

AL-SHAJARAH

JOURNAL OF ISLAMIC THOUGHT AND CIVILIZATION
OF
THE INTERNATIONAL ISLAMIC UNIVERSITY MALAYSIA (IIUM)

SPECIAL ISSUE:
ISLAMIC BANKING AND FINANCE

2018

COMPARATIVE SHARI'AH GOVERNANCE FRAMEWORK IN SELECTED MUSLIM COUNTRIES¹

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Abstract

Shari'ah compliance is the fundamental distinguishing feature between conventional and Islamic financial system. If Islamic financial institutions do not comply by the rules prescribed in Shari'ah, then there is no difference between conventional and Islamic financial institutions. Due to the paramount importance of Shari'ah compliance, regulatory authorities and Islamic financial institutions should focus on the Shari'ah governance framework. Different countries follow different Shari'ah governance framework, but everyone agrees with the importance of Shari'ah compliance and Shari'ah governance framework. This paper focuses on the cross-country comparison of different frameworks of Shari'ah governance namely Pakistan, Malaysia, Turkey, Indonesia and Kingdom of Saudi Arabia. These five Muslim countries are selected on the basis of growing focus of the governments on Islamic finance and penetration of Islamic finance in the current financial system. This paper is based on qualitative research and uses secondary sources of data. The objective is to show that the Shari'ah governance frameworks implemented by central banks in different countries varies from country to country and all the regulatory authorities have designed Shari'ah governance framework for the Islamic financial institutions. Some countries have a very rigorous and strong Shari'ah governance framework like Malaysia and Pakistan. Whereas the new entrants in Islamic finance industry like Turkey is focusing on establishing a strong and resilient Shari'ah governance framework. The research shows that there is need for continuous improvement of the Shari'ah governance framework across the countries. There is demand for a standardized Shari'ah governance framework across the world but there are several

¹ Article received: August 2018; article accepted: September 2018

challenges in order to establish a unified Shari'ah governance framework for Islamic financial institutions across the world.

Keywords: *Shari'ah* governance, Central Bank, Central *Shari'ah* Board, Islamic financial institutions, standardization

List of Key Abbreviations

AAOIFI	Accounting and Auditing Organization for Islamic Financial Institutions
BAC	Board Audit Committee
BNM	Bank Negara Malaysia
BOD	Board of Directors
DSN	National Shariah Council of Indonesia
EM	Executive Management
IAHs	Investment Account Holders
IBD SBP	Islamic Banking Department of State Bank of Pakistan
IBIs	Islamic Banking Institutions
IBs	Islamic Banks
IFIs	Islamic Financial Institutions
IFSB	Islamic Financial Services Board
ISAU	Internal Shariah Audit Unit
PD	Product Development
PLS	Profit and Loss Sharing
RSBM	Resident Shariah Board Member
SAC	Shariah Advisory Committee/Council
SB	Sharia Board
SBP	State Bank of Pakistan
SCD	Shariah Compliance Department
SECP	Securities and Exchange Commission of Pakistan
SGF	Shariah Governance Framework

1.0 Introduction

Islamic finance includes Islamic banking, Islamic insurance, Islamic capital markets and all other financing activities that comply with *Shari'ah*, the Islamic law. The differentiating features of the Islamic financial system which also form its core and strength include its direct link to economic transactions, backed by real assets and prohibition of interest and speculative activity. There are three basic objectives of the Islamic economic and financial system: the establishment of a practicable system of economy, enabling everyone to get what is rightfully due to them and eradicating the concentration of wealth².

To be deemed *Shari'ah* compliant means that an Islamic financial institution (IFI)'s activities are free from the prohibited elements as prescribed by Islamic law. The prohibited elements include interest (*riba'*), excessive uncertainty (*gharar*), speculative trading, gambling (*qimar*), and some activities or industries deemed forbidden (*haram*) in Islamic law, such as casinos, pornography, alcohol, pork manufacture, interest-based banking or insurance industry etc. Additionally, certain kinds of sales and contracts are also deemed invalid and hence forbidden, such as short selling, sale without ownership or possession, sale and buy back, sale of debt, speculative trading, future sales etc. These elements are prohibited because they lead to wealth accumulation and increase the divide between the rich and poor, giving rise to selfishness, greed, injustice and oppression all of which are against the values of Islam. Islamic banking focuses on a system which opens doors for collective welfare and prosperity, social fairness and justice through active economic participation of every individual.

After the financial crisis 2008, which brought to light the flaws of the conventional financial system, there was a gap created to be filled by a framework that was not only ethical and had a positive societal impact, but could also withstand the horrors faced by the conventional banks at the time. In 2008-2011 post financial crisis, Islamic financing and deposits experienced a double-digit compound

² Imran Ashraf Usmani, *Guide to Islamic Banking*. (Karachi: Maktaba Ma'ariful Quran, 2015).

annual growth rate (CAGR) of 14.3% and 17.6% respectively³. This signaled towards the relative strength of the Islamic financial system. The idea of Islamic banking gradually gained popularity in different parts of the world as people began to get a deeper understanding of its practical and ideological aspects. With its capacity to suit the needs of everyone, spanning from basic solutions for under-served markets as well as innovative products for the complex financial requirements of the modern times, Islamic banking is trying hard to establish itself as an alternative system of banking⁴.

Islamic Banking is overtaking conventional banking in terms of growth, in many parts of the Muslim world. The international Islamic financial industry has crossed the value of USD 1.88 trillion since 2015. This fast and significant development has forced the important industry players to view it as a competitive sector of banking industry. Demands and expectations from Islamic financial services are continuously rising. Today, over 700 Islamic Financial Institutions are operating in more than 100 countries holding about USD 1.2 trillion assets. The regions of Middle East, Far East, US and Europe to Africa, South and Central Asian republics are all entering or have entered the Islamic finance industry. Islamic banks' market shares increased in 18 and reduced slightly or remained same in 13 countries. This is a strong indication of a growing acceptance of Islamic finance in jurisdictions with dual financial systems. There are now 12⁵ jurisdictions where Islamic finance is of domestic importance. The share of Islamic banking in many countries ranges from 18-50% of the total banking industry⁶. The growth rate of the industry is 15-20% annually and it has the potential to serve 40-50% of the whole Muslim population in about 10 years. According to a recent estimate by Standards & Poor's the market capacity for

³ Islamic Financial Services Board (IFSB), *Islamic Financial Services Industry Stability Report*. Kuala Lumpur: IFSB, (2016).

⁴ Ahmed Ali Siddiqui, "Islamic Banking Industry Growing Amid Challenges", *Journal of Islamic Banking & Finance*, (2013, Jan.-March)

⁵ Islamic Financial Services Board (IFSB), *Islamic Financial Services Industry Stability Report*. Kuala Lumpur: IFSB, (2017).

⁶ Islamic Financial Services Board (IFSB), *Islamic Financial Services Industry Stability Report*, op. cit.

Islamic banks is estimated at USD 4.0 trillion⁷.

In accordance with the tremendous growth of Islamic finance globally, and the complexity of duties and responsibilities of different stakeholders, there must be a sound and proper *Shari'ah* governance system in place. The *Shari'ah* governance system strengthens the function of the Board of Directors, management, *Shari'ah* Board and its related institutions to ensure *Shari'ah* compliance⁸. Although many believe there is a need for a robust *Shari'ah* governance framework to ensure the wellbeing of IFIs, little research has been done on this issue. Cross country comparisons can help identify gaps so this paper focuses on comparison of the different *Shari'ah* governance frameworks followed by Pakistan, Malaysia, Turkey, Indonesia and Kingdom of Saudi Arabia. These five Muslim countries are selected on the basis of growing focus of the governments on Islamic finance and penetration of Islamic finance in the current financial system. This paper focuses on the *Shari'ah* supervisory practices across five Muslim countries to fill the gap of literature in this area. The paper provides useful information and relevant guidelines for future development of *Shari'ah* supervision in IFIs.

In Section 2, literature review of the past studies on *Shari'ah* governance is provided. Section 3 presents an overview of the guidelines on *Shari'ah* governance. In Section 4, the *Shari'ah* governance frameworks across Pakistan, Malaysia, Turkey, Indonesia and Kingdom of Saudi Arabia is compared. Section 5 gives the conclusion and recommendations for improvement of the *Shari'ah* governance framework.

2.0 Literature Review

Poor governance systems lead to banking crises which have increased poverty and destabilized economies and governments⁹. On

⁷ Ahmed Ali Siddiqui, "Islamic Banking Industry Growing Amid Challenges", op. cit.

⁸ International *Shari'ah* Research Academy for Islamic Finance (ISRA), *Islamic Financial System Principles & Operations*, (Kuala Lumpur: ISRA, 2016).

⁹ Ross Levine, "The Corporate Governance of Banks: A Concise

the other hand, good corporate governance ensures a better role performance of banks along with increasing stability of the financial system which ripples benefits to the community¹⁰. This significance of corporate governance has led to extensive research in how corporate governance should be designed and tailored for IFIs specifically. Many studies¹¹ have discussed issues regarding corporate governance of IFIs.

The main distinguishing feature of IFIs from conventional institutions is that they must follow *Shari'ah* principles in every aspect. If they fail to comply, the implications of *Shari'ah* non-compliance are very severe not only in terms of reputation but also loss of investments, funds and incomes. It is thus very important for corporate governance to check the structure of transactions of *Shari'ah* compliant businesses to ensure absence of any elements that make profits invalid¹². *Shari'ah* compliance focuses on substance as well as form. Corporate governance of IFIs has two key elements: compliance with Islamic law and maximization of shareholder's

Discussion of Concepts and Evidence”, *World Bank Policy Research Working Paper Series, No.3404*, (Washington D.C.: World Bank, 2004).

¹⁰ Wafik Grais and Matteo Pellegrini, “Corporate Governance and *Shari'ah* Compliance in Institutions Offering Islamic Financial Services”, *World Bank Policy Research Working Paper Series No.4054*, (Washington D.C.: World Bank, 2004).

¹¹ Masudul Alam Choudhry and Mohammad Ziaul Hoque, “Corporate Governance in Islamic Perspective”, *Corporate Governance*, 6(2), (2006), 116-128; Ali A. Ibrahim, “Convergence of Corporate Governance and Islamic Financial Services Industry: Toward Islamic Financial Services Securities Market”, *Georgetown Law Graduate Paper, Series 3*, (2006); Aznan Hasan and Ruslan Sabirzyanov. “Optimal *Shari'ah* Governance Model in Islamic Finance Regulation”, *International Journal of Education and Research*, 3(4), (2015, Apr.), 243-258; Abdussalam Mahmoud Abu-Tapanjeh, “Corporate Governance from the Islamic Perspective: A Comparative Analysis with OECD principles”, *Critical Perspectives on Accounting*, 3, (2009), 556-567; Sulaiman Abdullah Saif Alnasser and Joriah Muhammed, “Introduction to Corporate Governance from Islamic Perspective”, *Humanomics*, 28(3), (2012), 228-231.

¹² Ali A. Ibrahim, “Convergence of Corporate Governance and Islamic Financial Services Industry: Toward Islamic Financial Services Securities Market”, op. cit.

wealth¹³. *Shari'ah* corporate governance is a unique feature of IFIs' financial infrastructure. It is the Islamic alternative of corporate governance¹⁴. The main objective of *Shari'ah* corporate governance is to ensure operations of IFIs are according to the *Shari'ah* guidelines and principles.

Hassan¹⁵ defined *Shari'ah* governance as a system defined by *Shari'ah* principles and controlled by an effective *Shari'ah* Board (SB) to ensure *Shari'ah* compliance. Therefore, in IFIs, a *Shari'ah* Board is appointed to check the extent of *Shari'ah*-compliance of all its activities and operations. Ginena¹⁶ argued that *Shari'ah* governance system refers to the overall system including all transactions, activities and behaviors that govern the conformity of IFIs to the precepts of *Shari'ah*.

The *Shari'ah* Board plays the most crucial role in all *Shari'ah* aspects of the IFIs which include supervision, monitoring, auditing and issuing rules and fatwas. With the growth and development of Islamic finance, the complexity of its operations has also increased which has multiplied the importance of *Shari'ah* Board as a component of the governance framework with the most impact on activities of IFIs¹⁷. The SB is important for two main reasons. First, stakeholders of Islamic banks want assurance of conformity to *Shari'ah* principles. Any report of non-compliance can lead to loss of confidence among investors and clients. Second, the role of *Shari'ah* Board prevents unethical behavior which leads to lower transaction costs which result from incentive issues between shareholders, managers and debt holders. The *Shari'ah* governance framework can

¹³ Shamshad Akhtar, "Shari'ah Compliant Corporate Governance", Keynote Address at the *Annual Corporate Governance Conference*, Dubai, (November 27, 2006).

¹⁴ Aishath Muneeza and Rusni Hassan, *Shari'ah Corporate Governance: The Need for a Special Governance Code.* *Corporate Governance*, 14(1), (2014), 120-129.

¹⁵ Z. Hasan, "Regulatory framework of *Shari'ah* Governance System in Malaysia, GCC Countries and the U.K." *Kyoto Bulletin of Islamic Area Studies*, (2010), 82-115.

¹⁶ Karim Ginena, "Shari'ah Risk and Corporate Governance of Islamic Banks", *Corporate Governance*, 14(1), (2014), 86-103.

¹⁷ Z. Hasan, "Regulatory framework of *Shari'ah* Governance System in Malaysia, GCC Countries and the U.K.", op. cit.

act as an incentive to reduce inefficiency arising from asymmetric information and moral hazard¹⁸.

3.0 Overview on *Shari'ah* Governance

According to Islamic Financial Services Board (IFSB) guiding principles on *Shari'ah* Governance systems for institutions offering Islamic financial services issued in December 2009, *Shari'ah* governance system is¹⁹ “a set of institutional and organizational arrangements through which IFIs ensure that there is an 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”. A set of institutional and organizational arrangements refers to the *Shari'ah* Board and its related institutions e.g. internal audit department. The second essential component of the definition, effective independent oversight, tells us that the aim of *Shari'ah* governance system is to provide an efficient mechanism for the purpose of *Shari'ah* compliance. *Shari'ah* pronouncements, dissemination of information and an internal *Shari'ah* compliance review indicates the overall *Shari'ah* governance process.

The *Shari'ah* Board, the Board of Directors and the management are of key significance to the *Shari'ah* governance system. The *Shari'ah* Board advises the IFIs on matters pertaining to *Shari'ah* compliance. According to Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) *Shari'ah* Board is²⁰ “an independent body which performs the duty of directing, reviewing and supervising the activities of IFIs to ensure *Shari'ah* compliance and issue legal rulings on Islamic banking and finance”. To ensure that the *Shari'ah* governance system works

¹⁸ Nasser M. Suleiman, “Corporate Governance in Islamic Banks”, *Arab Gateway*, (2000), 98-116.

¹⁹ Islamic Financial Services Board (IFSB), *Guiding Principles on Shari'ah Governance Systems for Institutions Offering Islamic Financial Services*, (Kuala Lumpur: IFSB, 2009).

²⁰ *Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), Governance Standard for IFIs*, (Manama, Bahrain: AAOIFI, 2015).

efficiently to serve its purpose, there needs to be a clear framework in place. A robust *Shari'ah* governance framework will work effectively in matters of independence, the binding force of its rulings, its objectivity and full mandate. *Shari'ah* governance is unique to IFIs because of its concern with religious aspects of the overall activities. Conventional financial institutions and IFIs have a common institutional arrangement for their corporate governance framework but IFIs have an additional institutional arrangement of *Shari'ah* governance mechanism in the form of *Shari'ah* Board, internal or external *Shari'ah* review unit and internal *Shari'ah* compliance unit to ensure *Shari'ah* compliance in all aspects of business transactions and operations. *Shari'ah* governance system can be thought of as a further layer of governance to corporate governance framework.

Shari'ah governance framework has a comprehensive scope which covers every step from issuance of *Shari'ah* rulings and *Shari'ah* related information to a periodic internal *Shari'ah* review process. The *Shari'ah* governance system is an essential tool to manage *Shari'ah* non-compliance risk which also leads to mitigation of reputational risk. A sound and proper *Shari'ah* governance framework which is effectively followed can help mitigate *Shari'ah* non-compliance risk which can save IFIs from huge losses both monetarily and to credibility.

The existing standard setting bodies like Organization for Economic Cooperation and Development (OECD) and International Organization of Securities Commissions (IOSCO) have issued different guidelines on governance for financial institutions but there was a need for guidelines that dealt with issues specific to Islamic finance. Independent standard setting bodies were set up in 1992 and 2002 called AAOIFI and IFSB respectively, which filled this gap. While some jurisdictions have made governance standards issued by these bodies a mandatory regulatory requirement, others use them as a benchmark for national governance standards. When comparing the *Shari'ah* governance framework of different jurisdictions it is important to know the basic guidelines issued by AAOIFI and IFSB.

3.1 AAOIFI Governance Standards²¹

AAOIFI has issued seven governance standards which provide the basic principles for *Shari'ah* governance framework. The governance standard on Appointment, Composition and Report of *Shari'ah* Supervisory Board defines a *Shari'ah* Supervisory Board as an independent body of jurists specialized in *fiqh mu'amalat* and according to AAOIFI, it must consist of at least three members. All fatwas and rulings of the *Shari'ah* Supervisory Board are binding on IFIs. The governance standard focusing on *Shari'ah* review points out the *Shari'ah* Board's authority to access all necessary information to examine the extent of *Shari'ah* compliance of IFIs and highlights the review procedure which involves planning, designing, executing, preparation and review. The management must also have in place, proper mechanisms of internal *Shari'ah* review which must be conducted independently by a proficient reviewer having appropriate academic background and necessary training.

An audit and governance committee must also be established at the board level consisting of at least three independent and non-executive board members appointed by the Board of Directors (BOD). This committee will review the financial reporting process, safeguard stakeholders' interests, provide additional assurance on reliability of information and act as an independent link between the management and other stakeholders. The *Shari'ah* Board cannot consist of employees who are involved in managerial decisions and operational responsibilities and is not allowed to subordinate its judgments on *Shari'ah* supervision to third parties. Sound governance structures are necessary because there can be conflicts of interest between those who control the IFIs and those who provide funds. Thus, the selection of members of BOD, *Shari'ah* Supervisory Board and management should be transparent and based on certain criteria. IFIs are also guided by AAOIFI to implement a Corporate Social Responsibility (CSR) policy for screening prospective clients to avoid investment in *Shari'ah* non-compliant activities. CSR disclosures are to be made separately and IFIs must focus on the impact of their activities on economy, society and environment.

²¹ Ibid.

3.2 *IFSB Governance Standards*²²

IFSB insists that IFIs should develop an appropriate policy and institutional arrangements to manage *Shari'ah* compliance risks and specify a mechanism for the supervisory review process. IFSB-10 promotes best practices of *Shari'ah* governance through high quality guidelines.

There are four key elements and principles of IFSB-10 concerning the *Shari'ah* governance process. Competence highlights the need for a fit and proper criteria and professional training and assessment of all persons overseeing the *Shari'ah* governance framework. Independence focuses on the need for complete, adequate and timely information provided to *Shari'ah* Board and the board having adequate capability to exercise objective judgment. All members must strictly observe confidentiality regarding any documents and information provided by the IFIs. IFIs should observe the legal and regulatory framework of the jurisdiction where it operates. The *Shari'ah* Board must also comply with the relevant framework and promote the convergence of *Shari'ah* governance framework. Both IFSB and AAOIFI have issued comprehensive guidelines on *Shari'ah* governance, despite some inconsistencies that need to be standardized. IFSB is more focused towards regulators while AAOIFI focuses on individual IFIs. The IFSB guides central banks on the prudential regulations for IFIs in their jurisdiction and AAOIFI develops *Shari'ah*, accounting and governance standards for individual IFIs. While some countries like Bahrain and Qatar have adopted these standards, others have referred to them as the basis of their governance standards.

4.0 Comparative *Shari'ah* Governance Framework

4.1 Pakistan

The Islamic financial system was first introduced in Pakistan in 1980s but it did not succeed. It was reintroduced in 2002 and has been growing ever since. The market share of Islamic banking assets and deposits is 13.5 percent and 14.6 percent of the whole banking

²² IFSB, "Guiding Principles on *Shari'ah* Governance Systems for Institutions Offering Islamic Financial Services", op. cit.

industry respectively²³. There are 21 Islamic Banking Institutions of which 5 are full-fledged Islamic banks and 16 conventional banks with Islamic banking branches. In December 2003, the total deposits under Islamic modes were only 0.4 percent of the total deposits in the banking system²⁴. Today, that percentage has risen to 14.6, making it one of the most progressive segments within the banking system. There are about 2,500 Islamic banking branches operating in Pakistan, with Islamic banking assets totalling to PKR 2,334 billion and total deposits of PKR 1,916 billion²⁵. There has been an impressive rise in number of banks and increase in investment and financing which represents the importance of Islamic banking sector in Pakistan.

The Islamic Republic of Pakistan was established in the name of Islam and its constitution highlights the urgency to eliminate *riba* from its financial system as soon as possible. In this regard, Pakistan has a separate Islamic Banking department at the State Bank of Pakistan (SBP) and the Securities and Exchange Commission of Pakistan (SECP). The *Shari'ah* Advisory Board in SBP plays the most important authoritative role for IFIs in the country. The Islamic banking department of SBP frequently issues circulars for IFIs.

A comprehensive *Shari'ah* governance framework is adopted by the SBP to ascertain to the people that transactions, activities and operations of IFIs are compliant with *Shari'ah* rules and principles. SBP has been issuing regulations, instructions and guidelines to ensure conformity to *Shari'ah* guidelines. As Islamic Banking has been developing over the years, SBP revises these instructions. In 2005, a strong and robust *Shari'ah* Governance Framework was developed which was applicable to all IFIs. It was reviewed and a revised version was issued in June 2018 which aims to further strengthen the compliance and governance of IFIs. This framework²⁶ gives a comprehensive overview of seven key divisions and

²³ State Bank of Pakistan (SBP), *Islamic Banking Bulletin*, (Karachi: Islamic Banking Department SBP, 2018).

²⁴ State Bank of Pakistan (SBP), *Islamic Banking Bulletin*, (Karachi: Islamic Banking Department SBP, 2016).

²⁵ SBP, *Islamic Banking Bulletin*, (2018), op. cit.

²⁶ State Bank of Pakistan (SBP), *Shari'ah Governance Framework of Islamic Banking Institutions*, (Karachi: SBP, 2018).

highlights their roles and responsibilities along with the formation of these divisions: Board of Directors (BOD), Executive Management (EM), *Shari'ah* Board (SB), *Shari'ah* Compliance Department (SCD), Product Development (PD), internal auditors and external auditors. The minimum requirements included in the *Shari'ah* Governance Framework which all IFIs must comply with are as follows:

- IFIs should have a robust mechanism in place to allow the BOD to overview the IBI's *Shari'ah* compliance environment.
- When implementing the SGF, IFIs should also focus on accountability of management and staff.
- An independent and effective *Shari'ah* Board should be chosen after screening through fit and proper criteria. One member of the board is appointed as the Resident *Shari'ah* Board Member (RSBM).
- A *Shari'ah* Compliance Department should be in place to assist *Shari'ah* Board and to form a link between the *Shari'ah* Board and the management of an Islamic Banking Institutions (IBIs).
- There must be a mechanism to review *Shari'ah* compliance to analyze the extent of practical effectiveness of the framework devised by the *Shari'ah* Board and BOD.
- Every IFI should have an Internal *Shari'ah* Audit Unit (ISAU) which can be separate or a part of the existing audit department.
- To develop new and innovative products and departments, there should be a product development (PD) department.
- The external *Shari'ah* Audit and annual audit will be done together.

4.1.1 Role of Board of Directors (BOD)

The BOD plays a key role in *Shari'ah* Governance. It is responsible and accountable to ascertain full *Shari'ah* compliance and the board also needs to be aware of *Shari'ah* non-compliance risk leading to reputational risk and implications of such risks. To avoid such negative implications, the BOD should introduce a mechanism to overview the effectiveness of and compliance to the framework. The BOD also acts as a trustee for Investment Account Holders (IAHs) and depositors of Islamic banks. IFIs must not only use the IAHs'

funds with prudence and diligence but also ensure returns are earned and distributed in a *Shari'ah* compliant manner. In this regard, the BOD should introduce necessary systems to protect the interests of depositors.

The BOD also plays a role in appointing the SB which will implement an effective *Shari'ah* compliance framework. BOD also fixes the compensation of the SB members. The Country Manager/CEO in Pakistan will appoint the SB in foreign banks with Islamic Banking Branches. The BOD is required to meet the SB at least twice a year to discuss the environment of *Shari'ah*, any issues and recommendations for improvement, and ensure all SB's decisions, fatwas, observations and recommendations are being implemented duly and effectively. One meeting per year is allowed to be via video conferencing. The discussions in the meeting between *Shari'ah* Board and Board of Directors is to be properly recorded and documented by the Board of Directors.

4.1.2 Role of Executive Management (EM)

The EM of an IBI is responsible for implementation of the framework. The EM shall ensure that all material as approved by the SB is accessible and comprehensible by everyone working in their group or functional area. Guidelines given by SB relevant to a group or functional area should be implemented by group head or executive. There should be no tolerance on *Shari'ah* non-compliance and appropriate action needs to be taken against employees who fail in this regard. Management should ensure that complete and relevant information is submitted to the SB when referring matters for decisions. Any decisions made by the SB, thereafter, shall be binding on the IBI. Any operational and human resource issues resulting in *Shari'ah* non-compliance risk should be addressed by the EM.

Training also needs to be arranged by management in collaboration with training department and *Shari'ah* Compliance Department of the IBI for BOD members and senior executives. Trainings and programs on Islamic banking and finance will improve their understanding and knowledge of Islamic finance, importance of *Shari'ah* compliance and main differentiating features and will thus increase exposure to developments in Islamic banking and finance. By 15th January of following year, an annual statement on the actions

taken by the IBI is to be submitted to SBP.

4.1.3 *Shari'ah Board*

(a) Constitutions and Appointment

Shari'ah Board of IFIs should have at least three *Shari'ah* scholars appointed by the BOD after screening through fit and proper criteria. SB members can only be appointed after written clearance of SBP which will be applied for after approval from BOD. IBIs can also invite professionals e.g. accountants to advise the SB on relevant matters. Such members, however, will not have voting rights. The SB members shall be appointed for a period of three years and can only be reappointed after SBP's approval. The three years' term starts from the date of SBP's clearance and during the next three years the SB members, except RSBM, are allowed to be a part of three other banks' SBs. Confidentiality must be observed in accordance with the confidentiality clause.

Reappointment of members (including the Chairperson) of SB can be done by the BOD at least two months before the end of term of the SB. The process of SBP approval and passing criteria will be required to be done again. If IFIs do not extend the term of any member, the decision and its rationale need to be submitted to Islamic Banking Department (IBD), SBP three months before expiry. No member is terminated before expiry of term unless there is a valid reason which must be given to SBP along with evidence. Resignation can be submitted to BOD and any vacancies need to be filled within three months.

(b) Role of *Shari'ah Board*

The SB plays the role of deciding and supervising all *Shari'ah* related matters of the IBI. SB shall be accountable for all its decisions and all decisions made by SB shall be binding on the IBI. The *Shari'ah Board* also has to develop a comprehensive *Shari'ah* compliance framework for all areas of operations of the IFI. SB approves all products or services to be offered or launched by the IBI. The SB is also required to review and approve all documents, manuals, agreements, structures, etc. to check their *Shari'ah*

compliance. All necessary information must be provided to SB when asking for their approval. The SB must have easy and timely access to all appropriate sources of information. SB is required to rigorously deliberate issues under consideration before giving any decision and the deliberations are to be recorded and documented.

All reports of internal *Shari'ah* audit, external *Shari'ah* audit, *Shari'ah* compliance reviews and SBP *Shari'ah* compliance inspection have to be given to the SB. Any unresolved issues are discussed with management and included in the annual report. The Head of *Shari'ah* Compliance Department (SCD) and RSBM shall discuss both the significant and unresolved issues with SBP team during their onsite inspection. The SB must specify the process to change any rulings previously issued. The SB is not allowed to delegate its role to any other person. All decisions and rulings of the SB must conform to all relevant and applicable instructions and guidelines.

(c) Meetings

Quarterly meetings must be called and it is mandatory to attend two thirds of these meetings. The Chairperson of the SB may call for more meetings when necessary. The agenda of the SB meeting and other details and documents need to be sent to SB members so they come prepared. The meetings of the SB shall be held physically or through video conferences according to circumstances. Minutes of the meetings must be properly recorded with all necessary and important details. Furthermore, SB must discharge its duties independently and objectively and fulfil the roles and responsibilities outlined in the appointment letter. In the end, the *Shari'ah* Board will prepare a report on the *Shari'ah* compliance of the IFI based on its findings and reports of internal *Shari'ah* audit, external *Shari'ah* audit and *Shari'ah* compliance review.

4.1.4 Resident Shari'ah Board Member (RSBM)

One *Shari'ah* Board Member is appointed as the RSBM by SB after discussion with management. The RSBM will manage the process to be adopted for implementing the decisions of the SB. RSBM shall be appointed on a full-time basis and is not allowed to perform any role

in any other IBI in Pakistan. He can serve as a member of *Shari'ah* Board of a maximum of two other IFIs after approval from its SB. The RSBM is appointed with the role of giving explanations to management and staff of IBI pertaining to products, documents, process flows and on other operational *Shari'ah* related matters. The management must provide all necessary information when seeking an explanation. The RSBM has to provide guidance to the SCD in reviewing compliance of key businesses and review answers to *Shari'ah* related queries of IBI's clients given by SCD. He must also help the SCD and Training Department in conducting training activities and submit at least a quarterly report to the SB. The explanations given by RSBM shall be binding on the IBI.

4.1.5 *Shari'ah Compliance Department*

Every IBI should have a SCD which can be headed by a RSBM or any suitable person recommended by the SB. The SCD should have a dedicated staff and at least one qualified *Shari'ah* expert meeting the academic criteria. Moreover, IBI's are encouraged to appoint individuals with diverse backgrounds in terms of qualifications to strengthen its *Shari'ah* compliance function.

The SCD will be supervised by the SB. The SCD will provide all secretarial support to SB and act as a link between the SB and management of IBIs. It shall review and maintain record of all documentation. It doesn't play an operational role like product development but can perform research on *Shari'ah* issues and verify distribution of profit and loss to depositors. The SCD is also responsible for responding to queries of IBI's clients about products and services.

The SCD shall regularly check the IBI's *Shari'ah* compliance environment and after conducting a *Shari'ah* compliance review a report will be submitted on the results to SB. The SCD is responsible to implement actions suggested by SB after reviewing the internal *Shari'ah* report and SBP *Shari'ah* compliance inspection visit feedback. SCD will record pending issues and keep checking with SB regarding their status. The SCD shall also help the Training Unit to develop training material and to organize *Shari'ah* training activities to ensure necessary training is imparted. The SCD also

prepares the SOPs and ensures the website is updated with all relevant information of IBIs.

4.1.6 Product Development

Product Development (PD) Department Unit, present in every IB, will research and introduce new products and services aligning with the needs of the IBI and staying up to date with international progress. The IBI shall ensure PD has sufficient suitable staff. The PD must have adequate and trained staff to perform its role effectively.

4.1.7 Internal Shari'ah Audit

Every IBI should have an Internal *Shari'ah* Audit Unit (ISAU). Head of ISAU shall report to Head of Internal Audit in case it is part of Internal Audit Department and to Board Audit Committee (BAC) where it is independent. The ISAU should have a dedicated staff which is qualified and trained. The scope, methodology, audit manual and format of report shall be reviewed and approved by the SB. The Internal Audit Department is assigned the role of preparing Internal *Shari'ah* audit plan. After disbursement of the plan, audit shall be done on quarterly basis.

4.1.8 External Shari'ah Audit

For an independent evaluation of the *Shari'ah* compliance, an external audit is also conducted. The audit firms need to have resources and structure to conduct such an audit. The external *Shari'ah* audit will only audit the financial contracts and transactions to check if they follow the applicable guidelines. The external auditors have to prepare a report for the BOD giving their opinion on the overall *Shari'ah* compliance environment, the associated risks, the ability of the risk management system to manage these risks, the level of awareness of the EM and the BOD in managing these risks and any other significant issues. SB members cannot engage with any external audit firms and the external audit firms are responsible for developing and training their staff. For *Shari'ah* scholars to be engaged in external audit and criteria will be developed by the audit firm. External Audit will also oversee the bank's pool management practices & IT based system. The external *Shari'ah* audit report must

be according to the required format. A copy of the audited reports is to be sent to IBD SBP within 45 days.

4.1.9 Conflict Resolution

In case of any difference of opinion between the IFI and SBP, the matter will be taken to IBD SBP or even *Shari'ah* Advisory Committee of SBP if necessary. The SB of the IBI may also refer *Shari'ah* issues to SBP for seeking opinion of its *Shari'ah* Advisory Committee along with all necessary relevant information. All division's staff must have reasonable knowledge and training in the context of Islamic finance.

4.2 Malaysia

Malaysia²⁷ has been an important player in developing a support system for Islamic banks by devising the Islamic Financial Services Act 2013, the Central Bank of Malaysia Act 2009, Securities Commission Act 1993 and Financial Services Act 2013. Malaysia's Islamic finance industry has been developing and growing since it started over 30 years ago. The Islamic Banking Act of 1983 enabled the country's first Islamic Bank to be established and due to the liberalization of the Islamic financial system in the years that followed, more Islamic financial institutions have been established. Due to a conducive environment that is famous for continuous product innovation, a diversity of global financial institutions, a wide range of innovative Islamic investment instruments, a comprehensive financial infrastructure and adopting global regulatory and legal best practices, Malaysia's Islamic finance industry continues to cross milestones²⁸.

The Central Bank of Malaysia, Bank Negara focuses on the *Shari'ah* compliance of IFIs and considers it mandatory for the development of Islamic financial system. The Bank of Negara states that *Shari'ah* compliance can be achieved through two elements i.e. centralized *Shari'ah* advisory body at the Bank Negara Malaysia

²⁷ Ahsene Lahsasna and Syed Othman Alhabshi, *Shari'ah Governance in Islamic Financial Institutions*, (Kuala Lumpur: IBFIM, 2016).

²⁸ Bank Negara Malaysia (BNM), *Islamic Banking and Takaful* (2007), accessed on September 30, 2018 http://www.bnm.gov.my/index.php?ch=fs_mfs&pg=fs_mfs_bank.

(BNM) and internal *Shari'ah* committee formed at each Islamic Financial Institution (IFI). The *Shari'ah* Advisory Council (SAC) which is the *Shari'ah* Board of BNM determines all the laws for Islamic financial institutions.

The Bank has formed a robust *Shari'ah* governance framework for IFIs to primarily enhance the role of the Board, the *Shari'ah* Committee and the management regarding *Shari'ah* matters and to increase the key divisions responsible for execution of compliance. The SGF of Malaysia²⁹ sets out the requirements of *Shari'ah* governance structures, processes and arrangements to ensure *Shari'ah* compliance and provides comprehensive guidelines for the Board, *Shari'ah* Committee, *Shari'ah* review, *Shari'ah* audit, *Shari'ah* risk management and *Shari'ah* research. The SGF is divided into six sections.

4.2.1 General Requirements of the *Shari'ah* Governance Framework

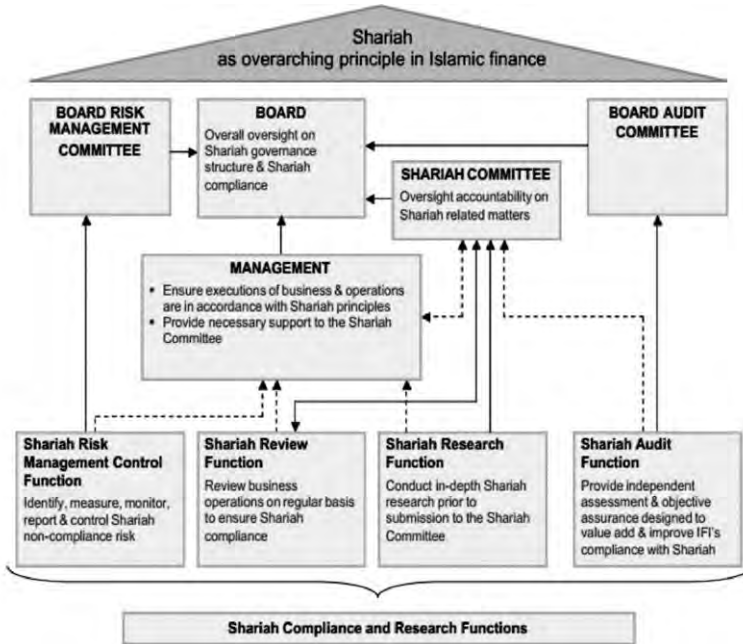
All IFIs are responsible to establish a sound and robust *Shari'ah* governance framework with emphasis on the roles of key functions to effectively implement the framework. IFIs need to ensure that all aspects of its operations are *Shari'ah* compliant at all times. Board and management, an independent *Shari'ah* Committee, internal *Shari'ah* research capacity, active *Shari'ah* review and audit and *Shari'ah* risk management process are all of key importance in this regard and must be a part of the SGF developed by any IFI.

The IFI's governance framework should outline the policies and procedures that explain the roles and responsibilities of the various functions within the IFI. Communication arrangements between the different functions should also be described. The framework should include the required actions to get the desired objectives and outcomes, including rules for conducting meetings, making and recordings decisions and preparing reports. To ensure effective reporting, formal reporting channels need to be established. The structure of the *Shari'ah* Governance Framework of Malaysia is presented in Figure 1³⁰.

²⁹ Bank Negara Malaysia (BNM), *Shari'ah Governance Framework*, (Kuala Lumpur: BNM, 2010).

³⁰ From BNM, *Shari'ah Governance Framework*

Figure 1.



The need for establishing *Shari'ah* research and compliance functions will depend on the kind of business operations. Smaller, less complex institutions can outsource after approval from BNM. Approval will be applied for using an alternate process and the approval will be valid for three years maximum, subject to periodic review. IFI's Board will remain accountable for *Shari'ah* compliance. A financial group can set up one *Shari'ah* committee for the whole group. Financial institutions within the financial group will have to apply to BNM for exemption of requirement of setting up a *Shari'ah* committee. BNM shall only grant exemption after ensuring that one *Shari'ah* committee is sufficient to fulfill *Shari'ah* needs of the whole group.

4.2.2 *Oversight, Accountability and Responsibility*

In the implementation of the *Shari'ah* governance framework, an IFI should identify responsibilities of all key functions and outline what they will be responsible for.

(a) Board of Directors

Ultimate accountability and responsibility of *Shari'ah* governance framework and *Shari'ah* compliance of the IFI rests with the BOD. The Board also needs to diligently check whether the framework is working effectively and it is suitable for the IFI according to its business. The Board will approve all *Shari'ah* related policies after consulting the *Shari'ah* Committee and ensure that these policies are implemented. The Board shall appoint no less than five *Shari'ah* Committee members after considering the recommendations of its Nomination Committee. Majority of the members should have *Shari'ah* knowledge and appropriate qualification and they must be aware of their duties and responsibilities. It can appoint one member of the *Shari'ah* Committee to serve as a link between the Board and the *Shari'ah* Committee. An effective communication policy must be ensured by the Board to allow matters to reach the Board easily and increase awareness among staff regarding *Shari'ah* compliance at all times. The Board will decide the remuneration of the *Shari'ah* Committee members after advice of its Remuneration Committee, according to the accountability, duties and responsibilities of members.

(b) *Shari'ah* Committee

The *Shari'ah* Committee bears responsibility and accountability for all its decisions, views and opinions on *Shari'ah* matters. Although the Board bears responsibility of overall governance of the IFI, the Board should rely on the *Shari'ah* Committee concerning all *Shari'ah* decisions, views and opinions. The *Shari'ah* Committee must also keep an overview of *Shari'ah* matters related to the institution's business operations and activities. *Shari'ah* review and audit reports allow the *Shari'ah* Committee to identify significant issues and their corrective actions. The Committee must also provide sufficient information on extent of compliance in the annual reports.

(c) Management

The management plays the role of implementing decisions of *Shari'ah* Advisory Council (SAC) and *Shari'ah* Committee. The

management also identifies any *Shari'ah* issues and refers them to *Shari'ah* Committee. It is required to provide complete and accurate information to the *Shari'ah* Committee on time along with being transparent in areas that require explanation by the *Shari'ah* Committee. The management must allocate sufficient resources to support the SGF in accordance with the type of IFIs business. Budget allocation, reference and research materials, trainings and development, etc. will all be provided by the management. Regular training programs need to be organized by management to keep the staff exposed to current developments in *Shari'ah* related matters. The management must adopt a comprehensive *Shari'ah* compliance culture which covers all operations. The frontline should regularly be reminded of importance of *Shari'ah* compliance and the impact of non-compliance, and to always refer to *Shari'ah* requirements in all procedures and activities. All relevant staff should be well versed on the Islamic products offered by the IFI and how they are different from conventional ones. The management should make sure that the *Shari'ah* policies and procedures are accessible and provide clarification on *Shari'ah* governance to those involved in implementation. The operations must comply with the policies and procedures which must be regularly updated. If management comes across non-compliant operations, they must immediately notify the Board, the *Shari'ah* committee and BNM, stop operations with the non-compliant business and devise a plan to correct the non-compliance.

4.2.3 Independence

The *Shari'ah* Committee must observe independence at all times in performing their duties. The Board must ensure that the committee is independent in exercising its objective judgment on issues brought before them. The *Shari'ah* Committee will report directly to the Board and keep them informed on *Shari'ah* matters. The Board will then ascertain that decisions of *Shari'ah* Committee are implemented by the IFI without any change. The *Shari'ah* Committee must be able to access accurate and complete information on time from the management. If they are not provided with sufficient information, the Board should be informed. If the *Shari'ah* Committee believes that the IFI has been performing non-compliant activities, the Board will

be informed to identify corrective actions. If no corrective action is taken by IFIs, BNM must be informed. Appointment of *Shari'ah* Committee members will be done by the Board subject to the approval by BNM and the SAC.

4.2.4 Competency

All staff relevant to *Shari'ah* governance framework must be sufficiently competent and continue to acquire knowledge and understanding on *Shari'ah* and its latest developments. The Board and management should have a broad understanding of the *Shari'ah* principles and their applications. The *Shari'ah* Committee should have knowledge on Islamic finance to be able to understand the issues presented to them. IFIs must have in place proper criteria for appointing any *Shari'ah* Committee member to ensure competency and credibility. BNM can also prescribe additional criteria if necessary. IFIs can invite professionals such as lawyers, to assist the *Shari'ah* Committee in issues of their expertise. IFIs must apply a formal procedure to assess the performance of the *Shari'ah* Committee members. The assessment should analyze individual performance and identify areas which require training and exposure. A succession plan should also be in place for the *Shari'ah* committee members.

4.2.5 Confidentiality and Consistency

Internal non-public information obtained by the *Shari'ah* Committee members while performing their duties must be kept confidential at all times and not be misused. The *Shari'ah* Committee is allowed to access all required material including confidential items. The information accessed must be that which is important for the committee to fulfill its responsibilities. Therefore, the members must follow the principle of confidentiality at all times. Confidential information is nonpublic information which includes information on new products and services; decisions of the Board or management; internal memorandums or reports; the event or content or conversations among members of the *Shari'ah* Committee; progress on a business transaction or non-public action; views of various parties during discussions on some matter deliberated and any material that the IFI has indicated as confidential.

The *Shari'ah* Committee can, however, disclose sensitive information to BNM in good faith to report non-compliance with *Shari'ah*. IFI cannot appoint any member of its *Shari'ah* Committee who is in the *Shari'ah* committee of another IFI in the same industry to avoid conflict of interest and ensure confidentiality. Professional ethics, judgment and consistency has to be exercised in ensuring *Shari'ah* compliance. The *Shari'ah* Committee should adopt a structured process to make decisions which must be documented to ensure credibility. The members of the *Shari'ah* Committee must observe the *Shari'ah* rulings issued by the SAC and their actions should not be against those rulings. When a difference of opinion rises, the IFI may ask the SAC for a ruling. The published rulings of the SAC shall be considered in court proceedings during disputes on *Shari'ah* issues regarding IFIs business operations and these rulings will be binding on IFIs.

4.2.6 *Shari'ah* Compliance and Research Functions

There should a strong *Shari'ah* compliance function to be implemented through the review and audit, risk management and internal research functions. Even if a part of these functions is outsourced, the IFI remains responsible for them. The independence, competency, control, management reporting structures and activities of these functions should meet the requirements of the framework.

(a) *Shari'ah* Review

The activities and operations of the IFI must be regularly assessed for *Shari'ah* compliance by qualified *Shari'ah* officers by analyzing the IFI's extent of compliance, corrective actions to rectify non-compliance and controls to prevent recurrences. This principle covers the overall operations and product development process. The *Shari'ah* review process will start by planning the program in terms of its objectives, scope, reporting, rectification and follow-up actions followed by the execution of the program. Then the process will be documented and the results communicated to *Shari'ah* committee and management. Any non-compliance needs to be corrected.

(b) *Shari'ah* Audit

Shari'ah audit is the periodic assessment to provide independent and objective assurance on the degree of compliance and to ensure a

robust internal control system for *Shari'ah* compliance. Internal auditors with relevant knowledge and qualification shall perform the audit. It may be conducted for specific areas, depending on the risk level and material impact of *Shari'ah* non-compliance in these areas. *Shari'ah* audit on critical areas should be conducted at least once a year.

The Board Audit Committee, after consulting with the *Shari'ah* Committee determines the deliverables of the *Shari'ah* audit function. The deliverables should comply with accepted auditing standards. The *Shari'ah* audit will cover all aspects of the IFI's business operations and activities, including financial statements, organizational structure, people, process and information technology application systems and the *Shari'ah* governance process. The process will also allow the IFI to decide whether a sound and effective internal control system for *Shari'ah* compliance has been implemented. The internal control system should cover understanding the business activities of the IFI to allow development of comprehensive scope of audit activity; developing a comprehensive internal audit program; obtaining and making references to relevant sources; conducting *Shari'ah* audit on a periodical basis; communicating results and providing recommendations. The *Shari'ah* Audit may be conducted by an external party and the IFI shall bear the related expenses.

(c) *Shari'ah* Risk Management

Shari'ah risk management is the function of identifying and managing *Shari'ah* non-compliance risks to allow IFIs to operate smoothly without exposure to unacceptable levels of risk. The *Shari'ah* risk management control function will be a part of the IFI's integrated risk management framework. This technical and complex function is to be performed by qualified and experienced risk officers. *Shari'ah* risk management function involves facilitating the identification and management of *Shari'ah* non-compliance risk; identifying controls in place to mitigate such risk; analyzing impact of such risk; monitoring the management and placing controls to prevent recurrence; formulating appropriate policies and implementing processes for risk awareness in the IFI.

(d) Shari'ah Research

An internal unit of qualified *Shari'ah* officers will not only ensure *Shari'ah* compliance, they will also approve products, research, study issues to be submitted and perform administrative and secretarial tasks related to the *Shari'ah* Committee. The *Shari'ah* research function will be performed by qualified *Shari'ah* officers who will conduct in-depth research on *Shari'ah* issues to provide advice and consultancy when required based on the decision of the *Shari'ah* Committee. Advice can be taken from professionals with expertise on technical issues e.g. actuaries to ensure proper understanding of the concepts.

(e) Shari'ah Secretariat

IFI should appoint a secretariat to serve the *Shari'ah* Committee who will coordinate meetings, compile proposal papers, communicate *Shari'ah* decisions to relevant stakeholders and engage with relevant parties.

4.3 Turkey

Islamic banking known as “participation banking” in Turkey started in 1985. Although it started at almost the same time as other Muslim countries, it has not been as successful comparatively. At first Islamic banks in Turkey were called “Special Finance Houses” (SFHs) to prevent any reference to *Shari'ah* compliance because of secular environment in the country. Due to the political culture, Islamic finance industry grew very gradually and so fell behind in following global practices of the industry. In 2002, the Justice and Development Party came into power. This proved to be a turning point because this party had a strong bond with Islamic values. In 2005, a new banking law was introduced which established a more robust legal framework and changed the name of Special Finance Houses to participation banks (PBs).³¹

Between 2014 and 2015, a major hurdle disturbed the

³¹ Halit Yanikkaya and Yasar Ugur Paguccu, “Causes and Solutions for the Stagnation of Islamic Banking in Turkey”, *ISRA International Journal of Islamic Finance*, 9(1), (2017), 43-61.

Islamic banking sector. Bank Asya, the leader of the market was playing a role in the Gulenist movement. Large numbers of depositors withdrew their funds because of this relation. Bank Asya rejected to share information about its privileged shareholders and its control was transferred to the Saving Deposit Insurance Fund in 2015. This event had a significant impact on Turkey's total market share. Recently, two state banks Ziraat Bankasi and Vakiflar Bankasi, established Islamic banking subsidiaries in 2015 and 2016, respectively. Islamic banking industry in Turkey still has a lot of potential to grow. The change in market share over the years has been stagnant compared to other countries.

Shari'ah governance and compliance issues remain grey areas for Turkey. There is absence of a national *Shari'ah* Board in Turkey. IFIs set up their own advisory boards and there are no rules and regulations regarding the setting up, function, roles and responsibilities of the board. Attempts are underway to establish a national advisory board for Islamic banking and for setting up a *Shari'ah* governance framework for those banks and to increase instrument variety and improve education. Meanwhile, an informal advisory board has been formed under the Participation Banks Association of Turkey. Considering the absence of a standardized framework the need for such a framework is high³².

4.4 Indonesia

Indonesia is the world's most populous Muslim nation. In Indonesia laws for Islamic Banking were introduced in 1992 and further reviewed in 1999. The Act of the Republic of Indonesia Number 21 issued in 2008 is concerned with Islamic Banking³³ This act has provided legal support to the development of Islamic banking in

³² Darren Stubing, "Turkey's Islamic Banking System, (2017, Oct. 2), accessed September 30, 2018, <https://www.gfmag.com/magazine/october-2017/turkeys-islamic-banking-system>.

³³ Rihab Grassa, "Shari'ah Supervisory Systems in Islamic finance Institutions Across the OIC Member Countries: An Investigation of Regulatory Frameworks", *Journal of Financial Regulation and Compliance*, 23(2), (2015), 135-160.

Indonesia and resulted in growth of the industry. The annual average asset growth was more than 65% in the last five years, so the role of Islamic banks in the economy of Indonesia is growing rapidly. Indonesia follows a dual banking system whereby Islamic banking and conventional banking systems operate in parallel to mobilize funds of the public and foster financial capability³⁴.

Indonesia's Islamic finance industry currently consists of 12 general *Shari'ah* banks, 22 Islamic units of conventional banks, 58 takaful operators, and 163 *Shari'ah* people's credit banks, around 5,500 rural cooperatives, seven Islamic finance-based investment firms, an Islamic microfinance portal and even one *Shari'ah*-compliant pawn shop. Indonesia has the highest numbers of Islamic banking institutions. Indonesia's Islamic finance industry had a market share of 5.3% of the country's total banking assets as of 2016 which is very low compared to other Muslim countries. Indonesia's Islamic finance industry has a customer base of only 23mn customers out of a total population of around 260mn. It suffers a low market share mainly because there are no big Islamic banks with a strong brand name and there is an underdeveloped Islamic banking infrastructure³⁵.

In the *Shari'ah* governance system of Indonesia, there is a *Shari'ah* supervisory regulatory framework at both the institutional and national level. The national level setting is known as the National *Shari'ah* Council (DSN) and the one at institutional level is known as *Shari'ah* Board (SB). DSN was first formed in 1999 by Indonesian Council of Ulemas. The members of the DSN are appointed by Ministry of Religious Affairs. The DSN is an independent body which has the responsibility to issue *Shari'ah* rulings on products and services offered by IFIs. The body helps Bank Indonesia, the central bank of Indonesia, in understanding the fatwas of Ulemas of

³⁴ Bank Indonesia (BI), "Sharia Banking: Islamic Banking in Indonesia in Brief", accessed on September 30, 2018 <https://www.bi.go.id/en/perbankan/syariah/Contents/Default.aspx>.

³⁵ Arno Maierbrugger, *Gulf Times*, "Indonesia takes big step towards boosting Islamic finance industry", (2017, August 1), accessed on September 30, 2018 <https://www.gulf-times.com/story/558660/Indonesia-takes-big-step-towards-boosting-Islamic->

Indonesia regarding Islamic banking, implementing the fatwas into Bank Indonesia's regulations and working for development of the Islamic finance industry. The central bank issues regulations based on the fatwas of DSN³⁶. There must be no more than 11 members who play a supervisory role.

On the institutional level, every IFI is required to establish a SB to ensure *Shari'ah* compliance of IFI's operations. Bank Indonesia has also established proper criteria for appointment of new members to the Board which includes understanding and knowledge of *Shari'ah*, Islamic banking, *fiqh mu'amalat* and law. The members are appointed by the General Meeting of shareholders on recommendation of the Indonesian Ulama Council. In Indonesia, members of the SB are only allowed to be members of SB at no more than two others banks and two IFIs simultaneously. Every six months, SB has to submit an independent report on the results of *Shari'ah* supervision to the BOD, the Board of Commissioners, the National *Shari'ah* Council and Central Bank. The duration of term of SB members is 2 years and can be renewed two times. The remuneration of members is determined by the BOD³⁷.

4.5 Kingdom of Saudi Arabia (KSA)

Saudi Arabia is the largest economy in the Gulf Cooperation Council (GCC) region. The Kingdom of Saudi Arabia has a number of dedicated Islamic Banks, as well as Islamic windows of conventional banks. Saudi Arabia is home to one of the leading Islamic finance markets which is of systemic importance according to the IFSB Stability Report of 2016. Islamic banking assets represent around 50% of banking assets within the Kingdom³⁸. The Islamic banking industry has been showing a strong fundamental performance in

³⁶ Rihab Grassa, "*Shari'ah* Supervisory System in Islamic Financial Institutions: New Issues and Challenges: A Comparative Analysis Between Southeast Asia Models and GCC Models", *Humanomics*, 29(4), (2013), 333-348.

³⁷ Rihab Grassa, "*Shari'ah* Supervisory Systems in Islamic finance Institutions across the OIC", op. cit.

³⁸ Gerald Ambrose, *Islamic Finance*, "Saudi Arabia Bank Deposits Turn Negative" (2016, October 1), <https://www.islamicfinance.com/2016/10/saudi-arabia-bank-deposit-turns-negative/>, accessed on September 30, 2018.

terms of revenue generation, assets growth and net profitability. Recently published reports by Fitch, Moody's and Standard & Poor's (S&P) all assured a stable outlook for the Saudi Arabian banking system. Strong supervision by regulating bodies, ideal operating environment, strong operational efficiency and a solid deposit base are important features of the Saudi Arabian banking system³⁹.

Although there is no comprehensive *Shari'ah* governance framework, KSA follows a decentralized *Shari'ah* governance system where each Islamic Bank has its own *Shari'ah* Board which makes decisions about *Shari'ah* compliance. There is no national SB. The SB of Islamic banks follow the *Shari'ah* standards of the Islamic Fiqh Academy. The SB in Islamic banks in KSA issue fatwas and *Shari'ah* review is carried out by the *Shari'ah* review committee. The members of the SB are appointed by nominations from the Islamic banks⁴⁰.

4.6 Cross Country Comparisons of *Shari'ah* Governance Frameworks

A comparison of cross-country *Shari'ah* governance frameworks is summarized in table 1.

³⁹ Fayaz Ahmad Lone and Salim Alshehri, "Growth and Potential of Islamic Banking in GCC: The Saudi Arabia Experience", *Journal of Islamic Banking and Finance*, 3(1), (2015, June), 35-43.

⁴⁰ Hichem Hamza, "*Shari'ah* Governance in Islamic Banks: Effectiveness and Supervision Model", *International Journal of Islamic and Middle Eastern Finance and Management*, 6(3), (2013), 226-237.

Table 1.

	Pakistan	Malaysia	Turkey	Indonesia	Saudi Arabia
Central Bank	State Bank of Pakistan (SBP)	Bank Negara Malaysia (BNM)	Central Bank of the Republic of Turkey (CBRT)	Bank Sentral Republik Indonesia (BI)	Saudi Arabian Monetary Authority (SAMBA)
National <i>Shari'ah</i> Authority	Central <i>Shari'ah</i> Board at SBP known as <i>Shari'ah</i> Advisory Committee (SAC)	<i>Shari'ah</i> Advisory Committee (SAC) in BNM	No National <i>Shari'ah</i> Authority yet. It is likely that an advisory board will be formed under the Participation Banks' Association of Turkey (PBAT)	National <i>Shari'ah</i> Council (DSN) is an independent body, not under Central Bank	No National <i>Shari'ah</i> Board
<i>Shari'ah</i> Governance requirement for Islamic Financial Institutions	Islamic Banks must have <i>Shari'ah</i> Supervisory Board (SSB).	<i>Shari'ah</i> Committee is required for all IFIs.	There is no legal requirement for Islamic banks to establish <i>Shari'ah</i> boards.	<i>Shari'ah</i> Supervisory Board is required for IFIs.	<i>Shari'ah</i> governance of IFIs is not required by law. <i>Shari'ah</i> Boards are formed optionally.
Conformity with AAOIFI <i>Shari'ah</i> Governance standards	Takes guidance from AAOIFI <i>Shari'ah</i> standards and Central Bank is implementing AAOIFI <i>Shari'ah</i> Standards in phase manner.	Doesn't follow AAOIFI <i>Shari'ah</i> standards	Doesn't follow AAOIFI <i>Shari'ah</i> standards	Doesn't follow AAOIFI <i>Shari'ah</i> standards	Doesn't follow AAOIFI <i>Shari'ah</i> standards

	Pakistan	Malaysia	Turkey	Indonesia	Saudi Arabia
<p>Appointment of Members of Shari'ah Board in Islamic Banks</p>	<ul style="list-style-type: none"> At least three <i>Shari'ah</i> scholars appointed by the BOD Appointed after written clearance of SBP which will be applied for after approval from BOD Can also invite professionals e.g. accountants to advise the SB on relevant matters. Such members will not have voting rights. Appointed for a period of three years and can only be reappointed after SBP's approval One <i>Shari'ah</i> Board Member is appointed as the RSBM by SB after discussion with management. SB members can be a part of three other <i>Shari'ah</i> Boards in Islamic banks. RSBM shall be appointed on a full-time basis and is not allowed to perform any role in any other IBI in Pakistan. He can serve as a member of <i>Shari'ah</i> Board of a maximum of two other IFIs after approval from its SB. 	<ul style="list-style-type: none"> The Board of Directors of IFIs, on recommendation from its Nomination Committee, appoints the <i>Shari'ah</i> Committee members for two years. The appointment and reappointment need written approval from BNM. Members proposed of SC should have qualification in <i>mu'amalat</i> and Islamic jurisprudence (<i>usul al-fiqh</i>) Minimum of three members required. Member of SAC cannot serve in a bank's SC. 	<ul style="list-style-type: none"> No specifications in terms of the number of <i>Shari'ah</i> scholars that can sit at <i>Shari'ah</i> boards of participation banks. Members are appointed by each participation bank Include leading religious scholars, academic or otherwise, who have special interest in <i>mu'amalat</i> or Islamic financial transactions. Decisions of the Fatwa Council of the Presidency of Religious Affairs are not legally binding or institutional. 	<ul style="list-style-type: none"> Appointed by the General Meeting of shareholders on recommendation of the Indonesian Ulama Council. Can be minimum two and maximum five <i>Shari'ah</i> Board members. Members of are only allowed to be members of SB at no more than two others banks and two IFIs simultaneously. Duration of term of SB members is 2 years and can be renewed two times. Members should have understanding and knowledge of <i>Shari'ah</i>, Islamic banking, <i>fiqh mu'amalat</i> and law. 	<ul style="list-style-type: none"> Not bound by rules. Members are appointed by Islamic banks themselves

	Pakistan	Malaysia	Turkey	Indonesia	Saudi Arabia
<p>Duties and Responsibilities of the <i>Shari'ah</i> Board of Islamic Financial Institutions</p>	<ul style="list-style-type: none"> Decides and supervises all <i>Shari'ah</i> related matters of the IBI. Has to develop a comprehensive <i>Shari'ah</i> compliance framework for all areas of operations Approves all products or services, documents, manuals, agreements, structures, etc. to check their <i>Shari'ah</i> compliance. Must specify the process to change any rulings previously issued Not allowed to delegate its role to any other person. All decisions and rulings of the SB must conform to all relevant and applicable instructions and guidelines. SB is accountable for all its decisions which must be made after deliberations. 	<ul style="list-style-type: none"> Responsible and accountable for all its decisions, views and opinions on <i>Shari'ah</i> matters. The Board should rely on the <i>Shari'ah</i> Committee concerning all <i>Shari'ah</i> decisions, views and opinions. Must keep an overview of <i>Shari'ah</i> matters related to the institution's business operations and activities. <i>Shari'ah</i> review and audit reports allow the <i>Shari'ah</i> Committee to identify significant issues and their corrective actions. The Committee must also provide sufficient information on extent of compliance in the annual reports. 	<ul style="list-style-type: none"> There are no specific roles and responsibilities. <i>Shari'ah</i> Board plays an advisory or supervisory role where present. 	<ul style="list-style-type: none"> SB has to ensure <i>Shari'ah</i> compliance. SB has to submit an independent report on the results of <i>Shari'ah</i> supervision to the BOD, the Board of Commissioners, the National <i>Shari'ah</i> Council and Central Bank biannually. 	<ul style="list-style-type: none"> The SB of Islamic banks makes decisions about <i>Shari'ah</i> compliance. Issue fatwas and <i>Shari'ah</i> review is carried out by the <i>Shari'ah</i> review committee.

	Pakistan	Malaysia	Turkey	Indonesia	Saudi Arabia
<p>General Shari'ah Governance Guidelines</p>	<ul style="list-style-type: none"> • IFIs should have a robust mechanism in place to allow the BOD to overview the IBI's <i>Shari'ah</i> compliance environment. • When implementing the SGF, IFIs should also focus on accountability of management and staff. • An independent and effective <i>Shari'ah</i> Board should be chosen after screening through proper criteria. One member of the board is appointed as the Resident <i>Shari'ah</i> Board Member (RSBM). • A <i>Shari'ah</i> Compliance Department should be in place to assist <i>Shari'ah</i> Board and to form a link between the <i>Shari'ah</i> Board and the management of an Islamic Banking Institutions (IBIs). • There must be a mechanism to review <i>Shari'ah</i> compliance to analyze the extent of practical effectiveness of the framework devised by the <i>Shari'ah</i> Board and BOD. • Every IFI should have an Internal <i>Shari'ah</i> Audit Unit (ISAU) which can be separate or a part of the existing audit department. • To develop new and innovative products and departments, there should be a product development (PD) department. • The external <i>Shari'ah</i> Audit and annual audit will be done together. 	<ul style="list-style-type: none"> • The board is ultimately responsible for the establishment of an appropriate <i>Shari'ah</i> governance framework of an IFI. • A <i>Shari'ah</i> Committee with qualified members who are able to deliberate Islamic finance issues brought before them and provide sound <i>Shari'ah</i> decisions. • Effective management responsibilities in providing adequate resources and capable manpower support to every function involved in the implementation of <i>Shari'ah</i> governance. • An internal <i>Shari'ah</i> review that is conducted on a continuous basis, which is a review of processes and deliverables. • A regular <i>Shari'ah</i> audit, at least on an annual basis, verifying that the IFI's key functions and business operations comply with <i>Shari'ah</i>. • <i>Shari'ah</i> risk management process to identify all possible <i>Shari'ah</i> non-compliance risks and, where appropriate, remedial measures that need to be taken to reduce the risk; • An internal <i>Shari'ah</i> research team to conduct research on <i>Shari'ah</i>. • Issuance and dissemination of <i>Shari'ah</i> decisions to the relevant stakeholders. 	<ul style="list-style-type: none"> • The Presidency of Religious Affairs operates a Fatwa Council to respond to issues commercial, business and finance issues. • Their judgements do not have any formal implications on the operations of participation Banks in Turkey. 	<ul style="list-style-type: none"> • The central bank issues regulations based on the fatwas of DSN. • The DSN issues <i>Shari'ah</i> rulings on products and services offered by IFIs. • It also helps Bank Indonesia in understanding the fatwas of Ulemas of Indonesia regarding Islamic banking, implementing the fatwas into Bank Indonesia's regulations and working for development of the Islamic finance industry. 	<ul style="list-style-type: none"> • They follow the <i>Shari'ah</i> standards of the Islamic Fiqh Academy.

5.0 Conclusion and Recommendations

A robust and comprehensive *Shari'ah* governance framework plays a key role in the development and growth of Islamic finance industry by not only acting as an extra layer of governance (above corporate governance) but also ensures credibility to its clients. It is based on transparency, trust, ethical behavior, credibility, values and beliefs underlying faith⁴¹. Inefficient *Shari'ah* governance system can have adverse consequences for the industry.

The *Shari'ah* governance system varies from country to country. The comparison of the frameworks in five countries found various gaps in those countries' current *Shari'ah* governance practices. Most of these shortages are related to the current regulatory frameworks, the roles and responsibilities of the national *Shari'ah* authority and the duties of the institutional *Shari'ah* Board. Malaysia and Pakistan have a robust *Shari'ah* governance framework at both the national and institutional level. Roles, responsibilities and specifications have been outlined for all the major divisions in IFIs. The central bank in these countries is working towards the effective implementation of the framework. While Indonesia, is trying to implement a framework similar to Malaysia, a lot of work is yet to be done in the area of *Shari'ah* governance. There is a framework at both the national and institutional level but more thoroughness is required. The rules and principles for various organs of IFIs need to be outlined. Turkey is focusing on establishing a strong and resilient *Shari'ah* governance framework but there is a dire need for a national *Shari'ah* authority to ensure effective *Shari'ah* governance. Such an authority once formed, can enforce the requirement of *Shari'ah* boards in IBs. KSA lags behind in *Shari'ah* governance due to the absence of *Shari'ah* authority at both the national and institutional level. Considering the *Shari'ah* standards of Islamic Fiqh Academy, a comprehensive and customized *Shari'ah* governance framework needs to be developed in KSA. The research shows that there is need for continuous improvement of the *Shari'ah* governance framework across the countries.

⁴¹ Samy Nathan and Vincent Ribiere, "From Knowledge to Wisdom: The Case of Corporate Governance in Islamic Banking", *The Journal of Information and Knowledge Management Systems*, 37(4), (2007), 471-483.

A standardized *Shari'ah* governance framework needs to be established worldwide for the global Islamic finance industry. For this to be made possible national *Shari'ah* authorities need to improve their role of monitoring and ensuring a comprehensive governance system in IFIs. The existing framework needs to be continuously revised to remain updated and applicable to the growing and changing Islamic finance industry. Of the five countries, only Pakistan is using the AAOIFI *Shari'ah* standards for guidance in its own framework. International and national Islamic financial organizations need to collaborate to identify ways to fill gaps and standardize an effective and efficient *Shari'ah* governance system.



AL-SHAJARAH

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WoS-Indexed under *Arts & Humanities Citation Index, Current Contents/Arts and Humanities* and **Scopus**

ISSN 1394-6870



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