



An Empirical Study of *Shari'ah* Compliance in Islamic Banks of Pakistan

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Abstract

The study is aimed to find out the need of *Shari'ah* compliance in general and specifically in Islamic banking. It is also to identify the loop holes in the existing *Shari'ah* compliance system and to recommend some measures to remove *Shari'ah* non-compliance in Islamic banks in Pakistan. The study is based on both primary and secondary material. Primary data is gathered through a survey and personal interviews with the Islamic banking experts, employees and researchers. This study is based on descriptive method, related testing tools like weighted average, standard deviation and variance. These methods are applied to ensure the reliability of data and research. *Shari'ah* compliance is regarded as the foundation of the Islamic banking. Though Islamic banks give priority on *Shari'ah* compliance, a number of factors hinder *Shari'ah* compliance. *Shari'ah* knowledge, efforts, and seriousness of the bank authorities and bank employees are the prerequisites for complying appropriately with *Shari'ah*. Regulatory bodies, executives, and employees of Islamic finance industry are expected to get the idea of the present situation of *Shari'ah* compliance and to identify their weaknesses. Clients are expected to get guidelines to choose and study Islamic banking products in a better way. The researchers are expected to find new issues and get a more comprehensive statistical and analytical study regarding *Shari'ah* compliance in Islamic banking which was not done so far.

Keywords: *Shari'ah* compliance, Islamic banks, and Islamic finance industry.

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1. Introduction

Shari'ah or Islamic law generally means a set of commands derived from *Al-Quran* and *Sunnah*. *Shari'ah* is regarded as the foundation of Islamic banks (Khanam and Ullah, 2014). That is why Islamic bank cannot be allowed to function without accepting *Shari'ah*'s rulings and regulations. Compliance means the action or fact of complying with a wish or a command. In general, it refers to every action that must be done according to a rule as per decided. It is also defined as conforming to a rule such as a specification, policy, standard or law. It ensures all necessary governance requirements can be met and done according to laws.

Shari'ah compliance is the major motivation for Islamic banks to operate under the umbrella of Islamic law. If they are not working according to the terms and regulations of *Shari'ah*, then they would not be named as Islamic banks. Therefore, the first priority of Islamic banks is to ensure that all their Islamic products and operations follow *Shari'ah*'s guidelines and clean from *riba* (interest) and other unlawful elements which are prohibited by Islamic laws (Ahmed and Chapra, 2002).

The conventional banking is based on interest. On the other hand, Islamic banking is based on trade and other *Shari'ah*-compliant modes. The main difference between Islamic and conventional banking is that Islamic banking must be in compliance with *Shari'ah* rules in financial transactions. If not, there will be *Shari'ah* non-compliance risk. To ensure that Islamic financial institutions comply with the *Shari'ah* rules, Islamic banks are required to utilize the services of a *Shari'ah* Supervisory Board (SSB). These SSBs consist of a number of *Shari'ah* experts who ensure *Shari'ah* compliance through the supervision of new product, issuing guiding fatwas and conduct internal *Shari'ah* audit.

Shari'ah knowledge, efforts, and seriousness of the Islamic banks' authorities and employees are the pre-requisites in complying with *Shari'ah*. Khanam and Ullah (2014) stated that there are some practical issues relating to *Shari'ah* compliance in banking sector from the perspectives of institution and employee. These issues are related to lack of knowledge and lack of seriousness of employee. It can also be traced from the government where they do not place the application of *Shari'ah* rulings in economic and banking sector as a priority. Although, *Shari'ah* compliance should be the prime concern of Islamic banks, but it was found that there were poor efforts from higher authorities and employees in achieving *Shari'ah* compliance (Ullah, 2014).

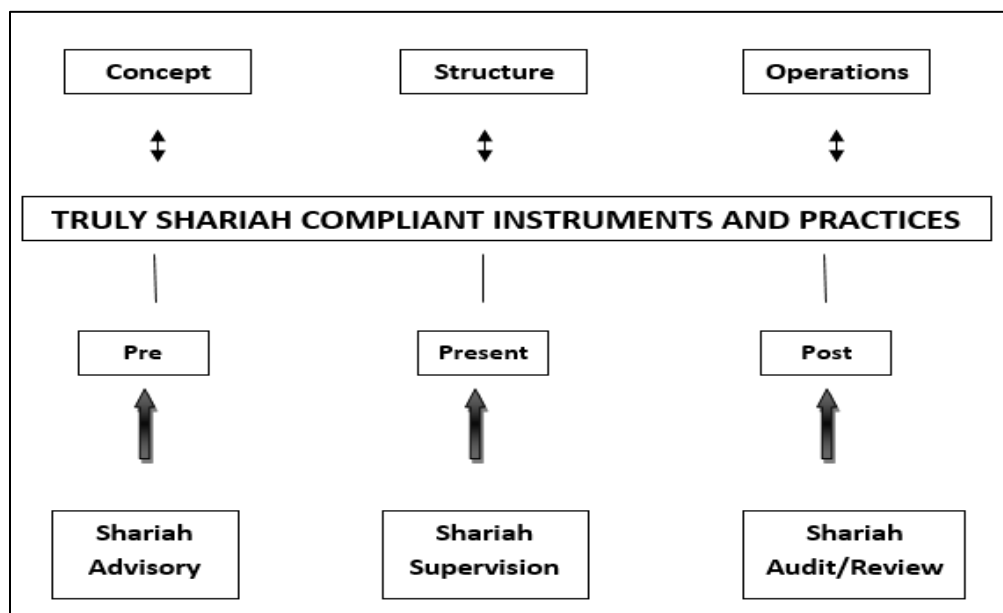
Akhter *et.al.* (2011) explain that Islamic banking is growing at a rapid rate. Today, Islamic banks are operating in nearly all Muslim countries and many non-Muslim countries. The practice of Islamic banking has been started in Pakistan from the last two decades. Interest is strictly prohibited in Islam and Islamic banking is a *Shari'ah*-compliant alternative to the conventional banking system. Ullah (2014) has done a brief research on Shariah compliance related to Islamic banks in Bangladesh where he discussed from different aspects like impediments in *Shari'ah* compliance in Islamic banks. Respectively, it is related to its importance and scope. He also pointed out some of the various practical hurdles that need to elaborate with the help of more studies on this practical aspect. Thus, it is necessary to check the level of *Shari'ah* compliance of Islamic banks in Pakistan and their practical structure. The relevant research objectives for this research are: (i) to have an idea of the needs for *Shari'ah* compliance in general and specifically in Islamic banking; and (ii) to recommends some measures to remove *Shari'ah* non-compliance in Islamic banks in Pakistan.

2. Literature Review

One of the main studies was done by Ullah (2014) on *Shari'ah* compliance of Islamic banks in Pakistan. He has performed an empirical survey with two sets of questionnaires. The questionnaire was designed in such a way that the first set focused on gathering data related to: (i) the significance of *Shari'ah*, (ii) impediments and obstacles to *Shari'ah* compliance, (iii) *Shari'ah* audit and research on *Shari'ah* compliance, and (iv) aspects of Islamic banking. The first set of the questionnaire used the 5-point Likert scale. The second set of the questionnaire focused in gathering data on the degree of *Shari'ah* violation scaling. The data was collected from four Islamic banks. At the end of the research, it concludes that there were errors found regarding *Shari'ah* compliance in these Islamic banks that should be avoided. It is expected to be easier to remove these errors with encouragement and motivation from higher authorities. Khaleequzzaman *et al.* (2016) focused on Islamic banks in Pakistan and studied the aspect of *Shari'ah* legitimacy in Islamic banks in Pakistan. This study concludes that this is an important area that should be explored more and Islamic banks need to be more concentrate on values-based judgments, taking care of *Maqasid Al-Shari'ah* and achieved the aim of distributive justice in a fair way.

Hassan *et al.* (2011) describe some important points that are relating to *Shari'ah* compliance in Islamic banks especially from *Shari'ah* advisory's perspective. There are two levels of *Shari'ah* advisory in Malaysia, i.e. the central level and the industry level. The central level deals with the establishment of *Shari'ah* Advisory Council (SAC) at the Central Bank of Malaysia. While at the industry level, they introduce *Shari'ah* advisories for each Islamic financial institution that are also known as *Shari'ah* Committees. They described that *Shari'ah* compliance requires *Shari'ah* advisors' consideration to investigate and get surety on *Shari'ah* compliance of the services and products that Islamic banks offered. The tools used are the instruments for supervision. 'Abd al-Hamid al-Ba'li' also explained in his Book *Taqnin A'mal al Hai'ah al-Shari'ah Muammalah was alihatuh*, that there are three instruments for supervisory activities are: (i) doing evaluation and research on operations of the Islamic bank; (ii) making decisions relating to the products and transaction which may be periodical; (iii) withdrawing or canceling decision and operations which are not in line with *Shari'ah* rules and principles (Hassan *et al.*, 2011). The following diagram shows three stages of *Shari'ah* compliance methods (Hassan *et al.*, 2011) (see Figure 1.0).

Figure 1.0: Fundamentals of Islamic banking products and instruments



Source: Hassan *et al.* (2011).

Malik and Mustafa (2011) described that there were some structures of Islamic banking services and products which were superficially (involved more than one way) done in ensuring *Shari'ah* compliance of a financing product or a service. Widiyanti and Jusoh (2012) also discussed about *Shari'ah* compliance portfolio in Islamic banks. Furthermore, Khanam and Ullah (2014) indicate the importance of *Shari'ah* compliance in Islamic banking. They conclude that it is the duty for every Muslim and organization. Ullah *et. al* (2012) claimed *Shari'ah* compliance is a complex process. This complexity is due to some factors including religious, ideological, regulatory, structural and internal self-interests. They also explained that *Shari'ah* scholars are standing at one end and Islamic banks' managers are at the other end in the whole picture of *Shari'ah* compliance.

Chong and Liu (2009) raised some concerns on the practices of Islamic banks due to direct adoption of conventional banking mechanisms. They highlighted that theory of Islamic finance is enriched with the discussion of profit-loss-sharing in products. Perves (2013) proclaimed that there are a lot of concerns and doubts in achieving the Objectives of *Shari'ah* and *Shari'ah* compliance in the modern Islamic banking. According to Usmani (2008), he clarifies that most of the issued sukuk are not in line with the essence of *Shari'ah*. *Shari'ah* Supervisory Boards or SSBs of Islamic banks have some challenges in reaching *Shari'ah* compliance such as independence, support from other departments, facilities, and also lack of full cooperation, and attention of higher management of the banks (Saqib *et. al.*, 2016).

3. Research Methodology

This research is done based on both primary and secondary materials. The primary data is gathered through distributed questionnaires. The secondary data is obtained from: (i) *Al-Quran*, (ii) *Hadith*/circulars/letters/manuals as provided by State Bank of Pakistan (SBP) on *Shari'ah* compliance, (iii) books, journals, annual reports, and websites of sample banks statistical tools like weighted average, percentage, standard deviation, and variance. The researchers depend on the statistical software which is known as SPSS version 22.0.

3.1 Sample Size

Out of six Islamic banks in Pakistan, there are four Islamic banks that have percentage of 66.7% of customers out of the total population. They are taken as sample by considering their size-based number of operations, branches, and age of their establishments. These Islamic banks are: (i) Meezan bank (MB); (ii) Dubai Islamic Bank (DI); (iii) Bank al Islami Pakistan (BI); and (iv) Al-Baraka bank (AB).

3.2 Questionnaire Design, Data Collection, and Limitations

Comprehensive questionnaires were distributed to the respondents. The questionnaire was developed based on five main aspects, i.e. (i) *Shari'ah* officers/advisors' appointment issues (SCOAAI), (ii) qualification and skills of *Shari'ah* compliance officers/advisors (QSSCOA), (iii) scope of *Shari'ah* compliance officers/advisors (SSCOA), (iv) *Shari'ah* audit role of *Shari'ah* advisors and SBP (RSASBP), and (v) *Shari'ah* research and prospects of Islamic banking (SASR).

Data was collected based on the 5-point Likert scale where: "2" indicates "strongly agree", "1" indicates "agree", "0" indicates "neutral", "-1" indicates "disagree", and "-2" indicates "strongly disagree". The mean score of the respondents' opinions were calculated for the purpose of analysis. This research collected 100 responses from 100 respondents from the abovementioned four banks for the purpose of analysis. As for the limitation, the researchers only selected the respondents from those four full-fledged Islamic banks out of six banks due to availability of personal contacts, accessibility, and difficulty in taking interviews for this study.

4. Findings and Discussion

4.1 *Shari'ah* Officers/Advisors Appointment Issues

From Table 1.0, the average score of opinions regarding *Shari'ah* compliance is 1.05 which shows that majority of the respondents agreed that Shariah compliance officers met the proper criteria for *Shari'ah* advisory notified by SBP. The average score of 0.428 in Question 2 indicates that respondents opined that *Shari'ah* compliance officers are not fully free and independent in giving fatwas in all financial matters in Islamic banks. Apart from this Question 2, the average scores of 1.268, 1.38, 1.178, 1.115 of all remaining questions clearly showed that majority of respondents were agreed with these statements.

This means that they opined that *Shari'ah* compliance officers ensure the *Shari'ah* compliance of the products, services, and policies of Islamic banks and also the management of Islamic banks examined their new products and services with *Shari'ah* compliance officers. Further, it showed that respondents claimed that *Shari'ah* compliance officers did some activities for their staffs, such as trainings regarding *Shari'ah* rulings of Islamic financial products and services. Finally, respondents agreed that *Shari'ah* compliance officers and *Shari'ah* committee had to reinforce their independence.

Table 1.0: Average Score of Respondents' Opinions

Questions	MB	AB	DI	BI	Average	SD	V
1. <i>Shari'ah</i> compliance officers met the fit and proper criteria for <i>Shari'ah</i> advisory notified by the SBP	.86	.97	1.29	1.08	1.05	0.183	0.034
2. <i>Shari'ah</i> compliance officers are free in means to put fatwa and rulings in all financial matters in Islamic banks.	.23	.58	.36	.54	0.428	0.163	0.026
3. <i>Shari'ah</i> compliance officers make ensure that all products and services and	1.07	1.26	1.43	1.31	1.268	0.150	0.022

related policies and agreements of IBIs are in compliance with <i>Shari'ah</i> rules and principles								
4. Before launch of new products and services, the related policies and agreements are dully vetted by the <i>Shari'ah</i> compliance officers	1.33	1.52	1.21	1.46	1.38	0.138	0.019	
5. <i>Shari'ah</i> compliance officers make arrangements with the coordination of management a training program for Staff of IBIs.	1.00	1.10	1.07	1.54	1.178	0.245	0.060	
6. <i>Shari'ah</i> Compliance Officers and <i>Shari'ah</i> Committee should report to the shareholders in order to reinforce their real independence	.98	1.10	1.00	1.38	1.115	0.184	0.034	

4.2 Qualification and Skills of *Shari'ah* Compliance Officers/Advisors

The average score of 1.517 from the first question (see Table 2.0) about the qualification of *Shari'ah* compliance officers showed that majority of the respondents opined that *Shari'ah* compliance officers have to be specialized in *Shari'ah* qualification and *Shari'ah* compliance. The average score of 1.4, 1.367, and 1.4 of next three statements respectively explained that majority of the respondents agreed and think that *Shari'ah* compliance officers should have proper knowledge and qualified in accounting, trained in banking and finance, and qualified with *Shari'ah*. Islamic banks should also take reasonable step to provide suitable trainings to *Shari'ah* compliance officers. The average scores of 0.993, 1.138, 1.143 of last three questions respectively indicated that majority of the respondents opined that the required minimum qualification for *Shari'ah* compliance officers should be a professional degree in *Shari'ah* compliance. It is more important than the requirement of only having certification and knowledge of accounting with Islamic law.

Table 2.0: Average Score of Opinions on *Shari'ah* Compliance Officers/Advisors

Questions	MB	AB	DI	BI	Average	SD	V
1. <i>Shari'ah</i> Compliance Officer should have specialized <i>Shari'ah</i> certification qualification on <i>Shari'ah</i> Compliance	1.49	1.39	1.57	1.62	1.517	0.100	0.010
2. <i>Shari'ah</i> Compliance Officer should be qualified in both <i>Shari'ah</i> and Accounting	1.44	1.26	1.21	1.69	1.4	0.217	0.047
3. <i>Shari'ah</i> Compliance Officer should be adequately trained in banking and finance	1.40	1.32	1.21	1.54	1.367	0.138	0.019
4. Islamic banks should provide adequate training to <i>Shari'ah</i> Compliance Officers in Pakistan	1.21	1.35	1.50	1.54	1.4	0.151	0.023

5. Required (Minimum) qualification of the “ <i>Shari’ah</i> Compliance Officer” is Degree/professional in Accounting and Islamic law	.81	1.16	1.00	1.00	0.993	0.143	0.020
6. Required (Minimum) qualification of the “ <i>Shari’ah</i> Compliance Officer” is Specialized certification in “ <i>Shari’ah</i> compliance”	.93	1.19	1.43	1.700	1.138	0.224	0.050
7. Required (Minimum) qualification of the “ <i>Shari’ah</i> Compliance Officer” is Degree/Professional qualification in <i>Shari’ah</i> compliance	.81	1.32	1.36	1.08	1.143	0.254	0.064

4.3 Scope of Duty for *Shari’ah* Compliance Officers /Advisors

Table 3.0 shows the scope of duty for *Shari’ah* compliance officers and advisors. The average score of 1.255 for the first question indicates that majority of the respondents opined that *Shari’ah* compliance is not merely limited to just one duty. It has broader areas in Islamic banks. The average scores of 0.97, 0.597, 0.72 and 1.085 of remaining consecutive questions respectively explained and supported the first question which is a general statement about the scope of *Shari’ah* compliance duty. These numbers show that respondents thought that *Shari’ah* compliance does not only covers the process of *Shari’ah* governance, not limited to financial statements in accordance to *Shari’ah*, or in compliance with Shariah policies only. Rather, it covers all these areas.

Table 3.0: Average Score of Opinions on Duty for Shariah Compliance Officers/Advisors

Questions	MB	AB	DI	BI	Average	SD	V
1. <i>Shari’ah</i> Compliance covers broader areas in Islamic banks	1.12	1.03	1.64	1.23	1.255	0.269	0.073
2. <i>Shari’ah</i> Compliance covers review of adequacy of the <i>Shari’ah</i> governance process only	.93	.81	1.14	1.00	.97	0.137	0.019
3. <i>Shari’ah</i> Compliance is limited to check the accordance of financial statement with <i>Shari’ah</i> only	.60	.45	.71	.62	0.595	0.107	0.012
4. <i>Shari’ah</i> audit is limited to confirm in accordance to financial contracts with <i>Shari’ah</i> only	.81	.52	.86	.69	0.72	0.151	0.022
5. <i>Shariah</i> Compliance is limited to check the compliance of procedures and policies with <i>Shariah</i> only	1.12	1.00	1.14	1.08	1.085	0.062	0.003

4.4 Role of Shari'ah Advisors and SBP

From Table 4.0, the average score of 1.033 was collected from the first question on the participation of Islamic bank's *Shari'ah* advisors in meetings as called by SBP. This score shows that majority of the respondents claimed that Islamic banks ensure the participation of their *Shari'ah* advisors in the annual or quarterly meetings of SBP. The average scores of 0.855, 0.653, 0.623 and 0.567 are collected from other four questions respectively. These numbers indicated that a smaller number of the respondents are agreed on that the submission of annual *Shari'ah* compliance report to SBP by the *Shari'ah* advisors of the Islamic banks.

Respondents also agreed that there are not enough efforts done to ensure the making of reference on a certain issue from the corresponding Islamic bank to *Shari'ah* board of SBP. Same responses were recorded relating to the making of reference on a particular issue that arises from a difference opinion between their *Shari'ah* Advisors with their board of directors (BOD). Surprisingly, majority of the respondents were having least surety about the reviewing operations done by the *Shari'ah* advisors of the Islamic banks on a periodical basis and the coordination with officials that are responsible for *Shari'ah* compliance.

Table 4.0: Average Score of Opinions on Role of *Shari'ah* Advisors and SBP

Questions	MB	AB	DI	BI	Average	SD	V
1. Did the bank ensure its <i>Shari'ah</i> Advisor's participation in various meetings called by the SBP?	1.05	1.16	1.07	.85	1.033	0.131	0.017
2. Did the <i>Shari'ah</i> Advisor prepare a report on the Bank's annual financial statement in respect of its <i>Shari'ah</i> compliance that was to be published in the IBI's annual report?	1.16	1.10	.43	.85	0.885	0.332	0.110
3. Did the IBI refer, any case arising due to difference of opinion between SA and SBP inspection staff, to SBP <i>Shari'ah</i> Board?	.81	.48	.86	.46	0.653	0.212	0.045
4. Did the IBI's management refer any ruling, on the basis of difference of opinion with their <i>Shariah</i> Advisor, to the Board's audit committee or BOD for decision?	.79	.52	.64	.54	0.623	0.123	0.015
5. Does the <i>Shari'ah</i> Advisor review operations of the IBI on a periodical basis in coordination with officials responsible for <i>Shari'ah</i> compliance to ensure that all the products and services being offered	.77	.45	.43	.62	0.567	0.159	0.025

by the IBI conform to the injunctions of *Shari'ah*?

4.5 *Shari'ah* Audit and *Shari'ah* Research

The average score of 0.372 was collected from the first question regarding the sufficiency of existing *Shari'ah* audit system (see Table 5.0). It indicates that majority of the respondents are not satisfied and not agree. This highlights that there are some loopholes in the existing system of Shariah audit and Shariah compliance at the level of Islamic banks. The average score of 0.962 of the second question shows that respondents opined that there is a need in emphasizing more on Shariah audit system at their branch's level.

The average score of 0.632, 0.837, 0.74 and 1.35 are found for the remaining four questions respectively. These numbers showed the interesting results in the sense that respondents opined that there is not enough research conducted by Islamic banks to facilitate *Shari'ah* decisions. Meanwhile, the respondents also claimed that such researches assisted *Shari'ah* committees to reach to a better decision. The numbers also showed that majority of the respondents was not sure about the conducive researches done by their corresponding Islamic banks. Finally, the majority of the respondents agreed that more *Shari'ah* researches are needed to be done to formulate new guidelines for creating avenues for Islamic banking.

Table 5.0: Average Score of Opinions on *Shari'ah* Audit and *Shari'ah* Research

Questions	MB	AB	DI	BI	Average	SD	V
1. Existing <i>Shari'ah</i> audit system is sufficient in complying <i>Shari'ah</i> at all levels of the bank	.65	.16	.14	.54	0.372	0.260	0.068
2. Branch level <i>Shari'ah</i> audit should be given more emphasis for accurate <i>Shari'ah</i> compliance of the bank	1.00	.87	1.21	.77	0.962	0.189	0.036
3. There is sufficient <i>Shari'ah</i> research conducted to facilitate <i>Shari'ah</i> decision	.81	.77	.57	.38	0.632	0.198	0.039
4. Research conducted by the <i>Shari'ah</i> research officers assist the <i>Shari'ah</i> Committee to reach good decisions	1.02	.84	.64	.85	0.837	0.155	0.024
5. Your institution has provided a conducive research function	.77	.71	.79	.69	0.74	0.047	0.002
6. More <i>Shari'ah</i> research needed to be done to formulate new guidelines for creating avenues for Islamic banking	1.49	1.29	1.29	1.31	1.35	0.097	0.009

Findings of the survey clearly highlight the current status of *Shari'ah* compliance in Islamic banks and also identifies the loopholes that exist in the existing system of *Shari'ah* compliance of Islamic banks. The results show that that majority of the respondents are agreed that *Shari'ah* compliance officers met the proper criteria for *Shari'ah* advisory as notified by SBP. *Shari'ah* compliance officers did some activities like trainings of staffs regarding *Shari'ah* rulings of Islamic financial products and services. On the other hand,

they also opined that *Shari'ah* compliance officers are not fully free and independent on giving fatwas in all financial matters in Islamic banks. This is one of the loopholes in the existing system of *Shari'ah* compliance of Islamic banks. *Shari'ah* compliance officers are not independent as they should be.

In terms of qualification of *Shari'ah* compliance officers, the findings show that majority of the respondents opined that *Shari'ah* compliance officers have to be specialized with *Shari'ah* qualification on *Shari'ah* compliance. They also think that *Shari'ah* compliance officers should be knowledgeable in accounting, banking and finance to some extent. Nevertheless, *Shari'ah* qualification and expertise in *Shari'ah* compliance are the most important thing. The respondents thought that *Shari'ah* compliance does not only covers *Shari'ah* governance and financial statements that in line with *Shari'ah* compliance policies. It also covers all areas that relevant to Islamic banks.

Majority of the respondents claimed that Islamic banks confirm the participation of their *Shari'ah* advisors in the annual or quarterly meetings of SBP. However, they do not sure about the making of reference on a certain issue from *Shari'ah* compliance officers to *Shari'ah* board of SBP or Board of Directors of Islamic banks.

Regarding the sufficiency of existing *Shari'ah* audit system, it indicates that majority of the respondents are not satisfied. This highlights that there are some loopholes in the existing system of *Shari'ah* auditing and *Shari'ah* compliance at the level of Islamic banks. Based on the survey, the respondents opined that there was not enough research conducted by Islamic banks to facilitate *Shari'ah* decisions. The respondents also claimed that such research assisted *Shari'ah* committees to reach to a better decision.

5. Recommendations

Based on the above discussion and findings, there are some measures recommended by the researchers through this research for all stakeholders (including officers, clients, and management) that have active participation in improving *Shari'ah* compliance of the Islamic banks in Pakistan. It is very necessary and important that the management of Islamic banks should empower *Shari'ah* compliance officers and provide them an environment in which they can make decision relating to *Shari'ah* compliance independently.

Islamic banks should conduct some workshops and training sessions for *Shari'ah* compliance officers to equip them with knowledge of accounting, banking, and financial mechanisms. This is also vice versa for other staffs of Islamic banks. Islamic banks should give more importance relating to *Shari'ah* inspection and *Shari'ah* compliance at their branches' level. They should hold either weekly or monthly a review meeting at their branches' level in order to evaluate *Shari'ah* compliance. Islamic banks also need to and have to provide more researches to facilitate *Shari'ah* compliance officers and *Shari'ah* committees for the sake of making strong and better decisions.

6. Conclusion

Shari'ah compliance is the major motivation of Islamic banks. They need to work according to terms and regulation of *Shari'ah*. Therefore, *Shari'ah* compliance needs to be strengthening in order to ensure that all products and operations as carried out by Islamic banks are in accordance to *Shari'ah* guidelines. *Shari'ah* compliance is also important to cleanse their operations from all prohibited elements such as *riba*.

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