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Organization of Islamic Cooperation (COMCEC)**

**Improving Shariah Governance Framework in Islamic Finance**

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## **LIST OF ABBREVIATIONS**

<b>AAOIFI:</b>	Accounting and Auditing Organization for Islamic Financial Institutions
<b>ACE:</b>	Advisory Committee of Experts
<b>ANZ:</b>	Australia and New Zealand
<b>BAC:</b>	The Board Audit Committee
<b>BAFIA:</b>	Banking and Financial Institutions Act
<b>BCBS:</b>	Basel Committee on Banking Supervision
<b>BCMC:</b>	Borneo Centralized Monitoring Centre
<b>BIS:</b>	Bank of International Settlements
<b>BIST:</b>	The Borsa Istanbul
<b>BLME:</b>	Bank of London and the Middle East
<b>BNM:</b>	Bank Negara Malaysia / Central Bank of Malaysia
<b>BNSP:</b>	The National Professional Certificate Institution
<b>BOD:</b>	Board of Directors
<b>BRSA:</b>	Banking Regulation and Supervision Agency
<b>CAC:</b>	Corporate Affairs Commission
<b>CBUAE:</b>	Central Bank of the United Arab Emirates
<b>CBB:</b>	Central Bank of Bahrain
<b>CBN:</b>	Central Bank of Nigeria
<b>CBUAE:</b>	The Central Bank of the United Arab
<b>CDC:</b>	Central Deposit Certificates
<b>CG:</b>	Corporate Governance
<b>CIA:</b>	Certified Internal Auditor
<b>CIBAFI:</b>	General Council for Islamic Banks and Financial Institutions
<b>CMB:</b>	Capital Markets Board
<b>COMCEC:</b>	The Standing Committee for Economic and Commercial Cooperation of the Islamic Cooperation
<b>CSR:</b>	Corporate Social Responsibility
<b>DIFC:</b>	Dubai International Financial Centre
<b>DFSA:</b>	Dubai Financial Services Authority
<b>DIEDC:</b>	The Dubai Islamic Economy Development Centre

<b>DMO:</b>	Debt Management Office
<b>DSN:</b>	Dewan Syariah Nasional / The National Shariah Board
<b>EM:</b>	Executive Management
<b>ESA:</b>	External Shariah Audit
<b>ESCA:</b>	The Emirates Securities and Commodities Authority
<b>FCA:</b>	The Financial Conduct Authority
<b>FSA:</b>	The Financial Services Authority
<b>FRACE:</b>	Financial Regulation Advisory Council of Experts
<b>FSMA:</b>	The Financial Services and Markets Act
<b>GCC:</b>	Gulf Cooperation Council
<b>GDP:</b>	Gross Domestic Product
<b>GSIFI:</b>	Governance Standard for Islamic Financial Institutions
<b>HSA:</b>	The Higher Shariah Authority
<b>IAHs:</b>	Investment Account Holders
<b>IAIS:</b>	International Association of Insurance Supervisors
<b>IBNR:</b>	Incurred But Not Reported
<b>ICD:</b>	Islamic Corporation for the Development of the Private Sector
<b>ICM:</b>	Islamic Capital Markets
<b>IDB:</b>	Islamic Development Bank
<b>IFA:</b>	Islamic Fiqh Academy
<b>IFI:</b>	Islamic Financial Institution
<b>IFIs:</b>	Islamic Financial Institutions
<b>IFR:</b>	Islamic Finance Rules
<b>IFRS:</b>	International Financial Reporting Standards
<b>IFSA:</b>	Islamic Financial Services Act
<b>IFSI:</b>	The Islamic Financial Services Industry
<b>IFSB:</b>	Islamic Financial Services Board
<b>IIFM:</b>	The International Islamic Financial Market
<b>IIAL:</b>	The Islamic Insurance Association of London
<b>IILM:</b>	International Islamic Liquidity Management
<b>IMF:</b>	International Monetary Found
<b>INCEIF:</b>	The International Centre for Education in Islamic Finance

<b>IPRS:</b>	Insurance and Private Pension Regulation and Supervision Agency
<b>IOSCO:</b>	International Organization of Securities Commissions
<b>IRTI:</b>	Islamic Research and Training Institute
<b>ISA:</b>	Internal Shariah Audit
<b>ISCC:</b>	Internal Shariah Control Committees
<b>ISRA:</b>	International Shariah Research Academy
<b>IT:</b>	Information Technology
<b>KGK:</b>	Kamu Gözetim Kurumu / Public Oversight Accounting and Auditing Standards Authority
<b>KNEKS:</b>	Komite Nasional Ekonomi dan Keuangan Syariah / The National Islamic Economy and Finance Committee
<b>LC:</b>	Letter of Credit
<b>MEP:</b>	The Ministry of Economy and Planning
<b>MTF:</b>	Ministry of Treasury and Finance
<b>MUI:</b>	Majelis Ulama Indonesia / The Indonesian Ulama Council
<b>NAICOM:</b>	The National Insurance Commission
<b>NCCG:</b>	The National Committee on Corporate Governance
<b>NDIC:</b>	The Nigerian Deposit Insurance Company
<b>NGOs:</b>	Non-Governmental Organizations
<b>NSA:</b>	National Shariah Authority
<b>NSB:</b>	National Shariah Board / Dewan Syariah Nasional
<b>OECD:</b>	The Organization for Economic Co-operation and Development
<b>OIC:</b>	Organization of Islamic Cooperation
<b>OJK:</b>	Otoritas Jasa Keuangan / The Financial Services Authority
<b>PBs:</b>	Participation Banks
<b>PBAT:</b>	Participation Banks Associations of Turkey / Türkiye Katılım Bankalar Birliği
<b>PENCOM:</b>	The National Pension Commission
<b>PESA:</b>	Public Expenditure Statistical Analyses
<b>PESA:</b>	Center for Political, Economic and Social Research / Politik, Ekonomik ve Sosyal Araştırmalar Merkezi
<b>PIA:</b>	Participants' Investment Account
<b>PIF:</b>	Participants' Investment Fund

<b>PLS:</b>	Profit and Loss Sharing
<b>PRA:</b>	The Prudential Regulation Authority
<b>POAASA:</b>	Public Oversight Accounting and Auditing Standards Authority (Kamu Gözetim Kurumu)
<b>PWC:</b>	Price Waterhouse Coopers
<b>ROSCA:</b>	Rotating Credit and Savings Associations
<b>SAC:</b>	Shariah Advisory Council
<b>SBB:</b>	Strateji ve Bütçe Başkanlığı
<b>SDLT:</b>	Stamp Duty Land Tax
<b>SEC:</b>	The Security and Exchange Commission
<b>SFHs:</b>	Special Finance Houses
<b>SG:</b>	Shariah Governance
<b>SGF:</b>	Shariah Governance Framework
<b>SHF:</b>	Shareholders' Fund
<b>SII:</b>	The Securities and Investment Institute
<b>SSB:</b>	Shariah Supervisory Board
<b>TKBB:</b>	Türkiye Katılım Bankalar Birliği / The Participation Banks Association of Turkey
<b>UAE:</b>	United Arab Emirates
<b>UK:</b>	United Kingdom
<b>USA:</b>	United States of America
<b>USD:</b>	United States Dollar
<b>ZIS:</b>	Zakat Infaq Shodaqoh

## EXECUTIVE SUMMARY

Islamic financial institutions (IFIs) stand out in contrast with conventional financial institutions. They differ in their business nature, as well as in their mechanism and systems of governance, designed to facilitate achieving their objectives. In Islamic finance, the main aim of the system is to comply with Shariah principles, whose rationale has been academically established (Al-Jarhi, 2017). IFIs can benefit from the governance rules internationally developed for conventional finance by international institutions such as the Organization for Economic Co-operation and Development (OECD) and the Basel Committee. A key distinguishing feature of the IFIs is their following of the principles and values of the Islamic corporate governance or Shariah governance. Undoubtedly, this is one of the most important building blocks in maintaining the confidence of shareholders as well as customers.

This study focuses on Shariah governance with an eye on improving Shariah governance frameworks in OIC countries. Besides, the study focuses on institutional development at both the national and international levels. The study starts with surveying the main concepts related to Shariah governance. It reviews the practices of current national and international Shariah governance frameworks within different Shariah governance regimes. It uses semi-structured interviews and a survey of the opinions of Shariah supervisory board (SSB) members to evaluate the self-perception of the Islamic finance industry of the effectiveness of the commonly used Shariah governance systems and procedures. Then, it draws certain policy recommendations based on semi-structured interviews and a survey conducted with Shariah scholars and specialists from 26 OIC countries and the UK to improve the Shariah governance structure both at the national and international levels.

The study surveys the theoretical and legal nature of the Shariah governance framework (SGF) in different jurisdictions. It reviews the current size and trends, modes, and instruments of Islamic finance special focus to SGF. In addition, it compares various models of implementation of SGF regimes, roles, and responsibilities of SSB. The selected countries' studies focus on the Shariah governance framework with special attention to the strength and weaknesses of the different Shariah governance models and providing case studies for Shariah non-compliance risk raised by the difference application/misinterpretations of the Islamic financial products.

Based on the analysis of such frameworks, the study provides concrete policy recommendations to policymakers in the OIC member countries, particularly taking into consideration the lessons learned from the best practices.

Conceptually, the Shariah governance system includes several elements. First, it starts with certain institutional, organizational arrangements, and procedures. Second, it must provide for an effective and independent Shariah supervision, supported by an internal Shariah compliance review. Third, the system must provide for issuing decisions and expert opinions related to the work of IFIs publicly. Fourthly, for the sake of harmony and uniformity of Islamic finance products, the aspect of dissemination of information to stakeholders on expert opinions and other decisions related to the Shariah, banking, and economics of Islamic finance operations must be included.

The OIC countries' Shariah governance regimes are classified according to the following factors: (i) The existence of a proper legal and/or regulatory framework. (ii) Having a robust Shariah governance structure and processes. (iii) Establishing SSB (centralized) at the national level. (iv) Establishment of an SSB at an institutional level, (v) External Shariah audit, (vi) Regulatory Shariah audit. Hence, IFIs are required to establish a Shariah control system to ensure the effective management of Shariah non-compliance risk in all aspects of their business transactions and operations.

The following six countries were selected as samples for in-depth case studies to analyze the improvement of the Shariah governance in Islamic financial institutions. The sample includes five OIC member countries: 1) Malaysia, 2) Turkey, 3) Indonesia, 4) Nigeria, 5) United Arab Emirates (UAE), and a non-OIC member country: United Kingdom (UK).

## **Key Recommendations and Responsible Stakeholders**

### **Institutional and National Shariah Supervisory Boards**

- (i) A national SSB should supervise all Islamic financial enterprises (banking, takaful, capital market, etc.) as an independent institution.
- (ii) SSBs at the institutional level should fall under the direct supervision of the national SSB.
- (iii) The composition of SSBs must have divided among Islamic monetary and financial economists and Shariah scholars.
- (iv) Shariah and economics scholar means having a PhD in the field from an accredited university as well as a track record of graduate teaching and relevant publications in peer-reviewed journals.
- (v) Institutional SSBs should consider the interests of all stakeholders, not just their shareholders or management.
- (vi) SSBs should not be limited to issuing expert opinions. They should have various functions such as ombudsmanship, technical office, product development, etc.
- (vii) SSBs at the national and institutional level must be provided with sufficient support and staff.
- (viii) The appointment and dismissal of both the national and the institutional SSBs members should be within the purview of the monetary supervisory authority, with safeguards that ensure their independence during their uninterrupted service periods.
- (ix) Shariah audit function should be structured as an important part of Shariah governance at the institutional level.

### **Legal & Regulatory Environment**

- (i) A strong/proper Shariah governance structure should be developed in the line with Shariah principles as required to improve Islamic finance.
- (ii) To support the implementation of Islamic law, regulators should issue a handbook of Islamic financial products and instruments.
- (iii) The banking law must be amended to include the definitions of all currently known and approved Islamic finance products as well as of all currently known impermissible products.
- (iv) The banking law should also authorize the regulator to add new products once they are approved, including the definitions of impermissible products.
- (v) The financial market law should be amended to contain the definitions of financial instruments. It should stipulate the general rule of prohibiting trade in pure risk and debt.
- (vi) The human resources necessary for good Shariah governance include Islamic monetary and financial economists as well as Shariah scholars. A serious effort must be directed to develop such human resources and employ them in the industry.

### **International Bodies & Standard Setters**

- (i) The regulator should resolve the conflict of rules made by different standard setters.
- (ii) The national SSB should be the ultimate standard setter.
- (iii) Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and Islamic Financial Services Board (IFSB) are well-advised to abide by the followed resolutions of the OIC International Fiqh Academy (IFA).

## **Involving Stakeholders**

- (i) Regulators must set rules to involve investment account holders (IAHs), in the IFI management, in proportion to the contributions they make to the mudaraba/musharaka pools of every IFI.
- (ii) Voting in the general assembly and the board of directors (BOD) must be apportioned between shareholders and IAHs in proportion to their contributed resources.
- (iii) Some of BOD seats should be assigned to the IAHs. It would be preferable to choose such representatives from amongst the holders of the largest accounts in proportion to the resources contributed by this group. However, the body of IAHs should be free to elect their representatives.

## **Islamic Finance and Monetary Policy**

For the purpose of facilitating the proper choice of short-term investments of mudaraba funds, and streamlining the Shariah governance rules in this regard as well as making monetary policy more inclusive to both conventional and Islamic financial institutions, the following is proposed:

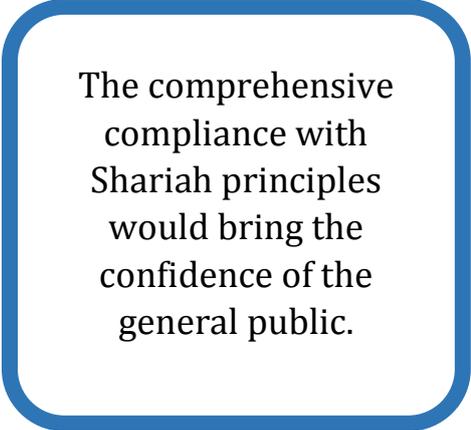
- (i) The monetary authority should issue an Islamic money-market instrument under the name of the central deposit certificate (CDC). As a start, an initial amount of central deposits (CDs) is to be issued against a proportion of the money supply that is equal to the IFI's share in the assets of the monetary and financial sector. An equal amount would be deposited in an investment account apportioned among all banks, owned and managed by the monetary authority. Its balance would be invested in the real sectors as per the instructions of the monetary authority.
- (ii) The monetary authority may wish to form a national investment priority committee with representatives of the ministries of finance, treasury, economy, and planning to set national priorities. An equal amount of the issued CDCs should be extinguished from the money supply through an increase in the legal reserve ratio.
- (iii) IFI's obtaining a share of central deposits should have an opportunity to train their relevant staff in investing CDs in Shariah-compliant investments, using products listed in the Islamic products handbook issued by the monetary authority.
- (iv) The monetary authority would set the instructions which seem fit to control the investment of central deposits. Such would set investment priorities and sectorial allocations to fulfill economic policies.
- (v) Changing the money supply would continue to be made through conventional means within the share of conventional finance in monetary and financial assets. The remaining part could be managed by increasing the monetary base against more CDCs. Besides, fine-tuning of the money supply can be done within the IFIs share through open market operations in CDCs.
- (vi) The rate of monetary expansion in the Islamic finance sector can be set equal to the rate of growth, estimated through the use of the CDCs rate of return. The required increase in the money supply can be apportioned between the Islamic and the conventional sector in proportions of their respective shares in monetary and financial assets.

# 1. INTRODUCTION

## 1.1. STUDY BACKGROUND

The emergence of the Islamic finance industry and its rapid developments have been a part of the attempt to respond to the requirements of the completeness of Islamic law as a way of life. Islam covers various aspects of human life, including economic activities, educational development, and social behavior. Each one of these aspects of human life cannot be treated in isolation from the rest.

The development of the Islamic financial system is a clear manifestation of the Islamic world strives to regain its way of life, as delineated by the Islamic law. In other words, Shariah or Islamic law provides the main principles of economic transactions and activities, since the Islamic law is not restricted to the relationship with Allah, but it extends to encompass all aspects of human life including economic transactions and dealings among human being.



The comprehensive compliance with Shariah principles would bring the confidence of the general public.

One of the most important aspects, which govern these economic activities in the Islamic financial system, is Shariah governance which is the main component in building and maintaining the confidence of the stakeholders in this financial system to comply with the Shariah principles at all times. In parallel with the rapid growth of the Islamic finance sector worldwide and the complexity of the duties and responsibilities of the key organs of corporate governance towards different stakeholders, there must be a proper and good Shariah governance system. This system aims to enhance and strengthen the function of the BOD, management, Shariah committees, and other related institutions to comply with Shariah. This comprehensive compliance with Shariah principles would strengthen the confidence of the general public and the financial markets towards the credibility of Islamic financial operations. Also, a robust Shariah governance regime can ensure Shariah compliance in IFIs.

Shariah non-compliance risk which is an intrinsic risk type to the IFIs may arise because of the non-Shariah compliance activities. Therefore, Shariah governance is vital not only for Islamic banks but also for all IFIs as a whole, which serves the public with different ranges of products. The best practices of current national and global Shariah governance framework vary within the different Shariah governance regimes. This report will present a detailed explanation regarding the current status of corporate and Shariah governance in OIC countries and analyze them with a different methodology. Furthermore, this report suggests policy recommendations to OIC member countries to have favorable and a well-organized Shariah governance framework to further facilitate and accelerate the development of Islamic finance.

## 1.2. AIMS, OBJECTIVES, AND SCOPE OF THE STUDY

The main objective of this study is to provide an analysis of the following items:

- (i) Theoretical and legal nature of the Shariah governance framework in Islamic finance, including the interpretation of various schools of thought.
- (ii) Detailed analysis of the current size and trends, structures, modes, and instruments of Islamic finance, with a special focus on the Shariah governance framework.
- (iii) Various models of implementation of Shariah governance framework/regimes, roles, and responsibilities of SSBs.

- (iv) Country analysis for the selected countries on the Shariah governance framework and specific focus on the strength and weaknesses of the different Shariah governance models, based on case studies for Shariah non-compliance risk raised by the difference application/misinterpretations of the Islamic financial products.

Based on the analysis within this framework, the study also provides concrete policy recommendations to the OIC member countries particularly taking into consideration the lessons learned from the best practices.

### 1.3. METHODOLOGY

This report uses a comprehensive approach to collect data and do the required analysis. It runs at different stages. At the initial stage, primary and secondary data is collected, in addition to reviewing the case studies. At the following stage, a synthesis comprising conclusions and recommendations based on the obtained information is composed. Meanwhile, the literature review is used to build a comprehensive framework for the Shariah governance analysis to discover the best practices in the industry. The surveys include both structured questionnaires and semi-structured interviews.

The survey contains (19) nineteen questions about the Shariah governance framework in OIC member countries and case studies of some OIC member countries as well as the UK as a non-member country in OIC. In particular, the questionnaire attempts to survey the perspective of industry insiders regarding Shariah governance, and to what extent they recognize gaps and the need to fill them.

The first section of the questionnaire rates the effectiveness and impact of the SGF in different jurisdictions, while the second section raises the issues of the effectiveness, independence, and transparency of the SSB in every jurisdiction. The third part covers the financial information of the institution, and how they spend their impermissible income. The fourth queries about the SSB roles and responsibilities, and other issues like their appointment, remuneration, competencies, and skills. The fifth and last part of the questionnaire concludes with the challenges and obstacles of the Shariah governance framework.

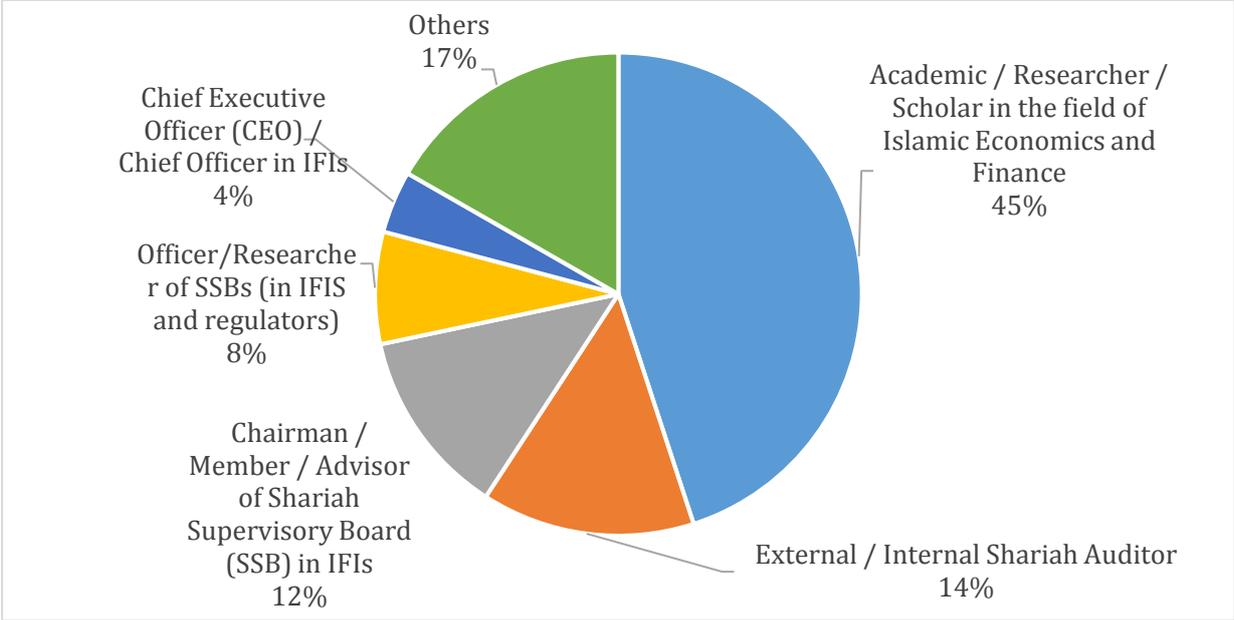
Besides, we have translated the survey into Arabic and Turkish in order to increase the potential responses from Shariah scholars and other related stakeholders. In addition to case study county interviews, we interviewed through open-ended interview questions more than one hundred SSB members, Islamic finance experts, and Shariah scholars from OIC countries and the UK, about their views for improving the Shariah governance framework across jurisdictions. The following table provides detailed responses by countries and regions.

**Table 1: Respondents by Regions and Countries**

Region	Groups	Countries	Number of responses
<b>OIC Countries</b>	Arab Region	Palestine, Iraq, Bahrain, Algeria, Jordan, Morocco, Oman, Qatar, Saudi Arabia, Somalia, Sudan, Syria, UAE, Yemen, Kuwait, Tunisia	60
	Asian Region	Afghanistan, Indonesia, Malaysia, Pakistan, Turkey, Brunei Darussalam, Maldives	51
	African Region	Nigeria	7
<b>Non-OIC</b>	Non-OIC Countries	United Kingdom	6
<b>TOTAL</b>			<b>124</b>

Source: Authors

**Figure 1: Profile of Respondents**

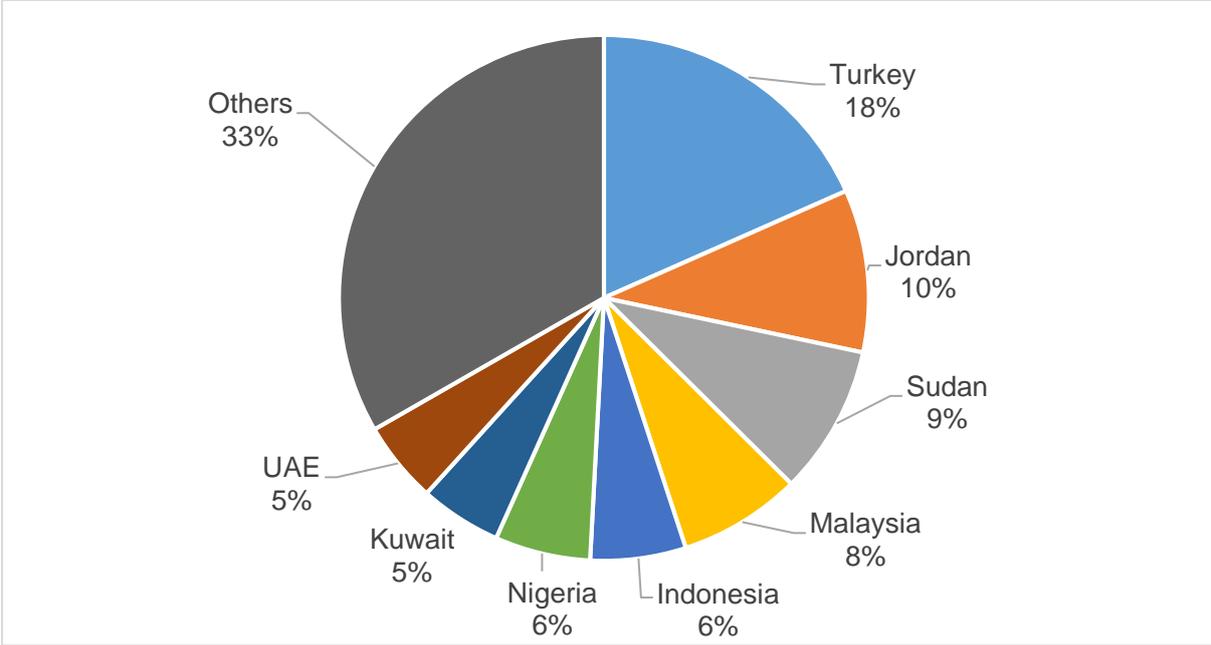


Source: Authors

From figure 1, as respondents are directly related to IFIs, their opinions represent the inside perception of the industry of itself. In other words, it is an insiders' perception that is merely a mirror picture or a selfie taken by the industry. Almost half of the survey participants are either academics, researchers, or scholars in the field of Islamic economics and finance. The survey participants (figure 1) reported 16 different positions. In general, there were more than 124 participants from 26 countries responded to the questionnaire. One-third of the participants were from Turkey, Jordan, and Malaysia.

124 participants from 26 countries responded to the questionnaire. One-third of the participants were from Turkey, Jordan and Malaysia.

**Figure 2: Countries of the Survey Participants**



Source: Authors

The report uses case studies of five OIC countries (Malaysia, Nigeria, Turkey, Indonesia, and the United Arab Emirates) and one non-OIC country (the United Kingdom) to provide an in-depth examination of the developments in promoting Islamic finance governance. Different criteria are used for determining countries for case studies. Firstly, to ensure regional diversification, countries from three OIC regions (Africa, Arab and Asian countries) are included. Secondly, the report assures the representation of countries that have different levels of development. Thirdly, we give due consideration to the size of the Islamic financial industry in relevant countries (table 2, table 3).

**Table 2: Selected Case Study Countries According to Their Islamic Finance Development Level**

Infancy	Developing	Matured
Nigeria	Indonesia Turkey UK	Malaysia UAE

Source: Authors

**Table 3: Selected Case Study Countries According to Their Regional Diversity**

Region	Asia	Arab	Africa	Europe
<b>OIC Countries</b>	Malaysia Indonesia Turkey	UAE	Nigeria	
<b>Non-OIC Countries</b>				UK

Source: Authors

The detailed selection criteria regarding case study countries were as following:

### **Malaysia**

- ✓ It has a comprehensive Shariah and corporate governance framework, which is claimed to be among the most-developed Islamic finance systems in the world.
- ✓ It is the frontrunner of Islamic finance in the region of Southeast Asia. It has established an infrastructure in order to ensure sustainable growth of Islamic finance, particularly, in areas of product developments, institutional establishment, as well as thought guidance.
- ✓ The enhancement and rapid development of the Islamic finance industry in Malaysia is reinforced by robust regulatory infrastructure and comprehensive Shariah governance created and supported by Bank Negara Malaysia (BNM).
- ✓ The Islamic banking system in the country is considered more advanced than many other Muslim countries implementing a similar system.
- ✓ Malaysia's regulatory and legal framework for Islamic banking and finance has always been referred to as the most comprehensive Islamic financial system in the world.
- ✓ Malaysia provides specific provisions for the detailed roles and functions to be performed by the Shariah supervisory boards.

### **Turkey**

- ✓ It is among the top ten countries in terms of the Islamic financial sector in the world with 82 million populations, of which 98% is Muslim, which means a substantial gap between the potential and actual situation of the Islamic financial sector in the country.
- ✓ There exists an intention officially to increase the share of the Islamic financial sector in the total financial sector. It is planned to increase the share of the Islamic Financial sector from 5% to 15% by 2025. Additionally, one of the main pillars of the Istanbul International Finance Center Project has been announced as Islamic finance as well as Fintech.
- ✓ Besides participation banking, recently, the other Islamic financial sectors such as takaful and sukuk market are developing rapidly in Turkey.
- ✓ There are lots of policy measures regarding the Islamic financial sector to improve its landscape in the Development Plan and the Presidency Annual Program for 2020 of which are two official policy documents in Turkey.
- ✓ Numerous regulations related to Shariah governance have come into force recently in Turkey. For instance, as an autonomous institution, the Central Advisory Board (CAB) was established in 2018 as affiliated to the Turkish Participation Banks Association.

### **United Arab Emirates**

- ✓ The UAE is considered one of the top three Islamic finance markets in terms of the overall development of Islamic finance.
- ✓ It has a Shariah governance model that is different from Asian countries and it is a good representative for the Gulf Cooperation Council (GCC) countries.
- ✓ Recently, it started to follow an improved form (best practices) of the existing models, as it established the High Shariah Authority at the central bank level.
- ✓ Despite the growth of Islamic finance in the UAE and the operation of many full-fledged IFIs and various Islamic windows, there has been a rather reserved regulatory Shariah governance mechanism compared to some OIC members.
- ✓ Dubai IFIs have the option to operate under the Dubai International Financial Centre (DIFC), a financial free zone, regulated by the Dubai Financial Services Authority (DFSA).
- ✓ The UAE follows AAOIFI governance standards. However, there is not much information concerning the application in the IFIs.

## **Nigeria**

- ✓ According to the Central Bank of Nigeria (CBN)(2018b), more than 30% of the adult population is excluded from proper financial services.
- ✓ Nigeria has a large population of about 200 million out of which 51% are Muslims.
- ✓ Due to the size of its population and its developing prospects, Nigeria is becoming the hub of Islamic finance in Africa.
- ✓ There is a big potential in the country, however, there are not adequate case studies related to Islamic financial issues.
- ✓ Nigeria Financial System Strategy 2020 (declared in 2008) aims to develop a robust and integrated financial system in order to make the Nigerian economy as one of the 20th largest economies in the world by the end of 2020.
- ✓ Despite some regulations, existing studies show that IFIs in Nigeria have some practical issues regarding the Shariah governance framework.

## **Indonesia**

- ✓ It has the largest Muslim population with 99% of Muslims (268 million in 2018). However, the development of Islamic finance in Indonesia is moving very slowly. Indonesia competes with Malaysia as a country with a highly developed Islamic financial ecosystem.
- ✓ Indonesia has more regulations pertaining to Islamic finance than any other country but sometimes regulations are split between different regulators.
- ✓ Indonesia's Shariah Advisory Council (SAC), the country's highest Shariah authority in Islamic finance, falls under the jurisdiction of the central bank. Indonesia's Shariah committee is an independent body. In Indonesia, the National Shariah Board, the Islamic Banking Committee, and the Shariah Supervisory Board are all involved in the introduction of any new products or services.
- ✓ There is a lack of data and a limited number of case studies about the practices of Islamic finance in Indonesia.
- ✓ Most of the literature about Islamic finance is in the Indonesian language (Bahasa Indonesia) and not much of it translated into English. Thus, access to this literature is limited.

## **United Kingdom**

- ✓ The UK is the leading western financial center for Islamic finance. London is seen as a growing global hub for Islamic finance.
- ✓ A wide range of supportive regulations policies over the last decade created a financial and regulatory framework intended to increase the market share for Islamic finance in the UK.
- ✓ There are over 20 banks licensed in the UK offering Islamic finance services, five of them are fully Shariah-compliant banks. The London Stock Exchange is considered as the key global place for issuing the sukuk with a total of 57. They have been listed on the London Stock Exchange, which has a total value of \$51bn.
- ✓ With the launch of the Islamic Insurance Association of London (IIAL) in 2015, the UK has set the stage to play a more active role within the global takaful market.
- ✓ The IFIs in the UK have a two-tier board structure consisting of a management board and a Shariah board. It needs to be examined whether if this two-tiered board structure of IFIs is legally unproblematic.
- ✓ The UK Government supports the development of common Shariah standards by international organizations, such as the IFSB and the AAOIFI. The efforts for standardization of Shariah governance could reduce Shariah compliance problems and enable bankers and investors to understand the Islamic financial market.

## **1.4. SUMMARY CONTENTS OF THE STUDY**

### **Chapter 1: Introduction**

This chapter provides a brief outlook on the Shariah governance, and it defines the background of the study, aims, objectives, and methodology of the study as well.

### **Chapter 2: Definition of Shariah Governance Framework**

This chapter defines the Shariah governance or Islamic corporate governance and it discusses the importance of the Shariah governance framework for an Islamic economy, in addition to the structure of the Shariah governance framework in IFIs.

### **Chapter 3: Comprehensive Analyses on Shariah Governance Framework**

This chapter provides comprehensive analyses of the Shariah governance framework. It discusses the current state of the Shariah governance in OIC Countries, IFSB and AAOIFI Shariah governance guidelines, and the Shariah control system and its details.

In addition, it deliberates over SSB and its roles and responsibilities, the issues of consistency of SSB decisions/fatwa nationally, and internationally.

### **Chapter 4: Issues and Challenges in Shariah Governance Framework**

This chapter defines the main issues and challenges facing the Shariah governance framework. Among the discussed issues; the independence of Shariah boards, disclosure, and transparency, consistency, and conflict of interest. Meanwhile, the challenges are divided into structural challenges, regulatory challenges, technical challenges, and lastly, standardization challenges.

### **Chapter 5: Country Case Studies and Survey Analysis**

In this chapter, six countries including one non-OIC country are selected as case studies.

Selected countries are analyzed in detail by focusing on their implementation of Shariah governance in the lights of the findings of the previous chapters considering the legal and regulatory framework as well as current challenges and issues.

### **Chapter 6: Conclusion and Policy Recommendations**

The chapter summarizes the research and survey findings and concludes the discussion of the report with general policy recommendations on the Shariah governance framework in the OIC countries.

Policy recommendations are designed in the form of a roadmap, which the OIC member countries could benefit in their efforts for developing and enhancing their implementation of the Shariah governance framework in their countries.

## 2. SHARIAH GOVERNANCE FRAMEWORK: HISTORY, ROLE & FORM

In this chapter, we take a closer look at the current status of IFIs, before we focus on the principles and historical evolution of their SGF. Our look goes deeper into the economic role, objectives, and structure of IFIs' SGF. We then move to do some comprehensive analysis of the SGF.

### 2.1. THE CURRENT STATUS OF ISLAMIC FINANCIAL INSTITUTIONS

Since IFIs first started to appear in the 1960s, Islamic finance has witnessed significant expansion throughout the world. IFIs managed during the last period to achieve improvements in the local and global markets in terms of expansion, size of assets, the multiplicity of investment tools, and entry into new markets in the world. The development of IFIs from the infrastructural and institutional levels is summarized in table 4.

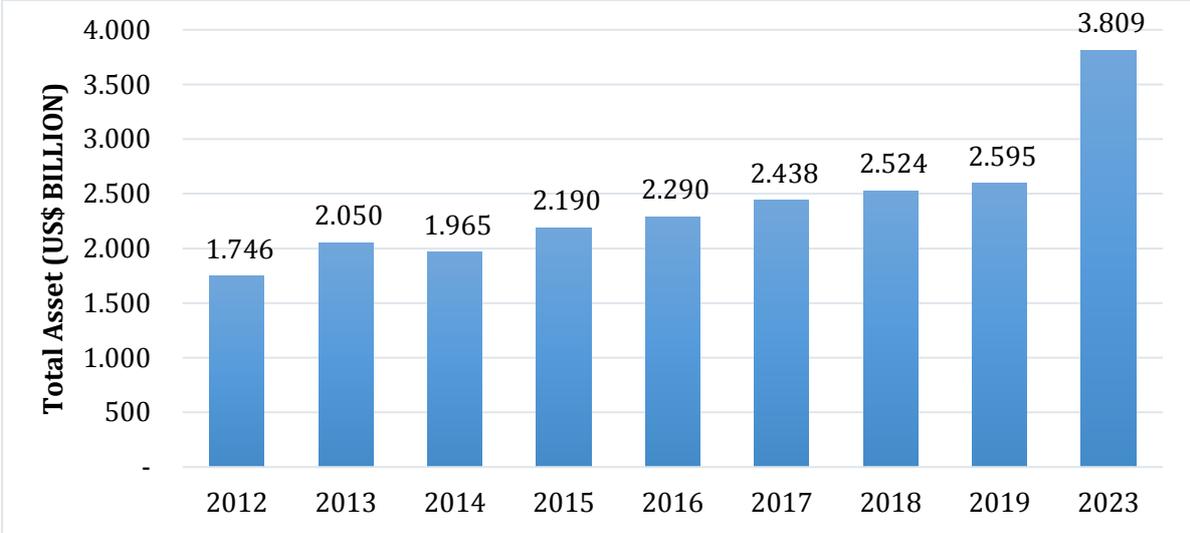
**Table 4: Development of IFIs From the Infrastructural and Institutional Level**

The 1960s	Mit Ghamr Saving Bank (Egypt), Tabung Haji (Malaysia)
The 1970s	Islamic Development Bank (IsDB); Dubai Islamic Bank, (UAE); Kuwait Finance House (Kuwait), Philippines Amanah Bank (Philippines); Faisal Islamic Bank (Egypt and Sudan); Jordan Islamic Bank (Jordan); Sudanese Islamic Insurance Company (Sudan)
The 1980s	Islamic Research and Training Institute (IRTI/IsDB), Al Baraka Islamic Bank (Bahrain), Bank Islam Malaysia (Malaysia), LARIBA Bank of Whittier (USA), Dar al-Mal al-Islami (Switzerland), Australia and New Zealand (ANZ) Global Islamic Finance (UK); Albaraka-Turk (Turkey); Kuveyt-Turk (Turkey); Converting of Conventional Banks into IFIs (Sudan, Pakistan, Iran).
The 1990s	AAOIFI (Bahrain), Bank Muamalat (Indonesia and Malaysia), Islamic Bank of Brunei (Brunei)
The 2000s	General Council for Islamic Banks and Financial Institutions (CIBAFI) (Bahrain), IFSB (Malaysia), International Islamic Liquidity Management Corporation (IILM) (Malaysia), Islamic Bank of Britain (UK), International Islamic Financial Market (IIFM) (Bahrain),
2010-2020	Many new Islamic financial institutions in existence and new markets have been opening up for Islamic Finance such as in Nigeria, Turkey, UK, Kazakhstan, Germany, and Sri Lanka, etc.

*Source: Authors*

The total worth of the Islamic Financial Services Industry (IFSI) has increased to \$2.52 trillion in 2018 compared to the USD 2.05 trillion recorded at the end of 2017 and 3.5 % year on year growth on the back of significant development across the three sectors of Islamic banking, Islamic capital market and takaful (IFSB 2019b; DinarStandard 2019; CIBAFI 2018). Figure 3 shows the growth of Islamic finance assets in the world and future expectations. Islamic finance industry includes so far 1,447 full-fledged Islamic financial institutions and windows.

**Figure 3: Growth of Global Islamic Finance Assets**



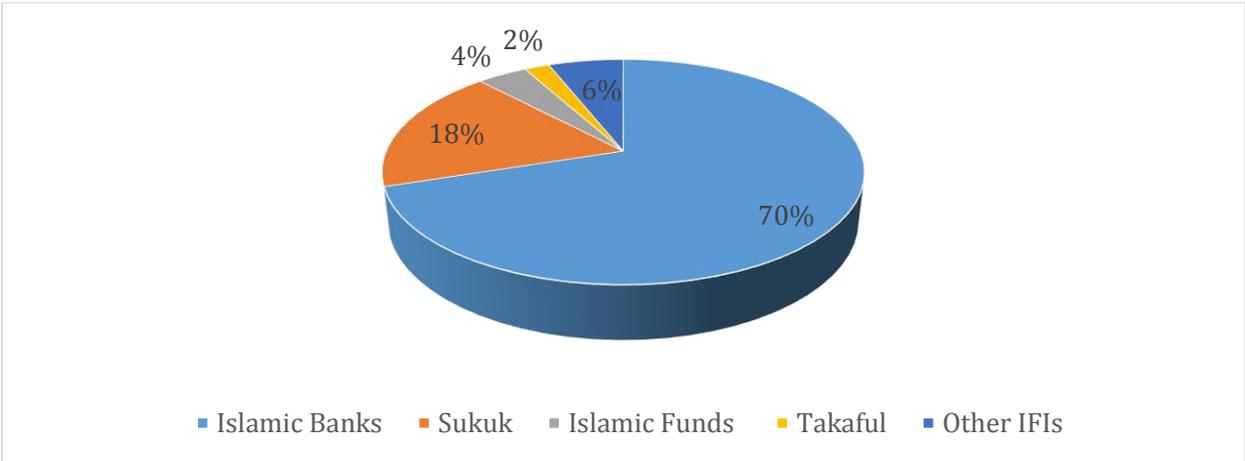
Source: ICD & IFSB & Authors

\* Expectation for 2019 and 2023 is projected according to ICD and IFSB data

With regards to the Islamic capital markets (ICM), the sector accounts for 27% of global IFSI assets, worth about \$591.9 billion. The Islamic sukuk market has achieved 18% global growth in 2018 and it reached \$530.4 billion (IFSB 2019b).

In specific terms, as shown in figure 4, the dominance of the Islamic banking sector is manifested in its share of 70% in total IFSI’s assets in 2018 (\$1,760 Billion), the sukuk market segment’s share of the total worth of the IFSI is 18% (\$470 Billion) in 2018. The Islamic funds and takaful sector’s share of the total worth of the IFSI remain at %4 (\$108 Billion) and 2% (\$46 Billion) respectively in 2018 (ICD 2019).

**Figure 4: Islamic Finance Sector Analysis 2019**



Source: ICD & Authors

## 2.2. THE PRINCIPLES AND HISTORICAL EVOLUTION OF ISLAMIC CORPORATE GOVERNANCE OR SHARIAH GOVERNANCE FRAMEWORK

The issue of corporate governance is one of the important pillars that align companies' work with legal, administrative and regulatory principles. The OECD principles of corporate governance originally adopted by the 30 member countries of the OECD in 1999 have become a reference tool for policymakers, corporations, institutional and regulatory frameworks. The OECD reviewed several times the principles considering the recent changes and related developments. Corporate governance is defined by OECD (2015) as: *"The relationships between a company's management, its board, its shareholders and other stakeholders."* Corporate governance provides the structure through which the objectives of the company are set, and the means of attaining these objectives and monitoring performance are determined. Accordingly, OECD (G20 & OECD 2015) and the Basel Committee on Banking Supervision (BCBS) (2015) have determined some corporate governance principles, including rights and equitable treatments of different stakeholders (shareholders, investors, owners, etc.), the role of stakeholders, disclosure, and transparency, and the responsibility of the board, etc. Accordingly, the concept of corporate governance plays an essential role in meeting the specific goals and objectives of a corporation. The distinct function of corporate governance in the financial services sector is mainly focusing on the determination of policies, a set of legal rules and managerial behaviors amongst the shareholders, the managers, the BOD, the depositors, and other stakeholders (Hasan, 2011). In fact, the difference between Shariah governance (SG) and corporate governance is only in scope. SG is part of corporate governance, which monitors the Shariah implementation, and compliance within the IFIs. The SSB or Shariah units fill the gap between Shariah governance and corporate governance (Rahajeng 2013; CIBAFI - World Bank 2017)

In fact, the difference between Shariah governance (SG) and corporate governance is only in scope. SG is part of corporate governance, which monitors the Shariah.

Some researchers confirm that IFIs have a broader corporate governance concept than conventional institutions, as IFIs aims to implement the principles of Shariah that have a juridical, business, and economic consequences. Hence, they have to implement Shariah-based governance. At the same time, CIBAFI & World Bank Report (2017) identified 6 corporate governance themes for IFIs corporate governance index: (i) board of directors, (ii) board committees, (iii) internal and external audit, (iv), risk governance, (v), Shariah governance, (vi) transparency and disclosure.

The nature of business in Islamic financial institutions differs from their conventional counterparts. IFIs use mechanisms and systems of governance to achieve objectives compatible with Shariah, which is not an object in conventional institutions. Following the principles and values of the Shariah or "Shariah governance" (CIBAFI - World Bank 2017) raises different issues in their case. The concept of "Shariah governance" has been defined recently by some international Islamic financial institutions. For example, the IFSB (2009) defines it as: *"the set of institutional and organizational arrangements through which an International/national IFIs ensures that there is effective independent oversight of Shariah compliance over Issuance of relevant Shariah pronouncements/ resolutions, Dissemination of information on such Shariah, and an internal Shariah compliance review for verifying that Shariah compliance."* It was defined by Bank Negara Malaysia (2019) as an integral part of the Islamic financial system stability. It states that *"(the) institutionalization of a sound Shariah governance framework strengthens public confidence in the integrity, management, and business operations of the Islamic financial institutions."*

Accordingly, the concepts of the Shariah governance system include the following elements:

- a- Institutional and organizational arrangements and procedures.
- b- Effective and independent Shariah supervision in accordance with the Shariah.
- c- An internal Shariah compliance review.
- d- Issuing decisions and fatawa related to the work of IFIs.
- e- Dissemination of their expert opinions and other decisions to the stakeholders.
- f- Fulfill all business and operations contracts in IFIs.

“Shariah governance” has been defined as: “institutionalization of a sound Shariah governance framework strengthens public confidence in the integrity, management and business operations of the Islamic financial institutions.”

Early Islamic banks such as Mit Ghamr (1963), Dubai Islamic Bank (1975), had no specialized departments in Shariah supervision. They relied on consulting some scholars. Faisal Islamic Bank, (Egypt, 1976) was the first Islamic financial institution that constituted an internal board of Shariah scholars who specialized in Fiqh al-Muamalat. The same was done later by Jordan Islamic Bank (JBI) (1978), and Faisal Islamic Bank of Sudan (1978), then Kuwait Finance House (1979) and other IFIs. Dubai Islamic Bank established a Shariah supervisory committee (1997), the IDB had been referring to the IFA as its SSB, until 2001, when it constituted its own SSB. CIBAFI established a Shariah supervisory board in 2003 (Malkawi 2010). The AAOIFI issued its first standard in 1999 regarding the Shariah governance for IFIs. It was followed by several standards to regulate the activities of Shariah reviewers and auditors etc. In the year 2006, the IFSB has issued its first corporate governance standard for IFIs. These standards include guidelines on corporate governance in IFIs in several areas. In 2009, the IFSB also developed and issued new standards for Shariah governance systems in IFIs (table 5).

**Table 5: Development of Shariah Governance Regulations**

1999	AAOIFI Governance Standard for Islamic Financial Institutions (GSIFI) No. 1: Shariah Supervisory Board: Appointment, Composition, and Report
1999	AAOIFI GSIFI No. 2: Shariah Review
1999	AAOIFI GSIFI No. 3: Internal Shariah Review
2001	AAOIFI GSIFI No. 4: Audit & Governance Committee for IFIs
2005	AAOIFI GSIFI No. 5: Independence of Shariah Supervisory Board
2005	AAOIFI GSIFI No. 6: Statement on Governance Principles for IFIs
2006	IFSB-3: Guiding Principles on Corporate Governance for Institutions offering only Islamic Financial Services (Excluding Islamic Insurance (Takaful) Institutions and Islamic Mutual Funds)
2008	IFSB-6: Guiding Principles on Governance for Islamic Collective Investment Schemes
2009	AAOIFI GSIFI No. 7: Corporate Social Responsibility (CSR) Conduct and Disclosure for IFIs
2009	IFSB-8: Guiding Principles on Governance for Takaful (Islamic Insurance) Undertakings
2009	IFSB-10: Guiding Principles on Shariah Governance Systems for Institutions Offering Islamic Financial Services

2011	Shariah Governance Framework (SGF) for IFIs
2017	The Securities Commission of Malaysia (SC) issued the new Malaysian Code on Corporate Governance (MCCG 2017)
2019	BNM Shariah Governance Policy Document

Source: Authors

### 2.3. ECONOMIC ROLE OF SHARIAH GOVERNANCE

Shariah governance has many important economic roles that include the following:

“(i) Following the increasing growth of the Islamic economy in the world, and the complication of the duties and responsibilities of various stakeholders, there must be suitable Shariah governance systems. The Shariah governance system supports the task of the management, Shariah board, board of directors, and relevant departments to ensure Shariah compliance.” (Saba 2018).

(ii) Shariah governance is an integral part of stability requirements. The institutionalization of a sound Shariah governance framework strengthens public confidence in the aims, management, and business operations of the IFIs (BNM 2017). It emphasizes the soundness of Shariah procedures.

(iii) The Shariah governance system mitigates a special type of exclusive risks facing the Islamic economy, known as “Shariah non-compliance risk” (Hasan, 2011).

The proper application of the Islamic finance paradigm, as mandated by Shariah, renders significant macroeconomic benefits (Al-Jarhi, 2016). Yet, such benefits are mostly external to IFIs managers. As Islamic finance appears more complicated and apparently costlier to conventionally trained bankers who manage the IFIs, they find it rational to mimic conventional finance. To the extent that SSBs are cooperative in designing finance products that are Islamic in attire but conventional in essence, IFI’s managers would find it to their financial statements advantage to introduce such products. This is perhaps one of the main challenges faced by Shariah governance.

Within the framework of the Islamic financial system, stakeholders of IFIs hope that Shariah governance processes will achieve Shariah compliance for all administrative and technical procedures and processes. CIBAFI (CIBAFI - World Bank 2017) determined some specific Shariah governance items/criteria for IFIs. They are: (i) the number of SSB members, (ii) duties of SSBs, (iii) member (nonvoting) with non-Shariah background, (iv) number of Shariah board meetings, (v) Shariah review/audit department/unit, (vi) statement on the use of prohibited income. We must add to this list the qualifications of SSBs members, particularly the right mix of economics, Shariah, and other subjects.

Compliance with Shariah is essential to enhance the confidence of the stakeholders of IFIs. There are important considerations of Shariah governance for stakeholders in IFIs. The IFSB (2009) identifies the IFIs stakeholders to include “(i) employees; (ii) customers (including IAHs and current deposit holders); (iii) suppliers; (iv) the community (particularly the Muslim Ummah); and (v) supervisors and governments, based on the unique role of IIFS in national and local economies and financial systems.” IFIs stakeholders’ interests include Shariah compliance, as well as transparency/clarity of procedures to support certainty in all work activities.

The proper application of the Islamic finance paradigm, as mandated by Shariah, renders significant macroeconomic benefits.

The core mission of an IFI according to Grais & Pellegrini (2006) is to meet stakeholders’ needs to ensure that their business, management- and finance-wise, is in accordance with the principles of

Shariah. Therefore, some mechanisms must ensure that their wealth is protected. Meanwhile, depositors and borrowers need to feel secure, confident that many kinds of assets and liabilities are competitive and offer an acceptable risk-return trade-off.

As for the effectiveness of Shariah governance in IFIs, the system should have effective mechanisms in governance to achieve its goal for Shariah compliance. It would strengthen the credibility of IFIs, and it must be able to address various issues pertinent to the foregoing discussion. Also, it is the vital element promoting the stability of the Islamic financial sector through setting institutional arrangements to supervise the Shariah-compliant aspects of their activities (Grassa 2013b; Hasan 2011).

## 2.4. OBJECTIVES OF SHARIAH GOVERNANCE

The Shariah control on Islamic finance means that (i) certain rules must be applied concerning Shariah, economics, and finance (ii) a degree of expertise in Shariah as well as in monetary and financial economics is required to make such control effective. There are two major ramifications. First, there could be no financing that ultimately boils down to the sale of present against future money. In other words, IFIs must not provide their customers with ready cash, except in four cases: (i) either in return for a shareholding in musharaka, (ii) PLS finance through mudaraba, and (iii) investment agency through wakala (iv) interest-free loan (qard hasan). The second and third contract types suffer from information asymmetry, which would require certain additional safeguards in the contract. However, musharaka would minimize the informational asymmetry, where the capital of the musharaka partner is also, at stake. The second major rule is that finance should be done through one of the twenty Islamic investment and finance contracts<sup>1</sup>. In addition, contracts should not be mixed or matched for the purpose of designing ruses to overstep the prohibition of providing present against future cash, as in the cases of eina and tawarruq.

Islamic finance contracts should not be mixed or matched for the purpose of designing ruses.

Consequently, it can be stated that Shariah governance is supposed to guarantee that the Shariah control system protects the interests of shareholders, IAHs, regulators, and the public in applying a properly operating Islamic financial system. The objectives of protecting the interests of each stakeholder are explained below:

### Shareholders

First, shareholders appear to be most interested in the proper application of the Islamic finance paradigm. After all, they have taken equity in the business and they would only benefit from the strong differentiation between Islamic and conventional finance. Besides, since Islamic finance properly practiced would yield returns that are much higher than the margin between the lending and the borrowing interest rates, they would be set to realize higher returns on equity capital. The profit differential is due to making investments that take business rather than collateral risks, in addition to sale finance<sup>2</sup>. There is an argument that shareholders are not informed, nor they have a definite vantage point regarding the nature of Islamic finance. However, their prospective benefits from an honest application of the paradigm should encourage them to learn and apply, particularly large

<sup>1</sup> They are: (i) Musharaka, (ii) Musharaka Mutanaqassa, (iii) Unrestricted Mudaraba, (iv) Restricted Mudaraba, (v) Unrestricted Mudaraba Mutanaqassa, (vi) Restricted Mudaraba Mutanaqassa (vii) Unrestricted Investment Wakala, (viii) Restricted Investment Wakala, (ix) Muzara'a, (x) Mugharassa, (xi) Mussaqah, (xii) Bai' Bethaman Ajel, (xiii) Murabaha (xiv) Ijarah Tashghiliyah (xv) Ijarah Muntahia Bettamleek (xvi) Ijarah Tashghiliyah Fil Zimmah, (xviii) Ijarah Muntahia Bettamleek Fil Zimmah, (xviii) Ijarah Alkhadamat, (xix) Istisna', (xx) Salam.

<sup>2</sup> Conventional finance is based on the classical loan contract, in which the finance provider takes the risk on collateral only and avoid business risk. Sale finance profitability depends on the IFIs working as information specialists in commodity markets and obtaining quantity discounts, in addition to providing finance users valuable trading services.

shareholders. The chance that the latter group could be elected to the IFIs boards of directors should be an effective means of control. Nonetheless, without sufficient sensitivity of their elected management to the benefits of true Islamic finance, shareholders with imperfect knowledge about the Islamic finance paradigm would have little leeway to enforce proper practice.

### **Investment Account Holders**

IAHs have more than one stake in the proper application of Islamic finance. First, it could be a matter of principle, as they have shunned placing their money in conventional time and saving deposits, which offer guaranteed principal and interest to depositors. Instead, they place their money in mudaraba accounts, based on profit and loss sharing (PLS). In this regard, one could argue that Islamic finance may be safer than conventional finance, as Islamic banks by nature would be less leveraged. The investment accounts with them would be equivalent to tier two capital as they share risk on equal footing with shareholder's equity. In addition, the finance provided by Islamic banks would be either collateralized by commodities in the case of sale finance or equity-based under other types of finance. Furthermore, finance provided by Islamic banks would be less exposed to risks of adverse selection and moral hazard, which result from the information asymmetry associated with the classical loan contract. However, we do not expect the average investment account holder to be so informed to be aware of such risk comparison.

The IAHs stake in the rate of return requires additional monitoring. As the rate of return on investment accounts should exceed the rate of interest offered by conventional banks, as it reflects more commodity and equity-based assets in the mudaraba pool, Shariah control must watch for the composition of the mudaraba pool assets as well as the comparison between the rate of return paid on investment accounts and that paid on time and saving deposits with conventional banks. In addition, it is obvious that the interests of investment accounts holders are similar to those of shareholders. This, therefore, mandates giving equal management rights to account holders. Regulators should, therefore, dictate that some of the largest IAHs should be elected/ appointed on IFIs BODs as representing all IAHs in a proportion of their balances as compared to shareholder's equity.

Naturally, a bank managed by both its shareholders and IAHs would rise as a banking institution that is radically different from what is currently available. Since investment account balances far exceed shareholder's equity, bank management would be dominated by IAHs. Hopefully, this would provide more stability for IFIs in general and provide stronger adherence to the Islamic finance paradigm.

### **Management**

Management like stakeholders is the most sensitive to the financial statements of the bank. Factors directly influencing their balance sheets and/or their income statement would be of utmost concern. Therefore, the proper implementation of the Islamic finance paradigm would not take priority. They would rather focus on streamlining their operations for reducing costs and generating profits. We would not expect experts in Islamic finance to turn into IFIs managers. Most probably, they would be appointed, based on banking experience which would be in line with the dominant conventional banking industry. They find themselves confronting a multitude of contracts, each of which has its set of safeguards and documentation. This stands in contrast with the simple classical loan contract, which is straightforward and requires minimum documentation. Their ultimate action is to simplify, seeking shortcuts leading to finance products that arguably appear to be Shariah-compliant but not necessarily Shariah-based. Some would argue that Islamic finance, properly implemented provides the economy with real benefits. However, such benefits cannot be internalized by IFIs managers who focus on their financial statements. In other words, such managers cannot be relied upon for the implementation of the true Islamic finance paradigm.

### **3. COMPREHENSIVE ANALYSES ON SHARIAH GOVERNANCE FRAMEWORK**

After looking into the basic elements in SG, we survey the current status of Shariah governance considering if there could be an optimal Shariah governance regime. As the Islamic finance sector has been ignored in monetary policy, the report considers the relationship between both and how to make monetary policy more inclusive.

#### **3.1. CURRENT STATE OF THE SHARIAH GOVERNANCE FRAMEWORK IN OIC COUNTRIES**

The state of Shariah governance in OIC countries is described below using four elements (Ahmed 2011). We will employ four factors to define Shariah governance regimes.

##### ***LEGAL & REGULATORY FRAMEWORK***

When the law sufficiently defines the framework to be followed by the IFIs, the existence of a national Supervisory authority or institutional SSBs is usually ignored. The IFIs must follow the law in all aspects of their business transactions and operations. Iran could be the example of such a system by issuing the Law for Interest-Free Banking in 1983 (Central Bank of Iran 2013). The Central Bank of Iran Law includes provisions on IFIs products and services that must be strictly applied. The central bank keeps an open channel of communications with banks, in its capacity as the highest authority to issue rulings and product endorsements, to guide the IFIs in their business. Central bank oversees the observance of the relevant laws and regulations by the IFIs. However, there are some Shariah governance developments recently in Iran. For example, the Securities and Exchange Organization (SEO) of Iran established SSB based on "the Regulations Governing the Formation and Mission of the Specialized Committee on the Islamic Jurisprudence" that was ratified by its board in 2006.

##### ***TWO-LAYER SHARIAH GOVERNANCE***

In this category, the regulator issues specific laws supporting the Islamic financial industry. There are two layers of this regime. The first layer is at the national level while the other is at the institutional level. In other words, there is a governmental regulatory framework and a self-regulatory framework. The former is in the form of legislation and guidelines imposed by the government upon IFIs. The latter implies regulations imposed by institutions upon themselves relying on the standards issued by relevant government authorities (ISRA 2013). Many countries' Shariah governance regimes can be considered under this category, including Malaysia, Indonesia, Brunei, Pakistan, etc.

Such a regime is sometimes called "robust" a term that gives the wrong impression of strict Shariah governance. However, unless government rules mandate the IFIs absolute adherence to the rules set up by the OIC IFA, or strictly prohibits ruses leading to controversial products, such a regime would not produce distinctively better results.

##### ***PASSIVE SHARIAH GOVERNANCE***

Under the passive Shariah governance regime, there is a governmental regulatory framework providing legislation and guidelines for the IFIs. However, the national SSB acts passively leaving the forms of their business transaction and operation at the discretion of IFIs. An IFI does not need to get approval of higher government authority in the process of their daily operations. Qatar, Kuwait, and Bahrain could be examples of such governance regimes. This regime provides the institutional SSB of the widest range of discretion. It opens the door for ruses with a significant degree of divergence between Islamic financial products among IFIs in each country. However, when the three aforementioned countries are compared with other countries that apply stricter Shariah governance

regimes, with respect to ruses, we find very little difference in the product composition offered. An example is institutional tawarruq. Such a product has been declared impermissible by the OIC IFA in all forms. While it exists in the three aforementioned three countries under the passive Shariah governance regime, it is also commonly practiced in Malaysia which can be distinguished by two-layers of Shariah governance (Table 6)<sup>3</sup>. This implies that none of the four configurations of Shariah governance currently prevailing in the OIC member countries provide insurance against Shariah violation<sup>4</sup>.

**UNREGULATED**

This regime has no specific legislation and guidelines for the IFIs. Shareholders can theoretically, through their powers at the general assembly, their choice of board of directors, their formulation of the articles of association, and their choice of SSB members, instill their vision of Islamic finance. This manifests itself in the form of guidelines, terms of references, and SSB pronouncements. It can finally materialize in how the role and functions of the different Shariah departments in an IFI are defined (Ahmed 2011). Thus, there is no national SSB imposing any legislation upon IFIs, which take their decisions on their own for all aspects of their business operations. The United Kingdom and Saudi Arabia could be an example of this type of regime.

Such a regime is sometimes claimed to be “market-driven.” This appears to be a misnomer. To be market-driven requires the public to be aware of the Islamic finance paradigm and the existence of a market mechanism that allows both IAHs and finance users to impose their perception on how an IFI operates through market choice. Such a mechanism is doubtful to exist. This regime would boil down to the IFIs management choosing the semi-conventional short-cuts to do nominally Islamic finance products.

Based on the discussion above, table 6 classifies OIC member countries according to their Shariah governance regime.

**Table 6: Shariah Governance Framework Table for OIC Member Countries**

**A. Arab Group**

Features	Legal & Regulatory Framework	Two-Layers of Shariah Governance	Passive Shariah Governance	Unregulated	Unspecified
<b>Countries</b>					
<b>Algeria</b>			√		
<b>Bahrain</b>			√		
<b>Comoros</b>					√
<b>Djibouti</b>			√		
<b>Egypt</b>				√	

<sup>3</sup> The case of organized tawarruq, its Shariah impermissibility as it involves ruses Malaysia has been documented by al-Ghazali (2014).

<sup>4</sup> We will discuss below whether there is an optimal Shariah governance system that prevents all Shariah violations.

<b>Iraq</b>					√
<b>Jordan</b>				√	
<b>Kuwait</b>				√	
<b>Lebanon</b>				√	
<b>Libya</b>				√	
<b>Mauritania</b>				√	
<b>Morocco</b>		√			
<b>Oman</b>		√			
<b>Palestine</b>				√	
<b>Qatar</b>				√	
<b>Saudi Arabia</b>					√
<b>Somalia</b>					√
<b>Sudan</b>	√				
<b>Syria</b>				√	
<b>Tunisia</b>					√
<b>UAE</b>		√			
<b>Yemen</b>				√	

### B: Asian Group

Features	Legal & Regulatory Framework	Two-Layers of Shariah Governance	Passive Shariah Governance	Unregulated	Unspecified
<b>Countries</b>					
<b>Afghanistan</b>			√		
<b>Albania</b>				√	
<b>Azerbaijan</b>				√	
<b>Bangladesh</b>				√	

<b>Brunei Darussalam</b>	√		
<b>Indonesia</b>	√		
<b>Iran</b>	√		
<b>Kazakhstan</b>			√
<b>Kyrgyz Republic</b>			√
<b>Malaysia</b>	√		
<b>Maldives</b>	√		
<b>Pakistan</b>	√		
<b>Tajikistan</b>			√
<b>Turkey</b>	√		
<b>Turkmenistan</b>			√
<b>Uzbekistan</b>			√
<b>Guyana</b>			√
<b>Suriname</b>			√

### C: African Group

<b>Countries</b>	<b>Features</b>	<b>Legal Regulatory Framework</b>	<b>&amp; Two-Layers of Shariah Governance</b>	<b>Passive Shariah Governance</b>	<b>Unregulated</b>	<b>Unspecified</b>
<b>Benin</b>					√	
<b>Burkina Faso</b>					√	
<b>Cameroon</b>					√	
<b>Chad</b>						√
<b>Ivory Coast</b>					√	
<b>Gabon</b>						√
<b>Gambia</b>					√	

<b>Guinea</b>		√
<b>Guinea-Bissau</b>		√
<b>Mali</b>		√
<b>Mozambique</b>		√
<b>Niger</b>		√
<b>Nigeria</b>	√	
<b>Senegal</b>		√
<b>Sierra Leone</b>		√
<b>Togo</b>		√
<b>Uganda*</b>	?	√

*\*Uganda is about to establish Shariah supervisory board to regulate and supervise the operations and activities of Islamic banks.*

*Source: Authors*

Based on the table above, nine OIC countries have not experienced any development in the field of Islamic finance at all. The majority of OIC countries, twenty-three, can be placed under the category of the unregulated regime in which there is no national SSB imposing any legislation upon Islamic financial institutions, which make their decisions on their own for all aspects of their business operations. Thirteen OIC countries are categorized under the passive Shariah governance regime having governmental regulatory framework providing legislation and guidelines for the IFIs. However, national SSBs acts passively allowing IFIs to form their business transaction and operation. Last but not least, the table illustrates that ten OIC countries have two-layers of Shariah governance in which there is an existence of SSB at national and institutional levels operating actively. There are only two countries that converted the entire system into a Shariah-compliant regime providing a legal and regulatory framework for their operation.

### **3.1.1. IS THERE AN OPTIMAL ARRANGEMENT?**

The review of the existing regimes of Shariah governance and their obvious failure to produce a genuine and true implementation of the true paradigm of Islamic finance raises an important and fundamental question: is there an optimal Shariah governance regime? Obviously, there are lessons to be learned from the application of the above regimes. Such lessons would eventually lead to highlighting a more effective structure. The optimal arrangement that guarantees sound Islamic finance products according to the honest application of its paradigm would, therefore, be formulated in light of the lessons learned. We will propose such optimal arrangements in the policy conclusions of the report.

### **3.1.2. ISLAMIC FINANCE AND MONETARY POLICY**

An important objective of Shariah governance, which is often ignored, is to make sure that the Islamic finance paradigm as applied under Shariah supervision keeps the whole monetary sector as seamless as possible. Consequently, Islamic finance sector remains an integral part of the monetary sector.

Monetary policy actions carried out by the regulator should transmit themselves equally through the whole monetary sector without hindrance. The Islamic finance sector becoming isolated and totally irrelevant to monetary policy actions implies that the paradigm applied through Shariah governance is an extraneous part that can be ignored or even done away with, without the monetary system losing its functionality. The ultimate objective of Shariah governance must maintain a high level of functionality for the Islamic finance sector. Actions to adjust the rate of monetary expansion to suit policy objectives should resonate through all the monetary sector combined and not be hindered to go through the Islamic finance sector. Shariah governance should instill the understanding of Shariah compliance to include the seamlessness of the whole monetary system, without being constricted to the mere creation of an isolated corner of Shari'ah compliance.

The Islamic finance sector, despite its growth, as it approaches or exceeds one-quarter of the monetary and financial sector in some countries, still lies outside the sphere of monetary policy. The dichotomy between the Islamic finance sector and monetary policy underestimates the importance of the sector to the extent it gets less attention from the regulator. As a result, the macroeconomy misses some of the important benefits of Islamic finance. Such benefits would include increasing the interconnection between the real and financial sectors, reducing the risks associated with information asymmetry in the finance sector, enforcing compactness of the economic system, and reducing exposure to instability and contagion. Another benefit is that Islamic finance shields the

local economy from contagion. Hot money movements through debt and pure-risk trading would not be available for this type of capital flows. Obviously, more regulatory attention would throw more light on the sector and provide more incentives to tighten up its governance. To help integrate the Islamic finance sector into the macroeconomy while making monetary policy more inclusive, the monetary authority is advised to do the following:

An important objective of Shariah governance, which is often ignored, is to make sure that the Islamic finance paradigm as applied under Shariah supervision keeps the whole monetary sector as seamless as possible.

1. Apportion the monetary base between Islamic and conventional finance in proportion to their respective shares in monetary and financial assets. The Islamic finance share of the monetary base would not be lent to the government or banks. Instead, the monetary authority establishes a mudaraba-based investment account with all banks, conventional or Islamic under the name of central deposits (CDs). Such accounts would be offered to provide finance according to the rule of Shariah. Conventional banks may be trained on how to do Islamic finance<sup>5</sup>.
2. The Islamic finance share would be issued against a proportional reduction in the legal reserve ratio on conventional deposits, coupled with a 100% reserve ratio on investment accounts as well as demand deposits with IFIs.
3. Issue a mudaraba-based money-market instrument, under the name of CDC's, to be traded in an open market, for the following purposes<sup>6</sup>:
  - 3.1. Placing the proceeds in central investment accounts with all IFIs<sup>7</sup>. The monetary authority would apportion the proceeds among IFIs, based on certain policy criteria.
  - 3.2. The instrument would be made available to IFIs and the public.

<sup>5</sup> Conventional banks would not be allowed to take CDCs from the public or hold/trade CDCs unless they convert into an IFI.

<sup>6</sup> See Al-Jarhi (1980, 2016) for more details.

<sup>7</sup> A central investment account is a monetary balance placed by the central bank in different member banks on the basis of Mudaraba or PLS. Apportionments of proceeds among banks could be based on profitability or sectoral growth objectives.

- 3.3. The market-determined rate of return on the instruments would be used as a monetary policy tool (as a basis to estimate a policy anchor).

Such restructuring of the monetary and financial sector would enable the monetary authority to use an equity-based money market instrument to control the money supply in the Islamic finance sector. The money supply attached to the Islamic finance sector would have been converted into an investment, not debt money. An additional anchor for monetary policy that is attached to the average rate of growth in the Islamic sector would enable monetary policy to better target economic stability instead of inflation targeting. The rate of monetary expansion can be set to influence the money supply in both the conventional and Islamic finance sectors, each with its respective tools. It can watch both sectors compete freely under their balanced regulation and supervision.

### 3.1.3. COMPOSITION of SSBs

IFIs operate in the monetary and financial sector, a domain with which Shariah scholars have little or no familiarity. However, the composition of SSBs has been mostly dominated by Shariah specialists. Such irony requires a reconsideration. The Shariah validity of transactions and their underlying contracts can be divided into two components. The first component is *formal validity*, which relates to the formal requirements for contracts. Admittedly, this aspect is mastered by Shariah scholars who specialize in *Fiqh Al-Muamalat*. However, this branch of Fiqh is limited in size and has a strong legal and economic flavor. A scholar of economics can master this topic in a short time. Should he/she know sufficient Arabic to refer directly to the original sources, it would take him/her even much shorter time.

The Shariah validity of transactions and their underlying contracts can be divided into two components: formal validity and purpose validity.

The other component is the *validity of purpose*. This depends on the ultimate consequence of transactions, which only a monetary and financial economist can analyze. Fuqaha is hardly trained in this field. Properly designed MA/PhD programs in Islamic economics must include Fiqh Al-Muamalat in addition to economics and its associated tools. Such programs bring up Islamic economists who master the required part of Fiqh as well as the core part of economics. Therefore, judging by specialization, the role of Shariah scholars in SSBs is not as important as the role of Islamic economists. The inevitable conclusion is that SSBs must be predominantly composed of economists. The dominance of Shariah scholars would lead to mistaken judgments regarding the validity of purpose. Such mistakes could take serious proportions, especially when the consequences relate to fundamental economic issues like growth, employment, equity, sustainability, and stability.

## 3.2. AAOIFI AND IFSB SHARIAH GOVERNANCE GUIDELINES

IFIs differ from their conventional counterparts in their underlying principals and nature of business operations. Standard-setting agencies have yet to completely address the specific issues encountered by IFIs. The need for international standard-setting agencies specially oriented towards IFIs has been evident. In this light, the AAOIFI and IFSB were inaugurated with the initiatives of various IFIs and

regulatory bodies. The IFSB focuses more on regulators' concerns, while AAOIFI focuses on the individual IFI level. While the standards and guidelines issued by both are not binding, the principals contained in these standards and guidelines are generally taken into account by policymakers and practitioners (Hasan 2011).

### **AAOIFI GOVERNANCE STANDARDS**

AAOIFI was established in Bahrain in 1991. It is one of the leading not-for-profit organizations mainly focusing on the development and issuance of standards for the global Islamic finance industry. So far, it has issued a total of 100 standards in the field of Shariah, ethics, auditing, accounting, and governance for Islamic finance. AAOIFI is backed by accounting and auditing firms, legal firms, financial institutions, central banks, and regulatory authorities from over 45 countries. Many Islamic financial institutions across the globe follow their standards (AAOIFI 2019).

AAOIFI has issued 10 Shariah governance standards so far. It has addressed many issues encountered by Islamic financial institutions. AAOIFI starts with identifying the need of the industry, then analyses the need with due care to come up with adequately designed standards. It aims to guide IFIs to improve its Shariah governance framework, with an aim to enhance the soundness and stability of the industry.

We summarize the main objectives and key elements of each of AAOIFI 10 governance standards. No. 1 addresses various issues related to the SSBs. It begins with the definition of SSB, followed by the selection, appointment, dismissal, and the composition of board members. It continues with the basic elements of SSB reports and publication of relevant reports. It ends with guidance on the publication of SSBs expert decisions, rulings, and guidelines.

No. 2 defines Shariah review with its principals, objectives, and responsibility for Shariah compliance. It also explains Shariah review and reporting procedures in addition to its quality assurance. No. 3 defines the internal Shariah review with its objective followed by its requirements of independence and objectivity. It emphasizes the *“professional proficiency of officers who conducts Shariah review.”* It frames *“the scope of Shariah review officer’s task in addition to the performance, management and quality assurance of Shariah review work advising factors of an effective Shariah review control system.”* No. 4 underscores the importance of the Audit and Governance Committee for IFIs. It underlines the functions, responsibilities, and procedures of establishing such a committee. No. 5 emphasized *“the importance of the SSB independence, stipulating that SSB member should ensure the objectivity on the decision of Shariah matters. Any issue that leads to the detriment of the objectivity of SSB should be resolved. Shariah rules and principals are determinants of the SSB objectivity, which is explained in detail in the AAOIFI Code of Ethics for the employees in IFIs.*

No. 6 provides *“rationale and the basis for the establishment of an SGF, such as enhancing confidence, Shariah compliance, business model, stakeholders’ interest, socially responsible and business ethics and culture.”* It ends with the explanation of detailed principles and governance structure. No. 7 addresses the issue of corporate social responsibility, conduct, and disclosure in light of the related Islamic values. It emphasizes the disclosure and presentation of reports in a transparent fashion. No. 8 specifies the significance of the central Shariah board to supervise and advise regulators regarding Islamic finance matters. It sets a framework for the appointment, composition, and dismissal of central Shariah board members and their code of conduct. No. 9 identifies the significance of the Shariah compliance function. It begins with its overall framework and then underlines the responsibilities and key considerations of IFIs in this respect. It describes the Shariah department structure with its scope, functioning, controls, and processes. No. 10 focuses on the issue of Shariah compliance and fiduciary ratings for Islamic financial institutions. It reveals the key compliance requirements for the rating agencies and the framework for the assessment of IFIs. The main procedures, documentation, archiving reporting, and confidentiality are all key elements underscored here.

## ***IFSB GOVERNANCE STANDARDS***

The IFSB was officially established in Kuala Lumpur in 2002 and began its operations in 2003. It issues standards for the regulatory and supervisory agencies to support the soundness and stability of the Islamic financial services, including banking, insurance, and capital market. It has added to the existing international standards of new standards. It complements BCBS, the International Organization of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS). So far, 179 institutions have subscribed to the IFSB that operates across 57 countries (IFSB 2019a).

As a standard-setting agency, the IFSB has issued 22 standards for the IFIs so far. IFSB-1 through IFSB-5 has underlined the need for a comprehensive Shariah governance framework. Up to the IFSB-10, the standards focus on other matters, while occasionally touching upon Shariah governance-related issues. The IFSB-10 provides a comprehensive Shariah governance framework. It provides a general approach to the Shariah governance mechanism. It addresses the basic competence of employees that are part of the SGF. It emphasizes the significance of fit and proper criteria, professional training, and formal evaluation of employees in the Shariah governance mechanism. Also, it stipulates that the supervisory role of SSBs should be played strongly and independently, with sufficient competence to exercise objective judgments concerning Shariah related issues. The information handed over should be complete, adequate, and timely. Moreover, each Shariah board member should observe the confidentiality of the information obtained during his/her work. Lastly, the IFI should comprehensively understand the legal and regulatory environment for the issuance of fatawa in the jurisdiction and the SSBs should closely fulfill said framework (IFSB 2019a).

### **3.3. SHARIAH CONTROL SYSTEM**

IFIs are required to establish a Shariah control system to ensure the effective management of Shariah non-compliance risk in all aspects of their business transactions and operations. Business ethics in the lights of Shariah principals are also another consideration. Shariah control department guides IFIs in conducting the overall Shariah review, whose implementation covers product structures as well as the Shariah oversight upon the institution itself, its branches, and affiliated companies. Shariah control system comprises Shariah non-compliance risk and risk management in Islamic finance, Shariah audit, Shariah review, and research and development.

#### **3.3.1. SHARIAH NON-COMPLIANCE RISK AND RISK MANAGEMENT**

Shariah non-compliance risk is an operational risk that could ultimately lead to loss of income as well as reputational risk and possible insolvency (IFSB 2007b). It may even lead to systemic risk jeopardizing the stability of the entire financial system. Bank Negara Malaysia (BNM 2017) describes Shariah risk management as “... (a) a function that systematically identifies, measures, monitors, and reports Shariah non-compliance risks to prevent any Shariah non-compliance.” Accordingly, the first stage of Shariah risk management is to identify the elements of possible Shariah non-compliance risk in the course of business operations and activities of IFIs. Then, the management evaluates the Shariah non-compliance risks and assesses the possible exposure that IFIs may encounter. Management ensures that they have taken adequate risk mitigation measures. In addition, the risk appetite of the IFIs activities along with possible Shariah non-compliance risk exposures must be closely monitored and reported to the SSB at specific time intervals. In the case of risk detection, the management must ensure there is a well-designed mechanism to mitigate the relevant risk.

If an IFI identifies any Shariah non-compliance risk, the management should take immediate steps to separate the amount gained through impermissible means and ensure the purification of the relevant amount from its budget. Implementation of such immediate steps will prevent IFIs from any potential occurrence of reputation risk and possible insolvency. The amount of money gained through impermissible means should be channeled to charity and not used for any other purposes.

The IFSB (2005) identifies six categories of risk, in parallel with conventional financial risks, in addition to the one specific to IFIs. The risk specific to IFIs is the Shariah non-compliance risk. The IFIs are similar to their conventional counterparts when exposed to credit, equity investment, market, liquidity, and rate of return risks. To eliminate them, the IFIs must have comprehensive risk management and reporting process.

Since conflicts of opinion among stakeholders about Shariah non-compliance risk are inevitable, there must be a dispute-resolution mechanism to prevent spillover effect on the institution's reputation and the reliability of the entire financial system, causing systemic risk. Such a mechanism is therefore required at the institutional as well as the national level. Its absence has caused serious problems as in the case of Dana Sukuk in the UAE and Revenue Indexed Bond in Turkey.

The dispute between the UAE-based Dana Gas and its sukuk holders arose after the issuance of Dana Sukuk. The company argued that changes in the Islamic financial practices rendered the sukuk invalid under the UAE law and therefore it is considered unredeemable (Torchia 2018). The UK court ruled that the company's purchase undertaking remained valid and the verdict was upheld. It stopped the company's dividend payment, ordering it to place a security payment into a British bank account until the dispute was resolved (Robert 2018). Meanwhile, the UAE court rejected withdrawing the company suits filed in the UAE court and suspended the enforcement of the British court order (Barbuscia and Alexander 2018). Finally, the company and the majority of the sukuk holders signed an out-of-court settlement favoring the company. This case underlines the importance of a dispute resolution mechanism, especially that the case had an impact on the global sukuk as well as the UAE capital market. Having a dispute resolution mechanism at the national SSB would reduce the need for litigation while providing a timely and efficient resolution.

In the second case, Revenue Indexed Bonds were issued by the Turkish Treasury in 2009 to mobilize resources from participation banks. Coupon payments were indexed to the income of state-owned enterprises, stipulating a guaranteed minimum and maximum returns. This raised suspicions about Shariah compliance, which had been approved by a Shariah scholar, who later changed his opinion shaking the financial market. This brought up two points of concern. First, the scholar was not a specialist in Islamic finance. Endorsing financial instruments requires a group of experts with a majority of specialists in monetary and financial economics and a minority of Shariah specialists. Second, due diligence is required for product approval. Similar cases have shaken the Islamic finance industry which could have been vetted by a properly composed SSB at the national level.

Considering "Is the Islamic Finance Industry Exposed to Non-Compliance Risk?" as an empirical question, it can be answered through evidence that shows the extent to which the Islamic finance industry has implemented its ideal paradigm. At the outset, the inspection of available standards of the acquisition and trading of Shariah-compliant companies, IFIs are presumed as 100 percent Shariah-compliant, with no need to cleanse dividends. However, the literature provides several contributions documenting the significant convergence of Islamic finance towards conventional finance<sup>8</sup>. The convergence is due to the use of ruses to camouflage the ultimate consequence of transactions amounting to the sale of the present against future money. Examples include international murabaha, tawarruq, debt-sale based transactions, and the partial securitization of debt, in addition to asset-backed (against asset-based) Islamic financial instruments and finance of short-term acquisition of financial instruments (dubbed by economists as Ponzi schemes).

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<sup>8</sup> See Al-Jarhi (2018) and several other citations in the same article.

### 3.3.2. SHARIAH AUDIT

As the IFIs grow in size and complexity, so will the need for an audit committee guide to ensure an effective overview of Shariah compliance in all business operations. Bank Negara Malaysia asserts, “*Shariah audit refers to a function that provides an independent assessment on the quality and effectiveness of the IFIs internal control, risk management systems, governance processes as well as the overall compliance of the IFIs operations, business, affairs, and activities with Shariah*” (BNM 2017).

Borneo Centralized Monitoring Centre puts forward “*Shariah audit refers to an independent and periodical assessment, conducted from time to time to provide objective assurance designed to add value and improve the degree of compliance of the financial institution's activities and operations. The main objective is to ensure a sound and effective internal control system for Shariah compliance*” (Lahsasna 2014).

State Bank of Pakistan affirms that “*The Board Audit Committee (BAC) shall ensure compliance of the corrective actions determined by SB on the reports of ‘internal Shariah audit’ and ‘external Shariah audit’*” (SBP 2018).

The quotations above indicate that the common responsibility of the audit department is to ensure overall Shariah compliance of business operations in addition to other factors varying from one country to another. Thus, taking up comprehensively, the audit unit must ensure to provide an independent evaluation of the quality and effectiveness of IFIs, robust risk management mechanism, and overall compliance with Shariah in the course of governance processes.

A survey was conducted on Shariah auditing in Malaysia after the announcement of the Malaysian new Shariah governance framework in October 2010 (PWC 2011). Malaysian-based 15 IFIs (including a foreign financial institution) participated in this survey through their chief internal auditor, head of internal audit units, and departments (including Shariah audit). Based on the survey, Price Waterhouse Coopers (PWC) found the followings:

- (i) All of the financial institution participants agreed that the Shariah audit team is sufficiently independent (40% strongly agreed, 60% agreed) and authorized to conduct the Shariah audit without any impediments from the management (50% strongly agreed, 50% agreed).
- (ii) A minority (10%) disagreed that the Shariah audit is formed to conduct a Shariah audit process.
- (iii) 30% of the total participants disagreed that the Shariah audit was designed to perform the Shariah consulting role.
- (iv) One-third of the total participants disagreed that the industry had sufficient staff to fulfill the Shariah audit effectively.
- (v) One-fifth of the total respondents disagreed that Shariah audit employees were sufficiently trained in banking operation and financing products.
- (vi) 40% of total participants disagreed that their Shariah audit staff were sufficiently trained in

One-third of the total participants in the PWC survey indicated that the scope of the Shariah audit is not adequately designed to cover the relevant processes in the institutions. This shows the need for a broader Shariah governance framework that encompasses all the aspects of relevant processes.

Shariah related audit risks and issues.

- (vii) One-third of the total participants indicated that the scope of Shariah audits was not comprehensive enough to cover all the relevant processes in the bank.
- (viii) 10% of total respondents believed that Shariah audit risk was not comprehensively and acutely assessed during the audit cycle and Shariah audit methodology and tools were not sufficient to conduct the Shariah audit.
- (ix) Half of the participants asserted that there was no dispute-resolution process in the bank's existing Shariah governance framework.
- (x) 20% of the total respondents disagreed that the bank's information technology (IT) systems were adequate to contribute Shariah audit with the necessary data and information to fulfill the Shariah audit.

Malaysian Shariah governance framework is considered one of the best practices across the globe. Yet, the survey has exposed some important strengths and weaknesses. While there is a general belief in Shariah audit team independence, some stressed the lack of human resources in the field of Shariah audit in addition to the insufficiently trained officers, particularly in the Shariah related audit risk and issues. To remedy the situation, educational and training institutions are required to produce more quality Shariah audit officers.

One-third of the total participants indicated that the scope of the Shariah audit is not adequately designed to cover the relevant processes in the institutions. This shows the need for a broader Shariah governance framework that encompasses all the aspects of relevant processes. Ironically, half of the respondents stated that there is no dispute-resolution process in the bank's existing Shariah governance framework. This issue needs greater attention as unresolved disputes might lead to the deterioration of IFIs reputation. Even this may jeopardize the stability of the entire financial system. As experiences show that there are still some issues to be resolved in the process of Shariah auditing.

### ***Internal & External Shariah Audit***

The internal Shariah audit (ISA) unit must have access to all the information available in an IFI, independently assess the Shariah compliance of the IFI overall business operations in the lights of (if any) regulation and the audit manual<sup>9</sup>. The ISA unit has to abide by the relevant legislation in addition to the audit manual that may be formed by either the IFI itself or as guidelines by the regulatory body.

During the process of auditing, the decision taken by the auditor must depend on the relevant sources including but not limited to the resolutions published by the SSB, respective guidelines from the authority, and the relevant internal Shariah audit manual. Auditing should be conducted regularly according to the time interval determined by the SSB. At the end of the auditing process, the ISA unit should prepare a report and present it to the SSB. After submission of the report, it will be analyzed by SSB and then passed to the BOD. If there is any incident of non-compliance, it must be reported to the SSB. Then the necessary measures must be taken to rectify the business operation process. If any amount of money is gained through the impermissible way, it should be separated from the institution's money and given to charity.

IFIs appoint the ISA unit members with qualifications in economics, finance, accounting, and Shariah. IFIs bear the remuneration and the expenses of employees. They should be subject to the same code of conduct applied to SSB members.

IFIs may employ or appoint an external party or purchase the service from an independent external Shariah audit firm to monitor Shariah compliance of IFIs overall business operation in the lights of (if any) regulation and the audit manual. In other words, IFIs hire qualified people or firms to carry out

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<sup>9</sup> Ideally, such manual can be produced by the regulator. However, shareholders may commission an outside consultant to produce it.

an independent external Shariah audit on the affairs, activities, transactions, and business operations of the IFI. The external audit is supposed to provide objective assurance on the effectiveness of Shariah governance implementation within the IFI (BCMC, 2018). The external Shariah audit (ESA) unit must abide by the governmental regulatory framework, legislation, and guidelines, should they exist. An audit manual that may be formed by either IFI itself or as guidelines placed by the regulatory authority. For better Shariah governance, the regulator must set the terms of reference and qualifications required to be employed by the ESA firm providing such service. Employees of such a firm should have sufficient knowledge of economics, finance, accounting, and Shariah.

The decision taken by the auditor must depend among other factors on the relevant resolutions published by the SSB and respective guidelines from the authority and relevant internal Shariah audit manual. Auditing should be conducted regularly according to the time interval determined by SSB. At the end of the auditing process, the ESA unit should prepare a report and present it to the SSB. The SSB must analyze the report and pass it to the BOD. All incidents of non-compliance must be reported to the SSB, which must take the necessary measures to rectify the business operation process. Money gained through impermissible ways should be separated and given to the charity.

### **3.3.3. SHARIAH REVIEW**

Shariah review refers to the regular evaluation of the Shariah compliance of business transactions and operations, products, activities, and affairs of IFIs. Shariah review covers the structure of offered products, as well as the Shariah oversight upon the institution itself, its all branches and affiliated companies. Shariah review is conducted upon the overall company ensuring the effective management of Shariah non-compliance risk in all aspects of business operation including code of conduct.

Non-compliant incidents must be reported to the SSB for necessary measures and possible solutions. The Shariah review unit should provide updated oversight to SSB including the latest developments in their IFI. The latest legal and regulatory amendments and their implementation must also be included. The Shariah review unit should be composed of a senior officer and experienced staff who have knowledge in the field of economics, finance, accounting, and Shariah.

### **3.3.4. RESEARCH AND DEVELOPMENT**

Some propose that a function of Shariah research be assigned to the Shariah review unit. While Shariah research comes in as an important factor in Islamic finance innovation, the department of R&D in an IFI should be qualified to look into issues of current practice and innovation, including:

1. Shariah matters (BCMC, 2018), like product development and structuring. As an IFI operates in the fields of investment and finance, fulfilling customers' needs may require some research to find the best modalities.
2. When finance requires syndication (of several IFIs) or securitization, alternative modalities need to be compared.
3. When finance involves other countries, it requires information regarding the legal, regulatory, and political environment there.
4. Investigating customers' attitudes as well as other IFIs approaches to streamline the bank operations.
5. National, regional, and international economic outlook and how the IFI can sail through different circumstances.
6. Shariah problems related to IAHS, relationships with banking suppliers, and others, to find solutions.

### 3.4. SHARIAH SUPERVISORY BOARD (SSB)

#### 3.4.1. INTRODUCTION

On the regulatory front, Islamic finance poses to regulators big challenges in its quest to gain a regulatory treatment that is at par with that given to conventional finance, while keeping its products Shariah-based. The most important challenges emanate from the development of capital adequacy and solvency, risk assessment and management, and corporate governance (Abdul Ghani 2006).

Corporate governance can be defined as a structure of rules, processes, and practices employed to control and manage corporations, to protect the interests of stakeholders. A corporation is managed and directed based on this structure, which specifies the rights and responsibilities of different participants. Corporate governance also applies to IFIs, for which it covers many sides, like operational, financial, managerial, and Shariah governance. The latter type of governance aims to safeguard the interest of stakeholders such as shareholders against Shariah compliance failure.

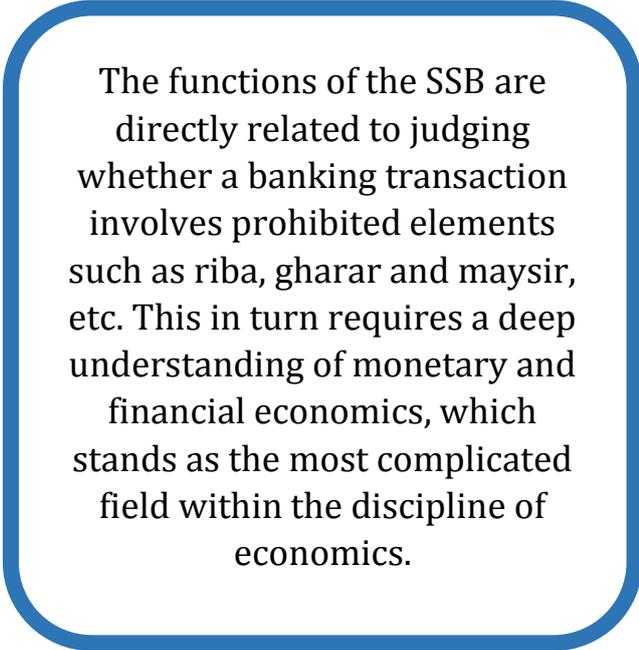
SG survey indicates the interest of stakeholders in Shariah governance (as shown in figure 26). Accordingly, we can state that SSB members have quite a higher interest in Shariah governance compared to other stakeholders.

Mainly, there are three types of structures for Shariah governance. It is either centralized by the establishment of the Shariah supervisory board at the national level or decentralized by the establishment of the Shariah supervisory board at the institutional level or combines a Shariah board at the national level with others at the level of each institution, with some coordination mechanism.

Centralized SSB is established under the central regulator of banking in the country either with or without final authority (ISRA 2013). For instance, Bank Negara Malaysia provides mandatory guidelines and regulations for the IFIs. However, the Shariah supervisory board, SSB in the Central Bank of Bahrain (CBB), plays the role of advising the central bank on Shariah matters. Thus, having a centralized SSB does not necessarily mean it has all the authority to supervise and intervene in the business operations of the IFIs, as the board could also be established just for the sake of advice.

Decentralized SSBs refer to the non-existence of a board at the national level. SSBs are established and appointed at the institutional level. The decisions of SSBs are just binding upon the relevant institution. The SSB in the UK could be an example of such a mechanism, where there is no central authority to decide upon Shariah matters. Each institution forms an SSB at its institutional level and decides Shariah matters on its own.

The functions of the SSB are directly related to judging whether a banking transaction involves prohibited elements (riba, gharar, and maysir, etc.). This in turn requires a deep understanding of monetary and financial economics, which stands as the most complicated field within the discipline of economics. Many economists not specialized in this field would not be expected to have sufficient insight into banking and finance. Judging monetary and financial transactions requires proper perception as well as the ability to evaluate its ultimate consequences. Naturally, Shariah scholars



The functions of the SSB are directly related to judging whether a banking transaction involves prohibited elements such as riba, gharar and maysir, etc. This in turn requires a deep understanding of monetary and financial economics, which stands as the most complicated field within the discipline of economics.

would have even more difficulties in formulating proper perception of such matters and their ultimate consequences. This mandates that the composition of an SSB should include several specialists in monetary and financial economics, with at least one Shariah scholar to provide Shariah insight.

Each member of an SSB should have a high degree of recognized scholarship. According to contemporary standards, a scholar should have a PhD in his/her field, an experience of teaching graduate students, and a track record of research published in refereed journals.

### **3.4.2. ROLES AND RESPONSIBILITIES OF SSBs**

The main objective of an SSB at the national or institutional level is overall Shariah compliance of IFIs with a view of protecting against Shariah non-compliance risk. This includes the following:

- (i) Even though IFIs are profit-oriented, SSBs should act to implement standards of social responsibility ensuring the interest of the entire stakeholder rather than limiting attention to shareholders' interests.
- (ii) SSBs should not be limited to issuing expert opinions and operational guidelines. They should rather cooperate with all IFIs departments. In this respect, they should work with product structuring and development and act as an arbiter between the IFI and its customers. Furthermore, they should also work with related departments to ensure all the transactions, activities, and contracts and documentation are Shariah-compliant.
- (iii) Since disputes would eventually rise in relationship with the application of Shariah rules, the national SSB must appoint an ombudsman under its supervision to resolve conflicts between customers and IFI management. An example, when a customer claims temporary insolvency and applies for free rescheduling, the management often allege delinquency and imposes penalty fees. Such disputes can be amicably resolved through an ombudsman.
- (iv) When in doubt regarding certain products, transactions, or activities, the SSB should provide proper solutions to stakeholders.
- (v) SSBs should establish mechanisms to detect unlawful income. It should take the responsibility of purifying the institution's account and dispensing unlawful income to charity.
- (vi) It should set up adequate accounting policy ensuring a fair distribution of profit and proper calculation of zakat.
- (vii) SSBs should keep all the information concerning the institution and its customers' confidential.
- (viii) SSBs should insist upon their autonomy and independence, ensuring it does not take biased decisions.
- (ix) SSB ensures full transparency and disclosure. Shariah pronouncements and fatawa must be published and made known to the public.
- (x) SSB should properly identify/assess Shariah non-compliance risk and reputational risk and effectually interconnect that risk information to suitable bodies in the institute.
- (xi) SSB must take the decision on time regarding the needs of the sector and institution.
- (xii) Decisions and resolutions of SSBs must convey their concern to implement Islamic principles.
- (xiii) SSBs should convey its decision to all stakeholders clearly and understandably.
- (xiv) SSB members must attend all meetings. If there is any incident or impediment that an SSB member encounters, it must submit necessary documents to the general assembly, with a copy to the management.

### **3.4.3. CONSISTENCY OF SSBs DECISIONS NATIONALLY AND INTERNATIONALLY**

The Islamic finance paradigm is unique and has a wide range of innovation, provided that SSBs have the right composition of expertise of Shariah, monetary, and financial scholars. However, due to the lack of such composition, less precise perceptions of Islamic finance rules arise<sup>10</sup>. The interest of Islamic banks management in less costly finance products has pushed SSBs with composition biased towards Shariah membership into approving controversial products, which often find their ways in most countries but not in few others.

AAOIFI Shariah Board has not given product harmonization and convergence among SSBs sufficient priority (Hasan 2011). Inconsistency between Islamic finance products internationally and even nationally is rampant. Countries hosting IFIs must find a practical way to maintain such harmony. One possibility is that monetary authorities in countries hosting IFIs, particularly OIC members can call for a yearly meeting of regulatory technicians under the auspices of the Bank of International Settlements (BIS) or the International Monetary Fund (IMF). This may be a more effective forum for product harmonization.

## **3.5. LESSONS FROM THE THEORY OF FINANCIAL REGULATION**

### **3.5.1. FINANCIAL REGULATION THEORY AND THE RECEIVED DOCTRINE**

The Great Recession of 2008 was more than the 100<sup>th</sup> banking crisis in the history of western capitalism. This system has been the victim of repeated crises<sup>11</sup>. This may be related to an institutional weakness in the system, including the regulatory side that repeatedly failed to confront the repeated crises. Undoubtedly, the received and currently dominant doctrine of neoclassical economics and its almost ideological belief in the persistence of stable equilibrium which in turn deprived financial regulation of its basic rationale, is also responsible. It could, therefore, be refreshing to remind ourselves with such a rationale, as presented by the theory of financial regulation.

The avoidance of crises in the finance system is more important than in the case of other businesses. Externalities from an individual bank failure to other banks as well as the wider economy are quite significant. Regulation attempts to internalize the social costs of potential bank failures by setting rules that insure banks' financial soundness. Regulation usually sets rules for best banking practice and sets regulatory capital at the prudential level. Systemic regulation attempts to make the system as a whole safe by simply ensuring that individual banks are safe. However, in trying to make themselves safer, banks, and similarly highly leveraged financial intermediaries, sometimes take actions that may appear prudent for one bank but become rather imprudent when taken collectively. An example is that a single bank may find it prudent to sell an asset when the price of risk increases. If such action were to be carried out simultaneously by many banks, the asset price would collapse. Banks would find themselves having to sell more assets to rectify the situation. Such pressures could lead to an economy-wide decline in asset prices, furthering the volatility in asset markets. This phenomenon is called the *indigeneity of risk*, which increases with common reactions of banks and financial institutions.

### **3.5.2. FINANCE OF GAMBLING, DEBT TRADE & PONZI SCHEMES**

One of the most important sources of instability in market economies is pure-risk and debt trading in the financial market. Such trading attracts hot money into the economy. In addition, prices of gambling instruments in the market do not follow fundamentals, as every speculator tries to predict the market

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<sup>10</sup> Islamic finance has at least 20 investment and finance contracts, in addition to a wide range of potential securitization. Mixing and matching contracts in addition to the use of securitization can produce an enormous number of products. However, innovation must be carefully balanced with commitments to uphold Shariah rules.

<sup>11</sup> Breuer (2004) counts 162 crises between 1972 and 1998.

trend rather than to consider the fundamentals behind each instrument. To give an example of how much gambling is done in financial markets, the Bank of International Settlements estimates the total notional amounts outstanding in the derivative market (both foreign exchange and interest rate derivatives) at USD 622.611 trillion (BIS 2019). As to debt trading, the total amount of bonds outstanding at the end of 2017 reached \$40.7 trillion, while the total capitalized value of the US stock market was \$30 trillion.

Comparing the above values with the estimated global gross domestic product (GDP) in 2018, which is around \$84.93 trillion, we can realize how enormous the debt and pure risk trading in financial markets. The total notional value of the derivative market, which is synonymous with gambling is many folds the world GDP. Meanwhile, bonds trading is close to one-half of world GDP.

Such astronomical figures of pure-risk and debt trading owe their size to the financing provided to speculators. Generous finance is offered to gamblers through brokers. To gamble with people's money appears to be deceptive to the original lenders, who mostly deposit their money with banks. In addition, it exposes the macroeconomy to the effects of sharp and sudden movements that could cause instability and contagion. That is why some economists use the term "Ponzi Scheme" to describe the financing of pure risk and debt trading. If Islamic finance is to be associated with a sound economic system, regulators must consider preventing its involvement in such a scheme.

### **3.5.3. MICRO AND MACRO-PRUDENTIAL REGULATION**

Micro-prudential regulation covers "the factors related to the stability of individual institutions. Meanwhile, macro-prudential regulation covers the factors related to the stability of the whole financial system." The type of the regulation suitable for a specific financial institution depends among other variables upon how systemic its undertakings are, which depends on its size, degree of leverage, and inter-connectedness with the rest of the system. Ideally, IFIs do not lend, but rather provide finance under different modes. Sale finance modes create debt, which has a nature that is different from conventional debt. First, Islamic finance debt is non-negotiable. It stays in the property of the creditor until repaid. Second, it is subject to mandatory free rescheduling in the cases of temporary insolvency of debtors. Third, in cases of delinquent debtors, penalties can be imposed only to be paid to charity.

Rule-based macro-prudential regulation must counter the decline in measured risks in the boom and the rise in measured risks in the collapse. Supervisors' discretion could be limited by a shortsighted desire to prolong a boom and by bankers' demand for equal treatment. Booms are associated with mutually reinforcing and excessive finance, on part of IFIs. Debt resulting from sale finance is often collateralized with financed commodities. Supervisors will not require using counter-cyclical capital charges, by increasing capital adequacy requirements<sup>12</sup>, to moderate growth of credit expansion and leverage. The reason is that proper commodity collaterals provide protection, which rises during the boom, with higher commodity prices. Conventional anticyclical policies of credit limitations through quantitative limits or higher capital adequacy are especially unnecessary in the cases of IFIs. Meanwhile, the regulator must discharge its duties in verifying the adequacy and propriety of collateral in all cases of sale finance. There are other important factors that would play an additional role when a monetary and financial system is in place, like the asset-based financial as well as monetary instruments. However, these are ignored, as no country has taken an initiative to apply such a system.

The remaining macro-prudential factor is related to assets and liabilities mismatch. This is the case when the maturity profile of investment accounts is of a shorter length than the literature on banking regulation tends to urge regulators to pay more attention to banks which are "more systemically important" (Brunnermeier et al. 2009). This is a disguised call for unequal treatment, based on "too big to fail." It is also based on a false assumption that banks differ only in size. When both conventional and Islamic financial institutions coexist side-by-side, a more inclusive approach should be used.

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<sup>12</sup> Based on an assessment of inherent risks

Besides, regulators should encourage balanced growth of bank size without allowing banking enterprises to dwarf others. In this regard, CDs can be allocated between banks to reduce their size dispersion.

#### **3.5.4. REGULATORY DIFFERENCES BETWEEN ISLAMIC & CONVENTIONAL BANKS**

In a modern economy, with a dual banking system, all banks, both conventional and Islamic are regulated and supervised by the same authority<sup>13</sup>. Conventional banks are commonly known to be regulated against financial failure and prudential risk. Their balance sheets and income statements usually issued quarterly are carefully reviewed to make sure that the bank is not exposed financially<sup>14</sup>. Financial ratios are carefully monitored to ensure that the bank can continue in the following financial periods to meet its obligations and provide its usual flow of banking services.

In contrast, an Islamic bank has to abide by a certain paradigm that is devoid of using the classical loan contract. In general, it has to avoid selling present for future money at a premium. In addition, there are several rules that control its investment decisions. Most importantly, the bank must not involve itself in financing unethical activities, like dealing in alcohol, tobacco, and other materials that cause harm to living beings (plants, animals, and humans) or the environment. More subtly, its finance should not result in economic harm, like inequity, unemployment, unsustainability, or instability. In general, Islamic finance must abide by the objectives or Maqasid al-Shariah, in general, and particularly in the economic sphere.

The most direct way to regulate Islamic banks within the above understanding is to assign such an important task to the regulatory authority, in a similar fashion to conventional banks. Specifically, the regulatory authority can incorporate the general rules of Islamic banking in the legal framework, including the banking law and the financial market law. Besides, the detailed rules can be listed in a handbook of supervisory rules, which can be applied directly to banking supervision. As to the legal environment, the banking law can incorporate all the twenty Islamic investment and finance contracts, several examples of lawful Islamic finance products, as well as a specific and exhaustive listing of unlawful products that can be structured through ruses, at which Shariah specialists are good. This can produce a regulatory system of Islamic finance.

However, having been bred into a conventional environment, central banks did not come forward to take over the regulatory functions both financially as well as Shariah-wise. This has been the case, despite the fact that Shariah has a limited number of easy to understand rules for economic transactions, which can be easily digested by the non-religiously trained regulators<sup>15</sup>. The final result came out to be a dichotomy in banking regulation between Islamic and conventional banks or the *regulatory dichotomy*. While both types of banks are financially regulated and supervised, only Islamic banks escape the regulators' Shariah supervision.

At any rate, we must consider and compare two alternative approaches to Islamic finance regulation. The first is the integrated method, in which all regulation is done by one regulatory authority. The second is the current system that contains dichotomy between financial and Shariah aspects.

There are special aspects of Islamic finance that are totally ignored by regulators who focus mainly on the side of commercial banking. Islamic banks carry out investment finance which involves agricultural, industrial, and commercial ventures. Regulators ignore the need to ascertain Islamic banks' capacity to do the required due diligence for investors. The decomposition of an Islamic bank's operations into sale and investment finance has not been subject to serious consideration. Such points should be highlighted when we come to analyze Shariah supervision.

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<sup>13</sup> It could be the central bank or the banking supervisory authority.

<sup>14</sup> Additionally, off-balance-sheet items would also be considered.

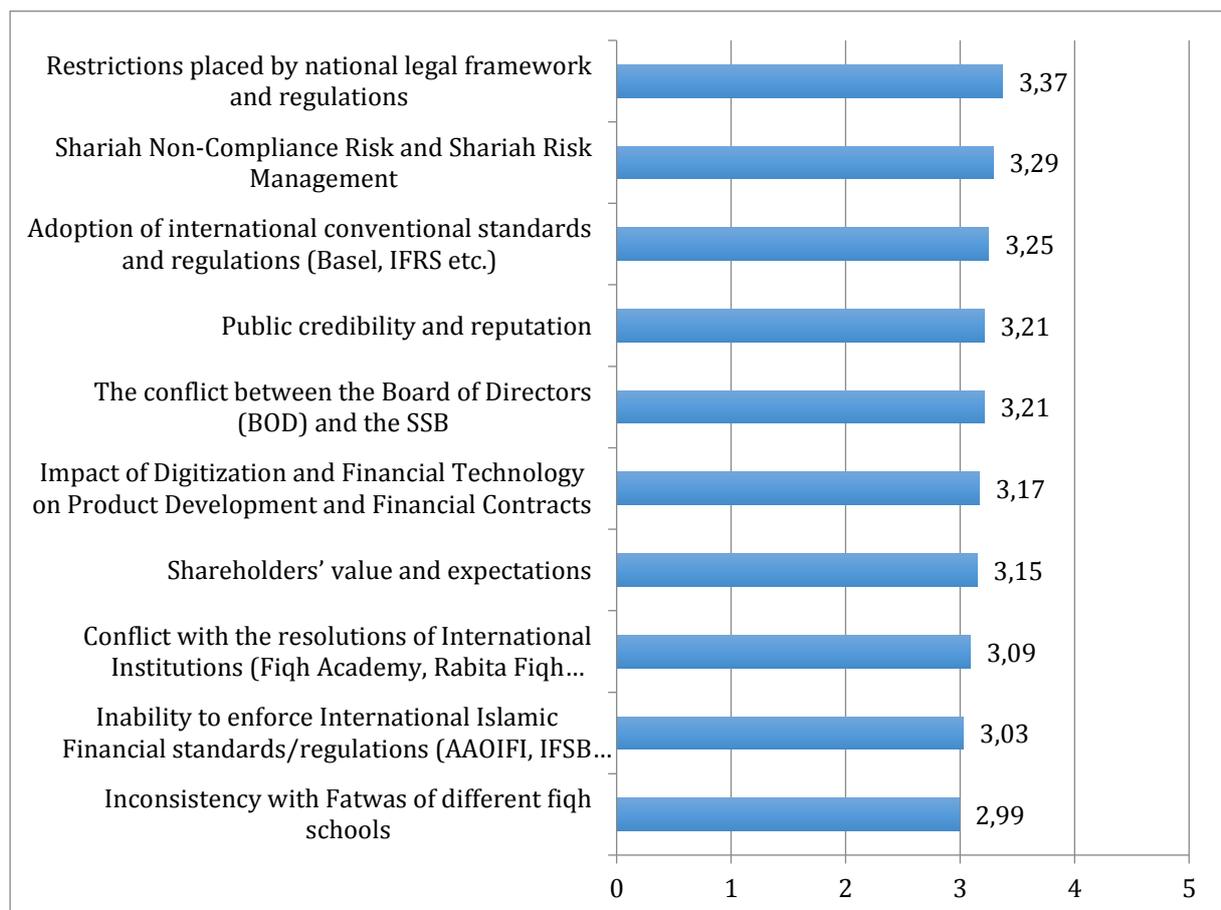
<sup>15</sup> This could have been resolved by adding one course in principles of Shariah and another on Shariah rules for transactions in undergraduate economics and finance programs.

#### 4. SHARIAH GOVERNANCE FRAMEWORK

The practice of Shariah governance in the Islamic finance industry at the global level faces important issues. Many issues are linked to the roles and responsibilities of the SSBs operating at the national level as well as at the institutional level. Also, important challenges of Shariah governance can be summarized, such as follows: (i) the lack of a legislative and regulatory environment for IFIs, (ii) standardization and consistency among IFIs, and (iii) regulatory and standardization challenges, etc. Additionally, there are some technical challenges related to the lack of digital systems that enhance communication between the relevant authorities concerning Shariah governance. This part of the study tries to explore the main issues/challenges regarding the Shariah governance framework and its implementation in different jurisdictions.

As for challenges and obstacles in terms of Shariah governance in surveyed countries, summarized in figure 5, the most important obstacle and the challenge seem to be the restrictions placed by the national legal framework and regulations in the countries. On the other hand, the conflict between BOD and SSB and inconsistency of expert opinions of different Fiqh schools do not seem to be a problem for the Shariah governance landscape in the countries.

**Figure 5: Shariah Governance Challenges and Obstacles as Viewed by Industry Insiders**



Source: Authors

**4.1. STRUCTURAL CHALLENGES**

Industry insiders seem to limit the structural challenges to two issues: The first is the absence of a unified legal framework for Shariah governance. The second is that the SSBs requires different legislative and executive authorities to execute their functions. This can be interpreted that the inside view of the industry, as perceived by Shariah-scholars-dominated SSBs, recognizes a few issues to be considered in Shariah governance. This is what we would expect from insiders under the prevalent circumstances. Obviously, we must rely on the outside view as well as the regulators’ perception which would take a wider scope.

**4.1.1. COMPREHENSIVENESS OF SHARIAH GOVERNANCE FRAMEWORKS**

The corporate governance (CG) structure in IFIs requires other measures of governance such as Shariah governance. Shariah governance is a mechanism at the institutional, industrial, and national levels that ensures IFIs practice Shariah-compliant products and services only.

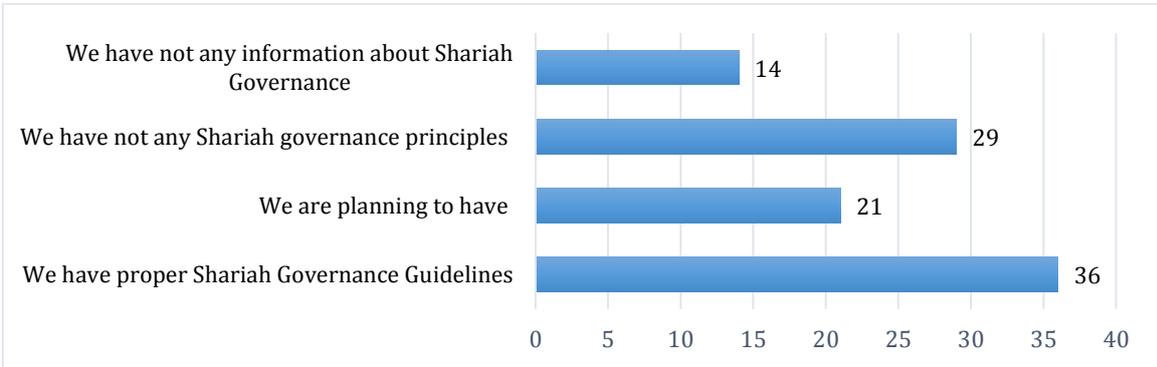
**Table 7: Additional Mechanisms in IFIs Compared to Conventional Institutions**

Functions	Conventional Financial Institution	Additions in IFIs
<b>Governance</b>	Board of Directors	Shariah Supervisory Board
<b>Control</b>	Internal Auditor External Auditor	Internal Shariah review/audit unit/department External Shariah review
<b>Compliance</b>	Regulatory and financial compliance officers, unit or department	Internal Shariah compliance unit/department

Source: (IFSB 2009) [Modified]

The Shariah governance frameworks and guidelines are the tools used to meet the unique requirements of the Islamic financial sector. In some jurisdictions, Shariah governance is not regulated, coupled with a lack of clear and comprehensive SGF for all IF products and services. Regulators are generally less likely to have dedicated frameworks for ICM compared to Islamic banking. For example, according to the IFSB Survey, only less than half IFSB member regulators had independent standards or guidelines for ICM<sup>16</sup> as shown in table 8.

**Table 8: Shariah Governance for Islamic Capital Markets Viewed by Regulators**



Source: IRTI & IFSB (2014) [Modified]

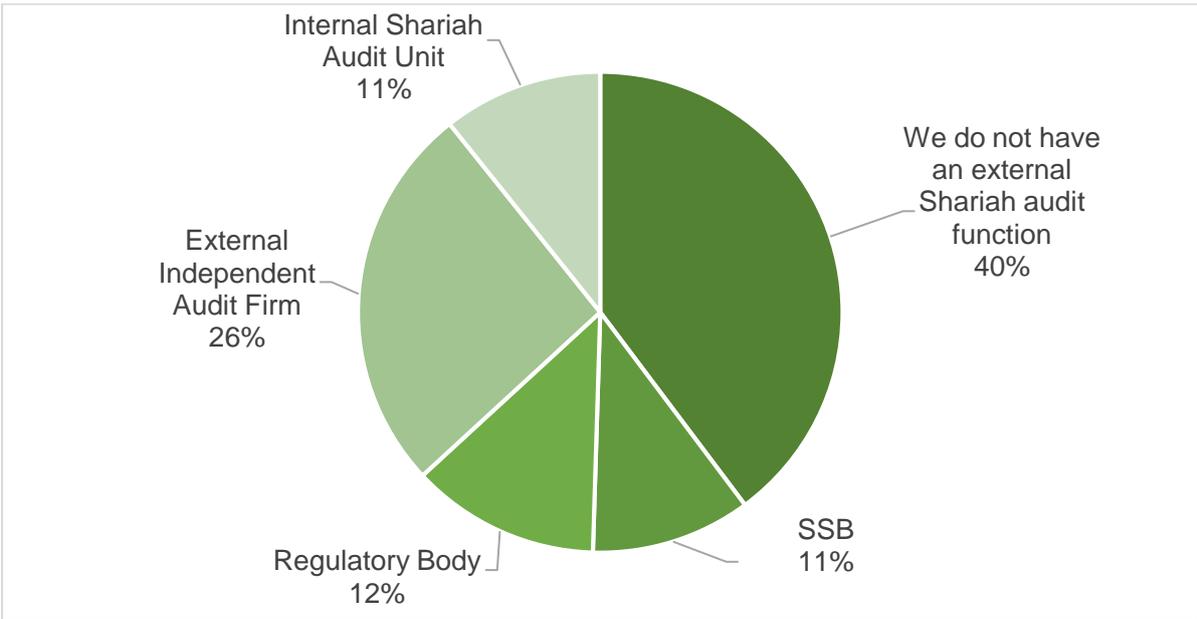
<sup>16</sup> Fourteen regulators engaged in IFSB Survey 12 countries such as Brunei, Turkey, Bahrain, Ireland, Luxemburg, UAE, Oman, Pakistan, Malaysia, Thailand, Kazakhstan, S. Korea.

More comprehensive SGF stands up with the greatest challenges. In fact, SGF should cover all Shariah compliance environment of IFIs and explicitly define the roles and responsibilities of different organs of IFIs including the BOD, executive management (EM), SSBs (national and institutional levels), Shariah compliance, product development, internal auditors and external auditors related to Shariah compliance.

IFIs establish an internal Shariah system to ensure Shariah compliance with the activities of the institution. This internal body may be formed through the SSB or expanded to include an internal Shariah system that consists of an SSB and an internal Shariah review unit or department to support the Shariah body in the performance of its function (Grassa 2013b).

Most of the regulatory frameworks have not imposed any requirement about establishing an external Shariah review. As stated by the Grassa (2013a), “the increasing development of Islamic finance worldwide, the sophistication of Islamic products and services and the need for an effective external Shariah audit seems to be very important at present more than before.” In some jurisdictions like Malaysia, the Shariah review function for IFIs is regulated by respective authorities such as by BNM (BNM 2019). For example, according to the Shariah governance survey for IFIs, there were 40% of respondents answered that they have not an external Shariah audit function (figure 6).

**Figure 6: Performing External Shariah Audit in IFIs**



Source: Authors

As stated by the IFSB (2009), comprehensive guidelines on the SGF would enable all stakeholders (i.e. customers, management, shareholders, supervisory authorities) to perform their roles in accomplishing the SG objectives, and help to promote soundness and stability of the IFIs.

**4.1.2. IMPROVING THE SHARIAH GOVERNANCE MODEL**

The ideal model of Shariah governance that we propose in this report finds its way to implementation, the structure of IFIs would change in many ways. First, Islamic banks would become more involved in real sector operations. Their use of the London Metal Exchange and other similar markets for controversial products would be stopped, while their involvement in real sector transactions would multiply. The rate of profit distributed to their IAHS would significantly rise. Their concern regarding the interests of the latter group would multiply, as they are integrated into the governance structure

of the IFIs. Islamic finance would attract more attention to monetary authorities, as its assets become increasingly influential on monetary policies. Their economic impact would rise in proportion to the amount of investment they undertake.

Would the IFIs be able to adjust to their higher importance? Can they truly abide by the instructions of the national SSB? Can they become fully committed to the decisions made by their standard setters, particularly AAOIFI, the IFSB, and the IFA, especially after having a higher number of Islamic monetary and financial economists sitting on such organizations? In a few words, we ask whether the Islamic finance industry can adjust themselves smoothly to their new structure which would ultimately result from a better model of Shariah governance. This in summary is the structural challenge that would pose itself to the industry.

#### **4.1.3. INDEPENDENCE OF SSBs**

The current practice of appointing an SSB member by IFIs management throws doubt about its independence. Obviously, board members are administratively attached to and can be influenced by IFIs' management. When a national SSB is appointed by and attached to the regulator, the suspicion of lack of independence is removed. Even when IFIs appoint their SSBs, they would automatically fall under the supervision of the national SSB.

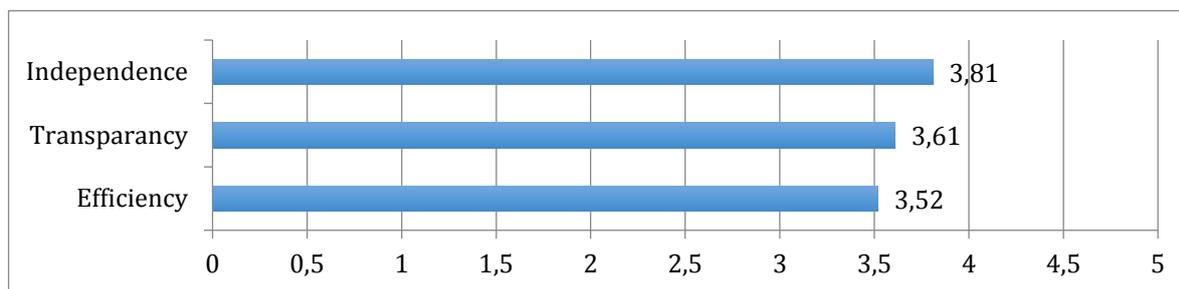
National and institutional SSBs have to be independent of all restrictions that hinder the independence of their decisions and the discharge of their duties. Independence is defined according to AAOIFI as *"an attitude of mind which does not allow the viewpoints and conclusions of their possessor to become reliant on or subordinate to the influences and pressures of conflicting interest. It is achieved through organizational status and objectivity. The principle of objectivity imposes obligations on SSB members to be fair intellectually honest and free of conflict of interests (neutral)."* (AAOIFI 2005, para. 2).

The appointment of SSB members by IFIs' managers may create a potential conflict of interest between shareholders and SSB members. The concern is that SSB members can accept suspicious processes to ensure their reappointment in theory. SSBs should provide an independent opinion on all related matters (Grassa 2013b). On the other hand, IFA (2009) states that SSB members should be appointed by the general assembly instead of the BODs of IFIs. Hence, resolving the issue of the independence of SSBs can be guaranteed if the appointment is made by the centralized body or the general assembly. Alternatively, the appointment, reappointment, dismissal or non-renewal should be in the hands of a central authority that takes into consideration the importance of the role and risks of the SSBs because of the reputation and efficiency of SSB members.

The appointment of SSB members by IFIs' managers may create a potential conflict of interest between shareholders and SSB members. The concern is that SSB members can accept suspicious processes to ensure their reappointment in theory.

The average score in the Shariah governance survey on the question of the independence of SSBs in their countries is 3.81 out of 5, while the average score on transparency and efficiency is 3.61 and 3.52 respectively (figure 7). Therefore, we can infer that the independence of SSB is in a better position compared to the transparency and effectiveness of the surveyed countries.

**Figure 7: Independence, Transparency, and Efficiency of SSB**



*Source: Authors*

In order to ensure the independence and confidentiality of SSBs, respective standard setter bodies and regulators should bring strict standardization for the sitting of SSB members in more than one institution. In addition, the national SSB supervising the institutional SSBs and the special powers of the national SSB should take Islamic finance steps forward towards product harmonization. The national SSB should act as an effective control mechanism to supervise the Shariah rulings and products at the institutional level. Otherwise, the absence/or weak control at the national level would bring doubtfulness on products (Grassa 2013b).

In some jurisdictions, national Shariah authorities / SSBs are called Advisory Boards<sup>17</sup> and the naming of advisor or advisory to the national SSB body reflects that the body has an advisory function rather than supervision and control. Accordingly, rulings and expert opinions of the body have the option of taking and accepting advice or not by respective institutions. In contrast, the national SSB shall be empowered to decide and supervise all Shariah related issues of the IFIs. All rulings, expert opinions of the national, as well as institutional SSBs, shall be mandatory on the IFIs.

There are some potential barriers to the independence of SSB members, which may lead to being an impeding handicap for independence and objectivity. Some of them can be summarized as follows:

- 1- Financial relations of SSB members with the institution
- 2- Family or personal relations with the management of the institution.
- 3- SSB members receive a large amount of money from several IFIs.
- 4- The SSB members receive services and rewards from the IFIs
- 5- Continuity and supervision of SSB members the same institution for a long time

Therefore, the need to create a national SSB that supervises the appointment and renewal of SSBs members cannot be overemphasized. This must be coupled with the regulator's initiative to supervise IFIs both financially as well as Shariah-wise.

## **4.2. REGULATORY CHALLENGES**

It is safe to say that regulators in general, and regardless of the regulatory scheme they currently apply to the IFIs, take an agnostic stand towards the Islamic finance industry. Even when regulators house a national SSB, their supervisory approach mainly focuses on financial soundness, almost equivalently interpreted for both Islamic and conventional finance. Regulators tolerate whatever commercial banks do, like predatory lending, synthetic securitization, generous finance of pure risk and debt trade, and the like. Such actions would run contrary to the rules of Islamic finance. However, regulators would naturally tolerate them on the side of Islamic finance. The regulatory challenge calls upon the

<sup>17</sup> SSBs are called in different jurisdictions with different names such as in Malaysia as Shariah Advisory Council (SAC), in Indonesia as the National Shariah Council; in Bahrain, the National Shariah Advisory Board, etc.

regulators to distinguish between the regulation and supervision of Islamic and conventional finance. This requires changing deep-rooted habits and conventions. However, it is necessary for a healthy finance industry for the whole economy.

Establishing a comprehensive SGF and the structuring of SSBs, its duties and responsibilities may change from one IFI to another, depending on size, complexity, and business nature.

Establishing a comprehensive SGF and the structuring of SSBs, its duties and responsibilities may change from one IFI to another, depending on size, complexity, and business nature. Also, the scope of the Shariah governance system may change from one region to another, depending on the nature of structures, market realities, and the stage of development of their IFIs. Setting standards for IFIs at the international level is a very important and necessary task to enhance consistency among IFIs across jurisdictions. When international standards are binding, they give a sense of reliability and bridge the gap between Islamic financial institutions' practices, Shariah decisions, and fatawa.

The Islamic financial industry is supported by some qualified international bodies such as the SSB of IDB and the IFA. The current status of SGF has been subject to multiple approaches around the world. Some jurisdictions adopt the (i) silent /hands-off approach, which means that the regulatory authorities do not interfere through regulatory or supervisory activities. While some jurisdictions adopt the (ii) minimal approach, the (iii) engaged approach and some adopt the (iv) proactive approach, and other jurisdictions adopt the (v) committed approach (Ginena and Hamid 2015b; M. K. Hassan and Lewis 2007).

### **4.3. OTHER REGULATORY CHALLENGES: TAKAFUL**

There are other regulatory challenges. For example, the takaful industry confronts a serious challenge in developing internationally acceptable standards for its regulation, specifically those associated with differing Shariah interpretations (Abdul Ghani 2006). We must, therefore, admit that Shariah differences require some way to be resolved in setting takaful products.

#### **4.3.1. QARD HASAN**

The first issue is related to the qard hasan, which is an interest-free loan given by the takaful operator when there is a deficit in the takaful. Such a loan is usually considered by the operator as an injection. Instead of confronting the deficit which should be remedied, the operator continues its unprofitable operations, using profits made on profitable transactions to cover the loss of the unprofitable. We, therefore, need an arrangement that forces the takaful operator to deal with the deficit (Odirneo 2009).

#### **4.3.2. RETAKAFUL**

The second challenge relates to retakaful. Quite often the takaful operator pays out a commission to the retakaful operator, which exceeds what the former receives from the latter (Odirneo 2009).

#### **4.3.3. DEALING WITH SURPLUS**

Another challenge is how to deal with the surplus, which is usually considered for sharing with policyholders. The takaful liability (in case of general takaful) is equal to unearned-contribution reserve plus *incurred but (still) not reported reserves* or IBNR for short. When coverage is short-tailed, as in auto Takaful, IBNR is known for certain. However, when takaful is long-tailed, IBNR may not be known for several years. Therefore, whatever appears as a surplus and is usually considered for distribution must be adjusted against the yet to be known liability (Odirneo 2009).

#### 4.3.4. INCLUSION OF POLICYHOLDERS IN GOVERNANCE

Another challenge is the exclusion of policyholders from decision-making, in a fashion similar to the exclusion of IAHs in IFIs. Such a group is important stakeholders that must be proportionately represented in the annual meeting as well as the board of directors. Their representation brings takaful closer to its Shariah conceptualization as a cooperative.

#### 4.3.5. INTERNAL SHARIAH COMPLIANCE

Another challenge is related to internal Shariah compliance. This function depends on the competency of human resources working in Shariah review and audit units. Some suggest that Shariah auditors must be knowledgeable in both Shariah and accounting (Puad 2014). This can be assured through training and development. Shariah review and auditing must be supported by a strong internal control system.

#### 4.4. STANDARDIZATION CHALLENGES

Islamic finance products are structured by mixing and matching Islamic finance contracts. Since the contracts themselves are numerous, the products from their mixing and matching would be large. The need for product standardization arises, hence. The best option for policymakers and regulators is to agree on a handbook for Islamic finance products, which would list each of the major products, annotated with its Shariah basis, economic rationale and its related documentation, including contract samples, memoranda of understanding, sample outlines of feasibility studies, prospectuses for financial instruments, etc. Such a handbook would expectedly grow in size by adding new product structures after their being approved by regulators. This facilitates the supervisory job over Islamic finance and ensures a high degree of standardization and harmony between Islamic finance.

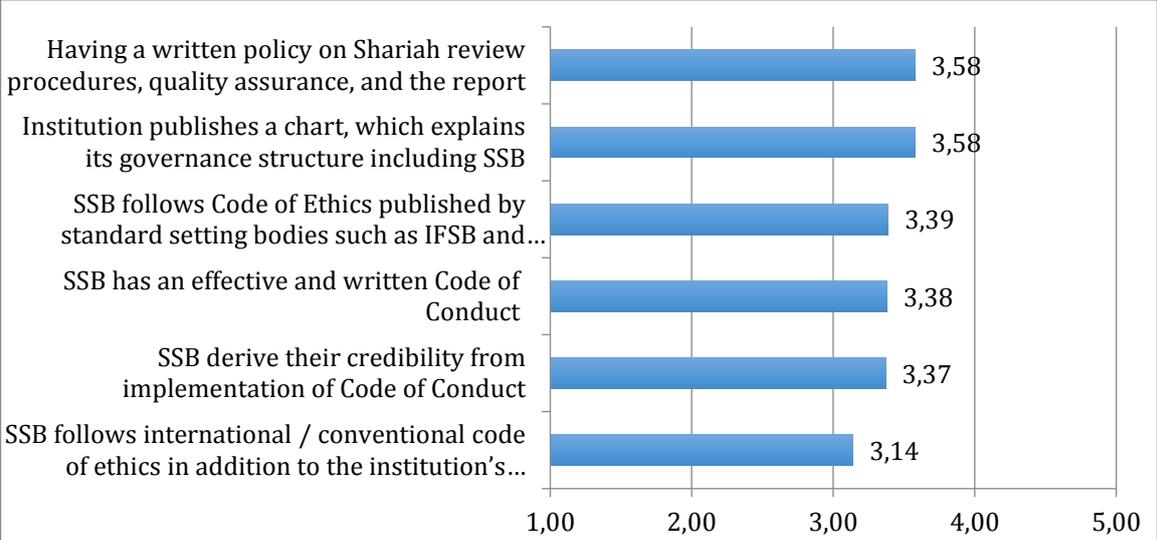
The lack of standardization of SGF in some jurisdictions and globally leads each IFI to manage its own Shariah governance independently from any generally accepted industry standard.

The lack of standardization of SGF in some jurisdictions and globally leads each IFI to manage its own Shariah governance independently from any generally accepted *industry standard*. Meanwhile, inflexible standardization would suppress innovation and development in the industry. In un-standardized jurisdictions, SSBs have a strictly advisory role that is nonexecutive as they cannot interfere in management related matters (ISRA 2013).

In different OIC regions, there are different Shariah governance approaches as well as different requirements. On the one hand, in some jurisdictions, there is no centralized body, each IFI has its SSB. On the other hand, the multiplicity of SSBs in IFIs leads to a conflict of opinions and inconsistencies. In fact, a national Shariah body may function to reduce the product differences.

In terms of the code of conduct of SSBs, it seems that the institutions in surveyed countries score of having a written policy on Shariah review procedures, quality assurance, and reporting is relatively higher than the other issues (figure 8). It is 3.58 out of 5. However, following the international/conventional code of ethics seems a problematic area in terms of code of conduct.

**Figure 8: Code of Conduct of SSB**



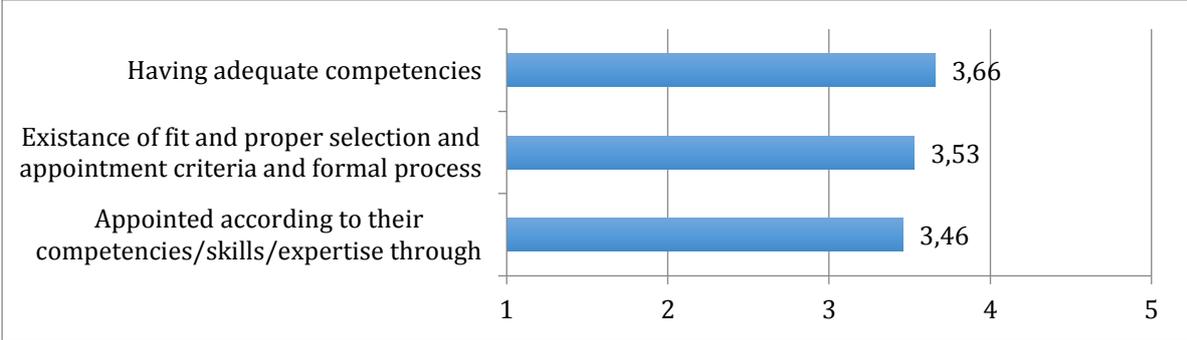
Source: Authors

**4.5. EDUCATIONAL AND HUMAN DEVELOPMENT CHALLENGES**

The practice of appointing SSBs membership exclusively from among Shariah specialists, even without setting minimum qualifications of academic degree, research, and teaching experience is one of the biggest challenges to Islamic finance.

AAOIFI defined some requirements for SSB and its members. “...independent body of specialized jurists in *Fiqh al-Muamalat* (Islamic commercial jurisprudence). However, the Shariah supervisory board may include a member other than those specialized in *Fiqh al-Muamalat*, but who should be an expert in the field of Islamic financial institutions and with knowledge of *Fiqh al-Muamalat*.” (AAOIFI 1997, para. 2). On the other hand, the Shariah governance survey indicates that the importance of competencies and skills of SSB members varies with the type of respondents as shown in figure 9.

**Figure 9: Competencies and Skills of SSB**



Source: Authors

On the other hand, some authors suggested some criteria such as (i) A PhD from an accredited university, experience on Shariah compliance auditing or supervising experience (at least 10 years), (ii) counseling on matters of Islamic commercial law (at least 10 years) (Farook and Farooq 2013, 155). Nonetheless, we explained above that SSB members must be scholars, with a PhD in Islamic economics or Fiqh Al-Muamalat, with a track record of graduate teaching as well as publications in peer-refereed journals. Some claim that the strict requirements for SSB members, coupled with the fact that they are employed only by one institution would leave some IFIs without any member, or would be forced to appoint an unqualified member (ISRA 2013). However, this seems to contradict the wide-spread religious colleges as well as departments of Islamic studies in universities located in Muslim countries. In addition, there is now an abundance of graduate schools that offer programs in Islamic finance.

Shariah supervisory board may include a member other than those specialized in Fiqh al-Muamalat, but who should be an expert in the field of Islamic financial institutions and with knowledge of Fiqh al-Muamalat.

Moreover, there is the absence of a unified and disciplined standard, which meets the requirements of the minimum qualifications of SSB members. For example, unlike Malaysia and Indonesia in many GCC countries, SSB members are not prevented from sitting in more than one institution (Funds@Work 2010). This exposes IFIs to negative reputation risk. One of the important criteria in the appointment of SSB members is a good reputation. There is a close relationship between the reputation on the one hand and honesty, integrity, and fairness on the other hand (Grassa 2013b). Actually, the success of the industry depends on public trust, investor, and consumer confidence. The joint membership of some SSB members in a multiple of SSBs of IFIs can decrease the confidence and credibility of the SSBs. Besides, the absence of young SSB members can be a serious problem that may hinder the performance and the efficiency of future SSBs in terms of human development (Grassa 2013b). As stated in Pakistan SGF (SBP 2018), IFIs should organize training and/or orientation programs on Islamic finance for the BOD members and appropriate training programs for senior executives to increase their understanding of Islamic Finance.

There are three steps necessary for remedying such a situation. First, the regulators must address the composition of SSBs to ensure that their majority is made of monetary and financial economists. Second, since the SSB members must be scholars, a PhD degree from an accredited university, teaching experience at the graduate level, and research publications in peer-reviewed journals must be made as requirements. Third, a national SSB attached to the regulator is a must, even if the appointment of an SSB at every IFI is the rule.

#### **4.6. DISCLOSURE, TRANSPARENCY AND CONSISTENCY**

Some empirical studies verify that IFIs around the world do not disclose details of reports, fatawa, decisions, and guidelines issued by SSB (Olayemi, Noureldin, and Siddiqui 2018). However, some IFIs SSBs have published their fatawa in volumes, which are often accessible to the public. This in itself is a step forward towards transparency. Yet, such fatawa must have impacted the financial statements of their respective IFIs. Disclosure of this aspect has been limited. While the IFIs financial statements attract the attention of regulators, there are certain aspects of special interest in assessing their performance as IFIs that are not always apparent. Examples are many. On the asset side, it is not easy to divide the mudaraba pool's assets by investment and financial contracts. The absence of such information makes it difficult to judge whether mudaraba pool assets are Shariah-based or not. Liabilities are sometimes lumped together without proper classification. Sometimes explanatory notes

are vague.

Since the structure of the financial statements is designed from the vantage point of judging solely the financial soundness of an IFI, such design must be modified to help assess how assets and liabilities are Shariah-based.

The IFSB (2007a, para. 78) defines transparency in IFIs from an operational perspective of a central bank or supervisory authority as “an environment where material and reliable information is made available in a timely and accessible manner to the market at large and all stakeholders. Such transparency can reduce asymmetric information and uncertainty in financial markets.” As transparency, IFIs should disclose all matters relating to the Shariah such as SSB duties, decision-making process, expert opinions, etc. It is known that disclosed Shariah reports of SSBs strengthens stakeholders' confidence in the credibility of the IFIs in terms of Shariah matters (Grassa 2013b).

On the asset side, it is not easy to divide the mudaraba pool's assets by investment and financial contracts. The absence of such information makes it difficult to judge whether mudaraba pool assets are Shariah-based or not.

According to the IFSB-22 (2018a), “the transparency is an important concern for IFIs, which must comply with Shariah rules and regulations, as any form of concealment, fraud or attempt at misrepresentation violates the principles of justice and fairness in Shariah as mentioned in the Holy Qur’an and Sunnah.”

It is a fact that sitting of SSB members in more than one SSB of IFIs affects confidentiality and as well as breaks the conflict of interest. In addition, it is safe to assume the judgments required for IFIs operations need significant amounts of time. This would imply that the membership on one SSB should be time-consuming, especially that as SSB members should also be involved in teaching and research. International and national bodies should, therefore, pay due attention to this issue. In some jurisdictions (i.e. Malaysia, Nigeria, etc.), sitting of SSB members in more than one institution is restricted. To avoid any conflict of interest and to protect confidentiality within the industry, the IFIs should not appoint SSB members in other IFIs of the same industry (BNM 2004, para. 19). According to Zawya Analysis (Funds@Work 2010), the top 20 Shariah scholars sit in 610 SSBs in IFIs, and the top 2 Shariah scholars each one of them sits in more than 85 SSBs in IFIs.

The issue of consistency between the fatawa of SSBs of different IFIs is important. We cannot accept that some IFIs are more lenient of Shariah's conformity than others. The fact that SSB members can access fatawa of other SSBs should be a factor in ensuring consistency among fatawa. How can we ensure consistency? This is an interesting challenge that should be confronted by the regulatory bodies.

#### **4.7. CONFLICT OF INTEREST AND CONFIDENTIALITY**

We have previously touched upon the competence aspect, calling for the setup of qualifications to ensure the competence of SSBs membership whether they are Shariah or Islamic economics scholars. Besides, we have proposed that a majority of members must be specialized in monetary and financial economics.

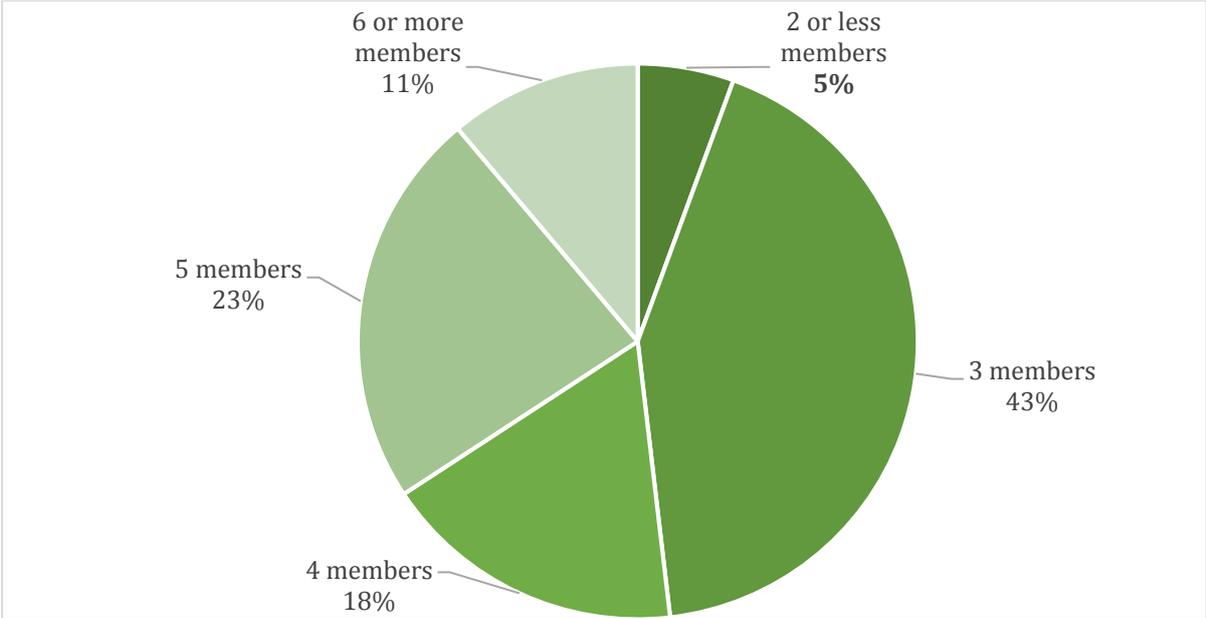
The issue of the conflict of interest emanates from the fact that some Shariah specialists are found to be members of several SSBs. Sometimes, the number of SSBs in which the specialist is a member would not perceivably allow attending all meetings or providing opinions, based on careful studies. We often

notice that SSB membership is for life, with hardly any turnover. This is suspected to be caused by Shariah arbitrage exercised by the IFIs themselves, in the absence of governance rules that would limit the number of memberships in the IFIs as well as the service period.

The regulator should setup the maximum number of memberships (we can perceive no more than one membership per scholar) as well as the maximum period of service (we prefer two periods in the same IFI). As shown in figure 10 below, with regard to the number of SSB members; %43 of the survey participants stated that the SSBs of the IFIs have 3 members. In general, the results show that %95 of the SSBs have either 3 or more members, and 5% have 2 or less SSB members.

The regulator should setup the maximum number of memberships (we can perceive no more than one membership per scholar) as well as the maximum period of service (we prefer two periods in the same IFI).

**Figure 10: The Number of Members of SSB of the IFIs**



Source: Authors

The lack of confidentiality arises when one person is a member of more than one SSB. Naturally, research, due diligence, and efforts made in product structuring would be copied from one IFI to another, without consideration to intellectual rights and business secrets. This particular aspect mandates that no one should be allowed as a member of more than one SSB.

**4.8. SHARIAH COMPLIANT VS SHARIAH BASED PRODUCTS**

As mentioned above, Islamic finance products require both formal validity and validity of purpose in order to be based on Shariah. It is often forgotten that Islamic finance is only a part of a wider Islamic economic arrangement. Formal validity is mainly concerned with contractual formalities. Meanwhile, the validity of purpose goes beyond formalities. It raises questions on the economic effects of the

transaction. Economists would agree that balanced growth, equitable distribution of wealth, full employment, stability, economic sustainability, and many other objectives can be listed among Maqasid al-Shariah. Transactions that fulfill the proper form are Shariah-compliant. However, if they do not fulfill the validity of purpose, they cannot be considered Shariah-based.

The important question is how the regulator, who is supposed to ensure the validity of purpose, for the sake of serving the national economic objectives, ascertains the validity of purpose. This lies beyond the ability of Shariah scholars to identify the ultimate economic consequences of transactions. Such ability requires economic expertise. Without a majority of Islamic monetary and financial economists in Shariah boards, ultimate consequences cannot be properly identified.

Some OIC countries (i.e. Malaysia, Pakistan) determined specific conditions regarding the reputation of SSB members such as follows:

1. Not have declared bankruptcy, or a petitioned against him under bankruptcy laws.
2. Not convicted of any criminal offense involving financial offenses.
3. Not found guilty for any serious criminal offense, or any other offense punishable with imprisonment of one year or more; or
4. Not subject to any order of detention, supervision, restricted residence, or banishment.
5. Not subject to any adverse findings or any settlement in civil or criminal proceedings with regard to investment, financial or business, etc. (BNM 2004; SBP 2018).

Obviously, the above conditions guarantee a crime-free background but stay silent on educational and practical experience.

**4.9. COMMUNICATION AMONG SSBs**

The IFSB Survey on Shariah Boards of IFIs indicates that there is a lack of communication between Shariah councils that facilitate coordination between issues and practices related to Shariah.

The application of the fatawa of IFA and the adoption of AAOIFI and IFSB standards will reduce conflict of fatawa among IFIs and will help harmonize across jurisdictions. A study shows that 65% of IFIs (out of sixty-nine) are unaware of the importance of AAOIFI Shariah standards in respective jurisdictions (Hassan, 2011). The application of the fatawa of IFA and the adoption of AAOIFI and IFSB standards will reduce conflict of fatawa among IFIs and will help harmonize across jurisdictions. A study shows that 65% of IFIs (out of sixty-nine) are unaware of the importance of AAOIFI Shariah standards in respective jurisdictions (Hasan 2017).

The IFSB Survey on Shariah Boards of IFIs indicates that there is a lack of communication between Shariah councils that facilitate coordination between issues and practices related to Shariah (Hasan 2011). Hence the Shariah governance at the global level ensures homogeneity in the fatwa and Shariah decisions of SSBs.

#### 4.10. TECHNICAL CHALLENGES

Simple observations in the finance sector reveal that finance and technology are intertwined. The whole world is moving increasingly towards electronic money. The irony is that money, regardless of its physical attributes, whether it is paper or electronic, is *debt money* in conventional finance while it is *investment money* in Islamic finance. The former is created and allocated, based on lending, while the latter is created and allocated, based on the investment.

The monetary authority as well as the regulatory authority will have to watch over a financial system with two different kinds of money, coupled with a myriad of payments and settlement techniques mixed with financial innovations. Besides, on the Islamic finance side, it has to cope with twenty investment and finance contracts, in addition to several types of Islamic financial instruments. Watching over such arrangements should appear to regulators as a highly complex job. While this in fact may be surmountable, it would require special efforts. In particular, the regulator has to look into IFIs investment activities to ascertain that they would not be overwhelmed with the lemon problem. This would require scrutiny of IFIs resources directed to due diligence and their efficiency.

Financial technology application builders should obey the Shariah principles by avoiding the prohibited elements in the transactions (i.e. interest, maysir, gharar). Also, the practice of transactions in fintech application should follow the rules, the pillars and the conditions of the contract.

The lack of technical skills of SSB members is also an important challenge facing the Shariah governance of IFIs across jurisdictions. Diversity of competencies (academic and technical) must be adopted among the SSB members. Actually, some jurisdictions stress that SSB should have specializations in Fiqh al-Muamalat (Islamic Commercial Jurisprudence). However, today, the financial system becomes more and more technical, complicated, and sophisticated. Also, the widespread implementation of financial technology in the industry covers a wide range of activities (i.e. payments, data security, and customer interface). Financial technology application builders should obey the Shariah principles by avoiding the prohibited elements in the transactions (i.e. interest, maysir, gharar). Also, the practice of transactions in *fintech* application should follow the rules, the pillars, and the conditions of the contract. Also, fintech application should aim at achieving the purposes of the Shariah (Maqasid al-Shariah). However, the existing SGF does not address fintech and how to supervise its Shariah compliance. Moreover, the issue of Shariah compliance in fintech applications should be taken into consideration by the regulators/bodies (Laldin 2017). Hence, the SSBs may seek the advice of professional bankers, IT in addition to Islamic (monetary and financial) economists and Shariah scholars. The role of SSBs in terms of technical challenges can be monitored such as follows:

- 1- Examination of the contracts, transactions, and forms.
- 2- Periodic examination of Islamic financial transactions procedures
- 3- Approving the balance sheet
- 4- Reporting and clearly expressing opinions on the degree of reliability of transactions.
- 5- Report on the Shariah violations, explain the reasons for and effect of violations.
- 6- Report on adherence to Shariah compliance, ethics, and social responsibility .”(Grassa 2013b)

Hence, the greatest challenge of SGF is linking to the scarcity of availability of these skills in SSB members. Improvement of this system would promote transparency and disclosure.

## 5. CASE STUDIES AND SURVEY ANALYSIS

### 5.1. CASE STUDY: MALAYSIA

#### 5.1.1. OVERVIEW OF SHARIAH GOVERNANCE

Malaysia continues to be the main driver for many segments in Islamic finance including the sukuk market as it represented 49.7% of the total global outstanding sukuk which stood at USD 466.8 billion, by the end of 2019<sup>18</sup>. In the Islamic banking sector, Malaysia ranked third globally after Iran and Saudi Arabia with total Islamic banking assets of \$201 billion by the end of 2017 (ICD 2019).

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Regarding the development of the Islamic finance industry in Malaysia, it is worth to mention that Malaysia adopts a unique approach to implement Islamic finance in the country, which includes the contribution from every stakeholder in the industry such as (BNM), Securities Commission (SC) Malaysia, independent advisory governmental bodies, financial institutions, accountants, auditors, and legal practitioners, in addition to the customers.

This holistic approach could be divided into four phases as explained in table 9:

**Table 9: Islamic Finance Development Phases in Malaysia**

1983-1992 Establishing the Foundation	Government Funding Act 1983
	The Islamic Banking Act (1983)
	Takaful Act (1984)
	Bank Islam Malaysia Berhad (BIMB) was established (1983)
	Syarikat Takaful Malaysia Berhad (STMB) was established (1984)
	Banking and Financial Institutions Act (1989)
1993-2000 Institutional Building	The Islamic Interbank Money Market (1994)
	Shariah Advisory Council (SAC) (1997)
2001 to 2013 Strategic Positioning & International Integration	INCEIF (The Global University of Islamic Finance) was set up (2005)
	The Islamic Financial Services Board (IFSB) was inaugurated
	The Islamic Financial Services Act (IFSA) (2013)
	The Malaysia International Islamic Financial Centre (MIFC) (2006)
	Shariah Governance Framework (SGF) for IFIS (2011)

<sup>18</sup> Malaysia International Islamic Financial Centre (MIFC estimates).

	International Islamic Liquidity Management (IILM) (2014)
2014-2020 Exponential Growth of Islamic Finance	The Securities Commission of Malaysia (SC) issued the new Malaysian Code on Corporate Governance (MCCG 2017)
	Shariah Governance Policy Document (BNM 2019)

Source: Authors

Concerning the Shariah governance development in Malaysia, one of the most significant development in Islamic banking and finance in the country was the introducing the Islamic Financial Services Act 2013 (IFSA) which repealed the Islamic Banking Act 1983 and the Takaful Act 1984. The IFSA 2013 provides BNM with the required supervisory roles and powers in order to fulfill its essential authorization within a complex and interconnected environment given the regional and international nature of financial developments in the country.

The development of Shariah governance in Malaysia can be traced back to the Shariah governance framework for IFIs in 2010. It states that Shariah governance meets three main objectives, which are: (i) every Islamic financial institution has to follow the central bank requirements by having Shariah governance processes, structures, and arrangements to ensure that of their business activities and operations are in line with the Shariah principles; (ii) when the BOD, Shariah committee and management of the Islamic financial institutions successfully discharge their duties in Shariah issues; and (iii) It completes the outlined functions concerning Shariah review, Shariah audit, Shariah risk management and Shariah research (BNM 2010). The BNM (2010) acknowledges the existence of a two-tier Shariah governance infrastructure. They are the centralized Shariah advisory body at the central bank level and the internal Shariah committee that is established in each Islamic financial institution (Islamic Financial Services Act, 2013).

One of the most significant development in Islamic banking and finance in Malaysia was the introducing the Islamic Financial Services Act 2013 (IFSA) which repealed the Islamic Banking Act 1983 and the Takaful Act

Based on the previous argument, there is an agreement that Malaysia is playing a very important role in the Islamic finance industry. BNM (2019) mentioned that the Shariah governance framework for IFIs had played a critical role in the development of Islamic finance in the country, which has comprehensive Shariah governance framework in the world. This Shariah governance framework which is supported by the strong legal system is considered crucial to enhance the stability of the Islamic financial system. The institutionalization of a proper and strong Shariah governance framework strengthens public confidence in the management and business operations of different Islamic financial institutions.

All these guidelines and acts aim to provide comprehensive direction and guidance on the roles and responsibilities of the Shariah committees, boards of directors, and management in order to ensure Shariah compliance for every product and service in a consistent manner.

### 5.1.2. THE LEGAL SYSTEM AND JURISPRUDENCE OF SHARIAH GOVERNANCE

The Malaysian financial system is considered as a dual financial system where conventional and Islamic financial institutions are operating together. Whereas BNM is providing certain laws and regulations for both systems to distinguish the characteristics of each system as section 27 of the act mentioned: “The financial system shall consist of conventional & Islamic financial system”.

The Securities Commission (Commission) is a statutory body set up under the Securities Commission Act 1993 (SCA), reporting directly to the minister of finance. It is the sole regulatory body for the regulation and development of the capital market in Malaysia. It is directly responsible for the regulation and supervision of the activities of the market institutions, including the stock exchanges, clearinghouses, and monitoring of licensees under the Securities Industry Act 1983 (SIA) and Futures Industry Act 1993 (FIA)<sup>19</sup>.

The Malaysian financial system is considered as a dual financial system where conventional and Islamic financial institutions are operating together.

SAC of the commission was established in order to make sure that the implementation of the Islamic capital market products and services was compliant with Shariah principles. It was endorsed by the minister of finance in order to advise the commission on all related Shariah matters of the Islamic capital market. In introducing the Islamic capital market instruments, the SAC adopted two approaches. The first approach was to study the validity of conventional instruments used by the local capital market from the Shariah perspective. While the second approach entailed formulating and developing new financial instruments based on Shariah principles.

The SAC is also responsible for issuing a list of Shariah-compliant securities, and this list is constantly updated and the Commission announces the updated list twice a year. It is essential for helping Muslim investors identify Shariah-compliant securities and at the same time, increase their confidence when making investments.

The Federal Constitution puts Islamic banking and finance matters under the civil court’s jurisdiction. This is because Islamic banking falls under the item ‘finance’ in the Federal Constitution. The BNM, with co-operation from the judicial body, has agreed to set up a special High Court in the Commercial Division known as the Muamalah bench (Hasan 2010). According to Practice Direction No.1/2003, paragraph 2, all cases under Code 22A filed in the High Court in Malaya will be registered and heard in the High Court Commercial Division 4, and this special High Court will only hear cases relating to Islamic banking matters (R. Hassan 2006).

With regard to the legal system for IFIs, Bank Negara Malaysia had issued several acts and guidelines to govern the Shariah governance framework where the main objectives of this framework were;

- (i) Setting out a framework for the IFIs concerning their Shariah governance structures, processes & arrangements so that they ensure all their operations and business activities are in accordance with Shariah law.
- (ii) Supporting the boards, Shariah committees, and the management of the IFIs with comprehensive guidance related to Shariah matter.

<sup>19</sup> Securities Commission Act 1993, section 15

- (iii) Outlining the functions of Shariah audit, Shariah review, Shariah non-compliance risk management, and Shariah research.

With the introduction of the Malaysian Islamic Banking Act, BNM begins regulating the licensing and governance of fully-fledged Islamic banks. The main features of this act were as follow:

- (i) The top authoritative body for the ascertainment of Islamic law for Islamic financial business has the responsibility to advise the banks and IFIs on any Shariah issue relating to Islamic financial businesses and services.
- (ii) SAC of BNM is appointed by the King, on the advice of the finance minister after consultation with the Bank Negara Malaysia.
- (iii) The court and arbitrator shall take into consideration any published rulings of the SAC - BNM, prior to any proceedings on Shariah matters related to Islamic finance.
- (iv) Rulings made by the SAC of BNM shall be binding on Islamic financial institutions, court or arbitrator.

These two tiers Shariah assurance supported by the strong Shariah governance structure assure Shariah compliance to enhance the public confidence in Islamic financial operations:

- (i) SACs legislative stature as the highest authority for Shariah issues and matters in IFIs are granted under the Central Banking Act.
- (ii) All the Shariah Committee of IFIs has to be fully accountable for their decision and opinions related to Shariah matters.
- (iii) IFIs should have a board and senior management with sufficient expertise and capability in dealing with different issues specific to Islamic financial transactions.
- (iv) Any member of the Shariah Committee of another institution within the same industry (banking – takaful) shall not be appointed in order to avoid conflict of interest and maintain the confidentiality of the information.
- (v) Shariah parameters guide the main features, principles & rulings of Shariah contracts.

Any member of SSB of another institution within the same industry (banking – takaful) shall not be appointed in order to avoid conflict of interest and maintain the confidentiality of the information.

These rules and guidelines, mentioned previously, apply to all IFIs under the supervision of Bank Negara Malaysia. This includes all Islamic banks operating under the Islamic Banking Act, all financial institutions participating under the Islamic Banking Scheme of BAFIA, all development financial institutions which carry out the Islamic Banking Scheme, and all the takaful operators operating under the Takaful Act.

In general, it is found that the BNM is providing a comprehensive regulatory framework for the Shariah advisors, auditors, industry players in Malaysian IFIs through IFSA 2013. The principles concerning the Shariah governance are discussed from section 30 to section 36 from the law as following; Section 30 provides specific requirements for IFIs, which every institution has to apply directly to the BNM for the establishment of the Shariah committee. This will enable Bank Negara to have direct information about the members of the Shariah committee in IFIs.

While in section 31 of IFSA 2013 it states only those who are qualified and experienced can be selected as members of the Shariah committee. This requirement makes sure that every member of the Shariah committee has the required experience and can fit in the Committee according to the requirements by BNM.

Section 32 contributes to the significance of Shariah committees in every institution through the introduction of the Shariah governance that does not only set out the duties of the Shariah committees in the institution but rather blend into the structure of the company itself.

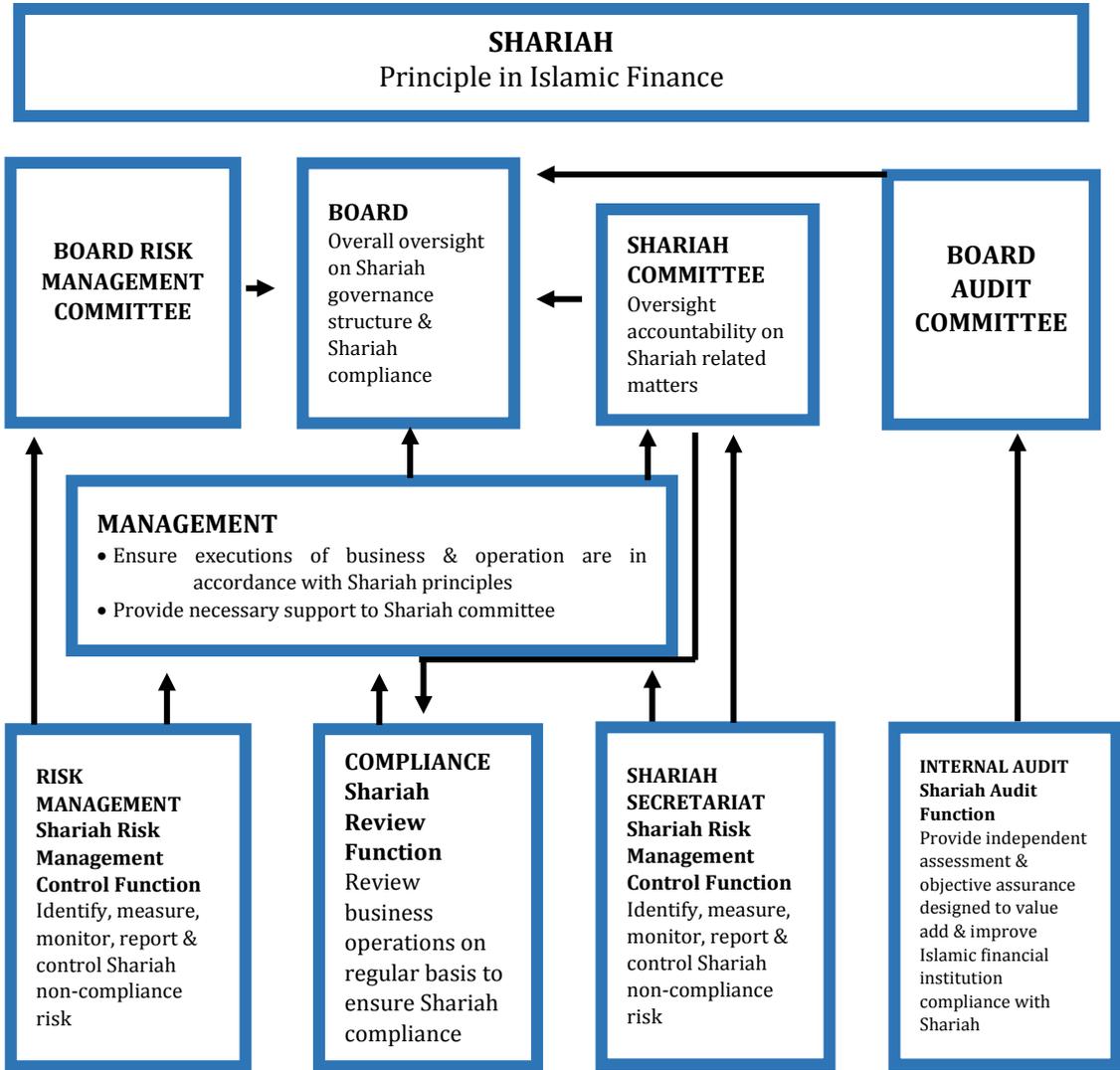
Section 33 and 34 of the IFSA 2013 allow BNM to monitor continuously the updates by the IFIs of its Shariah committee members. In order to maintain its aim of having qualified and experienced members, the provision set out the clause relating to the cessation of the members including situations that would disqualify from becoming Shariah committee members. As for 35, it has made it obligatory for the management to provide information to the Shariah Committee in exercising its tasks and duties.

Besides, section 36 emphasizes the confidentiality of the Shariah committee to keep any kind of information including the confidential ones. While maintaining the confidentiality, the Shariah committees are also protected under the qualified privilege that protects them from any legal action by the Islamic financial institution, if it can be proven that such duties were conducted in good faith (IFSA 2013).

With regard to the Islamic capital market, the Securities Commission of Malaysia is the statutory body entrusted with the responsibility of regulating and systematically developing the capital markets in the country. They issued a recently Malaysian Code on Corporate Governance or MCCG 2017 for accountability and transparency. The Report of SC concerns about the internalization of corporate governance culture for those listed companies and also those non-listed entities. Such non-listed entities are: (i) state-owned enterprises; (ii) small and medium enterprises or SMEs, and (iii) licensed intermediaries (Securities Commission 2017). Also, in promoting corporate governance culture, it provides 36 practices that are suitable to support the main principles of the code such as (i) board leadership and effectiveness; (ii) effective audit, risk management, and internal controls; and (iii) corporate reporting and relationship with the stakeholders, etc. Shariah governance framework structure is explained in the following page with figure 11.

The Securities Commission of Malaysia is the statutory body entrusted with the responsibility of regulating and systematically developing the capital markets in the country.

**Figure 11: Shariah Governance Framework in Malaysia**



Source: BNM 2011

This framework encourages several principles which need to be observed in ensuring that the Islamic financial institution’s operations and business activities are in line with the Shariah principles. The need to establish a sound and robust Shariah governance framework is significant to enhance the practice of Islamic financial institutions in Malaysia. The SGF mentions the accountability and responsibility of the board of directors, the management, and the Shariah committee in particular as they are the main bodies in any institution that ensure the Shariah compliance. The optimal accountability for Shariah governance depends on the board, whereas the Shariah committee will be responsible and accountable for the decisions made. As for the management board, they have the responsibility to observe and implement Shariah rulings and any decisions made by the SAC and the Shariah committee of Islamic banks and takaful operators.

**5.1.3. DEVELOPMENTS OF SHARIAH GOVERNANCE**

The Malaysian Shariah governance system has been implemented and developed through several and different stages. Also, it was developed through different endeavors either top-down initiatives by the Bank Negara Malaysia or by bottom-up efforts by the industry players who form the practice of Shariah governance. Furthermore, BNM had established The International Shariah Research Academy for Islamic Finance (ISRA) and the International Centre for Education in Islamic Finance (INCEIF) and other higher learning institutions in Malaysia to improve the research and development of Shariah governance matters.

The Malaysian Shariah governance system has been implemented and developed through several and different stages.

In the year 2010, the first Shariah governance framework was issued, which laid down the Shariah requirements to ensure that every Islamic financial institution is governed by and following the Shariah principles at all times. To further strengthen its impact on the industry, given the increasing size, nature, and sophistication of the business of Islamic finance, some improvements were proposed to the framework in the exposure draft issued in November 2017. This exposure draft encouraged more implementation of Shariah governance practices that are more effectively integrated within the industry and risk processes of Islamic financial institutions. It calls for, among others, strengthening of responsibilities of the board of directors to include matters concerning Shariah governance, while supporting the independence of the Shariah committee in its advisory and decision-making roles. Furthermore, the exposure draft proposes to mandate that each Shariah committee include at least one industry practitioner to allow for practical and commercial dimensions of Shariah issues in order to be more thoroughly deliberated. Taken together, the main aim of these proposals was to elevate the role of Shariah committees in providing sound and innovation centered Shariah advice to the management and board of IFIs. Lastly, the finalized policy document has been issued in December 2018 and takes effect in April 2020.

The main key factors that underpin the Shariah governance framework in Malaysia are the requirements and regulations determined by Bank Negara Malaysia, which rapidly enhance the industry.

For example, the latest development of the Shariah governance framework was mentioned by the IFSA 2013 can be summarized in table 10.

**Table 10: Shariah Governance Framework in IFSA-2013**

<b>Mechanisms of Shariah Governance</b>	<b>Paragraph</b>
Establishment of Shariah committee	Part-IV, Section-2, par. 30/1-3
Appointment of Shariah committee and its members	Part-IV, Section-2, par. 31; 29/2 (a/ii)
Duties of Shariah Committee members	Part-IV, Section-2, par. 29/2 (a/i)
Termination of Shariah committee member	Part-IV, Section-2, par. 33/1-2; 29/2 (a/ii); 29/1 (c)

Notice of cessation as member of Shariah committee	Part-IV, Section-2, par. 34/1-2; 33 (1/a, b, c, d)
Information to be provided to the Shariah committee	Part-IV, Section-2, par. 35/1-2
Qualified privilege and duty of confidentiality	Part-IV, Section-2, par. 36 (a/i-ii, b)

Source: IFSA-2013 & Authors

Following to the IFSA 2013, Bank Negara Malaysia had issued recently (December 2019) a new Shariah governance policy document to be implemented starting from April 2020. This policy had contained seven parts as follows:

**Part A:** It contains an overview of the Shariah governance and its importance in IFIs in Malaysia since IFIs should demonstrate that “their Shariah governance arrangements are operating effectively and appropriate to their size, nature of the business, complexity of activities and structure. The Bank also expects to see evidence of better alignment in promoting a strong Shariah compliance risk culture within Islamic financial institutions. This is in line with the expectation of more active roles of the board, Shariah committee, and senior management.”

**Part B:** The Board. It contains the key responsibilities and interaction with the Shariah committee. The key responsibilities of the board that the board must institutionalize a robust Shariah governance framework that is commensurate with the size, complexity, and nature of the IFI’s business. The board’s oversight accountability over Shariah governance and compliance must reflect the integration of Shariah governance considerations within the business and risk strategies of the IFI.

**Part C:** Shariah Committee and it was divided into five sections as follows: Key responsibilities, Shariah committee meeting, appointment, cessation and disqualification, composition, and lastly the secretariat to the Shariah Committee.

It defines the key responsibilities of the Shariah committees as it must have a charter that sets out the mandate, responsibilities, and procedures of the Shariah committee including matters reserved for its decision or advice.

**Part D:** Senior Management. It discusses their key responsibilities. For example, the CEO in leading senior management has primary responsibility for the day-to-day management of the IFI. This includes that the IFI’s operations, business, affairs, and activities comply, at all times, with Shariah. While each member of senior management of an IFI must continuously develop and strengthen his knowledge and understanding of Islamic finance, as well as keep abreast of the developments that may impact upon Islamic financial business.

**Part E:** Control Functions, and it contains four sections: Control functions under Shariah governance, Shariah risk management, Shariah review, and Shariah audit. It mentions that each IFIs must ensure that the oversight and management of the overall Shariah non-compliance risk are structured in a way that the senior officers entrusted with control functions under Shariah governance can exercise clear accountability over Shariah non-compliance risk.

**Part F:** Shariah Compliance Culture and Remuneration. It discusses the Shariah compliance culture and their remuneration as a board must ensure that the remuneration policy and performance measures for senior officers are reasonable.

Developments in the Shariah governance framework in Malaysia had improved the industry and increased the harmonization in IFIs.

**Part G: Transparency and Disclosures.** It addresses the requirement of disclosures by the board and the Shariah committee. As each IFI must disclose its information on its Shariah governance policies and practices in the annual report. Such disclosures must include – (a) disclosure by the board on its oversight accountability for Shariah governance implementation and the IFI’s overall compliance with Shariah; and (b) disclosure by the Shariah committee on its responsibilities relating to Shariah governance; and opinion on the state of the IFI’s compliance with Shariah.

All of these developments in the Shariah governance framework in Malaysia had improved the industry and increased the harmonization in IFIs.

**5.1.4. ISSUES AND CHALLENGES**

There are certain issues and challenges about the Shariah governance in Malaysia. One of them is the difference between the Shariah resolutions. It is discussed in detail below.

**Addressing Issue on differences of Shariah resolution**

One of the serious challenges of Shariah governance is the absence of compatibility between the Shariah committees across the country.

One of the serious challenges of Shariah governance is the absence of compatibility between the Shariah committees across the country. This may hinder the development of Islamic finance. This issue stems from the contradictory rulings and fatwa among the Shariah committees. This case also occurs when international banks or financial institutions establish their branches in one country and their main office is in another country. The Shariah ruling may differ in these two countries, which triggers the existence of opinions; did the Shariah committee have to follow the Shariah law in their mother country or Shariah law of their established country?

The IFSB survey presented in the year 2018 mentioned and indicated a “low percentage of reconciled Shariah issues pertaining to the difference in Shariah resolutions. Bahrain, Bangladesh, Indonesia, and Sudan indicate less than 20 percent, UAE slightly more than 20 percent, and Malaysia 40 percent” (IFSB 2018b). This important finding indicates that “most of the Shariah issues related to Shariah resolution differences are not reconciled in many countries”.

The differences between Shariah interpretation may affect the determination of certain rulings on a particular issue where one IFI would accept a new product as being Shariah-compliant while others would decide to be non-compliant (McMillen 2006, 139–40). To solve this issue, there are a few possible approaches that could be implemented. These include establishing the national Shariah board at a high level providing legal provision on the final authority of the Shariah board’s rulings, allowing interdisciplinary experts to be appointed as the Shariah board members, and issuing universal Shariah prudential standards.

**Having Scholars from different backgrounds**

Another issue of Shariah governance is the formation of the Shariah committee in IFIs to include scholars from different backgrounds besides Islamic law, for example: (economy, finance, and law). This is a critical issue of Shariah committees in Malaysia, as SC members (or at least one of them) should require to be familiar with the terms and writing style of legal documentation.

This issue appears when some of Islamic banking product documentation being converted from conventional products, it is well known that the documentation and certain concepts will be revised like interest, tobacco, or liquor. The spirit and the nature of the transactions should also be revised to reflect the Shariah-compliant products from the Islamic law perspective. In other words, checking the

documentation from the Shariah - legal experts should be beyond using certain concepts and terminology and avoiding some words, but the most important to understand that the trading system is absolutely different from an interest-based system, which requires the right experts to deal with it.

On the other hand, the economy and finance experts should be included to the Shariah committees in order to analyze the products and services from the economic and financial angle and to observe whether these products and services are stable, suitable and beneficial for the institutions in the long term.

**Paying the remuneration to the Shariah committee members**

The third issue of Shariah governance is the independence of Shariah committees in financial institutions. The issue of conflict of interest is raised here since the appointment, removal, renewal, and paying the remuneration of Shariah committee members are decided by the financial institution in most countries.

In Malaysia, the central bank in order to solve this issue had decided that the appointment, removal, and renewal of Shariah committee members are directly decided by BNM, which expects financial institutions to recommend certain candidates. The approval or rejection comes directly from the central bank after the due diligence process. However, the central bank only mentions remuneration of the Shariah committee members in the Shariah governance guidelines issued on 20 September 2019 that: “The board must ensure that the remuneration policy and performance measures for senior officers responsible for ensuring Shariah compliance reinforce a risk culture that is in line with Shariah governance objectives”. This means that the central bank leaves the quantum to the respective IFIs and raises an issue in this regard.

**5.1.5. COUNTRY SPECIFIC RECOMMENDATIONS**

There are several policy recommendations that may enhance Shariah governance in Malaysia. First of all, in order to obtain smooth management in the Shariah operation, there should be effective and efficient communication among the main key operators of any Islamic financial institution. This communication ensures that the staff in IFIs are aware of the ongoing processes and they understand the need of institutions to observe the Shariah requirements all the time. This will help them to update the Shariah governance framework either from the institution itself or from the central bank.

The IFIs should have clear and proper criteria for the appointment of the Shariah committee.

Secondly, the IFIs should have clear and proper criteria for the appointment of the Shariah committee. For example, the Shariah committee should be directly appointed by the board of directors, and this board shall nominate the members of the Shariah committee upon the recommendation of its nomination committee. And any new appointment or reappointment must have prior approval of the central bank.

Thirdly, the IFIs should establish clear and effective communications between the Shariah committee and their board of directors in all matters related to Shariah non-compliance risks so that there would be no conflicting decisions among Shariah committees.

## 5.2. CASE STUDY: TURKEY

### 5.2.1. OVERVIEW OF SHARIAH GOVERNANCE

Turkey is the 13<sup>th</sup> largest economy in the world, in terms of PPP (purchasing power parity) with about USD 2.300 billion GDP as of 2019 ((World Bank 2019). Additionally, the Muslim population consists of around 98% out of a total population, of about 82 million as of 2019 (TUIK 2019; Konda 2006).

The application of Islamic finance dates back to Ottoman times and even before. However, the rise of the contemporary version of IFIs has begun only decades ago, with the establishment of “Special Finance Houses” later known as participation banks in the 1980s (COMCEC 2019a).

**Table 11: Milestones of Developments of Islamic Finance in Turkey**

<b>1983</b>	<ul style="list-style-type: none"> <li>• Establishment of Special Finance Houses (SFHs)</li> </ul>
<b>1999</b>	<ul style="list-style-type: none"> <li>• SFHs became subject to the same umbrella of regulations with conventional banks</li> </ul>
<b>2005</b>	<ul style="list-style-type: none"> <li>• SFHs were transformed to Participation Banks (PBs) with Banking Law 5411.</li> </ul>
<b>2009</b>	<ul style="list-style-type: none"> <li>• The first Takaful Company was established.</li> </ul>
<b>2010</b>	<ul style="list-style-type: none"> <li>• Lease Certificate (Sukuk) Communique was enacted</li> <li>• The first private Sukuk issuance</li> </ul>
<b>2011</b>	<ul style="list-style-type: none"> <li>• Introducing of Islamic Index (Participation Index) Borsa Istanbul (the former Istanbul Stock Exchange)</li> <li>• The first Islamic private pension company was established.</li> </ul>
<b>2012</b>	<ul style="list-style-type: none"> <li>• Law on Regulating Public Finance and Debt Management was amended to enable the Turkish Treasury to issue Sukuk</li> <li>• The sukuk-related items was included into the new Capital Markets Law.</li> </ul>
<b>2015</b>	<ul style="list-style-type: none"> <li>• Ziraat Participation Bank (State-owned) was established.</li> <li>• Interest-free Finance Coordination Board was launched.</li> </ul>
<b>2016</b>	<ul style="list-style-type: none"> <li>• Vakif Participation (State-owned) was established.</li> </ul>
<b>2017</b>	<ul style="list-style-type: none"> <li>• Regulation on working principles and procedures of Participation Insurance was issued in Official Gazetta</li> <li>• Gold indexed Ijara Sukuk started to be issued.</li> </ul>
<b>2018</b>	<ul style="list-style-type: none"> <li>• Central Shariah Advisory Board was introduced as affiliated to PBAT.</li> </ul>
<b>2019</b>	<ul style="list-style-type: none"> <li>• Emlak Participation Bank (state-owned) was established.</li> <li>• Public Oversight Accounting and Auditing Standart Authority issued 1 ethic norm and 6 interest-free auditing standarts based on AAOIFI standarts.</li> <li>• The relevant article in Public Finance and Debt Management Law, which forms the legal basis for the Turkish Treasury’s Sukuk issuance, was amended to enhance the general framework of Sukuk structure.</li> </ul>

Source: Authors

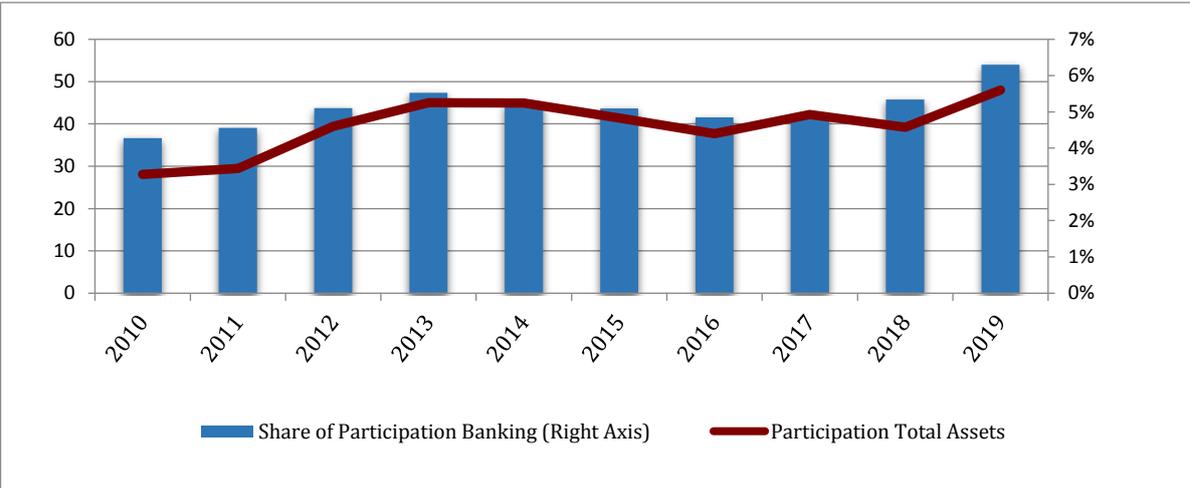
Table 11 demonstrates the main milestones of Islamic finance in Turkey. As seen in the table, it could be concluded that initiatives to improve the landscape for Islamic finance in Turkey accelerated with the new millennium.

As of 2019, there are 6 participation banks of which 3 are state-owned and 12 takaful companies of which 4 of them operate fully-fledged in Turkey (COMCEC 2019a). As of 2019, as seen in figure 12, the total assets of participation banking approached \$48 billion, and the share of participation banking in the total banking sector is around 6.3% (BRSA 2019).

Turkey is the 13th largest economy in the world, in terms of PPP (purchasing power parity) with about \$2.300 billion GDP as of 2019.

The takaful sector in Turkey is rapidly growing, especially after issuing the “Regulation on Working Principles and Procedures of Participation Insurance” in 2017, when it has gained momentum (COMCEC 2019a).

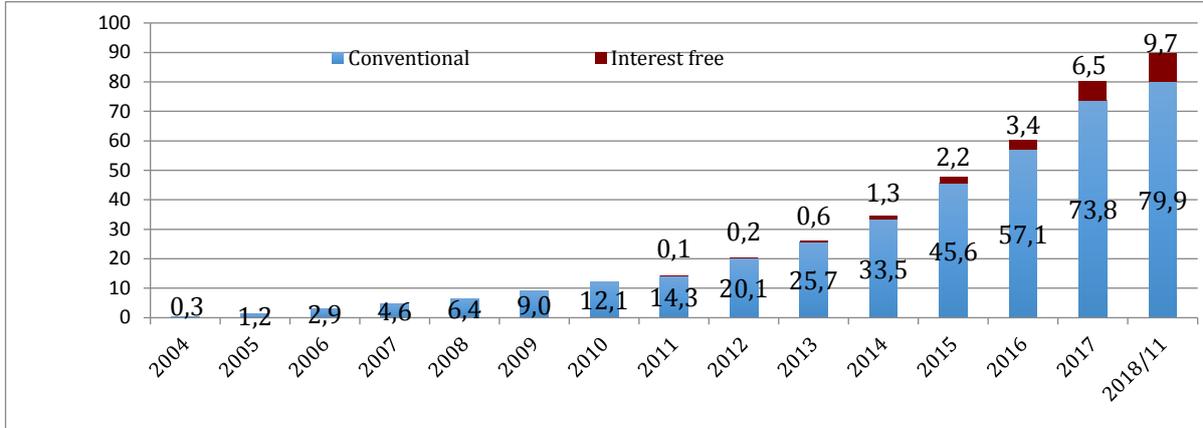
**Figure 12: Participation Banking Sector in Turkey (Billion \$, %)**



Source: BRSA (2019) & Authors

In figure 13, the red bar demonstrates interest-free funds in the private pension system in Turkey. Therefore, even if we see, in general, a dramatic increasing trend in the size of private pension funds in Turkey, we should underline the fact that there has been a huge growth in interest-free private pension funds in the last couple of years too.

**Figure 13: Size of Funds in Private Pension System in Turkey (Million TL)**



Source: Pension Monitoring Centre (2019) & Authors

In addition, the Turkish Treasury and participation banks in Turkey have issued approximately \$14.4 billion domestic and international sukuk until 2018 after the first sukuk regulation introduced in 2010 and amendment of the Public Finance and Debt Management Law as to enable issuing sukuk in 2012, (PBAT, 2019; White & Case, 2016).

As of today, when we look at the Islamic finance landscape in Turkey, we may divide the Islamic financial industry into four different sectors. There are capital markets that cover sukuk markets, Islamic funds, Islamic indices; participation and investment & development banking sector; takaful sector, and non-banking financial institutions. Non-banking financial institutions mean rotating credit and savings associations (ROSCA) providing finance to the people to buy houses and cars. Even if no legal regulations are defining them as financial institutions in Turkey, since they functionally exist in the financial sector, they should be considered into the Islamic financial industry of Turkey.

Turkish Treasury and participation banks in Turkey have issued approximately USD \$ 14.4 billion domestic and international sukuk until 2018.

There are numerous actors in the current Islamic finance landscape of Turkey as seen in figure 14 public institutions such as Banking Regulation and Supervision Agency (BRSA), Ministry of Treasury and Finance (MTF), Capital Markets Board (CMB), and Insurance and Private Pension Regulation and Supervision Agency (IPPRS) are mainly responsible for regulation and monitoring of the Islamic financial sector. In addition, there are private institutions and professional organizations with public institution status such as participation banks, takaful, firms, and the Participation Banks Association of Turkey (PBAT= TKBB). Besides, we may include universities to the landscape since there exist BA, MA, and PhD programs in some universities in Islamic economics and finance working to meet the needs of qualified human resources.

**Figure 14: Current Islamic Finance Landscape in Turkey**



Source: Authors

The Islamic finance sector has a huge potential in Turkey, which has yet to be realized. The Turkish government has included numerous policy actions in its 11<sup>th</sup> Development Plan covering 2019-2023, to enhance the landscape of the Islamic financial sector. The plan has 12 policy actions regarding Islamic finance, ranging from regulations to strengthening Islamic finance by improving human resources and diversifying Islamic financial tools to establishing the necessary mechanisms to support the policy development process (SBB 2019). Moreover, the Turkish government has announced that one of the main pillars of the Istanbul International Finance Project will be Islamic finance.

There have been no legal regulations regarding Shariah governance for IFIs in Turkey until 2017 as in most Muslim countries with an Islamic finance sector. In 2017, the government issued “The Regulation on Working Principles and Procedures of Participation Insurance (No. 30186),” based on Insurance Law (No: 5684) which includes the governance of Shariah Advisory Committee of Takaful Companies in Turkey (COMCEC 2019a).

Prior to 2018, participation banks in Turkey formed Shariah advisory boards under their jurisdiction or outsourced this service from a prominent Islamic scholar (Güney 2015). It was not allowed for IFIs to use any instrument or a standard

**BRSA constituted an independent Central Shariah Board for the Participation Banks Association of Turkey (PBAT) to set standards and ethical principles in February 2018.**

in their financial transactions without a fatwa from a Shariah board. IFIs abided by such fatawa in their transactions, although they were nonbinding in principle (Dinç 2016). Despite their independence, the structure of advisory boards is one of the most important issues criticized in terms of transactions of IFIs in Turkey as they served under the board of directors of IFIs (Terzi 2013). Moreover, the decisions of the boards are not recognized by civil law in Turkey (Dinç 2016).

Decisions or fatawa by Shariah advisory boards have often differed even in some fundamental issues of Islamic finance. Accordingly, this could lead to some doubts; particularly whether the finances are interest-based and their instruments are reliable or not (TKBB and BDDK 2014). In this light, BRSA constituted an independent Central Shariah Board for the PBAT to set standards and ethical principles in February 2018. PBAT followed by forming an independent Central Shariah Board in April 2018 (PBAT, 2018). Detailed information about the structure of the Central Shariah Board, called as “Advisory Board”<sup>20</sup> in Turkey will follow what is required by PBAT. It should be kept in mind that both “Advisory Board” and “Advisory Committee” are only for participation banks, not for all IFIs in Turkey.

### 5.2.2. THE LEGAL SYSTEM AND JURISPRUDENCE OF SHARIAH GOVERNANCE

Turkey has a Civil Law system, which is based on codified laws. Accordingly, the hierarchy of norms in the Turkish legal system is accepted as such: the constitution, then laws, then regulations, communiques (Aksel 2013; Kuluçlu 2008). Accordingly, there are 5 main public institutions, which regulate the legal landscape for IFIs, based on their legislative acts as shown in table 12.

The banking law (No: 5411) of 2005 provided the legal basis for participation banks. Therefore, BRSA is the main public authority regulating and supervising the banking sector, based on this banking act. It also regulates and supervises financial leasing, factoring based on the Financial Leasing, Factoring, and Funding Companies Law (No. 6361).

The public finance and debt management law (No: 4749) of 2012, has provided the legal basis for sovereign sukuk. As for the legal basis of takaful, it is put into the effect in 2019 with the declaration based on insurance law (No: 5684)

On the other hand, CBRT is the sole authority for payment systems tasks and responsibilities as of 2020.

As of 2019, the legal jurisprudence related to Shariah governance for participation banks and takaful companies was issued.

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<sup>20</sup> Shariah Boards of IFIs have been called “Advisory Boards” in Turkey. However, in the new regulation effect in 2018, while it is renamed as “Advisory Committee”, The Central Shariah Board is called an “Advisory Board.” Therefore, in this case study, the “Central Advisory Board” refers to the Central Shariah Board effective from 2018, “Advisory Committee” refers to Shariah boards within participation banks working as affiliated to Board of Directors of participation banks in accordance with the new regulation of 2018 by BRSA (Official Gazette No: 30888)

**Table 12: Diversification of Islamic Finance Instruments by Regulators in Turkey**

				
<p>Banking Regulation and Supervision Agency (Act No: 5411)</p> <ul style="list-style-type: none"> <li>• Participation Banks</li> <li>• Investment &amp; Development Banks</li> </ul>	<p>Capital Market Board (Act No: 6362)</p> <ul style="list-style-type: none"> <li>• Corporate Sukuk</li> <li>• Participation Funds</li> <li>• Real Estate Certificates</li> </ul>	<p>Ministry of Treasury and Finance (Act No: 4749)</p> <ul style="list-style-type: none"> <li>• Sovereign Sukuk</li> </ul>	<p>Insurance and Private Pension Regulations and Supervision Agency (Act No:5684)</p> <ul style="list-style-type: none"> <li>• Takaful</li> </ul>	<p>Central Bank of Turkey (Act No: 1211)</p> <ul style="list-style-type: none"> <li>• Liquidity facilities</li> <li>• Payment systems</li> </ul>

Source: (COMCEC 2017) & Authors

As of 2019, the legal jurisprudence related to Shariah governance for participation banks and takaful companies was issued. For the takaful sector, there is currently no central SSB. According to “The Regulation on Working Principles and Procedures of Participation Insurance (No. 30186)” in 2017, takaful companies are supposed to form an advisory committee inside their institutions or outsource similar services for auditing and monitoring of compliance of their participation insurance activities to the principles and the procedures of participation finance and insurance. The advisory committees work as affiliates to the BODs of the IFIs or it is outsourced and it reports directly to the BOD of the institution.

**Table 13: Jurisprudence of Turkey Shariah Governance**

	Advisory Committee within Institutions	Central Advisory Board
<b>Participation Banks</b>	✓	✓
<b>Takaful Companies</b>	✓	None

Source: Authors

In contrast, there are both “Advisory Committees” inside participation banks and a Central SSB for participation banks according to the regulations in 2018 and 2019.

The PBAT Board of Directors formed the Central Advisory Board by issuing a communique (decision no: 253) titled “Declaration for Formation of Advisory Board and its Duties and Working Principles” on 2 April 2018, based on a previous decision of BRSA. According to this declaration;

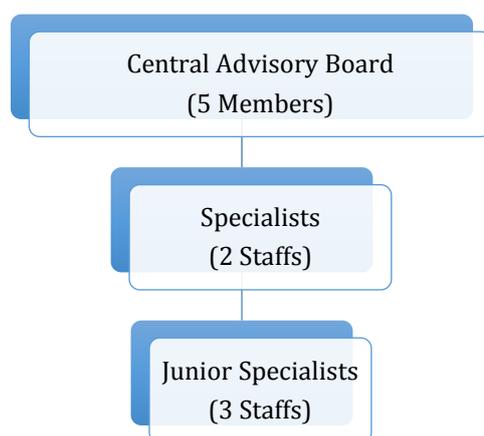
- The Advisory Board performs its duties assigned to it under this declaration impartially and independently under its responsibility,
- The BOD of PBAT appoints the members of the Advisory Board for 5 years, provided that appropriate opinion of BRSA is obtained,
- 3 out of 5 members of the “Central Advisory Board” must have a PhD in the field of Islamic sciences, 1 out of 5 members must have a bachelor or master degree in the fields of management, economics, law, finance or banking; or have 7 years management experience in

the participation banking sector. Moreover, one member should be the candidate(s) recommended by the Presidency of Religious Affairs among the members of the High Board of Religious Affairs.

- (iv) The Board of Directors of PBAT constitutes board secretariat for the Central Advisory Board with enough number of staffs,
- (v) Except for compelling reason such as sickness or those who did not attend three times to the meetings of the Advisory Board without excuse, the members of the Central Advisory Board cannot be dismissed for any reason before the term of office expires,
- (vi) The Central Advisory Board meets at least once a month and also it can be gathered when deemed necessary by the Chairman,
- (vii) The Central Advisory Board can invite representatives from financial institutions or specialists when necessary to the meetings. However, the decisions are only taken in the meeting where only advisory board members exist,
- (viii) Decisions of the Central Advisory Board are published on the website of PBAT, provided that the appropriate opinion of the Board of directors of PBAT is obtained,
- (ix) Central Advisory Board determines the professional principles and standards that participation banks should follow by following the standards published by international organizations in the field of participation banking,
- (x) Where necessary, it makes general decisions to eliminate the differences in implementations between participation banks,
- (xi) It evaluates transactions of participation banks in terms of determining occupational standards,
- (xii) Upon the application, it gives an opinion on the scope of interest-free financial transactions

Moreover, on 27 June 2018 Board of Director of PBAT issued an internal directive (no: 260/2) titled *“Working Procedures and Principles of Advisory Board”* With this internal directive the details of the meeting time and place, agenda of the meeting, research and reporting issues, decisions procedures and issues related to request for information, documents and guarantees were determined.

**Figure 15: Structure of Central Advisory Board and Number of Current Staff**



*Source: PBAT & Authors*

The newly established Central Advisory Board has been conducting its operation with 5 advisory members (one of them is the chairman), 2 specialists, and 3 junior specialists (PBAT 2019). Up until December 2019, the Advisory Board has drafted 3 standards and finalized 21 decisions. There are currently 10 decisions published on the website (PBAT 2019).

Furthermore, the *“Declaration on Compliance with Principles and Standards of Interest-Free Banking (No: 30888).”* by BRSA in 2019 regulates the structure of the “advisory committee” inside participation banks. To this communique;

- (i) Participation banks must employ an “advisory committee” apart from the Central Advisory Board affiliated to PBAT, which consists of at least three members, within its institution for compliance to principles and standards of interest-free banking. The advisory committee is linked to the BOD of the participation bank,
- (ii) The tenure of the members of the advisory committee is three years,
- (iii) The advisory committee is independent in their decisions.

According to the communique, at least 2 out of 3 of members of the advisory committee must have a bachelor’s degree in Fiqh or master or PhD in the field of Islamic finance with at least 3 years’ experience in the field of Islamic finance. As for the duties of the advisory committee:

- (i) It decides on the application of principles and standard of interest-free banking related to the bank,
- (ii) It evaluates and approves in-bank regulations and products by bank in terms of the principles and standards of interest-free banking,
- (iii) It submits a periodic report including its decisions to the Central Advisory Board.
- (iv) It cannot take a decision against the decisions of the Central Advisory Board.

In this communique, the working principles of the advisory committee have been determined in detail. To this, the advisory committee meets at least once a month. It also determines the details regarding auditing facilities to comply with the principles of interest-free banking. According to the communique, the internal audit authority conducts this auditing process, reported at least quarterly. Also, participation banks must place information about the members of their advisory committee on their websites as well as any changes in their structure in 6 months after issuance of the declaration. Other issues regulated by the communique are independence of the advisory committee, working procedures, and principles of the advisory committee, Shariah compliance function, Shariah internal audit function, responsibilities of the board of directors, issues regarding bank personnel, and customer notification and disclosure.

Turkey is one of the most compliant countries with international Shariah governance standards like Malaysia, Bahrain, Pakistan, Nigeria, etc.

Overall, after the recent regulations related to Shariah governance in Turkey, it could be concluded that Turkey is one of the countries with international Shariah governance standards like Malaysia, Bahrain, Pakistan, Nigeria, etc. According to the recent regulations related to Shariah governance in Turkey, two-thirds of advisory committee members are supposed to be a resident in Turkey, and they are also allowed to sit a maximum of two committees. Moreover, authorization of the internal audit unit to perform Shariah internal audit function is remarkable provisions of the Shariah governance framework in Turkey as in the case of Indonesia (Soysal 2019).

### 5.2.3. DEVELOPMENTS OF SHARIAH GOVERNANCE

As known, Shariah compliance of transactions by the IFIs matters for shareholders such as customers, employees, and competitors in Islamic finance, apart from the conventional peers, the IFIs must provide Shariah-compliant products as well as they are supposed to obey nationally and internationally accepted accounting and auditing standards (Dinç 2016). Accordingly, as in the case of other countries where Islamic financial tools are employed, in Turkey, transactions or tools used by IFIs, especially by participation banks have been subject to inspection and supervision of the Shariah board called in Turkey as “*Advisory Committee*” (Gün 2016).

As mentioned in the previous chapters there have been various implications in terms of forming Shariah boards in different countries. As for the implication of Shariah governance in Turkey, it is possible to divide Shariah governance implication models into two time periods. While the first period covers 1984 - 2017, the later covers after 2017 in which the first legal regulation was enacted to regulate the structure of the advisory committee in takaful companies in Turkey (Soysal 2019). Therefore, until 2017, Turkey has been within the scope of countries applying the free model (Gün 2016).

Central Shariah Advisory Board called “*Central Advisory Board*” was established under PBAT (TKBB) in 2018 to determine working principles and standards of participation financing for participation banks. And then, several months later, the “*Declaration on Compliance with Principles and Standards of Interest-Free Banking*” was published in the Official Gazette by BRSA on 14 September 2019 (No: 30888), which determines the structure of the advisory committee in participation banks. Accordingly, we may conclude that the Shariah governance model has transformed from a free model to a hybrid model after the legal regulations in 2017, 2018, and 2019.

Until 2018, there have been no legal regulations related to the Shariah governance framework, binding participation banks in Turkey (Güney 2015). Accordingly, participation banks in Turkey employed some prominent Islamic scholars to issue a fatwa for their transactions. However, since the number of prominent Islamic scholars who have experience and knowledge in Islamic finance is so limited in Turkey, most of the IFIs in Turkey had to employ those prominent Islamic scholars in their advisory committee at the same time, which means those Islamic scholars took positions in different advisory committees (Partner 2015)<sup>21</sup>. Moreover, fatawa of the different advisory committees could contradict each other from time to time. This may have caused some lack of confidence that kept savers outside the Islamic finance sector. Moreover, the lack of legal regulations coupled with international Islamic financial standards has limited the ability of Islamic funds to attract customers (TKBB and BDDK 2014).

Before 2018, participation banks either had an advisory committee of their own or outsourced this service from other institutions (Dinç 2016). Therefore, the Islamic financial tools used by these participation banks had been subject to the approval of the advisory committee of the participation bank or the outsourced ones. However, it was difficult to find any information regarding the members of the advisory committee of participation banks in Turkey on their website unlike most of the other countries. As known, in most countries, IFIs place their Shariah board members and their fatawa on their website (Esen and Karabacak 2014). On the website of participation banks, one could see some documents called “*icazetname*” signed by Islamic scholars. These documents say briefly that “*the transaction employed by the participation bank comply with Islamic norms.*” Yet, it was not possible to find detailed information about the decisions of the advisory committee.

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<sup>21</sup> Upon preliminary inspection, Turkey has plenty of Shariah scholars graduating from the department of Islamic studies working in many Turkish universities. Participation banks must employ those so that they may gain the required experience by time. Moreover, departments and centers of Islamic economics have plenty of graduates qualified in Islamic economics and finance, who should be able to provide enlightened opinions regarding the economic consequences of transactions, while they are familiar with Fiqh al-Muamalat. Therefore, we believe that the scope of choice is not as limited as commonly claimed.

Table 14 shows the structure of Shariah governance in the participation banks in Turkey before 2018. As seen in the table, on one hand, except for Ziraat Katılım, which is a state-owned participation bank, the others somehow have an advisory committee, which is generally affiliated to the board of directors of the banks. On the other hand, only Kuveyt Turk has Shariah supervisors.

**Table 14: Structure of the Advisory Committee in Turkish Participation Banks Before 2018**

Name of Participation Bank	Advisory Committee	Shariah Supervisors
Albaraka Turk	Yes (Affiliated to Board of Directors)	No
Kuveyt Turk	Yes (Affiliated to Board of Directors)	Yes (Advisory board auditors)
Türkiye Finans	Yes (Affiliated to General Director)	No
Emlak Katılım	Yes (Affiliated to General Assembly)	No
Vakıf Katılım	Yes (Affiliated to Board of Directors)	No
Ziraat Katılım	No exist (Outsourcing)	No

Source: Dinc (2016) & Participation Banks Annual Reports & Authors

Shariah governance has been the subject of several workshops, resulting in declarations and reports prepared by notable institutions. In the final declaration of the Islamic Economics and Finance Workshop held in 2013, it was underlined that there was a lack of an explicit and credible Shariah governance mechanism for Islamic finance (ISEFAM 2015).

The lack of an explicit and credible Shariah governance mechanism for Islamic finance in Turkey is one of the most important drawbacks of the current ecosystem for Islamic finance.

In another workshop held in 2013 by PBAT and BRSA titled “Participation Banking and Interest-Free Finance”, one of the main topics was determined as “Advisory Boards.” The committee of the workshop dealing with the improving Shariah governance framework in Turkey proposed the fact that “an autonomous Central Advisory Board should be established either under a public authority such as BRSA and Religious Affairs Administrations or under non-public institutions such as PBAT or Istanbul International Financial Centre.” The proposals in the workshop report regarding Central Advisory Boards are as follows:

Additionally, in the report prepared by Public Expenditure Statistical Analyses (PESA) based on survey results with Muslim businessmen in Turkey, it is concluded that the lack of an explicit and credible Shariah governance mechanism for Islamic finance in Turkey is one of the most important drawbacks of the current ecosystem for Islamic finance (Savasan, Sarac and Guldal 2013). Finally, in the 2015-2025 Strategy Document by PBAT, it was stated that it was a must to form a Central Advisory Board to eliminate the differences in the implementations of advisory committees of participation banks for improvement of the sector (TKKB 2015). Approximately 4 years after this workshop, on 22 February BRSA (2018) took a decision (decision no: 7736) commanding that,

- An advisory committee by PBAT as to determine occupational principles and standards for participation banks is to be established,

- Participation banks are supposed to comply with the decisions of the committee,
- PBAT, provided that appropriate opinion of BRSA is obtained, is to determine working principles, duties and powers, and formation of the committee-

In the following period, BRSA published a declaration titled "Declaration on Compliance with Principles and Standards of Interest-Free Banking" on 14 September 2019 (Official Gazette No: 30888), which determines the structure of the advisory committee in participation banks and development and investment banks using interest-free financing methods.

Regarding the Shariah governance ecosystem in Turkey, the last regulation based on AAOIFI standards was published by the Public Oversight Accounting and Auditing Standards Authority (POAASA), as a committee decision regarding auditing standards of interest-free finance on 14 December 2019 (No: 30978) to improve the interest-free financial sector in Turkey. This includes 1 ethical norm and 6 auditing standards (KGK 2020).

#### 5.2.4. ISSUES AND CHALLENGES

In Turkey, regarding the Islamic financial sector and Shariah governance, it could be mentioned following issues and challenges;

- (i) Although 98% of its population is Muslim, the Islamic financial sector in Turkey is below its potential. One of the quoted reasons for this situation is the fact that the majority of the people in Turkey think that transactions of participation banks do not differ from their conventional counterparts (Toraman et al. 2015). However, Turkey is not unique in this aspect. We can point many Muslim majority countries in similar situations.
- (ii) Since there was no legal regulation regarding the advisory committee for a long time, participation banks had to form their advisory committees themselves without any legal regulations. As contradictions appeared between advisory committees' decisions, the public became skeptical of interest-free transactions, as they suspected that the differences between conventional and Islamic finance are only in terminology.
- (iii) Even though there have been bachelor, master, and doctorate programs in many universities recently, the Islamic finance sector continues to complain about the dearth of Islamic finance scholars. Several Shariah scholars are in charge of more than one Islamic financial institution. Participation banks need to use the services of available scholars with high degrees in Shariah, Islamic economics, and finance who are many.
- (iv) There is still a lack of product diversification in the Islamic financial sector. The vast majority of transactions of participation banks are still based on a few limited tools such as murabaha and tawarruq. The dominance of murabaha increased public doubts in its Shariah compliance.
- (v) The institutional and legal infrastructures of the Islamic financial system and the Shariah governance framework have yet to be properly constituted (TKBB and BDDK 2014).
- (vi) Even though in the last couple of years, regarding Shariah governance, few new regulations have been made for participation banks and takaful companies, the Shariah governance framework is still under development in Turkey especially in terms of legal regulations.

Although 98% of its population is Muslim, the Islamic financial sector in Turkey is below its potential. One of the quoted reasons for this situation is the fact that the majority of the people in Turkey think that transactions of participation banks do not differ from their conventional

## 5.2.5. COUNTRY SPECIFIC RECOMMENDATIONS

- (i) The Shariah governance landscape in Turkey should be linked to international Islamic financial standards such as the standards of AAOIFI. Even though several AAOIFI standards have recently adopted, efforts and initiatives regarding this issue should be improved.
- (ii) Since the recently established Central Advisory Board is authorized for only participation banks in Turkey, there is still no Central Advisory Board for other IFIs such as the takaful sector in Turkey. In addition, the Central Advisory Board for participation banks is not housed under the regulatory authority, which deprives it of being an authority over institutional advisory boards. Besides, placing the Central Advisory Board under the regulator would enable expanding its purview to cover the other IFIs.
- (iii) The institutional structure of both advisory committees inside the IFIs and Central Advisory Board should be improved, especially in terms of the Shariah audit issue, which consists of internal Shariah audit and external Shariah audit.
- (iv) National and institutional SSBs should be more active in developing solutions to raising problems in terms of Shariah issues (ISEFAM 2015).
- (v) There are no separate laws that govern IFIs and legally IFIs in Turkey are required to obey the rules designed for the conventional finance sector. Therefore, a legal framework for IFIs in Turkey should be prepared with a holistic approach and enacted. To do so, it could be possible for Turkey to increase the share of the Islamic financial sector to 15%, which is the target of 2025.
- (vi) The quality of universities offering BA, MA, and PhD in the field of Islamic economics and finance should be improved and their graduates must be employed by the Islamic finance industry, especially as members of the advisory committee as well as in Shariah auditing and control.
- (vii) IFIs, related regulatory institutions, and other stakeholders of the Islamic finance industry of Turkey should somehow increase the awareness of the public regarding Islamic financial instruments. In this regard, the unfavorable public perception related to some Islamic financial instruments seems one of the most important challenges. Islamic financial institutions should have an agenda to raise awareness among the public about what they are doing and what kind of differences exist between them and conventional counterpart. This could be done through education in schools by forming a new educational curriculum or advertisements, workshops seminars, and so on.

IFIs, related regulatory institutions and other stakeholders of the Islamic finance industry of Turkey should somehow increase the awareness of the public regarding Islamic financial instruments.

### 5.3. CASE STUDY: THE UNITED ARAB EMIRATES

#### 5.3.1. OVERVIEW OF SHARIAH GOVERNANCE

The UAE’s Islamic finance assets represent 20.6% of its domestic banking sector. Additionally, the UAE is the third-largest sukuk issuer due to its involvement in corporate issuances after Malaysia and Saudi Arabia in the world. Also, in addition to the high general takaful penetration rate, the family takaful business is ranked highest in the UAE with a double-digit growth rate of approximately 13% in 2017 (IFSB 2019b). In terms of Shariah compliance and regulation, in 2018 the Higher Shariah Authority (HSA) of the Central Bank of the United Arab Emirates (CBUAE) announced that the Shariah Standards issued by the AAOIFI shall be binding on the SSBs of the IFIs, that perform all their activities in accordance with Shariah principles, including fully fledged Islamic banks, Islamic windows of conventional banks and finance companies offering Shariah-compliant products from September 2018 (CBUAE 2018b).

The UAE’s Islamic  
finance assets  
represent 20.6% of  
its domestic banking  
sector.

**Table 15: Islamic Finance Key Milestones in the UAE**

1975	The first private Islamic bank, Dubai Islamic Bank
2004	The Dubai International Financial Centre (DIFC)
2006	World’s first Islamic stock exchange, the Dubai Financial Market, constructed
2013	The Dubai Islamic Economic Development Centre (DIEDC)
2016	High Shariah Authority approved by the UAE Cabinet
2017	Dubai Islamic Economic Development Centre, DIEDC, launched its refreshed Islamic economic strategy (2017-2021)
2018	AAOIFI Shariah Standards was adopted by the CBUAE upon the recommendation of the has

Source: Authors

CBUAE regulates matters of monetary affairs and finance for the whole UAE. In addition, the Central Bank regulates and supervises the IFIs. The CBUAE is bound to follow Federal Law (1985, No. 6-old and 2018, No. 14-new) for the regulation of the Islamic financial industry. At the same time, IFIs in the DIFC are regulated by The Dubai Financial Services Authority (DFSA). The DIFC was designated as an economic free zone in line with its regulations and legal framework. In addition to Central Bank and DFSA, there are various regulators for different financial instruments, as shown in table 16.

**Table 16: Diversification of Islamic Finance Instruments by Regulator in the UAE**

Regulators	The Central Bank of the UAE (CBUAE)	The Dubai Financial Services Authority (DFSA)	The Emirates Securities and Commodities Authority (ESCA)	The Ministry of Economy and Planning (MEP)
Instruments	Monetary affairs and finance	The Dubai International Financial Centre (DIFC)	Securities and Commodity Exchanges	Insurance Sector

Source: Authors

### 5.3.2. THE LEGAL SYSTEM AND JURISPRUDENCE OF SHARIAH GOVERNANCE

In terms of SG, the UAE had adopted “passive Shariah governance” approach until 2018, like Bahrain and Kuwait that entails providing the main regulations but leaving some aspects to the decision of IFIs or the respective authorities of the country (ISRA 2014, 68:6; Hasan 2011). The Shariah governance model of the UAE is identified between a centralized model like Southeast Asian countries<sup>22</sup> in reality and a decentralized model as in the case of many other GCC countries. This model was called as “exclusive central Shariah body”<sup>23</sup> model (ISRA 2014). The decentralized SGF model has some benefits in fostering a diversity of opinions and keeps the CBUAE out of having to opine on Shariah matters. However, there are some drawbacks of both centralized and decentralized models (IRTI and IFSB 2014; ISRA 2014, 68:6; Hasan 2011, 177).

The Shariah governance for IFIs in the UAE can be divided into two frameworks due to two different regulators and two respective sets of laws and regulations: (i) the SGF for the whole the UAE and (ii) SGF for DIFC.

CBUAE set up an Islamic Banking Committee (IBC) to review different Shariah governance models and frameworks at the regulator’s level and to propose a suitable model for the CBUAE for implementation. The IBC assessed also the merits and demerits of different models practiced in other countries (Nazir 2012). By 2018 with the activating the HSA under the Central Bank, the UAE started to follow a more active approach in terms of Shariah governance.

The Shariah governance for IFIs in the UAE can be divided into two frameworks due to two different regulators and two respective sets of laws and regulations: (i) the SGF for the whole the UAE and (ii) SGF for DIFC.

### 5.3.3. COUNTRY-WIDE SHARIAH GOVERNANCE FRAMEWORK

In the UAE, the first Islamic Banking Law (1985, No. 6) stated that each IFI (financial institution or investment company) should establish its SSB to ensure that its businesses and transactions comply with Shariah principles at the institutional level. Recently, the UAE has issued (the new law) Federal Law (2018, No. 14) governing the CBUAE and the organization of financial institutions and activities. According to the law, all current regulations, decisions, and circulars of CBUAE will remain in force until the replacement of regulations, decisions, and circulars according to the new law within three years.

### 5.3.4. THE HIGH SHARIAH AUTHORITY (HSA)

The HSA was established under the UAE Cabinet resolutions, commencing in February 2018 as an affiliated institution to the CBUAE like the Malaysian version. The main purpose of the HSA is “to set standards for Islamic finance products, oversee the sector, approve products and set rules and principles for the industry to harmonize and standardize the practices of IFIs, aligning them to international Shariah standards and widely recognized practices through collaboration with the relevant stakeholders.” Another goal of HSA is “to support the creation of a robust infrastructure that enables further development of the Islamic financial sector in the country and advances the UAE’s vision in

<sup>22</sup> “Centralized Shariah governance authority” refers to countries that have their own central body to govern the Islamic banks and financial institutions; for example, Malaysia, Indonesia and Pakistan (ISRA 2013).

<sup>23</sup> This definition refers to countries that have their own central body to govern IFIs but strictly restricts them to their central bank like Bahrain.

becoming an internationally recognized hub for Islamic finance” (CBUAE 2018a). Articles 17, 78, 79, 80, and 82 in the provisions of the (new) law are relevant to the Shariah governance. The main responsibilities of the HSA are defined by the article 17/5-6 such as follows:

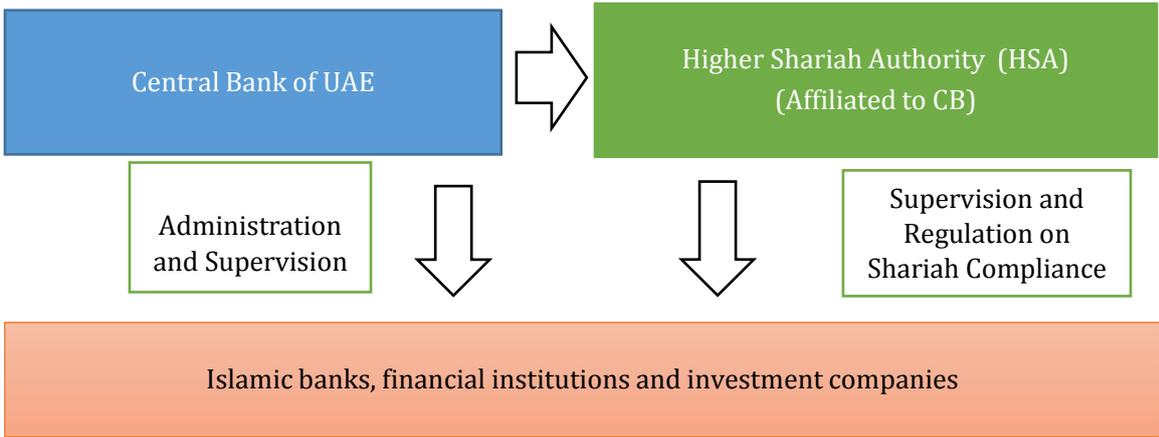
(i) Determining the rules, standards, and general principles applicable to Shariah-compliant businesses and financial activities. One of the Shariah experts clarifies this: “HSA issues/determines national standards, regulations, and guidelines. It helps harmonization and standardization of the regulations in terms of Shariah governance and compliance in the country. Also, it issues technical notes to facilitate the implementation of AAOIFI standards.”

(ii) Approving of Islamic monetary and financial tools issued and developed by the CBUAE to manage monetary policy operations in the State.

(iii) Supervision and oversight of the internal Shariah supervisory committees of respective institutions. According to some Shariah experts, HSA members should not be staff or members in SSBs of IFIs to stay away from conflict of interest.

(iv) Providing opinions regarding the specific regulatory rules and instructions relating to the operations and activities of IFIs.

**Figure 16: Shariah Governance Framework Based on Federal Law No. (14) of 2018**



Source: CBUAE & Authors

Theoretically, all fatawa and opinions of the HSA are binding on the entire Islamic financial industry, particularly for the institutional SSBs of IFIs. By 2018, HSA held various meetings, during which it discussed various matters related to the Islamic banking industry and issued 40 resolutions and guidance notes. HSA’s meetings covered four focus areas (CBUAE 2018a):

1. Ascertainment of Shariah Compliance: For example, the HSA works to adopt AAOIFI Shariah standards as the minimum requirement for Shariah compliance.
2. Strengthening Shariah Governance: The HSA works on the development of several documents related to Shariah governance. It shares the governance standards with the relevant stakeholders for a consultation and receiving their feedback before their issuance.
3. Research and Development: The HSA conducts studies to identify the best practices and make adequate recommendations related to the UAE market.

4. Strengthening Harmonization: The HSA works closely with the UAE IFIs to smooth the implementation of Shariah standards and harmonize practices and work out solutions to any potential challenge that may occur during application.

For years (until 2018), the regulator (CBUAE) has not structured Higher Shariah Authority and left the role of Shariah compliance to the IFIs despite the clear provisions for its establishment in Federal Law (ISRA 2013). For IFIs, the boards of directors of IFIs should ensure that IFIs fully comply with the Shariah rules and establish a sound and effective Shariah governance framework with the key mechanisms and functionalities to ensure effective and independent Shariah oversight, as per the requirements set by HSA and the CBUAE (CBUAE 2019, para. 2/k).

According to Federal Law No. 14 of 2018, every IFI must establish an SSB, which consists of experienced professionals in Islamic finance and banking transactions jurisprudence to carry on all or part of its activities and businesses in accordance with the requirements of Shariah.

According to Federal Law No. 14 of 2018, every IFI must establish an SSB, which consists of experienced professionals in Islamic finance and banking transactions jurisprudence to carry on all or part of its activities and businesses in accordance with the requirements of Shariah. These activities and businesses include Shariah supervision of all products, services, contracts, documents, and conduct of business charters of the respective institution.

The law stipulates that the appointment of SSB members in the IFIs shall only be made after presenting to the HSA for approval, prior to presentation thereof to the general assembly. SSB members shall be appointed by the general assembly of the IFIs, under the provisions of the referenced Commercial Companies Law (Federal Law No. (14) 2018, para. 79/2).

The legislation requires SSBs in the UAE to adhere to the AAOIFI Shariah and Governance Standards. On the other hand, according to one Shariah expert from CBUAE, "Accounting and Auditing Standards of AAOIFI are not implemented yet by the IFIs in the UAE."

### **5.3.5. SHARIAH GOVERNANCE FRAMEWORK FOR THE DIFC**

IFIs under the DIFC have specific regulations and laws. They are regulated by the DFSA. The DFSA Rulebook and Islamic Finance Rules (IFR or the Law) regulate the Shariah governance framework within the DIFC and explain different rules and regulations relating to Shariah governance in the DIFC. IFR covers IFIs and Islamic windows that operate in three areas related to Islamic finance: "(i) providing Shariah-compliant financial services, (ii) offering of Shariah-compliant securities, and (iii) Shariah-compliant investment funds offered to the public and domiciled or managed in the DIFC." Regarding regulating Islamic Financial Industry DIFC Law (2004, No. 13), IFIs in the DIFC must implement and maintain procedures regarding Shariah compliance. Some of these procedures are identified as: "(i) how Shariah compliance will be undertaken, (ii) how SSBs will oversee/advise business, (iii) how SSBs decisions and fatawa will be issued/recorded/implemented, (iv) how internal Shariah review will be conducted, (v) how disputes between the SSBs and the business will be handled, (vi) approval process for internal controls regarding Shariah compliance, (vii) how, for an Islamic window, conventional businesses will be kept separate from the Shariah-compliant business" (DFSA 2013, para. 3.4.1.). Also, theoretically, DFSA appoints an SSB for itself and sets rules prescribing the appointment, formation, conduct, and operations of SSBs (13/1-2). However, according to interviewed experts from the UAE, "there is no centralized SSB inside of the DIFC." Shariah governance in the DIFC has a decentralized model and the regulation of the Shariah governance was left to the respective IFIs.

It expects from IFIs to establish and maintain their systems and controls, which enables it to comply with the applicable Shariah requirements (DFSA 2013).

Regarding the SSBs members, the Rulebook states that SSBs must have at least three members, and the members appointed to the SSB are supposed to be competent to perform their functions as SSB members.” (DFSA 2013). However, it does not specify the required qualifications for the SSB members. One of the interviewed Shariah advisors from the UAE stated that “DIFC should have a centralized SSB or should be supervised and controlled by the HSA like other financial institutions inside country.”

Regarding the SSBs members, the Rulebook states that SSBs must have at least three members and the members appointed to the SSB are supposed to be competent to perform their functions as SSB members.

IFR gives responsibility to IFIs to put in place all the policies relating to the appointment, and dismissal and remuneration, etc. IFIs should assess and record the competency of the SSB members for six years (DFSA 2013). The IFR also brings some principles regarding the SSBs independence and working mechanism. For example, IFIs should provide required assistance for the SSBs to discharge their duties, give the SSBs right of access at all reasonable times to relevant records and information and not interfere with the SSBs’ domain. In terms of independence, it states that IFIs should not interfere with the SSBs ability to discharge its duties (DFSA 2013).

The main functions of the SSB members are defined by the IFR in terms of overseeing and advising regarding the Islamic financial business. As a requirement, the DFSA obliges IFIs to adopt the AAOIFI Shariah governance standards to ensure consistency and compliance with the Shariah. For example, the Rulebook stipulates that the SSBs annual report and Shariah review will be conducted according to AAOIFI Standards (GSIFI-1 and GSIFI-2 (3.4.1).

On the other hand, the UAE has close relationships with other international standard setter and regulatory bodies such as AAOIFI and IFSB. CBUAE contributes to the work of the IFSB as a Chair of its Technical Committee and works as a council member in 2018. CBUAE’s staff were nominated to support the IFSB working groups to develop “the IFSB-15 Capital Adequacy Standard” update and the technical note on financial inclusion (CBUAE 2018a).

The DFSA established the self-regulation of Shariah compliance in DIFC. There are not any provisions to establish a Supreme SSB in the DIFC like the HSA of the UAE as a whole. The DFSA allows IFIs to put in place the requirements and adequate mechanism and procedures to ensure that the determination of Shariah compliance is done in a proper manner (ISRA 2013). On the other hand, there is a reason to suspect that civil liabilities might be insufficient in ensuring Shariah compliance. For example, the opinion of an SSB that a particular product or activity which is Shariah-compliant may be considered solely as an opinion, not a statement of fact which may form the basis of liability (Lee 2016, 10–11).

### **5.3.6. DEVELOPMENTS OF SHARIAH GOVERNANCE**

The IFIs in the UAE are generally regulated by the CBUAE. According to the UAE Federal Law (1985, No. 6 or revised 2018, No. 14), the respective IFIs are required to appoint their SSB consisting of not less than three members. As stated by the ISRA report (ISRA 2013), the Shariah advisory framework is vested solely in the SSB of each IFIs. The Federal Law (1985, No. 6) requires the establishment of a national SSB “HSA” as a supreme body for deciding matters relating to Shariah compliance. HSA has five board members. According to one interviewed expert from CBUAE, “Main responsible institution is the HSA for IFIs in the UAE in terms of Shariah audit and other Shariah related issues. However, there is still staff. It should be improved in various ways.” Other Shariah expert states that “there is

currently no separated Shariah audit unit in the HSA of CBUAE. But there is an intention regarding establishment specific Shariah audit department.”

The Federal law does not mention any departments/units/bodies conducting Shariah auditing and review for IFIs. Besides, there is no clear distinction between the Shariah review and the Shariah audit. Shariah review is conducted by the SSB of the IFIs. However, in terms of auditing, only a small percentage of IFIs’ SSBs in GCC indicated that the functions had been delegated to the internal Shariah compliance unit.

The UAE established a consultation and working committee from the members of the internal Shariah control committees (ISCC) / SSBs of IFIs operating in the UAE. This committee has no authority to decide on Shariah related matters of IFIs. It simply functions as a mechanism to ensure better coordination and harmonization in Shariah resolution and decision.

### 5.3.7. ISSUES AND CHALLENGES

(i) The Shariah governance framework in the UAE is still largely vested with the SSBs of IFIs. As required by the Federal Law, HSA should complete its establishment and do its functions more effectively. Despite implementing AAOIFI, GSIFI standards, the Shariah governance standards of IFIs are generally in line with the local market standards of the country. It can be argued that the presence of a national SSB could enhance overall governance standards by ensuring another step of independent review and oversight (IRTI and IFSB 2014).

(ii) DIFC has a different and weak structure of Shariah governance; thus, this ‘ring-fenced’ business zone is exempted from the HSA. However, when compared with the DIFC, the HSA of CBUAE has established a suitable SGF mechanism.

(iii) The main purpose of the establishment of HSA is to standardize fatwa and harmonize Shariah practices in IFIs. On the other hand, still, the governance and Shariah assurance practices in the UAE (between overall the UAE and DIFC) as well as in GCC are found to be inconsistent and non-standardized (Grassa 2019, 343). One of the surveyed experts says that “All conditions and terms for HSA members and SSB members in IFIs should be clear. Appointment and dismissal requirements for SSB members should be determined clearly for doing their responsibilities independently.”

The main purpose of the establishment of HSA is to standardize fatwa and harmonize Shariah practices in IFIs.

(iv) The Federal Law (2018, No. 14) requires legal supervision and audit in Islamic finance and banking transactions. However, there are no specific restrictions for the appointment of Shariah scholars to an SSB. Hence, they can be appointed to multiple SSBs of various institutions at one particular time. For years, many SSB appointees have enjoyed the right to sit on various SSBs without restriction in the UAE and other GCC countries (Hasan 2011). The top Shariah specialists hold 48.47 % and the top 10 specialists represent 73.01% of all 163 available positions in the UAE IFIs (Funds@Work 2010). In comparison with the Malaysian experience, there is no accreditation system for the qualifications of SSB members. According to interviewed Shariah experts from the UAE, “In recent regulations, there are some restrictions for non-local Shariah advisors. For example, sitting on more than one institution. However, there is not any limitation for local Shariah advisors.” One Shariah audit expert stated that “There should be professional certification training and education at the international level. It is a deficiency for the sector. There should be professional certification programs like Certified Internal

Auditor (CIA). CIBAFI and AAOIFI programs should be developed and offer some training and experience sharing in addition to theoretical training.”

(v) One of the issues in the UAE is transparency and ethical behavior in Shariah governance processes. According to one Shariah advisor in the UAE, “Shariah pronouncements and fatawa are not published in the UAE, like other countries. It is one of the big issues for HSA and ISSCs / SSBs in IFIs in terms of transparency.

### 5.3.8. COUNTRY SPECIFIC RECOMMENDATIONS

- (i) The Central Bank of the UAE may wish to consider setting requirements on how Shariah compliance is governed within the IFIs as is done by the DFSA in the DFCI. Many interviewed experts state that all financial centers such as DIFC should be under the control of HSA in terms of Shariah governance and compliance.
- (ii) Provisions of laws in the DIFC are relatively sufficient to clarify the SG practices in the DIFC. Conversely, more analysis of SG practices on their impact is required within IFIs in the DIFC. Regulatory bodies may increase awareness about the Shariah governance standards among IFIs and the general public.
- (iii) Even though the regulations for Shariah governance in the wider the UAE differ from those of the DIFC, the actual practice of Shariah governance is similar to IFIs, which handle their own Shariah compliance independently. Hence, without a national SSB, there is no national uniformity, but each IFI has greater flexibility in adopting the standards and resolutions acceptable to its SSB.
- (iv) It is imperative to have well planned and executed Shariah audit functions within HSA and IFIs to promote transparency and comparability of Shariah governance and assurance mechanisms. HSA should have a separate committee to facilitate/supervise the implementations of regulations and decisions in terms of Shariah governance in IFIs.
- (v) HSA should disallow sitting their members in institutional IFIs, because of conflict of interest. At the same time, HSA should restrict sitting one scholar in many IFIs without discrimination among SSB members based on their citizenship. All regulations and principles should be implemented for all Shariah advisors in the country. Additionally, there should be an age limit in the hiring of SSB members.
- (vi) The UAE’s actual provisions on Shariah governance seem to be inadequate to properly supervise the fast-growing industry. More rigorous regulation is needed to ensure proper mechanisms have been established. It is essential to have a comprehensive, robust, and well-functioning Shariah control system to ensure that Shariah governance is upheld at all times within the independence of SSB at the institutional level. One of the Shariah advisors suggested that “SSB members of IFIs should not be less than five members to do its function.”
- (vii) Regulations should facilitate hiring young Shariah experts, advisors, researchers in the IFIs. The fact that without offering opportunities to serve in the industry, a new generation could not get the required experiences, qualifications, and skills. One of the interviewed experts suggested improving independence in Shariah governance, that “SSBs in IFIs should be located outside of the banking structure in terms of governance to ensure the independence.”

It is imperative to have well planned and executed Shariah audit functions within HSA and IFIs to promote transparency and comparability of Shariah governance and assurance mechanisms.

## 5.4. CASE STUDY: NIGERIA

### 5.4.1. OVERVIEW OF SHARIAH GOVERNANCE

Islamic finance development has become an attraction in many African countries. Several market developments and regulatory efforts have taken place in recent years in Nigeria, Sudan, South Africa, Senegal, Kenya, Morocco and Niger, Uganda, etc. Many African countries have put in place the required legal/ regulatory frameworks to enable offering Islamic finance in their respective jurisdictions (MIFC 2017). Considering the size of its population and its developing prospects, Nigeria is becoming the hub of Islamic finance in Africa (Abdullahi 2016, 9).

The Nigerian financial industry consists of commercial banks (deposit-taking banks), development banks, and other financial institutions that include microfinance banks, finance companies, discount houses, and primary mortgage institutions, etc. (Momodu 2013). According to the Central Bank of Nigeria (CBN) (2018a, 90), Nigeria had 628 registered financial institutions by the end of 2018, comprising of 21 commercial banks, 551 microfinance banks, 4 merchant banks, 4 development finance institutions, 1 specialized (non-interest) bank, 34 finance companies, and 13 non-bank financial institutions. In terms of Islamic financial development, as shown in table 17 below there is only one full-fledged Islamic bank.

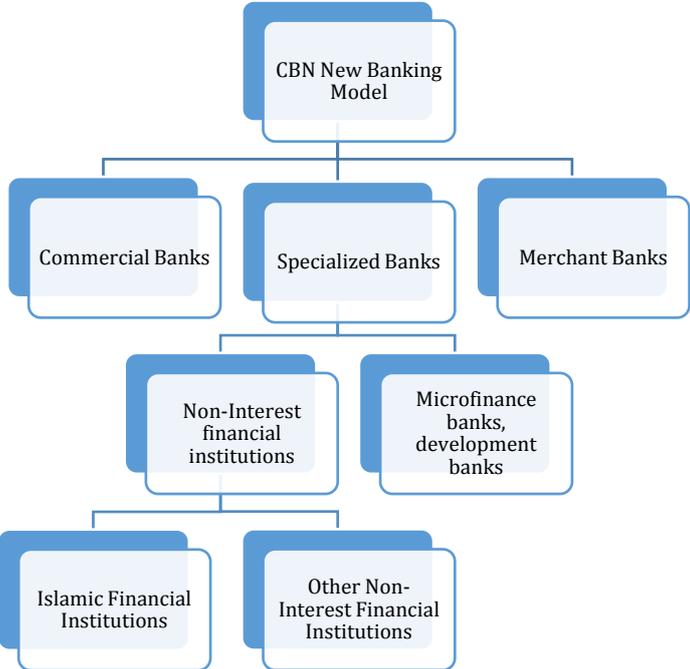
**Table 17: IFIs and Conventional Banks That Offer Islamic Financial Services**

Institution	Type of Sector/Institution
Jaiz Bank	Full-fledged Islamic Bank
Sterling Bank Stanbic Bank	Conventional Banks with Islamic Windows
Al-Baraka Nigeria Microfinance Bank Tijara Microfinance Bank I-Care Microfinance Bank	Islamic Microfinance banks
Jaiz Takaful Noor Takaful	Full-fledged Takaful companies
Lotus Capital Halal Fund Stanbic IBTC Imaan Fund	Islamic Funds
Other Financial Institutions offer Islamic Financial Services	Takaful Windows Islamic Capital market Investment companies

Source: Authors

As shown in figure 17, according to CBN Guidelines, IFI models are broadly categorized into two categories: (i) IFIs based on Islamic commercial jurisprudence; (ii) IFIs based on any other established non-interest principle.

**Figure 17: IFIs Models in Nigeria**



Source: (CBN 2011) & Authors

The CBN Framework (2010, 2) broadly categorizes IFIs as the following :

“**i.** Full-fledged Islamic bank or Islamic banking subsidiary of a conventional bank; **ii.** Full-fledged Islamic merchant or full-fledged Islamic banking subsidiary of a conventional merchant bank; **iii.** Full-fledged Islamic microfinance bank; **iv.** Islamic branch or window of a conventional bank; **v.** Islamic subsidiary, branch or window of a non-bank financial institution; **vi.** A development bank regulated by the CBN offering Islamic financial services; **vii.** A primary mortgage institution licensed by the CBN to offer Islamic financial services either full-fledged or as a subsidiary; and **viii.** A finance company licensed by the CBN to provide financial services, either full-fledged or as a subsidiary.”

In terms of the Shariah governance framework, the CBN is the main regulatory and supervisory organization for the financial institutions in Nigeria, including IFIs and microfinance. In addition to the CBN, there are also some other regulatory bodies such as the Security and Exchange Commission (SEC), Corporate Affairs Commission (CAC), and the Nigerian Deposit Insurance Company (NDIC).

The CBN Act 2007 Section 33 (1) (b)<sup>24</sup> (FRNOG 2007) established a legal foundation for IFIs in Nigeria. Accordingly, the CBN (2009) issued a draft framework for the regulation and supervision of IFIs in Nigeria. After the revision of provisions of the Banks and Other Financial Institutions Act (BOFIA) (1999, vol. 2, paras 55, 59), the CBN (CBN 2011) has established two Shariah Advisory bodies for both itself and all IFIs in Nigeria.

<sup>24</sup> Section 33(1)(b) of the CBN Act 2007 provides: “In addition to any of its powers under this Act, the Bank may issue guidelines to any person and institution under its supervision”

#### 5.4.2. THE LEGAL SYSTEM AND JURISPRUDENCE OF SHARIAH GOVERNANCE

Nigeria has some different law sources that form a mixed legal system. They are: (i) English law, (ii) common law, (iii) customary law, and (iv) Shariah (Islamic) law. The additional main sources are (i) Nigerian Constitution, (ii) Legislation, and (iii) Judicial precedents (Efobi and Ehima 2019). The regulations of financial institutions are dependent on the model of the conventional financial system. Accordingly, the Islamic finance industry in Nigeria operates under the conventional legal and regulatory regime. According to Kunhibava & Muneeza, Nigeria's conventional courts lack expertise in handling issues of Islamic commercial law and Islamic banking and finance (Mustapha, Kunhibava, and Muneeza 2019).

Nigeria has some different laws sources that form a mixed legal system. They are: (i) English law, (ii) common law, (iii) customary law and (iv) Shariah (Islamic) law. The additional main sources are (i) Nigerian Constitution, (ii) Legislation, and (iii) Judicial precedents.

In terms of Shariah governance, the CBN established and institutionalized levels of Shariah governance structures of IFIs at both macro and micro levels. They are: (i) Financial Regulation Advisory Council of Experts (FRACE) at the regulatory (CBN/macro) level. (ii) Advisory Committee of Experts (ACE) at the financial institution (micro) level. There are relationships at different levels between FRACE and ACE. The relationships between the FRACE and the ACEs encourage the merging of SG standards within the industry.

#### 5.4.3. DEVELOPMENTS OF SHARIAH GOVERNANCE

The guidelines defined the “terminology”<sup>25</sup> of labeling as FRACE at the regulator’s level and ACE at the institution level. It is a fact that CBN Guidelines mainly covers conventional financial institutions that have decided to offer Islamic banking services either as a product or by way of opening branches/windows (Momodu 2013).

**Table 18: Development of Islamic Finance**

1990	The Supreme Ruling Council promulgated a decree which allows the establishment of a profit and loss sharing (PLS) bank.
1992	Habib Bank was approved to operate an Islamic banking window
1997	The Central Bank Act 2007 made a legal foundation for Islamic Banks in Nigeria
1999	The Central Bank of Nigeria (CBN) issued a draft framework for the regulation and supervision of IFIs in Nigeria
1999	Provisions of the Banks and Other Financial Act (BOFIA) 1999 provided for the establishment of Islamic banking in Nigeria
2011	The CBN issued guidelines for the regulation and supervision of IFIs
2011	The CBN approved a banking license for Jaiz International Bank to operate as a first full-fledged Islamic bank

<sup>25</sup> In the earlier Guidelines ACEs were referred to as SAC at the regulators level (the CBN) and SAC at the institutions level.

2011	The CBN guidelines require all IFIs to establish a SAC/SSB
2013	Nigeria witnessed its inaugural sukuk issuance
2013	The CBN established as a national advisory body on IFIS, the FRACE
2015	The CBN guidelines changed SAC's name as "Advisory Committee of Expertise (ACE)"
2015	The CBN issued guidelines on the governance of FRACE

Source: Authors

#### 5.4.4. THE FINANCIAL REGULATION ADVISORY COUNCIL OF EXPERTS

The CBN guidelines (CBN 2011) offer the establishment of an advisory body at the CBN on Islamic banking and finance. The FRACE shall advise the CBN on matters relating to Islamic commercial jurisprudence as they relate to the activities of IFIs for the effective regulation and supervision of IFIs in Nigeria.

An essential governance structure of regulatory oversight for IFIs is the establishment of an advisory body at the CBN to assure that the strategic direction and conduct of financial businesses of IFIs comply with the rules and principles behind their operations (CBN 2015).

The CBN framework (CBN 2015) sets out the membership, composition, the minimum qualification of its members, duties, and responsibilities of the FRACE and its members, the working relationships between the FRACE and the ACEs of IFIs, code of conduct for the members of the FRACE.

An essential governance structure of regulatory oversight for IFIs is the establishment of an advisory body at the CBN to provide assurance that the strategic direction and conduct of financial businesses of IFIs are in compliance with the rules and principles behind their operations.

At the macro level, the FRACE's central role is advisory and it does not end at the CBN level or IFIs level; it is empowered to advise other regulatory bodies related to the IFIs governance across the whole industry (Abikan and Ahmad 2017, 306). For example, CBN Guidelines (CBN 2015) states that FRACE gives expert opinion and assistance on Islamic banking matters referred to it by other regulatory agencies in the Nigerian financial system, which shall include but not limited to NDIC, SEC, the National Insurance Commission (NAICOM), the National Pension Commission (PENCOM) and Debt Management Office (DMO), etc.

#### 5.4.5. THE ADVISORY COMMITTEE OF EXPERTS

At the micro-level, IFIs as part of their governance structure is required to establish ACE to ensure compliance with Shariah in their products and transaction operations, practices and developments, subject to the FRACE supervisory powers (Abikan and Ahmad 2017). As provided by CBN Guidelines (CBN 2011) All IFIs "shall have an ACE as part of their governance structure."

To establish a competent and an independent ACE, the law sets a standard for the required number of Shariah members (a minimum of three members) as a minimum composition of ACE, the appointment, qualification, application procedures, disqualification, resignation, termination, and dismissal, etc. (CBN 2010). According to the same guideline, the BODs of IFIs shall appoint members of the SAC subject to the approval of the CBN. Also, it determines the details of the ACE's duties and the responsibilities (CBN 2010), duties, and responsibilities of IFIs to ACE (CBN 2010) and reporting relationships and the reporting procedures of the ACE (CBN 2010). (2010, paras 9, 10).

According to CBN guidelines, the responsibilities of IFIs to ACE can be summarized as follows: "(i) Refer all Shariah issues to the ACE, (ii) Implement the ACE's advice and decision. (iii) Ensure that

documentation of products is validated. (iv) Prepare a Shariah compliance manual. (v) Provide access to the ACE to all relevant documents. (vi) Provide sufficient resources to the ACE.”

#### **5.4.6. INTERNAL SHARIAH COMPLIANCE UNIT (ISCU)**

The guidelines require the establishment of ISCU signifies that its establishment is mandatory by the Central Bank. The CBN guidelines state that “All IFIs are required to have a dedicated internal Shariah compliance unit comprising officer(s) with appropriate qualifications and experience in Shariah and conventional finance to serve as the first point of reference for Shariah compliance issues. The unit may also serve as the secretariat to the ACE. The appointment and removal of members of the secretariat shall be appropriately carried out in consultation with the ACE” (CBN 2010).

The ISCU is responsible for verifying whether Shariah compliance requirements have been fulfilled, and any non-compliance incident will be recorded and reported, and as far as possible, addressed and rectified. Shariah resolutions of the ACE are to be strictly adhered to and observed (Abikan and Ahmad 2017).

The CBN has developed the guidelines for the appointment, duties, and responsibilities of the ACEs of IFIs. The members of ACE are appointed by the BOD of IFIs and approved by the CBN. CBN determined some qualifications, it states that “the proposed member shall have at the minimum an academic qualification or possess the necessary knowledge, expertise or experience in the sciences of the Shariah with a particular specialization in the field of Islamic transactions/commercial jurisprudence (Fiqh al-Muamalat)” Also there are some additional requirements such as follows: “(i) Skills in the philosophy of Islamic law (Usul al-Fiqh), (ii) Good knowledge of written Arabic. (iii) Ability to speak in both Arabic and English, and (iv) Exposure in the areas of business or finance especially Islamic finance (CBN 2010, 3). (v) ACE members cannot sit on more than one IFIs of the same category.

The CBN has determined some qualifications for the FRACE members at the central bank level. It states that “A member shall at a minimum possess the required knowledge, expertise and experience in the field of Islamic jurisprudence with specialization in the field of Islamic commercial jurisprudence. A member should also demonstrate:

- (i) Knowledge in the philosophy of Islamic law,
- (ii) Knowledge of written and spoken Arabic as well as English languages and
- (iii) Exposure in the field of business, economics, or finance especially Islamic finance.” (CBN 2015)

AAOIFI and IFSB standards are so recognized by the CBN for its application to the Nigerian Islamic finance industry. However, if there is any conflict between AAOIFI – IFSB standards with the local standards (Nigerian Accounting Standard Board (NASB), then the local standards prevail in order to achieve harmonization and uniformity (Abikan and Ahmad 2017). For example, CBN guidelines state that All IFIs shall comply with the NASB local standards, and IFRS/IAS “For transactions, products and activities not covered by these standards, the relevant provisions of the financial accounting and auditing standards issued by the AAOIFI shall apply.” (CBN 2011).

In terms of code of conduct for the FRACE and its members, the CBN guidelines make IFSB governance standards obligatory for the FRACE such as follows:

“The FRACE shall, in the discharge of its duties, be guided by the principles of independence, competence, confidentiality, and consistency as outlined in the IFSB Standard on Guiding Principles of Shariah Governance Systems for Institutions Offering Islamic Financial Services (IFSB-10) and other relevant regulations.” (CBN 2015).

The empowerment of the FRACE to give expert opinion and assistance on matters referred to it by all the regulatory agencies in the financial sector NDIC, SEC, NAICOM, and PENCOM are aligned to centralized SG in all the sectors of the industry. This is a step towards the harmonization of SG in the Nigerian IFIs.

#### 5.4.7. ISSUES AND CHALLENGES

Since the introduction of the first IFI in Nigeria, there has been a debate on the effects of the new financial system. Some still have a wrong perception of Islamic finance. The misconception of Islamic finance calls for concerted efforts among the institutional stakeholders, regulatory bodies (i.e. CBN and SEC), and IFIs to raise greater awareness about the objectives/ benefits of the Islamic finance services (Abdullahi 2016).

The lack of knowledge of accounting, auditing, and governance standards relevant to IFIs is another obstacle for the development of Islamic finance in Nigeria (Abdullahi 2016). In that issue, IFIs may meet active requirements such as lack of evidence of training and development of ACE members and inadequate disclosure of the activities of the ACE and the Shariah compliance of the institutions (Abikan and Ahmad 2017).

Lack of accessibility to necessary Shariah compliance information not only by the public but also by many stakeholders themselves portends a great confidence risk to the institutions (Abikan and Ahmad 2017). The FRACE provides wide coverage on SG in Nigeria. On the other hand, in terms of the court of law or arbitrators that would handle disputes of IFIs, the FRACE's duties and responsibilities don't extend to courts and arbitrators (Mustapha, Kunhibava, and Muneeza 2019).

The misconception of Islamic finance calls for concerted efforts among the institutional stakeholders, regulatory bodies (i.e. CBN and SEC), and IFIs to raise greater awareness about the objectives / benefits of the Islamic finance services.

#### 5.4.8. COUNTRY SPECIFIC RECOMMENDATIONS

- (i) The absence of a separate regulatory system for Islamic finance is one of the obstacles in the development of IFIs in the region. For example, the IFIs' financial products have the same taxes as conventional financial institutions' products.
- (ii) IFIs and financial regulators (e.g. CBN and SEC) may promote the Islamic financial model to create awareness about the Islamic financial system. This can be achieved by launching education and training programs for practitioners and clients through specific organizations (social media, internet, etc.).
- (iii) The composition of ACE should also be expanded by adding more members for developing local talents and expertise for effective governance (Abikan and Ahmad 2017). CBN should put pressure on IFIs on the training and human source development of ACE members within the industry.

## 5.5. CASE STUDY: INDONESIA

### 5.5.1. OVERVIEW OF SHARIAH GOVERNANCE

Globally, Indonesia is seen to have great potential and strength in global Islamic finance development. It is one of the 10 largest countries in the field of Islamic financial services (OJK 2015). In Indonesia, there are 14 full-fledged Islamic banks, 20 Islamic banking business units/windows, and 196 Shariah rural banks. These several types of IFIs have unique features that differ from other countries.

Indonesia is one of the 10 largest countries in the field of Islamic financial services.

The development path of Islamic finance always referred to other strategic plans of the country, such as “Indonesian Banking Architecture, Indonesian Financial System Architecture as well as Medium-Term National Development Plan and Long-Term National Development Plan.” Therefore, the policies for the improvement of Islamic finance are a part of macro-level strategic planning which is developed at the national level (Bank Indonesia 2020).

There is an improvement in Shariah governance within Indonesia’s Islamic finance industry with the launch of Shariah (Islamic) Banking Act 21 in 2008. The Act regulates various aspects of Islamic finance products and transactions including licensing, prudential supervision, Shariah compliance supervision, management, conversion of conventional banks into IFIs, and sanctions in cases of violation, etc.

### 5.5.2. THE LEGAL SYSTEM AND JURISPRUDENCE OF SHARIAH GOVERNANCE

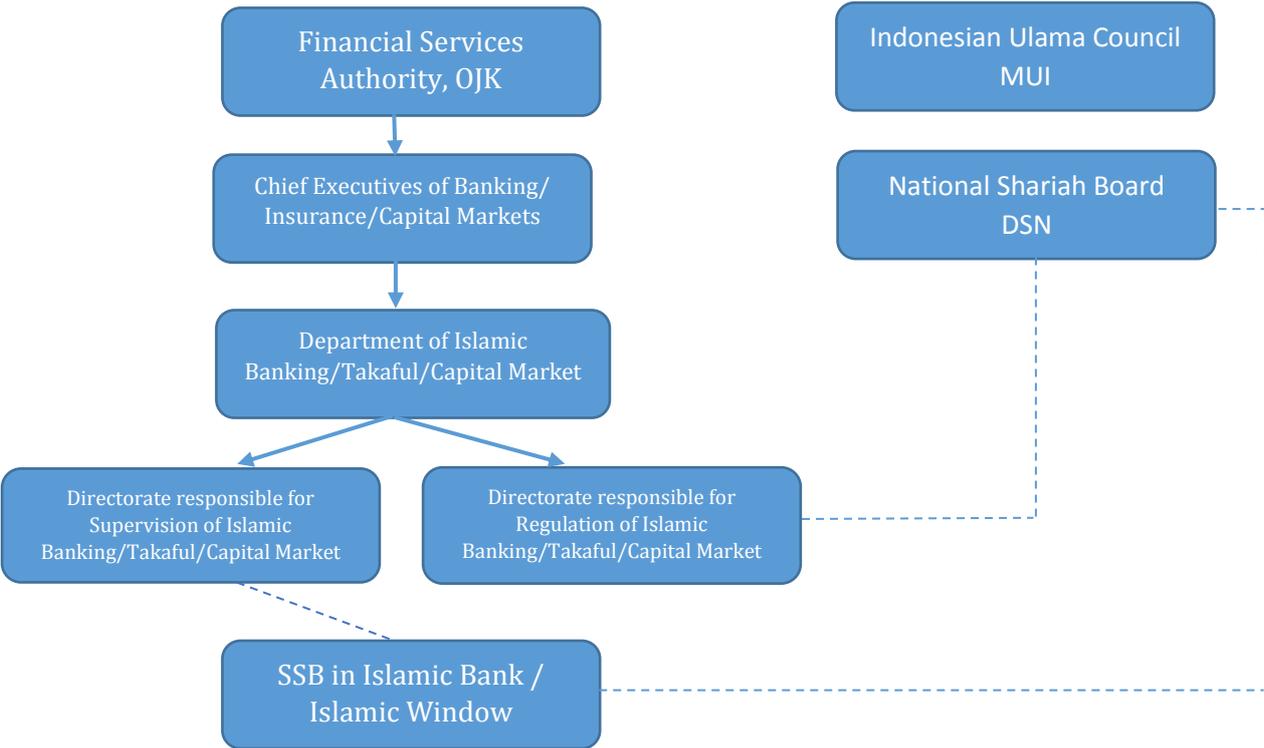
Governance of Islamic finance in Indonesia is influenced by the civil law system on which Indonesia’s legal system is based. The Financial Services Authority (Otoritas Jasa Keuangan – OJK) is the standard-setting government body for governance in the financial services sector. The OJK is actively being part of various forums and collaborates with international bodies, such as the Financial Stability Board (FSB), the BCBS and the IFSB (Setyowati, Abubakar, and Rodliah 2017).

There are two Shariah supervisory bodies. They are: (i) The SSBs in IFIs and also in conventional banks’ Islamic windows, and (ii) the National Shariah Board (Dewan Syariah Nasional – DSN). The Shariah Banking Act determines matters related to SSBs in IFIs. Some important articles in the Act (2008, para. 32) are such as follows:

1. IFIs (full-fledged or windows) must establish SSBs,
2. SSB shall be appointed by the general meeting of shareholders on the recommendation of the Indonesian Ulama Council (Majelis Ulama Indonesia – MUI). In practice, the recommendation is made by the DSN, a body within the MUI.
3. SSB has to give advice and recommendation to the BOD and supervise the IFIs’ activities in terms of Shariah compliance.

The DSN is a national-level Shariah supervisory body whose main duty and responsibility is to examine and formulate main Shariah principles such as the issuance of fatawa and guidance in the Islamic financial business etc. (ISRA 2013). The fatawa of the DSN regarding Islamic financial matters are binding for SSBs within the IFIs.

**Figure 18: Relationship Between the OJK, the DSN, and the SSB**



Source: (ISRA, 2013) & Authors

Within the OJK’s structure, there is the commissioner for banking managing the department of Islamic banking and the directorate of supervisory under it. There is also a directorate of regulation, license, and research for Islamic banking. The appointment process for SSB members is as follows:

1. IFI appoints the SSB member.
2. An appointed member should have a recommendation from the DSN. The DSN gives recommendations to those who have a Shariah audit certificate issued by the DSN.
3. Become an SSB member officially, the appointed member should apply to OJK. From the appointment to the approval, the applicant is not allowed to do anything officially.
4. OJK makes an interview with the applicant to investigate the applicant’s documents and financial situation and clarify this information. The OJK does not examine the competency and qualification of the applicant, because the DSN already checks for these.
5. OJK can either approve or refuse the application.

There are also directorates for Islamic insurance and Islamic capital market within the OJK’s body. The OJK does not have a separate framework for Shariah governance since it exists as a part of good corporate governance. The OJK and the DSN hold an annual meeting which is called the annual meeting for SSB Members (Ictima Senevi). They also have a common working group for discussing current issues that meet irregularly.

**Table 19: Islamic Finance Landscape in Indonesia**

Authorities	<ul style="list-style-type: none"> <li>▪ Financial Services Authority of Indonesia (Otoritas Jasa Keuangan)</li> <li>▪ Bank Indonesia (Central Bank of Indonesia)</li> </ul>	<ul style="list-style-type: none"> <li>▪ Ministry of Cooperatives and Small and Medium Enterprises</li> <li>▪ The National Board of Zakat</li> <li>▪ The Indonesian Waqf Board</li> </ul>
Commercial IFIs	<ul style="list-style-type: none"> <li>▪ Capital Markets</li> <li>▪ Commercial Banks</li> <li>▪ Investment Banks</li> <li>▪ Insurance Companies</li> </ul>	<ul style="list-style-type: none"> <li>▪ Pension Funds</li> <li>▪ Finance Companies</li> <li>▪ Microfinance Institutions</li> </ul>
Social IFIs	<ul style="list-style-type: none"> <li>▪ Cooperatives</li> <li>▪ Zakat Institutions</li> </ul>	<ul style="list-style-type: none"> <li>▪ Waqf Institutions</li> </ul>

Source: Authors

Once the DSN issues a fatwa, the relevant government body, which is usually the OJK, discusses the implementation of the fatwa on the regulation basis. Other than the IFIs, zakat and waqf institutions, cooperatives, and as well as the central bank and the ministry of finance also need to have fatwa for their new instruments and implementations. The core principles for zakat and waqf that were issued in 2019 require zakat and waqf institutions to establish SSBs within their body.

**5.5.3. DEVELOPMENTS OF SHARIAH GOVERNANCE**

The first Indonesian Code of Good Corporate Governance was developed in 1999 by The National Committee on Corporate Governance (NCCG). The Code has been revised several times. The CG Code constitutes the reference points for all companies in Indonesia including companies operating on the basis of Shariah (IFC 2014).

**Table 20: Milestones of Developments of Islamic Finance in Indonesia**

1997	A joint workshop held by Bank Indonesia and Majalis Ulema Indonesia. This was the starting point of how SGF could be developed in Indonesia.
1998	Law No. 10 permitted for the public to establish banks based on Shariah principles
1999	Indonesian Code of Good Corporate Governance, National Committee on Corporate Governance. The NSB was established within the MUI. (Until now, the structure is the same).
2002	The Blueprint of Islamic Banking Development in Indonesia, Bank Indonesia
2007	Investment Guide to Islamic Banking in Indonesia, Bank Indonesia
2008	Issuing of Shariah Banking Act No: 21
2008	Codification of Islamic Banking Products, Directorate of Islamic Banking, Bank Indonesia

2008	Grand Strategy of Islamic Banking Market Development, Directorate of Islamic Banking, Bank Indonesia
2011	The Code of Good Governance Shariah Business, National Committee on Governance (NCG)
2014	Assessment of Commercial Banks and Shariah Unit Shariah (POJK No: 8/POJK.03)

Source: Authors

The decision of the DSN (No.01/2000) serves as the main reference to the duties and responsibilities of the DSN itself. The DSN and the SSBs' responsibilities can be classified into three aspects: (i) conducting supervision and advisory towards BODs in numerous banking activities from the Shariah principles perspective, (ii) acting as the mediating body between the bank and the DSN in the implementation of fatawa and rulings of the council; and (iii) providing periodic reports on their supervisory activities to the council since the appointment of the SSB members in any bank is determined partly by the DSN (ISRA 2013).

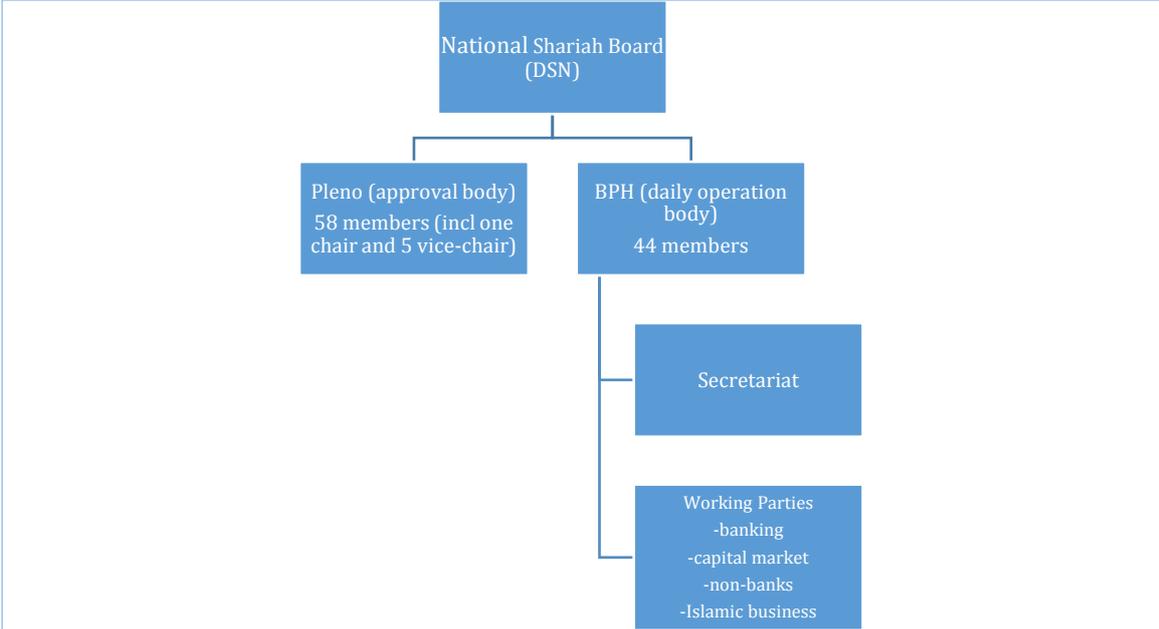
The main duties of the DSN are summarized such as follows:

1. Issuing fatawa which are to be considered as a basis for the proposed regulations issued by relevant authorities, such as the Department of Finance of the Republic of Indonesia and the Central Bank of Indonesia.
2. Delivering opinions for the appointment or revocation of the appointment of any person for the membership of an SSB within the financial industry.
3. Proposing the involvement of the experts and officials of any governmental bodies in the areas related to Shariah issues in which fatawa must be issued.
4. Issuing letters of a reminder to any IFI for any noncompliance with fatawa of the DSN.
5. Proposing that governmental authorities take the necessary legal action when the above-mentioned letter of reminder is ignored." (ISRA 2013).

The difference between Indonesia and other countries is that Indonesia has the MUI and DSN. The purpose of the MUI is to issue the fatawa and rulings relating to all aspects of life. However, the DSN issues fatawa and rulings regarding financial issues. The DSN also coordinates with the OJK, the regulator, as the source of a fatwa for Islamic financial issues (Rahajeng 2013). The DSN's fatwa is not binding unless they are adopted into regulation by the relevant government body, such as the OJK.

The difference between Indonesia and other countries is that Indonesia has the MUI and DSN. The purpose of the MUI is to issue the fatawa and rulings relating to all aspects of life. However, the DSN issues fatawa and rulings regarding financial issues.

**Figure 19: The Organization of the DSN**



Source: Authors

DSN’s members come from different Islamic organizations. The DSN issues different types of certificates for Islamic banking, Islamic insurance, ICM, cooperatives, etc. There are also two types of certificates for professionals and non-professionals. The non-professional certificate can be acquired after training and exam carried on by the DSN. The professional certificate is issued in collaboration with the National Professional Certificate Institution (BNSP), a government body for certification. Non-professional certificate owners generally sit on the SSBs of cooperatives and microfinance institutions.

Bank Indonesia boosted the Islamic finance and economic development, as part of Bank Indonesia’s policy mix as well as in coordination with the National Islamic Economy and Finance Committee (Komite Nasional Ekonomi dan Keuangan Syariah– KNEKS). KNEKS was established in 2017 as a government body under the presidency to harmonize the activities and regulations regarding Islamic finance and halal business which are carried out by different government bodies. KNEKS is only responsible for the coordination of these activities according to national strategy – National Blueprint of Islamic Finance Development, however, it does not have regulatory power. In 2018, several Shariah instruments were issued. Bank Indonesia initiated the development of core principles for Shariah social finance instruments such as Zakat Infaq Shodaqoh (ZIS) and waqf to support economic empowerment (Bank Indonesia 2018). In, 2019, the OJK announced various new regulations, including on sukuk, fintech, takaful, and asset management, to name a few.

#### 5.5.4. ISSUES AND CHALLENGES

There is no Shariah audit body within the IFIs in Indonesia because there are no Shariah audit standards or procedures put in regulation or framed so far. Shariah audit is conducted by internal auditors who are appointed by risk control units. An internal auditor needs to have both internal and external training to conduct the audit efficiently.

There is no Shariah audit body within the IFIs in Indonesia because there are no Shariah audit standards or procedures put in regulation or framed so far.

Shariah experts can be SSB members in five different Islamic banks and four different boards for the other sectors, as they are allowed by the regulation. On the other hand, some DSN members are also SSB members of some IFIs. This is due to the shortage of Shariah advisors in Indonesia which arises from the obligation to establish SSBs imposed on thousands of cooperatives and microfinance institutions. However, the issue that SSB members sitting on different boards raises potential conflicts of interest.

There is no legal basis for the DSN. To set up a legal basis for the DSN could raise the problem for it to become a half-government body. The fatwa of the DSN is not binding unless they are put into regulation by the relevant government body, such as the OJK. However, instead of following the regulations, SSB members generally look at the fatwa of the DSN and make their decisions accordingly.

Many banks do not have officers specialized in Shariah compliance. And also, many of them do not have the Shariah advisory/ legal unit, because there is no such regulation for IFIs to have it. IFIs need to accommodate sufficient staff who are capable of Shariah issues.

The DSN and the OJK have different requirements for the formation of SSBs. The DSN requires three or more members for SSBs, however, the OJK regulation requires two or more.

#### 5.5.5. COUNTRY SPECIFIC RECOMMENDATIONS

- (i) The SGF in Indonesia is a centralized structure that puts the DSN in the center. There are 40 provinces in Indonesia and all IFIs in these provinces need to ask Shariah opinion from the DSN. This structure can be made more effective by decentralizing the DSN.
- (ii) There are thousands of zakat and waqf institutions, cooperatives and microfinance institutions which are all obliged to have SSB. This means there is a need for thousands of SSB members who should be a Shariah expert and certified by the authorities. However, there are only more than one thousand certified Shariah experts. This implies that for many institutions, it is almost impossible to confirm with this obligation. Therefore, only large institutions could establish SSBs but others could not. There are two options as solutions. The authorities can change the regulation in a way to decrease the need, for example by establishing regional SSBs which would also help them to minimize costs. If not, more and more Shariah experts needed to be trained and certified.

- (iii) The OJK has not defined where the SSBs should be under the organization structure. This is a flexibility for the IFIs, however, this issue needs to be taken into consideration for a better Shariah governance performance.
- (iv) SSB members of the IFIs mostly have a background in Islamic law, however, more members needed who has a background in Islamic economics and finance and other related fields in which the IFIs operate.

## 5.6. CASE STUDY: UNITED KINGDOM

### 5.6.1. OVERVIEW OF SHARIAH GOVERNANCE

The UK is the top non-OIC country for Islamic finance with \$6 billion total assets (TheCityUK, 2019) of UK-based institutions that offer Islamic financial services. The UK government achieved this development by creating a fiscal and regulatory framework intended to broaden the Islamic finance sector over the last three decades.

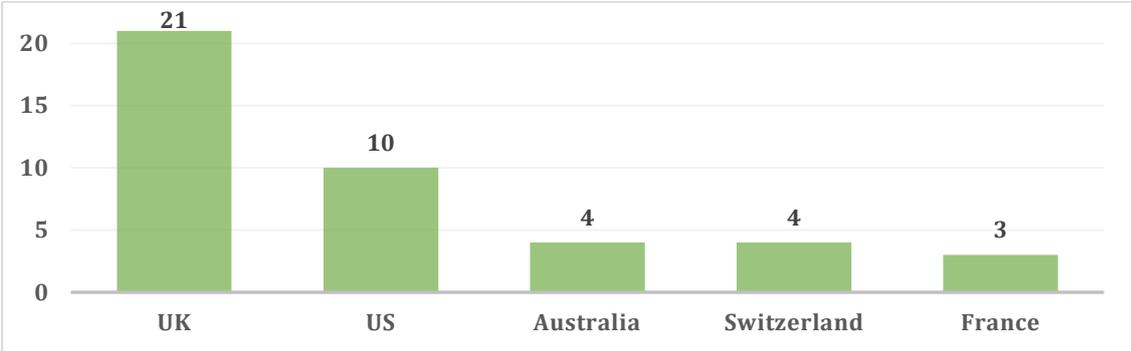
Islamic banking is the leading Islamic financial sector in the UK. There are 5 fully Shariah-compliant banks licensed in the UK with 17 domestic branch offices and also more than 15 conventional banks and institutions which offer Shariah-compliant services (TheCityUK 2019). The list of fully Shariah-compliant banks and conventional banks that offer Islamic financial services in the UK can be seen in table 21. The total number of banks that offer Islamic financial services in the UK is more than any other non-OIC country.

**Table 21: IFIs and Conventional Banks That Offer Islamic Financial Services in the UK**

Islamic Banks	Number of SSB members	Conventional Banks	Number of SSB members
Abu Dhabi Islamic Bank (corporate banking)	5 members	ABC International Bank	3 members
Al Rayan Bank (retail banking)	4 members	Ahli United Bank	3 members
Bank of London and the Middle East (retail and corporate banking) (BLME)	3 members	Bank of Ireland	?
Gatehouse Bank (wealth management)	3 members	Barclays	?
QIB UK (investment banking)	3 members	BNP Paribas	3 members
		Bristol & West	?
		Citi Group	?
		Deutsche Bank	?
		Europe Arab Bank	?
		IBJ International London	?
		Lloyd's Banking Group	2 members
		Royal Bank of Scotland	2 members
		Standard Chartered	3 members
		UBS	?
United National Bank	?		

Source:(TheCityUK 2015, 2019) & Authors

**Figure 20: The Number of Banks That Offer Islamic Financial Services in Non-OIC Countries**



Source: (TheCityUK 2015)

The government issued its first sovereign sukuk in the global ICM in 2014 and the UK became the first non-OIC country to issue a sovereign sukuk (COMCEC 2017). On the market side, the London Stock Exchange has become a key global venue for sukuk issuances, where over \$53bn had been raised through 72 issues (TheCityUK 2019). To meet the requirements of Islamic investors globally, the UK developed Shariah-compliant indices to be used as the basis for Shariah-compliant investment products (COMCEC 2017).

The insurance industry in the UK is regulated by the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA). The Islamic Insurance Association of London (IIAL) was established in 2015 as an international body to support the practices of industry players (COMCEC 2019b). However, there is a lack of data on the takaful industry in the United Kingdom. There are only two full-fledged retail takaful companies in the UK (COMCEC 2017).

In 2001, the Bank of England established the Islamic Finance Working Group to investigate obstacles facing the Islamic finance industry and to enable the development of Islamic finance in the UK. The working group consisted of representatives from the UK Treasury, Financial Services Authority, the Council of Mortgage Lenders, IFIs, and the Muslim community. The UK government continued to take initiatives to facilitate the development of Islamic finance in the latter years. In 2003, tax and regulatory changes have been introduced to enable financial institutions to offer a range of Islamic finance products, such as Stamp Duty Land Tax (SDLT) has been amended to remove the double charge on Shariah-compliant mortgages (Azma et al. 2018).

One of the main legislation for the financial services in the UK is the Financial Services and Markets Act 2000 (FSMA), which sets out the activities and entities that fall within the scope of UK financial services regulation. FSMA does not specify any provision on the Shariah governance framework. Therefore, Islamic financial institutions have the discretion to form the Shariah governance framework and the authorities would not intervene in Shariah governance matters, as long as any extraordinary issue is not raised. This approach gives room to the individual Islamic financial institutions to set their Shariah governance standards independently, without adhering to any particular national or international standards. There is no central body authorized to monitor the practice of Shariah governance in the UK. The FCA and the PRA are the main authorities that supervise Islamic financial institutions in the same way they supervise conventional financial institutions.

Some claim that such an unregulated environment regarding Shariah governance has a positive effect on the development of the Islamic banking industry in the UK (R. Hassan et al. 2013). However, in light of the alternative SG regimes, each with its advantages and disadvantages, the lack of regulation would lead to missing a good opportunity to cash in some of the advantages of a good SG regime for the Islamic finance industry in the UK.

The number of Shariah board members varies among the banks and the institutions which offer Shariah-compliant services in the UK. For instance, the QIB (UK) and the European Finance House had three members in their Shariah boards, the Bank of London and the Middle East and the European Islamic Bank had four Shariah advisors and Gatehouse Capital had one Shariah advisor. This variety in the number of Shariah board members arises from the absence of a regulatory framework for Shariah governance which creates flexibility for the IFIs in the UK to organize and manage their own Shariah governance (Hasan 2011; R. Hassan et al. 2013). However, the IFIs in the UK can follow voluntary codes advanced by transnational non-governmental organizations such as the IFSB and the AAOIFI (Morrison 2014). This shows that even the IFIs in the UK have the legal discretion to arrange their Shariah governance structure in any manner they choose, they refer to the IFSB and AAOIFI guidelines. (Hasan 2011; R. Hassan et al. 2013)

### 5.6.2. THE LEGAL SYSTEM AND JURISPRUDENCE OF SHARIAH GOVERNANCE

The UK does not have a separate legislative framework for the Islamic financial sector. Instead, existing legislation governing conventional financial instruments was adjusted to serve this need. However, the UK has been proactive while monitoring and responding to any unequal treatment between conventional finance and Islamic finance by introducing remedial legislation and regulations. Some key facilitating initiatives have included the special exemptions to stamp duty land tax to relieve the unintended double taxation charges on Islamic mortgages. Therefore, there is a lack of a single codified body of Islamic law altogether which leaves space to different Shariah opinions among scholars about the application of Islamic principles to financial instruments (Dewar and Hussain 2019).

The IFIs in the UK have the liberty to establish Shariah boards without being legally constrained. However, rules setting members' qualifications and SSBs authorities and guidelines are missing.

According to section 154 of the UK Companies Act 2006, private companies must have at least one director and public companies must have at least two directors. There are no provisions regarding the board of directors, however, there is also no restriction or prohibition for establishing internal bodies, such as the board of directors and Shariah board. Therefore, the IFIs in the UK have the liberty to establish Shariah boards without being legally constrained. However, rules setting members' qualifications and SSBs authorities and guidelines are missing.

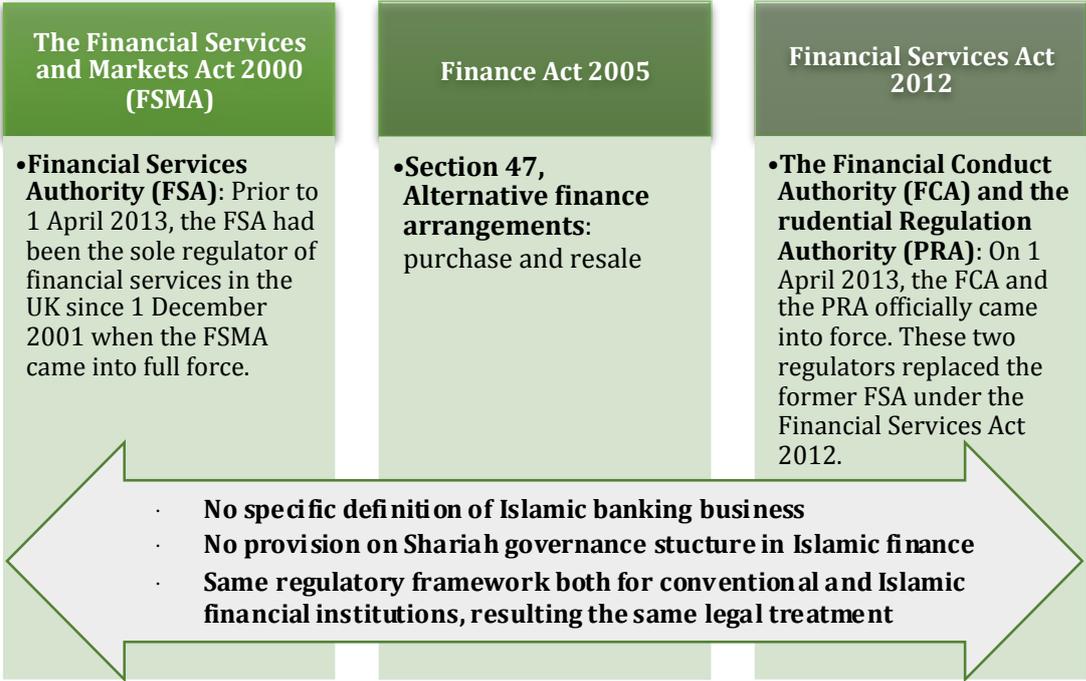
One of the main legislation for the financial services in the UK is the FSMA, under which financial institutions are permitted by the FCA and the PRA to conduct a regulated activity in the UK. Before 2013, the only central body under the FSMA was the Financial Services Authority (FSA), which was then split into two bodies: the FCA and the PRA. The FCA<sup>26</sup> is the conduct regulator for 59,000 financial services firms and financial markets in the UK and the prudential regulator for over 18,000 of those firms. The FCA is an independent public body and is accountable to the Treasury, which is responsible for the UK's financial system. The PRA<sup>27</sup>, which is a part of the Bank of England, regulates and supervises the firms in the financial services industry to ensure that the financial services and products are provided safely and soundly. The PRA supervises over 1,500 financial institutions including banks and insurance companies.

<sup>26</sup> <https://www.fca.org.uk/>

<sup>27</sup> <https://www.bankofengland.co.uk/prudential-regulation>

The regulation and monitoring of Islamic financial institutions in the UK are conducted by the FCA and the PRA. Since the FCA has the supervisory responsibility for Islamic finance in the UK, all Islamic banks in the UK have to be authorized and licensed by the FCA. The PRA is responsible for the prudential regulation of financial institutions, including Islamic banks in the UK. Both Islamic and conventional financial institutions are subject to the same standards of the FCA and the PRA, including stipulated sanctions and fines, because the IFIs are just considered to be financial institutions in the FSMA (Dewar and Hussain 2019).

**Figure 21: Legal Framework Governing IFIs in the United Kingdom**



Source: Authors & (R. Hassan et al. 2013)

Since the Islamic banking sector dominates the Islamic financial sector in the UK, most of the applications regarding Islamic financial operations have been made to establish new Islamic banks. All authorized financial institutions that operate in the UK, are subject to the same standards, regardless of their religious principles, as the UK considers itself as a secular country. This approach is sought to facilitate innovation and avoid unnecessary barriers to entry or expansion within the financial markets (Ainley et al. 2007).

The Finance Act 2005, which is the primary legislation that governs the Islamic financial sector, characterizes Islamic financial transactions as alternative finance arrangements. There is no provision on Shariah governance in this act. However, AAOIFI standards can be regarded as the major reference for the appointment, qualifications, and composition of Shariah boards. Most of the Shariah boards in Islamic financial institutions are comprised of at least three members (R. Hassan et al. 2013).

In line with its neutral approach and for an unjustifiable claim to be a secular regulator, the UK government does not intervene in the IFIs for the choice of evaluative criteria such as whether an Islamic financial product or service complies with the Shariah. Therefore, the IFIs have the whole responsibility for the Shariah compliance of their products and services. The IFIs have different internal Shariah audit systems depending on their articles of association or national regulatory

requirements. Most of the IFIs established Shariah boards by appointing scholars with experience in classical Islamic commercial law, however, some IFIs resort to Shariah consultancy services (Ercanbrack 2011).

On the other hand, this self-regulation model for the Shariah governance model in the UK does not necessarily mean the IFIs are not accountable to the government for their actions regarding Shariah compliance. If an IFI, which claims in its articles of association that it adheres to Shariah tenets but fails to comply with it can be brought to justice by the stakeholders. According to the Trade Descriptions Act of 1968, it is an offense to make false statements about the provision of services. And also, according to the Fraud Act of 2006, it is an offense to make misleading representations of products and services (Ginena and Hamid 2015a). Nonetheless, self-regulation is a slippery road for the Islamic finance industry. Without the setup of a proper SG regime, the industry would be seriously exposed to apprehensive risks of Shariah violations.

### **5.6.3. DEVELOPMENTS OF SHARIAH GOVERNANCE**

The regulatory framework in the UK for Islamic finance has been improved by some facilitating initiatives taken in the last decade. The foremost ones are the removal of double tax on Islamic mortgages, reform of arrangements for issues of sukuk that makes London a more attractive location for issuing and trading sukuk, and the FCA's efforts to ensure that Islamic finance is treated according to Shariah principles and objectives (TheCityUK 2019).

On the one hand, there are some facilities in the UK which support the development of the Islamic financial sector. For example, the UK has the largest share in the legal services market in Europe and more than 25 law firms are supplying Islamic legal services in the UK. Also, all of the UK's largest professional firms have Islamic finance departments and nine fund managers serve their clients by providing Islamic asset management. Moreover, professional institutes and universities offer new standards and qualifications in Islamic finance, which is significant for the development of Shariah governance in the UK (Azma et al. 2018). On the other hand, the absence of serious regulation could turn in negative results in the Islamic finance industry, despite the impressive infrastructure of the London financial market.

On the positive side, the qualifications and requirements for being a Shariah board member are not regulated by any authority in the UK. AAOIFI's guiding principles advise that Shariah board members should be jurists in Islamic commercial jurisprudence. However, experts in the field of Islamic finance who know Fiqh al-Muamalat can also be appointed as Shariah board members. The Shariah board members of the IFIs generally meet these qualifications in the UK, they are leading and renowned Islamic scholars in Fiqh and Islamic finance. To prevent conflict of interest situations in the IFIs, the AAOIFI standards also advise that Shariah board members should not be the members of the board of directors or significant shareholders of IFIs at the same time. The IFIs in the UK conform with that standard, such that no member is appointed from the board of directors to the Shariah board in the same IFI (R. Hassan et al. 2013).

The UK government's equal treatment policy had enabled do what is needed to facilitate alternative financial arrangements. IFIs, Muslim community leaders, and Shariah scholars together were able to find practical solutions to remove the barriers in the way of Islamic finance development. Besides their regular duties, the Shariah scholars in IFIs were in the endeavor for Islamic finance development by taking up additional responsibilities, such as consumer education and advocacy, dispute resolution, media interviews, liaison with external auditors, regulators, and law firms (Barkatulla 2017).

The UK government's willingness to develop the Islamic finance industry in the UK and its efforts towards this ambition, such as creating a fiscal and regulatory framework intended to broaden the Islamic finance sector, could be taken into account as more efforts would be put for the construction of a better and more efficient regulatory framework for Islamic finance industry. In this sense, UK

regulatory bodies intend to work with international industry bodies that have their Islamic finance initiatives. The FSA supported the actions of the IFSB and AAOIFI towards developing common Shariah standards. However, these standards have never been formally adopted in the UK (Dewar and Hussain 2019).

In reaction to the potential issues of confidentiality and conflict of interest regarding IFIs in the UK, such as some advisors occupied different Shariah boards in a given time, HM Treasury has recommended the standardization of products and practices of Islamic financial services by supporting the roles played by the international standard-setters, such as the AAOIFI, the IFSB, and the IIFM. The standardization has positive side effects like reducing cost and time, improving documentation and confidence, lessening the burden on Shariah scholars, and mitigating the Shariah compliance risk, which would ultimately enhance further growth of the Islamic financial industry in the UK (Hasan 2011).

From the regulatory perspective, the key point is if the role and responsibilities of the Shariah board are advisory and it does not interfere in the management of the firm. The regulators' main concerns about the Shariah board are its governance structure, reporting lines, fee structure, and the terms and conditions of the SSBs contracts (Ainley et al. 2007). The FCA tries to determine whether the role of Shariah jurists are executive or advisory. The FCA Approved Person rules require that the directors must pass the Fit and Proper Test for Approved Persons. However, if the role of Shariah jurists is advisory and they do not interfere in the management, they are exempted from these requirements (Ginena and Hamid 2015a).

A Scholar Development Program, which provides a wide range of subjects with knowledge of the conventional system, is offered specifically for Shariah advisors or potential Shariah scholars by the joint initiative of the Islamic Finance Council and the Securities and Investment Institute (SII) to fill the gap of Shariah scholars in the UK (Hasan 2011).

#### **5.6.4. ISSUES AND CHALLENGES**

Shariah is not recognized as a system of law capable of governing a contract in the UK and English law. The Convention on the Law Applicable to Contractual Obligations 1980 (the Rome Convention), requires that a governing law of an agreement must belong to a country. However, there are some cases where the English courts had jurisdiction to decide cases involving Shariah-compliant products and structures that are documented under contracts governed by English law. At this point, a controversy arises that in what manner the courts in a non-Muslim jurisdiction can address matters that concern Shariah compliance (Dewar and Hussain 2019).

The absence of a regulatory framework for Islamic finance reflects the lack of a single codified body of Islamic law and enables different opinions among Shariah scholars regarding the Islamic principles to financial practices and instruments (Dewar and Hussain 2019).

The FCA does not have Shariah scholars for reviewing the Shariah-compliant financial products and practices of IFIs. This is apparently not a concern of the UK authorities since they treat the IFIs in the same way as conventional firms. Therefore, to carry on their activities in the finance industry, the IFIs would follow the same ordinary way to get authorization and obtain the necessary permissions from the FCA. The IFIs can experience more obligations in certain circumstances, such as the role of Shariah board whether if it performs in relation to operational and financial matters (Dewar and Hussain 2019).

In terms of Shariah governance, the FCA is mainly concerned about the role of Shariah board in the IFIs, as from the FSA's perspective, as long as it does not have an executive role rather than a directorial role, there will be no significant issue. By looking at the practices of the five existing Islamic banks in the UK, it can be inferred that the Shariah governance is managed by the individual IFIs, which can adapt their own Shariah governance. Since the UK authorities consider a proactive role in regulating IFIs would run contrary to its avowed secularism, the UK government is reluctant to follow the Shariah governance approach

By looking at the practices of the five existing Islamic banks in the UK, it can be inferred that the Shariah governance is managed by the individual IFIs, which can adapt their own Shariah governance.

of other jurisdictions (Hasan 2011). The main issue here is that Shariah rules related to investment, finance, and trade can be considered separately from religious beliefs by market agents as well as regulators. Such rules need not refer to religious beliefs, once a government body permits their application. Such permission should be a good basis for treating the Islamic finance rules as similar to their (secularly) conventional counterparts.

The FCA shies away from assessing the suitability of the scholars of Shariah boards, as well as the efficiency of the Shariah governance regime in protecting the Islamic finance industry from the Shariah-violation risks. At the same time, it supports the development of common Shariah standards by international organizations, such as the IFSB and the AAOIFI, albeit without acting to enforce them. The efforts for standardization of Shariah governance could reduce Shariah compliance problems and enable bankers and investors to understand the Islamic financial market (Ainley et al. 2007).

In general, the role and functions of Shariah boards in IFIs are advisory, which is practiced all over the world including the UK. The FSA has not defined the role of Shariah boards and the role of the Shariah scholars in the Shariah boards as well. These roles could be advisory or executive, however, the existing practice in the UK shows that Shariah boards of the IFIs have a strictly advisory role and cannot interfere in management matters. Therefore, fatawa and rulings of Shariah boards may not be binding upon the IFIs. Moreover, SSBs are liable to BODs, which implies that the rulings issued by Shariah boards are not binding because the board of directors has the last word (R. Hassan et al. 2013).

The Shariah board members are free to be on multiple boards of different IFIs. Some of the prominent Shariah advisors enjoy this freedom by being a Shariah board member in three different IFIs concurrently. This redundancy in membership of Shariah boards runs contrary to the claim that the Islamic finance industry in the UK should have no problems in finding qualified Islamic finance specialists or experts in this field. Besides, the practice of the appointment of the same person as a member of more than one Shariah board can raise concerns on the issue of confidentiality (R. Hassan et al. 2013).

The UK's legal system has substantial similarities with that of Malaysia, which is a common-law jurisdiction so that for the regulatory framework concerning Shariah governance, the UK authorities can take lessons from the case of Malaysia. However, the characteristics and the diversity of beliefs and orientations among the Muslim people in the UK is different from the Muslim people in Malaysia. Moreover, the Islamic finance industry in the UK is shaped by international reach and aspirations. These constraints challenge the regulators and IFIs in the UK to establish Shariah advisory boards or other similar Shariah governance bodies. In addition to these, how the political reaction would be if such bodies were to be established in a secular jurisdiction. Besides all these, because of the lack of Shariah related regulatory framework, instituting a central Shariah advisory body would expectedly

reduce the legal uncertainty to which Islamic financial institutions in the UK are susceptible (Morrison 2014).

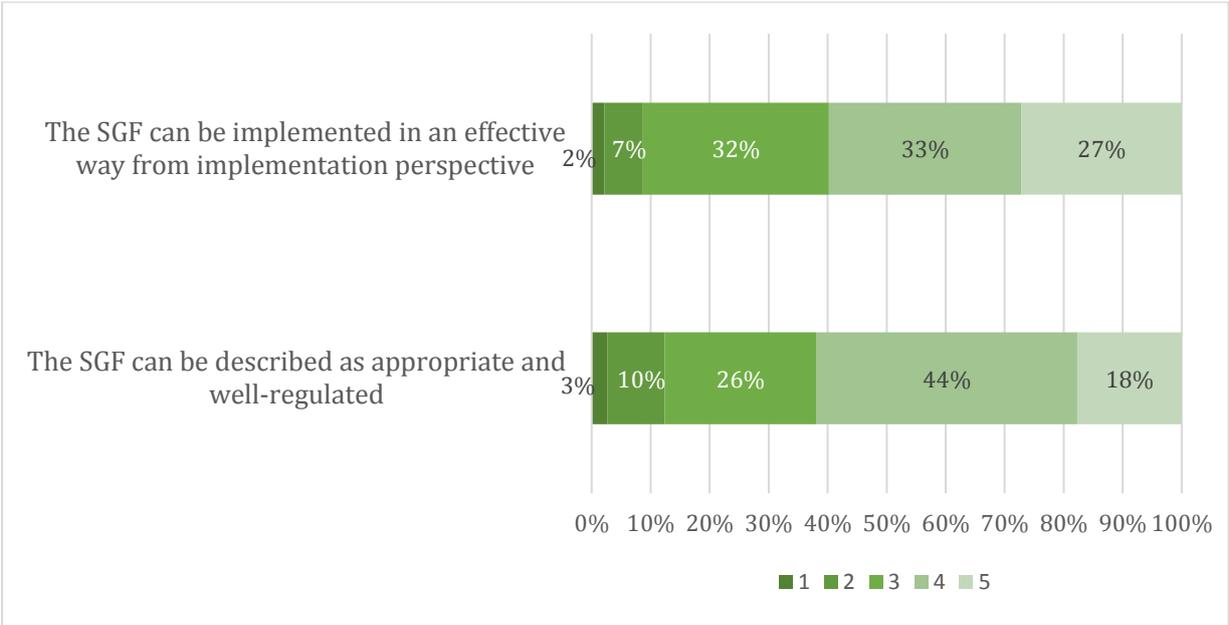
#### **5.6.5. COUNTRY SPECIFIC RECOMMENDATIONS**

- (i) The absence of a regulatory framework for Shariah governance gives IFIs flexibility to regulate their governance at their discretion. In practice, this flexibility leads IFIs to focus on the products and services that must be Shariah-compliant without considering the operational aspect. Therefore, the authorities (the FSA) needs to understand the significance of the Shariah board and emphasize its potential contribution to the operational and financial aspects of IFIs. Also, to establish a base for resolving disputes, a regulatory framework could be designed for the role and functions of Shariah boards and to what extent the rules set out by the Shariah board could be identified (R. Hassan et al. 2013).
- (ii) The qualifications and the performance of Shariah board members are influential in the credibility of the IFIs in the UK, as it is important for the customers and investors of the IFIs. Other shortcomings in the eyes of the customers and investors are the practice of the Islamic windows model, the absence of a central body authorized to monitor the practice of Shariah governance and the lack of an institutional check for Shariah issues that arises from the absence of a central body. A central advisory or enforcement body needs to be established with an acceptable degree of freedom from the government and the IFIs to bolster the integrity and improve Shariah governance in the UK (Morrison 2014).
- (iii) The UK regulator is inhibited from proper regulation of Islamic finance, based on an unjustifiable claim to be a secular and not a religious regulator. However, Shariah rules of Islamic finance can be effectively separated from its religious source for the purpose of its application in a free but regulated market. It would not be appropriate for the FCA to judge between different resolutions of Shariah boards of the IFIs. However, from a financial and operational perspective, the FCA should consider the role of the Shariah board. The FCA must have a clear understanding of how the Shariah board affects the conduct of the firm. It is undeniable that SSBs members should have an executive role. This would raise the serious question of whether they have the necessary competence and capability requirements (Ainley et al. 2007). It would open the door to the regulator to positively influence the Shariah governance regime.

**5.7. CASE STUDIES ANALYSIS OF SURVEY RESULTS**

Two-thirds of the Shariah governance survey participants opine that the SGF implementation is effective and the SGF can be described as appropriate and well regulated. The average score for the effectiveness of the SGF is 3, 74 out of 5, and for the impact of SGF is 3, 57.

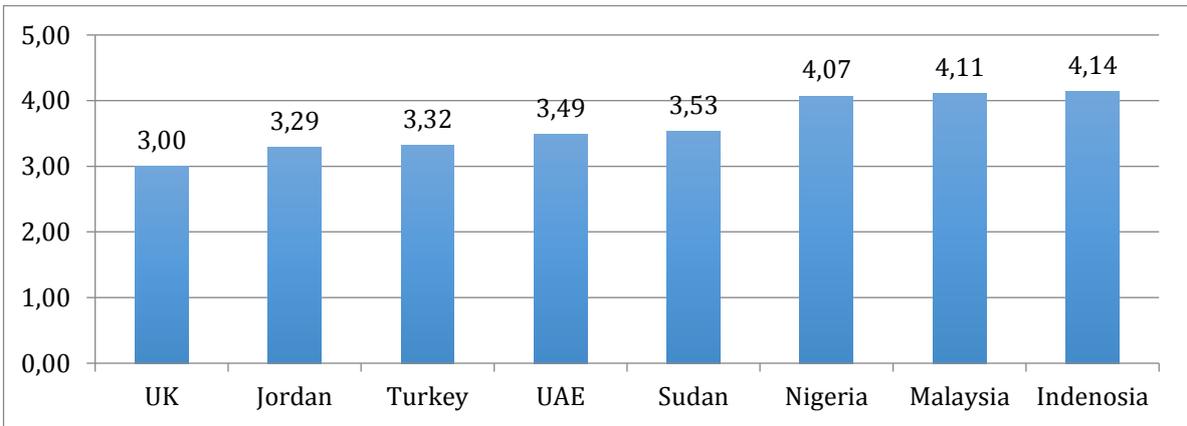
**Figure 22: The Effectiveness and Impact of SGF**



Source: Authors

When we look at the survey results in terms of selected countries, the report found that Indonesia has the highest score for the effectiveness and impact of SGF, the UK has the lowest one.

**Figure 23: Effectiveness and Impact of SGF in Selected Countries**

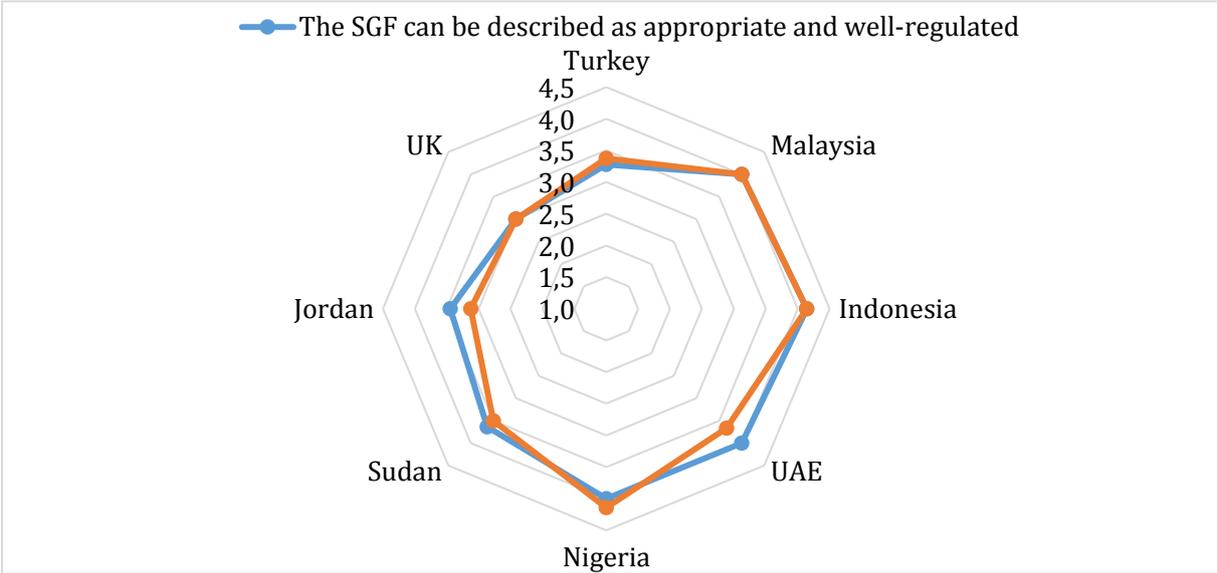


Source: Authors

As seen in figure 25, SSBs in Indonesia, Sudan, and Malaysia are more effective, independent, and transparent than the other countries. On the other hand, SSB members in Indonesia, the UAE,

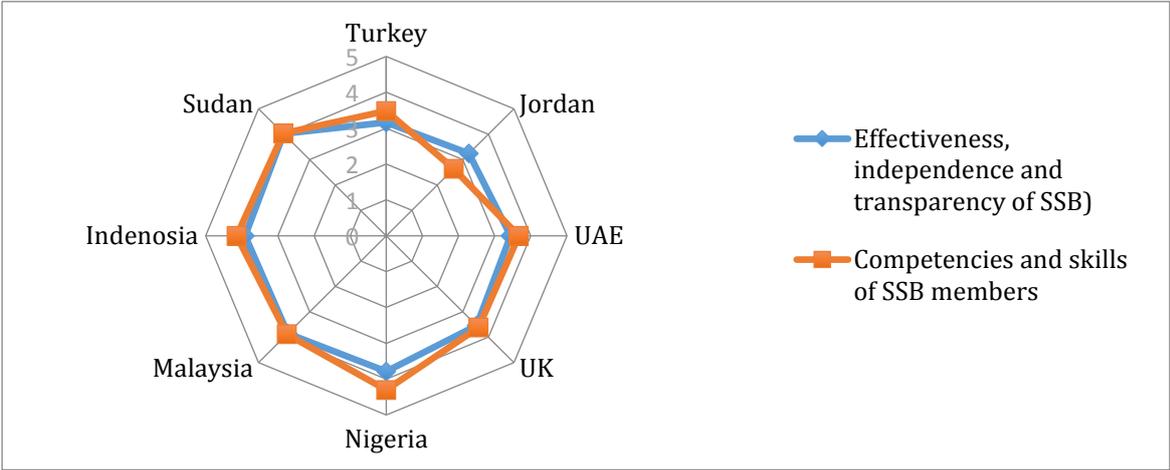
Nigeria, Sudan, and Malaysia seem necessary skills and have the required competencies for being a SSB member.

**Figure 24: Effectiveness and Implementation of SGF in Selected Countries**



Source: Authors

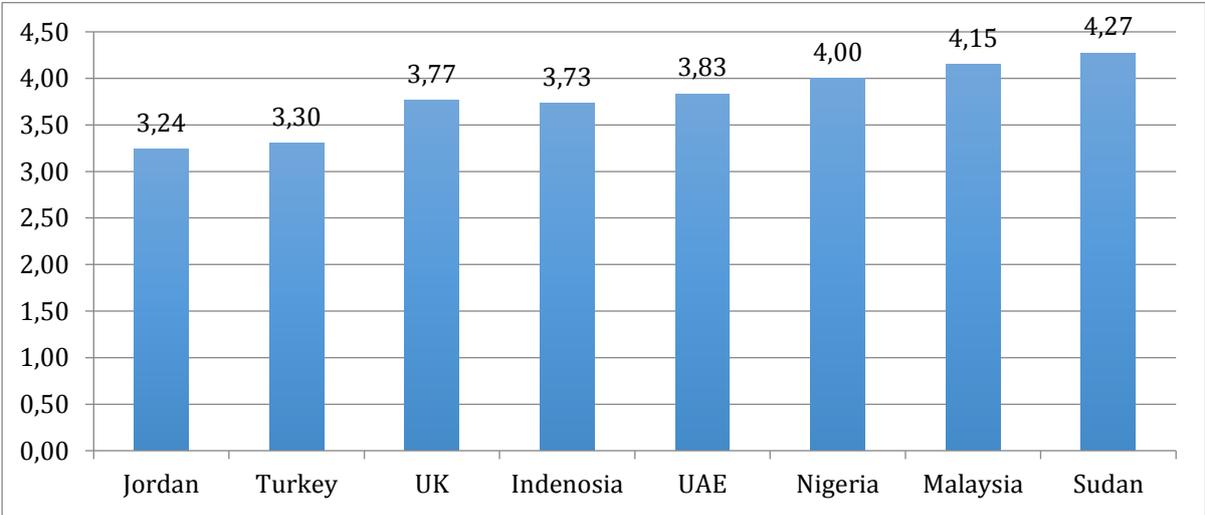
**Figure 25: Effectiveness, Independence and Transparency of SSB and Competencies of SSB Members in Selected Countries**



Source: Authors

As seen in figure 26, the highest interest of stakeholders in terms of Shariah compliance is Sudan, Malaysia respectively.

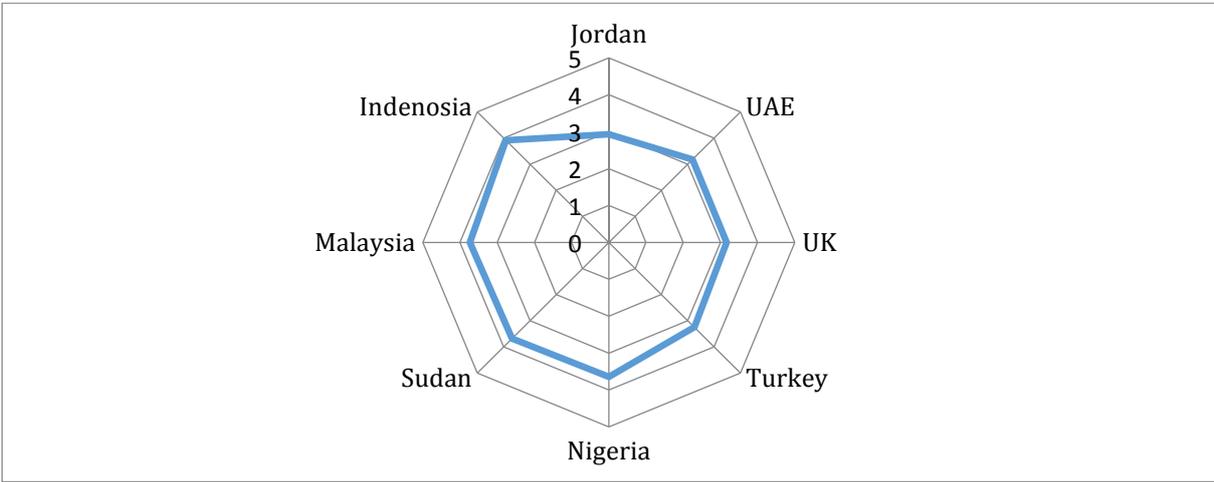
**Figure 26: Level of Interests of Stakeholders in Shariah Compliance in Selected Countries**



Source: Authors

In terms of existence and successful implication of the code of conduct, Indonesia seems the best among the other selected countries. The general score of Indonesia is around 4 while Jordan and the UK where are the lowest one is around 3 points.

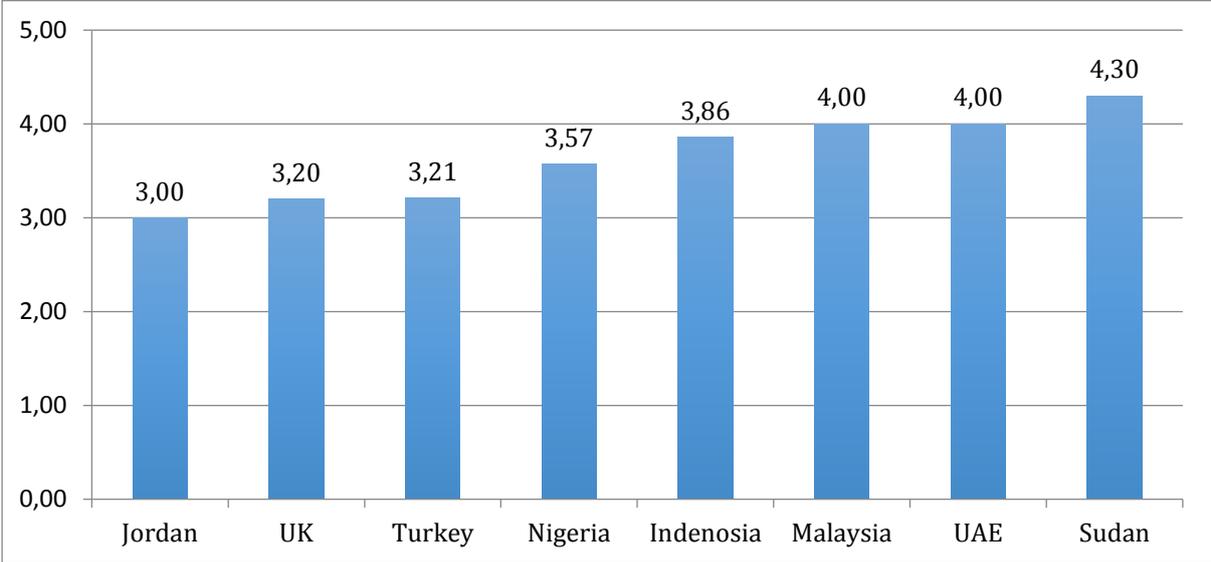
**Figure 27: Code of Conduct of SSB in Selected Countries**



Source: Authors

Shariah governance survey indicates that the overall success of the Shariah governance landscape in selected countries, we may state that Sudan is the successful one among selected countries with 4.3 points out of 5, as seen in figure 28 below. After Sudan, the UAE, Malaysia, and Indonesia come with scores of 4, 4, and 3.86 respectively. On the other side, Jordan and the UK have the lowest score respectively in terms of successful Shariah governance landscape.

**Figure 28: Success of Overall Shariah Governance in Selected Countries**



*Source: Authors*

The above survey results must be taken with great apprehension. The surveyed people are mostly members of the Islamic finance industry. Their opinions would obviously represent industry self-perception. Perhaps it would have been more useful to survey other stakeholders. However, many practical difficulties would arise. Most importantly, the lack of awareness of the nature of Islamic finance and how best to conduct it would be a serious obstacle. Therefore, while the industry feels good about itself, this is no indication of having proper Shariah governance

## 6. CONCLUSION AND POLICY RECOMMENDATIONS

### Shariah supervisory boards

- (i) It appears that the best option is to have a national Shariah board, without a real need for an institutional SSB. However, if institutional SSBs were to be kept, they should be under the direct supervision of the national SSB.
- (ii) The composition of Shariah boards must be divided among Islamic monetary and financial economists<sup>28</sup>, capable of formulating the proper perception of transactions in questions as well as identifying the ultimate economic consequent of each and Shariah experts would be required to identify the Shariah rule, given the right perception as well as the ultimate consequence. Other specializations with expertise in the new banking and financial technologies should be made handy to advise the SSBs
- (iii) The national SSBs should consider the interests of all stakeholders, not just shareholders.
- (iv) SSBs should not be limited to issuing fatawa. They should have the following arms:
  - ✓ An ombudsman to resolve conflicts between IFIs and customers.
  - ✓ A technical office to advise
  - ✓ The IFIs on product structuring and development,
  - ✓ The national SSB and the IFIs on standards and securitization.
  - ✓ The national SSB on the approval of new products.
  - ✓ Overseeing the IFIs on proper income purifications and how it is dispensed with.
  - ✓ Review of the yearly accounting of profit and zakat calculation and distribution.
  - ✓ Assessing and regularly reporting Shariah non-compliance risk to shareholders and IAHs.
- (v) To ensure confidentiality and prevent conflict of interest, the national SSB should disallow membership of more than one national or institutional SSB. In addition, a membership period of 4 years, renewable only once should be set for institutional and national SSBs.
- (vi) To ensure the autonomy of national SSBs, the monetary authority prepares a list of all Islamic monetary and financial economists and another list of all Shariah scholars in the country, both ordered by seniority. All listed must fulfill the conditions to be scholars, including a PhD from an accredited university, a track record of teaching graduate students, publishing in peer-refereed journals, and providing non-exceptional expert opinions, e.g., allowing riba, tolerating debt or pure risk trading. The listed should be ordered according to a point system that measures their scholarships using the preceding criteria. Members of national/institutional SSBs would be drawn from both lists, after excluding those currently charged with conflicting duties or employed by private or public enterprises.
- (vii) Pronouncements of national and institutional SSBs must be collected, published, indexed, and made public.
- (viii) SSB members must attend all meetings. Participation through video conferencing can be substituted for physical presence. SSB members who unexpectedly face attendance impediments must be terminated.
- (ix) The remuneration of SSBs would be paid by the monetary authority. Remuneration of institutional SSBs should also be paid by the monetary authority and billed to respective IFIs. Part of the remuneration must be tied to meetings attendance.

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<sup>28</sup> Islamic economists are those educated in the analytical (as opposed to actual) Islamic economics while mastering Fiqh Al-muamalat.

## Legal & regulatory environment

- (i) The banking law must be amended to contain the definitions of all currently known and approved Islamic finance products. The law should also authorize the regulator to add new products once they are approved. It should include the definitions of impermissible products with a stipulation for their prohibition. Such products can be easily identified as leading to the sale of present for future money at a premium<sup>29</sup>. Besides, the finance of pure risk and debt trading as well as the short-term holding of financial assets should be strictly prohibited<sup>30</sup>.
- (ii) The financial market law should be amended to contain the definitions of Islamic financial instruments. It should stipulate the general rule of prohibiting trade in pure risk and debt. A rule of the dominance of Shariah-compliant assets must be included as a listing requirement for “Islamic companies,” as well as for the assets underlying Islamic financial instruments (sukuk, fund certificates and shares). We suggest starting with 51 percent which would be raised by 5 percent every two years until it reaches 95 percent with the eventual maturity of the Islamic financial market. This must be coupled with a mechanism to cleanse income accrued from unlawful sources, which should not exceed 5 percent.
- (iii) A special standard for listed companies as well as listed Islamic financial instruments should be attached to the law, with a stipulation of an annual review. Such standards must set conditions ensuring Shariah compliance, including sustainability. Besides Islamic financial instruments must be “green”.
- (iv) A handbook of Islamic financial products and instruments should be issued by the regulator to support the implementation of the law.

## Involving stakeholders

Regulators must set rules to involve IAHS in IFI management, in proportion to the resources they contribute to the mudaraba pool. In this regard, we suggest the following mechanism:

- (i) Voting in the general assembly and board of directors must be apportioned between shareholders and IAHS in proportion to their resources.
- (ii) The resources contributed by IAHS should be measured as of the beginning of the financial year and compared to the total capitalization value of the IFI.
- (iii) The number of BOD, seats, and general assembly votes should be set according to the portion of total investment accounts as compared to the total capitalization value of the IFI.
- (iv) IAHS must be allowed to appoint their representatives in the general assembly of IFIs.
- (v) The number of BOD seats should be assigned to the IAHS with the largest accounts unless IAHS appoint other representatives. They together would cast the voting share of the account holders in the general assembly.
- (vi) Paying the management remuneration of IFI manager’s part in cash and fringe benefits and part in IFI stock.

## Elements for an optimal Shariah governance arrangement

- (i) Banking and financial market laws that contain
  - ✓ The definitions of Islamic finance products and instruments.
  - ✓ The definitions of the popular controversial products designed through ruses, with a stipulation for their prohibition.
  - ✓ A governance structure that allows IAHS to be represented in the general assembly and the board of directors of IFIs in proportion to their balances.

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<sup>29</sup> Economists understand that such products include international Murabaha, Bay Al-Inah, Tawarruq and debt sale.

<sup>30</sup> This includes the finance of acquisition of Shariah-compliant financial instruments for sale within a short time (e.g., 90 days) and asset portfolios (lumped as Sukuk, fund and investment certificates dominated by debt).

- (ii) Shares, sukuk, fund certificates standards, which must be met for listing companies as well as listed financial instruments in Islamic financial markets, must be set by the national SSB. Such standards must adopt a dominance rule of 51% to start with for securitized assets as well as assets of the financial statements of companies, in order to qualify for listing in an Islamic financial market. The dominance rule should be augmented by 5% every two years until it reached 95%. Besides, sustainability rules must be established to ensure green Islamic companies and financial instruments.
- (iii) Regulatory rules that stipulate how IFIs are supervised to ensure their strict application of the banking and financial market laws. The ultimate objectives are to keep the IFIs' finances as well as investment sound.
- (iv) A central Islamic finance advisory board, under the umbrella of the monetary regulator. The board would be composed of a majority of Islamic monetary and financial economists and a minority of Shariah scholars. Its functions would be:
  - ✓ To advise the regulator on how to keep IFIs in line with the Islamic finance paradigm.
  - ✓ To provide judgments on new products brought about through financial regulation
  - ✓ To speedily advise on questions raised by IFIs related to their daily operations.
  - ✓ To appoint an ombudsman that helps the board in arbitrating conflicts related to Islamic finance transactions.

### **Monetary policy and Islamic finance**

To integrate the Islamic finance sector into the macroeconomy and to make monetary policy more inclusive, the monetary authority is advised to do the following:

- (i) To issue CDC's in proportion to the ratio of total Islamic finance assets to the total financial assets in the whole economy, against their cash value which would be placed as CD's in IFIs<sup>31</sup>. In parallel, the monetary authority may wish to reduce the money supply by the same amount or any amount that would make such issue non-inflationary, by increasing the legal reserve ratio.
- (ii) The monetary authority would set the instructions it sees fit to control the investment of central deposits.
- (iii) The monetary authority can issue more CDC's and make them available for sale to the public, including IFIs. Their proceeds would be added to the central deposits with IFIs.
- (iv) The monetary authority allows trading of CDCs in the money market.
- (v) The monetary authority can change the rate of growth of money through:
  1. Adding or subtracting from its CD balances with IFIs,
  2. For fine-tuning, it can use open market operations in CDC's to adjust the rate of growth of the money supply.

### **Standard setters**

The regulator should resolve the conflict of rules made by different standard setters in the following manner.

- (i) The national SSB should be the ultimate standard setter.
- (ii) It should follow all pronouncements issued by the OIC International Fiqh Academy
- (iii) AAOIFI and IFSB should be instructed to abide by the resolutions of the OIC International Fiqh Academy.

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<sup>31</sup> The monetary authority can start by allowing all banks which are properly equipped to carry out investment (through the ability to carry out and/or review feasibility studies as well as investment monitoring to compete for central deposits.). This allows more competition and wider use of such funds for investment. In addition, the monetary authority can establish an investment priorities committee, with the participation with ministries of finance, planning and economy, to set sectoral priorities and issue directions for their implementation.

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## APPENDIXES

### APPENDIX-I: TERMINOLOGY

No	Terminology	Definition
1.	CDC, CDCs	Central deposit certificate, an Islamic money-market instrument issued by the monetary authority, to be sold to the public and held by the issuer, banks, and the public. They are traded in a secondary money market. Issuance and open market operations of CDCs are used to change the rate of monetary expansion or contraction.
2.	Fatwa (sing.), Fatawa (pl.)	A ruling or a juristic opinion of facts given by individually by an Islamic scholar or a mufti or a faqih or collectively recognized authority (Shariah board) on any matter related to Shariah issues. Since such experts' opinions regarding Islamic finance operations are issued by a team of economists and Shariah experts, we prefer to call them “expert opinions” and limit the use of “fatwa” to opinions related to acts of worship.
3.	Fiqh	Islamic jurisprudence is a human understanding of Shariah law as revealed in the Qur’an and the Sunnah. Knowledge of the legal rulings related to conducting, which has been acquired from detailed proofs in the Shariah.
4.	Gharar	Gharar is uncertainty and lack of knowledge in contracts. It is a negative element in Islamic financial contracts so that one of the contract parties does not guarantee the outcome of the contract such as selling something that is not at hand or selling something that doesn’t know its characteristics.
5.	Qard Hasan	Qard Hasan refers to an interest-free loan. It means providing money or financing without interest. In this transaction, the borrower repays the principal amount of the loan without interest, Because if the borrower returns the money with an increase, he will be treated as interest.

6.	Maqasid al-Shariah	The First word "Maqasid" means objective, purpose, intent, or wisdom. The second word "Shariah" refers to Islamic law (please see Shariah). They are the major goals of Islamic law, through which it aims to achieve the interest in preserving religion, self (nafs), mind (aql), lineage (nasl), and money (property).
7.	Maysir	Maysir is one of the prohibitions in Islamic law. It is every gain based on the mere luck so that the winning partner earn the sum of what the gamblers lost, games of chance, like Zero Sum Game.
8.	Mudaraba	It is a contract between the financier and entrepreneur whereby the financier would fund capital to an initiative, which is managed by the entrepreneur as the labor provider. Profit shared in accordance with the Mudaraba agreement terms.
9.	Murabaha	It is a sale contract whereby the IFIs sells to a customer a specified asset that is already in their ownership at cost plus an agreed profit margin.
10.	Musharaka	A contract between the IFIs and a customer to contribute capital to an enterprise. Profits generated by the enterprise in accordance with the musharaka agreement terms.
11.	Shariah	"Shariah" literally means "the way", as a term means Islamic religious law that covers all aspects of human life and day to day life.
12.	Sukuk	Certificates that represent the holder's proportionate possession in an undivided part of the principal asset, where the holder undertakes all rights/obligations to such asset.
13.	Takaful	It is a type of insurance system developed to comply with the Islamic law principles, wherein takaful participants contribute money into a pool system to guarantee/help each other against loss or damage.
14.	Usul al-Fiqh	Knowledge of the rules and principal (general evidence) of Shariah to conclude the Islamic provisions from their detailed evidence

15.	Tawarruq	It is as a contract to buy the goods by a person on a deferred basis, and then sell it with a lesser price on a cash basis to somebody else other than the first seller to get cash.
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**APPENDIX-II: QUESTIONNAIRE**

**Shariah Governance Survey (SGS) for Islamic Financial Institutions (IFIs)**

The SGS is an initiative of Social Sciences University of Ankara (ASBU) - International Center for Islamic Economics and Finance (ICIEF/ULIFAM). It is conducted on behalf of the Standing Committee for Economics and Commercial Cooperation of the Organization of the Islamic Cooperation (COMCEC) with the aim of improving Shariah Governance Framework in IFIs in Organization of Islamic Countries, (OIC) member countries. The output of the survey will be used for the COMCEC Report: Improving Shariah Governance Framework in IFIs.

This survey questionnaire covers various major issues in Shariah Governance of IFIs, it should preferably be completed by a person connected with Shariah Committee or Shariah Audit Unit / Department. All information provided in the responses will be treated with the utmost confidentiality.

Kindly submit the completed questionnaire to us by **xxx** at the latest either online or by sending an email to **xxx**.

Should you have any further inquiries or require any clarification with regard to the survey, please do not hesitate to contact the person in charge, **xxx**, at email: **xxx** or Tel: **xxx**.

COMCEC and ICIEF / ULIFAM appreciates and values your time and efforts in responding to this survey and contributing to the development of improving Shariah Governance Practices in IFIs.

In which country does your institution mainly operate?

<b>Please specify the name of your organization and contact details (institution, name, phone, e-mail) of responder (Optional)</b>

## Questionnaire

1. Specify your position in your institution?

Chief Executive Officer (CeO) / Chief Officer in IFIs	Chairman/Member /Advisor of Shariah Supervisory Board (SSB) in IFIs	Chairman/Member/Advisor of SSB in regulatory bodies	External /Internal Shariah Auditor	Officer/Researcher of SSBs (in IFIs and regulators)	Academic/Researcher/Scholar in the field of Islamic Economics and Finance	Other (Please specify)
(1)	(2)	(3)	(4)	(5)	(6)	(7) .....

2. Rate **the effectiveness and impact of Shariah Governance Framework (SGF)** in your jurisdiction on a scale of 1-5 (where **(5)** = strongly agree and **(1)** =strongly disagree).

1	The SGF can be described as appropriate and well-regulated	(1)	(2)	(3)	(4)	(5)
2	The SGF can be implemented in an effective way from implementation perspective	(1)	(2)	(3)	(4)	(5)

3. Provide your comments and suggestions to improve/increase Shariah Governance of IFIs.

4. Rate **the effectiveness, independence and transparency of Shariah Supervisory Board (SSB)** in your jurisdiction on a scale of 1-5 (where 5 = strongly agree and 1 = strongly disagree).

1	The SSB can be described as independent and has autonomous structure	(1)	(2)	(3)	(4)	(5)
2	The Fatwas and rulings of the SSB are always binding (the management always implements the decisions of SSB)	(1)	(2)	(3)	(4)	(5)
3	The SSB is given full access to confidential information (records, transactions, and information etc.)	(1)	(2)	(3)	(4)	(5)
4	Shariah pronouncements and fatwas are published and made known to the public	(1)	(2)	(3)	(4)	(5)
5	All related cases are presented to SSB (fund placement, impermissible income and so on)	(1)	(2)	(3)	(4)	(5)

6	Investments, projects and off balance sheet items etc. shown to the SSB.	(1)	(2)	(3)	(4)	(5)
7	The SSB has properly identified / evaluated Shariah non-compliance risk and reputational risk, and effectively communicate that risk information to appropriate bodies in the organization	(1)	(2)	(3)	(4)	(5)
8	SSB has sufficient diversity according to their expertise and Shariah background	(1)	(2)	(3)	(4)	(5)
9	SSB take decisions in time regarding the needs of the sector	(1)	(2)	(3)	(4)	(5)
10	Decisions and resolutions of SSB always convey to Islamic principles	(1)	(2)	(3)	(4)	(5)
11	Decisions of SSB are always clear and <i>understandable</i>	(1)	(2)	(3)	(4)	(5)
12	The SSB is given sufficient time to focus / deliberate on matters tabled before the meeting	(1)	(2)	(3)	(4)	(5)
13	All or majority of members always attend SSB meetings	(1)	(2)	(3)	(4)	(5)
14	The SSB is equipped with sufficient supportive resources to operate efficiently	(1)	(2)	(3)	(4)	(5)
15	Members don't leave blank signed papers for absentee voting (proxy voting)	(1)	(2)	(3)	(4)	(5)
16	The majority of SSB members in SSB have PhD in Fiqh	(1)	(2)	(3)	(4)	(5)
17	Some SSB member/s hold PhD. in Economics and Finance/Islamic Economics	(1)	(2)	(3)	(4)	(5)
18	Decisions of SSB has not been rejected	(1)	(2)	(3)	(4)	(5)
19	SSB Members cannot sit on more than one Shari'ah board	(1)	(2)	(3)	(4)	(5)
20	They don't use ruses (hiyal) to justify some prohibited products	(1)	(2)	(3)	(4)	(5)

5. How often is **the financial statement** shown to the Shariah Supervisory Board?

Annually	Semi-annually	Quarterly	Every two-three months	Monthly
(1)	(2)	(3)	(4)	(5)

6. What is the percentage of **impermissible income** out of total income in the last year?

Less than 50%	Less than 20%	Less than 10%	5%	Less than 1%
(1)	(2)	(3)	(4)	(5)

7. How often does the management calculate impermissible income?

Annually	Semi-annually	Quarterly	Every two-three months	Monthly
(1)	(2)	(3)	(4)	(5)

8. How is the impermissible income, if any, spent?

Write your answer here:
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9. Who has the power to approve the appointment and dismissal of SSB members in your jurisdiction?

Management/C EO	BOD	Shareholders in the Annual General Meeting	Central Bank/Centralized body	Government/ministry
(1)	(2)	(3)	(4)	(5)

10. Who determines the SSB members' remuneration?

Management/C EO	BOD	Shareholders in the Annual General Meeting	Central Bank/Centralized body	Government/mini stry
(1)	(2)	(3)	(4)	(5)

11. How many members are there in SSB in your institution?

2 or less members	3 members	4 members	5 members	6 or more members
(1)	(2)	(3)	(4)	(5)

12. What is the frequency of meetings of SSB in your institution?

Annually	Semi-annually	Quarterly	Every two months	Monthly
(1)	(2)	(3)	(4)	(5)

13. How does your institution perform external Shariah audit?

We do not have an external Shariah audit function	SSB	Regulatory Body	External Independent Audit Firm	Internal Shariah Audit Unit
(1)	(2)	(3)	(4)	(5)

14. Score your opinion regarding **the competencies and skills** of SSB members in your institution/or jurisdiction? (Where 5 = Strongly agree and 1 =strongly disagree)

1	Have the necessary and adequate competencies	(1)	(2)	(3)	(4)	(5)
2	They are appointed according to their competencies/skills/expertise through evaluation by a committee of experts	(1)	(2)	(3)	(4)	(5)
3	There is a 'fit and proper criteria' and formal process for the selection and appointment of SSB members	(1)	(2)	(3)	(4)	(5)

15. What is considered as the most important elements of competency for SSB Members in your jurisdiction?

Having Bachelor's Degree	Education or Certificate / qualification in related field	Teaching Islamic Economics and Finance	Having experience in Islamic Finance	Having PhD in Usul ul Fiqh
(1)	(2)	(3)	(4)	(5)

16. Indicate the degree of **challenges and obstacles** regarding Shariah Governance? (where 5 = strongly agree and 1 =strongly disagree)

1	Restrictions placed by national legal framework and regulations	(1)	(2)	(3)	(4)	(5)
2	Inability to enforce International Islamic Financial standards/regulations (AAOIFI, IFSB etc.)	(1)	(2)	(3)	(4)	(5)
3	Adoption of international conventional standards and regulations (Basel, IFRS etc.)	(1)	(2)	(3)	(4)	(5)
4	Conflict with the resolutions of International Institutions (Fiqh Academy, Rabita Fiqh Academy etc.)	(1)	(2)	(3)	(4)	(5)

5	Inconsistency with Fatwas of different fiqh schools	(1)	(2)	(3)	(4)	(5)
6	Impact of Digitization and Financial Technology on Product Development and Financial Contracts	(1)	(2)	(3)	(4)	(5)
7	Shariah Non-Compliance Risk and Shariah Risk Management	(1)	(2)	(3)	(4)	(5)
8	The conflict between the Board of Directors (BOD) and the SSB	(1)	(2)	(3)	(4)	(5)
9	Public credibility and reputation	(1)	(2)	(3)	(4)	(5)
10	Shareholders' value and expectations	(1)	(2)	(3)	(4)	(5)

17. Indicate the level of interests of the following stakeholders in Shariah compliance: (1 is the lowest degree of interest and 5 is the highest)

1	Shareholders	(1)	(2)	(3)	(4)	(5)
2	Management / BoD	(1)	(2)	(3)	(4)	(5)
3	SSB members	(1)	(2)	(3)	(4)	(5)
4	Employees	(1)	(2)	(3)	(4)	(5)
5	Central bank	(1)	(2)	(3)	(4)	(5)
6	Customers	(1)	(2)	(3)	(4)	(5)

18. Score your opinion regarding the **Code of Conduct** of SSB in your jurisdiction? (where 5 = Strongly agree and 1 =strongly disagree)

1	Institution publishes a chart, which explains its governance structure including SSB	(1)	(2)	(3)	(4)	(5)
2	Institution has a written policy on Shariah review procedures, quality assurance, and the report	(1)	(2)	(3)	(4)	(5)
3	SSB has an effective and written Code of Conduct that sets out SSB members' responsibilities, appointment, composition, selection, and dismissal etc.	(1)	(2)	(3)	(4)	(5)
4	SSB derive their credibility from implementation of Code of Conduct	(1)	(2)	(3)	(4)	(5)
5	SSB follows Code of Ethics published by standard setting bodies such as IFSB and AAOIFI	(1)	(2)	(3)	(4)	(5)
6	SSB follows international / conventional code of ethics in addition to the institution's specific code	(1)	(2)	(3)	(4)	(5)

19. How do you evaluate the success of overall Shariah Governance of your institution?

(where 5 = Highly satisfied and 1 =highly dissatisfied)

(1)	(2)	(3)	(4)	(5)
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**Thank you for taking the time to complete this questionnaire.**

**Your assistance in providing this information is very much appreciated**