regulatory Issues

Regardless of the positive developments on the *Shari‘ah* governance framework in the case countries, it is observed that there are a few significant regulatory issues which are inherently essential to the *Shari‘ah* governance system, such as the legal status of the *Shari‘ah* pronouncements, court’s jurisdiction, addressing issues on differences of *Shari‘ah* rulings and the *Shari‘ah* board’s advisory and executive roles. This section attempts to highlight these regulatory issues in order to enlighten further discussion on the legal framework of *Shari‘ah* governance.

5.3.1 Legal Status of *Shari‘ah* Pronouncements

One of the debatable issues on *Shari‘ah* governance is the status of *Shari‘ah* rulings. The issue refers to whether the *Shari‘ah* rulings are binding on IFIs, courts or any other related institutions. To illustrate this important issue, we may refer to a survey conducted on the perception of *Shari‘ah* rulings, which found that only 56.6% of IFIs consider *Shari‘ah* rulings to be binding, 20% as merely advisory and 22.4% gave no response (Dawud, 1996: 43). The result of this survey indicates that there are loopholes and shortcomings in the *Shari‘ah* governance framework, particularly in positioning *Shari‘ah* board decisions as binding and mandatory. Ironically, the IFSB survey on *Shari‘ah*

¹⁸⁷ A study conducted by Ahmad and Hassan (2006: 41–57) on the potential for the adoption of the UK regulatory framework for Islamic finance in Australia revealed that the Australian authorities may follow the UK model by passing legislation to strengthen the Islamic financial market, which will enable the Muslim and non-Muslim communities to find viable Islamic finance services.

boards across jurisdictions demonstrates that 60% of respondents agreed that the national *Shari‘ah* authority should be the highest authority in Islamic finance, yet only a few jurisdictions have affirmed this practice (IFSB, 2008b: 18).

With reference to the existing *Shari‘ah* governance framework in some countries, they have already provided clear legal provision on the superiority of *Shari‘ah* board decisions. This is in parallel with the AAOIFI governance standard, which stresses that *fatwa* issued by the *Shari‘ah* board shall be binding and fully enforceable (AAOIFI, 2005: 4). It is a similar situation in the case of the IAIB *Shari‘ah* board as all the board’s decisions for *Shari‘ah* supervision are binding on the banks which are members of the institute (Wilson, 1997: 83–93).

In Malaysia, sections 57 and 58 of the CBA vividly provide clear provision on the status of *Shari‘ah* pronouncements issued, which are binding to IFIs, courts and arbitration. Similarly, in the case of the UAE, by which Article 5 of the Federal Law No. 6 of 1985 provides the establishment of the Higher *Shari‘ah* Authority (HSA) as the final authority in *Shari‘ah* matters pertaining to Islamic banking and finance. All determination and decisions made by the HSA are binding and mandatory to all IFIs in the UAE. Paragraph A (ix) of the Instructions for *Shari‘ah* Compliance in Islamic Banking Institutions makes it clear that all *fatwa* or rulings issued by *Shari‘ah* boards are binding upon IFIs (SBP, 2008: 1). While the legal frameworks of Malaysia, the UAE and Pakistan have provided clear positions on *Shari‘ah* rulings, the situation is different in other countries such as the UK, Saudi Arabia, Kuwait, Qatar and Bahrain, since the status of *Shari‘ah* pronouncements is still ambiguous.

In light of the above, laws and legal arrangements in certain jurisdictions, such as the UAE and Malaysia, seem capable of providing a clear position on the status of the *Shari‘ah* board decisions to be binding and mandatory, whereas in many other countries the situation is otherwise. With this in mind, there must be a practical solution to resolve the issue by examining and studying the respective countries’ legal environments and

structures.¹⁸⁸ Proactive efforts and continuous endeavours should be carried out to place *Shari‘ah* as the supreme law and authority and to ensure that *Shari‘ah* board rulings are binding and mandatory upon the IFIs, the arbitrators and the courts of justice.

5.3.2 Court Jurisdiction

Section 5.2 clearly explains that Islamic finance cases often fall under the jurisdiction of non-*Shari‘ah* courts, as in the cases of Malaysia, Kuwait, Qatar, the UAE, Bahrain, the UK and the BDS in Saudi Arabia. Basically, this is not appropriate, since Islamic finance is part of Islamic law and ideally it should be under the jurisdiction of a *Shari‘ah* court in, which does not happen in some jurisdictions, particularly the UK. In this instance, two issues might be significant in respect to the *Shari‘ah* governance system, peculiarly judges' ability to decide Islamic finance cases and to what extent the judges' attitude is to refer Islamic finance disputes to a *Shari‘ah* board for deliberation.

The significance of the former issue can be illustrated in the case of *Arab Finance Malaysia Berhad v Taman Ihsan Jaya and Ors* (2008) 5 MLJ, in which the High Court ruled that the profit derived from the BBA facility was unlawful and illegitimate as it involved an element of interest and therefore IFIs may only claim the principal amount of financing. This judgment will seriously affect the Islamic finance industry in Malaysia as the BBA represents more than 80% of total financing in Malaysia. By referring to the inadequate arguments of the learned judge, particularly in explaining *riba* and elaborating the BBA from a *Shari‘ah* point of view, it indicates that the court may need the deliberation of an expert who specializes in *Shari‘ah*, particularly *fiqh al muāmalāt*. In this context the *Shari‘ah* board is the ideal institution to be referred to by the court. Hitherto, after more than a decade of the implementation of Islamic finance with

¹⁸⁸ It is worth noting the recommendations of the Council of Islamic Fiqh Academy for the purpose of *Shari‘ah* enforcement in its Fifth Meeting in Kuwait in 1988. The council provides five recommendations to solve the problem of enforcing the *Shari‘ah* rules namely: to continuously conduct thorough and comprehensive research relating to the issue of *Shari‘ah* enforcement; to ensure coordination between the council and other scientific institutions entrusted with the enforcement of *Shari‘ah* rules; to collect bills relating to Islamic law from Islamic countries and to benefit from them; to urge for the reform of education programmes and various means of communication in order to mobilize them towards the enforcement of *Shari‘ah*; and to widen the training ground of research in order to prepare human resources for the application of *Shari‘ah* (IFA and IRTI, 2000: 96–97).

numerous cases reported, there was only one case the court has referred to a *Shari‘ah* board. This indicates the court’s passive attitude towards having the deliberation of a *Shari‘ah* board pertaining to *Shari‘ah* matters involving Islamic finance cases, in spite of its limited knowledge of the subject.

5.3.3 Addressing Issues of Differences of *Shari‘ah* Resolution

The absence of a comprehensive set of regulatory frameworks on *Shari‘ah* governance may cause problems to the development of Islamic finance. The issue on the differences of various *fatwa* rulings¹⁸⁹ amongst the *Shari‘ah* boards may affect Islamic finance, especially when it involves international entities and cross-border transactions. The IFSB survey indicates the low percentage of reconciled *Shari‘ah* issues pertaining to different *Shari‘ah* resolutions in which Bahrain, Bangladesh, Indonesia and Sudan indicate issue resolution of less than 20%, the UAE slightly more than 20%, and Malaysia 40% (IFSB, 2008b: 42). This crucial finding denotes that most of the *Shari‘ah* issues related to resolution of *Shari‘ah* differences are not reconciled in many countries.

The diversity of interpretation of *Shari‘ah* may affect the determination of certain rulings on particular issues, where one IFI would accept a new product as being *Shari‘ah*-compliant while others would decide it is non-compliant (McMillen, 2006: 139–140). To tackle this issue, there are a few approaches that can be possibly implemented and these include establishing a *Shari‘ah* board at national level, providing legal provision on the final authority of the *Shari‘ah* board rulings, allowing interdisciplinary experts to be appointed as *Shari‘ah* board members, and issuing universal *Shari‘ah* prudential standards.

In the case of conflict of opinions amongst members of the *Shari‘ah* boards in Kuwait, the BOD of the designated IFIs may transfer the matter to the *Fatwa* Board in the Ministry of Awqaf and Islamic Affairs and the *Fatwa* Board shall be the final authority on the matter (Article 93 of the CBK Law 32/1968). Similarly in Malaysia, section 51 of the

¹⁸⁹ Sheikh Mohammed Taqi Usmani claims that there has been near consensus amongst the *Shari‘ah* scholars on *Shari‘ah* related issues in Islamic banking and finance and only about 10% of disputed opinions which are yet to be resolved (New Horizon, 2004: 15). According to the CIBAFI, who sampled about 6,000 *fatwa*, it was found that 90% were consistent across the IFIs (Grais and Pellegrini, 2006: 11).

CBA grants the power to the SAC as the sole *Shari'ah* authority that will be referred to by the court or arbitrator in disputes involving *Shari'ah* issues in Islamic banking, finance and *takāful* cases. In Pakistan, the Instructions for *Shari'ah* Compliance in Islamic Banking Institutions provides that, in the case of difference of opinion arising between *Shari'ah* boards of IFIs, the matter shall be referred to the SBP *Shari'ah* board and any deliberation made by them board shall be final and binding (SBP, 2008: 3).

Another possible approach to address the issue of various legal opinions is to allow interdisciplinary experts or professionals to be appointed as *Shari'ah* board members. A combination of interdisciplinary experts in the composition of a *Shari'ah* board may enable the board to come out with more integrated *Shari'ah* rulings. For instance, the *Shari'ah* board members of the BNM consist of *Shari'ah* scholars, chartered accountants, lawyers, judges¹⁹⁰ and central bankers. This approach is preferable because any issues discussed in the *Shari'ah* board deal not only with *Shari'ah* matters but also legal and financial aspects.

It is also crucial to see some uniformity and standards are set to ensure that the differences of legal opinion are addressed effectively. In this respect, the issuance of *Shari'ah* standards is really necessary with the purpose of bringing diverse *Shari'ah* opinions to a universally acceptable practice. The AAOIFI *Shari'ah* standards nevertheless have been adopted by only a few countries since the standards are not made obligatory except in Bahrain, Jordan, Sudan, Qatar and Dubai. The standards are used as guidelines in Saudi Arabia, Kuwait, Malaysia, Lebanon and Indonesia. It is expected that numerous IFIs will adopt the AAOIFI *Shari'ah* standards in order to address any *Shari'ah* issues arising from differences in *Shari'ah* rulings.

5.3.4 Executive, Advisory and Supervisory Roles of the *Shari'ah* Board

The *Shari'ah* board plays a significant role in ensuring *Shari'ah* compliance in all products, transactions and operations of IFIs. The issue here is whether the *Shari'ah*

¹⁹⁰ On 1st November 2004 the BNM appointed Tun Abdul Hamid Haji Mohamad, then Chief Justice of Malaysia, as a member of the National *Shari'ah* Advisory Council for Islamic Banking and *Takāful* (New Horizon, 2005: 5).

board has an executive role in exercising its power or whether it is just an advisory authority. This issue is very significant, especially in non-Islamic legal environments such as the UK, where the FSA has a standard requirement to authorize a person to be a director who has an executive role in the company. There are two main consequences if *Shari‘ah* board members are seen to have executive power or a directorship role in IFIs in the UK, i.e. it is possible that many *Shari‘ah* scholars may not meet the fit and proper criteria required by the FSA and the existing practice of multiple membership of *Shari‘ah* boards in various IFIs may be considered as contrary to the rule of conflict of interest (Ainley et al., 2007: 13). At the moment, there is no controversial issue on this matter since the FSA’s perspective of the role of the *Shari‘ah* board is that it is advisory and the board does not interfere in the management of the IFI.¹⁹¹ It is assumed that potential conflict is likely to exist due to the increasing numbers of *Shari‘ah* boards in IFIs and the rapid growth of the Islamic finance industry in the UK¹⁹² and Europe.

On the other hand, if the role and responsibilities of the *Shari‘ah* board are considered neither executive nor supervisory but merely advisory, it raises another significant issue as to the actual function of the *Shari‘ah* board and to what extent its deliberations bind the IFIs. If it is merely advisory, the IFIs may ignore the decisions made by the *Shari‘ah* board since it does not have the authority to enforce its deliberations. It gives the impression that the decisions made by the *Shari‘ah* board are not binding upon the court or the respective IFIs or even in alternative dispute resolution such as arbitration. In fact, the absence of a supervisory role for the *Shari‘ah* board may negate the efficiency of *ex post* monitoring of *Shari‘ah* compliance aspects. This issue hence needs proper deliberation and indeed the *Shari‘ah* board must be given full authority to have supervisory and advisory roles that address the *Shari‘ah* compliance aspects of IFIs.

¹⁹¹ The FSA considers that the *Shari‘ah* board has an advisory role based on the existing governance structure, reporting lines, fee structure and the terms and conditions of the *Shari‘ah* boards of IFIs in the UK (Ainley et al., 2007: 13–14).

¹⁹² Kahf (1999: 454) mentions that the failure of Al Barakah Bank in London to clearly clarify the relationship of its management and *Shari‘ah* board to the Bank of England is one of the factors that contributed to its closure in 1995.

5.4 Conclusion

The *Shari‘ah* governance system in Malaysia, GCC Countries and the UK can be classified into two types, namely regulated via legal and supervisory requirements, as in the cases of Malaysia, Bahrain, Kuwait, the UAE and Qatar, or through self-regulation, as in the cases of Saudi Arabia and the UK. In terms of classification from a regulatory perspective, Malaysia is identified as strong proponent of a ‘regulatory-based approach’, Bahrain, Kuwait, the UAE and Qatar as a ‘minimalist approach’, Saudi Arabia as a ‘passive approach’ and the UK as a ‘reactive approach’. In view of numerous legal issues involved in the existing *Shari‘ah* governance framework, the need to have a comprehensive legal framework and an effective *Shari‘ah* governance system is really crucial. Failure to provide efficient *Shari‘ah* governance either through law or legislation on the part of regulators and the players would impede the future development of the Islamic finance industry.

In this aspect, the AAOIFI *Shari‘ah* standards are an important effort to standardize *Shari‘ah* practices, while the IFSB guidelines on governance would be able to guide and promote the best practice of a *Shari‘ah* governance system. Referring to the diverse perception and acceptability of the AAOIFI standards and IFSB guidelines, there must be strong mechanisms to guarantee their universal adoption and one of them is through having a proper legal framework. For this purpose, thorough and intense studies need to be conducted to examine, analyse and scrutinize the possible adaptation of the AAOIFI standards and the IFSB guidelines in various markets and legal environments.

The foregoing discussion seems to suggest that the existing regulatory framework of *Shari‘ah* governance needs further enhancement and improvement in order to reinforce the development and growth of the Islamic finance industry. This brings into focus the measures and efforts that need to be taken to strengthen the IFIs through enhancing the *Shari‘ah* governance framework. It is important that some common and fundamental legal elements underlying and promoting good governance and best practices are to be drawn up to facilitate the creation of and optimize a healthy and viable environment for *Shari‘ah* governance without impeding the further growth of the industry.

CHAPTER 6

RESEARCH METHODOLOGY

6.0 Introduction

Selection of appropriate research methodology is a prerequisite for good research, whether social or scientific. It is also imperative for the purpose of ensuring the originality and quality of the research. Philip and Pugh (1994: 61) provide guidelines on the originality of work within the context of PhD research and these include carrying out empirical work that has not been done before, making new interpretations of existing material, introducing substantial new evidence to old issues, being cross-disciplinary and using different methodologies, and studying something in a particular area that has not been carried out in that area before. In view of these guidelines and to ensure the originality and quality of the research, the researcher employed triangulation research methods to carry out the study.

The researcher humbly claims that this study is indeed original, since the empirical work in this research is conducted in different countries with a mixed method approach, which represents the research's distinctiveness and uniqueness. In fact, the study offers a new interpretation of the existing secondary data as well as the primary sources that significantly introduce substantial new evidence and findings that would be beneficial for players in the Islamic finance industry, including policymakers and regulators to enhance and improve the *Shari‘ah* governance framework. This chapter hence aims at providing elaboration and embellishment on the research methodology used in this study. It explains specific methods of data collection and data analysis including research design, reliability and validity, data collection, sampling and data analysis methodology. Apart from that, this chapter also provides detailed information about the research instruments, the process of data collection and data analysis approaches. In summary, the overall research processes are illustrated and explained in this chapter, which attempts to demonstrate the quality and originality of the study.

6.1 Research Methodology

Research methodology refers to “a way of thinking about and studying social reality” (Strauss and Corbin, 1998: 3). The term ‘methodology’ may be taken to be inclusive of “research design, theoretical frameworks, the selection and analysis of literature, and justified preferences for particular types of data gathering activities” (Murray and Lawrence, 2000: 218).

In the social sciences, there are two main types of research methodologies, namely quantitative and qualitative. Quantitative research methodology is mainly deductive and it emphasizes procedures and statistical measures of validity (Frankfort-Nachmias and Nachmias, 1996: 554). On the other hand, qualitative research methodology usually emphasizes words rather than quantification in the collection and analysis of data (Bryman, 2001: 264). Frankfort-Nachmias and Nachmias (1996: 554) view that, unlike quantitative methodology, the qualitative approach is inductive and descriptive in character and involves participant observations, case studies and fieldwork research methods. At this point, it is clear that the qualitative approach is useful to indicate as to “how the observation prompted the study to analyze and isolate variables (induction) and how in turn these variables may be developed into a theory” (Frankfort-Nachmias and Nachmias, 1996: 554).

It is important to note that, although qualitative research is mostly concerned with the generation of theories, there are qualitative studies that have been employed to test the theories rather than to generate them (Bryman, 2001: 21). With this motivation, this study employed qualitative research methodology to answer the research questions and to test the hypothesis formulated from the literature review. Since this study is classified as social research, the researcher considers that the qualitative research approach is an appropriate methodology to ensure the originality and quality of the study. It is also important to state that this research is mainly based on primary data gathered through questionnaires and interviews, which reveals the perceptions and opinions of the participants. This hence implies also that it should be considered as a qualitative research. The researcher also chose a qualitative methodology on the basis that it requires

fieldwork and empirical study to analyse the perceptions, opinions and practices of the research participants. In fact, a qualitative methodology would be able to meet the research aims, questions and objectives in view of the small sample size and scarce information as well as offer reliable findings on the area of study (Silverman, 2004: 6).

6.2 Research Design

With regard to research strategies, there are six major strategies in the mixed-method approach, namely sequential explanatory strategy, sequential exploratory strategy, sequential transformative strategy, concurrent explanatory strategy, concurrent exploratory strategy and concurrent transformative strategy (Creswell, 2003: 215). This study used the sequential exploratory strategy to gather data and information; this involved two phases, with the priority given to the qualitative data collection and analysis, which was then followed by a phase of quantitative data collection and analysis (Creswell, 2003: 215). In terms of data collection and analysis, several instruments were used to ensure the validity and reliability of the data.

Preliminarily, the study utilized a descriptive research method in collecting secondary data and information for the literature review. The study chose a theoretical and methodological rather than an integrative form of literature review. In these forms of literature review, the researcher focuses on the theoretical aspects and conceptual frameworks that relate to the issues involved in the study (Creswell, 2003: 32). The literature review was conducted intensively and critically to justify the viability of the research topic as well as to identify gaps and issues related with the research. Since the availability of primary data on the research topic is very limited, this study used questionnaires to generate data and feedback from the research participants. In the light of several weaknesses and disadvantages of the questionnaires, this study also conducted semi-structured interviews and content analysis methods in order to provide additional evidence and to strengthen the justification of the research findings. In the content analysis approach, the researcher developed disclosure indices to generate and interpret data derived from secondary sources, namely websites, annual reports and financial statements.

6.3 Research Methods

A research method is a technique and procedure used for data collection and analysis (Cohen, Manion and Morrison, 2007: 47). There are two main types of research method, namely qualitative and quantitative; the former mainly refers to a research strategy that emphasizes words and has non-numerical characteristics, whereas the latter emphasizes quantification in the collection and analysis of data (Bryman, 2001: 20). This study employed both quantitative and qualitative research methods in collecting and analysing the qualitative and quantitative data known as triangulation, multiple methods and mixed methods. Creswell (2003: 19–20) defines mixed methods as “strategies of inquiry that involve collecting data either simultaneously or sequentially”, which normally involves gathering both numeric and textual data in which the findings represent both quantitative and qualitative information.

Madey (1982) notes that the mixed-method approach is very useful, particularly to “assist the researcher to develop a conceptual framework, to validate quantitative findings and to construct indices from qualitative data that can be used to analyze qualitative data” (Onwuegbuzie and Leech, 2005: 384). It also enhances the credibility of the research account by providing an additional way of generating evidence to support the research findings (Seale, 1999: 53–72). Axxin and Pearce (2006: 2) add that a mixed-method strategy enables the study to develop a comprehensive empirical record and to counterbalance the strengths and weaknesses of other research methods. Bryman (2001: 449–450) uses the term triangulation to explain the mixed-method approach and views that qualitative research facilitates quantitative research and vice versa in terms of providing hypotheses and aiding measurements. Realizing these advantages, the research adopted a mixed-method approach that would be able to verify the findings from one method to another.

6.4 Data Collection Methods

6.4.1 Questionnaire

A questionnaire is a self-administered interview, which requires self-explanatory instructions and question design (Smith, 1981: 153). It is very useful in qualitative research as an effective tool for data collection and serves the function of measurement (Oppenheim, 1992: 100). Since this study is exploratory in character, and with the view of the scarcity of the primary data on the research topic, the study employed the survey method to generate fresh data to answer the research hypothesis and questions.

Simon (1969: 242–244) discusses the advantages and disadvantages of the survey method. This method is often used in social research studies and has remained the preferable way of retrieving information about the respondents' background, history and perceptions, as well as being able to provide techniques for the study of attitudes, belief and motives (Simon, 1969: 244–248). It is also preferable because it has high amounts of data standardization due to its data and collection efficiency (Smith, 1981: 184–186). On the basis that the advantages of survey questionnaires overwhelm the disadvantages, the study chose this approach to generate the primary data that would be able to fulfil the research aim and objectives.

6.4.1.1 Questionnaire Design

The questionnaire design is important to determine and shape the research data and information. There are two main types of survey questions, namely open-ended questions that leave the respondent free to respond in an unrestricted manner and closed-ended question that restrict the choice of responses by providing answers in terms of given categories or alternatives (Frankfort-Nachmias and Nachmias, 1996: 253–254). The survey questions in this study were designed to be closed-ended and specific enough to reveal all the desired answers from the research participants.

In designing the questionnaires, the researcher first developed research questions based on the gaps analysed from the literature review. After identifying the gaps and issues on

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the research topic, six hypotheses were formulated. From these hypotheses, fifty survey questions were generated to specifically answer all of the research questions. With the purpose of improving the quality and viability of the survey questions, the study relied on several international guidelines and standards on corporate governance and *Shari'ah* governance including the OECD Principles of Corporate Governance, Guidance by the BCBS on Enhancing Corporate Governance for Banking Organizations, the AAOIFI governance standards and the IFSB-3, the IFSB-5 and the IFSB-10.

Several approaches were taken to ensure the clarity and readability of the survey questions. Firstly, the sentence structure of the survey questions was kept simple and fewer than twenty words long. Secondly, comments and feedback from colleagues and experts were obtained to ensure that the survey questionnaires were clear and precise as well as to mitigate the potential for errors and misleading questions. Thirdly, the survey questions were divided into six sections and each question contained only one research issue. Finally, the survey questions were structured in a way so that the respondents would be able to answer them by clicking the appropriate box in the survey form. These processes are imperative not only to ensure the readability of the survey questions but to minimize any potential for invalidity or unreliability of the data collected.

6.4.1.2 Layout of the Questionnaires

The formulation of proper research questions and an accurate layout of the questionnaires will improve the quality of the responses. The study developed six research questions on the basis of identified issues and gaps analysed in the literature review. The survey questions were then structured in a way that would be able to meet all of the research objectives which are as follows:

Table 6.1: The Linkage between the Questions and Research Objectives

Questions Linked to Objectives	Questions
i. To investigate the different approaches of IFIs to <i>Shari‘ah</i> governance	Q1–Q7
ii. To study the regulatory framework and internal policies or by-laws* of <i>Shari‘ah</i> governance in IFIs	Q8–Q11
iii. To examine the roles and functions of the <i>Shari‘ah</i> board in IFIs	Q12–Q15
iv. To examine the attributes of <i>Shari‘ah</i> board members on independence, competence and transparency, and confidentiality	Independence: Q16–Q23 Competence: Q24–Q29 Transparency and confidentiality: Q30–Q33
v. To examine the operational procedures of <i>Shari‘ah</i> governance in IFIs	Q34–Q45
vi. To investigate the perception of IFIs of the <i>Shari‘ah</i> board’s performance	Q46–Q50

The layout of the questionnaire is very important for both research participants and the researcher. As to the research participants, proper layout of the questionnaire enables them to understand the objectives, topics and survey questions of the research, while for the researcher, it guarantees the quality and quantity of the data and information. In this aspect, the researcher used unambiguous and brief survey questions and each question covered only one issue. The survey was divided into six sections consisting of the general approach to *Shari‘ah* governance, regulatory and internal frameworks, roles of the *Shari‘ah* board, attributes of the *Shari‘ah* board with regards competence, independence, disclosure and transparency, operational procedures, and the *Shari‘ah* board’s assessment. These sections represent the main elements of a sound and proper *Shari‘ah* governance system, as laid down by the AAOIFI governance standards and the IFSB-10.

With regard to the types of survey questions, two types of survey question, namely open-ended and closed-ended, are commonly used in survey questionnaires. As part of the research strategy to improve the response rate and feedback from the respondents, all the survey questions were drafted and structured as closed-ended questions. Closed-ended questions can be further classified into Likert scale, multiple choice questions, ordinal

* By-laws refer to the constitutive documents and any other documents that establish corporate policies and these include rules and regulation pertaining *Shari‘ah* governance.

questions, categorical questions and numerical questions. Sections 1–7 of the survey questionnaires utilized categorical questions, which requested answers from explicitly mentioned answer categories (Saris and Gallholfer, 2007: 126). An additional remarks column was provided in the survey questionnaire in order to enable the respondents to highlight or to comment on the survey questions. While sections 1–7 used categorical questions, section 8 utilized ordinal questions, where answers were to be ranked in order (Strongly Disagree, Disagree, Neutral, Agree and Strongly Agree) to measure the general perception of IFIs on the *Shari‘ah* board’s performance. In summary, the survey questions were meticulously prepared and organized by taking into account all relevant factors that may improve the validity, practicability and reliability of the data collected as well as the research findings.

6.4.1.3 Validity and Reliability

There are various potential errors that could happen while carrying out the research process. These potential errors may lead to the invalidity or unreliability of the data acquisition, data processing analysis and interpretation of the research findings. In this regard, validity and reliability are important to determine whether the findings are accurate from the viewpoint of researcher, the research participants and the readers of an account (Creswell, 2003: 195–196). Basically, reliability is concerned with issues of consistency of measures and validity refers to the issue of whether an indicator that is devised to gauge a concept really measures that concept (Bryman, 2001: 72). The study seriously took into account the validity and reliability aspects of the research.

In terms of validity, the researcher used the construct validity method (Bryman, 2001: 72–73). The study minimized invalidity at the design stage by carefully scrutinizing the selection of methodologies for answering the questions and instrumentation for gathering the data. The extent of validity then was managed through a process of careful sampling and appropriate instrumentation by using a simple statistical analysis of the data. At the stage of data gathering, in view of the impossibility of getting a 100% response rate, the researcher took several steps to improve the research participants’ feedback by sending ordinary mail and email reminder notices as well as following up with a personal

telephone call (Cohen et al., 2007: 144). All of these measures would be able to ensure the validity of the research data and findings.

6.4.1.4 Administration of the Questionnaire

The process of data collection involves several exercises and instruments. The survey questionnaires used mixed-mode data collection and instruments to improve the response rate and these included ordinary mail surveys, email surveys, telephone interviews and self-administered questionnaires. The telephone interviews, ordinary mail surveys and email surveys are much more preferable ways of data collection as they are convenient and produce a significant cost and time saving (Saris and Gallholfer, 2007: 165). Despite the advantages of these instruments, it was found that not all respondents were willing to respond and give feedback via ordinary mail, email or telephone. As such, personal interviews were also conducted in order to get responses from some respondents who preferred to be interviewed personally. Nevertheless, most of the survey questionnaires were distributed through ordinary mail and email and only a few respondents were personally interviewed because of cost and time factors.

Cover letters and follow-up letters or reminder notices are other important instruments that can be used to improve the response rate of survey questionnaires. The need for these is not a new phenomenon as some researchers have already reported that responses rates to social surveys are declining in many countries (Bryman, 2001: 95). Realizing this, the researcher issued a specific cover letter attached together with the survey questionnaire to all the research participants. This cover letter contained several essential points and explanations about the research including the purpose of the survey, the potential value of the research, the importance and benefit of the research, the simplicity of the survey questions, an assurance of confidentiality and a note of appreciation (Cohen et al., 2007: 339). On top of that, three reminders were sent out to respondents by ordinary mail and email as well as following up with personal telephone call. Accurate and precise information in the cover letter and appropriate reminder notices and follow-up letters will help the respondents to really understand and appreciate the importance and significance of the research and therefore will improve the response rate of the survey.

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Since the survey target group was internal *Shari‘ah* officers or compliance officers in *Shari‘ah* departments, the survey was only distributed to IFIs’ head offices, therefore excluding the participation of branches. The researcher began the survey in the UAE when he was offered a position as an intern in the Dubai International Financial Centre and this was followed by Malaysia and the UK respectively. In the UAE and Malaysia, the researcher conducted personal interviews as well as distributing the questionnaires by ordinary mail and email. As to the other GCC countries, namely Saudi Arabia, Qatar, Kuwait and Bahrain and the UK, only ordinary mail and email instruments were used to get feedback from the respondents.

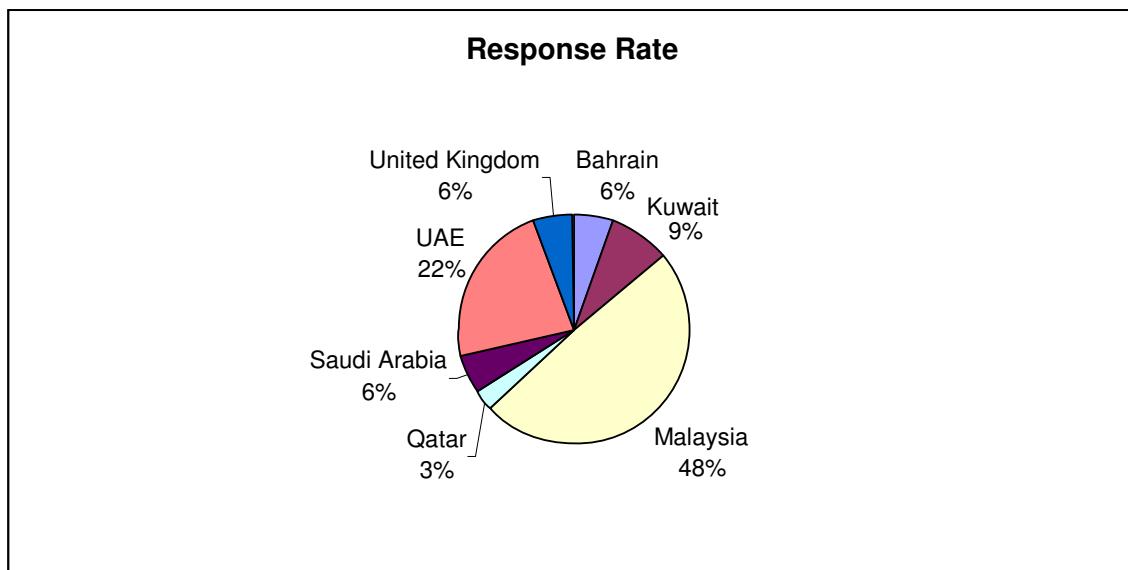
6.4.1.5 Response Rate

Since the availability of secondary data on *Shari‘ah* governance practices is very limited, a detailed survey questionnaire was generated in order to source primary data from IFIs, excluding Islamic insurance institutions. The survey was distributed to eighty IFIs in Malaysia (20), GCC countries (Bahrain 12, the UAE 13, Qatar 10, Kuwait 10 and Saudi Arabia 9) and the UK (6).

The response rate of 43.8% out of eighty IFIs is relatively satisfactory and significant. This is affirmed by Sekaran (2003: 237), who considers that a response rate of 30% is acceptable. The survey was launched on 1st April 2009 and ended on 1st June 2009 and the timeline for the survey was extended to 30th December 2009 due to the small response rate. In view of the difficulties in getting responses from the industry players and practitioners due to some inherent factors, the feedback of thirty-five IFIs from Malaysia, GCC countries and the UK is considered significant and acceptable for this research.¹⁹³ Figure 6.1 illustrates the percentage of the response rate according to the case countries.

¹⁹³ This is affirmed by other surveys such as Chapra and Ahmed (2002), where the response rate of the study was only 23.3% (fourteen IFIs out of sixty). A study conducted by Aboumouamer (1996) demonstrated a very minimal response rate where only fifteen IFIs from twenty different countries participated in the survey. In addition, only sixty-nine IFIs from eleven countries responded to the IFSB Survey on *Shari‘ah* Boards of Institutions Offering Islamic Financial Services across Jurisdictions, despite getting special assistance from the IFSB’s full members from fifteen countries (IFSB, 2008b).

Figure 6.1: The Response Rate



6.4.2 Semi-Structured Interview

The interview method is one of the prominent data collection strategies and has been used in a wide variety of social movement studies (Blee and Taylor, 2002: 93). As part of the qualitative research strategies, the study conducted semi-structured interviews with *Shari‘ah* scholars who are members of the *Shari‘ah* boards in IFIs. Unlike structured interviews, semi-structured interviews allow the researcher to vary the sequence of questions as well as to ask further questions whenever he thinks necessary (Bryman, 2001: 110). All interviewees were given the same questions that would be able to answer the research questions of the study. These semi-structured interviews were conducted face to face with the *Shari‘ah* scholars to find out their views and opinions on selected *Shari‘ah* governance issues.

6.4.2.1 Interview Design

There are four types of semi-structured interview, namely oral history interviewing, life history interviewing, focus group interviewing and key informant interviewing (Blee and Taylor, 2002: 105). The study used the key informant interviewing approach in designing the interview questions. In the key informant interviewing method, the study selected the respondents by considering their position, role and willingness to communicate (Blee and

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Taylor, 2002: 105). In this regard, the study chose *Shari‘ah* board members in IFIs, considering their essential functions in *Shari‘ah* governance.

Based on the research questions formulated in this study, the researcher generated nineteen interview questions which are segmented into seven parts. The majority of the questions were open-ended, to which all the interviewees could answer in whatever way they wished; only a few of them were closed-ended. Open-ended questions are very useful in getting clean and unbiased feedback because the interview participants can answer in their own terms, it allows unusual responses to be derived and enables the potential to explore new areas in which the researcher has limited knowledge (Bryman, 2001: 143). The few questions that were closed-ended were for the researcher to confirm and validate certain *Shari‘ah* governance issues with an option for respondents to elaborate their affirmative or negative answers.

Similar to the method used in designing the questionnaires, the study generated nineteen questions which were divided into seven parts to answer the research questions and to fulfil all of the research objectives; they can be summarized as follows:

Table 6.2: The Linkage between the Questions and Research Objectives

Questions Linked to Objectives	Questions
i. To investigate the different approaches of IFIs to <i>Shari‘ah</i> governance	Q1–Q4
ii. To study the internal policy of <i>Shari‘ah</i> governance in IFIs	Q5
iii. To examine the roles and functions of the <i>Shari‘ah</i> board in IFIs	Q6–Q7
iv. To examine the attributes of <i>Shari‘ah</i> board members on independence, competence and transparency, and confidentiality	Independence: Q11–Q12 Competence: Q8–Q10 Transparency and confidentiality: Q13–Q14
v. To examine the operational procedures of <i>Shari‘ah</i> governance in IFIs	Q15–Q17
vi. To investigate the perception of IFIs of the <i>Shari‘ah</i> board’s performance	Q18

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All the interview questions were standardized and drafted in short sentences. Each question represents only one specific issue. This enables the respondents to understand exactly the context of the questions and therefore provide good quality answers. In addition, proper selection of question design is very important for the purpose of processing the data. The study took into consideration this aspect and all questions were generated, structured and arranged in a way that all the data could be analysed easily through a coding and thematic approach.

6.4.2.2 Mitigating Error in Interview

The study used two approaches to reduce the potential for errors during interview, namely the standardization of asking questions and the recording of answers (Sekaran, 2003: 107). The interviewees were given a copy of the interview questions and the researchers posed the questions to them and, if necessary, explained their meanings and objectives. This approach is significant to the validity of the interview findings since it is able to reduce interviewer variability and thereby to mitigate any potential for errors. The study only addressed the issue on intra-interviewer variability and not inter-interviewer variability as the interviews were conducted solely by the researcher.

6.4.2.4 Administration of Interview Survey

The researcher prepared a list of potential respondents consisting of *Shari‘ah* scholars in Malaysia, GCC countries and the UK. Several attempts were made to contact the respondents via email and telephone. Despite numerous problems and constraints in getting *Shari‘ah* scholars for interview, the researcher successfully interviewed fourteen *Shari‘ah* scholars representing IFIs in Malaysia, GCC countries and the UK. Two interviews were conducted in Dubai, one in London and eleven in Kuala Lumpur.

At the beginning of each interview, the researcher introduced himself, explained about the background of the study and stated the purpose and objective of the interview. The researcher also explained the significance of the study and the reason why the respondents had been selected. These modes of interviewing are very useful for

establishing rapport and motivating the respondents to offer quality answers (Sekaran, 2003: 230). In order to reduce potential sources of error, the respondents were given a copy of the questions and the researcher kept exactly to the wording of the questions with some explanations and clarifications.

The researcher employed two methods to record the interviews, namely taking notes and tape recording. As a matter of courtesy, the researcher asked for permission from the respondents to record the interview on tape and if they refused the researcher just made written notes. It is important to record all the answers either in writing or on tape because information recalled from memory is imprecise and likely to be incorrect (Sekaran, 2003: 231). After all of the answers were recorded and gathered, the data was transferred onto the computer in the form of tables and was analysed using a coding and thematic approach.

6.4.3 Unobtrusive Method of Data Collection: Documents

The present study, by nature, is exploratory research to evaluate and measure the level of disclosure of *Shari‘ah* governance practices. An exploratory approach is adopted by analysing information and data available on websites and annual reports as well as the financial statements of IFIs through an unobtrusive method of data collection. Unobtrusive method refers to any method of observation that derives from official statistics and information and these include annual reports, financial statements, websites, media articles and diaries (Bryman, 2001: 209). This unobtrusive method is used in this study as an additional research strategy to basically examine the level of disclosure and transparency of *Shari‘ah* governance through official documents already published by the sampled IFIs. It presents some descriptive data which is not derived or obtained by interview or questionnaire.

By employing the unobtrusive method of data collection, various types of secondary data could be a potential source of information and these include written documents as well as information on websites. This study used annual reports and financial statements as well as websites as sources of information to obtain the desired data and findings. Internet

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communication through websites is now becoming popular as it provides easy access to information (Bondy et al., 2004: 452). In view of the prevalence of information available on the Internet, the examination of websites will make a valuable contribution to the extent of disclosure practice of *Shari‘ah* governance. The study nevertheless was limited to searching databases and information available on IFIs’ websites and knowledge provider websites, such as zawya.com, that provide the researcher with easy access to all necessary documents and materials.

Annual reports of 2007–2008 were also used to obtain the data and information used in this study. In cases where the annual reports were not available, the study referred the financial statements of 2007–2008. The annual reports and financial statements are very useful tools in gaining data and information, while websites provide quick and real time access to information. The study took the initiative to analyse the annual reports and financial statements on top of the websites because more information and data could be extracted from them that would be able to further support and justify the research findings.

The study undertook systematic processes in collecting the data. All the data gathered from these resources was coded and classified as qualitative information. The electronic version of the annual report was downloaded from each IFI’s website. In the case of the absence of annual reports or financial statements on the websites, the researcher downloaded these documents from knowledge provider websites such as zawya.com. If the annual reports and financial statements of IFIs could not be obtained by either means, the researcher either requested a hard copy of these documents from the IFIs or requested them personally at the IFI’s premises.

Sixty-three annual reports and seventeen financial statements out of eighty of the respondents were successfully gathered via these processes. With regard to the websites, all respondents have developed their own websites that helped the researcher to gather and extract the necessary information for the research. The information derived from the websites supports the findings from the annual reports and financial statements. After

collecting and gathering all the data, the reports and information were carefully examined and the relevant pieces of information and disclosure were extracted for each of the six categories of disclosure indicators. The data was then transferred onto the computer in the form of a scoring sheet. Finally, all the data collected and recorded was processed by simple statistical analysis utilizing Microsoft Excel. From this process, histograms, charts, graphs and tables were generated to clearly illustrate the research findings.

6.5 Sampling

Sampling is important in order to make sure that the sample is representative of the population (Sekaran, 2003: 266). The researcher undertook several approaches in selecting and developing an appropriate and valid research sample, including determining the type and size of the sampling and the instruments used to identify the research participants. The aim of this research sampling process is to get an accurate estimate of the population's characteristics from measuring the sample's characteristics (Simon, 1969: 423).

There are two main types of sampling, namely probability and non-probability sampling. This study used non-probability sampling in selecting the research respondents as the sample was selected not in accordance with the rules of probability sampling (Bryman, 2001: 97). There are four main types of non-probability sampling: the convenience sampling that is simply available to the researcher by virtue of its accessibility; the snowball sampling that uses initial contact with a small group of people to establish connections with others; the quota sampling that reflects a population in terms of relative proportions of people in different categories; and the purposeful sampling that identifies a specific group of respondents that would be able to reflect the purpose and objectives of the research (Bryman, 2001: 97–100). This study utilized the method of purposeful sampling, which is a kind of non-probability sampling, in selecting and choosing the research respondents.

Based on the above sampling process, eighty IFIs were selected for the survey and the content analysis approach and fourteen *Shari‘ah* scholars were interviewed in the semi-

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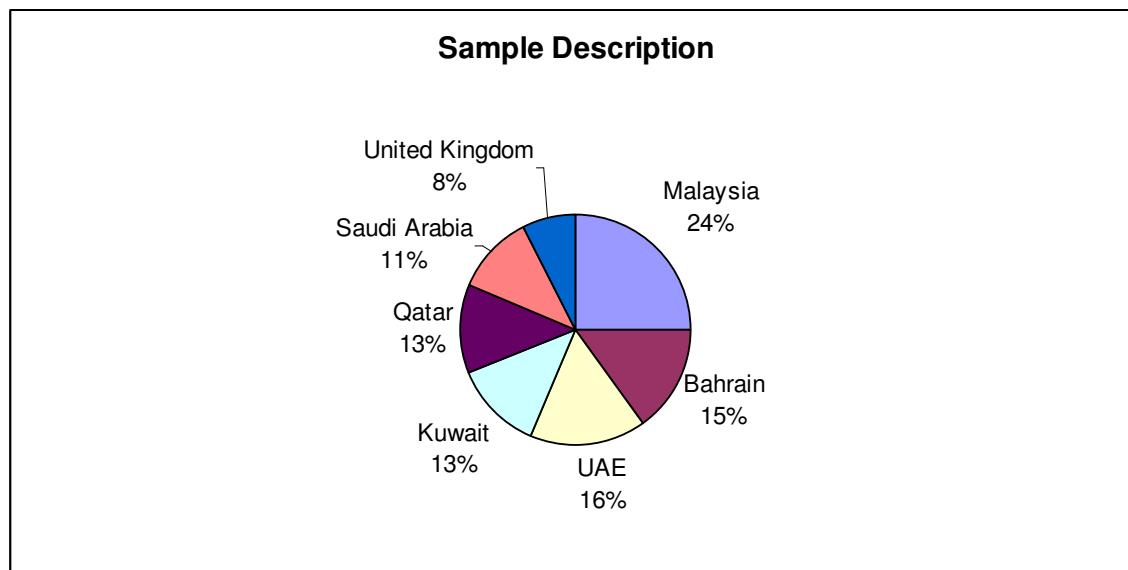
structured interviews. Those eighty IFIs in Malaysia, GCC countries and the UK were chosen from the list of the top 500 financial institutions published by *The Banker*, including the list of IFIs from websites of the respective central banks and regulatory authorities. *The Banker* has published quite a comprehensive analysis of the Islamic finance industry comprising 500 financial institutions from forty-seven countries. From these various lists, the study selected only eighty IFIs from seven countries, namely Malaysia, GCC Countries (Bahrain, the UAE, Qatar, Kuwait and Saudi Arabia) and the UK, consisting of commercial banks, investment banks and asset management companies that offer Islamic financial services and regulatory authorities. *Takāful* operators and mutual funds firms were excluded from the study. The choice of these IFIs was based on the grounds that they significantly represent the Islamic finance industry in the case countries.

With regard to sample size estimation, the study used the Roscoe approach that a sample size of 30–500 is appropriate for most research (Sekaran, 2003: 295). Although the research sample is relatively small in this study, it is sufficient to represent IFIs in the the case countries. In fact, Simon (1969: 423) claims that accuracy is slightly greater in a smaller research sample. Table 6.3 and Figure 6.2 illustrate the research sample descriptions, which are as follows:

Table 6.3: Research Sample

Country	Commercial Bank	Investment Bank/ Asset Management Company	Regulatory Authority	Total
Malaysia	18		2	20
Bahrain	8	4		12
UAE	11	2		13
Kuwait	5	5		10
Qatar	6	4		10
Saudi Arabia	5	4		9
United Kingdom	2	4		6
Total	55	23	2	80

Figure 6.2: Sample Description



Most of the IFIs sampled are fully-fledged Islamic banks (55), followed by investment bank/asset management companies (23) and regulatory authorities (2). Malaysia represents 24% of the overall sample, the UAE 16%, Bahrain 15%, Saudi Arabia 11%, Kuwait and Qatar both 13%, and the UK 8%. The sample of IFIs in this study varied in terms of size and market capitalization and this enabled the study to evaluate and measure the level of transparency and disclosure of *Shari'ah* governance practices within each individual IFI in various jurisdictions of the case countries.

6.6 The Analysis of Data

Valid research findings are not only dependent upon a proper choice of research methodology but also the reliability of the data gathered and the applicability of the statistical tools used (Walker, 1997: 157). This subsection elaborates on the data analysis methodology employed in this study. The data analysis methodology used illustrates the process of giving further meaning to the data gathered from the whole research process and provides justification and verification for the research findings.

6.6.1 Analysis of the Questionnaires

The process of data analysis involves several research exercises. It involves organizing and preparing data analysis, reading through all the data and detailed data analysis

(Cohen et al., 2007: 461). In order to eliminate errors and to reduce deficiencies, the researcher carried out meticulous checking of the responses and feedback so as to ensure that all findings are accurate, valid and reliable.

Data needs to be edited before it can be analysed and this involves a process of coding, categorizing and creating a data file programme (Sekaran, 2003: 301). In the early process of data analysis, the data was organized categorically and chronologically, reviewed repeatedly and continually checked. The researcher then manually keyed the data into the computer in a specific form. This form was specifically designed to ensure that all data gathered was stored, structured and organized efficiently. The information and data were codified in a grid format. In the grid, each row represents each IFI and each column represents specific variables. Since the research sample is relatively small and the data is fairly small in size, the study used Microsoft Excel to process all the information for analysis.

In terms of data analysis presentation, Cohen et al. (2007: 467–472) describe four ways of organizing and presenting data analysis: data presentation by people, either respondents or individuals, data presentation that is relevant to a particular issue, data presentation by instrument, and data presentation by research question. The researcher employed data presentation by research question in organizing the data analysis in this study. This method is very useful to enable the research findings to be clearly and systematically presented.

In analysing the data, the study utilized descriptive analysis and an interpretative method to provide examination of the data derived from the survey. The study also constructed a specific *Shari‘ah* governance index to measure and to quantify the extent of *Shari‘ah* governance practices. This *Shari‘ah* governance index enables the study to rank and rate IFIs according to the level of practices, which either fall into ‘Underdeveloped Practice’, ‘Emerging Practice’, ‘Improved Practice’, ‘Good Practice’ and ‘Best Practice’. With the descriptive analysis, the study illustrates all the research findings with frequency of distribution, histograms and bar charts. Cross-tabulation is used to answer the research

questions and discover the significant differences in respondents' answers. In addition, the interpretative method is utilized to provide further meaning to the data as part of the qualitative analysis. To provide integrated and comprehensive data analysis, both descriptive and interpretative approaches are employed by highlighting the aggregate behavioural responses as well country-specific behaviour responses of the research.

6.6.2 Analysis of the Semi-Structured Interviews

Interpretation of the semi-structured interviews involved several research processes and these included transferring answers on to the computer, search and extraction of the answers, pattern identification and highlighting important themes in the answers. In analysing the data, the study employed systematic procedures of coding and categorizing (Blee and Taylor, 2002: 111). The process of coding and categorizing was done systematically in a specific format on the computer.

In the coding process, all the answers given by the respondents were coded descriptively following the sequence of research questions which were divided into six parts, namely general approach to *Shari‘ah* governance, internal policy on *Shari‘ah* governance, attributes of *Shari‘ah* board on independence, competence, and transparency and confidentiality, operational procedures, roles of *Shari‘ah* board, and its assessment. From this coding, the researcher summarized the answers given and developed a theme for each interview question.

6.6.3 Content Analysis

There are several methods of analysing IFIs' annual report and financial statement narratives and these can be summarized into subjective analyst ratings, disclosure indices, readability studies, linguistic analyses and content analyses (Beattie, McInners and Fearnley, 2004: 208–213). In light of the disadvantages of the survey¹⁹⁴ and the interview methods, the content analysis method attempted to complement the research findings in

¹⁹⁴ The survey questionnaires are “open to memory and viewpoint biases, questionnaire proctor biases present distorting influences, surveys depend heavily on the subject’s motivation and ability to respond and inappropriate study of many social phenomena of interest to social scientist” (Smith, 1981: 182–184).

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Chapters 7 and 8, which raise several important issues concerning the *Shari‘ah* governance system. Unlike these previous two chapters that discuss results derived from primary data through questionnaires and interviews, the method used in this chapter was of a library research character. The study predominantly utilized the content analysis approach and disclosure indices in extracting and analysing the data and factual input derived from websites, annual reports and financial statements. These methods are very useful and the most appropriate approaches to provide a description of the extent of corporate disclosure and these include the disclosure of *Shari‘ah* governance practices.

Krippendorff (1980: 21) defines content analysis as “a research technique for making replicable and valid inferences from data” and Berelson, 1952: 18) refers it as “a research technique for the objective, systematic, and quantitative description of the manifest content of communication” (Berelson, 1952: 18).¹⁹⁵ In the context of this study, content analysis is used because disclosure, particularly non-financial disclosure as in the case of *Shari‘ah* governance, is largely disclosed qualitatively. This method enabled the researcher to capture the extent, nature, volume and size of the data collected. The researcher analysed all the *Shari‘ah* governance disclosures on selected sections of the annual reports and financial statements, including the notes on the financial statements.

In analysing the data, the researcher undertook several structured exercises. Firstly, the researcher organized, read and transferred all the data on to the computer in the form of a scoring sheet through a coding method. Secondly, the researcher calculated the average assessment scores for each of the six disclosure categories for each respondent. Thirdly, tables, histograms, charts and graphs were generated from the data for analysis. Finally, the researcher analysed all the data and the results of the research to provide further meaning to the data analysis.

The content analysis method used in this study specifically aims at measuring the level of transparency of *Shari‘ah* governance practices in IFIs. In this regard, the study employed

¹⁹⁵ The content analysis approach is a very transparent and highly flexible research method as it enables information to be generated that is difficult to gain access to and allows a certain amount of longitudinal analysis with relative ease (Bryman, 2001: 189–190).

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the disclosure indices approach. This research approach has been described as a useful tool for measuring the extent of company disclosure (Beattie, McInners and Fearnley, 2004: 210). In analysing the annual reports, financial statements and websites, the study first identified research questions and then used the literature, especially the principles set forth in relevant corporate governance guidelines and *Shari'ah* governance guiding principles, to formulate disclosure indices. The study introduces unique *Shari'ah* governance disclosure indices to assess the extent of transparency of *Shari'ah* governance practices as formulated in the research objectives.

Table 6.4: The Linkage between the Disclosure Indicators and Research Objectives

Disclosure Indicators Linked to Research Objectives	Indicators
i. To ascertain the extent of disclosure practice of <i>Shari'ah</i> governance practices in IFIs	Disclosure of Commitment to <i>Shari'ah</i> Governance (D1–D3)
	Disclosure of <i>Shari'ah</i> Board Information (D4–D18)
	Disclosure of <i>Shari'ah</i> Board Remuneration (D19–D20)
	Disclosure of <i>Shari'ah</i> Report (D21–D24)
	Disclosure of <i>Shari'ah</i> Pronouncements (D25–D27)
	Disclosure of <i>Shari'ah</i> Compliance Review (D28)
	Disclosure of <i>Shari'ah</i> Report (D29–D30)

There are several approaches to develop a theoretical concept and operational measure of disclosure indices. Patton and Zelenka (1997: 606) suggest four methods of developing disclosure indices: extending the index from the normative decision model to ascertain the usefulness of the disclosures; expert evaluation of the disclosure quality; selection of disclosure that may significantly affect the market reaction; and fulfilment of disclosure regulation. The study used the normative decision model and fulfilment of disclosure regulation to develop the indices. At this point, the researcher relied on the same international guidelines for corporate governance as well as *Shari'ah* governance guiding principles in the questionnaires in order to develop the *Shari'ah* governance indices. With

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these international benchmarks, the study is able to evaluate and measure the level of disclosure and transparency of IFIs pertaining to *Shari‘ah* governance matters.

The measurement of this *Shari‘ah* governance disclosure practice purely relied on information from the annual report, financial statements and websites. The study first identified a comprehensive list of disclosure indicators and subsequently selected only thirty of the most meaningful, available and accessible parameters. These indicators were then divided into five sections: Commitment to Good *Shari‘ah* Governance, *Shari‘ah* Board Information, *Shari‘ah* Report, *Shari‘ah* Pronouncements, *Shari‘ah* Review, and Products and Services Information. To standardize the measurement of the extent of disclosure amongst the respondents, the researcher developed a scoring sheet to list down all thirty indicators. This scoring sheet simplified the indices and enabled the researcher to easily make comparisons of the disclosures practice. These thirty indicators would be able to adequately provide the quantitative and qualitative aspects of *Shari‘ah* governance disclosure and transparency.

In order to quantify the extent of *Shari‘ah* governance disclosure practices, the study used a quantitative measure to rank IFIs into five categories: 1–5 disclosures is ranked as ‘Underdeveloped Practice’, 6–10 as ‘Emerging Practice’, 11–15 as ‘Improved Practice’, 16–23 as ‘Good Practice’ and 24–30 as ‘Best Practice’. The study also used a qualitative measure to analyse the data since the indicators are based on the previous data and records. Finally, frequencies and cross-tabulation techniques were used to discover the significant difference in disclosure practices in IFIs. In this regard, the study interpreted and gave further meaning to the data by using simple calculation through frequency tables and figures.

The study was also concerned with the issues of reliability and validity of using content analysis method. In this aspect, reliability issues may arise due to ambiguity of meanings or category definitions while validity problems are related to the “extent to which a variable measures the construct the investigator intends it to measure” (Weber, 1985: 15).

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In view of these issues, precautionary measures have been taken to improve both reliability and validity.

Generally, there are three approaches to measuring validity and reliability, namely content, contextual and internal validity methods. The study used the content validity method to enhance the validity of the data. In this aspect, all *Shari'ah* governance indices and categories were carefully developed from the review of *Shari'ah* governance literature. The researcher considers that the *Shari'ah* governance disclosure indices in this research have acceptable content validity since the indices are derived from authoritative resources and international guidelines.

6.7 Conclusion

This chapter has presented an overview of the research methodology and methods used in this study. It provides an insight into the whole research process, which is imperative for the purpose of ensuring the originality and quality of the research. Since the mixed-method approach is the most appropriate research strategy in this study, the researcher chose this methodology in organizing, structuring and designing the whole research process, including research design, development of research questions, reliability and validity, mitigating potential of errors, data collection, sampling and data analysis. These overall research processes demonstrate the extent of the quality and originality of this study.

CHAPTER 7

LOCATING THE ASPECTS OF SHARI'AH GOVERNANCE SYSTEM IN ISLAMIC BANKING: ANALYSIS OF THE QUESTIONNAIRE SURVEY¹⁹⁶

7.0 Introduction

Shari'ah governance is peculiarly important to IFIs as part of its corporate governance arrangement. In view of the scarcity literature on this subject, this study is considered as a small effort to contribute to development of a *Shari'ah* governance system by presenting its current practices across jurisdictions. This chapter hence presents the research findings derived from the survey, which constitutes one of the methods of getting factual input of the state of the current *Shari'ah* governance framework and practices in this study. The survey aims at understanding the extent of current *Shari'ah* governance practices by examining its general approach, regulatory and internal framework, roles of the *Shari'ah* board, attributes of the *Shari'ah* board in terms of independence, competence, transparency and confidentiality, operational procedures, and assessment of the *Shari'ah* board.

It is worth to mention that this study is conducted for researching the Islamic finance industry's internal perceptions of *Shari'ah* governance. This is significant to the study as the IFIs' perceptions will be able to demonstrate the extent and actual practices of *Shari'ah* governance. For this purpose, the questionnaire was distributed via ordinary mail and email to the selected commercial banks, investment banks, asset management companies and regulatory authorities that offer Islamic financial services in Malaysia, GCC countries (the UAE, Bahrain, Saudi Arabia, Qatar and Kuwait) and the UK. Personal interviews were also conducted in order to get responses from some IFIs. The study limited the scope of the survey to IFIs that offer Islamic financial services, including regulatory authorities that have established their own *Shari'ah* board.

¹⁹⁶ Some parts of this Chapter 7 were presented during the Durham Islamic Finance Conference at Durham University on 14-15th July 2010 and will be published in the International Journal of Islamic and Middle Eastern Finance and Management this year.

7.1 Searching the Particularities of *Shari‘ah* Governance in Islamic Banking: Research Findings*

7.1.1 *Shari‘ah* Board Members

It is clear from the survey that most of the *Shari‘ah* boards in IFIs meet the minimum requirement of the AAOIFI governance standards and the IFSB-10 as a majority of them consist of three board members (40%); 22.8% of *Shari‘ah* boards comprise four members, 17.1% five members, 5.8% six members, 5.8% ten members, and only 2.9% of IFIs engaged one or two *Shari‘ah* scholars. In Malaysia, the *Shari‘ah* board of the BNM and the SC consists of ten members, while the trend at individual IFI level shows that having three members is the most preferable practice. Significant numbers of *Shari‘ah* board members of the BNM and the SC indicate their functional roles and position as being the highest *Shari‘ah* authority. On the other hand, in GCC countries practice shows that there are significant variations of the number of *Shari‘ah* board members practised in IFIs, where the majority of them prefer five or three members. This is similar to the practice of IFIs in the UK, where it was found that their *Shari‘ah* boards consist of four or three members.

With regard to female *Shari‘ah* board members, only six out of thirty-five IFIs (17.1%) have female board members and all of them are from Malaysia. This indicates that the boardrooms in GCC countries and the UK are still male territory. The study presumes that the issue of the shortage of *Shari‘ah* scholars specialized and experienced in Islamic finance and *muamalāt* may be overcome by liberalizing the practice of accepting female *Shari‘ah* scholars as *Shari‘ah* board members as in the case of Malaysia.¹⁹⁷

* It is important to note that the percentages on a comparative overview to illustrate country-specific behavior practices in this section refer to the total group of IFIs and not to the IFIs in the individual jurisdictions

¹⁹⁷ Qudeer Latif, a prominent corporate lawyer in the Islamic finance industry agrees that the market is experiencing a shortage of scholars with expert knowledge of finance as he had to travel to several countries to meet just one Islamic scholar for *Shari‘ah* advisory services (Devi, 2008). Mohammad Masum Billah, a prominent *Shari‘ah* scholar from Malaysia also indicates the same and he personally finds that Islamic finance industry is about 80% short of having enough qualified and competent *Shari‘ah* scholars (El Bataji, 2010).

7.1.2 *Shari'ah* Governance Approach

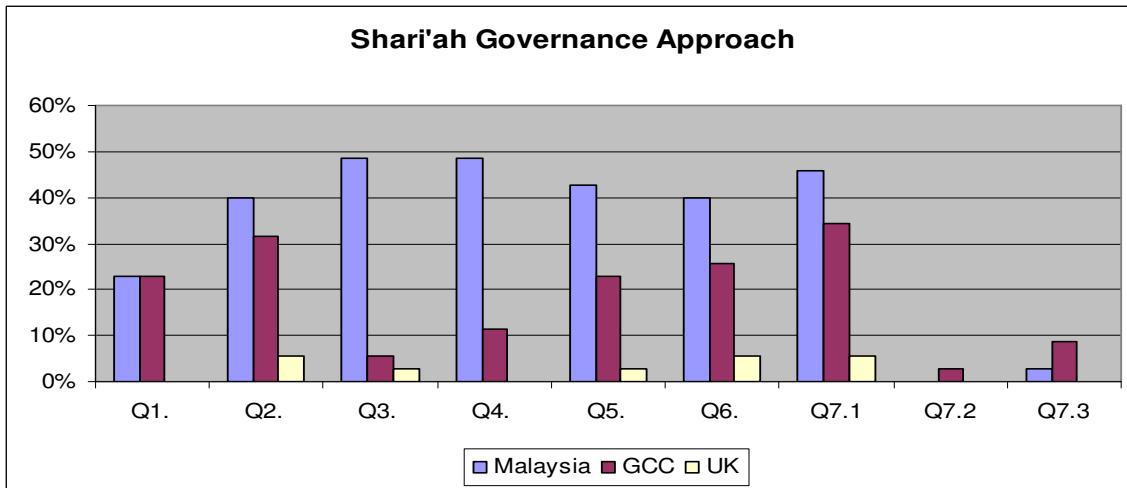
This section attempts to examine the different approaches of IFIs to *Shari'ah* governance. The study identified seven questions to explore the state of *Shari'ah* governance practices in the case countries. Table 7.1 illustrates the overall findings of IFIs' approaches to *Shari'ah* governance and Figure 7.1 represents its comparative overview.

Table 7.1: *Shari'ah* Governance Approach

Questionnaires	Percentage
Q1. Adoption of AAOIFI governance standards	45.7%
Q2. Aware of the IFSB Guiding Principles on <i>Shari'ah</i> Governance System	77.1%
Q3. Standards for <i>Shari'ah</i> governance set for Islamic financial institutions	57.1%
Q4. IFIs' requirement to provide any guidelines for <i>Shari'ah</i> governance	60%
Q5. Develop standard processes for <i>Shari'ah</i> compliance, audit and review of the <i>Shari'ah</i> rulings	68.5%
Q6. Professional code of ethics and conduct for members of the <i>Shari'ah</i> board	71.4%
Q7. Organizational arrangement for <i>Shari'ah</i> governance	85.7%
	2.8%
	11.4%

The majority of IFIs (54.3%) did not adopt the AAOIFI governance standards and some of them (22.9%) were even unaware of the existence of the IFSB-10. A total of 57.1% of IFIs claimed that there are *Shari'ah* governance standards set for *Shari'ah* governance at the national level. 68.5% of IFIs showed good commitment to *Shari'ah* governance by having a standard process for *Shari'ah* compliance, audit and review and 60% of IFIs provided guidelines on *Shari'ah* governance. In general, 71.4% of IFIs indicated that they have a professional code of ethics for their *Shari'ah* board. This demonstrates that 28.6% of IFIs' *Shari'ah* boards are not guided by a code of ethics. More than 85% of IFIs had established their own internal *Shari'ah* board while 2.8% of IFIs appointed a *Shari'ah* advisory firm for advisory services and 11.4% of IFIs had both an internal *Shari'ah* board and used a *Shari'ah* advisory firm. Investment banks preferred to engage a *Shari'ah* advisory firm rather than to have their own *Shari'ah* board.

Figure 7.1: Comparative Overview on *Shari'ah* Governance Approach



As a general observation, Malaysia presents a slightly better general framework of *Shari'ah* governance by scoring higher in every question asked as compared to GCC countries and the UK. An interesting observation is that, despite having less interference from regulatory authorities than Malaysia, IFIs in GCC countries and the UK proactively developed their own *Shari'ah* governance framework. In fact, the majority of IFIs in GCC countries have developed their own *Shari'ah* guidelines and standard processes on *Shari'ah* compliance. Although some GCC countries clearly stated in their regulations the adoption of the AAOIFI governance standards, it was found that only 22.8% had implemented them. In spite of the absence of any provision on the AAOIFI governance standards, 22.8% of IFIs in Malaysia had indicated the adoption of the standards based on voluntary practices.

7.1.3 *Shari'ah* Governance and Regulation

The literature in Chapter 5 provides a comprehensive overview of the regulatory framework of *Shari'ah* governance in the case countries. The study classifies Malaysia as the proponent of a ‘Regulatory-based Approach’, Saudi Arabia as a ‘Passive Approach’, Qatar, the UAE, Kuwait and Bahrain as a ‘Minimalist Approach’, and the UK as a ‘Reactive Approach’. This section hence tries to explore the general understanding and perception of IFIs of the regulatory and internal framework of *Shari'ah* governance as illustrated in Table 7.2 and Figure 7.2.

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Table 7.2: Regulatory Frameworks and Internal Policies on *Shari'ah* Governance

Questionnaires	Percentage
Q8. Are there separate rules and regulations concerning <i>Shari'ah</i> governance?	37.1%
Q9. Does the bank have any written policies or by-laws specifically referring to the conduct of the <i>Shari'ah</i> board?	57.1%
Q10. What type of dispute settlement is there to redress legal matters concerning Islamic finance (e.g. conflict of laws)?*	Q10.1 Civil court Q10.2 <i>Shari'ah</i> court Q10.3 Arbitration Q10.4 <i>Shari'ah</i> authority of the central bank or the ministry of religious affairs**
Q11. What is the legal position of the <i>Shari'ah</i> board's rulings?	Q11.1 Binding Q11.2 Non-binding

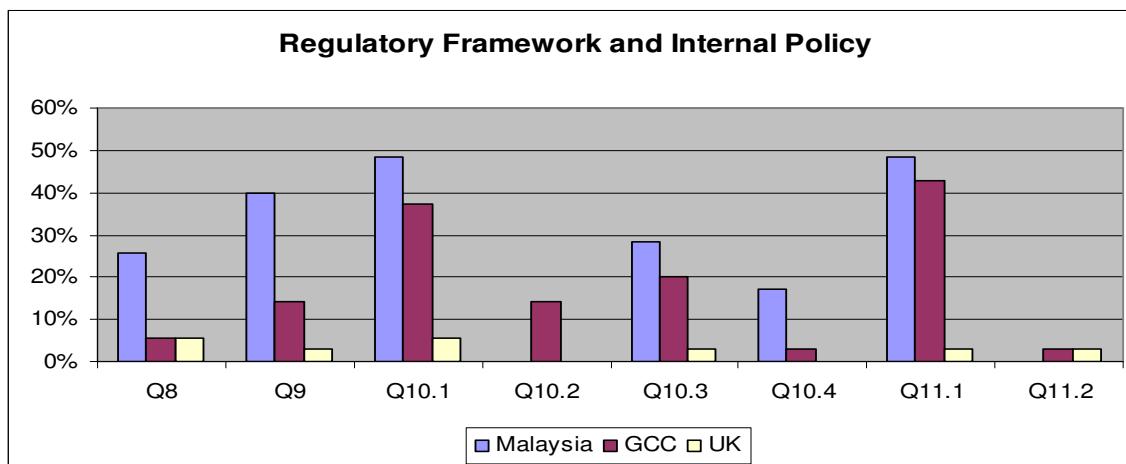
* Some of the research participants ticked more than one answer provided in the questionnaire form, which indicates that there are several legal avenues to redress matters concerning Islamic finance as highlighted in Q10.1–Q10.4.

** Q10.4 is an additional answer given by the respondents.

Only 37.1% of IFIs indicated that there were separate rules and regulations concerning *Shari'ah* governance. This figure shows that Malaysia is a strong proponent of the regulatory-based approach to a *Shari'ah* governance system while GCC countries prefer less regulator interference. In terms of internal policies or by-laws on the affairs of the *Shari'ah* board, 57.1% of IFIs indicated that they have written policies on it. With regard to jurisdictions on Islamic finance, almost all IFIs (91.4%) indicated that the civil court has jurisdiction pertaining to cases on Islamic finance, 14.2% of IFIs refer cases to the *Shari'ah* court, 51.4% of IFIs to arbitration, and 20% of IFIs to a *Shari'ah* authority such as the central bank or Ministry of Awqaf.

All countries put Islamic finance cases under the civil court's jurisdiction and this may lead to some legal and *Shari'ah* issues. While acknowledging this important issue, only a few countries provided other alternative legal avenues, such as arbitration or a national *Shari'ah* board as the highest *Shari'ah* authority. Another important aspect on regulation is the legal status of *Shari'ah* rulings, by which it was found that almost all IFIs (94.2%) indicated that the *Shari'ah* rulings are binding upon them and only 5.7% of IFIs view them as non-binding. It is clear from the findings that IFIs are generally bound by the rulings or pronouncements of their *Shari'ah* board.

Figure 7.2: Comparative Overview on Regulatory Framework and Internal Policy



Out of 37.1% of the total percentage on Q8, most IFIs in Malaysia (25.7%) indicated that there is a comprehensive set of rules and regulations concerning *Shari'ah* governance, while only 5.7% of IFIs in GCC countries and the UK indicated the same. With reference to internal policies or by-laws, IFIs in Malaysia (40%) claimed that they had written policies specifically referring to the conduct of the *Shari'ah* board. On the other hand, IFIs in GCC countries (14.2%) and in the UK (2.8%) indicated that they have specific by-laws on it. All IFIs rightly viewed that Islamic finance cases were put under the auspices of the civil court¹⁹⁸ and most of them agreed that there were other alternative legal avenues available such as arbitration. With respect to alternative dispute resolution, 51.4% of IFIs posit that there are alternative legal avenues for Islamic finance disputes in the form of arbitration and 20% in the form of a *Shari'ah* authority. IFIs in Malaysia (17.1%) and GCC countries (2.8%) indicated that, despite arbitration being a possible legal avenue to redress disputes on Islamic finance, the *Shari'ah* authority at the national level also offers alternative dispute settlements. In the aspect of the legal position of *Shari'ah* rulings, IFIs in Malaysia (48.5%) and GCC countries (42.8%) affirmed that they

¹⁹⁸ In the case of Malaysia, a specific High Court Division known as the *Muāmalāt* Bench was established to hear cases pertaining to Islamic finance cases. The information retrieved from the record of the High Court Commercial Division 4 from 2003 until November 2009 states that there are 233 *muāmalāt* cases registered with code 22A before the learned judge Dato' Rohana Yusuf and, as at December 2009, only seventy-seven cases had been resolved (Saiful, 2010). This position indicates that Malaysia has established a comprehensive Islamic finance framework and this includes how it handles issues related to *Shari'ah* governance.

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are bound by the *Shari'ah* board's pronouncements. Only a small percentage of IFIs in the UK and GCC countries (2.8%) respectively indicated otherwise.

7.1.4 Role of *Shari'ah* Board

The ideal roles of the *Shari'ah* board involve *ex ante* and *ex post* aspects of *Shari'ah* governance and these include *Shari'ah* pronouncements, supervision and review. The survey attempts to clarify the actual functions of the *Shari'ah* board in various IFIs in the case countries. Table 7.3 and Figure 7.3 illustrate the overall findings and a comparative overview of the roles of the *Shari'ah* board.

Table 7.3: Roles of the *Shari'ah* Board

	Questionnaires	Percentage
Q12. What are the roles of the <i>Shari'ah</i> board?*	Q12.1 Advisory	77.1%
	Q12.2 Supervisory	51.4%
	Q12.3 Executive	2.8%
Q13. Do the functions of the <i>Shari'ah</i> board include**: Q14. Does the <i>Shari'ah</i> board perform the <i>Shari'ah</i> audit? Q15. Does the <i>Shari'ah</i> board have the power to delegate some of its functions to the internal <i>Shari'ah</i> compliance unit?	Q13.1 <i>Shari'ah</i> pronouncements?	100%
	Q13.2 <i>Shari'ah</i> review or audit?	68.5%
	Q13.3 Endorsing and validating documentations pertaining to the products and services, as well as the internal policies, manuals and marketing advertisements, etc.?	74.2%
	Q13.4 Endorsement of <i>Shari'ah</i> compliance?	100%
	Q13.5 Overseeing the computation and payment of <i>zakah</i> ?	71.4%
	Q13.6 Examining any enquiries referred to by the IFIs?	74.2%
	Q13.7 Developing <i>Shari'ah</i> approved instruments?	51.4%
	Q13.8 Acting as the <i>Shari'ah</i> highest authority pertaining to Islamic finance?	71.4%
	Q13.9 Approving model agreements of Islamic modes of financing?	68.5%
	Q13.10 Achieving harmonization in the concepts and applications amongst the <i>Shari'ah</i> boards?	62.8%

* Some of the research participants ticked more than one answer provided in the questionnaire form, which indicates that the *Shari'ah* board has both advisory and supervisory functions.

** Some of the research participants ticked more than one answer provided in the questionnaire form, which indicates that the *Shari'ah* board has numerous functions, as highlighted in Q13.1–Q13.10.

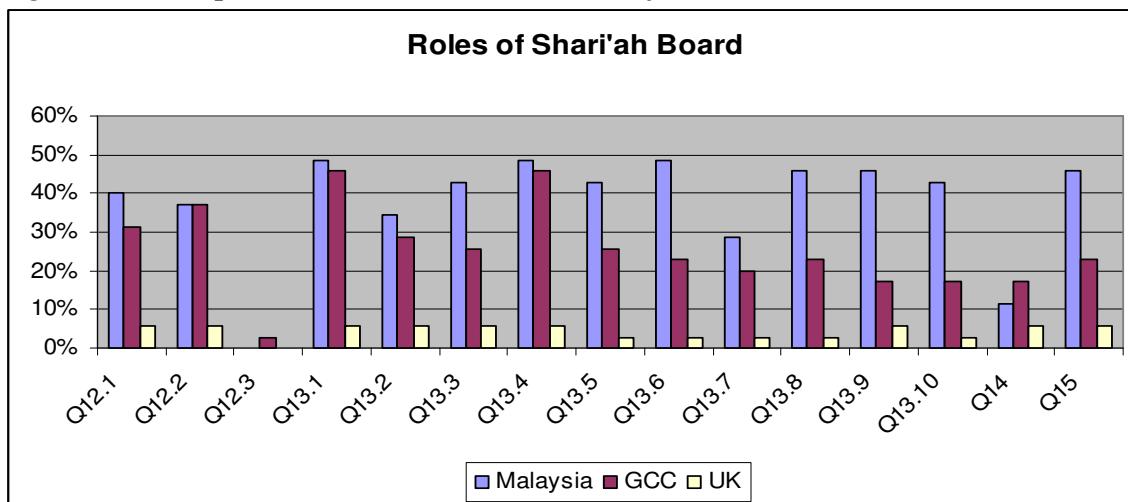
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The survey illustrates that IFIs had different perspectives on the roles and responsibilities of the *Shari‘ah* board. Around 77.1% of IFIs considered the *Shari‘ah* board as advisory, 51.4% as supervisory and, interestingly, 2.8% of IFIs viewed them as having executive power. The majority of IFIs considered their *Shari‘ah* board to have advisory and supervisory powers in which they had responsibility to undertake *ex ante* and *ex post* responsibilities. With respect to advisory functions, all IFIs agreed that the *Shari‘ah* board plays a role in issuing *Shari‘ah* pronouncements and declaration of *Shari‘ah* compliance. On the other hand, there are different views of IFIs concerning the supervisory function of the *Shari‘ah* board, where more than 21% of IFIs asserted that the *Shari‘ah* board does not have *Shari‘ah* review responsibility and does not oversee the computation of *zakah* payments.¹⁹⁹

The survey also found an inconsistency in the responses pertaining to *Shari‘ah* review or audit. While most *Shari‘ah* boards had the function of conducting the *Shari‘ah* audit, only 34.2% of IFIs indicated that their *Shari‘ah* board undertook *Shari‘ah* audit responsibilities. In the event that the *Shari‘ah* board did not undertake the *Shari‘ah* review task, 74.2% of IFIs granted authority to the *Shari‘ah* board to delegate its function of *Shari‘ah* review to the internal *Shari‘ah* compliance unit. This position demonstrates that numerous *Shari‘ah* boards do not conduct *Shari‘ah* reviews as they are only concerned with the *ex ante* aspects of *Shari‘ah* governance. We can see from this finding that there are shortcomings in the existing practices of *Shari‘ah* governance, particularly with regards the clear mandate and authority of the *Shari‘ah* board’s functions and responsibilities.

¹⁹⁹ This finding significantly shows the different practices of IFIs in late 1980s. A study conducted by Aboumouamer (1989: 285–288) demonstrates that the majority of *Shari‘ah* boards performed *Shari‘ah* audit functions, where 78% of the *Shari‘ah* board members carried out the pre-audit function, 80.5% the audit work and 6% the post-audit function.

Figure 7.3: Comparative Overview on the Roles of the *Sharī'ah* Board



The survey on the roles of the *Sharī'ah* board indicates some interesting observations. Most IFIs in Malaysia (40%), GCC countries (31.4%) and the UK (5.7%) pointed out that the *Sharī'ah* board has only advisory authority, while 2.8% of IFIs in GCC countries has executive power. This position denotes that the *Sharī'ah* board is an independent body within the IFIs' governance structure that has advisory and supervisory authorities. The executive power is still in the hands of the BOD. The overall findings show that the majority of IFIs' *Sharī'ah* boards undertake *ex ante* tasks of the *Sharī'ah* governance process. On the other hand, only 11.4% of IFIs in Malaysia, 17.1% of IFIs in GCC countries and 5.7% in the UK carried out *ex post* duties of the *Sharī'ah* governance process, namely the *Sharī'ah* review. This position demonstrates a weak *Sharī'ah* governance practice with respect to the *Sharī'ah* review process, particularly in Malaysia. This weak position nevertheless is compensated with another approach where 45.7% of IFIs in Malaysia and 5.7% of IFIs in the UK have delegated the *Sharī'ah* board's audit functions to their internal *Sharī'ah* compliance unit. Unlike Malaysia and the UK, only 22.8% of IFIs' *Sharī'ah* board in GCC countries indicated that the functions had been delegated to the internal *Sharī'ah* compliance unit.

7.1.5 Attributes of *Sharī'ah* Board Members

7.1.5.1 Appointment Criteria for *Sharī'ah* Board Membership

IFIs in various jurisdictions adopt different processes and fit and proper criteria for *Sharī'ah* board members. This section specifically demonstrates the appointment criteria

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of the *Shari'ah* board as a mechanism to ensure the competence of the IFIs in the case countries. Table 7.4 and Figure 7.4 illustrate general and comparative overviews of the mechanism of competence of *Shari'ah* boards in the case countries.

Table 7.4: Mechanism of Competence *

Questionnaires		Percentage
Q16. Does your institution have policies on the fit and proper criteria for the members of the <i>Shari'ah</i> board?		77.1%
Q17. If yes, what are those criteria?	Q17.1 Academic qualification	77.1%
	Q17.2 Experience and exposure (knowledge and skills in financial services industry)	74.2%
	Q17.3 Track record	60%
Q18. What are the requirements in terms of academic qualifications?	Q18.1 Specialized in <i>muamalāt</i>	74.2%
	Q18.2 Specialized in Islamic jurisprudence	71.4%
	Q18.3 Knowledge of Arabic and English	54.2%
	Q18.4 Knowledge of banking	2.8%
Q19. What are the requirements in terms of experience and exposure?	Q19.1 Understanding of <i>Shari'ah</i> rules and principles	80%
	Q19.2 Understanding of general legal and regulatory framework	65.7%
	Q19.3 Understanding of the impact of the <i>Shari'ah</i> pronouncements	77.1%
	Q19.4 Skills in the financial services industry	65.7%
Q20. What are the requirements in terms of track record?	Q20.1 Good character	74.2%
	Q20.2 Competence, diligence, capability and soundness of judgment	71.4%
	Q20.3 Suitability in and exposure to <i>muamalāt</i> .	2.8%
Q21. In the event your institution allows a non- <i>Shari'ah</i> background individual as a member of the <i>Shari'ah</i> board, what is the qualification for such appointment?	Q21.1 Well-verses in law	40%
	Q21.2 Well-verses in economy	28.5%
	Q21.3 Well-verses in finance	34.2%
	Q21.4 Basic <i>Shari'ah</i>	2.8%
	Q21.5 Strategic objective such as representative from religious council	2.8%
Q22. Do the <i>Shari'ah</i> board members receive adequate training to understand their role in the internal control process?		51.4%
Q23. Is there any evaluation of the <i>Shari'ah</i> board?		57.1%

*Some of the research participants ticked more than one answer provided in questions 17-21

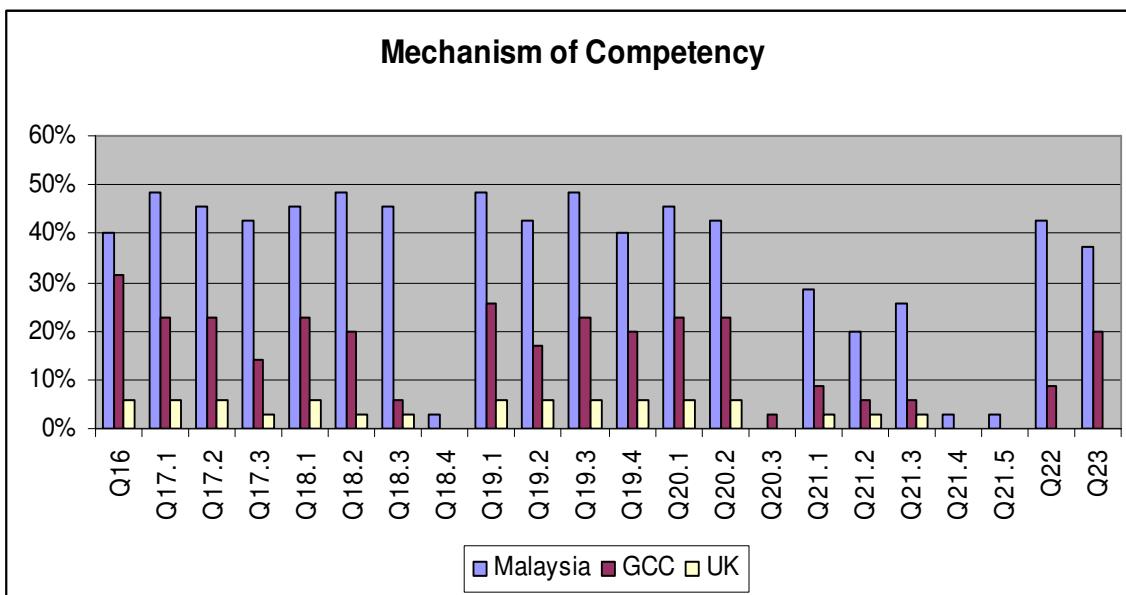
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Most of IFIs (77.1%) indicated that they have clear internal fit and proper criteria to access the competence of *Shari'ah* board members prior to their appointment. These criteria nevertheless vary from one IFI to another. More than 77% of IFIs have the criteria of academic qualification, 74.2% of experience and exposure, and 60% of track record and good character. In terms of academic qualification, IFIs were more concerned with the requirement pertaining to knowledge of *muamalat* (74.2%) and Islamic jurisprudence (71.4%). Meanwhile, in the aspect of experience and exposure, they preferred the candidates who have good understanding of *Shari'ah* rules and principles (80%) as well as understanding the impact of *Shari'ah* pronouncements (77.1%). Generally, IFIs agreed that they are also concerned with the requirement of track record, particularly good character (74.2%) and soundness of judgment (71.4%).

While acknowledging the need for expert, experienced and well-known scholars to be part of the *Shari'ah* board, only 51.4% of IFIs provided professional training, especially in the matters of finance and banking, to their *Shari'ah* board. Moreover, more than 42.9% of IFIs do not evaluate or assess the performance of the *Shari'ah* board. This figure illustrates that significant numbers of IFIs do not assess the *Shari'ah* board's contribution and performance, even in the event of renewal of their contracts.

The issue of lack of training and exposure on the part of *Shari'ah* board members has already been highlighted many years ago. An earlier study on Islamic banking practices revealed that the majority of *Shari'ah* board members did not have proper training in or exposure to technical aspects of banking and finance; it was found that the majority of *Shari'ah* board members had qualifications in *Shari'ah*, only 8.6% were well-versed in *Shari'ah* and commercial law, and only 11.4% had expertise in *Shari'ah*, law and economics (Bakar, 2002: 78). Another earlier study also found that more than 40% of forty-one *Shari'ah* board members had had no exposure to or proper training in banking and finance (Abomouamer, 1989: 226). The findings in this recent study further indicate that improving the competence of *Shari'ah* board members needs serious attention from regulators, supervisors and IFIs. For this purpose, there must be significant effort and continuous endeavour to develop programmes and training for *Shari'ah* boards as well as allocation of funds to produce talented and knowledgeable *Shari'ah* scholars.

Figure 7.4: Comparative Overview of Mechanism of Competence



Most IFIs in Malaysia had comprehensive mechanisms for *Shari‘ah* boards' competence with an average of 40% of IFIs having fit and proper criteria, as well as criteria of academic qualification, experience and exposure, and track record. IFIs in GCC countries (31.4%) and the UK (5.7%) demonstrated a quite similar situation except with regards admitting non- *Shari‘ah* background individuals as members of *Shari‘ah* boards. Only IFIs in Malaysia would appoint a non-*Shari‘ah* scholar as a member of a *Shari‘ah* board such as the BNM or the SC. Interestingly, the BNM also has added the extra criterion of strategic objective to its *Shari‘ah* board member requirements. In this regard, the BNM has appointed different personnel from various institutions, such as courts and religious councils.²⁰⁰ As a general observation, this implies that IFIs prefer to have only *Shari‘ah* scholars as members of a *Shari‘ah* board and not other individuals who are not specialized in *fiqh al muamalāt* or *usul al fiqh*.

In terms of a *Shari‘ah* board's training to strengthen their understanding of internal control processes and knowledge of technical aspects of banking and finance, most IFIs in Malaysia (42.8%) indicated that they had allocated funds and necessary training for such a purpose. A small number of IFIs in GCC countries (8.5%) and none in the UK

have initiated the same things. The study presumes that the good practice of initiating training for the *Shari'ah* board by IFIs in Malaysia is influenced by the requirement laid down in the BNM/GPS²⁰⁰. With respect to assessment of the performance of the *Shari'ah* board, 37.1% of IFIs in Malaysia, 20% of IFIs in GCC countries and none in the UK conduct assessments of the *Shari'ah* board's performance and evaluate their contribution to *Shari'ah* compliance aspects. This significant finding demonstrates that the majority of IFIs do not evaluate their *Shari'ah* board. This position presents a weak governance practice as the assessment and evaluation on contract of service by each individual *Shari'ah* board is crucial with the purpose of maintaining standards of competence and to avoid any potential conflict of interest.

7.1.5.2 Independence

There are various ways of ensuring the professional independence of the *Shari'ah* board. The survey identifies four important elements of independence, namely method of appointment, remuneration, *Shari'ah* board mandate and means of mitigating potential conflict of interest. Table 7.5 and Figure 7.5 present the market practice as to how IFIs manage the issue of *Shari'ah* board independence.

²⁰⁰ The BNM appointed non- *Shari'ah* experts, such as a judge and the director general of the Department of Islamic Development of Malaysia, for the purpose of coordinating the various government agencies and judicial bodies (Ismail, 2009).

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Table 7.5: Mechanism of Independence*

Questionnaire	Percentage
Q24. Who has the power to approve the appointment and dismissal of the <i>Shari'ah</i> board?	Q24.1 Shareholders 40%
	Q24.2 BOD 74.2%
	Q24.3 Management 5.7%
	Q24.4 Government 11.4%
	Q24.5 Nomination committee 2.8%
Q25. How long is the tenure of the appointment?	Q25.1 One year 2.8%
	Q25.2 Two years 45.7%
	Q25.3 Five years 2.8%
	Q25.4 Three years 11.4%
	Q25.5 Permanent 20%
Q26. What do you think is the appropriate body for the <i>Shari'ah</i> board to be accountable to?	Q26.1 Shareholders 51.4%
	Q26.2 BOD 57.1%
	Q26.3 Management 14.2%
	Q26.4 Government 5.7%
	Q26.5 National <i>Shari'ah</i> board 2.8%
Q27. Who determines the <i>Shari'ah</i> board's remuneration?	Q27.1 Shareholders 2.8%
	Q27.2 BOD 60%
	Q27.3 Management 22.8%
Q28. What mechanisms are in place to mitigate conflict of interest in relation to <i>Shari'ah</i> scholars sitting in various boards?	Q28.1 Restriction on multiple appointment 34.2%
	Q28.2 Disclosure on <i>Shari'ah</i> board's information 48.5%
	Q28.3 Declaration in writing 48.5%
	Q28.4 Integrity 2.8%
Q29. Is the power and authority of the <i>Shari'ah</i> board clearly mentioned in the following documents?	Q29.1 Articles of association 17.1%
	Q29.2 Memorandum of association 20%
	Q29.3 Letter of appointment 62.8%

* Some of the research participants ticked more than one answer provided in questions 24 and 26

Despite the AAOIFI governance standards' requirement of appointments being made by the general assembly, more than 74% of the appointments were made by the BOD and only 40% by the shareholders.²⁰¹ With regard to the *Shari'ah* board at the national level, the appointments were made by the government in Malaysia. Only 2.7% of IFIs appointed *Shari'ah* board members through its nomination committee. The survey finds inconsistency in the actual practice of appointment of *Shari'ah* board members and the

²⁰¹ Earlier findings in a study carried out by the International Institute of Islamic Thought in 1996 also indicated the same thing, where 80% of the appointments of the *Shari'ah* board were done by the BOD and a survey by Hasan in the same year also discovered that only 39% were made by the shareholders (Bakar, 2002: 78).

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IFIs' perception as to who the *Shari‘ah* board should be accountable to. At this point, 51.4% of IFIs viewed that *Shari‘ah* board should be accountable to shareholders and 57.1% to the BOD, although the actual practice showed that 74% of the appointments were made by the BOD and 40% by the shareholders. The survey reveals that the majority of IFIs grant authority to the BOD (60%) to determine the *Shari‘ah* board's remuneration, whilst a minority of IFIs i.e. 5.7% and 2.8% respectively, indicated that the government or the national *Shari‘ah* board could exercise such powers.

Although most IFIs acknowledged a potential conflict of interest in the event of *Shari‘ah* board members holding numerous positions in various institutions, more than 50% of IFIs do not have a mechanism to mitigate such potential conflict. The survey demonstrates that multiple appointments are a common occurrence in IFIs in GCC countries and this may raise concerns for *Shari‘ah* scholars in the aspects of conflict of interest and maintaining confidentiality. In order to manage this kind of potential conflict, 34.2% of IFIs claimed that they would not appoint *Shari‘ah* board members who hold numerous board positions, 48.5% of IFIs made open disclosures on the *Shari‘ah* board's composition to the public and made declarations in writing.

Most *Shari‘ah* board members served IFIs on a contractual or part-time basis and only 20% of IFIs' *Shari‘ah* board members were permanent employees. This position seems to contradict the AAOIFI governance standards, which restrict the appointment of *Shari‘ah* board members who work in the same institution. With regard to mandate, more than 37.2% of IFIs did not specify the authority in the letter of appointment and more than 80% of IFIs did not specify it, in the articles or memorandum of association. This figure illustrates that there are uncertainties about the actual authority and mandate of the *Shari‘ah* board on the part of *Shari‘ah* scholars, employees, management, BOD, shareholders and even the public at large.

Figure 7.5: Comparative Overview of Mechanism of Independence

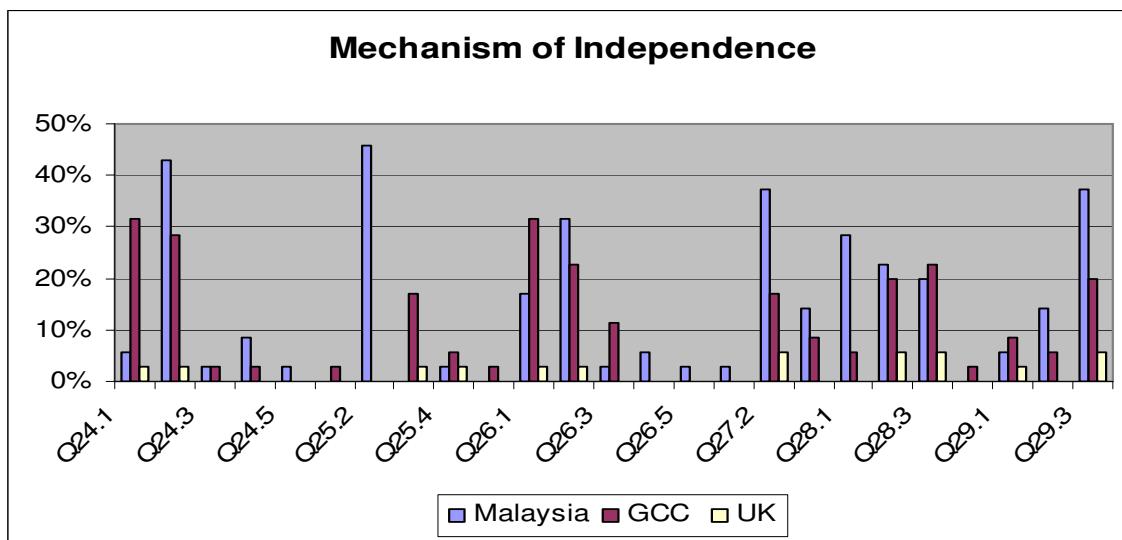


Figure 7.5 demonstrates a comparative overview of the mechanism of independence practised by the IFIs in the case countries. The overall findings present significant differences in the mechanism of independence by IFIs in Malaysia, GCC countries and the UK. Most IFIs (42.8%) in Malaysia indicated that the appointment of members is made by the BOD, only 5.7% of IFIs by shareholders, 2.8% of IFIs by management, and 8.5% of IFIs by government. On the other hand, most IFIs in GCC countries indicated that the appointment is made by shareholders, 31.4% of IFIs by the BOD, and 2.8% of IFIs by either the management or government.²⁰² In the case of the UK, the appointment is made by the BOD (5.7%). While most IFIs in GCC countries (31.4%) indicated that the appropriate body for the *Shari‘ah* board to be accountable to was shareholders, the practice showed that 28.5% of *Shari‘ah* boards were appointed by the BOD and 17.1% of IFIs indicated that their remuneration was also determined by the BOD. This position shows inconsistency between the ‘ideal’ and ‘actual’ *Shari‘ah* governance practice, particularly with regards the mechanism of independence. Although, the practice in Malaysia seems to raise an issue of potential conflict of interest, such conflict is mitigated by requiring all the appointments and dismissals to be made subject to the approval of the BNM.

²⁰² This position supports the finding by Aboumouamer (1989: 185), where 75% of forty-one *Shari‘ah* board members indicated that their authority is derived from the shareholders.

In terms of other mechanisms in place to mitigate conflict of interest, 28.5% of IFIs in Malaysia indicated that they have a restriction on multiple appointments, 22.8% of IFIs a restriction on disclosure of *Shari'ah* board information and 20% of IFIs a declaration of confidentiality in writing. This position demonstrates that *Shari'ah* governance practice in Malaysia has initiated various means of mitigating any potential conflict of interest of the *Shari'ah* board. Interestingly, the enforcement of the restriction on multiple appointments has significantly produced more *Shari'ah* scholars and more than 100 have registered as qualified *Shari'ah* advisors with the BNM (Ismail, 2009). In the case of GCC countries, 5.7% of IFIs indicated that they had policy of restriction on multiple appointments,²⁰³ 20% of IFIs on disclosure on *Shari'ah* board information, and 22.8% of IFIs on declaration in writing. IFIs in the UK indicated that they only had a policy on disclosure of *Shari'ah* board information and written declaration (5.7% respectively).

With regard to the issue of mandate and authority, most IFIs in Malaysia (37.1%) and 20% of IFIs in GCC countries indicated that the power and authority of the *Shari'ah* board are mentioned in the letter of appointment. A total of 5.7% of IFIs in Malaysia indicated that the authority is confirmed in the articles of association and 14.2% of IFIs in the memorandum of association, while less than 9% of IFIs in GCC countries indicated the same. IFIs in the UK indicated that mandate and authority were clearly stipulated in the articles of association (2.8%) and the letter of appointment (5.7%). In summary, the overall findings imply that some IFIs do not grant a full mandate or fail to provide a clear mandate and authority to the *Shari'ah* board.

7.1.5.3 Transparency and Confidentiality

The existing literature indicates that *Shari'ah* governance practices in IFIs are less than transparent. The survey attempts to explore the mechanism used by IFIs to ensure transparency and to observe confidentiality on the part of their *Shari'ah* board. The survey included one question on the aspect of confidentiality and three questions on transparency, i.e. written policy on preparation and dissemination of *Shari'ah*

²⁰³ A survey of Unal (2009) supports the above finding where the top ten listed *Shari'ah* scholars have monopolized more than 58% of 956 *Shari'ah* board positions in 271 organizations in twenty-two countries.

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information, right to access to all documents and necessary information and publication of *Shari'ah* rulings. Table 7.6 and Figure 7.6 demonstrate the *Shari'ah* governance practices of the case countries on the mechanisms of transparency and confidentiality.

Table 7.6: Mechanisms of Transparency and Confidentiality

Questionnaires	Percentage
Q30. Does the <i>Shari'ah</i> board have a written policy in respect to the preparation and dissemination of <i>Shari'ah</i> information?	51.4%
Q31. Does the <i>Shari'ah</i> board have access to all documents, information, records, etc.?	80%
Q32. Are the <i>Shari'ah</i> pronouncements published and made known to the public?	31.4%
Q33. Is the <i>Shari'ah</i> board fully aware of the issue of confidentiality and sensitive information obtained in the course of performing their duties?	74.2%

Surprisingly, Table 7.6 shows that more than 49% of IFIs do not have a written policy on preparation and dissemination of *Shari'ah* information. In addition, not all IFIs (80%) grant authority to the *Shari'ah* board to have access to all documents, information and records for the purpose of *Shari'ah* compliance. This is a serious issue, since the *Shari'ah* board is expected to endorse a declaration of *Shari'ah* compliance in the annual report. This position may disrupt the effectiveness of the *Shari'ah* review and its impact is likely to be of material significance to IFIs, particularly with respect to the *Shari'ah* compliance process.

Moreover, more than 68% of IFIs do not publish *Shari'ah* pronouncements, which are of the essence to all organs of governance, customers, depositors and the public. These overall responses demonstrate that IFIs are less than transparent. In the aspect of confidentiality, 74.2% of IFIs indicated that the *Shari'ah* board is fully aware of its fiduciary duty to observe confidentiality and to handle any sensitive information professionally. In spite of this positive finding, it was nevertheless found that more than 25% of IFIs viewed that their *Shari'ah* board is not aware of such confidentiality issues.

Some *Shari'ah* scholars even hold more than 70 *Shari'ah* board memberships. It is observed that the majority of the *Shari'ah* board positions were represented by IFIs in GCC countries.

Figure 7.6: Comparative Overview of Mechanisms of Transparency and Confidentiality

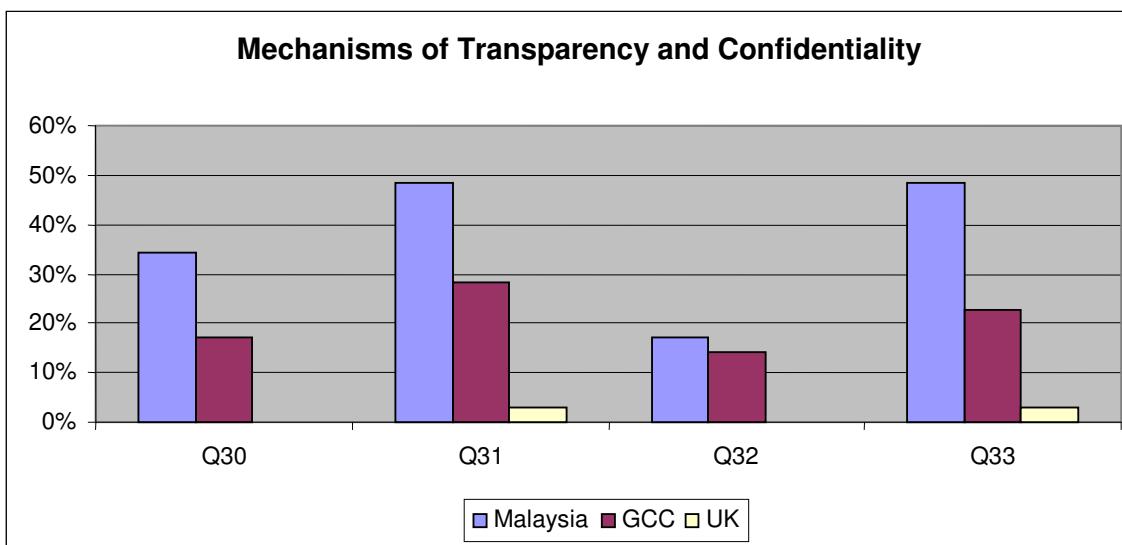


Figure 7.6 illustrates the *Shari‘ah* governance practices with regard to transparency and confidentiality. These two elements are very important for a good and sound *Shari‘ah* governance system. The survey demonstrates that 34.2% of IFIs in Malaysia and only 17.1% of IFIs in GCC countries indicated that they had a written policy in respect of the preparation and dissemination of *Shari‘ah* information. All IFIs in Malaysia indicated that they granted full authority to the *Shari‘ah* board to have access to all documents and information, while only 28.5% in GCC countries and 2.8% in the UK did the same. A small number of IFIs in Malaysia (7.16%), GCC countries (14.2%) and none in the UK indicated that they had published *Shari‘ah* rulings and made them known to the public.

In terms of confidentiality, all IFIs in Malaysia, 22.8% in GCC countries and 2.8% in the UK indicated that their *Shari‘ah* boards are fully aware of sensitive information obtained in the course of performing their duties. The survey shows that IFIs in the UK are less concerned about the issue of transparency and confidentiality with respect to *Shari‘ah* governance. Presumably IFIs in the UK are bound to comply with the existing corporate laws and related regulation concerning transparency and confidentiality without the need for a separate internal policy on *Shari‘ah* governance. The overall findings tend to

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suggest that there are several shortcomings in the existing *Shari'ah* governance practice with regard to the issues of transparency and confidentiality.

7.1.6 Operational Procedures

Different IFIs adopt various processes and procedures with respect to the *Shari'ah* compliance process. The survey attempted to discover the state of operational procedures in the context of *Shari'ah* governance practices, particularly standard operational procedures, *Shari'ah* board meetings, quorum, basis of decision, voting rights, preparation and dissemination of documents to *Shari'ah* board, *Shari'ah* report and its content, and the institutional arrangement for *Shari'ah* review. Table 7.7 and Figures 7.7, 7.8 and 7.9 illustrate the different practices of IFIs pertaining to the operational procedures of the *Shari'ah* compliance process.

Table 7.7: Operational Procedures *

Questionnaires	Percentage	
Q34. Is there any standard operational procedure for the <i>Shari'ah</i> board?	54.2%	
Q35. Does the <i>Shari'ah</i> board hold its meeting regularly?	Q35.1 Weekly	5.7%
	Q35.2 Monthly	37.1%
	Q35.3 Quarterly	22.8%
	Q35.4 Twice a month	2.8%
	Q35.5 Ad hoc	14.2%
	Q35.6 Every two months	2.8%
	Q35.7 Biannually	5.7%
Q36. What is the quorum for the <i>Shari'ah</i> board meeting?	Q36.1 Three	48.5%
	Q36.2 Seven	2.8%
	Q36.3 Six	2.8%
	Q36.4 Two	20%
Q37. On what basis are decisions made at the <i>Shari'ah</i> board meeting?	Q37.1 Simple majority	31.4%
	Q37.2 Two-thirds majority	11.4%
	Q37.3 Consensus	45.7%
Q38. In the event of the <i>Shari'ah</i> board including non- <i>Shari'ah</i> background members, do they have the right to vote?	20%	

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Questionnaires		Percentage
Q39. Is an agenda prepared and distributed in advance of <i>Shari'ah</i> board meetings?	Q39.1 A week in advance	54.2%
	Q39.2 Two weeks in advance	11.4%
	Q39.3 A month in advance	5.7%
	Q39.4 Ten days in advance	2.8%
	Q39.5 Three days in advance	2.8%
Q40. Who is responsible for dealing with the organization of the <i>Shari'ah</i> board meetings?	Q40.1 Internal <i>Shari'ah</i> officer	74.2%
	Q40.2 Company secretary	2.8%
	Q40.3 Head of product development	2.8%
	Q40.4 Head of the legal department	2.8%
	Q40.5 Capital market department	2.8%
	Q40.6 Outsource company	2.8%
Q41. Besides the <i>Shari'ah</i> board, who attends the meeting?	Q41.1 Representative from the internal <i>Shari'ah</i> compliance unit	77.1%
	Q41.2 Representative from the risk management department	17.1%
	Q41.3 Representative from the legal department	20%
	Q41.4 Representative from the product department	34.2%
	Q41.5 Representative from an external legal firm	5.7%
	Q41.6 Representative from the IFI	8.5%
	Q41.7 Management	5.7%
	Q41.8 Executive director	2.8%
	Q41.9 Managing director	2.8%
	Q41.10 Board risk committee	2.8%
	Q41.11 Chief internal auditor	2.8%
	Q41.12 Company secretary	2.8%
	Q41.13 CEO	5.7%
Q42. Are the <i>Shari'ah</i> pronouncements reviewed whenever necessary?		74.2%
Q43. Is the <i>Shari'ah</i> board required to submit a <i>Shari'ah</i> report?		68.5%
Q44. What are the contents of the <i>Shari'ah</i> report?	44.1 Information on duties and services of the <i>Shari'ah</i> board	40%
	44.2 <i>Shari'ah</i> pronouncements	42.8%
	44.3 <i>Shari'ah</i> board activities	31.4%
	44.4 Declaration of <i>Shari'ah</i> compliance	68.5%
Q45. What is the organizational arrangement for the internal <i>Shari'ah</i> review?	45.1 Independent division/ department	80%
	45.2 Part of the internal audit department	25.7%
	45.3 Outsource company	2.8%
	45.4 <i>Shari'ah</i> division	2.8%
	45.5 <i>Shari'ah</i> compliance unit	2.8%

* Some of the research participants ticked more than one answer provided in questions 41, 44 and 45.

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The majority of IFIs (54.2%) have standard operational procedures for *Shari'ah* governance; 5.7% of IFIs conduct weekly *Shari'ah* board meetings, 37.1% monthly, 22.8% quarterly, 2.8% twice a month, 2.8% every two months, 14.2% on an ad hoc basis, and 5.7% biannually. Most *Shari'ah* board decisions are made by consensus (45.7%) and 31.4% by simple majority. In the event of a *Shari'ah* board including non-*Shari'ah* background members, only 20% of IFIs viewed that they should have a voting right in decision-making. The majority of IFIs agreed that those members should not be granted such voting rights.

With regard to *Shari'ah* coordination, the majority of IFIs (74.2%) appointed their internal *Shari'ah* officer to deal with and handle *Shari'ah* governance matters and this includes *Shari'ah* board meetings. Some IFIs employed their company secretary, head of product development, head of legal department, officer in the Islamic capital market department or an outsource company to coordinate *Shari'ah* governance-related matters. This position indicates that most of IFIs have a proper internal arrangement for *Shari'ah* coordination.

Interestingly, 5.7% of IFIs submit the agenda and documents to the *Shari'ah* board a month in advance and all of them are from GCC countries, while most IFIs (54.2%) do the same thing a week in advance. The *Shari'ah* board meetings are attended by various parties including the executive director, CEO, managing director, board's risk committee, internal auditor and legal advisor. The majority of IFIs (77.1%) indicated that the normal attendees of the *Shari'ah* meeting include the representative of the internal *Shari'ah* compliance unit.

According to the survey, 68.5% of IFIs confirmed that the *Shari'ah* board is required to submit a *Shari'ah* report but the survey also indicated that more than 31% of IFIs do not issue a *Shari'ah* report.²⁰⁴ With respect to the contents of the report, most IFIs (68.5%)

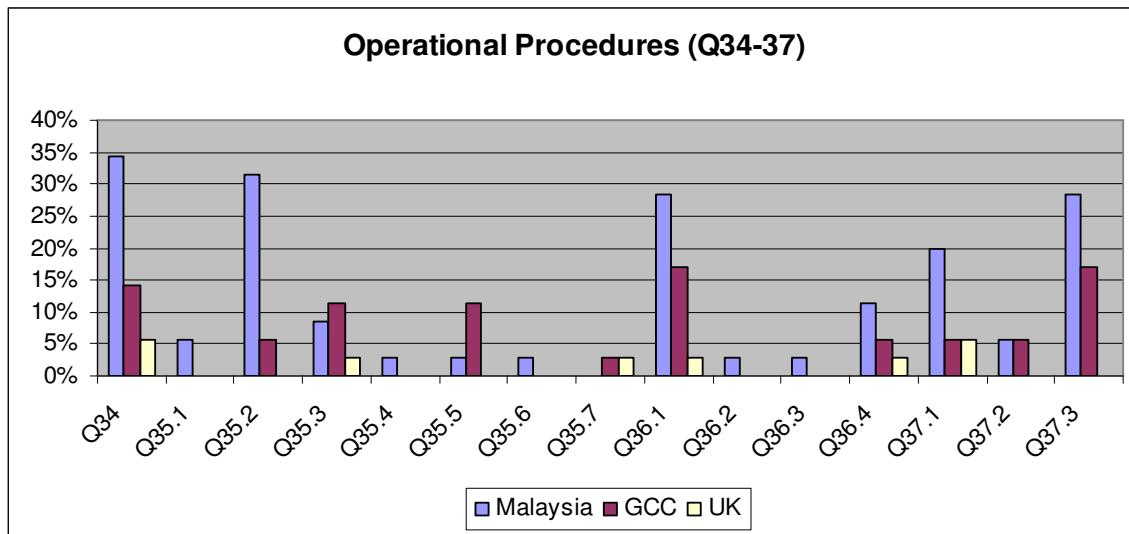
²⁰⁴ This finding demonstrates a negative indication of IFIs' commitment to *Shari'ah* governance, particularly the preparation of the *Shari'ah* report. Two earlier studies show weak practice with regards the *Shari'ah* report. Maali et al. (2006: 285) revealed that 72% of twenty-five IFIs provide the report of the *Shari'ah* board and a survey conducted by Grais and Pellegrini (2006: 34) found that 30.8% of thirteen IFIs

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just publish a declaration of *Shari'ah* compliance rather than details of *Shari'ah* compliance activities. This illustrates poor disclosure on the part of IFIs upon *Shari'ah*-related information. In spite of the *Shari'ah* report, it is also found that more than 25% of IFIs do not review the *Shari'ah* board pronouncements.

In terms of the *Shari'ah* compliance review, 80% of IFIs set up an independent department, 25.7% of IFIs delegate the function to the existing internal audit department and 2.8% of IFIs to an outsource company.²⁰⁵ A sound *Shari'ah* internal audit mechanism is a tool to deter malpractice and to mitigate *Shari'ah* non-compliance risk. Realizing this, most IFIs have set up an independent internal *Shari'ah* review department to conduct a *Shari'ah* compliance review, which is commendable and in line with the best practice of *Shari'ah* governance.

Figure 7.7: Comparative Overview of Operational Procedures (Q34–37)



Significant variations were found across the case countries on the operational aspect of *Shari'ah* governance practices. Most IFIs in Malaysia (34.2%) indicated that they had standard operational procedures for the *Shari'ah* governance process while 5.7% of IFIs

failed to issue a *Shari'ah* report. The finding of the recent survey in this study indicates that there has been no major improvement on the part of *Shari'ah* report practice in IFIs.

²⁰⁵ This finding supports the study conducted by the IFSB, which showed that more than 90% of sixty-nine IFIs undertook a *Shari'ah* compliance review (IFSB, 2008b: 27). This position indicates a positive development in *Shari'ah* governance in IFIs.

in the UK and 14.2% of IFIs in the GCC countries indicated the same. IFIs in GCC countries indicated slightly lower standards of practice in terms of providing clear operational procedures for the *Shari‘ah* governance process. In terms of *Shari‘ah* board meetings, most IFIs in the case countries conduct more than four meetings a year; 35.2% of IFIs in Malaysia and 5.7% of IFIs in GCC countries indicated that they conduct monthly meetings, and 8.5% of IFIs in Malaysia, 11.4% in GCC countries and 2.8% in the UK conduct quarterly meetings.²⁰⁶ A small percentage of 2.8% of IFIs in both GCC countries and the UK indicated that they conduct meetings fewer than four times annually.

With regard to the quorum for *Shari‘ah* board meetings, 17.1% of IFIs in GCC countries and 28.5% of IFIs in Malaysia indicated three board members as their quorum. Only a minority of IFIs indicated a quorum of six or seven. With respect to the decision-making process, most IFIs in Malaysia (20%), 5.7% of IFIs in GCC countries and 2.8% in the UK indicated that decisions made at the *Shari‘ah* board meeting were based on a simple majority, while 28.5% of IFIs in Malaysia and 17.1% of IFIs in GCC countries make decisions by consensus. This practice demonstrates that the majority of IFIs prefer decisions to be made by consensus rather than a simple or two-thirds majority.

²⁰⁶ The survey witnesses a slightly different trend in GCC countries to the study conducted by Aboumouamer (1996: 188), which revealed that 24.4% of forty-one *Shari‘ah* board members have a weekly meeting, 7.3% have a monthly meeting, 48.8% have a quarterly meeting and 2.4% have a biannual meeting.

Figure 7.8: Comparative Overview of Operational Procedures (Q38–41)

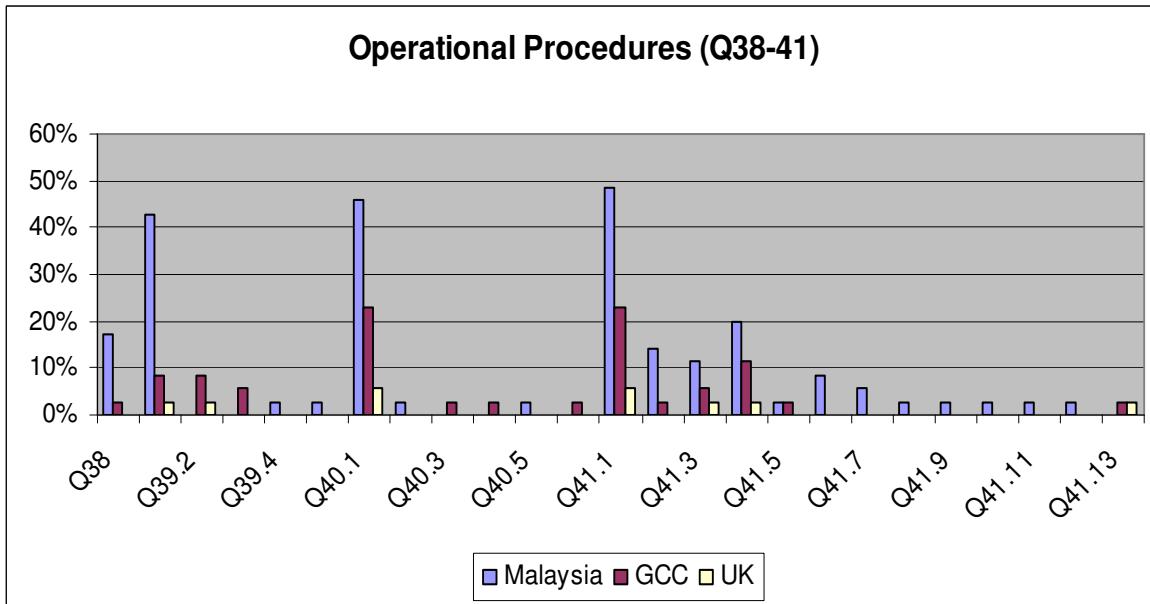


Figure 7.8 presents a continuation of the survey results pertaining to operational procedures with respect to voting rights, agenda, coordinator and attendees of *Shari'ah* board meetings. In terms of voting rights for non-*Shari'ah* experts, most of IFIs did not prefer such appointment; although 17.1% of IFIs in Malaysia and 2.8% of IFIs in GCC countries indicated that they may have voting rights, the majority of IFIs preferred to give such a right solely to *Shari'ah* scholars.

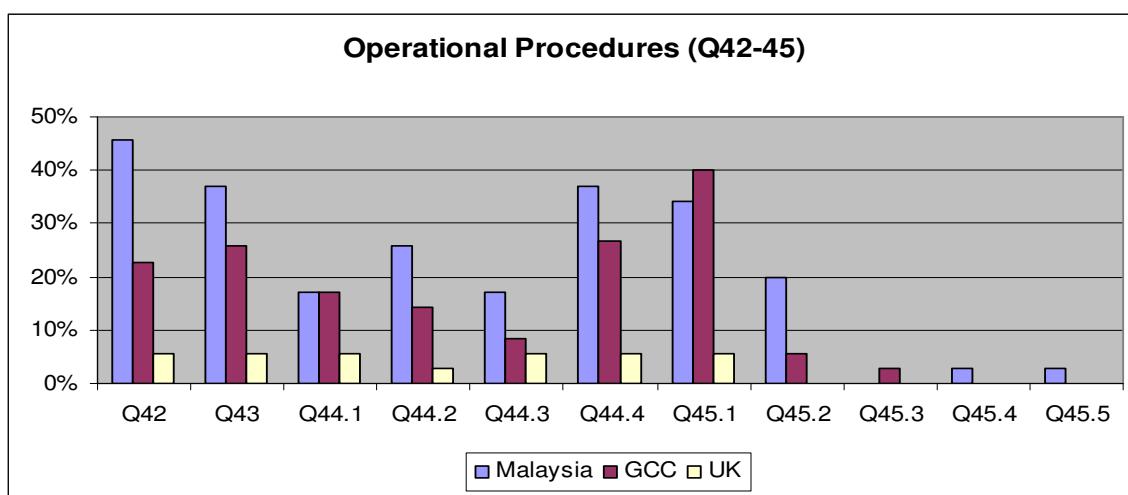
Most IFIs in Malaysia (42.8%), 8.5% in GCC countries and 2.8% in the UK indicated that the agenda and documents for *Shari'ah* board meeting are prepared and distributed a week in advance. Interestingly, 5.7% of IFIs in GCC countries indicated that they submit the agenda and documents to the *Shari'ah* board a month in advance. With regard to *Shari'ah* coordination, most IFIs in Malaysia (45.7%),²⁰⁷ 22.8% of IFIs in GCC countries and 5.7% of IFIs in the UK indicated that their internal *Shari'ah* officer is responsible for handling the *Shari'ah* board meeting and *Shari'ah*-related matters. A minority of IFIs grant the responsibility to the company secretary, head of product development, head of legal department, and a representative from the capital market or outsource company.

²⁰⁷ In the case of Malaysia, the issue of the remit of various *Shari'ah* boards at individual IFI level as well as the SAC and *Shari'ah* board of the SC is resolved by having proper coordination amongst the *Shari'ah* officers of these different institutions, led by the officers at the Islamic Banking and *Takāful* Department of the BNM (Ismail, 2009).

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With respect to the attendees of the *Shari'ah* board meeting, all IFIs in Malaysia, 22.8% of IFIs in GCC countries and 3.7% of IFIs in the UK indicated that a representative from the internal *Shari'ah* compliance unit is a permanent attendee. Besides that, there were some other parties who were invited to attend the meeting, such as representatives from the risk management department (14.2% of IFIs in Malaysia and 2.8% of IFIs in GCC countries), the legal department (11.4% of IFIs in Malaysia, 5.7% in GCC countries and 2.8% in the UK) and product development (20% of IFIs in Malaysia, 11.4% of IFIs in GCC countries and 2.8% in the UK). The survey found some interesting observations on *Shari'ah* governance practice in Malaysia and the UK where some IFIs invite the CEO, managing director, executive director, board risk committee and chief internal auditor to attend the *Shari'ah* board meeting.

Figure 7.9: Comparative Overview of Operational Procedures (Q42–Q45)



In the aspect of review of *Shari'ah* rulings, almost all IFIs in Malaysia (45.7%), 22.8% of IFIs in GCC countries and 5.7% of IFIs in the UK indicated that they conduct such reviews. On another aspect of review, namely the *Shari'ah* compliance review, 34.2% of IFIs in Malaysia and 40% of IFIs in GCC countries indicated that they have established an independent division for that purpose. A small number of IFIs in the case countries indicated that the *Shari'ah* compliance review was conducted by the existing internal audit department and some of them have even appointed a *Shari'ah* advisory firm to perform that task.

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Despite the regulatory requirement to submit a *Shari‘ah* report in Malaysia, only 37.1% of IFIs indicated that the *Shari‘ah* board is required to submit a *Shari‘ah* report. Even in the absence of such a regulatory requirement, 25.7% of IFIs in GCC countries and 2.8% of IFIs in the UK indicated that the *Shari‘ah* report is part of their internal requirement. In terms of the content of the *Shari‘ah* report, 17.1% of IFIs in Malaysia indicated that the *Shari‘ah* report contains information on the duties and services of the *Shari‘ah* board, 25.7% of IFIs on *Shari‘ah* pronouncements, 17.1% of IFIs on *Shari‘ah* board activities and 37.1% of IFIs on a declaration of *Shari‘ah* compliance. A similar situation is apparent in the case of GCC countries and the UK, by which a majority of IFIs indicated that the content of the *Shari‘ah* report is just a declaration of *Shari‘ah* compliance.

7.1.7 Assessments of the *Shari‘ah* Board

There have been numerous criticisms and negative allegations about the roles and functions of the *Shari‘ah* board. The problem with all sorts of criticism is that such allegations have not been proven or supported by any empirical evidence or reliable data. The survey included five questions to specifically address this important issue. These questions consist of a general assessment of IFIs of their *Shari‘ah* board in terms of organizational accountability, communication with other organs of governance, ability to identify and evaluate *Shari‘ah* non-compliance risk, contribution to promotion of Islamic ethics and values as well as *Shari‘ah* control processes. Table 7.8 and Figure 7.10 illustrate the IFIs' perception of the performance of their *Shari‘ah* boards in the case countries.

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Table 7.8: Perception of Performance of *Shari'ah* Board

Questionnaires	Percentage				
	Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree
Q46. The <i>Shari'ah</i> board has demonstrated effective organizational accountability.			20%	45.7%	34.2%
Q47. The <i>Shari'ah</i> board has communicated effectively with other organs of governance, including the BOD, management and auditors.			25.7%	45.7%	28.5%
Q48. The <i>Shari'ah</i> board has properly identified and evaluated the organization's exposure to <i>Shari'ah</i> non-compliance and reputational risk, and effectively communicates that risk information to appropriate bodies in the organization.		2.8%	22.8%	42.8%	31.4%
Q49. The <i>Shari'ah</i> board promotes Islamic ethics and values within the organization.		5.7%	20%	40%	34.2%
Q50. The <i>Shari'ah</i> board promotes continuous improvement of the organization's <i>Shari'ah</i> control processes.		2.8%	17.1%	51.4%	28.5%

Regardless of the numerous criticisms of *Shari'ah* boards, the overall responses demonstrate that most IFIs are satisfied with the performance of their *Shari'ah* board. Only 2.8% of IFIs viewed that the *Shari'ah* board had failed to identify and evaluate *Shari'ah* compliance risk and to promote continuous improvement of *Shari'ah* control processes and 5.7% of IFIs had neglected the duty to promote Islamic values and ethics. With understanding that the responses might be biased on the part of IFIs since they engage advisory services from the *Shari'ah* board, the findings on the failure of *Shari'ah* boards to identify and evaluate *Shari'ah* non-compliance risk and to promote Islamic ethics and values is considered slightly significant.

Figure 7.10: Comparative Overview of Perception of Performance of *Shari'ah* Board

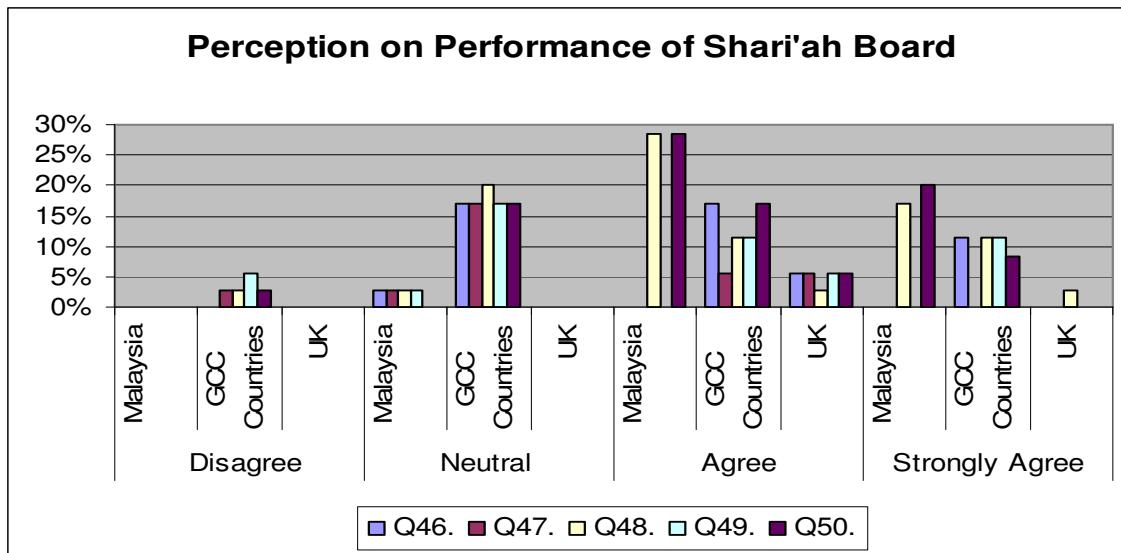


Figure 7.10 demonstrates IFIs' perception of the roles and functions played by the *Shari'ah* board in five aspects, namely accountability, organizational communication, *Shari'ah* non-compliance risk, Islamic ethics and values, and *Shari'ah* control processes. The overall findings in Malaysia indicated that IFIs are generally satisfied with the performance of *Shari'ah* boards, as 22.8% of IFIs 'Strongly Agree' on Q46, Q47 and Q49, 28.5% of IFIs 'Agree' on Q48 and Q50, and 2.8% of IFIs are 'Neutral' on Q46–50. None of the IFIs in Malaysia indicated a negative perception of the assessment of their *Shari'ah* board. Similarly, IFIs in the UK were positively satisfied with the performance of their *Shari'ah* boards by indicating 'Agree' and 'Strongly Agree' on Q46–Q50.

Unlike Malaysia and the UK, some interesting observations were found on the perception of IFIs in GCC countries. While the majority of IFIs 'Strongly Agree' on Q46 (11.4%) and Q48–50 (11.4%), a small percentage of IFIs indicated that they are dissatisfied with the performance of the *Shari'ah* board, as 2.8% of IFIs 'Disagree' on Q47, Q48, and Q50 and 5.7% of IFIs 'Disagree' on Q49. This interesting finding tends to show that some IFIs have identified that their *Shari'ah* board has neglected some important aspects of *Shari'ah* governance, particularly with respect to the effectiveness of organizational communication, identifying *Shari'ah* non-compliance risk, contributing to Islamic ethics

and values, as well as *Shari'ah* control processes. It is clear from the finding that the assessment and evaluation of the *Shari'ah* board's performance is of the essence to IFIs.

7.2 Developing *Shari'ah* Governance Index

The survey reveals that significant numbers of IFIs in Malaysia, GCC countries and the UK do not have an adequate framework of the best or ideal *Shari'ah* governance practices as laid down by the AAOIFI governance standards and the IFSB-10. Based on the findings from the survey, the study summarizes the state of the overall *Shari'ah* governance practices in the case countries by classifying them into five different levels of practice, namely 'Underdeveloped Practice', 'Emerging Practice', 'Improved Practice', 'Improved Practice' and 'Best Practice'.

For the purpose of clarity, the study illustrates the extent of the implementation of *Shari'ah* governance in IFIs by constructing specific *Shari'ah* governance indicators using a scoring method. These indicators allow the study to quantify and rank the IFIs according to their *Shari'ah* governance scores. The study has generated fifty key principles for best *Shari'ah* governance practices which are divided into six sections: approach to *Shari'ah* governance (seven indicators), regulation and internal framework of *Shari'ah* governance (four indicators), roles of *Shari'ah* board (five indicators), attributes of *Shari'ah* board with respect to competence (eight indicators), independence (five indicators), transparency and confidentiality (four indicators), operational procedures (twelve indicators), and assessment of *Shari'ah* board (five indicators). These fifty indicators represent the key principles of best practice of *Shari'ah* governance as promoted in the AAOIFI governance standards and the IFSB-10, including the existing literature pertaining to *Shari'ah* governance. The overall key principles of best *Shari'ah* governance practices are summarized in Table 7.9.

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Table 7.9: *Shari'ah* Governance Indicators

Key Principles of <i>Shari'ah</i> Governance	Indicators
Approach to <i>Shari'ah</i> Governance	7
P1. IFIs that adopt the AAOIFI governance standards.	
P2. IFIs that are sensitively aware of the development of <i>Shari'ah</i> governance such as the IFSB-10.	
P3. IFIs that have standards or guidelines for <i>Shari'ah</i> governance.	
P4. IFIs that develop standard processes for <i>Shari'ah</i> compliance, audit and review of the <i>Shari'ah</i> board's legal rulings.	
P5. IFIs that have a professional code of ethics for the <i>Shari'ah</i> board.	
P6. IFIs that have an internal <i>Shari'ah</i> board.	
P7. IFIs that have at least three <i>Shari'ah</i> board members.	
Regulatory and Internal Framework of <i>Shari'ah</i> Governance	4
P8. IFIs that have specific rules and policies concerning <i>Shari'ah</i> governance.	
P9. IFIs that have written policies or by-laws specifically referring to the conduct of the <i>Shari'ah</i> board.	
P10. IFIs that have good understanding of types of dispute settlement to redress legal matters concerning Islamic finance.	
P11. IFIs that have good understanding of the legal position of the <i>Shari'ah</i> board's rulings.	
Roles of <i>Shari'ah</i> Board	5
P12. IFIs that provide clear advisory and supervisory authority to their <i>Shari'ah</i> board.	
P13. IFIs whose <i>Shari'ah</i> board performs ex ante and ex post <i>Shari'ah</i> governance processes.	
P14. IFIs that grant authority to the <i>Shari'ah</i> board to oversee the payment and computation of <i>zakah</i> .	
P15. IFIs whose <i>Shari'ah</i> board performs the <i>Shari'ah</i> audit function.	
P16. IFIs that delegate <i>Shari'ah</i> review functions to the internal <i>Shari'ah</i> compliance unit to assist the <i>Shari'ah</i> board.	
Attributes of <i>Shari'ah</i> Board (Competence)	8
P17. IFIs that have policies on the fit and proper criteria for the members of the <i>Shari'ah</i> board.	
P18. IFIs that put conditions of academic qualification, experience and track record on their <i>Shari'ah</i> board members.	
P19. IFIs that put requirements of being specialized in <i>muamalāt</i> , Islamic jurisprudence and knowledge of Arabic and English in terms of academic qualifications on their <i>Shari'ah</i> board members.	
P20. IFIs that put requirements on their <i>Shari'ah</i> board members of understanding of <i>Shari'ah</i> and general banking law as well as the impact of <i>Shari'ah</i> rulings in terms of experience and exposure.	
P21. IFIs that put requirements of good character and competence and diligence in terms of track record.	

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Key Principles of <i>Shari'ah</i> Governance	Indicators
P22. IFIs that allow non- <i>Shari'ah</i> background individuals as members of the <i>Shari'ah</i> board who are well-versed in law, economy and finance.	
P23. IFIs that organize adequate training for the <i>Shari'ah</i> board.	
P24. IFIs that have proper assessment of the <i>Shari'ah</i> board.	
Attributes of <i>Shari'ah</i> Board (Independence)	5
P25. IFIs that appoint the <i>Shari'ah</i> board through their shareholders.	
P26. IFIs that appoint the <i>Shari'ah</i> board on a contractual basis.	
P27. IFIs that determine the <i>Shari'ah</i> board's remuneration through the BOD but subject to the approval of shareholders.	
P28. IFIs that have a mechanism in place to mitigate conflict of interest in relation to <i>Shari'ah</i> scholars sitting on various boards.	
P29. IFIs that clearly provide full mandate and authority to the <i>Shari'ah</i> board.	
Attributes of <i>Shari'ah</i> Board (Transparency and Confidentiality)	4
P30. IFIs that have a written policy in respect to the preparation and dissemination of <i>Shari'ah</i> information.	
P31. IFIs that grant full authority to <i>Shari'ah</i> board to have access to all documents, information and records.	
P32. IFIs that publish the <i>Shari'ah</i> pronouncements and ensure they are available to the public.	
P33. IFIs that ensure their <i>Shari'ah</i> board is fully aware of the issue of confidentiality and sensitive information obtained in the course of performing their duties.	
Operational Procedures	12
P34. IFIs that have standard operational procedures for their <i>Shari'ah</i> board.	
P35. IFIs that hold a <i>Shari'ah</i> board meeting at least once a month.	
P36. IFIs that have a requirement of at least three as their quorum for the <i>Shari'ah</i> board meeting.	
P37. IFIs that have a requirement of a simple majority as a basis for the decisions of <i>Shari'ah</i> board meetings.	
P38. IFIs that do not grant voting rights to non- <i>Shari'ah</i> background members of the <i>Shari'ah</i> board.	
P39. IFIs that ensure their agenda is prepared and distributed at least a week in advance of <i>Shari'ah</i> board meetings.	
P40. IFIs that set up a <i>Shari'ah</i> department/unit/division to coordinate the <i>Shari'ah</i> governance process.	
P41. IFIs that require the attendance of management or directors in the <i>Shari'ah</i> board meeting.	
P42. IFIs that require their <i>Shari'ah</i> board to review the previous rulings.	
P43. IFIs that have a mandatory requirement for a <i>Shari'ah</i> report.	
P44. IFIs that detail the contents of the <i>Shari'ah</i> report to include information on duties and activities, <i>Shari'ah</i> pronouncements and a declaration of <i>Shari'ah</i> compliance.	

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Key Principles of <i>Shari‘ah</i> Governance	Indicators
P45. IFIs that set up independent organizational arrangements for the internal <i>Shari‘ah</i> audit.	
Assessment of <i>Shari‘ah</i> Board	5
P46. IFIs whose <i>Shari‘ah</i> board demonstrates effective organizational accountability.	
P47. IFIs whose <i>Shari‘ah</i> board communicates effectively with other organs of governance, including the BOD, management and auditors.	
P48. IFIs whose <i>Shari‘ah</i> board properly identifies and evaluates the organization’s exposure to <i>Shari‘ah</i> non-compliance risk and reputational risk, and effectively communicates that risk information to appropriate bodies in the organization.	
P49. IFIs whose <i>Shari‘ah</i> board promotes Islamic ethics and values within the organization.	
P50. IFIs whose <i>Shari‘ah</i> board promotes continuous improvement of an organization’s <i>Shari‘ah</i> control processes.	
Total Indicators	50

Based on the above fifty formulated key principles of *Shari‘ah* governance, the study ranks IFIs into five levels of *Shari‘ah* governance practices. IFIs that score 1–15 key principles of *Shari‘ah* governance are ranked as ‘Underdeveloped Practice’, 16–25 as ‘Emerging Practice’, 26–35 as ‘Improved Practice’, 36–45 as ‘Good Practice’ and 46–50 as ‘Best Practice’. This classification will provide a clear illustration of the extent of *Shari‘ah* governance implementation as practised by IFIs in the case countries. The ranking process and scoring method used in this study is further explained in Table 7.10.

Table 7.10: *Shari‘ah* Governance Scoring Method

Level of Practice	Score	Explanation
Underdeveloped Practice	1–15	IFIs that have a minimal score of best <i>Shari‘ah</i> governance practices and need immediate reform.
Emerging Practice	16–25	IFIs that have a minimal score of best <i>Shari‘ah</i> governance practices but indicate positive development.
Improved Practice	26–35	IFIs that have a fair score of best <i>Shari‘ah</i> governance practices and indicate strong improvement.
Good Practice	36–45	IFIs that have a good score of best <i>Shari‘ah</i> governance practices and generally adhere to most of its key principles.
Best Practice	46–50	The ideal IFIs that represent the best practice of <i>Shari‘ah</i> governance.

7.2.1 The Overall Score of *Shari'ah* Governance

The study illustrates the overall scores of *Shari'ah* governance in Malaysia, GCC countries and the UK in Figure 7.11. This illustration provides an overview of the extent of *Shari'ah* governance practices in IFIs.

Figure 7.11: The Overall Scores of *Shari'ah* Governance

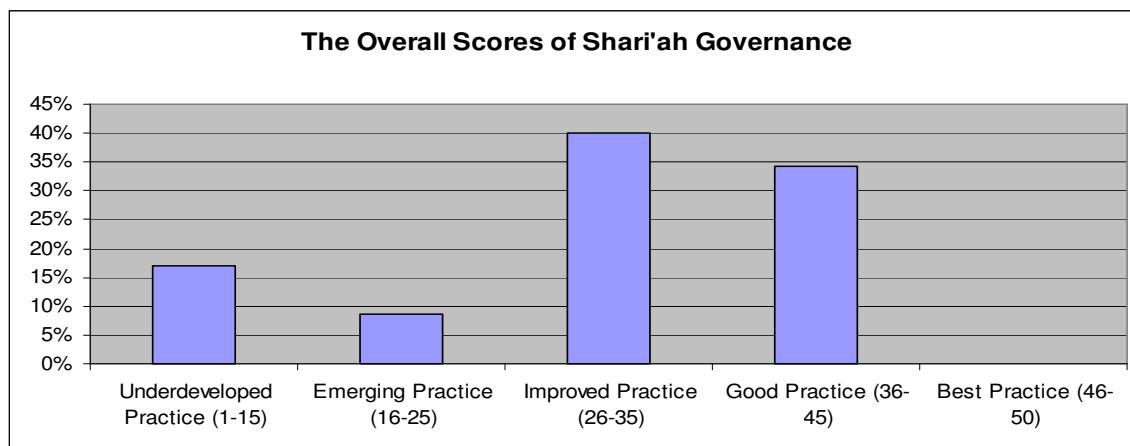
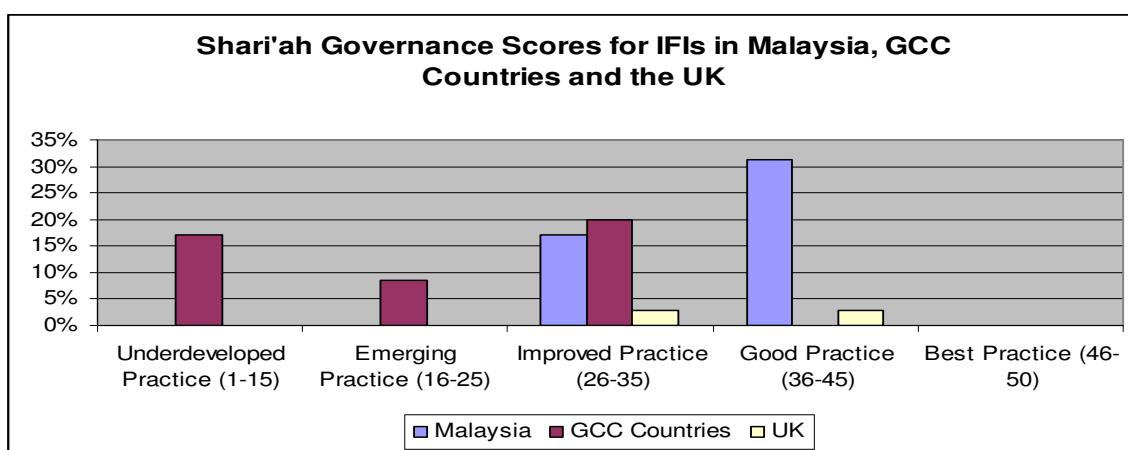


Figure 7.11 demonstrates that the average *Shari'ah* governance score is 30.1 best indicators. The majority of IFIs (40%) fall into the 'Improved Practice' category, with an average of 32.9 best indicators. Meanwhile 8.6% of IFIs fall into the 'Emerging Practice' category and 17.1% into 'Underdeveloped Practice'. This finding indicates that a significant number of IFIs (more than 25%) scored less than 25 of the best indicators of *Shari'ah* governance, indicating very weak practice and 40% of IFIs show some positive improvements. The survey reveals that only 34.2% of IFIs fall into the 'Good Practice' category and none of the IFIs were categorized as 'Best Practice'. This position indicates that only a minority of IFIs are categorized as having 'Good Practice' of *Shari'ah* governance while the remaining majority of IFIs urgently need further enhancement and improvement to their *Shari'ah* governance frameworks and practices. On the whole, the overall scores of *Shari'ah* governance above affirm that there are gaps and shortcomings in the existing frameworks and practices of *Shari'ah* governance in IFIs, in spite of the available international guiding principles and governance standards.

7.2.2 *Shari'ah* Governance Scores for IFIs in Malaysia, GCC Countries and the UK

The overall *Shari'ah* governance scores affirm that more than 65% of IFIs are ranked in the ‘Improved Practice’, ‘Emerging Practice’ and ‘Underdeveloped Practice’ category, while less than 35% of IFIs were ranked in the ‘Good Practice’ category. This section further illustrates a comparative overview of the *Shari'ah* governance scores according to the country’s specific behaviour. Figure 7.12 and Table 7.11 demonstrate the different and average *Shari'ah* governance scores for IFIs in the case countries. This comparative perspective is very useful in explaining the effectiveness of diverse *Shari'ah* governance approaches as practised by IFIs.

Figure 7.12: Comparative Overview of *Shari'ah* Governance for IFIs in Malaysia, GCC Countries and the UK



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Table 7.11: The Average *Shari'ah* Governance Scores *

Countries	Scores					Total Scores (35x50 =1750)	Average
	Underdeveloped Practice	Emerging Practice	Improved Practice	Good Practice	Best Practice		
Malaysia (17 IFIs)			202	430		632	37.1
GCC Countries (16 IFIs)	62	66	227			355	22.2
UK (2 IFIs)			32	37		69	34.5
Total	62	66	461	467		1056	30.1

* The scores are generated from 50 indicators of *Shari'ah* governance key principles as illustrated in table 7.9. The total scores of each IFI are 50. IFIs in Malaysia score 632 out of 850 (17x50), GCC Countries, 355 out of 800 (16x50) and the UK, 69 out of 100 (2x50). The ‘average’ is formulated as the scores divide by the number of IFIs.

Figure 7.12 and Table 7.11 illustrate that there are significant differences in the state of *Shari'ah* governance practices in IFIs. Basically, IFIs in Malaysia presented a slightly better score compared to GCC countries and the UK. Most of the IFIs in Malaysia (31.4%) fall into the ‘Good Practice’ category and only 17.1% into the ‘Improved Practice’ category. This finding demonstrates that the overall score of IFIs in Malaysia is relatively good, with an average of 37.1 best indicators for each IFI, which can be categorized as ‘Good Practice’. The researcher presumes that the finding of good *Shari'ah* governance practice in IFIs in Malaysia is contributed to by several external and internal factors. With regard to external factors, well-conceived regulation and the proactive approach of the regulatory and supervisory authorities, such as the issuance of the BNM/GPS1, have contributed to better development of the *Shari'ah* governance system. Meanwhile, the internal factors refer to the positive initiative at the individual IFI level to facilitate the implementation of Islamic finance by emphasizing the requirements of *Shari'ah* compliance. It was found that the BNM, as well as individual IFIs, have organized training for the *Shari'ah* board and practitioners and allocated a significant amount of funds to develop various programmes pertaining to *Shari'ah* governance.

Unlike Malaysia, the overall finding for IFIs in GCC countries demonstrates that they have a slightly weak *Shari'ah* governance practice with an average of 22.2 best

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indicators, which can be ranked as ‘Emerging Practice’; 20% of IFIs fall into the ‘Improved Practice’ category, 8.6% into the ‘Emerging Practice’ category and 17.1% into the ‘Underdeveloped Practice’ category. This position indicates that more than 50% of IFIs in GCC countries scored less than 25 best indicators, which demonstrates very weak practice of *Shari'ah* governance. Moreover, it was found that several IFIs have failed to comply with the AAOIFI governance standards as well as the directives or guidelines of their regulatory and supervisory authorities. The researcher presumes that weak supervision and monitoring by the supervisory authorities as well as less initiative at individual IFI level are amongst the contributory factors that have led to these negative findings.

The study did not expect too much in terms of *Shari'ah* governance scores for IFIs in the UK as the implementation of Islamic finance is within a purely secular legal environment. The findings, on the other hand, surprisingly demonstrate that IFIs in the UK scored slightly better than GCC countries, as 2.8% fall into each of the ‘Improved Practice’ and ‘Good Practice’ categories with an average of 34.5 best indicators. This phenomenon suggests that strong regulation and supervision is not the sole factor that may positively influence *Shari'ah* governance practice. In the absence of regulations and directives from the FSA, IFIs in the UK have proactively developed their own *Shari'ah* governance system that falls into the ‘Improved Practice’ category.

In view of the absence of any specific study to measure and evaluate the extent of *Shari'ah* governance practice in IFIs, this study has introduced *Shari'ah* governance indicators to rank IFIs according to their *Shari'ah* governance scores. With fifty identified key principles of best *Shari'ah* governance practices, the research evaluates and examines the state of *Shari'ah* governance practice based on the feedback from the survey. The overall findings demonstrate that more than 25% of thirty-five IFIs fall into the ‘Underdeveloped Practice’ and ‘Emerging Practice’ categories, while the majority of them fall into the ‘Improved Practice’ category. Only 32.4% of IFIs fall into the ‘Good Practice’ category and the majority of them are from Malaysia. In spite of some shortcomings and weaknesses of *Shari'ah* governance practices, the 40% of IFIs that fall into the ‘Improved Practice’ category is a positive sign and points to a growing awareness

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of *Shari'ah* governance. These findings strongly indicate that there is a huge potential for improvement and enhancement on the part of IFIs to develop their *Shari'ah* governance framework.

7.2.3 *Shari'ah* Governance Scores According to Year of Incorporation

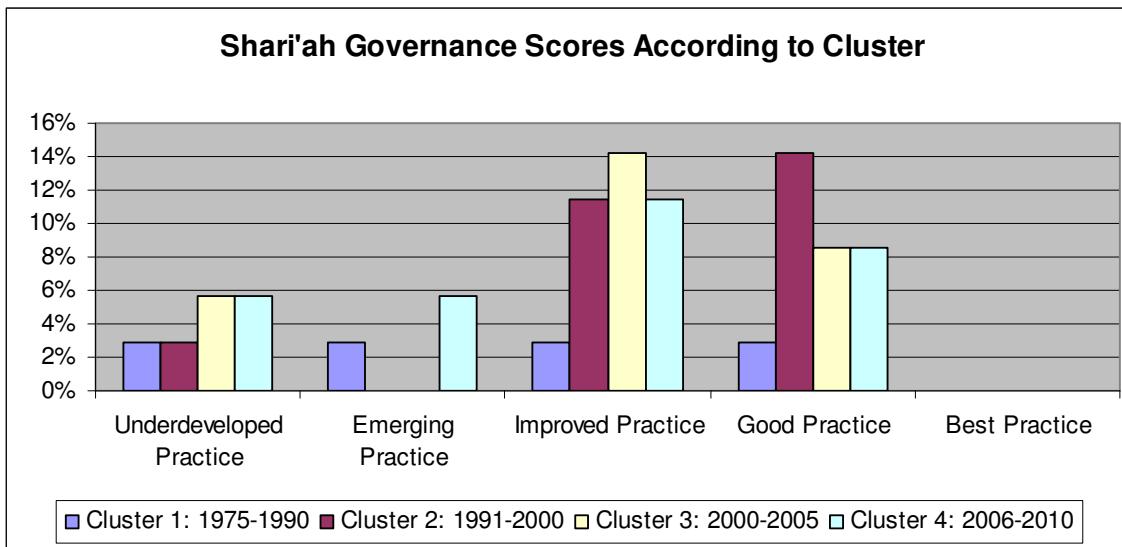
This section attempts to further demonstrate the extent of *Shari'ah* governance practices in IFIs by classifying them into four different clusters. Unlike section 7.2.2 which presented *Shari'ah* governance scores from a country-specific behaviour perspective, this section highlights the level of *Shari'ah* governance scores on the basis of the year of incorporation. In the case of Islamic windows, the study refers to the year they started offering Islamic financial products and services. The majority of IFIs established their *Shari'ah* board in the same year of their incorporation and some of them set up their *Shari'ah* board later on, particularly when they started offering Islamic financial products and services. Table 7.12 illustrates the details of the classification.

Table 7.12: Classification of IFIs According to Year of Incorporation

IFIs	Malaysia	GCC Countries	UK	Total	Percentage
Cluster 1: 1975–1990	1	3		4	11.40%
Cluster 2: 1991–2000	7	2		9	25.70%
Cluster 3: 2000–2005	8	3		11	31.40%
Cluster 4: 2006–2010	3	6	2	11	31.40%

The IFIs are classified into four clusters. Cluster 1 refers to the IFIs that were established between 1975 and 1990, Cluster 2 between 1991 and 2000, Cluster 3 between 2000 and 2005, and Cluster 4 between 2006 and 2010. There are 11.4% of IFIs classified as Cluster 1, 25.7% as Cluster 2, 31.4% as Cluster 3 and 31.4% as Cluster 4. These figures indicate that the IFIs in Clusters 3 and 4 represent the majority of the research sample. Based on the above classification, the study quantifies the *Shari'ah* governance scores and ranks them into ‘Underdeveloped Practice’, ‘Emerging Practice’, ‘Improved Practice’, ‘Good Practice’ and ‘Best Practice’ categories, as explained in Table 7.10. Details of the findings are illustrated in Figure 7.13.

Figure 7.13: *Shari'ah* Governance Scores According to Cluster



It is clear from Figure 7.12 that there are significant differences between the *Shari'ah* governance practices in IFIs. IFIs in Clusters 2 and 3 represent better *Shari'ah* governance scores compared to their counterparts in Clusters 1 and 4. The majority of IFIs (40%) fall into the ‘Improved Practice’ category, while a minority of them fall into the ‘Emerging Practice’ (8.6%) and ‘Underdeveloped Practice’ (17.1%) categories. A total of 14.2% of IFIs in Cluster 2 fall into the ‘Good Practice’ category, while the majority of IFIs (14.2%) in Cluster 3 fall into the ‘Improved Practice’ category. IFIs in Cluster 1 show slightly lower *Shari'ah* governance scores, with most of them falling into the ‘Improved Practice’, ‘Emerging Practice’ and ‘Underdeveloped Practice’ categories. IFIs in Cluster 4 indicated positive improvement in *Shari'ah* governance matters, where a significant percentage of 11.4% are ranked as being in the ‘Improved Practice’ category.

The above figures demonstrate interesting findings which are contrary to the research expectations that IFIs in Cluster 1 will have better *Shari'ah* governance scores than IFIs in Clusters 3 and 4. IFIs in Cluster 1, which are considered pioneers in Islamic finance, indicated weak *Shari'ah* governance practices. The majority of them are ranked in the ‘Emerging Practice’ and ‘Underdeveloped Practice’ categories. On the other hand, IFIs in Cluster 4, which are considered new to the Islamic finance industry, show positive improvement and slightly better *Shari'ah* governance practices than the IFIs in Cluster 1.

These results affirm that the early establishment of IFIs is not the determining factor for the extent and quality of *Shari'ah* governance practices. The level of *Shari'ah* governance practices is much more influenced by external and internal factors, where the former refers to the regulatory framework and commitment by the regulatory and supervisory authorities and the latter concerns well-conceived by-laws and internal policies on *Shari'ah* governance, as well as voluntary initiatives by the IFIs themselves.

7.3 Conclusion

In view of the lack of available data and information on *Shari'ah* governance practices in IFIs, the researcher employed the survey research method to investigate and examine the extent of *Shari'ah* governance practices in Malaysia, GCC countries and the UK. The survey response rate of 43.8% clearly indicates that the research findings in this study are acceptable and significant. The survey responses affirm that IFIs in the case countries have different and diverse *Shari'ah* governance practices and further acknowledge that there are shortcomings and weaknesses to the present governance framework in the following main areas: approach to *Shari'ah* governance, regulatory frameworks and internal policies on *Shari'ah* governance, roles of *Shari'ah* board, attributes of *Shari'ah* board members with respect to independence, competence, transparency and confidentiality, operational procedures, and assessment of *Shari'ah* board.

To sum up, the *Shari'ah* governance scores of the thirty-five IFIs in the case countries demonstrate that more than 65% of them require significant enhancement and improvement as they are ranked in the ‘Improved Practice’, ‘Emerging Practice’ and ‘Underdeveloped Practice’ categories. With a small percentage of 35% of IFIs falling into the ‘Good Practice’ category with an average of 30.2 best indicators, the study concludes that the overall *Shari'ah* governance practices are still in the stage of development and need immediate attention by policymakers and regulatory authorities as well as the internal organs of governance in the IFIs, such as shareholders, the BOD and senior management.

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The need for the above enhancement of *Shari'ah* governance practice is crucial as it would then strengthen the performance and credibility of IFIs. In this regard, regulatory authorities should take the initiative to establish *Shari'ah* governance standards or to adopt the existing *Shari'ah* governance guidelines for IFIs. In the meantime, IFIs should initiate efforts to create well-conceived by-laws for their *Shari'ah* governance system. A sound *Shari'ah* governance practice would enhance the potential role of Islamic finance in contributing towards corporate reform and mitigating certain types of risk exclusive to IFIs.

CHAPTER 8

SEARCHING FOR THE PERCEPTIONS OF THE SHARI'AH SCHOLAR ON SHARI'AH GOVERNANCE SYSTEM IN ISLAMIC BANKING: ANALYSIS OF THE SEMI-STRUCTURED INTERVIEWS

8.1 Introduction

The *Shari'ah* board is the most important organ of governance in the *Shari'ah* governance system. It plays an essential role in ensuring that all objectives of *Shari'ah* governance are met and these include directing, reviewing, supervising the activities of IFIs and issuing legal rulings. In this regard, the study decided to explore *Shari'ah* board members' views and opinions pertaining to *Shari'ah* governance issues. This chapter hence aims at examining their views in six different areas: namely issues on *Shari'ah* governance, internal policy framework, role of the *Shari'ah* board, attributes of the *Shari'ah* board in terms of mechanisms of independence, competence, transparency and confidentiality, operational procedures, and assessment of *Shari'ah* board.

As part of the qualitative research strategies, the study conducted semi-structured interviews with *Shari'ah* scholars from different IFIs. Despite facing numerous problems and constraints in getting *Shari'ah* scholars for interview, the study successfully interviewed fourteen *Shari'ah* scholars (two in Dubai, one in London and eleven in Kuala Lumpur) representing IFIs in Malaysia, GCC countries and the UK. The researcher considers that the interview findings from those fourteen *Shari'ah* scholars are acceptable and significant.

The interviews were conducted specifically to explore the *Shari'ah* scholars' perception on selected issues pertaining to *Shari'ah* governance. It is worth mentioning that the findings presented in this chapter are integrated and dependent on the views and issues raised in each part of the interview section. In this regard, the findings will be more useful if analysed as a whole and not read in isolation. For the purpose of clarity, the findings are summarized in a coded and thematic way, using the content analysis method. The results of the coding analysis are then discussed in detail after the presentations of the main findings in the tables.

8.2 Research Findings

8.2.1 Issues of *Shari'ah* Governance

Four questions were posed to *Shari'ah* scholars in this section. The study generated these questions in order to examine *Shari'ah* scholars' views on *Shari'ah* governance issues, the AAOIFI governance standards, the IFSB-10 and the impact of poor *Shari'ah* governance practices.

Question 1: What is the main issue you currently face in relation to *Shari'ah* governance?

Focused Coding:

- (i) Coding 1: Regulatory and supervisory authorities;
- (ii) Coding 2: Regulation;
- (iii) Coding 3: *Shari'ah* rulings; and
- (iv) Coding 4: Management and internal officers of IFIs

Theme: There are four main *Shari'ah* governance issues that need to be appropriately addressed, namely the function of regulatory and supervisory authorities, the extent of regulation, the *Shari'ah* rulings, and the role of management in IFIs.

Table 8.1: Focused Coding 1, 2, 3 and 4 for Question 1

Focused Coding	Interviewee	Answer
1) Regulatory and supervisory authorities	Interviewee 1	<ul style="list-style-type: none">• Regulator does not actually understand or appreciate the nature of the <i>Shari'ah</i> board's duty.• The regulator tries to intervene and question the role played by the <i>Shari'ah</i> board.
	Interviewee 2	<ul style="list-style-type: none">• There is lack of enforcement on the aspects of <i>Shari'ah</i> governance.
	Interviewee 5	<ul style="list-style-type: none">• Regulator looks more from a macro perspective while IFIs see from a micro perspective.
2) Regulation	Interviewee 5	<ul style="list-style-type: none">• Restriction on multiple appointments has led to the issue of a shortage of <i>Shari'ah</i> advisors. Some IFIs have to take individuals who are not specialized in <i>muāmalāt</i>. Therefore IFIs have to train them and this incurs time and cost.

Searching for the Perceptions of the *Shari'ah* Scholar on *Shari'ah* Governance System in Islamic Banking: Analysis of the Semi-Structured Interviews

Focused Coding	Interviewee	Answer
3) <i>Shari'ah</i> rulings	Interviewee 6	<ul style="list-style-type: none"> Some people are still not clear about the position of S16B of the Central Bank of Malaysia (Amendment) Act 2003, and whether it is persuasive or not. The SAC should be the highest position of <i>fatwa</i> in <i>muāmalāt</i> in Malaysia. The idea that the rulings made by the SHC should be endorsed by National Fatwa Council should not be the way to resolve the issue. It is advisable that the court of law refers to the SAC for any <i>Shari'ah</i> issue.
	Interviewee 8	<ul style="list-style-type: none"> The main issue is regulation, i.e. lack of regulation. The Central Bank should come out with rules and regulations and set up its own <i>Shari'ah</i> board. The regulations must consist of auditing, reviewing and qualification pertaining to the <i>Shari'ah</i> governance system.
	Interviewee 10	<ul style="list-style-type: none"> The procedure of <i>fatwa</i>. The qualifications and position of the <i>Shari'ah</i> board members.
	Interviewee 3	<ul style="list-style-type: none"> Standardization and harmonization of IFIs' practices. Problems with the differences in <i>Shari'ah</i> rulings.
	Interviewee 5	<ul style="list-style-type: none"> There is a gap between <i>Shari'ah</i> board's understanding and the actual practice.
	Interviewee 7	<ul style="list-style-type: none"> To address the micro issues that meet the market and industry needs.
	Interviewee 9	<ul style="list-style-type: none"> There are issues that are not real issues, such as conflict of interest. There is no conflict of interest because <i>Shari'ah</i> scholars perform the job for the sake of Allah. With regard to the allegation that <i>Shari'ah</i> scholars are just a rubber stamp, this is not true and it is a baseless allegation. The existing practice of Islamic banking such as <i>murābahah</i> and <i>mushārakah</i> is actually the practice of the Prophet. There is no problem in practising either debt financing or equity financing.
	Interviewee 12	<ul style="list-style-type: none"> Consistency and transparency.

Searching for the Perceptions of the *Shari'ah* Scholar on *Shari'ah* Governance System in Islamic Banking: Analysis of the Semi-Structured Interviews

Focused Coding	Interviewee	Answer
	Interviewee 13	<ul style="list-style-type: none"> Since the chairman of the <i>Shari'ah</i> board is a <i>Shari'ah</i> scholar from the Middle East and another member is originally from the subcontinent, many decisions and views are much influenced by their school of thought and interpretations. Nevertheless, it is a good form of harmonization of <i>Shari'ah</i> interpretations between Malaysia and other regions.
	Interviewee 14	<ul style="list-style-type: none"> Focusing on substance and not only on form.
4) Management and internal officers of IFIs	Interviewee 2	<ul style="list-style-type: none"> The management does not understand the extent of <i>Shari'ah</i> issues.
	Interviewee 10	<ul style="list-style-type: none"> Poor understanding of the management about <i>Shari'ah</i>.
	Interviewee 11	<ul style="list-style-type: none"> Advisor is given insufficient time to peruse and go through the documents and product's detail. Lack of skill of the bank's officials in explaining products to the <i>Shari'ah</i> advisor. Low expertise of the internal <i>Shari'ah</i> officer.
	Interviewee 13	<ul style="list-style-type: none"> <i>Shari'ah</i> governance structure within the financial group is still minimal compared to the fully-fledged IFIs, such as no internal <i>Shari'ah</i> officer and no internal <i>Shari'ah</i> audit.

Question 2: Do you think the adoption of the AAOIFI governance standards may resolve issues of *Shari'ah* governance?

Focused Coding:

- Coding 1: It positively resolves *Shari'ah* governance issues; and
- Coding 2: There are some weaknesses and constraints within the AAOIFI governance standards.

Theme: The AAOIFI governance standards may positively resolve the *Shari'ah* governance issues but there are some weaknesses and constraints on its implementation.

Table 8.2: Focused Coding 1 and 2 for Question 2

Focused Coding	Interviewee	Answer
1) It positively resolves <i>Shari'ah</i> governance issues	Interviewee 2	<ul style="list-style-type: none"> • Yes, it resolves some issues such as the qualification of <i>Shari'ah</i> advisors.
	Interviewee 3 and 14	<ul style="list-style-type: none"> • Partly, yes.
	Interviewee 12	<ul style="list-style-type: none"> • Certainly adopting the AAOIFI governance standards would be a step in the right direction.
	Interviewee 13	<ul style="list-style-type: none"> • It might resolve some issues of <i>Shari'ah</i> governance by using the same standards across the board. However, in terms of implementation, it would still depend on the structure of the Islamic and financial sector of the country, the policies, regulations and also the readiness of various market players. It is basically back to the issue of divergence and convergence in the industry.
2) There are some weaknesses and constraints within the AAOIFI governance standards	Interviewee 1	<ul style="list-style-type: none"> • <i>Shari'ah</i> boards are generally not well-versed in the AAOIFI standards. They are written in a way that <i>Shari'ah</i> boards are not familiar with. The document is written as accounting standards. It may resolve some issues but will not resolve them completely.
	Interviewee 4	<ul style="list-style-type: none"> • It may resolve some issues but the problem is the AAOIFI standard itself. It may be a good reference only. The AAOIFI may not be appropriate in some jurisdictions.
	Interviewee 5	<ul style="list-style-type: none"> • It may resolve <i>Shari'ah</i> governance and procedural issues but not substantive issues.
	Interviewee 6	<ul style="list-style-type: none"> • It should be an option to adopt it. There are certain standards that are not appropriate to Malaysia. Let Malaysia develop its own standards because of its different legal environment.
	Interviewee 7	<ul style="list-style-type: none"> • The adoption of the AAOIFI governance standards will not resolve issues and is insufficient but it is a good step and effort towards resolving <i>Shari'ah</i> governance issues. • The AAOIFI standards must be reviewed by professionals, bankers, accountant, lawyers, etc. This is because the AAOIFI standards have never been reviewed so far.

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Focused Coding	Interviewee	Answer
	Interviewee 9	<ul style="list-style-type: none"> Yes it may resolve some issues. But the problem with the AAOIFI is that the majority of <i>Shari'ah</i> scholars are <i>Malikis</i> and its <i>Shari'ah</i> standard may not be applicable in certain jurisdictions, such as in Malaysia. For example, in the case of <i>bay' al dayn</i> and <i>bay' al inah</i>, the standards may not be applicable or appropriate in Malaysia.
	Interviewee 10	<ul style="list-style-type: none"> I am not sure whether it tackles the issue of <i>Shari'ah</i> governance. As far as <i>Shari'ah</i> parameters and rules are concerned, the AAOIFI standards are definitely very useful.
	Interviewee 11	<ul style="list-style-type: none"> No.

Question 3: What is your view on the IFSB-10?

Focused Coding:

- (i) Coding 1: The IFSB-10 is comprehensive and good for *Shari'ah* governance; and
- (ii) Coding 2: There are some challenges for its implementation.

Theme: The IFSB-10 is a good reference but there are some challenges with respect to its implementation.

Table 8.3: Focused Coding 1 and 2 for Question 3

Focused Coding	Interviewee	Answer
1) The IFSB-10 is comprehensive and good for <i>Shari'ah</i> governance	Interviewee 2	<ul style="list-style-type: none"> • It is quite comprehensive.
	Interviewees 1, 5, 8, and 10	<ul style="list-style-type: none"> • Not yet read the draft.
	Interviewee 3	<ul style="list-style-type: none"> • It is a good attempt.
	Interviewee 6	<ul style="list-style-type: none"> • There are some similarities with the BNM/GPS1 and the AAOIFI governance standards. It could be a main reference for <i>Shari'ah</i> governance system.
	Interviewee 9	<ul style="list-style-type: none"> • Yes, it is a good guideline.
	Interviewee 11	<ul style="list-style-type: none"> • Fair.
	Interviewee 12	<ul style="list-style-type: none"> • It is excellent guidance for IFIs to follow, with a view to further improvements.
	Interviewee 13	<ul style="list-style-type: none"> • In my point of view, the recent IFSB <i>Shari'ah</i> governance guidelines is a well-drafted standard to strengthen the <i>Shari'ah</i> board's functions and roles in IFIs. • Apart from safeguarding the independence of the <i>Shari'ah</i> board, it also highlights the ideal structure of the <i>Shari'ah</i> board by appointing <i>Shari'ah</i> advisors with diverse backgrounds that hold board positions in different countries, <i>madhāhib</i>, experience levels and qualifications. • It is also a good move if there are more female <i>Shari'ah</i> board members to break the stigma of the ‘man monopolized club’ in <i>Shari'ah</i> board practice.
	Interviewee 14	<ul style="list-style-type: none"> • A step in the right direction.
	Interviewee 2	<ul style="list-style-type: none"> • There should be different approaches to <i>Shari'ah</i> governance in different jurisdictions. • The issue of advisory or supervisory role of <i>Shari'ah</i> board at national and international level.
	Interviewee 4	<ul style="list-style-type: none"> • It is a good guideline but there are a lot of challenges to implement it. The difference with the IFSB and the AAOIFI governance standards refer to the target audience where the former relies upon the regulators and the latter upon the individual IFIs. • A big challenge to the IFSB refers to the enforcement issue, whether the guidelines are acceptable in various jurisdictions.

Question 4: Are you aware any of any failure or serious impact on the IFIs directly or indirectly attributable to poor *Shari'ah* governance practices?

Focused Coding:

- (i) Coding 1: Failure to promote Islamic values;
- (ii) Coding 2: Communication gap between IFIs and the *Shari'ah* board; and
- (iii) Coding 3: The impact upon the image, credibility and reputation of IFIs

Theme: There are some discrepancies in the practice of Islamic finance that may impede the development of its image, credibility and reputation, such as failure to promote Islamic values, lack of communication in *Shari'ah* supervision and failure to mitigate the *Shari'ah* non-compliance risk.

Table 8.4: Focused Coding 1, 2 and 3 for Question 4

Focused Coding	Interviewee	Answer
1) Failure to promote Islamic values	Interviewee 2	<ul style="list-style-type: none"> • Yes. For instance in the aspect of <i>Shari'ah</i> supervision and monitoring. Islamic values are part and parcel of the business. My observation is that the IFIs' objective is to make profit and maximize the customer's satisfaction. There is a lack of Islamic values. • To have a minimum standard of Islamic values.
	Interviewee 8	<ul style="list-style-type: none"> • The failure of the <i>Shari'ah</i> board is to give input in formulating pure and original Islamic products. At the moment, the existing products are only mimicking conventional products.
	Interviewee 10	<ul style="list-style-type: none"> • Yes, since <i>Shari'ah</i> compliance is the backbone of IFIs and their very reputation.
2) Communication gap between IFIs and the <i>Shari'ah</i> board	Interviewee 2	<ul style="list-style-type: none"> • Poor level of communication between <i>Shari'ah</i> board and IFIs. The documents do not really translate the contract. For instance, in the case of <i>bay' al inah</i>, there are terms that contradict the conditions of the contract. The <i>Shari'ah</i> board must monitor meticulously the details of documentation.
	Interviewee 4	<ul style="list-style-type: none"> • Another issue is the understanding of the <i>Shari'ah</i> board of certain issues deliberated upon during the board meetings. Once again it depends on the IFI's duty to disclose all relevant information to the <i>Shari'ah</i> board and then the board can deliver solid <i>Shari'ah</i> rulings.

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Focused Coding	Interviewee	Answer
	Interviewee 5	<ul style="list-style-type: none"> • Oversight. Issues on how products are approved, marketed, etc. For example, equity financing products such as <i>mudhārabah</i>. Basically, the bank cannot guarantee profit. When the product is marketed, the product is presumed to be guaranteed. The management thinks this might not be serious. We have seen complaints from customers. <i>Shari'ah</i> non-compliance may have an impact on public perception.
	Interviewee 8	<ul style="list-style-type: none"> • Yes. For example, <i>tawarruq</i>; the problem with <i>tawarruq</i> is that the <i>Shari'ah</i> board does not monitor the implementation of <i>Shari'ah</i> rulings. Reversed <i>tawarruq</i> is prohibited but organized <i>tawarruq</i> is permissible if it follows the conditions.
	Interviewee 9	<ul style="list-style-type: none"> • Yes, <i>Shari'ah</i> scholars have already warned IFIs about the issues of <i>Shari'ah</i> non-compliance risk. But sometimes, the IFIs do not hear what the <i>Shari'ah</i> scholars say. The <i>Shari'ah</i> rulings are properly made but there are problems with implementation. There were cases where the IFIs did not comply with the <i>Shari'ah</i> and this was really unethical. I am of the view that the credibility of <i>Shari'ah</i> scholars also plays an important role. For example, in the case of LRT Project Financing based on <i>istisnā`</i> and <i>ijārah</i>, where the <i>Shari'ah</i> board is comprised of Sheikh Yusof al Qaradhawi and Sheikh Taqi Usmani, it was found that the company followed strictly all the advice given.
3) The impact upon the image, credibility and reputation of IFIs	Interviewee 1	<ul style="list-style-type: none"> • From the <i>Shari'ah</i> board's perspective, there is no impact. The impact will be upon the Islamic finance industry.
	Interviewee 4	<ul style="list-style-type: none"> • The impact is more on the decision made by the <i>Shari'ah</i> board.
	Interviewee 6	<ul style="list-style-type: none"> • From my perspective it does not have much impact but puts more pressure on the industry to find a better alternative.
	Interviewee 10	<ul style="list-style-type: none"> • Yes, since <i>Shari'ah</i> compliance is the backbone of IFIs and their reputation.

8.2.1.1 Analysis of the Issues of *Shari'ah* Governance

In the analysis of the interviews, the study identifies four main issues pertaining to *Shari'ah* governance, namely roles of regulators, regulation, IFIs' management and *Shari'ah* rulings. *Shari'ah* scholars have admitted that there are gaps between the regulator, IFIs' management and the *Shari'ah* board in terms of communication and understanding. While regulators try to impose a series of regulations upon the *Shari'ah* board, some *Shari'ah* scholars consider it unnecessary since they are bound by Islamic ethics. *Shari'ah* scholars also highlighted that some IFIs' management failed to understand the extent of *Shari'ah* non-compliance risk. At this point, *Shari'ah* scholars insisted on the need to strengthen the *Shari'ah* functions and break down the communication barrier between the IFIs' stakeholders and these include regulators, shareholders, management, *Shari'ah* board, employees and consumers.

In terms of the AAOIFI governance standards and the IFSB-10, the majority of answers tend to show that they may only resolve certain *Shari'ah* governance issues, such as procedural issues, but not the substantive issues. Some *Shari'ah* scholars questioned the acceptability of both documents being suitable for various jurisdictions. The AAOIFI governance standards also have credibility issues, and one of the *Shari'ah* scholars complained that the standards have not been reviewed. They further criticized that the standards were approved by the same *Shari'ah* scholars who advised numerous IFIs in various jurisdictions. The study also reveals that some *Shari'ah* scholars are not sensitive and alert to the development of *Shari'ah* governance. It is found that four of them were unaware of or had not yet read the IFSB-10.

With regards the impact of poor practice of *Shari'ah* governance, the majority of *Shari'ah* scholars highlighted their concerns on this matter. In fact, a few of them have expressed their concerns on the impact of poor *Shari'ah* governance, particularly the perception of the public of the IFIs' credibility. Three *Shari'ah* scholars highlighted that the current practice of *Shari'ah* governance to a certain extent has failed to promote Islamic values, while the rest of them have expressed their concerns about the

communication gap between them and IFIs. Both these factors may contribute to the negative impact of *Shari'ah* governance upon the image and credibility of IFIs. At this point, the study indicates that *Shari'ah* scholars have admitted that there were discrepancies and weaknesses in the existing practice of *Shari'ah* governance. These findings nevertheless indicate that *Shari'ah* scholars have a lack of understanding of the actual impact of poor *Shari'ah* governance upon IFIs. The implication of poor *Shari'ah* governance actually goes beyond the aspects of credibility and the image of IFIs. An inappropriate *Shari'ah* governance system will not only negate the public confidence in the legitimacy of the products and services but also will expose IFIs to *Shari'ah* non-compliance risk, which may have numerous impacts, both financial and non-financial, on IFIs.

8.2.2 Internal Framework of *Shari'ah* Governance

This section identifies one question pertaining to by-laws or internal policies of IFIs to carry out a *Shari'ah* review. This question attempts to demonstrate the state of IFIs' internal policies framework to ensure the effectiveness of *Shari'ah* governance implementation.

Question 5: Do the bank by-laws allow you to carry out a *Shari'ah* review to ensure that the bank's operation is in accordance with *Shari'ah*?

Focused Coding:

- (i) Coding 1: Affirmative; and
- (ii) Coding 2: Negative.

Theme: There are significant differences in the *Shari'ah* review frameworks and some IFIs do not have specific by-laws or formal internal policies on *Shari'ah* review.

Table 8.5: Focused Coding 1 and 2 for Question 5

Focused Coding	Interviewee	Answer
1) Affirmative	Interviewee 4	<ul style="list-style-type: none"> Yes, generally in Malaysia. But not in the Middle East where the <i>Shari'ah</i> reviews are conducted on the IFIs' own initiatives. Neither jurisdiction, however, regulates the requirements for the <i>Shari'ah</i> review.
	Interviewee 6	<ul style="list-style-type: none"> Yes, in terms of reference. IFIs have a <i>Shari'ah</i> compliance manual and it is binding on the individual bank.
	Interviewee 9	<ul style="list-style-type: none"> <i>Takāful</i> Malaysia has started to do its <i>Shari'ah</i> review based on its own initiative.
	Interviewees 10, 11, and 12	<ul style="list-style-type: none"> Yes.
	Interviewee 13	<ul style="list-style-type: none"> The new <i>Shari'ah</i> governance framework will be issued this year and become effective in year 2011 will replace the BNM/GPS1. It is clearly stated that every <i>Shari'ah</i> board decision, view and opinion related to the IFI is binding and the management is responsible for observing and implementing those decisions. At the same time, any pronouncement issued by the SHC which is validated by the SAC is legally binding upon the court by virtue of the CBA.
2) Negative	Interviewees 2	<ul style="list-style-type: none"> In principle yes but in practice no. Decisions are based on <i>Shari'ah</i> board meetings and assumptions. We sign the declaration of <i>Shari'ah</i> compliance in the annual report.
	Interviewees 3 and 8	<ul style="list-style-type: none"> No.
	Interviewee 5	<ul style="list-style-type: none"> I have not seen any. <i>Shari'ah</i> compliance reviews are conducted but not very often.

8.2.2.1 Analysis of the Internal Framework of *Shari'ah* Governance

There are significant differences in *Shari'ah* governance practices with respect to the internal regulation of IFIs pertaining to the *Shari'ah* review. Basically, *Shari'ah* scholars unanimously agreed that IFIs should have an internal policy or by-laws relating to the *Shari'ah* review. *Shari'ah* scholars nevertheless highlighted that some IFIs have by-laws on the *Shari'ah* review while the other IFIs simply ignore this matter. The study also reveals that some *Shari'ah* scholars do not perform a *Shari'ah* review function but only

focus on the *ex ante* functions of *Shari'ah* governance. In fact, they only sign the declaration of *Shari'ah* compliance in the annual report without carrying out a proper *Shari'ah* review process.

This finding indicates that there are some weaknesses in the existing internal framework of *Shari'ah* governance in IFIs. While the *Shari'ah* board is expected to perform *Shari'ah* review functions to ensure *Shari'ah* compliance, the majority of IFIs have not issued by-laws or policies to detail with the processes, authorities, scopes and framework of the *Shari'ah* review. In line with the AAOIFI governance standards and the IFSB-10, IFIs are recommended to have specific by-laws or internal policies that provide comprehensive guidelines on the whole process of *Shari'ah* governance. These by-laws should be the main reference for the internal use of IFIs to help the *Shari'ah* board, internal *Shari'ah* audit and all organs of the governance structure of IFIs to carry out their functions effectively.

8.2.3 Roles of the *Shari'ah* Board

Considering the AAOIFI governance standards, the IFSB-10 and any other standards on *Shari'ah* governance that specifically elaborate the roles of the *Shari'ah* board, the study identified two questions pertinent to this issue. The first question explores *Shari'ah* scholars' understanding of their functions as *Shari'ah* board members while the second question highlights their views on the framework of *Shari'ah*-compliant and *Shari'ah*-based finance.

Question 6: What are the roles of the *Shari'ah* board?

Focused Coding:

- (i) Coding 1: Advisory roles; and
- (ii) Coding 2: Advisory and supervisory

Theme: The *Shari'ah* board has advisory and supervisory roles as well as conducting *Shari'ah*-related training for IFIs.

Table 8.6: Focused Coding 1 and 2 for Question 6

Focused Coding	Interviewee	Answer
1) Advisory roles	Interviewee 1	<ul style="list-style-type: none"> To advise upon <i>Shari'ah</i> matters and sometimes other matters. There are two types of IFIs. Firstly, IFIs that are obsessed with profit maximization and, secondly, IFIs that have made some efforts to instil values and to affect economic growth.
	Interviewee 2	<ul style="list-style-type: none"> To ensure <i>Shari'ah</i> compliance for all functions of IFIs. All views must be supported with reliable evidence and circulated internally with detail reasons. To attend all <i>Shari'ah</i> board meetings. To provide advisory role including adjustment of products.
	Interviewee 9	<ul style="list-style-type: none"> To advise upon <i>Shari'ah</i> compliance matters.
2) Advisory and supervisory roles	Interviewee 3	<ul style="list-style-type: none"> Consultancy, training, product approval and product review.
	Interviewee 4	<ul style="list-style-type: none"> To endorse all operations and products in line with <i>Shari'ah</i> as well as complying with Islamic ethics.
	Interviewee 5	<ul style="list-style-type: none"> To ensure that the bank products are actually <i>Shari'ah</i>-compliant.
	Interviewee 6	<ul style="list-style-type: none"> To oversee operations and products for <i>Shari'ah</i> compliance.
	Interviewee 8	<ul style="list-style-type: none"> Advisory and supervisory.
	Interviewee 9	<ul style="list-style-type: none"> To advise on <i>Shari'ah</i> compliance.
	Interviewee 10	<ul style="list-style-type: none"> The BNM/GPS 1 states that the <i>Shari'ah</i> committee has a supervisory role.
	Interviewee 11	<ul style="list-style-type: none"> To endorse, approve and review all products and services offered by IFIs. The <i>Shari'ah</i> board's approval is thus required on all product programme documents, product development documents, country addenda and other similar documents. The <i>Shari'ah</i> board has a duty to periodically review all of these documents. To advise and review the IFIs' operation and to ensure that it is in compliance with the <i>Shari'ah</i>. To guide, review and approve all legal contracts, agreements and documentations including all marketing material, sales illustrations, advertisements and brochures. To satisfy itself that the formulated endorsements, approvals, advice and guidelines are being properly implemented by IFIs.

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Focused Coding	Interviewee	Answer
		<ul style="list-style-type: none"> • To provide guidance and advice upon request to the IFIs' legal council, auditors, consultants, etc. • To provide written opinions on <i>Sharī'ah</i> matters. • To advise the chairman on matters that require consultation with the BNM.
	Interviewee 12	<ul style="list-style-type: none"> • Advisory, supervisory and regular <i>Sharī'ah</i> audit.
	Interviewee 13	<ul style="list-style-type: none"> • To advise IFIs on issues related to <i>Sharī'ah</i> and to review the products and services to ensure <i>Sharī'ah</i> compliance. • To vet various types of documents which require the endorsement of the <i>Sharī'ah</i> board. • To attend <i>Sharī'ah</i> board meetings. • To deliver lectures or presentations to IFIs' personnel on topics related to <i>Sharī'ah</i>, <i>fiqh al muāmalāt</i> and Islamic banking. • To liaise with relevant advisors, including accountants, tax advisors, rating agencies and <i>Sharī'ah</i> advisors from other institutions.
	Interviewee 14	<ul style="list-style-type: none"> • To develop products and to oversee product delivery, sales force and execution.

Question 7: What is your opinion on the issue of *Sharī'ah*-compliant and *Sharī'ah*-based finance?

Focused Coding:

- (i) Coding 1: There is no difference between *Sharī'ah*-compliant and *Sharī'ah*-based finance; and
- (ii) Coding 2: The *Sharī'ah* board should look beyond the legal and mechanistic aspects of *fiqh*.

Theme: Some *Sharī'ah* scholars viewed that *Sharī'ah*-compliant and *Sharī'ah*-based products and services are the same, while the rest acknowledged the difference by highlighting that the *Sharī'ah* board should also be concerned with and give consideration to larger issues than the *fiqh* aspect.

Table 8.7: Focused Coding 1 and 2 for Question 7

Focused Coding	Interviewee	Answer
1) There is no difference between <i>Shari'ah</i> -compliant and <i>Shari'ah</i> -based finance	Interviewee 2	<ul style="list-style-type: none"> • <i>Shari'ah</i>-compliant means anything related to all <i>Shari'ah</i> principles. The terms <i>Shari'ah</i>-compliant and <i>Shari'ah</i>-based products confuse the public. • <i>Shari'ah</i>-compliant products also take into consideration the element of <i>maqāsid Shari'ah</i>. <i>Shari'ah</i>-compliant and <i>Shari'ah</i>-based products are the end result of <i>ijtihād</i>.
	Interviewee 3	<ul style="list-style-type: none"> • Both are equally important.
	Interviewee 5	<ul style="list-style-type: none"> • Ideally it should be the same. <i>Maqāsid Shari'ah</i> is the end result of <i>Shari'ah</i>-compliant products. • No dichotomy between the two.
	Interviewee 6	<ul style="list-style-type: none"> • It is the same. Be it <i>Shari'ah</i>-compliant, <i>Shari'ah</i>-based or <i>Shari'ah</i>-tolerant. It should not be an issue. For example, only 5% of Islamic financial products are not unified. The remaining 95% are unified.
	Interviewee 7	<ul style="list-style-type: none"> • <i>Shari'ah</i> scholars are concerned with the issue of <i>fiqh</i>. As <i>fiqh</i> scholars, the <i>Shari'ah</i> board focuses on the <i>illah</i> (<i>ratio decidendi</i>) rather than <i>hikmah</i> (wisdom). These two things should not be mixed as the latter provides uncertainty to the rulings. • The problem here is that <i>Shari'ah</i> scholars are more concerned with the micro issues, i.e. specific issues of certain unresolved <i>fiqhī</i> problems. While the major criticisms by economists are more concerned with the macro aspects of it. <i>Shari'ah</i> scholars make decisions based on the science of <i>fiqh</i>. • I am of the opinion that what Islamic finance needs nowadays is a solution and added value. Let us say that the customer needs cash to purchase something, to what extent can Islamic financial products meet this customer's need? A criticism and allegation is that Islamic finance concentrates on debt financing rather than equity is also based on assumption and no clear textual injunction on it.
	Interviewee 9	<ul style="list-style-type: none"> • It should not be the issue. In <i>fiqh</i>, the element of <i>maqāsid Shari'ah</i> is there. <i>Shari'ah</i> scholars have already applied this. • I disagree with the allegation that <i>Shari'ah</i> scholars have neglected the element of <i>maqāsid Shari'ah</i>.
	Interviewee 10	<ul style="list-style-type: none"> • They should be concerned with both.

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Focused Coding	Interviewee	Answer
2) The <i>Shari'ah</i> board should look beyond the legal and mechanistic aspects of <i>fiqh</i>	Interviewee 11	<ul style="list-style-type: none"> Both are acceptable and I am of the view that differentiating both terminologies is not really necessary since rules in <i>fiqh al muāmalāt</i> are open to new contracts and arrangements as long as they do not contravene the Islamic principles. Any of the <i>Shari'ah</i>-compliant products must also be approved based on its objective and not limited to their structure and documentation only. There is no standard and clear definition of these terminologies. Scholars may vary in understanding such terminologies. I also do not agree with the statement which proclaims that <i>Shari'ah</i>-based products absolutely adhere to <i>Shari'ah</i> objectives, whereas, in contrast, <i>Shari'ah</i>-compliant product do not. Yes, any <i>Shari'ah</i> resolution should pay great attention to the <i>maqāsid Shari'ah</i> but it will not be based on whether or not it is <i>Shari'ah</i>-compliant or <i>Shari'ah</i>-based. This is not the indicator. I am of the view that there might be a product which is based on the classical <i>fiqhī</i> concept but still contradicts with the <i>Shari'ah</i> objectives, for example an Islamic bank offered an equity-based (<i>mudhārabah</i>) product to a client without proper due diligence on the business and the reliability of the customer. In such a case, although the product is <i>Shari'ah</i>-based, it is still not satisfying the <i>Shari'ah</i> objectives. Fulfilling <i>Shari'ah</i> objectives is also an <i>ijtihādī</i> matter which differs from one scholar to another. It depends on how they look into things and scrutinize information given. There is no way to make a simple conclusion that a <i>Shari'ah</i> -based product will adhere to <i>maqāsid</i>, while the other will not.
	Interviewee 12	<ul style="list-style-type: none"> There are no distinctions between <i>Shari'ah</i> -compliant and <i>Shari'ah</i> -based. Everything should be approved within the parameters of <i>Shari'ah</i> with the view to fulfil the objectives of the <i>Shari'ah</i>.
	Interviewee 1	<ul style="list-style-type: none"> Yes, the <i>Shari'ah</i> board must play its role to instil the values and spirit of the <i>Shari'ah</i>. The proponents of turning the institution into a welfare and profit-making institution are not giving strong reasons and <i>dalil</i> for their claim and view. IFIs as banking and financial institutions should also play their role in promoting social welfare and ethical values.

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Focused Coding	Interviewee	Answer
	Interviewee 4	<ul style="list-style-type: none"> • Islamic finance now has moved a step forward pertaining to <i>Shari'ah</i> pronouncement. <i>Shari'ah</i> opinion should not be confined to legal aspects only but must go beyond that. It does not mean that the previous practice has neglected <i>maqāsid Shari'ah</i> but the situation during that time has influenced decisions since Islamic finance is relatively new to the market. Now is the time to move to a new phase of Islamic finance. • Once again it still depends on jurisdiction. In some jurisdictions, Islamic finance is still relatively new.
	Interviewee 8	<ul style="list-style-type: none"> • I prefer the latter because Islamic finance is not about <i>fiqh</i> alone. I refer to the Ibnu Abbas story when he gave two different <i>fatwa</i> upon the same issue, namely <i>hukm</i> on murder. In the first <i>fatwa</i>, Ibnu Abbas gave a <i>fatwa</i> that the murderer did not have the right to repent because he knew that the man was asking for <i>fatwa</i> to validate his future action. In the second <i>fatwa</i>, Ibnu Abbas gave a <i>fatwa</i> that the murderer could be pardoned by Allah because he knew that man sincerely wanted to repent.
	Interviewee 10	<ul style="list-style-type: none"> • They should be concerned with both.
	Interviewee 13	<ul style="list-style-type: none"> • Personally, in my opinion, the issue of <i>Shari'ah</i>-compliant and <i>Shari'ah</i>-based finance is more a debate of terminology akin to substance over form. It will go nowhere. Even if we look at Islamic banking itself, there are still many people who are sceptical about its practices because of the capitalist system. • However, amid the banking and financial sector moving forward to emphasize Corporate Social Responsibility and Social Responsibility Investment, the <i>Shari'ah</i> board also has to look into the spirit of <i>Shari'ah</i> in terms of the aims and impacts of the products and services that are being offered to the community at large.
	Interviewee 14	<ul style="list-style-type: none"> • We are a <i>Shari'ah</i>-based institution. Islamic banking must offer an added value to the consumer and not just verbal and financial engineering of contracts to make them look 'Islamic'.

8.2.3.1 Analysis of the Roles of the *Shari'ah* Board

Shari'ah scholars classified their functions as being advisory and supervisory and these include giving advice, conduct training, approving and reviewing products and endorsement of *Shari'ah* compliance. Only two *Shari'ah* scholars mentioned that *Shari'ah* board have a duty beyond giving ordinary advice on *Shari'ah* matters, where they stated that it is important for them to promote and instil Islamic ethics and values.²⁰⁸ This finding indicates that majority of *Shari'ah* scholars are actually focused on advising IFIs upon the legitimacy of products and services from a *fiqh* perspective, rather than going further to educate IFIs about the ethics and values.

Some *Shari'ah* scholars even further classified IFIs into two types, namely IFIs that are obsessed with profit maximization and IFIs that insist on values and are concerned about economic growth. In this regard, *Shari'ah* scholars have problems with the former type of IFIs. This finding reveals that *Shari'ah* scholars face difficulties in promoting the socio-economic function of IFIs when their aims and objectives are solely motivated by profit maximization. This indicates that the corporate governance model adopted by majority of IFIs is based on the shareholder-oriented value system. Contrary to the ideal model of Islamic corporate governance that is founded on the epistemology of *Tawhīd* and the stakeholder value orientation, some IFIs have failed to expand their corporate objectives dimension beyond the maximization of shareholders' profit.

There are significant differences of opinions amongst *Shari'ah* scholars with respect to the issue of *Shari'ah*-compliant and *Shari'ah*-based finance. Some of them view that both terms carry the same meaning while some scholars think otherwise. This position creates a paradox in the actual framework of the *Shari'ah* board's roles in IFIs, where the former

²⁰⁸ This is what is expected by the industry where the *Shari'ah* board should not only play its advisory, approval and audit roles but should also contribute to the development of the industry in terms of social responsibilities and ethical behaviour (Schoon, 2009: 138–140). For instance, the *Shari'ah* board members of LARIBA allocate their time and effort to educate the company as well as the customers by spending approximately 3,000 minutes a month on their mobile phones to answer enquiries and questions pertaining to *Shari'ah* and Islamic financial products (Abdul-Rahman, 2010: 234). The *Shari'ah* board of LARIBA not only has fiduciary duties on the aspect of product approval but also includes participation in the design and hands-on implementation of training programmes in *Shari'ah* compliance, as well as educating the employees about the religion of Islam (Abdul-Rahman, 2010: 78).

concentrate on *fiqh* issues and the latter view that *fiqh* and other aspects of Islam, such as ethics, values and *maqāsid Sharī'ah*, must also be taken into consideration.

Based on the above finding, the study classifies *Sharī'ah* scholars into two types, namely ‘Conservative’ and ‘Pragmatic’. The ‘Conservative’ scholars consider the legitimacy of Islamic financial products and services to be based on the legal and mechanistic aspects of *Sharī'ah*. The products and services are classified as lawful and *Sharī'ah*-compliant or *Sharī'ah*-based if they meet the conditions of a valid *muāmalāt* transaction after going through the ordinary process of *usul al fiqh*.²⁰⁹ On the other hand, the ‘Pragmatic’ scholars admitted that the *Sharī'ah* board should not confine their function by solely emphasizing the *fiqh* aspect. The ‘Pragmatic’ scholars acknowledged that Islamic financial products and services should not only be valid and lawful but must fulfil the spirit of *maqāsid Sharī'ah*. Inspired by the foundational dimension of governance in Islam that puts *maqāsid Sharī'ah* as the central objective, the study strongly recommends the view of the ‘Pragmatic’ scholars. In view of the lack of concentration on social welfare and socio-economic development in IFIs, *Sharī'ah* scholars, as the key players of *Sharī'ah* governance, should play a significant role to educate IFIs not only in matters pertaining to *Sharī'ah* but also to expand this dimension towards a more holistic Islamic approach.

8.2.4 Attributes of *Sharī'ah* Board Members

Questions on the attributes of *Sharī'ah* board members are divided into three aspects, namely mechanisms of competence, independence, and transparency and confidentiality. Three questions were posed to *Sharī'ah* scholars with regard to competence, two questions pertaining to independence and two questions on transparency and confidentiality issues. *Sharī'ah* scholars’ views on these three aspects are extremely important as the *Sharī'ah* board plays a significant role in the *Sharī'ah* governance

²⁰⁹ Sheikh Saleh Kamel raised his concern about the Islamic finance industry when he highlighted that the majority of Islamic financial products and services available in the market are unIslamic (Mahdi, 2008). This is affirmed by Jawad Ali, a prominent lawyer in a Dubai-based legal firm, who claims that 40–50% of Islamic financial products in the areas of capital guarantees, fixed income and derivatives are considered as merely form over substance (Pasha, 2010).

system and they are expected to be independent, competent, transparent and to observe secrecy.

8.3.4.1 Competence

Question 8: Does the bank organize adequate training for the *Shari'ah* board?

Focused Coding:

- (i) Coding 1: Affirmative; and
- (ii) Coding 2: Negative.

Theme: While *Shari'ah* scholars are expected to have a high standard of competence, only some IFIs have initiatives to improve the competence of the *Shari'ah* board by organizing training on the technical aspects of banking and finance or allocating funds for such a purpose.

Table 8.8: Focused Coding 1 and 2 for Question 8

Focused Coding	Interviewee	Answer
1) Affirmative	Interviewee 5	<ul style="list-style-type: none"> • IFIs sponsor <i>Shari'ah</i> board members to attend conferences and seminars. Sometimes fund managers and financial analysts are asked to explain their work to <i>Shari'ah</i> scholars. There is no formal course or training.
	Interviewee 6	<ul style="list-style-type: none"> • Yes, in fact <i>Shari'ah</i> scholars also give them training either at regional or headquarters level.
	Interviewee 9	<ul style="list-style-type: none"> • The BNM organizes training for <i>Shari'ah</i> scholars but not IFIs. The BIMB group, however, has started to train their <i>Shari'ah</i> scholars. In fact it is the demand of <i>Shari'ah</i> scholars themselves to have such training.
	Interviewee 11	<ul style="list-style-type: none"> • There is a fair budget for <i>Shari'ah</i> board members to get the necessary training.
	Interviewee 14	<ul style="list-style-type: none"> • Yes, on a continuous basis.

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Focused Coding	Interviewee	Answer
2) Negative	Interviewee 1	<ul style="list-style-type: none"> If it refers to training on the aspect of <i>Shari'ah</i>, it is not relevant because it is presumed that the <i>Shari'ah</i> board is already well trained and has such qualifications. If it refers to the term of exposure it is relevant. As to my experience, there was no training at all for the <i>Shari'ah</i> board in the aspect of finance and banking. In fact, the <i>Shari'ah</i> board provides training to the IFI's employees.
	Interviewee 2	<ul style="list-style-type: none"> Yes, at least the <i>Shari'ah</i> board is required to attend conferences and seminars. There is no specific training pertaining to the technical and operational aspects of banking and finance.
	Interviewees 3 and 12	<ul style="list-style-type: none"> No.
	Interviewee 8	<ul style="list-style-type: none"> No training. <i>Shari'ah</i> scholars need training, especially in aspects of modern banking.
	Interviewee 10	<ul style="list-style-type: none"> It depends, some IFIs are not willing to spend money for that purpose.
	Interviewee 13	<ul style="list-style-type: none"> No. It is upon the <i>Shari'ah</i> board members to seek out and keep themselves up to date with the latest developments in the industry. Nevertheless, the <i>Shari'ah</i> board members can apply to attend any related training courses to enhance their knowledge mostly in the new products, laws and regulations.

Question 9: Is there any assessment or evaluation of the *Shari'ah* board?

Focused Coding:

- (i) Coding 1: Affirmative; and
- (ii) Coding 2: Negative.

Theme: The majority of IFIs do not assess or evaluate the *Shari'ah* board.

Table 8.9: Focused Coding 1 and 2 for Question 9

Focused Coding	Interviewee	Answer
1) Affirmative	Interviewee 4	<ul style="list-style-type: none"> • In Malaysia, the BNM will call the candidate for interview before he can be admitted and registered as a <i>Shari'ah</i> scholar of IFIs. In Bahrain, the IFIs must get approval from the CBB. With regard to assessment of IFIs upon the <i>Shari'ah</i> board, there is no formal evaluation.
	Interviewee 9	<ul style="list-style-type: none"> • The BIMB conduct an evaluation of the <i>Shari'ah</i> board but this is a self-evaluation. The BOD then evaluates the assessment done by the <i>Shari'ah</i> board.
	Interviewee 13	<ul style="list-style-type: none"> • Yes, by the BOD and bank personnel before the end of year contract based on their performances, meeting attendance and contributions throughout the year of service.
	Interviewee 14	<ul style="list-style-type: none"> • Yes.
2) Negative	Interviewees 1, 2, 3, 11, and 12	<ul style="list-style-type: none"> • No.
	Interviewee 8	<ul style="list-style-type: none"> • The issue here is who has the capacity to evaluate the <i>Shari'ah</i> board. No evaluation as to their knowledge but there is in the aspects of operational performance, attendance and commitment. • It is more preferable that the <i>Shari'ah</i> board conducts a self-evaluation. For example, there was a case that a <i>Shari'ah</i> scholar was always reserved in answering any queries and frequently asked other board members to give opinions. The chairman of the <i>Shari'ah</i> board finally recommended for the management not to renew his tenure as a <i>Shari'ah</i> board member.
	Interviewee 10	<ul style="list-style-type: none"> • Perhaps the management will do that.

Question 10: What is your view on interdisciplinary members of the *Sharī'ah* board?

Focused Coding:

- (i) Coding 1: It is an acceptable practice with some conditions; and
- (ii) Coding 2: It would create problems rather than benefit.

Theme: The practice of the appointment of interdisciplinary members of the *Sharī'ah* board is acceptable with the condition that they must not have voting rights and the majority of the members consist of *Sharī'ah* scholars for the purpose of avoiding conflict and problems in the case of dispute.

Table 8.10: Focused Coding 1 and 2 for Question 10

Focused Coding	Interviewee	Answer
1) It is an acceptable practice with some conditions	Interviewee 1	<ul style="list-style-type: none"> • It is a good idea to combine interdisciplinary members of the <i>Sharī'ah</i> board. My concern is only on the roles play by them. They can be invited and give their opinion but they must not have voting rights. My experience shows that all decisions made by the <i>Sharī'ah</i> board are made by consensus. The role play by the chairperson is important in order to convince the <i>Sharī'ah</i> board members who disagree on certain issues.
	Interviewee 2	<ul style="list-style-type: none"> • Good but preferably not to give them voting rights.
	Interviewee 3	<ul style="list-style-type: none"> • Agree, but better to have more experts of different areas to give a balanced decision.
	Interviewee 4	<ul style="list-style-type: none"> • Most welcome but the majority of <i>Sharī'ah</i> board members must be <i>Sharī'ah</i> scholars in order to avoid any problems in the future. • No problem to grant voting rights to non-<i>Sharī'ah</i> experts but the majority of the board must be <i>Sharī'ah</i> scholars.
	Interviewee 5	<ul style="list-style-type: none"> • It is good to have. However, if all the members are from a non-<i>Sharī'ah</i> background, there will be problems. Some IFIs have a <i>Sharī'ah</i> board where the majority of members are non-<i>Sharī'ah</i> experts and this has created problems. With regard to the voting rights, it depends, if the non-<i>Sharī'ah</i> members have necessary knowledge on <i>Sharī'ah</i>, they can have it.

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Focused Coding	Interviewee	Answer
	Interviewee 6	<ul style="list-style-type: none"> • I agree but the majority of members should be <i>Shari'ah</i> scholars and non- <i>Shari'ah</i> background members must not have voting rights.
	Interviewee 7	<ul style="list-style-type: none"> • This practice is commendable. I am of the view that a non- <i>Shari'ah</i> expert who sits on the <i>Shari'ah</i> board should not have voting rights. In the event that there is equal voting, his vote should not be counted. • I am of the opinion that the decisions should be based on a simple majority rather than consensus. In Malaysia, the BNM, for example, opts to make decisions by consensus. This method means the <i>Shari'ah</i> scholars who are dissenting against the majority must agree on the decision. This leads to less transparency. On the other hand, in the GCC a simple majority is enough. In the <i>Shari'ah</i> report, you may see the <i>Shari'ah</i> scholars who agree and disagree on certain issues. This makes them more accountable and transparent in relation to their decisions.
	Interviewee 9	<ul style="list-style-type: none"> • The BIMB is the first institution that did that. In 1983, the BIMB appointed Professor Ahmad Ibrahim, a law professor, as a <i>Shari'ah</i> board member.
	Interviewee 11	<ul style="list-style-type: none"> • I agree but a proper mechanism should be in place.
	Interviewee 13	<ul style="list-style-type: none"> • It is acceptable but, from my point of view, the chairman of the <i>Shari'ah</i> board should be well-versed and articulate in <i>Shari'ah</i> especially <i>fiqh al muāmalāt</i>, from different schools of thought and Islamic jurisprudence. He must also be competent in modern banking and capable of delivering his services in both Arabic and English.
	Interviewee 14	<ul style="list-style-type: none"> • This is a must in order to exchange training and experience.
2) It would create problems rather than benefit	Interviewee 8	<ul style="list-style-type: none"> • I disagree with this practice. The <i>Shari'ah</i> board must consist of <i>Shari'ah</i> scholars or jurist. • It is still acceptable if the non-<i>Shari'ah</i> expert members do not have voting rights. They have the right to be involved in the meeting but their vote should not be counted. An example is the case of <i>Majma' Buhus Islamiah</i> in Egypt. Previously, when all committee members were jurists, interest was not permissible. But as soon as the board members consisted of interdisciplinary experts, the <i>Majma Buhus Islamiah</i> declared that interest is lawful and Sheikh Tantawi, who was not a jurist, further declared the same thing.

Focused Coding	Interviewee	Answer
	Interviewee 10	<ul style="list-style-type: none"> • <i>Sharī'ah</i> members should only be those who are well trained in <i>Sharī'ah</i> disciplines; experts in other fields like economy, finance and law should be appointed as experts and not <i>Sharī'ah</i> members.

8.2.4.1.1 Analysis of Competence

The research findings reveal that *Sharī'ah* scholars admit that they need training to improve their competence, particularly on the technical aspects of banking and finance. The practice nevertheless showed that only some IFIs conduct training or allocate funds for such a purpose, while the majority of them have ignored this important aspect. The study also finds that *Sharī'ah* scholars in Malaysia are more exposed to and trained in the technical aspects of banking and finance and there are initiatives by both the BNM and at individual IFI level to organize specific training for *Sharī'ah* scholars.

The study reveals that majority of IFIs did not assess or evaluate the *Sharī'ah* board's performance and this was affirmed by *Sharī'ah* scholars. It was also found that many *Sharī'ah* boards do not conduct a self-evaluation or peer assessment. In the case of Malaysia, *Sharī'ah* scholars are evaluated by the BNM before they can be appointed as *Sharī'ah* board members but not afterwards. Some IFIs only evaluate the commitment of *Sharī'ah* scholars such as attendance. The overall answers given by *Sharī'ah* scholars indicate that it is not an established practice of IFIs to assess or evaluate the *Sharī'ah* board's performance.

Sharī'ah scholars have different views on the issue of interdisciplinary members of *Sharī'ah* board. The majority of them considered it as a good practice while some scholars viewed otherwise. *Sharī'ah* scholars who agreed on the practice nevertheless put two conditions, namely non-*Sharī'ah* experts on the *Sharī'ah* board should not be given voting rights and the majority of members must be *Sharī'ah* scholars. Those scholars that disagreed with the practice claimed that such a practice may create problems and confusion as to the actual function of *Sharī'ah* board, as in the case of *Majma' Buhus Islamiah* in Egypt. The researcher considers that having interdisciplinary members on the

Sharī'ah board is a commendable practice provided that they also have a good knowledge of *Sharī'ah*. The appointment of economists, accountants, bankers, judges and others who have not adequate knowledge on *Sharī'ah* may create further problems for the *Sharī'ah* board in carrying out its functions effectively.

To address this competence issue, *Sharī'ah* scholars are in favour of the idea of establishing a professional body for *Sharī'ah* advisors. This professional body will have the authority to grant licences for *Sharī'ah* advisors, to offer professional courses and qualifications and to regulate the ethical principles of *Sharī'ah* advisors. In this respect, Malaysia has already made an effort to establish the Association of *Sharī'ah* Advisors, a professional body for *Sharī'ah* scholars regulated by specific laws and regulations. The researcher strongly supports this initiative and further suggests this idea at regional and international levels.

8.2.4.2 Independence

Question 11: Who has the power to appoint and dismiss the *Sharī'ah* board?

Focused Coding:

- (i) Coding 1: Shareholders or regulator; and
- (ii) Coding 2: CEO and BOD.

Theme: The method of appointment should not be the sole mechanism to ensure the independence of *Sharī'ah* board but the extent of transparency and disclosure and any other approaches should also be given due consideration.

Table 8.11: Focused Coding 1 and 2 for Question 11

Focused Coding	Interviewee	Answer
1) Shareholders or regulator	Interviewee 8	<ul style="list-style-type: none"> Shareholders.
	Interviewee 2	<ul style="list-style-type: none"> It must come from the regulator.
	Interviewee 12	<ul style="list-style-type: none"> Shareholders with the consent of the chairman of the <i>Shari'ah</i> board.
	Interviewee 14	<ul style="list-style-type: none"> The shareholders based on recommendations of <i>Shari'ah</i> board.
2) BOD and CEO	Interviewee 1	<ul style="list-style-type: none"> Generally, the BOD appoints the <i>Shari'ah</i> board. Ideally it should be the shareholders who appoint the <i>Shari'ah</i> board. It is good practice if there is a search committee on the part of regulators to identify potential <i>Shari'ah</i> board members.
	Interviewee 3	<ul style="list-style-type: none"> CEO.
	Interviewee 4	<ul style="list-style-type: none"> In Malaysia, the BOD with the approval of the BNM. In the Middle East, the <i>Shari'ah</i> board is either appointed by the BOD or shareholders. My view is that <i>Shari'ah</i> board must be accountable at least to the BOD and not lower than that.
	Interviewee 5	<ul style="list-style-type: none"> It can be either the shareholders or BOD. The important things are to ensure accountability, mandate and <i>Shari'ah</i> compliance. In the context of Malaysia, the appointment made by the BOD is proper since the nature of IFIs is that they are not much concerned with shareholders' activism. Moreover, the <i>Shari'ah</i> board just has an advisory role and is not treated as an employee of the company.
	Interviewees 6, 9, and 10	<ul style="list-style-type: none"> The BOD should be the proper body.
	Interviewee 7	<ul style="list-style-type: none"> In GCC countries, some IFIs appoint the <i>Shari'ah</i> board through the shareholders but the majority of them do it through the BOD. I am of the view that the shareholders are the right body to appoint the <i>Shari'ah</i> board. Nevertheless, some mechanisms may be imposed to guarantee <i>Shari'ah</i> board independence. With regard to the issue of the independence of the <i>Shari'ah</i> board, in the event that they are appointed by the BOD, this should not be a reason to say that they are not independent. If it is so, the whole professional body will collapse. It is because the appointment per se does not guarantee the state of independence but the mechanism and transparency should be more important.

Focused Coding	Interviewee	Answer
		<ul style="list-style-type: none"> On the idea of a centralized <i>Shari'ah</i> board, I am of the view that it is more concerned with the administrative issues. The more important thing is that the <i>Shari'ah</i> board is able to meet the needs of the industry in terms of delivery of <i>Shari'ah</i> rulings and compliance. The administrative issues can be left to either a centralized or decentralized <i>Shari'ah</i> board, both are acceptable.
	Interviewee 11	<ul style="list-style-type: none"> The BOD has the power to renew the contract or not.
	Interviewee 13	<ul style="list-style-type: none"> The BOD appoints the <i>Shari'ah</i> board based on the recommendation of the Nomination Committee.

Question 12: What is your view on the issue of *Shari'ah* scholars sitting on various *Shari'ah* boards?

Focused Coding:

- (i) Coding 1: The restriction on multiple appointments is necessary to mitigate potential of conflict of interest and to resolve the issue of shortage of scholars; and
- (ii) Coding 2: The practice of *Shari'ah* scholars sitting on numerous *Shari'ah* boards is acceptable.

Theme: The practice of *Shari'ah* scholars sitting on numerous *Shari'ah* boards is acceptable but it is also necessary to mitigate potential of conflict of interest and to resolve the issue of shortage of scholars by having some limitations.

Table 8.12: Focused Coding 1 and 2 for Question 12

Focused Coding	Interviewee	Answer
1) The restriction on multiple appointments is necessary to mitigate potential of conflict of interest and to resolve the issue of shortage of scholars.	Interviewee 1	<ul style="list-style-type: none"> The regulators look from a different angle and they claim that there is conflict of interest. I disagree with the notion of to the restriction of one IFI for one scholar. As long as they can perform honestly and responsibly, there will be no problem. However, there must be certain limits for the <i>Shari'ah</i> board to sit on any IFIs. There are pros and cons about this issue. There will be harm to IFIs if they appoint inexperienced <i>Shari'ah</i> scholars who may give wrong rulings.
	Interviewee 3	<ul style="list-style-type: none"> I disagree if the multiple appointments are made in the same category of IFIs due to the potential for conflict of interest.
	Interviewee 4	<ul style="list-style-type: none"> There must be a limit, such as three at one particular time.
	Interviewee 8	<ul style="list-style-type: none"> There are advantages and disadvantages. If there is no limitation, it may lead to the issue of shortage of scholars. The disadvantages, however, overwhelm the advantages.
	Interviewee 10	<ul style="list-style-type: none"> It depends. Sometimes it is not good since <i>Shari'ah</i> scholars do not have time to monitor a number of IFIs, but sometimes it is good to avoid divergence of <i>fatwa</i>.
	Interviewee 12	<ul style="list-style-type: none"> There should be an upper limit based on the capacity of an individual.
	Interviewee 13	<ul style="list-style-type: none"> There are good and bad points. In negative ways, the same <i>Shari'ah</i> scholars will be overloaded with work and end up sitting on a <i>Shari'ah</i> board for the sake of their name being used as a marketing strategy to sell the products and services.
	Interviewee 14	<ul style="list-style-type: none"> It is not a healthy practice. It may raise an issue of conflict of interest.
2) The practice of <i>Shari'ah</i> scholars sitting in numerous <i>Shari'ah</i> boards is acceptable	Interviewee 2	<ul style="list-style-type: none"> Different in nature is good.
	Interviewee 5	<ul style="list-style-type: none"> There is no harm provided that they can allocate time but should be at reasonable numbers. Conflict of interest can be managed in many ways such as by confidentiality agreements. Perhaps three board positions at one particular time is enough.

Focused Coding	Interviewee	Answer
	Interviewee 8	<ul style="list-style-type: none"> • There are advantages and disadvantages. The advantages are that rulings will be made by very experienced <i>Shari'ah</i> scholars and there is less potential for difference of opinions. As long as the <i>Shari'ah</i> scholars can do their jobs accordingly that would be fine.
	Interviewee 9	<ul style="list-style-type: none"> • No problem as long as he can perform his job very well.
	Interviewee 11	<ul style="list-style-type: none"> • It is apparently not an ideal situation but to appoint unspecialized (in <i>fiqh al muāmalāt</i> and modern finance) scholars to the board would bring more harm to the industry. So it depends on the scholar to know his limit.
	Interviewee 13	<ul style="list-style-type: none"> • There are good and bad implications. In positive ways, the experienced <i>Shari'ah</i> scholars can be mentors to the less experienced <i>Shari'ah</i> scholars who are sitting on the same board. Thus, it is a good platform to transfer the expertise and knowledge to the young generation of <i>Shari'ah</i> scholars.

8.2.4.2.1 Analysis of 'Independence' Factors

The study reveals that the majority of *Shari'ah* scholars view that the BOD is the proper body to appoint and dismiss *Shari'ah* board members, while some of them prefer shareholders or even regulators. *Shari'ah* scholars mentioned that the appointment issue should not be the sole mechanism to ensure the independence of the *Shari'ah* board but the extent of transparency and disclosure and any other approach should be given more consideration. The answers given by *Shari'ah* scholars indicate that the extent of their independence does not solely depend on the method of appointment.

The above finding denotes that some *Shari'ah* scholars have a lack of understanding on the actual meaning of independence in the context of *Shari'ah* boards in IFIs and they failed to differentiate between independence, professional independence and practitioner independence. The independence of the *Shari'ah* board refers to practitioner

independence and professional independence, in which it is very important to maintain a proper attitude toward planning, performance and reporting when conducting their functions and to avoid any appearance which may negate the perception of independence. Any element that may negate the public perception of its independence, such as the method of appointment, must be eliminated. At this point, the method of appointment should be one of the main elements that ensures professional and practitioner independence as it involves public perception of and stakeholders' confidence in the IFIs.

With reference to the issue of conflict of interest due to *Shari'ah* scholars sitting on numerous *Shari'ah* boards at one particular time, the majority of them accepted this contention while the rest denied it.²¹⁰ Those *Shari'ah* scholars who deny any potential of conflict of interest viewed that this issue was not a real issue as they were bound by Islamic ethical principles. They nevertheless agreed that there should be limits to such a practice not because of conflict of interest but due to time factors²¹¹ and to overcome the problem of the shortage of *Shari'ah* scholars.²¹² The researcher takes a different position on the answers given by those *Shari'ah* scholars and is in favour of the *Shari'ah* scholars who admitted that there is a potential of conflict of interest while performing their duties and functions. Ideally, *Shari'ah* scholars are presumed to be honest and truthful because they are bound by the Islamic ethical principles and accountable to God. Nevertheless, considering they are human beings, in reality the issue of conflict of interest may happen,

²¹⁰ This view is supported by several prominent *Shari'ah* scholars, such as Sheikh Hussein Hamid Hassan, Dr Mohammad Daud Bakar, Sheikh Yusuf Talal DeLorenzo and Dr Muhammad Akram Laldin, who opine that *Shari'ah* scholars should be treated similar to other professionals such as lawyers, auditors, accountants and actuaries (Siddiqui, 2010).

²¹¹ Yusuf Talal DeLorenzo, a US prominent *Shari'ah* scholar, raised his concern on the issue of the quantity and quality of the *Shari'ah* advisors. He reminds the *Shari'ah* scholars who serve on multiple boards while at the same time working in another institutions, such as academicians, to be very careful and to balance their time and diligence to perform their functions and responsibilities effectively (Siddiqui, 2010).

²¹² Mohammad Akram Laldin, Executive Director of ISRA and a well-known *Shari'ah* scholar, claims that the industry is actually not short of *Shari'ah* advisors. He further raises his concern that those potential *Shari'ah* advisors are not given a fair chance and opportunity to serve on a *Shari'ah* board as the IFIs prefer to have well known and prominent figures (Siddiqui, 2010). A similar view was highlighted by Sheikh Hussein Hamid Hassan, who disagrees with any claim that there are a small number of *Shari'ah* scholars that lead the Islamic finance industry (Siddiqui, 2010). This finding indicates that issue of lack of *Shari'ah* scholars is to certain extent not true and perhaps the actual reason for IFIs engaging certain reputable *Shari'ah* scholars is mainly for the purpose of increasing the marketability of their products and services.

especially when they sit on the boards of various IFIs.²¹³ With this position, there must be certain limitations on multiple appointments of *Sharī'ah* scholars in order to mitigate the issue of conflict of interest as well as to ensure that the *Sharī'ah* board can perform its functions effectively.

8.2.4.3 Transparency and Confidentiality

Question 13: Does the *Sharī'ah* board have access to all documents, information, records, etc.?

Focused Coding:

- (i) Coding 1: Negative; and
- (ii) Coding 2: The *Sharī'ah* board relies on the documents presented or submitted to them for approval.

Theme: Some *Sharī'ah* board members have not been given due access to all documents, information and records. Most of them, nevertheless, have access to all documents for *Sharī'ah* compliance purposes but they rely heavily on the documents presented to them.

Table 8.13: Focused Coding 1 and 2 for Question 13

Focused Coding	Interviewee	Answer
1) Negative	Interviewee 8	<ul style="list-style-type: none"> • Most likely no.
	Interviewee 9	<ul style="list-style-type: none"> • The ideal is that it should have that privilege. In practice, it does not actually happen.
2) The <i>Sharī'ah</i> board relies on the documents presented or submitted to them for approval	Interviewee 1	<ul style="list-style-type: none"> • The <i>Sharī'ah</i> board only has access to documents presented to them. It is unethical for IFIs to hide or not disclose documents for approval.
	Interviewee 2	<ul style="list-style-type: none"> • Yes, but it is focused more on products. In fact, all documents must be endorsed including forms, advertisements, pamphlets and flyers.
	Interviewees 3, 4, 6, 10, 11, 13, and 14	<ul style="list-style-type: none"> • Yes.

²¹³ The issue of conflict of interest may also arise in the case of *Sharī'ah* scholars who have *Sharī'ah* advisory firms where they have to balance between the interest of their companies as well as the interest of IFIs.

Focused Coding	Interviewee	Answer
	Interviewee 5	<ul style="list-style-type: none"> Theoretically, yes. In practice, it depends on the IFI's management disclosing it unless requested by the <i>Shari'ah</i> board. We rely on the management to disclose.

Question 14: Is the provision of confidentiality clearly mentioned in the terms of reference in the letter of appointment?

Focused Coding:

- (i) Coding 1: Affirmative

Theme: The provision of confidentiality is clearly mentioned in the terms of reference.

Table 8.14: Focused Coding 1 for Question 14

Focused Coding	Interviewee	Answer
1) Affirmative	Interviewees 1, 2, 3, 4, 5, 6, 8, 10, 11, 12, 13, and 14	<ul style="list-style-type: none"> Yes
	Interviewee 9	<ul style="list-style-type: none"> Yes, but it is not necessary because in Islam the concept of secrecy and confidentiality must be preserved. <i>Shari'ah</i> scholars know about all of this.

8.2.4.3.1 Analysis of Transparency and Confidentiality

In terms of transparency, *Shari'ah* scholars theoretically have access to all documents, information and records for *Shari'ah* compliance purposes. The study reveals that *Shari'ah* scholars have rarely exercised this privilege but, in actual practice, they rely heavily on the documentation presented to them rather than proactively require any necessary documents for additional evaluation. *Shari'ah* scholars put their trust in IFIs and expect that they will not hide any documents or information. This position indicates that decisions made by *Shari'ah* scholars may be influenced and determined by the way IFIs present the documents.

With regards to confidentiality, the study finds that *Shari'ah* scholars unanimously agree that such provision is clearly stipulated in the terms of reference of the letter of appointment. Some *Shari'ah* scholars mentioned that they did not even need any terms of reference in the contract about the confidentiality and secrecy obligation because Islam itself requires them to do so. This finding denotes that IFIs have adequate mechanisms to ensure confidentiality and this is in line with the best practice of *Shari'ah* governance system as laid down in the AAOIFI governance standards and the IFSB-10.

8.2.5 Operational Procedures

Standard operational procedures are of the essence for a sound *Shari'ah* governance framework. In this aspect, the study identified three questions for *Shari'ah* scholars on three different issues, namely the existence of standard operational procedures, *Shari'ah* board meetings and the reliance of the *Shari'ah* board on the internal *Shari'ah* audit.

Question 15: Is there any standard operational procedure for the *Shari'ah* board?

Focused Coding:

- (i) Coding 1: Affirmative; and
- (ii) Coding 2: Negative.

Theme: Most *Shari'ah* boards have standard operational procedures but with certain differences in practice.

Table 8.15: Focused Coding 1 and 2 for Question 15

Focused Coding	Interviewee	Answer
1) Affirmative	Interviewees 1, 3, 10, 11, and 12	<ul style="list-style-type: none"> • Yes, internally.
	Interviewee 2	<ul style="list-style-type: none"> • Yes, for instance, in terms of product development, the <i>Shari'ah</i> department will review the product proposal and all of its related documents will be circulated to <i>Shari'ah</i> board members a week in advance of the meeting.
	Interviewee 4	<ul style="list-style-type: none"> • In Malaysia, we use the BNM GPS1. In the Middle East, they only have it internally. The <i>Shari'ah</i> board even discusses it internally during the terms of reference of the first board meeting.
	Interviewee 5	<ul style="list-style-type: none"> • Some IFIs have a standard operational procedure and some of them still in the process of developing it. The BNM/GPS 1 will be used as a reference.
	Interviewee 6	<ul style="list-style-type: none"> • <i>Shari'ah</i> compliance manual and operation manual.
	Interviewee 9	<ul style="list-style-type: none"> • Yes, there is a flowchart. The <i>Shari'ah</i> officer filters any submissions for products approval. There are three types of document: rejected up front, accepted with amendment and accepted without amendment.
	Interviewee 13	<ul style="list-style-type: none"> • Yes, and it has already been reviewed and endorsed by the BOD.
2) Negative	Interviewee 8	<ul style="list-style-type: none"> • No.

Question 16: Does the *Shari'ah* board hold its meetings regularly? How frequently?

Focused Coding:

- (i) Coding 1: The *Shari'ah* board holds its meeting weekly, fortnightly, monthly, quarterly and sometimes on an ad hoc basis

Theme: There is no standard requirement for *Shari'ah* board meetings and different IFIs have dissimilar practices.

Table 8.16: Focused Coding 1 for Question 16

Focused Coding	Interviewee	Answer
1) The <i>Shari'ah</i> board holds its meeting weekly, fortnightly, monthly and sometimes on an ad hoc basis	Interviewee 1	<ul style="list-style-type: none"> Yes, the <i>Shari'ah</i> board normally holds meetings at quarterly intervals, sometimes on an ad hoc basis, or via circular or even weekly meetings. It actually depends on the people who are sitting on the board. If the <i>Shari'ah</i> scholars are amongst the most utilized ones, there will be fewer meetings.
	Interviewee 2	<ul style="list-style-type: none"> Four times a year and we have calendar meetings.
	Interviewees 3, 8, and 11	<ul style="list-style-type: none"> Once a month.
	Interviewee 4	<ul style="list-style-type: none"> Once a month and sometimes once every three months. At least 3–4 meetings a year. It is a good idea to have calendar meetings.
	Interviewee 5	<ul style="list-style-type: none"> The SAC holds a meeting once a month based on ongoing communication. We have calendar meetings, monthly meetings, special meeting and by circulation.
	Interviewee 6	<ul style="list-style-type: none"> Once a month ongoing communication. We have calendar meetings.
	Interviewee 9	<ul style="list-style-type: none"> No calendar meetings. The articles of association require the <i>Shari'ah</i> board to hold a compulsory meeting twice a year. In 1983 there were meetings almost every day and every week. After 1990, three times a year and depending on necessity.
	Interviewee 10	<ul style="list-style-type: none"> Yes, the <i>Shari'ah</i> board holds meetings on a weekly, fortnightly, monthly and ad hoc basis.
	Interviewee 12	<ul style="list-style-type: none"> Yes, the <i>Shari'ah</i> board holds meetings on a quarterly basis and the executive member of the <i>Shari'ah</i> board communicate with the IFIs on a daily basis and may have a meeting on a conference call from time to time.
	Interviewee 13	<ul style="list-style-type: none"> Supposedly the <i>Shari'ah</i> board holds meetings on a quarterly basis but sometimes it depends on the issues and products that need approval.

Question 17: To what extent does the *Shari'ah* board rely on the bank's internal *Shari'ah* audit?

Focused Coding:

- (i) Coding 1: The *Shari'ah* board relies heavily on the internal audit.

Theme: In carrying out their *ex post* function of *Shari'ah* governance, the *Shari'ah* board relies heavily on the internal audit.

Table 8.17: Focused Coding 1 for Question 17

Focused Coding	Interviewee	Answer
1) The <i>Shari'ah</i> board relies heavily on the internal audit	Interviewee 1	<ul style="list-style-type: none"> The <i>Shari'ah</i> board relies very much on the internal audit. The internal audit should only audit the <i>Shari'ah</i> compliance process. Internal audit has no capacity to audit the rulings. Some IFIs outsource the <i>Shari'ah</i> audit task to external firms and sometimes it is done by the internal audit department.
	Interviewee 2	<ul style="list-style-type: none"> Yes, we rely on them very much. It is because the <i>Shari'ah</i> officers that conduct the <i>Shari'ah</i> audit have appropriate auditing knowledge and capabilities.
	Interviewee 3	<ul style="list-style-type: none"> Yes.
	Interviewee 4	<ul style="list-style-type: none"> In the Middle East, generally, IFIs do not have internal <i>Shari'ah</i> audit departments, except al Rajhi and Bank al Bilad. They use an internal audit department and some IFIs outsource to a <i>Shari'ah</i> department like in the case of Kuwait Finance House.
	Interviewee 5	<ul style="list-style-type: none"> My bank is about to introduce the internal <i>Shari'ah</i> audit.
	Interviewee 6	<ul style="list-style-type: none"> Yes. We rely on them very much. All their findings must be presented before the <i>Shari'ah</i> board for review. The <i>Shari'ah</i> officer at the <i>Shari'ah</i> department prepares the detail of the <i>Shari'ah</i> report.
	Interviewee 8	<ul style="list-style-type: none"> We rely heavily on the internal audit.
	Interviewee 9	<ul style="list-style-type: none"> The <i>Shari'ah</i> audit is not compulsory. It is carried out by the <i>Shari'ah</i> department. They submit the details of the <i>Shari'ah</i> report to the BOD.
	Interviewee 10	<ul style="list-style-type: none"> We rely on them very much, about 90%.
	Interviewee 12	<ul style="list-style-type: none"> Only as guidance to ease the process but the responsibility lies with the <i>Shari'ah</i> board.
	Interviewee 13	<ul style="list-style-type: none"> So far, we still do not have an internal <i>Shari'ah</i> audit but we outsource this task to an advisory firm.

8.2.5.1 Analysis of the Operational Procedures

The majority of *Sharī'ah* scholars confirmed that there were standard operational procedures for the *Sharī'ah* board, either internally or regulated by certain guidelines, while only one of them indicated otherwise. *Sharī'ah* scholars also claimed that they were familiar with all of these procedures. The study finds that IFIs have good practice in terms of providing specific guidelines or operational procedures for the *Sharī'ah* board.

With regards to *Sharī'ah* board meetings, the study clearly indicates the different practices amongst the *Sharī'ah* boards. *Sharī'ah* scholars indicated that their *Sharī'ah* boards hold their meetings on a monthly, quarterly, fortnightly or ad hoc basis. This practice indicates that the majority of *Sharī'ah* boards hold meetings more than four times a year, which is in line with the standard of good practice. It is also good practice that the majority of *Sharī'ah* scholars mentioned that the *Sharī'ah* board has annual calendar meetings. Although the *Sharī'ah* board is expected to supervise the *ex post* *Sharī'ah* governance processes, such as the *Sharī'ah* review, it is observed that *Sharī'ah* scholars rely heavily on the internal audit department of IFIs. This practice indicates that the *ex post* processes of *Sharī'ah* compliance are greatly determined by the internal audit function of IFIs and not the *Sharī'ah* board itself.

8.2.6 Assessment of *Sharī'ah* Board

In view of numerous criticisms of *Sharī'ah* boards, the study posed one question to *Sharī'ah* scholars pertaining to their roles in considering the social dimension of *fiqhi* rulings. This question enables the study to understand *Sharī'ah* scholars' perceptions and practices in issuing any *fiqhi* verdicts pertinent to Islamic finance.

Question 18: Do you think that the *Sharī'ah* board takes social dimensions into consideration in making their decisions?

Focused Coding:

- (i) Coding 1: The *Sharī'ah* board stresses the social dimension in issuing its rulings.

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Theme: *Shari'ah* boards take into consideration social dimensions in promulgating *Shari'ah* rulings and carrying out their functions but they face numerous challenges in materializing it and influencing the IFIs.

Table 8.18: Focused Coding 1 for Question 18

Focused Coding	Interviewee	Answer
The <i>Shari'ah</i> board stresses the social dimension in issuing its rulings.	Interviewee 1	<ul style="list-style-type: none"> Yes. We stress the social dimension and economic growth as well as values. We try to accommodate the bank and at the same time try to promote the spirit of <i>Shari'ah</i>. It is a little bit difficult if it involves a company owned by non-Muslims. It also depends on the IFI's management.
	Interviewee 2	<ul style="list-style-type: none"> Yes, we do take it into consideration.
	Interviewee 3 and 14	<ul style="list-style-type: none"> Yes.
	Interviewee 4	<ul style="list-style-type: none"> Most <i>Shari'ah</i> scholars do that, such as promoting consumer rights in products approval, but that is not to say that they doing it strongly. It is worth noting that <i>Shari'ah</i> scholars do not make business decisions. <i>Shari'ah</i> scholars can merely suggest but it is up to the management to decide. For instance, in the case of <i>bay' al inah</i>, the <i>Shari'ah</i> scholars had suggested an alternative solution but the management could not proceed due to certain legal constraints.
	Interviewee 5	<ul style="list-style-type: none"> Yes to some extent. We think about what would be the effect on the customer. We emphasize the customer interest such as credit consumerism, poverty, financial distress and the role of <i>zakah</i>.
	Interviewee 6	<ul style="list-style-type: none"> Yes but it is difficult to materialize it. There is a conflict between commercial and social motives. The bottom line is profit. We try to promote the social aspect of it by promoting Corporate Social Responsibility, <i>zakah</i> and fair prices. For example, we emphasize the aspect of full freedom of transaction (<i>hurriyat taaqqud</i>).
	Interviewee 8	<ul style="list-style-type: none"> Yes. For instance, the <i>Shari'ah</i> board of the Dubai Islamic Bank (DIB) advised the management to allocate a special fund for social welfare purposes in the form of <i>Qardhul Hasan</i>. The DIB then allocated 10 million <i>dirham</i> for <i>Qardhul Hasan</i> financing.

Focused Coding	Interviewee	Answer
	Interviewee 9	<ul style="list-style-type: none"> This refers to <i>maṣlahah īamah</i> (public interest). The social dimension is actually part of <i>Shari'ah</i> scholars' consideration in making decisions. Islamic banking products are approved based on this principle. It is the need of the community. It is worth mentioning that the BIMB in the early years of its practice tried to offer equity financing but failed due to moral hazards. That was why the BIMB moved from equity-based financing to debt-based financing. In fact, the BNM has advised the BIMB to get involved in low-risk financing. To be fair, it is not only the burden of IFIs to think about social welfare but the public must also be educated, particularly entrepreneurs, to be trustworthy so that equity financing can be more popular than debt-based financing.
	Interviewee 10	<ul style="list-style-type: none"> Yes but only sometimes.
	Interviewee 11	<ul style="list-style-type: none"> Yes, but it depends on which definition of social dimension.
	Interviewee 12	<ul style="list-style-type: none"> Yes, in many cases.
	Interviewee 13	<ul style="list-style-type: none"> Based on my experience dealing with various <i>Shari'ah</i> boards, I could observe that some <i>Shari'ah</i> scholars are concerned with this and take the social dimension very seriously, but some are taking this for granted in making their decisions.

8.2.6.1 Analysis of the Assessment of the *Shari'ah* Board

Shari'ah scholars disagree with the allegation that they have neglected the social dimension in making any *Shari'ah* decisions. All of the *Shari'ah* scholars claimed that they took into consideration the aspects of *maṣlahah* and *maqāsid Shari'ah*. They nevertheless highlighted several challenges in promoting this aspect, especially influencing IFIs to become more socially responsible. *Shari'ah* scholars also contended that they face problems reconciling the conflict between profit and social motives as IFIs are commercial institutions and not charitable organizations.

Although *Shari'ah* scholars have made numerous efforts to promote social responsibility in IFIs by emphasizing consumer rights, the role of *zakah* and corporate social responsibility, the existing literature tends to show that IFIs are still motivated by profit maximization values. This indicates that *Shari'ah* scholars should multiply their efforts and initiatives in educating IFIs to expand their corporate objective dimension to be more socially responsible and fulfil the *maqāsid Shari'ah*. On top of that, all these efforts should be made known to the public by improving corporate disclosure practices so as to rectify the negative perceptions of the roles played by the *Shari'ah* board.

8.2.7 Additional Insights Proposed by the Participants

This section provides additional insights of the *Shari'ah* scholars pertaining to the *Shari'ah* governance system. *Shari'ah* scholars were asked to give their views, suggestions, recommendations and arguments on any *Shari'ah* governance issues.

Question 19: Please provide any other insights which you think are relevant in relation to the *Shari'ah* governance system.

Focused Coding:

- (i) Coding 1: The need for strong regulatory frameworks and revision of the AAOIFI standards;
- (ii) Coding 2: Better communication environment through appropriate coordination amongst the institutions; and
- (iii) Coding 3: Institutional approach.

Theme: There must be a reform of the *Shari'ah* governance system with respect to regulation, revision of the AAOIFI standards, communication and institutional coordination as well as an institutional approach in ensuring the integrity, professionalism and competence of *Shari'ah* scholars.

Table 8.19: Focused Coding 1, 2 and 3 for Question 19

Focused Coding	Interviewee	Answer
1) The need for strong regulatory frameworks and revision of the AAOIFI standards	Interviewee 3	<ul style="list-style-type: none"> • There should be a proactive role for the BNM in terms of supervision and monitoring adherence to <i>Sharī'ah</i> governance.
	Interviewee 5	<ul style="list-style-type: none"> • Internal and external regulation of <i>Sharī'ah</i> governance.
	Interviewee 8	<ul style="list-style-type: none"> • The AAOIFI standards were approved and endorsed by the same scholars who hold numerous board positions in the industry. The AAOIFI standards must be revised by external institutions and not by its own <i>Sharī'ah</i> scholars.
	Interviewee 10	<ul style="list-style-type: none"> • The BNM should play a more effective role to ensure that IFIs comply with <i>Sharī'ah</i>, to ensure that they conduct <i>Sharī'ah</i> audits and to take action against those IFIs that do not comply.
2) Better communication environment through appropriate coordination amongst the institutions	Interviewee 2	<ul style="list-style-type: none"> • To strengthen the <i>Sharī'ah</i> functions and to break the communication barrier down within the system. <i>Muzakarah</i> of <i>fatwa</i> only once a year is insufficient.
3) Institutional approach	Interviewee 4	<ul style="list-style-type: none"> • <i>Sharī'ah</i> advisory services must have an international qualifications institution or professional body to give them a licence and to maintain standard of services. This idea can be started on a small scale basis like a professional <i>Sharī'ah</i> body at national level.
	Interviewee 5	<ul style="list-style-type: none"> • To have a professional body for <i>Sharī'ah</i> advisors. It can be started at country level and then followed with an international initiative.
	Interviewee 12	<ul style="list-style-type: none"> • Having the internal <i>Sharī'ah</i> capability at Gatehouse Bank, we can proudly say <i>Sharī'ah</i> governance lies at the heart of the bank.
	Interviewee 13	<ul style="list-style-type: none"> • It is imperative to improve <i>Sharī'ah</i> board members' integrity and credibility. <i>Sharī'ah</i> scholars should elevate their professional standards to at least be on a par with other professionals such as accountants and lawyers. In order to achieve this, more effort needs to be made to produce more <i>Sharī'ah</i> experts through training, qualifications and sponsorship.

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Focused Coding	Interviewee	Answer
	Interviewee 14	<ul style="list-style-type: none"> • There must be an independent, inexpensive source of <i>Shari'ah</i> scholars that are drawn from Western societies, who are familiar with the local laws and regulations to help develop the business in the West. Most <i>Shari'ah</i> scholars are now busy serving the needs of the very rich GCC countries and other large mega banks in the West. They create, through financial engineering and structured finance lawyers, schemes that may look Islamic but which are very expensive and impossible to even be considered by smaller community-oriented Islamic banking institutions.

The study finds that *Shari'ah* scholars generally have admitted that there are weaknesses and discrepancies in the existing *Shari'ah* governance practices. In view of these issues, they have given some recommendations for the purpose of improvement; these can be categorized into three aspects, namely regulatory frameworks, improving the communication environment and having an institutional approach. With respect to regulatory frameworks, *Shari'ah* scholars highlighted the need for a strong regulatory environment and this includes supervisory and enforcement aspects. *Shari'ah* scholars also raised their concern on the acceptability and credibility of the AAOIFI standards and they strongly viewed that the standards should be revised by independent institutions.

Acknowledging the communication gap in *Shari'ah* governance amongst the key stakeholders, such as regulators, supervisors, BODs, shareholders and others, the *Shari'ah* scholars opined that there must be proper coordination to improve the communication environment. With this improvement, any misunderstanding or lack of information on certain issues pertaining to *Shari'ah* governance may be mitigated and further resolved. In addition, *Shari'ah* scholars also have strong faith in an institutional approach framework. They are of the view that *Shari'ah* advisors need a specific professional body that can govern, direct and control their affairs and professionalism. In summary, all these recommendations indicate that *Shari'ah* scholars are actually open for criticism and in fact they have admitted the defects and weaknesses of the existing *Shari'ah* governance system.

8.3 Conclusion

The research findings from the semi-structured interviews highlight several important points pertaining to the *Shari'ah* governance system. The analysis findings indicate that there are gaps and shortcomings in the existing *Shari'ah* governance practices of IFIs in Malaysia, GCC countries and the UK, particularly the aspects of the general approach to *Shari'ah* governance, the internal *Shari'ah* governance framework, the attributes of the *Shari'ah* board in terms of mechanisms of competence, independence, and transparency and confidentiality, operational procedures, and *Shari'ah* board's assessment. The study indicates that different *Shari'ah* scholars have dissimilar views on particular issues and they have also admitted that there are serious gaps and weaknesses in all these six major areas of *Shari'ah* governance.

The answers given by the *Shari'ah* scholars reveal that the existing practice of *Shari'ah* governance needs further enhancement and improvement, at least in these six major areas. As highlighted by those *Shari'ah* scholars, regulation plays very important role in providing a sound and proper framework for *Shari'ah* governance. This must be followed with serious implementation, supervision and enforcement. In addition, any gaps or communication barriers amongst the stakeholders in IFIs must be eliminated. The insistence of *Shari'ah* scholars of the establishment of a professional body for *Shari'ah* advisors indicates that they are willing to compromise with any institutions and approaches for the betterment of Islamic finance.

CHAPTER 9

INVESTIGATING SHARI'AH GOVERNANCE THROUGH UNOBTURSIVE RESEARCH: ANALYSIS OF THE ANNUAL REPORTS, FINANCIAL STATEMENTS AND WEBSITE FINDINGS

9.0 Introduction

Shari'ah governance favours accurate and true disclosure and transparency as a prerequisite to accountability. The fundamental concept of governance in *Shari'ah* is accountability and hence it requires IFIs to make true disclosures and to provide accurate and necessary information to all stakeholders. This is in line with the spirit of *al Qur'an* as mentioned in *surah al Baqarah* verse 282 about the importance of recording and putting in writing any business dealing and transaction in a very transparent way. In the context of *Shari'ah* governance, Islam promotes greater transparency on *Shari'ah*-related information in order to foster accountability and to strengthen the credibility of IFIs.

This chapter is basically aimed at examining the level of disclosure and transparency of *Shari'ah* governance in IFIs. This is in line with the IFSB-4 that provides guidelines for greater disclosure and transparency for IFIs. This study attempts to complement the research findings in Chapters 7 and 8, which raised several important issues concerning *Shari'ah* governance system. Unlike the research findings in Chapters 7 and 8, which are derived from primary data through the questionnaires and the semi-structured interviews, the method used in this chapter is of a library research character. The study offers disclosure indicators on the state of *Shari'ah* governance practices and illustrates the extent to which information on *Shari'ah* governance has been disclosed.

9.1 Research Findings

Analyses of the research findings in this chapter are divided into macro and micro perspectives. The macro analysis provides a general overview of the overall scores of *Shari'ah* governance disclosure and transparency by ranking them into five categories. Meanwhile, the micro analysis illustrates the extent of disclosure and transparency in each of the thirty disclosure indicators, which are divided into six main sections. A sound

and good *Shari'ah* governance framework should assure that timely and accurate disclosure is made on all matters regarding *Shari'ah* compliance. Both macro and micro analyses demonstrate the level of transparency of *Shari'ah* governance in IFIs by looking at the aggregate and country-specific behavioural responses.

9.1.1 Macro Analysis

This study attempts to rank IFIs in accordance with the level of disclosure of *Shari'ah* governance practice. The study uses multiple indicator measures to measure the level of transparency of IFIs. There are thirty identified disclosure indicators of best practice of *Shari'ah* governance which are divided into six sections, namely Commitment to Good *Shari'ah* Governance, *Shari'ah* Board Information, *Shari'ah* Report, *Shari'ah* Pronouncements, *Shari'ah* Review, and Products and Services Information. The study indicates that these thirty indicators represent the best practice of disclosure on *Shari'ah* governance-related information. The indicators are also able to adequately provide quantitative and qualitative aspects of *Shari'ah* governance disclosure and transparency in IFIs. Table 9.1 illustrates the overall indicators of *Shari'ah* governance disclosure practices.

Table 9.1: Disclosure Indicators

Disclosure Indicators	Number of Indicators
Disclosure of Commitment to <i>Shari'ah</i> Governance	3
D1. The existence of guidelines/charter on <i>Shari'ah</i> Governance	
D2. The existence of fit and proper criteria for the <i>Shari'ah</i> board	
D3. Statement of <i>Shari'ah</i> compliance	
Disclosure of <i>Shari'ah</i> Board Information	15
D4. Method of appointment	
D5. Organization chart of <i>Shari'ah</i> board structure on the website	
D6. The list of <i>Shari'ah</i> board members (names)	
D7. Details about <i>Shari'ah</i> board members other than name and title	
D8. Details about other employment and position	
D9. When each <i>Shari'ah</i> board member joined the board	
D10. A named chairman of <i>Shari'ah</i> board listed	

Disclosure Indicators	Number of Indicators
D11. Details about the chairman, other than name and title	
D12. Details about role of the <i>Shari'ah</i> board	
D13. <i>Shari'ah</i> board performs the <i>Shari'ah</i> review	
D14. Board size is no fewer than three	
D15. <i>Shari'ah</i> board members sit on more than three other IFIs	
D16. Attendance record of <i>Shari'ah</i> board meetings	
D17. Board meets more than four times a year.	
D18. Tenure of appointment	
Disclosure of <i>Shari'ah</i> Board Remuneration	2
D19. Who determines the <i>Shari'ah</i> board's remuneration	
D20. The specifics of the <i>Shari'ah</i> board's pay	
Disclosure of <i>Shari'ah</i> Report	4
D21. <i>Shari'ah</i> report published in the annual report	
D22. Information on duties and services	
D23. <i>Shari'ah</i> board activities	
D24. Declaration of <i>Shari'ah</i> compliance	
Disclosure of <i>Shari'ah</i> Pronouncements	3
D25. <i>Shari'ah</i> pronouncements are made known to the public via website, etc.	
D26. <i>Shari'ah</i> resolution only	
D27. <i>Shari'ah</i> resolution with detailed <i>Shari'ah</i> explanation	
Disclosure of <i>Shari'ah</i> Compliance Review	1
D28. IFIs undertake <i>Shari'ah</i> review	
Disclosure of Information on Products and Services	2
D29. List of <i>Shari'ah</i> -compliant products and services	
D30. <i>Shari'ah</i> concepts and principles of products and services	
Total Indicators	30

This chapter employs similar techniques of scoring methodology to Chapter 7, with slight modifications to quantify the disclosure practice of *Shari'ah* governance. The above disclosure indicators enable the study to classify the IFIs into five categories of *Shari'ah* governance disclosure practices, namely ‘Underdeveloped Practice’, ‘Emerging Practice’, ‘Improved Practice’, ‘Good Practice’ and ‘Best Practice’. As an explanation to the

scoring methodology used in this chapter, Table 9.2 specifically elaborates the description of these five categories.

Table 9.2: *Shari'ah* Governance Disclosure Scoring Method

Level of Practice	Score	Explanation
Underdeveloped Practice	1–5	IFIs that have a very minimal score of <i>Shari'ah</i> governance disclosure and need immediate reform.
Emerging Practice	6–10	IFIs that have a minimal score of <i>Shari'ah</i> governance disclosure but indicate positive development.
Improved Practice	11–15	IFIs that have a fair score of <i>Shari'ah</i> governance disclosure and indicate strong improvement.
Good Practice	16–23	IFIs that have a good score of <i>Shari'ah</i> governance disclosure and generally adhere to key elements of good disclosure practice.
Best Practice	24–30	The ideal IFIs that represent the best practice of <i>Shari'ah</i> governance disclosure.

As a general rule, IFIs that have more transparent and disclosure practices are more highly regarded and valued not only by investors but also by the public at large. IFIs that score 24–30 disclosure indicators are ranked as a ‘Best Practice’ and represent the ideal and best practice of *Shari'ah* governance disclosure. IFIs that fall into the ‘Good Practice’ category indicate a good score of *Shari'ah* governance disclosure while IFIs that have fair score but show some positive improvements are classified as an ‘Improved Practice’. The ‘Underdeveloped Practice’ category refers to IFIs that have a very minimal score that represents very weak *Shari'ah* governance disclosure practice. This is followed by IFIs that have minimal score of 6–10 disclosure indicators, which are ranked in the ‘Emerging Practice’ category.

9.1.1.1 *Shari'ah* Governance Disclosure in Malaysia, GCC countries and the UK

As an illustration of the general findings on the level of transparency of *Shari'ah* governance in all eighty IFIs included in this study, Figures 9.1–9.4 demonstrate the significant differences of the extent of *Shari'ah* governance disclosure practices by using frequencies and cross-tabulation techniques. The research findings affirm that there are significant differences in the extent of *Shari'ah* governance disclosure practices, where

the majority of IFIs fall into the ‘Emerging Practice’ category and only 1.3% of IFIs can be ranked as in the ‘Best Practice’ category.

Figure 9.1: Overall *Shari'ah* Governance Disclosure

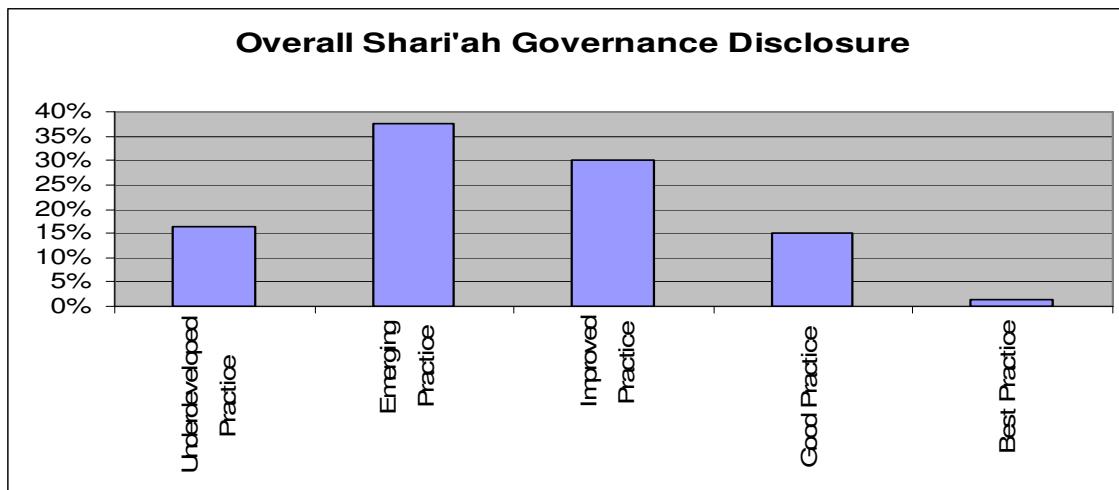


Figure 9.1 demonstrates the overall disclosure of *Shari'ah* governance-related information by IFIs in the case countries. Most IFIs (37.5%) are ranked in the ‘Emerging Practice’ category, followed by 30% in ‘Improved Practice’, 16.3% in ‘Underdeveloped Practice’, 15% in ‘Good Practice’ and 1.3% in ‘Best Practice’. This finding indicates that the overall level of transparency of *Shari'ah* governance practices in IFIs is relatively low. Only 13% out of eighty IFIs fall into the ‘Good Practice’ and ‘Best Practice’ categories; the remaining 87% of IFIs fall into the ‘Improved Practice’, ‘Emerging Practice’ and ‘Underdeveloped Practice’ categories. These figures vividly indicate the failure of the majority of IFIs to seriously take into consideration the essence of disclosure and transparency in Islam within the context of *Shari'ah* governance. While Islam promotes transparency to the extreme, the practice demonstrates a negative indication where only 1.3% of IFIs fall into the ‘Best Practice’ category. The low percentage of disclosure and transparency of *Shari'ah* governance practices demonstrates that there are deficiencies and shortcomings in the current *Shari'ah* governance framework of IFIs.

Figure 9.2: Sharī'ah Governance Disclosure for IFIs in Malaysia

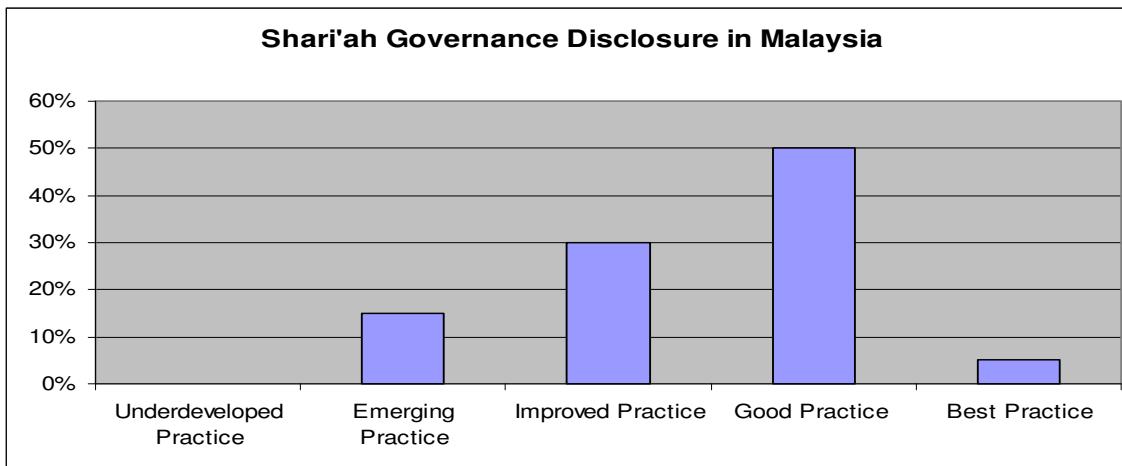
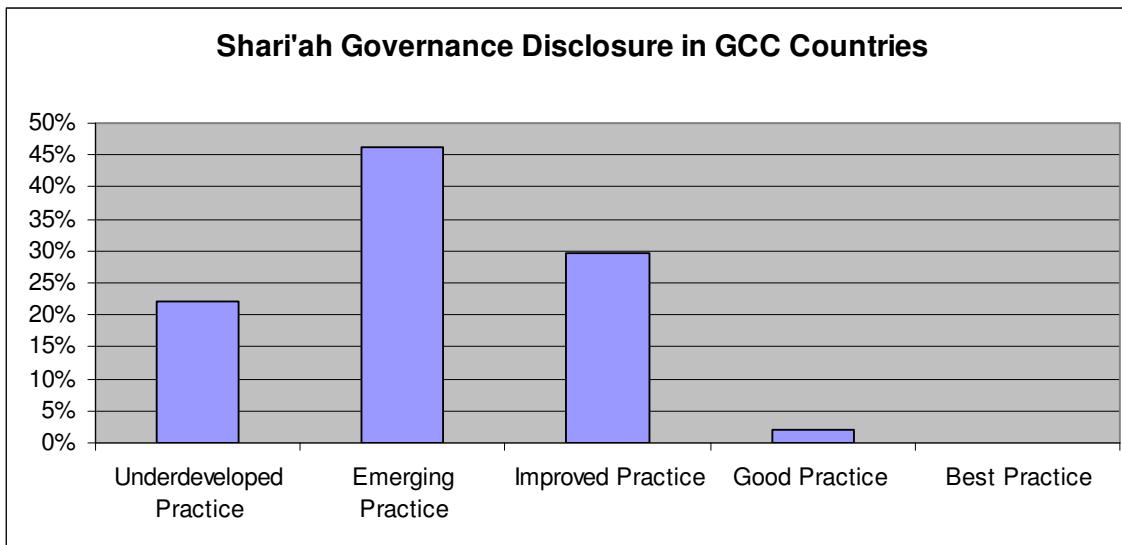


Figure 9.2 illustrates the level of disclosure of IFIs in Malaysia. The graph demonstrates that IFIs in Malaysia are generally producing fair and better disclosure compared to GCC countries and the UK. A total of 50% of IFIs are ranked in the ‘Good Practice’ category, 30% in ‘Improved Practice’, 15% in ‘Emerging Practice’ and 5% in ‘Best Practice’. This result indicates that the proactive approach of Malaysian regulatory authorities, who facilitate *Sharī'ah* governance practices through comprehensive regulatory frameworks, leads to better disclosure and transparency. In addition, IFIs in Malaysia also demonstrate serious commitment on the aspect of *Sharī'ah* governance, where the majority of the *Sharī'ah* governance disclosures that have been made were classified as voluntary disclosures and are not mandatory by law or regulation. These two external and internal factors have positively influenced the *Sharī'ah* governance practices in Malaysia, particularly in terms of transparency. In spite of these findings, it is worth noting that the level of transparency in the majority of IFIs in Malaysia are still in the ‘Good Practice’ category and this indicates that there are numerous efforts that could be initiated to improve and enhance the *Sharī'ah* governance practices to achieve the level of ‘Best Practice’.

Figure 9.3: *Shari'ah* Governance Disclosure for IFIs in GCC Countries



The overall level of disclosure of *Shari'ah* governance in GCC countries is minimal. The majority of IFIs (46.2%) are ranked in the 'Emerging Practice' category, followed by 22.2% in 'Underdeveloped Practice' and 29.6% in 'Improved Practice'. Only 1.9% of IFIs achieved the level of 'Good Practice' and none of them fall into the 'Best Practice' category. This position indicates that less interference from regulatory authorities and lack of regulatory frameworks on *Shari'ah* governance contribute to the minimal transparency on the part of IFIs in GCC countries. Although the majority of GCC countries clearly mention the adoption of the AAOIFI governance standards as compared to Malaysia and the UK, the implementation of these governance standards nevertheless has not significantly increased the level of transparency with regards to *Shari'ah* governance. In fact, the research findings reveal that the majority of IFIs only score between 6 and 10 *Shari'ah* governance disclosure indicators, which demonstrates serious shortcomings and weaknesses with respect to *Shari'ah* governance transparency in GCC countries.²¹⁴

²¹⁴ These findings are contrary to the result found in the study conducted by Al-Baluchi (2006) on thirty-four IFIs in Bahrain, Qatar, Jordan and Sudan. Al-Baluchi revealed that the implementation of the AAOIFI governance standards had significantly increased the level of voluntary disclosure in IFIs' annual reports with an average of 35% improvement in Bahrain, Qatar and Jordan (Al-Baluchi, 2006: 192). This position denotes that the adoption of the AAOIFI governance standards is not the sole factor that may improve the level of transparency of IFIs.

Figure 9.4: Sharī'ah Governance Disclosure for IFIs in the UK

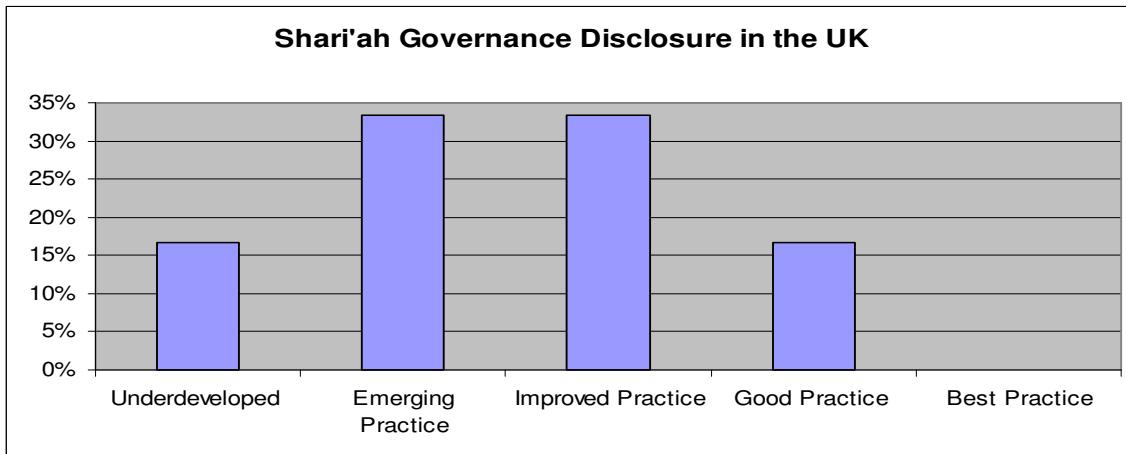


Figure 9.4 presents the disclosure of *Sharī'ah* governance practices of IFIs in the UK. Although, IFIs in the UK are relatively new, the level of disclosure and transparency is fair and better than GCC countries. The graph shows that 33.3% of IFIs are ranked in the 'Emerging Practice' and 'Improved Practice' categories and 16.7% of IFIs in the 'Good Practice' category. As compared to IFIs in GCC countries, the fair disclosure practices of IFIs in the UK proves that the regulatory-based approach of Malaysia is not the sole factor in determining the level of disclosure and transparency of *Sharī'ah* governance. The reactive approach of the UK regulatory authorities, with less regulatory interference, lets IFIs develop their *Sharī'ah* governance framework independently. This finding proves that the internal factors within the IFIs are far more important than the external factors in influencing the level of transparency of *Sharī'ah* governance. Commitment and awareness of the IFIs' management on the importance of transparency on *Sharī'ah* governance are actually the significant factors that could improve the extent of *Sharī'ah* governance transparency.

9.1.1.2 Sharī'ah Governance Scores According to Year of Incorporation

This section uses the same formula as section 7.2 of Chapter 7 to further demonstrate the extent of *Sharī'ah* governance practices in IFIs in four different clusters. Table 9.3 illustrates the details of the classification of the eighty IFIs in the case countries.

Table 9.3: Classification of IFIs According to Year of Incorporation

IFIs	Malaysia	GCC Countries	UK	Total	Percentage
Cluster 1: 1975–1990	1	11		12	15%
Cluster 2: 1991–2000	7	8		15	18.8%
Cluster 3: 2000–2005	7	16	3	26	32.5%
Cluster 4: 2006–2010	5	19	3	27	33.8%

The IFIs are classified into four clusters. Cluster 1 refers to the IFIs that established their *Shari'ah* board between the years of 1975 and 1990, Cluster 2 between 1991 and 2000, Cluster 3 between 2000 and 2005, and Cluster 4 between 2006 and 2010. A total of 15% of IFIs are classified as Cluster 1, 18.8% as Cluster 2, 32.5% as Cluster 3 and 33.8% as Cluster 4. These figures indicate that IFIs in Clusters 3 and 4 represent the majority of the research sample. This reflects the phenomenon from early 2000 until recent years where numerous IFIs were established worldwide because of the tremendous growth and opportunity in Islamic finance. On the basis of this classification, the study quantifies the *Shari'ah* governance scores and ranks them into five categories as illustrated in Figure 9.5 below.

Figure 9.5: Shari'ah Governance Score According to Cluster

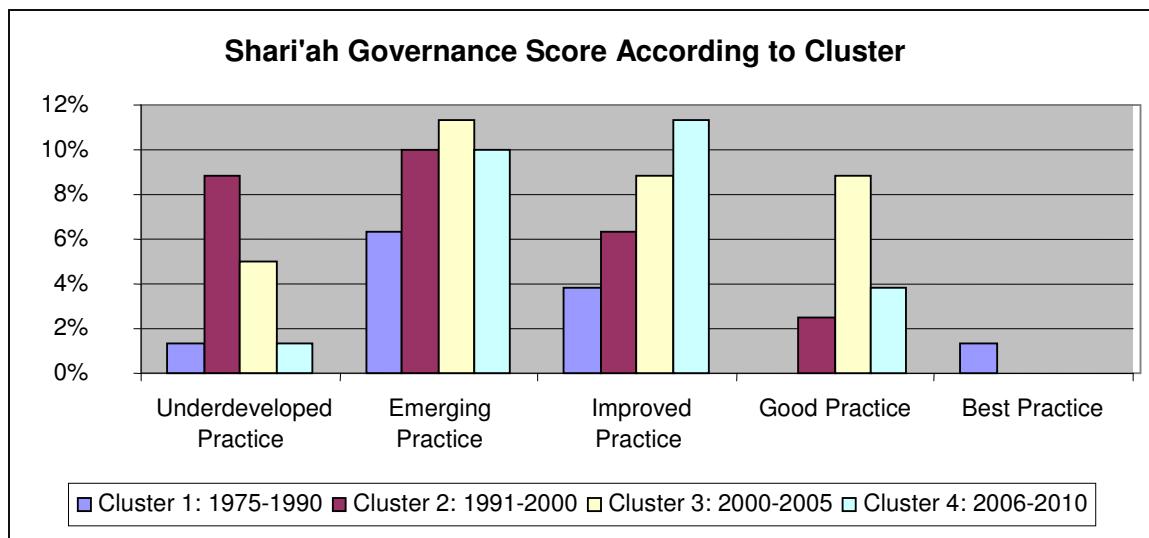


Figure 9.5 presents an overview of the level of *Shari'ah* governance disclosure practices in the four different clusters. The research finding shows that the majority of IFIs (54%) fall into the ‘Improved Practice’ category, 37.6% into the ‘Emerging Practice’ category, 16.4% into the ‘Underdeveloped Practice’ category, 15.1% into the ‘Good Practice’ category and only 1.3% into the ‘Best Practice’ category. IFIs in Cluster 3 represent better *Shari'ah* governance disclosure scores, where the majority of them are ranked in the ‘Good Practice’ category. On the other hand, IFIs in Cluster 2 demonstrate weak disclosure practices, where most of them are classified in the ‘Emerging Practice’ category. In fact, a significant percentage of IFIs in Cluster 2 fall into the ‘Underdeveloped Practice’ category. In view of the emergence of good *Shari'ah* governance disclosure practice, it was nevertheless found that only 1.3% of IFIs meet the ideal criteria for the ‘Best Practice’ category as formulated in this study. These findings affirm that the level of *Shari'ah* governance disclosure practice in many IFIs is significantly low. This disclosure issue should be taken seriously by IFIs as well as regulators and supervisors because transparency is one of the prerequisites for a good and sound *Shari'ah* governance framework in IFIs.

9.1.2 Micro Analysis²¹⁵

9.1.2.1 Commitment to *Shari'ah* Governance

The study analyses IFIs’ commitment to *Shari'ah* governance by examining the vision and mission, articles of association and memorandum of association, chairman’s message on the annual report, CEO’s statement, and any other statements indicating the IFIs’ commitment and devotion to *Shari'ah* governance-related matters.

Table 9.4: Disclosure of Commitment to *Shari'ah* Governance

Disclosure of	Percentage
D1. The existence of guidelines/charter on <i>Shari'ah</i> governance	8.8%
D2. The existence of fit and proper criteria for the <i>Shari'ah</i> board	7.5%
D3. Statement of <i>Shari'ah</i> compliance	60%

²¹⁵ It is important to note that the percentages on a comparative overview to illustrate country-specific behavior practices in this section refer to the group of IFIs in the individual jurisdictions.

Table 9.4 demonstrates poor *Shari'ah* governance practice on the part of IFIs' commitment to *Shari'ah* governance. Only 8.8% of IFIs indicated that they had guidelines or a charter on *Shari'ah* governance and 7.5% of IFIs on the existence of fit and proper criteria for the *Shari'ah* board. On the other hand, the majority of IFIs (60%) indicated their commitment to *Shari'ah* compliance. Generally, it is observed that the level of disclosure on the aspect of commitment to *Shari'ah* governance of IFIs is relatively low. The finding that more than 91% of IFIs do not have guidelines for *Shari'ah* governance or fit and proper criteria for their *Shari'ah* board clearly indicates a deficiency in *Shari'ah* governance disclosure practice.

Figure 9.6: Comparative Overview (D1–D3)

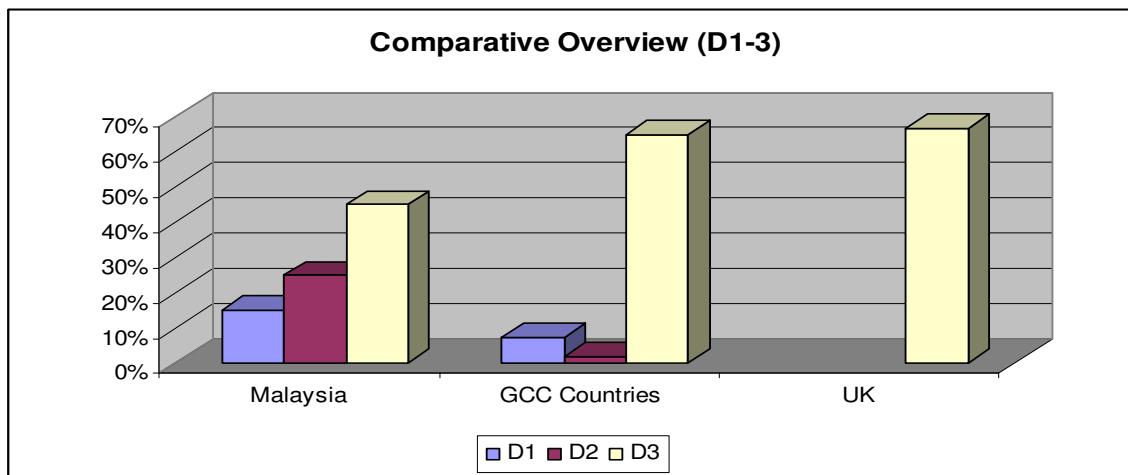


Figure 9.6 illustrates the different *Shari'ah* governance disclosures in Malaysia, GCC countries and the UK. Only 15% of twenty IFIs in Malaysia disclosed that they have guidelines or a charter on *Shari'ah* governance, 25% of IFIs have fit and proper criteria for the *Shari'ah* board and 45% of IFIs gave a statement of *Shari'ah* compliance. A similar situation is found in GCC countries, where only 7.4% of fifty-four IFIs disclosed the existence of guidelines on *Shari'ah* governance and 1.9% of IFIs disclosed the existence of *Shari'ah* board requirements. A significant number of IFIs in GCC countries (64.8%) disclosed a statement of *Shari'ah* compliance as compared to IFIs in Malaysia. In the case of the UK, none of the IFIs disclosed the existence of *Shari'ah* governance guidelines or *Shari'ah* board criteria and 66.7% of IFIs mention a statement on the

Shari'ah compliance of their products and services. While IFIs in Malaysia are more transparent than IFIs in GCC countries and the UK in terms of disclosure of the existence of a charter or guidelines of *Shari'ah* governance and fit and proper criteria for the *Shari'ah* board, the situation is different in the aspect of disclosure of a statement on *Shari'ah* compliance. On a whole, the overall level of transparency in IFIs in all the case countries with reference to their commitment to *Shari'ah* governance is low and not significant.

9.1.2.2 *Shari'ah* Board Information

Shari'ah board information is of an essence to *Shari'ah* governance in IFIs. The study identified fifteen indicators to measure the level of disclosure of *Shari'ah* governance practices on the aspect of *Shari'ah* board information. Tables 9.5–9.7 and Figures 9.7–9.9 illustrate the disclosure of *Shari'ah* governance practices pertaining to *Shari'ah* board information. Furthermore, Tables 9.8–9.12 demonstrate the state of *Shari'ah* board meeting practices, the size of *Shari'ah* boards and the *Shari'ah* boards' engagement in various IFIs.

Table 9.5: Disclosure of *Shari'ah* Board Information (D4–D6)

Disclosure of	Percentage
D4. Method of appointment	16.3%
D5. Organization chart on <i>Shari'ah</i> board structure on the website	11.3%
D6. The list of <i>Shari'ah</i> board members (names)	88.8%

Table 9.5 demonstrates the disclosure practice of *Shari'ah* governance in three different aspects. Only 16.3% of IFIs disclosed the method of appointment of their *Shari'ah* boards while 11.3% published the organization chart of the *Shari'ah* board structure on their website. In terms of the list of *Shari'ah* board members, a significant number of 88.8% of IFIs disclosed information on their *Shari'ah* board members. The disclosure on the method of appointment is important in defining their relationship within the organ of governance and to maintain the state of independence of the *Shari'ah* board, while publication of the organization chart will demonstrate the overall corporate structure of

IFIs. The disclosure of the list of *Shari'ah* board members is also significant as it indicates the credibility of IFIs and the legitimacy of the products and services offered.

Figure 9.7: Comparative Overview (D4–D6)

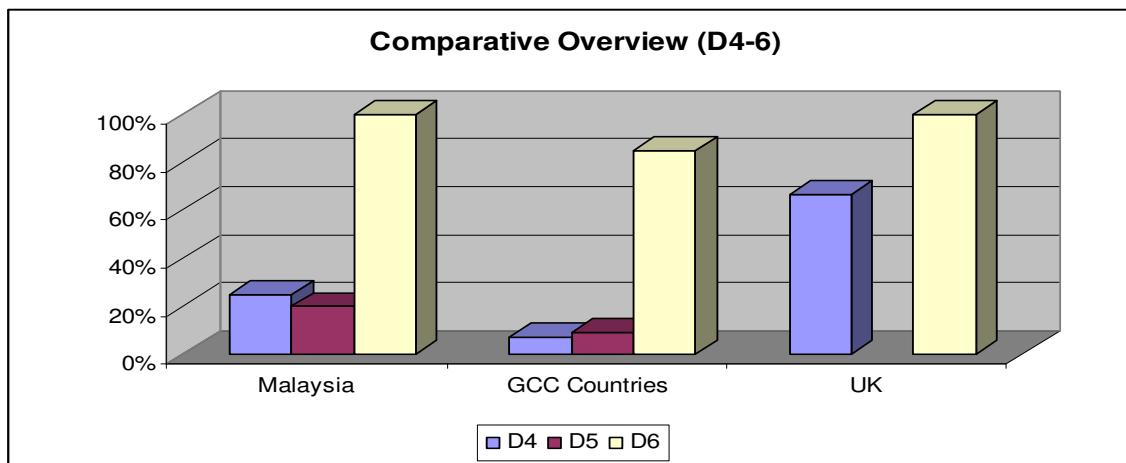


Figure 9.7 shows the cross-border practice of *Shari'ah* governance disclosure. Only 25% of twenty IFIs in Malaysia disclosed the method of appointment of their *Shari'ah* board and 20% published the organization chart of the *Shari'ah* board structure on their website. All IFIs in Malaysia disclosed the list of *Shari'ah* board members. A similar practice is found in GCC countries, where 7.4% of IFIs disclosed the method of appointment, 9.3% the organization chart and 85% the list of *Shari'ah* board members. Unlike Malaysia and GCC countries, all of the IFIs in the UK revealed the list of *Shari'ah* board members and 66.7% disclosed the method of appointment. None of the IFIs in the UK published the organization chart of the *Shari'ah* board structure either on the website or in the annual report or financial statements.

Table 9.6: Disclosure of *Shari'ah* Board Information (D7–D11)

Disclosure of	Percentage
D7. Details about <i>Shari'ah</i> board members, other than name and title	52.5%
D8. Details about other employment and position	51.3%
D9. When each <i>Shari'ah</i> board members joined the board	10%
D10. A named chairman of <i>Shari'ah</i> board listed	88.8%
D11. Details about the chairman, other than name and title	52.5%

Information on the background of *Shari'ah* board members provides important insights into the credibility of *Shari'ah* governance. The public and all stakeholders deserve to know the background and necessary information of the *Shari'ah* board members who are advising and supervising the institutions. Table 9.6 provides findings on the disclosure of *Shari'ah* board information pertaining to the details and background of *Shari'ah* board members. The majority of IFIs (52.5%) disclosed details about *Shari'ah* board members, other than name and title, 51.3% of IFIs about other employment and position and 52.5% about the chairman, other than name and title. Only 10% of IFIs disclosed the date each *Shari'ah* board member joined the board. A significant number of 88.8% of IFIs disclosed the name of the *Shari'ah* board's chairman. The disclosure of the name of the *Shari'ah* board's chairman is important because he plays an active role in tailoring and determining the direction and effectiveness of the *Shari'ah* board. The normal practice in the industry shows that senior or prominent *Shari'ah* scholars who have more experience and excellent academic qualifications will be appointed as the chairman of the *Shari'ah* board.

Figure 9.8: Comparative Overview (D7–D11)

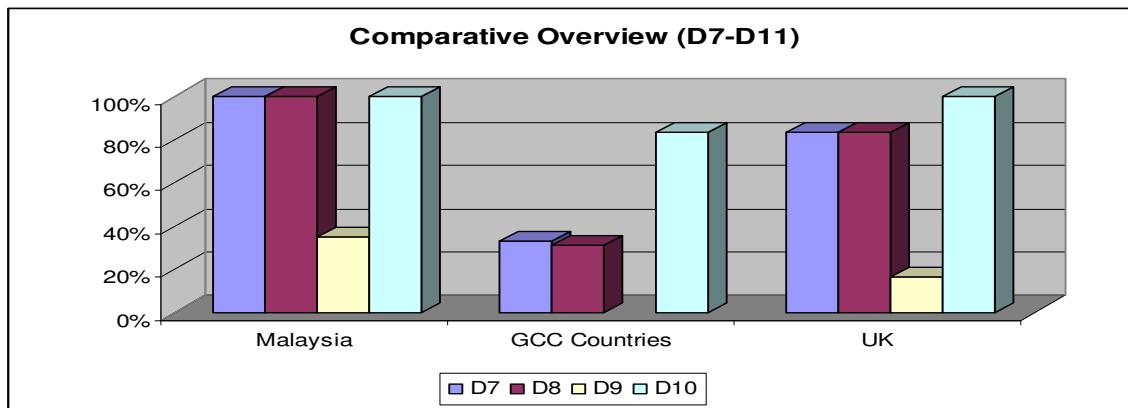


Figure 9.8 demonstrates the different levels of disclosure on the details and background of *Shari'ah* board members. In Malaysia, all IFIs disclosed the details of *Shari'ah* board members, other than name and title, including the name of the *Shari'ah* board's chairman and the details of the chairman, other than name and title, while only 35% disclosed the date each member joined the *Shari'ah* board. A low level of disclosure is found in GCC

countries, where only 33.3% of IFIs disclosed on D7, 31.4% on D8, 33.3% on D11 and 83.3% on D10. None of the IFIs in GCC countries or in the UK disclosed the date each *Shari'ah* board member joined the board. Fair disclosure practice is found in the UK, in which 83.3% of IFIs disclosed on D7, D8 and D11 and 16.7% on D9. As in the case of Malaysia, 100% of IFIs in the UK disclosed the name of the *Shari'ah* board's chairman.

Table 9.7: Disclosure of *Shari'ah* Board Information (D12–D18)

Disclosure of	Percentage
D12. Details about the role of the <i>Shari'ah</i> board	53.7%
D13. <i>Shari'ah</i> board performs the <i>Shari'ah</i> review	36.2%
D14. Board size is no fewer than three	83.7%
D15. <i>Shari'ah</i> board members sit on more than three other IFIs	20%
D16. Attendance record of <i>Shari'ah</i> board meetings	6.3%
D17. Board meets more than four times a year	7.5%
D18. Tenure of appointment	6.3%

Table 9.7 describes the level of disclosure of *Shari'ah* governance practice on the aspect of roles of the *Shari'ah* board, *Shari'ah* review, size of *Shari'ah* board, meetings and tenure of appointment. The majority of IFIs (53.7%) disclosed the details of the role of the *Shari'ah* board, while 83.7% of IFIs disclosed that the board size is no fewer than three members. Only 36.2% of IFIs revealed that the *Shari'ah* board performs the *Shari'ah* review and 20% of IFIs disclosed that their *Shari'ah* board members sit on the boards of more than three other IFIs. A low level of disclosure is found with respect to the attendance records of *Shari'ah* board meetings (6.3%), whether the board meets more than four times a year (7.5%) and tenure of appointment (6.3%).

Figure 9.9: Comparative Overview (D12–D18)

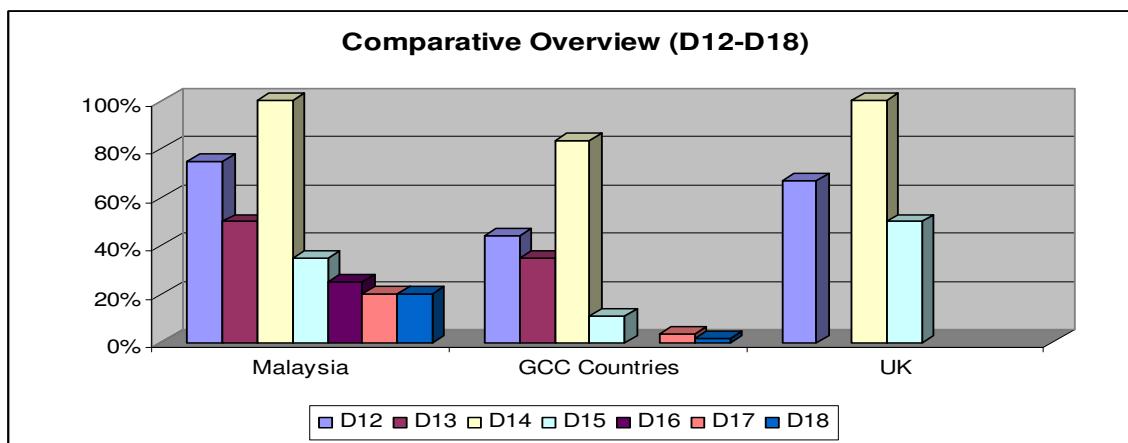


Figure 9.9 demonstrates the different levels of *Shari'ah* governance disclosure practice on D12–D18. A significant number of 75% of IFIs in Malaysia disclosed the details of the *Shari'ah* board's role, 50% disclosed that the *Shari'ah* board performs the *Shari'ah* review, 100% that the size of the *Shari'ah* board is not fewer than three members. On the other hand, a low level of disclosure is found on the aspect of *Shari'ah* board members sitting on the boards of more than three other IFIs (35%), attendance record (25%), whether the board meet more than four times a year (20%) and tenure of appointment (20%). A different scenario is found in GCC countries, where 44.4% of IFIs disclosed on D12 and 83.3% on D14. In fact, poor disclosure of *Shari'ah* practice was found on D13 (35.1%), D15 (11.1%), D17 (3.7%) and D18 (1.9%) and none of the IFIs disclosed the attendance records of *Shari'ah* board meetings. In the UK, disclosure was only made for D12, D14 and D15, i.e. 66.7% of IFIs disclosed the details of *Shari'ah* board's roles, 100% disclosed that the board size is no fewer than three members and 50% that *Shari'ah* board members sit on boards of more than three IFIs. Furthermore, it is found only six IFIs disclosed the details of *Shari'ah* board meetings in the annual reports, as illustrated in Table 9.8.

Table 9.8: *Shari'ah* Board Meetings

IFIs	<i>Shari'ah</i> Board Members	Meetings	Attendance	
			<i>Shari'ah</i> Board Members	Percentage
BIMB	6	6	4	100%
			1	17%
			1	83%
Bank Muamalat Malaysia Berhad (BMMB)	4	24	1	92%
			1	96%
			1	86%
			1	71%
Maybank Islamic Berhad (MIB)	3	3	1	60%
			2	100%
RHB Islamic Bank Berhad (RHB)	5	7	2	71%
			2	100%
			1	86%
CIMB Islamic Bank Berhad (CIMB)	7	3	3	100%
			3	66.6%
			1	33.3%
Kuwait International Banks (KIB)	6	4	N.A	
Bank Al Bilad	6	17	N.A	

Sources: BIMB (2008: 40), BMMB (2008: 24), MIB (2008: 23), RHB (2008: 16), CIMB (2007: 41–42), KIB (2008: 12) and Al Bilad (2008).

Table 9.8 shows that there are significant differences in *Shari'ah* board meeting practices based on the available information derived from seven IFIs in Malaysia (5) and Kuwait (1) and Saudi Arabia (1). The *Shari'ah* board of the BMMB meets twenty-four times per year, followed by Bank Al Bilad with seventeen times per year, RHB with seven times per year, BIMB with six times per year, KIB with four times per year, and CIMB and MIB, both with three times per year. This position denotes that there is no minimum setting of standard practice for *Shari'ah* board meetings. In view of the standard practice of BOD meetings being held at least four times a year, the above findings show that current *Shari'ah* board meeting practices constitute good *Shari'ah* governance practices, with the exception of the MIB and the CIMB.

The study is nevertheless of the view that a monthly *Shari'ah* board meeting is the ideal practice for *Shari'ah* governance. Unlike the BOD, who is responsible for setting the IFI's direction and general policies, the *Shari'ah* board is expected to perform *ex ante* and *ex post* functions of the *Shari'ah* governance process, which requires more time, effort and due diligence from them. On the face of it, the *Shari'ah* board is also anticipated to inculcate awareness and to educate the IFIs on the aspects of *Shari'ah* principles as well as Islamic ethics and values. In this regard, the study suggests the practice of monthly meetings as the best practice for *Shari'ah* board meetings. In view of the notion of this study to set the standard of best practice of *Shari'ah* board meetings to be twelve times per year, the research reveals that only two out of seven IFIs currently meet that standard.

In terms of attendance, the majority of *Shari'ah* board members attended more than 70% of *Shari'ah* board meetings, 45% attended 100% of the meetings, 17% attended more than 80% of the meetings, 11% attended more than 90% and 70% of the board meetings respectively and 6% of *Shari'ah* scholars attended 17% of the board meetings. It is worth mentioning that five of eighteen *Shari'ah* board members of IFIs in Malaysia have failed to attend more than 75% of *Shari'ah* board meetings. In accordance with section 16 of the BNM/GPS1, those *Shari'ah* board members may be disqualified unless they give a reasonable excuse for their absence. Despite that, the research findings appear to show that the general practice of the attendance and commitment of *Shari'ah* board members is in line with what would be conceived as good practice, with 73% of *Shari'ah* scholars attending more than 80% of the *Shari'ah* board meetings.

Table 9.9: Board Position and Size of *Shari‘ah* Board

Country	IFIs	Board Position	<i>Shari‘ah</i> Scholars	<i>Shari‘ah</i> Board Size	Percentage
GCC Countries	54	199	76	1	2%
				2	4%
				3	52%
				4	15%
				5	15%
				6	13%
Malaysia	20	90	82	3	55%
				4	15%
				5	15%
				8	5%
				10	5%
UK	6	15	11	1	20%
				3	40%
				4	40%

Table 9.9 summarizes the findings on *Shari‘ah* board sizes. Basically, an appropriate size of a *Shari‘ah* board is important to enable them to hold productive and constructive discussions and make prompt *Shari‘ah* decisions. Having 3–5 *Shari‘ah* board members is considered as a good *Shari‘ah* board practice. There are 169 identified individual *Shari‘ah* scholars with eighty-two of them holding *Shari‘ah* board positions in twenty IFIs in Malaysia, seventy-six *Shari‘ah* Scholars in fifty-four IFIs in GCC countries and eleven *Shari‘ah* scholars in six IFIs in the UK. In GCC countries 2% of IFIs have only one *Shari‘ah* scholar, 4% of IFIs have two *Shari‘ah* board members, 52% of IFIs have three *Shari‘ah* board members, 15% of IFIs have six *Shari‘ah* board members, 15% of IFIs have five *Shari‘ah* board members and 13% of IFIs have four *Shari‘ah* board members. A similar scenario is found in Malaysia where 71% of IFIs have three *Shari‘ah* board members, 14% of IFIs have four *Shari‘ah* board members, 14% of IFIs have five *Shari‘ah* board members, 5% of IFIs have eight *Shari‘ah* board members and 5% of IFIs have ten *Shari‘ah* board members. In the UK, 40% of IFIs have three *Shari‘ah* board members, 40% of IFIs have four *Shari‘ah* board members and 20% of IFIs have only one *Shari‘ah* board member. The overall findings show that *Shari‘ah* boards in IFIs generally have the right board size and appear to be in line with the AAOIFI governance standards and the IFSB-10 with exception of three IFIs in GCC countries and one IFI in the UK.

Fewer *Shari'ah* board members provide less leverage while a large *Shari'ah* board size may increase the IFIs' expenses.

In addition, Table 9.9 also demonstrates that Malaysia has more individual *Shari'ah* scholars with an average of 4.1 compared to the UK (average of 1.8) and GCC countries (average of 1.4). There are eighty-two individual *Shari'ah* scholars for twenty IFIs in Malaysia, while there are only seventy-six *Shari'ah* scholars for fifty-four IFIs in GCC countries and eleven *Shari'ah* scholars for six IFIs in the UK. These figures indicate that GCC countries and the UK experience some degree of shortage of *Shari'ah* scholars. The restriction on multiple appointments of *Shari'ah* board members of IFIs at one particular time is one of the factors determining the numbers of individual *Shari'ah* scholars and an average *Shari'ah* board in Malaysia is larger than an average *Shari'ah* board in GCC countries and the UK.²¹⁶

In order to illustrate the relationship of the *Shari'ah* board size to the *Shari'ah* governance disclosure practice, Table 9.10 demonstrates the correlation between these two aspects.

Table 9.10: Correlation between the *Shari'ah* board size and the State of *Shari'ah* Governance Disclosure Practices

Countries	Average <i>Shari'ah</i> Board Size	State of <i>Shari'ah</i> Governance Disclosure Practice				
		Underdeveloped Practice	Emerging Practice	Improved Practice	Good Practice	Best Practice
Malaysia	4.5		3.75%	7.5%	12.4%	1.25%
GCC Countries	3.6	15%	31.25%	20%	1.25%	
UK	2.5	1.25%	2.5%	2.5%	1.25%	

Table 9.10 clearly indicates the positive finding on the correlation of the board positions of *Shari'ah* scholars and the extent of *Shari'ah* governance disclosure practice. Although

²¹⁶ The BNM, (2009: 100) reports that the rules on the restriction on individuals sitting on more than one *Shari'ah* board increased the total number of *Shari'ah* experts in the period 2004-2009 to more than 100 individual *Shari'ah* scholars.

admittedly there are other factors that contribute to the state of *Shari'ah* governance disclosure, the researcher considers that the size of the *Shari'ah* board may also lead to better disclosure practices. The average size of *Shari'ah* board in Malaysia is 4.5 (out of ninety board positions and eighty-two *Shari'ah* scholars) and the result indicates that the majority of IFIs in Malaysia fall into the ‘Good Practice’ category, which is better than its counterparts in GCC countries and the UK. The situation is different in GCC countries where the average *Shari'ah* board size is 3.6 (out of 199 board positions and seventy-six *Shari'ah* scholars) and the majority of IFIs are ranked in the ‘Emerging Practice’ category. The same thing occurs in IFIs in the UK, where the average *Shari'ah* board size is 2.5 (out of fifteen board positions and eleven *Shari'ah* scholars) and most of them fall into the ‘Emerging Practice’ and ‘Improved Practice’ categories.

The study suggests two main propositions that lead to findings of better disclosure practices in Malaysia as compared to GCC countries and the UK. Firstly, having a significant number of *Shari'ah* scholars who can allocate more time and effort to performing their duties is a very important factor in improving *Shari'ah* governance disclosure and transparency. *Shari'ah* scholars are not only expected to approve or disapprove the Islamic financial products and services but also to go beyond that by promoting Islamic ethics and values, including insisting on the aspect of disclosure and transparency. Secondly, the practice of *Shari'ah* scholars having numerous board positions without a certain limitation may negate the effort and initiative of good disclosure of *Shari'ah* governance. Too many board positions for *Shari'ah* scholars will in no way enable them to allocate sufficient time to put their efforts into improving and promoting disclosure and transparency in IFIs.

To support the above two propositions, the study illustrates the board and chairman positions of the top ten *Shari'ah* scholars in eighty IFIs of the case countries in Table 9.11. This finding is substantiated with the *Shari'ah* scholars’ network analysis of Unal and Ley (2009) and Unal (2009 and 2010), as illustrated in Table 9.12.

Table 9.11: Sharī'ah Board Members Engagement in the Research Sample

Shari'ah Scholars	GCC Countries		Malaysia		UK	
	Member	Chairman	Member	Chairman	Member	Chairman
Sheikh Abdul Sattar Abu Ghuddah	16	4	1	1	3	
Sheikh Nizam Muhammad Saleh Yaquby	14		1		3	1
Sheikh Muhammad Ali Elgari	11	2				
Sheikh Abdullah Sulaiman AlManea	8	7				
Sheikh Abdul Aziz Khalifa Al Qassar	6				1	1
Sheikh Hussain Hamid Hassan	4	3				
Sheikh Abdullah Muhammad Al Mutlaq	4	1				
Sheikh Ali Mohyulddin Al Qarradaghi	8	2	1			
Sheikh Mohamad Daud Bakar	3		2	1		
Sheikh Ahmad Bazie Al Yaseen	5	5	1	1	1	
Sheikh Ajeel Jassim Al Nashmi	5		1			
Sheikh Yusuf Al Qaradawi	4	4				
Sheikh Walid Hadi	6	3	1		1	
Sheikh Fareed Hadi	3					1
Sheikh Muhammad Taqi Usmani	3	3			1	1
Sheikh Khaled Mathkour Al Mathkour	5	1				

Based on the information available on the websites, annual reports and financial statements, the study has identified sixteen of the most utilized or top *Sharī'ah* scholars in the eighty sampled IFIs in Malaysia, GCC countries and the UK. Table 9.11 illustrates that those sixteen top *Sharī'ah* scholars have 105 *Sharī'ah* board positions in IFIs in GCC countries, with an average of 6.5 *Sharī'ah* boards for each scholar. The study also finds that the eleven top *Sharī'ah* scholars hold thirty-five positions as chairman of *Sharī'ah* boards, with an average of 3.1 for each scholar. Ten of those sixteen top *Sharī'ah* scholars also have *Sharī'ah* board positions in Malaysia and the UK. These figures indicate that *Sharī'ah* board positions in fifty-four IFIs in GCC countries and five IFIs in the UK (excluding Malaysia) are shared mainly by only sixteen top *Sharī'ah* scholars.

Amongst the sixteen top *Sharī'ah* scholars, Sheikh Abdul Sattar Abu Ghuddah is ranked first as he holds sixteen *Sharī'ah* board positions in GCC countries, one in Malaysia and three in the UK, followed by Sheikh Nizam Muhammad Saleh Yaqubi with fourteen board positions in GCC countries, one in Malaysia and three in the UK, Sheikh Muhammad Ali Elgari with eleven board positions and Sheikh Abdullah Sulaiman Al Manea and Sheikh Ali Mohyuldin Al Qarradaghi, both with eight board positions. With regard to the chairman position, Sheikh Abdullah Sulaiman Al Manea holds seven chairman positions, followed by Sheikh Ahmad Bazie Al Yaseen with five chairman positions and Sheikh Abdul Sattar Abu Ghuddah and Sheikh Yusuf Al Qaradawi, both with four chairman positions. This finding is supported by the *Sharī'ah* scholars' network analysis of Unal and Ley (2009) and Unal (2009 and 2010). Table 9.12 illustrates the board and chairman positions of the top ten *Sharī'ah* scholars in 2008, 2009 and 2010 based on the studies by Unal and Ley (2009) and Unal (2009 and 2010).

Table 9.12: Board and Chairman Positions of Top Ten *Shari'ah* Scholars

<i>Shari'ah</i> Scholar	Data as of 31.12.2008	Data as of 10.10.2009	Data as of 12.04.2010	
	467 Board Positions in 19 Countries	956 Board Positions in 22 Countries	1050 Board Positions in 24 Countries	Chairman Positions in 24 Countries
Sheikh Nizam Mohammed Saleh Yaquby	46	77	78	10
Sheikh Abdul Satar Abdul Karim Abu Ghuddah	45	72	77	21
Sheikh Muhammad Ali Elgari	31	64	65	8
Sheikh Abdulaziz Khalifa Al Qassar	22	37	38	9
Sheikh Mohd Daud Bakar	22	35	38	
Sheikh Abdulla Bin Sulaiman Al Manea	20	37	38	20
Sheikh Hussein Hamid Hassan	19	29	32	21
Sheikh Ali Mohyuldin Al Qarradaghi	17	23	31	7
Sheikh Essa Zaki Essa	17	25	25	
Sheikh Ajeel Jasim Al Nashmi	15	24	22	
Average Board and Chairman Position Per Scholar	25.3	42.3	44.4	9.6

Sources: Unal and Ley (2009) and Unal (2009 and 2010): modified.

These findings positively affirm that there are deficiencies in the current practice of *Shari'ah* governance, particularly in the aspects of confidentiality, competence and accountability of the *Shari'ah* board. Despite some advantages in serving multiple *Shari'ah* boards, such as knowledge and experience, too many *Shari'ah* board positions at one particular time in numerous IFIs may affect the efficiency of *Shari'ah* scholars' performance and raise the potential for conflict of interest.²¹⁷ In fact, numerous chairman positions of *Shari'ah* board may raise significant issues of confidentiality and accountability of the *Shari'ah* scholars.

²¹⁷ This is highlighted by Jawad Ali who mentions that there were mistakes committed by *Shari'ah* boards due to them merely focusing on the instruments being presented by the IFIs rather than monitoring and meticulously scrutinizing the whole implementation of certain Islamic financial products and services (Pasha, 2010).

The situation is different in the case of Malaysia by which there is regulatory restriction on multiple appointments to *Shari‘ah* boards, as stipulated in the BNM/GPS1. It is reported that the adoption of this kind of limitation on multiple appointments has produced more than 100 registered and qualified *Shari‘ah* advisors that are available to fill in the gap in the industry (Ismail, 2009). Besides this, the study also finds that non-*Shari‘ah* experts, such as judges and economists, are appointed as *Shari‘ah* board members. Furthermore, there are nine individual female *Shari‘ah* scholars holding *Shari‘ah* board positions in nine different IFIs in Malaysia, whereas the *Shari‘ah* boards of IFIs in GCC countries and the UK are still exclusively male territory. The distinct position of *Shari‘ah* board engagement in Malaysia is mainly due to the regulatory framework and moderate *Shari‘ah* approach, as well as the market initiative and motivation of having an effective and sound *Shari‘ah* governance system. These internal and external factors have significantly influenced the *Shari‘ah* governance practices of IFIs in Malaysia.

9.1.2.3 *Shari‘ah* Board’s Remuneration

The ideal *Shari‘ah* governance practice promotes more transparency and disclosure and this includes the *Shari‘ah* board’s remuneration. The researcher explores the disclosure of *Shari‘ah* board’s remuneration by IFIs in terms of the authority who determines the amount of remuneration and the specifics of the *Shari‘ah* board’s pay, as stated in their annual reports and financial statements.

Table 9.13: Disclosure of *Shari‘ah* Board’s Remuneration

Disclosure of	Percentage
D19. Who determines the <i>Shari‘ah</i> board’s remuneration	25%
D20. The specifics of the <i>Shari‘ah</i> board’s pay	23.8%

Table 9.13 demonstrates that only 25% of IFIs disclosed the authority who determines *Shari‘ah* board’s remuneration, whether the BOD, management or shareholders in the annual general assembly. Interestingly, 23.8% of the sample disclosed the specifics of the *Shari‘ah* board’s pay indicating the growth of transparency and disclosure of *Shari‘ah* governance practice by IFIs. Setting an appropriate amount of remuneration is important

to safeguard the status of the *Shari'ah* board as well as to mitigate the potential for the unhealthy practice of ‘shopping’ for *Shari'ah* rulings. The disclosure on the amount of remuneration of the *Shari'ah* board, apart from the BOD and external audit fees, is significant to investors, depositors and the public, particularly to provide an accurate perception of the roles played by the *Shari'ah* board.

Figure 9.10: Comparative Overview (D19–D20)

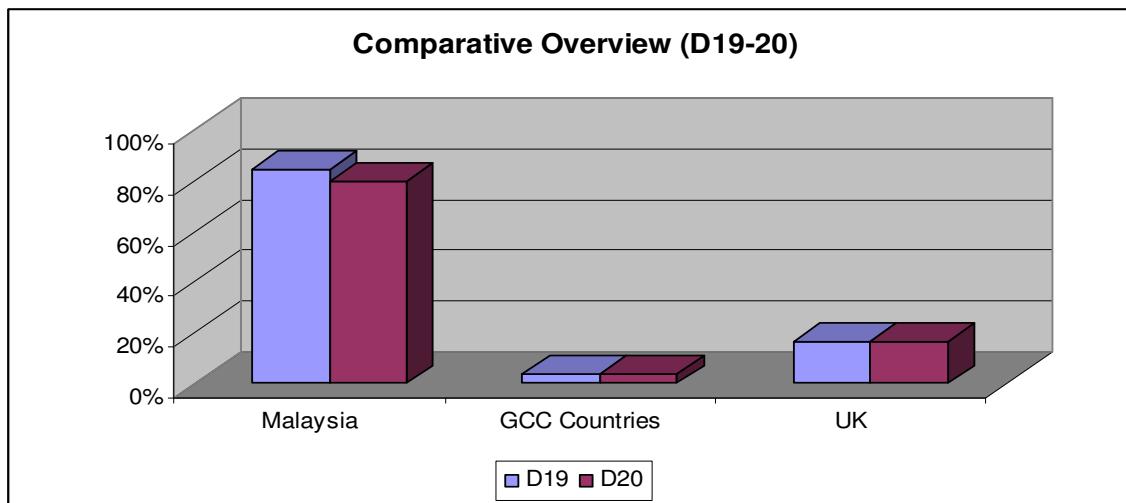


Figure 9.10 illustrates a comparative overview of the disclosure of the *Shari'ah* board's remuneration in Malaysia, GCC countries and the UK. Malaysia represents a good *Shari'ah* governance disclosure practice, where 85% of twenty IFIs disclosed the authority who determines the *Shari'ah* board's remuneration and 80% of IFIs disclosed the specifics of the *Shari'ah* board's pay. This contradicts the disclosure of IFIs in GCC countries and the UK of which only a small percentage of 3.7% of fifty-four IFIs in GCC countries disclosed D19 and D20 and only 16.7% of IFIs in the UK disclosed the same. It is clear from this finding that the level of disclosure of *Shari'ah* governance in GCC countries and the UK is significantly low compared to Malaysia.

Table 9.14: *Shari'ah* Board Remuneration

Country	IFIs	Remuneration (2008)	Size of <i>Shari'ah</i> Board	Average Per Scholar
Malaysia	Affin Islamic Bank Berhad	USD 32,951	5	USD6,590
	Alliance Islamic Bank Berhad	USD 12,401	3	USD4,113
	Asian Finance Bank Berhad	USD 40,971	3	USD13,657
	Bank Islam Malaysia Berhad	USD 60,018	6	USD10,003
	CIMB Islamic Bank Berhad	USD106,208	3	USD35,403
	Hong Leong Islamic Bank	USD 36,187	3	USD12,062
	KFH Malaysia Berhad	USD 91,792	3	USD30,057
	Bank Muamalat Malaysia Berhad	USD 38,247	4	USD9,561
	Al Rajhi Banking and Investment Corporation Malaysia Berhad	USD119,447	4	USD29,861
	EONCAP Islamic Bank Berhad	USD 25,007	3	USD8,836
	Maybank Islamic Berhad	USD 22,947	3	USD7,649
	RHB Islamic Bank Berhad	USD 76,199	5	USD15,239
	Bank Simpanan Nasional	USD 15,004	4	USD3,751
	HSBC Amanah Malaysia Berhad	USD 10,003	3	USD3,334
GCC Countries	Bahrain Islamic Bank	USD382,158	5	USD76,432
United Kingdom	Islamic Bank of Britain	USD223,659	3	USD74,553

Sources: AIB (2008: 60), Alliance (2009: 58), AFB (2008: 33), BIMB (2008: 125), CIMB (2007: 126), HLIB (2008: 75), KFH (M) (2008: 61), BMMB (2008: 92), Al Rajhi (M) (2008: 48), EONCAP (2008: 50), MIB (2008: 75), RHB (2008: 81), BSN (2008: 199), HSBC (M) (2008: 50), BIB (2008: 56) and IBB (2004: 27).

Table 9.14 illustrates the amount of remuneration of the *Shari'ah* board, as stated in the financial statements of sixteen of the eighty sampled IFIs in Malaysia, GCC countries and the UK. The average remuneration for the total sixty *Shari'ah* board members is USD9834 a year, while the average amount of remuneration for the fifty-two *Shari'ah* board members in Malaysia is USD9767 a year. The *Shari'ah* board members of IFIs in Bahrain and the UK receive a larger amount of remuneration compared to their counterparts in Malaysia with averages of USD76,432 and USD74,553 respectively.

The overall figures are considered relatively small compared to the BOD and management's remuneration. These figures also indicate and clearly prove that the allegation of *Shari'ah* arbitrage by establishing *Shari'ah* boards in IFIs, which increases transaction costs to certain extent, is not accurate as the amount of *Shari'ah* board remuneration is not significant on an institutional level. Nevertheless, *Shari'ah* board members of IFIs in the UK and GCC countries enjoy the privilege of sitting on the boards of numerous IFIs without any sort of restriction. The insignificant amount of remuneration of *Shari'ah* board members will be very significant if they sit on the boards of numerous IFIs at one particular time.

By using the same logic, inferences can be made for the whole sample. This position can be simply illustrated by referring to the average of 6.5 *Shari'ah* board positions, which amounts to USD63,921 annually per scholar. In contrast, the global situation can be analysed by examining the surveys of Unal and Ley (2009) and Unal (2009 and 2010) on the world's top ten *Shari'ah* scholars. The surveys reveal that more than three *Shari'ah* scholars sit on more than sixty-five *Shari'ah* boards and seven *Shari'ah* scholars sit on more than twenty-four boards. As an indication of the potential amount of remuneration for *Shari'ah* scholars, the top five *Shari'ah* scholars will earn more than USD582,172 annually if the estimation is based on the average amount of remuneration of USD9,834 with an average of 59.2 board positions. As shown by the study, the amount will be greater if the basis of the calculation is based on the average amount of remuneration in Bahrain, i.e. USD76,432, in which the top five *Shari'ah* scholars will earn more than USD4,524,774 annually.²¹⁸

The negative indication from the above finding may repudiate the credibility of *Shari'ah* scholars and hence negate the image of IFIs when there is no limitation. Investors as well as the public may lose confidence in the legitimacy of Islamic financial products and services. This requires serious consideration on the part of regulators and IFIs to maintain

²¹⁸ It is worth mentioning that these figures may not represent the actual amount of remuneration of *Shari'ah* board members in IFIs. Such estimation and simulation of *Shari'ah* board members attempt to highlight the need for immediate measures to control and govern *Shari'ah* board remuneration practices.

the confidence of the investors, depositors, customers and other stakeholders by having appropriate mechanisms to limit and govern the practice of *Shari'ah* scholars.

9.1.2.4 *Shari'ah* Report

The study analyses the *Shari'ah* reports published in the annual reports and financial statements of 2007 and 2008. There are four indicators for good *Shari'ah* governance disclosure practice pertaining to the *Shari'ah* report, namely publication of the *Shari'ah* report in the annual report, information on duties and services, *Shari'ah* board activities and declaration of *Shari'ah* compliance.

Table 9.15: *Shari'ah* Report

Disclosure of	Percentage
D21. <i>Shari'ah</i> report published in the annual report	52.5%
D22. Information on duties and services	18.8%
D23. <i>Shari'ah</i> board activities	6.3%
D24. Declaration of <i>Shari'ah</i> compliance	53.8%

The majority of IFIs disclosed the *Shari'ah* report in the annual report (52.5%). With regards to the content of the *Shari'ah* report, 53.8% of IFIs disclosed the declaration of *Shari'ah* compliance while a small percentage of 18.8% of IFIs disclosed information on duties and services, and 6.3% on *Shari'ah* board activities. These findings indicate that significant numbers of IFIs in Malaysia, GCC countries and the UK do not meet the specification of the AAOIFI format of the *Shari'ah* report as specified in sections 9-26 of the AAOIFI Governance Standard for IFIs No. 1: *Shari'ah* Supervisory Board: Appointment, Composition and Report. In fact, the contents of the *Shari'ah* reports reviewed are also very brief and inadequate. This issue should be taken seriously by IFIs as well as regulators since the *Shari'ah* report in the annual report is the main available document and reference for the general public, consumers, investors and depositors.

Figure 9.11: Comparative Overview (D21–D24)

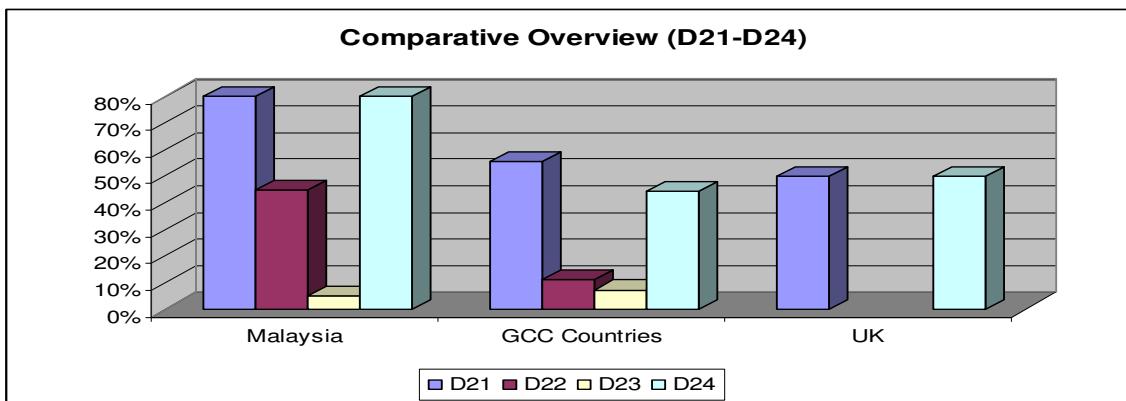


Figure 9.11 further illustrates the different levels of *Shari'ah* governance disclosure practice pertaining to the *Shari'ah* report. The majority of IFIs in Malaysia (80%), GCC countries (56%) and the UK (50%) disclosed the *Shari'ah* report by publishing it in the annual report. With regard to the contents of the *Shari'ah* report, only 45% of IFIs in Malaysia disclosed information on the duties and services of the *Shari'ah* board and 11.1% of IFIs in GCC countries. A small percentage of 5% of IFIs in Malaysia and 7.4% of IFIs in GCC countries disclosed *Shari'ah* board activities in the *Shari'ah* report while none of IFIs in the UK disclosed the same.

The study has found that the majority of IFIs (80% in Malaysia, 44.4% in GCC countries and 50% in the UK) disclosed a statement of *Shari'ah* compliance in the *Shari'ah* report. This finding indicates the weaknesses of disclosure practices with respect to the contents of the *Shari'ah* report in the IFIs' annual report. While IFIs are expected to at least state the declaration of *Shari'ah* compliance duly endorsed by their *Shari'ah* board, a significant percentage of them have failed to comply with this requirement and in fact more than 47% of eighty IFIs have not published a *Shari'ah* report in their annual report. This position requires immediate concern on the part of IFIs as the *Shari'ah* report or the declaration of *Shari'ah* compliance in the annual report is important. Since the annual report is the main reference providing financial and non-financial information on IFIs, therefore the *Shari'ah* report should be a mandatory requirement of the annual report.

9.1.2.5 *Shari'ah* Pronouncements

Transparency in *Shari'ah* pronouncements would strengthen the stakeholders' confidence in the IFIs' credibility on the state of *Shari'ah* compliance. The study explores the extent of transparency of *Shari'ah* governance in the aspect of *Shari'ah* pronouncements. There are three selected indicators to measure the level of disclosure of *Shari'ah* pronouncements, namely *Shari'ah* rulings are made known to the public, the content of *Shari'ah* resolution only and *Shari'ah* rulings with detailed *Shari'ah* explanations.

Table 9.16: Disclosure of *Shari'ah* Pronouncements

Disclosure of	Percentage
D25. <i>Shari'ah</i> pronouncements are made known to the public via website, etc.	10%
D26. <i>Shari'ah</i> resolution only	8.8%
D27. <i>Shari'ah</i> resolution with detailed <i>Shari'ah</i> explanation	3.8%

Table 9.16 indicates the low level of disclosure practice of *Shari'ah* pronouncements. A total of 90% of IFIs have not published or made known to the public their *Shari'ah* rulings. In addition, with regard to the content of the *Shari'ah* rulings, 8.8% of IFIs disclosed the *Shari'ah* resolution only and 3.8% disclosed the *Shari'ah* rulings with a detailed *Shari'ah* explanation. These findings clearly indicate that the disclosure practice of *Shari'ah* rulings in IFIs is still at a very minimal and weak level of practice. The finding that only 10% of eighty IFIs published *Shari'ah* rulings demonstrates serious shortcomings in *Shari'ah* governance disclosure practice. The declaration of *Shari'ah* compliance in the annual report per se is not adequate or sufficient to educate and create awareness on the essence of *Shari'ah* rules and principles to the consumers, investors, depositors and general public. At this point, IFIs are expected to provide reliable and appropriate information pertaining to the *Shari'ah* pronouncements issued by their *Shari'ah* board.

Figure 9.12: Comparative Overview (D25–D27)

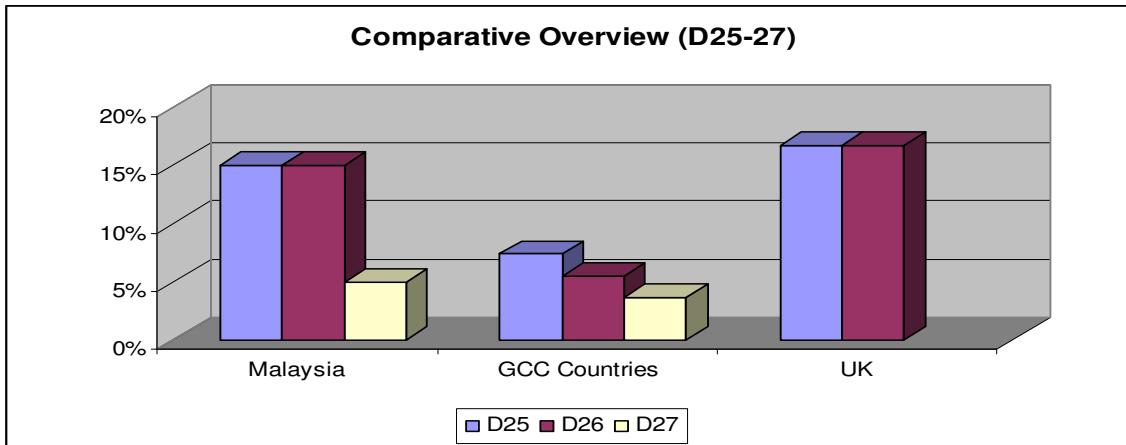


Figure 9.12 illustrates the different practices of disclosure of *Shari'ah* pronouncements in Malaysia, GCC countries and the UK. Generally, the majority of IFIs in the case countries have neglected the disclosure and transparency aspects of *Shari'ah* pronouncements. In Malaysia, only 15% of IFIs' *Shari'ah* rulings were made known to the public. In terms of the content of the *Shari'ah* rulings, 15% of IFIs disclosed the *Shari'ah* pronouncements only while 5% disclosed them with a detailed *Shari'ah* explanation. A significantly low level of disclosure practice of IFIs in GCC countries was found, by which only 7.4% of IFIs published the *Shari'ah* rulings, 5.5% disclosed *Shari'ah* rulings only and 3.7% disclosed rulings with a detailed *Shari'ah* explanation. A similar situation is found for IFIs in the UK, where 16.7% of IFIs disclosed the *Shari'ah* rulings and made them known to the public in the form of the *Shari'ah* rulings only. No IFIs in the UK have published *Shari'ah* resolutions with detailed *Shari'ah* explanations. These findings appear to demonstrate that the disclosure pertaining to *Shari'ah* pronouncements is lacking in all of the case countries.

9.1.2.6 *Shari'ah* Compliance Review

The *Shari'ah* compliance review is of the utmost important to ascertain that all transactions, operations and dealings implemented by IFIs comply with *Shari'ah* principles. Although most of the IFIs have established specific institutional arrangements for the *Shari'ah* compliance review, it is also essential for them to disclose and mention this exercise somewhere, whether in the annual report, financial statement or on their

website. In view of the limited information available on the *Shari'ah* compliance review, the study only identified one indicator to indicate the level of disclosure practice with respect to the *Shari'ah* compliance review.

Table 9.17: Disclosure of *Shari'ah* Compliance Review

Disclosure of	Percentage
D28. IFIs undertake <i>Shari'ah</i> review	38.8%

A *Shari'ah* compliance review is adopted by most of the IFIs in all the case countries. Table 9.17 nevertheless demonstrates that more than 61% did not mention their undertaking of a *Shari'ah* compliance review exercise. Only 38.8% of the IFIs disclosed their undertaking of a *Shari'ah* review, either on their website or in their annual report or financial statements. This denotes that the depositors, investors and the general public are unaware or uncertain of the *Shari'ah* compliance review process undertaken by IFIs. While the *Shari'ah* review is crucial to IFIs for the purpose of ensuring the legitimacy of Islamic financial products and services; the finding of no more than 39% of IFIs disclosing their undertaking of a *Shari'ah* compliance review demonstrates their weak disclosure practices of *Shari'ah* governance.

Figure 9.13: Comparative Overview (D28)

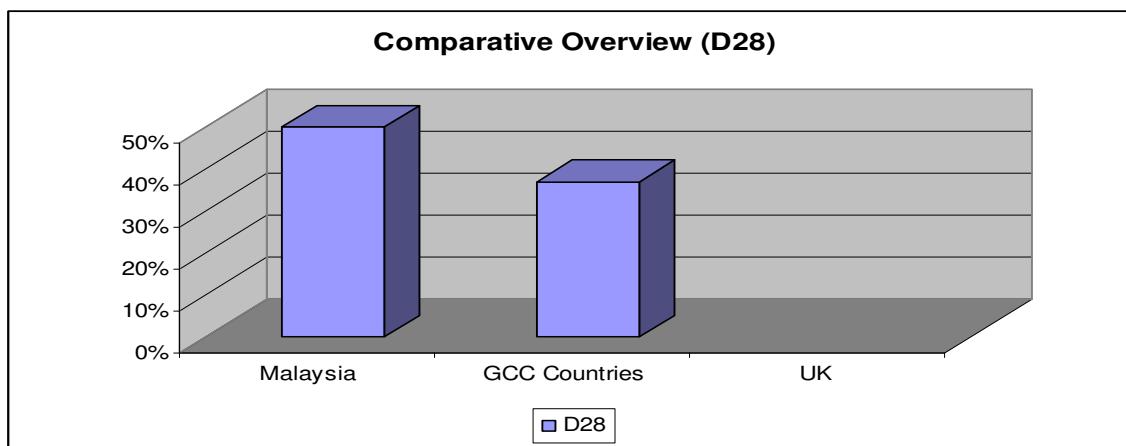


Figure 9.13 provides a comparative overview of the disclosure practices of IFIs with respect to the *Shari'ah* compliance review. A total of 50% of IFIs of twenty in Malaysia mentioned their undertaking of a *Shari'ah* compliance review, while 37% of fifty-four

IFIs in GCC countries and none of the six IFIs in the UK did the same. This finding shows that IFIs in Malaysia are slightly more transparent than IFIs in GCC countries and the UK with respect to the *Shari'ah* compliance review disclosure.

9.1.2.7 Information on Products and Services

The study analyses the level of disclosure of *Shari'ah* governance practices pertaining to information on products and services. Two indicators are identified to demonstrate the extent of disclosure and transparency of information on products and services by IFIs, namely a list of *Shari'ah*-compliant products and services and the details of *Shari'ah* concepts and principles of products and services.

Table 9.18: Disclosure of Information on Products and Services

Disclosure of	Percentage
D29. List of <i>Shari'ah</i> -compliant Products and Services	91.3%
D30. <i>Shari'ah</i> Concepts and Principles of Products and Services	33.8%

Table 9.18 provides that a significant number of IFIs (91.3%) disclosed the list of their *Shari'ah*-compliant products and services. On the other hand, only 33.8% of IFIs disclosed or mentioned the details of the *Shari'ah* concepts and principles of products and services on the websites or in the annual reports. The lack of disclosure and transparency on the details of the concepts and structure of products and services demonstrates the low level of initiative on the part of IFIs to educate customers, consumers and the public at large about Islamic financial transactions. It is the duty of each IFI to create awareness, to inculcate understanding and to educate people about specific features of Islamic financial products and services, differentiating them from their conventional counterparts.

Figure 9.14: Comparative Overview (D29–D30)

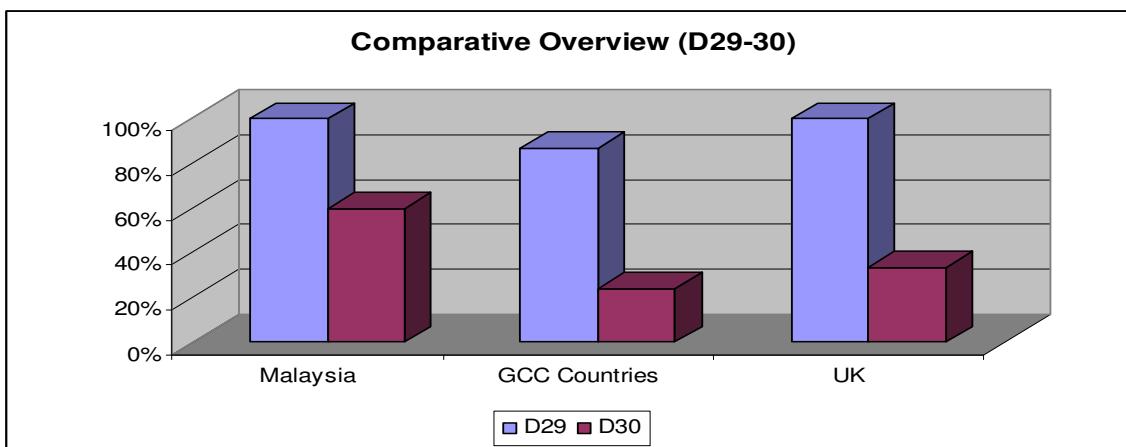


Figure 9.14 illustrates the cross-border disclosure of *Shari'ah* governance practices on the aspect of information on products and services. There is good disclosure and transparency of information on products and services by IFIs in Malaysia (100%), GCC countries (87%) and the UK (100%). Nevertheless, a slightly low percentage of disclosure is found on the details of *Shari'ah* concepts and principles (60% of IFIs in Malaysia, 24% in GCC countries and 33.3% in the UK). These figures also indicate that the majority of IFIs in Malaysia have initiated efforts to educate the public and consumers about details of Islamic financial products and services, while these practices are not so popular in GCC countries and the UK. This indirectly demonstrates that Malaysian consumers have better access to information on the Islamic financial products and services compared to consumers in GCC countries and the UK.

9.1.3 Summary of the Overall *Shari'ah* Governance Scores

This section provides a summary of the overall findings of *Shari'ah* governance scores from a country-specific behaviour perspective as well as according to year of incorporation. Both perspectives demonstrate different indications as to the extent of *Shari'ah* governance disclosure in IFIs in each of the thirty indicators.

9.1.3.1 Country-Specific Behaviour

The study attempts to highlight the significant differences in the *Shari'ah* governance practices of IFIs in the case countries. Table 9.19 illustrates the state of *Shari'ah*

governance disclosure practices by presenting the overall scores of *Sharī'ah* governance indicators for each country. The findings suggest that IFIs in Malaysia have better *Sharī'ah* governance scores compared to their counterparts in GCC countries and the UK.

Table 9.19: Sharī'ah Governance Scores According to Country-Specific Behaviour*

Disclosure Index		Malaysia	GCC Countries	UK	Total Score
Section	Indicator				
Commitment to <i>Sharī'ah</i> Governance	D1	3	4	0	7
	D2	5	1	0	6
	D3	9	36	4	49
<i>Sharī'ah</i> Board Information	D4	5	7	1	13
	D5	4	5	0	9
	D6	20	47	6	73
	D7	20	19	5	44
	D8	20	18	5	43
	D9	7	0	1	8
	D10	20	47	6	73
	D11	19	19	5	43
	D12	15	24	4	43
	D13	10	19	0	29
	D14	19	43	6	68
	D15	7	6	3	16
	D16	5	0	0	5
	D17	4	2	0	6
	D18	4	1	0	5
	D19	17	2	1	20
	D20	16	2	1	19
<i>Sharī'ah</i> Report	D21	16	24	3	43
	D22	9	6	0	15
	D23	1	4	0	5
	D24	16	25	3	44
<i>Sharī'ah</i> Pronouncements	D25	3	4	1	8
	D26	3	3	1	7
	D27	1	2	0	3
<i>Sharī'ah</i> Review	D28	10	21	0	31
Information on Products and Services	D29	20	48	6	74
	D30	12	13	2	27
Average Score		16	8.4	10.7	10.5
Level of Practice		'Good Practice'	'Emerging Practice'	'Improved Practice'	'Improved Practice'

* The scores are generated from 30 *Sharī'ah* governance disclosure indicators as illustrated in table 9.1. The total scores of each IFI are 30. IFIs in Malaysia score 320 out of 600 (20x30), GCC Countries, 452 out of 1620 (54x30) and the UK, 64 out of 180 (6x30). The total scores are 836 out of 2400. The 'average' is formulated as the scores divide by the number of IFIs.

Table 9.19 clearly shows the level of practice of *Shari'ah* governance disclosure from a country-specific behaviour perspective. The overall findings reveal that IFIs in Malaysia have better *Shari'ah* governance disclosure scores with an average of 16 that falls into the 'Good Practice' category. On the other hand, IFIs in GCC countries fall into the 'Emerging Practice' category with an average score of 8.4. This is followed by IFIs in the UK that fall into the 'Improved Practice' category with an average score of 10.7. The average score of 10.5 for all eighty IFIs indicates that the state of *Shari'ah* governance disclosure practices is still at a minimal level as they just fall into the 'Improved Practice' category.

Most of the IFIs (more than 50%) in Malaysia have disclosed information on sixteen indicators, namely D6, D7–D11, D12–D14, D19–D21, D24 and D28–D30. In contrast, most of the IFIs in GCC countries have disclosed *Shari'ah*-related information on only five indicators, i.e. D3, D6, D10, D14 and D29. Interestingly, IFIs in the UK have better disclosure practices compared to IFIs in GCC countries in that most of them have disclosed information on twelve indicators, namely D3, D6–8, D10–D12, D14–D15, D21, D24 and D29. Generally, all of the IFIs have good disclosure practices for the information pertaining to products and services and very weak practices with respect to the disclosure of *Shari'ah* pronouncements. These findings strongly affirm the research proposition of there being significant differences in *Shari'ah* governance disclosure practices in the case countries.

9.1.3.2 *Shari'ah* Governance Score According to Cluster

As well as analysing country-specific behaviour of IFIs in relation to *Shari'ah* governance disclosure practices, the study further examines the disclosure practices from the year of incorporation perspective. It is worth noting that this section should be read together with section 9.1.1.2. Unlike the macro analysis presented in section 9.1.1.2, this section exhibits a micro analysis of the *Shari'ah* governance disclosure index in the four different clusters of IFIs. Table 9.20 demonstrates the relationship between the ages of the IFIs and the extent of *Shari'ah* governance disclosure practice in each of the thirty

indicators. The study finds that IFIs in Cluster 3, namely institutions which were incorporated in 2001–2005, have better disclosure practices compared to IFIs in Clusters 1, 2 and 3.

Table 9.20: Sharī'ah Governance Scores According to Cluster*

Disclosure Index		Cluster 1: 1975- 1990 (12 IFIs)	Cluster 2: 1991-2000 (15 IFIs)	Cluster 3: 2001- 2005 (26 IFIs)	Cluster 4: 2006-2010 (27 IFIs)	Total Score
Section	Indicator					
<i>Commitment to Sharī'ah Governance</i>	D1	2	2	1	2	7
	D2	2	2	0	2	6
	D3	8	3	16	22	49
<i>Sharī'ah Board Information</i>	D4	3	3	4	3	13
	D5	1	3	4	0	9
	D6	10	14	26	23	73
	D7	10	2	16	16	44
	D8	2	9	16	16	43
	D9	1	3	3	1	8
	D10	10	14	26	23	73
	D11	2	10	16	15	43
	D12	8	4	15	16	43
	D13	7	3	12	7	29
	D14	8	14	24	22	68
	D15	1	3	6	6	16
	D16	1	1	1	2	5
	D17	1	1	2	2	6
	D18	0	2	1	2	5
	D19	3	5	7	5	20
	D20	3	5	7	4	19
<i>Sharī'ah Report</i>	D21	10	9	15	9	43
	D22	2	1	8	4	15
	D23	1	0	2	2	5
	D24	10	9	16	9	44
<i>Sharī'ah Pronouncements</i>	D25	1	2	4	1	8
	D26	0	2	3	1	7
	D27	0	1	2	0	3
<i>Sharī'ah Review</i>	D28	8	4	11	8	31
<i>Information on Products and Services</i>	D29	12	13	26	23	74
	D30	6	5	9	7	27
Average Score		11	9.9	11.5	9.4	10.5
Level of Practice		'Improved Practice'	'Emerging Practice'	'Improved Practice'	'Emerging Practice'	'Improved Practice'

* The scores are generated from 30 *Sharī'ah* governance disclosure indicators as illustrated in table 9.1. The total scores of each IFI are 30. IFIs in Cluster 1 score 133 out of 360 (12x30), Cluster 2, 149 out of 450 (15x30), Cluster 3, 299 out of 780 (26x30) and Cluster 4, 253 out of 810 (27x30). The total scores are 836 out of 2400. The 'average' is formulated as the scores divide by the number of IFIs.

Table 9.20 reveals that there is a negative correlation between the age of the IFI based on year of incorporation and the extent of *Shari'ah* governance disclosure practice. The findings show that the average scores of the senior IFIs in Cluster 1 is eleven, which falls into the 'Improved Practice' category, while IFIs in Clusters 2 and 4 fall into the 'Emerging Practice' category, with average scores of 9.9 and 9.5 respectively. IFIs in Cluster 3 show slightly better disclosure practices with an average of 11.5, which falls into the 'Improved Practice' category.

IFIs in Cluster 4 scored very low on the *Shari'ah* governance disclosure index. In fact, fewer than five IFIs in Cluster 4 disclosed information on fifteen indicators, namely D1, D2, D4, D5, D9, D16, D17, D18, D19, D20, D22, D23, D25, D26 and D27. On the other hand, the IFIs in Cluster 3 scored slightly better than the rest of the IFIs in Clusters 1,2 and 4. Most of the IFIs in Cluster 3 disclosed information on eleven indicators, i.e. D3, D6, D7, D8, D10, D11, D12, D14, D21, D24 and D29. These findings affirm the study's proposition of the negative correlation between the age of an IFI based on year of incorporation and the level of *Shari'ah* governance disclosure practice. The early established IFIs in Cluster 1 that have more experience compared to other IFIs in Cluster 3 have a very minimal score of *Shari'ah* governance disclosure indicators. This is rather a disappointing result as the earlier IFIs were established by those people closer to the aspirational view of an Islamic moral economy.

9.2 Conclusion

Basically, this study specifically explores the level of disclosure and transparency of *Shari'ah* governance practices. Disclosure and transparency in *Shari'ah* governance practices are effective mechanisms for exposing IFIs to market discipline and encouraging them towards a good governance framework and, more importantly, strengthening the stakeholders' confidence in the IFIs' credibility and in their *Shari'ah*-compliant products and services. The study indicates that there are significance differences in the disclosure and transparency of *Shari'ah* governance practices in Malaysia, GCC countries and the UK. Despite considerable efforts being made by IFIs to

improve the level of transparency and disclosure of *Shari'ah* governance, the study proves that the level of disclosure practices of *Shari'ah* governance-related information is relatively low, where 37.5% of IFIs are ranked in the ‘Emerging Practice’ category, followed by 30% in ‘Improved Practice’, 15% in ‘Good Practice’, more than 16% in ‘Underdeveloped Practice’ and only 1.3% in the ‘Best Practice’ category. The results further indicate that there are weaknesses and deficiencies in the current system of disclosure of *Shari'ah* governance practices.

The research findings make it clear that the current state of disclosure and transparency of *Shari'ah* governance practices deserves immediate attention, further reform and improvement, at least in the aspects of commitment to *Shari'ah* governance, *Shari'ah* board information, *Shari'ah* report, *Shari'ah* compliance review, *Shari'ah* pronouncements and information on products and services. It was observed that IFIs in Malaysia are slightly more transparent than their counterparts in GCC countries and the UK in all six disclosure aspects of *Shari'ah* governance practices. This position denotes that a proactive regulatory approach to the *Shari'ah* governance framework, as practised by Malaysia, significantly influences the state of disclosure and transparency of *Shari'ah* governance practices as compared to the reactive regulatory approach in the UK and the minimalist regulatory approach in GCC countries. In this regard, undeniably, Malaysia’s model of *Shari'ah* governance has proven that a strong and comprehensive regulatory framework for Islamic finance would be able to drive the market towards more transparent governance practices.

On top of the analysis from a country-specific behaviour perspective, the study also indicates the research proposition that there is a negative correlation between the ages of IFIs based on year of incorporation and the level of *Shari'ah* governance disclosure practice. IFIs in Cluster 3, which were incorporated in 2001–2005, have less experience compared to the IFIs in Clusters 1 and 2 yet have a better score on the *Shari'ah* governance disclosure index. This indicates that the level of *Shari'ah* governance disclosure practice is determined by other internal and external factors, such as regulation and well-conceived by-laws and internal policies of IFIs.

In view of the diverse *Sharī'ah* governance practices and distinct legal environments in the UK and GCC countries, the adoption of the Malaysian model alone would not be able to foster more transparent *Sharī'ah* governance practices. In fact, excessive government interference and too many regulations and restrictions may affect the level of efficiency and competitiveness of IFIs in the market. At this point, an integrated and eclectic approach, achieved by identifying the best practices, would be the ideal and appropriate way of promoting a good *Sharī'ah* governance framework. In addition, good practice of disclosure and transparency would be able to enhance the comparability of cross-border *Sharī'ah* governance practices that promote stable, coherent and consistent *Sharī'ah* practices. This comparability factor would be useful for regulatory authorities as well as financial institutions to make information on the ideal and appropriate *Sharī'ah* governance framework that governs *Sharī'ah* practices available to all stakeholders; this could then be formalized in the forms of institutions, resolutions, regulations, guidelines or requirements.

CHAPTER 10

CONTEXTUALISING THE FINDINGS AND CONCLUSION

10.0 Introduction

This chapter represents one of the most important parts of the thesis. It provides a brief discussion of the research findings and offers some recommendations for further enhancement of the *Shari‘ah* governance system. Based on the analysis of the survey, the semi-structured interview and the content analysis approach carried out in this research, subsection 10.1 illustrates how the research findings answer all of the hypotheses and research questions formulated in this study in an integrated manner. From these analyses, the chapter will extract and identify the issues, weaknesses and problems pertaining to the existing *Shari‘ah* governance system. Eventually, the chapter suggests some practical recommendations in subsection 10.2 for policy makers, regulators, IFIs, practitioners and other stakeholders to enhance and strengthen the *Shari‘ah* governance framework that is necessary for the development of the Islamic finance industry in the future.

10.1 Discussion on the Overall Research Findings

This section discusses the overall research findings and attempts to illustrate how they answer the research questions and hypotheses. The findings were extracted from three different analysis and research methods, namely the survey questionnaires, the semi-structured interviews and the content analysis. The study employed two methods, the questionnaires and the semi-structured interviews, to test the research hypotheses 1–6, while the content analysis method was exclusively utilized to answer the research hypothesis 7. The analysis in this section will be based on the findings from the survey questionnaires and the interviews of the fourteen *Shari‘ah* scholars as well as the content analysis of the annual reports, financial statements and websites of eighty IFIs in Malaysia, GCC countries and the UK. A brief discussion on all these findings will be made in separate subsections 10.1.1–10.1.7. In summary, this study has yielded substantial findings and successfully fulfilled all of the research aim and objectives. After

this brief summary of the research process, the discussion on the findings is now presented with reference to each hypothesis.

10.1.1 Hypothesis 1: There are differences in the various IFIs' approaches to *Shari'ah* governance.

In responding to this hypothesis, seven questions were formulated in the questionnaires and four questions in the semi-structured interviews. Consistent with the prediction in hypothesis 1, the survey findings reveal significant differences in the approaches of regulators and IFIs to *Shari'ah* governance. The results show that Malaysia presents a better commitment to *Shari'ah* governance by scoring a higher percentage in every question compared to IFIs in GCC countries and the UK; this includes the adoption of the internal *Shari'ah* governance standards and guidelines, standard processes for *Shari'ah* compliance, code of ethics and organizational arrangement. It was shown that more than 70% of IFIs in Malaysia have developed standard processes for *Shari'ah* compliance and a code of ethics for their *Shari'ah* board. On the other hand, IFIs in GCC countries and the UK are relatively still in the period of developing their *Shari'ah* governance framework. Although Malaysia's approach might not be the ideal model for IFIs in GCC countries and the UK, certain positive policies on the Malaysian regulatory-based approach might be appropriate to be adopted. Findings from the semi-structured interviews affirm the above position. The *Shari'ah* advisors also acknowledged the differences in *Shari'ah* governance approaches in IFIs. In fact, the *Shari'ah* scholars highlighted four main *Shari'ah* governance issues that need to be appropriately addressed, namely roles of regulators, regulation, IFIs' management and *Shari'ah* rulings.

Out of the above overall analysis, it is worth highlighting two further very important issues, namely the problems with the AAOIFI governance standards and *Shari'ah* scholars' understanding of the impact of poor practice of *Shari'ah* governance. While the AAOIFI governance standards are expected to provide guidelines of best practice of the *Shari'ah* governance system, it was found that these standards have not been reviewed and to a certain extent some of the principles are not relevant or appropriate to implement

in the current market practice. In addition, some *Shari‘ah* scholars highlighted their concern about the credibility of the standards as they have been approved by the AAOIFI *Shari‘ah* board who are at the same time advising numerous IFIs around the world, which is improper and inappropriate. The researcher considers that these two factors are amongst the reasons why only 45.7% of IFIs indicated that they have adopted the AAOIFI governance standards.

With regards to the second issue, the research findings from the semi-structured interviews reveal that some *Shari‘ah* scholars have a lack of understanding of the aspect of *Shari‘ah* non-compliance risk and its implications. They viewed that the impact of poor *Shari‘ah* governance practice is solely related to the perception and credibility of the IFI. This is a serious misconception as the implication of a poor *Shari‘ah* governance system goes beyond image and credibility but may in fact expose the IFIs to significant *Shari‘ah* non-compliance risks. Failure to mitigate this *Shari‘ah* non-compliance risk will lead to numerous impacts for IFIs, both financial and non-financial. Consistent with the findings on the attributes of the *Shari‘ah* board in terms of competence, the study found that *Shari‘ah* boards have generally not received or undergone adequate training to expand their knowledge of the technical aspects of Islamic banking and finance or to understand any kind of risk management.

10.1.2 Hypothesis 2: There are differences in the regulatory and internal frameworks of *Shari‘ah* governance in IFIs.

To test this hypothesis, the findings of four questions in the questionnaires and only one question in the semi-structured interviews are utilized. The survey reveals that there are significant differences in the regulations and by-laws or internal policies of IFIs pertaining to *Shari‘ah* governance. It was found that a small percentage of 6% of IFIs in GCC countries viewed that there were separate rules and regulations on *Shari‘ah* governance and 10% claimed that they had written policies pertaining to the *Shari‘ah* board. IFIs in Malaysia, on the other hand, indicated positively to the regulatory and internal policies by scoring higher in every question posed in the survey. While the UK

regulatory authority is still reluctant to interfere with *Shari‘ah* governance, the survey shows that the UK IFIs have developed their own internal by-laws on *Shari‘ah* governance. The answers given by the *Shari‘ah* scholars in the semi-structured interviews affirm that different IFIs have different internal frameworks of *Shari‘ah* governance and only some IFIs have written policies or by-laws on it.

Having considered that the Islamic finance industry is still at a developing stage, the findings in this study indicate that the *Shari‘ah* governance system needs comprehensive regulatory frameworks at the macro level as well as internal by-laws at the micro level. These two components are very important to complement each other as the internal by-laws would set clear frameworks and well-defined policy on *Shari‘ah* governance for internal use, whereas the regulatory framework at the macro level will provide clear guidelines and principles for the best *Shari‘ah* governance practice that would be able to boost the confidence of the public, investors and other stakeholders. In view of the minimal regulations on the *Shari‘ah* governance system in most of the case countries, the researcher insists on the notion of strengthening the practice of *Shari‘ah* governance by adopting the regulatory-based approach as well as self-regulation.

10.1.3 Hypothesis 3: There are differences in the roles and functions of the *Shari‘ah* board.

To answer this hypothesis, four questions were posed in the questionnaires to the respondents and two questions to the *Shari‘ah* scholars. The survey reveals that most of the IFIs view that the *Shari‘ah* board has advisory and supervisory functions and only 3% pointed out that it has executive power. The results from the survey show that there are significant differences in the *ex post* and *ex ante* functions of *Shari‘ah* boards. With respect to the *ex ante* functions of the *Shari‘ah* board, such as *Shari‘ah* pronouncements, the *Shari‘ah* review, endorsing documentation and *Shari‘ah* compliance, the majority of IFIs in Malaysia indicated that their *Shari‘ah* board clearly had these functions, while the IFIs in GCC countries and the UK showed otherwise. Meanwhile, most of the IFIs in the case countries demonstrated weak practices in the area of *ex post* functions of the

Sharī‘ah board. In the semi-structured interviews, most of the *Sharī‘ah* board agreed that they have advisory and supervisory authorities.

In discussing the roles of *Sharī‘ah* board, the study strongly recommends the notion of expanding its scope of duties and functions. The *Sharī‘ah* board should not only focus on and emphasize the legal and mechanistic aspects of *Sharī‘ah* pronouncements but rather take into consideration elements of Islamic ethics and values as well as the social dimension. On the basis of the stakeholder-oriented system being the aspirational dimension of Islamic corporate governance, the *Sharī‘ah* board should play an active role as the stakeholders' representative in promoting Islamic values, ethics and social responsibility. It is also important for the *Sharī‘ah* board to have a paradigm shift by invoking the principles of substance over form. Despite different views amongst the *Sharī‘ah* scholars on this issue, the findings in the semi-structured interviews affirm that some *Sharī‘ah* scholars have acknowledged their additional roles in promoting these three core elements. This indirectly indicates that *Sharī‘ah* scholars have admitted that the current *Sharī‘ah* governance practice pertaining to the scope of responsibilities of the *Sharī‘ah* board is very narrow and is mainly confined to the issuance of *Sharī‘ah* rulings.

10.1.4 Hypothesis 4: There are differences in the attributes of *Sharī‘ah* board members in terms of competence, independence, and transparency and confidentiality.

In answering this hypothesis, eighteen questions were asked in the questionnaires (eight on competence, six on independence and four on transparency and confidentiality) and seven questions in the semi-structured interviews (three on competence, two on independence and two on transparency and confidentiality). The findings show that most of the IFIs in Malaysia, GCC countries and the UK (77%) have mechanisms in place pertaining to the competence of the *Sharī‘ah* board. It was nevertheless found that there are significant differences in the fit and proper criteria for the *Sharī‘ah* board, namely academic qualifications, experience and exposure, and track record. The survey reveals some concerns about the adequacy of the *Sharī‘ah* board's ability in the technical aspects of banking and finance. Only a small percentage of IFIs conduct formal training or

Contextualising the Findings and Conclusion

allocate a certain amount of funds for training for their *Shari‘ah* board members. This was affirmed by the *Shari‘ah* scholars in the semi-structured interviews. Majority of them have not undergone any specific training to enhance and improve their technical ability in banking and finance. The *Shari‘ah* scholars also affirmed that it is not an established practice for IFIs to evaluate the *Shari‘ah* board’s performance.

The survey demonstrates significant differences in the mechanisms of independence of the *Shari‘ah* board. Despite the AAOIFI governance standards requiring the appointment to be made by the shareholders, the majority of IFIs have nevertheless made the appointments through the BOD. Almost all of the IFIs in Malaysia and the UK appointed their *Shari‘ah* board through the BOD, while most board members in the GCC countries were appointed by the shareholders. The *Shari‘ah* scholars affirm that they were generally appointed by the BOD. While *Shari‘ah* scholars generally agreed on the issue of potential conflict of interest and independence, they nevertheless were of the view that some other mechanism might be needed to be in place to avoid that in spite of the method of appointment. It was also found that there is no restriction on multiple appointments of *Shari‘ah* board members in GCC countries or the UK as in the case of Malaysia. Similarly with the issue of mandate and authority, the overall findings indicate that some IFIs did not grant clear mandate and authority to the *Shari‘ah* board.

The study identifies some inconsistencies with reference to the issues of independence and potential conflict of interest. While it is generally accepted that there must be mechanisms in place to ensure the independence of the *Shari‘ah* board, the present practice indicates that a significant percentage of IFIs have not addressed this issue appropriately. In addition, the findings in this study reveal that some *Shari‘ah* scholars have denied any potential conflict of interest as they are bound by Islamic ethical principles. In view of these circumstances, the researcher intends to highlight the misconceptions of the terms independence and conflict of interest. Independence should be the hallmark of *Shari‘ah* boards’ profession, which means that they are expected to be professionally independent and any appearance that may undermine the perception of

independence must be avoided. With regard to the issue of conflict of interest, although ideally *Shari‘ah* scholars are presumed to be honest, truthful and worthy of confidence, considering that they are human beings, in reality the issue of conflict of interest may happen, especially when they sit on the boards of various IFIs at one particular time. At this point, the researcher considers that the issues of independence and potential conflict of interest are real and the framework of *Shari‘ah* governance must be able to address these specific issues in order to ensure that the *Shari‘ah* board can perform its functions effectively and with full credibility.

The survey shows that the majority of IFIs do not have a written policy on the preparation and dissemination of *Shari‘ah* information and not all IFIs grant authority to the *Shari‘ah* board to have full access to information. Similar situation is found in the aspect of *Shari‘ah* rulings that are made known to the public. In addition, the majority of IFIs do not have a policy on mechanisms of confidentiality for the *Shari‘ah* board. The *Shari‘ah* scholars conceived that they have access to information and they are bound by the terms of the contract with respect to the issue of confidentiality. In reality, some *Shari‘ah* scholars intentionally or unintentionally have disclosed certain confidential information to other third parties which may impede the business strategy of particular IFIs (Madzlan, 2009). These findings indicate that there are shortcomings and weaknesses in the *Shari‘ah* governance framework in terms of full disclosure, transparency and mechanisms to ensure confidentiality, which may result in *Shari‘ah* and reputational risks.

10.1.5 Hypothesis 5: There are differences in the operational procedures of *Shari‘ah* governance practices.

In examining this hypothesis, twelve questions were formulated in the survey questionnaires and three questions in the semi-structured interviews. The survey reveals significant differences in the operational procedures of *Shari‘ah* governance in terms of meetings, basis of the decisions, meeting procedures, review of *Shari‘ah* rulings, the *Shari‘ah* report and its contents. Most of the IFIs in Malaysia have standard operational

procedures but only a small percentage of IFIs in the UK and GCC countries have the same. Similarly in the aspect of the *Shari‘ah* report, where it is found that only 16% of IFIs in GCC countries indicated that the *Shari‘ah* report was part of their internal requirements. In the semi-structured interviews, the *Shari‘ah* scholars affirmed the differences in operational procedures in IFIs. They also heavily rely on the internal *Shari‘ah* audit and are not proactive in carrying out their *ex post* functions.

In analysing the significant differences in the operational procedures, the researcher to highlight three core issues in this subject, namely the requirement of having standard operational procedures, the *Shari‘ah* report and the heavy reliance on the internal *Shari‘ah* audit. The findings from both the questionnaires and the semi-structured interviews affirm that a significant percentage of *Shari‘ah* boards of IFIs are operating within unclear and ambiguous frameworks. The absence of standard operational procedures on the *Shari‘ah* governance system may create problems and impede the smooth running of the *Shari‘ah* governance process, which may expose the IFIs to potentially significant *Shari‘ah* non-compliance risk. The study also reveals the weak *Shari‘ah* report practice both in the aspect of reporting structure as well as its content. With respect to the *ex post* functions of *Shari‘ah* board, the issue of heavily reliance on the internal *Shari‘ah* audit indicates that these functions are actually greatly determined by the internal audit department rather than by the *Shari‘ah* board itself.

10.1.6 Hypothesis 6: The IFIs are satisfied with the performance and contribution of the *Shari‘ah* board.

In analysing this hypothesis, five questions were asked in the questionnaires and one question in the semi-structured interviews. As expected, the survey reveals the broad satisfaction of IFIs with the performance and contribution of the *Shari‘ah* board. Almost all of the IFIs were satisfied with the contribution made by the *Shari‘ah* board in terms of organizational accountability, communication, evaluation of *Shari‘ah* non-compliance risk, promotion of Islamic ethics and improvement of *Shari‘ah* control processes. Interestingly, it was nevertheless found that some IFIs in GCC countries indicated that

they are dissatisfied with the *Sharī‘ah* board’s performance and contribution, particularly in the aspects of effective organizational communication, identifying *Sharī‘ah* non-compliance risks, promoting Islamic ethics and values as well as *Sharī‘ah* control processes. On the other hand, in the semi-structured interviews the *Sharī‘ah* scholars strongly denied any allegation that they have neglected the social and ethical considerations in making *Sharī‘ah* decisions. In fact, some *Sharī‘ah* scholars did mention that they are also concerned about the social dimension and ethical values in carrying out their functions. However, they highlighted the problems and challenges in influencing the IFIs to be more socially responsible due to their commercial and profit-driven nature.

While examining the *Sharī‘ah* governance practices on the aspect of assessment and evaluation of the *Sharī‘ah* board’s performance and contribution, the researcher tends to emphasize certain negative findings extracted from the questionnaires and the semi-structured interviews. Despite the majority of IFIs indicating that they are satisfied with the *Sharī‘ah* board’s contribution, 2.8% of IFIs viewed that the *Sharī‘ah* board has failed to identify and evaluate *Sharī‘ah* non-compliance risk and to promote continuous improvement in *Sharī‘ah* control processes and 5.7% of IFIs have neglected the duty to promote Islamic values and ethics. Considering the earlier finding that only 57.1% of IFIs have conducted a proper evaluation and assessment of the *Sharī‘ah* board, these negative findings are considered relatively significant. In fact, the findings from the semi-structured interviews further reveal that the *Sharī‘ah* board is often unable to influence IFIs towards being more ethical and socially responsible due to the conflict between profit and social motives. These circumstances indirectly affirm the criticisms and concerns of numerous scholars such as Siddiqi (2007), El Gamal (2006), Chapra (2010) and even Sheikh Saleh Kamel, the founder of Dallah Baraka Group,²¹⁹ about the exact roles and contribution of the *Sharī‘ah* board towards fulfilling the *maqāsid Sharī‘ah*. Having analysed the overall issues relating to the poor evaluation of the *Sharī‘ah* board’s performance contribution, the IFIs should continuously perform formal *Sharī‘ah* board

²¹⁹ Sheikh Saleh Kamel raises concerns about the present practice of Islamic finance, indicating that most Islamic financial products and services available in the market are not Islamic (Mahdi, 2008).

assessments at least in respect of effective organizational accountability, communication with other organs of governance, ability to identify and evaluate the *Sharī‘ah* risk, effort to promote Islamic ethics and values, and continuous improvement of an organization’s *Sharī‘ah* control processes.

10.1.7 Hypothesis 7: There are differences in the extent of disclosure of *Sharī‘ah* governance practices.

The study exclusively used the content analysis approach of the annual reports, financial statements and websites in answering research hypothesis 7. The study introduced thirty *Sharī‘ah* governance disclosure indicators in order to measure and quantify the extent and state of disclosure practice in IFIs. The overall findings of the survey reveal that there are significant differences in the extent of disclosure of *Sharī‘ah* governance practices. The level of disclosure in GCC countries is very minimal, where 55% of IFIs are ranked in the ‘Emerging Practice’ category and none of them in the ‘Good Practice’ or ‘Best Practice’ categories. Interestingly, the extent of disclosure practices in the UK is fair and better than GCC countries as 20% of UK IFIs are ranked in each of the ‘Improved Practice’ and ‘Good Practice’ categories. On the other hand, the results for IFIs in Malaysia were slightly better than GCC countries and the UK, as more than 80% of IFIs fall into the ‘Improved Practice’, ‘Good Practice’ and “Best Practice” categories.

The finding of poor and fair *Sharī‘ah* governance disclosure practices in the eighty IFIs in Malaysia, GCC countries and the UK indicates their failure to appreciate the core values of Islamic corporate governance, namely accountability and transparency. The study also reveals that, in fact, the so-called senior IFIs that were established by those people closer to the aspirational view of Islamic economics also only demonstrated ‘fair’ *Sharī‘ah* governance disclosure practices. We can see from this finding that good commitment and initiative to improve transparency, which indicates accountability, do not depend on the years of operation but rather it is determined by the internal organs of governance in IFIs, particularly the *Sharī‘ah* board, the BOD and the senior management. As Islam strongly emphasizes these two principles, the disclosure of all information

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relating to *Shari‘ah* advisory services is imperative as it is able to promote the confidence of the public and stakeholders as to the credibility of IFIs.

10.1.8 Overall Conclusion

Based on the overall research findings, this study summarizes the state of *Shari‘ah* governance practices in IFIs in Malaysia, GCC countries and the UK by classifying them into five different categories, as illustrated in Tables 10.1 and 10.2.

Table 10.1: State of Shari‘ah Governance Practices for Hypotheses 1–6

<i>Shari‘ah</i> Governance Practices	‘Underdeveloped Practice’	‘Emerging Practice’	‘Improved Practice’	‘Good Practice’	‘Best Practice’	Average Practice
Malaysia (17 IFIs)			35.2%	64.7%		‘Good Practice’
GCC Countries (16 IFIs)	35.2%	18.8%	43.8%			‘Emerging Practice’
UK (2 IFIs)			50%	50%		‘Improved Practice’
Overall (35 IFIs)	17.1%	8.6%	40%	32%		‘Improved Practice’

Table 10.2: State of Shari‘ah Governance Practices for Hypothesis 7

<i>Shari‘ah</i> Governance Practices	‘Underdeveloped Practice’	‘Emerging Practice’	‘Improved Practice’	‘Good Practice’	‘Best Practice’	Average Practice
Malaysia (20 IFIs)		15%	30%	50%	5%	‘Improved Practice’
GCC Countries (54 IFIs)	22.2%	46.2%	29.6%	1.9%		‘Emerging Practice’
UK (6 IFIs)	16.7%	33.3%	33.3%	16.7%		‘Emerging Practice’
Overall (80 IFIs)	16.3%	37.5%	30%	15%	1.3%	‘Improved Practice’

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Table 10.1 illustrates the state of *Shari‘ah* governance practices pertaining to hypotheses 1–6 whereas Table 10.2 specifically demonstrates the level of *Shari‘ah* governance disclosure practice for hypothesis 7. Both tables reveal that the average level of *Shari‘ah* governance practices in IFIs only falls into the ‘Improved Practice’ category, showing the weak governance practices and indicating the need for major improvement in almost all aspects of *Shari‘ah* governance. Within these negative findings, the study demonstrates that IFIs in Malaysia have better *Shari‘ah* governance practices when compared to IFIs in GCC countries and the UK in that they fall into the ‘Good Practice’ category for hypotheses 1–6 and the ‘Improved Practice’ category for hypothesis 7. The study suggests three main propositions from the above research findings. Firstly, a strong regulatory framework leads to better *Shari‘ah* governance practices. Secondly, less interference from regulatory authorities and lack of a regulatory framework for *Shari‘ah* governance contribute to the weak *Shari‘ah* governance practices. Thirdly, the extent of *Shari‘ah* governance practices is also determined by the attitude of IFIs’ management.

A comprehensive regulatory framework is one of the factors that significantly influences the level of *Shari‘ah* governance practices. Well-conceived regulation and a proactive approach of the regulatory authorities, such as in the case of Malaysia, contribute to better development of a *Shari‘ah* governance system. Considering the importance of an integrated regulatory approach, the study suggests that having numerous rules and regulations on *Shari‘ah* governance will not guarantee the improvement of *Shari‘ah* governance practices in the industry per se. Supervision and enforcement are essential to ensure compliance with the existing rules, regulations and guidelines. This important point then leads to the formulation of the second proposition.

The study suggests that less interference and lack of a regulatory framework for *Shari‘ah* governance is one of the factors that impedes the extent of *Shari‘ah* governance practices. In view of the market immaturity in the Islamic finance industry, and lack of self-initiative on the aspect of governance, we cannot expect that IFIs will develop and portray strong *Shari‘ah* governance practices voluntarily and without proper supervision.

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This is affirmed by the findings on the state of *Shari‘ah* governance practices in GCC countries. Although regulatory frameworks in Bahrain, the UAE and Qatar clearly mention the adoption of the AAOIFI governance standards, the implementation of these governance standards has nevertheless not significantly or positively influenced the level of *Shari‘ah* governance practice. This position denotes that having an appropriate legal framework without proper supervision and enforcement will not guarantee the betterment of *Shari‘ah* governance practices in IFIs.

While the first two propositions refer to the external factors of *Shari‘ah* governance practices, the third proposition concerns an internal factor in that it denotes the importance of a proactive approach of the individual IFI to facilitate the implementation of Islamic finance by emphasizing the requirement of *Shari‘ah* compliance. In this regard, the state of *Shari‘ah* governance practices in IFIs is greatly dependent on the attitude of IFIs’ management, particularly its BOD, senior management and *Shari‘ah* board. Full commitment of the IFIs’ management to the aspect of *Shari‘ah* compliance is one of the determining factors for better *Shari‘ah* governance practice. Well-conceived by-laws and internal policies on *Shari‘ah* governance at IFI or micro level will then complement the rules and guidelines regulated at the macro level.

In summary, the study concludes that the overall *Shari‘ah* governance practices in Malaysia, GCC countries and the UK are still at a very minimal level. Based on the whole research analysis and observations, the study suggests that the extent of *Shari‘ah* governance practices is greatly dependent on the regulatory frameworks, the proactive approach of regulatory authorities and the positive attitude of the IFIs’ management. These three components are the determining factors to ensure better *Shari‘ah* governance practices in IFIs. Therefore, any efforts and initiatives at the micro or macro level for the improvement and enhancement of *Shari‘ah* governance practices must be supported and facilitated with a comprehensive and integrated regulatory framework, strong support from regulatory authorities and the positive attitude of IFIs’ management.

10.2 RECOMMENDATIONS

Based on the revealed findings of the analyses presented in this research, this section presents a number of recommendations. It should be stated that the recommendations put forward in this study are consistent with the existing guidelines on corporate and *Shari‘ah* governance of the AAOIFI and the IFSB. The study also takes into consideration two documents jointly initiated by the IFSB and the Islamic Research and Training Institute of the IDB, namely the Islamic Financial Services Industry Development; Ten Year Framework and Strategies²²⁰ and Islamic Finance and Global Financial Stability.²²¹ In this systematic effort, some recommendations might overlap with the guiding principles and governance standards as well as the IFSB and IRTI documents, but the study takes another approach by emphasizing and detailing out necessary measures for further enhancing existing *Shari‘ah* governance practices. Besides, the recommendations also take into account the general principle of good corporate governance as promoted by the OECD Principles of Corporate Governance and the standard on enhancing corporate governance for banking organizations by the BCBS.²²² The researcher considers that the key principles of corporate governance contained in those guidelines and principles are also applicable to *Shari‘ah* governance in IFIs.

As a basis of the recommendations, the study emphasizes six key elements of sound corporate governance, as recommended by Iqbal and Mirakhori (2007: 285): “(i) a well articulated corporate strategy; (ii) setting and enforcing clear assignments of

²²⁰ IFSB and IRTI (2009: 58–59) insist on the legal, information and governance infrastructure of Islamic finance, particularly the *Shari‘ah* and corporate governance system.

²²¹ IFSB and IRTI (2010: 40–41) emphasize three key areas to strengthen and enhance the Islamic financial system by “strengthening the infrastructural building blocks of the Islamic financial services industry; accelerating the effective implementation of *Shari‘ah* and prudential standards and rules to facilitate the creation of a more stable, efficient and internationally integrated Islamic financial services industry; and creating a common platform for the regulators of the Islamic financial services industry to enhance constructive dialogue”.

²²² In analysing the OECD Principles on Corporate Governance with Islamic principles, Abu-Tapanjeh (2009: 556–567) claims that the recommended set of the OECD Principles is not new to Islam but in fact has existed since the early stage of Islamic civilization. There are numerous verses of *al-Qur'an* and *al-Sunnah* mentioning the principles of accountability, responsibility, disclosure, transparency, business ethics, book-keeping and final accounts.

responsibilities, decision-making authority and accountabilities that is appropriate for the bank's risk profile; (iii) a strong financial risk management function, adequate internal control systems and functional process design; (iv) adequate corporate values, codes of conduct and other standard appropriate behaviour and effective systems used for ensuring compliance; and (v) financial and managerial incentives be consistent with the firm's objectives, performance and ethical values." The study also offers some recommendations to enhance the existing *Shari'ah* governance framework by promoting the key elements of a good *Shari'ah* board and these include independence, competence, transparency and disclosure, consistency, well-defined operating procedures, a sound code of ethics, and clear mandate and responsibility.

10.2.1 *Shari'ah* Governance Approach

10.2.1.1 Stakeholder-Oriented Approach

The foundational dimension of Islamic corporate governance is rooted in the stakeholder-oriented approach, in which its governance style aims at protecting the rights and interests of all stakeholders rather than maximizing the shareholders' profit as in the shareholder value orientation. Considering the dominant position of the shareholder value model of corporate governance, particularly in Malaysia, GCC countries and the UK, the researcher strongly insists the IFIs depart from this inappropriate system by adopting the stakeholder-oriented approach to corporate governance.²²³ The adoption of the stakeholder-oriented approach would be able to enhance the corporate governance dimension of IFIs, where all stakeholders, such as the *Shari'ah* board, the BOD, the shareholders, the depositors and the managers play significant roles in ensuring the realization of the corporation's goal and fulfilling the *maqāsid Shari'ah*. This will help to bring the IFIs closer to the aspirational position of an Islamic moral economy.

²²³ This is in line with the recommendation of the World Bank on Risk Analysis for Islamic Banks. It states that "Islamic banks emphasize service to multiple stakeholders. Governance processes and structures inside and outside the firm are needed to protect the ethical and pecuniary interests of shareholders and stakeholders" (Greuning and Iqbal, 2008: 269). This position indicates that the stakeholder value orientation is the ideal model for corporate governance including *Shari'ah* governance in IFIs as it is concerned with a broader group of stakeholders as inspired by its philosophical foundation.

10.2.1.2 Regulatory-Based Approach

The research findings reveal that the jurisdiction with the strongest regulatory framework has better *Shari‘ah* governance practices in almost every aspect. The call for a strong regulatory and supervisory framework for IFIs has actually been made since 1981 in the detailed report of the governors of the central banks of the OIC countries on the “Promotion, Regulation and Supervision of Islamic Banks” (Chapra and Ahmed, 2002: 76) and followed by the World Bank Note on Risk Analysis for IFIs (Greuning and Iqbal, 2008: 193). El Hawary, Grais and Iqbal (2004: 789–791) suggest the need for regulation in IFIs by emphasizing the elements of public opinion, protection of public resources, integrity of fiduciary duties arising from contractual agreements, and ensuring *Shari‘ah* compliance.

In view of the infancy of the Islamic finance industry and the numerous challenges that may impede the development of Islamic finance, it is strongly recommended that a *Shari‘ah* governance system be systematically regulated. In outlining the appropriate legal framework for Islamic finance, a study by the IMF on prudential and supervision issues in Islamic finance laid down three important key points pertaining to governance in IFIs, namely the legal foundation for supervision of IFIs must be in place, all kinds of risk must be dealt with, and there must be adequate information disclosure (Errico and Farahbaksh, 1998: 15). In this regard, the study strongly recommends that the regulators and policy makers should promulgate specific regulations on a *Shari‘ah* governance system by taking into consideration the key points formulated by Errico and Farahbaksh (1998). This regulatory framework should cover the whole process of *Shari‘ah* governance by considering the overall market practice and the local legal environment. While regulation is expected to govern and regulate the market effectively, it is worth noting that over-restrictive regulation can also be counter-productive and may impede the development of Islamic finance. With this understanding, the regulators should also take into consideration all aspects in tailoring the regulatory framework for *Shari‘ah* governance.

10.2.1.3 Centralized *Shari'ah* Board

The ideal *Shari'ah* governance system requires a proper structure for a *Shari'ah* board. It is good practice to have two layers of *Shari'ah* board structure, namely *Shari'ah* boards at both micro and macro levels. The establishment of a *Shari'ah* board at the macro level is strongly recommended as it may become the highest authority in Islamic finance in a country and may resolve any issues raised in the *Shari'ah* boards in IFIs. The setting up of a national *Shari'ah* board is expected to build and maintain the confidence of various stakeholders in IFIs. As an independent body that operates within non-profitable institutions, the national *Shari'ah* board would be able to play its role to enhance the practice of Islamic finance by promoting the integration of *maqāsid Shari'ah* where all stakeholders' interests and rights are protected.²²⁴

Another layer of *Shari'ah* board structure at the international level is needed in order to resolve issues involving cross-border jurisdictions and for *Shari'ah* harmonization purposes. In this aspect, the existing AAOIFI *Shari'ah* board may be considered as the main reference *Shari'ah* board for any jurisdiction. It is worth noting that this recommendation may not be appropriate to some jurisdictions, particularly to purely secular legal environments. In this instance, the regulatory authorities should have a clear understanding of the market practice and identify which model would be appropriate to IFIs under their supervision.

10.2.1.4 Composition of BOD

The ideal function of the *Shari'ah* board is advisory and supervisory but with the executive power still in the hands of the BOD. The researcher agrees with the principle in

²²⁴ A few *Shari'ah* scholars disagree with the idea of a centralized *Shari'ah* board, such as Elgari, who considers that this practice is against the egalitarian nature of the Islamic system (Parker, 2010). The researcher begs to differ with this point of view and is firmly in favour of the centralized *Shari'ah* board model. The central purpose of the centralized *Shari'ah* board is to harmonize the *Shari'ah* governance practices and to act as the highest *Shari'ah* authority to resolve any conflicts pertaining to *Shari'ah* matters. The establishment of a national *Shari'ah* board will not in any case interfere with the authority and mandate given to *Shari'ah* boards at the individual IFI level.

the IFSB-10, which requires the BOD and senior management of IFIs to have certain minimum criteria in terms of knowledge and experience pertaining to *Shari‘ah*-related matters. The selection of the BOD members and senior management should be based on these additional criteria.²²⁵

In view of the importance of *Shari‘ah* input during the BOD meetings, it is strongly recommended that the BOD has at least one member with sound knowledge of *Shari‘ah* as an independent director.²²⁶ This independent director will be able to provide input, information and views on the aspects of *Shari‘ah*, Islamic ethics and values, which are important for any basis of decision-making. This representation is also essential as an indication of the stakeholder value orientation in protecting the rights and interests of stakeholders, particularly the IAHs.

10.2.1.5 Composition of the *Shari‘ah* Board

It is clear from the research findings that different practices with regards the composition of *Shari‘ah* board are currently prevailing. It would be a good practice of the *Shari‘ah* board to have a minimum number of three members. In line with the IFSB-10 and the AAOIFI Governance Standards,²²⁷ it is recommended for the IFIs to have mixed members from different *madhahib* and different nationalities without neglecting the local expertise. *Shari‘ah* rulings coming out from mixed members of a *Shari‘ah* board would mitigate any potential inconsistency as well as ensure its acceptability in other jurisdictions.

²²⁵ Interestingly, Inovest, an investment company in Bahrain has appointed Dr Fareed Mohammed Hadi, a member of its *Shari‘ah* board, as a BOD member (Inovest, 2009). This practice is contrary to the AAOIFI governance standards, which state a director cannot be appointed as a *Shari‘ah* board member for the purpose of mitigating any potential conflict of interest.

²²⁶ This is in parallel with the recommendation of the Islamic Development Bank, which encourages IFIs to appoint a director who has sound knowledge of *Shari‘ah* to play a role as a bridge between the BOD and the *Shari‘ah* board (Hawkamah, 2010: 6).

²²⁷ See also Chapra and Ahmed (2002), Greuning and Iqbal (2008), Chapra (2007) Siddiqi (2007) and Hawkamah (2010).

The practice of appointing non-*Shari‘ah* experts, such as scholars and experts in law, finance, banking, economics, accounting and finance, is also acceptable subject to certain limitations. Those members may provide their views and actively participate in the *Shari‘ah* board meetings but they should not have voting rights. This is affirmed by the findings from the semi-structured interviews, where the majority of *Shari‘ah* scholars agreed on such a practice and admitted their limited knowledge on subjects other than *Shari‘ah*. It would also be a very good *Shari‘ah* board practice if the board has an executive member who would engage and deal with the day-to-day operations. Unlike the normal *Shari‘ah* board members, those executive members of the *Shari‘ah* board should be full-time staff in the IFIs and work on a daily basis to provide *Shari‘ah* consultancy services from time to time.

10.2.6 *Shari‘ah* Advisory Firms

The study reveals that some IFIs opt to engage a *Shari‘ah* advisory firm as their organizational arrangement for *Shari‘ah* governance and this practice is popular for Islamic windows, Islamic investment collective scheme institutions and Islamic fund management companies. Since the *Shari‘ah* advisory firm is not one of the internal organs of governance in IFIs, some mechanisms may need to be imposed to regulate such a practice. The IFSB-10 seems to fail to adequately address this issue and has only very minor provision stating the position pertaining to *Shari‘ah* advisory firms.²²⁸

The regulators should take into consideration the framework for *Shari‘ah* advisory firms and this includes licensing, professional indemnity insurance, mandatory reporting, confidentiality and transparency. Another important aspect that needs to be addressed is the rules on shareholding of *Shari‘ah* scholars and advisory services provided by their companies.²²⁹ It would be a good practice if the regulators issued licences for the

²²⁸ The earlier exposure draft of the IFSB-10 did provide some extensive guiding principles on the *Shari‘ah* advisory firms. Those principles were unfortunately removed in the final version of the IFSB-10 (Madzlan, 2009).

²²⁹ The AAOIFI has made an initiative to issue new standards to regulate the practice of *Shari‘ah* advisory firms (Richter, 2010). In fact, Mohammad Nedal Elchaar, secretary-general of the AAOIFI raised the

Sharī‘ah advisory firms and put certain conditions on them. This licence could be renewed if the *Sharī‘ah* advisory firms satisfy all the necessary conditions set by the regulators. It is also necessary for the regulators to require the *Sharī‘ah* advisory firms to have professional indemnity insurance. In the event that the *Sharī‘ah* advisory firms have a relationship with particular IFIs, such as common shareholders or directors, they should exclude themselves from doing any business with them. This may help the IFIs to mitigate risk due to negligence or being wrongly advised by the *Sharī‘ah* advisory firm. Furthermore, the policy for the *Sharī‘ah* advisory firm must cover the aspects of mandatory reporting, confidentiality and transparency.

10.2.1.7 Adoption of the IFSB-10 and the AAOIFI Governance Standards

The survey clearly indicates that the level of awareness of IFIs on the development of *Sharī‘ah* governance is slightly low, where more than 22% of IFIs were not aware of the existence of the IFSB-10. In fact, only 45.7% of IFIs have adopted the AAOIFI governance standards.²³⁰ This position indicates that numerous IFIs do not have adequate and sound guidelines for their *Sharī‘ah* governance system. The AAOIFI governance standards lay down key principles, guidelines, standard formats and a code of ethics that are very important for the purpose of *Sharī‘ah* governance.²³¹ On top of that, based on the comprehensive study of the issue of *Sharī‘ah* governance in various countries, the IFSB-10 provides guidelines and standards of best practice of *Sharī‘ah* governance for IFIs. Furthermore, the key principles of competence, independency, consistency, transparency and confidentiality formulated in the IFSB-10 are really important for the purpose of a *Sharī‘ah* governance system. The study hence strongly recommends the adoption of the IFSB-10 by regulators or supervisors as well as IFIs to enhance and strengthen the

AAOIFI's concern about the issue of *Sharī‘ah* advisory firms owned by *Sharī‘ah* scholars. He highlighted the issue of potential conflict of interest, information leakage and competition impact (El Baltaji, 2010).

²³⁰ The recommendation for the adoption of the AAOIFI governance standards is subject to the condition that the standards must be revised and updated accordingly.

²³¹ The adoption of the AAOIFI governance standards has positively influenced the corporate disclosure of IFIs. A study conducted by Al-Baluchi (2006: 192) on thirty-four IFIs in Bahrain, Qatar and Jordan revealed that the implementation of the AAOIFI governance standards had significantly increased the level of voluntary disclosure in the annual report with an average of 35% improvement. The researcher is of the view that the implementation of the IFSB-10 will also positively contribute towards better *Sharī‘ah* governance practices at least in the aspects of disclosure and transparency.

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Shari‘ah governance framework. Once the documents are adopted, the IFSB, with proper coordination by the AAOIFI, can play a watchdog role to monitor, supervise and revise the implementation of the *Shari‘ah* governance system.

10.2.2 Regulatory and Internal Frameworks

10.2.2.1 Proactive Approach and Integrated Corporate and *Shari‘ah* Governance

In view of the numerous challenges faced by Islamic finance, it is recommended that the industry needs a regulatory-based approach framework as explained before. As a prerequisite, *Shari‘ah* governance must be part of the concerns of regulators and policymakers. The regulators should proactively monitor the implementation of *Shari‘ah* governance and learn from the experience of other jurisdictions in nurturing the *Shari‘ah* governance framework. The principle of ‘one-size-fits-all’ *Shari‘ah* governance is not appropriate as the market and local legal environments are different from one place to another.

In designing the *Shari‘ah* governance framework, it is a matter of necessity to have an integrated corporate and *Shari‘ah* governance framework. These two things must not be segregated as they complement each other. In this aspect, the principles or guidelines on corporate governance must take into account the element of *Shari‘ah* governance when it involves institutions offering Islamic financial services. This is important because the stakeholder-oriented model of governance in IFIs requires them to protect the rights and interests of all stakeholders.

10.2.2.2 Supervision and Enforcement

The regulators should have a comprehensive framework in the aspects of supervision and enforcement and these include written guidelines on supervision for supervisors, directives for IFIs issued by supervisors, sufficient resources with adequate knowledge on *Shari‘ah* governance-related matters and full authority to carry out the enforcement

functions. The supervisors should provide guidelines and make sure that they evaluate the internal policies and procedures as well as the implementation of these procedures. It is also important for the supervisors to consistently inspect the IFIs by having a proper framework in place which allows them to make an assessment of IFIs' *Shari'ah* governance policies and tools to redress any deficiencies.

10.2.2.3 Dispute Settlement

The existing framework for dispute settlement puts Islamic finance cases under the jurisdiction of the civil court, with exception of Saudi Arabia where they fall under the auspices of the Banking Dispute Settlement. This position raises an issue as to the ability of the court or the judge to hear cases involving *Shari'ah* matters. Therefore, it would be an ideal development if the regulators initiated a special bench for Islamic finance cases as part of the court's structure. In this special bench, the court may appoint judges who are knowledgeable in Islamic finance or the regulators may allocate a certain amount of funds to provide training for those judges. On top of that, a reliable *Shari'ah* litigation system must also be in place. It is understood that in a secular legal environment, such as in the UK, the above arrangement is slightly difficult to implement. Therefore, it is important for the regulators in the secular legal environment to consider a court referral to a *Shari'ah* board or a *Shari'ah* expert to determine cases involving *Shari'ah* issues. Alternatively, a special tribunal for Islamic finance cases may be established to handle disputes involving IFIs in this kind of jurisdiction.

The policymakers should also take into account other legal avenues for dispute settlement, such as arbitration and mediation. At this point in time, there are several institutions for international dispute resolution, such as the Dubai Centre for Arbitration and Conciliation, the GCC Commercial Arbitration Centre, the Bahrain Centre for International Commercial Arbitration Centre, the International Chamber of Commerce's International Court of Arbitration, the London Court of International Arbitration, the Kuwait Centre for Commercial Arbitration, the Kuala Lumpur Arbitration Centre and others. In view of these numerous arbitration centres, it is recommended that there should

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be one specific institution that offers alternative dispute resolutions and settlement for Islamic finance cases. Alternatively, the existing arbitration centres should develop and enhance their expertise and capabilities in Islamic finance in terms of resources, frameworks, procedures and facilities. At this point, these institutions for arbitration must prepare to facilitate themselves with necessary facilities and resources to address the need for dispute settlement involving Islamic finance cases.

In order to ensure the effectiveness of the arbitration, the decision or solution of the arbitration should be made binding and conclusive. The legally binding effect in arbitration is crucial for the purpose of ensuring credibility and confidence in any solution made in the arbitration. In spite of that, it is also important for the regulators to encourage arbitration as an alternative legal avenue for dispute settlement and to issue policies and procedures that clearly acknowledge Islamic law as the main source of law as a basis for decision-making.²³²

The research findings reveal that the *Shari‘ah* board rulings are non-binding in certain jurisdictions. This may create implications as to the aspects of enforcement and supervision in the event of disputes. Realizing these potential consequences, the *Shari‘ah* pronouncements should therefore be made binding with a full legal effect that binds the IFIs. It is also recommended that the *Shari‘ah* pronouncement should be made a mandatory reference for the court of justice as well as the arbitration of any other alternative disputes.

10.2.2.4 Well-conceived By-laws and Internal Policies

The research findings reveal that many IFIs do not have by-laws or internal policies pertaining to *Shari‘ah* governance. Well-conceived by-laws and internal policies are

²³² In the case of *Ruler of Qatar v International Marine Oil Co. Ltd* (1953) 20 ILR 534, the arbitrators in this case ignored the ability of Islamic law to resolve contemporary issues by claiming that it was not sufficient to interpret certain particular types of contract. In actual fact, the arbitrators had failed to appreciate and understand the extensive Islamic legal scholarship that is able to resolve any disputes. It is important for the arbitrators and the institutions of arbitrators to refer to Islamic law as the main basis for decision-making in cases pertaining to Islamic finance.

prerequisites of effective *Shari‘ah* governance. Realizing this, the IFIs should have appropriate by-laws and policies as guidelines for their internal use in terms of meeting procedures, decision-making, preparing reports and dissemination of information, records and reviews. At this point, the IFSB-10 and the AAOIFI governance standards may be the basis for such by-laws, with some modifications that would be appropriate to be implemented within the local market and regulatory environment.

10.2.3 Roles of the *Shari‘ah* Board

10.2.3.1 Full Mandate and Clear Definition of Duties and Functions

The regulators should define the *Shari‘ah* board’s duties and functions precisely and these include their areas of responsibilities, authority level and reporting lines. The functions of the *Shari‘ah* board should only be limited to the advisory and supervisory roles. The effectiveness of the *Shari‘ah* board functions can only be achieved if the regulators as well as the IFIs precisely define the relationship between the *Shari‘ah* boards and other organs of governance in IFIs. This is crucial to give full mandate and authority to the *Shari‘ah* board and at the same time other organs of governance such as management, the BOD and employees must respect and comply with the directions and instructions given by the *Shari‘ah* board. With regard to IFIs operating in numerous jurisdictions, the *Shari‘ah* board should understand IFIs’ operational structure. The *Shari‘ah* board should constantly review the appropriateness of *Shari‘ah* pronouncements and take into consideration all aspects, including the legal environment, difference of *madhhab* and implications of the rulings.

10.2.3.2 Expanding the Scope of Duties and Functions

The present practice on the scope of the *Shari‘ah* board’s duties and functions, as demonstrated by the research findings, mainly emphasizes the issuance of *Shari‘ah* pronouncements rather than going beyond this horizon and hence their role does not include any proactive approach. It is imperative to stress the need to inculcate Islamic ethics and values as well as the social dimension into the *Shari‘ah* board’s responsibility.

This aspect will truly add value to the existence of Islamic finance as part of the existing financial system. At this point, the *Shari‘ah* board should play more active roles in the IFIs’ operations and activities, such as participating in the design of policies, procedures and training programmes. The regulators should encourage the IFIs, through the *Shari‘ah* board, to implement Islamic ethics and values and to give more consideration to the social dimension. Perhaps, some incentives in the form of awards to individual *Shari‘ah* scholars as well as the institution of a *Shari‘ah* board systematic programme would be a good initiative.

10.2.3.3 Limitation on Multiple Appointments

The research findings reveal that some *Shari‘ah* scholars have enjoyed the privilege of sitting on the boards of numerous IFIs without any sort of limitation. This may raise a serious issue of credibility and damage the image of the *Shari‘ah* board as well as introducing a potential conflict of interest. While the researcher claims that multiple sittings on numerous *Shari‘ah* boards is an acceptable practice due to market considerations and, to a certain extent, the shortage of qualified *Shari‘ah* scholars, the study strongly recommends that some limitations must be in place for efficiency and, more importantly, for overcoming any conflict of interest and promoting transparency. In this regard, a maximum of five *Shari‘ah* boards at one particular time might be appropriate as a standard practice. In the event that there is a potential conflict of interest, the IFIs or the *Shari‘ah* board members themselves must disqualify individuals from being involved in those transactions.²³³ In addition, the IFIs are also recommended to monitor and assess the commitment and discipline of the *Shari‘ah* board members so that they will allocate sufficient time and effort to perform their duties with due diligence.

²³³ The IFSB-10 explains the state of lack of independence as being unable to exercise judgment because of undue influence, duress, having blood or intimate relationship with IFIs and, in the case of *Shari‘ah* advisory firms, due to having common shareholders or directors (IFSB, 2009c: 15–16).

10.2.4 Attributes of the *Shari‘ah* Board on Competence

10.2.4.1. Minimum and High Standard of Fit and Proper Criteria

The findings in this study reveal that there are significant differences in the attributes of *Shari‘ah* boards relating to competence and independence. Some IFIs did not even have a clear policy on the requirement of fit and proper criteria for the *Shari‘ah* board. In this regard, it would be proper if both the regulators and the IFIs set minimum standards on the fit and proper criteria for the *Shari‘ah* board members. Four attributes must be taken into consideration, namely academic qualifications, experience and exposure, track record and good character. Before their appointment, additional measures may be taken requiring the *Shari‘ah* board members to make statutory declarations pertaining to all of those criteria. A particularly high standard of fit and proper criteria might be needed in the case of *Shari‘ah* boards at the international and national levels, including *Shari‘ah* advisory services involving sophisticated Islamic financial products.

It is contended that the effectiveness of the *Shari‘ah* board mainly depends on the roles played by its chairman. At this point, it is important to set up different criteria for the chairman of *Shari‘ah* board. Senior *Shari‘ah* scholars with vast experience in the industry would be ideal for this position. In addition, it is also important to limit individual scholars to chairmanship of not more than three IFIs at one particular time as multiple chairmanship positions may raise serious issues of conflict of interest. It is also worth considering a rotation of the chairman of the *Shari‘ah* board.

10.2.4.2 Corporate Governance Committee and Nomination Committee

In line with the recommendation of the IFSB, it is recommended that the IFIs set up a corporate governance committee. This committee should consist of mixed expertise from interdisciplinary members including representatives of the *Shari‘ah* board. The function of this corporate governance committee is to monitor the IFIs’ implementation with respect to corporate and *Shari‘ah* governance guidelines and principles. Besides this, the

corporate governance committee should have a function of overseeing and implementing the governance framework that will protect the interest of all stakeholders, particularly IAHs, since they have no right of governance participation. While the corporate governance committee are concerned with the implementation of corporate governance matters, the nomination committee that normally aims at selecting and nominating the BOD can also be used to identify and filter the appropriate members of the *Shari‘ah* board. This nomination committee will have a specific policy on the fit and proper criteria of *Shari‘ah* board members.

10.2.4.3 Specific Funds and Continuous Training Programme

The study discloses that the majority of the *Shari‘ah* scholars do not have backgrounds in banking, finance or economics. This position may distract their ability to provide sound and solid *Shari‘ah* rulings because such knowledge is a tool to understanding and appreciating the whole picture of certain products and services. With respect to this, the *Shari‘ah* board should undergo ongoing training on technical and industry specific knowledge on banking and finance and any other necessary areas that enhance their professional, ethical and technical skills. It would be a good practice for newly appointed *Shari‘ah* board members to attend orientation and induction programmes to make them familiar with the operational and technical aspects of IFIs. At the same time, the IFIs should consistently introduce measures for annual training for *Shari‘ah* board members.

In light of the above, a specific allocation of funds should be established either at the national or IFI level. At the national level, the regulators should allocate a certain amount of funds to develop training programmes for *Shari‘ah* boards as well as *Shari‘ah* auditors. For long-term development, it is also important to consider an academic approach, such as developing a syllabus and academic programme in the institution of higher learning and any research institutions. At the IFIs’ level, an annual financial allocation for the *Shari‘ah* training programme should be put in place. This is important for the purpose of continuous training for employees, *Shari‘ah* board members,

managers, directors and even shareholders pertaining to *Shari‘ah* and its related knowledge.

10.2.4.4 Young *Shari‘ah* Scholar Programme

The research findings reveal that the top sixteen *Shari‘ah* scholars hold more than 100 board positions with an average of 6.5 positions for each scholar. In fact, some individual scholars hold up to 78 board positions and twenty-one chairman positions around the globe (Unal, 2010: 6). This may entail serious issues as to independence, conflict of interest and confidentiality, as well as the ability of *Shari‘ah* scholars to provide their services with due diligence. With the understanding of the issue of the shortage of qualified scholars, it is recommended that the regulators, with the cooperation of IFIs, develop a “Young *Shari‘ah* Scholar Programme”. This programme might be in the form of ‘mentor–mentee’ approach, where potential young *Shari‘ah* scholars are allowed to sit on the *Shari‘ah* board under the auspices of senior *Shari‘ah* scholars.²³⁴ After a certain stipulated time, with the recommendation of the chairman of the *Shari‘ah* board, those young scholars will then be admitted and qualified to be full members of the *Shari‘ah* board.

10.2.5 Attributes of the *Shari‘ah* Board on Independence

10.2.5.1 Method of Appointment

The research findings reveal that there are significant differences in the method of appointment of the *Shari‘ah* board between IFIs. It is also found that numerous IFIs did not comply with the AAOIFI governance standards in that their appointments are made by the BOD and not the shareholders. In view of the actual market practice and more practical tools for ensuring independence, the researcher considers that there are other mechanisms that would be appropriate to achieve such an objective. Firstly, the appointment must be made either by the BOD or the shareholders. Secondly, the

²³⁴ This is in line with the IFSB-10 recommendation to address issue of shortage of qualified and competent *Shari‘ah* scholars (IFSB, 2009c: 8).

appointment must be subject to the approval of the regulatory authorities. Thirdly, the appointment must not be permanent but rather contractual subject to renewal. Fourthly, the termination and dismissal must also be subject to the approval of the regulatory authorities.

10.2.5.2 Code of Conduct

The research clearly indicates that the majority of IFIs do not have a code of ethics for *Shari‘ah* board. The existing practices seem to presume that *Shari‘ah* board members are bound by Islamic ethical principles. In view of the need to have a certain and precise code of ethics specific and exclusive to the *Shari‘ah* board, the regulatory authorities as well as the IFIs may prescribe certain acceptable behaviour for *Shari‘ah* board members. It is incumbent upon the IFIs to initiate and develop an internal code of conduct for the *Shari‘ah* board. This code of ethics should be enforceable and there must be a mechanism within the organizational structure to ensure its strict implementation. Breach of this code of ethics may incur disciplinary action such as suspension, termination or other kinds of sanctions.

10.2.5.3 Professional Body

The study finds that there is no professional body specifically established to set a standard practice for the *Shari‘ah* board as is the case for other professionals such as lawyers, accountants, medical practitioners and engineers. The establishment of a professional body to set the qualifications of the *Shari‘ah* board, to introduce a standard code of conduct, to develop a training programme and to enhance the professionalism of the *Shari‘ah* board is consider necessary at this point in time. At the moment, different bodies attempt to provide qualification programmes for *Shari‘ah* boards, such as the AAOIFI Certified *Shari‘ah* Adviser and Auditor, the Scholar Development Program initiated by the IFC Islamic finance council and the SII and the IBFIM *Shari‘ah* Scholars Introduction Program, but it was found that such qualifications have not been accepted universally. The study strongly recommends the establishment of The Association of

Sharī‘ah Advisors at the national and international levels.²³⁵ With this association, the quality of the *Sharī‘ah* board can then also be rated by an independent agency similar to a credit-rating agency.

10.2.5.4 Remuneration Policy

The research findings demonstrate that there are significant differences in the remuneration of different *Sharī‘ah* boards. The absence of any policy limitation or guidelines on the *Sharī‘ah* board’s remuneration may lead to unhealthy practices. The top ten *Sharī‘ah* scholars who dominated the board positions in IFIs around the world earn a very lucrative and significant amount of remuneration. It was found that a chairman of a *Sharī‘ah* board could earn USD50,000 to USD100,000 per board (Pasha, 2010a) and a top scholar could even gain up to USD250,000 on a typical capital markets deal (Devi, 2008). This study further estimates that the top five *Sharī‘ah* scholars may earn up to a million dollars per year for servicing more than a hundred board and chairman positions around the world. While there is no standard benchmark or scale fee for *Sharī‘ah* advisors, the regulators as well as the IFIs should establish a specific policy for the remuneration of *Sharī‘ah* board members based on the appropriate scale fees. In the context of the internal policy of IFIs, the *Sharī‘ah* board scale fees should be approved by the shareholders and disclosed in the annual report.

10.2.6 Attributes of the *Sharī‘ah* Board on Confidentiality

The study reveals that there were *Sharī‘ah* scholars who have unintentionally or indirectly disclosed some confidential information, particularly those sitting on the boards of numerous IFIs (Madzlan, 2009). In addition, the survey results indicated that 29% of IFIs view that the *Sharī‘ah* board is not fully aware of the issue of confidentiality. Realizing this, the IFIs should have a proper mechanism to resolve this issue and this

²³⁵ Malaysia has put serious effort into providing a sound *Sharī‘ah* governance system and this includes the recent initiative for the establishment of a professional body for *Sharī‘ah* scholars known as The Association of *Sharī‘ah* Advisors (ASA) (Siddiqui, 2010). It is expected that the ASA will be the professional body to govern the *Sharī‘ah* advisors in terms of qualifications, code of conduct, licensing, training and any other matters related with *Sharī‘ah* governance.

includes terms of reference in the letter of appointment, enforcement of the code of ethics and disciplinary proceedings for any misconduct by the *Shari‘ah* board. In defining the scope of confidentiality, a reference may be made to section 52 of the IFSB-10. The IFSB-10 nevertheless does not provide guidelines for disciplinary proceedings in the event that *Shari‘ah* board members breach confidentiality or disclose sensitive or confidential information. As such, the IFIs are recommended to have proper disciplinary proceedings, such as hearing procedures, and rules of evidence with an appropriate organizational structure.

10.2.7 Consistency

10.2.7.1 Codification and *Shari‘ah* Harmonization

The ideal approach to ensure consistency is by way of codification of *Shari‘ah* standards and a *Shari‘ah* harmonization process. It is worth mentioning that such an approach must be carried out with proper coordination, commitment and agreement of the industry players. As a good start, the adoption of the AAOIFI *Shari‘ah* standards should be the first approach in minimizing the inconsistency of *Shari‘ah* rulings. In view of the different market environments, legal frameworks and local needs, IFIs in those jurisdictions may adopt the AAOIFI *Shari‘ah* standards with some flexibility as to their application.²³⁶

The issue of inconsistency of *Shari‘ah* pronouncements and conflicting views of *Shari‘ah* board can also be resolved by having central *Shari‘ah* body at the national level. The *Shari‘ah* boards at the IFIs level should try in the first instance to comply with the *Shari‘ah* standards and in the absence of specification of the products in the *Shari‘ah* standards, IFIs should adopt the *Shari‘ah* pronouncements issued by the central *Shari‘ah* board. This will reconcile the issue of inconsistency as the decision made by the *Shari‘ah* board at the national level will prevail over any *Shari‘ah* rulings at the individual IFI

²³⁶ Malaysia has made an initiative towards standardization at national level by issuing *Shari‘ah* Parameter Reference I on *Murābahah* in 2009 and is now in the stage of consultation for *Shari‘ah* Parameter on *Ijārah, mushārakah* and *mudhārabah* (Dar and Azami, 2010: 186).

level. In the event that both the AAOIFI *Shari‘ah* standards and central *Shari‘ah* board pronouncements are unable to provide any solution, IFIs then may issue new and fresh rulings. The efforts to have consistency in the *Shari‘ah* pronouncements can only be achieved if there is proper coordination and alignment of policy and frameworks from all *Shari‘ah* boards at the individual IFI level as well as at national and international levels.

10.2.7.2 Proper Channel for Conflicting Views of *Shari‘ah* Scholars

Inconsistency may also happen when the *Shari‘ah* scholars have conflicting opinions in the public forums. This position will confuse the general public as well as the industry players, particularly in the event that different *Shari‘ah* rulings are issued upon the same financial products. In view of this issue, it is important for the *Shari‘ah* scholars to air their conflicting views in a proper forum and not in the public forum. In this regard, the *Shari‘ah* board should have a spokesperson that will make a statement on behalf of the institution. In the event that the individual *Shari‘ah* scholars intend to air their own opinion, they must clearly make a declaration as to the opinion being their personal one.

10.2.8 Disclosure and Transparency

10.2.8.1 Full Access to Information and Disclosure Policy

The IFIs need to improve their transparency and disclosure on *Shari‘ah* governance as the findings show poor disclosure practice. *Shari‘ah* boards should have access to all information pertaining to *Shari‘ah* compliance matters. They must be granted the right and authority to obtain views from the staff, particularly the internal *Shari‘ah* auditors, as well as the external auditors. It is important for the *Shari‘ah* board to receive adequate resources, information and recognition to carry out their duty.

With respect to the nature of operation and structure of IFIs, information disclosure is more important than in conventional banking. Unlike conventional banking institutions that tend to concentrate on financial disclosure and risk assessment, in addition to these the IFIs need to disclose necessary information pertaining to *Shari‘ah* governance-related

matters. The regulators as well as the IFIs should develop suitable information on disclosure requirements within a market transparency framework. Amongst the types of *Shari‘ah* governance information that should be ordinarily disclosed are the *Shari‘ah* board information, products and services, corporate governance structure, code of conduct, treatment of *zakah* and corporate social responsibility and remuneration of the *Shari‘ah* board. It is also a good practice to disclose in the annual report, the activities, products and services, including the percentage of profit contributions that have an element of unlawful and doubtful transactions.

10.2.8.2 Publication of *Shari‘ah* Rulings

The study found weak practices in IFIs in the aspect of disseminating *Shari‘ah* information, particularly publication of the *Shari‘ah* rulings. The practice indicates that only the *Shari‘ah* board at the regulatory level proactively publishes and disseminates information on *Shari‘ah* pronouncements. With respect to this, it is recommended that the *Shari‘ah* board compile and publish the *Shari‘ah* pronouncements and makes them known to the public in a consistent manner. In view of the commercial nature of IFIs, the researcher admits that publication of the *Shari‘ah* pronouncements may be considered unfair to the industry players as they have to compete with one another and any disclosure of information on new products, including new *Shari‘ah* rulings, may impede their business strategy as well as create additional cost to IFIs. At this point, it is recommended that the publication of *Shari‘ah* rulings be made annually with full compilation and details of their pronouncements and these can be published via their websites.

10.2.8.3 *Shari‘ah* Governance Disclosure Index

The content analysis approach in this study attempts to introduce a simple *Shari‘ah* governance index for IFIs, which is quite similar with other types of indexes such as Environmental, Social and Governance Index. It is strongly recommended that the independent institutions, such as the IFSB or the AAOIFI, with the cooperation of another institution develop and introduce a specific *Shari‘ah* governance index for IFIs.

The IFIs then can be rated and ranked in accordance with the *Shari‘ah* governance index score which can be formulated from the IFSB-10, the AAOIFI governance standards and any other *Shari‘ah* governance guidelines. Some incentives, such as Award for the Best IFI for *Shari‘ah* Governance, may be introduced at national, regional and international levels. As a matter of fact, the *Shari‘ah* governance index introduced in this study may be a good model to develop a more comprehensive index that would be accepted by IFIs worldwide. The researcher considers that this *Shari‘ah* governance index will directly and indirectly influence the IFIs to enhance and improve their *Shari‘ah* governance practices.

10.2.9 Operational Procedures

10.2.9.1 *Shari‘ah* Reporting Standards

Baydoun and Willet (2000) view that IFIs need to have a wider scope of Islamic corporate reporting due to the nature and foundational dimension of Islamic finance as compared to its conventional counterpart. The researcher positively supports the notion of having a different scope of Islamic corporate reporting by Baydoun and Willet (2000) with some further enhancement to the scope of reporting. In spite of the need for having specific Islamic financial reporting standards, the study also suggests the call for *Shari‘ah* reporting standards.²³⁷

In view of the weak practice of *Shari‘ah* reports, as demonstrated by the sampled IFIs, it is very important for the regulatory authorities as well as IFIs to set a minimum standard for the *Shari‘ah* report. The regulatory authorities should issue directives or guidelines on the standard format of the *Shari‘ah* report. The IFIs then should use these standard guidelines and format in preparing their *Shari‘ah* report, which must be submitted to the BOD with the approval of shareholders before it can be further reported to the respective

²³⁷ Although the AAOIFI provides guidelines on Islamic financial accounting, it was nevertheless found that it fails to set a standard for the *Shari‘ah* report. Furthermore, there are also numerous criticisms of the standards developed by the AAOIFI. Kamla (2009: 926–927) claims that the AAOIFI standards are heavily based on Western international accounting standards and therefore have failed to educate the public about the significant differences of Islamic financial services products compared to the conventional ones (see El-Gamal, 2006 and Maurer, 2002). Despite this debatable argument, the study strongly suggests a specific standard on the *Shari‘ah* report that fulfils the requirement of sound and best practice for the *Shari‘ah* governance system.

regulatory authorities. The ideal *Shari‘ah* report should contain necessary information on *Shari‘ah* compliance. Unlike the financial reporting format, the *Shari‘ah* report is classified as non-financial disclosure and therefore requires a different format. At this point, it is recommended for the *Shari‘ah* report to contain activities of the *Shari‘ah* board, including training and meetings, details of the meetings, *Shari‘ah* pronouncements with detailed explanations, an *ex ante* report pertaining to products and services, an *ex post* internal *Shari‘ah* review report and certification of the *Shari‘ah* compliance report. In terms of the *Shari‘ah* report structure, the IFIs are encouraged to prepare a separate chapter on the *Shari‘ah* report as part of the annual report or, alternatively, the *Shari‘ah* report may form part of the corporate governance report.

10.2.9.2 *Shari‘ah* Coordination

The study reveals that some IFIs have not established a *Shari‘ah* department to coordinate *Shari‘ah* governance matters or they consider it under the auspices of the company secretary or compliance officer. It would be a good practice for IFIs to set up a *Shari‘ah* department that may carry out numerous functions on the *Shari‘ah* governance process, such as coordinating the *Shari‘ah* board meetings, recording the minutes of the meetings, research and development, developing internal policies for *Shari‘ah* governance, conducting *Shari‘ah* training, publishing the *Shari‘ah* pronouncements and coordinating enquiries from employees, consumers or any other parties.

Another important function of *Shari‘ah* coordination is to assist the *Shari‘ah* board and IFIs in conducting research and development pertaining to *Shari‘ah*-related matters. It would be a good practice to have a specific unit for *Shari‘ah* research and development under the auspices of the head of the *Shari‘ah* department. This unit will assist the *Shari‘ah* board in terms of *Shari‘ah* research and development as well as disseminating information for the purpose of educating IFIs, customers, employees and other stakeholders about *Shari‘ah* rules and principles. Appropriate *Shari‘ah* coordination is important to ensure the efficiency of the *Shari‘ah* board as well as the *Shari‘ah* control process. With high market competitiveness, *Shari‘ah* coordination to some extent will

have a considerable impact on the efficiency of IFIs, both in terms of products and services offered and also the quality of *Shari‘ah* compliance.

10.2.9.3 *Shari‘ah Internal Control*

The research findings reveal that the *Shari‘ah* board relies heavily on the internal *Shari‘ah* audit and other employees in carrying out its *ex post* functions. With respect to this, it is crucial for the IFIs to enhance the role of internal *Shari‘ah* auditors by having a proper policy on documentation, clear segregation of duties, and appropriate fraud prevention and detection controls. To operate this function effectively, the IFIs are recommended to establish a *Shari‘ah* internal audit department or alternatively to set up a *Shari‘ah* internal audit unit under the existing audit department. This is in line with the IFSB-10 recommendation of having an Internal *Shari‘ah* Compliance Unit and Internal *Shari‘ah* Review Unit as a point of reference for *Shari‘ah* compliance issues, to manage the clerical and secretarial matters and to provide *Shari‘ah* input for executive decisions (IFSB, 2009c: 10).

In spite of the above, the IFIs should ensure that the *Shari‘ah* internal control unit has adequate resources and the capability of doing the audit and review effectively. In addition, the IFIs are recommended to have an appropriate policy on *Shari‘ah* internal control. These policies should be designed so that *Shari‘ah* compliance can be inspected and monitored in daily activities. The role of the internal audit is to evaluate and assess the effectiveness of *Shari‘ah* governance and compliance with the *Shari‘ah* rulings. Internal *Shari‘ah* audit department should have a specific charter approved by the BOD to guarantee that the review can be made independently, impartially and objectively. In terms of reporting structure, the *Shari‘ah* internal audit should report to the *Shari‘ah* board and the BOD, not to the audit committee since the committee does not have expertise in *Shari‘ah*. The study offers another alternative approach for *Shari‘ah* internal audit reporting lines. The report may be made to the audit committee with the condition that one of the audit committee members must be a representative of the *Shari‘ah* board.

10.2.9.4 External *Shari‘ah* Auditors

The research findings show that there are shortcomings with respect to the *Shari‘ah* auditing process and this includes the external audit practices. Chapra and Ahmed (2002: 68–69) propose three options in addressing the issue of *Shari‘ah* audit and the most preferable one is for the existing chartered audit firm to undertake the *Shari‘ah* audit function. In addition, the researcher considers that *Shari‘ah* advisory firms that have the necessary expertise may also undertake the *Shari‘ah* audit responsibilities.

To regulate and monitor these external *Shari‘ah* auditors, appropriate guidelines and directives must be in place. In this aspect, the regulators should issue a policy on the requirements of external *Shari‘ah* auditors as well as scope, framework, criteria, conditions, process, qualification, training programme and reporting structure. To address the issue of the shortage of audit firms and *Shari‘ah* advisory firms, as well as lack of experts capable of performing the *Shari‘ah* audit, the regulators may initiate some incentives and provide support to develop the *Shari‘ah* audit programme. Another important aspect of the external *Shari‘ah* audit is method of appointment. Similar to the normal audit practice, the appointment of the external *Shari‘ah* auditors should be made by the shareholders.

10.2.9.5 *Shari‘ah* Board Meetings

The research findings affirm that the majority of *Shari‘ah* scholars spend most of their time and effort on the IFIs during the *Shari‘ah* board meetings. This point indicates that the *Shari‘ah* board should carefully consider the frequency of their meetings in order to enable them to fulfil their responsibility with due diligence. A minimum standard of requirements for the meeting should be implemented and calendar meetings should be mandatory for them. Furthermore, the *Shari‘ah* board should proactively plan and arrange quarterly interval meetings with the BOD to discuss *Shari‘ah* -related issues.

In terms of meeting procedures, the study reveals that there are differences in practices with regard to the quorum for the meetings. In parallel with the ideal practice of the *Sharī‘ah* board, the quorum of a simple majority from the total numbers of *Sharī‘ah* board members should be acceptable. With regard to the basis for decision-making, unlike principle 57 of the IFSB-10 which requires a consensus decision, the researcher thinks that the practice of simple majority votes is acceptable.²³⁸ The practice of unanimous decision-making may create certain issues for IFIs, such as potential for delay and silent disagreement amongst the *Sharī‘ah* scholars. With the simple majority approach, the dissenting opinion of the disagreeing *Sharī‘ah* scholars can be evaluated and this may contribute to further healthy discussion. In the event that the *Sharī‘ah* board consists of non-*Sharī‘ah* scholars, their votes should not be counted.

10.2.9.6 Well-Defined Lines of Reporting and Proper Communication Channels

One of the issues highlighted by the *Sharī‘ah* scholars in the semi-structured interviews was communication barriers and unclear lines of reporting. Therefore, the IFIs should have well-defined lines of reporting and establish appropriate communication channels within the organization as well as with the consumers, regulators and supervisors. In terms of reporting structure, the *Sharī‘ah* board should report administratively to the BOD and the *Sharī‘ah* report should be approved of and directed by the shareholders to be included as part of the annual report as recommended by the IFSB-10.

With respect to communication, there must be proper coordination between the supervisory authorities and the IFIs' *Sharī‘ah* board and other organs of governance, particularly senior management and the BOD. In this regard, it is recommended that the senior management, such as the CEO, head of risk management department and head of legal department, attend the *Sharī‘ah* board meetings. On top of that, some mechanism

²³⁸ This is agreeable to most of the *Sharī‘ah* scholars interviewed in this study including prominent *Sharī‘ah* scholar, Mohamed Ali El Gari. Sheikh El Gari considers that empowering the power of voting by accepting the simple majority as a basis for decision-making is one of the components for strong *Sharī‘ah* governance practice (Parker, 2010).

Contextualising the Findings and Conclusion

can also be invoked allowing customers, employees, business partners, suppliers and auditors to indirectly act as agents on the IFIs' actions, relationships and dealings through formal and informal checks such as effective consumer enquiries and complaint policies.

10.2.9.7 *Shari‘ah* Non-Compliance Risk Management

Shari‘ah scholars in the semi-structured interview acknowledge that management of *Shari‘ah* non-compliance risk is extremely important. The existing practice puts the *Shari‘ah* board as the main organ of governance to address this risk, with the assistance of the *Shari‘ah* internal audit team, while other types of risks are under the auspices of the risk management department. Since *Shari‘ah* non-compliance risk is one of the operational risks which then constitute systemic risks, the risk management department or unit should have strong coordination with the *Shari‘ah* board. A representative of the risk management unit should be a permanent attendee of the *Shari‘ah* board meetings. Furthermore, they must have adequate resources and staff who have good knowledge and capabilities in *Shari‘ah*-related matters.

10.2.9.8 Islamic Quality Management System-Requirement Standard

Quality management system-requirement 9001 via the International Standard of Organizations or ISO is the internationally accepted standard on quality management. This standard aims at enhancing and improving the quality of the management system by providing guidelines and principles for the best management practices. In the absence of a specific quality management system-requirement standard for IFIs, it is recommended that regulatory authorities, together with other institutions, develop a national or international standard of Islamic quality management.²³⁹ This Islamic quality management system-requirement should be able to improve the quality of the

²³⁹ The Institute of Islamic Understanding of Islam, Malaysia and the Standards and Industrial Research Institute of Malaysia under the Ministry of Science, Technology and Innovation have developed the internationally accepted Halal Quality Management System-Requirement that incorporates the principles of Islamic management known as MS 1900: 2005 (Mustaffa, 2008). This is considered as a very good effort and it can be further enhanced and developed so as to suit the requirements and needs of IFIs that offer financial products and services.

management in IFIs by incorporating the *Shari‘ah* rules and principles as well as inculcating Islamic values and ethics.

10.2.10 Assessment of the *Shari‘ah* Board

10.2.10.1 Evaluation of the *Shari‘ah* Board

The survey and semi-structured interview affirm that numerous IFIs do not evaluate or assess the performance of the *Shari‘ah* board. The assessment of the *Shari‘ah* board is important for the purpose of improving its functions and identifying its previous shortcomings and weaknesses. With respect to this, the IFIs are recommended to have performance measures for the *Shari‘ah* board as a collective assessment as well as individual member evaluations. The assessment report then should be submitted to the BOD for determination and recording. The performance of individual *Shari‘ah* board members and the *Shari‘ah* board as a whole should be regularly evaluated. Continuous monitoring of *Shari‘ah* board competencies must be carried out so that they may function effectively. The IFIs should consistently evaluate the *Shari‘ah* board, which should incorporate an assessment of member competencies, and this should be made mandatory.

10.2.10.2 *Shari‘ah* Pronouncements Review

The research findings reveal that the scope of the *Shari‘ah* review in IFIs only focuses on the compliance aspects of the products and services. Another area which is equally important for review is revision of the *Shari‘ah* pronouncements. The *Shari‘ah* board, with the assistance of the *Shari‘ah* department, should adopt a specific process to ensure the revision of all of the *Shari‘ah* rulings. At this point, it is recommended that the IFIs establish a research and development unit under the *Shari‘ah* department to carry out the review process as well as to assist the *Shari‘ah* board to conduct necessary research on *Shari‘ah*-related matters.

10.2.10.3 Key Performance Indicators

The semi-structured interviews revealed that some *Shari‘ah* scholars are aware of the assessment of their performance but they had no knowledge about the scope of such performance measures. In this instance, it would be good practice if the IFIs set some key performance indicators (KPIs) for the *Shari‘ah* board. The KPIs for the *Shari‘ah* board would not be in the form of financial considerations but rather *Shari‘ah* compliance, meeting the datelines, positive contributions to the organization, having a proactive approach and assisting the IFIs in setting goals and direction. The set of KPIs, which must be agreed in advance by the individual *Shari‘ah* board members, should then be evaluated by the BOD and be subject to the approval of the shareholders.

10.3 CONTRIBUTIONS OF THE RESEARCH

The distinctive contributions of this study are fourfold. Firstly, it refers to the deconstruction of the theoretical framework of a *Shari‘ah* governance system which provides a foundational dimension of governance from an Islamic perspective within the context of IFIs. In view of the scarcity of literature on this subject, the study offers valuable and beneficial information on the conceptual framework of *Shari‘ah* governance through discourse analysis and comparative overview approaches. The basic understanding of the aspects of *Shari‘ah* governance within the context of IFIs is essentially important in order to further analyse and explore its implementation in actual practices.

Secondly, the study offers comprehensive examination and exploration of the extent of the *Shari‘ah* governance framework as practised in IFIs. This will substantially provide useful information to further enhance and improve the present *Shari‘ah* governance system. Thirdly, the study highlights selected *Shari‘ah* governance issues as well as identifies shortcomings and weaknesses in the present *Shari‘ah* governance practice. Finally, the study proposes several suggestions and policy recommendations derived from the research analysis, which require strong cooperation and commitment from all

stakeholders. Drawing from the whole research analysis, the findings of this study call for relevant stakeholders, IFIs, policy makers, practitioners and *Sharī‘ah* scholars to develop and enhance the best practice of the *Sharī‘ah* governance system.

10.4 LIMITATIONS AND FUTURE RESEARCH

Despite the researcher’s utmost effort to provide comprehensive, reliable and significant research on the topic of *Sharī‘ah* governance, undeniably the study has experienced several research limitations. Firstly, there is a limitation due to the scarcity of literature, which raised difficulties in deconstructing the conceptual framework of *Sharī‘ah* governance. Secondly, the researcher acknowledges the limitation on the survey method, particularly with regard to the minimal response rate to the survey as well as the small number of respondents to the semi-structured interviews. With respect to the content analysis approach, the findings may not be robust as the time period of analysis is short, involving only data and information from 2007–2008.

Thirdly, the present research also limits the scope of study by focusing on the *Sharī‘ah* governance practices in Malaysia, GCC countries and the UK. In other words, the research findings cannot be concluded as applicable to and representative of the *Sharī‘ah* governance systems practised by other jurisdictions. In this regard, the scope of study could be broadened further to other countries in future research efforts. Notwithstanding these limitations, the study has yielded sufficient facts, evidence, figures and information to meet the research aim and objectives as well as being able to answer the research questions and to positively prove the research hypotheses.

10.5 EPILOGUE

This section is a useful point to review the overall contents of the research. The literature review on the comparative corporate governance between the western and Islamic models clearly indicates the deficiencies of the literature and the gap which thesis is filling. This comparative overview set the initial theoretical framework of corporate governance for the debate and thoughtful discussion. In search of an Islamic perspective on corporate

Contextualising the Findings and Conclusion

governance through analysing the existing western models particularly shareholder value system and stakeholder value orientation, the researcher suggests that corporate governance in IFIs is inclined towards the stakeholder value framework. This preposition is based on the epistemological orientation founded on the fundamental principles of *Tawhīd*, *shura*, property rights and commitment to contractual obligation which enhances the definition of stakeholders.

Since Islamic corporate governance is considered as having faith-based orientation, *Shari‘ah* rules and principles then becomes part of the corporate governance framework in IFIs. At this point, corporate governance in IFIs needs a set of institutional arrangement to ensure that there is effective independent oversight of *Shari‘ah* compliance. Whilst *Shari‘ah* governance is expected to be an effective mechanism to ensure *Shari‘ah* compliance, the discussion on the topic of *Shari‘ah* governance system in IFIs nevertheless indicates that there are certain deficiencies on the existing *Shari‘ah* governance practices including issues pertaining to regulatory challenges.

After identifying and formulating the research question through gap analysis in the literature review, the researcher conducted an empirical study to investigate and examine the current state of *Shari‘ah* governance practices in IFIs by employing mixed-method research approach namely the survey, the semi-structured interviews and the content analysis approach. To sum up the research findings, chapter 10 significantly provides the overall conclusion of the study by highlighting the significance of the theoretical and empirical research conducted and their relationship to the research hypotheses. From the research analysis and hypothesis testing analysis, the study positively meets the expectations of the research, answers all the research questions and meets the aim and objectives.

Despite some research limitations, the study has yielded substantial findings revealing that there are shortcomings and weaknesses in numerous aspects of the *Shari‘ah* governance system as practised by IFIs. There are significant differences in the general

Contextualising the Findings and Conclusion

approach to *Shari‘ah* governance, the regulatory framework and internal policies, the roles and functions of the *Shari‘ah* board, the attributes of *Shari‘ah* board in terms of competence, independence, transparency and confidentiality, operational procedures, and performance measures of the *Shari‘ah* board. In spite of that, the extent of *Shari‘ah* governance disclosure is at a minimal level. With respect to this, the study strongly recommends a continuous and systematic approach in enhancing and improving the existing *Shari‘ah* governance practices.

With the IFSB-10 and the AAOIFI governance standards as the main basis for recommendations, along with the OECD and the BCBS Principles on Corporate Governance, the study has listed several key recommendations in every aspect of the *Shari‘ah* governance system. The recommendations might overlap with the principles contained in the aforementioned documents, but this research nevertheless highlights some criticisms and disagreement on these and further explains the reasons for such recommendations based on the findings extracted from the facts, information, evidence and figures found in this study. Despite some of the recommendations put forward in this study perhaps seeming too ambitious, considering the importance of the *Shari‘ah* governance system to IFIs, the researcher has strong faith in those recommendations and considers that they would be able to facilitate and contribute towards a sound and solid *Shari‘ah* governance system in both the short and long term. It is worth mentioning that the expectation of such recommendations will not materialize unless all stakeholders give their full support and strong cooperation. It is hoped that this exploratory study can further motivate and trigger future research to extend further discourse on the topic of *Shari‘ah* governance in IFIs.

APPENDIX 1: QUESTIONNAIRE

A Survey of Sharī'ah Governance in Islamic Financial Institutions

Your participation in this research is greatly appreciated. Most of the questions merely require you to tick the appropriate box. All the information given will be treated in the strictest confidence.

General Instructions and Information

1. The survey aims at providing factual input on the current practice of Shari'ah governance system. The present questionnaire is sent to the selected IFIs from Malaysia, GCC Countries and the UK. The study may be helpful to increase understanding and to promote best practice of Shari'ah governance system in IFIs.
2. Please do not worry about questions that seemingly look alike. If you do not have the exact answer to a question, please provide your best judgement by ticking the appropriate boxes in the questions. **Your answers are very important to the accuracy of the study.**
3. If you wish to make any comment, please feel free to use the space at the end of the questionnaire.

Please return the completed questionnaire via email at z.b.hasan@durham.ac.uk before

For Office Use Only:

Date of Interview/Questionnaire Returned: ____/____/2009
Time of Interview: _____ A.M. /P.M.

Bank's Branch Code: €€€
Respondent Number: €_____

School of Government and International Affairs
University of Durham, United Kingdom.
E-mail: z.b.hasan@durham.ac.uk
Weblog: <http://zulkiflihasan.wordpress.com>

Appendix 1

GENERAL INFORMATION

Name and Location of the Institution :

Contact Person :

Position :

Composition of the *Shari'ah* Board Members :

	Number
Male	
Female	

SHARI'AH GOVERNANCE SYSTEM

(Please tick (x) in an appropriate box)

H1: General Framework for *Shari'ah* Governance

	Yes	No	Comment
Q1. Is the AAOIFI Governance Standards adopted as the guidelines?	<input type="checkbox"/>	<input type="checkbox"/>	
Q2. Are you aware on the recent exposure draft of the IFSB <i>Shari'ah</i> governance Guiding Principles?	<input type="checkbox"/>	<input type="checkbox"/>	
Q3. Are there any standards for <i>Shari'ah</i> governance set for Islamic financial institutions (IFIs)?	<input type="checkbox"/>	<input type="checkbox"/>	
Q4. Are IFIs required to provide any guidelines for <i>Shari'ah</i> governance?	<input type="checkbox"/>	<input type="checkbox"/>	
Q5. Does your institution develop standard processes for <i>Shari'ah</i> compliance, audit and review of the <i>Shari'ah</i> boards' legal rulings?	<input type="checkbox"/>	<input type="checkbox"/>	
Q6. Does your institution have professional code of ethics and conduct for members of the <i>Shari'ah</i> board?	<input type="checkbox"/>	<input type="checkbox"/>	
Q7. What is the organisational arrangement for <i>Shari'ah</i> governance?	<input type="checkbox"/>	<input type="checkbox"/>	
	<input type="checkbox"/>	<input type="checkbox"/>	
	<input type="checkbox"/>	<input type="checkbox"/>	

H2: Regulatory Framework

	Yes	No	Comment
Q8. Are there separate rules and regulations concerning <i>Shari'ah</i> governance?	<input type="checkbox"/>	<input type="checkbox"/>	
Q9. Does the bank have any written policies or by-laws specifically referring to the conduct of the <i>Shari'ah</i> board?	<input type="checkbox"/>	<input type="checkbox"/>	
Q10. What type of dispute settlement is there to redress legal matters concerning Islamic finance (e.g. conflict of laws)?	<input type="checkbox"/>	<input type="checkbox"/>	
	<input type="checkbox"/>	<input type="checkbox"/>	
	<input type="checkbox"/>	<input type="checkbox"/>	
	<input type="checkbox"/>	<input type="checkbox"/>	
	<input type="checkbox"/>	<input type="checkbox"/>	
Q11. What is the legal position of the <i>Shari'ah</i> board's rulings?	<input type="checkbox"/>	<input type="checkbox"/>	
	<input type="checkbox"/>	<input type="checkbox"/>	
	<input type="checkbox"/>	<input type="checkbox"/>	
	<input type="checkbox"/>	<input type="checkbox"/>	

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H3: The Role of Sharī'ah Board

		Tick (x)	Comment
Q12. What are the roles of the Sharī'ah board?	Advisory	<input type="checkbox"/>	
	Supervisory	<input type="checkbox"/>	
	Executive	<input type="checkbox"/>	
	Others (Please specify)	<input type="checkbox"/>	
Q13. Do the functions of the Sharī'ah board include:	Sharī'ah pronouncements?	<input type="checkbox"/>	
	Sharī'ah review or audit?	<input type="checkbox"/>	
	Endorsing and validating documentations pertaining to the products and services, as well as the internal policies, manuals and marketing advertisements, etc.?	<input type="checkbox"/>	
	Endorsement of Sharī'ah compliance?	<input type="checkbox"/>	
	Overseeing the computation and payment of zakah?	<input type="checkbox"/>	
	Examining any enquiries referred to by the IFIs?	<input type="checkbox"/>	
	Developing Sharī'ah approved instruments?	<input type="checkbox"/>	
	Acting as the Sharī'ah highest authority pertaining to Islamic finance?	<input type="checkbox"/>	
	Approving model agreements of Islamic modes of financing?	<input type="checkbox"/>	
	Achieving harmonization in the concepts and applications amongst the Sharī'ah boards?	<input type="checkbox"/>	
Q14. Does the Sharī'ah board perform the Sharī'ah audit?	Others (Please specify)	<input type="checkbox"/>	
	Yes	<input type="checkbox"/>	
	No	<input type="checkbox"/>	
Q15. Does the Sharī'ah board have the power to delegate some of its functions to the internal Sharī'ah compliance unit?	Yes	<input type="checkbox"/>	
	No	<input type="checkbox"/>	

H4: Mechanism of Sharī'ah Governance System

H4.1: Competence

		Yes	No	Comment
Q16. Does your institution have policies on the fit and proper criteria for the members of the Sharī'ah board?		<input type="checkbox"/>	<input type="checkbox"/>	
Q17. If yes, what are those criteria?	Academic qualification	<input type="checkbox"/>	<input type="checkbox"/>	
	Experience and exposure (knowledge and skills in financial services industry)	<input type="checkbox"/>	<input type="checkbox"/>	
	Track record	<input type="checkbox"/>	<input type="checkbox"/>	
	Others (Please specify)	<input type="checkbox"/>	<input type="checkbox"/>	
Q18. What are the requirements in terms of academic qualifications?	Specialized in Muāmalāt	<input type="checkbox"/>	<input type="checkbox"/>	
	Specialised in Islamic Jurisprudence	<input type="checkbox"/>	<input type="checkbox"/>	
	Knowledge of Arabic and English	<input type="checkbox"/>	<input type="checkbox"/>	
	Others (Please specify)	<input type="checkbox"/>	<input type="checkbox"/>	

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Q19. What are the requirements in terms of experience and exposure?	Understanding of <i>Sharī'ah</i> rules and principles	<input type="checkbox"/>	<input checked="" type="checkbox"/>	
	Understanding of general legal and regulatory framework	<input type="checkbox"/>	<input checked="" type="checkbox"/>	
	Understanding of the impact of the <i>Sharī'ah</i> pronouncements?	<input type="checkbox"/>	<input checked="" type="checkbox"/>	
	Skills in the financial services industry	<input type="checkbox"/>	<input checked="" type="checkbox"/>	
	Others (Please specify)	<input type="checkbox"/>	<input checked="" type="checkbox"/>	
Q20. What are the requirements in terms of track record?	Good character	<input type="checkbox"/>	<input checked="" type="checkbox"/>	
	Competence, diligence, capability and soundness of judgment	<input type="checkbox"/>	<input checked="" type="checkbox"/>	
	Others (Please specify)	<input type="checkbox"/>	<input checked="" type="checkbox"/>	
Q21. In the event your institution allows a non- <i>Sharī'ah</i> background individual as a member of the <i>Sharī'ah</i> board, what is the qualification for such appointment?	Well-versed in law	<input type="checkbox"/>	<input checked="" type="checkbox"/>	
	Well-versed in economy	<input type="checkbox"/>	<input checked="" type="checkbox"/>	
	Well-versed in finance	<input type="checkbox"/>	<input checked="" type="checkbox"/>	
	Others (Please specify)	<input type="checkbox"/>	<input checked="" type="checkbox"/>	
Q22. Do the <i>Sharī'ah</i> board members receive adequate training to understand their role in the internal control process?	Yes	<input type="checkbox"/>	<input checked="" type="checkbox"/>	
	No	<input type="checkbox"/>	<input checked="" type="checkbox"/>	
Q23. Is there any evaluation of the <i>Sharī'ah</i> board?	Yes	<input type="checkbox"/>	<input checked="" type="checkbox"/>	
	No	<input type="checkbox"/>	<input checked="" type="checkbox"/>	

H4.2: Independence

		Tick (x)	Comment
Q24. Who has the power to approve the appointment and dismissal of the <i>Sharī'ah</i> board?	Shareholders in the Annual General Meeting	<input type="checkbox"/>	
	BOD	<input type="checkbox"/>	
	Management	<input type="checkbox"/>	
	Government	<input type="checkbox"/>	
	Others (Please specify)	<input type="checkbox"/>	
Q25. How long is the tenure of the appointment?	One year	<input type="checkbox"/>	
	Two years	<input type="checkbox"/>	
	Permanent	<input type="checkbox"/>	
	Others (Please specify)	<input type="checkbox"/>	
Q26. What do you think is the appropriate body for the <i>Sharī'ah</i> board to be accountable to?	Shareholders	<input type="checkbox"/>	
	BOD	<input type="checkbox"/>	
	Management	<input type="checkbox"/>	
	Others (Please specify)	<input type="checkbox"/>	
Q27. Who determines the <i>Sharī'ah</i> board's remuneration?	Shareholders	<input type="checkbox"/>	
	BOD	<input type="checkbox"/>	
	Management	<input type="checkbox"/>	
	Others (Please specify)	<input type="checkbox"/>	
Q28. What mechanisms are in place to mitigate conflict of interest in relation to <i>Sharī'ah</i> scholars sitting in various boards?	Restriction on multiple appointment	<input type="checkbox"/>	
	Disclosure on <i>Sharī'ah</i> board's information	<input type="checkbox"/>	
	Declaration in writing	<input type="checkbox"/>	
	Others (Please specify)	<input type="checkbox"/>	

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Q29. Is the power and authority of the <i>Shari'ah</i> board clearly mentioned in the following documents?	Article of association	<input type="checkbox"/>	
	Memorandum of association	<input type="checkbox"/>	
	Letter of appointment	<input type="checkbox"/>	
	Others (Please specify)	<input type="checkbox"/>	

H4.3: Transparency and Confidentiality

	Yes	No	Comment
Q30. Does the <i>Shari'ah</i> board have a written policy in respect to the preparation and dissemination of <i>Shari'ah</i> information?	<input type="checkbox"/>	<input type="checkbox"/>	
Q31. Does the <i>Shari'ah</i> board have access to all documents, information, records, etc.?	<input type="checkbox"/>	<input type="checkbox"/>	
Q32. Are the <i>Shari'ah</i> pronouncements published and made known to the public?	<input type="checkbox"/>	<input type="checkbox"/>	
Q33. Is the <i>Shari'ah</i> board fully aware of the issue of confidentiality and sensitive information obtained in the course of performing their duties?	<input type="checkbox"/>	<input type="checkbox"/>	

H5: Operational Procedure

	Tick (x)	Comment
Q34. Is there any standard operational procedure for the <i>Shari'ah</i> board?	<input type="checkbox"/>	
	<input type="checkbox"/>	
Q35. Does the <i>Shari'ah</i> board hold its meeting regularly?	<input type="checkbox"/>	
	<input type="checkbox"/>	
Q36. What is the quorum for the <i>Shari'ah</i> board meeting?	<input type="checkbox"/>	
	<input type="checkbox"/>	
	<input type="checkbox"/>	
	<input type="checkbox"/>	
Q37. On what basis are decisions made at the <i>Shari'ah</i> board meeting?	<input type="checkbox"/>	
	<input type="checkbox"/>	
	<input type="checkbox"/>	
	<input type="checkbox"/>	
Q38. In the event of the <i>Shari'ah</i> board including non- <i>Shari'ah</i> background members, do they have the right to vote?	<input type="checkbox"/>	
	<input type="checkbox"/>	
Q39. Is an agenda prepared and distributed in advance of <i>Shari'ah</i> board meetings?	<input type="checkbox"/>	
	<input type="checkbox"/>	
	<input type="checkbox"/>	
	<input type="checkbox"/>	
Q40. Who is responsible for dealing with the organization of the <i>Shari'ah</i> board meetings?	<input type="checkbox"/>	
	<input type="checkbox"/>	

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Q41. Besides the <i>Shari'ah</i> board, who attends the meeting?	Representative from the Internal <i>Shari'ah</i> compliance unit	<input type="checkbox"/>	
	Representative from risk management department	<input type="checkbox"/>	
	Representative from legal department	<input type="checkbox"/>	
	Representative from product department	<input type="checkbox"/>	
	Representative from an external legal firm	<input type="checkbox"/>	
	Representative from the IFIs (Example, in the case of <i>Shari'ah</i> board at the regulatory level)	<input type="checkbox"/>	
	Others (Please specify)	<input type="checkbox"/>	
Q42. Are the <i>Shari'ah</i> pronouncements reviewed whenever necessary?	Yes	<input type="checkbox"/>	
	No	<input type="checkbox"/>	
Q43. Is the <i>Shari'ah</i> board required to submit a <i>Shari'ah</i> report?	Yes	<input type="checkbox"/>	
	No	<input type="checkbox"/>	
Q44. What are the contents of the <i>Shari'ah</i> report?	Information on duties and services of the <i>Shari'ah</i> board	<input type="checkbox"/>	
	<i>Shari'ah</i> pronouncements	<input type="checkbox"/>	
	<i>Shari'ah</i> board activities	<input type="checkbox"/>	
	Declaration of <i>Shari'ah</i> compliance	<input type="checkbox"/>	
	Others (Please specify)	<input type="checkbox"/>	
Q45. What is the organizational arrangement for the internal <i>Shari'ah</i> review?	Independent division/department	<input type="checkbox"/>	
	Part of the internal audit department	<input type="checkbox"/>	
	Others (Please Specify)	<input type="checkbox"/>	

H6: General Assessment of the *Shari'ah* board.

	Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree
Q46. The <i>Shari'ah</i> board has demonstrated effective organisational accountability.	<input type="checkbox"/>				
Q47. The <i>Shari'ah</i> board has communicated effectively with other organs of governance, including the BOD, management and auditors.	<input type="checkbox"/>				
Q48. The <i>Shari'ah</i> board has properly identified and evaluated the organization's exposure to <i>Shari'ah</i> non-compliance risk and reputational risk, and effectively communicate that risk information to appropriate bodies in the organization.	<input type="checkbox"/>				
Q49. The <i>Shari'ah</i> board promotes Islamic ethics and values within the organization.	<input type="checkbox"/>				
Q50. The <i>Shari'ah</i> board promotes continuous improvement of the organization's <i>Shari'ah</i> control processes.	<input type="checkbox"/>				

Thank you for taking the time to complete this questionnaire. Your assistance in providing this information is very much appreciated. If there is anything else you would like to tell us about this survey or other comments, please provide any other insights which you think are relevant to *Shari'ah* governance in the space provided below.

Appendix 2

APPENDIX 2: SEMI-STRUCTURED INTERVIEW QUESTIONS

H1: General Framework for *Shari'ah* Governance

- Q1. What is the main issue you currently face in relation to *Shari'ah* governance?
- Q2. Do you think the adoption of the AAOIFI standard may resolve issues of *Shari'ah* governance?
- Q3. What is your view on the recent IFSB *Shari'ah* governance standard?
- Q4. Are you aware any of any failure or serious impact of the IFIs directly or indirectly attributable to poor *Shari'ah* governance practices?

H2: Regulatory Framework

- Q5. Do the bank by-laws allow you to carry out a *Shari'ah* review to ensure that the bank's operation is in accordance with *Shari'ah*?

H3: The Role of *Shari'ah* Board

- Q6. What are the roles of the *Shari'ah* board?

- Q7. What is your opinion on the issue of *Shari'ah*-compliant and *Shari'ah*-based finance? The latter adhere to the *Shari'ah* objectives and spirit of the *Shari'ah* while the former comply with the legal aspect of *Shari'ah* law but not necessarily the spirit of *Shari'ah*. Do you think that the *Shari'ah* board should concern solely on the *fiqh* aspect or beyond it?

H4: Mechanism of *Shari'ah* Governance

H4.1: Competence

- Q8. Does the bank organize adequate training for the *Shari'ah* board?
- Q9. Is there any assessment or evaluation of the *Shari'ah* board?
- Q10. What is your view on interdisciplinary members of the *Shari'ah* board?

H4.2: Independence

- Q11. Who has the power to appoint and dismiss the *Shari'ah* board?
- Q12. What is your view on the issue of *Shari'ah* scholars sitting on various *Shari'ah* boards?

H4.3: Transparency and Confidentiality

- Q13. Does the *Shari'ah* board have access to all documents, information, records, etc.?
- Q14. Is the provision of confidentiality clearly mentioned in the terms of reference in the letter of appointment?

H5: Operational Procedure

- Q15. Is there any standard operational procedure for the *Shari'ah* board?

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Q16. Does the *Shari‘ah* board hold its meetings regularly? How frequently?

Q17. To what extent does the *Shari‘ah* board rely on the bank’s internal *Shari‘ah* audit?

H6: General Assessment of the *Shari‘ah* board

Q18. Do you think that the *Shari‘ah* board takes social dimensions into consideration in making their decisions?

7: Additional Insights

Q19. Please provide any other insights which you think are relevant in relation to the *Shari‘ah* governance system.

Appendix 3

APPENDIX 3: SAMPLE DESCRIPTION

No.	IFIs	Country
1.	Central Bank of Malaysia (BNM)	Malaysia
2.	Securities Commission	Malaysia
3.	Affin Islamic Bank	Malaysia
4.	Alliance Islamic Bank Berhad	Malaysia
5.	Asian Finance Berhad	Malaysia
6.	Bank Rakyat	Malaysia
7.	Bank Islam M Berhad	Malaysia
8.	CIMB Islamic	Malaysia
9.	Hong Leong Islamic	Malaysia
10.	Kuwait Finance House Malaysia Berhad	Malaysia
11.	Bank Muamalat Malaysia Berhad	Malaysia
12.	AMIslamic	Malaysia
13.	Al Rajhi Bank (Malaysia) Bhd	Malaysia
14.	EONCap Islamic	Malaysia
15.	Maybank Islamic Berhad	Malaysia
16.	RHB Islamic	Malaysia
17.	Public Islamic Bank	Malaysia
18.	BSN	Malaysia
19.	HSBC Amanah Malaysia	Malaysia
20.	Standard Chartered Saadiq	Malaysia
21.	Al Baraka Islamic Bank B.S.C	Bahrain
22.	Al Salam Bank	Bahrain
23.	Khaleiji Commercial Bank	Bahrain
24.	Bahrain Islamic Bank	Bahrain
25.	Shamil Bank of Bahrain	Bahrain
26.	Ahli United Bank	Bahrain
27.	Albaraka Banking Group	Bahrain
28.	ABC Islamic Bank	Bahrain
29.	Capinnova Investment Bank	Bahrain
30.	Ithmaar Bank	Bahrain
31.	Global Banking Corporation	Bahrain
32.	Investors Bank	Bahrain
33.	Kuwait International Bank	Kuwait
34.	Al Aman Investment Company	Kuwait
35.	Bank of Kuwait and the Middle East	Kuwait
36.	Boubyan Bank	Kuwait
37.	Al Dar Asset Management Company	Kuwait
38.	Bayt Al Māl Investment Company	Kuwait
39.	Rasameel Structured Finance	Kuwait
40.	International Investment Group	Kuwait
41.	Investment Dar	Kuwait
42.	Kuwait Finance House	Kuwait

Appendix 3

No.	IFIs	Country
43.	Commercial Bank of Qatar	Qatar
44	Al Rayan Bank	Qatar
45.	Doha Islamic Bank	Qatar
46.	Qatar International Islamic Bank	Qatar
47.	Qatar Islamic Bank	Qatar
48.	QNB Al-Islami	Qatar
49.	Investment House	Qatar
50.	Qinvest	Qatar
51.	The First Investor	Qatar
52.	Qatar Islamic Financial Securities	Qatar
53.	Abu Dhabi Commercial Bank	UAE
54.	Abu Dhabi Islamic Bank	UAE
55.	Ajman Bank	UAE
56.	Amlak Finance	UAE
57.	Dubai Islamic Bank	UAE
58.	Al Hilal Bank	UAE
59.	Dubai Bank	UAE
60.	Emirates Islamic Bank	UAE
61.	Noor Islamic Bank	UAE
62.	Sharjah Islamic Bank	UAE
63.	Badr Al Islamic Bank	UAE
64.	Al Safwa Islamic Financial Services	UAE
65.	Abu Dhabi National Islamic Finance	UAE
66.	Bank Al-Jazira	Saudi Arabia
67.	Al Rajhi Bank	Saudi Arabia
68.	Alinma	Saudi Arabia
69.	Bank Al Bilad	Saudi Arabia
70.	Al Jazira Capital	Saudi Arabia
71.	Arabian Capital	Saudi Arabia
72.	Jadwa Investment	Saudi Arabia
73.	Riyadh Bank	Saudi Arabia
74.	Siraj Capital	Saudi Arabia
75.	Islamic Bank of Britain	United Kingdom
76.	Gatehouse Bank	United Kingdom
77.	Bank of London and Middle East	United Kingdom
78.	European Islamic Investment Bank	United Kingdom
79.	European Finance House	United Kingdom
80.	Lloyds TSB	United Kingdom

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