

**THE PRINCIPLES OF SHARIAH GOVERNANCE AS PRACTISED
BY ISLAMIC FINANCIAL INSTITUTIONS**

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The candidate confirms that the work submitted is his own and that appropriate credit has been given where reference has been made for the work of others.

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Abstract

Shariah governance is a system by which Islamic financial institutions (IFI) ensure that there is an effective independent oversight of the *Shariah* compliance process. For some reason, *Shariah* governance is explored through its functional and organisational division rather than its fundamental background. The genesis of this field of research is somehow still lacking in effort as it is in its infancy. Currently, despite attempts have been initiated by some scholars, the members of the Islamic financial industry, whether they are practitioners, academics or policy-makers are giving more attention to industrial applications such as product structuring, managerial efficiency and market expansion. Without undervaluing those aspects of Islamic finance, this research is more interested in exploring the underlying fundamentals of the Islamic finance namely on *Shariah* governance. To do so, this research applied doctrinal research method. The data is collected from documents relevant to research themes. It is then analysed inductively and deductively to formulate a fundamental epistemological characteristic of *Shariah* governance. As a result, this research emphasises that there are three main principles applied by the IFIs, the *aqidatic* worldview, *Shariah* compliance and *akhlaq*-based ethics. Those three fundamentals are then brought into real-world implementation through three mechanisms: the governing law, the *Shariah* supervision and the *Shariah* audit. The combination of those principles and their mechanisms has demonstrated a great deal of potential in terms of implementation as manifested by this research in the UK jurisdiction.

Table of Contents

Acknowledgement	iii
Abstract	iv
Table of Contents	v
List of Abreviations	x
List of Tables	xi
List of Figures	xii
Chapter 1 Introduction	- 1 -
1.1 Research Background	- 1 -
1.2 Research Questions	- 5 -
1.3 Research Methodology.....	- 6 -
1.4 Research Scope	- 8 -
1.5 Chapters and milestones.....	- 8 -
Chapter 2 An Examination of the <i>Shariah</i> Governance	- 10 -
2.1 Introduction.....	- 10 -
2.2 <i>Shariah</i> Governance Preamble	- 11 -
2.2.1 The meaning of <i>Shariah</i>	- 11 -
2.2.2 <i>Shariah</i> Characteristics as a Law: The Flexibility and Rigidity of <i>Shariah</i> - 15 -	
2.2.3 <i>Shariah</i> Characteristics as a Law: <i>Maqasid Shariah</i>	- 17 -
2.2.4 Corporations in Islam.....	- 19 -
2.2.5 Definition of Governance	- 28 -
2.2.6 <i>Shariah</i> Governance Definition.....	- 31 -
2.2.7 Overview of Islamic Financial Institutions	- 35 -
2.3 The Objectives of <i>Shariah</i> Governance.....	- 38 -
2.4 The Need to a Robust <i>Shariah</i> Governance for the IFIs	- 40 -
2.5 Conclusion.....	- 48 -
Chapter 3 Developments of Standard-setters and Codes of <i>Shariah</i> Governance	- 50 -
3.1 Introduction.....	- 50 -
3.2 Historical Overview of <i>Shariah</i> Governance in Islam	- 51 -

3.2.1	The Time of Prophet-hood.....	- 51 -
3.2.2	The Time of the Caliphs.....	- 52 -
3.2.3	The Time of Modern Islamic Finance	- 54 -
3.3	Standardisation of <i>Shariah</i> Governance Framework.....	- 58 -
3.4	The Accounting and Auditing Organization for Islamic Financial Institutions <i>Shariah</i> Governance Codes.....	- 61 -
3.4.1	<i>Shariah</i> Supervision Body, Appointment, Composition and Report Standards (GSIFI No.1).....	- 62 -
3.4.2	<i>Shariah</i> Review (GSIFI No.2)	- 63 -
3.4.3	Internal <i>Shariah</i> Review (GSIFI No.3)	- 63 -
3.4.4	Audit and Governance Committee for Islamic Financial Institutions (GSIFI No.4) -	64 -
3.4.5	The Independence of the <i>Shariah</i> Supervisory Board (GSIFI No.5) -	64 -
3.4.6	Statement on Governance Principles for Islamic Financial Institutions for Islamic Financial Institutions (GSIFI No.6)	- 65 -
3.4.7	Corporate Social Responsibility Conduct and Disclosure for Islamic Financial Institutions (GSIFI No. 7)	- 67 -
3.4.8	Viewpoints on the AAOIFI Standards	- 68 -
3.5	The Islamic Financial Services Board <i>Shariah</i> Governance Codes	- 70 -
3.5.1	The Guiding Principles on Corporate Governance for Institutions Offering Only Islamic Financial Services (IFSB-3)	- 70 -
3.5.2	Viewpoints on the IFSB-3	- 72 -
3.5.3	Guiding Principles on <i>Shariah</i> Governance Systems for Institutions Offering Islamic Financial Services (IFSB-10).....	- 74 -
3.5.4	Viewpoints on the IFSB-10	- 77 -
3.6	Malaysian <i>Shariah</i> Governance Codes	- 80 -
3.6.1	Guidelines on the Governance of the <i>Shariah</i> Committee of the Islamic Financial Institution.....	- 81 -
3.6.2	<i>Shariah</i> Governance Framework.....	- 82 -
3.6.3	Viewpoints on Malaysian <i>Shariah</i> Governance Guidelines	- 85 -
3.7	Conclusion.....	- 86 -
Chapter 4 <i>Shariah</i> Governance Models		- 88 -
4.1	Introduction.....	- 88 -
4.2	<i>Shariah</i> Compliance Process	- 88 -

4.3	IFIs' <i>Shariah</i> Supervision Structure	- 90 -
4.3.1	<i>Shariah</i> Committee	- 92 -
4.3.2	<i>Shariah</i> Compliance Department.....	- 93 -
4.4	<i>Shariah</i> Governance Supervision Models	- 94 -
4.4.1	Two-tier <i>Shariah</i> Committee	- 95 -
4.4.2	Single-tier <i>Shariah</i> Committee.....	- 101 -
4.4.3	The Market-Driven Model	- 102 -
4.4.4	Fully Regulated Model.....	- 104 -
4.5	Conclusion.....	- 105 -
Chapter 5 Corporate Governance Theories in Perspective		- 106 -
5.1	Introduction.....	- 106 -
5.2	Corporate Governance Theories: A <i>Shariah</i> Dialogue	- 106 -
5.2.1	Conventional Corporate Governance Theories	- 107 -
5.2.2	Shareholder Wealth Maximisation Theory.....	- 108 -
5.2.3	Stakeholder Theory	- 116 -
5.3	<i>Shariah</i> -Based Governance Theories	- 123 -
5.3.1	<i>Tawhid</i> and <i>Shura</i> Theory	- 123 -
5.3.2	Stakeholder-oriented <i>Shariah</i> Governance Theory	- 126 -
5.4	Conclusion.....	- 129 -
Chapter 6 Principles of <i>Shariah</i> Governance.....		- 131 -
6.1	Introduction.....	- 131 -
6.2	Epistemological Worldview of <i>Shariah</i> Governance	- 133 -
6.2.1	Islamic Belief System	- 137 -
6.2.2	Humans as Vicegerents.....	- 140 -
6.2.3	Wealth as Trust for Vicegerent to Manage	- 143 -
6.2.4	Theory of Ownership in Islam.....	- 145 -
6.3	<i>Shariah</i> Compliance	- 150 -
6.3.1	<i>Shariah</i> Compliance Characteristics in Finance	- 151 -
6.4	<i>Akhlaqic</i> Ethical Codes.....	- 176 -
6.4.1	Concept of <i>Akhlaq</i> (Islamic Ethics)	- 177 -
6.4.2	Ethics and Law in Islam	- 178 -
6.4.3	Functions of <i>Akhlaq</i>	- 181 -

6.5	Conclusion.....	- 184 -
Chapter 7 <i>Shariah</i> Governance Mechanisms.....		- 186 -
7.1	Introduction.....	- 186 -
7.2	Governing Law	- 186 -
7.2.1	Rationales for Regulating Islamic Finance	- 187 -
7.2.2	Virtues of <i>Shariah</i> Law.....	- 196 -
7.3	<i>Shariah</i> Supervision Mechanism.....	- 201 -
7.3.1	Fiduciary Duty of IFIs' Directors.....	- 201 -
7.3.2	<i>Shariah</i> Committee Functions	- 205 -
7.3.3	Role of <i>Ijtihad</i>	- 209 -
7.4	<i>Shariah</i> Audit Mechanism.....	- 213 -
7.4.1	<i>Shariah</i> Audit Objective	- 215 -
7.4.2	<i>Shariah</i> Audit Scopes	- 216 -
7.5	Conclusion.....	- 218 -
Chapter 8 Adopting <i>Shariah</i> Governance System into the UK Islamic Finance Market: Remarks and Observations.....		- 219 -
8.1	Introduction.....	- 219 -
8.2	Islamic Finance Footsteps in the United Kingdom	- 219 -
8.2.1	Market Expansion Milestones.....	- 221 -
8.2.2	Legal and Regulatory Developments.....	- 224 -
8.2.3	Supervision and Audit Authorities.....	- 228 -
8.3	Factors Contributing to Islamic Finance Market Expansion and Regulatory Reform in the UK.....	- 230 -
8.3.1	Islamic Market Exploration and Expansion.....	- 231 -
8.3.2	Legal Flexibilities	- 233 -
8.3.3	Economic Uncertainties	- 233 -
8.4	Islamic Finance in the UK: Remarks and Observations	- 236 -
8.5	Conclusion.....	- 244 -
Chapter 9 Conclusion.....		- 246 -
9.1	Introduction.....	- 246 -
9.2	Research Originality	- 246 -
9.3	Research Findings.....	- 247 -

9.3.1	<i>Shariah</i> Governance Definition, Characteristics and its Relationship to Conventional Corporate Governance.....	- 247 -
9.3.2	Conventional Corporate Governance Theories under <i>Shariah</i> Purview..	- 248 -
9.3.3	<i>Shariah</i> Governance Principles	- 250 -
9.3.4	<i>Shariah</i> Governance Mechanisms.....	- 252 -
9.3.5	Jurisdictional Compatibility	- 254 -
9.4	Recommendations.....	- 254 -
9.4.1	Academia.....	- 255 -
9.4.2	Policy Makers	- 255 -
9.4.3	Financial Institution Practitioners.....	- 257 -
9.5	Overall Conclusion	- 259 -
	Bibliography	- 261 -

List of Abbreviations

AAOIFI	Accounting and Auditing Organisation for Islamic Financial Institutions
BCBS	Basel Committee on Banking Supervision
BNM	Bank Negara Malaysia
FCA	Financial Conduct Authority
FRC	Financial Reporting Council
FSA	Financial Services Authority
IFI	Islamic Financial Institutions
IFSB	Islamic Financial Services Board
ISRA	International <i>Shariah</i> Research Academy for Islamic Finance
OECD	The Organisation for Economic Co-operation and Development
PLS	Profit-Loss-Sharing
PRA	Prudential Regulation Authority
SAC	<i>Shariah</i> Advisory Council
SGF	<i>Shariah</i> Governance Framework

List of Tables

Table 1 : Purposes of Governance Frameworks in Multiple Level.....	- 61 -
Table 2 : The GSIFI No.6 <i>Shariah</i> Governance Principles Annotations.	- 67 -
Table 3 : The IFSB-3 Principles Annotations	- 72 -
Table 4 : The IFSB-10 Executive Summary	- 76 -
Table 5 : The IFSB-10 Guiding Principles Annotations.....	- 77 -
Table 7 : The SGF Principles Annotations	- 85 -
Table 8 : <i>Shariah</i> Governance Structure	- 208 -
Table 9: Islamic Finance in the UK: Timeline of Selected Events	- 221 -
Table 10: <i>Shariah</i> Experts in the UK Full-fledged Islamic Banks.....	- 240 -
Table 11: UK's Islamic Bank Ownerships.....	- 242 -

List of Figures

Diagram 1 : Overlapping Governance Standards to be Adopted by the IFIs-	
60 -	
Diagram 2 : Malaysian <i>Shariah</i> Governance Structure	- 84 -
Diagram 3 : <i>Shariah</i> Compliance Process.....	- 90 -

Chapter 1

Introduction

1.1 Research Background

This thesis is a study of the underlying principles of the Islamic version of corporate governance, known as *Shariah* governance.¹ According to the Islamic Financial Services Board (IFSB), a *Shariah* governance system refers to a set of institutional and organisational arrangements through which Islamic financial institutions (IFI) ensure that there is effective independent oversight of *Shariah* compliance.² This means, *Shariah* governance acts as a directive system that enables the institutions that are offering Islamic financial products and services, to be managed coherently within the principles derived from Islamic tenets. To accomplish this, *Shariah* governance has its own guidelines that prevent the IFIs from getting involved with noncompliant business activities that are considered prohibited by *Shariah* financial law such as the taking of usury or interest³ (*riba*), excessive uncertainty (*gharar*)⁴ and gambling (*maysir*).⁵ In this regard, the *Shariah* committee as an imperative organ of *Shariah* governance to move towards such a preference, is regarded as responsible and accountable for ensuring the products and services of the IFIs comply with what is required by *Shariah*.

Since *Shariah* governance concerns about the adherence of the IFIs products and services with *Shariah* principles, the *Shariah* committee plays a pivotal role

¹ Some researchers such as Wilson and Hassan use the term of *Shariah* governance to address the discussion on Islamic corporate governance and for the purpose of this research, *Shariah* governance terminology will be used.

² IFSB, (Guiding Principles in *Shariah* Governance Systems for Institutions Offering Islamic Financial Services 2009).

³ There was a debate as to whether *riba* relates to interest or usury, there now to be consensus of opinion among Islamic scholars that the term extends to all form of interest; Mervyn K Lewis and Latifa M Algoud *Islamic Banking* (Edward Elgar 2001) 2.

⁴ *Gharar* is the excessive uncertainty in contracts where details concerning the sale item are unknown or uncertain, or there is lack of information or control in a contract.

⁵ Feisal Khan, 'How Islamic is Islamic Banking?' (2010) 76 *Journal of Economic Behaviour & Organization* 805-820; Hussein Elasrag, 'Corporate Governance in Islamic Finance: Basic Concepts and Issues' <<http://ssrn.com/abstract=2442014>> accessed 25 April 2018 7.

in achieving this overarching mission.⁶ As assurance that it exercises its function, the *Shariah* committee is assisted by an internal *Shariah* department consisting of an Internal *Shariah* Compliance Unit (ISCU), Internal *Shariah* Review Unit (ISRU) and *Shariah* Audit. These components are structured within the IFIs in order to satisfy the requirement of complying with *Shariah* principles in both *ex-ante* and *ex-post* stages.⁷ More importantly, during the occurrence of noncompliance whether it is in terms of product offering or operation, each *Shariah* governance organ should have the capability to rectify the surging issue diligently.

It is worth mentioning that *Shariah* governance is about satisfying the interests of the stakeholders, especially Muslim stakeholders on *Shariah* compliance.⁸ In achieving this notion, IFIs as sought-after institutions are responsible to the Muslims who chose to reflect their religious beliefs in business and economics activities. Arguably, the stakeholders of the IFIs are comparable as to their conventional counterparts. They could be shareholders, customers, creditors, suppliers or governments. The main diversity might only be on their prescription of doing business. That is why their intention on utilising *Shariah* compliant finance could be perceived as wanting it to inherit an alternative way of business, where in this case the way it is taught by Islam.

It is argued that most of the part of the *Shariah* governance system when applied in the real world application takes the same role as to the conventional corporate governance in the financial institutions, especially in areas regarded as unrelated to *Shariah* matters. By that, *Shariah* governance is an attribute of the task of setting the direction⁹ which is in correspondence with the function of the conventional counterpart. In the conventional interpretation, corporate governance refers to the method by which a corporation is directed and controlled as defined by Cadbury.¹⁰ This definition is highly likely to be in correlation with the IFIs despite of their uniqueness, in the light that IFIs are in fact corporations which are offering financial products and services. In a similar sense, *Shariah* governance has no less intention of increasing shareholder value and institutional

⁶ Karim Ginena and Azhar Hamid, *Foundations of Shari'ah Governance of Islamic Banks: The Role of Sharia Supervisory Boards, Internal Audit and Advisory Firms* (John Wiley and Sons 2015) 254-256.

⁷ *ibid* 329-335.

⁸ Muhammad Umer Chapra and Habib Ahmed, "*Corporate Governance in Islamic Financial Institutions*" (Islamic Research and Training Institute 2002) 18.

⁹ Donald Nordberg, *Corporate Governance; Principles and Issues* (SAGE Publication 2011) 7.

¹⁰ Adrian Cadbury, (Report of the Committee on The Financial Aspects of Corporate Governance).

sustainability. Perhaps, it could be concisely expressed as an Islamic version of corporate governance.

Based on recorded literature, discussions on *Shariah* governance are relatively new, in contrast to its counterpart, which have been developed since the 1980s. Many debates and discourses on corporate governance have taken place over many years. It became the crux of the matter in the US and UK after the under-par performance by 'too big to fail' corporations such as Enron and WorldCom, and in Asia after the East Asian countries financial crisis. Since then, the conception of corporate governance has gained popularity when more corporate failures happened due to insufficient and ineffective corporate governance. Asserting this, some researchers such as Tricker and Mallin argue that the factors behind the emergence of corporate governance include corporate fraud and corporate collapse, such as the cases of web fraud and deception involving big corporations in the US.¹¹ Interestingly, more eyes have seemingly turned their attention to *Shariah* governance after the 2007 global economic crisis.¹² Following the Lehman Brother bankruptcy, regulators are looking for alternative approaches to govern business institutions by securing more control through regulatory regimes and ethical codes.

However, it is imperative to note that the emergence of *Shariah* governance is not a reaction to the 2007 financial crisis but rather as a response to the strong growth of Islamic financial sectors fuelled by global consumer's demand for *Shariah*-compliant financial products and services.¹³ This could be seen in the rapid growth of the IFIs market itself. According to the IFSB, the assets of IFIs have grown significantly and reached double-digit rates during the past decade, from about USD200 billion in 2003 to USD1.6 trillion at the end of 2012¹⁴ and USD1.89 trillion at the end of 2016¹⁵. ICD-Thompson Reuters predicted that this market would be growing up to USD 3.7 trillion by 2022.¹⁶ Nevertheless, these numbers are still small compared to the global financial market as a whole. It should also be noted, it is vital to have the understanding that no matter how small the market is, it should be guarded with vigilance in order to foster its future prospects for decades to come.

¹¹ Bob Tricker, *Corporate Governance: Principles, Policies and Practices* (OUP 2009).

¹² Ginena and Hamid (n 6).

¹³ *ibid*

¹⁴ IFSB, (Islamic Financial Services Industry Stability Report 2013) 7.

¹⁵ IFSB, (Islamic Financial Services Industry Stability Report 2017) 7.

¹⁶ ICD-Thompson Reuters, (Islamic Finance Development Report 2017) 11.

The growing amount of attentions given to *Shariah* governance is perceptible from the presentative expanding body of related literature on the subject since early this recent millennium. Researchers such as Umer Chapra, Habib Ahmed, Rodney Wilson, Abbas Mirakhor, Zamir Iqbal and Mervyn K Lewis are among the earliest writers who went through the details on what *Shariah* governance truly is. Because of their diverse backgrounds, the focuses vary greatly and reflected the experience and expertise held by each one of them. Meanwhile, many multilateral standard setters such as the IFSB and Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) have also taken initiatives towards empowering *Shariah* governance through the issuance of standards and codes of best practice of *Shariah* governance. As clearly stated by them, the attempts are to provide a set of universal principles and guidelines compatible and comparable with facilitation by IFIs globally.

In the same vein, some writers like Iqbal and Mirakhor have explored the principles of *Shariah* governance by integrating it with conventional corporate governance theories. They argue that *Shariah* governance could be classified as a stakeholder-oriented system, which is to some degree has no significant contradictions.¹⁷ This argument is on the basis of two fundamental concepts of Islamic law; namely, the principles of property rights and the principles of the commitment to explicit and implicit contractual obligations that govern the economic and social behaviour of individuals, institutions, corporations, societies and states. These two principles provide strong justification for the notion of classifying *Shariah* governance as a stakeholder-oriented model.¹⁸ Furthermore, this idea seems to agree with the IFSB guidelines, which enlisted in details the stakeholders that are involved and effected in the IFIs business activities.¹⁹ Moreover, some countries like Malaysia has implemented a two-tier *Shariah* board as their *Shariah* governance model to tackle *Shariah* matters, not only within the institutional level but also within the national level by having an internal *Shariah* Supervisory Board embedded within the central bank supervision structure.²⁰

Since the world economic crisis in 2007, discussions on *Shariah* governance have also deepened and broken the subject down into wider topics. For instance, the Islamic view on governance and Islamic governance instruments appeared to be of concern to the researchers. The idea is to suggest a special code of

¹⁷ Zamir Iqbal and Abbas Mirakhor, 'Stakeholder Model of Governance in Islamic Economic System' (2004) 11 (2) Islamic Economic Studies 43.

¹⁸ *ibid*

¹⁹ Ginena and Hamid (n 6).

²⁰ This will be further discussed in Chapter 4.

governance²¹ or theories for the *Shariah* governance instead of staying with the conventional theories as suggested above. The latest development has shown that governance is no stranger to Islamic literatures. To exemplify this, Hassan in his research has come up with the notion that some *Shariah* governance organs have implemented the concept of *shura* or mutual consensus, and an audit which is comparable to *hisbah*.²² By looking at conceptual similarities, he asserted that corporate governance is a well implemented system in the Islamic world, despite the differences in terms of form.

These developments are the factors that have triggered this research, which looks to perform a detailed exploration to excavate what are the principles that underlie *Shariah* governance. This is in part because the available standards, frameworks, guidelines or codes of conduct pertaining to *Shariah* governance to this end lack of comprehensive details of their *Shariah* principles. For whatever reason, this situation, it is believed could bring about difficulties in the implementation of a *Shariah* governance system, especially when it is involved with unconducive legal and regulatory features. It is rather detrimental for the IFIs if they are to expand their market. Furthermore, a lack of clarity around the mechanisms used to uphold the said *Shariah* principles is arguably jeopardising *Shariah* compliance processes and it is likely it could hinder the IFIs from their full potential. Whether it is to be applied in jurisdictions dominated by Muslim customers or otherwise, the obvious conclusion is that the IFIs have no choice but to ensure this substantial feature of their business is well understood.

1.2 Research Questions

The questions arise as responses to the abovementioned problem statement are various. As a result of the foregoing, this thesis poses the following questions:

- a. What is *Shariah* governance, in terms of its definition, characteristics and relationship to the corporate governance?
- b. How does *Shariah* views the existing corporate governance theories?
- c. How does Islamic literature develop the underlying principles that lie behind *Shariah* governance?
- d. What are the mechanisms of *Shariah* governance used to make its implementation possible?

²¹ Aishath Muneeza and Rusni Hassan, 'Shari'ah Corporate Governance: The need for a special governance code' (2014) 14 (1) Corporate Governance: The International Journal of Business in Society 120.

²² Zulkifli Hassan, 'Shariah Governance in Islamic Financial Institutions in Malaysia, GCC Countries and the UK' (DPhil Thesis, Durham University 2011) 58.

e. Are those principles compatible to be applied in UK jurisdiction?

To answer these questions, this research explores relevant literature on *Shariah* governance, in order to interpret the underlying principles that lie behind it, within a new paradigm. At the same time, the literature on conventional corporate governance is collected and analysed in the light of searching for the answer of how far it correlates with the understanding of *Shariah* governance. Other than that, the real application as practised by the IFIs in such matters is also a concern of this research.

1.3 Research Methodology

This is a research study in law.²³ It adopts doctrinal study to administrate a pure research of legal philosophy to explicate a multidisciplinary-built environment.²⁴ The aim is to synthesise the underlying normative principles of *Shariah* governance as practised by the IFIs.²⁵ It is done, due to the small size of available literature, so that the principles of the corporate governance of the IFIs thus far are rather a vague and non-coherent doctrine. The fact that it is mostly described in a practical aspect owing to its development, which was closely contributed to the industry, has resulted in a lack of philosophical expressions to characterise the phenomenon. That is the reason why non-doctrinal study as in social legal is not a choice for this research. By looking at the researchers, most of whom have taken social sciences approaches, the articulations of what is the real deal of *Shariah* governance is its lack of comprehensiveness. Operating in an intuitive and arcane doctrinal paradigm, this research is attempting to articulate the genesis of the principles by projecting them from the relevant sources. In order to do so, this research is collecting the data by reviewing the documents from the primary and secondary sources of legal studies and Islamic studies as well as other disciplines, in relation to the emerging themes, especially Islamic finance. Those data will be analysed to formulate the conception at hand inductively and deductively.

In terms of data collection procedure, in order to determine the documents relevant to the research, it is done by looking at the primary sources that are describing the pertinent themes. As for legal studies, law, statutes, case laws, reports and codes are collected for analysis. Meanwhile, the primary sources of Islamic studies, the Quran and the Hadith, are consulted to determine texts

²³ T Hutchinson & N Duncan, 'Defining and Describing What We Do: Doctrinal Legal Research' (2012) 17 (1) Deakin Law Review 83.

²⁴ Paul Chynoweth, 'Legal Research' in Andrew Knight & Les Ruddock (eds), *Advanced Research Methods in the Built Environment* (Wiley-Blackwell 2008) 28-38.

²⁵ This is the prescribed built environment of the research.

carrying the said themes. The secondary sources, which are substantive in understanding the primary sources, are also collected to be analysed; namely, in the case of they provide an interpretation and explanation of the primary sources. Therefore, interpretations of the Quran and Hadith, relevant articles in law journals, books and so forth are collected for analysis. To wrap up the discussion in a multidisciplinary built environment, other sources that are supportive and significant in strengthening the emerging themes are secured as one of the bricks of the research. That is why reports from central banks, financial institutions and related multilateral bodies are collected to fit this purpose.

The collected data are then analysed inductively and deductively. The inductive approach is to formulate a fundamental epistemological characteristic of the *Shariah* governance. It is done by tracking down the theories to clarify which ambiguities lie within the sources and draw them up under correlative themes. This approach is mostly applied in the beginning chapters. Despite the fact that there are no specific chapters designated as the literature review in a direct manner, initial chapters serve the purpose; in a sense, they conceptualise the comprehensive understanding of *Shariah* governance by mapping it from the corporate governance narrative. The aim is to draw a fine line at a fundamental level between conventional corporate governance and *Shariah* governance bodies of knowledge. At the end of those chapters, conclusive remarks will be secured as a doorway to the explication of the principles of *Shariah* governance in the upcoming chapters. The inductive approach is applied to construct a dialogue that formulates the principles of *Shariah* governance, from the data collected. This process takes place in Chapter 6, as the answer to the questions remarked on the previous chapters. At some point, the chapter is also organised in a deductive manner answering prior remarks observed inductively. This double approach serves as a tool to secure an in-depth normative narrative of the *Shariah* governance, as though the title were 'the principles of *Shariah* governance as normatively practised by the IFIs'.

This process then will be followed by deductive approach. The objective is to conceptualise the mechanisms that allow the theoretical aspects of *Shariah* governance to find a solid ground in the practical spectrum. The selected themes for the mechanisms are deducted from the literature, sprinkled throughout the discursive comprehension of the subject. As a strategy to prove how this research secures a new body of knowledge on *Shariah* governance, there will be a dedicated chapter to demonstrate a case study. By adopting the principles of *Shariah* governance into the UK's IFIs corporate governance system, the chapter will apply a comprehensive form of understanding the principles to deduce remarks and observations on the case.

1.4 Research Scope

As mentioned above, this is a doctrinal research. By giving up a high regard on documentary analysis, this research has managed to engage with three primary and diverse fields of studies at once; the legal studies, Islamic studies and corporate governance. Other than that, it also has to engage with other minor subjects in those fields respectively to support the analysis. Due to this, a large amount of time is required in order to form a comprehensive discussion in every part of this research. It would have been better if the chosen approach were triangulated with a social legal approach, where data from fieldwork would be able to be collected. However, due to time constraints and the vastness of the resulting analysis if such an approach were taken, it is believed that a full doctrinal study is rather sufficient as far as the research objectives are concerned. In addition, this research assumed the school of *Ahl Sunnah wal Jamaah* in its explication on the Quran and the Sunnah and when it interacts with Islamic literature. Other schools such as *Shi'i* are out of the question since the majority of the IFIs are operating in the jurisdictions accommodating *Sunni* approach, as their *Shariah* legal approach. Furthermore, financial matters are not at the centre of the contradictions happen between two schools. If this research were to address all Islamic schools, a longer research term and bigger area of focus would be required which would hinder research feasibility.

1.5 Chapters and milestones

The discussions in this research are spreaded across nine chapters, collaborated from the data collected. All chapters are a developing models for newly found *Shariah* governance principles. The first chapter of this thesis plays as an introduction. It consists of the research background, problem statement, research questions, research methodology and the proposed chapters. It outlines the whole research direction and the core elements of this thesis.

The first half of this research study, starting from the second chapter up to Chapter 5 is the exploration of the extensive literature review available on the subject of *Shariah* governance. Regarding this, the second chapter serves as an examination of *Shariah* governance. It provides a preamble discussion on the definition of *Shariah* governance and its characteristics. The objectives of *Shariah* governance and the justifications of the need of the IFIs to adopt a resilient system to look after *Shariah* compliance are located at the end of the chapter. Chapter 3 then succeeds with the explanation of the development of *Shariah* governance. It starts with the emphasis on the genesis of the conception. It then introduces standard-setters, responsible for developing the codes of the best of conduct in *Shariah* governance and observes the implementation of this

peculiar system. Available standards issued by the respective bodies are then analysed by offering viewpoints to be highlighted under the purview of this research. As a continuity from Chapter 3, Chapter 4 then offers discussions on the *Shariah* governance models. Then, the fifth chapter deals with the theories of corporate governance. One of the fundamental parts of this chapter explores the theories within corporate governance models from an Islamic perception to establish a distinctive analysis on which part of these theories adhere to *Shariah* and part do not. The objective is to bring the dialogue of the *Shariah* governance close to the corporate governance narrative, so it would be more easily understood and thus better appreciated.

After reviewing the literature on the subject, the research continues with its main concern in Chapter 6. This chapter deals with the principles of *Shariah* governance. This chapter intends to explore the basic knowledge of Islamic precepts regarding to *Shariah* governance within its epistemological theological worldview, *Shariah* compliance rulings, and *akhlaq*-based ethics. Understanding the concept of human as a vicegerent of Allah is the first and foremost as an introduction to the basic for Islamic epistemological worldview. It gives the whole picture of how this world should be governed by humans as delegate representatives of Allah as God of the universe. *Shariah*-compliant rulings that are particularly related to business are the part of this chapter, composed by Islamic jurisprudence and Islamic contractual law, including the *maqasidic* approach to resolve disputes. An ethical code based on *akhlaq* will excavate, how the universal ethical concept proposed by Islamic thought is applicable in the diverse economic environments of multiple jurisdictions.

Chapter 7 comes with the mechanisms to implement *Shariah* principles as per discussed in the earlier chapters. By looking at the governing law, *Shariah* supervision and *Shariah* audit, this chapter explains how these mechanisms work as the instrumental elements of *Shariah* governance in place. This chapter plays the role as the bridge to the implementation of theoretical principles exposed by this research. Then, Chapter 8 will take up the implementation of the principles of *Shariah* governance in a selected jurisdiction. By focusing on *Shariah* governance mechanisms, this chapter demonstrates what is to be done if *Shariah* governance is to be adopted by the IFIs in the UK's jurisdiction. The UK is selected for this research since it has exhibited a great deal of interest in exploring Islamic finance and its regulatory regime has been flexible in adapting various modes of finance. Last but not least, Chapter 9 offers conclusions as a signature of this research.

Chapter 2

An Examination of the *Shariah* Governance

2.1 Introduction

In the previous chapter, an introduction to what this research is about has been addressed. It has provided essential elements to be understood in order to anticipate the discussions of the upcoming chapters. Commencing from there, this chapter is going to be the doorway to the discussion of the principles of *Shariah* governance. The aim is to provide the opening answers to the first research question- what is *Shariah* governance?- in terms of its definition, characteristics and relationship to the corporate governance. By adapting corporate governance narrative, this chapter focuses on examining an introductory level of *Shariah* governance discourse.

The terminology of the *Shariah* governance, which consists of two different words, will be excavated to unearth the topics underneath. It is worth noting that this corpus of research is rather in its infancy, thus, written literature on it has been, to some extent, rare.¹ However, as recently seen, efforts to expand its breadth and depth have been done by scholars as well as various multilateral standard setters.² Truthfully, *Shariah* governance is indeed remote to the mainstream audience, especially in the market where Islamic finance remains less-explored. Therefore, as this research is going to inductively formulate the principles of *Shariah* governance, excavating the essence of *Shariah* governance is considered as more than necessary.

In this chapter, inductive approach will be applied to articulate an initial idea of *Shariah* governance. The themes revealed from analytical observation of the literature will be positioned in a logical manner. In this regard, this chapter begins with the understanding of *Shariah* governance, which consists of the meaning of *Shariah*, its characteristics and objectives, a discussion on corporations and the *Shariah*-related issues as well as the correlation between corporate governance and *Shariah* governance, mainly in the context of its interpretations. The

¹ Most of the discussions on *Shariah* governance topic are focusing on the *Shariah* committee, in terms of its functions, transparency and independence; see S Abdullah Saif Alnasser, 'Introduction to Corporate Governance from Islamic Perspective' (2012) 28 *Humanomics* 221.

² ISRA and Thomson Reuters (Islamic Commercial Law Report 2016) 11-39.

discussion continues with the relevance of *Shariah* governance for the IFIs, which explains the purposes of the existence *Shariah* governance within the IFIs.

2.2 *Shariah* Governance Preamble

Shariah governance is a new terminology used by researchers to signal on a governance system of Islamic financial institutions or Islamic corporations.³ It is also known as Islamic corporate governance, but the preferred terminology for this research henceforth is the *Shariah* governance. Similar to corporate governance narrative, the concern of *Shariah* governance lies on the objectives of the corporation and its constituents.⁴ Furthermore, *Shariah* governance extends the discussion to how the governance system should be conducted, in order to ensure *Shariah* compliance⁵ within the corporation, trying to fill the gaps⁶ left in the theories of corporate governance related to the corporations offering Islamic products and services. Therefore, in order to understand the discussion that will be addressed by this particular research, a clear overview on the subject of *Shariah*, in general, *Shariah* as law and corporation in the eye of *Shariah* are rather vital.

2.2.1 The meaning of *Shariah*

The word *Shariah* originates from the Arabic language. The Quran, as the source of *Shariah* law, has mentioned the word *Shariah* in many occasions such as '*Shir'atan*'- شَرِيعَةً⁷ and '*Shari'ah*'- شَرِيعَةً.⁸ *Shariah* means 'begin' as mentioned by Ibn Kathir. For example, *shara'a fulan al-kitabah* - شَرَعَ فُلَانٌ فِي الْكِتَابَةِ - meaning 'a

³ Those terminologies were commonly used by many researchers as seen in Rodney Wilson, '*Shariah* Governance for Islamic Financial Institutions' (2009) 1 (1) ISRA International Journal for Islamic Finance 59; Zulkifli Hassan, 'Regulatory Framework of *Shariah* Governance System in Malaysia, GCC Countries and the UK' (2010) 3 (2) Kyoto Bulletin of Islamic Area Studies 82; Tadashi Mizushima, 'Corporate Governance and *Shariah* Governance at Islamic Financial Institutions: Assessing form Current Practice in Malaysia' (2014) 22 (1) Reitiku Journal of Interdisciplinary Studies 59.

⁴ See Mervyn K Lewis, 'Islamic Corporate Governance' (2005) 9 (1) Review of Islamic Economics 5.

⁵ *Shariah*-compliant refers to compliance to *Shariah* rulings and decisions issued by the SAC and *Shariah* Committee of the IFI respectively, and as determined by other relevant bodies.

⁶ The implementation of the conventional corporate governance theories in the IFIs is lack of focus on features that peculiar to the needs of IFIs, especially on how governance constituents are to play the role to fulfil the Islamic business objective that ban interest-based products, gambling and excessive uncertainties.

⁷ Quran: (5) 48; Quranic translations are referred to *The Qur'an* (trs) MAS Haleem (2nd edn OUP 2010).

⁸ Quran: (45) 18

person begins the writing'. *Shariah* also means the clear path.⁹ In a practical context, *Shariah* has been defined as the pathway for the water¹⁰, the path to the watering-place¹¹, the clear path to be followed and the path which the believers have to tread in order to obtain guidance in this world and deliverance in the next. In its original usage, *Shariah* has been defined as the road to the watering place or a path leading to the water, such as the way to the source of life. In its common usage, *Shariah* refers to commands, prohibitions, guidance and principles that God has addressed to mankind pertaining to their conduct in this world and salvation in the next.¹²

Terminologically, *Shariah* means the commandments from Allah to Mankind, which were revealed to the Prophet Muhammad PBUH (Peace and Blessing be upon Him), that guide the faith of humans towards Him as their Creator and the relationship of Muslims with their Muslim brothers as well as to the humanity and nature.¹³ In this regard, Auda has interpreted *Shariah* as the way of life¹⁴, which is in conjunction with the notion proposed by Ramadan.¹⁵ Al-Jurjani defined *Shariah* as the way of the religion.¹⁶ In the Islamic tradition of knowledge, Ibn Taymiyah defined *Shariah* as everything that commanded by Allah either in faith or in physical actions.¹⁷ *Shariah* is also known as a law that was revealed in the Quran, or through the teaching of the Hadith (traditions of the Messenger), in the context of inner faith, practical actions and good ethics.

The inner faith or belief of a Muslim is called *aqidah* while the practical part of the *Shariah* or Islamic law known as *fiqh*. *Aqidah* is the things that must be believed by heart, things that bring the inner peace of the soul, a belief that is not mixed with slightest hesitation or doubt¹⁸. Strong faith in Allah is vital in a Muslim life where righteous faith will create a correct world view about the life in the world (*dunya*) and in the afterlife. *Shariah* covers and regulates humans' entire life from

⁹ Sulaiman Asyqar, *Khasais al-Syari'ah al-Islamiyyah* (Maktabah al-Falah 1982) 11.

¹⁰ Ibn Manzur, *Lisan al-'Arab* (Dar Sadir 1993) vol 10 176.

¹¹ Arabic Language Academy, *Mu'jam al-Wasit* (Maktabah al-Syuruq al-Daqliyyah 2004) 479.

¹² Muhammad Hashim Kamali, *Shariah Law: An Introduction* (Oneworld publications 2008) 14.

¹³ Muhammad Shaltut, *Islam: 'Aqidah wa Shari'ah* (8th edn, Dar al-Shuruq 2001) 10.

¹⁴ Jaser Auda, *Maqasid al-Shari'ah as Philosophy of Islamic Law a Systems Approach* (The International Institute of Islamic Thought 2007) 57.

¹⁵ Tariqq Ramadan, *To Be a European Muslim* (Islamic Foundation 1999), 28.

¹⁶ Ali al-Jurjani, *Mu'jam al-Ta'rifat* (Dar al-Fadilah 2004) 108.

¹⁷ Ibn Taymiyah, *Majmu' Fatawa* (King Fahd National Library 2004) vol 19 306.

¹⁸ Sulaiman Asyqar, *al-'Aqidah fi Allah* (Dar Annafaes 1999) 11.

the cradle to the grave, containing both doctrine and law¹⁹ as a guidance, as far as Muslims are concerned. According to this belief, the main function of *Shariah* is to guide actions performed by humans.

As for *fiqh* understanding, it is defined as the Islamic law that is related to the actions of the *mukallaf* (the person who has passed puberty), which is derived from the specific provisions.²⁰ To some extent, *fiqh* is recognised as legal science and can sometimes be used synonymously with *Shariah*. The two terms are, however, different in the way that *Shariah* is closely identified with divine revelation, the knowledge of which could only be obtained from the Quran and the Hadith as *fiqh* has, on the other hand, been largely developed by jurists and consists of rules which are mainly found on human reasoning and *ijtihad*.²¹ *Shariah* is thus a wider circle, and it embraces in its orbit all human actions, whereas *fiqh* is narrower in scope and addresses mainly what is referred as practical legal rules.²²

Specifically, the terminology of *Shariah* used in a discussion related to the law specified for the actions of humankind, derived from the Quran and the Hadith, excluding the discussions on the inner faith which normally called as *Usul al-Din*, and the Islamic ethics that known as *Akhlak*.²³ In the same vein, al-Qaradawi mentioned two main divisions of *Shariah* as a law, a division that fixed by the provisions of the Quran and the Hadith directly, and a division that being derived by the jurists from their understanding of the provisions from the Quran and the Hadith.²⁴ It is worth mentioning that the formation of *fiqh* by the jurists is not merely initiated by their self-understanding of the provisions, but it is derived by a strict reasoning process formulated from the provisions itself.

The instant example of this process was performed by the tradition of Prophet Muhammad PBUH as reported by Abu Daud. When the Messenger of Allah PBUH intended to send Muaz ibn Jabal to the Yemen, he asked him, '*How will*

¹⁹ Etim E Okon, 'Islamic Jurisprudence and the Primacy of *Shariah*' (2013) 3 (1) International Journal of Asian Social Science 138-149.

²⁰ Yusuf al-Qaradawi, *Madkhal li Dirasah al-Syari'ah al-Islamiyyah* (Muassasah al-Risalah 1993) 22.

²¹ *Ijtihad* or personal reasoning is a total expenditure of effort made by a jurist in order to infer, with a degree of probability, the rules of Shari'ah from their detailed evidence in the sources; See MH Kamali, *Principles of Islamic Jurisprudence* (The Islamic Texts Society Cambridge 2003) 315

²² Kamali, *Shariah Law: An Introduction* (n12) 16.

²³ Asyqar, *Khasais al-Syari'ah al-Islamiyyah* (n 9) 11.

²⁴ Al-Qaradawi, *Madkhal li Dirasah al-Syari'ah al-Islamiyyah* (n20).

you judge when the occasion of deciding a case arises? He replied, 'I shall judge in accordance with Allah's Book'. He asked, '*(What will you do) if you do not find any guidance in Allah's Book?*' He replied, '(I shall act) in accordance with the Sunnah of the Messenger of Allah PBUH.' He asked, '*(What will you do) if you do not find any guidance in the Sunnah of the Messenger of Allah PBUH and in Allah's Book?*' He replied, 'I shall do my best to form an opinion and I shall spare no effort'. The Messenger of Allah PBUH then patted him on the breast and said, '*Praise be to Allah who has helped the messenger of the Messenger of Allah to find something which pleases the Messenger of Allah*'.²⁵

The discussions of the *fiqh* have been divided by the jurists into five major sections, consisting of *ibadat* (law of worshiping), *muamalat* (financial law), *munakahat* (matrimonial law) and *jinyat* (criminal law) as well as *qada'* and *siasah* (judicial and politics). Each of these sections are derived by the scholars using a robust discipline of Islamic jurisprudence to deduce laws from the texts of the Quran and the Hadith. Muslim scholars have generally regarded *fiqh* as understanding of the *Shariah*, and not the *Shariah* itself.²⁶ To a certain degree, *Shariah* is considered as the precept general goal and *fiqh* as the pathway towards the goal.²⁷

In terms of governance, a question arises. Will the injection of *Shariah* law, as preference, into the modern banking system make the bank a religious institution? Essentially, it is vital to have the understanding that complying with *Shariah* in its general sense and *Shariah* financial law in specific, from the untrained eyes has no difference compared to other business counterparts. The expression of an Islamic bank is not to be interpreted as if it is a type of financial system that is strictly religious in the way which forbids dealing with non-Muslims.²⁸ For example, if it is a bank, it could still offers loans and mortgages as well as investments and fund-raising similar to the conventional banks, with the exception that all of those financial activities must be *Shariah*-compliant. The crucial point to be noted here is that governing the institutions within the perspective of *Shariah* does not represent a rigid system and only serves to pleasure God.²⁹ Islam is a religion that promotes an ideal way of life, personally,

²⁵ Abu Dawud, *Sunan Abi Dawud* (International Ideas Home Inc. ND) no. 3592

²⁶ Kamali, *Shariah Law: An Introduction* (n 12) 16.

²⁷ Al-Qaradawi, *Madkhal li Dirasah al-Syari'ah al-Islamiyyah* (n 20).

²⁸ Abdul Karim Al-Dohni, *Islamic Banking in the United Kingdom: Is the Current Legal and Regulatory Framework Capable of Hosting an Islamic Banking Sector?* (PhD Thesis University of Leeds 2008) 9.

²⁹ In fact, the actions that please God are the actions that fulfil the public interest, which is the correct understanding to this notion in the view of Islam.

publicly or even in the context of international relationships. According to this, the objective of injecting the *Shariah* principles into the governance system is to ensure the business and transaction activities are run within the Islamic tenets.

This is rather substantive since understanding *Shariah* transaction law (*muamalat*) is not a matter that is only authorised in the hand of the jurists, but it is also a general knowledge that should be mastered by all Muslims. In fact, Umar al-Khattab, the second caliph of Islam, said that one should gain knowledge prior to becoming a businessman. To ensure these business activities are *Shariah*-compliant, the Islamic government places someone in charge to supervise market activities and to attend disputes between shoppers, customers and authorities. As recorded by jurists, the Prophet Muhammad PBUH walked in the market and had done the supervision by himself where he occasionally named capable persons to do the job.³⁰ This system had been applied throughout the history of the Islamic empire for more than a millennium under *hisbah* institution.

2.2.2 *Shariah* Characteristics as a Law: The Flexibility and Rigidity of *Shariah*

As an Islamic version of law, *Shariah* has its own characteristics that distinguish it from other laws, whether they are derived from the common law,³¹ civil law,³² or other religious beliefs. The major characteristics³³ of *Shariah*, as enlisted by scholars, amongst others, is that it upholds the balance between flexibility and rigidity.

On the one hand, some parts of *Shariah* are rigid and will not tolerate any effort to overrule the predetermined tenets. Commonly, they are considered as the pillars of Islam and the pillars of *iman*. This rigidity is necessary to ensure these pillars will remain intact upon the tests and hardship through one's life. However, on the other hand, *Shariah* also provides elasticity in legislation to meet the needs

³⁰ The Prophet named a woman to administer the supervision, and her name was Nuhaik al-Asadiyyah.

³¹ The Anglo-American corporate governance model is well known in the jurisdictions that have implemented common law such as the US, UK, Australia and many other countries including Malaysia, one of the countries prominent in its Islamic finance system developments.

³² Germany's corporate governance model works in the civil law environment; see Bob Tricker, 'Reinventing the Limited Liability Company' (2011) 19 (4) Corporate Governance: An International Review 384.

³³ AL-Qaradawi, *Madkhal li Dirasah al-Syari'ah al-Islamiyyah* (n 20).

of the society rather than stick to divine law.³⁴ Therefore, some areas of Islam are considered flexible, and left to humans to make sensible decisions. For instance, as Muslims, we are taught to dress in a decent manner. Our dress must cover the parts that referred as *aurah* by *Shariah* which is for a male, between the knees and the centre of the abdomen and for a female, all the body except the face and palms.³⁵ After covering all of these parts with proper dress, we are however, free to choose the materials, colours, cuttings, design and fashions. In a broader sense, the dress is not limited to a certain dressing code such as the Arabic dress code as a sign of its Islamicity but the main characteristic is rather on how it covers the *aurah* in so far as that is the rigidity conducted by *Shariah*.

In terms of Islamic transactions, the parts that are strictly forbidden are those that charge interest on debt, the contract that consists of extensive uncertainties, and the prohibited actions or substances such as the gambling and intoxicating substance.³⁶ Besides that, a Muslim is, however, free to enter into any kind of transaction and contractual agreement as long as it is free from the aforementioned features. Furthermore, 'presumption of validity and permissibility applies to all contracts and conditions'³⁷ is one of the legal maxims implied in the business contract in Islam.³⁸ Therefore, the legitimation of business transactions is regarded licit until there is evidence of being illicit.³⁹ In the sense of business customs, *Shariah* gives mankind freedom to exploit the opportunities that lie in such a sector, domestically or internationally, under the maxim 'customs is an arbiter',⁴⁰ which is regarded as one of the sources of Islamic legal formation.

³⁴ Malik M Hafeez, 'Evolution of Corporate Entity in Islamic and Western Perspective' *South East Asia Journal of Contemporary Business* (2013) 2 (3) Economics and Law 77.

³⁵ The discussion on the body parts are that considered as *aurah* and the concept of dressing manners could be traced in *Al-Mawsu'ah al-Fiqhiyyah al-Kuwaitiyyah* (2nd edn, 1986) vol 6 128.

³⁶ Engku Rabiah Adawiyah Engku Ali, 'Riba and Its Prohibition in Islam' <<http://www.maybank2u.com.my/iwov-resources/islamic-my/document/my/en/islamic/scoe/knowledge-centre/research-paper/riba-and-its-prohibition.pdf>> accessed 25 April 2018.

³⁷ Muhammad Akram Laldin and others, *Islamic Legal Maxims & Their Application on Islamic Finance* (ISRA Publication 2013) 10.

³⁸ *Shariah* legal maxim is known as *al-Qawa'id al-Fiqhiyyah* is a predominant rule by which the ruling for particular cases can be directly known; *ibid* v.

³⁹ Munzir Kahf, 'Islamic Banks: The Rise of a New Power Alliance of Wealth and *Shariah* Scholarship' in CM Henry and R Wilson (eds), *The Politics of Islamic Finance* (Edinburgh University 2004) 17-36.

⁴⁰ Laldin and others, *Islamic Legal Maxims & Their Application on Islamic Finance* (n 37) 135.

Shariah considers the need of individuals and the public accordingly. It will not tolerate the importance of an individual in the name of public interest as well as not neglecting the interest of the public over a personal matter.⁴¹ This particular characteristic of *Shariah* plays a crucial role in the development of Islamic financial industries in the world that tend to classify *Shariah* as a rigid law that rejects the flexibility of the industries. In this matter, Islam sees the economic activities as the instruments to move mankind towards prosperity; hence, creating economic equilibrium is essential in the eyes of *Shariah*. To achieve that, *Shariah* encourages fairness and justice in wealth distribution, by preventing the exploitation of the economic deficit units and the monopoly on the economic production factors by surplus economic units. At the same time, *Shariah* looks at the factors that contribute to economic instability as an illness that needs to be prevented from happening and cured if it has already spread into the system. Likewise, *Shariah* emphasises the importance of asset-based products, which are regarded as a certain and solid transaction because of the presence of the asset during the process.⁴² The presence of solid asset or the materiality⁴³ is considerable as a security for the contracting parties if they decide to nullify the contract, in time of dispute or even when it is classified as a void.

2.2.3 *Shariah* Characteristics as a Law: *Maqasid Shariah*

As a law, other than being flexible in one hand and rigid in the other, *Shariah* also puts a high regard on the objective of the law derived from the sources. The objectives of *Shariah* or *Maqasid Shariah* as terminologically mentioned by the jurists, refer to the overall goals and meanings to be achieved by *Shariah* law under the principles of realisation of benefits and prevention of harm.⁴⁴ In this vein, al-Fasi defined *Maqasid Shariah* as the end sought behind the enactment of each of *Shariah* law.⁴⁵ His definition covers two spectrums, general objectives (*amm*) and specific objectives (*khass*). These objectives are achieved through a comprehensive understanding of the alluded meaning depicted by the texts and how the objective of each single law is deduced, respectively.⁴⁶

⁴¹ Al-Qaradawi, *Madkhal li Dirasah al-Syari'ah al-Islamiyyah* (n20) 22.

⁴² Karim Ginena, 'Shariah Risk and Corporate Governance in Islamic Banks' (2014) 14 (1) Corporate Governance 86.

⁴³ Ahmad H Jum'ah, 'The Implications of Materiality concept on Accounting Practices and Decision Making' (2009) 5 (1) Inter Metro Business Journal 22.

⁴⁴ Under legal studies perspective, *maqasid* could be defined as the virtues of *Shariah* law.

⁴⁵ Alal al-Fasi, *Maqasid al-Shariah al-Islamiyyah wa Makarimuha* (Dar al-Gharb al-Islami 1993) 7.

⁴⁶ Ahmad Al-Raysuni, *Muhadarat fi Maqasid al-Shariah* (Dar Alkalema 2014) 8.

As said by scholars such as al-Ghazali and al-Shatibi, there are five general objectives of *Shariah* which are the preservation of faith, life, posterity, wealth and intellect.⁴⁷ The five objectives are then categorised into three levels of implementation, the *daruriyyat* (necessities), the *hajiyyat* (needs), and the *tahsiniyyat* (luxuries) as firstly mentioned by al-Ghazali.⁴⁸ To some extent, these objectives are regarded as the macro objectives that cover the whole system of human life. Under each general objective, there are many other specific objectives, possessing supportive functions to secure each element of the general objectives are achievable at the micro level and could cover the smallest part and parcel of an entire humans' life. In other words, specific objectives are meant to assist the scholars to look into specific provisions to be applied for specific cases, so they could come up with the resolutions that uphold general objectives.⁴⁹ In the case of Islamic finance, it is perceivable that the primary objective of the *Shariah* governance within the IFIs is to ensure *Shariah* compliance in wealth acquisition. It is in fact, the *raison d'être* of the IFIs. *Shariah* compliance is the crux of wealth acquisition in *Shariah* law as to preserve the wealth and prevent it from being wasted. It is rather imperative due to the fact that it will determine the validity of the contract and thus the legal title of the transacting assets. Any non-compliant acquisition, will render the contract as null and void.

Other than this, the essence of the *Shariah* governance arrangement is to ensure the value of Islamic transaction is well instilled within the IFIs. It is not merely about adhering to the technicality of the contract but also becoming involved with the objective of the *Shariah* law itself. By large, the objective of *Shariah* is to secure the realisation of benefit (*maslahah*) and the prevention of harm (*mafsadah*). In this vein, the *Shariah* scholars have determined that wealth is one of the five main necessities of human life which ought to be well preserved in the enactment of *Shariah* financial law. Therefore, it is of significance for each *Shariah* governance constituent to carry out such a duty diligently and responsibly so that *Maqasid Shariah* is achievable.

⁴⁷ These five general objectives were suggested by al-Ghazali and al-Shatibi based on close observation on the texts from the Quran and the Hadith. They then ranked the objectives by looking at the impact of each objectives towards humans' life respectively. Despite agreement between the scholars, these five objectives are not rigid and are open for discussion due to other variables. Many modern scholars such as Ibn Asyur and al-Raysuni have discussed *Shariah* law under *maqasid* approach to reveal the virtues of *Shariah* law so it would be comprehensible to modern law style of implementation.

⁴⁸ Audah (n 14) 3.

⁴⁹ Further discussion on the specific objectives of *Shariah* law will be held in Chapter 6 under the virtues of *Shariah* law.

To conclude, it is conceivable that *Shariah* governance is about the existence of additional systems to ensure the compliance of the operations of the IFIs in *Shariah* matters. *Shariah* compliance in terms of contractual agreement seemed to be the main concerns of *Shariah* governance. However, it is worth mentioning that when we deal with *Shariah* matters in products and services, the knowledge of the objectives of *Shariah* is a crucial factor. Since composing *Shariah* resolutions is about striving for and seeking for the underpinning meanings behind the texts of Islamic sources, a deep understanding of the objectives of *Shariah* is inseparable from *Shariah* scholars who carry out such a duty.

2.2.4 Corporations: A *Shariah* Perspective

The understanding of corporation, as seen in the literature, has evolved simultaneously with the expansion of the corporate world, in terms of its objectives, functions, mechanisms and structure. Starting from the joint stock business activities between merchants and principals during the Middle Ages, the attempt to describe the relationship which existed amongst the relating parties has never been brought to a stop. Literally, the word corporation is derived from the Latin word *corpus* which means a group of people authorised to act as an individual and recognised in law as a single entity.⁵⁰ Subsequently, the American Heritage Dictionary defines a corporation as an entity such as a business, municipality or organisation that involves more than one person but that has met the legal requirements to operate as a single person, so that it may enter into contracts and engages in transactions under its own identity.⁵¹ In a general manner, Sawyer has classified corporation as a fundraising entity by defining corporation as any person or group of people who turn inputs into outputs.⁵² Sawyer, however, asserted that his definition is restricted to those organisations or individuals which produce marketable output and the exclusion of many forms of government activities as well.⁵³

Monks and Minow have described the corporation in a more practical way, as they define it as a mechanism established to allow different parties to contribute

⁵⁰ English Oxford Living Dictionary <<https://en.oxforddictionaries.com/definition/corporation>> accessed 210 September 2018

⁵¹ The American Heritage Dictionary of English Language (5th edn, 2016) <<https://www.ahdictionary.com/word/search.html?q=corporation&submit.x=43&submit.y=16>> accessed 25 September 2018.

⁵² Malcom Sawyer *Theories of the Firm* (Fakenham Press Limited 1979) 10.

⁵³ *ibid*

capital, expertise, and labour, for the maximum benefit of all of them.⁵⁴ This definition is in fact, coherent with the idea of the corporation that is simply a legal fictitious entity, which serve as a nexus for a set of contracting relationships amongst individuals as defined by Jensen and Meckling.⁵⁵ In this relationship, the investors ought to gain the chance to participate in a sharing profits of an enterprise without taking responsibility for the daily operations, whereas, the management get the chance to run the company without taking the responsibility of providing the funds. This mutual agreement is crucial for the respective parties as the objective of the corporation is to form a large joint stock entity to pursue trading and business toward maximisation of the shareholders' value as well as the value of other affected stakeholders.⁵⁶

Historically, the significant turning point that triggered the rapid development on corporation was the formation of the East India Company, which was granted a Royal Charter in 1600, for merchants of London trading in the East Indies.⁵⁷ The East India Company was not only representing the achievement of a joint stock corporation but was also the evolution of the idea of limited liability of the shareholders consequently throughout the centuries. Hence, according to Hafeez, in the nineteenth century, two developments related to the corporation, as well as the concept of limited liability, occurred in British corporate law: first, the enactment of the Joint Stock Companies Act 1844 which enacted that any company comprising more than twenty five members with transferable shares might obtain incorporation by registering a deed of settlement executed by its members; and second, the passing of the Limited Liability Act 1855 which provided limited liability to the members of a company.⁵⁸ Both laws eventually recognised that the group of people who formed the corporation could act as one legal person and the shares of the corporation are transferable as well as the laws gave limited liability to all shareholders, whether they were involved in the management of the company or not.⁵⁹

⁵⁴ Robert Monks and Nell Minow, *Corporate Governance* (3rd edn, Blackwell Publishing 2004) 9.

⁵⁵ Michael C Jensen and William H Meckling, 'Theory of The Firm: Managerial Behaviour, Agency Costs and Ownership Structure' (1976) 3 (4) *Journal of Financial Economics* 305.

⁵⁶ The question of the firm's objective lies in between the two theories: firm should follow the principle of shareholder value maximisation in the long run; however, at the same time it should take also into account the stakeholders' interests, which should be subordinated to the shareholder value maximisation objective.

⁵⁷ J Solomon, *Corporate Governance and Accountability* (3rd edn, John Wiley and Sons 2010) xxi.

⁵⁸ Hafeez (n 34) 80.

⁵⁹ Tricker, 'Reinventing the Limited Liability Company' (n 32).

One of the most significant achievements of the corporation is the recognition of the notion of limited liability.⁶⁰ Limited liability is regarded as the main feature of corporations that could make a corporation act as a person by law. Under the Limited Liability Partnerships Act 2000, limited liability is considered as a corporate body with a legal personality separate from that of its members.⁶¹ This limitation is a condition under which a partner of a business secures himself from bearing a loss greater than the amount he has invested in a corporation or partnership.⁶² In a bigger sense, this conception considers a corporation as a legal entity, which is somehow separated from the shareholders despite their stock ownership, hence providing a shielding condition for them in the case of loss and failure. At least, that is a part of the idea. Another part of this notion which has no less importance, is that the company could contract, employ, own assets, and incur liabilities, yet the shareholders are no longer responsible for the company's debts.⁶³ Moreover, the formation of an entity with a large amount of capital would allow them to penetrate bigger market with the higher potential of profits and the controlled risk could bring in better prospects of success without having concerns about loss of equity more than the invested amount. Limited liability in this part, makes it easier for a corporation to raise capitals for the enterprise because shareholders are assured that they will not be held personally liable for the corporation's debts.⁶⁴

In the light of its positive impacts, Blair have identified four key functions of limited liability: providing continuity and a clear line of succession in property and contract; providing and identifying persons to serve as a central actors in carrying out the business activity; providing a mechanism for separating pools of assets belonging to the corporation from those belonging to the individuals participating in the enterprise; and; providing a framework for self-governance of certain businesses or commercial activities.⁶⁵ All of these well-structured functions are indeed, products of a long term achievement of the idea of the corporation, and

⁶⁰ Many cases have shown that the court has been put in an exhaustive situation in order to pierce the corporate veil as seen in many cases such as *Petrodel Resources Ltd v Prest* [2013] UKSC 34, [2013] 2 A.C. 415

⁶¹ Limited Liability Partnership Act 2000.

⁶² Muhammad Taqi Usmani, *An Introduction to Islamic Finance* (Kluwer Law International 2002) 152.

⁶³ Tricker (n 32).

⁶⁴ Margaret M Blair, 'Corporate Personhood & Corporate Persona' (2013) 3 *University of Illinois Law Review* 785.

⁶⁵ *ibid*

have been moulded since its emergence decades ago wherein the form of the corporation has evolved as a result.⁶⁶

2.2.4.1 Corporation: An Islamic View

The IFIs are corporate entities offering financial products and services that comply with the Islamic prescriptions of doing business. It is because of that, that explaining the Islamic point of view in this case is not optional. Noted, the discussion of the conception of corporation in Islam should consist of two separate sub-issues, which are the status of corporation business activities from the Islamic perspective, and the legality of corporation as a fictitious entity under *Shariah* law. The former issue is related to the contractual form of the corporation and the latter issue is the key that holds the concept of limited liability as a corporation considered as a legal person. When a corporation is created and wanted to be run Islamically, these two fundamentals should be contemplated thoroughly in order to enlighten its permissibility under the perspective of *Shariah* law. As mentioned by Mervyn, the fundamental difference between a legal structure that is incorporated and one that is not is the fact that the corporation is given contractual rights, just like an individual under law.⁶⁷ Therefore, the recognition of the corporation as a person under a *Shariah* legal perspective is essential as without it IFIs will face a great challenge in the modern and dynamic economic system.⁶⁸

According to the Islamic legal maxim, the judgment is to be based on knowledge and understanding.⁶⁹ To acquire the required understanding, scholars scrutinise the surrounding issues related to a concept, to anticipate the connections between the concept and the provisions from *Shariah* sources. It is perceivable that *Shariah* law is regulated after a deep contemplation and adequate interpretation on the subject matter, which plays a vital role in *Shariah* law literature, as almost every topic will address a thorough conceptual definition.

It is worth noting that the development of the Islamic business system could be considered as lost from the sight of modern civilisation after the collapse of the Ottoman Caliph Empire. Mervyn claimed that the economic organisation and

⁶⁶ The evolution of the corporation has formed a complex ownership structure which originated from the concept of limited liability; See also Tricker (n 32).

⁶⁷ Mervyn K Lewis, 'Islamic Corporate Governance' (n 4).

⁶⁸ Maria Bhatti, 'Development in Legal Issues if Corporate Governance in Islamic Finance' (2009) 25 (1) Journal of Economic and Administrative Sciences 68.

⁶⁹ Laldin and others, *Islamic Legal Maxims & Their Application on Islamic Finance* (n 37) 1.

commercial practices were inherited from Western colonial powers and therefore, the Islamic legal system lost its intellectual legacy and scholarship, instead it was left to the masses to interpret according to their own whims.⁷⁰ Therefore, to understand the relationship that exists between the contractual parties within the corporation and the idea of limited liability under Islamic law, a journey should be taken to address the connection points, through the Islamic literature pertaining to corporations.

In terms of contractual form, a corporation with a joint stock and partnership contract share has its similarity with Islamic contractual agreements which are called *musyarakah*⁷¹ and *mudarabah*.⁷² The application of *musyarakah* and *mudarabah* are widely known as among the main underlying contracts implied in the Islamic world's trading system. The jurists reported that the Prophet, His companions and generations after had entered into such contractual obligations which allowed them to trade either domestically or internationally.⁷³

Musharakah is defined as an arrangement between two or more people to do some type of work in order to make profit and such profit is distributed among the contracting parties as a dividend rather than salary.⁷⁴ Under a *musharakah* agreement, the shareholders contribute their capital to a partnership to initiate a business entity called *shirkah* (company). The partners of the *musharakah* will name the *amils* or managers, who are capable and will be responsible for the *shirkah*, and who could be amongst the shareholders and, under some schools of *fiqh*, will enjoy a salary, along with the dividend.⁷⁵ The profit and loss will be divided and distributed based on the share proportionately or with pre-agreed terms by the shareholders. The *musyarakah* agreement is also categorised into

⁷⁰ Bhatti (n 68).

⁷¹ *Musharakah* refers to the partnership between two or more parties, which may take effect through contractual relationship or by operation of Islamic law, whereby all contracting parties will share the profit and bear loss from the partnership.

⁷² *Mudarabah* is a contract between a *rabbul mal* and a *mudarib* under which the *rabbul mal* provides capital to be managed by the *mudarib* and any profit generated from the capital is shared between *rabbul mal* and *mudarib* according to mutual agreed profit-sharing ratio whilst financial losses are borne by the *rabbul mal* provided that such losses are not due to the *mudarib*'s misconduct, negligence or breach of specified terms.

⁷³ Wahbah al-Zuhaily *Fiqh al-Islamic wa Adillatuh* (2nd edn, Darul Fikr 1985) vol 5 836.

⁷⁴ Hafeez (n 34).

⁷⁵ Moustafa Khin and others, *al-Fiqh al-Manhaji* (2nd edn, Dar al-Qalam 1996) vol 6 61-68.

four different types; the *syirkah inan*, *syirkah mufawadah*, *shirkah amal* and *shirkah wujuh*.⁷⁶

Another form of company in Islam is the *mudarabah* based company. Some jurist such as al-Siddiqi and al-Zuhaily, justified *mudarabah* as one of the type of *shirkah*⁷⁷, whilst others formulated *mudarabah* as a stand-alone contract. *Mudarabah* is a contract whereby the principal who known as *rabbulmal* (principal) provides capital and the other party known as the *mudarib* (manager) contributes his labour.⁷⁸ In contrast to *musharakah*, the manager of a *mudarabah* agreement is an unconnected person who will enjoy the benefit of profit if the venture succeeds and will not receive any financial benefit in the case of loss.⁷⁹ The real world application of *mudarabah* could be implemented in a form similar to today's joint-stock company with limited liability wherein the traders contribute their capital in stocks and delegate their business activities to be executed by the appointed managers. The part that distinguishes those two contracts is the authority of the manager. The *mudarabah* manager has complete control to daily activities of the *shirkah* and the shareholders are not allowed to interfere. On the other hand, the *musharakah* manager, who could be among the shareholders, cannot avoid other shareholders from joining the management team of the *shirkah* if they see necessary.

These partnership forms are not alien to the conventional corporate entities. The previous implementations of joint stock and partnership in European countries usually involved a merchant sea captain and one or more passive partners who would provide financing for a fleet of ships that would sail to some faraway place to purchase spices or other goods.⁸⁰ On this level, the underlying contract between the merchant and the principle, which normally a joint stock company, is in resemblance with *mudarabah* agreement.⁸¹ When the ship returned, the

⁷⁶ All of these types of *shirkah* will be discussed further in Chapter 5.

⁷⁷ Muhammad Nijatullah Siddiqi *Banking Without Interest* (The Islamic Foundation, Leicester 1983) 15; Al-Zuhaily, *Fiqh al-Islamic wa Adillatuh* (n 73).

⁷⁸ International Shariah Research Academy for Islamic Finance, *ISRA Compendium for Islamic Financial Terms* (ISRA 2011) 288.

⁷⁹ In terms of salary, managers still enjoy a flexible payment based on generic formula used in the market; Zuhaily, *Fiqh al-Islamic wa Adillatuh* (n 73).

⁸⁰ Franklin A Gevurtz, 'The Historical and Political Origins of the Corporate Board of Directors' (2004) <<http://ssrn.com/abstract=546296>> accessed 25 April 2018.

⁸¹ However, the Islamic contracts are to some extent stagnant in terms of its modern development. Most cases exhibits their classical form and if we try to make comparison with modern conventional contracts along with their complexities, the Islamic forms are rather simplistic in many respects. See also Timur Kuran, *The Long Divergence: How Islamic Law Held Back Middle East* (Princeton 2011).

merchandise acquired would be sold, the revenues would be divided and the partnership dissolved⁸² which coincides with the ultimate function of *mudarabah*.

In terms of modern applications of *mudarabah*, Al-Zuhaily mentioned the potential diversities for modern corporate models to accommodate the ideal models proposed in the Islamic literature and previous applications.⁸³ The attention lies on the distinguished features of both models, in order to find out their permissibility in Islamic law, since the Islamic legal maxim of contracts connotes that greater weight is given to intention and meaning than words and forms or substance over form.⁸⁴ Eventually, the default status of Islamic law of any new developments in contractual formation is permissible which is rather flexible and open for innovation. However, another notion useful to clarify here is this; *musharakah* and *mudarabah* are actually the method of how Islamic literatures define the meaning of corporation itself, whereby the understanding of the corporation in Islam should not only pointing to its legitimation from the *Shariah* point of view but also to the readiness of Islam as a religion that promulgates the idea of economic prosperity and best codes of conduct in business activities.

In terms of the concept of a legal person, the main issue is the legality of the concept that allows a corporation to hold its own liability within the Islamic perspective. According to Hassan,⁸⁵ contemporary Muslim scholars such as Audah, Zarqa and Hasanuzzaman have accepted the concept known as *shahsiyyah iktibariyyah* (legal personal) based on principles of *qiyas* (analogical reasoning), *istihsan* (equity in Islamic law), *masalih mursalah* (consideration of public interest) and *zimmah*.⁸⁶ Whilst advocating the legality of a legal person holding liability in Islamic law, Hasanuzzaman also mentioned the disapproval of the concept.⁸⁷ Similarly, Siddiqi proposed, in parallel with the classical model of *mudarabah*, that the liability of a shareholder of the Islamic bank should be unlimited as if the bank suffers losses its capital is insufficient to pay its liabilities, the deficiency must be met by the partners from their personal assets.⁸⁸ However, Hasanuzzaman has argued that limiting the liability of shareholders of a joint-

⁸² Blair, 'Corporate Personhood & Corporate Persona' (n 64).

⁸³ Al-Zuhaily, *Fiqh al-Islamic wa Adillatuh* (n 73).

⁸⁴ Laldin and others, *Islamic Legal Maxims & Their Application on Islamic Finance* (n 37) 46.

⁸⁵ Zulkifli Hassan, 'Regulatory Framework of *Shariah* Governance System in Malaysia, GCC Countries and the UK' (2010) 3 (2) *Kyoto Bulletin of Islamic Area Studies* 82.

⁸⁶ *Zimmah* is a capacity to hold an obligation or to be obliged; Al-Jurjani (n 16) 93.

⁸⁷ SM Hasanuzzaman, 'Limited Liability of Shareholders: An Islamic Perspective' (1989) 28 (4) *Islamic Studies* 353.

⁸⁸ Siddiqi, *Banking Without Interest* (n 77) 18.

stock company does not seem to be in conflict with any legal rule in Islam which would only require a careful examination of the legal position of a joint-stock company.⁸⁹

Likewise, a corporation's legal personality could be compared to the existing Islamic financial bodies and activities such as *baitulmal*⁹⁰ and *waqf*.⁹¹ Usmani, as one of the most prominent supporters of this notion, has appointed *baitulmal* and *waqf* as the Islamic version of legal entity. Usmani has justified his argument as firstly, if a property is purchased with the income of a *waqf*, the purchased property cannot become a part of the *waqf* automatically. The property so purchased shall be treated as property owned by the *waqf*. So, it is clearly meant that a *waqf*, like a natural person, can own a property.⁹²

Secondly, the jurists such as al-Mawardi has clearly mentioned that the money given to a mosque as a donation does not form part of the *waqf*, but it passes into the ownership of the mosque. As for the *baitulmal*, according to al-Sarakhsi, in the case if the head of an Islamic state needs money to give salaries to his army, but he finds no money in the *kharaj* department of the *baitulmal* he can give salaries from the *sadaqah* department, but the amount so taken from the *sadaqah* department shall be deemed as a debt on the *kharaj* department. In this regard, Usmani has argued that following on from this, not only the *baitulmal* but also the different departments therein can borrow and advance loans to each other. The liability of these loans does not lie on the head of state but on the concerned department of *baitulmal*. It means that each department of *baitulmal* is a separate entity where with the capacity to advance and borrow money, that may be treated a debtor or a creditor, and hence can sue and be sued in the same manner as a juridical person can.⁹³

The argument that a corporation is a model resembling the *waqf* and *baitulmal* institutions has similarities with the origin of corporations in the West. The early corporations were formed with charters granted by the local lords or kings for the

⁸⁹ Hasanuzzaman (n 87); He referred to the Islamic legal maxim 'profits are concomitant to risk' and mentioned the case of renting out one's house on the condition that the tenant would be liable to the value of the house if it is damaged to flood or earthquake, which is unlawful in Islam, whereas, the owner who is earning its rent has to bear the damage.

⁹⁰ *Baitulmal* is a public treasury of the Islamic government. See also ISRA (n 78) 222.

⁹¹ It is to make a property the inalienable property of its owner while making its yield and usufruct a charitable donation to specified beneficiaries.

⁹² Usmani (n 62) 155.

⁹³ *ibid*

purposes of governing municipalities, churches and religious institutions in Europe during the Middle Ages.⁹⁴ The idea of the granted charters was to give the institutions the entity shielding to hold ownership, power to sue and be sued, and be separated from the people who work as managers. After the authority of the monarch and parliament were no longer recognised in granting the charter, the task was taken over by state legislators, and thus, more different types of corporations were formed and in greater frequency than in the time of the King and Parliament.⁹⁵

On the other hand, Zahraa and Hasanuzzaman proposed that limited liability is recognised as *zimmah* in Islamic applications.⁹⁶ *Zimmah* is a characteristic of an independent person, either as a real person or a legal person, such as *baitulmal* and *waqf*.⁹⁷ According to Al-Kabashi, the term *zimmah* is synonymous with *ahliyyah* (capacity), which both represent the entities that have rights and bear responsibilities and obligations.⁹⁸ The conception of *zimmah* is crucial in the application of *Shariah* law. Zahraa has asserted that *Shariah* scholars attribute the concept of *zimmah* to certain entities other than human beings such as *waqf*, *baitulmal*, schools, orphanages, hospitals, mosques and other charitable institutions and furthermore, modern Islamic scholars extended the concept of *zimmah* to commercial corporations as well.⁹⁹ He added, in the case of *waqf*, the administrator of a *waqf* should act as an agent or representative worker on behalf of the *waqf* business for the benefit of its beneficiaries which resembles the relationship between managers and principals of a business corporation. All powers, rights and obligations of the administrators are designed to achieve that end.¹⁰⁰

To conclude the discussion, *Shariah* law does recognise a company as a fictitious entity. It can sue and be sued, own and transfer the ownership. This premise is vital to the body of knowledge of *Shariah* governance. Commencing from it, the question on the relationship between the IFIs' stakeholders would be more clearly

⁹⁴ Blair, 'Corporate Personhood & Corporate Persona' (n 64).

⁹⁵ Philip I Blumberg, *The Multinational Challenges to Corporation Law: The Search for New Corporate Personality* (OUP 1993) 10.

⁹⁶ Mahdi Zahraa, 'Legal Personality in Islamic View' (1995) 10 (3) ALQ 193; Hasanuzzaman, (n 87).

⁹⁷ *Al-Mausu'ah al-Fiqhiyyah al-Kuwaitiyyah* (2nd edn, 1983) vol 21 276.

⁹⁸ Zurina Zainal and others, 'Separate Legal Entity under *Shariah* Law and its Application on Islamic Banking in Malaysia: A Note' (2009) 6 (2) International Journal of Banking and Finance 139.

⁹⁹ Zahraa (n 96).

¹⁰⁰ *ibid*

answered. The person responsible for any actions or inactions of the Islamic corporations is also determinable. Under this purview, rather than personalising the IFIs' directors as the agents or *amilis* who work for the shareholders or *rabb mal*, the real agent is actually the respective IFI itself. Other than that, the shareholders of the IFIs too should not be regarded as the 'owners' of the IFIs but rather the 'owners of shares'.

2.2.5 Definition of Governance

The word governance in *Shariah* governance terminology refers to the conventional definition of corporate governance. The proposed term of *Shariah* governance has signalled that the fundamental of *Shariah* governance concept is not a contrarian nor impairs the fundamental discussions of the corporate governance. *Shariah* governance ought to be an evolution of corporate governance and would be regarded as a contribution of Islamic literature to the body of knowledge of corporate governance transcending religious boundaries.

Literally, the term governance derives from the Latin word *gubernare*, meaning to steer, usually applied to the steering of a ship, which implies that corporate governance involves the function of direction rather than control.¹⁰¹ In this matter, the Oxford English Dictionary provides a wider meaning of governance as to include any 'act or manner of governing'.¹⁰² Minhas mentioned that governance is a method which an organisation adopts to ensure that components of the organisation follow the set rules, regulation, policies and processes.¹⁰³ All these definitions present a wide meaning of governance as the term may cover areas of politics, economics, social justice and public administration. Put differently, the term governance in a sense means the style or way an organisation, institution or corporation is guided, steered and controlled. Meanwhile, our focus for this research is on the corporate governance system of business entities, with a specific attention in particular to the IFIs.

Technically, Sir Adrian Cadbury, as the chairman of the Cadbury Committee, defined corporate governance as a system by which companies are directed and controlled.¹⁰⁴ Pertaining to this, corporate governance could be characterised as a system wherein shareholders ought to have control, managers have a fiduciary duty to serve shareholder interests alone, and the objective of the firm ought to

¹⁰¹ Solomon (n 57) xix.

¹⁰² <https://en.oxforddictionaries.com/definition/governance> accessed 10 September 2018.

¹⁰³ Imran Minhas, 'Shariah Governance Model (SGM) and Its Four Pillars' (2012) *Journal of Islamic Banking and Finance* 30.

¹⁰⁴ Adrian Cadbury, (Report of the Committee on the Financial Aspects of Corporate Governance)

be the maximisation of the shareholders' wealth.¹⁰⁵ In order to achieve the aforementioned characteristics, corporate governance has to deal with those legal and organisational structures that look after the internal integrity of a corporation,¹⁰⁶ to maximise the value of the shareholders within the border precept by the shareholders as the real owners of the corporation. This spectrum of definition, which basically lies on the shareholder primacy theory, narrowing the focus group only to the shareholders, is concerned with the directors of the corporation. The upshot is that it could increase the efficiency of the corporate governance system in the light that the directors can work more efficiently because they are focusing only on one objective and the interests of one type of investor.¹⁰⁷

In a similar notion, the OECD stated that corporate governance is a set of relationships between a company's management, its board, its shareholders and other stakeholders which provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined.¹⁰⁸ The OECD has come with a functional definition¹⁰⁹ and this definition too describes a wider focus group considering the importance of various stakeholders rather than focusing on the shareholders as stated in the definition given by the Cadbury Report.

In the banking sector, the Basel Committee on Banking Supervision (BCBS) described corporate governance as the manner in which the business and affairs of individual institutions are governed by their board of directors and senior management affecting how a bank sets its corporate objectives, daily business, and interests of the stakeholder, to align corporate activities to operate in a safe and sound manner and to comply with laws and regulations, and to protect the interests of depositors.¹¹⁰ While focusing on a particular sector, the BCBS concentrates more on the fiduciary duty of the directors and their definition also includes a few other stakeholders that need to be put into consideration in the

¹⁰⁵ Zamir Iqbal and Abbas Mirakhor, 'Stakeholders Model of Governance in Islamic Economics System' (2004) 11(2) *Islamic Economics Studies* 43.

¹⁰⁶ Muhammad Ziaul Houge, 'Corporate Governance in Islamic Perspective' (2006) 6 (2) *International Journal of Business in Society* 116.

¹⁰⁷ Andrew Keay, 'Ascertaining the Corporate Objective: An Entity Maximisation and Sustainability Model' (2008) 71 (5) *Modern Law Review* 663.

¹⁰⁸ OECD, *G20/OECD Principles of Corporate Governance* (OECD 2015) 9.

¹⁰⁹ Thomas Clark, *Theories of Corporate Governance* in Thomas Clarke (eds), *Theories of Corporate Governance The Philosophical Foundations of Corporate Governance* (New York, Routledge 2004) 1.

¹¹⁰ Basel Committee on Banking Supervision, (Guidelines Corporate Governance Principles for Banks 2015)

decision-making in the boardroom. The BCBS expands the term 'stakeholders' to include employees, customers, depositors, suppliers, supervisors, government and the community.¹¹¹ Accordingly, the BCBS also advocates a governance structure composed of a board of directors and senior management.¹¹² Indeed, the more the players are listed in the definitions, the wider the concern lies and by that there are a wider range of stakeholders that will be involved in the particular corporate governance system and the question related to the efficiency will be more complicated. As stated by Grais and Pellegrini, Tirole conveys that relying on enlarging management's fiduciary duty to various stakeholders may leave it with too much power to pursue its own objectives.¹¹³

According to these definitions, there is no single definition that has gained consensus among researchers to interpret the real meaning of corporate governance. This is because the development of the corporate governance corpus has been affected by theories from numerous disciplines including finance, economics, accounting, legal studies, and management and organisation behaviour.¹¹⁴ That is one of the reasons why the subject may be treated in a narrow or a broad manner, depending on the view point of the interpreters, whether he or she is a policy-maker, practitioner, researcher or theorist. The research in this field is still open for new discoveries and expansions. Seemingly, the existing definitions of corporate governance fall along the spectrum, with a narrow view on one end and more exclusive, broad views placed on the other.¹¹⁵ This spectrum stands on how to define the relationship between the managers and the shareholders as well as their relationship with other stakeholders. In this relationship, the directors tend to gain more authority in decision-making and less responsibility for the consequences, while the shareholders as well as other stakeholders are trying to obtain more control and security over their investment and interest, under the scope of fiduciary duty. It is broadly, as defined by Dyck, a complex set of socially defined

¹¹¹ Zulkifli Hassan, '*Shariah* Governance in Islamic Financial Institutions in Malaysia, GCC Countries and the UK' (DPhil Thesis, Durham University 2011) 14.

¹¹² Alnasser (n 1).

¹¹³ Wafik Grais and Matteo Pellegrini, 'Corporate Governance in Institutions Offering Islamic Financial Services: Issues and Options' (2006) World Bank Policy Research Working Paper 4052 12.

¹¹⁴ Hafeez (n 34) ; Clark *Theories of Corporate Governance* (n 107).

¹¹⁵ Solomon (n 57) 5.

constraints that affect the willingness to make investments in corporations in exchange for promises.¹¹⁶

Explaining corporate governance in the context of the financial services sector, Arun and Turner have mentioned the importance of ensuring capital and investment returns and protecting depositors as well as shareholders.¹¹⁷ In a broader manner, corporate governance in financial institutions to some extent is different to that of other types of business organisation, as it involves a larger group of stakeholders. With this position, Zulkifly asserted that financial institutions are much more regulated as compared with other commercial entities.¹¹⁸ Nevertheless, despite the diversity of the definitions of various bodies, the key role of corporate governance is still at a similar notion which is derived from the underlying principle of assuring the economic well-being of the whole community on the basis of universal brotherhood, justice, mutual accountability, truthfulness and transparency, protection of minorities, adequate disclosure and equitable distribution of wealth.¹¹⁹ Hence, it can be concluded here that corporate governance is a set of mechanisms that help in confirming, with fair and just dealing with all the stakeholders and to strengthening transparency and accountability.¹²⁰

2.2.6 *Shariah* Governance Definition

Since the emergence of the *Shariah* governance corpus is rather in its infancy, there is no consensus definition to interpret the whole concept of *Shariah* governance. Thus far, the IFSB is the only standard setter that provides an operative definition of the *Shariah* governance. Others, such as Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and Bank Negara

¹¹⁶ Alexander Dyck, 'Ownership Structure, Legal Protections and Corporate Governance' < <http://siteresources.worldbank.org/DEC/Resources/84797-1251813753820/6415739-1251814020192/dyck.pdf>> accessed 25 September 2017.

¹¹⁷ TG Arun and JD Turner, Corporate Governance if Bank in Developing Countries: Concepts and Issues (2004) 12 (3) Corporate Governance: An International Review 371.

¹¹⁸ Zulkifli Hassan, '*Shariah* Governance in Islamic Financial Institutions in Malaysia, GCC Countries and the UK' (n 111).

¹¹⁹ Enfandiar Malekian and Abbas Ali Daryaei, 'Islamic Value Forward Into Better Corporate Governance Systems' (2010) <<http://cism.my/sites/default/files/publications/Islamic%20Values%20Forward%20Into%20Better%20Corporate%20Governance%20Systems.pdf>> accessed 25 April 2018.

¹²⁰ Abdussalam Mahmoud Abu Tapanjeh, 'Corporate Governance from the Islamic Perspective: A Comparative Analysis with OECD Principles' (2009) 20 Critical Perspectives of Accounting 556.

Malaysia (BNM) who have also issued their *Shariah* governance codes, happened to apply a similar definition to that given by the IFSB rather than proposing their own interpretation.

According to the IFSB, a *Shariah* governance system refers to the set of institutional and organisational arrangements through which IFIs ensure that there is effective independent oversight of *Shariah* compliance.¹²¹ Clearly, *Shariah* governance could be an attribute to the job of setting the direction¹²² which corresponds with the function of conventional corporate governance. However, IFSB's definition has asserted the distinguished feature of *Shariah* governance is it should be focusing on how to verify the Islamic business entity activities run with the adherence to *Shariah* law. This understanding is in coherent with the description proposed by Ahmed. He described *Shariah* governance as the structures and processes in place to ensure that principles and requirements of Islamic law are fulfilled in all contractual and operational aspects of the IFIs from the perspectives of different stakeholders.¹²³

In order to carry out the required task, the IFIs must ensure the existence of a mechanism that will deal with *Shariah* issues and its must be administered by *Shariah* experts. Therefore, a *Shariah* committee has been introduced into the IFIs' corporate governance structures, consisting of a combination of experts in *Shariah*, business and legal matters as practised by most of the IFIs around the globe.¹²⁴ This internal organ can be constituted by a simple *Shariah* committee or extended to an internal *Shariah* entity composing a *Shariah* committee and an internal *Shariah* review unit or department to support the *Shariah* committee in performing its function.¹²⁵ Since *Shariah* is the backbone and foundation for the existence of the Islamic banking and finance industry, Islamic finance experts

¹²¹ IFSB, (Guiding Principles in *Shariah* Governance Systems for Institutions Offering Islamic Financial Services 2009).

¹²² Donald Nordberg *Corporate Governance; Principles and Issues* (SAGE Publication 2011) 7.

¹²³ Habib Ahmed, *Shari'ah Governance Regimes for Islamic Finance: Types and Appraisal* (2011) 44 (4) *Journal of Institute of International Economics* 393, 396.

¹²⁴ A *Shariah* committee is also known as a *Shariah* Advisory Board, *Shariah* Supervisory Board, *Shariah* Board or *Shariah* Council depending on the jurisdictions. This research prefers *Shariah* committee as the term to be used throughout. It is justified in detail in Chapter 6.

¹²⁵ Rihab Grassa and Hamadi Matoussi, 'Corporate Governance of Islamic Bank: A Comparative Study Between GCC and Southeast Asia Countries' (2014) 7(3) *International Journal of Islamic and Middle Eastern Finance and Management* 346; Z Hassan, 'Regulatory Framework of *Shariah* Governance System in Malaysia, GCC Countries and the UK' (n 85).

assert *Shariah* governance should be considered as the single most important distinction between a conventional and an Islamic financial institution.¹²⁶

The definition given by the IFSB also illustrates the extensive duties that need to be carried out by the *Shariah* committee. It is observed that the prominent duty of the *Shariah* committee is to oversee and supervise the IFIs on *Shariah* compliance; as such, their competency is essential to form a robust committee. More importantly, the existence of a *Shariah* committee is crucial to the *Shariah* governance structure as the highest internal authoritative organ in ensuring *Shariah* compliance.¹²⁷

Looking to articulate what *Shariah* governance truly is, some researchers such as Muneeza and Hassan have argued that *Shariah* governance is an Islamic version of corporate governance.¹²⁸ On the other hand, it is also believed that it is how the conventional corporate governance with the same background and foundation works in an Islamic corporation, which has triggered contradictions and issues to be addressed to ensure the business runs Islamically.¹²⁹ Muneeza and Hassan also suggested that *Shariah* governance is a governance system which derives its rules from the sources of Islamic law.¹³⁰ Similarly, Hassan and Bhatti mentioned that the main difference between *Shariah* governance and its counterpart is that it uses the premise of Islamic socio-scientific epistemology premised on the divine oneness of God.¹³¹

The crucial parts of this distinctive discussion are on the underlying worldview of both *Shariah* governance and the corporate governance, and how the goals of the corporations should be organised and achieved by the governance constituents. In this regard, Choudhury and Hoque described the primary epistemological worldview of *Shariah* governance as the oneness of God.¹³² As

¹²⁶ Mizushima (n 3).

¹²⁷ Abdurrahman Raden Aji Haqqi, '*Shariah* Governance in Islamic Financial Institutions: An Appraisal' (2014) 2 (112) *US-China Law Review* 112.

¹²⁸ Aishath Muneeza and Rosni Hassan, '*Shariah* Corporate Governance: The Need for a Special Governance System' (2014) 14(1) *Corporate Governance* 120.

¹²⁹ Detailed discussions on the theories of *Shariah* governance will be carried out in the upcoming chapter.

¹³⁰ Muneeza and Hassan, '*Shariah* Corporate Governance: The Need for a Special Governance System' (n 128).

¹³¹ Bhatti (n 68).

¹³² Masudul Alam Choudhury and Muhammad Ziaul Hogue, '*Corporate Governance in Islamic Perspective*' (2006) 6 (2) *Governance: The International Journal of Business in Society* 116.

asserted by Muneeza and Hassan, a corporation needs to have a *Shariah*-compliant corporate governance structure in order for it to be an Islamic corporation owing to the fact that the concern of *Shariah* governance is on the religious aspects and the Islamicity of the activities of the IFIs.

Furthermore, Lewis has described the meaning of *Shariah* governance by emphasising the essential art of decision making in governance, regardless of the theories and its applications, in three dimensions of decision-making,¹³³ which are “by whom”, “for whom”, and “with what” or “to whom”. Explaining the “by whom”, he correlated the concept of *shura* or consultative council, quoting the reasons behind the *shuratic* decision-making process of which is it will promote the Islamic precept of justice by participating with whose most affected by the decision. “For whom” is considered straightforward in Islam as the starting points are from Allah. Meanwhile, *hisbah* as a core element of Islamic corporate governance, regarded as an institution that will safeguard the way towards Allah. Last but not least, is the “with what or to whom”, which is the process of religious supervision as a guarantee that all of the enterprise’s operations, contracts and procedures conform to the Islamic code.¹³⁴

Another perspective observed from the literature indicates that *Shariah* governance is a way for conventional corporate governance operates under the Islamic framework. Haqqi and Minhas have concluded that *Shariah* corporate governance is simply the alignment of corporate governance according to the Islamic principles.¹³⁵ Uniquely, this approach has a clearer theoretical understanding since it has similarities of characteristics overview which only differs in term of a broader stakeholder participation. As the conventional corporate governance seems to be upholding the shareholder supremacy, the *Shariah* governance system is arguably a stakeholder-oriented model where governance structure and process, at system and corporation level, protect the rights of stakeholders who are exposed to any risk as a result of a firm’s activities.¹³⁶ At some point, it is preferred as the way in which the boards oversee the running of a company by its managers, and how board members are, in turn, accountable to shareholders, stakeholders and the company.¹³⁷ The accountability of *Shariah* governance elements are not only to the stakeholders

¹³³ Hafeez (n 34)

¹³⁴ Lewis, 'Islamic Corporate Governance' (n 4).

¹³⁵ Haqqi (n 127); Minhas (n 103).

¹³⁶ Iqbal and Mirakhor, 'Stakeholders Model of Governance in Islamic Economics System' (n 105).

¹³⁷ Malekian and Daryaei (n 119).

as enlisted traditionally but to the Divine as the Islamic law maker or *Shariah* itself.

2.2.7 Overview of Islamic Financial Institutions

An Islamic Financial Institution (IFI) refers to an institution that offers Islamic financial services, and includes finance houses that offer provide commercial and investment services.¹³⁸ According to the IMF, Islamic finance represents the provision of financial services in accordance with *Shariah*.¹³⁹ Islamic finance is a system that reflects financial business operated in adherence with the principles of *Shariah*¹⁴⁰, which consist of the prohibition of interest¹⁴¹ (*riba*), excessive uncertainty (*gharar*)¹⁴² and gambling (*maysir*).¹⁴³ This mode of financing system could be categorised as *Shariah*-compliant and *Shariah*-based.¹⁴⁴ The most important part of this system is that the Islamic financial system promotes profit-sharing in the conduct of banking business as well as prohibiting paying or receiving interest in any transaction as *Shariah* does not recognise interest.¹⁴⁵ Moreover, all transactions must be underpinned by real economic activities, and there must also be a sharing of risks in economic transactions.¹⁴⁶ If the IFIs operate in the same society where conventional financial institutions are operating, they will correspondingly perform all those functions which are expected from a financial institution.¹⁴⁷ The two systems are, however, philosophically diverse.

¹³⁸ Grais and Pellegrini (n 113).

¹³⁹ Alfred Kammer and others, 'Islamic Finance: Opportunities, Challenges and Policy Options' (2015) IMF Staff Discussion Notes.

¹⁴⁰ Jordan Islamic Bank (Annual Report 2015) 7; BIMB (Annual Report 2015) 9.

¹⁴¹ There was a debate as to whether *riba* relates to interest or usury, there now seems to be a consensus of opinion among Islamic scholars that the term extends to all form of interest; See also Mervyn K Lewis and Latifa M Algoud *Islamic Banking* (Edward Elgar 2001) 2.

¹⁴² *Gharar* is the excessive uncertainty in contracts where details concerning the sale item are unknown or uncertain, or there is a lack of information or control in a contract.

¹⁴³ Feisal Khan, 'How Islamic is Islamic Banking?' (2010) 76 *Journal of Economic Behaviour & Organization* 805; Hussein Elasrag, 'Corporate Governance in Islamic Finance: Basic Concepts and Issues' <<http://ssrn.com/abstract=2442014>> accessed 6 August 2016, 7.

¹⁴⁴ Muhammad Hanif and Abdullah Muhammad Iqbal, 'Islamic Financing and Business Framework: A Survey' (2010) 15 (4) *European Journal of Social Sciences* 475.

¹⁴⁵ Kammer and others (n 139).

¹⁴⁶ *ibid*

¹⁴⁷ Muhammad Hanif, 'Differences and Similarities in Islamic and Conventional Banking' (2011) 2 (2) *International Journal of Business and Social Science* 166.

In terms of business relationships, IFIs are distinguished from their conventional counterparts. The services provided by the conventional financial system, particularly conventional banks, rely on taking deposits from, and providing loans to, the customers. Therefore, the contractual relationship between banker and customers is as lenders and borrowers. The key aspect of conventional banking is the giving or receiving of interest, which is strictly prohibited by *Shariah*. On the other hand, the IFIs relationships with their depositors and other customers are based on partnership, whereby the main contractual agreement involved between those parties is on profit-loss sharing.¹⁴⁸

In terms of services and products, the IFIs introduced alternatives to interest-based services and products as offered by the conventional financial institutions. Siddiqi distinguished the services offered by the IFIs into three categories: services which the IFIs renders on fee, commission or on fixed charges; investment of capital on the principles of partnership or *mudarabah*; and; free or uncharged services.¹⁴⁹ In the same vein, the IMF mentioned that the products offered by the IFIs as classified by Hussain¹⁵⁰ and others into three broad categories as well:

- a. Debt-like financing structured as sales, which could be sales with mark-up and deferred payments (*murabahah*) or purchases with deferred delivery of the products (*salam* contract for basic products and *istisna'* contract for manufactured products), and lease (*ijarah*) with different options to buy. Pure lending is allowed only when benevolent (*qard hasan*) which is often used for current deposits.
- b. Profit-and-loss-sharing like financing with two modalities: (i) profit-sharing and loss-bearing (*mudarabah*)¹⁵¹ whereby the financier (investor or bank) provides capital and the beneficiary provides labour and skills. Profits are shared, but losses would be borne by the financier who does not have the right to interfere in the management of the financed operation, unless negligence, misconduct, or breach of contract can be proven; and (ii) pure

¹⁴⁸ Lewis and Algoud *Islamic Banking* (n 141).

¹⁴⁹ Siddiqi *Banking Without Interest* (n 77) 19.

¹⁵⁰ Mumtaz Hussain and others, 'An Overview of Islamic Finance' (2015) IMF Working Paper WP/15/20 5.

¹⁵¹ A partnership for profit in which one partner (the *rabb al-mal*) provides capital and the other partner (the *mudarib*) contributes his labour. The profit will be shared between them according to the terms they agree to.

profit-and loss-sharing (*musharakah*)¹⁵² where the two parties have equity-like financing of the project and would share profits and losses.

- c. Services, such as safe-keeping contracts (*wadi'ah*)¹⁵³ as for current deposits, or agency contracts (*wakalah*),¹⁵⁴ which are also increasingly used for money market transactions.

The model of the Islamic financing system seems to be accepted by the customers and has gained its popularity. Historically, as could be witnessed from the last few decades, the IFIs have experienced escalated and constant growth. According to the IFSB, the assets of IFIs have reached double-digit rates during the past decade, from about USD 200 billion in 2003 to USD 1.6 trillion at the end of 2012¹⁵⁵ and USD1.89 trillion at the end of 2016¹⁵⁶. In 2017, the Islamic financial market passed the USD 2 trillion mark.¹⁵⁷ ICD-Thompson Reuters predicted that this market would be growing up to USD 3.7 trillion by 2022.¹⁵⁸

Not only have IFIs shown a promising strength in growth, it also proved to be resilient in facing the world financial instability throughout the recent decade.¹⁵⁹ Nonetheless, despite excellent achievement, the plunge in the oil price has resulted in the volatile performance of the IFIs as most of the main IFIs players such as Iran (37.3% of global Islamic banking sectors), Saudi (19%) and Malaysia (9.3%) are oil-producing nations. Furthermore, downwardly a revised economic growth outlook, geopolitical conflicts, exchange-rate depreciations and an assets sell-off spree in emerging markets have also played a role in creating more challenges to the stability of this sector.¹⁶⁰

¹⁵² A confirmation of the rights of two or more people over a common property.

¹⁵³ A contract to leave a property with a person for safekeeping.

¹⁵⁴ It refers to authorising another person to undertake any dealings on one's behalf.

¹⁵⁵ IFSB, (Islamic Financial Services Industry Stability Report 2013) 7.

¹⁵⁶ *ibid*

¹⁵⁷ IFSB, (Islamic Financial Services Industry Stability Report 2018) 3.

¹⁵⁸ ICD-Thompson Reuters, (Islamic Finance Development Report 2017) 11,

¹⁵⁹ Asad Khan and others, 'Comparative Analysis of Regulatory and Supervisory System of Islamic Banks: Evidence from Pakistan, Malaysia, Bahrain and United Kingdom' (2015) 6 (6) *Mediterranean Journal of Social Sciences* 629; Lewis and Algoud, *Islamic Banking* (n 141).

¹⁶⁰ *ibid*

To wrap up, *Shariah* governance is a corporate governance system peculiar to the Islamic corporation offering *Shariah*-compliant products and services. This governance arrangement plays the role of an assurance to the stakeholders that the IFIs are operating in accordance with *Shariah* precepts. In this notion, a *Shariah* committee, which consists of a group of *Shariah* scholars, was introduced within the IFI organisational structure. This board, acting as an advisory board will evaluate the products and services before its execution in case of any non-compliant aspects due to the *Shariah* rulings. The existence of such a committee is a crucial evidence of the IFIs' endeavour to ensure the adherence of their products and services accordingly with their underlying principles.

2.3 The Objectives of *Shariah* Governance

Broadly speaking, the objectives of *Shariah* governance are not in contradiction with conventional corporate governance as practised by various corporations. Concurrently with its counterparts, the *Shariah* governance system plays a pivotal role in enhancing stakeholders' confidence by promoting transparency and accountability in governing corporations. The only characteristic that differs between the systems is that, *Shariah* governance is a system that upholds the Islamic values of doing business. It is also in fact promoting independence and competency. Therefore, to understand this notion, there are three main objectives needing to be addressed: to ensure *Shariah* compliance, to optimise corporation value within the Islamic perspective and to ascertain corporate sustainability.

Firstly, to ensure *Shariah* compliance, *Shariah* governance is a safeguarding system to ensure that the IFIs will always comply with the *Shariah* requirements in all parts of its operations, as per se, compliance with the *Shariah* requirements is what differentiates IFIs from their conventional counterparts.¹⁶¹ The most important mission for the IFIs is to meet stakeholders' wishes in conducting their business so it is done in accordance with *Shariah* principles.¹⁶² Without a clear objective that appreciates the value of the teaching of Islam, the tenets of Islam would only be put as one of the business strategies, and may not be considered as a fundamental guidance to steer the direction of the IFIs. Technically, *Shariah* governance addresses the governance structure of the IFIs, and its functionality in the way to ensure *Shariah* compliance. To execute the said duty, a *Shariah* committee is set up to oversee the IFIs and certify the transactions.¹⁶³ On top of

¹⁶¹ Sherin Kunhibava, '*Shariah* Governance of Islamic Banking in Malaysia' (2012) The Law Review 20.

¹⁶² Grais and Pellegrini (n 113)

¹⁶³ Alnasser (n 1).

that, the *Shariah* committee is also advising the board of directors in *Shariah* matters, endorsing and validating relevant documentation pertaining to the products and services as well as the internal policies and manuals and marketing advertisements¹⁶⁴.

Secondly, to optimise IFIs' corporate value Islamically. Economically, the IFIs are money generating bodies, similar to their conventional counterparts, but run based on the Islamic teachings. That is what gives them a unique interpretation of how a business entity should be governed. Other than that, the IFIs are mainly fashioned like the conventional financial institutions in many ways.¹⁶⁵ Most importantly, the economic propeller of the IFIs is generated from an Islamic worldview. Under this worldview, the IFIs see the wealth as a trust handed over by God to humans to manage on His behalf. Hence, it should be acquired, managed and transacted in adherence with the law of the Owner.¹⁶⁶ Additionally, Islam sees economic activities as instruments to serve the needs of society. This, to some extent seems to contradict capitalism, which puts the focus on wealth maximisation. On achieving their covenant feature, the IFIs requires a better preference on *Shariah* governance as the economic justice promulgated by Islam is also urges for fair distribution and prescribes a certain level of ethical codes. The final objective of those is to provide equal treatment for the deficit and surplus units of the economy. In fact, it is the duty of each *Shariah* governance organs to search for this economic equilibrium, so it could gain the sought-after stakeholders' confidence.

The third objective is to ascertain corporate sustainability. It is noteworthy that it is a crucial responsibility of the directors to ascertain that the IFIs could sustain themselves in the longest run possible. In the light of the *Maqasid Shariah*, IFIs ought to preserve the generated wealth and prevent it from any harm, so it could serve the *ummah* as stakeholders. Under the purview of this research, it could be done by adopting the principles of *Shariah* governance. In this regard, Minhas has suggested that the provision of adequate resources, system procedures, infrastructure and code of ethics for acceptance of business and its legitimacy according to *Shariah* governance entirely depends on the management.¹⁶⁷ In terms of other *Shariah* governance organs, such as the *Shariah* committee, they are in need of having a sound and prudent standard operating system to tackle

¹⁶⁴ *ibid*

¹⁶⁵ Grais and Pellegrini (n 113).

¹⁶⁶ Further explanation on the worldview of the *Shariah* governance will be thoroughly illustrated in Chapter 5.

¹⁶⁷ Minhas (n 103).

multiple events that could jeopardise the IFIs' corporate sustainability.¹⁶⁸ Effective management responsibilities in providing adequate resources and capable manpower support to the function are involved in the implementation of *Shariah* governance.¹⁶⁹ However, providing proper policies and systems will be inadequate if they are not implemented and supervised positively.¹⁷⁰ The failure in governing this aspect could be disastrous to the IFIs as they would suffer the risks more than their counterparts would, the *Shariah* risk. Furthermore, this aspect of *Shariah* governance might well be the catalyst required by the IFIs to promote transparency and avoid mismanagement, especially on *Shariah* matters.

As a conclusion, the objective of the *Shariah* governance is to optimise the value and to ascertain the sustainability of the IFIs in a way that comply with *Shariah* law. This is the ground that lies as the covenant of *Shariah* governance discourse which is meeting the need of today's stakeholders without compromising the future stakeholders in economic, environmental and social aspect.¹⁷¹ To some extent, it has similarities to the conventional corporate objective with a slight diversification. It is done in that way in order to demonstrate that this corpus of knowledge is not a complete stranger to the existing corporate governance body of knowledge. However, as would be repeatedly emphasised in this research, *Shariah* compliance is what fashions the IFIs corporate objectives under the *Shariah* governance flagship.

2.4 The Need to a Robust *Shariah* Governance for the IFIs

The hard experience learned from the global financial crisis has shown the need to develop and implement a comprehensive, uniform and globally accepted regulatory and supervisory framework.¹⁷² As for the IFIs, this framework is translated into the need for a good corporate governance system that represents a robust and resilient system. Good governance is termed as corporate governance when a business entity is operated, regulated and controlled by the well-designed risk management policies, processes, corporate regulations, rules and laws that lead the entity to achieve its ultimate goals.¹⁷³ Since the emergence of the discipline, three decades ago, the discussions have focussed on the

¹⁶⁸ The details on the *Shariah* governance organs are in the upcoming chapters.

¹⁶⁹ BNM, (*Shariah* Governance Framework for Islamic Financial Institutions 2010) 6

¹⁷⁰ Minhas (n 103).

¹⁷¹ Thomas Dyllick and Kai Hockerts 'Beyond the Business Case for Corporate Sustainability' (2002) 11 (2) *Business Strategy and the Environment* 130.

¹⁷² Khan and others (n 159).

¹⁷³ Minhas (n 103) 31.

understanding of the corporate problems in order to introduce improved mechanisms. Although the solutions come up from diverse approaches, the objective remains in a consensus alignment. In this notion, it is imperative to note that the *Shariah* governance is not in contradiction to the existing discipline. The only difference occurs within the question of 'how', which has created a unique approach guided by the Islamic tenets. In this sense, *Shariah* governance would be regarded as the brain of the Islamic financial industry.¹⁷⁴ For the IFIs, there are many reasons why the need of *Shariah* governance is crucial, which are as follows:

a. Ensuring Accountability and Transparency

Accountability and transparency are likely to be the products of good corporate governance and seem to be considered as the benchmark sought by the stakeholders. The importance of transparency has been widely recognised by both academics and regulators, resulting in numerous rules and regulations being introduced over time to ensure timely and reliable disclosure of financial information, creating standards to which companies must adhere with.¹⁷⁵ Many corporations have put their efforts into strengthening the governance system in order to achieve a certain level of accountability and transparency. It is argued that adherence to corporate governance codes, reveals a firm's commitment towards maintaining transparency, accountability and proper risk techniques.¹⁷⁶

Recently, the G20/OECD's Principles of Corporate Governance have profoundly stated that the corporate governance framework should ensure the accountability of boards to the company and the shareholders.¹⁷⁷ Accountability and transparency in the eyes of the Anglo-American system, is a condition whereby the manager is ready to share the information to satisfy the shareholders and run the corporation in-line with the idea of maximising shareholder value. As an assurance, the shareholders authorised a group of capable people, which are, in most cases selected from the shareholders to be the members of the board of directors, as stewards to ensure transparency and avoid information asymmetries. To enhance accountability and transparency, the single board model introduced Non-Executive Directors (NED) as board members. On the

¹⁷⁴ *ibid*

¹⁷⁵ Benjamin Fung 'The Demand and Need for Transparency and Disclosure in Corporate Governance' (2014) 2 (2) *Universal Journal of Management* 72.

¹⁷⁶ Gary Herrigel, 'Corporate Governance' in G Jones & J Zeitlin (eds), *The Oxford Handbook of Business History* (OUP 2006) 470; HN Malkawi and others, 'Internal mechanisms of Corporate Governance and Firm Performance: A Review of Theory and Empirical Evidence' (2012) 8 (4) *Journal of Modern Accounting and Auditing* 549.

¹⁷⁷ OECD (n 108) 51.

other hand, under the European stakeholder models, the managers are not only accountable to the shareholder but also to the players who are affected and could be affected by the businesses run by the corporation. As a result, they introduced a two-tier board system, a board of directors and a supervisory board. The supervisory board in this model has broadened the fiduciary duty of the directors by enlisting other stakeholders that need to be addressed in the boardroom.

The IFIs have, to some extent, adopted the proposed aspect that would contribute positively towards achieving accountability and transparency as promoted by the conventional corporate governance codes, especially the codes issued by the OECD.¹⁷⁸ It has been argued that accountability is the icon of good governance, which is coherent with the values appreciated by the *Shariah* governance system. Nonetheless, the underlying principles between the two systems are distinguished, and, therefore, the *Shariah* committee as the main organ of *Shariah* governance has its own range of stakeholders to be accounted for. Accountability in *Shariah* governance terms somehow mostly relies on the *Shariah* committee. Regarding this, the *Shariah* committee shall be accountable to its own rulings and decisions. Accountability in this context is accountable to the board of directors as well as to the community, which is known as *ummah* or society¹⁷⁹ as the stakeholders of the IFIs and to the Divine. One of the features peculiar to the IFIs is the presence of investment account holders (IAH). In spite of dispersed shareholding, IAHs bear the risk of poor performance of the investment pool, and are not excluded from misconduct on the part of the financial institutions,¹⁸⁰ similar therefore to common shareholders. In this scenario, the *Shariah* governance mechanisms are deemed to be accountable and transparent to the IAHs, more or less, as to shareholders.

b. Mitigate *Shariah* Risk¹⁸¹

Shariah risk occurs when a corporation has failed to adhere to the guidelines pertaining to *Shariah* matters. In most occasions, the risk arises when the IFIs become unsuccessfully attempt to adhere to the rulings endorsed by the *Shariah* committee.¹⁸² The non-compliant aspects could be in operation, marketing,

¹⁷⁸ IFIs as corporations that offer financial products and services are deemed to follow all of the OECD and BSBC corporate governance principles as well as the *Shariah* governance principles endorsed by AAOIFI, IFSB and other Islamic financial supranational organisations. Detailed discussions on this topic are in Chapter 3.

¹⁷⁹ Bhatti (n 68).

¹⁸⁰ Grais and Pellegrini (n 113).

¹⁸¹ Mahmood Ahmed and Maksuda Khatun, 'The Compliance with *Shariah* Governance System of AAOIFI: A study n Islamic Banks Bangladesh' (2013) 9 (3) Journal of Islamic Economics, Banking and Finance 177.

¹⁸² Muneeza and Hassan, '*Shariah* Corporate Governance: The Need for a Special Governance System' (n 128).

product structuring and investments. It also occurs when a certain contract is applying a remote opinion of *Shariah* legal schools.¹⁸³ In some cases, *Shariah* risk refers to the risk of non-compliance resulting from the failure of an IFI's internal system and personnel.¹⁸⁴ These non-compliance risks might well be contributing losses to the IFIs, financially and morally. The IFIs will suffer from the invalidation of the contracts, non-halal income, which will not be included as a profitable income for IFIs and capital adequacy ratio (CAR) impact, financially.¹⁸⁵ At the same time, IFIs will be reckoned as running the business against the Divine law, contravening the enacted law in some jurisdictions and jeopardising its reputation in the eyes of the stakeholders, morally. Some researchers such as Ali have asserted that *Shariah* non-compliance could prompt excessive withdrawals of deposits, resulting in bank failure.¹⁸⁶ Whether it is financial or not, the risk ought to be treated diligently by the IFIs before it could turn into a threat. It must be identified, measured, mitigated and reported through a standard operating procedure of risk management by the IFIs.

Furthermore, *Shariah* risk can also be attributed to a lack in *Shariah* governance standards, which has the potential to mislead the divergent IFI governance system in different jurisdictions. Notably, a uniform and standard framework is a vital answer.¹⁸⁷ Moreover, although effective *Shariah* governance is consistent with Islamic principles,¹⁸⁸ and the IFIs have implied the Islamic teaching in their business activities, it does not mean that IFIs are immune from uncertainty in the future, because that is the nature of the financial business itself. In addition to this, it is vital to note that the risks faced by the IFIs do not only positively coincide with their counterparts,¹⁸⁹ but there are also risks that are uniquely applied to the IFIs owing to their characteristics. Apart from the generic risks such as credit risk,

¹⁸³ See also *Affin Bank Bhd v Zulkifli bin Abdullah* [2006]3 MLJ; *Bank Islam Malaysia Bhd v Adnan Omar & Ors* [1994] 3 CLJ 735.

¹⁸⁴ Simon Archer and Abdullah Haron, 'Operational Risk Exposure of the Islamic Bank' in Archer and Abdel Karim (eds), *Islamic Finance: The Regulatory Challenge* (John Wiley and Sons 2007) 124.

¹⁸⁵ See also Asian Institute of Finance, *Risk Management in Islamic Bank* (AIF 2013) 2.

¹⁸⁶ Ahmad Mohamed Ali, 'The Emerging Islamic Financial Architecture: The Way Ahead' (The Fifth Harvard University Forum on Islamic Finance, Center for Middle Eastern Studies, Harvard University, Cambridge 2003) 147.

¹⁸⁷ E Oz, 'Regulatory and Supervisory Framework in Islamic Financial Services Industry (IFSI) from the Perspective of Risk Management' (3rd Meeting of the COMCEC Financial Cooperation Working Group October 2014); Muhamed Zulkhibri Abdul Majid and Reza Ghazal, 'Comparative Analysis of Islamic Banking Supervision and Regulation Development' (2012) 6 (3) *Money and Economy* 113.

¹⁸⁸ Bhatti (n 68).

¹⁸⁹ Noraini Ariffin and others, 'Risks in Islamic Banks: Evidence from Empirical Research' (2009) 9 (1) *Journal of Banking Regulation* 153.

market risk, liquidity risk and operational risk, the IFIs also have to encounter the *Shariah* risk, rate of return risk, displaced commercial risk and equity investment risk.¹⁹⁰ The major risk that needs to be taken care of most is, of course, the *Shariah* risk that could cause a domino effect as it has the potential to trigger other essential issues for the corporation. To mitigate such a risk, IFIs are in need for creating a governance structure and management process that would reassure the stakeholders on the *Shariah*-compliant aspects of all transactions.¹⁹¹

One of the main organs of the *Shariah* governance that functions to mitigate the risks is the *Shariah* committee. This committee is membered by experts in *Shariah* matters and plays a pivotal role to minimise the risks by ensuring the adherence of the IFIs products and services with the *Shariah* law. The duty of the *Shariah* committee may vary according to the provisions stipulated in the articles of association of the institutions or by regulators, but this committee assures the customers that the IFIs drive their business in accordance with *Shariah*.¹⁹² Mainly, it provides an *ex-ante* measure by introducing the rulings on policies and guidelines for operations, products and services, before execution. This process will be followed by the *Shariah* audit as an *ex-post* stage of the *Shariah* supervision by the *Shariah* committee.¹⁹³ In the event of non-compliance, in some jurisdictions, the *Shariah* committee has the function to rectify the non-compliances due to the *Shariah* precepts or to be duly approved by the board and endorsed by the *Shariah* committee.¹⁹⁴ In order to execute these functions, the *Shariah* committee will utilise other *Shariah* governance organs such as the Internal *Shariah* Compliance Unit (ISCU), Internal *Shariah* Review Unit (ISRU) and other related management counterparts. The main concern of these organs is to assist the *Shariah* committee to ease *Shariah* non-compliance if it is a risk mitigation mechanism for the IFIs.¹⁹⁵

To some extent, some researchers concluded that the financial turmoil that erupted since 2007 was attributed to the weakness of corporate governance

¹⁹⁰ Shahrul Ezwan Illias, *Risk Management in Islamic Banking* (2012) 55 (32) IPEDR 159.

¹⁹¹ Grais and Pellegrini (n 113).

¹⁹² *ibid*

¹⁹³ Karim Ginena and Azhar Hamid, *Foundations of Shari'ah Governance of Islamic Banks: The Role of Sharia Supervisory Boards, Internal Audit and Advisory Firms* (John Wiley and Sons 2015) 333.

¹⁹⁴ BNM, (SGF 2010) (n 169) 14.

¹⁹⁵ *Shariah* non-compliance risks refer to possible failures to meet the obligation to *Shariah* principles or in other words, possible incidences of *Shariah* non-compliances.

mechanism.¹⁹⁶ The failure of risk management due to improper corporate governance systems is regarded as one of the factors that contributed to the eruption of the last decade's financial crisis.¹⁹⁷ Researchers pointed to the managers who have been greedy and potentially incompetent that encouraged or turned a blind eye to excessive risk-taking.¹⁹⁸ This poor and lack of risk management practice is among other factors credited as one of the causes of the crisis.¹⁹⁹ Shareholders and boards encouraged the management to increase shareholder return through aggressive risk-taking.²⁰⁰ Bankers and credit brokers used aggressive lending tactics working under the same notion.²⁰¹ Ironically, this crisis occurred after extensive measures taken by the US government to strengthen the corporate governance mechanism via the Sarbanes-Oxley Act 2002.²⁰²

c. Increasing stakeholders' confidence. Investment Account Holders (IAH)

Having a strong *Shariah* governance mechanism to mitigate *Shariah* risk not only could increase the probability of success for the IFIs, but are also crucial in the way it could raise the level of confidence of the stakeholders in the IFIs.²⁰³ Put differently, a robust *Shariah* governance is desired to augment the trust and confidence of the stakeholders in the IFIs.²⁰⁴ It is worth noting that the IFIs' stakeholders are diverse as opposed to their conventional counterparts. Indeed, the Muslim community would choose the IFIs over the conventional institutions due to the religious factor, but the fact that the majority of their customer are non-Muslim should not be eliminated from the equation and left unattended. In order to penetrate the non-Muslim market, an effective *Shariah* governance is

¹⁹⁶ OECD, (Steering Group on Corporate Governance Report 2009); Hussein Tarraf, 'The Role of Corporate Governance in the Events Leading Up to the Global Financial Crisis: Analysis of Aggressive Risk-Taking' (2011) 5 (4) *Global Journal of Business Research* 93.

¹⁹⁷ G Kirkpatrick, 'The Corporate Governance Lessons from the Financial Crisis' (2009) 1 *Financial Market Trend*, 7.

¹⁹⁸ Simon Ashby, 'The 2007-09 Financial Crisis: Learning the Risk Management Lesson' (Research Paper 2010) 13.

¹⁹⁹ Gheorghe Voinena and Sorin Gabriel Anton, 'Lessons from the Current Financial Crisis: A Risk Management Approach' (2009) 3 *Review of Economic and Business Studies* 140.

²⁰⁰ David H Erken and others, 'Corporate Governance in the 2007-2008 Financial Crisis: Evidence from Financial Institutions Worldwide' (2009) Working Paper no 124/2009 European Corporate Governance Institute.

²⁰¹ Tobias F Rotheli, 'Causes of the financial crisis: Risk Misperception, Policy Mistakes and Banks' Bounded Rationality' (2010) 39 *The Journal of Socio-Economics* 119.

²⁰² Sarbane-Oxley Act 2002.

²⁰³ Rosni Hassan and others, 'Report on Empirical Study on *Shariah* Governance Framework (SGF 2010)' (ISRA Research Paper 68/2014) 10-12.

²⁰⁴ IFSB, (Guiding Principles in Shari'ah Governance Systems for Institutions Offering Islamic Financial Services 2009) 14.

extremely useful to draw their attention. Furthermore, one of the dominant stakeholders of the IFIs is Investment Account Holders (IAH), who play an influential role by entering into a *mudarabah* contract that has allowed them to be recognised as shareholder-like stakeholders.²⁰⁵

Conversely, poor *Shariah* governance system could carry heavy financial costs for the stakeholders.²⁰⁶ Numerous studies have shown positive relationship between good corporate governance and high profitability and investment performance measures. For instance, in 2004, Brown and Caylor research findings indicated that, after the passing of the Sarbane-Oxley Act in 2002, which increased the independence of boards of directors, nominating committees, and compensation committees, the firm was associated with good performance, eventually suggesting that these exchange requirements may facilitate improvement in terms of performance.²⁰⁷ Consecutively, Vo and Phan's study indicated that elements of corporate governance such as the presence of female board members, the duality of the CEO, the working experience of board members, and the compensation of board members have positive effects on the performance of the firms, as measured by the returns on assets.²⁰⁸ These studies are maybe pointing at the conventional Anglo-American corporate governance system, but needless to say that these results are applicable to the IFIs as well, since the *Shariah* governance is also dealing with the familiar governance constituents.

Meanwhile, in the UK, where stewardship corporate governance codes are popular with the notion of 'comply or explain', the aim for the issued codes and standards to be adopted are not only based on the regulation but also because companies, investors and the professions believe they make sense, rather than because they have to comply.²⁰⁹ Self-regulation under the 'comply or explain' flagship is believed to provide flexibilities, in terms of implementation of the code to the companies. It also would drive them towards compliance in the way they could and if not, sufficient explanation should be provided. According to the data, between 2012 and 2014, the number of FTSE 350 companies complying with all

²⁰⁵ Grais and Pellegrini (n 113).

²⁰⁶ *ibid*

²⁰⁷ Lawrence D Brown and Marcus L Caylor, 'Corporate Governance and Firm Performance' (Research Report Dec 2004) 31.

²⁰⁸ Duc Vo and Thuy Phan, 'Corporate Governance and Firm Performance: Empirical Evidence from Vietnam' Research Paper Apr 2013 <http://www.murdoch.edu.au/School-of-Management-and-Governance/_document/Australian-Conference-of-Economists/Corporate-governance-and-firm-performance.pdf> accessed 30 June 2016.

²⁰⁹ Financial Reporting Council (FRC Annual Report 2015) 11.

provisions of the code increased gradually from 50% in 2011 to 61% in 2014, with the non-compliance aspects have been explained rather than left undiscussed. In 2015, 57% of FTSE 350 companies were fully compliant with the code.²¹⁰ Compared with 2014, this figure represents a slight drop from 61% as shown in the previous year; however, the non-compliances come with better explanations.²¹¹ The stewardship governance approach in the UK corporate governance codes is more than just voting. The investors are deemed to get involved in monitoring and engaging with the company matters such as strategy, performance, risk, capital structure and corporate governance, which may include corporate culture and remuneration system.²¹² The bottom line is corporate governance is a crucial tool that could be facilitated by the investors to measure the risk that they are running and willing to take before considering their investment participation.

d. Avoid Institutional Failure

The studies of the practice of the Islamic financial system, has shown evidences of the possibility of the occurrence of financial crisis to the IFIs. The cases of the Ihlas Finance House in Turkey, the Islamic Bank of South Africa and the Islamic Investment Companies of Egypt and Malaysian Islamic Bank Berhad in Malaysia proved that despite its ideal code of business conducts and ethics, IFIs are not immune to crisis. Hirschman argued that under any economic, social or political system, individuals, business firms, and organisations in general are subject to lapses.²¹³ Furthermore, the objectives that take place as the foundation that built the IFIs is rather coherent with the conventional financial institutions. The fact is, IFIs are the corporations formed to create wealth, to some extent, are exposed to the risk of greed, shareholder risky actions, market exploitation, economic instability, fraud and lack of governance mechanism. Likewise, the IFIs are no less prone to suffer from breaches of fiduciary responsibilities or the consequences of asymmetric information.²¹⁴ As a mitigation element to reduce the causes of these crises, the need for an efficient and robust *Shariah* governance is inevitable.

In the case of the Ihlas Finance House in Turkey for instance, control failure as a reference to failure in corporate governance and lack of internal as well as external checks and balances have been clarified as the key factors that caused

²¹⁰ Corporate Governance Review 2015 (Grand Thornton 2015) 18.

²¹¹ *ibid*

²¹² Financial Reporting Council (UK Stewardship Code 2012) 1.

²¹³ Albert O Hirschman, *Exit Voice and Loyalty: Responses to Decline in Firms, Organizations and States* (HUP 1970) 1.

²¹⁴ Grais and Pellegrini (n 113).

the event.²¹⁵ It arises when decision-making becomes too centralised, when there is a rubber-stamp board of directors, when the board members are ignorant of financial and economic facts and the workings of the company, when board members are not motivated, when the bank staff lack relevant experience and training, and when things are run on trust without proper systems of internal control.²¹⁶ Thus, it is essential that the *Shariah* governance plays its roles, to conform the adherence to the precept of *Shariah* law of business and work as a prevention mechanism for possible future failure. Nonetheless, to play with such a role, *Shariah* governance should not focus only on the compliance of the underlying contracts of the business but also expand its ability to create a prevention mechanism that will detect and come up with a potential solution to the problematic issues before they cause more damage.

2.5 Conclusion

As a conclusion, there are a few points need to be addressed as the headlines of this chapter. These points stand as the fundamental viewpoints on the issue in hand, the principles of *Shariah* governance, as it could secure a proper guidance towards understanding the chapters to come. First, *Shariah* governance is a corporate governance system that is concerned with the functions of the governance constituents of IFIs in ensuring *Shariah* compliance. In a broader sense, the IFIs *Shariah* governance system has no difference to the conventional counterpart. It is concerned with accountability, transparency, enhancing stakeholders' confidence and so on. However, since the IFIs are operating with a peculiar code of conduct known as *Shariah* compliance, *Shariah* governance organs are moving towards such a notion. It is due to this, the objective of the *Shariah* governance has diversified despite similar narratives as opposed to the conventional corporate governance. Second, due to the above-sense, the sensible objective of the *Shariah* governance as observed is to optimise the value and to ascertain the sustainability of the IFIs in a way that complies with *Shariah* law. This objective is formulated based on the worldview of the Islam on wealth, a subject to be further excavated by this research in the future discourse. However, it is imperative to note here that because of this reason, the IFIs cannot fully utilise the corporate governance codes published by multilateral standard-setters without considering their *Shariah* requirements. In this sense, a comprehensive understanding of *Shariah* governance is pivotal as an additional code of conduct to ensure *Shariah* compliance. Third, *Shariah* is perceived as the fundamental teaching of Islam. It is sometimes conceived of the Islamic law, as well as the Islamic teaching as a whole. Both make irrevocable impacts to the

²¹⁵ *ibid*

²¹⁶ Syed Ali Salman, 'Financial Distress and Bank Failure: Lessons from Closure of Ihlas Finans in Turkey' (2007)14 (1) *Islamic Economics Studies* 1.

IFIs operating systems. Whether it is a law or a teaching, it is the concept fully upheld by the IFIs systemic and operational arrangement. As a result, the existence of the *Shariah* governance is a distinctive element for the IFIs as a way to ensure *Shariah* compliance at all costs.

Chapter 3

Developments of Standard-setters and Codes of *Shariah* Governance

3.1 Introduction

After introducing the reality of *Shariah* governance in the last chapter, this research will continue the discussion to bring about an in-depth comprehension of the subject. In the conventional counterpart, corporate governance is an issue under the eyes of standard-setters, who normally develop codes of best conduct -an important part and parcel of a business corporation. The codes function as soft law to be adhered to by the corporation along with relevant local black letter regulations. The IFIs do nothing less in this regard. They are required to adopt such codes, while additional features regarding *Shariah* compliance processes are also to be incorporated.

The development of the *Shariah* governance codes in their modern form is new to the IFIs. Islamic finance itself has been available for only around 50 years after the incorporation of Mit Ghamr Bank, Egypt and the Tabung Haji, Malaysia in 1963.¹ At that particular time, *Shariah* governance was not an issue at all, and corporate governance as we know it today did not yet exist either. Arguably, the subject of *Shariah* governance has only experienced significant development since the formation of the AAOIFI. Prior to that, *Shariah* governance was only reviewed under relevant corporate law without having any special treatment, as long as it could serve the *Shariah* compliance purpose. Since the rapid expansion of the Islamic financial market, the subject has gained popularity owing to the pressing demand on specific corporate governance mechanisms to tackle the IFIs' peculiarities. Regarding this, in this chapter, we are going to explore the available governance codes that serve *Shariah* compliance purposes. It is to position the *Shariah* governance corpus within a well-structured comprehension as with the conventional corporate governance body of knowledge. Owing to the fact that those subjects are by and large pointing out similar corporate issues despite their peculiarities, a comprehensible narrative therefore, is believed to be useful in this level of discussion before we jump into a deeper dialogue in chapters to come.

¹ <<https://www.islamicfinance.com/2015/05/modern-journey-development/>> accessed 25 April 2018.

3.2 Historical Overview of *Shariah* Governance in Islam

When we are exploring the concept of *Shariah* governance, we need to realise that the concept is no stranger to the Islamic literature, in which it can be traced back to the time of the Prophet-hood. However, we have to bear in mind that the forms of governance were considerably diverse and un-identical in comparison with the modern governance system. As more than likely happens in other systems, it has evolved due to time, places and circumstances. As long as it is compatible and comparable in terms of the principles and the idea, it is considerable as the same subject matter. As mentioned by the path dependence advocates, the historic events in the past, determine future paths.² Here are the stages of the *Shariah* governance development over a period starting from the time of the Prophet-hood to the most recent developments on the subject.

3.2.1 The Time of Prophet-hood

In the Islamic tradition, after the Quran, the Hadith is the second source of the law.³ The hadith contains amongst others, commands to be followed by Muslims on multiple occasions. As an example for the functions of the Hadiths, we can look at some of the actions of the Prophet as the ruler of Medina. During His PBUH's lifetime, the Prophet applied Islam in all aspects of government and economics. In order to improve the economic activity of the citizens of Medina and the migrants, who came from Mecca, the Prophet PBUH set up a new market and encouraged them to get involved. He said:

'By Him whose hand myself is, to take your rope and gather firewood on your back is better for you than that you come to a man to whom Allah has given some of His favour and ask him so he gives to you or refuses'.

He also said:

*'Nobody has ever eaten a better for you than that which one has earned by working with one's hands. The Prophet Allah David used to eat from the earning of His manual labour'.*⁴

In terms of the market supervision practices, the Prophet Muhammad PBUH nominated his companions as *muhtasib*.⁵ In this case, Umar ibn al-Khattab was nominated as *muhtasib* in Medina, as Said ibn al-'As in Makkah and Uthman ibn

² See also Gerd Schienstock, Path Dependency and Path Creation: Continuity vs. Fundamental Change in National Economies (2011) 15 (4) Journal of Future Studies 63.

³ Further discussion on this topic will be on Chapter 6.

⁴ This hadith is narrated by Bukhari as reported from Abu Hurairah; M Bukhari, *Sahih al-Bukhari* (5th edn, Dar Ibn Kathir 1993) vol 2 no 1967, 730.

⁵ *Muhtasib* means supervisor. There are the people who are appointed to carry out *hisbah* duties, which include supervising market activities.

al-'As in Ta'if. The Prophet even named a woman to carry out the task by putting Samra' bint Nuhaik al-Asadiyyah as a *muhtasib*, and she was recorded as using a stick, patrolling and supervising the market.⁶ The Prophet Himself was a supervisor of the market. It was told by Abu Hurairah, that the Messenger of Allah PBUH happened to pass by a heap of corn. He then thrust his hand in that (heap) and his fingers felt wetness. He said to the owner of that heap of corn, '*What is this?*' He replied, 'O Messenger of Allah! These have been drenched by rainfall'. He remarked, '*Why did you not place this (the drenched part of the heap) over the corn so that people might see it? He who deceives is not of us*'.⁷

The conception of market supervision at this level, somehow, was at its early stage. However, the above-mentioned provisions were referred to by the following generations of jurists when explaining the Islamic governance system as in the works of al-Mawardi and al-Farra'. In this regard, both of Al-Mawardi and al-Farra' authored two different books with an identical title, *al-Ahkam al-Sultaniyyah* (The Law of Islamic Governance), as a manual for the Abbasid's caliph.⁸

3.2.2 The Time of the Caliphs

The golden era of the Islamic empire lasted over a millennium and it saw tremendous achievements in sciences, economics, politics, and the military as well as the governance system for the succeeding generations. It is thought that the concept of *hisbah* as introduced during the time of the Prophet-hood had gained prominence over the centuries. The *hisbah* institution was one of the main organs of the caliphate governance structure, along with other institutions such as the judiciary, *waqf*, *baitul mal* and the army under the name of *diwan*.⁹ For example, the wealth of the caliphate was managed under *baitulmal*, as the government treasury. The sources of the *baitulmal* come from *zakah*, *sadakah*, *ghanimah*, *usyur*, *kharaj*, *jizyah* and other relevant sources of tax. The *baitulmal* funds are distributed using the instruments derived from the provisions of the Quran and the Hadith and shall be discharged by the government with accountability and transparency.

In the private sector, *waqf* could be considered as the classic example of a former form of Islamic financial institution. *Waqf* is an endowment institution. It reached

⁶ Salahuddin Safadi, *al-Wafi bi al-Wafiyat* (Beyrut 2000) 274.

⁷ This hadith is narrated by Muslim as reported from Abu Hurairah; H Muslim, *Sahih Muslim* (Dar al-Fikr 2003) no 186, 71.

⁸ Abu al-Hassan Ali bin Muhammad bin Habib Al-Mawardi, *Al-Ahkam al-Sultaniyyah* (Dar al-Hadith 2006) 349.

⁹ See also A Abdullah, Harking Back to *Hisbah Accountant Today* (April 2010) 12-14.

its golden peak during the era of the Islamic empire. Known as one of the key players that contributed to the development of Islamic civilisation, *waqf* provided critical support to the functioning of the Islamic cities, which were far larger than any town in the West without direct involvement from the state¹⁰ or the government. *Waqf* also provided the drinking water system, paved streets, assistance to travellers, the financing of pilgrimages and even the wedding dress for brides.¹¹ It served as a vehicle for financing Islam as a society, as mentioned by Marshall Hodgson.¹²

The mechanism to govern these institutions was known as *al-diwan* and the prominent organ pertaining to the economics activities was *diwan al-hisbah*. Al-Mawardi and al-Farra' categorised the functions of *diwan al-hisbah* relating to the business activities, into three main areas: firstly, monitoring the market price of the goods.¹³ In some jurisdictions, based on the *Shariah* legal school of the local government, a *muhtasib* was authorised to take action under the law in certain circumstances related to the price, especially in the case of monopoly, price exploitation by hoarding and over-pricing of the goods classified as basic needs. Secondly, they were authorised for asserting measurements and scales. The *hisbah* institution was responsible for the standardisation of business tools, including the use of standard currency in transactions.¹⁴ In this regard, a *muhtasib* held the power to nominate an eligible person to assist him. Thirdly, they supervised business activities. Such a function was carried out by confirming the adherence to the business conducts of the *Shariah* precepts and preserving the consumers' rights such as in the case of disputes due to fraud and negligence.¹⁵

The scope of *diwan al-hisbah* did not stop at the level of business and market matters. The head of *diwan al-hisbah* was a member of the *shura*, the highest council of the government at the central level. *Diwan al-hisbah* was an independent body, and its accountability is beyond the caliph himself. It is argued that the expressed *hisbah* jurisdiction was, at least as stated in the provision, to remove a caliph if he seen as no longer fit for the post. By any means, *diwan al-hisbah* was a vital governance organ within the Islamic empire that served as a supervisory and auditing institution. To some extent, this central power represents a model of a supervisory mechanism that is answerable to a higher

¹⁰ Timur Kuran, 'The Absence of the Corporation in Islamic Law: Origin and Persistence' (2005) 53 AJCL 785.

¹¹ *ibid*

¹² Marshall GS Hodgson, *The Venture of Islam: Conscience and history in a world civilisation* (University of Chicago Press 1974) 124.

¹³ Al-Mawardi (n 8) 367.

¹⁴ Abdullah (n 9) 14

¹⁵ Al-Mawardi (n 8) 367.

authority, which is God. In this sense, answerable to God, should not be regarded as answerable to an unclear authority, but rather interpreted answerable to the highest law of the state, which is the *Shariah* law.

3.2.3 The Time of Modern Islamic Finance

3.2.3.1 Development of Islamic Financial Institutions

Historically, the developments of the IFIs are under a conventional setup. However, with the rapid growth of the Islamic financial industry, each jurisdiction has adopted a separate regulatory structure based on its institutional setup and market practices.¹⁶ To understand these circumstances, scholars in this area of research have divided the modern era of IFIs into phases. Prominently, Khurshid Ahmad mentioned that the development of the Islamic financial system has gone through three significant phases.¹⁷

First Phase: The time of theoretical concept of interest-free banking

After the collapse of the Ottoman's caliphate, the final empire of Islam, no known formal institution offering business transactions with *Shariah* compliance. The Ottoman Empire had broken into several countries, each forming individual governments, either by claiming their independence or by being colonised by the Western civilisations. Not one of those countries seemed to be proclaimed as an Islamic country, implementing the same notions as the former empire, neither politically nor economically.

By this time, the financial system introduced by the Western colonisers dominated the market and spread widely over all the regions previously known for their Islamicity. In fact, the Westernisation process had already taken place decades before that, which traceable by the formation of many banks in several localities throughout the Ottoman Empire. Since the 19th century, some Islamic regions started opening branches of foreign banks. For instance, in Egypt, the first conventional bank opened its doors in 1856 under the name Bank of Egypt, which was actually a branch of an English bank.¹⁸ In 1898, the National Bank of Egypt, was established and is still in operation today.¹⁹ These developments were followed by many other financial institutions, which finally created the need for

¹⁶ Asad Khan and others, 'Comparative Analysis of Regulatory and Supervisory System of Islamic Banks: Evidence from Pakistan, Malaysia, Bahrain and United Kingdom' (2015) 6 (6) *Mediterranean Journal of Social Sciences* 629.

¹⁷ Muhammad Umer Chapra, *Towards a Just Monetary System* (Leicester 1985) 9.

¹⁸ Ahmad Alharbi, 'Development of the Islamic Banking System' (2015) 3 (1) *Journal of Islamic Banking and Finance* 12.

¹⁹ *ibid*

the Muslim community to create a similar banking system but under *Shariah* prescriptions.

As mentioned by Siddiqi, the earliest writing on the subject of Islamic banking and finance dated back to the 1940s.²⁰ At this stage, scholars were looking for an alternative system to overcome the domination of the interest-based finance which eventually triggered the possibility for modern IFIs to emerge, a few decades after that. There is no trace of any specific discussion on the subject relating to *Shariah* governance system.

Second Phase: The emergence of the Islamic banks

After almost two decades since the first idea appeared of an alternative financial model, the first batch of IFIs emerged in 1963 in Malaysia with the formation of *Tabung Haji* and in Egypt Mit Ghamr Bank as well as interest-free-based bank of Karachi. Amongst those three IFIs, the *Tabung Haji* is the only one that has survived throughout the decades. Truthfully, there was no specific body responsible to advise, supervise or monitor those IFIs on *Shariah* matters. The establishment of the first modern Islamic bank, Mit Ghamr in 1963, was made without setting up any *Shariah* body as part of its internal corporate governance structure.²¹ To this point, the need for a robust *Shariah* governance system was not an issue and moreover, the collapse of the other two IFIs were due to external factors: political factors, in particular.

Early in the 1970s, came the Dubai Islamic Bank, which took deposits in current as well as investment accounts and engaged in profit-making activities directly as well as through working partners. Consecutively, the Islamic Development Bank, which started its operations in 1975, was designed to serve Muslim countries and communities by arranging finance for trade and development on a non-interest basis. By the late 1970s there were half a dozen more banks in the private sector in Egypt, Jordan, Kuwait, and the Gulf states. The following decade saw rapid expansion bringing the number of banks into the dozens by the end of the decade. More importantly, with the commencement of the Dubai Islamic Bank and the Islamic Development Bank in 1975, neither had designated *Shariah* department within their governance structure. In order to resolve *Shariah* matters, they established relationships with several scholars for consultation on their

²⁰ Muhammad Nijatullah Siddiqi, *Banking Without Interest* (The Islamic Foundation, Leicester 1983)18.

²¹ Ribah Grassa, '*Shariah* Supervisory System in Islamic Financial Institutions New Issues and Challenges: A Comparative Analysis between Southeast Asia Models and GCC Models' (2013) 29 (4) *Humanomics* 333, 336.

activities, transactions, products and services as well as asking for *fatwas* for specific questions and transactions²².

Third Phase: Islamic finance expansion

Scholars stated that, during that period of time, the IFIs had spread all around the world and many IFIs that were established in the early 1970s and 1980s are still in operation.²³ The need for an alternative robust financial system due to repeating financial crises has encouraged the IFIs to grow. Along with this progress, the importance of a prudent and sound governance system to tackle the expansion of the institutions has intensified. This situation has resulted in the emergence of the *Shariah* governance codes and standards issued by several standard-setters at national or international levels such as the AAOIFI, IFSB and BNM.

3.2.3.2 Emergence of *Shariah* Governance Codes

In the last millennium, we could witness exponential growth in concern on *Shariah* governance, coinciding with the expansion of the Islamic financial industry, either theoretically or practically. The proliferation of the IFIs in the past decades has started to create multiple issues for policy makers and regulators.²⁴ Notably, for the *Shariah* governance, various codes have been issued by numerous standard-setters, nationally and internationally, to overcome the specific needs of the IFIs for a robust governance system. The objective is to sustain the credibility of the *Shariah* compliance mechanism, which is crucial and plays a pivotal role as the primary objective of the IFIs.²⁵ However, this development is still in its early stages as compared to their counterparts and they have experienced several improvements since their first appearances during the 1980s.²⁶ Over the years, *Shariah* governance has been discussed in the context of how to saddle the *Shariah* committee with duties that are capable of achieving the IFIs economic and religious objectives.²⁷ Latest developments in the industry show that *Shariah* governance has gained more attentions and more efforts have been made to

²² Munzir Kahf, 'Islamic Banks: The Rise of a New Power Alliance of Wealth and *Shariah* Scholarship' in CM Henry and R Wilson (eds), *The Politics of Islamic Finance* (Edinburgh University 2004) 17-36.

²³ Adnan M Abdeen and Dale N Shook, *The Saudi Financial System in the Context of Western and Islamic Finance* (John Wiley and Sons 1984) 167; Alharbi (n 18).

²⁴ Khan and others (n 16).

²⁵ See also Habib Ahmed, 'Shari'ah Governance Regimes for Islamic Finance: Types and Appraisal' (2011) 44 (4) *Journal of Institute of International Economics* 393.

²⁶ See also Bob Tricker, *Corporate Governance: Principles, Policies and Practices* (OUP 2009).

²⁷ Malek Marwan Yousef Injas and others, 'The Importance of *Shariah* Supervisory Boards (SSBS) in the Islamic Banking System' (2016) 9 (2) 25 *South East Asia Journal of Contemporary Business, Economics and Law* 26.

observe the complete *Shariah* compliance chain, due to the fact, non-compliant features with could injure IFIs and cause adverse effects on the industry.²⁸ In the same vein, it is believed that the lack of a standard framework is also regarded as one of the factors that exacerbate the risk exposure to the IFIs.²⁹

It is argued that the most significant and well referred standards and codes were those issued by the AAOIFI, the IFSB and the BNM.³⁰ The AAOIFI and the IFSB are carrying out the effort internationally. Both have published several standards and codes as guidelines and references for the national controlling bodies to adopt within their jurisdictions, regardless of their models. These codes have their own specialties, designed to cater for the needs of the IFIs on multiple occasions. All jurisdictions are at liberty to find out the best way to adapt the guidelines accordingly in conjunction with their own characteristics, legally or economically.³¹ In this regard, Malaysia is considered one of the most advanced markets that has implemented almost all, if not all, of the notions narrated by the guidelines. It is also worth mentioning that those guidelines and codes share the same notions with other corporate governance codes, especially those published by the OECD and the BCBS. Concerning this, Archer and others mentioned that the roles of AAOIFI, the IFSB and the BNM in the development of the *Shariah* standards, the frameworks or the guidelines for the Islamic finance industry differ in some ways: AAOIFI is concerned with the substance of *Shariah* rulings at an international level; the IFSB is concerned with systems and procedures for compliance, but not the substance, also at an international level; and the BNM and the Malaysian SAC are concerned with both substance and systems and procedures, but on a national or jurisdictional level.³²

To conclude this section, we can see that *Shariah* governance is a new expanding *Shariah* compliance mechanism embedded within the IFIs corporate governance. It is a system formulated from the Islamic teachings. Despite the fact that the early IFIs were not utilising the concept, *Shariah* governance is not

²⁸ Muhammad Akram Laldin, 'Overview of *Shariah* Governance in Malaysia and Globally' (The International *Shariah* Audit Conference & Workshop, Kuala Lumpur, May 2011).

²⁹ Edib Smolo and Abbas Mirakhor, 'The Global Financial Crisis and Its Implications for the Islamic Financial Industry' (2010) 3 (4) International Journal of Islamic and Middle Eastern Finance and Management 372, 373.

³⁰ Bank Negara Malaysia (BNM) is used throughout as a direct translation for Malaysia Central Bank.

³¹ See also M Ahmed and M Khatun, 'The Compliance with *Shariah* Governance System of AAOIFI: A study in Islamic Banks Bangladesh' (2013) 9 (3) Journal of Islamic Economics, Banking and Finance 177.

³² Simon Archer and others, 'Evolution of *Shariah* Standards and Guidelines For AAOIFI, IFSB And Bank Negara Malaysia' (Islamic Commercial Law Report 2016, ISRA & Thompson Reuters) 55.

strange to Islam as the basis that built the IFIs. Coinciding with the expansion of the market, *Shariah* governance evolves by attending to the Islamic characteristics of the IFIs. In addition to that, *Shariah* governance also looks after the areas spared by the conventional corporate governance. Owing to that, *Shariah* governance is in a similar mode to the conventional counterpart in the sense it has to be standardised and monitored by a certain kind of body, either nationally or internationally.

3.3 Standardisation of *Shariah* Governance Framework

Standardisation refers to a formulation, publication and implementation of guidelines, rules and specifications for common and repeated use, aimed at achieving an optimum degree of order and uniformity in a given context, discipline or field.³³ Standardisation has a crucial role in the global development of the IFIs as it could harmonise the divergences and peculiarities of the multiple policies of the jurisdictions, where a certain IFI operates. The existence of a recognisable and effective standard-setter is a consequential factor in order to secure the success of the IFIs in pursuing their *Shariah* compliance objective. To achieve the required expectation, the standard must be compatible and comparable with market dynamics. Most importantly, such a standardisation will help to regulate the transaction of the Islamic financial instruments which enable IFIs to enhance the possibility of cross-border transactions, strengthen global financial connections and maximise profitability.³⁴ Conversely, the lack of standardisation could cause *Shariah* risks to the IFIs where it could potentially mislead the divergent IFIs governance system in different jurisdictions. As a result, a uniform and standard framework is a vital answer.³⁵

It is worth mentioning that an ineffectual internal *Shariah* arrangement or control could lead to inadequate *Shariah* compliance tools and disastrous side effects.³⁶ In order to mitigate such a risk, IFIs are in need to create a governance structure and management process that would reassure the stakeholders of the *Shariah* compliance aspects of all transactions.³⁷ Some researchers such as Ali have

³³ <<http://www.businessdictionary.com/definition/standardization.html>> accessed 25 September 2018.

³⁴ Said Bouharaoua, 'The Concept and Practices of Standardisation' in *Islamic Finance* (Islamic Commercial Law Report 2016) 48.

³⁵ Muhamed Zulkhibri Abdul Majid and Reza Ghazal, 'Comparative Analysis of Islamic Banking Supervision and Regulation Development' (2012) 6 (3) *Money and Economy* 113.

³⁶ Karim Ginena, '*Shariah* Risk and Corporate Governance in Islamic Banks' (2014) 14 (1) *Corporate Governance* 86, 94

³⁷ Wafik Grais and Matteo Pellegrini, 'Corporate Governance in Institutions Offering Islamic Financial Services: Issues and Options' (2006 World Bank Policy Research Working Paper 4052) 12.

asserted that *Shariah* noncompliance could prompt excessive withdrawals of deposits, resulting in bank failure.³⁸ Stating a similar notion, Smolo and Mirakhor argued that many analysts believed that an appropriate and effective regulatory and supervisory framework could be one of the main factors to ease the current global financial instability.³⁹

As for the corporate governance system, the IFIs have their characteristics as compared to the conventional counterparts. As a result, the IFIs are subject to multiple regulations.⁴⁰ As financial institutions, they ought to follow standards and governance codes issued by the OECD and the BCBS.⁴¹ Simultaneously, they are deemed to adopt *Shariah* governance standards as required by the AAOIFI and the IFSB as well as the local central bank. As a matter of fact, the implementation of the *Shariah* governance codes competes with other conventional codes especially on the parts whereby the codes tend to be in convergence with each other. Therefore, the prior presumption in the commitment to follow the IFSB codes, for example, is that international standards in general, and the IFSB standards in particular, will be concurrently adopted.⁴² Diagram 1 (below) shows the multiple jurisdictional overlap on the adoption of the guidelines by the IFIs.

³⁸ Ahmad Mohamed Ali, 'The emerging Islamic financial architecture: the way ahead' (The Fifth Harvard University Forum on Islamic Finance, Centre for Middle Eastern Studies, Harvard University, Cambridge 2003) 147.

³⁹ Smolo and Mirakhor (n 29) 380.

⁴⁰ See also discussion presented by Rodney Wilson, *Legal, Regulatory and Governance Issue in Islamic Finance* (EUP 2012).

⁴¹ See also Bedj Bedj Toufik, 'The Role of *Shariah* Supervisory Board in Ensuring Good Corporate Governance Practice in Islamic Banks' (2015) 2 (2) *International Journal of Contemporary Applied Sciences* 109.

⁴² Peter Casey, 'Comparative Study on the Implementation of Selected IFSB Standards' (IFSB Paper Series 2015) 26.

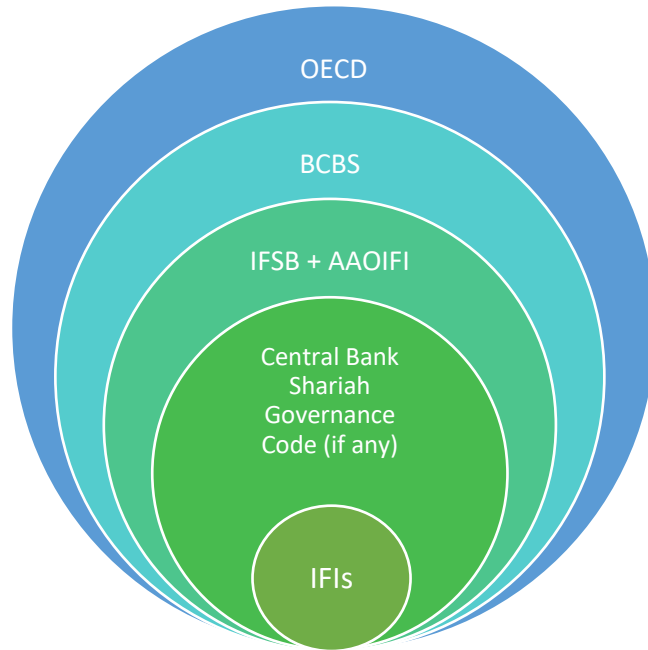


Diagram 1 : Overlapping Governance Standards to be Adopted by the IFIs

These are the purposes of each governance frameworks in multiple level as applied by the IFIs:

Level	Standards	Purpose of the Standards
International financial and governance codes	The OECD principles of corporate governance	Draw the universal codes of good governance for business institutions
	BCBS guidance on banking supervision on enhancing corporate governance for banking organisations.	Codes of corporate governance in the financial and banking institutions
International Islamic finance governance codes	IFSB guidelines on corporate governance for institutions offering Islamic financial services.	Promulgating <i>Shariah</i> governance principles which are regarded as a specific need for the IFIs due to universal principles promoted by OECD and BCBS.

	AAOIFI standards which consist of 7 governance standards in multiples aspects of financial requirements	Emphasises the existence of the unified mechanism of <i>Shariah</i> review and accounting standards in the IFIs governance system
National governance codes	Corporate governance framework	General guiding principles for financial institutions which suite the jurisdictional needs.
	<i>Shariah</i> governance framework	Guidelines for the IFIs in a national level jurisdiction.

Table 1 : Purposes of Governance Frameworks in Multiple Level

On the basis of the above discussion, this section of the chapter will discuss the codes of *Shariah* governance issued by three *Shariah* governance standard-setters which are the AAOIFI, the IFSB and the BNM.⁴³ The codes will be analysed and compared as well as correlated with the codes related to the corporate governance principles produced by the OECD and BCBS. Arguably, the OECD and the BCBS corporate governance principles are well-accepted codes, implemented all over the globe where the IFIs are doing nothing less. Furthermore, IFIs have their own corporate governance system known as the *Shariah* governance codes, which have their own characteristics of governance principles and practices. All of these diverse codes were compressed into a single system presumed to be accommodated by the IFIs. To some extent, the AAOIFI the IFSB, and the BNM guidelines work as complementary requirements for those which proposed by the OECD and the BCBS.

3.4 The Accounting and Auditing Organization for Islamic Financial Institutions *Shariah* Governance Codes

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) was created on 26 February 1990 to ensure that participants conform to the regulations in Islamic finance.⁴⁴ The AAOIFI is an Islamic international

⁴³ The *Shariah* governance framework issued by BNM is chosen in the light of the fact that the development of the legal structure of IFIs in Malaysia is considered ahead of the rest of the world, as well as its *Shariah* governance framework with its holistic approach; Muhammad Naim Omar and others, 'The Implementation of *Shariah* Governance Framework of 2010: Advantages and Constraints' (2014) 8 (13) Australian Journal of Basic and Applied Sciences 684.

⁴⁴ Ines Nur Latifah and others, 'History and Development of IFRS and AAOIFI and Their Future Challenge' (Cambridge Business & Economics Conference, Cambridge, June 2012)

autonomous non-profit corporate body that prepares accounting, auditing governance, ethics and *Shariah* standards for Islamic financial institutions.⁴⁵ Since the AAOIFI was established for the purpose to satisfy the peculiar needs of the IFIs, the standards issued by the AAOIFI serve as guidelines that reflect the unique characteristics of the IFIs and as a practical tool to ease such needs.⁴⁶ In terms of the *Shariah* governance, since its inauguration, AAOIFI has issued 7 Governance Standards for IFIs (Governance Standards): *Shariah* Supervision Body, Appointment, Composition and Report (1997); *Shariah* Review (1998); Internal *Shariah* Review (1999); Auditing and Governance Committee for Islamic Financial Institutions (2002); Independence of *Shariah* Supervisory Board (2005); Statement on Governance Principles for Islamic Financial Institution (2005), and; Corporate Social Responsibility Conduct and Disclosure for Islamic Financial Institutions (2009).⁴⁷ The AAOIFI Governance Standards approach is concerned more with the individual aspects of the IFIs, in terms of the *Shariah* compliance mechanism. As international and general standards, the AAOIFI *Shariah* governance standards are compatible to be accommodated by various jurisdictions. At the same time, it is also comparable to other widely accepted international governance standards, such as that of the OECD and the BCBS. It is said that the AAOIFI has been actively seeking for an alternative to reconcile international accounting standards with the specific Islamic accounting standards and provides useful guidance on the *Shariah* standards.⁴⁸

3.4.1 *Shariah* Supervision Body, Appointment, Composition and Report Standards (GSIFI No.1)

The objective of the GSIFI No.1 is to establish standards and provide guidance on the features regarding to the *Shariah* Supervisory Board (SSB).⁴⁹ It envisages the definition of the SSB, the appointment procedures of its members, the member composition and the format on reporting the compliance of the IFI's products and services in all of its dealings and transactions. The SSB is defined by the present standards as an independent body of specialised jurists in *fiqh al-Muamalat* or *Shariah* financial law. Interestingly, the standards also include those who are experts in the field of Islamic financial institutions with the knowledge of

⁴⁵ E Oz, 'Regulatory and Supervisory Framework in Islamic Financial Services Industry (IFSI) from the Perspective of Risk Management' (3rd Meeting of the COMCEC Financial Cooperation Working Group October 2014).

⁴⁶ Adel Mohammed Sarea and Mustafa Mohd Hanefah, 'The Need of Accounting Standards for Islamic Financial Institutions' (2013) 9 (2) International Management Review 50, 50

⁴⁷ See also Umar A Oseni and others, 'Corporate Governance and Effective Dispute Management in Islamic Financial Institutions' (2012) 6 (11) Australian Journal of Basic and Applied Sciences 361.

⁴⁸ Nasser Saidi, 'Corporate Governance in Islamic Finance' (Chapter 33 of Islamic Wealth) 433, 433.

⁴⁹ *Shariah* Supervisory Board is known as *Shariah* Committee by this research.

fiqh al-Muamalat.⁵⁰ This inclusive understanding has widened the choice of experts who are eligible to be considered as members of the SSB to a bigger, if not all, range of talents. The GSIFI No.1 also mentions the entrusted duties of the SSB which include directing, reviewing and supervising the operations of the IFIs in ensuring that those business activities are in compliance with the *Shariah* principles.⁵¹ Most importantly, the GSIFI No.1 underscores that *fatwas* and the rulings of the SSB are binding on that particular IFI.

3.4.2 *Shariah* Review (GSIFI No.2)

The GSIFI No.2 provides a detailed process for the SSBs to perform the *Shariah* review in order to ensure compliance to the *fatwas* issued by them. According to the GSIFI No.2, the *Shariah* review is an examination of the IFIs' compliance in all of their business activities with the *Shariah* law.⁵² It includes contracts, agreements, policies, products, transactions, memoranda and articles of association, financial statements, reports and circulars.⁵³ The reason is to ensure *Shariah* requirements such as certified *fatwas* are followed by their representative IFIs. The uniqueness of the GSIFI No.2 is it specifies the management as the governance constituent that is responsible to carry out the task to comply with *Shariah*. Each SSB is required to assist the management to work effectively by giving advice and to review the execution by expressing their opinion. It is argued that an effective *Shariah* review process will be able to assist the *Shariah* committee in forming their opinion with the appropriate evidence either of the *Shariah*-compliant or non-compliant aspects.⁵⁴ In this regard, two-way communication is vital for both constituents, whereby the SSB should provide guidance to the relevant managerial parties and the management is to provide sufficient information concerning the *Shariah* matters to the SSB.

3.4.3 Internal *Shariah* Review (GSIFI No.3)

The internal *Shariah* review includes the details of the requirements of the independent internal *Shariah* review department or any appropriate arrangement to be established within the IFIs as a complement mechanism to assist the SSB. It is essential for the IFIs to have such a governance organ, to examine and

⁵⁰ AAOIFI, Governance Standards no. 1: *Shariah* Supervision Body, Appointment, Composition and Report Standards in AAOIFI (eds) *Shariah Standards* (Dar Almaiman for Publishing and Distributing, Manama 2015).

⁵¹ *ibid*

⁵² AAOIFI, Governance Standards no. 2: *Shariah* Review in AAOIFI (eds) *Shariah Standards* (Dar Almaiman for Publishing and Distributing, Manama 2015).

⁵³ *ibid*

⁵⁴ Mohd Hairul Azrin Besar and others, 'The Practice of *Shariah* Review as Undertaken by Islamic Banking Sector in Malaysia' (2009) 5 (1) *International Review of Business Research Papers* 294, 303.

evaluate the extent of compliance with the *fatwas* issued by the SSB.⁵⁵ This internal organ is meant to ensure that the management has discharged their duty in relation to the implementation of the *Shariah* rulings as determined by the SSB. The GSIFI No.3 emphasises the features of the internal *Shariah* reviewers as to be independence and objectivity.⁵⁶ To ensure that, the Guiding Principles-3 recommend that the organisational status of the internal *Shariah* review should not be lower than the internal audit department and the representative personnel must have an independent attitude.⁵⁷

3.4.4 Audit and Governance Committee for Islamic Financial Institutions (GSIFI No.4)

The purpose of the GSIFI No.4 is to define the role and responsibilities of an Audit and Governance Committee (AGC) for the IFIs. It also highlights the prerequisites for an effective AGC arrangement. The AGC is essential for the IFIs as its role is to achieve the fundamental objectives of the IFIs by enhancing greater transparency and disclosure in financial reporting and enhance public confidence towards the IFIs by legitimising the authenticity of its compliance with the *Shariah* principles.⁵⁸ The regarding notions are obtained by assisting the board of directors to carry out an independent and objective monitoring system by preserving the integrity of the financial report; safeguarding the interest of shareholders, investors and other stakeholders; providing a higher reliabilities of financial information presented to the board; and acting as independent link between the management and IFIs' stakeholders.

3.4.5 The Independence of the *Shariah* Supervisory Board (GSIFI No.5)

Independence is key to customers' confidence in that it is one of the credential elements. In terms of *Shariah* compliance matters, such a confidence is deemed to be earned by the IFIs through a sound *Shariah* governance arrangement.⁵⁹ To this point, the GSIFI No.5 is a guidance for the SSB of the IFIs regarding its independence on how to monitor such independence along with the rectification actions to resolve any issues relating to independence. It is rather intriguing to realise that the present standards provide a clear understanding of independence

⁵⁵ AAOIFI, Governance Standards no. 3: Internal *Shariah* Review in AAOIFI (eds) *Shariah Standards* (Dar Almaiman for Publishing and Distributing, Manama 2015).

⁵⁶ The similar concept applied to the internal audit practices. See also Besar and others (n 54) 302.

⁵⁷ AAOIFI, Governance Standards no. 3 (n 55).

⁵⁸ AAOIFI, Governance Standards no. 4: Audit and Governance Committee for Islamic Financial Institutions in AAOIFI (eds) *Shariah Standards* (Dar Almaiman for Publishing and Distributing, Manama 2015).

⁵⁹ See also Hussain G Rammal, 'The Importance of *Shariah* Supervision in Islamic Financial Institutions' (2006) 3 (3) Corporate Ownership and Control 204.

for the SSB members to perceive. It is an attitude of mind which does not allow the viewpoints and conclusions of its possessor to become reliant on or subordinate to influence or pressures of the conflicting interests. To achieve that is through an organisational status and in an objective way.⁶⁰

Additionally, the GSIFI No.5 also envisages that the SSB members ought to be objective. Such an open-ended conception is also quantified by the standards where it is defined as an independent mental attitude which SSB members should maintain while performing a *Shariah* supervision. The SSB members are not to subordinate their judgment on the *Shariah* supervision matters to that of others.⁶¹ In order to maintain the demanded attitude, the SSB members should continuously assess their relationships with their IFIs to identify any situations that may impair independence and resolve it or report to the SSB such situations in which an issue of independence impairment is present or may reasonably be inferred, and how to resolve it. Any independence impairments such as financial involvement of affairs with clients and personal or family relationships should be documented and reviewed internally with the SSB.⁶²

3.4.6 Statement on Governance Principles for Islamic Financial Institutions for Islamic Financial Institutions (GSIFI No.6)

The GSIFI No.6, issued in 2009, is considered as the latest version of the AAOIFI governance standards in terms of the conceptualisation of the *Shariah* governance for the IFIs' implementation. The statements of the present standards as the successor are rather comprehensive compared to the prior standards. The purpose of the GSIFI No.6, amongst others is to lay down the key principles and concepts relevant to the IFIs' governance system.⁶³ It is also to establish the foundation upon which the development of future governance or compliance standards will take place. In order to do so, the present standards seek to ensure that those charged with governance and those employed by an IFI, as well as those associated with an IFI in any important functional capacity shall perform their respective roles effectively and in a manner that is consistent with *Shariah*. As with its predecessors, among the characteristics of the GSIFI No. 6 are enhancing the confidence of the industry towards the IFIs and to ensure *Shariah*

⁶⁰ AAOIFI, Governance Standards no. 5: Independence of *Shariah* Supervisory Board in AAOIFI (eds) *AAOIFI Shariah Standards* (Dar Almaiman for Publishing and Distributing, Manama 2015).

⁶¹ *ibid*

⁶² *ibid*

⁶³ AAOIFI, Governance Standards no 6: Statement on Governance Principles for Islamic Financial Institutions for Islamic Financial Institutions in AAOIFI (eds) *Shariah Standards* (Dar Almaiman for Publishing and Distributing, Manama 2015)

compliance.⁶⁴ To obtain such notions, the Guiding Standard-6 somehow has been the first standards enlisted with the principles of the *Shariah* governance.

Principles	Annotations
Principle 1: Effective <i>Shariah</i> compliance structures	An IFI should establish an effective structure for ensuring the <i>Shariah</i> compliance. Such a structure should cover effectiveness of the role played by BOD, SSB, management, and auditors in so far as they relate to <i>Shariah</i> compliance.
Principle 2: Fair treatment of equity holders	An IFI should provide the equity holders with voting rights, adequate opportunity to have a dialogue with the institution, ability to select members of the governing BOD and SSB and also ensure fair disclosure of financial and banking practices adopted to allow them to make appropriate decisions regarding their investment in the IFI.
Principle 3: Equitable treatment of fund providers and other significant stakeholders	An IFI should ensure equitable and unbiased treatment of fund providers and other significant stakeholders and associated investments as well as in relation to the provision of adequate financial and non-financial information to allow them to take appropriate decisions regarding their dealing with the institution.
Principle 4: Fit and proper conditions for board and management	An IFI should lay down a set of criteria to govern the appointment of persons to serve on the BOD and SSB as well as for appointment of management.
Principle 5: Effective oversight	The BOD should play an effective role in leadership, direction and monitoring the implementation of its policies as well as in promoting a sound control of the <i>Shariah</i> -compliant culture within the IFI.
Principle 6: Audit and governance committee	An IFI should have an audit and governance committee whose role and responsibilities are set in appropriate terms of reference which should include, among other matters, the process for financial reporting, internal controls, internal audit oversight, external audit oversight and <i>Shariah</i> compliance.
Principle 7: Risk management	The BOD of an IFI should be actively involved in setting the risk appetite and should make sure that there are appropriate policies and systems for identification, measurement, analysis, reporting and mitigation of risks.

⁶⁴ *ibid*

<p>Principle 8: Avoidance of conflicts of interest</p>	<p>An IFI should set appropriate governance structures to ensure that members of BOD, members of SSBs, management and staff as well as external parties, such as external auditors, rating agencies, and other parties with substantial dealings with it avoid conflicts of interest.</p>
<p>Principle 9: Appropriate compensation policy oversight</p>	<p>An IFI should set appropriate governance structures in relation to remuneration policies for the BOD, SSB and management. Compensation policies should be developed on an independent and transparent basis.</p>
<p>Principle 10: Public disclosures</p>	<p>An IFI should adopt high standards of reporting and satisfy the information needs of owners, investment accountholders, other counterparties, regulatory, Zakah and other related agencies. The IFI should maintain high standards of transparency and market discipline to build trust with shareholders and other stakeholders. Accurate, adequate, timely and fair reporting of financial and non-financial performance measures should be ensured.</p>
<p>Principles 11: Code of conduct and ethics</p>	<p>An IFI should adopt policies, procedures consistent with <i>Shariah</i> to promote a code of ethical and responsible behaviour by members of BOD, members of SSB, management and employees.</p>
<p>Principles 12: Appropriate enforcement of governance principles and standards</p>	<p>An IFI should have a mechanism to ensure that the principles and standards on governance are adhered to and monitored.</p>

Table 2 : The GSIFI No.6 *Shariah* Governance Principles Annotations

3.4.7 Corporate Social Responsibility Conduct and Disclosure for Islamic Financial Institutions (GSIFI No. 7)

The corporate social responsibilities (CSR) of the IFIs refers to the activities carried out by the IFIs to fulfil their religious, legal, economic, ethical and discretionary responsibilities as financial intermediaries.⁶⁵ Essentially, the CSR that are implemented by the IFIs do not implement completely similar approaches as compared with their conventional counterpart. The GSIFI No.7 disclosed the peculiar characteristics of the IFIs' CSR implementation onto achieving such responsibilities. The intriguing part of the present standards is that it has broken

⁶⁵ AAOIFI, Governance Standards no. 7: Corporate Social Responsibility Conduct and Disclosure for Islamic Financial Institutions in AAOIFI (eds) *Shariah Standards* (Dar Almaman for Publishing and Distributing, Manama 2015)

down those responsibilities into mandatory and recommended. In terms of the religious perspective, as the *Shariah* compliance is the highest concern of the IFIs, the adherence with *Shariah* principles ought to be a mandatory.⁶⁶ The IFIs are even responsible to ensure that their potential client's business criteria comply with the notion underscored by the *Shariah* principles. To do so, the IFIs should arrange a proper and sound screening mechanism executed by the SSB on such a matter.⁶⁷ In the same vein, any prohibited earning and expenditure through their operations are also the subject mentioned by the GSIFI No.7. Appropriate measures and the organs in-charge should be clearly stated by the IFIs to carry out those responsibilities.

3.4.8 Viewpoints on the AAOIFI Standards

The primary purpose of the standards published by the AAOIFI is to support the development of sound and prudent governance practices within the IFIs. To do so, the approach of the AAOIFI standards is stand on a 'comply or explain' basis. This notion is perceived by the IFIs as an obligation, whereby if they do not comply, they have to come up with sensible and reasonable explanations.⁶⁸ Such an approach, it is believed could provide flexibility in terms of the implementation and mechanism to assess the compliance aspects.⁶⁹ Owing to the multiverse jurisdiction complexities, the AAOIFI employ a vigilant notion as promoted by the OECD. The OECD principles as soft law are non-binding and do not aim at detailed prescriptions for national legislation.⁷⁰ This 'comply or explain' is embedded in the implementation process of the standards in order to ensure that the provisions recommended by the standard-setters are workable and flexible for any kind of regulatory requisites. This implementation method is also the key to arouse the concern of the IFIs regardless of their jurisdiction regarding the best way to deploy the recommended provisions. A process that will provide the AAOIFI with reliable responses and suggestions that are to be made use in the future.

The AAOIFI *Shariah* governance standards do not favour any single corporate governance theories either. However, the likelihood is that the standards put more emphasis on the stakeholders as the relationship between the IFIs and their stakeholders is rather diversified as compared to the conventional counterparts.

⁶⁶ See also Nasser M Suleiman, 'Corporate Governance in Islamic Banks' (2000) Arab Gateway 98.

⁶⁷ AAOIFI, Governance Standards no. 7 (n 65).

⁶⁸ See also Andrew Keay, 'Comply or Explain in Corporate Governance Codes: in Need of Greater Regulatory Oversight?' (2014) 34 (2) Legal Studies 279, 287

⁶⁹ See also David Seidl and others, Applying 'Comply or Explain': Conformance with Codes of Corporate Governance in the UK and Germany (Centre for Business Research, University of Cambridge Working Paper no. 389)

⁷⁰ OECD, (G20/OECD Principles of Corporate Governance 2015) 11.

Since the IFIs utilise the *mudarabah* instrument on their contractual agreement with the shareholders as well as to some customers, such as in the case of the IAHs, the stakeholders of the IFIs are the only ones with something at stake, but some of the customers somehow share the same risk akin to the shareholders. In this regard, the IFIs' governance model, to some extent, is a stakeholder-oriented model as mentioned by Iqbal and Mirakhor.⁷¹

In terms of the *Shariah* governance structural models, none of the AAOIFI standards mentioned any specific model that is considered the best and most favourable. Additionally, all standards have recognised the peculiarities of each jurisdiction by recommending universal guiding principles, not only to fulfil the IFIs' requirements, but also those promulgated by other standard-setters, either internationally or nationally. Most importantly, the IFIs must strive their effort to follow the recommendations consequently based on their legal stipulations, institutional arrangement, market flexibility and their capability to absorb the modifications.⁷² Essentially, the guiding standards have no intention of imposing a single model to fit all the needs of the multiple jurisdictions, as far as they put their commitment towards the betterment of the *Shariah* compliance governance mechanism.

One of the main concerns of the AAOIFI standards, especially the GSIFI No. 6, is equal treatment for the equity-holders or the shareholders. As emphasised by the BCBS best practice of corporate governance, each shareholder is to be treated equally regardless of the size of their shares.⁷³ The primary reference of the both, BCBS and the AAOIFI seem to be in agreement when dealing with multiple sizes of shareowners. However, for the IAHs of the IFIs, this notion is imperative and rather more significant, as they hold the rights akin to the shareholders to obtain timely financial or non-financial information concerning the IFIs business progress to allow them to make sensible decisions. A unique governance challenge has eventually emerged due to the specific nature of the IFIs including the recognition of the IAHs as one of the shareholder alike stakeholders.⁷⁴

⁷¹ Zamir Iqbal and Abbas Mirakhor, 'Stakeholders Model of Governance in Islamic Economics System' (2004) 11(2) *Islamic Economics Studies* 43.

⁷² See also Ahmed and Khatun (n 31).

⁷³ BCBS, (Guidelines Corporate Governance Principles for Banks 2015)

⁷⁴ Alejandro Lopez Mejia and others, Regulation and Supervision of Islamic Banks (IMF Working Paper WP/14/219 2014) 14.

3.5 The Islamic Financial Services Board *Shariah* Governance Codes

Another prominent standard-setter for Islamic finance is the Islamic Financial Services Board (IFSB), based in Kuala Lumpur. The IFSB was officially inaugurated on 3rd November 2002 and started operations on 10th March 2003. Since then, the IFSB has issued several guiding principles and standards for the Islamic financial industry to ensure its soundness and stability.⁷⁵ The IFSB serves as an international standard-setter of regulatory and supervisory agencies with interest in ascertaining the soundness and stability of the Islamic financial services industry, which is defined broadly to include banking, capital market and insurance. In advancing this mission, the IFSB promotes the development of a prudent and transparent Islamic financial services industry through introducing new, or adapting existing international standards consistent with the *Shariah* principles, and recommends them for adoption.⁷⁶ It plays a remarkable role in developing prudential standards and guiding principles unique to the Islamic financial industry.⁷⁷ To this end, the work of the IFSB complements that of the AAOIFI as the international standard-setting body for the IFIs, as well as the OECD and the BCBS as the international corporate governance best practices advocates.

3.5.1 The Guiding Principles on Corporate Governance for Institutions Offering Only Islamic Financial Services (IFSB-3)

The Guiding Principles of Corporate Governance for Institutions Offering Only Islamic Financial Services (IFSB-3), published in 2006, is the first document pertaining to *Shariah* governance guiding principles issued by the IFSB. It is the third set of guiding principles produced by the respective body, which comes after Guiding Principles of Risk Management for Institutions (other than Insurance Institutions) Offering Only Islamic Financial Services (IFSB-1) and Capital Adequacy Standard for Institutions (other than Insurance Institutions) Offering Only Islamic Financial Services (IFSB-2). This document excluded the Islamic Insurance (Takaful) institutions and the Islamic mutual funds from its scope as those forms of institutions will be mentioned in other documents.

The IFSB-3 Guiding Principles was designed to achieve the objective of facilitating the IFIs in establishing and implementing effective corporate governance practices.⁷⁸ It is said that a sound and prudent governance

⁷⁵ Alharbi (n 18).

⁷⁶ <http://www.ifsb.org/background.php>

⁷⁷ UK IFC and ISRA (External *Shariah* Audit Report 2016) 14.

⁷⁸ IFSB, (Guiding Principles on Corporate Governance for Institutions Offering Only Islamic Financial Services 2006) 15.

formulated from *Shariah* and ethical perspective is rather crucial for the proper functions of the IFIs.⁷⁹ Most importantly, the IFSB-3 aims to complement the corporate governance principles issued by the OECD, the BCBS and other international standard-setting bodies.

Each consecutive part of the IFSB-3 are summarised as below;⁸⁰

Parts	Principles Annotation
<p>Part 1: General Governance Approach of IFI</p>	<p>Principle 1.1: IFI shall establish a comprehensive governance policy framework which sets out the strategic roles and functions of each organ of governance and mechanisms for balancing the IFI's accountabilities to various stakeholders.</p> <p>Principle 1.2: IFI shall ensure that the reporting of their financial and non-financial information meets the requirements of internationally recognized accounting standards which are compliance with <i>Shariah</i> rules and principles and are applicable to the Islamic financial services industry as recognized by the supervisory authorities of the country.</p>
<p>Part 2: Rights of Investment Account Holders (IAHs)</p>	<p>Principle 2.1: IFI shall acknowledge IAHs' right to monitor the performance of their investments and the associated risks, and put into place adequate means to ensure that these rights are observed and exercised.</p> <p>Principle 2.2: IFI shall adopt a sound investment strategy which is appropriately aligned to the risk and return expectations of IAH (bearing in mind the distinction between restricted and unrestricted IAH), and be transparent in smoothing any returns.</p>
<p>Part 3: Compliance with <i>Shariah</i> Rules and Principles</p>	<p>Principle 3.1: IFI shall have in place an appropriate mechanism for obtaining rulings from <i>Shariah</i> scholars, applying fatāwā and monitoring <i>Shariah</i> compliance in all aspects of their products, operations and activities.</p> <p>Principle 3.2: IFI shall comply with the <i>Shariah</i> rules and principles as expressed in the rulings of the IFI's</p>

⁷⁹ Issa Almansour, 'Corporate Governance in Global Islamic Financial Institutions' (2015) 3 (11) International Journal of Education and Research 125, 128.

⁸⁰ IFSB, IFSB-3 (n 78).

	<i>Shariah</i> scholars. The IFI shall make these rulings available to the public.
Part 4: Transparency of Financial Reporting in Respect of Investment Accounts	Principle 4: IFI shall make adequate and timely disclosure to IAH and the public of material and relevant information on the investment accounts that they manage.

Table 3 : The IFSB-3 Principles Annotations

3.5.2 Viewpoints on the IFSB-3

The IFSB-3 comes with two approaches. It emphasises the structure and process of the related governance organs and then followed by the recommendation of best practices.⁸¹ Each approach is designed to achieve the primary objective of establishing a *Shariah*-compliance supervision mechanism in the IFIs corporate governance systems. In this respect, the IFSB-3 recognises the magnitude of such a notion as to ensure and enhance the confidence of the customers of the IFIs.

There are four significant features that could be credited as the characteristics of the IFSB-3 as the first *Shariah* governance codes, disclosed and disseminated by the IFSB. First, the IFSB-3 introduces the viewpoint embraced by the IFIs towards other related corporate governance codes, especially those which published by the OECD and the BCBS. The IFSB stand is monotone with that of the OECD and the BCBS as well as other Islamic finance standard-setters like the AAOIFI. It is worth mentioning that any ideas proposed for the betterment of the operation of the IFIs as business institutions are acceptable in the event that they do not contravene with any *Shariah* principles. Therefore, it is the obligation of the IFIs to confirm such intent to be embedded within their governance system. However, any peculiarities which exist are recognisable by all codes, as one size does not fit all and there is no single model that could satisfy all the necessities. This approach is believed to be more adaptable regardless of their jurisdictions or market flexibilities or the size of the firm and its annual growth.⁸²

⁸¹ *ibid*

⁸² Sridhar R Ascot and Valentina G Bruno, 'One Size Does Fit All, After All: Evidence From Corporate Governance' (15 January 2007) <http://siteresources.worldbank.org/INTFR/Resources/Valentina_Bruno_Feb_8.pdf> accessed 22 February 2017 16.

Second, as one of the foundations of a set-up of a more sophisticated *Shariah* governance system, the IFSB-3 mentions the processes for obtaining rulings from *Shariah* scholars, applying *fatwas* and monitoring *Shariah* compliance.⁸³ The processes include both the *ex-ante* and the *ex-post* aspects of all financial transactions carried out by the IFIs that is, to ensure the *Shariah* compliance of the contracts and, later, the performance of obligations under the contracts; and the operations of the IFIs, including aspects such as the *Shariah* compliance review, investment policies, disposal of *Shariah* non-compliant income and charitable activities. At this point, a prudent internal *Shariah* compliance reviewer should act as a catalyst for the *Shariah* committee to carry out their duty more effectively.⁸⁴ Both members of the *Shariah* committee and internal assisting constituents ought to acquire 'fit and proper' criteria to carry out their task.⁸⁵ It is considered the factor that will strengthen public confidence in the *Shariah* compliance process of the IFIs.

Third, as the introduction of an additional layer of governance of the IFIs, the IFSB-3 comes with solutions to rectify possible redundancies. As we know, *Shariah* governance is somehow new and has only emerged recently compared to its counterpart. As a result, many elements and roles of this additional feature may duplicate or overlap with the existing governance system. Therefore, the IFSB-3 recommends the IFIs establish the Governance Committee to oversee such an issue. The Governance Committee comprises three personnel, a member of the audit committee, a *Shariah* scholar and a non-executive director. This committee is meant to coordinate and integrate the implementation of the IFSB-3 policy framework and provide the board of directors with reports and recommendations based on their findings in the exercise of their functions.⁸⁶ It is to be noted that the Governance Committee works for the interest of the stakeholders, not for the shareholders alone.⁸⁷ On the other hand, the audit committee places their attention on the shareholders, as it ought to be.

Fourth, the IFSB-3 emphasises the relationship between the IFIs and the Investment Account Holders (IAHs). IAHs are more akin to shareholders than stakeholders. The *mudarabah* financial instrument utilised in regard of the IAHs' investment account contract means they bear the risk of losing the invested capital, in a similar way as the shareholders. Despite the fact they do not invest the capital to own the shares, the contract has elevated their position that as the owners of the respective IFIs to a certain point and they bear the risk of poor

⁸³ IFSB, IFSB-3 (n 78) 11.

⁸⁴ Ginena (n 36) 93.

⁸⁵ MA Laldin (n 28).

⁸⁶ IFSB, IFSB-3 (n 78) 3.

⁸⁷ Iqbal and Mirakhor (n 71).

performance of the investment pool, and are not excluded from misconduct on the part of the financial institutions.⁸⁸ This arrangement is one of the peculiarities of the IFIs that need a thorough engagement in terms of their governance mechanism. The list of the stakeholders of the IFIs are not fully congruous with the conventional financial institutions. Other than that, more prudent investment strategies are applicable to the management of the IFIs to appropriately align the risk and the return, as expected by the IAHs.⁸⁹ The degree of transparency somehow outweighs the typical governance arrangement as the IAHs also hold the right to access information with a high degree of transparency regarding their investment necessities.⁹⁰ However, to some extent, it is rather impractical to provide the IAHs with all documents and information that go to the shareholder.⁹¹

3.5.3 Guiding Principles on *Shariah* Governance Systems for Institutions Offering Islamic Financial Services (IFSB-10)

The Guiding Principles on *Shariah* Governance Systems for Institutions offering Islamic Financial Services (IFSB-10) is expected amongst others to highlight in more detail the supervisory authorities and the components of a sound *Shariah* governance system, with regard to competence, independence, confidentiality and consistency of *Shariah* committees.⁹² The IFSB-10 sees the *Shariah* governance as referring to structures and processes to oversee the *Shariah* compliance matters. It also defines what *Shariah* governance truly is. According to the IFSB-10, *Shariah* governance is a set of institutional and organisational arrangements through which an IFI ensures that there is effective oversight of *Shariah* compliance over certain structures and processes.⁹³

In terms of the *Shariah* governance structures, IFSB-10 envisages the importance of the Internal *Shariah* Compliance Unit (ISCU) in assisting the *Shariah* committee in carrying out the day-to-day operation of the IFIs. The *Shariah* committee is also to be assisted by the Internal *Shariah* Audit or Review Unit (ISRU) in order to verify that the *Shariah* compliance has been satisfied within the IFIs' operations. Any incident of non-compliance will be recorded and reported and, if possible, addressed and rectified by the ISRU as a similar governance component as the internal audit committee. It is the first appearance of such an organisational arrangement by a *Shariah* governance code despite

⁸⁸ Grais and Pellegrini (n 37)

⁸⁹ See also Terry McNulty and others, 'Board of Directors and Financial Risk During the Credit Crisis' (2013) 21 (1) *Corporate Governance: An International Review* 58.

⁹⁰ Ginena (n 36) 94.

⁹¹ Mejia and others (n 74).

⁹² UK IFC and ISRA (External *Shariah* Audit Report 2016) 15.

⁹³ IFSB (Guiding Principles on *Shariah* Governance Systems for Institutions offering Islamic Financial Services 2009) 2.

the similar notion already being well-embedded in prior codes, such as the IFSB-3.

As for the *Shariah* governance processes, the IFSB-10 gives an emphasis on the procedure to issue a *Shariah* pronouncement or a *fatwa* and the dissemination process of relevant *Shariah*-related documents to the operative personnel of the IFIs. Such a task would be executed by the ISCU. Because of the characteristics of the processes, the task must be undertaken by a designated department or well-equipped officers with a certain set of skills, with relevant and specialised *Shariah* knowledge as well as monitoring techniques.⁹⁴ In relation to the *Shariah* pronouncement, the IFSB-10 interpreted the connotation of the *Shariah* scholars, who are the members of the *Shariah* committees. The word ‘scholars’ has been preferred by the IFSB-10 as a translation for *alim*, which refers to a person who is learned and expert with a specialised level of *Shariah* financial law or *fiqh muamalat*, rather than the general knowledge of *Shariah* or other areas of Islamic studies.⁹⁵ A ‘fit and proper’ criterion has been imposed on the members of the *Shariah* committee as an assurance of competency, whilst they carry out their duties.⁹⁶ It is the duty of the management, especially the board of directors, to cultivate *Shariah*-compliant culture within the IFIs operations and organisational behaviours.⁹⁷

Each consecutive part of the IFSB-10 are summarised as follows;⁹⁸

Part I	relates to the general approach to a <i>Shariah</i> governance system, whereby various ex-ante and ex-post processes considered as essential parts of good governance practices in other internationally recognised governance standards, such as the precise terms of reference for <i>Shariah</i> boards, appropriate alignment of incentives, proper record-keeping, adoption of a professional code of ethics, etc., are adapted in order to strengthen the <i>Shariah</i> governance system.
Part II	in the area of competence, suggests various measures to ensure reasonable expertise and skill-sets in <i>Shariah</i> boards, and to evaluate their performance and professional development.

⁹⁴ Yusuf Talal Delorenzo, ‘*Shari’ah* Compliance Risk’ (2007) 7 (2) Chicago Journal of International Law 397, 400.

⁹⁵ IFSB (n 93) 4.

⁹⁶ See also Laldin (n 28).

⁹⁷ Ginena (n 36) 98.

⁹⁸ IFSB, (Guiding Principles on *Shariah* Governance Systems for Institutions offering Islamic Financial Services 2009) 5.

Part III	aims at safeguarding the independence of <i>Shariah</i> boards, particularly from the management of IFI, by highlighting various issues arising from potential conflicts of interest and recommending how they should be managed.
Part IV	emphasises the importance of observing and preserving confidentiality by the organs of <i>Shariah</i> governance.
Part V	focuses on improving consistency in terms of the professionalism of members of the <i>Shariah</i> board, which would be crucial in enhancing their credibility and confirming their integrity through a set of best practices.

Table 4 : The IFSB-10 Executive Summary

Parts	Principle Annotations
Part I: General Approach to the <i>Shariah</i> Governance System	<p>Principle 1.1: The <i>Shariah</i> governance structure adopted by the IFI should be commensurate and proportionate with the size, complexity and nature of its business .</p> <p>Principle 1.2: Each IFI must ensure that the <i>Shariah</i> board has : clear terms of reference regarding its mandate and responsibility ; well-defined operating procedures and lines of reporting; and good understanding of, and familiarity with, professional ethics and conduct .</p>
Part II: Competence	<p>Principle 2.1: The IFI shall ensure that any person mandated with overseeing the <i>Shariah</i> Governance System fulfils acceptable fit and proper criteria .</p> <p>Principle 2.2: The IFI shall facilitate continuous professional development of persons serving on its <i>Shariah</i> board, as well as its ISCU and ISRU,</p> <p>Principle 2.3: There should be a formal assessment of the effectiveness of the <i>Shariah</i> board as a whole and of the contribution by each member to the effectiveness of the <i>Shariah</i> board.</p>

<p>Part III: Independence</p>	<p>Principle 3.1: The <i>Shariah</i> board should play a strong and independent oversight role ,with adequate capability to exercise objective judgement on <i>Shariah</i>-related matters. No individual or group of individuals shall be allowed to dominate the <i>Shariah</i> board’s decision-making .</p> <p>Principle 3.2: In order to fulfil their responsibilities, the <i>Shariah</i> board should be provided with complete, adequate and timely information prior to all meetings and on an ongoing basis .</p>
<p>Part IV: Confidentiality</p>	<p>Principle 4.1: <i>Shariah</i> board members should ensure that internal information obtained in the course of their duties is kept confidential .</p>
<p>Part V: Consistency</p>	<p>Principle 5.1: The IFI should fully understand the legal and regulatory framework for issuance of <i>Shariah</i> pronouncements/resolutions in the jurisdiction where it operates. It should ensure that its <i>Shariah</i> board strictly observes the said framework and, wherever possible, promotes convergence of the <i>Shariah</i> governance standards.</p>

Table 5 : The IFSB-10 Guiding Principles Annotations

3.5.4 Viewpoints on the IFSB-10

As a universal code of the *Shariah* governance, adaptable to all sorts of the *Shariah* governance models, the IFSB-10 has provided many prominent features that need to be addressed vigilantly. First, as its most prominent features, it describes an explicit definition of the *Shariah* governance. It refers to the set of institutional and organisational arrangements through which the IFIs ensure that there is effective independent oversight of *Shariah* compliance.⁹⁹ As mentioned in the previous chapter, to this point, the *Shariah* governance could be an attribute of the job of setting the direction.¹⁰⁰ This definition also implies that the institution of the *Shariah* committee is crucial to the *Shariah* governance system as an

⁹⁹ IFSB, IFSB-10 (n 98) 2.

¹⁰⁰ Donald Nordberg, *Corporate Governance; Principles and Issues* (SAGE Publication 2011) 7.

authoritative body ensuring *Shariah* compliance.¹⁰¹ Most importantly, the definition given by the IFSB is a cutting-edge effort in understanding what the *Shariah* governance is really about.

Second, the IFSB-10 promotes the approach of 'no single model' or 'one size fits all' which somehow matches not only with the IFSB-3 but also to that of the OECD and the BCBS codes. This approach is rather vital for the *Shariah* governance codes, so it is implementable, regardless of the jurisdictional characteristics. According to Part I, the guiding principles of IFSB-10, the codes are adaptable to any sort of *Shariah* governance models.¹⁰² Sole argued that the introduction of the IFIs in the conventional legal system has aggravated the supervisory authorities.¹⁰³ Therefore, it is imperative to the regulators of the related markets to choose an appropriate *Shariah* governance structure so that it could safeguard the fulfilment of fiduciary duties including good faith, care, skill and diligence towards the stakeholders.¹⁰⁴

Third, the IFSB-10 explicitly lists the primary functions of the *Shariah* governance components in ensuring *Shariah* compliance which have no contravention with other governance standards. It enhances and strengthens the functions of the *Shariah* committee and the relating constituents to ensure *Shariah* compliance.¹⁰⁵ Those functions divided into the *ex-ante* and the *ex-post* processes. The *ex-ante* process refers to the consideration that should take place during the development of the products before it can be offered to the customers.¹⁰⁶ At this point, the role of the members of the *Shariah* committee is extremely critical because such a stage includes the issuance of *Shariah* pronouncements or *fatwas* and the compliance checks. If this *Shariah* certification process is well-managed, by anticipating potential impacts of the products or services to the customers, possible rejection from the targeted market could be prevented.¹⁰⁷ Regarding this, reputable and credible *Shariah* committee members, the support system by the internal *Shariah* department and the officer and sufficient number of members of the *Shariah* committee are considered the primary concern of the IFSB-10. Meanwhile, the *ex-post* process refers to the consideration that should be given

¹⁰¹ Abdurrahman Raden Aji Haqqi, '*Shariah* Governance in Islamic Financial Institutions: An Appraisal' (2014) 2 (112) US-China Law Review 112.

¹⁰² The *Shariah* governance model is going to be further explained in the upcoming chapter.

¹⁰³ Juan Sole, 'Introducing Islamic Banks into Conventional Banking Systems' (IMF Working Paper WP/07/175 2007).

¹⁰⁴ IFSB, IFSB-10 (n 98) 7.

¹⁰⁵ Ahmed and Khatun (n 31) 179.

¹⁰⁶ IFSB, IFSB-10 (n 98) 8.

¹⁰⁷ Delorenzo (n 94) 404.

to observe the product-offering stage.¹⁰⁸ The affirmation of the implementation of the designated *fatwa* applicable to the products is the primary topic of the observation. Other than that, this stage is also essential to monitoring the consistency of the compliance and the effectiveness of the *Shariah* risk management during product offering.

Fourth, the IFSB-10 underscores that the mandated person to oversee the *Shariah* compliance should be competent or fulfill the 'fit and proper' criteria.¹⁰⁹ Such criteria are meant to be acquired by the members of the *Shariah* committee as well as the *Shariah* officers of the ISCU. Each member ought to present a good characters, one of honesty, integrity, fairness and reputation, and he/she also needs to show competence, diligence, capability and soundness of the judgement. One of the keys to quantifying the required competencies is, the members of the *Shariah* committee should demonstrate the capacity to carry out such an exhaustive responsibility successfully during the designated tenure.¹¹⁰ As for the ISCU, amongst other things, *Shariah* officers should acquire adequate training in *Shariah*, possess of additional qualifications in the relevant areas, and demonstrate good communication skills to work effectively and good organisational skills to work with other governance constituents.¹¹¹ The notion is to put the members of the *Shariah* committee in a challenging position, to ascertain their accountability and independence in discharging their duty, or otherwise the function of Islamic religious ideology to act as an incentive mechanism to reduce inefficiencies arising from asymmetric information and moral hazard will be gone in vain.¹¹² It is worth mentioning here that the 'fit and proper' notion in the IFSB-10 also quantifies most of the open-ended features proposed by the superseded IFSB-3 as well as the AAOIFI standards.

Fifth, in order to ensure consistency of the competencies, the IFSB-10 urges the IFIs to have continuous development and training in relating skills for the relating *Shariah* governance constituents. To this end, IFSB-10 recommends the IFIs to develop in-house training for the *Shariah* committee members and the *Shariah* officers of the ISCU and the ISRU, as the mechanism to confirm that they have acquired and consistently possessed the minimum level of competencies.¹¹³ It is believed that knowledge of *Shariah* depends on the scholars, as well as the

¹⁰⁸ IFSB, IFSB-10 (n 98) 9.

¹⁰⁹ Laldin (n 28).

¹¹⁰ IFSB, IFSB-10 (n 98) 12.

¹¹¹ *ibid*

¹¹² Suleiman (n 66) 105.

¹¹³ IFSB, IFSB-10 (n 98) 12.

officers that have undergone rigorous and proper studies and training.¹¹⁴ Hence, the IFIs are also urged to adopt a proper mechanism to assess the effectiveness of those respective parties. This kind of assessment is crucial as assurance for the IFIs whether to reappoint their members or to nominate new members and it is closely related to the notion of 'fit and proper' criteria as mentioned beforehand.

Sixth, to avoid information asymmetry, the IFSB-10 stresses to the management, the obligation to provide adequate documentation to the *Shariah* committee timely and in advance of each meeting. In relation to this matter, the IFSB-3 as the preceding code, recommended that the IFIs should develop comprehensive procedures and policies for the *Shariah* committee to have access to the relevant documents and information. To ensure governance efficiency, this aspect should be complied by the IFIs, cautiously. However, it is also to be dealt with diligent to avoid excessive exposure of sensitive documents and information to the *Shariah* members as the external parties. This is because a weak and feeble processing of such a matter would jeopardise the confidentialities of the respective documents, especially when it consists of strategic business information. In this regard, the IFSB-10 also reminds the *Shariah* committee members to ensure the internal information is kept confidential. However, in some cases, the respective IFI would be better off through greater transparency on their 'intellectual properties' as those innovations might also somehow be benefitted by others in the way it could possibly increase trade volumes as well as market activities.¹¹⁵

3.6 Malaysian *Shariah* Governance Codes

In the conventional corporate governance realm, the UK is one of the jurisdictions that took a distinguished lead on the issuance of codes of best practices, from the Cadbury report in 1992 to the UK Corporate Governance Code in 2016.¹¹⁶ Similar development appears to have taken place in Malaysia, in terms of the development of the *Shariah* governance codes. As the hub for the global Islamic financial industry, Malaysia has an advanced legal system and operational mechanisms to accommodate Islamic finance as compared to other jurisdictions, especially the Middle-East countries.¹¹⁷ Those advantages were acknowledged by the 2016 Islamic Finance Development Indicator report, in which Malaysia was highlighted as one of the best countries along with Bahrain and Pakistan in terms of its governance of the IFIs.¹¹⁸ In this regard, Malaysia's endeavour has

¹¹⁴ Ashraf M Hashim and Ziyaat Isaacs, 'Major Challenges in Establishing Global *Shariah* Framework' (Islamic Commercial Law Report 2016) 37, 39.

¹¹⁵ Smolo and Mirakhor (n 29) 380

¹¹⁶ Christine Mallin, *Corporate Governance* (4th Edition OUP) 27.

¹¹⁷ Zulkarnain Mohd Sori and Shamsir Mohamad, Is the *Shariah* Governance Framework Effective? (Banking Insight Dec 2015) 33, 34.

¹¹⁸ Islamic Finance Development Indicator Report 2016.

contributed a number of reputable documents to the *Shariah* governance framework. There are two codes of best practices regarding to the *Shariah* governance, which are Guidelines on the Governance of the *Shariah* Committee of the Islamic Financial Institution (GPS-1) and the *Shariah* Governance Framework for Islamic Financial Institutions (SGF). Prior to those documents, in 1983, Malaysia regulated the IFIs to include the *Shariah* committee in their articles of association to oversee their operation through the Islamic Banking Act 1983 (IBA 1983), which could be regarded as an advance approach as opposed to the other Islamic financial players. The BNM has been playing an important role in ensuring that the overall Islamic financial system operates in accordance with the *Shariah* principles. Such a role is to be carried out by the two-tier *Shariah* governance model, comprising two indicative components, which are a centralised *Shariah* Advisory Council (SAC) nationally, formed since 1997, and *Shariah* committees within each respective IFIs institutionally.

3.6.1 Guidelines on the Governance of the *Shariah* Committee of the Islamic Financial Institution

The proliferation of Malaysian *Shariah* governance arrangement started from the issuance of specific guidelines for *Shariah* governance in 2004 which known as the Guidelines on the Governance of the *Shariah* Committee of the Islamic Financial Institutions (GPS-1).¹¹⁹ The objectives of GPS-1 were to set out the rules, regulations and procedures in the establishment of a *Shariah* Committee; to define the role, scope of duties and responsibilities of a *Shariah* Committee; and to define the relationship and working arrangement between a *Shariah* Committee and the SAC of Bank Negara Malaysia.¹²⁰ It also provides guidance to the IFIs on the relationship and working arrangement between a *Shariah* committee and the SAC of the BNM.¹²¹

According to GPS-1, IFIs are required to establish a *Shariah* Committee consisting of at least three members.¹²² The members of the *Shariah* committee are appointed by the board of directors upon recommendation of the IFI's nomination committee and shall obtain prior written approval from the BNM.¹²³ The proposed member of the *Shariah* Committee is at least either to acquire the qualification of necessary knowledge, expertise or experience in the Islamic jurisprudence or Islamic financial law. It is imperative to mention that, to ensure

¹¹⁹ BNM, (Guidelines on Corporate Governance for Licensed Institutions 2004); This will be known as 'Guidelines 2004' thereafter.

¹²⁰ *ibid* 2.

¹²¹ Rosni Hassan and others, 'Report on Empirical Study on *Shariah* Governance Framework (SGF 2010)' (ISRA Research Paper 68/2014) 1.

¹²² BNM, Guidelines 2004 (n 119) 2.

¹²³ *ibid* 3.

accountability and transparency, the IFIs are not allowed to appoint any member of the SAC at the central bank to serve for their *Shariah* Committees. They also should not appoint any member of a *Shariah* Committee of another IFIs in the same industry at the same moment.¹²⁴

The GPS-1 emphasised the duties and responsibilities of the *Shariah* committee. The *Shariah* committee is responsible, amongst other tasks, for advising the board on *Shariah* matters and provide *Shariah* opinions. In order to support the *Shariah* committee to carry out such duties, the IFIs are obliged by the guidelines to refer all *Shariah* issues to the *Shariah* Committee and to adopt the *Shariah* committee's advice.¹²⁵ The key element of the GPS-1 is on the list of tasks that should be executed by the *Shariah* committee rather than focusing on the structural functions of each *Shariah* governance constituents. Therefore, the formation of the internal *Shariah* department was not required by the GPS-1. The relationship between the institutional *Shariah* committee and the central bank *Shariah* Advisory Council (SAC) emphasised by the GPS-1 by mentioning the legal status of the SAC resolutions. As the sole *Shariah* authority, the SAC will be referred to by the court or arbitrator in disputes or litigations involving *Shariah* matters with the IFIs.¹²⁶

3.6.2 *Shariah* Governance Framework

To enhance the effectiveness of the *Shariah* committee as proposed by the preceding guidelines, and to cater to the market demand for a comprehensive *Shariah* supervision model, the BNM issued other guidelines pertaining to the *Shariah* governance in 2010 known as *Shariah* Governance Framework for Islamic Financial Institutions (SGF). The SGF has been implemented by the Malaysian IFIs since early 2011.¹²⁷

As argued by Ramli, the introduction of the SGF is to achieve its primary objective, which is to enhance the role of the board, the *Shariah* Committee and the management in relation to *Shariah* matters.¹²⁸ The SGF superseded the GPS-1 by amplifying the functions of the *Shariah* committee and emphasising the responsibility of the stakeholders to ensure that the operations of the IFIs are

¹²⁴ BNM, (Shariah Governance Framework for Islamic Financial Institutions 2010) 32; This will be known as SGF 2010 hereafter.

¹²⁵ BNM, Guidelines 2004 (n 119).

¹²⁶ *ibid* 1.

¹²⁷ Hassan and others (n 121).

¹²⁸ Nathasa Mazna Ramli and others, '*Shariah* Governance Disclosure Index and Institutional Ownership of Islamic Financial Institutions in Malaysia' (paper presented at the 5th Asia-Pacific Business Research Conference 17-18 February 2014, Kuala Lumpur) 3.

conducted in compliance with *Shariah*.¹²⁹ The significant features that exist in the SGF include a wider range of *Shariah* governance constituents. It includes the board of directors and the management of the IFIs, instead of only focusing on the *Shariah* committee. The SGF sets out new requirements for the IFIs to ascertain a proper *Shariah* governance structures, processes and arrangement in order to fulfil its fiduciary duty to supervise the conformity of the IFIs in *Shariah* matters. The SGF also puts a heavy emphasis on the functions of *Shariah* review, *Shariah* audit, *Shariah* risk management and *Shariah* research.¹³⁰

As compared to the GPS-1, the SGF emphasises the functions of the internal *Shariah* department, which are, to some extent, in coherence with the IFSB-10. In this regard, it is argued that Malaysia has tailored a corporate governance framework under the guiding principles of the IFSB and in view local circumstance, to specifically address the issues of the IFIs.¹³¹ Technically, the SGF addresses 8 *Shariah* governance subjects of board of directors (BOD), *Shariah* supervisory board (SSB), internal *Shariah* review (ISR), *Shariah* audit (SA), *Shariah* risk management (SRM), *Shariah* research (SR), management (M), and *Shariah* secretariat (SS).¹³² The functions and connections of each *Shariah* governance mechanisms enshrined by the SGF, depicted by diagram 2.¹³³

¹²⁹ Izyan Farhana Zulkarnain and Rosni Hassan, *Shariah* Governance Structure of IBF in Malaysia, Indonesia and Kuwait (Lambert Academic Publishing 2014) 37

¹³⁰ Hassan and others (n 121).

¹³¹ Khan and others (n 16).

¹³² Ramli, and others (n 128) 5.

¹³³ BNM, SGF 2010 (n 124) 8.

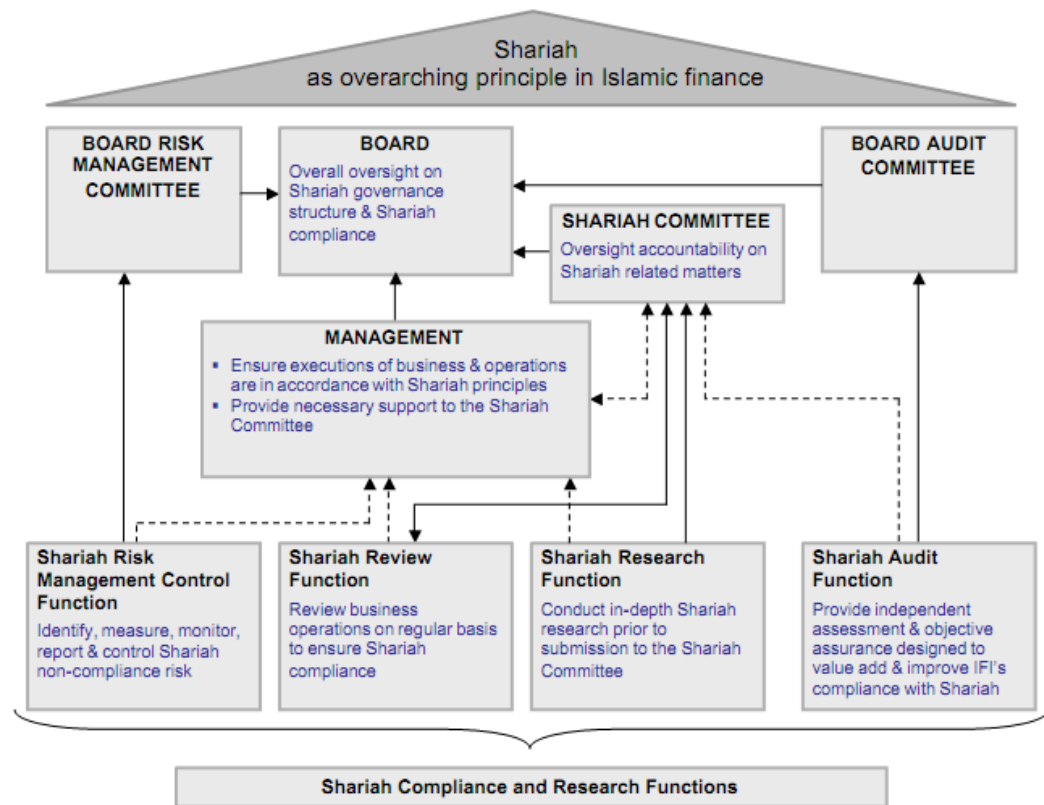


Diagram 2 : Malaysian *Shariah* Governance Structure

Each consecutive section of the SGF are summarised as below;¹³⁴

Sections	Annotation
Section I: General requirements of the <i>Shariah</i> governance framework	Principle 1 It is the duty and responsibility of an IFI to establish a sound and robust <i>Shariah</i> governance framework with emphasis placed on the roles of key functionalities in ensuring effective implementation of the <i>Shariah</i> governance framework
Section II: Oversight, accountability & responsibility	Principles 2 An IFI shall set out the accountability and responsibility of every key functionary involved in the implementation of <i>Shariah</i> governance framework.

¹³⁴ ibid 7-27.

Section III: Independence	Principles 3 Independence of the <i>Shariah</i> Committee shall be observed at all times in exercising their duties to make objective and informed judgment
Section IV: Competency	Principle 4 Any person bearing responsibilities outlined in the <i>Shariah</i> governance framework for an IFI shall possess the necessary competency and continuously enhance their knowledge and understanding on the <i>Shariah</i> as well as keep abreast on the latest developments in Islamic finance.
Section V: Confidentiality & consistency	Principle 5 Internal and privileged information obtained by the <i>Shariah</i> Committee members in the course of their duties shall be kept confidential at all times and shall not be misused. Principle 6 Professional ethics, judgment and consistency shall be maintained in ensuring <i>Shariah</i> compliance
Section VI : <i>Shariah</i> compliance & research functions	Principle 7 There shall be a robust <i>Shariah</i> compliance function, comprising review and audit functions, supported by risk management control process and internal research capacity

Table 6 : The SGF Principles Annotations

3.6.3 Viewpoints on Malaysian *Shariah* Governance Guidelines

The SGF is strongly influenced by its Malaysian banking system background, which is a dual financial system, whereby conventional and Islamic financial systems co-exist and operate in parallel under the supervision of the BNM. The approach of the SGF is coherent and complies with the Malaysian Code on Corporate Governance (MCCG) for Licenced Institutions, issued by BNM as well. The code was formulated based on the fundamental concept of responsibility, accountability and transparency as promoted by the OECD and equal treatment to the shareholders as promulgated by the BCBS codes.¹³⁵ Furthermore, the SGF is upholding all the promoted notion as far as it has not contravened with the *Shariah* principles of governance and focuses on emphasising the specific governance features, peculiar to the IFIs. The SGF has the potential as a

¹³⁵ BNM, (Guidelines on Corporate Governance for Development Financial Institutions).

reference for similar market systems especially for those upholding a parallel banking system.

Furthermore, Malaysia enacted the Islamic Financial Services Act (IFSA 2013) in 2013. This Act provided a clear division for the *Shariah* Governance, an action that has elevated some elements of the *Shariah* governance guidelines from soft law to hard law. The key point of this division is the appointment of the *Shariah* committee. The IFSA 2013 has clearly states that the division of the *Shariah* governance, by which includes; functions and duties of the board of directors, senior officers and members of the *Shariah* committee of an institution in relation to compliance with *Shariah*; fit and proper requirements or disqualifications of a member of a *Shariah* committee; and internal *Shariah* compliance functions¹³⁶.

To a certain degree, the IFSA 2013 resembles the previous IBA 1983, which was enacted to allow the establishment of Bank Islam Malaysia Berhad (BIMB). However, the IFSA 2013 has enshrined the *Shariah* governance aspects of the IFIs whereas the IBA 1983, as an initial act, only underscored the establishment of the *Shariah* committee.¹³⁷ However, the IBA 1983 could be considered as one of the earliest measures has taken by Malaysia that shares the idea of the *Shariah* governance system for the IFIs. The IBA 1983 clearly stated that an Islamic bank may seek the advice of the SAC on *Shariah* matters relating to its banking business and the Islamic bank shall comply with the advice of the SAC.¹³⁸

3.7 Conclusion

Shariah governance is an evolving subject. Despite its infant modern form, market supervision conception is however traceable from classical application through rich historical and vast literature proves. Modern *Shariah* supervision as seen in the *Shariah* committee is a rejuvenation of the *hisbah* institution to oversee economic activities to be in compliance with the *Shariah* law. As happened to the conventional corporate governance counterpart, *Shariah* governance codes are formulated to enhance stakeholders' confidence. The difference, however, is on the focus, which is by assuring the stakeholders that their investments are managed Islamically. During the early stages, there was no dedicated code, and *Shariah* governance requirements were left to the existing corporate law.

¹³⁶ Islamic Financial and Services Act 2013 (Malaysia) s 28.

¹³⁷ *ibid* s 30.

¹³⁸ Islamic Banking Act 1983 (Malaysia) s 13A.

Arguably, all *Shariah* governance codes use the 'comply or explain' notion as the basis. Therefore, even if the IFIs are subject to multilayer *Shariah* governance codes, to some extent, there would not be significant contradictions. One of the reasons is the codes are coherently putting the focus on the formation of *Shariah* committee as the main *Shariah* governance organs. Other than that, supportive constituents are also addressed in a detailed manner namely on their functions. As addressed in the viewpoints of this research on the available codes, thus far they are considered to be in correspondence with each other. Nevertheless, rooms for improvement are acknowledged. One potential improvement addresses the underlying principles of the codes, so it could be more comprehensible by the stakeholders. Other than that, deep understanding on the principles that stand behind the codes are believed to be advantageous in cases of non-compliance.

Chapter 4

Shariah Governance Models

4.1 Introduction

This chapter is a continuity of the previous chapter. By applying the same methodological approach, this chapter will describe the existing models of *Shariah* governance as practised by the IFIs. As happens in conventional corporate governance, the main reason for those models to be diversified is jurisdictional preferences. The IFIs operate in three main modes, which are fully Islamic system such as in Iran and Sudan, parallel systems such as in Malaysia, Pakistan, Brunei and many others as well as conventional system such as in Singapore and the UK.¹ Under those multiple jurisdictions, *Shariah* governance models have evolved accordingly in order to fulfil all the IFIs peculiarities as well as following the needs of local regulations. However, all models express the importance of the *Shariah* committee as the main constituent that functions as the safeguard for the IFIs to operate within the Islamic tenets as we will see in the upcoming chapters.

4.2 *Shariah* Compliance Process

Before we go through the prominent issues of this chapter, it is important to have an overview of the *Shariah* compliance process. *Shariah* compliance process is a standard procedure of ensuring the products and services offered by the IFIs adhere to the *Shariah* standards as stipulated by a designated group of experts in *Shariah* and other related areas. Regarding this, Adawiyah has proposed 7 essential steps of the *Shariah* compliance process: inception and conceptualisation of Islamic instruments; structuring the product according to *Shariah*; legal documentation; execution and implementation of Islamic instruments; audit and review; restructuring (if needed); recovery mechanisms and dispute resolution.² However, in terms of its implementation, it is still not in a full scale. Researchers have found evidence that the *Shariah* compliance practice is still in its infancy and there is room for improvement in terms of its methods of adopting such practices. On this score, Shafii reported that Malaysia, one of the main Islamic financial leaders, has only fulfilled 3 of those compliance steps, which are inception and conceptualisation of Islamic instrument; structuring the product according to *Shariah*; legal documentation. Another 4 steps are still an

¹ See also M Hussain and others, 'An Overview of Islamic Finance' (IMF Working Paper WP/15/20 2015).

² Engku Rabiah Adawiyah Engku Ali, *Shariah* Framework for *Shariah* Compliance Review (Paper presented in Workshop on *Shariah* Review, Audit and Governance for Islamic Financial Institutions on 30-31 January 2007, Kuala Lumpur).

on-going process.³ However, the recent development of the Central Bank of Malaysia Act 2009 (CBMA 2009) and IFSA 2013 in the Malaysian legal system have provided more possibilities for the remaining steps to be adopted by the IFIs. For instance, according to CBMA 2009, in the case of a dispute, the judge shall refer to the interpretations and resolutions of the SAC in *Shariah* matters.⁴ Other than Malaysia, other Islamic finance players are still in the on-going stage of adopting those *Shariah* compliance processes since some of them are merely in the early stage of introducing a more complicated *Shariah* governance model.⁵

To conclude, perhaps it is appropriate to bring forwards the *Shariah* compliance process, as observed from the published codes. There are five steps of *Shariah* compliance process.⁶ It starts from the formation of institutional article of association (*mu'ahadah*), which is then followed by supervision (*muraqabah*), audit (*muhasabah*), rectification (*muaqabah*) and ends with continuing improvement (*mujahadah*). To realise the process, there must be functional governance organs and supporting mechanisms in place. All of those processes are supported by the *Shariah* governance components on each level. But amongst others, three main mechanisms that are significant enough to be thoroughly addressed: namely, governing law, *Shariah* supervisory, and *Shariah* audit.⁷

³ Zurina Shafii and others, 'Management of *Shariah* Non-compliance Audit Risk in the Islamic Financial Institutions via the Development of *Shariah* Compliance Audit Framework and *Shariah* Audit Programme' (2010) 3 (2) Kyoto Buletin of Islamic Area Studies 3, 8.

⁴ Central Bank of Malaysia Act 2009, s 56 (1).

⁵ This will be discussed further in the upcoming topics.

⁶ See also the following process in diagram 3.

⁷ These topics will be thoroughly explained in Chapter 7.

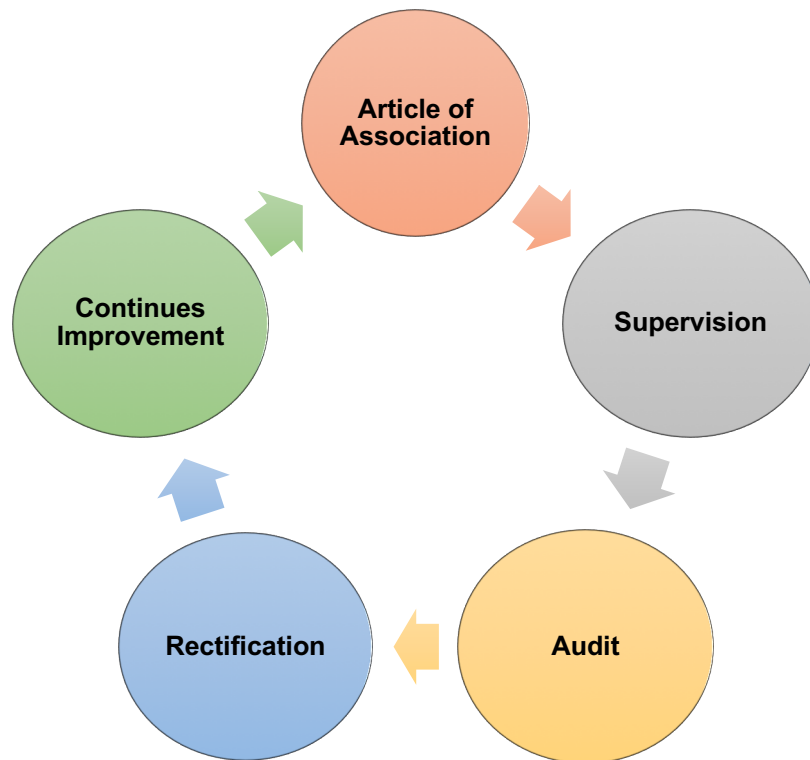


Diagram 3 : *Shariah* Compliance Process

4.3 IFIs' *Shariah* Supervision Structure

Shariah supervision structure is another topic to be addressed before we jump into the discussion on the existing models of the *Shariah* governance. It is essential to have initial knowledge of the basic organisational arrangement of an IFI to carry out *Shariah* compliance assurance functions. As discussed, the primary objective of the IFIs as business entities, is to ensure the stakeholders can secure their objectives to optimise their value Islamically.⁸ In achieving that, IFIs have the responsibility to accommodate a system that is upholding *Shariah* law.⁹ In this regard, the functions of the *Shariah* governance are fashioned based on such an objective which must be suitable for the said interconnected profit and non-profit demands respectively.¹⁰

⁸ The notion of carrying out the economic activities Islamically connotes to those that are in adherence to the *Shariah* financial laws.

⁹ See also Habib Ahmed, 'Shari'ah Governance Regimes for Islamic Finance: Types and Appraisal' (2011) 44 (4) *Journal of Institute of International Economics* 393.

¹⁰ Malek Marwan Yousef Injas and others, 'The Importance of *Shariah* Supervisory Boards (SSBS) in the Islamic Banking System' (2016) 9 (2) *South East Asia Journal of Contemporary Business, Economics and Law* 25, 26.

In order to do so, other than having a regular structure, such as a board of directors as shareholders' proxies to oversee the management, the IFIs are also in need of an extra layer of governance organs to carry out the duty of supervising the business under a strict conformity with the *Shariah* law and the expectations of the Muslim community.¹¹ That is what has been referred to by the IFSB as a set of institutional and organisational arrangements to ensure effective independent oversight of *Shariah* compliance.¹² Note that the notion of *Shariah* compliance does not mean that the IFIs' operate outside the norms established for the conventional counterparts, neither in terms of the overall models and structures nor the regulation enforcements.¹³ The primary concern of the *Shariah* governance as practised by the IFIs is about the existence of a prudent mechanism in their governance system, which would guarantee *Shariah* compliance characteristics. This is because, the impact of *Shariah* non-compliance is rather vital for the IFIs. In terms of financial impacts, *Shariah* noncompliance means the invalidation of contracts, un-permissible income and Capital Adequacy Ratio (CAR).¹⁴ Therefore, the IFIs have to put their efforts into establishing and enhancing a robust monitoring mechanism in order to carry out the *Shariah* supervision task.

It is believed that having a proper *Shariah* governance framework is the augmentation of compliance with the *Shariah* principles.¹⁵ Regarding this, the regulators ought to be reassured that the banks perform their fiduciary duty by complying with these principles.¹⁶ Furthermore, the existence of a prudent *Shariah* supervision regime has a significant weight in determining the Islamic Finance Country Index (IFCI) for the global Islamic Finance Report (GIFR).¹⁷ Because of the need for a *Shariah* compliance process, the *Shariah* governance models and structures are subject to an additional layer of governance mechanism.¹⁸ The core element of *Shariah* governance models and structures is

¹¹ Bedj Bedj Toufik, 'The Role of *Shariah* Supervisory Board in Ensuring Good Corporate Governance Practice in Islamic Banks' (2015) 2 (2) International Journal of Contemporary Applied Sciences 109, 115.

¹² IFSB, (Guiding Principles in *Shariah* Governance Systems for Institutions Offering Islamic Financial Services 2009).

¹³ Yusuf Talal Delorenzo, '*Shari'ah* Compliance Risk' (2007) 7 (2) Chicago Journal of International Law 397, 398.

¹⁴ See also Mohd Nazri Chik, '*Shariah* Audit: *Shariah* Perspective' (International *Shariah* Audit Conference and Workshop, Kuala Lumpur 9 Mei 2011)

¹⁵ Hichem Hamza, '*Sharia* Governance in Islamic Banks: Effectiveness and Supervision Model' (2013) 6 (3) International Journal of Islamic and Middle East Finance and Management 226, 226.

¹⁶ Ahmed (n 9).

¹⁷ GIFR, (Global Islamic Finance Report 2016) 44-58.

¹⁸ NM Suleiman, 'Corporate Governance in Islamic Banks' (2000) Arab Gateway 98, 99.

the existence of the framework of the *Shariah* supervision,¹⁹ monitoring and review mechanism to ascertain *Shariah* compliance requirements. To carry out such a duty, as mentioned by the *Shariah* governance codes, the IFIs have formed the external *Shariah* committee and the internal *Shariah* compliance department.

4.3.1 *Shariah* Committee

As mentioned earlier, the *Shariah* committee is one of the structural mechanisms accountable to *Shariah* compliance. It has been considered as one of the most powerful institutional arrangements for *Shariah* governance.²⁰ According to the AAOIFI, the *Shariah* committee is an independent body entrusted with the duty of directing, reviewing and supervising the activities of the IFIs in order to ensure that they are in compliance with *Shariah* law.²¹ These include the advisory process of issuing the *Shariah* resolution (*fatwa*), supervision and monitoring (*raqabah*) of the compliance aspects and reviewing and auditing (*muhasabah*).²² In order to carry out these tasks, the *Shariah* committee is assisted by the internal *Shariah* compliance department.

The members of the *Shariah* committee are required to acquire 'fit and proper' criteria or to accomplish a sufficient level of expertise in *Shariah*, finance and regulations.²³ Each *Shariah* committee has to have a sufficient number of members to carry out its duty. To manage the disagreements, an odd number of members is normally used. If there are multiple opinions on a single *Shariah* issue, each member of the committee is qualified to the right to cast a vote. To some extent, a higher *Shariah* authority is also constituted at the central or national level as a final decision-maker if the disagreement is irreconcilable institutionally.

¹⁹ Ahmed (n 9).

²⁰ Rihab Grassa, 'Shariah Supervisory Systems in Islamic Finance Institutions Across the OIC Member Countries' (2015) 23 (2) *Journal of Financial Regulation and Compliance* 135, 138.

²¹ AAOIFI, Governance Standards no. 1: *Shariah* Supervision Body, Appointment, Composition and Report Standards in AAOIFI (eds) *Accounting, Auditing and Governance Standards* (Almainan Publication and Distribution, Manama 2015) 885.

²² See also Zulkifli Hassan, 'A Survey in *Shariah* Governance Practices in Malaysia, GCC Countries and the UK' (2011) 4 (1) *International Journal of Islamic and Middle Eastern Finance and Management* 20, 35; Toufik (n 11); Grassa (n 20) 138.

²³ One of the keys to quantify whether the members of the *Shariah* committee demonstrate sufficient required knowledge is through continual assessment and evaluation during their tenure. It will be further discussed in the upcoming topics.

The functions of the *Shariah* committee involve the *ex-ante* and the *ex-post* *Shariah* supervision processes.²⁴ Normally, during the *ex-ante* process, the *Shariah* committee is involved in product research and development and will formally certify compliance by means of *fatwa*.²⁵ This *fatwa* endorsement, conducted by the *Shariah* experts, is a crucial means to enhance the confidence of the customers that such a product or service has already gone through a due diligence process and that it is in adherence not only to the related governing laws but also has been scrutinised by the experts on its compliance with *Shariah* law.²⁶ This process is rather sensible to the customers as a *fatwa* has the capacity to immediately relieve an ordinary customer of the burden of having to make such due diligence procedures for himself.²⁷ In terms of the *ex-post* compliance process, the survey conducted by Hassan showed that many *Shariah* committees did not conduct the *ex-post* process as their main concern is more over the *ex-ante* aspect of the *Shariah* matters.²⁸

Other than ensuring the products and the services offered by the IFIs are *Shariah*-compliant, the *Shariah* committee is akin to mitigating the *Shariah* risk of the IFIs as well. As mentioned in the previous chapter, the *Shariah* risk, amongst others, including *Shariah* non-compliance, return rate risk and reputational risk, ought to be identified, categorised and mitigated. To perform that, the experts of the respective areas are required to assist the *Shariah* committee to carry out their duty. Being able to identify and to anticipate the *Shariah* compliance risk is an important step to providing a consistent framework for managing the risks.²⁹ Therefore, it is argued that the existence of the internal *Shariah* compliance department to execute such a task is compulsory for the IFIs.

4.3.2 *Shariah* Compliance Department

Apart from *Shariah* committee, there is the *Shariah* compliance department, as another structural mechanism of the *Shariah* compliance supervision function. As discussed above, *Shariah* committee will verify transaction compliant aspects to its adherence to the endorsed *fatwa*. It then will be followed by the reviewing and auditing process which is executed by an internal *Shariah* department. Regarding this, according to the IFSB-10, it is a requirement for the IFIs to have a designated *Shariah* compliance unit or department or at least a *Shariah* compliance officer. This *Shariah* compliance department has to be well equipped with the monitoring skill and relevant knowledge of *Shariah*, whether by having a single person who

²⁴ IFSB, IFSB-10 (12) 5.

²⁵ Delorenzo (n 13) 399.

²⁶ See also Injas (n 10).

²⁷ Delorenzo (n 13) 398.

²⁸ Hassan (n 22) 36

²⁹ Delorenzo (n 13) 398.

has both the sets of skills or by assembling a team of staff with a different sets of skills.³⁰

During the *ex-post Shariah* compliance process, internal *Shariah* compliance department roles are more concerned with the implementation of certified *fatwas*. In Malaysia and other countries with established internal *Shariah* compliance departments within the IFIs, the *Shariah* committee delegates the conducting power of such a function to the Internal *Shariah* Audit, Internal *Shariah* Compliance and Internal *Shariah* Review units.³¹ Other than checking on *fatwa* implementation, the *ex-post Shariah* supervision also includes the task to internally disseminate the information on *Shariah* resolutions to the operative personnel within the IFIs. It also has to monitor day-to-day operations of the IFIs in order to ensure that they are in compliance with the certified *fatwas* of the *Shariah* committees. In this vein, for the purpose of the successful management of *Shariah* compliance in all steps, *Shariah* committee ought to work closely with management throughout the process of product development and its cycle.³²

The IFIs are also obligated by the IFSB standard to have a designated internal *Shariah* compliance review or unit, to verify the internal *Shariah* compliance process. The internal *Shariah* review has an established function similar to the internal audit unit. The main difference between those two auditory units is on the accountability chain. The internal audit report verified by the board of directors, and the report of the internal *Shariah* review certified by the *Shariah* committee. In the event of non-compliance, the internal *Shariah* review will recommend the management of the IFIs on how to address and rectify the issues.³³

4.4 Shariah Governance Supervision Models

Despite peculiar organisational arrangements such as mentioned above, *Shariah* governance models are mostly influenced by local regulation. In this sense, managers of the IFIs are subject to a dualist system of governance, based on the principles of the conventional corporate governance imposed by the international corporate and financial regulations and by the Islamic version of the governance system desired by stakeholders.³⁴ It is worth saying that, in a general sense, the IFIs do not to avoid implementation of the universal standards but rather have an additional layer of the system to ascertain that such an intertwined requirement

³⁰ IFSB, IFSB-10 (12) 3.

³¹ Rosni Hassan and others, 'Report on Empirical Study on *Shariah* Governance Framework (SGF 2010)' (ISRA Research Paper 68/2014) 1.

³² Hamza (n 15) 228.

³³ IFSB, IFSB-10 (12) 3.

³⁴ Toufik (n 11) 113.

is satisfactory. Accordingly, as asserted by Cadbury, corporate governance is affected partly by the law, partly by the participants themselves and by society.³⁵ Put differently, regulatory provisions from conventional frameworks as well as Islamic counterparts have an indicative role in the structural determination of the *Shariah* governance.

As *Shariah* supervision is a vital duty of the IFIs' *Shariah* governance constituents, a framework of the functions of a *Shariah* committee and its supportive organs has become the primary concern of the standard-setters.³⁶ Concerning this, Ahmed mentioned that there are four main approaches of the *Shariah* governance framework: regulatory constructed, robust, passive and market-driven.³⁷ From the regulatory view, there are two kinds of *Shariah* supervision models implemented by the IFIs in various jurisdictions.³⁸ On one hand, some jurisdictions such as Pakistan and Malaysia require a centralised *Shariah* committee with a handful of power to oversee the institutional *Shariah* committees. It is known as a two-tier *Shariah* committee model. On the other hand, some jurisdictions such as Jordan require only one *Shariah* committee which is the institutional *Shariah* committees, to carry out the duty of *Shariah* supervision; this is known as a single *Shariah* committee model. Other than those models, there are jurisdictions that have no specific focus on introducing a compulsory *Shariah* committee, neither institutionally nor nationally, but rather leaving such arrangements to the demand of the market such as in the UK and Saudi Arabia or to their full established Islamic regulatory systems, such as in Iran.

4.4.1 Two-tier *Shariah* Committee

The notion of the two-tier *Shariah* committee implies a requirement for the existence of both internal and the external *Shariah* compliance mechanisms. The internal mechanism includes the *Shariah* committee and *Shariah* compliance department at the institutional level, which are embedded within the IFI's governance structure. However, the external *Shariah* compliance mechanism includes the formation of the centralised *Shariah* committee at the central bank or the existence of an independent national Islamic authority such as a national *fatwa* council that has a certain level of jurisdiction on IFIs *Shariah* matters. The present model is mostly accommodated by the countries with high interference

³⁵ Adrian Cadbury, 'Highlights of the Proposals of the Committee on Financial Aspects of Corporate Governance' in DD Prentive and PRJ Hollad (eds) *Contemporary Issues in Corporate Governance* (2003 OUP).

³⁶ See also Samy Nathan Garas and Chris Pierce, *Shari'a* Supervision of Islamic Financial Institutions (2010) 18 (4) *Journal of Financial Regulation and Compliance* 386.

³⁷ See also Ahmed (n 9).

³⁸ See also Grassa (n 20).

from the regulatory authorities.³⁹ It is believed that providing regulatory guidelines to the banks will ensure the quality and the consistency of the *fatwa* certification of the *Shariah* committees at the institutional level.⁴⁰ It also has the advantage of harmonising the variations in the *Shariah* opinions of the scholars.⁴¹ Arguably, the key objective of having such a double-layer mechanism is to enhance transparency and accountability of the institutional *Shariah* committees.

The features of the present model are varied. Firstly, the standardisation of the compliance process of the committees addresses the primary concern of both central and institutional constituents, which is the assurance of the *Shariah* compliance. The idea is the institutional *Shariah* committees of the representative banks are monitored by a single *Shariah* committee at the central bank level. The main difference is the job prescription of each. The institutional *Shariah* committees are concerned with the adherence of the products and services from a particular IFI, without possessing any jurisdiction on other IFIs. The central *Shariah* committee, meanwhile, is granted the jurisdiction to interfere and deal with general *Shariah* compliance issues as well as to rectify the conflicting *Shariah* matters between the *Shariah* committees or the members of the same committee, especially a disagreement or dispute caused by *fatwa* variations on a single *Shariah* matter. Under this model, the central *Shariah* committee is entitled to codify the applicable *Shariah* instruments. Therefore, it is believed that it could ease the differences in *Shariah* interpretation.⁴² As both the central bank and the institutional *Shariah* committees refer to the same *Shariah* standard, through a clear chain of governance, potential disagreements between the internal *Shariah* advisors could also be pacified.⁴³

The second feature of the present model is the independence of the institutional *Shariah* committee members. The institutional *Shariah* committees are not under the influence of the board of directors but rather under the central *Shariah* committee, which is the central or the highest authority. Institutionally, these elements of independence are identified through the appointment, remuneration,

³⁹ Hassan (n 22) 34.

⁴⁰ Rodney Wilson, 'Shariah Governance for Islamic Financial Institutions' (2009) 1 (1) ISRA International Journal of Islamic Finance 59, 73.

⁴¹ Alejandro Lopez Mejia and othes, 'Regulation and Supervision of Islamic Banks' (IMF Working Paper WP/14/219 2014), 14

⁴² Muhammad Umer Chapra and Tariqullah Khan, Regulation and Supervision of Islamic Banks (Islamic Development Bank 2000).

⁴³ Anne-Sophie Gintzburger, 'An Analysis of Global Trends and Regional Pockets in the Application of Islamic Finance Contracts in Malaysia and the Gulf Corporation Council' (Paper presented in International Conference on Islamic Banking & Finance, Cross Border Practices & Litigations, Kuala Lumpur, Malaysia, June 2010).

the mandate and the means of mitigation of conflict of interest.⁴⁴ In this regard, AAOIFI standard requires that the members should be appointed by the general meeting.⁴⁵ In some cases, institutional *Shariah* committee members were appointed by the board of directors with the consent of the central bank as in Malaysia and by national religious council as in Indonesia.⁴⁶ Due to this, it is believed that this model could strengthen the position and the independence of the institutional *Shariah* committees.⁴⁷ The likelihood is that the central *Shariah* committee holds the key on effectiveness of the institutional *Shariah* committees by monitoring the functionality of the respective committees.

Thirdly, the present model is also believed to be capable of mitigating *Shariah* risks. From a business standpoint, leaving the *Shariah* governance appliance only at the bank level could diversify the risks that could adversely affect the stability and growth of the industry.⁴⁸ Muslim stakeholders such as consumers, investors and depositors are keen on *Shariah* compliance matters, because of the demand of the consumption of good and wholesome by *Shariah*.⁴⁹ Failure to meet such an underpinning principles of the Islamic finance would give rise to *Shariah* risk and damage the credibility and the reputation of the IFIs in the eyes of the stakeholders, causing a serious loss of trust.⁵⁰ Therefore, IFIs have to ensure that they operate accordingly to the *Shariah* guidelines. *Shariah* risks such as the *Shariah* non-compliance risk could affect stakeholders' confidence in the IFIs and exposes the IFIs to other risks such as reputational risk that could also hit the IFIs' asset values severely and trigger bank failure.⁵¹

In terms of its implementation, the present model is effectively exemplified by Pakistan, the UAE, Malaysia, Indonesia and Sudan. Those jurisdictions feature the centralised *Shariah* committee at the central bank. The UAE, which had favoured the single-tier *Shariah* committee model has also adopted the same path as the present model at the moment. In Indonesia, the Majelis Ulama Indoensia (MUI) works independently as an authoritative body to endorse *fatwa* on *Shariah* matters, where it will be followed up by the central bank. In Pakistan, the government amended the law to accommodate the IFIs and enacted the

⁴⁴ Hassan (n 22) 39.

⁴⁵ AAOIFI, Governance Standards no. 1 (n 21).

⁴⁶ BNM, (*Shariah* Governance Framework for Islamic Financial Institutions 2010); The Act of Republic of Indonesia (21/2008) Concerning Sharia (Islamic) Banking.

⁴⁷ Hamza (n 15) 226.

⁴⁸ Ahmed (n 9) 405.

⁴⁹ Delorenzo (n 13) 398.

⁵⁰ Muhammad Umer Chapra and Habib Ahmed, '*Corporate Governance in Islamic Financial Institutions*' (Islamic Research and Training Institute 2002).

⁵¹ Grass (n 20) 137.

Banking and Financial Services Ordinance (1984). Similarly, the State Bank of Pakistan (SBP) established the central *Shariah* Board (SB) to guide the IFIs in Pakistan regarding *Shariah* matters. The functions of SB include reviewing and approving *Shariah*-compliant products proposed and submitted by the IFIs. Despite the fact that the SB does not possess any legislative power, it is still entitled to approving or disapproving of the proposal made by the IFIs on their products or services.

In Malaysia, it is explicitly regulated by law that the IFIs must appoint a group of experts in *Shariah* to oversee *Shariah* matters institutionally. Such a notion is traceable in the Islamic Banking Act (IBA1983) and later on in the Islamic Financial and Services Act (IFSA 2013).⁵² In terms of the central *Shariah* committee, the Malaysian Central Bank or Bank Negara Malaysia (BNM) established the *Shariah* Advisory Council (SAC) in 1997 as the highest authority to encounter *Shariah* matters in Islamic finance.⁵³ In this regard, the Malaysian *Shariah* supervision mechanism has two components, the internal *Shariah* committee formed within each IFIs, and the centralised SAC at the BNM.⁵⁴ According to IFSA 2013, it is the responsibility of the IFIs through their *Shariah* committees to guarantee that their products and services are in compliance with the SAC's rulings. As a matter of fact, the BNM is entitled to specify standards on *Shariah* matters and to give effect of the SAC's rulings on the IFIs. At this point, BNM uses the SAC as the mechanism to scrutinise all new products submitted before endorsing any approval or disapproval.⁵⁵ In the event of noncompliance, the IFIs are obliged to notify the BNM, cease the non-compliant products or services and then, within a certain time-period, submit to the BNM the rectification plan addressing the particular noncompliant aspects. Other than being entitled to attend to *Shariah* matters, the BNM may also attend to *Shariah* governance matters that do not require views from a *Shariah* perspective. These include the functions of the *Shariah* committee and the requirements of the *Shariah* members as well as the internal *Shariah* compliance functions.⁵⁶

⁵² Islamic Banking Act 1983 (Malaysia) s 13A; Islamic Financial and Services Act 2013 (Malaysia) s 31-33.

⁵³ <www.bnm.gov.my/index.php?ch=en_about&pg=en_thebank&ac=439&lang=en> accessed 15 January 2017

⁵⁴ Nathasa Mazna Ramli and others, '*Shariah* Governance Disclosure Index and Institutional Ownership of Islamic Financial Institutions in Malaysia' (paper presented at the 5th Asia-Pacific Business Research Conference 17-18 February 2014, Kuala Lumpur) 3.

⁵⁵ Central Bank Act 2009 (Malaysia) s 52.

⁵⁶ Islamic Financial and Services Act 2013 (Malaysia) s 33.

In Sudan, the government of Sudan established a *Shariah* committee within the central bank in 1992, known as the Higher *Shariah* Control Commission (HSCC).⁵⁷ The HSCC is appointed by the President of the Republic, in consultation with the Minister.⁵⁸ According to the Banking Business Act 2003, the HSCC provides *fatwas* or '*Shariah* edicts', recommendations and consultancy for the IFIs.⁵⁹ The main concern is to unify the *Shariah* instruments for the use of the IFIs. The Commission, amongst others, shall have the functions to consider, and express opinions, in such matters as may be submitted by any IFIs. If there are any problematic issues faced by the IFIs, the HSCC will suggest the solutions. In addition to that, the HSCC shall also consider the disputes over *Shariah* matters, as may arise between the IFIs. In order to ensure IFI compliance to the opinions from the HSCC, in the case where there are different opinions from the scholars, it possesses the power to give a final decision, and is a binding procedure for the particular IFI.⁶⁰

Indonesia has a similar but unique approach. The uniqueness lies in the authority of the *fatwa* stipulation. The Indonesia *Shariah* (Islamic) Banks or any conventional commercial banks with *Shariah* Business Units (UUS) are obliged to form their own institutional *Shariah* Supervisory Board (SSB). Members of the SSB are appointed by the general meeting of the shareholders on the recommendation of the Indonesian Ulama Council known as Majelis Ulama Indonesia (MUI). The MUI is an independent body, authorised by Bank Indonesia to look at the regulation of the *Shariah* principles.⁶¹ According to the Act of Republic of Indonesia (21/2008) Concerning *Shariah* (Islamic) Banking, *Shariah* principles are defined as the Islamic law principles in the banking business based on the *fatwa* issued by the institution having the authority in stipulating *fatwas* in *Shariah* matters. The main duties of the SSB are to give advice and recommendations to the boards of directors and supervise its representative bank activities, to ensure its adherence with the *Shariah* principles endorsed by the MUI. To follow up the *fatwa* of the MUI, a centralised *Shariah* committee was set up internally in the Indonesia Central Bank, consisting of representatives from Bank Indonesia, the Religious Department and community elements with a balanced composition.⁶² Such an external committee is a forum comprising experts in multiple related fields whose duty is to assist Bank Indonesia in implementing the MUI's *fatwa* into the Bank Indonesia Regulations.⁶³ In terms of the approval of the *Shariah*

⁵⁷ See also Hamza (n 15).

⁵⁸ <<http://www.cbos.gov.sd/en/node/434>> accessed 15 January 2017

⁵⁹ The Banking Business Act 2003 (Sudan) s 15.

⁶⁰ *ibid*

⁶¹ The Act of Republic of Indonesia (21/2008) Concerning *Shariah* (Islamic) Banking

⁶² *ibid*

⁶³ Nurhastuty Wardhany and Shaista Arshad, 'The Role of *Shariah* Board in Islamic Banks: A Case Study of Malaysia, Indonesia and Brunei Darussalam' (Islamic

compliance products and services, the SSB in *Sharia* (Islamic) Bank or Commercial Bank with UUS works as the intermediary between those banks and the Bank Indonesia *Shariah* committee. The suggestion will come from the institutional *Shariah* department to the board of the representative banks which eventually will bring the proposal of certain products or services to the SSB. The Bank Indonesia *Shariah* committee will then endorse the approvals of the proposals to the SSB of the banks.⁶⁴

The UAE is one of the most recent jurisdictions that joined the two tier *Shariah* governance model.⁶⁵ Article (5) of the UAE Federal Law no-6 of 1985 mentions that the Higher *Shariah* Authority (HSA) shall be formed by a cabinet, incorporating *Shariah*, legal and banking personnel. The HAS will undertake higher supervision over the banks, institutions and investment companies which involved with *Shariah* compliance activities to ensure the legitimacy of their transactions according to the provision of the *Shariah* principles. It is also to offer opinions on *Shariah* matters which those agencies may come across while conducting their activities. More importantly, the law also mentions that the opinions of the HAS shall be binding on the said agencies.⁶⁶ At the institutional level, article (6) of the same law mentioned that every Islamic banks, financial institutions and investment companies should clearly stipulate their *Shariah* Supervision Authority (SSA). The SSA is to render the represented institution's transactions and practices in accordance with the provision of the *Shariah* principles. The law also mentioned that the article of the association of each institution shall determine the way in which the SSA shall be formed, the manner of which it will discharge its duties and other relating terms of reference.⁶⁷

In the case of Kuwait, the Central Bank of Kuwait Law of 1968 stipulates that the IFIs should have the *Shariah* Supervisory Board (SSB) of at least three members appointed by the General Assembly.⁶⁸ In the case of conflict of opinions among the members of the SSB, the bank may transfer the matter to the *Fatwa* Board of the Ministry of *Awqaf* and Islamic Affairs, as the final authority. According to this, the *Fatwa* Board could be considered a national *Shariah* committee.⁶⁹ Despite

Finance in a Challenging Economy: Moving Forward 2nd ISRA Colloquium, Sasana Kijang, Bank Negara Malaysia 27th November 2012).

⁶⁴ *ibid* 11.

⁶⁵ <www.thenational.ae/business/economy/uae-cabinet-approves-sharia-authority-launch> accessed 15 January 2017.

⁶⁶ Federal Law no-6 of 1985 (UAE) art 5.

⁶⁷ *ibid* art 5.

⁶⁸ Central Bank of Kuwait Law of 1968 s 9.

⁶⁹ Rodney Wilson, *Shari'a* Governance for Islamic Financial Institutions (Presented at the Meeting Re-Imagining the *Shari'a*: Theory, Practice and Muslim Pluralism at Play, Venice September 2009).

the availability of central authority in this regard, Ahmed categorised Kuwait as having a passive central supervision. He emphasised that there is no specific provision of the law for the higher *Shariah* authority to approve the products.⁷⁰

4.4.2 Single-tier *Shariah* Committee

The single-tier *Shariah* committee model refers to the jurisdictions that do not require the existence of a centralised *Shariah* committee at the central bank or a national *fatwa* council that is entitled to oversee *Shariah* matters in Islamic finance. It is important to note that the IFIs are obliged to have an institutional *Shariah* committee and follow general regulations as to other financial institutions. The functions of the *Shariah* committee are relatively similar without any significant interference from a higher authority in the *Shariah* matters.⁷¹ Normally, any *Shariah* disputes or disagreements will be brought to the national *fatwa* council as to seek independent advice on the said matter, where the council does not acquire any judicial power on the institutions.

Having a diverse approach compared to the two-tier model, which is centralised in nature, the single-tier *Shariah* committee model has rather decentralised *Shariah* compliance functions. It is believed that it could persuade institutional *Shariah* committees to be more independent in the exploration of new applications of *Shariah* instruments implanted within their products and services. Since the interference from the central bank in *Shariah* matters is rather passive, the institutional *Shariah* committees ought to have more creativity in how they adhere with *Shariah* compliance requirements. On this score, Hassan has reported, despite the fact that there is less interference from the regulatory authorities, that IFIs in GCC countries such as the UAE and Kuwait, the countries that were accommodating the present model, have pro-actively developed their own *Shariah* governance mechanisms to handle *Shariah* matters.⁷²

The present model is best exemplified by Jordan and GCC countries such as Bahrain. The number of jurisdictions with the implementation of the present model has recently decreased. As reported by Grassa and Hassan, there were more GCC countries with such a model, and some of them also regarded as having a passive central supervision.⁷³

⁷⁰ Ahmed (n 9) 402.

⁷¹ Grassa considered the existence of the religious councils at national level as sufficient to be regarded as a centralised model. Meanwhile, Ahmed addressed the degree of interference by looking at whether the central institution has to deal with the approval or disapproval of certain *Shariah* standards.

⁷² Hassan (n 22) 34.

⁷³ See also Grassa (n 20).

In Jordan, the Central Bank of Jordan Law no 28 of 2000 mentioned that the Islamic banks shall comply with the conditions and restrictions on their operations and activities within the recognised opinions endorsed by the designated Islamic Jurisprudence Supervision Board (IJSB). The IJSB members are appointed by the general assemblies of the shareholders. The IJSB will discharge the duties of monitoring the compliance of the operations and activities of the IFIs with Islamic jurisprudence rules, giving opinions on the text of contracts required for the operations and activities of the IFIs and considering any matters referred to specific orders from the Central Bank of Jordan.⁷⁴ However, at the moment, there is no specific provision concerning the formation of the national IJSB at the Central Bank of Jordan.

In Bahrain, the IFIs have been practicing self-regulation *Shariah* compliance mechanisms on their operations. There is no indication of a centralised *Shariah* committee of the central banks in the Central Bank of Bahrain Rulebook, volume (2), Islamic Banks.⁷⁵ However, the Governor of the Central Bank of Bahrain, Rasheed al-Maraj said that they are in progress of setting up a central *Shariah* board to oversee the IFIs as it is an increasingly favoured model across the globe.⁷⁶

4.4.3 The Market-Driven Model

The market-driven model is the formation of the *Shariah* compliance supervision mechanism based on the demand of the market without ignoring the *Shariah* compliance requirements. In the present model, there is no *Shariah* committee required by regulation neither within the financial institutions nor the central bank. The only reason of the existence of the *Shariah* committee is driven by the demands of the stakeholders.

In Saudi Arabia, despite its acknowledgement of *Shariah* as the rule of law, where the expectation is that the IFIs will be the preferable choice, Islamic finance for a matter of fact is merely a realistic logical alternative to conventional banking system. According to article (2) of Saudi Arabian Monetary Agency (SAMA), the Saudi financial regulatory system somehow has decided interest free is the norm of its monetary system rather than only as a regulation. Therefore, the SAMA 1952 and the Capital Markets Authority (CMA) 2003 have no interest in identifying

⁷⁴ Banking Law of 2000 (Jordan) art 58 (A).

⁷⁵ CBB Rulebook, volume (2).

⁷⁶ Bernardo Vizcaino, Bahrain to Develop Central Sharia Board for Islamic Banks, Reuters 2nd Dec 2014 <www.reuters.com/article/bahrain-islam-regulations-idUSL3N0TN1A020141203> accessed 25th April 2018.

Shariah supervision as one of its responsibilities. Each IFI operating in the Saudi Arabia banking ecosystem is free to recognise its *Shariah* characteristics, and most importantly, the *Shariah* committee is an acceptable concept.⁷⁷ There is no designated *Shariah* committee on the central bank level. There are institutional *Shariah* committees within the IFIs which are only influenced by the *Shariah* standards of the International Islamic *Fiqh* Academy.⁷⁸ From the perspective of jurisprudence, the International Islamic *Fiqh* Academy is involved in establishing legal norms and the treatment of subject's differences.⁷⁹

In the UK, the Islamic financial system is operating under a secular financial environment and dealing with a relatively small market as compared to its conventional counterpart.⁸⁰ According to the UK's company law, there is no explicit requirement for a single board system for the companies and *Shariah* governance is an irrelevant issue. However, the UK's traditional corporate governance structure is basically a single-tier board model.⁸¹ Regarding additional governance organs to support *Shariah* compliance mechanism, the main concern, to date, is more on the clarity whether the *Shariah* committee has an executive role or simply an advisory one rather than looking at which *Shariah* governance model is compatible for the UK.⁸² More importantly, it is to be understood that the corporate governance framework implied for IFIs in the UK still resembles those facilitated by the conventional industry without any significant concern to comply, at least at the moment, with the IFSB or other IFIs standards⁸³.

⁷⁷ Reem M Asaad, 'The Regulatory Framework of Islamic Banking in Saudi Arabia' <<http://cibafi.org/ControlPanel/Documents/Library/Pdf/A85.pdf>> accessed 9th August 2018.

⁷⁸ International Islamic *Fiqh* Academy is an academy for the advanced study of Islam based in Jeddah, Saudi Arabia. Besides the traditional Islamic sciences, the academy also seeks to advance knowledge in the realms of culture, science and economics.

⁷⁹ Hamza (n 15) 232.

⁸⁰ Asad Khan and others, 'Comparative Analysis of Regulatory and Supervisory System of Islamic Banks: Evidence from Pakistan, Malaysia, Bahrain and United Kingdom' (2015) 6 (6) *Mediterranean Journal of Social Sciences* 629, 638.

⁸¹ Abdul Karim Al-Dohni, 'Islamic Banking in the United Kingdom: Is the Current Legal and Regulatory Framework Capable of Hosting an Islamic Banking Sector?' (DPhil Thesis, University of Leeds 2008) 130.

⁸² Michael Ainley and others, *Islamic Finance in the UK: Regulation and Challenges* (Financial Services Authority 2007)

⁸³ Chowdhury Shahed Akbar, '*Shariah* Governance Framework for Islamic Banks: An Assessment' (2014) 11 (45) *Islamic Finance News* 23.

4.4.4 Fully Regulated Model⁸⁴

The fully regulated model refers to a market with *Shariah* principles as their point of reference in terms of the financial regulatory system. The present model exhibits an Islamic financial ecosystem wherein the IFI operates within the tenets of the *Shariah* law. *Shariah* not only refers to stipulating terms and conditions, but also well embedded in their financial culture and environment.

The historical record has given the evidences of the determination of Iran and Pakistan to bring about the Islamisation of their financial system.⁸⁵ Both countries have gone through the process properly and Iran has made tremendous achievements and has been crowned as one of the world's Islamic finance leaders.⁸⁶ Iran is also the country which has accommodated such a model of the *Shariah* governance. In 1983, the Islamic Majlis of Iran passed the Islamic Banking law of Iran. According to this law, the Iranian banks could only participate in the interest-free transactions after interest or usury was considered forbidden, as mentioned by *Shariah* law.⁸⁷ Under the articles of the Usury Free Banking Act 1983, with the approval of the Council of Ministers, the Bank Markazi Iran (BMJII) or the Central Bank of Iran possessed the power to intervene and supervise the banking and monetary activities of the financial institutions.⁸⁸ With full *Shariah* compliance in financial law, the intervention and the supervision procedures not only have to do with the financial activities, but also without any doubt *Shariah* matters. Most importantly, the act has no indication of any specific committee to carry out the task. The example presented by Iran in terms of its fully fledged *Shariah* law implementation in the financial system is, to some extent, considered the benchmark for the predominant Muslim markets. Many features could be learnt and adopted despite the peculiarities of the jurisdictions. However, for non-Muslim predominant markets, other models are more compatible as far as this research is concerned.

⁸⁴ Some might argue that the jurisdictions discussed are not fully Islamic. However, detail discussions on the Islamicity of the relating jurisdictions especially Iran is not the concern of this research.

⁸⁵ Some may argue that Iran and Pakistan are not the real example of full version of Islamic finance, this research credited the both based on their endeavour to offer such a model to stand as the only system rather than looking at the perfectionity of the concept in terms of the implementation. See also Muhammad Anwar, 'Islamic Banking in Iran and Pakistan: A Comparative Study' (1992) 31 (4) The Pakistan Development Review 1089.

⁸⁶ Based on the annual reports by various bodies, Iran has consistently proved itself as the leader of the Islamic financial sector with more than a 30% share the global Islamic finance market.

⁸⁷ S Hussain Asyraf and Ali Alizadeh Giashi, 'Islamic Banking in Iran' (2011) 1 (2) Kuwait Chapter of Arabian Journal of Business and Management Review 31, 33.

⁸⁸ The Law for Usury Free Banking Act (1983) art 20.

4.5 Conclusion

To conclude this chapter, it is imperative to have an understanding that *Shariah* governance is about ensuring *Shariah* compliance. Therefore, in terms of corporate structure, there must be designated organs to carry out such a function. To do so, the *Shariah* committee and internal *Shariah* department are introduced into the IFIs' organisational arrangements in order to execute the *Shariah* compliance process. However, when it comes to the implementation, a few models are available to appreciate local regulatory requirements proportionately. Regarding this, four models have been thoroughly addressed in this chapter. Those models could be classified into centralised and decentralised approaches. Regardless of the approaches, all models are working towards similar notion, which is to ensure that there is an independent mechanism to oversee the *Shariah* compliance processes within the IFIs.

Chapter 5

Corporate Governance Theories in Perspective

5.1 Introduction

By focusing on applying the same methods as in the last chapters, this chapter continues to knit a discursive analysis in order to excavate the understanding of the *Shariah* governance dialogue under corporate governance narrative. The said narrative is chosen so it could steer the discussion onto a less-grey area rather than wandering around in a fully uncharted one. The dialogue is somehow representing an Islamic perspective on the narrative. To some extent, this could be perceived as an original contribution from this research to the corporate governance body of knowledge. As mentioned in the research methodology, in this chapter, we will apply an inductive approach to construct the *Shariah* governance dialogue. It is also to generate the themes for the narrative incorporated into the conventional corporate governance. The selected themes as revealed from analytical observation of the literature, would be the theories of corporate governance. The respective narrative will be invariably observed by a dialogue as the way to exhibit inherent similarities and differences.

Since this chapter is applying the conventional narrative, bringing up conventional corporate governance theories is inescapable. Fundamentally, the descriptions of the corresponding theories will explore the overlapping as well as the contradictory features from the *Shariah* perspective. It is observed that, there are also theories that already described the fundamental aspects of *Shariah* governance from the Islamic finance point of view, as an addition. It is imperative to note that the question is not about which theory is better or closer to the *Shariah*. Most importantly, under *Shariah* purview, each theory introduced are acceptable as far as it is in compliance with its teachings. In the case of any potential areas that could be regarded as in contradiction, reconciliation is highly favourable by scholars rather than rejection. However, it is worth mentioning that such contradictories need to be either amended or revised.

5.2 Corporate Governance Theories: A *Shariah* Dialogue

To date, various theories have been defined, discussed and even debated by the researchers, practitioners and authoritative bodies as the articulation of their understanding on what corporate governance truly means and what mechanism ought to be in place. Some have put their focus on the relationships between all governance constituents where company serves as the nexus of the contract, whilst some on the objectives of the corporation as what happened on the

previous century.¹ Many debates have occurred, which mostly could be seen between the shareholder theorists and the stakeholder theorists. However, thus far, none seemed to be won by any school of thought. Likewise, as for the IFIs, similar attempts have been done by many researchers in the early part of the present century.² Two prominent theories have gained popularity at the moment, which are the stakeholder-oriented theory³ and the *tawhid* and *shura* theory.⁴ What has happened in the *Shariah* governance corpus might be not as overwhelming as its counterpart, but the capability of this corpus to escalate and endure the same experience is highly likely, eventually. Therefore, the attempt to investigate the potential area of improvement is rather consequential.

5.2.1 Conventional Corporate Governance Theories

Corporate governance theories are about the understanding of the existing relationship between the principal or the owner and the agent or the manager of the corporation. To justify this relationship, theorists from distinct areas of studies have been proposing various ways of explanation based on their backgrounds and experiences, which are rather diversified.⁵ Some theorists tend to pay attention to the functions of those relationships by emphasising the objective of the company is towards the shareholder's primacy whereas some have the tendency to show consideration for the other affected parties or the stakeholders. The debates on this matter have happened for almost a century, and it has mostly occurred between the shareholder wealth maximisation theory and the stakeholder theory.

In this part, the shareholder wealth maximisation theory and the stakeholder theory will be encapsulated in a compressed discussion on their descriptions as

¹ See also A Berle, 'Corporate Powers as Powers in Trust' (1931) 44 HLR 1049; EM Dodd, 'For Whom are Corporate Managers Trustees?' (1932) 45 HLR 1145; M Friedman, 'The Social Responsibility of Business is to Increase its Profits' *The New York Times Magazine* (New York, 13 September 1970); RE Freeman, *Strategic Management: A Stakeholder Approach* (CUP 1984)

² See also Zamir Iqbal and Abbas Mirakhor, 'Stakeholder Model of Governance in Islamic Economic System' (2004) 11 (2) *Islamic Economic Studies* 43-63; MK Lewis, 'Islamic Corporate Governance' (2005) 9 (1) *Review of Islamic Economics* 1-30; Abu Tapanjeh, 'Corporate Governance from the Islamic Perspective: A Comparative Analysis with OECD Principles' (2009) 20 *Critical Perspectives of Accounting* 556-567.

³ Zamir Iqbal and Abbas Mirakhor, 'Stakeholder Model of Governance in Islamic Economic System' (2004) 11 (2) *Islamic Economic Studies* 43.

⁴ Masudul Alam Choudhury and Muhammad Ziaul Hogue, 'Corporate Governance in Islamic Perspective' (2006) 6 (2) *Governance: The International Journal of Business in Society* 116.

⁵ The articulation of the corporate governance has been addressed by many researchers from business, finance, law and regulation as well as by many authoritative bodies especially the OECD.

well as the arguments on their strengths as argued by the advocates. The point of reference of the discussion is mainly the objective of the firm as it is in correlation with the trajectory of this research. After the narrations of those corresponding theories, dialogues under Islamic perspectives will take place in order to investigate part and parcel of such theories that are in compliance as well as those which are considered to contravene *Shariah*. It is important to note here that the selection of both theories is purely because of their reputation not only to the IFIs but also to the conventional system. Both theories have been classically defined, discussed and debated as well as most of the governance features being already well embedded by many advocates and opponents in their proposition concerning those theories. In fact, most IFIs are operated in accordance with one of those theories. Meanwhile, other theories such as the stewardship theory, agency theory, transaction cost theory, firm ascertaining theory and many more, might be less of a concern here as most of them are the by-products or the hybrids of the first two.

On the other hand, it is worth noting that the emergence of the *Shariah* governance corpus is rather new, not only to the global financial market, but also in the Islamic financial market itself. To date, there is a growing amount of literature attempting to articulate the underlying theories behind *Shariah* governance to cater to all the features peculiar to the IFIs in terms of its corporate governance system. Some researchers such as Iqbal and Mirakhor connoted the existing theories of corporate governance, paying special attention to the stakeholder theory to interpret what *Shariah* governance system really is.⁶ Meanwhile, some other researchers such as Choudhury and Hoque suggested the concept of *tawhid* and *shura* as the basic principles of *Shariah* governance.⁷ Eventually, at the moment, none of those approaches have gained the threshold of adequacy in order to be championed as the sole theory to explain the phenomenon. Therefore, this chapter will provide an academic counterbalance to those approaches in the light of investigating their pros and contras for the purpose of addressing the potential improvements to be proposed at the end of this research.

5.2.2 Shareholder Wealth Maximisation Theory

The shareholder wealth maximisation theory applies mostly in Anglo-American jurisdictions and Australia. The fundamental of this theory is moulded on the promise made by the directors to the shareholders of the company that their primary objective is to maximise the wealth of the shareholders.⁸ Directors are

⁶ Iqbal and Mirakhor (n 3).

⁷ Choudhury and Hogue (n 4).

⁸ Andrew Keay, 'Ascertaining the Corporate Objective: An Entity Maximisation and Sustainability Model' (2008) 71 (5) *The Modern Law Review* 663, 667.

the agents of the shareholders - who are the principals - and are employed to run the company's business for the shareholders who do not have the time or ability to do so, and it is therefore the shareholders who are best suited to guide and discipline directors in the carrying out of their powers and duties.⁹ This principal and agent notion emerged from an idea proposed by Alchian and Demsetz and Jensen and Meckling, who explained the corporation as the nexus of contracts among individual factors of production.¹⁰ Such a dichotomous corporate structure is depicted by Jensen and Meckling in contractual terms:

*The agency contract or a contract under which one or more person (principal(s)) engages another person (the agent) to perform some service on their behalf which involves delegating some decisions making authority to the agent.*¹¹

The shareholder wealth maximisation advocates articulate the theory based on four inter alia arguments,¹² which are the agency problem, shareholder ownership, shareholders as residual claimants and simply because it is more efficient.¹³

First, it is argued that the separation of ownership and control between the shareholders as the owners and the managers and the agents for the shareholders has caused the agency problem.¹⁴ Commencing from this, shareholder wealth maximisation theorist inherent Smithian moral assumption on human behaviour assuming that managers are self-interested agents or in other words, they cannot be trusted to achieve shareholders primary objective.¹⁵ This

⁹ John Matheson and Barent Olson, 'Corporate Law and the Long-term Shareholder Model of Corporate Governance' (1992) 76 Minnesota Law Review 1313.

¹⁰ Thomas Clarke, 'Theories of Governance-Reconceptualising Corporate Governance Theory After the Enron Enterprise' in Thomas Clarke (eds), *Theories of Corporate Governance the Philosophical Foundations of Corporate Governance* (New York, Routledge 2004) 5.

¹¹ Michael C Jensen and William H Meckling, 'Theory of the Firm: Managerial Behaviour, Agency Cost and Ownership Structure' (1976) 3 (4) Journal of Financial Economics 305, 308.

¹² Many debates have occurred mainly between shareholder value and stakeholder value advocates throughout the centuries. The classic example is denoted by in Berle vs Dodd. The post-modernisation debate happened in Friedman vs Freeman and the most recent debate can be witnessed in Sundaram and Inkpen vs Freeman.

¹³ Sundaram and Inkpen proposed the recent arguments of the present theory and advocated more about the efficiencies of the shareholder theory. Their arguments ignited further debate with the stakeholder theorist as each points were put across with the comparisons towards the stakeholder theory.

¹⁴ Anand K Sundaram and Andrew C Inkpen, 'The Corporate Objective Revisited' (2004) 15 (3) Organization Sciences 350, 350.

¹⁵ Bob Tricker, *Corporate Governance: Principles, Policies and Practices* (OUP 2009) 222.

argument is based on the premise that bringing together business and ethical codes is oxymoronic as those two premises are inherently incoherent. Such assumptions are also represented in the conflicting goals between individual level and organisation level, which in this case is between the company owned by the shareholders and its managers.¹⁶ Likewise, directors of the companies, managing other people's money, are unlikely to be expected to watch over it with the same vigilance with which they watch over their own.¹⁷ Moreover, the shareholders as the risk bearer at most can only depend on their right on the residual claims from the company's earnings after the managers settle the promised payoffs to all the contractual claimants.¹⁸

One of the distinctive feature that has gained some interest of the agency problem debates is information asymmetric. According to the advocates of the theory, shareholders who have delegated day-to-day decision-making to the directors, could only rely on limited access of information and at the same time the directors know the details of company's day-to-day operations.¹⁹ In fact, the shareholders are at disadvantage in contrast to those who manage the company.²⁰ In this relationship, as argued, directors could have the tendency to shirk or self-deal to maximise their personal benefit by taking actions that are advantageous to themselves but could have detrimental effects for the shareholders' value. Put differently, the directors will not always act in the best interest of the principals as the view of the directors as to how the business should be managed somehow might well be different, and contradictable to that of the shareholders.²¹ Most importantly, this shirking behaviour is to be monitored and controlled by appropriate incentives, where it could possibly increase the agency cost expenditure of a company. This includes the cost of structuring, monitoring and binding contracts between agents with conflicting interests.²² To this point, Mallin asserted that agency theory views corporate governance mechanisms, especially the board of directors, as being an essential monitoring device to try to ensure that any problem that may be brought about by the principal-agent relationship are minimised.²³

¹⁶ KM Eisenhardt, 'Agency Theory: An Assessment and Review' in T Clarke (eds), *Theories of Corporate Governance The Philosophical Foundations of Corporate Governance* (New York, Routledge 2004) 78, 83.

¹⁷ Tricker (n 15) 217.

¹⁸ Eugene Fama and Michael C Jensen, 'Separation of Ownership and Control' in Thomas Clarke (eds), *Theories of Corporate Governance the Philosophical Foundations of Corporate Governance* (New York, Routledge 2004) 64, 64.

¹⁹ Jensen and Meckling (n 11).

²⁰ Christine Mallin, *Corporate Governance* (4th edn OUP 2010) 17.

²¹ Jensen and Meckling (n 11) 308.

²² Fama and Jensen (n 18) 65.

²³ Mallin (n 20).

Second, the advocates of shareholder wealth maximisation theory also stated that the shareholders are the real owners and a corporation only exists as a vehicle to make money for their shareholders.²⁴ The origin of this presumption has a close relationship with the understanding of property rights.²⁵ Berle, as one of the preeminent advocates, asserted that the power given to the agents of the companies at all times is exercisable only for the rateable benefit of all the shareholders as their interest appears²⁶ in so far as the company was made up of assets which come from the capital that was the private property of the shareholders. Therefore it should provide them with a mission that would maximise their value.²⁷ In this regard, Allsop's analysis concluded that any action taken by the directors to fulfil anyone else's interests other than those of the shareholders' could be interpreted as a blatant breach of those shareholders' rights and would result in the directors being held in breach of trust.²⁸ Thus, the focal point of the director's fiduciary duties is merely to ensure the company run solely on the interest of making money for those shareholders. To some extent, Allsop regarded this argument as of the strongest argument put forward by those who advocate shareholder primacy, whereby the directors have a duty to act in accordance with their best interests.²⁹

Third, in order to support their argument, the advocates of the shareholder wealth maximisation also argued that shareholders are residual claimants of the profit produced by the positive performance of the company. In other words, the company must be run for the benefit of the shareholders while still solvent.³⁰ As the nexus³¹ of the complex set of explicit and implicit contracts,³² the company is a centre of a collective interest of the stakeholders and most of them are non-shareholders who enjoy the benefit of fixed claims from the contracts between them and the company. In this sense, it is argued that the contracts entered into

²⁴ Laura Allsop, 'Should Companies Be Run Purely to Serve the Interests of Shareholders?' (2012) 1 (1) UK Law Student Rev, 61.

²⁵ Harold Demsetz, 'Towards a Theory of Property Rights' (1967) 57 (2) The American Economic Review 347.

²⁶ Adolf Berle, 'Corporate Powers as Powers in Trust' (1931) 44 HLR 1049.

²⁷ Julia Bistrova and Natalja Lace, 'Defining Key Factors to Sustain Maximum Shareholder Value' (2012) Journal of Financial Studies and Research 1.

²⁸ Allsop (n 24).

²⁹ *ibid* 62.

³⁰ Keay, 'Ascertaining the Corporate Objective' (n 8) 667.

³¹ Coase argued that companies are the nexus of contracts to minimise the transaction costs of the market; See also Ronald Coase, 'The Nature of the Firm' (1937) 4 *Economica* 386.

³² Jonathan R Macey, 'Fiduciary Duties as Residual Claims: Obligations to Non-shareholder Constituencies from a Theory of the Firm Perspective' (1999) 84 *Cornell Law Review* 1266.

by non-shareholder groups such as employees, managers, and creditors are explicit contracts entitling them to fixed payments, such as salaries and interest payments. On the other hand, the shareholders only rely on the implicit contract that entitles them to the remainder of the claim after the company has met its explicit obligations and paid its fixed claims.³³ Therefore, the focus of the directors as the agents who work for the shareholders must be on maximising the value of the claims. Macey said that as the residual claimants, shareholders have the greatest stake in the outcome of the company's performance.³⁴ They will gain a positive benefit if the company performed well but will suffer if the company has negative financial performance. Furthermore, as they are only eligible to the claims if the company remains solvent, the shareholders are the only claimants who will act in their best effort to maximise the total value of the company.³⁵

Fourth, part and parcel of the shareholder value maximisation theory is efficiency. The theorist emphasises the directors would be more efficient only if they were a single group who are at the highest stake to be favoured.³⁶ Another side of this argument is that it is more efficient as the directors execute the business only to maximise shareholders' wealth, in the light that the least cost is expended in doing so.³⁷ By providing the managers a clearer goal on managing the company, the task is also more likely to succeed.

5.2.2.1 The Counterbalance

As a start to the counterbalance aspect of this theory from *Shariah* perspective, it is worth noting the background that forms the method of our dialogue. In this sense, Islamic jurists look at realism as the way to perceive the existing circumstances and compare it with the ideal conceptual teachings that are available in the Islamic sources. When there are circumstances, the first step taken is to figure out the compliance aspects of the subject as well as its non-compliance, which is then followed by discussions over whether that would be the best proposal to deal with such.

As for the shareholder wealth maximisation theory, despite the fact that it urges the directors to serve their purpose as agents to maximise the shareholder's

³³ Frank Easterbook and Daniel Fischel, *The Economic Structure of Company Law* (HUP 1991) 36-39.

³⁴ Macey (n 32) 1267.

³⁵ Sundaram and Inkpen (n 14) 353.

³⁶ Thomas Donaldson and Lee E Preston, 'The Stakeholder Theory of the Corporation: Concepts, Evidence and Implications' (1995) 20 (1) *Academy of Management Review* 65, 78.

³⁷ Thomas A Smith, 'The Efficient Norm for Corporate Law: A Neo-traditional Interpretation of Fiduciary Duty' (1999) 98 *Michigan Law Review* 214, 227.

wealth by putting less consideration on morality,³⁸ there are several aspects that could be regarded as in agreement with certain provisions within *Shariah* principles. First, the *Shariah* financial law recognises the ownership of shareholders of the company. By deploying *mudarabah* and *musharakah* agreements, shareholders are regarded as *rabb-mals*, the owners of the property or the principal.³⁹ Meanwhile, companies as fictitious entity is the agent for the *rabb-mals* known as *mudarib*.⁴⁰ At the same time, directors serve as agents of the respective companies who are bounded with agency contract called *wakalah*.⁴¹ The *rabb-mals* as the shareholders, through the company, delegate the directors with managerial power over the principal for the shareholders' benefit. In this relationship, the directors who were appointed by shareholders, ought to manage the business in accordance with their will as the owner has stated in the company's article of association. Directors could not take any business decisions and actions that would have potentially jeopardised the invested principal. Reasonable business risks are accepted but it has to be with the consent of the shareholders. Considering the company as the private property of the shareholders might be naive in modern circumstances.⁴² However, such an interpretation still holds its ground if it is going to be used as the way to articulate a small and developing company.

Second, as the owners, shareholders have the right to put necessary controlling mechanisms on directors. In this regard, through agency and *mudarabah* contracts, *Shariah* financial law provides directors with the power to manage day-to-day business without any interference from the shareholders as silent partners.⁴³ In fact, shareholders only have the rights of the overall decision-making for the primary purpose of such contracts.⁴⁴ Moreover, the shareholder's primary objective is to enable them to invest without exposing themselves to liabilities in access to capitals; meanwhile, the managers to gain freedom in

³⁸ Some have credited Friedman with the 'business is business' notion, which could be regarded as one of the most extreme arguments by the advocates of the present theory. However, many other advocates argue that moral values is essential and unavoidable in order for the company to survive and prosper.

³⁹ Muhammad Nijatullah Siddiqi, *Banking without Interest* (The Islamic Foundation, Leicester 1983) 15.

⁴⁰ This is based on the accepted opinion that the company is an independent entity as per discussed in Chapter 2. By this, company is entitled to perform contractual obligations as if it were a living entity.

⁴¹ Usman Hayat and Adeel Malik, *Islamic Finance: Ethics, Concepts and Practice* (CFA Institute Research Foundation 2009) 32.

⁴² Tricker (n 15) 225.

⁴³ Mahmoud A ElGamal, *Islamic Finance: Law Economics and Practice* (CUP 2006) 118.

⁴⁴ Nasser M Suleiman, 'Corporate Governance in Islamic Banks' (2000) *Arab Gateway* 98, 102.

managing the entrusted capitals.⁴⁵ However, such freedom is not to be left unattended. In this matter, *Shariah* law protects the shareholders' rights to enclose a safe-guarding mechanism to mitigate the risk of self-maximising, short-termism and self-dealing process by the directors especially to ascertain the sustainability of the company.

Third, *Shariah* law also honours the company as the nexus of contracts. Commencing from the shareholder-director agency contract, directors will then enter into another collective contractual agreement with other business parties as they see fit.⁴⁶ Each one of those agreements, such as employees, customers and suppliers has a standalone contract that would bind each party to fulfil the stipulated obligations. The main task of the directors is to configure the need of each claimant for the best benefit of the business and to ensure that the company entrusted to them will remain solvent and earn profit, so the shareholder as a residual claimant could claim her/his share.

Fourth, shareholders are the residual claimants of the profits gained by the company. It is important to note that the *mudarabah* and *musyarakah* agreements attested that the shareholders are the risk-bearers since those contracts stipulate that in the case of loss, it would be bore by the principal.⁴⁷ Regardless of profit or loss, other residual claimants are given priority to make claims especially those who are contractual claimants. In order to ensure that there is 'residue' to be claimed, shareholders are allowed to put necessary mechanisms capable of mitigating the risk and enhance the possibility of success for the company.⁴⁸ Thus, addressing the shareholders as the director's main concern and needing to be diligently served might not be an over-statement.

On the other hand, notwithstanding that there are features of the shareholder wealth maximisation theory concurred by *Shariah*, it is still contended in several ways. First, under the *Shariah* perspective, an agent should be treated as a trustee unless he/she commits negligence and fraud.⁴⁹ This notion stands as a

⁴⁵ Frank E Vogel and Samuel L Hayes, *Islamic Law and Finance: Religion, Risk and Return* (Kluwer Law International 1998) 130.

⁴⁶ *Shariah* law sees all the contracts involved by the company independently from the formation of company's partnership to each contractual agreement between the company with the employees, customers, creditors and other constituents. *Shariah* law upholds the obligations disclosed within every contracts.

⁴⁷ Hennie Van Greuning and Zamir Iqbal, *Risk Analysis for Islamic Banks* (The World Bank 2008) 24.

⁴⁸ *ibid* 126.

⁴⁹ Muhammad Taqi Usmani, *An Introduction to Islamic Finance* (Kluwer Law International 1998) 107.

fundamental notion of agency contract under *Shariah* law. If directors are untrustworthy, how is it possible for the shareholders to name them as their agents to manage the property on their behalf? Such assumptions have also attenuated the moral value of business and could be credited as one of the factors behind demoralising business activities by modern society, which is rather in contrast with the Islamic teachings. Moreover, this claim also somehow has provided the shareholders with the justification, as the sole owner, to pursue their own interest that could violate the rights of other stakeholders, who are to some extent also affected by the existence of the company from the beginning.⁵⁰ In fact, a director should be a person that could be trusted to ease the conflicting objectives of the collective governance constituents and bring them into an equilibrium configuration within a contractual framework.⁵¹

Second, claiming that business and moral value being together is an oxymoron is far beyond the teaching of Islam. The idea proposed by the separation thesis,⁵² assuming that ethics and economics can be neatly and sharply separated, is unacceptable in many respects.⁵³ This view also downplays the language of morality and moral complexity. Since Islam is the way of life that emphasises the important role of ethics, business and ethics are considered as inseparably intertwined. The link of the both is irrevocable. Each stakeholder has moral responsibility regardless of their positions. The shareholders and the directors for instance, should be responsible morally for whatever business decisions and actions they choose to take. In addition to that, shareholders also ought take action by withdrawing their share if they see the managers run the business without moral consideration. Similar power also should be utilised by other stakeholders accordingly. Most importantly, those who are affected because of the operations of the company should not be ignored whether they come in humanity, constitutional or environmental forms. It is worth noting that business from the Islamic perspective is not only about making money for those who own the capital, but it is also about creating a better life for the stakeholders.⁵⁴ The easiest way to determine business success might be through the amount of wealth that is created by the particular business. However, how that wealth could

⁵⁰ R Edward Freeman and others, 'Stakeholder Theory and "The Corporate Objective Revisited' (2004) 15 (3) *Organisation Science* 364, 365.

⁵¹ Jensen and Meckling (n 11) 311.

⁵² The separation thesis is the idea that business and morality could be separated in a certain way, where it has been rejected by many as argued by Sanberg: See also J Sanberg, 'Understanding the Separation Thesis' (2008) 18 (2) *Business Ethics Quarterly* 213.

⁵³ Jared D Harris and R Edward Freeman, 'The Impossibility of the Separation Thesis: A Response to Joakim Sanberg' (2008) 18 (4) *Business Ethics Quarterly* 541.

⁵⁴ Toseef Zaid and others, 'Theory of The Firm, Management And Stakeholders: An Islamic Perspective' (2007) 15 (1) *Islamic Economic Studies* 1, 6.

bring prosperity for the *ummah* is essential in Islamic teachings and should not be taken for granted.

Third, the notion of private property rights is diversely articulated by *Shariah* law as opposed to that of capitalism.⁵⁵ In the Islamic view, Allah is the Creator, hence, He is the absolute owner of everything that exists in this world. This notion of belonging does not mean that the human has no rights to privately possess the property. For the matter of fact, private property rights, whether for a Muslim or non-Muslim, are protected by *Shariah* law, and nobody has the rights to violate such provision unless it comes with acknowledged transactions.⁵⁶ It is important to note that humans as His vicegerents are merely trustees of the property.⁵⁷ Therefore, they are obliged to utilise and manage the property in accordance with the *Shariah* law.⁵⁸ This means that whatever business decisions and actions taken by the shareholders and the directors, it should be in compliance with such an obligation. The ultimate goal of this notion is to keep the balance between the rights of the individuals, society and the state.⁵⁹ All parties are responsible for each action they have taken and the subject under *Shariah* law especially when they trespass the rights of others. There is no such thing as absolute ownership by certain groups, i.e., shareholders that could not be questioned simply because it is privately owned by them.

5.2.3 Stakeholder Theory

The stakeholder theory is mostly implemented in Continental European countries such as Germany and it is well applied in Japan. Commencing from the premise of the objective of the company, Donaldson and Preston explained the theory as the inherently managerial task of the directors, as supported by Freeman, the pioneer of this school of thought.⁶⁰ It is articulated as such, in the way that it reflects and directs how managers ought to operate a company to achieve company's objectives. The sole purpose of the firm is, in the view of the present theory, to serve as a vehicle for coordinating stakeholders' multidimensional interests.⁶¹ Essentially, there are two fundamental questions asked by the advocates of this theory, which are 'who are legitimate stakeholders?' and 'how to manage those who are the stakeholders?' The accuracy of the stakeholder

⁵⁵ Usmani (n 10) 10.

⁵⁶ Hayat and Malik (n 41) 15.

⁵⁷ Abdel Hameed M Bashir, 'Property Rights in Islam' (3rd Harvard University Forum on Islamic Finance: Local Challenges, Global Opportunities, Harvard University October 1999) 71.

⁵⁸ Iqbal and Mirakhor (n 3) 50.

⁵⁹ *ibid* 53.

⁶⁰ Freeman and others (n 50); Donaldson and Preston (n 36).

⁶¹ Evan and Freeman 1993 102- 103

identification process is considerably overreached in this theory as it holds the key of the success of the second question. It possesses the tips of how directors should act to serve the interests of those stakeholders at best. Likewise, the both *identify* and *manage* processes are intimately intertwined and crucial.⁶²

In their way of identifying who and what should be entitled stakeholders, the advocates of the theory have been defining the stakeholders in many forms. Freeman defined stakeholders as any group or individual who can affect or is affected by the achievement of the organisation's objectives.⁶³ He also cited the 1963 Stanford Research Institute memo, the document that used the phrase 'stakeholder', which defined first as those groups without whose support the organisations would cease.⁶⁴ In similar intent, Hill and Jones have considered the constituents with a legitimate claim on the firm as the stakeholders.⁶⁵ Later on, Donaldson and Preston stated that stakeholders could be identified through the actual or potential harms and benefits that they experience or anticipate experiencing as a result of the firm's actions or inactions.⁶⁶ Despite the fact that most of these definitions have come with a fairly wide array of explanations,⁶⁷ the point of reference of this identification is primarily on the key stakeholders that hold the intrinsic value of the company. They are also identified by their interests in the corporation, whether or not the corporation has any corresponding functional interest in them.⁶⁸

In this regard, multiple models have been suggested to carry out the task, as could be seen in many writings.⁶⁹ However, by large, to enquire who and what matters neither complex nor sophisticated to be discovered. Stakeholders could be employees, customers, suppliers, stockholders, banks, environmentalists, governments and other groups who can help and hurt the corporations. Some researchers like Hill and Jones are classified stakeholders based on their

⁶² Fran Ackermann and Collin Eden, 'Strategic Management of Stakeholders: Theory and Practice' (2011) 44 Long Range Planning 179.

⁶³ R Edward Freeman, *Strategic Management: A Stakeholder Approach* (CUP 1984) 46.

⁶⁴ *ibid*

⁶⁵ Charles WL Hill and Gareth R Jones, *Strategic Management: An Integrated Approach* (9th edn 2008 Cengage Learning) 16.

⁶⁶ Donaldson and Preston (n 36) 85.

⁶⁷ Samantha Miles, 'Stakeholder: Essentially Contested or Just Confused?' (2012) 108 (3) *Journal of Business Ethics* 285.

⁶⁸ Hill and Jones (n 65) 347.

⁶⁹ See also John M Byron, 'What to Do When Stakeholders Matter: Stakeholders Identification and Analysis Techniques' (2004) 6 (1) *Public Management Review* 21; Jeffrey Cummings and Jonathan P Doh, 'Identifying Who Matters: Mapping Key Players in Different Environments' (2000) 42 (2) *California Management Review* 83.

priorities either externally or internally to the company.⁷⁰ Some others have divided those stakeholders into primary stakeholders, secondary stakeholders and the key stakeholders. Ackermann and Eden, used the stakeholder theory to identify the stakeholders for a certain corporation and the dynamics of their relationships and to answer the question of how to attend to the needs of those stakeholders who are diverse strategically.⁷¹ In this regard, they suggested that each stakeholder is identified and managed by the mapping of their level of interest and power that could affects the company.⁷² This is one of the examples of many other approaches.

After considering which stakeholders matter and count, for the sake of the company, the present theory addresses managerial strategies that should be brought into action. At this point, the theory revolves around the idea of managing the broader interests of the stakeholders, rather than merely focussing on the shareholders.⁷³ In doing so, the advocates acknowledge, inter alia, ethical codes as part and parcel of the stakeholder theory. In order for a business to be successful, they believe that companies should not only be viewed as a money generators, but also needs to be viewed as a social service, which has a profit-making function.⁷⁴ Therefore, the separation thesis is incompatible as it sees the business affairs should be dealt away from ethical affairs.⁷⁵ Regarding this, the normative theorist said, the directors ought to consider the affected parties in their business decision and actions.⁷⁶

On the real occasion, most of our daily business activities require the maintenance of basic ethical standards to be presented by all parties, such as being honest, not taking unreasonable advantage of other parties, respecting each other, especially workers and clients, and cooperation with colleagues.⁷⁷ For instance, the directors should be endowed with the ability to acquire sufficient knowledge of what is demanded by the customers before they decide what sort

⁷⁰ Hill and Jones (n 65) 374.

⁷¹ Ackermann and Eden, 'Strategic Management of Stakeholders' (n 62).

⁷² Fran Ackermann and Collin Eden, *Making Strategy: Mapping Out Strategic Success* (2nd edn Sage Publications 2004) 256-262.

⁷³ Lynn A Stout, 'Bad and Not-So-Bad Arguments for Shareholder Primacy' (2002) 75 Southern California Law Review 1189, 1189.

⁷⁴ E Merrick Dodd, 'For Whom are Corporate Managers Trustees?' (1932) 45 HLR 1145, 1148.

⁷⁵ R Edward Freeman, 'Politics of Stakeholder Theory: Some Future Directions' (1994) 4 (4) Business Ethics Quarterly 409, 420.

⁷⁶ Darryl Reed, 'Stakeholder Management Theory: A Critical Theory Perspective' (1999) 9 (3) Business Ethics Quarterly 453.

⁷⁷ John W Collin, 'Is Business Ethics an Oxymoron?' (1994) Business Horizon September-October 1.

of products to be offered to the market. To execute this mission, the directors are obligated to anticipate the effects of their decision to offer such products to the shareholders, suppliers, employees and so on. They ought to ensure that all those who are at stake have been attended to accordingly by balancing the best offer that could be delivered for each of them while keeping the company solvent. This task is rather tough, but not impossible as it has been proven by Cadbury⁷⁸, Apple Inc.⁷⁹ and many more across the globe.

In terms of its implementation, the stakeholder theory could be credited as one of the widest theory accepted as reference of corporate governance systems. There are several reasonable explanations for the present theory holding its ground as a prominent theory describing such phenomenological issues in the company. Essentially, it is simply because the stakeholder theory recognises humans' value and has articulated the right ways of doing business to the managers. In contrast with the shareholder value maximisation advocates, Freeman and Evan emphasised the notion of fairness by spreading the profit among the stakeholders, which extinguishes the separation thesis out of the discussion.⁸⁰ In his later debates, Freeman, together with another advocates, asserted that the economic value that is created by people who voluntarily come together and cooperate to improve everyone's circumstances.⁸¹ It is the reality of our modern economics environment that underscores the importance of all relating governance constituencies.

The stakeholder theory also provides the right way of dealing with business parties. One could not deny the actual fact about managing a company, where we are actually dealing with people with faces, names, families and so on, who would affect and affected by any decision made by the directors. To deal with this, the present theory provides them with the solution so close with humanity and it is certainly the right way to conduct business. As in the UK, despite the fact that the enlightened shareholder theory does not mention implementing the

⁷⁸ Cadbury Schweppes established relationships with their stakeholders by consulting regularly with their employees, responding positively to their needs and aspirations and generally treating them well. Cadbury Schweppes also maintains a close relationship with its consumers to ensure it is making products that meet their needs. Listening to consumers in this way helps the company to maximise its investment in product research and development and grow its market share.

⁷⁹ Apple Inc. offer a wide range of support for the customer if they are having problems. On the Apple website they have a service which gives a number of different ways to contact Apple. This helps Apple to research the most common problems in their products are and it helps them to see more ways they can improve through customer feedback.

⁸⁰ Evan and Freeman 1993

⁸¹ Freeman and others (n 50) 364.

stakeholder theory, it could not resist the importance of the stakeholders.⁸² There is ample descriptive evidence, some of it already cited, that many managers somehow believe themselves, or are believed by others, to be practicing the stakeholder-based management,⁸³ implicitly, under the model that favours the shareholder value maximisation. It simply means that, as humans, the directors could not avoid the value of humanity. In this regard, Freeman once asked how else could a manager create shareholder value other than by creating products and services that customers are willing to buy, offering jobs that employees are willing to fill, building relationships with suppliers that companies are eager to have, and being good citizens in the community?⁸⁴

Last but not least, the stakeholder theory comes with the notion of recognising as many constituencies as we can, especially when we come across with the definition given by Freeman. Implicitly, this notion has included the shareholders as one of the constituents that are at stake because of the company's decisions and actions. Dividing the shareholders and the stakeholders into different groups of concern is roughly the logical equivalent of contrasting apples with fruit. Creating the value for the stakeholders creates the value for the shareholders.⁸⁵

5.2.3.1 The Counterbalance

In terms of the Islamic perspective on the present theory, some researchers have upgraded the theory into a new dimension which combines it with those of Islamic values.⁸⁶ In this sense, Oseni argued that it is undoubtedly that the present theory has exhibited some modicum of Islamic understanding of justice, transparency and ethics in doing business.⁸⁷ Like the previous theory, the present theory also shares the pros and contras with the values promulgated by *Shariah*.

As for the similarities, first and foremost, *Shariah* law values stakeholders as the present theory does. Business is not only about creating wealth for the owning shareholders but also the constituents that are at stake because of the company's business decisions and actions into a reasonable consideration. Non-shareholder stakeholders such as the employees, customers, suppliers and

⁸² Collins C Ajibo, 'A Critique of Enlightened Shareholder Value: Revisiting the Shareholder Primacy Theory' (2014) 2 (1) Birkbeck Law Review 37.

⁸³ Donaldson and Preston (n 36) 75.

⁸⁴ Freeman and others (n 50) 366.

⁸⁵ *ibid*

⁸⁶ It is known as the stakeholder-oriented *Shariah* governance approach and it will be discussed further in this chapter consecutively within the forthcoming subtitles.

⁸⁷ Umar M Oseni and others, 'Corporate Governance and Effective Dispute Management in Islamic Financial Institutions' (2012) 6 (11) Australian Journal of Basic and Applied Sciences 361,362.

others share similar attention accordingly from the present theory and *Shariah* law. The main task of the directors is to configure a strategy that could cater to the needs of those stakeholders in order to create equilibrium.⁸⁸

Second, the present theory has a similar perspective to *Shariah* in the way it values morality and ethics, whereby the separation thesis is far beyond recognition. Humanity is a natural moral instinct and trying to separate those features from its host is disastrous. It is not only putting the stakeholders at stake, but could also eventually victimised the shareholders in the similar way that they victimised others in the light of a neutral moral value premise.⁸⁹ As argued by Harris and Freeman, dichotomising business and ethics is a fool's errand that is not useful, helpful or even meaningful or in other words is impossible.⁹⁰

On the other hand, the stakeholder theory does have its controversial aspects when it comes to the *Shariah* perspective. As a starter, despite the fact that the present theory values morality, it is still contended in terms of how to define such a notion. Moral value itself holds a universal definition that is fairly diverse from one civilised society to another and has no time limitation. As Reed argued, it has been about the employment of different ethical traditions to elaborate different normative stakeholder theories.⁹¹ In this regard, the potential dispute is undeniable and irreconcilable when it comes to a multicultural application.⁹² In our multinational globalised business world, forming such a value into a singularity is quite impossible and if the directors are meant to deal with this, it could potentially cause the overriding focus not only on the shareholder but also other stakeholders, which eventually divert them from their ultimate goals.⁹³ At this rate, the notion of balancing the needs of the stakeholders is no longer a matter for them.⁹⁴ If having more than one objective function could create confusion in decision-making,⁹⁵ as argued by the opponents of the present theory, how about having those unclear multidimensional moral values?

⁸⁸ Jensen and Meckling (n 11) 311.

⁸⁹ See also Andrew Abela, 'Adam Smith and the Separation Thesis' (2001) 106 (3) *Business and Society Review* 187, 190.

⁹⁰ Harris and Freeman (n 53) 542.

⁹¹ Darryl Reed, 'Employing Normative Stakeholder Theory in Developing Countries: A Critical Theory Perspective' (2002) 41 (2) *Business and Society* 166.

⁹² Elaine Sterberg, 'The Defect of Stakeholder Theory' (1997) 5 (1) *The International Journal of Business in Society* 3.

⁹³ Mallin (n 20) 20.

⁹⁴ Keay, 'Ascertaining the Corporate Objective' (n 8) 669.

⁹⁵ Sundaram and Inkpen (n 14) 354.

Second, there are no clear and substantive suggestions on how to manage the affected stakeholders. As argued, the question of which stakeholder should matter or matter more is left unanswered, whereby it is rather wishful thinking to suggest that directors must juggle those multiple goals in a complex hierarchy of collective contractual relationships.⁹⁶ Many advocates have suggested different approaches to identify which constituents should be counted and given priority as the key stakeholders; however, they seem to be open for further debates. To some extent, this is a fairly strong argument put across by the opponents of this theory. It is argued that because of this unclear notion, the company is seemed to be ruled by too many masters, which could have caused the inefficiency and the managers are not accountable to a specific person, where it may lead to an escapism.⁹⁷ This problem is grounded from the failure to form a universality on how to configure such an issue. It is argued that the present theory has been interpreted with a wide array of definitions, discussions and focus.⁹⁸ At the first glance, it could be regarded as a positive sign; however, in terms of the implementation, it seems to provide too many options that eventually may lead to confusion.

Third, in conjunction with the previous argument, *Shariah* law has a fairly different connotation to a contractual agreement between bank and its customers. This argument is essential since this research is going to be implemented into the financial institutions. In many circumstances, especially in the conventional systems, customers at some point are creditors to the bank.⁹⁹ It could be seen when both of the abovementioned theories applied to the banking companies, customers will be seen as money lenders that could charge interest at a certain rate to the bank for each penny deposited. In contrast, *Shariah* law prohibits¹⁰⁰ such contractual agreement and it is regarded as one of the factors that put the shareholders and the directors in an unfavourable situation. As argued, the uncertain amount of interest charge to be paid by the bank, to some extent, has put the creditors as non-shareholding shareholders. What makes it worse is that the rights of creditors to claim the credited amount along with the interest are above the rights of the shareholders who could only be considered as the residual claimants. Such a situation has positioned the creditors at the top of the stakeholder pyramid,¹⁰¹ even higher than the owners, no matter whatever theory is employed especially when the company is or nearly insolvent.

⁹⁶ *ibid*

⁹⁷ Byron (n 69).

⁹⁸ Miles (n 67).

⁹⁹ Suleiman, (n 44) 99.

¹⁰⁰ Mervyn K Lewis and Latifa M Algoud, *Islamic Banking* (Edward Elgar 2001) 2.

¹⁰¹ Andrew Keay, 'Tackling the Issue of the Corporate Objective: An Analysis of the United Kingdom's Enlightened Shareholder Value Approach' (2007) 29 *Sydney Law Review* 577, 582.

To conclude this part of the present chapter, it is clear here that even the mentioned theories are not from *Shariah* origin, they are not fully unacceptable. This is a substantial point of reference to be emphasised as it could be the starting point to find similarities between those theories under the Islamic dialogue. Having said that, there are features agreed by the *Shariah* to be implemented by the IFIs in their corporate governance systems along with additional *Shariah* governance mechanisms. We could also say that the *Shariah* perspective provides a new way of viewing the issue, other than the existing corporate governance school of thoughts. The result might be different in many ways, but apparently it widens the horizon of the corporate governance body of knowledge.

5.3 *Shariah*-Based Governance Theories

The discussions on the *Shariah* governance theories are considered to be in their infancy. The use of '*Shariah* governance', the phrase itself, only started from the writing of the IRTI guidelines issued in 2002 by Ahmed and Chapra. The point of reference of the *Shariah* governance topics is somehow diverse as opposed to the corporate governance, in terms of the interpretation of the objective of the firm. The *Shariah* governance was formed based on the objective of the IFIs to meet its stakeholder's desire to conduct their financial business according to *Shariah* law.¹⁰² Therefore, the Islamic financial standard-setters and the IFIs practitioners tended to fix their lens on the mechanism that could improve them to achieve their peculiarities on the *Shariah* compliance needs, not only on the mechanism to maximise the value of the institutions.

There are two primary versions of discussion discovered from the literature, the pure *Shariah* based and conventional oriented version. For the *Shariah* based theory, there is the *Tawhid* and *Shura* theory proposed by Choudhury and Hoque. Meanwhile, Iqbal and Mirkahor proposed the stakeholder-oriented theory, a conventionally oriented version.

5.3.1 *Tawhid* and *Shura* Theory

Many researchers have credited Choudhury and Hoque for the *tawhid* and *shura* theory of the *Shariah* Governance.¹⁰³ In conjunction with this notion, Grassa mentioned that this theory could be regarded as the first model of corporate

¹⁰² See also Wafik Grais and Matteo Pellegrini, 'Corporate Governance in Institutions Offering Islamic Financial Services: Issues and Options' (2006 World Bank Policy Research Working Paper 4052).

¹⁰³ Choudhury and Hogue (n 4).

governance in the Islamic finance.¹⁰⁴ The present theory has normative features in describing the notion of the *Shariah* governance, by which it is fundamentally moulded based on the principle of the *tawhid* or the oneness of God and the *shura* or consultation. Those intertwined conceptions provide the foundation of the *Shariah* governance wisdom.¹⁰⁵ The concept of *tawhid*, has been expressed by Choudhury and Hoque as the unity of knowledge that stands as an epistemological element of the *Shariah* governance. In addition to that, they referred to *shura* as a total organic process and the medium of discovering the unity of knowledge through systemic interrelationships, by which considered as an organic relational epistemology.¹⁰⁶

Each constituent of the *Shariah* governance is immersed in a discursive cognitive understanding of *tawhid* or the unity of knowledge as a long-life learning process of decision-making. The complementary elements of that knowledge could be attained using the interactive, integrative and evolutionary (IIE) process through systemic stimulation and realisation.¹⁰⁷ The IIE process steers all constituents towards the interacting environmental factors: the principle of fairness and justice, the principle of productive engagement of resources in social and economic activities and the principle of recursive intention.¹⁰⁸ In this regard, Hassan argued that the present principle of *tawhid* derives important realisations of concepts of vicegerent, trustworthiness and justice conception for all governance constituents.¹⁰⁹ Those elements emerge from the decisions and actions made in compliance with the *Shariah* law as the main preference of the *Shariah* governance system.

On the other hand, *shura* is considered a medium for all organic constituents and with their cognitive capabilities, after the attainment of discursive understanding of the unity of knowledge, to come together and participate in the real issues with the goal of reaching a relational unification.¹¹⁰ To this end, all constituents have the responsibility to get involved in order to achieve a consensus through their

¹⁰⁴ Rihab Grassa, 'Shariah Supervisory System in Islamic Financial Institutions' (2013) 29 (4) Humanomics 333.

¹⁰⁵ Zulkifli Hassan, 'Corporate Governance: Western and Islamic Perspective' (2009) 5 (1) International Review of Business Research Paper 277, 285.

¹⁰⁶ Choudhury and Hogue (n 4) 116.

¹⁰⁷ *ibid* 122.

¹⁰⁸ Masudul Alam Choudhury, *Islamic Economic Cooperation* (Macmillan 1989).

¹⁰⁹ Hassan, 'Corporate Governance: Western and Islamic Perspective' (n 105) 284.

¹¹⁰ Choudhury and Hogue (n 4) 122.

collective contractual relationship. Each affected stakeholder has their right to be considered with the goal of far-reaching social wellbeing.¹¹¹

5.3.1.1 The Counterbalance

The present theory is a prominent concept to interpret the worldview of Muslims of how to understand the phenomenon of corporate governance. This method provides reasonable explanations of the variety and sometimes contradictory articulations on familiar subjects by different parties. It is simply rooted from the fundamental expression of a diversified worldview on a certain issue. Notwithstanding, the present theory is based on a similar view as shared by this research, that there is still room for improvement, which would be valuable, if it could be brought into this discussion.

First and foremost, the present theory is rather unclear and fairly ambiguous in terms of how it could be adopted and implemented in the current corporate governance system.¹¹² The concept of unity of knowledge has been articulated without any definition of which knowledge must be mastered by the constituents. When all related constituents are about to gain consensus through *shura*, the capability and the efficiency of certain information is required. In this regard, not only the Islamic knowledge, but also other complementary aspects of information are demanded, which could assist the right choice during decision-making. Regarding this, a *Shariah* committee as the most recent form of *shura* within the IFIs also faces a similar issue. The members of the *Shariah* committee are expected to be well equipped with contemporary scholarship, especially in both the *Shariah* and on the matter of business strategies.¹¹³

Second, the present theory is also lacks of mechanisms that would make the implementation of the theory an eventuality. The Islamic literature is full of references that could be deployed in order to bring the present theory into action. Beside the epistemological aspects of *tawhid* and *shura*, there are numerous applicable mechanisms available, addressing those notions.¹¹⁴ The only obstacle is how to adopt the theoretical form of them into our modern multidimensional

¹¹¹ Masudul Alam Choudhury and Mohammad Nurul Alam, 'Corporate Governance in Islamic Perspective' (2013) 6 (3) Journal of Islamic and Middle Eastern Finance and Management 180.

¹¹² Hassan, 'Corporate Governance: Western and Islamic Perspective' (n 105) 285.

¹¹³ Zulkifli Hassan, 'In Search of the Perceptions of the *Shariah* Scholar on *Shariah* Governance System' (2014) 7 (1) International Journal of Middle Eastern Finance and Management 22, 28.

¹¹⁴ This research will address a comprehensive discussion on such mechanisms in the forthcoming chapters.

corporate models: a process that requires not only a brief understanding, but also an in-depth insight into such mechanisms.

5.3.2 Stakeholder-oriented *Shariah* Governance Theory

The stakeholder-oriented *Shariah* governance theory is a theory that utilises the features proposed by the stakeholder theory in a way that it could possibly be implemented by the IFIs. In other words, they are discussing the same stakeholder theory, but from the Islamic perspective which is why some might see this part of the discussion contents similarities to the theory respectively. As with its counterpart, it is a managerial theory for the IFIs corporate governance system, as mostly practised in the market. According to this theory, the principal objective of the company is not only to maximise shareholder's wealth but also to maximise the welfare of all affected stakeholders. Iqbal and Mirakhor as introducing this intriguing model, argued that governance structure and process at systemic and company levels are the mechanisms that protect the rights of the stakeholders, who are exposed to any risk as a result of the company's activities.¹¹⁵ Concerning this, they defined a stakeholder as the one whose property rights are at stake or at risk due to voluntary or involuntary actions of the company.¹¹⁶ This means, if someone's rights are threatened by the result of a company's decisions and actions, those individuals, groups, or communities will become stakeholders for the particular company.

The present theory follows the steps of the stakeholder theory in the light that the foundation of such a model could be found in Islamic principles. It has been argued that the foundations of this theory are observable within the Islamic principles of property rights and the commitment to explicit or implicit contractual obligations.¹¹⁷ Most importantly, this theory emphasises the importance of protecting the interests of all stakeholders. With regard to this matter, the *Shariah* committee is considered a consequential governance structure peculiar to the IFIs that ascertain *Shariah* compliance in all of the IFIs products and services. At the same moment, the board of directors is responsible to protect the financial interest of the shareholders, as well as to perform all contractual obligations, explicit or implicit, to other stakeholders. Conjointly, regulatory and supervisory authorities are considered the providers of a regulatory and supervisory environment in order to enable such a governance system performing its functions accordingly.¹¹⁸

¹¹⁵ Iqbal and Mirakhor (n 3) 43.

¹¹⁶ *ibid* 57.

¹¹⁷ Hassan, 'Corporate Governance: Western and Islamic Perspective' (n 105) 285.

¹¹⁸ Muhammad Umer Chapra and Habib Ahmed, *Corporate Governance in Islamic Financial Institutions* (Islamic Research and Training Institute 2002); Iqbal and Mirakhor (n 3).

In terms of property rights, it is important to note that there are differences in how the concept of property rights are defined by the present theory as compared to that of capitalism, which could be the basis of the conventional corporate governance theories. Above all others, as a Divine law, the *Shariah* declares Allah is the absolute owner of wealth including property, and humans are merely trustees to manage it as His vicegerents.¹¹⁹ This understanding implies the obligation for Muslims to use and manage the entrusted property in accordance with the *Shariah* law.¹²⁰ The rules that define the property rights in Islam deal with the rights of ownership, acquisition, usage and disposition of the property.¹²¹ The principle of property rights under *Shariah* law also clearly provides a comprehensive framework to identify, recognise, respect and protects the interests and rights of each individual, community, state and corporation.¹²² As a the matter of fact, rights of ownership, acquisition, usage and disposition of the property itself are considered property that has beneficial use and value.¹²³

As further discussed, the concepts of the stakeholder-oriented theory from the Islamic perspective are understood through the way the *Shariah* put the balance between individual and collective rights on a particular property. Social interest and the collective dimensions of human life demands individual freedom to be kept within certain borders, which could possibly bring balance to the individual, to society, and to the state where each of them has legitimate claim on the property, explicitly or implicitly.¹²⁴ As mentioned by Iqbal and Mirakhor, none of the property rights of these three agents should come into conflict with one another, nor should the exercise of those rights by any one of these agents jeopardise the exercise of rights by the others.¹²⁵ Each element of God's creation has been endowed with certain rights and each is obliged to respect and honour the rights of others.¹²⁶

In terms of explicit and implicit aspects of contractual agreement, the advocates of the present theory have chosen the spectrum of company as a nexus of contracts. According to them, a contract in *Shariah* law is a bounding instrument,

¹¹⁹ Bashir (n 57).

¹²⁰ Iqbal and Mirakhor (n 3) 50.

¹²¹ Bashir (n 57); Iqbal and Mirakhor (n 3) 49.

¹²² Saba Habachy, Property, 'Right and Contract in Muslim Law' (1962) 62 (3) Columbia Law Review 450, 452.

¹²³ Hassan, 'Corporate Governance: Western and Islamic Perspective' (n 105) 285.

¹²⁴ Muhammad Akram Khan, *An Introduction to Islamic Economics* (International Institute of Islamic Thought and Institute of Policy Studies 1994) 6.

¹²⁵ Iqbal and Mirakhor (n 3) 51.

¹²⁶ Zaid and others (n 54).

whereby each party is obliged to fulfil stipulated covenant and trust in order to achieve the objectives of the contract.¹²⁷ Any valid contractual terms are protected by *Shariah* law, no less securely than the institution of property.¹²⁸ *Shariah* law does not authorise any rights to the state to invalidate or change a contract by unilateral action, whether such an action taken by administrative, judicial or even legislative.¹²⁹ The explicit element of the contract is usually clearly expressed and applied as reference during dispute. In addition to that, the implicit element of the same contract has similar influence. For instance, explicitly, a company that offers products to the customers has the obligation to fulfil all the stipulated terms in the contract whether it is directly relates to the product or to the transactional agreement, wherein the customers are bound to fulfil their obligations by paying the desired amount as the price of the products. Implicitly, both parties are obliged to respect each other and offer or demand only products that would not bring harm to them both, or to any other stakeholders that might be at stake because of their transaction.¹³⁰ Despite the fact that the decisions and actions taken by the contracted parties concerning their transaction need are solely based on free will, they are answerable to whatever consequences caused by such a transaction to other affected stakeholders.

In this regard, the advocates realise the implication of the emphasis placed on the contracts in Islam is that it makes the members of the society and economic agents aware of the obligations arising from their contractual agreements. The applications of this concept are implied in all Islamic contractual agreements whether they are verbal or written, explicitly or implicitly. The principles of property sharing rights or collective rights are implicit contracts to preserve and protect the rights of others and thus establish a wide spectrum of implicit obligations.¹³¹ Within this understanding, some parts of the stakeholder theory are considered as the reflection of the Islamic methods of corporate governance.

5.3.2.1 The Counterbalance

The present theory advocates applied the understanding of the stakeholder theory to establish a similar model of corporate governance. This notion is rather a convergence of the *Shariah* law into the stakeholder theory and is actually realistically implementable by the IFIs as for the most of the current IFIs the governance system is still based on the existing conventional theories.

¹²⁷ Khan (n 124) 39.

¹²⁸ Iqbal and Mirakhor (n 3) 55.

¹²⁹ Habachy (n 122) 451.

¹³⁰ *ibid* 461.

¹³¹ Iqbal and Mirakhor (n 3) 56.

Notwithstanding those features, the present theory still endures loopholes that are opened for improvements.

First and foremost, there are no discussions on the mechanism implementing such a theory in a real-world corporate application. The differences between the present theory and the stakeholder theory have been articulated clearly; nevertheless, the detailed explanation of the mechanism that could bring those understandings into action is left unclear. Whether the existing conventional governance mechanism is adequate or not has not been discussed thoroughly. As mentioned above, there are several applications available within the extensive literature of Islamic knowledge. Offering an alternative description of how to articulate a certain issue, without any suggestions on the methods to ensure such understanding could be implemented, would result in another open debate. On one side, it could be viewed positively; however, on the other side, such loopholes should not be left uncovered.

Second, the advocates of the present theory did not put across the importance of their model to the *Shariah* compliance issues for the IFIs. The reason might be, it is opened to be implemented irrespectively by any kind of business models. However, reconciling *Shariah* compliance issues would be one of the primary points of reference of the *Shariah* governance system. Whatever business models are involved here, it should emphasises the *Shariah* compliance notion since each business shares the same attention under the *Shariah* law. The prohibition of interest-taking (*riba*), extensive uncertainty (*gharar*) and gambling (*maysir*) are still applicable regardless of the nature of the business involved. Moreover, businesses that engage more in transactions have something peculiar to some extent within the *Shariah* law. Addressing the need for a Muslim to avoid any transactions that involve goods and activities classified as prohibited (*haram*)¹³² is not to be ignored lightly.

5.4 Conclusion

As a conclusion to the dialogue of the respective narratives, it should be understood that not all of the conventional corporate governance theories are eliminated from the equation. The dialogues on the respective narratives have procured aspects, some of which are within the acceptable borders and some of which are not. Some seem to be elemental and some other supplemental. More importantly, this part of the research has located the dialogue of the *Shariah* governance within the breadth of corporate governance discourse. Be reminded that it is the objective of this research to present the answers to the highlighted

¹³² All Muslims are forbidden from having connection to businesses relating to alcoholic drinks, pork, illegal drugs, etc.

ambiguities in the upcoming discourses. From the beginning of this research, we have seen many aspects of *Shariah* governance, either in conjunction with conventional corporate governance or otherwise. Having said that, starting from the next chapter, the chapters to come will excavate the underlying principles of *Shariah* governance in order to shine light on all of the similarities as well as the differences referenced in prior chapters. There are three angles of explanation chosen to explicate the principles, and three mechanisms to be used as a way to bring those principles into action. Bear in mind that the upcoming discussion could be normative in approach of some respects as well as descriptive to some extent. This is due to the fact that some part the principles are already in action whilst some are yet to be revealed.

Chapter 6

Principles of *Shariah* Governance

6.1 Introduction

Since the beginning of this research, we have been excavating the fundamental features of the *Shariah* and the corporate governance. Leading from that, we have encapsulated the conventional corporate governance theories and their compatibilities in relation to IFIs. We also have discussed what a *Shariah* governance system really is and how it is might different from the conventional corporate governance system. As a conclusion, we could say that the *Shariah* governance system is an additional layer in addition to the conventional corporate governance with the function of fulfilling the peculiarities of the financial institutions which to offer *Shariah* compliance products and services. As happens to the conventional corporate governance, the *Shariah* governance system is guided by numerous standards and codes of best conduct, with most offering details of suggested organisational and operational mechanisms to ensure *Shariah* compliance. Apart from that, we could also see how *Shariah* governance is a living system rooted in Muslims' lives and has been accommodated diversely throughout the history.

Broadly speaking, it is observed that the IFIs' boards duty in many respects is no less than to that of conventional institutions. In addition to that, the fiduciary duty of the board ought to be in line with the *Shariah* compliance notion, the *raison d'être* of *Shariah* governance. Put differently, other than conventional fiduciary duty, ensuring *Shariah* compliance is also a fiduciary duty to be discharged by the boards of directors of the IFIs. As a result, by securing *Shariah* compliance functions, what are considered the duty of care and the duty of loyalty of the boards are somehow elevated into another level. To execute this, the IFIs have put on another layer of organisational arrangement to assist their boards to carry out the task; this arrangement is the *Shariah* committee. Arguably, this committee is an indication of power delegation delivered by the board to a specific group of experts with 'fit and proper' criteria, to discharge a specific range of duties, ensuring compliance in *Shariah*-related matters.¹ In this context, the board is akin to the primary stakeholder of the *Shariah* committee as they inherit first-hand consequences from any actions or inactions of the *Shariah* committee.

¹ Despite the power vested to the *Shariah* committee being delegated by the Board of Directors, the committee supercede the board regarding issues related to *Shariah* matters. This is the reason why a national *Shariah* committee within the central bank is crucial as counterbalance, as we could see in the previous chapters.

From an organisational view, the task of *Shariah* committee is to assist the board to achieve the objective of the institution: compliance with the *Shariah* law. As a supportive element to the board, the *Shariah* committee to some extent bears a similar fiduciary duty as the board. The members of the *Shariah* committee ought to perform duty of care and loyalty as if they are the members of the board itself. They shall work for the best interests of the institutional stakeholders, especially the shareholders. On top of that, they also ought to deliver a critical eye on business matters that have merit from the *Shariah* perspective. However, in a plain language, the way the *Shariah* committee executes its duty is rather unique and peculiar. Due to this, the discussion on it will be further encapsulated in the upcoming chapters.

As mentioned earlier, the objective of the *Shariah* governance is to optimise the value and to ascertain the sustainability of the IFIs. It closely interacts with the Islamic worldview, which is in contrast with the worldview of other theories. It is worth mentioning that the struggle amid the theories of corporate governance essentially circulate in this circumstance in many respects. For many reasons, a well-discussed theory is the reflection of such a struggle, where one corporate governance theory is distinguished from another in the manner in which it recaptures the relevant worldview. For instance, we could see the worldview of the shareholder theory advocates, which puts the emphasise on the shareholders ownership ending up with the strengthening effort of the legal aspect to assert their rights and the disregard of morality in pursuit of their primary objective of wealth maximisation. Similarly, this notion seems to be applicable to other theories. This part of this research, however, is not to seek the conclusion of which one is on the right path or consider which is the best school of thought to follow. It is rather a medium of discussion of another principles, to articulate the subject in parallel with that are already well-covered by prominent researchers.

It is argued that, the articulation of the principles of the *Shariah* governance is propelled by an in-depth comprehension of the teaching of Islam. As far the IFIs are concerned, *Shariah* is a *modus vivendi* that is practical for everyone and compatible with any sort of dynamic human lifestyle in all respects. As a divine way of life for humans to embrace, the teachings of *Shariah*, revealed through the Quran and the Hadith, somewhat consist in a sense of both rigid and flexible dimensions. By accommodating the both features, this chapter will illustrate the derivation of the principles of the *Shariah* governance from those sources. It is rather important to apprehend such a notion since we have seen its consequences in the comparative scrutiny regarding the theories of corporate governance in the previous chapters. Complying with the *Shariah* precepts is the essence of the counterbalances that have come from a comprehensive understanding of the prevailing principles. It is also based on the discursive interpretation of an epistemological worldview of life which eventually has its role

on describing the right norm that ought to be followed by humans in economic activities: namely in this case, the governance of economic financial corporations.

On the account of this, this chapter will explore the crux of the concept of the *Shariah* governance, namely *Shariah* compliance. It will elucidate the principles that have been followed by the IFIs which have enabled them to enter the financial market with their own identity. These principles will provide the rationale for why some of the features in the conventional corporate governance system are acceptable and some others are objectionable. This chapter will thoroughly explore this notion through three primary divisions of *Shariah* governance. It will reveal the worldview of the IFIs, their comprehension of the *Shariah* compliance and the *akhlaq*-based governance ethics that underpin the whole concept of corporate governance in the eye of the *Shariah*. These principles will be the brace that shapes the canvas of the *Shariah* governance corpus. It substantiates the fiduciary duty of the IFIs' governance constituents, especially the boards' duty of care on *Shariah* compliance, and the influence that shapes the ethical business judgement in the IFIs' operation.

This chapter is substantial in the light that it will employ the underpinning principles applied to the discourse of the principles of *Shariah* governance. To serve as an answer to the discussed issues in the previous chapters which are constructed from the existing literature with its lack in idealistic domain, it is imperative to be situated in the middle of the whole discussions. To some extent, it bridges the two separated spectrums of the research, which are what is there and what is supposed to be there. Despite the infancy of this topic, it seems to gain more attention from many stakeholders, particularly those who have interest in the *Shariah* compliance financial system. Bear in mind, our point of reference henceforth will deepen into three primary themes deduced from the comprehension of the previous integral discussions. These three fundamental and essential elements are inherently embedded in the *Shariah* sources. It is worth mentioning that, to apprehend a deep comprehension, one not only requires exceptional knowledge of Islam, but also it is demanded one experiences as a true believer of the given notion.

6.2 Epistemological Worldview of *Shariah* Governance

By saying epistemological, the first part of the present chapter is dealing with the worldview of Islam which is believed not merely an invention of humans' comprehension fabricated from the observation of the surrounding realm or what is visible to their naked eyes, but also consisting of the unseen elements,

deducing from the revealed sources with the righteous interpretation.² It is argued that the epistemological worldview of *Shariah* gives the answers to the fundamental questions asked by humans. Where did we come from? What is the purpose of our existence? Is there life after death? This part of the present chapter however is not about answering all those questions. It is more inclined to the explanation of why this epistemological concept gives impetus to the scholarly path of the *Shariah* governance and how to appreciate it in our modern governance sense of logic.

However, note here that there are several corporate governance themes relevant to this discussion. It will explain how Islam views private ownership, resources manipulation and the objective of wealth maximisation. The comprehension of these relationships will allow us to contemplate the board's fiduciary duty towards the task of adhering to the notion of *Shariah* compliance. Other than that, this part is also essential to calibrate the Islamic morality with business activities. All these are due to the fact that, as a Muslim, Islam is a religion to be believed, so it could become a propellant to guide the way of one's life, both legally and morally. The submission of Muslims to the teachings of Islam, in fact, is what constitutes their worldview and is the sole reason why the idea of *Shariah* compliance really matters.

Before we go deeper, it is necessary to grasp the basics of this topic. Worldview or *Weltanschauung*³ is a sense of our ability to understand and represent the world that we experience in our mind.⁴ It could be inspired by religious tenets or other philosophical or moral principles that are independent of any religion. The Oxford English Dictionary defines worldview as the philosophy of life or conception of the world.⁵ To some extent, it is a set of beliefs about fundamental aspects of reality that ground, and influence all of one's perceiving, thinking, knowing and doing.⁶ In relation to *Shariah* governance, it is literally about how those institutions which offer *Shariah* compliance products and services are supposed to conceive the world around them: specifically, the resources and the wealth available on earth. One fact for certain is that there are impairments between the worldview of the IFIs as opposed to their conventional counterparts

² The notion of monotheism in Islam is not merely constructed based on physical observation. More than that, it is supported by revealed knowledge that eventually manoeuvred the observation conducted to jump into a concrete conclusion.

³ Germanic compound word

⁴ See also Immanuel Kant, *Critique of Power Judgment* (trs) Paul Guyer and Eric Mathews (CUP 2000)

⁵ Oxford Dictionary of English (2nd edn OUP 2003) 2030.

⁶ Muhammad Abdullah and Muhammad Junaid Nadvi, 'Understanding the Principles of Islamic World-view' (2011) 6 (3) *The Dialogue* 269, 270.

in many respects. Some may argue that Islam is a religion of morality and therefore IFIs are operating under a strict morality regime.

Since the financial institution is regarded as one of the units in the economic framework, the importance of the rules of economic philosophical dimensions is undeniable. To this extent, it is worth mentioning that in regulating a comprehensive understanding of the *Shariah* governance, we should differentiate between the distinctive underlying philosophy or ideology by reference to which the sphere of an institution is delimited and an explicit mechanism employed for resolving problems and regulating its actions.⁷ The fact that conventional corporate governance theories are discussed within the capitalism or socialism spectrum is obvious. The better the understanding on such concepts, the easier it becomes to divest oneself from the uncertain. Therefore, to comprehend the notion of the *Shariah* governance, we should put ourselves into the worldview of *Shariah*, or Islam in a broader sense, for such a discussion. It is rather imperative to do so, as it could lead us to decipher the *Shariah* algorithmic thinking of the *Shariah* experts⁸ and the function of Islamic morality on the upcoming topics. One way to perceive the reason why a Muslim upholds the concept of *Shariah* compliance is by deciphering the underpinning system of belief and faith of Islam and what is the role of such a system in a daily devotion as to the life of a Muslim.

The *Shariah* epistemological worldview encompasses both *dunya* and *akhirah*. *Dunya* is the present realm that we are in at this moment. It is the vision of reality and truth that appears before our mind's eye, revealing what existence is all about.⁹ Economically, it is the world where humans are typically in pursuit of wealth that is visible to their naked eyes to see and senses to enjoy. The *akhirah*¹⁰, on the other hand, is the world of heaven and hell which could have never been seen by eyes, perceived by thought or befall on someone's heart.¹¹ Such connotation is given by the Prophet PUBH as it is a world untangled from space and time, which is beyond the humans' capabilities to apprehend. As our present realm is limited in space and time, the possibility of such a world existing

⁷ Main M Nazeer, *The Islamic Economic System: A Few Highlight* (Pakistan Institute of Development Economics, 1981) 1.

⁸ *Shariah* expert term refers to *Shariah* scholars who member *Shariah* committee. On the other hand, *Shariah* scholar refers to scholars with general knowledge of *Shariah* law and other area of Islamic studies.

⁹ Syed Muhammad Naquib al-Attas, *Prolegomena to the Metaphysics of Islam: A Exposition of the Fundamental Elements of the Worldview of Islam* (ISTAC 1995) 1.

¹⁰ Al-Akhirah it is a derivative Arabic word meaning for the final-destination.

¹¹ This hadith is narrated by Al-Bukhari as reported from Abu Hurairah; Muhammad bin Ismail al-Bukhari, *Sahih al-Bukhari* (5th edn, Dar Ibn Kathir 1993) vol 3 no 3072, 1185.

has transcended the logical explanation of our observation. To be exact, we are restricted by our own limited capabilities.

In relation to this, it is borne in the minds of all Muslims that Islam teaches there is no bifurcation or separation of the worlds in Islam.¹² The *dunya* aspect must be related in a profound and inseparable way to the *akhirah* aspect.¹³ As far as Muslims are concerned, actions that they take in this life, are always in correlation with the afterlife. There is no such thing as separation thesis. Everything is connected. Their economic actions for instance, cannot be separated from ethical consideration as all actions are going to be taken into account, for the sake of their own well-being, in the *akhirah*. For a real devoted Muslim, the short term of life in the *dunya* is worth nothing, compared to the value of the afterlife in the *akhirah* for eternity. However, one thing to be aware of is that this is not an escapist excuse not to work for the betterment of the present realm. It in fact plays as the primary reason for Muslims to pursue the life in the *dunya* with their best efforts. Muslims are urged to pursue success in daily prayer addresses through *adhan*.¹⁴ For Muslims, it is believed that the commitment given in the *dunya* will be gathered in the *akhirah*. Therefore, as exemplified by the work of farmers, to procure the best harvest is to grow the best seed we could acquire and deploy the most effectual means to hand to cultivate it.

It is the nature of humans to believe in the divine as they are creations that possessed the ability to observe the visible world in physical form along with the invisible (*ghaib*), which is metaphysical.¹⁵ In fact, other than having the ability to apprehend the science of the physical world, humans are also capable of sensing elements that are invisible to the naked eyes. For instance, they could observe the changing states of the cosmos and come up with scientific discoveries. At the same time, they are also able to sense the changes of the invisible surroundings such as consciousness and cognitive abilities but could not yet come up with the tangible explanation of those elements, despite sensing them within their selves. As described by Usmani, there are areas in which human reason could not produce proper guidance or was at least susceptible to errors.¹⁶

¹² Abdullah and Nadvi (n 6) 271.

¹³ Naquib al-Attas (n 9).

¹⁴ One of the lines in the prayer address, the addresser says (حي على الفلاح) *hayya ala al-falah* or 'hasten to success'.

¹⁵ The Quran mention one the fundamental Islamic beliefs is belief in the *ghaib*, the unseen being, such as angels, devils, good dead, sin, heaven and hell, and so on. See also Ibn Kathir, *Tafsir Ibn Kathir* v.1 trs al-Mubarakpuri (Darussalam 2000) 113.

¹⁶ Muhammad Taqi Usmani, *An Introduction to Islamic Finance* (Kluwer Law International 1998) 10.

To appreciate such a conception of the surrounding world, humans need to be consciously realise that, as the greatest creation of God, they are inherently pure in nature. Each soul at its conscious level is benevolent and benign, free from any ill-natured or evil-minded intention. As said by the Prophet PBUH, every child is born with pure instinct or *fitrah*, and it is the parent who decides for them whether to be a Jew or a Christian or a Zoroastrian.¹⁷ This means that every single person is like a pure canvas, spotless and faultless. It is the people, surroundings and environment that shape their worldview, whether to believe that they are untrustworthy and greedy or benevolent and whole-hearted by nature. Islam however, does not put humans into the state of denial about their ill-nature. Instead of encouraging it, Islam has come with solutions to control the negative side and stimulates as well as cultivates the positive values, systematically. Therefore, Islam has never treated humans as untrustworthy, as Smithians would argue, yet it prepares precautions measures in their system of life, so human cannot harm one another. Instead of disregarding human nature by condemning them as untrustworthy, Islam chooses to see their potential and provides guidance accordingly. Like the gravity that holds the universe in its proper and systematic manner, Islam is a constructive belief system adopted into humans' productive lives as their central nerve in moving forwards towards a genetically programmed goal: meeting the Creator.

6.2.1 Islamic Belief System

6.2.1.1 Tawhid System

The Islamic belief or *aqidah* is based on the principle of *tawhid*. Literally, *tawhid* means unification, union or consolidation.¹⁸ It is the unification or asserting the oneness of God or, as mentioned by scholars such as al-Attas, as the oneness of God and the unity of God.¹⁹ As argued by Hashi, *tawhid* is an advance version of monotheism which is scripture-based, not merely a conclusion perceived from the speculative theological debates.²⁰ Other than working as the philosophy of a Muslim's life, how does this fundamental belief system affect the essence of the *Shariah* governance system?

¹⁷ This hadith is narrated by Al-Bukhari as reported from Abu Hurairah; M Bukhari, *Sahih al-Bukhari* (5th edn, Dar Ibn Kathir 1993) vol 1 no 1292, 456.

¹⁸ Hans Wehr, *A Dictionary of Modern Written Arabic* (4th eds J Milton Cowan, Otto Harrassowitz, Wiesbaden, 1979) 1236.

¹⁹ Muhammad Umer Chapra, *Islam and Economic Development* (The International Institute of Islamic Thought and Islamic Research Institute, 1981), 5

²⁰ For further discussion, see also Abdurezak A Hashi, 'Between Monotheism and Tawhid: A Comparative Analysis' (2013) 3 (2) Revelation and Science 23.

The oneness of God is a revealed understanding that reveres Allah as the only God, the only Creator and the Supreme Lord of the universe.²¹ Allah alone is the Sovereignty, humans as His creation are considered His subjects that hold the job as His vicegerents to manage the world on His behalf.²² For every Muslims, the oneness of God is declared by a testimony called as *shahada*, through which the believers testify their submission by saying this essential faith declaration: ‘I bear witness there is no god but Allah, and Muhammad PBUH is the Messenger of Allah’. This testimony is one of the pillars of submission, known as *arkan al-Islam*.²³ It is a method to quantify the presence of humans’ ‘inner acceptance’, based on their inquisitive nature, that Islam is their way of thinking, what defines good and bad norms, the source of answers to metaphysical nature invisible to their naked eyes, reference for scientific discoveries and, most importantly, their way of life. It is not merely a recognition of the reality of human nature, but in fact, it is an active response to that nature.²⁴ This ‘inner acceptance’ is known as *arkan al-Iman* or the pillars of faith.²⁵ The point of reference to the concept of the oneness of God is on the absoluteness of Allah as the one and only God that should be worshiped and the declaration of His lordship of the universe. It is borne in the mind of Muslims that Allah is One, without partner in His dominion and without rival in His divinity and in worship.²⁶ It is imperative to say here that the belief in any others described as associates to Allah is considered an act of *shirk* and could jeopardise one’s testimony.²⁷

Accordingly, the concept of *tawhid* is fixed in the unity of God resolved as the substantial element that underpins the epistemological worldview of Muslims towards the surrounding world that is sensible to humans’ physical senses as well as to the invisible world. The unity of God means realising and maintaining Allah’s unity in all of humans’ actions, directly or indirectly related to Him.²⁸ Everything in this realm, humans and surrounding resources are connected to

²¹ Abdullah and Nadvi (n 6) 272.

²² See also *ibid*

²³ *Arkan al-Islam* or the pillars of submission include giving testimony that ‘none has right to be worshipped but Allah and Muhammad the messenger of Allah’, offering prayer or *salat*, paying compulsory alms or *zakah*, fasting during the month of Ramadhan and performing pilgrimage or Hajj for those who are capable. For further discussion, see also Abdur Rahman Hammad, *The Religion of Truth* (Maktaba Dar-us-Salam, 1991).

²⁴ Chapra, *Islam and Economic Development* (n 19) 5.

²⁵ *Arkan al-Iman* or the pillars of faith include believe in Allah, the Messengers of Allah, the books of Allah sent to the Messengers, His Angels, the day of judgement, and the fate and Divine decree; Hammad (n 23).

²⁶ Bilal Philips, *The Fundamentals of Tawheed* (2nd eds, International Islamic Publishing House, 2005), 17.

²⁷ *Shirk* is constituting God with associates.

²⁸ Philips (n 26).

God as the Creator. As discussed by Choudhury and Hoque in the earlier chapter on this concept, *Shariah* governance constituents should feel the connection of knowledge: namely, the informative aspect of governance with the sense of His presence.²⁹ The related parties should be mindful of the Muslims belief that God is All-Knowing and All-Seeing. Apart from being responsible for the tasks given by the institutions, they are answerable to God for any considerations, strategies and actions executed due to the fact that they are in search for the real attention of the Divine sources. As argued by Iqbal and Mirakhor, since the IFIs are akin to *Shariah* compliance, God as the Lawgiver of *Shariah* is considered as one of the stakeholders.³⁰

6.2.1.2 Belief in God as Humans' Nature

It is argued that belief in the existence of a supreme being that possessed the power of creation and to sustains what is created is innately human. This is imaginable as we have not seen any group throughout recorded human history who have lived without having their own way of thinking to account for unexplained phenomena, a supreme power and life after death, and so forth.³¹ In this regard, each group has its own way, regardless of the truth, based on their worldview. We also could see some groups of humans, who care nothing for religious issues, whose lives are driven by materialism.³² This, however, does not mean that they do not believe in anything or whatsoever. Most importantly, either way of thinking somehow has its legitimacy for the respective group as the source of norm creation and in the long run as their legal source. This is how the Islamic belief system affects the value judgement system of the IFIs. They choose to belief in business approaches that appreciate the *Shariah* legal system.

Having said this, the IFIs as business institutions believe that as the Creator and the Sustainer of the universe, God created the earth for humans to prosper and utilise its resources. In this vein, humans as the vicegerents of Allah are entrusted to manage and govern the world in the approved way.³³ To carry out such tasks, humans are empowered, within their genetic make-up, with a specialty that was not given to other organic creatures of God: cognitive abilities (*'aql*). The cognitive abilities or the process of knowing is a specific quality that distinguishes humans from most of God's other creations. It has made learning and gaining new

²⁹ See also Masudul Alam Choudhury and Muhmaad Ziaul Hogue, 'Corporate Governance in Islamic Perspective' (2006) 6 (2) *Governance: The International Journal of Business in Society* 116.

³⁰ See also Zamir Iqbal and Abbas Mirakhor, 'Stakeholder Model of Governance in Islamic Economic System' (2004) 11 (2) *Islamic Economic Studies* 43.

³¹ Muhammad Youssef Moussa, *Islamic and Humanity's Need of It* (The Supreme Council for Islamic Affairs 1993), 17.

³² *ibid* 18.

³³ Usmani (n 16) 9.

knowledge a possibility for humans where they could utilise it for the sake of all humankind or the surrounding world. Human's actions at their animalistic level are propelled by basic instinct. It somehow transcends from this level to another, due to the possession of cognitive abilities. Therefore, humans are called 'talking animals' in some philosophical statements, if they rule out cognition as the nature of humanity.³⁴ Accordingly, the Quran mentions how God Himself taught Prophet Adam PBUH the names.³⁵ The only obstacle towards maximising humanity's learning curve is its own negativity.

As the highest creation of God, humans are also empowered with the liberty of free choice. Nourished by cognitive abilities to acquire knowledge, humans can freely and wisely determine the meaning of good and evil as well as right and wrong where all the choices are answerable to God. It is something that could not be imagined as present in the actions of other organic creatures. In addition to this, humans are granted the capabilities of overpowering other creations so that they can use them for their own benefit. However, it is imperative to bear in mind that such capabilities could also bring about disastrous changes to the earth as described by the Quran.³⁶ Despite vast capabilities, humans could not claim to have unlimited power to reach the absolute truth since most of their lives are spent under the shadow of spatial and temporal factors,³⁷ hence, they are in need of guidance from the absolute source to shed some light.

6.2.2 Humans as Vicegerents

6.2.2.1 Who are the Vicegerents?

Literally, vicegerent means a person exercising delegated power on behalf of a sovereign or a ruler.³⁸ From the Islamic perspective, humans are God's vicegerents or the caliph of Allah on earth which underscores the notion of humans as trustees of God managing the available resources on earth for their benefit in the way considered the best manner taught by God Himself. The entitlement of humans as vicegerents is stated in the Quran as follows:

*And when your Lord said to the angels: I am making a **caliph** on the Earth. They said: Are You making therein one who corrupts it and sheds blood, while we hymn Your praise and sanctify You? He said: Surely I know that which you do not know. ³⁹*

³⁴ Ali al-Jurjani, *Mu'jam al-Ta'rifat* (Dar al-Fadilah 2004), 35.

³⁵ Quran (2 :31)

³⁶ Quran (2: 30)

³⁷ See also Usmani (n 16) 10.

³⁸ Oxford Dictionary of English < <https://en.oxforddictionaries.com/definition/vicegerent>> accessed 10 September 2018.

³⁹ Quran (2:30)

The original word used in the passage was 'caliph'. In its literal context, the word caliph connotes the meaning of 'being the successor'.⁴⁰ The Quranic commentators such as Ibn Kathir mention that this name refers to the nature of humans that breed and pass their legacy through inheritance, generation by generation.⁴¹ It is also refers to the task carried out by humans, the children of Adam and Eve (peace and bless be upon them), as God's trustees to manage the earth as well as to bring prosperity and justice on His behalf.⁴² It is observed from the above Quranic passage that from the beginning of the creation of Adam PBUH, humans wer created to manage the earth.

6.2.2.2 Vicegerent's Task

The task as His vicegerent is not merely an honour to humans as His best creation.⁴³ As a matter of fact, it is an extremely heavy burden can never imaginably be undertaken by other creations. The fact that Prophet Adam PBUH, the first ever created human who was taught the names of creations⁴⁴ by God Himself is the factor of this entitlement.⁴⁵

*...We have **honoured** the children of Adam and carried them by land and sea; We have provided good sustenance for them and favoured them specially above many of those We have created...*

*...We offered the **Trust** (of succession, caliphate) to the heavens and the Earth and the mountains, yet they refused to undertake it, and were afraid of it. And (but) the mankind undertook it-they have always been very inept and rash...⁴⁶*

As His stewards to manage the world, humans are provided with the manual of how to live in this world in the best manner. This manual portrayed by the teachings of Islam, which are considered as 'din', the word denotes the way of life that promulgated by God.⁴⁷ Through the course of human's history, there are many prophets sent by God, starting from Prophet Adam PBUH to Prophet Muhammad PBUH. All those selected individuals are the conveyers of revelations, from the Creator to the humans as His creation, to bring the revealed

⁴⁰ Wehr (n 18) 297.

⁴¹ Ibn Kathir (n 5) 182-183.

⁴² ibid

⁴³ Quran (17:62)

⁴⁴ Names are the connotation of the capability of Adam PBUH and his descendants to acquire knowledge.

⁴⁵ Quran (2:31)

⁴⁶ Quran (33: 72)

⁴⁷ *Din* representing the meaning of way of life that is favoured by God. See also al-Jurjani (n 34) 92-93.

divine teachings to the earth for humans to follow. As far as Muslims are concerned, Islam is not only about the relationship of a man to his God through rituals and dogmatic faith, as usually perceived from the concept of religion, but also the whole way of life for humans, which covers personal and public relationship, either between a man to another or a human to other creations of God.⁴⁸

From the Islamic perspective, the task of prime importance as vicegerent is to bring justice. It is the nature of humans to seek justice in their lives which is, in fact, one of the primary goals for sending of the chain of Prophets.⁴⁹ With regards to this, Islam is designed to attend to humans' well-being by compensating the material needs of humans with morality, and the actualisation of economic justice and brotherhood in society.⁵⁰ Since humans have limited capabilities of determining what justice really is as an absolute definition; to achieve such a noble notion, they would not be able to execute the task by merely reliance on reasoning and empirical observations. Somehow, humans are incapable of proposing an ultimate meaning of justice that is acceptable to all. Most attempts ended up with the solution that a certain concept of justice was only acceptable in certain circumstances due to the dynamic and variations of their surroundings, which to some extent has a significant role in nurturing their worldview. Adversely, such attempts had also caused chaotic results as can be seen in the colonial historical records. When the colonials came, the values of the superior newcomers were somewhat immersed by the weaker natives, irrespective of their indefinite truth.

Justice is defined as a state of true equality and fairness.⁵¹ In the eye of Islam, justice is a harmonious condition or state of affairs whereby everything is in its right and proper place.⁵² It is to be justified by the sources of Islam for its general rules which essentially function as the foundation that could unify the humanity regardless of their various backgrounds. For a Muslim, justice is considered as the closest virtue to piety (*taqwa*).⁵³ More profoundly, justice refers to the harmonious and correctly balanced relationship between man and himself, and

⁴⁸ Mohamed Aslam Mohamed Haneef, 'Islam, the Islamic Worldview and Islamic Economics' (1997) 5 (1) IIUM Journal of Economics and Management 39, 40.

⁴⁹ Quran (57:25)

⁵⁰ Muhammd Umer Chapra, *Towards A Just Monetary System* (The Islamic Foundation, 1986) 14.

⁵¹ Timur Kuran, 'On the Notion of Economic Justice in Contemporary Islamic Thought' (1989) 2 (2) International Journal of Middle East Study 171, 172.

⁵² Naquib al-Attas (n 9) 25.

⁵³ Quran (5: 8)

secondarily, to that between him and others.⁵⁴ In this sense, human's economic interaction involves a significant portion of the view of Islam, in the way that economic equilibrium is justified in Islam. The IFIs, an economic unit with *Shariah* as its genetic make-up, is a vessel to uphold the notion of justice as promulgated by the *Shariah*.

It is argued that Islam never condemns the human tendency for wealth acquisition. It is innately human. Therefore, pursuing economic value maximisation through production is recognised and promoted by Islam. Perhaps, the valid argumentation here is about how to channel the pursuit so it can prevent humans from causing harm and injustice to each other.⁵⁵ The love of wealth and the acquisition for its own sake in the light of excessive attention to materialistic desires, without considering the negative impact or giving the positivism on others, is what opposed by Islam.⁵⁶ As far as Islam is concerned, wealth is a trust given by God to humans as vicegerent to manage on His behalf. The core element of this divine task is how to execute their duty in the way that is in adherence and compliance with the notions predefined by the *Shariah*, the law of God.

6.2.3 Wealth as Trust for Vicegerent to Manage

Wealth is defined as all that could be acquired by actions whether it is a corporeal, such as gold and silver (money), animals and plants, or incorporeal, the ability to enjoy the benefits of the corporeal assets such as the right to ride, to wear and to stay.⁵⁷ It is rather philosophical and vague as compared to the technical terms as understood by modern financial theories and practices. However, to realise the sole reason of human existence, it is imperative to prevail the concept to such a philosophical level that the diverse dynamic of human life throughout the world could be sheltered under the same umbrella. Wealth should not only be understood in terms of financial stability, which is one of its rules, but also as a tool towards humans' well-being.

As God's vicegerents, humans ought to appreciate the surrounding resources as tools to execute their divine task in this world. As mentioned above, from the beginning of human creation, they are branded as trustees who are capable of managing the available resources on earth on behalf of God. In this vein, Muslims

⁵⁴ Naquib al-Attas (n 9) 25.

⁵⁵ Muhammad Akram Khan, *An Introduction to Islamic Economics* (International Institute of Islamic Thought and Institute of Policy Studies) 5.

⁵⁶ Zulkifli Hassan, 'Treatment of Consumption in Islamic Economics: An Appraisal' (2005) 18 (2) L.KAU: Islamic Economics 29-46, 42; See also Saiful Azhar Rosly, *Critical Issues on Islamic Banking and Financial Markets* (Author House, 2005) 7.

⁵⁷ Al-Zuhayli, *Al-Fiqh al-Islami wa Adillatuhu* (4th edn Dar al-Fikr 2002) vol 4 2875.

see the world as the bridge to the life in the hereafter where they will be tested by God through the beings existing in this realm, to distinguish between those who are the righteous and those who are not. The test is simply to follow His commands and avoid what is prohibited. In the light of *Shariah* governance, the relevant question centres on how to strive towards well-being (*falah*), the postulated Islamic economic equilibrium, in the hereafter through the economic means of this life.⁵⁸

To accomplish wellbeing, humans ought to manage the measured sources in the manner permitted by God, the Owner, and not step on the prohibited areas. To execute this task, theoretically, the areas considered as prohibited by *Shariah* in the economy are rather limited since the presumption of validity and permissibility applies to all contracts and conditions.⁵⁹ The main theme of the *Shariah* compliance in financial activities involves only the prohibition of *riba*, uncertainty and the involvement with activities that are contravened with the *Shariah* law such as gambling, cheating, bribery, hoarding, monopoly, and so forth. The elimination of interest through prohibition of *riba* might be the most controversial policy of the IFIs, since it has been the heartbeat of the financial market for quite a long period of time.⁶⁰ Apart from that, other emphasises are considered as resemblance, if not exactly, to what have been perceived as economic causes of injustice.

Furthermore, wealth management in the view of *Shariah* includes the wealth creation process, the distributive instruments and most importantly, the redistribution mechanisms of the idle wealth possessed by those who are rich to those in need to achieve equilibrium.⁶¹ Given this, the question of scarcity is inevitable and *Shariah* encourages any attempt to understand such an economic phenomenon since it could contribute accordingly to the better delivery system of Islamic economic notions. For some reason, it somehow plays a significant role in Islamic economic corpus, where two differing approaches emerged from the debate of how to define Islamic economics.⁶² However, no one chooses to defy that the objective of the economic activities according to *Shariah* is to achieve wellbeing as mentioned earlier.

⁵⁸ See also Muhammad Akram Khan, 'Islamic Economics: Nature and Need' (1984) 1 (2) *Journal of Research in Islamic Economics* 51.

⁵⁹ Muhammad Akram Laldin and others, *Islamic Legal Maxims and Their Application in Islamic Finance* (International Shari'ah Research Academy for Islamic Finance, 2013)10.

⁶⁰ MH Mohsin, 'Islamic Interest Free Banking: A Theoretical Analysis' (1986) 33 (1) *Palgrave Macmillan Journal* 1, 2.

⁶¹ Chapra, *Islam and Economic Development* (n 19) 6.

⁶² For further discussion, see also Amir Wahbalbari and others, 'The Concept of Scarcity and its Influence on the Definitions of Islamic Economics: A Critical Perspective' (2015) 31 (2) *Humanomics* 134.

As far as *Shariah* is concerned, wealth is neither to be accumulated, hence left idle, nor to be recklessly utilised without considering the logical reasoning behind it. Wealth is not to be excessive, exceeding in respect of the right objects expenditure, called *israf* or in a manner other than in obedience of God, whether little or much, known as *tabdhir*.⁶³ Additionally, it is also not to be withheld from obligatory, approved or permissible pursuits or *bukhl*.⁶⁴ This notion of wealth management is due to the way *Shariah* addresses ownership. The reason why humans are obligated to follow this how-to doctrine is simply because they are not the absolute owner of the wealth. As they are deemed to be accountable to the shareholders, they are also held accountable to the Creator of the wealth Himself.

6.2.4 Theory of Ownership in Islam

The discussion on the ownership is rather imperative to the *Shariah* governance discourse. It will shed the light on the accountability of the *Shariah* governance constituents which is somewhat diverse as compared to the conventional counterpart. It will also manifest a different concept of ownership, distinguished from what is commonly understood by the conventional corporate governance, especially to the shareholders or the shareholder alike stakeholders.⁶⁵

Under the *Shariah* law perspective, ownership is a legal right on assets or legal right to take benefit from assets, that renders those with the right to take benefit of the asset whether by possession or transactional means.⁶⁶ It is a dominion of a person on an asset that would hinder acquisition from others where the owner enjoys the right to dispose of the asset absolutely as far as it is permissible by the *Shariah* law.⁶⁷ In this case, the right of ownership of particular asset is acquired by the means of, amongst others, asset transaction as in sale and purchase, benevolent acquisition as in charity and free giving, biological right as in inheritance and occupying as in land occupying or capturing an animal.⁶⁸ Whoever possesses an absolute right of ownership enjoys the power to enter transactional activities with no restrictions as far as it is *Shariah* compliance and his dominion is without any time limitation.⁶⁹ By saying this, any parties who

⁶³ Sayyid Muhammad Yusuf, *Economic Justice in Islam* (SH Muhammad Asraf Kashmiri Bazar, 1971) 56.

⁶⁴ *ibid*

⁶⁵ Those who are entering into *mudarabah* and *musharakah* agreements such as the shareholders and the Investment Account Holders (IAH).

⁶⁶ Shihabuddin Al-Qarafi, *al-Furuq*, (Dar al-Salam 2001) 1009.

⁶⁷ Al-Zuhayli, *Al-Fiqh al-Islami wa Adillatuhu* (n 57) vol 4 2893.

⁶⁸ *Al-Mawsuah al-Fiqhiyyah al-Kuwaitiyyah* (1st eds Dar al-Safwa 2000) vol 39 38.

⁶⁹ *ibid* 36.

intend to transact the right or to transfer the legal title of the asset must get into permissible procedures with the consent of the relevant parties.⁷⁰ It is worth mentioning that the consent of the parties involved is the essence of Islamic legal transfer. In this regard, as an example, the *Shariah* law put a distinctive concern, in the case of legal transfer for the bedridden, in order to avoid any possibility of disregard or manipulation.⁷¹

In terms of the ownership of the asset, the *Shariah* acknowledges private as well as public ownership, respectively. In the light of this, humans' propensity to possess and obtain property is essentially recognised. Humans are free to acquire wealth and maximise the value of the acquired wealth through *Shariah*-compliant means and as far as it is not bringing about harm to the public interest.⁷² Additionally, *Shariah* law recognises and protects the implied or expressed terms construed in contracts by the parties involved regardless of their religious beliefs. The Quran, in fact, mentions that humans are made with love of desires, of women and sons and hoarded treasures of gold and silver and well-bred horses and cattle and tillage.⁷³ Furthermore, *Shariah* views production and labour as the utmost way to wealth creation and the possession of private property. For a Muslim, being able to be productive by working with their own hands given them by God is an honour as said by the Prophet PBUH;

*By Him whose hand myself is, to take your rope and gather firewood on your back is better for you than that you come to a man to whom Allah has given some of His favour and ask him so he gives to you or refuses.*⁷⁴

*Nobody has ever eaten a better for you than that which one has earned by working with one's hands. The Prophet Allah David used to eat from the earning of His manual labour.*⁷⁵

It is imperative to note here that *Shariah* also puts a certain amount of restrictions on private property acquisition. The intended objective is to protect the public interest⁷⁶ by putting controls on certain properties from being monopolised by

⁷⁰ Quran (4: 29)

⁷¹ In the case of a patient with a potentially fatal illness, any transaction by the patient must not equal more than one third of the whole possession to avoid any question of mislead consent.

⁷² Al-Zuhayli, *Al-Fiqh al-Islami wa Adillatuhu* (n 57) vol 4 2893.

⁷³ Quran 3:13

⁷⁴ This hadith is narrated by Al-Bukhari as reported from Zubair Al-Awwam; M Bukhari, *Sahih al-Bukhari* (5th edn, Dar Ibn Kathir 1993) vol 2 no. 1402 535.

⁷⁵ *ibid* no.1967 730.

⁷⁶ The consideration of public interest or *maslahah mursalah* is one of the legal sources in *Shariah* law. The authority has the right to take an action based on the reason to fulfil public interest especially in providing necessities that are essential to ease people's lives. Public interest is also applied to justify *Shariah* law, where any

private sectors. Under this provision, *Shariah* law put in public ownership properties that provide social services - such as a school, mosque or road - properties that exist naturally without humans' intervention - such as minerals, water, grass and fire - and the state property - such as the wealth of the treasury. The source of law for these state interventions into private acquisition is the hadith of the Prophet PBUH on the common ownership of public natural necessities such as water sources, grass and fire, as well as other natural resources that are needed by living creatures by nature.⁷⁷ Commencing from this, the *Shariah* scholars assess other resources by employing analogical reasoning or *qiyas* to other properties with similar *ratio decidendi*.⁷⁸ In this regard, *Shariah* compensates the ownership of individuals, societies and the state. The state has the right to nationalise those common resources for the sake of the society to withdraw any hardship from their daily lives based on the consideration of public interest (*masalih mursalah*).

Islam also has instruments to encourage the process towards nationalising individual ownership by private sectors such as *waqf*. *Waqf* is an endowment grant to transfer private legal ownership of tangible or intangible assets to God for the benefit of the public beneficiaries.⁷⁹ In many circumstances, Muslims use *waqf* to nationalise their private property that has the potential to ease the need of the public such as land, water or grass. It is a benevolent act that played a significant role during the Ottoman Empire, whereby most of the private services for the travellers were *Waqf* based.⁸⁰ Other than *waqf*, *Shariah* also provides *zakat* or compulsory alms as a redistribution instrument of idle wealth from the rich to the specific predetermined eligible receivers. As mentioned by the Quran, they are the poor (*fuqara*), the vulnerable (*masakin*), administrators who collect *zakat* (*amilin*), those whose heart are to be won over (*muallaf*), those freeing of human beings from bondage, those overburdened with debts (*riqab*), those that struggle in the God's cause (*fi sabilillah*) and wayfarers (*ibn sabil*).⁸¹ Apart from these, *Shariah* also encourages benevolent charity or *sadaqah* to ease each other's burden and hardship, on the basis of synergy and cooperative action.

hardship inflicted on the people because of a certain law implementation must be prevented. See also Muhammad Hashim Kamali, *Principles of Islamic Jurisprudence* (The Islamic Texts Society Cambridge 2003) 351.

⁷⁷ This hadith is narrated by Ibn Majah as reported from Ibn Abbas; See also Ibn Majah, *Sunan Ibn Majah* (Al-Ma'arif Publication) no. 2472 422.

⁷⁸ This will be discussed further on the next subtopic.

⁷⁹ Transferring ownership to God means returning the ownership of what was once a private property back under public administration.

⁸⁰ Timur Kuran, 'The Absence of the Corporation in Islamic Law: Origin and Persistence' (2005) 53 AJCL 14.

⁸¹ Quran (9: 60)

As far as Muslims are concerned, Islam as a way of life is moderate or *wasatiyyah*. It embraces moderation and intertwines with the middle course. In this regard, Islam blends the concept of justice with freedom, equality with incentive, liberty with limits and acquisition with sharing.⁸² There is no extreme spectrum upheld in the teaching of Islam. The action of the state in an economy must not trespass private initiatives, whereas maximisation of output by the private sectors joins with constructive redistribution governed by the state. This is how both sectors flourish in the economic ecosystem where conflicting issues between them should not exist based on rivalry but rather on companionship and supportive competition. The reality is, neither state nor private sector could stand alone without the presence of the other.

It is important to realise that the understanding discussed above is the product of the Muslim worldview on the concept of the absolute Owner of the universe. Allah as God of the universe is the One and only Owner of everything ever to exist in the universe. The reason is simple. He is the Creator and, therefore, He owns everything of His creations, including humans. Technically, everything in this universe has been made subservient to Him.⁸³ However, He is also without the need for His own creations. So, what is the purpose of all the creations? He expresses the answer to that question in one of the Quranic passages by saying that there is no purpose for the creation of jinn and humans except for them to obey Him.⁸⁴ It is important to mention here that by saying obedience to the commands of the God, it is not merely restricted to ritual activities. He sent His manuals to the humans by revealing it to the chosen ones amongst the humans as His prophets. The message is clear: testify His Divineness and live the life as you wish, as long it is in compliant with His commands.

Under the premise that the absolute owner of all property is God Himself, *Shariah* condemns the concentration of ownership to a small group of rich and powerful people hoarding and squandering of wealth for self-interest. In this view, God mentions that all those redistributions is to hinder the circulation of wealth within the rich amongst them to achieve economic equilibrium.⁸⁵ The state of equilibrium in Islamic economic system includes justice and fairness in wealth distribution, which is in terms of material achievement, as well as the tranquillity or the state of mental and spiritual peace.⁸⁶ Therefore, Islamic economic discussions do not deal merely with the question of wealth creation and distribution methods or economic decision-making variables and so on, as occurred in scarcity debate,

⁸² Nazeer (n 7) 3.

⁸³ *ibid* 5.

⁸⁴ Quran (51: 56)

⁸⁵ Quran (59: 7)

⁸⁶ Chapra, *Islam and Economic Development* (n 19) 6.

but also in terms of morality and human values. Additionally, wealth is not something to be grabbed and chased by all possible means, but rather a medium to enrich the state of one's life and give it to those in need. It is imperative to note here that by saying that wealth is to be given to others does not mean one should completely put aside one's own interest.

Despite the fact that wealth is desired by humans to fulfil their necessities, it is regarded as a tool to acquire Godly tasks rather than merely a worldly objective for one's life. Therefore, the race of Muslims towards wealth creation is not about wealth value maximisation only, but also supersedes such a short-sighted objective. The question of how to acquire, preserve and utilise the wealth is not restricted to a human perspective, where it will take into account the pertinent commands given by God. Craving the wealth for self-seeking privilege, especially without considering the aspect of *Shariah* compliance and its negative impacts in the community is what is considered as a disapproved way of wealth creation.

Shariah emphasises the function of wealth as an instrument to get a better live which is to sustain a strong, stable and united society. Any discussion on wealth will end up with how to ensure the possession of the wealth is done in adherence with *Shariah* as well as its distribution. This is because *Shariah* condemns any act of hoarding the wealth without spending or dispersing it for the sake of economic sustainability. Wealth is only renowned as genuine wealth after it serve the purpose of human wellbeing.⁸⁷ Therefore, this is the comprehension of what *Shariah* compliance really is, rather fundamental and doctrinal to apprehend *Shariah* governance discourse.

As a conclusion, one aspect that needs emphasising here is the impacts of the Islamic epistemological worldview regarding the ways of the IFIs should deal with economic activities. First of all, IFIs with the genuine intention to uphold Islamic teachings would never deem the managers as untrustworthy and waste their labour production talents. Secondly, the IFIs should also be delicate and creative in business strategies, as they are the dedicated vicegerents of God managing the available resources entrusted to humans. Thirdly, the IFIs should serve as an economic agent to achieve economic equilibrium by wealth-sharing and balance ownership. The last but not least, the IFIs should promotes this notion to their conventional counterpart and find out the way to merge both systems for everybody's benefit.

⁸⁷ See also Mark Anielski, *Genuine Wealth Accounting: Measuring Sustainability of Communities* (Anielski Management Inc, 2007)

6.3 *Shariah* Compliance

Shariah compliance, the notion that has been emphasised by this research is the *raison d'être* of *Shariah* governance. The word 'compliance' means the state or fact of according with, or meeting rules or standards.⁸⁸ In this sense, '*Shariah* compliance' is perceivable as to meet the standards required by the *Shariah* law. Despite wider application in other subjects, this connotation is mostly implied in Islamic finance. It is due to the fact the IFIs are accommodating a sizeable number of contracts admissible under the *Shariah* law. Therefore, it is imperative for the IFIs, as the biggest players of the Islamic financial market, to apprehend the variables that indicate compliance with the respective law. In this regard, the notion of *Shariah* compliance refers to the concept of financial activities in adherence with the tenets prescribed by *Shariah*. In other words, all products and services offered by the IFIs are fabricated from the idea that *Shariah* is the reference of the norm creation to prescribe what is right or wrong, licit or illicit, as well as what is lawful or unlawful. Each dispute or litigation, if any, will employ *Shariah* as the source of authority, hence the governing law, disregarding whatever terms are used. It is reflected by the existence of the *Shariah* committee as the primary structural constituent. The *Shariah* committee is a governance organ that executes the duty of care and loyalty in their way to comply with *Shariah* matters. The notion brought about by the duty of this respective organ plays as the banner of the IFIs in a way how they ensure that each products and services had gone through a deliberation of critical and delicate procedures under the supervision of a group of experts with 'fit and proper' criteria, before being offered to the market.

It is worth mentioning in this regard that on most occasions, *Shariah* will come with a general prescription of 'what ought' or 'what ought not to be'. This part will form the principle law as a normative preference for the relevant cases, under the same chapter. By referring that, *Shariah* law expands the ruling to the events that are currently occurring. If the event adheres to the principle law, it is admissible and the decision made is regarded as the law as well. For example, in the case of the *Shariah* financial law, there are three main principle laws, that work as normative preferences, which are the prohibition of *riba*, the avoidance of uncertainties and the abolition of non-permissible business activities.⁸⁹ These three laws are 'what ought' or 'ought not to be' deemed to be considered by Muslims in their business. Business arrangements that are operated by business counterparts, are regarded as admissible, if they are complying with the three principle laws. The Islamic contractual arrangement, for instance, such as

⁸⁸ English Oxford Living Dictionary < <https://en.oxforddictionaries.com/definition/compliance>> accessed 10 September 2018.

⁸⁹ Other writers might categorise this aspect with a different arrangement, however, the themes are similar in many ways.

mudarabah, musharakah, wadi'ah, wakalah, and so on, are the list of the occurring cases that happened to be deduced by the *Shariah* scholars. They are the products that have prevailed over the general characteristics and have been submitted by the *Shariah* scholars as the listed *Shariah*-compliant contracts, known as the *uqud musamma*.

As an extension to what has been discussed in Chapter 2 on the meaning and the characteristics of *Shariah*, this part will focus on how *Shariah* law is derived, not merely the description of its features and objectives. *Shariah* as the law of Muslim lands, provides the depictions of human's starvation to a higher interpretation of norm. By nature, *Shariah* does not come to draw all human life in detail, from the biggest to the tiniest part and parcel of life, so it could put a full control on humans to ensure that they behave as they ought to under the *Shariah* framework. The Quran and the Hadith as the sources that come from God, the Creator, rather enlighten the weak spectrum of human capabilities and strengthen its strong spectrum. As data centric sources, many topics are well-addressed in the Quran and the Hadith, in which a collection of legal aspects, known as the *Shariah* law, is also well encrypted. During the time of Prophet Muhammad PBUH, the companions had gone through a fully structured educational process for 23 years, from the Prophet PBUH himself; hence they could see the data presented by the sources in a coherent mind. This skill has been transferred to many generations afterwards and has been expanded exponentially by multiple *Shariah* legal schools during the golden age of Islamic knowledge.

As the experts, it is rightfully the duty of the members of the *Shariah* committee to deduce the rulings on the operation of the IFIs under *Shariah* law. This procedure known as *ijtihad*. *Ijtihad* is a law-deducing procedure to figure out the principle laws from the sources, then apply them to the cases brought upon them. This task is of prime importance and exhaustive since it is the configuration of 'what ought' or 'ought not to be' and 'what is' of *Shariah* law.⁹⁰

6.3.1 *Shariah* Compliance Characteristics in Finance

As far as the IFIs are concerned, there are three primary characteristics to be applied to ensure *Shariah* compliance in Islamic finance, i.e the prohibition of *riba*, avoidance of uncertainties and the abolition of non-permissible business activities. These three characteristics are deduced by *Shariah* scholars from the Quran and the Hadith and stand as the point of reference to determine whether a certain contract is in compliance with *Shariah* law or otherwise.

⁹⁰ This will be further discussed in the upcoming chapters.

6.3.1.1 Prohibition of *Riba*

6.3.1.2 Definition of *Riba*

The word *riba* is the connotation for interest and usury in Arabic.⁹¹ It is a noun derived from the word *rabaa* (ربا), *yarbu* (يربوا) and *rabwan* (ربوا). Literally, it means to increase, to grow, to exceed and to raise.⁹² In this regard, Al-Mawdudi asserted *riba* is commonly associated with an excessive amount of wealth and an addition to the principal.⁹³

Terminologically, the understanding of *riba* is closely related to the practice of Arabs during the time of *jahiliyyah* or the darks age of Arabs. This is due to the fact the alluded meaning (*isharah al-nass*) of the provision of the Quran pertaining to this notion is in a definitive form, signalling to a specific understanding of the time of revelation. The Quran says, 'God has permitted trade and has forbidden interest'. The word form of *riba* in the Quran is mentioned in a singular form of noun, preceded by the definite article of 'al'. From an Arabic lingual perspective, this form of word literally means 'the *riba*', a well-known subject, the form of interest charged over credit provided. As a result, it is observed that the Quranic interpreters will always narrate the form of *riba* widely practised by the Arabs during the time of the Quranic revelation. The Arab *jahiliyyah* merchants used to give credit to a person in return for an additional amount from the principal that would be paid after a certain tenure. When the date approached, the payment tenure would be extended to a new date and the amount of the debt raised due to the new tenure.⁹⁴ In short, the amount would multiply and it is reported that some of borrowers ended up becoming slaves to the debtor due to the unpaid debt.⁹⁵ This form of credit practice is also known as *riba jahiliyyah*. Since our modern economic system is connected on a vast scale to credit activities, the risk of *riba* as an excessive premium imposed on the borrower in a loan transaction⁹⁶ is, highly likely, unavoidable.

⁹¹ See also Masudul Alam Choudhury and Uzir Abdul Malik, *The Foundation of Islamic Political Economy* (M Macmillan 1992) 103.

⁹² Wehr (n 18) 347.

⁹³ Abu A'la al-Maududi, *First Principles of Islamic Economics* trs AS Hashemi eds K Ahmad (The Islamic Foundation, 2011) 144.

⁹⁴ AR al-Jazairi, *Kitab al-Figh ala al-Mazhab al-Aba'ah* (eds 2 Dar al-Kutub al-Ilmiyah 2003) vol 2 222.

⁹⁵ Those who were enslaved because of indebtment are eligible to receive *zakah* funding so they could be freed.

⁹⁶ Chapra, *Towards a Just Monetary System* (n 50) 56-57.

Besides *riba jahiliyyah*, the Prophet Muhammad PBUH explained the application of *riba* in other variants. As reported by Abu Said al-Khudry, the Prophet PBUH said,

*[Exchange] gold with gold, silver with silver, wheat with wheat, barley with barley, dates with dates, salt with salt in equal quantities and spot. Anyone who increases the quantity or asks for increase indulges in riba.*⁹⁷

According to this, apart from being the excess or increasing amount over the principal credited, *riba* is also occurred in barter transaction of certain commodities due to excess amount or deferment in acceptance.

Having this as the point of reference, *Shariah* scholars came up with numerous operational definitions. The classical works of the Hanafi school defined *riba* as a compensation without due consideration on specific goods based on standard matrix made conditional for either party of the contract.⁹⁸ In one of the celebrated legal books of the Shafie school, *riba* is referred to as a contract of specific goods without due of return based on a standard matrix, during transaction or with a deferred transfer of either one or both items.⁹⁹

As observed from the aforementioned definitions, to contemplate whether the risk of *riba* has taken place in a transaction or not, three characteristics should be taken under consideration, i.e. the transferred items, the means of transaction and the paid amount. Leading by these characteristics, note that not all transactions are deemed to bear the risk of *riba*. The risk of *riba*, by and large, is only present in the transactions of *ribawi*¹⁰⁰ items. As clearly said by the text, with a definitive meaning, the items included as *ribawis* are gold, silver, wheat, barley, dates and salt. Other than that, *riba* only occurs if those items are not transacted according to the proposed way of transactions. Additionally, *riba* also happens in barter transactions of subjects with a single genus, if the paid price and the sale article are uneven in terms of weight. Regarding this, one of the fundamental questions under discussion here is how to trade the *ribawi* items without being involved in prohibited actions. To answer that, this part of discussion will

⁹⁷ This hadith is narrated by Muslim as reported from Abu Hurairah; Muslim bin Hajjaj, *Sahih Muslim* (Dar al-Fikr 2003) no 3959 778.

⁹⁸ *Riba* is defined by the scholars of Hanafi school as (فضل خال عن عوض مخصوص بمعيار الشرعي مشروط) (لاحد المتعاقدين في المعاوضة): See also M Ibn Abidin, *Radd al-Muhtar ala al-Dar al-Mukhtar* (Dar Alam al-Kutub 2003) vol 7 398.

⁹⁹ *Riba* is defined by Shafie school scholars as (عقد على عوض مخصوص غير التماثل في المعيار الشرعي حالة العقد) (أو مع تأخير في البدلين أو أحدهما): See also M Khatib Shirbini, *Mughni al-Muhtaj ila Ma'rifat Alfaz al-Minhaj* (Dar al-Ma'rifah 1998) vol 2 30.

¹⁰⁰ Arabic adjective derivation of *riba*.

encapsulate an in-depth discussion of *riba*, especially in the area that is crucial to bringing about understanding of the complexity of its implementations.

6.3.1.2.1 Proofs on *Riba* Prohibition

Shariah scholars are in consensus on the prohibition of *riba*.¹⁰¹ The proofs of *riba* prohibition are resolved from the Quran and the authentic Hadiths. Both sources, especially, the Quran are revealed to the Prophet PBUH in a gradual manner, which took place over a period of 23 years. Regarding this, some of the passages of the Quran were revealed on an occasional basis, such as the texts relating to the proof of *riba* prohibition. This is due to the fact *riba* is a well-rooted tradition of the Arab *jahiliyyah* economic system and hardly eliminated without causing detrimental effects to the system as a whole.

The proofs of *riba* from the Quran are concluded in four levels, as follows:

a. First level

*... whatever you lent out in usury to gain value through other people's wealth will not increase in God's eye...*¹⁰²

The Quranic interpreters like Ibn Abbas, Ibn Jarir, Tawus and Mujahid mentioned that this text alludes to a *hibah* (gift) that is given with the intention of receiving benefits from the receiver.¹⁰³ In this case, the intention of the donor is not benevolent but rather to seek advantage in return.¹⁰⁴ By the way of inference (*dalalah al-nass*) to a greater intention, this text does not directly mention the regulation regarding excess amounts charged over the debt, but more on drawing the attention of the society to the morality of giving and its added value in the eyes of God. Despite interest not being prohibited by this text, it emphasises how wealth generated from interest charged is not blessed by God.¹⁰⁵

b. Second level

For the wrongdoings done by the Jews, We forbade them certain good things that had been permitted to them before: for having frequently debarred others from God's path; for taking usury when they had been forbidden to do so; and for wrongfully devouring other people's

¹⁰¹ Zuhayli, *Al-Fiqh al-Islami wa Adillatuhu* (n 57) vol 5 3700.

¹⁰² Quran (30: 39)

¹⁰³ Muhammad ibn Ahmad Al-Qurtubi, *al-Jami' li Ahkam al-Quran* (Dar al-Kutub 2002) vol 7 361.

¹⁰⁴ Al-Tabari, *Jami' al-Bayan 'an Ta'wil al-Qur'an* (Dar al-Salam 2007) vol 8 6529.

¹⁰⁵ Chapra, *Towards a Just Monetary System* (n 50) 56.

*property. For those of them that reject the truth we have prepared an agonising torment.*¹⁰⁶

This passage was revealed in the early days after the event of the *hijrah* (migration) of the Prophet PBUH and his companions from Mecca to Medina. During that time, Medina was the settlement of numerous Jewish tribes. Since the Quran is the latest testament from God, it mentions how the former generations reacted to the testaments that came before the Quran. In this case, God started to give indications as to what happened to former generations due to their unwillingness to follow the guidance. As mentioned in the text above, God had forbidden the Jews what was once permitted for them because of their act of charging interest over credit.¹⁰⁷ This is the reminder from God for them not to follow such an example, as far as Muslims are concerned.

c. Third level

*...you who believe, do not consume usurious interest, doubled and redoubled. Be mindful of God so that you may prosper...*¹⁰⁸

This text was revealed during the second year after *hijrah*. As stated by Mujahid, it is a clear message from God to those who charge doubled and multiplied amounts of interest on credit activities.¹⁰⁹ Unlike the first two texts relating to *riba*, this text indicates the regulatory aspect of *riba*. The used of *do not consume* (*تأكلوا*) is a derivative form of command to omit the action of consuming interest. However, the focal point of this command of this level was on interest with doubled and multiplied charges.

d. Fourth level

...but those who take usury will rise up on the Day of Resurrection like someone tormented by Satan's touch. That is because they say: 'Trade and usury are the same', but God has allowed trade and forbidden usury. Whoever, on receiving God's warning, stops taking usury may keep his past gains - God will be the judge-but whoever goes back to usury will be an inhabitant of the Fire, there to remain. God blights usury but blesses charitable deeds with multiple increase: He does not love an ungrateful sinner. Those who believe, do good deeds keep up the prayer, and pay the prescribed alms will have their reward with their Lord; no fear for them, nor will they grieve. You who

¹⁰⁶ Quran (4: 160-161)

¹⁰⁷ Syed Qutb, *Tafsif fi Zilal al-Quran* (Dar al-Syuruq) 803.

¹⁰⁸ Quran (3: 130)

¹⁰⁹ Wahbah al-Zuhayli, *Al-Tafsir al-Munir* (3rd edn Dar al-Fikr 2003) vol 4 82.

*believe, beware of God: give up any outstanding dues from usury if you are true believers. And if you do not, then be warned of war from God and His Messenger. You shall have your capital if you repent, and without suffering loss or causing others to suffer loss.*¹¹⁰

These texts are the conclusion of the regulation of *riba* resolved from the Quran. In the *Shariah* regulatory point of view, the quote 'God has permitted sale and forbidden *riba*' is a direct exclamation to clarify the regulatory statute of *riba* in the eyes of *Shariah* law. As far as the IFIs are concerned, the word *forbade* solidifies the prohibition of *riba* with an explicit meaning (*ibarah al-nass*). This command is derived from definitive proof with a definitive meaning pointing out the prohibition of *riba* in *Shariah* law. In addition, the later part of the texts also indicates the magnitude of this prohibition. Those who defy this order are similar to those who are at war with God Himself. Such a great condemnation.

Apart from the Quranic texts, the prohibition of *riba* is also deduced by authentic hadiths as partly the abovementioned. Broadly speaking, the hadiths function as supportive proofs for the mentioned cases from the Quran. There are also hadiths associated as determiners to what had been said by the Quran by providing further explanation, the qualified over the absolute meaning or the particularisation of general meaning of the Quran. Other than that, hadiths could deliver rulings that are silenced by the Quran.¹¹¹ In the case of *riba*, the relevant hadiths to *riba* prohibition are as follows:

*"Avoid the seven destructive things." It was asked: (by those present): "What are they, O Messenger of Allah?" He replied, "Associating anyone or anything with Allah in worship; practising sorcery, killing of someone without a just cause whom Allah has forbidden, devouring the property of an orphan, consuming of usury, fleeing from the battlefield and slandering chaste women who never even think of anything touching their chastity and are good believers."*¹¹²

*The Messenger of Allah PBUH cursed the one who accepts Ar-Riba (the usury) and the one who pays it.*¹¹³

¹¹⁰ Quran (2: 275-279)

¹¹¹ Wahbah al-Zuhayli, *al-Wajiz fi Usul al-Fiqh al-Islami* (2nd edn Dar al-Khayr, 2006) vol 1 222.

¹¹² This is narrated by Muslim as reported from Jabir; Muslim, *Sahih Muslim* (Dar al-Fikr 2003) no 3984 783.

¹¹³ This hadith is narrated by Muslim as reported from Jabir; Muslim, *Sahih Muslim* (Dar al-Fikr 2003) no 3984 783.

To some extent, these hadiths are examples of how the hadiths function as the supportive proof to the Quran. In this context, these hadiths are illustrating how *Shariah* perceives *riba*. *Riba* is something to be avoided and even cursed by the Prophet PBUH. The commanding words such as 'avoid' and condemnation words such as 'cursed' indicate the dictation of command to omit the acts.¹¹⁴ As a result, these texts are considered as definitive proofs for the prohibition of *riba*, as far as the *Shariah* scholars are concerned.

Other than the aforementioned hadiths, there are also hadiths that illustrate the technical aspect of *riba*, as follows:

*Gold is to be paid for by gold, silver by silver, wheat by wheat, barley by barley, dates by dates, and salt by salt, like for like and equal for equal, payment being made hand to hand. If these classes differ, then sell as you wish if payment is made hand to hand.*¹¹⁵

*Gold is to be paid for by gold, silver by silver, wheat by wheat, barley by barley, dates by dates, salt by salt, like by like, payment being made hand to hand. He who made an addition to it, or asked for an addition, in fact dealt in usury. The receiver and the giver are equally guilty.*¹¹⁶

Unlike the previous hadiths, these hadiths specify the general indication of *riba* mentioned by the Quran. Based on the hadiths above, there are six items listed as having the risk of *riba*. They are evidently mentioned in an explicit narrative with a definitive meaning. As a result, the *Shariah* scholars established those items as *ribawis*, and they stand as the point of reference for *ijtihad* procedure in relation to *riba* matters. Other than establishing these *ribawi* items, the Prophet PBUH also stipulated the way how those items should be traded to avoid the risk of *riba*.

6.3.1.2.2 'Illah of Riba Prohibition

The insight of the '*illah* (effective cause) of *riba* is crucial to allow *Shariah* committee to contemplate relevant *Shariah* legal aspects of the deals entered by the IFIs. It is as a direct result of the fact that the presence of *riba* in trade could render the contract null and void. Under *Shariah* law, such a prohibition could also revoke the legal title of the assets as it is obtained through a non-admissible action which is by charging *riba*. Apart from that, the dynamic of financial instruments has allowed the transformational forms of *riba* to excel. Thus, a quantifiable description is required to elucidate the substantial rationales of *riba*

¹¹⁴ Abdul Karim Zaydan, *Al-Wajiz fi Usul al-Fiqh* (Muassasah al-Risalah 2014) 279.

¹¹⁵ This hadith is narrated by Muslim as reported from Abu Sa'id al-Khudri; Muslim, *Sahih Muslim* (Dar al-Fikr 2003) no 3954 778.

¹¹⁶ This hadith is narrated by Muslim as reported from Abu Sa'id al-Khudri; Muslim, *Sahih Muslim* (Dar al-Fikr 2003) no 3955 778.

prohibition. It is to play the role as the tangible basis in articulating the *Shariah* legal ground for any cases related to *riba* using the valid analogical reasoning.

Before any further discussions on *riba*, it is important to note that the comprehension of this topic relies on the understanding of *qiyas* (analogical reasoning) owing to the fact that '*illah*' is one of the elements of *qiyas*. *Qiyas* is an *ijtihad* process of the extension of the *Shariah* value from an original case to a new case, in the light of the latter having the same effective cause as the former.¹¹⁷ As mentioned by al-Amidi and Ibn Hajib, it is an equalisation of the new case with the original case due to the similarity of their *ratio decidendi*.¹¹⁸ This definition is deduced by Isnawi based on the given definition by al-Baidawi. Al-Baidawi addressed *qiyas* as the affirmation of the ruling of the original case on the new case due to the proven association of *ratio decidendi*.¹¹⁹ To deploy *qiyas*, *Shariah* scholars will scout for four elements that are deemed to be compulsory. These elements are the original case (*asl*), the new case (*far'u*), the ruling (*hukm*) and the effective cause (*'illah*).¹²⁰

In terms of its validity, *qiyas* is unanimously agreed by scholars as one of the sources of *Shariah* law.¹²¹ The proofs of this argument are the Quran and the authentic hadiths. One the celebrated proofs is the hadith narrated by Abu Dawud on the conversation of the Prophet PBUH and Muaz ibn Jabal when he intended to send him to Yemen. The Prophet PBUH asked him, '*How will you judge when the occasion of deciding a case arises?*' He replied, 'I shall judge in accordance with Allah's Book'. He asked, '*(What will you do) if you do not find any guidance in Allah's Book?*' He replied, (I shall act) in accordance with the Sunnah of the Messenger of Allah PBUH. He asked, '*(What will you do) if you do not find any guidance in the Sunnah of the Messenger of Allah PBUH and in Allah's Book?*' He replied 'I shall do my best to form an opinion and I shall spare no effort'. The Prophet PBUH then patted him on the breast and said, '*Praise be to Allah who has helped the messenger of the Messenger of Allah to find something which pleases the Messenger of Allah*'.¹²²

¹¹⁷ Kamali (n 76) 264.

¹¹⁸ Jamal al-Din Al-Isnawi, *Nihayah al-Sul fi Syarh Minhaj al-Wusul* (Dar Ibn Hazm 1999) vol 2 792.

¹¹⁹ Nasiruddin A al-Baidawi, *Minhaj al-Wusul ila 'Ilmi al-Usul* (Dar Ibn Hazm 2008) 189.

¹²⁰ Al-Zuhayli, *al-Wajiz fi Usul al-Fiqh al-Islami* (n 111) vol 1 238.

¹²¹ There were schools such as Zahiri and Muktazilah who opposed *qiyas* as a tool to regulate rulings of *Shariah* law. Despite its extinction, it is important to mention this opinion due to the fact some of the contradictions of the scholars on *Shariah* matters were caused by this jurisprudential distinction: See also Kamali (n 76) 265.

¹²² Abu Dawud, *Sunan Abi Dawud* (International Ideas Home Inc. ND) no. 3592.

The '*illah* is deemed to coexist in both old and recent cases before the *qiyas* is deployed.¹²³ It is an aggregate description of the rationale of the original case, which is ostensibly available in the new case.¹²⁴ As discussed by Hashim Kamali, '*illah* refers to the rationale of injunction or *ratio decidendi* in *Shariah* rulings. It is an attribute of the original case, which is constant and evident and bears a proper relationship to the law of the text.¹²⁵ Despite differences in details, '*illah* also has its similarities with cause (*sabab*) in many respects. As far as this research is concerned, '*illah* is more than merely a cause or rationale of the rulings. It is a tangible outline of reasoning which could be understood by the *mujtahid* to make use of *qiyas* for the unprecedented cases by referring to the original cases depicted by the *Shariah* sources.

The justification of '*illah* in the case of *riba* is utterly imperative. The fundamental of this notion is the alluded meaning conferred by the word *riba* in the Quran. The Quran has mentioned *riba* in a singular form of noun, preceded by the definite article of '*al*', as an indication of generalisation ('*amm*'), without providing specification (*khass*), neither from other Quranic texts nor hadiths to elaborate its real meaning. Regarding this, from the *Shariah* jurisprudential perspective, the general form generalises the implementation of the mentioned word.¹²⁶ In the case of *riba*, this word form indicates that the ruling of *riba* is applicable to others, without ostensive restriction. Moreover, in spite of the hadith that mentioned the number of specific items that fit as *ribawis*, *Shariah* scholars unanimously opined the implied meaning of *ribawi* is extended beyond the said list in a more general manner.¹²⁷

It is important to note here that there is no specific provision stating the '*illah* of *riba*.¹²⁸ Therefore, in seeking the '*illah* of *riba*, *Shariah* scholars employed the process known as *takhrij al-manat*, or the extraction of the '*illah* that is silent in the texts.¹²⁹ As a result, there are contradictory of views occurred amongst the *Shariah* scholars about what is the valid '*illah* of *riba*. In order that an '*illah* fits as a valid reference, it must be tangible, quantifiable, and applicable to other sort of

¹²³ Abdul Wahhab Khallaf, *Ilm Usul al-Fiqh* (ar al-Fikr al-Arabi 1996) 72.

¹²⁴ al-Zuhayli, *al-Wajiz fi Usul al-Fiqh al-Islami* (n 111) vol 1 239.

¹²⁵ Kamali (n 76) 275.

¹²⁶ Al-Zuhayli, *al-Wajiz fi Usul al-Fiqh al-Islami* (n 111) vol 2 49-50.

¹²⁷ Ibn Rusyd, *Bidayah al-Mujtahid wa Nihayah al-Muqtasid* (Bayt al-Afkar al-Dawliyyah 2007) 656.

¹²⁸ In some cases like the prohibition of alcoholic drink, the '*illah* of its prohibition was clearly stated by the hadith as *muskir* (intoxicant). Commencing from this, any intoxicating substance is deemed to be prohibited.

¹²⁹ The process to extract '*illah* mentioned explicitly in the text called as *tanqih al-manat*.

cases.¹³⁰ For the purpose of legal consideration, these jurisprudential characteristics are decisive in respect to the role of an *'illah* as legal basis for a *Shariah* law deduction. There is an opinion, for instance, that depicted *zulm* (injustice) as the *'illah* of *riba*.¹³¹ However, the concept of injustice is unquantifiable. How to put a tangible definition of injustice? If we simply say, as a certain party obtained more in terms of financial gain compared to other parties of the same agreement as a justified *'illah*, we will end up with implicating those who stand as the principals of our economic units. Moreover, we will see those who are blessed with wealth as deprivors rather than entrepreneurs.

As of this, the *Shariah* scholars have come up with two main categories of *ribawi* items by compiling gold and silver into a single group, and wheat, barley, dates and salt into another group. As for gold and silver, the Hanafi school and one of the opinion of the Hanbali school argued that the rationale for those items to be *ribawis* is that they are scaled and estimated by measure and weight.¹³² The unanimous agreement of scholars from the schools of Maliki, Shafie and one of the opinions of Hanbali school asserted that the effective cause of ruling for gold and silver as *ribawi* items is the medium of exchange.¹³³ As for wheat, barley, dates and salt, the Hanafi and the Hanbali schools judged them as items scaled and estimated by measure and weight, the Maliki school as edible food and life sustenance and Shafie school as humans' edible food.¹³⁴ These distinctions have caused disagreements between the *Shariah* scholars to impose *ribawi* to the extended items. For instance, in the case of those who deduced everything that is scaled by weight as *ribawi* items, other items such as steel and metal are reckoned as the derivation of *ribawis*, but fiat money made of paper and not measured by weight is not. The same principles applied to those who see medium of exchange as *'illah*. In this case, fiat money is ostensibly a *ribawi* item. Regarding this, as decided by the contemporary *Shariah* scholars, such as the International Fiqh Council and the AAOIFI, fiat money is a *ribawi* item due to the fact it has taken the function of gold and silver as the medium of transaction, in parallel with the opinion of the unanimous ancient *Shariah* scholars.¹³⁵

¹³⁰ Khallaf (n 123) 65-67.

¹³¹ Chapra, *Towards a Just Monetary System* (n 50) 38.

¹³² Abdullah al-Nasafi, *Kanz al-Daqaiq* (Dar al-Bashaer 2011) 231: Abidin(n 98) 403: See also al-Jazairi (n94) 225.

¹³³ Muhammad Dusuqi, *Hashiyah al-Dusuqi ala al-Syarh al-Kabir* (Dar Ihya' al-Kutub al-Arabiyyah) vol 3 47; Muhammad al-Zuhri al-Ghamrawi, *al-Siraj al-Wahhaj* (Dar al-Ma'rifah) 177-178; See also al-Jazairi (n94) 225.

¹³⁴ As the implication of the primary traded items in finance, the focus of this research is more on the *'illah* of gold and silver

¹³⁵ International Fiqh Council, Resolution no. 21 (9/3) visited 16 June 2017 <http://www.iifa-aifi.org/1679.html>

6.3.1.2.3 Types of *Riba*

The risk of *riba* exists in sale and debt transactions of *ribawi* items. It could occur in the transaction of *ribawi* items with delayed payment or excess amount in one of the counter values. Regarding this, *riba* in delayed payment is known as *riba al-nasih* whereas *riba* in the excess payment is known as *riba al-fadl*.

a. *Riba al-Nasih*

Literally *nasiah* means credit and delayed payment.¹³⁶ *Riba al-nasih* refers to the extra charged on credit because of the delay in payment.¹³⁷ Terminologically, it is an additional premium to be paid to the debtor as a payment for the deferment in return of the loan given to the borrower.¹³⁸ It is considered as in equivalent with the practice of charging interest in the modern financial system. This type of *riba* commonly happens in debt-based transactions, as in loans and sales with deferred payment. That is the reason why it is known as *riba al-duyun* (interest on debt) on several occasions. Ibn Qayyim addressed *riba al-nasih* as *riba-jalli* (explicit) because of its blatant end-result of debt-based transactions, which is the additional amount to be paid on top of the principal due to the payment tenure.¹³⁹ This type of *riba* is exemplified by A who borrowed from B an amount of GBP100 with the promise of payment within 3 months. B as the debtor asked A to pay him an additional amount of money based on, let say x% per annum of the principal, as a charge for his kindness in lending the money for the stipulated tenure. If A cannot fulfil his promise to pay within the tenure, x% per annum will be recalculated and a new tenure will be applied. Under common circumstances, this type of *riba* appears in debt transactions or purchasing with deferred payments associated with price increment due to time. The tenure and the percentage of the charged amount are in correlation.

The indication for *riba al-nasih* is resolved from the Hadiths of the Prophet's PBUH, as follows:

*Gold is to be paid for by gold, silver by silver, wheat by wheat, barley by barley, dates by dates, and salt by salt, like for like and equal for equal, payment being made hand to hand. If these classes differ, then sell as you wish if payment is made hand to hand.*¹⁴⁰

¹³⁶ Oxford Arabic Dictionary (OUP 2014) 803.

¹³⁷ Muhammad Abu Zahrah, *Buhuth fi Riba* (Dar al-Fikr 1986) 19.

¹³⁸ *Al-Mawsu'ah al-Fiqhiyyah al-Kuwaitiyyah* (2nd eds Dar al-Safwa 1992) vol 22 57.

¹³⁹ Ibn Qayyim, *l'lam al-Muwaqqi'in li Rabb al-'Alamin* (Dar Ibn al-Jawzi 2002) vol 3 397.

¹⁴⁰ This hadith is by Muslim as reported from Abu Sa'id al-Khudri; Muslim bin Hajjaj, *Sahih Muslim* no. 3954 (Dar al-Fikr 2003) 778.

*There is no Riba except when it is not done from hand to hand.*¹⁴¹

b. Riba al-Fadl

Literally, *fadl* means excess and surplus.¹⁴² *Riba al-fadl* refers to the excess amount to be paid in credit and trade. Terminologically, it is an unbalanced amount that occurs between the price and sale article in the case of the trade of the *ribawi* items with a single genus. In this sense, the semblance of this type of *riba* is more distinctive to barter trade of the *ribawis*. This type of *riba* is exemplified by A buying from B 1000kg of process wheat paid for by 1200kg of raw wheat to be paid in a said time and place. In this example, the fact that both items are in a single genus has caused *riba* to occur regardless of the quality.

The indication of *riba al-fadl* is resolved from the Hadiths of the Prophet's PBUH, as follows:

*Gold is to be paid for by gold, silver by silver, wheat by wheat, barley by barley, dates by dates, salt by salt, like by like, payment being made hand to hand. He who made an addition to it, or asked for an addition, in fact dealt in usury. The receiver and the giver are equally guilty.*¹⁴³

6.3.1.2.4 Trading *Ribawi* Items

After considering the types of *riba* and how it could occur in the transaction, it is worth addressing how to avoid the occurrence of such a forbidden feature. Regarding this, there are three conditions to be considered when we deal with *ribawi* items respectively i.e. the genus of the items, the amount of the transacted items and the delivery methods.¹⁴⁴ The genus of the items reflects the '*illah*' whilst the amount of exchange conjectures the possibility of *riba al-fadl* and the delivery method holds the potential risk of *riba al-nasiah*. Firstly, if the transactional counter-values are in a single genus, they are to be traded hand to hand with equivalent measure or weight. For instance, a 1kg of gold bar is to be traded hand to hand with a 1kg of gold coin or a credit of GBP 100 is to be paid by GBP 100. Secondly, if the transactional counter-values are not in a single genus yet in a similar group, they are to be transacted hand to hand with no consideration on the measure or weight. For example, a 1kg of gold bar is to be traded hand to hand with a 2kg of silver bar, or GBP 100 is to be traded hand to hand with USD

¹⁴¹ This hadith is narrated by Al-Bukhari as reported from Abu Sa'id al-Khudri; M Bukhari, *Sahih al-Bukhari* (5th edn, Dar Ibn Kathir 1993) vol 2 no. 2069 762.

¹⁴² Wehr (n 18) 841.

¹⁴³ This hadith is narrated by Muslim as reported from Abu Sa'id al-Khudri; Muslim, *Sahih Muslim* (Dar al-Fikr 2003) no 3955 778.

¹⁴⁴ M Khin and others, *al-Fiqh al-Manhaji* (eds. 2 Dar al-Qalam 1996) vol 6 71.

120. This type of transaction is similar to the nature of forex trading (*sarf*).¹⁴⁵ Thirdly, if the transactional counter-values are neither in a single genus nor group, they are free to be traded without giving consideration, neither on delivery method nor on measure or weight. Therefore, a 1000kg of wheat can be traded with any currency counter-values equivalent to its economic value, using any delivery method the traders see fit. Meaning, the purchasing of wheat paid for by money is the subject of deferment and price fluctuation. In regard to the *riba* items that are transferred with or purchased by other *riba* items with no resemblance in the effective cause of ruling, the aforementioned conditions are inapplicable.

One way to demonstrate how this *Shariah* requirement is brought into practice, is by looking at the forward foreign currency exchange transactions. In conducting a forward foreign currency exchange, which to some extent seems impossible for the IFIs to execute, the *Shariah* committee proposed the adoption of a unilaterally binding promise by one party (*wa'ad mulzim*).¹⁴⁶ In this sort of transaction, the customer agrees to make a unilateral promise to buy foreign currency from an IFI that will be settled at a specified date. As risk mitigation, the customers have to compensate the actual amount of losses suffered by the bank in the event of default.¹⁴⁷ In this model, the real transaction will only occur on the promised date and the made promise is not tantamount to a contract. In the event of deferred payment, which holds the potential risk of *riba al-nasiah*, the T+2 case seems to properly demonstrate the IFIs' practice. In this case, the *Shariah* committee has put an exemption for transactions of the items in the case of non-avoidant deferment as takes place in spot foreign currency exchange. In a spot transaction, the payment is settled on T+2 or two days after the transaction date. To resolve this issue, the *Shariah* committee have considered its permissibility by giving consideration that such a duration is required by the relevant parties to confirm the trade transaction, where it is an accepted and recognised method of settlement in business practice.¹⁴⁸

As a conclusion, what is to be understood here is the dynamic of product offering procedure should be broadened to comply with *Shariah* law. It is not merely the feasibility and flexibility of the *Shariah* financial contracts, but the respective financial products should also be more tolerable and adaptable to the *Shariah* requirements which somehow demand a creative and innovative mind from the *Shariah* governance constituents.

¹⁴⁵ *ibid* 93.

¹⁴⁶ AS al-Manea, *Buhuth fi Iqtisad Islami* (al-Makatabah al-Islamic 1996) 140.

¹⁴⁷ BNM, *Shariah Resolutions in Islamic Finance* (2 edn, Kuala Lumpur, 2010) 137-138.

¹⁴⁸ *ibid*

6.3.1.2.5 Reasons of *Riba* Prohibition

There are many reasons why *riba* or interest as the cost of borrowing money ought to be paid by the borrower and the excess of payment in trade of certain goods is unlawful and prohibited by the *Shariah* law. The primary theme of the prohibition, as stated by many researchers such as Chapra is injustice, exploitation and instability, both socially and economically.¹⁴⁹ Leading from these themes, the reasons of *riba* prohibition have come to light.

Firstly, as far as *Shariah* law is concerned, the excess payment paid by the borrower to the debtor is an injustice (*zulm*). This credit compensation is obtained without due consideration. In other words, such an extra payment is paid out of nothing in return. In the light of this notion, the idea of borrowing and lending money in the eyes of *Shariah* is rather a benevolent act instead of an economically motivated act: benevolent credit under the *Shariah* financial law known as *qard hasan*. This credit facility is based on morality and has no financial benefit for the debtor. This sort of credit arrangement is due to the fact that under common circumstances, borrowing activities are related to deficit economic units whereas the lenders are the surplus economic units.¹⁵⁰ How could we expect those who are in need and would have a negative amount of money to pay more than what they have taken whilst on the other side who possessed idle amount of money, which somewhat undesirable, to get more than what they have given?

Regarding this, if we see loan as an instrument to facilitate investment, *Shariah* prefers such a facility to be carried out based on profit and loss sharing, not as a window of opportunity to exploit the potential gain without bearing the risk of loss. A *Shariah* legal maxim stipulates that benefit goes with liabilities (*al-kharaj bi al-daman*).¹⁵¹ One might argue that the debtor also bears the risk of loss in the case of default due to the lack of business performance. However, the consequence of loss that could potentially occur in debt-based investment is not a subject to be shared in a fair manner but rather to be endured by one party, the borrower, who would already experience loss if the business is under performing.¹⁵² This double impact has increased the liability on the shoulder of the borrower out of necessity but not the debtor. Therefore, *Shariah* distinguishes credit activities for desired necessities with investment initiatives for value generation. As an alternative, credit with benevolent (*qard hasan*) is suggested as a credit facility

¹⁴⁹ Chapra, *Towards a Just Monetary System* (n 50) 25.

¹⁵⁰ RH Abdrurrahman, *Mawqif al-Shariah al-Islamiyyah Min al-Bunuk, al-Muamalat al-Masrafiyyah wa al-Ta'min* (Dar al-Salam 2005) 16.

¹⁵¹ Laldin and others, (n 59) 156.

¹⁵² M Mashkooor, 'The Meaning of Riba and its Prohibition in Islam' (2010) 16 Research journal of International Studies 58, 60.

for personal purpose whilst symmetrical profit and loss sharing investment instruments such as *musharakah* and *mudarabah* are commonly utilised as investment instruments for business purposes.¹⁵³

Secondly, *riba* is also regarded as an exploitation of the labour force, while a free enterprise corporative system is maintained.¹⁵⁴ This notion is due to the fact that the borrowers, regardless of the attention of the loan, are vulnerable and at risk of manipulation by the surplus units. Islamic morality upholds the concept of courtesy and kindness (*ma'ruf*) as it also denounces exploitation.¹⁵⁵ As a preventive measure, any action that could bring about the exploitation of the labour force is subject to this prohibition. Chapra asserted that the prohibition of *riba* would help to minimise the manipulative elements of money demand which somehow promote greater efficiency out of scarce economic resources.¹⁵⁶ Moreover, this exploitative initiative also narrows the circulation of wealth. By having interest charges on each penny borrowed for production purposes, any output produced by the labour force is entitled to additional cost to be paid to the debtor. Out of resources scarcity, these desperate deficit units who are already short in options have to bear the cost of lending on top of other business expenses. This exploitative initiative to some extent has reduced efficiency and could diminish the productive factors of the both sides of economic units.¹⁵⁷ The charge of *riba* in credit facilities, it is also believed, has encouraged people to get involve with debt-based economic activities instead of the real economic scheme that build based on trade and equity.

Thirdly, it is argued that *riba* is one of the factors to cause instability of the financial system. Since the conventional financial system is highly entangled with debt-based financing, fluctuations in the interest rate is considerably influential. This debt-based financial system mitigates the risk of using risk transfer mechanisms, which is mostly borne by borrowers, not the risk-sharing mechanism.¹⁵⁸ This financial instability exacerbated under the recessionary economy. This is due to the fact that the *riba*-based system is incapable of allocating the liquidity among

¹⁵³ *ibid*

¹⁵⁴ Masudul Alam Choudhury, 'Principles of Islamic Economics' (1983) 19 (1) Middle Eastern Study 93, 96.

¹⁵⁵ Abdurrahman,, (n 150) 16.

¹⁵⁶ Muhammad Umer Chapra, 'Monetary Management in an Islamic Economy' (1996) 4 (1) Islamic Economic Studies 1, 28.

¹⁵⁷ Muhammad Arif and others, 'Free Riba Economic System' (2012) 2 (6) International Journal of Humanities and Social Science 141, 143.

¹⁵⁸ The Islamic financial system promulgates equity-based financial products under profit loss sharing flagship. However, debt-based financial products are not to be demolished, but merely restructured under different financial instruments to adhere *Shariah* compliance.

the firm and society according to the consideration of efficiency, productivity and growth. It is asserted that public demand for money has proven to be more stable in the absent of interest-based financial systems.¹⁵⁹

Other than that, this instability is also stimulated by the commoditisation of currency. Under *Shariah* perspective, currency is merely a medium of exchange to obtain genuine wealth. It is believed that the risk of speculation inspired by currency trading also could destabilise the floating value of money. By having *riba* as mechanism to value money out of money, the real value of certain currency in the long run is technically diminished.¹⁶⁰ This consequential concept of trading somehow has situated the value of productive output contributed by labour force into an unbalanced circumstance. Through floated currency trading, the economic gap between surplus and deficit economy units has widened. The Asian monetary crisis during the end of 1990s manifested itself as a living proof of this instability. Many developed nations suffered severe economic damage as their wealth drained overnight due to currency depreciation resulting from irresponsible speculation.¹⁶¹

6.3.1.3 Avoiding *Gharar*

6.3.1.3.1 Definition of *Gharar*

Literally, *gharar* means risk, hazard and danger.¹⁶² *Shariah* scholars are in disagreement on the terminological meaning of *gharar*. Jurjani defined *gharar* as something that has an obscure outcome, whether the desired result is possible or not.¹⁶³ Similarly, according to Ramly, *gharar* refers to the possibility of two things occurring where the likelihood is the one you fear happening.¹⁶⁴ Dusuqi viewed *gharar* as the oscillation between two things, one of which is the subject matter.¹⁶⁵ Evolving from this, Sarakhsy mentioned that *gharar* is the result when the consequences of the deal are concealed, or as said by Ibn Taymiyah, it is the unknown consequences.¹⁶⁶ It is to be noted here that the disagreement of the

¹⁵⁹ Habib A Zubeiri, 'Interest Free Banking and Economic Stability' (1992) 31 (4) The Pakistan Development Review 1077, 1085.

¹⁶⁰ Zahrah (n 137) 56.

¹⁶¹ See also Zulkifli Hassan, 'The 1997-98 Financial Crisis in Malaysia: Causes, Response and Results' (2002) 9 (2) Islamic Economic Studies 1.

¹⁶² Wehr (n 18) 782.

¹⁶³ al-Jurjani (n 34) 135.

¹⁶⁴ Ibn Shihab al-Din al-Ramli, *Nihyat al-Muhtaj ila Sharh al-Minhaj* (Dar al-Kotob al-Ilmiyah 2003) vol 3 405.

¹⁶⁵ Dusuqi (n 133) 143.

¹⁶⁶ Al-Sarakhsi, *al-Mabsut* (Dar al-Ma'rifah 1989) vol 12 194.

scholars on the meaning of *gharar* is mostly because it offers a wide range of context and is rather not straightforward.¹⁶⁷

In relation to this, it is argued that *gharar* has a close meaning with other connotations such as *jahalah*, *ghabn* and *tadlis*.¹⁶⁸ Explaining this, Qurafi resolved to differentiate *gharar* and *jahalah*. According to him, *gharar* is an event with obscure outcome whilst *jahalah* is something with definite outcome but the details are in disguised. For instance, future selling of a certain currency if it drops to a certain value is a *gharar* due to the fact that the possibility of such a prize being reached is obscure. Whereas the buying of a customised manufactured product with no exact reference from the manufacturer is a *jahalah* because of the ambiguous details of the product. However, the definition pointed out by Sarakhsy and Ibn Taymiyah asserted that *gharar* includes both, the uncertainty of an event's occurrence and the unknown details of the deals, which is to some extent, fairly in difference as compared to what had offered by Qurafi.¹⁶⁹ This understanding is rather in alignment with this research to explain the nature of *Shariah* governance, which not only addresses the uncertain business events but also the asymmetric information of all business deals entered into by the IFIs.

Speaking of the *Shariah* governance, as currently said, the contemporary economic definition points out *gharar* as asymmetric information.¹⁷⁰ In this sense, *gharar* is considered as exposing oneself to excessive risk and danger in a business transaction as a result of uncertainty about the price, the quality and the quantity of the counter-value, the date of delivery, the ability of either the buyer or the seller to fulfil his commitment, or ambiguity in the terms of the deal; thereby, exposing either of the two parties to unnecessary risks.¹⁷¹ It could be a risk, uncertainty or even anything that could have threaten the business. In this vein, the closest meaning of *gharar* as suggested by Badawi is uncertainty which is rather wider than risk.¹⁷² This is based on the definition offered by Knight.¹⁷³ According to Knight, risk is obtained if the randomness facing an economic agent

¹⁶⁷ Abdul Karim al-Dohni, 'A Quest for a Better Legal and Regulatory Framework for Islamic Banking' (2015) 17 Ecclesiastical Law Journal 15, 20.

¹⁶⁸ *Jahalah* (ignorance) is an action without due efficient knowledge of the details, *ghabn* is short in details and *tadlis* is enshrouding the details, especially the defects of the products.

¹⁶⁹ Siddiq Muhammad al-Dareer, 'Al-Gharar in Contracts and Its Effect on Contemporary Transactions' (Eminent Scholar's Lectures Series no. 16) 10

¹⁷⁰ <<http://iei.kau.edu.sa/Pages-E-JournalCGlossary.aspx>> accessed 8 May 2018.

¹⁷¹ *ibid*

¹⁷² See also Z Badawi, 'The Question of Risk' (1998) 32 Islamic Banker 16.

¹⁷³ There are many other debates regarding risk and uncertainty. See also Abdul Rahim al-Saati, 'The Permissible *Gharar* (risk) in Classical Islamic Jurisprudence' (2003) 16 (2) J.KAU: Islamic Economy 3.

can be expressed using specific probability judgment whilst uncertainty arises when the agent cannot assign real probabilities to the alternative possible occurrences.¹⁷⁴ As a conclusion, the precise meaning of *gharar* depends on the angle of the viewer. If they see it in a broader sense, it offers an indefinite and random possibilities with uncertain results. However, if they narrow down the angle, it could be seen as a measurable risk or a quantifiable uncertainty.

6.3.1.3.2 Proof of *Gharar* Abolition

In terms of its legal status, *gharar* is ostensibly prohibited by *Shariah* law. One of the main proofs of *gharar* prohibition is the following hadith:

*Abu Huraira (Allah be pleased with him) reported that the Messenger of Allah forbade a transaction determined by throwing stones, and the type which involves some uncertainty.*¹⁷⁵

According to the aforementioned text, the word *forbade* (نَهَى) that appears in the hadith is considered as a definitive form of a prohibition to render a definite subject which is also explicitly mentioned by the text.¹⁷⁶ Interestingly, whilst *gharar*, which is inherently unavoidable in business is prohibited, *Shariah* law does not render a full abolition of business deals. Regarding this, it is believed that the financial market is about the right configuration of numerous variables which contribute various possibilities to business to be successful or otherwise. The fact that the understanding of *gharar* is intertwined with business practices has made this subject even more intriguing in terms of its application in the corporate governance. Perhaps the real issue of the utmost relevance here is not the prohibition of *gharar* itself, but rather the comprehensive explication of what *gharar* really is. Thus, according to this, it is not an overstatement to argue that the proof of *gharar* prohibition indicates a strong recommendation from the *Shariah* to avoid *gharar* and if not, minimise it in the business deals. It is also implied the need for a *gharar* determination module through identification, assessment and mitigation.

In this vein, the *Shariah* scholars have rendered minor *gharar* as permissible based on *istihsan* (equity) and *maslahah* (public interest).¹⁷⁷ The basis of this is the reported case that mentioned the Prophet PBUH and his companions when they arrived in Medina. They noticed that one of the business practices of Medina

¹⁷⁴ See also Frank H Knight, *Risk, Uncertainty and Profit* (The Riverside Press Cambridge 1921).

¹⁷⁵ This hadith is narrated by Muslim as reported from Abu Hurairah; Muslim, *Sahih Muslim* (Dar al-Fikr 2003) no 3699 736.

¹⁷⁶ Al-Zuhayli, *al-Wajiz fi Usul al-Fiqh al-Islami* (n 111) vol 1 352.

¹⁷⁷ Al-Saati (n 137) 15.

people was the Salam contract.¹⁷⁸ The problem with the later practice of Salam was the ambiguity in the terms of the deal, especially the date of delivery and the weight of the item purchased. Therefore, at the first glance, this type of business arrangement was non-permissible by the *Shariah* law. However, considering the *maslahah* of the people, and by applying *istihsan*, the Prophet PBUH was reported to say, 'those who pay in advance for anything must do so for a specified weight and for a definite time'.¹⁷⁹ Apart from that, it is also reported that Ibn Abbas, when he joined a *mudarabah* business venture, he stipulated that the merchant must not travel with the merchandise across the sea without decent vessel, pass through the desert without a proper camel and climb to the mountainous ridge without well-prepared means.¹⁸⁰ Based on the aforementioned texts, it is clearly stated that the original standard of *gharar* is non-permissible. However, it is rendered by *Shariah* scholars to permissibility when the unavoidable *gharar* is a necessity and it is mitigatable.

6.3.1.3.3 Effective *Gharar*

To understand how *gharar* could bring about effectual implication to the deals, it is important to note the types of *gharar*. *Gharar* is distinguished by the *Shariah* scholars into major (*fahish*) and minor (*yasir*).¹⁸¹ Both types render the legal aspect of the deal in a different manner.

For a *gharar* to be considered as effective to render a deal as null and void, it must be a substantive *gharar*. *Shariah* scholars enlisted the conditions to quantify a substantive *gharar*. A *gharar* ought to be major and extensive, auxiliary to the contract, respectively, occurring in a contract with no definite need and the deal must be transactional.¹⁸² A major *gharar* is prohibited and must be avoided. It is a type of *gharar* that has a decisive effect on influencing the outcome of the deal. On the other hand, if it is a minor *gharar* with an indecisive power to dictate the upcoming result, it is permissible. The consideration is also given if the *gharar* and the respective contract are auxiliary to each other and could affect the principal elements of the deals. Meanwhile, an external *gharar* is regarded as acceptable if it is not substantive. Other than that, if the contract is important to meet the economic needs of the people, and the occurred *gharar* is minor and

¹⁷⁸ *Bay' al-salam*, which refers to a sale contract in which payment is made in advance by the buyer and the delivery of the goods is deferred by the seller. The date of delivery and accurate description of goods must be given in the contract.

¹⁷⁹ This hadith is narrated by Muslim as reported from Ibn Abbas; Muslim, *Sahih Muslim* (Dar al-Fikr 2003) no 4010 789.

¹⁸⁰ This hadith is narrated by Al-Baihaqi as reported from Ibn Abbas; A Al-Baihaqi, *al-Sunan al-Baihaqi* (Dar al-Kutub al-Ilmiyyah 2003) vol 6 no 11611 184.

¹⁸¹ Ibn Taymiyah, *Majmu al-Fatawa* (3rd edn, Dar al-Wafa' 2005) vol 29 18.

¹⁸² *Al-Mawsuah al-Fiqhiyyah al-Kuwaitiyyah* (1st eds Dar al-Safwa 1994) vol 31 150-154.

manageable, the *Shariah* status of such an existing *gharar* is also considerably tolerable since necessity begets facility (*al-darurat tubihu al-mahzurat*).¹⁸³ Finally, the *gharar* is only effective if it occurs in transactional and commutative deals as asserted by the Maliki school. However, this opinion is in a minority as opposed to the unanimous opinion of the *Shariah* scholars from other legal schools, who see *gharar* to be potentially existed not only in transactional deals, but also in other types of deals.¹⁸⁴

It is observed that the discussion on *gharar* indicates that despite the prohibition of *gharar*, *Shariah* provides flexibilities for this peculiar feature of business. It is argued that trading in *gharar* is not a definite prohibition since business deals are inherently full of uncertainties. This is due to the fact the available evidence in relation to *gharar* suggests that the uncertainty is only prohibited if extensive.¹⁸⁵ In this sense, the questions under discussion are how to assess the degree of *gharar* permissibility and how to manage these uncertainties. These questions are also correlated with the *gharar* determination module, as addressed before. In this vein, it is imperative to note that, one of the main tasks of *Shariah* governance constituents on this respective topic in fact is on the quantification of *gharar fahish* (major) and *gharar yasir* (minor).¹⁸⁶ The IFIs, as financial entities, could not afford the occurrence of *gharar fahish* out of poor anticipation of potential losses and disputes.¹⁸⁷

6.3.1.4 Abolition of Non-Permissible Activities

Broadly speaking, transactions of legal title are permissible by *Shariah* law. This permissibility is mentioned by definite proofs with a definite meaning from the Quran. For instance, God says, 'God has permitted sale and forbidden *riba*' using word sale (البيع) in a singular form of noun, preceded by the definite article of 'al', as an indication of generalisation ('*amm*'). This form indicates that all kind of sales are permissible in under *Shariah* law. However, there are other evidences with indications forbidding the sale with certain conditions such as in the case of sale with uncertainty (*gharar*) or the sale that involves an interest charge. In these cases, the later proofs come as the specification (*takhsis*) for the general permissible act.¹⁸⁸ This part will manifest examples in the non-permissible sale

¹⁸³ Muhammad al-Zarqa, *Sharh al-Qawaid al-Fiqhiyyah* (2nd edn Dar al-Qalam 1989) 185.

¹⁸⁴ *Al-Mawsuah al-Fiqhiyyah al-Kuwaitiyyah* (n 182) vol 31 150-154.

¹⁸⁵ This is due to the fact that *gharar* is only prohibited if it is *fahish*, or extensive.

¹⁸⁶ See also Sami al-Suwailem, 'Towards an Objective Measure of *Gharar* in Exchange' (2000) 7 (1-2) *Islamic Economic Studies* 61.

¹⁸⁷ Mahmoud A Elgamal, 'An Economic Explication of the Prohibition of *Gharar* in Classical Islamic Jurisprudence' (2001) 8 (2) *Islamic Economic Studies* 29, 30.

¹⁸⁸ See also AA al-Ba'ly, *al-Qawaid wa al-Fawaid al-Usuliyyah* (Sunnah Muhammadiyyah Publication 1956) 194.

activities apart from the case of *riba* and *gharar*, specified by the *Shariah* law, after rendering the general permissibility of sale.

The non-permissible activities include financial and non-financial as prohibited by *Shariah* law. The prohibited financial activities such as payment and taking of *riba* and involvement with *gharar* are the essence of the *Shariah* compliance notion. Other than that, practices such as gambling, cheating and bribery are also regarded as significant, and have the potential to render the contracts entered by the IFIs as unlawful. According to this concept, anything that is prohibited for a Muslim to consume is not permitted to be traded. Therefore, there are forbidden commodities to be taken into account, such as liquor or alcoholic drink, pork and dead meat or that are not managed in the way deemed permissible under *Shariah* law.

In this vein, the primary focus of the *Shariah* governance constituents of the IFIs is to ensure that they are not getting involved with this particular substance. Since the IFIs are financial institutions, their involvement might not be in the form of offering products with such a substance as an ingredient. The real trick is whether the customers who seek financial instruments are involved or not with what are prohibited. The task of primary concern of the *Shariah* committee would be the invocation of *ijtihad* on the case basis to come up with the best solution, for the best sake of the stakeholders.

6.3.1.4.1 Prohibited Activities

a. Gambling

Gambling is the action of taking risk in the hope of a desired result.¹⁸⁹ It engages with wild financial speculation, for the sake of possible financial advantage.¹⁹⁰ Gambling is about risking something of value on an uncertain event in hopes of winning something of greater value. Therefore, commonly, it will involve a wager. Using the wager, the players will put their bet on the outcome of the game. In this sense, gambling is reckoned as the action to bet with conditions stipulated that all contestants are to put an amount of money, and the stake yielded would be the prize for the winner.¹⁹¹ Jurjani defined betting as a game that required the players to risk the wager as the prize to be owned by the winner.¹⁹² The winner determined by who has come up with the right prediction and collect the bet whilst

¹⁸⁹ Oxford Dictionary of English (2nd edn OUP 2003) 710.

¹⁹⁰ The Chambers Dictionary (11th edn Chambers Harrap Publisher 2008) 624.

¹⁹¹ *Al-Mawsuah al-Fiqhiyyah al-Kuwaitiyyah* (n 68) vol 39 407.

¹⁹² al-Jurjani (n 34) 150.

the losers lose the bet. Depends on the type of the game, there could be more than one winner.

The proof of this prohibition is the Quranic text, as mentioned below:

O you who have believed, indeed, intoxicants, gambling, stone alters, and divining arrow are but defilement from the work of Satan, so avoid it that you may be successful. ¹⁹³

Based on the Ibn Umar, the word *maysir* is the Arabic word of gambling.¹⁹⁴ Gambling used to be famed among Arabs during the time of *jahiliyah*. It came in many forms. One known version was *azlam* (divining arrow) which was used as a lottery for decision-making.¹⁹⁵ Other than that, it was also called *qimar*, which is to some extent similar to betting.¹⁹⁶

As asserted by Ibn Taymiyah, *Shariah* law prohibits gambling as it is related to the possession of what belonged to others without admissible transaction and getting involved with nonsense activities.¹⁹⁷ From the Islamic standpoint, gambling is neither an investment nor a substantive speculation. It is rather an assumption with hopes of gaining something without concrete evidence of probability. It plays with luck and fortune without due consideration. In many cases, gambling resolved the relating parties with loss.

It is worth mentioning that the crux of the prohibition is the use of a wager as the winning prize.¹⁹⁸ The *Shariah* law does not ban fair competition. It is rather encouraged by Islam, especially if it is beneficial for physical health. The technicality of the competition, however, must be free from gambling nature. No betting allowed. Furthermore, the financial sources of the prize for the winner must come from a third party who has no direct financial relation to the participants or one of the participating parties without additional financial gain if he/she wins.¹⁹⁹

¹⁹³ Quran (5: 90)

¹⁹⁴ al-Qurtubi (n103) vol 3 623.

¹⁹⁵ Ibn Kathir, *Tafsir Ibn Kathir* (trs al-Mubarakpuri Darussalam 2000) vol 3 255.

¹⁹⁶ See also the translation in *Oxford Arabic Dictionary* (OUP 2014) 1262.

¹⁹⁷ Ibn Taymiyah (n 181) 15.

¹⁹⁸ *Al-Mawsuah al-Fiqhiyyah al-Kuwaitiyyah* (1st eds Dar al-Safwa 1990) vol 24128.

¹⁹⁹ *ibid*

b. Monopoly

In *Shariah* law, monopoly is known as *ihtikar* (الاحتكار). It is an action to restrain the goods to control the price.²⁰⁰ *Shariah* scholars defined monopoly as purchasing and restraining the sustenance goods such as food in order to gain the benefit from a price increment.²⁰¹ In this vein, business entities use their privilege on the access to collect and store goods to manipulate price. This business practice in a way is a strategy to boost the profitable revenue, but at the same time, would jeopardise customers' right on having access to certain goods, especially that of life sustenance. Pertaining this, Hanafi, Shafie and Hanbali schools mentioned that the restrained goods must be the sustenance foods whilst Maliki schools opined that the prohibition applied to all sort of goods that could bring about hardship to the community.²⁰²

Other than goods monopolisation, Ibn Qayyim mentioned about joint monopoly and brand monopoly. Joint monopoly is an action to control the price of goods or the payment of service by a group of business entities with similar business natures. Meanwhile, brand monopoly refers to a situation where a single brand controls the whole market. These two types of monopolistic practices are also by definition, as asserted by Ibn Qayyim rendered under the same regulation.²⁰³ To some extent, the abolition of monopoly practices in Islam is not as different as described by anti-trust law, competition law or anti-monopoly law which is to promote fair competition. The basis of the law might well be originated from difference sources, the objective however is in resemblance in many respects. Regarding this, the primary objective of this *Shariah* anti-monopoly law is to avoid hardship from the people because of the limited access of the goods due to higher offered prices.²⁰⁴ For the customers, it is the right of every soul to gain access to necessities in the market with an appropriate price. As for business entities, it is their right to have a fair ground of business competition.

6.3.1.4.2 Prohibited Commodities

Literally, anything that is created by God and suitable for human consumption is permissible. This is based on the Quranic text that mentions '*Eat from the good things with which We have provided you*'.²⁰⁵ The word 'eating' here refers to the general reason for food possession. The alluded meaning of the text is literally generalised to all sort of activities benefited from the possession, including

²⁰⁰ al-Jurjani (n 34) 13.

²⁰¹ Khin and others (n 144) 42.

²⁰² al-Jazairi (n94) 225.

²⁰³ *Al-Mawsuah al-Fiqhiyyah al-Kuwaitiyyah* (2nd eds Dar al-Safwa 1983) vol 2 94.

²⁰⁴ *ibid* 91.

²⁰⁵ Quran (2: 172)

trading.²⁰⁶ Based on the harmonious meaning (*mafhum muwafaqat*) of the text, everything that is consumable is also permissible for transaction. However, there are some sustenance, such as dead animal, flesh of swine and intoxicating drink are prohibited for humans' consumption. The Quranic texts also emphasise that any permitted substance is not to be prohibited unless it is done by referring to the texts as well. In this regard, the texts also come up with a specification on a certain group of food for that reason.

The *ratio* of the prohibition of these commodities is due to the fact that they are considered by *Shariah* law as 'dirt' and 'non-beneficial' items.²⁰⁷ The rulings on such matters are contradictory in most cases, on the ground that the prohibited commodities with definite proofs are rather small in number. Other than intoxicating substances, pork or porcine by-products and dead meat, which were explicitly mentioned by definite proofs, most of the commodities under the same regulation are affected by spatial and temporal factors. Regarding this, it is the task of the local and contemporary *Shariah* scholars to do *ijtihad* and adopt the alluded meaning of the texts and come up with the rulings based on the cases. Notably, the *illah* of the cases is the existence of the meaning of 'dirt' or 'non-beneficial' in the referred cases.

a. Intoxicating Substance (*khamr*)

The prohibition of intoxicating substance is based on the prohibition of *khamr* (الخمير). It is a type of wine, made of grape through brewing process. The reason of the name is speculated on the fact that such a drink could cause mental impairment to humans, as mentioned by another hadith.²⁰⁸ Since, the preservation of mental health is one of the primary objectives of *Shariah* law, it is intolerant with such a substance.²⁰⁹

In the Quranic text, God says;

*O you who have believed, indeed, intoxicants, gambling, [sacrificing on] stone alters [to other than Allah], and divining arrows are but defilement from the work of Satan, so avoid it that you may be successful.*²¹⁰

²⁰⁶ Al-Zuhayli, *Al-Tafsir al-Munir* (n 109) vol 1 444.

²⁰⁷ Rusyd (n 127) 652.

²⁰⁸ This hadith is narrated by Ibn Majah as reported from Ibn Umar: I Majah, *Sunan Ibn Majah*, (Al-Ma'arif Publication) no. 3390, 569.

²⁰⁹ Further discussion is in Chapter 2 on *Maqasid Shariah*.

²¹⁰ Quran (5: 90)

The command to 'avoid' is perceived as a definite indicator on the ruling of the mentioned actions and substances. Accordingly, al-Qurtubi concluded that this Quranic text is the specification proof towards the general meaning of permissible substance in another texts.²¹¹ One of the Quranic texts mentions that '*Eat from the good things with which We have provided you*'.²¹² This text renders that, generally speaking, any creation that is suitable for humans' consumption is permissible. However, there are some sustenance, such as dead animal, flesh of swine and intoxicating drink which are prohibited for humans' consumption.

As far as Muslims are concerned, the issue of intoxicating drink is rather imperative because there is a definite proof from the text of hadith mentioned about the curse upon ten groups of people in relation to *khamr*. It is reported that the Prophet PBUH said:

*Wine is cursed from ten angles: The wine itself, the one who squeezes (the grapes etc), the one for whom it is squeezed, the one who sells it, the one who buys it, the one who carries it, the one to whom it is carried, the one who consumes its price, the one who drinks it and the one who pours it.*²¹³

b. Pork and Porcine By-products

Pork refers to the meat or flesh of pig or swine. Literally, *Shariah* law prohibits Muslims from consuming such a dietary substance. Apart from that, the porcine by-products or products manufactured from swine, also fall under the same regulation.²¹⁴ This prohibition is based on the Quranic text as below;

*He has only forbidden to you dead animals, blood, the flesh of swine, and that which has been dedicated to other than Allah.*²¹⁵

Since, there is no clear evidence from the texts, stating the *ratio decidendi* of the prohibition, other than as 'dirt and non-beneficial', many Muslim scholars have come up with the speculative rationales to justify this prohibition from medical

²¹¹ Al-Qurtubi (n 103) vol 3 22.

²¹² Quran (2: 172)

²¹³ This hadith is narrated by Ibn Majah as reported from Ibn Umar: I Majah, *Sunan Ibn Majah*, (Al-Ma'arif Publication) no. 3380 568.

²¹⁴ Under Shafie and Hanbali legal schools, the transformation of porcine into a completely different by-product falls under the same regulation as if it is in the original form. However, the Hanafi and Maliki legal schools opined that, porcine by-product that has gone through a complete transformation from its original form is admissible. On the account of this, it is the duty of the *Shariah* committee to deploy *ijtihad* based on the cases, to endorse the opinion, prevailed by the institution.

²¹⁵ Quran (2: 173): the similar text appears in another chapter with the same expression; see also Quran (16: 115)

perspective. In terms of its legal aspect, the unanimous *Shariah* scholars deployed *qiyas khafi* (hidden analogy) on the text, concluding that, the swine is completely prohibited.²¹⁶ The mentioning of 'flesh' is due to the fact of the main part of its body that provides the most benefit is the flesh itself.²¹⁷ It does not mean that, it is the only reason of selling or purchasing. One of the benefit of flesh is for consumption. However, that is not the only benefit possible.

c. Dead Meat

In Islam, warm-blooded land animals that are permissible for consumption should be slaughtered beforehand. This is what is known as Halal Meat in today's market trend. The slaughtering process must also comply with the requirements, such as, the slaughterer must be a Muslim, or the people of the book (*ahl kitab*).²¹⁸ During the process, there must be a clean slaughtering, which ends up with a clean cut of the prescribed veins and arteries, and not by strangling or knocking-out. Otherwise, the dead animal will be considered as dead meat or carcass (*mayyit*) and non-halal for consumption. This prohibition is based on the Quranic text below:

*He has only forbidden to you dead animals, blood, the flesh of swine, and that which has been dedicated to other than Allah.*²¹⁹

Such a prerequisite in meat management is due to the fact that Islam has a high demand for the human diet to be hygienic. However, it is worth mentioning here that the exemption of a number of 'dead meats', which include sea creatures and the grasshopper, is mentioned in another authentic hadith.²²⁰

6.4 *Akhlaqic* Ethical Codes

The discussion of the principles of *Shariah* governance is now expanding to include the third part of the whole concept. This part is another essential element that makes the comprehension of these principles a holistic set of ideas which only work if collectively deployed; it is about the ethical principles of *Shariah* governance. This ethical aspect is what is commonly perceived as the religiosity

²¹⁶ The Zahiri school, an extinct school of *fiqh*, suggested that the prohibited part of the swine is the flesh, not others. Therefore, any swine by-products, produced from a certain process is not to be rendered under the same ruling.

²¹⁷ Al-Zuhayli, *Al-Tafsir al-Munir* (n 109) vol 3 426.

²¹⁸ Al-Zuhayli, *Al-Fiqh al-Islami wa Adillatuhu* (n 57) vol 4 2758.

²¹⁹ Quran (2: 173): the similar text appears in another chapter with the same expression; see also Quran (16: 115)

²²⁰ This hadith is narrated by Ibn Majah as reported from Ibn Umar; See also Ibn Majah, *Sunan Ibn Majah*, (Al-Ma'arif Publication) no.3218 544.

of a religion in general, and Islam in particular. However, if we look deeper, the Islamic ethic has more significance than that.

6.4.1 Concept of *Akhlaq* (Islamic Ethics)

Akhlaq is Islamic term for morality and ethics.²²¹ It is the plural form of the word *khulq*.²²² As literally defined, it means good manners, ethics and morality.²²³ Many discussions on *akhlaq* refers to the values of human behaviour, whether it is good or bad, and right or wrong.²²⁴ The determination of right and wrong is in regard to the revelations of the Quran and the Hadith. In terminological terms, *akhlaq* is an internal personal quality that naturally emanates physical actions without consideration or deliberation. If the emanated actions are acceptable, the person is considered as a person of good behaviour (*husn al-khuluq*), and if it is otherwise, they are known as a person of bad behaviour (*suk al-khuluq*).²²⁵ In this sense, *akhlaq* is considered as the Islamic model for determining ethical codes and morality, a collection of ideas of right and wrong in the eyes of Islam.

In behavioural studies, morality refers to the rules of conduct that are associated with certain distinctive psychological and social attributes.²²⁶ Humans in their best state have the capability to determine the concepts of right and wrong. They somehow come to an understanding on the general concept of morality. In this sense, it might be the product that comes about in part through a complex process of socialisation, learning and inculcation.²²⁷ At its initial stage, morality could be propelled by a descriptive comprehension of the respective values, which are then incorporated as normative rules of morality, after being collectively accepted. The later stage is the stage where what was embodied as the nature of good or bad, turned into a concrete legalised rule, providing praise to those who obey and sanction to those who choose otherwise. No matter what the discourse is of the confluence between morality and law, one cannot defy the historical facts of the link between both, at the early stage of the modern legal form.²²⁸

²²¹ There is no clear consensus amongst scholars on what distinguishes ethics and morality. Most philosophers, such as Kant, describe the words as similar in meaning. For the purposes of this research, the words ethics and morality are going to be used interchangeably.

²²² Wehr (n 18) 299.

²²³ R Baalbaki, *Al-Mawrid* (Dar el-Ilmi Lilmalayin 17th eds 2003) 776.

²²⁴ SA Azim, *Khuluq al-Muslim* (Dar al-Qimah 2004) 6.

²²⁵ al-Jurjani (n 34) 89.

²²⁶ Steven Shavel, 'Law versus Morality as Regulators of Conduct' 2002 (4) 2 American Law and Economics Review 227, 230.

²²⁷ *ibid*, 231.

²²⁸ Robert A Hinde, 'Law and the Source of Morality' (2004) 359 Phil. Trans. R. Soc. Lond., 1685,1693.

To possess the best of character in oneself is one of the main concerns of a Muslim.²²⁹ Having a good *akhlaq* is not only about the feeling of virtue, or guilt if it is otherwise, but it is considered as the good deeds of the Muslims for God. *Akhlaq* in Islam is not only about the decency that beautifies the person who expresses it, but also a commitment to fulfil the obligations of one's life. To some degree, it is about the educational objectives of obediences and the commitment to be decent in daily life that could make one's life stand in kindness and goodness.²³⁰ Those commitments will be quantified by ethical manners that could be seen by the naked eyes of others.

Good *akhlaq* in oneself is essentially human nature and Islam propagate such an innate quality. As far as Muslims are concerned, one of the reasons for the sending of the Prophet PBUH to humans is to uphold the best of characters.²³¹ For Muslims, the best characteristics are the characteristics exhibited by the Prophet PBUH. His characters, as described by the Quran, is one of glorified and exalted characteristics (*khuluq azim*).²³² Aisyah R.A, the wife of the Prophet PBUH, also described His characters as the characteristics of the Quran,²³³ which is perceived as meaning fully following the teaching of the Quran.

6.4.2 Ethics and Law in Islam

Ethics and law in Islam are intertwined and intersecting domains.²³⁴ In fact, ethics or morality, is the essence, propagated by *Shariah* law. The conception of right and wrong in moral domains are invariably in line with Islamic legal domains.²³⁵ As far as Muslims are concerned, upholding moral values is the highest regard of life in all aspects, including the legal aspect. In terms of dominion, the morality domain might be broader and more diversified as opposed to the legal domain; something that is morally wrong might not be against the law, but anything that is unlawful is surely morally impaired.²³⁶ This is due to the fact *Shariah* law functions as a controlling device of the moral domain that is impactful to Muslims, personally as well as collectively.

²²⁹ Sulayman Asyqar, *Khasais al-Syari'ah al-Islamiyyah* (Maktabah al-Falah 1982) 94.

²³⁰ Manna' Kattan, *al-Tashri' wa al-Fiqh al-Islam* (Wahbah Publisher 2001) 21.

²³¹ The Prophet PBUH said: 'I am sent by God to perfect the best of characters'

²³² Ibn Kathir (n 15) vol 10 103.

²³³ This hadith is narrated by as reported from Qatadah; Muslim, *Sahih Muslim* (Dar al-Fikr 2003) no 1623, 341.

²³⁴ Andrew Crane and Dirk Matten, *Business Ethics* (3rd OUP 2010) 5-6.

²³⁵ The mufti or mujtahid who perform as central function were private legal specialists who were lagally and morally responsible to the society: See also Wael Hallaq, *An Introduction to Islamic Law* (CUP 2009) 9.

²³⁶ Asyqar (n 229)94.

Morality and law in Islam is also about the configuration of what is and what ought to be since neither are static.²³⁷ Both are the regulatory preference for Muslims but come with different sanction magnitude. Morality provides the values of what a person should and should not do. Meanwhile, *Shariah* law is mostly focussed on what a person ought not to do, as listed in *hudud* and *qisas* laws in *Shariah* criminal law, and as in the prohibition of *riba* and extensive uncertainty in *Shariah* financial law. The main differences between the two might be at the level of the cost of the sanctions provided. Morality involves virtuous feeling and praise if the act is approved or good, and guilt and disapprobation if the wrong acts are involved. To some degree, the sanctions of moral approval or disapproval are not tangible, rather it is resolved in terms of internal appreciation or devaluation. *Shariah* law, on the other hand, provides a more tangible sanction mechanism, such as monetary, custodial and death penalties.

In a common Muslim community, morality remains the optimal domain if it has the capability to control the conduct of the population, and legal enforcement is absent. In the case of the 'what should be done', if the good and praised moralities are present and detectable in the public, legal enforcement is unnecessary.²³⁸ Likewise, in the case of what should not be done, if there are immoral actions done by a certain group of members of the public, that is not contagious and still under the control of the majority, enforcement of the law might not be required. However, if the praiseworthy actions are undetected and immoral actions are dominant and effecting to the population, legal enforcement from the authorities is crucial to bring back the good conducts. It is worth mentioning that in the situations ,involving actions that breach the personal rights of the members of the public, legal enforcement must be the prevalent remedy, regardless.

Muslims believed that they are answerable to any actions they take in life. Answerable means those actions are the subject of judgement by God on the day of Judgement as to whether they were good or bad deeds. It is also means that there are certain actions answerable to humans' authority, especially if the actions give rise to negative impacts or breach the right of others, as recognised by *Shariah* law. Regarding this, *akhlaq* does not see the consequences of the actions as the factor that determines whether it is right or wrong, as the consequence theorist may think.²³⁹ The preposition of right or wrong is the

²³⁷ Hinde (n 228) 1692

²³⁸ Abu al-Hassan Ali bin Muhammad bin Habib Al-Mawardi, *Al-Ahkam al-Sultaniyyah* (Dar al-Hadith 2006) 270.

²³⁹ The consequence theory says that the determination of whether actions are right or wrong is due to the consequences brought about by those actions.

subject before any sort of action is taken by Muslims. It might not involve the human authorities at the time, but it is surely under the divine surveillance.

To exemplify this, we examine the case of one person fulfilling a promise (*wa'ad*) to another. It is morally Islamic but not necessarily a subject for *Shariah* legal concern. However, when the promise is made based on mutual agreements with impactful negative causes to the relevant parties if it is not executed, the *Shariah* sees it as morally and legally incumbent. In the context of the relationship between directors and shareholders, the pertinent moral judgement is that directors must be judged as trustworthy by the shareholders. They ought to exercise their duty with care and loyalty. However, this moral basis for judgement does not mean that the both parties cannot put forward a contractual relationship to ensure the said duties from the trustees are performed. This is because, the shareholders face the risk of loss without tangible rights, especially following due process, if the relationship is only the incumbent on a moral basis. The contractual terms stipulated by the relevant parties can also clarify the boundaries of the trust to help the dictation of sanctions in the case of that trust being breach.

Other than that, the prohibition of *riba* is another clear example to elucidate how morality and law are the intertwining factors of consideration in *Shariah* law. One of the moral reasons for the prohibition is, the interest charged on the loan given is regarded as the exploitation of the labour force.²⁴⁰ Those with a deficit economic status are vulnerable and at risk of manipulation by those with a surplus. By exploiting this vulnerability, a person is beyond the bounds of courtesy and kindness.²⁴¹ Furthermore, charging of interest taking is also downgrades the value of labour. How those expended endeavours end up with minimum monetary freedom as a result of the additional cost over the principal, without fair risk-sharing mechanisms from the debtors, is blatant evidence of this immoral, manipulative scheme.²⁴² The rights of the debtors as the owners of the principals who lost the right of use of the money as claimed by the capitalists is a failure of labour allocation. This is due to the *Shariah* legal maxims that state liability accompanies gain (*al-ghunmu bi al-ghurmi*) and benefit goes with liabilities (*al-kharaj bi al-daman*),²⁴³ where the one who expects profit must accept responsibility in the case of loss.²⁴⁴ On top of the alluded meanings, as deduced from the texts of the Quran and the Hadith, the said moral considerations are also reckoned as the supportive rationales for the prohibition of *riba*. These elementary prepositions are even more easily understood by the members of the

²⁴⁰ Choudhury (n 154) 96.

²⁴¹ Abdurrahman (n 150) 16.

²⁴² Chapra (n 156).

²⁴³ al-Zarqa (n 183) 429-439.

²⁴⁴ Laldin and others (n 59) 161.

public than the legal statements of the prohibition itself. This is due to how it could inflict the people at their interpersonal level as moral-based organisms.

6.4.3 Functions of *Akhlaq*

There are, amongst others, three main roles of the *akhlaqic* ethical codes that are relevant to our discussion on the *Shariah* governance. Firstly, *akhlaq*-based ethics provides a universal acceptable conceptualisation of morality. Secondly, it functions as the propeller of the actions of the IFIs' governance constituents, towards the goal of achieving *Shariah* compliance. Last, but not the least, it stands as the reference for the business ethics of the IFIs.

6.4.3.1 Unify code of best conduct

As stated in the relativism theory, ethics and morality are rather diversified and flexible; they will change due to time and space.²⁴⁵ What is ethical today in a certain location is not necessarily the same in the past or in the future, or even at the same time in other localities. Therefore, the need for an anchor that could pacify such changeability is of prominent importance. This sensible controlling mechanism is rather indicative to the IFIs, as something despised as immoral in the past somehow gaining the merit of morality and appreciation by some in the present. For instance, greedy, a concept somehow associated with bad affliction, to some degree is today an acceptable justification for business judgement under the flagship of the maximisation of the capital value.²⁴⁶ A similar change has happened to the prostitution. This disgraceful action has somehow shifted into becoming a woman's right, or even economically moralised, due to the changes in time and circumstances. The question is, up to what point do we want to let this continue before all of what makes us different with our primate cousins is totally diminished?

Since the determination of morality is rather flexible as compared to what is right or wrong under the law, *Shariah* furnishes universality in order to understand what the best of conduct is, so humans do not end up debating the establishment of right and wrong, such as honesty and justice, as well as deceit and injustice. This uniformity will also gives conformity to reconcile the debates of the morality-based business judgements of the stakeholder theory.²⁴⁷ In this sense, the *akhlaq* morality model standardises a morality that is referable globally.

²⁴⁵ Richard T. de George, 'Business Ethics' (1986) 5 (6) *Journal of Business Ethics* 421.

²⁴⁶ Morris B Holbrook, 'The Greedy Bastard's Guide to Business' (2013) 33 (4) *Journal of Macromarketing* 369.

²⁴⁷ Darryl Reed, 'Employing Normative Stakeholder Theory in Developing Countries: A Critical Theory Perspective' (2002) 41 (2) *Business and Society* 166.

As a preference, *akhlaq* provides universality by referring to the sources of Islam, thereby standing as a normative model of morality. The overriding values exist due to cultural backgrounds being remedied by the acceptance of the Islamic sources as the final preference. This process reduces the number of unacceptable and confusing descriptive moralities, thereby minimising the potential for moral-juggling decisions by the directors.²⁴⁸ Anything that does not contravene the concept of good character (*husn khuluq*) will remain part of good *akhlaq*. By that, the intersocietal contradictions of morality no longer circumvent the process of getting free from unacceptable moralities but rather help us learn the moralities of other societies, since they are already something in compliance with the concept of *akhlaq*. It is to be perceived that *akhlaq* only unifies the standards, but it is not the way to achieve it, which may vary depending on how the society puts it forward.

The abovementioned is based on the understanding that morality is established through a long process of civilisation. The well-established moralities are somehow learnable as well as transferable where the esteem of certain morality values are heightened in the process, as a result of a wider and cross-societal acceptability. The understanding of this notion is exemplified by the globalisation of certain moralities in our modern world. From the formation of trending food to market direction, global morality values are fashioned somewhat towards value unification, through a learning process caused by the borderless world. Out of propensity, people revalue local values, so they could become in line with the values of the people on the other side of the world.

6.4.3.2 Propellant of *Shariah* Compliance

Akhlaq functions as the first propellant channelling behaviour towards *Shariah* compliance. The conformity of *Shariah* compliance might need the informational input, as the evidence to determine whether it has been achieved or not by the relevant governance constituents. The process ending in endorsement for sanction or gratitude is rather a thorough procedure. To ensure the said notion is going to be strived, even before the exhaustive process is required, an internal self-mechanism is of vital importance. The governance constituents that hold the internal sanction or gratitude in advocating *Shariah* compliance could be the most consequential element in its legal achievement. Put differently, the imposition of *akhlaq* would not only bring about people complying with *Shariah* law out of legal requirement, but also because they do believe so. By saying that, the endeavour strived by the IFIs to comply with *Shariah* law should already fulfilling all moral judgements where any *Shariah* compliant products and services are morally approved.

²⁴⁸ Anand K Sundaram and Andrew C Inkpen, 'The Corporate Objective Revisited' (2004) 15 (3) Organization Sciences 350, 354.

As far as Muslims are concerned, compliance with *Shariah* law is a direct result of piety. Piety is about practicing what is ordered by God, and avoiding what is forbidden, either secretly or publicly.²⁴⁹ To reach that state, a Muslim must abide by the moral and legal aspects of *Shariah*. Since *akhlaqic* morality and *Shariah* law are deduced from the similar sources, for many reasons, each is in alignment with the other. As a result, in deducing the process of the law, *Shariah* scholars have the tendency to enclose the moral basis or the virtue of the law. However, not all Islamic moral values are legalised as law to give sanction or gratitude to the doer. In most cases, individual rights are under the subject of morality, whilst most of the legalised law is in relation to injurious actions.

Apart from piety, Muslims are taught to develop the virtue of *ihsan* as their self-esteem. As mentioned by the Prophet PBUH, *ihsan* is submitting to God as if He is seen in front of you and if not, as if He sees you. It is the feeling of being accountable to God in everything.²⁵⁰ This self-accountability is what beautifies ones' actions, which makes the people adhere to the law, not out of legal requirement, but rather because they believe so.

6.4.3.3 Akhlaq as Source of Business Ethics

As mentioned above, *akhlaq* is the reference to decipher the code of best of conduct. This code also could be utilised as the source of the ethical attitude of the IFIs as business entities. It is also the answer for the discussion of the ethical preference in business as opposed to the separation theory, which sees business ethics as an oxymoron.²⁵¹ On many occasions, *akhlaq* and ethics are interchangeably defined. However, the meaning of *akhlaq* is wider and tends to evaluate ethical values in a broader sense. Considering this, the concept of ethics is perceived as being sheltered by *akhlaq* in its narrower sense.

In this case, *akhlaq* stands as the umbrella of ethics determination, accepted by the IFIs. The deployment of *akhlaq* as the preference to perceive the acceptable business ethics is the IFI's eccentricity. This is the fundamental distinction between the IFIs and their conventional counterparts. Most importantly, it clarifies why certain business operations are denounce by the IFIs, despite their legality under the conventional law. It also reveals the partial and temporal elements of ethics: that something that is believed as ethical by certain groups of people, might not be similarly acceptable to others.

²⁴⁹ Al-Zuhayli, *Al-Tafsir al-Munir* (n 109) vol 3 558.

²⁵⁰ This hadith is narrated by Bukhari as reported from Abu Hurairah; M Bukhari, *Sahih al-Bukhari* (5th edn, Dar Ibn Kathir 1993) vol 1 no 50, 27.

²⁵¹ John W Collin, 'Is Business Ethics an Oxymoron?' (1994) *Business Horizon* September-October 1-8; J Sanberg, 'Understanding the Separation Thesis' (2008) 18 (2) *Business Ethics Quarterly* 213.

As the source of business ethics, *akhlaq* functions as a universal Islamic comprehension of good characters. It is then narrowed down into several specific codes that will describe the meaning of *akhlaq* in a practical manner on the account of respective aspects subsequently. For instance, a person with good character must be somebody that is trustworthy (*amanah*), honest (*sidq*), just (*adl*) and decent (*layyin*). These values are then quantified by code of conduct into the actions that are in line with the respective notions: for instance, being transparent and accountable when reporting. These codes of good conduct are the business ethics of the directors towards the stakeholders that is subsequently supporting the notion of *amanah*. Upholding the *amanah* as ethics also demands that directors to execute their duties with care and loyalty.

6.5 Conclusion

This chapter is a principle-based explicator of the practice of, as well as what should be practised by the IFIs. The comprehension of these principles works as the main reference to envisage the duty held by *Shariah* governance constituents. It provides the epistemological fundamentals that could introduce a new model of thinking to the governance system: namely, catering to the IFIs' characteristics. The worldview of *Shariah* governance that based on *tawhid*, is believed to be capable of enabling the IFIs to see the natural resources in a different manner as opposed to the interpretation from classical economic theories. With the awareness that humans are not the sole owners of the earth, they would see themselves as utilisers and managers of the resources, rather than as manipulators or exploiters. The resources are not the objective, but the tools to achieve the objective instead, which to seek equilibrium in the economic ecosystem.

This chapter has also elucidated how *Shariah* governance constituents give high regard to the divine sources to govern the legal aspects of business actions. Commencing from the grip on *tawhidic* epistemology, the IFIs choose to operate and offer the products and services in line with the divine law known as *Shariah* law. Despite the prohibition of *riba*, most of the virtues of *Shariah* financial law remains uncontroversial when adopted by the modern financial market. Other than that, *Shariah* governance is also similar with conventional ideas in many respects, especially the organisational mechanisms. Like its conventional counterpart, *Shariah* governance addresses accountability, transparency, risk mitigation, customer confidence and so on. Perhaps one of the most intriguing parts of the principles of *Shariah* governance is the intertwined aspect of morality and the law. Morality, in the eyes of *Shariah*, is the propellant to achieve *Shariah* compliance. Muslims are not simply committing to the idea simply out of legal requirement but rather derived by the internal perception built up from the

tawhidic epistemological wisdom. Any economical or business judgement taken by governance constituents must adhere to this as a belief so the issue of moral hazard becomes somewhat irrelevant.

Chapter 7

***Shariah* Governance Mechanisms**

7.1 Introduction

After having the pleasure of excavating the underlying principles of the *Shariah* governance, which has made clear the reasons why it is unique compared to the conventional corporate governance system, this chapter will put the focus on the *Shariah* governance mechanisms. In order to substantiate those mechanisms from the *Shariah* governance perspective, this chapter will appreciate the given principles deductively, along with the literature sprinkled throughout the research. Note that, this chapter is also overlaps in terms of the themes but is a more analytical comprehension. It seeks to depict how those principles are put into actions by the IFIs.

In the conventional corporate governance system, there are internal and external governance mechanisms. Likewise, for the IFIs, a similar form of mechanism also exists to work hand-in-hand to achieve its objective, which is *Shariah* compliance in operating financial business. *Shariah* governance mechanisms include the monitoring system to control the actions, policies, practices and corporate decisions, the agents and the affected stakeholders. The governing law, the supervisory system and the audit regime are three *Shariah* governance mechanisms that are always interrelated with internal and external constituents. Whether it is to be conceived as the private affairs of the institutions or otherwise, internal constituents play a consequential role in the robustness of the *Shariah* governance. The willingness of the management to uphold this notion is crucial to the institutional stability; therefore, it is credited as one of the factors to enhance external supports, which comes from customer confidence.

7.2 Governing Law

In Islam, law is the mechanism to seek justice.¹ It is the supreme virtue and conferred as one of the overriding objectives in *Maqasid Shariah*, derived from the belief in the Oneness of the God (*tawhid*). However, since *Shariah* is a law exclusive to Muslims lands, therefore at some point alien to many others, it is mostly viewed and known for its severe punishments in some remote cases. Noted that, research in *Shariah* law is a worthwhile pursuit and a fascinating experience. Perhaps a minor presentation on the law deduction procedure (*ijtihad*) in the upcoming topics of this chapter could speaks for itself.

¹ Quran (4: 58)

Under the *Shariah* governance purview, justice in economics is achievable through *Shariah* compliance. To achieve that, *Shariah* could not be left as a mere conception without a solid grounding. Apart from that, to provide an effective supervision on the IFIs, there must be preconditions necessary to fit the purpose.² Additionally, bringing the best quality of the respective governance mechanisms is mostly manifested by the authority externally as well as any self-regulation initiatives which plays a supportive role internally. Therefore, the *Shariah* regulatory spectrum must be sufficient and supportive for the IFIs to be governed without rolling out any conventional requisites as financial institutions, except for the interest-free model of financial products. In relation to this, thus far, the IFIs are operating under three different types of jurisdictions: fully Islamic, as in Iran and Pakistan; parallel system, as in Malaysia and Bahrain; and conventional, as in the UK.³ Each jurisdiction offers diverse legal issues due to numerous variables such as market power and institutional internal affairs.

7.2.1 Rationales for Regulating Islamic Finance

Islamic finance is a form of banking and financial system where the respective financial institutions have given their commitment to run the business in accordance with a certain notion known as *Shariah* compliance. It also indicates that such a system involves a contractual agreement between many parties relevant to the subjects, assembling and mix-matching a certain form of contractual relationship, diverse again to its conventional counterpart. According to the principles discussed in the previous chapter, this sort of banking system is not merely based on innovation but rather a complex and well-established financial concept. Therefore, it is perhaps sensible to note here that this eccentric financial system is in need of a legitimate legal authority to govern the system as an assurance to protect the rights of the relevant parties from the inherent risks, to project the system towards its full potential and to secure justice. Accordingly, the approach of these regulations needs to reflect the nature of the risk to which the IFIs are exposed and the financial infrastructure desirable for effective regulation and supervision.⁴

To date, the main focus of the existing regulations has been mostly on the licensing and the procedural aspects of the formation of the IFIs.⁵ On top of that, the jurisdiction of the *Shariah* supervisory system is also included. This effort is

² IFSB, (The Core Principles for Islamic Finance Regulation (Banking Segment) (CPIFR) 2015) 9.

³ See also Mumtaz Hussain and others, 'An Overview of Islamic Finance' (2015) IMF Working Paper WP/15/20.

⁴ IFSB, (IFSB-17) (n 2) 1.

⁵ Muhammad Zulhibri Abdul Majid and Reza Ghazal, 'Comparative Analysis of Islamic Banking Supervision and Regulation Development' (2012) 6 (3) Money and Economy 113.

more of a preface than the attempt to tackle the real challenges of the Islamic financial market as a whole; it is still far from its full potential. This development has to some extent only brought Islamic finance out of the shadows. Therefore, a holistic regulation including the formation of the *Shariah* financial law as reference for both industry and the judiciary is not only rhetoric, but rather an utter demand. Many cases have shown real intimidating regulatory challenges faced by the IFIs.⁶ If these are not to be sorted out soon, those challenges, it is believed, will impede the future development of the industry: namely, in the markets where Muslim customers are not dominant. Given this fact, having a well-regulated environment for the IFIs to operate in is not a remote idea. There are numbers of rationales imaginable to justify a designated law to govern the IFIs' operations. In this part of the chapter, we will explore amongst others, four rationales for regulating Islamic finance: namely, to justify *Shariah* legal authority; to mitigate the risk; to protect the stakeholders; and to codify *Shariah* financial law.

7.2.1.1 To justify *Shariah* legal authority

There must be regulations to legitimise the authority of *Shariah* legal and supervisory issues to designated regulatory and supervisory bodies. This is to be done either by enhancing the function of the existing bodies or commencing anew, out of the proportion with the jurisdictions. Thus far, as already noted on multiple occasions, the authority to ensure *Shariah* compliance is held by the *Shariah* committee, either internally or externally. It is done by the internal *Shariah* committees of the respective IFIs and the external *Shariah* committees of the central banks.⁷ The legality of the contract lies in this type of regulation and supervision in terms of its legal endorsement where in some jurisdictions, such as in Malaysia, the court has to make reference to such.⁸ This procedure, among others, still lacks of two aspects: the authority of the court to adjudicate the cases and the redundancy of the *Shariah* committee supervisory opinions. This regulatory loophole somehow has forced the IFIs to imitate the conventional counterpart through mix-matching methods to reduce the costlier procedures of product offering due to legality issues with the *Shariah* contracts.⁹ It has extended to a more complicated implication, which started from the legal requirement of the *Shariah*-compliant products under the eyes of the regulatory perspective.

This is in part because, in many jurisdictions, the law was made without concern on financial products from which the *Shariah*-compliance business model is

⁶ See also H Hesse and others, 'Trends and Challenges in Islamic Finance' (2008) 9 (2) World Economics 175.

⁷ The structure differs from one jurisdiction to another as discussed in prior chapters.

⁸ See also Islamic Financial and Services Act 2013 (Malaysia).

⁹ Mabid Ali MM al-Jahri, 'An Economic Theory of Islamic Finance Regulation' (2016) 24 (2) Islamic Economic Studies 1, 3.

excluded. In this vein, the question arises as to whether interest-free-based product is controversial or not from the respective regulatory view point.¹⁰ Under the former jurisdictions, the upcoming challenge is a regulatory supportive infrastructure. Meanwhile, under the later jurisdiction, *Shariah*-compliant products have to find a mechanism that adheres to the regulatory requisites at the same time. As the result of these twin challenges, the mix-matching product structuring strategy is the best alternative solution thus far, as approved and supervised by their *Shariah* committees. In addition, the uniqueness of the IFIs has to certain degree impaired the industry within the existing regulatory system. From product structuring to the litigation of disputes between the relevant parties in the Islamic financial industry, the IFIs are invariably on many occasions exposed to legal risk.

Apart from the above, the enforceability of *Shariah*-compliant forms of contract and therefore their effectiveness, also requires justification. It is imperative to note here that the general principle conferring validity of contracts is the consent of the contractual relating parties.¹¹ However, some cited cases related to Islamic finance mentioned that the only party falling under *Shariah* compliance is the IFIs. This is due to the article of association of the IFIs, which they are obliged to uphold.¹² Whether or not the customers or other relating parties are obliged to comply with *Shariah* law under the circumstances is still optional. As observed, the absence of regulation to enforce the interest-free contract form has given rise to the issue of the choice of law to the litigants.¹³ The rights of the contractual parties to the choice of law to govern their contracts without having a sound and solid regulation to attend the case, could end up with the case being adjudicated largely with unprecise interpretation and therefore, false judgment. In addition, the fact that the non-black-letter *Shariah* law is referred to as 'unqualified' as reference to the contractual parties 'therefore meaningless', is a grave fact about the potential of the future cases to be put aside from the accurate *Shariah* contractual framework. To make it worse, it has consequens to the institutional stakeholders as well as to the protection of consumers' rights as far as this research is concerned.

In addition to that, the court ought to have a clarification of its jurisdiction to adjudicate *Shariah* related cases. It will justify the court's jurisdiction to interpret the contracts construed under the *Shariah* law. As referred to *BIMB v Adnan*

¹⁰ Hesse and others (n 6) 179.

¹¹ Muhammad Akram Laldin and others, *Islamic Legal Maxims & Their Application on Islamic Finance* (ISRA Publication 2013) 26.

¹² *Beximco Pharmaceutical Ltd v Shamil Bank of Bahrain EC* [2004] APP.L.R 01/28.

¹³ *The Investment Dar Company v Blom Development Bank* [2009] EWHC 3545.

Omar in the Malaysian jurisdiction.¹⁴ The defendant contented that the Malaysian Civil Court has no jurisdiction to hear the case. Other than that, cases such as *Beximco v Shamil*, has shown that non-Muslim dominated jurisdiction especially British court is not escapable from disputes in Islamic finance.¹⁵ Notwithstanding, the arguments of the cases might not be similar, but the concern of the related parties somewhat on the similar legal issue. In connection to that, the issue of whether the judges are familiar with the case facts is also amusing. Judgment should be based on knowledge and understanding.¹⁶ It is a prerequisite to the judge to ensure justice for the disputing parties.¹⁷ This judicial support is one of the crucial infrastructure required for effective regulation of a resilient and robust Islamic financial market.¹⁸

7.2.1.2 To mitigate the risk

The relationship between the depositors and the IFIs as compared to the conventional counterpart is somewhat inconsistent. The contracts between the depositors of the conventional institutions are based on lending which is already under the protection of credit risk through depositor protection scheme. On the other hand, owing to profit and loss sharing (PLS) contracts, the depositors of the IFIs, are not the creditors and the institutions are not the borrowers. They are in fact investors to the IFIs, whose as the agents therefore fairly share the rate-of-return risk with the institutions.¹⁹ As a result, the conventional depositor protection scheme on credit risk is inapplicable to the IFIs' depositors in many respects due to this inherent incoherence.²⁰ If the IFIs' depositors are to be bundled together with the conventional depositors, it might give rise to the question of *Shariah* non-compliance risk.²¹

Additionally, the PLS-based products, as in *mudarabah* and *musharakah* financing, are vulnerable in terms of the information asymmetric on the potential

¹⁴ *Bank Islam Malaysia Bhd v Adnan Omar & Ors* [1994] 3 CLJ 735; See also Ruzian Markom and others, 'Adjudication of Islamic Banking and Finance Cases in the Civil Courts of Malaysia' (2013) 36 Eur J Law Econ 1, 3.

¹⁵ *Beximco v Shamil Bank* (n 12).

¹⁶ *MA Laldin and others* (n 11) 1.

¹⁷ *Al-Majalla Al-Ahkam Al-Adliyyah*, Book XVI Chapter I, Section I no. 1794.

¹⁸ IFSB, (IFSB-17) (n 2) 1.

¹⁹ Mahmoud A El-Gamal, 'Islamic Bank Corporate Governance and Regulation: A Call for Mutualisation' <<http://www.ruf.rice.edu/~elgamal/files/IBCGR.pdf>> accessed 25 April 2018.

²⁰ In some jurisdictions such as in Malaysia, IFI depositors are protected by the government.

²¹ See also Karim Ginena, '*Shariah* Risk and Corporate Governance in Islamic Banks' (2014) 14 (1) *Corporate Governance: The International Journal of Business in Society* 86.

rate of return.²² Rate of return is utilised by the IFIs to predict the profitability of their investments as well as financings. As required by *Shariah* financial law, for PLS products, the IFIs are allowed to predetermine the profit ratio but the rate of return of the investment is the subject to be determined only after the end of the investment period. Due to this, the expectation of the IAHs might be higher or mismatched with the profit earned from the investment.²³ To avoid the investors from withdrawing the funded capital, the IFIs might need to waive their right to the dividend, which could give rise to displaced commercial risk (DCR).²⁴ This problem is closely related to the IFIs in their way of ensuring effective asset and liability management on the balance sheet, which, if not diligently reconciled, could cause reputational risk for the institutions. The mentioned risks are amongst other risks that are uniquely faced by the IFIs and are to be identified, measured, evaluated, monitored, reported and controlled to mitigate the effect. By saying that, a comprehensive, robust and sound regulation and supervisory legal system is an undeniable requisite.

In this sense, it is also worth mentioning that the modes of the conventional risk mitigation techniques are not fully compatible with the *Shariah* compliance requirements. This is a result of the PLS relationship.²⁵ In contrast to the conventional model, instead of transferring the risk to the borrowers, the depositors of the IFIs are investors, therefore they are sharing the risk of their investment with the institutions as the agents.²⁶ Coherently, to mitigate the risk of loss to the institutions and to ensure the deposited amount is returnable, the institutions offer the customers products with the same principle. Another type of risk-mitigation mechanism is through asset-and equity-based risk management. The way the IFIs fabricate the mechanism is indeed unique and inconsistent compared to the conventional model which might also be legally incapacitated in many respects. However, this sort of economic strategy is technically what makes the IFIs unique and has bonded a close link between Islamic finance and the real

²² Zakaria Bahari, 'The Changes of Products Structure in Islamic Banking: Case Study of Malaysia' (Paper presented at Conference on Islamic Perspective on Management and Finance organised by School of Management, Leicester University, 2-3 July 2009) 8.

²³ IFSB, (Guiding Principles of Risk Management for Institutions (Other Than Insurance Institutions) Offering Only Islamic Financial Services) 23.

²⁴ Displaced commercial risk is the risk accrued to the IFIs due to the commercial pressure of having to pay a rate of return equivalent to a competitive rate of return and absorb a portion of losses which normally would have been borne by investment account holders (IAH) in order to prevent massive withdrawal of funds; See also Hennie Van Greuning and Zamir Iqbal, *Risk Analysis for Islamic Bank* (The World Bank 2008) 175.

²⁵ Nabil Maghrebi and Abbas Mirakhor, 'Risk Sharing and Shared Property in Islamic Finance' (2015) 23 (2) *Islamic Economic Studies* 85.

²⁶ See also Hossein Askari and Abbas Mirakhor, Risk Sharing, 'Public Policy and Contribution of Islamic Finance' (2014) 67 (271) *PSL Quarterly Review* 345.

economy.²⁷ The advantage of such a system is believed to be illustrated during the crisis, as the assets are retrievable to regain the capital lost. It is not a wishful thinking, since the 2007 financial crisis has witnessed the robustness of the IFIs in facing the turbulence in contrast to the interest-based financial system. It is in fact one of the main factors that has drawn the attention of the conventional market to the *Shariah* compliant financial system.

7.2.1.3 To protect stakeholders

The objective of *Shariah* governance is to optimise institutional value and ascertain sustainability to the institutions for the sake of the stakeholders. It is to protect the firm from failure and the stakeholders, especially the finance users, from the firm's insolvency as well as profit instability.²⁸ Sustainability is about fulfilling the need of today's stakeholders without compromising the future stakeholders in economic, environmental and social aspect.²⁹ This is somehow what is promulgated by the the objective of *Shariah*, which is to preserve good. In doing so, the IFIs have to take into account the fact that their stakeholders are characteristically unique. The existence of shareholder alike stakeholders such as the IAHs, for instance, has distinguished the list of the stakeholders in many respects. The IAHs at some point represent the real conflict of this complex relationship. The challenge faced by the IFIs in managing IAHs as stakeholders is the power of the IAHs as depository investors with the contractual nature of shareholders. As the investors, they are entitled to a certain percentage of profit and keen on the highest margin possible, in a relatively short term compared to the shareholders. To make it more consequential, the IAHs are also depositors, who enjoy the right to withdraw their investment in a short run if there is a mismatch between the profit earned and what has been expected.³⁰ In order to ease that, the IFIs could waive their profit portion to the IAHs to avoid the withdrawal risk. In this case, it is should be apparently managed diligently or otherwise, it would minimise or even threaten the overall rate of profitability, claimable by the shareholders as residual claimants in the long run. Adversely, if the shareholders see the given waiver as favourable to the IAHs, it could bring up the potential problem of shareholders selling their share.³¹

Apart from that, the IFIs are also facing an information asymmetry issue in a dissimilar way as compared to the conventional counterparts, owing to the fact

²⁷ Abdul Karim Abdullah, *Economic Benefit of Risk Sharing, Islamic and Civilisation Renewal* (IAIS Malaysia).

²⁸ Al-Jahri (n 9) 2.

²⁹ Thomas Dyllick and Kai Hockerts 'Beyond the Business Case for Corporate Sustainability' (2002) 11 (2) *Business Strategy and the Environment* 130.

³⁰ Greuning and Iqbal (n 24) 178.

³¹ This is the displaced commercial risk (DCR) as mentioned earlier.

that Islamic finance products are mostly based on PLS and multilayer sale arrangements.³² In terms of rights, the PLS-based contract widens the numbers of the stakeholders who are entitled to the information, which is conventionally conceived as one of the exclusive rights of the shareholders. Additionally, the way the PLS contracts behave posits the risk of being shared by the firm and the customers. By granting a symmetrical right to the customers, the IFIs are unable to fully burden the customers in the case of default and the relevant parties have the right to be made aware of such a risk with sufficient information. This contractual structure demands a more delicate due diligence process to be executed by the institutions on possible customers, and by the stakeholders on the institutions: namely examining the information to access whether or not the invested funds are retrievable and profitable. For instance, the lack of information on the customer's ability to pay the predetermined price could increase the credit risk in deferred payment sale-based products, which is the most important feature to be screened prior to disbursement.³³

On top of that is the understanding of the notion of *Shariah* compliance by the stakeholders. It should not merely appear on the form of the contract but include the virtue of the Islamic contract as well as its operational aspects. For instance, let us observe the fact that an IFI as *mudarib* is liable to guarantee the invested capital in the case of any misconduct and negligence.³⁴ This is one of the reliable approaches of insuring shareholders' investments. From its *Shariah* legal perspective, it is *Shariah* compliance, which would simply be endorsed by the *Shariah* committee. On one hand, it is the best way of protection imaginable for the sake of the shareholders. However, the IFIs as agents in a more complex relationship will absorb the risk on behalf of them and put it on the shoulder of other stakeholders. The customers, for instance, would suffer with higher rates of return required by the institutions stated in their financing agreement in order to allow the institutions to enjoy potentially higher returnable margins commensurate with the absorbed risk. Some cited cases put forwards in their argument the large or even abusive margin of profit gained by the IFIs.³⁵ It might be justified by a calculation as per agreed upon by the relating parties; however, the high payment obliged to the customer once a contract is sealed could be perceived as non-Islamic.³⁶

³² Greuning and Iqbal (n 24) 197.

³³ M Kabir Hassan and Mervyn K Lewis, *Handbook of Islamic Banking* (Edward Elgar 2007) 145.

³⁴ AAOIFI, *Shariah Standard no (13) Mudarabah* in AAOIFI (eds) *Shari'ah Standards*, (Almainan Publication and Distribution, Manama 2015) 384.

³⁵ *Affin Bank Bhd v Zulkifli bin Abdullah* [2006]3 MLJ; See also *BIMB v Adnan* (n 15).

³⁶ Some argue that this argument is due to the IFIs' transparency requirements on the final price of the sold asset. The policy mentioned that to be compliant with Islamic contractual form, the price must be clearly and agreed upon by the relating parties

If cases are observed more closely, the stakeholders are at great risk due to effects of externalities brought by the actions of the relevant parties, especially the agents.³⁷ The *Shariah*-compliant resolutions taken by the IFIs are most noticeable. The fact that many litigations came up with arguments on the illegality of the contracts under the *Shariah* law, thus unenforceable is an afflictive evidence in this particular issue.³⁸ It might not be correlated with the point whether or not the Islamic financial system is well regulated, but the potential for such an excuse being most frequent deployed in the cases of default payment is worth mentioning. There are many stakeholders at stake if this is not going to be addressed diligently by the authorities by offering robust regulatory remedies. Furthermore, minimising the risk binding onto the stakeholder is the objective of having a robust *Shariah* governance system. A solid regulation system could function as risk mitigation by putting forward a well-developed system to be adhered to by the institutions.

7.2.1.4 To Codify *Shariah* Financial Law

This justification might be more reasonable in a Muslim-majority market. This is acknowledged on the basis of multiple application of *Shariah* legal schools adopted by the IFIs in construing the contracts, which gives rise to the *Shariah* non-compliance risk. Some disputes highlighted the contentious facts, offered mainly by the defaulting parties, in their attempts to quash the contract, that the *Shariah* principles applied to disputed products are contradictory in terms of their legality, owing to the multiple different *Shariah* opinions, and therefore invalid.³⁹ For instance, a contract might be construed based on a certain *Shariah* legal school. The stipulated characteristics could be differentiated from other *Shariah* legal schools. To some extent, the contract might be lawful according to the *Shafie* legal school but rendered otherwise by other schools. This is what happened with the *Bay Bithaman Ajil* (BBA) products as witnessed in the Malaysian court cases. The BBA is a product construed based on the *Bay al-Inah* contract, which was legal according to the *Shafie* legal school, but considered a trick to backdoor *riba* by the majority of other schools. This type of contention also recently conceded in the case of *Dana Gas v Dana Gas*.⁴⁰

when the agreement take place. This final price is not an issue in the conventional financial system since it is a subject to change due to annual interest fluctuation, which is a *gharar* and therefore unlawful in the eyes of *Shariah* law.

³⁷ Shelagh Heffernan, *Modern Banking* (John Wiley and Sons 2005)174.

³⁸ See also *Beximco v Shamil Bank* (n 12).

³⁹ *Affin v Zulkifli* (n 35).

⁴⁰ *Dana Gas PJSC v Dana Gas SUKUK Ltd* [2017] EWHC 2928.

These indefinite feature could be remedied by the enforcement power of the authority. On the basis of the *Shariah* legal maxim, the opinion prevailed by the authority transcends the legal school contradictions, any multidimensional opinions on the case are irrelevant and the prevailed opinion is the one chosen by the authority as referral.⁴¹ Additionally, if the contracting parties are made aware of the existence of other opinions, and chose to go with the stipulated items, other legal opinions are no longer a choice and therefore are irrelevant during the dispute. However, the issue of a lack of unification of *Shariah* legal approach is not to be abundant. The fact that is has given rise to *Shariah* legal ambiguity should be attended to diligently. To do so, the authority must justify the chosen legal school under its jurisdiction for the IFIs to accommodate.⁴² Other than that, it could also be done by commencing standard procedures for legal justification if there are *Shariah* salient issues due to legal school contradictions.⁴³ Additionally, the issuance of *Shariah* parameters is also considered a good strategy.⁴⁴ The objective is clear, which is to achieve harmonisation of the concepts and application among the *Shariah* committees, so it could avoid contradiction and inconsistency regarding the implementation of *fatwas*.⁴⁵

To conclude this discussion, there is an inexorable need for the respective jurisdictions to ensure their legal environments are conducive for the Islamic financial market to flourish. Due to the justifications put forward, the relevant question here is not why but rather what and how. While perspectives on what constitutes the right mix of regulations and governance models may vary between jurisdictions, the view believed to be widely shared here is that an agile and responsive regulatory ecosystem will allow the IFIs to thrive to their full potential while minimising the risks embarked on by the customers therefore ensuring stability and prosperity to the market. However, it is worth noting here that the regulations sought here must be in line with the virtues promulgated by *Shariah*.

⁴¹ Shihabuddin Al-Qurafi, *al-Furuq* (Dar al-Salam 2001) 540.

⁴² This was the way of the Islamic governments during the time of caliphates. One *mazhab* will be chosen by the authority as a referee, whilst other *mazhabs* are in liberty to be accommodated in personal matters or when agreed upon by the related parties. It is cited that there were also regional courts, that applied certain *mazhab* which was not the national *mazhab*, based on their local requirements; See also Abu al-Hassan Ali bin Muhammad bin Habib Al-Mawardi, *Al-Ahkam al-Sultaniyyah* (Dar al-Hadith 2006).

⁴³ There are numerous researchers regarding this, mostly done by *Shariah* experts. In most cases, the focus is on finding the best *Shariah* solution for the issues that have arisen due to the mix-matching approach.

⁴⁴ Malaysian Central Bank (BNM) through its *Shariah* Advisory Council has been publishing in a timely manner, numbers of *Shariah* parameters for the IFIs as reference.

⁴⁵ AAOIFI, *Shari'ah Standards* (Almainan Publication and Distribution, Manama 2015) 28.

7.2.2 Virtues of *Shariah* Law⁴⁶

It is utterly vital that the virtues of *Shariah* law are adopted under the circumstances. This is to avoid non-Islamic virtues taking their place in the so-called *Shariah* compliance notion.⁴⁷ These objectives stand as the preferences of the *Shariah* law and the *Shariah* legal principles. Based on the previous discussion, it is conceivable that Islamic corporate governance is about the existence of additional mechanism to ensure compliance in IFI operations, especially in *Shariah* matters. *Shariah* compliance in terms of contractual agreement seems to be the main concerns of such mechanisms. However, it is worth mentioning that when we deal with *Shariah* matters in products and services, the knowledge of the objectives of *Shariah* is a crucial factor. Since composing *Shariah* resolutions is about striving and seeking the underpinning meanings behind the texts of the Islamic sources, a deep understanding of the objectives of *Shariah* is inseparable from a *Shariah* scholar who carries out such a duty.

The name for the virtue of *Shariah* law is *Maqasid Shariah*.⁴⁸ *Maqasid Shariah* refers to the overall goals and meanings aimed by *Shariah* law to accomplish under the principles of realisation of benefit and prevention of harm. This intertwined concept is embedded into Islamic jurisprudence regulated from Islamic sources since *Shariah* law comes with reasons and explanations. As said by scholars, there are five general objectives of *Shariah* which are the preservation of faith, life, posterity, wealth and intellect. These objectives are regarded as the general objectives that cover the whole system of human life at the macro level. Under each general objective, there are many other specific objective acting as the support objectives to ensure all the elements of the general objectives are achievable at the micro level and could cover the smallest part and parcel of human life. From regulatory perspective, specific objectives should support the scholars to look into specific provisions for specific cases in order to come up with the resolutions that could uphold general objectives. This means each topic in *Shariah* will have its own objectives at the lowest level as the point of reference that does not contradict the general approaches of the *Shariah* as a whole system.

⁴⁶ This topic is closely related to as discussed in Chapter 2, under the characteristics of the *Shariah* law: *Maqasid Shariah*.

⁴⁷ *Affin v Zulkifli* (n 35); See also Markom and others (n 15) 11.

⁴⁸ The words virtue and objective are interchangeably used for this topic. It is because, in common usage, *Maqasid Shariah* is translated as the objective of the law. Considering the vast discussion of the topic, the word objective is rather literal in understanding of what *Maqasid Shariah* really is.

At the micro level, recent developments in Islamic finance have witnessed many attempts carried out by scholars such as Laldin and Furqani to cater for the need of deep understanding of the applications of the objectives of *Shariah*.⁴⁹ Preservation of wealth is regarded as the point of reference on this topic. It is imperative to say that the preservation of wealth is about the encouragement to generate, accumulate, preserve and distribute the wealth in a just and fair manner.⁵⁰ It is also the promulgation of the concepts of economic wellbeing, universal brotherhood and justice, equitable distribution of income, and freedom of the individual within the context of social welfare.⁵¹ In this part of the chapter, four objectives of *Shariah* related to the corporate governance will be brought upon for discussion: namely, transparency of deal; preservation of contract validity; wealth as instrument not goal; and fair distribution and circulation. Most importantly, these objectives are specific in nature if we consider them as part of the method to achieve the notion of preservation of wealth. On the other hand, corporate governance constituents, especially those who are sitting in the higher governance organisational hierarchy, serve as helicopter viewers of the company to some extent naturally deal with general approaches that move the company towards its goals. Therefore, these same objectives also general in nature in the corporate governance corpus. It is vital that such a notion is embraced in order to assist the understanding of this topic.

7.2.2.1 Transparency of Deal

The conventional corporate governance corpus has been discussing information asymmetries that occur between shareholders and managers. In Islamic finance, such issues extend to customers and other stakeholders as some of them are considered as shareholder alike stakeholders, especially the IAH.⁵² In this regard, transparency is the essence of each Islamic financial contracts. All contracts must clearly stipulate terms and conditions and the contractual parties ought to be notified. Having knowledge and understanding of such during the deal process is consequential in quantifying the consent of the relating parties. Items such as price, payment method, period of the deal and other reasonable terms and conditions are encouraged to be expressed in an explicit manner in any kind of dealings entered into by the IFIs. Any ambiguity is considered *gharar* (uncertainty) which could render the contracts to be null in the eyes of *Shariah*

⁴⁹ Muhammad Akram Laldin and Hafaz Furqani, 'The Objective of the Shari'ah in Islamic Finance: Identifying the Ends and the Means' (2013) *New Horizon* 26.

⁵⁰ *ibid*

⁵¹ See also Muhammad Umer Chapra, *Towards a Just Monetary System* (The Islamic Foundation, 1986).

⁵² Since the investment account holders are bonded with *mudarabah* and *musharakah* agreement, their contractual relationship with the institutions are similar to the shareholders.

law.⁵³ Therefore, the governance constituents of the IFIs must work to observe this notion, especially when it comes to the products and services offered to the customers. It is not only because of the need to gain the customer's confidence but also to uphold the objectives of *Shariah* in financial transactions.

This objective of *Shariah* is traceable in the prohibition of extensive uncertainties present in any transactions that normally occur because of the inadequate information. For instance, if we go back to the practices showed by the Prophet PBUH, it is narrated that when the Prophet PBUH permitted the people of Medina to proceed with the *Salam* contract, He emphasised the need for the contract to stipulate the explicit date of delivery and the exact amount of price.⁵⁴ Other than that, in *murabahah*-based products - an Islamic mark-up price instrument implemented for asset financing - the IFIs are strictly required to mention purchasing price and the profit generated by them from the agreement before stating the selling price to the customer. The same principle is applied to the *Bay' Inah* financing where specific amount taken and offered by the IFIs from and to the customers must be explicitly stated in the agreement.⁵⁵ This action somehow triggers customer's awareness of the exact amount of profit taken by the IFIs, which on the other hand also revealing the uncertain amount generated by the same nature of interest-based products offered by conventional financial institutions.

7.2.2.2 Preservation of Contract Validity

Other than focussing on the permissibility of the contracts, the *Shariah* committee should also put their attention and effort into preserving the validity of the contracts. Any contract, especially those which are fabricated based on general provisions and do not contravene any specific provision from the Islamic sources, brought to the committee should be presumed as permissible and valid, respectively. This is a crucial notion in dealing with financial institutions since a non-compliant contract could compromise or even nullify the agreed deals. The impact of non-compliance could not only affect the IFIs internally, but also diminish customer's confidence in the IFIs adversely.

This objective of *Shariah* in this particular matter is moulded based on the presumption of continuity. It means that each closed deal should be presumed in continuation of both the positive and the negative until the contrary is established

⁵³ *Al-Mausu'ah al-Fiqhiyyah al-Kuwaitiyyah* (1st eds Dar al-Safwa 1993) vol 31 150-154.

⁵⁴ *Bay' al-salam*, which refers to a sale contract in which payment is made in advance by the buyer and the delivery of the goods is deferred by the seller. The date of delivery and accurate description of goods must be given in the contract.

⁵⁵ *Bay' al-'Inah* is the crux of the *Bay' Bithaman 'Ajil* (purchasing with deferred payment) home financing product offered by the Islamic banks in countries such as Malaysia.

by evidence.⁵⁶ It is also based on the maxim that any financial transaction is considered as licit until proven as illicit.⁵⁷ A transaction is normally considered illicit if there is evidence of interest (*riba*), extensive uncertainty or gambling. As long as there is no involvement in an interest-based agreement, the uncertainty, if any, is under control as advised by the experts, and no gambling products or services offered, the contracts should be scrutinised by serving the objective of preserving their validity.

The source of the present objective of *Shariah* is apprehensible from the tradition of the Prophet PBUH. When the Prophet PBUH and His companions arrived at Medina, He recognised the transactions that had been practised by the local people, called *Salam*, despite the fact that such a contract was construed without the existence of an item for purchase during the deal. He also urged Muslims to not to waste the wealth they possessed. Wealth is wasted when it is spent unwisely, or on non-permissible transactions. To avoid such a condition from happening is to uphold the objective promulgated by *Shariah*.

7.2.2.3 Wealth as Instrument Not Goal

Commencing on the epistemological worldview of a Muslim on the meaning of life on earth as the Caliph of God, a Muslim believes that a human is the steward of God managing the earth according to His will. The sole absolute owner of the wealth is God Himself and humans are His vicegerents, possessing the right to earn wealth through permissible means. Technically, everything in this universe has been made subservient to Him.⁵⁸ In this relationship, humans ought to use wealth to fulfil their needs as an instrument to attain the other general objectives of *Shariah*. Such a worldview also distinguishes the *Shariah* governance point of reference from its conventional counterpart, where wealth maximisation is considered as the main goal, especially for the advocates of the shareholder theory.⁵⁹

To this end, it is imperative for the *Shariah* committee to ensure that any strategic approach taken by the management of the IFI for the sake of the institution does not only consider profit generation as well as its adherence to *Shariah* law. They

⁵⁶ Muhammad Hashim Kamali, *Principles of Islamic Jurisprudence* (The Islamic Texts Society Cambridge 2003) 384.

⁵⁷ This is based on the maxim, 'the thing shall remain as it was originally', - meaning, if it was originally permissible, it will remain permissible until proven otherwise; Al-Majalla Al-Ahkam Al-Adliyyah, Part II. Maxims of Islamic Jurisprudence, no. 5.

⁵⁸ *The Islamic Economic System: A Few Highlight* (Pakistan Institute of Development Economics, 1981) 5.

⁵⁹ Andrew Key, 'Ascertaining the Corporate Objective: An Entity Maximisation and Sustainability Model' (2008) *The Modern Law Review* 663-698, 667.

should also encourage the management to look beyond such horizons, namely to the sustainability and capability of the institutions to serve the *ummah* for a longer period of time and a wider group of stakeholders. Only in that way will the wealth generated by the IFIs serve its purpose as the instrument for the prosperity of the stakeholders as well as to obtain other objectives of *Shariah*.

The present specific objective of *Shariah* is traceable from the condemnation of the rich people who gathered the treasure without spending it in a righteous manner. *Shariah* law also provides various instruments such as *mudarabah*, *musyarakah*, *muzara'ah*, *musaqat* and many others that are capable of supporting people with surplus funds to invest their capital in order to generate the economy.

7.2.2.4 Fair Distribution and Circulation

To achieve the objective of preservation of wealth, Islamic governance constituents ought to put their attention onto the wealth creation, distribution and consumption process so that the wealth is not circulated only among the rich in the society.⁶⁰ It is worth mentioning that financial activities in Islam are not about wealth concentration, but rather concern with how to create and circulate the wealth in the best manner of distribution, as promulgated by *Shariah*. Income created from the economic activities should be distributed in a just and fair approach, regardless of the economic status of the recipients.

In this regard, it is imperative to say that the meaning of justice encapsulated by *Shariah* is not about equality but rather putting everything in its righteous place. Therefore, making everybody rich is not considered justice in Islam. Other than wishful thinking, such an effort also denies the fact that each person has different potential. What we need to do is to create optional as well as compulsory mechanisms that will collect the wealth from those with surplus funds for the benefit of the people who are in need.

This notion is demonstrated in Islam by the encouragement of charity or *sadaqah* and the enactment of compulsory alms or *zakah* from those with surplus funds. The collected resources are then distributed to those with deficit funds possessing a certain characteristic to ensure everybody gets what they need. For instance, poor people with income less than 50% of their daily needs will be given more compared to the poor people who earn more than 50% of their daily needs

⁶⁰ Muhammad Umer Chapra, *Islam and Economic Development* (The International Institute of Islamic Thought and Islamic Research Institute, 1981) 6.

but less than the minimum daily threshold. Sometimes, rich people who go into debt in order to help others are considerable as eligible to receive *zakah*.

As a conclusion, it is believed that a clear understanding of the specific objectives of *Shariah* in corporate governance is the key towards the preservation of wealth as propagated by the general objectives of *Shariah* law. Apart from this general guidance, the *Shariah* committee should also take advantage of specific objectives in each case that comes before them in the committee meetings to find the best solution possible. This is due to the fact that these specific objectives are deemed to assist the achievement of the general principles through the realisation of benefits and the prevention of harm. It is important to note that, being able to deploy these specific objectives in the relevant cases will be the key to demonstrating the real soul of the *Shariah* law, beyond its literal expression. It will also manifest the feasibility of the *Shariah* law, passing through the spatial and temporal factors. It is believed that after combining all of these aspects, the true potential of the Islamic financial market will be more visible to stakeholders.

7.3 *Shariah* Supervision Mechanism

After discussing the governing law and its virtues, we will proceed with the second part of *Shariah* governance, the supervision mechanism. From the governance viewpoint, there must be a sound supervision mechanism ensuring the IFIs operate in adherence with the required conventional financial regulations and the same time the *Shariah* compliance principles. This supervision mechanism should have the capability to enhance the performance of the IFIs and mitigate the potential threats that could weaken the institutions. In order to do so, this part of the present chapter will focus on the duty of the governance constituents, namely the *Shariah* committee and its managerial supporting system, in ensuring *Shariah* compliance. It will discuss the duty of the directors as the fiduciaries to the stakeholders, especially the shareholders, and the role of *ijtihad* in the executing of their duty of care and due diligence. Be noted that other general duties perceived as the nature of the IFIs as financial subsidiaries are not in the scope of this discussion due to the objective of the research and its limitations.

7.3.1 Fiduciary Duty of IFIs' Directors

Broadly speaking, the duties of the directors of the IFIs are similar to those of their conventional counterparts. Whether they are executive or non-executive board members, the duty of care and loyalty are mandatory. Arguably, the starting point of this fiduciary duty is moulded according to the nature of the relationship and the facts of the case.⁶¹ As prescribed by a *mudarabah* contract, the IFIs are the agents (*amil*) and the shareholders are the principals (*rabb mal*), where the

⁶¹ *Hospital Product Ltd v United State Surgical Corporation* (1984) 156 CLR 41, 102.

directors, as the persons responsible for the actions and inactions of the IFIs, are the agents to the institutions. The main distinguishing feature is the fact that they carry out the business in compliance with *Shariah* law, concurrently with the law of the land in which they are operating. In the IFIs, the contracts of the directors and their *Shariah* committee members are construed based on trust or *amanah*. In a contractual sense, *amanah* is the underlying essence of the agency contract. The first reference is to be made in the expressed terms of the agency contract of the board respectively. It is then extended to the accountability of the board towards the stakeholders and the *Shariah*, as the law referred to by the IFIs, alongside with the law of the land. This multi-dimensional interrelation shapes the peculiarities of the *Shariah* governance fiduciary model.

On the way towards *Shariah* compliance, a notion specific to the IFIs' operating mode, the directors are accountable to ensure its success, which is a challenge closely supervised by the stakeholders. In the real world, experts who possessed the capabilities to comprehend the notion is rather rare in business, let alone in the financial market. From there, the idea of having a designated committee, membered by a group of people with expertise in *Shariah* law, is the best option imaginable thus far. In organisational terms, this committee is a subsidiary to the board of directors, delegated with a certain level of fiduciary duty towards the institutions, in order to ensure *Shariah* compliance. Put differently, it is a modernised version of the duty of care and due diligence to fit the purpose of the IFIs' operating systems.

7.3.1.1 Fiduciary Duty of *Shariah* Committee

There are many standards featuring the duties deemed to be discharged by the *Shariah* committee. Surprisingly, the focus is commonly on technical and procedural requirements or job prescriptions of those on the committee, which are mostly related to *Shariah* issues. As far as this research is concerned, a specific research on the respective duties from the viewpoint of *Shariah* experts as fiduciaries should be initiated. As members of a committee with power delegated by the board of directors, *Shariah* committee members, to some degree possess a similar fiduciary duty, as if they themselves were directors.⁶² The only difference might be in the job prescriptions, which is mainly focusing on *Shariah*-related matters. This is to support the idea that the board should be able to exercise independent judgement on corporate affairs.⁶³ In this vein, it is done by having a unique board structure, consisting of the *Shariah* committee directly under the board of directors, supervising and observing *Shariah* matters on behalf of the board. As a subsidiary to the board, the *Shariah* committee reports

⁶² IFSB, (Guiding Principles on *Shariah* Governance Systems for Institutions Offering Islamic Financial Services 2009) 7.

⁶³ OECD, *G20/OECD Principles of Governance* (OECD 2015) 50.

to the board on any *Shariah*-related issues in a timely manner or if deemed necessary.⁶⁴

Additionally, based on the concept of *amanah*, by virtue of agency contract, the power given by the shareholders and the implied duty to the stakeholders, the governance constituents of the IFIs, including the *Shariah* committee, must exercise their duty in-line with the objective of the institutions, to optimise the value and ascertain the sustainability of the institution.⁶⁵ Therefore, apart from ensuring *Shariah* compliance, the *Shariah* committee are subject to fiduciary duty, which consists of the duty of loyalty and duty of care. The most important task executed by *Shariah* experts here is to ensure the IFIs, as the nexus of implicit and explicit *Shariah* compliance contracts, would uphold such a virtue at any time and at any permissible cost.

7.3.1.1.1 Duty of Loyalty of *Shariah* Committee

Shariah committee members are a group of people with a special set of skills entrusted to be the IFIs' safeguarding mechanism for the stakeholders from any misinterpretation of the *Shariah* law.⁶⁶ In fact, their existence is to protect the rights and interests of the stakeholders as clients from any *Shariah* misconducts possibly executed by relevant governance constituents. As trustees, the duty of loyalty is applicable to them, a notion conceived from their contracts as agents. The idea is that they must act in accordance with the best interest of the institutions and for the best sake of the stakeholders. It is to ensure the idea that has brought the IFIs into existence is upheld unconditionally. In order to do so, they must act with undivided loyalty, within the delegated power given by the institution, which is in *Shariah*-related matters. For that reason, in jurisdictions with higher numbers of talent, like Malaysia, a *Shariah* expert cannot be appointed to be the member of multiple *Shariah* committees in the same industry at the same time.⁶⁷ This is to avoid the occurrence of a conflict of interest that could possibly be detrimental to the beneficiaries.

⁶⁴ See also CBO, *Islamic Banking Regulatory Framework* (CBO 2012).

⁶⁵ *Amanah* based contract means the contract that construed based on trust, whether it is explicitly or implicitly mentioning about the delegated tasks to be executed. The agency contract for instance is one of the contract with implicit tasks, and the *mudarah* contract is a contract with an explicit task entrusted to the agent as trustee.

⁶⁶ A *Shariah* committee, an independent body of specialised jurists in Islamic commercial jurisprudence; See also AAOIFI, Governance Standards no. (1): *Shariah* Supervision Body, Appointment, Composition and Report Standards in AAOIFI (eds) *Accounting, Auditing and Governance Standards* (Almainan Publication and Distribution, Manama 2015) 885.

⁶⁷ BNM, (*Shariah* Governance Framework for Islamic Financial Institutions 2010) 20.

From a governance viewpoint, the *Shariah* experts are also subject to accountability and transparency. As gate-keepers, they are accountable for the effects of any actions and decisions taken within the delegated power towards the shareholders, as the contractual owners, and to the stakeholders, as implied through the reason of the existence of the IFIs. In this sense, the mutual interest of the stakeholders of the IFIs, especially the shareholders, rests on the idea of *Shariah* compliance. Apart from that, they are required to be transparent. All actions and decisions ought to be clearly recorded and timely reported to the relevant parties respectively.⁶⁸ Any incidents of *Shariah* non-compliance, for instance must be promptly reported for immediate actions.⁶⁹ However, be noted that the institutional loyalty of *Shariah* committee does not simply means that they should favour the clients at any cost. In executing their duty as fiduciaries, they are to be independent in order to act and decide in accordance with the best virtues of the *Shariah* law. If the resulting decisions and actions are in conflict with such a notion, it is actually an act of disloyalty as fiduciaries to the stakeholders as beneficiaries and could be perceived as a blatant breach of contract. The main function of the *Shariah* committee members here is somehow to play the role of *Shariah* law practitioners. Whether the law is as codified as the law of the land or provided by the standard setter as a followed standard, *Shariah* experts are the catalysts who have the capability to interpret *Shariah* law into action by ensuring it adhered to by the relevant parties.

It is also imperative to note here that, the nature of loyalty of institutional *Shariah* committees is heterogeneous with the central *Shariah* committee. The central *Shariah* committee is a supportive authoritative body, assisting the central bank in Islamic financial policy-making and implementation supervision. That is the reason why it functions as a referral to institutional committees in the case of unresolvable issues at institutional level. On the other hand, institutional *Shariah* committees within the IFIs play the roles of market-players. Their function as advisors or supervisors in *Shariah*-related matters should not be perceived as policy making-process as if they are in the central bank. On the account of this, their decisions and actions are subject to confidentiality.⁷⁰

7.3.1.1.2 Duty of Care of *Shariah* Committee

The duty of care of the *Shariah* committee indicates a task to make a prudent judgement when taking decisions in *Shariah*-related matters.⁷¹ Each *Shariah*

⁶⁸ The G20/OECD Principles of Governance requires stakeholders to have access to relevant, sufficient and reliable information on a timely and regular basis regarding the firm, regardless of the nature of the business. See also OECD (n 63) 34.

⁶⁹ IFSB, (Guiding Principles on *Shariah* Governance Systems for Institutions Offering Islamic Financial Services 2009) 6.

⁷⁰ See also BNM, (SGF 2010) (n 67) 20; OECD (n 63) 34.

⁷¹ IFSB, (IFSB-10) (n 68) 11.

issue should be attended to with full effort in capacity and fair in judgement. In doing so, they ought to possess a 'fit and proper' criteria of knowledge in *Shariah* law, especially in *fatwa* deduction procedures. This is to enable the committees to conduct adequate *Shariah* reviews on the IFIs' business affairs with the correct *Shariah* perspective. In doing so, it is an unavoidable requisite that a member of a *Shariah* committee ought to master skills in *ijtihad*. *Ijtihad* is a mandate given by the stakeholders to *Shariah* committees to discharge under the umbrella of duty of care and due diligence. This process is rather sensible from the customer perspective as a *fatwa* deducted by *ijtihad* conducted by *Shariah* experts has the capacity to relieve ordinary customers from the burden of doing such a *Shariah*-related due diligence procedures.⁷² This *fatwa* endorsement is believed to be a crucial means in enhancing customer confidence, that such a product or service has already gone through a due diligence process and adheres not only to the relevant governing laws but has also been scrutinised by the experts on its compliance with *Shariah* law.⁷³ That is the reason why any *fatwa* endorsed by respective *Shariah* committees is a binding verdict for the representative IFIs.⁷⁴ In this vein, Ginena and Hamid emphasise the authority possessed by the *Shariah* committee, especially, at the central bank level, on the *Shariah* matters.⁷⁵

Taking this into account, all *Shariah* committee members, whether individually or collectively, are required to have the capability to act in good faith with their full capacity. The capability of executing *ijtihad* to determine *Shariah* perspective on a certain product or service is one of the key elements of the success of the IFIs thus far. Since Islamic finance is exploring many grey areas of *Shariah*-compliant financial approaches, this task is rather exhaustive and requires a thorough execution. Therefore, the upcoming part of this chapter will be dedicated to a deeper excavation of *ijtihad*, so it can be substantiated in a more proper manner, to support the objective of this research.

7.3.2 *Shariah* Committee Functions

Since the reason of the existence of the IFIs is to operate in compliance with *Shariah* law, there must be a governance mechanism committed to ensuring this

⁷² Yusuf Talal Delorenzo, 'Shari'ah Compliance Risk' (2007) 7 (2) Chicago Journal of International Law 397, 398.

⁷³ See also Malek Marwan Yousef Injas and others, 'The Importance of *Shariah* Supervisory Boards (SSBS) in the Islamic Banking System' (2016) 9 (2) South East Asia Journal of Contemporary Business, Economics and Law 25.

⁷⁴ AAOIFI, Governance Standards no. 1: *Shariah* Supervision Body, Appointment, Composition and Report Standards in AAOIFI (eds) *Accounting, Auditing and Governance Standards* (Almainan Publication and Distribution, Manama 2015) 885; Central Bank Act 2009 (Malaysia).

⁷⁵ Karim Ginena and Azhar Hamid, *Foundations of Shari'ah Governance of Islamic Banks: The Role of Sharia Supervisory Boards, Internal Audit and Advisory Firms* (John Wiley and Sons 2015) 316.

to happen. In doing so, there comes the *Shariah* committee, an independent body of jurists specialising in Islamic commercial jurisprudence.⁷⁶ It is entrusted with the duty of directing, reviewing and supervising the IFIs where the role of the utmost importance is ensuring the implementation of *Shariah* compliance in the IFIs' operational systems, especially on products and services offered to the market. As far as this research is concerned, recent developments of this type of governance mechanism have shown positive enhancement, namely in terms of the roles of the *Shariah* committee and its organisational arrangement.⁷⁷ In this vein, as mentioned by many standard-setters, the *Shariah* committee role is carried out through *Shariah* review and *Shariah* audit of the IFIs' *Shariah*-related matters, supported by internal *Shariah* division, consisting of internal *Shariah* review, internal *Shariah* research and internal *Shariah* audit.⁷⁸

7.3.2.1 *Shariah* Review Role

On many occasions, the *Shariah* review role is described in technical and organisational terms.⁷⁹ The *Shariah* committee is, amongst others, responsible for advising the board and the IFIs, especially on matters to be reported to the central bank *Shariah* council, endorsing *Shariah* policies and procedures, endorsing and validating relevant documents, assessing the work of the internal *Shariah* department and providing *Shariah* opinions.⁸⁰ In terms of execution, the *Shariah* committee will have *Shariah* meetings with internal *Shariah* department in a timely manner or if deemed necessary. Some standard-setters require the meetings to be held at least once in every two months.⁸¹ Decision-making is based on a majority vote by *Shariah* background members, if the committee also membered by other background experts.⁸² Apart from that, the *Shariah* committee may also nominates one of the members, commonly its chairman, to carry out consultation if the case is urgent.⁸³ Any non-compliance issue if occurred should be recorded and reported to the board. During this event, the

⁷⁶ It is also known as the *Shariah* Supervisory Board (SSB) by AAOIFI *Shariah* Governance Standard; See also AAOIFI, Auditing Standard No. (1): Objective and Principles of Auditing in AAOIFI (eds) *Accounting, Auditing and Governance Standards* (Almainan Publication and Distribution, Manama 2015) 885.

⁷⁷ The discussion on the related multilateral bodies responsible for the development was depicted at the earliest stages of this research.

⁷⁸ See also IFSB, (Guiding Principles on *Shariah* Governance Systems for Institutions Offering Islamic Financial Services 2009) 18-19; BNM, (SGF 2010) (n 67) 20.

⁷⁹ See also also the discussion on the standards issued by the AAOIFI, IFSB and BNM in the previous chapters.

⁸⁰ BNM, (SGF 2010) (n 67) 35.

⁸¹ *ibid* 36.

⁸² AAOIFI Standards suggest the attendance of the experts of relevant areas to enhance the capability of a *Shariah* committee.

⁸³ If there is any *Shariah* decision taken through consultation, it must be reported to the *Shariah* committee in the upcoming meeting.

Shariah committee is responsible for providing and suggesting the best solutions possible for the rectification process.

From the *Shariah* perspective, the reviewing function executed by the *Shariah* committee is an exercise of *ijtihad* or a deduction procedure of *Shariah* law to derive and apply *fatwa* on financial matters.⁸⁴ The principles referred to by the exercise are as thoroughly discussed in the previous chapter. However, there are two different methods apprehensible as far as this research is concerned, which are the *Shariah*-compliance and the *Shariah*-based. In terms of operations, the IFIs are commonly assembling and mix-matching two or more *Shariah* financial contracts to construct an alternative product that behaves similarly to a conventional product.

7.3.2.2 Internal *Shariah* Compliance Department

As mentioned by many standard-setters, the internal *Shariah* division consists of the internal *Shariah* review, internal *Shariah* research and internal *Shariah* audit. The internal *Shariah* division is the eyes and ears of the *Shariah* committee in the IFIs' day-to-day operations. This function allows the IFIs to endure *Shariah* issues on a daily basis which sometimes might well in need to prompt decisions and actions from the respective governance constituents. In this vein, some researchers argue that the *Shariah* governance organs have intermingled functions, active and reactive.⁸⁵ Perhaps the most comprehensive model of the recent application is the Malaysia *Shariah* governance structure, as promoted by the *Shariah* Governance Framework 2010 (SGF).⁸⁶

⁸⁴ This issue will be discussed further to make it more comprehensive in the upcoming subtopic.

⁸⁵ International *Shariah* Research Academy for Islamic Finance, *Islamic Financial System Principles and Operations* (2nd edn ISRA Publication 2016) 731.

⁸⁶ The Malaysian *Shariah* Governance model is favoured by many researchers as a reference. This is due to its comprehensiveness, and clarity in terms of its operational aspect. Therefore, as far as this research is concerned, the understanding of this part of the chapter will be more conclusive if such a model is utilised as a reference.

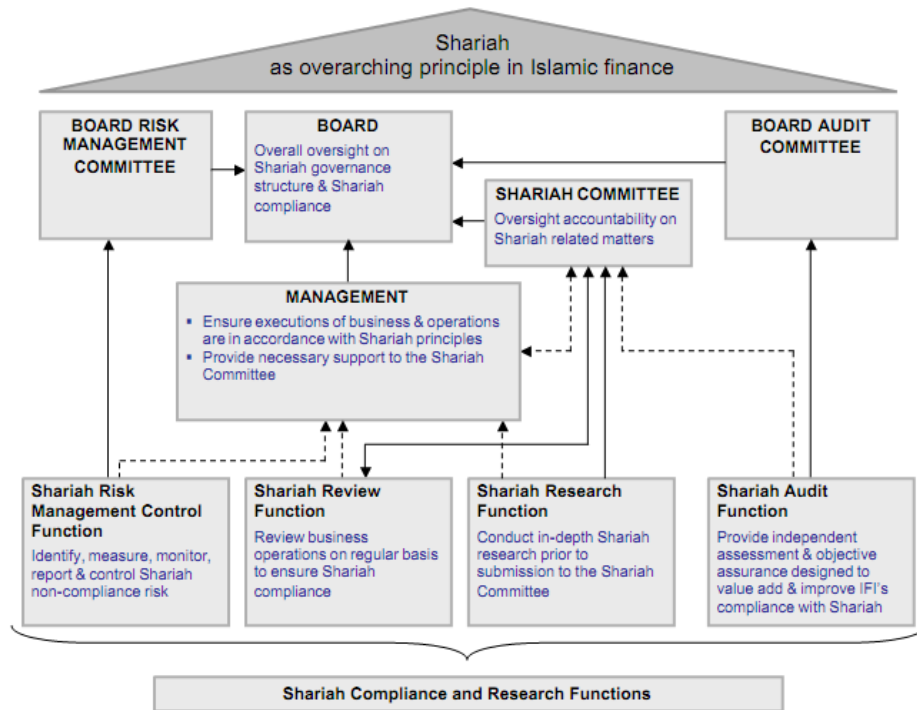


Table 7 : Shariah Governance Structure

By looking at the above *Shariah* governance structure, we can see that the organisational arrangement of *Shariah* compliance consists of the *Shariah* committee as the highest reviewer, assisted by the internal *Shariah* review, internal *Shariah* research and internal *Shariah* audit. It also shows that the *Shariah* committee is situated directly under the board of directors. Due to the fact that the delegated power is only on *Shariah*-related matters, whereas wholly institutional oversight such as business strategy remains with the board members to decide, the board of directors is still on the highest hierarchy holding overall responsibilities. As long as the *Shariah* committee is independent from the board's influence, this type of organisational arrangement is believed to be adequate to execute the obligatory duty diligently with true and fair judgement. The functions are carried out with the support of the internal *Shariah* division. Under this model, there is a direct connection between the internal *Shariah* division with the *Shariah* committee, which is also a two-way communication, whilst the communication with other governance constituents is more on procedural and managerial aspects. Notably, the interaction between the *Shariah* committee with the internal *Shariah* audit is rather limited. Under the SGF model, the internal *Shariah* audit reports to the audit committee and may communicate with the *Shariah* committee, but the deliverables are subject to audit committee approval to ensure standards of reporting as required by accounting standards.⁸⁷

⁸⁷ Zurina Shafii and others, 'Post Implementation of Shariah Governance Framework: The Impact of Shariah Audit Function Towards the Role of Shariah Committee'

Interestingly, at Central Bank of Oman (CBO), the internal *Shariah* audit unit presents its report to the *Shariah* committee known as the *Shariah* Supervisory Board with a copy should be presented to the audit committee of the board.⁸⁸ This feature is considered evidence of the flexibility in terms of the implementation of AAOIFI *Shariah* governance and auditing, which is commensurable with the market proportionately. One size does not fit all after all.

7.3.3 Role of *Ijtihad*

In order to comprehend the notion of *Shariah* compliance, it is imperative to further investigate on the role of *ijtihad*, which is the primary instrument to achieve it. *Ijtihad* is an action involving maximum effort expended by *Shariah* scholars to master and apply the principles of *Shariah* jurisprudence as to discover the law from Islamic legal sources.⁸⁹ *Ijtihad* is, especially in the case of Islamic finance, a living example of the scholarship of *Shariah* scholars on jurisprudence, extended from the early era of Islam until now.⁹⁰ With regards to the task of the *Shariah* committee, *ijtihad* is the procedural requisite to seeking for the *Shariah* rulings of the products or services that are about to be offered. This is the 'behind the scene' of *Shariah* compliance matters. It is the duty of care and due diligence of the *Shariah* experts towards *Shariah* and therefore, to carry it out, they ought to be equipped with the wisdom of a deep understanding of *Shariah* sources.

Ijtihad is one of the authorities in the hands of *Shariah* scholars. This is in part because, the *fatwa* or verdict deduced by a *mujtahid* has a great influence in the legal, political and social dimensions of the Muslim life.⁹¹ Therefore, to allow a *Shariah* expert to devote himself to *ijtihad*, a strict prerequisite quality as qualification is a necessary duty to be embarked, so he could be recognised as a legitimate *mujtahid* with a 'fit and proper' criteria.⁹² This is due to the fact that the Quran and the Hadith do not specify the law as it might be stated in a detailed manner, but merely a set of rulings and indications that lead to the *illah* (*ratio*

(2013) 13 Middle-East Journal of Scientific Research (Research in Contemporary Islamic Finance and Wealth Management) 7, 8.

⁸⁸ CBO, General Obligations and Governance in CBO (eds) *Islamic Banking Regulatory Framework* (CBO 2012) 26.

⁸⁹ Kamali (n 56) 468.

⁹⁰ See also Wael Hallaq, 'Was the Gate of *Ijtihad* Closed?' (1984) 63 International Journal of Middle East Studies 3.

⁹¹ Ginena and Hamid (n 75) 318.

⁹² A *mujtahid* must be an expert in Quranic and hadith interpretation relating to *Shariah* law, the list of the consensus of the scholars, conditions of *qiyas*, Arabic language, text abrogation, and so on; See also NA al-Baidawi, *Minhaj al-Wusul ila 'Ilmi al-Usul* (Dar Ibn Hazm 2008) 250.

decidendi).⁹³ Commencing from these indications and remarks, *mujtahids* carry out *ijtihad* by employing, for example, the procedure of analogical reasoning (*qiyas*) to discover rulings for unprecedented cases.⁹⁴ The effort to acquire an in-depth understanding of Islamic jurisprudence is somehow more important than the effort to understand the substance of Islamic law itself.⁹⁵ The comprehension of the Islamic financial law is merely the surface of *Shariah* and scholars are in need of deepening their skills in other aspects of *Shariah* law: namely, its procedural and jurisprudential principles.

7.3.3.1 Objective of *Ijtihad*

The chief objective of *ijtihad* is to understand the effect of communication of the divine messages or to determine which rules apply to the real world.⁹⁶ It is an effort by the *Shariah* scholars, who are humans, to find the connection between the divine aspects of the *Shariah* and the reality of human life. The human realm is not a perfect world, or rather it is its imperfection that makes the world perfect. Therefore, it is important to note that the process of law deduction in *Shariah* is the process to bring down the divine nature of the messages to earth by fitting it into human reality so it could be as close as it is ideally prescribed by God. The more the understanding obtained by the scholars in the messages, the closer the *Shariah* gets to the subject. In the process, as assurance of a definitive deliberation, the authentication of the messages is at the most important procedure, before jumping into the interpretation step as well as the conclusion.

The prohibition of *riba* for instance, has triggered concern amongst the conventional economists that it could bring failure to the institutions offering products in compliance with such a notion. As mentioned before, it might be the most controversial feature of the IFIs in the modern interest based financial system. In this vein, the task of *Shariah* experts therefore is not merely to bring up the proofs of these prohibitions or the admissibility. They are also duty-bound to manifest how the IFIs might survive in a market that is moving in the opposite direction from what they uphold, so the market could put confidence on such a business approach. This is the reason why *ijtihad* is considered as an exhaustive task that would take all of the disposable mental effort, an expert could confer.

⁹³ Kamali defined *illah* as effective cause. See also Kamali (n 56) 275; See also Hallaq (n 90) 4.

⁹⁴ Examples on *qiyas* application will be articulated in the subtopic on the prohibition of *riba*.

⁹⁵ Imran Khan Nyazee, *Theories of Islamic Law* (The Other Press, Kuala Lumpur, 2002) xi.

⁹⁶ MA Laldin and others (n 11) 167.

7.3.3.2 *Shariah* Committee *Ijtihad* Mechanism

To date, there is no specific writing depicting the method of *ijtihad* conducted by the *Shariah* committee. Other than general explanation on *fatwa* deduction process or *ijtihad*, it remains at the discretion of the experts in the field, owing to the complexity of the skills. In relation to this, thus far, there are international *Shariah* standards issued by the AAOIFI. These standards are considered as one of the compendia of contemporary *Shariah* law in Islamic finance.⁹⁷ The publication of the compendium is done through its *Shariah* board, which is composed of nearly twenty members of *fiqh* scholars or *Shariah* experts, who represent both the central or institutional *Shariah* committees of the respective members globally. By having such a wide range of experts, the *Shariah* standards should achieve harmonisation and convergence in the concepts and application among the *Shariah* committees, in order to avoid contradiction and inconsistency between *fatwas*.⁹⁸ At the national level, the central bank *Shariah* committee adopts the standards proportionately to market behaviour and the local *Shariah* legal school. Despite flexibility in adoption, the AAOIFI's *Shariah* standards, have provided referral *fatwas* for the IFIs as a benchmark of their *Shariah* committees' *ijtihad* processes.

By looking at this multilevel referencing system, and as depicted in *Shariah* governance models,⁹⁹ perhaps it is worth noting that the *ijtihad* process at institutional level is more of an adoptive *ijtihad* (*ijtihad tanzili*). In most cases especially after the formation of the multilateral standard-setters and the issuance of national standards by the central bank, the *ijtihad* of the *Shariah* committee is not an attempt to start from square one anymore. However, under the shadow of this complexity, there are two methods recognisable from the literature: the *Shariah*-compliant and the *Shariah*-based.¹⁰⁰ By applying the *Shariah*-compliant method, the notion of this research, the *Shariah* committee will review the products by looking at any non-permissibility in terms of the given principles, and if any, rectify the non-permissible features. On the other hand, the *Shariah*-based method is an initiative to formulate a financial product from the desired virtues promulgated by *Maqasid Shariah*, which is mostly by building the contract based

⁹⁷ Other than AAOIFI, the *fatwa* compendium endorsed by Dallah Baraka and Kuwait Finance House are also recognisable as the international references.

⁹⁸ AAOIFI, *Sharia'ah Standards* (Almainan Publication and Distribution, Manama 2015) 28.

⁹⁹ See also Chapter 3.

¹⁰⁰ Some experts such as MB Bakar and ER Adawiyah considered the segregation of the both methods as quite paradoxical and more to academic purposes. To determine the right *Shariah* perspective on any financial product hence its permissibility or non-permissibility, it must have gone through the *Shariah*-based thinking method.

on certain *Shariah* financial principles rather than combining it or resolving on its compliant aspects.

As far as this research is concerned, whether the *Shariah*-compliant or the *Shariah*-based method, the both approaches will end up with the combination of multiple *Shariah* contracts either way in order to make them operational. This is in part because the segregation of the *Shariah* financial contracts is done by the jurists for the sake of theoretical development. The reality is, when it comes to the formation of an operational product, the scattered topics will be brought together into one place. This is the crucial part of the understanding of the nature of the *fiqh* discussion, especially in the case of real-world applications. For instance, looking at the *mudarabah* partnership principles, at first glance, this PLS-based contract stands alone without needing any supportive contract to make it operational. However, it should be noted that, the agent (*amil*) is a person who would manage the business on behalf of the investor (*rabb mal*). At this level, the investor is actually delegating his right to manage his wealth to another person who works for him as an agent. Whether or not it should be confirmed in black and white, as documented proof, the agency contract is applicable.

Apart from that, determining compliance is a continuous responsibility for Muslims. The Quran and the Hadith on most occasions depict general principles for humans to follow and it is up to them to make decisions on those bases. It is an unavoidable feature of life. Let alone the nature of financial market, which relentlessly evolves and behaves with unimaginable changeability. Whether the *Shariah*-compliant or the *Shariah*-based approaches are involved, the both are invariably in need of innovation in order to stay relevant, whereas *Shariah* is believed to be always relevant. As far as this research is concerned, the methods are merely the effects of *Shariah*'s multi-dimensional approaches to a certain aspect of human action. Whether the action is a product fabricated from a well-depicted *Shariah* principle, or an idea to be evaluated from the *Shariah* point of view, as long as the result remains under the same umbrella, which is *Shariah* compliance, the strategy is to be left to humans to choose.

To wrap up, *Shariah* supervision is the key to *Shariah* compliance. The governing law might be the mechanism to define what *Shariah* compliance is, but the real deal depends on the supervision mechanism available as a profoundly fundamental tool to uphold the rule of law. However, due to Islamic finance peculiarities, the fiduciary duty of the *Shariah* committee in this vein is not completely similar to the conventional counterparts. *Ijtihad* as the centre of *Shariah* supervision is crucially significant to carry out the due diligence role to secure IFIs' adherence to *Shariah* law. It is because of this that the IFIs are in need of *Shariah* experts. Nevertheless, the supervisory functions of the *Shariah*

governance still to be observed by another layer of a check-and-balance mechanism, which is the *Shariah* audit. This third mechanism is an attempt to ensure not only the flow of funds to be in accordance with *Shariah* but also that the *Shariah* compliance process goes beyond on paper requirements.

7.4 *Shariah* Audit Mechanism

As far as *Shariah* is concerned, *Shariah* audit is based on the principle of *hisbah*. It is an operational mechanism, derived from the *Shariah* virtue to preserve goodness and prevent harm. Under the *Shariah* purview, *hisbah* is a vital mechanism in ensuring public safety, including monitoring the market.¹⁰¹ Classic implementations of *hisbah* include internal and external mechanisms. As an internal mechanism, *hisbah* is one of the main structures to supervise and monitor the market. Any misconducts carried out by a citizen is under *muhtasib*'s jurisdiction. It possesses the power to protect the citizen from malpractices done by business associates.¹⁰²

As an external mechanism, the *hisbah* institution is an audit mechanism to monitor the government. The head of the *hisbah* department is one of the members of the highest council in the government. He is empowered to monitor the decisions and actions taken by the caliph to ensure that it is complies with *Shariah* law. Ibn Taymiyah asserted that *hisbah* is the monitoring mechanism carried out by authorities to supervise the personnel or institutions under their jurisdictions, which is mostly accommodated by the military, police, governors or even treasury officers.¹⁰³ It executes the duty to assure the implementation of supervised areas to follow the pre-proposed conception. If we look it from a governance perspective, *hisbah* could be perceived as a supervision and audit mechanism, to oversee the relevant division as assurance of its adherence to the predetermined virtues respectively.

On the basis of the discussed principles, the *Shariah* audit is defined in two approaches, value-centric and financial plus *Shariah*-centric, due to the interconnected profit and non-profit nature of the IFIs.¹⁰⁴ Under the former approach, the *Shariah* audit is defined as an independent assessment that is conducted on a periodical basis in order to improve the degree of compliance and to ensure a sound and effective internal *Shariah* control system for *Shariah*

¹⁰¹ Abdul Karim Abdullah, 'Harking Back to Hisbah, Accountants Today' (April 2010) 12, 13.

¹⁰² MA Khan, *An Introduction to Islamic* (Economics International Institute of Islamic Thought and Institute of Policy Studies 1994) 83-84.

¹⁰³ Ibn Taymiyah, *al-Hisbah fi al-Islam* (Dar al-Fikr 1992) 11.

¹⁰⁴ Injas and others (n 73) 26.

compliance in the institution.¹⁰⁵ On the other hand, under the latter purview, it is conceptualised in terms of the peculiar need of the IFIs for specific methods of accounting to cater to *Shariah* compliance.¹⁰⁶ Both approaches however are in agreement that it is a process of assuring the integrity of the *Shariah* compliance supervision. It includes the administrative division of the supervision, the *fatwa* or ruling deduction procedures and the implementations of the endorsed rulings. As repeatedly mentioned by this research, the IFIs are operating with adherence to *Shariah* law. To satisfy with such a specific objective, the *Shariah* audit mechanism has to be the governance constituent that works as the controlling function to conform the achievement of such a notion.¹⁰⁷ This is the benchmark of the confidence of the shareholders and other stakeholders in the IFIs.

As observed, *Shariah* compliance process has a connotation of interiority. This is in part because as the main function of the *Shariah* committee is to review the practice of the IFIs from a *Shariah* perspective,¹⁰⁸ the conformity with *Shariah* is monitored from the *ex-ante* process where any non-compliance is the responsibility *Shariah* committee.¹⁰⁹ Such a stage should ensure that any approved product offered to the market has already been scrutinised and granted its *Shariah* permissibility by the committee internally. On the other hand, despite the existence of the internal *Shariah* audit department, *Shariah* audit functions are, arguably, exterior. As the third defence of a check-and-balance mechanism, the exteriority of the *Shariah* audit is crucial as an assurance that represents independence in the assessment since the audit is associated with independent verification of the truth and fair scrutiny of the information.¹¹⁰

The *Shariah* audit mechanism differs from the conventional auditing system in terms of its foundation. Aside from merely focusing on auditing the technical aspects, such as verifying the accounting and transactional accuracy, the *Shariah* audit supersedes this by looking forward to the operational and financial reviews, with commentary on the strategy, performance and quality of management.¹¹¹ It has a larger scope of auditing, which from the conventional concept of attesting

¹⁰⁵ BNM, (SGF 2010) (n 67) 23.

¹⁰⁶ See also Moustafa F Abdel-Magid, 'The Theory of Islamic Bnking: Accounting Implications' (1981) 17 (1) International Journal of Accounting 79.

¹⁰⁷ BNM, (SGF 2010) (n 67) 23.

¹⁰⁸ AAOIFI, Governance Standards no. 3: Internal *Shariah* Review in AAOIFI (eds) *Accounting, Auditing and Governance Standards* (Almainan Publication and Distribution, Manama 2015) 899.

¹⁰⁹ See also Zulkifli Hassan, 'A Survey in *Shariah* Governance Practices in Malaysia, GCC Countries and the UK' (2011) 4 (1) International Journal of Islamic and Middle Eastern Finance and Management 20, 36; Ginena and Hamid (n 75) 329-335.

¹¹⁰ See also Aasmund Eilifsen and others *Auditing and Assurance Seriveces* (3rd Eds McGraw-Hill 2014).

¹¹¹ A Banaga and others, External Audit and Corporate Governance in Islamic Banks: A Joint practitioner-academia Research Study (Avebury 1994).

and authority to reporting on various social and economic aspects of business organisations.¹¹² As asserted by Kassim, it is expected to be extensive, detailed and complex, expressing opinions on honesty, regulatory, economy, efficiency or effectiveness, or reporting any incidences of fraud, malpractice in administration, or failures to attain a goal.¹¹³

7.4.1 Shariah Audit Objective

The objective of a *Shariah* audit is supposedly in-line with *Maqasid Shariah*, which to preserve goodness and prevent potential harm from occurring, to ascertain institutional sustainability. Therefore, the extensiveness of the *Shariah* audit is beyond the conventional model, as mentioned above. As observed, the objective of the *Shariah* audit is to enhance the credibility of the financial statement. It is done by having an external auditor to give opinion on the financial statement with true and fair views. Additionally, through independent assessment and objective assurance, the *Shariah* audit is designed to value add the degree of compliance with the objective to ensure a sound and effective internal control system for *Shariah* compliance is in place.¹¹⁴

The objectives mentioned earlier are attained through ensuring the flow of funds is in accordance with *Shariah*. Sources of funds must be originated from permissible activities, and they should be spent in the same way. Most importantly, it must not have any direct connection with activities deemed as non-compliant with *Shariah*.¹¹⁵ The most important focus is on the *zakah* expenditure, which is consisting of 2.5% of the profitable margin, to be given to a group of people who are in need, as assigned by *Shariah*. Other than that, the auditors are to assert the choice of contracts applied to products and services. The contracts must be appropriate and capable of accommodating the nature of the transaction. In this vein, it is best for the *Shariah* auditors to justify the available choices of contract, so it might well be referred to for future transactions or even in the case of potential disputes.

Somehow, the *Shariah* committee is on most occasions prior to the formation of such mechanisms only given a chance to look at the product structure, legal

¹¹² Abu al-Hassan Ali bin Muhammad bin Habib Al-Mawardi, *Al-Ahkam al-Sultaniyyah* (Dar al-Hadith 2006) 367.

¹¹³ Nawal Kassim et al, 'Assessing the Current Practice of Auditing in Islamic Financial Institutions in Malaysia and Indonesia' (2013) 4 (6) *International Journal of Trade, Economics and Finance* 414, 415.

¹¹⁴ BNM, (SGF 2010) (n 67) 23.

¹¹⁵ See also Muhammad Akram Khan, 'Role of Auditor in Islamic Economy' (1985) 3 (1) *Journal of Rec Islamic Economy* 31.

documentation and the marketing collateral related to the product.¹¹⁶ Therefore, as an effort to improve the *Shariah* audit mechanism, *Shariah* committee members are required to play a more interactive role. This is done by enhancing the reviewing function of the *Shariah* committee which at a certain point is akin to an advisory role rather than a monitoring role.¹¹⁷ By enhancing their role in *Shariah* audit process, *Shariah* committee members would be able to engage and become involved with the operational aspect of the IFIs, rather than merely in a theoretical aspect.

7.4.2 *Shariah* Audit Scopes

The scopes of audits are part and parcel of the standards issued by the Islamic finance standard setters, notably the AAOIFI and the BNM. At the international level, the AAOIFI Auditing and Governance Standards state that the audit scope refers to the audit procedures deemed necessary by the auditors, in order to achieve the objective of the audit. The standard also emphasises that the auditors should determine the appropriate requirement by Islamic rules and principles (*Shariah* compliance), the Auditing Standard for Islamic Financial Institutions (ASIFI) and the International Standard on Auditing (ISA) in executing the audit process.¹¹⁸

By virtue of this, national standard-setters have issued their own *Shariah* audit scopes through relevant standards, taking into account the peculiarities of the market proportionately. In this vein, in the case of Malaysia, for instance, the *Shariah* auditing scopes as suggested in BNM *Shariah* Governance Framework 2010 include the audit of the IFIs' financial statements, compliance audit on organisational structure, people and process, and reviews of the adequacy of the *Shariah* governance process.¹¹⁹ On the other hand, in the case of Oman, under the CBO Islamic Banking Regulatory Framework, the scopes of *Shariah* audit encompass the examination and evaluation of the adequacy and effectiveness of the Licensee's (bank) system of *Shariah* compliance and the quality of performance in carrying out the responsibilities.¹²⁰

Regardless of market uniqueness, it is not an overstatement to say that the existing scopes thus far are focusing mostly on the financial technicality, namely the financial statement, as this type of discipline has been developed from such

¹¹⁶ Shafii and others (n 87) 8.

¹¹⁷ *ibid* 10.

¹¹⁸ AAOIFI, Auditing Standard No. (1) (n 76) 816.

¹¹⁹ BNM, (SGF 2010) (n 67) 24

¹²⁰ Central Bank of Oman, General Obligations and Governance in CBO (eds) *Islamic Banking Regulatory Framework* (CBO 2012) 23.

an industry. Without denying the importance of the conventional auditing system, a *Shariah* audit scope should be more 'engaging' with *Shariah* issues endorsed by the *Shariah* committee and other relevant parties. It should include different elements of focus which could lead to auditing the '*Shariah* compliance' rather than merely the '*Shariah* compliance process'.¹²¹ In order to do so, there must be an emphasis on ruling implementation, which secures the *Shariah* not merely by letter but must also by virtue.¹²²

Complying with the ruling in terms of its permissibility, for instance, has been the focus of the relevant *Shariah* governance constituents. However, the IFIs still facing a crisis of trust especially in the eyes of Muslim communities. There has been a perception that IFIs as backdoor *riba* institutions. Regarding this, as financial institutions, the IFIs were somehow viewed as manipulators of the Islamic financial contract in order to achieve the same goal as the conventional financial system. One of the reasons is the lack in *Shariah* virtue in the *Shariah*-compliant contracts. The products might already be *Shariah*-compliant in technical terms, but similar to the conventional products in substance. By that token, it is imperative to note here that the duty of the *Shariah* audit is not to put aside the virtue and substance of the *Shariah* ruling endorsed by the *Shariah* committee. It is the responsibility of the auditors to pick up this loophole, if any, especially in the products and services offered to the market.

As a conclusion, the *Shariah* audit is a profound mechanism of *Shariah* governance. It functions as a mechanism to double check, not only the IFIs' accounting system but also the *Shariah* compliance process. The objective is to gain and enhance stakeholders' confidence, especially of those Muslim customers who see *Shariah* compliance assurance done by the *Shariah* committee as their way to be released from the burden of doing so themselves. In terms of its structural arrangement, *Shariah* audit resembles the conventional model yet deploys specific additional tasks. As for that, traditional auditing skills are not fully sufficient to carry out the prescribed duty. To that end, the regulators, as one of the stakeholders, need to be made aware of this, so they can be ready

¹²¹ Other issue of the utmost concern in *Shariah* audit is the lack of numbers in the talent pool of *Shariah* auditors. This is due to the infancy of the discipline, which is closely in collaboration with the younger age group in the Islamic financial market compared to the conventional counterpart. Empirical study has revealed that one of the reasons for this is the incoherence between the auditors' talent pool and the need of the Islamic financial market. The *Shariah* auditors are mostly educated either in *Shariah* or conventional audit, separately, whilst the market needs an auditor to be an expert in both, conjointly; See also NA Ali et al, 'Competency of *Shariah* Auditors in Malaysia: Issues and Challenges' (2015) 4 (1) *Journal of Islamic Finance* 22-30.

¹²² The virtue of the *Shariah* law is referred to the *Maqasid Shariah* as discussed previously.

with a more agile regulatory framework to facilitate such a characteristic in the Islamic financial industry.

7.5 Conclusion

Shariah governance mechanisms are structurally similar to their conventional counterparts. Owing to Islamic finance's unique principles, *Shariah* governance mechanisms have provided constructive supports to the IFIs towards achieving their organisational objectives. Close observation of these mechanisms has revealed the contributions of *Shariah* principles to the expansion of the corporate governance corpus. It also has proven the possibility of the intermingling of *Shariah* virtues with the system regardless of its religious inspiration. The search for enrichment of the values to be adopted into corporate governance research should not disregard such a potential.

In this vein, the governing law is the pillar mechanism of the *Shariah* governance. Without it, the idea of *Shariah* compliance would not be attained in the way it is supposed to be. It procures a cohesive framework in the way that how business institutions should be managed and controlled to make them achieving the sought-after virtues. Since the Islamic financial system is still in its infancy, its operational aspect must be observed and supervised under the scrutiny of the *Shariah* experts to ensure compliancy. As per discussed, the focus is on whether to secure *Shariah* compliance or to form the products from the *Shariah*-based conception. However, in the long run, the desired outcome is to make *Shariah* the solution for economic uncertainties, namely in the financial sector. That is the reason why the third mechanism, which is the audit system, has to be in place as well. Each layer of *Shariah* governance mechanisms somehow act as a defence mechanism that walks towards the same objective, which is to optimise firm values and ascertain sustainability in an Islamic way.

Chapter 8

Adopting *Shariah* Governance System into the UK Islamic Finance Market: Remarks and Observations

8.1 Introduction

After excavating the underlying principles of *Shariah* governance and the mechanisms relevant to ensure its implementation, this part of the research explores the possibilities to apply such principles and mechanisms into financial institutions offering *Shariah* compliant products and services in the UK. Broadly speaking, the UK is not a country dominated by its Muslim population and its legal system is based on the doctrine of secularism. However, due to its flexibility, English law is one of the choices made by the IFIs as reference for their contractual agreements. As seen in the case of *Beximco v Shamil*, English Common Law along with *Shariah* law are referred to by the contracted parties to govern their contracts respectively. Other than that, the UK Islamic financial market is progressing at a promising pace despite its non-Islamic legal and market environment. By saying that, there are aspects to be discussed under the purview of this research. The objective is to find out the way for the UK financial market and its relevant regulatory system to facilitate *Shariah* governance within the institutions offering *Shariah*-compliant products and services.

In order to do so, this chapter will be begun with the analysis of the recent development of Islamic finance in the UK. It is done by collecting the documents provided by several sources relevant to the discussion, especially reports published by authorities in Islamic finance in the UK. The focal point is on *Shariah* governance practices in the market to see what is happening in order to form a comprehensive understanding of the issue within grasp. Other than that, related legal provisions are also analysed to uncover the obstacles and challenges facing Islamic finance. Therefore, this chapter will discuss market and regulatory milestones of Islamic finance in the UK. It then will be pointing out remarks and observations relevant to the respective aspects in order to raise problematic issues for the implementation of a *Shariah* governance system and offer relevant insights as refinements.

8.2 Islamic Finance Footsteps in the United Kingdom

In general, the UK Islamic financial market is growing at a promising pace. The UK legal and regulatory system is a secular-based, and it is a non-Muslim dominant demographical region; nevertheless, the Islamic finance has proudly managed to tap into the UK financial market with astonishing achievements. Thus far, the UK is ranked as the leading Western centre for Islamic finance offerings.

It is argued that the development of the UK as a centre for Islamic finance has been the result of a range of supportive UK government policies which have created fiscal and regulatory frameworks intended to broaden the market for the IFIs to flourish in.¹

1970s	Shariah-compliant aviation leasing contract offered in London.
	London market brokers offer wholesale liquidity management using commodities.
1980s	Earliest Islamic mortgages offered in the United Kingdom by Albaraka Bank.
1997	Islamic mortgages offered in the United Kingdom by United Bank of Kuwait (Ahli United Bank).
2003	HSBC Amanah launches Islamic mortgages and bank account in the United Kingdom.
2004	Al Rayan Bank plc authorised (former Islamic Bank of Britain).
	Court case of Beximco vs Shamil Bank of Bahrain establishes principles that secular authorities cannot opine on Shariah compliance.
	ABC International Bank offers Islamic mortgages under Al Buraq brand.
2005	Children's Mutual launches Shariah-compliant Child Trust.
	Lloyds TSB offers Shariah-compliant current account
2006	European Islamic Investment Bank plc authorised (converted to investment firm in 2014-Rasmala plc, no longer authorised).
2007	Bank of London and Middle East plc authorised.
	Investment firm Amiri Capital authorised.
	FSA outlined regulatory approach to Islamic finance in 'Islamic finance in the United Kingdom: regulation and challenges'.
2008	QIB (UK) plc authorised (former European Finance House).
	Gatehouse bank plc authorised.
	British Islamic Insurance Holdings/Principles Insurance authorised (dissolved in 2015).
	Consultation paper CP-8/22 outlines the liquid asset buffer requirement for all banks.

¹ The City UK, (Global Trend in Islamic Finance and the UK Market 2017) 9.

2012	ADIB (UK) Ltd authorised.
	HSBC Amanah exited UK market.
2013	Cobalt Underwriting authorised.
2014	UK Government issues its first sovereign <i>sukuk</i> .
	Investment firm Arabesque Asset Management authorised.
2015	Islamic Insurance Association of London established
	Bank of England commences Shariah-compliant facilities (SCF) project.
2017	Shariah-compliant crowd-funding firm Yelders authorised.

Table 8: Islamic Finance in the UK: Timeline of Selected Events²

By observing the table above, the growth of Islamic finance can be addressed along two mapping viewpoints: market expansion, and legal and regulatory reform. Those two aspects are inseparable within a body of the discursive comprehension of the respective subjects under the purview of the *Shariah* governance mechanisms. The legal and regulatory aspects represent the approach of the governing law regime on the *Shariah*-compliant financial schemes and the market developments exhibit the confidence of the market players in the resiliency of the existing governing law to accommodate IFIs as legitimate institutions offering legal and legit financial products and services.

8.2.1 Market Expansion Milestones

The UK has proven to be conducive for both Islamic retail and wholesale finance. To date, there are five standalone institutions, offering Islamic finance, having an aggregate balance sheet of approximately 3.2 billion pounds sterling. On top of that, there are also 20 conventional financial institutions, offering *Shariah*-compliant windows, investment managements, and advisory and insurance sector institutions.³ Assets of the UK-based IFIs are estimated as up to 4.5 billion pound in total at the end of 2014.⁴ The UK is in first place in Europe and in fourth place among non-Muslim majority nations, after Singapore, Sri Lanka and South Africa.⁵

² Bank of England (Islamic Banks and Central Banking in Quarterly Bulletin 2017 Q3) 159.

³ *ibid* 157.

⁴ TheCityUK (The UK: Leading Western Centre for Islamic 2015) 4.

⁵ TheCityUK (Global Trend in Islamic Finance) (n 1); ICD-Thomson Reuters

Islamic finance made its first appearance on British soil back in the 1970s and has been no stranger ever since. Firstly, there was an Islamic aviation leasing contract offered in London. A significant progress was made in the 1980s with the earliest Islamic mortgages offered by Al Baraka International Bank Ltd. In 1982, Al Baraka Bank started its operation by taking over Hgrave Securities.⁶ Despite impressive accomplishments in early 1990s, Al Baraka Bank stopped its operations, due to, as asserted by al-Dohni, institutional structuring issues, rather than regulatory incompatibility or business failure.⁷ In 1997, United Bank of Kuwait, currently known as Ahli United Bank, started to offer Islamic mortgages in the UK. Apparently, through its *manzil* financing scheme, the United Bank of Kuwait managed to tackle the need of those seeking *Shariah*-compliant property financing, the gap left by Al Baraka Bank.⁸

In the following millennium, the IFIs have participated more aggressively in the UK financial market. In 2003, HSBC Amanah entered the market, offering Islamic mortgages as well as current accounts. This was followed by the establishment of Islamic Bank of Britain in 2004. The two banks, however, experienced closure and rebranding. Considering Islamic finance as outside of 'our risk appetite', the HSBC Amanah stopped its operations in 2014.⁹ In December of the same year, the Islamic Bank of Britain changed its name to Al Rayan Bank Plc, to reflect the status of its new parent company, Masraf Al Rayan, the fifth largest Islamic bank in the world. From a business strategy point of view, this was to explore a new and wider group of customers as the number of non-Muslim investors has increased.¹⁰ This strategy has delivered promising results through the bank increase its profit before tax year-on-year up to 32% annually.¹¹ In 2005, the Lloyds TSB launched its *Shariah*-compliant current account to the customers.¹² The first wholesale Islamic investment bank in the UK, the European Islamic Investment Bank (EIIB), also known as Rasmala plc, was established in the same year. In 2007, another wholesale Islamic investment bank, the Bank of London

⁶ Rodney Wilson, 'Challenges and Opportunities for Islamic Banking and Finance in the West: The United Kingdom Experience' (2000) 7 (1) *Islamic Economic Studies* 35, 40.

⁷ Abdul Karim al-Dohni, 'The Quest for a Better Legal and Regulatory Framework for Islamic Banking' (2015) 17 *Ecc LJ* 15, 34.

⁸ Wilson, 'Challenges and Opportunities for Islamic Banking and Finance in the West' (n 6) 49

⁹ This closure is regarded as one of the major business restructuring strategies taken by HSBC, which it happened globally.

¹⁰ <www.cityam.com/1414071782/islamic-bank-britain-gets-rebrand> accessed 20 February 2018.

¹¹ Al Rayan Bank (Annual Report and Financial Statement 2016) 8.

¹² <www.mediacentre.lloydstsb.com/media/pdf_irmc/mc/press_releases/2005/feb/islamic_account.pdf> accessed 20 February 2018

and Middle East plc (BLME) was granted its licence by the FSA. Rasmala Plc, however has recently lost its authorisation to operate by the FCA.

In 2008, two consecutive banks were authorised to operate *Shariah*-compliant banking, Qatar Islamic Bank (UK) plc and Gatehouse Bank plc. Since its first appearance, over 6,500 homes in the North West and the Midlands are currently being financed by a 700 million pound investment by Gatehouse Bank.¹³ On the other hand, QIB (UK) plc was formerly operated through European Finance House (EFH) before being rebranded as QIB (UK) plc.¹⁴ This was to bring the identity of EFH under that of its parent bank, QIB, the world's fourth largest Islamic bank in terms of assets. In 2012, Abu Dhabi Islamic Bank plc (ADIB) was authorised to start its operations in the UK. The focus of ADIB Bank is the customers from Gulf Cooperation Council (GCC) and Middle East and North Africa (MENA) countries.¹⁵ As one of the newest Islamic banks in the UK, ADIB Bank is still on its early stages but progressing in exploring the market. In 2014, the UK government issued a 200 million *sukuk*, the first sovereign *sukuk* issued by the a government outside the Islamic world.¹⁶ Maturing in 2019, the corresponding *sukuk* is considerably small as to the size UK financial market accumulatively, but this development has demonstrated the readiness of the UK government to explore Islamic finance as one of its future economic tools and the possibility of creating UK as a base for the Islamic financial market. This is proven by the second UK *sukuk* issued by the first British Islamic Bank, Al Rayan Bank plc, in 2018. The 250 million pound sterling denominated issuance is backed by UK mortgages with a maturity in 2052.¹⁷

The latest progress regarding the Islamic financial market in the UK is the authorisation of Yielders plc, a *Shariah*-compliant crowd-funding company. It is recognised as the first UK financial technological (fintech) company to gain a *Shariah* compliance certification from the FCA.¹⁸ Yielders is the latest form of banking and finance using the latest online fintech in offering their services. The first innovation brought by Yielders is a fully integrated proposition with

¹³ TheCityUK (The UK: Leading Western Centre for Islamic 2015) (n 4) 3.

¹⁴ QIB (UK) plc received authorisation to operate from FSA on 29 January 2008.

¹⁵ Abu Dhabi Investment Bank (ADIB Annual Report 2016), 33.

¹⁶ <www.gov.uk/government/news/government-issues-first-islamic-bond> accessed 26 February 2018.

¹⁷ <www.sukuk.com/article/first-british-bank-issues-sukuk-6774> accessed 26 February 2018.

¹⁸ <www.crowdfundinsider.com/2017/04/98411/yielders-claims-uks-first-islamic-fintech-firm-receive-full-authorization-fca/> accessed 26 February 2018.

investment selection, acquisition, value creation and placement on the platform to crowd investors.¹⁹

As a conclusion of the above, the UK market is apparently open to the Islamic finance to participate. Its religious identity somehow is not a detrimental factor for an IFI to gain market confidence and flourish. The uptrend in achievement stands as a solid proof of the great potential of what the UK market has to offer to the Islamic financial industry in the future. However, it is worth mentioning here that, based on the data shown, most of the IFIs that managed to tap into the UK market are Middle East-based financial and banking companies. One obvious possible reason to be highlighted here is their capital capabilities, which is akin to petrol-cash. As far as this research is concerned, this development has a direct connection to the governance system. It will be further explained in the upcoming topics.

8.2.2 Legal and Regulatory Developments

In terms of legal and regulatory aspects, despite the fact that Islamic finance started its operation in the UK since 1970s, there were no impactful developments until the early 2000s. In this regard, the Bank of England established the Islamic Financing Working Group chaired by Lord George, to investigate the obstacles faced by the Islamic finance industry and enable the development of Islamic finance in the UK.²⁰ It is under this occasion that the Finance Act 2003 was amended to allow stamp duty and land tax to be relieved for those who are utilising alternative property financing. To realise that, the FSA introduced the Home Purchase Plan (HPP) as a regulated mortgage contract, to regulate Islamic home-financing arrangements.²¹

The IFIs are financial business institutions, sharing similar features as to their conventional counterparts. Leading from that, the IFIs are likely to be bundled together with conventional companies or corporations offering deposits and financing despite their *Shariah* compliance principles. Other than the local legal frameworks where they operate, the IFIs are also subject to *Shariah* law as upheld in the *Shariah* compliance notion.²² Therefore, if we are to contemplate how would the IFIs might tap into the UK financial market, the knowledge of the English legal and regulatory approach to financial institutions with religious-based business arrangements is required. Regarding this, the regulations relevant to the IFIs are the Companies Act 2006, Finance Act 2003 and Financial Services

¹⁹ <www.yielders.co.uk/our-story> accessed 26 February 2018.

²⁰ Further discussion addressed in the UK Trade and Investment report in 2014, UK Excellence in Islamic Finance.

²¹ Financial Conduct Authority (The Perimeter Guidance Manual) 14.

²² Rodney Wilson *Legal, Regulatory and Governance Issues in Islamic Finance* (Edinburgh University Press 2012).

Act 2012.²³ Other than that, the IFIs are also the subject to related corporate governance codes to ensure best of practice accordingly. In this vein, it is necessary to note that the English legal system is the mother of the common law. Despite a close historical relationship to Christianity, the current English legal system is by far a secular-based law. As frequently happens in the common law system, there are small numbers of codified laws as oppose to a civil law, which it is developed instead by the judges through the doctrine of legal precedent.²⁴ It is by this virtue, on most occasions, the UK regulatory regime provides both, black letter and soft governing laws for the financial institutions to operate in its jurisdiction.

In connection to this, the UK regulatory system observes Islamic finance within the same unitary and principles-based framework as the conventional financial system. The institutions offering Islamic finance are not subject to dual regulation.²⁵ Therefore, in terms of licence, for instance, the IFIs have no exception. They are under the sphere of the Companies Act 2006 as well as other relevant financial regulations.²⁶ Accordingly, to establish a financial intermediary, first and foremost, application to obtain authorisation must be made to the relevant authorities. In this regard, all companies must be registered with the Companies House where the IFIs enjoy nothing less.²⁷ Additionally, as per the Financial Services Act 2012, regardless of their *Shariah*-compliant nature, the IFIs must obtain formal authorisation from and must meet the threshold conditions at all time as underlined by the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA).²⁸

Other than that, the mode of corporate structure must be decided, which is likely to reflect the business conduct proportionately.²⁹ By virtue of the Companies Act 2006, the IFIs must comply with the same provision in terms of corporate governance as adhered to by their conventional counterparts. In addition to that,

²³ These governing laws have direct connection to the *Shariah* governance.

²⁴ Joseph Dainow, 'The Civil and the Common Law: Some Pints of Comparison' (1966-1967) 15 (3) *The American Journal of Comparative Law* 419, 425.

²⁵ Bank of England (Islamic Banks and Central Banking in Quarterly Bulletin 2017 Q3), 158.

²⁶ Abdul Karim Al-Dohni, 'Islamic Banking Challenges Modern Corporate Governance: The Dilemma of the *Shari'a* Supervisory Board' (2008) 29 (5) *The Company Lawyer* 156.

²⁷ <www.companieshouse.gov.uk> accessed 6 March 2018

²⁸ The PRA and FCA carry out the functions formerly executed by the Financial Services Authority (FSA), the former authority regulated by the Financial Services and Markets Act 2000.

²⁹ The details of the process can be obtained from the Department for International Trade.

the UK Corporate Governance Code is applicable in this case.³⁰ To some extent, the Combine Code 2016, just like its predecessors, provides general guidance and it is up to the institutions to find out their way to comply with the outlined features where non-compliances, if any, should be adequately explained.³¹ Put differently, the institutions, including IFIs, are encouraged to self-regulate to achieve best practice and if they do not, they ought to provide sufficient explanation. Perhaps, the relevant governance issue under concern here is the *Shariah* governance supervision mechanism. The UK corporate governance structure is a unitary board model, applying monitory and supervisory functions concurrently by having non-executive members alongside with the executive members.³² The presence of the *Shariah* committee within the IFIs has given rise the question of how this type of governance arrangement is going to be reflected under Combine Code 2016. In this regard, it is argued that there is no legal contradiction barring the *Shariah* governance system from being adopted within the institutions.³³ This is supported by years of implementations by the IFIs operating in the UK without having significant concerns. Despite there being some issues for the sake of argument, *Shariah* committees are seen within the organisational structure of the IFIs.³⁴

Other than incorporating the institutions, we can also witness how the UK legal and regulatory regime reacts to the way the IFIs construe their contracts. As observed, UK legal footsteps are moving towards securing a level playing field for the IFIs. This is done by looking at the legal provisions that match the IFI product arrangements or taking appropriate actions with regulatory amendments to reduce the legal obstacles accordingly. As for the former, for instance, since the *murabahah*-based product arrangement meets the necessary conditions, it is included under the regulated mortgage contracts. As for the latter, the FSA has introduced home purchase plans (HPP) to regulate *ijarah* and diminishing *musharakah*. The FSA, as a regulatory authority, explicitly incorporated HPP, into the Finance Act 2003. Section 72 of the act depicted the implementation of *ijarah* and section 73, the diminishing *musharakah* arrangement.³⁵ Both financing modes are applying buy and let processes which to some extent are subject to double taxation on the asset under transaction. Prior to that, there were no regulated activities taking into account such Islamic financing modes in which the IFIs need to endure additional taxations. Double taxation has been one of the main challenges that hit the IFIs' notorious mix-matching mode in countless jurisdictions. This amendment allows relief from stamp duty and land tax for those

³⁰ It will be known as the Combine Code 2016 henceforth.

³¹ Andrew Keay, 'Comply or Explain in Corporate Governance Codes: in Need of Greater Regulatory Oversight?' (2014) 34 (2) *Legal Studies* 279, 287.

³² Further discussions in the upcoming topics.

³³ Al-Dohni, 'Islamic Banking Challenges Modern Corporate Governance' (n 26).

³⁴ The relevant arguments will be brought forwards in the upcoming topics.

³⁵ Finance Act 2003, s 72-73.

who are using alternative property financing. Since the IFIs are utilising multilayer contracts to structure a product, this tax relief is essential to secure a conducive market for the IFIs to operate in and considered as one of the keys that has stimulated the UK Islamic financial market.

The latest progress to exemplify how the English regulatory regime plans to cement a level playing field for the Islamic finance is on the establishment of the *Shariah*-compliant liquidity facility (SCF). The IFIs are not exempted from overall liquidity adequacy role. They must ensure that their liquidity resources contain an adequate buffer for higher quality, unencumbered assets and maintain a prudent funding profile.³⁶ It is further described as the liquid asset buffer (LAB). The IFIs must include in their LAB only high-quality debt securities issued by governments or central banks, securities designated by multilateral development banks, reserves in the form of sight deposits with a central bank or investments in a designated money market fund. The problem is, those are not provided in a *Shariah*-compliant market, thus far. Therefore, the SCF will help the UK's IFIs to meet the LAB as required by Bank of England as well as the Basel III. A *Shariah*-compliant open market operation (OMO) will be introduced, using amongst others commodity *murabahah* and *wakalah* instruments.³⁷ To realise this, the Bank of England commenced a preliminary survey in 2015. This development as far as this research is concerned, is rather progressive for a non-Muslim-majority market. This is a solid proof of a supportive effort by the English Law to accommodate Islamic finance, in its own way.

Apart from the governing laws to regulate Islamic finance, having robust dispute resolution procedures in place is another crucial part of the overall Islamic financial legal framework. In this regard, the English judiciary system is apparently the first jurisdiction outside the Muslim realm to gain trust in handling disputes occurring in Islamic finance. It is argued that, the UK legal infrastructure provides the best practice for alternative dispute resolution.³⁸ To date, there are four referable cases standing as precedents in English courts.³⁹ As clearly delivered by the verdicts of the cases, the sensible approach is that the English judiciary is not to interpret *Shariah* rulings provided by the *Shariah* committees of

³⁶ Financial Conduct Authority, BIPRU 12.2.9

³⁷ Bank of England (Islamic Banks and Central Banking in Quarterly Bulletin 2017 Q3) 157-160.

³⁸ Umar A Oseni, 'Alternative Dispute Resolution' in the Islamic Capital Market in ISRA & Thomson Reuters (Islamic Commercial Law Report 2017) 52.

³⁹ *Islamic Investment Company of the Gulf (Bahamas) Ltd v Symphony Gems NV & others* [2002] ER (D) 171; *Beximco Pharma v Shamil Bank of Bahrain EC* [2004] APP.L.R. 01/28; *The Investment Dar Co KSCC v Blom Developments Bank Sal* [2009] EWHC 3545; *Dana Gas PJSC v Dana Gas SUKUK Ltd* [2017] EWHC 2928

the respective banks. Other than the fact it is a complicated process, *Shariah* law deduction is not the expertise of the English judges.⁴⁰

As happened in the market, it is possible to conclude that the English regulatory system is also open to the operation of Islamic finance. Perhaps, it is not an overstatement to say that the maxim 'everything which is not forbidden is allowed' is applied here. In many respects, the Islamic financial system is rather operating in an alternative way rather than working on the opposite of what is legal and what is not. Therefore, as observed, finding the way to accommodate and facilitate *Shariah*-compliant products and services has a greater weight than liberating the existing regulations to allow Islamic finance to operate.

8.2.3 Supervision and Audit Authorities

By and large, there is no specific body focussing a particular kind of attention into observing the Islamic financial market, especially on the *Shariah* compliance process. No special treatment has been accepted by the IFIs in scrutinising their *Shariah* characteristics. Likewise, the implementation of the *Shariah* governance system is based on the decentralised model, which is left to the individual bank, under the purview of self-regulation as the way to achieve best practice in governance.⁴¹ This is in part because Islamic finance is observed under the same unity supervisory mechanism as to the conventional counterparts. That is the reason why there is no national body designated to function as a central *Shariah* authority to oversee the overall practices of the institutional *Shariah* committees.

As for the fact that IFIs are financial intermediaries, prior to 2013, the Financial Services Authority (FSA) was regulated by the Financial Services and Markets Act 2000, taking the roles of regulating and supervising financial institutions,⁴² including those that operate with *Shariah* compliance. Currently, following the Financial Services Act 2012, FSA's roles have been undertaken by two separate bodies: the Financial Conduct Authority (FCA), and the Prudential Regulatory Authority (PRA).⁴³ One of the major steps taken by the FSA with regards to Islamic finance was the regulation of HPP. It had expanded the room for the offering of Islamic mortgages schemes. Other than the tax relief given under SDLT as prior discussed, this measure is exhibiting how the English legal system could accommodate *Shariah* principles in its own way. However, since the English legal system is also detached from any religious purview, there is no

⁴⁰ *Beximco v Shamil Bank* (n 39).

⁴¹ For further discussions, refer to Chapter 3 on *Shariah* supervision models.

⁴² Financial Services Market Act 2000 s1.

⁴³ Financial Services Act 2012 s6.

provision emphasising the requirement of having a designated body to oversight business matters related to *Shariah*.

In terms of corporate governance practices, the Combine Code 2016 has neither explicitly approved nor disapproved of the IFIs adopting *Shariah* compliance process within their institutional structure. However, it is essential to note here that the aim of this code is to deliver high quality corporate governance with in-built flexibility for companies to adapt their practices, taking into account their particular circumstances.⁴⁴ To ensure effectiveness, the board and its committees should have the appropriate balance of skills, experience, independence and knowledge of the company, to enable them to carry out their duty effectively.⁴⁵ Accordingly, the Companies Act 2006 requires board members to be qualified to exercise the duty,⁴⁶ which, as far as the IFIs are concerned, is the task carried out by the *Shariah* experts. In this sense, the existence of the *Shariah* committee is by virtue in-line with the said notion in many ways. Coherently with the Combine Code 2016, the IFSB and AAOIFI *Shariah* governance standards emphasise that the persons sitting in as *Shariah* committee members must fulfil a 'fit and proper' criteria, as a qualification.⁴⁷ As a result, we might concede that *Shariah* governance codes are akin to ensuring best practices of *Shariah*-compliant business arrangements. Despite its Islamic origin, the ethical principles of the *Shariah* governance are reflecting the same concerns as the conventional corporate governance codes in many respects.⁴⁸

From a structural point of view, it is observed that *Shariah* committees to some degree share similarities with the two-tier boards system. In a direct way, it seems to be in contradictory with the UK unitary board model. However, the 'two-tier' concept of *Shariah* governance is not entirely identical to the European two-tier board model. Under the purview of this research, the *Shariah* committee carries out specific duties delegated by the board of directors, which is why it is conferred as an additional governance structural arrangement, in accordance with the definition of 'committee'. The respective 'two-tier' conception also explains the existence of the central *Shariah* committee as a 'check and balance' mechanism. This type of governance strategy is more to empowering the board, a sentiment supported by the Combine Code 2016 rather than a contradiction of it. On top of that, it is argued that the functions carried out by the *Shariah* committee members

⁴⁴ Financial Reporting Council, *The Corporate governance Code 2016* (The FRC Limited 2016) 2.

⁴⁵ *ibid* 10.

⁴⁶ Companies Act 2006 s 170-177.

⁴⁷ IFSB (Guiding Principles on *Shariah* Governance Systems for Institutions offering Islamic Financial Services 2009) 5.

⁴⁸ For further discussions, refer to Chapter 5 on *Akhlaqic* Ethical Code.

are similar to those of the non-executive board members.⁴⁹ Both have the power to influence business decisions and the operation of the institutions in their own ways.

In terms of the accounting regime, as a corporation, the UK financial institutions are given the chance whether to adopt the International Reporting Standards (IFRS) or UK Generally Accepted Accounting Principles (UK GAAP).⁵⁰ Likewise, the IFIs have nothing less in this regard. From the observation of the legal and regulatory approach, accounting and auditing regime seems to take a similar point of view. There is no special treatment for such an alternative financial plan. Apart from that, an audit on *Shariah* related matters also lacks of clear statement as to how it should be practised within the UK market. There is no either internal or external *Shariah* audit model on-tap for the UK's IFIs to refer to.

To wrap up, the UK financial market is more than ready to adopt any peculiar features in *Shariah* audit to function as a check-and-balance mechanism in *Shariah* matters. Known as a frontier in a conventional auditing regime, establishing this additional requirement is rather not a big deal since what is already there is not an issue. On top of that, due to market flexibility, thus far the *Shariah* audit is relatively left to the respective IFIs to sort it out within their institutional level. It is their moral responsibility towards their Muslim stakeholders after all. However, the potential of this *Shariah* governance feature to expand is not to be taken for granted if the UK is going to take a more significant role in the Islamic financial industry. As repeatedly mentioned, what is important for the *Shariah* governance system here is consistent and robust mechanisms to interconnect and work together to formulate a solid ecosystem.

8.3 Factors Contributing to Islamic Finance Market Expansion and Regulatory Reform in the UK

The search for the potential of offering of Islamic financial products by the UK market is driven by many factors. Under the purview of this research, there are three factors, believed to have been contributing to the market expansion and regulatory reform in the UK: the Islamic financial market exploration and expansion, legal and regulatory flexibilities, and economic uncertainties.

⁴⁹ Al-Dohni, 'Islamic Banking Challenges Modern Corporate Governance' (n 26).

⁵⁰ To be exact, the Companies Act 2006 state the accepted accounting standard is in accordance with the International Accounting Standard (IAS), and the UK GAAP is a statutory terms in the UK Taxes Acts; Companies Act 2006, s 386.

8.3.1 Islamic Market Exploration and Expansion

Islamic finance is a global phenomenon and has gained popularity with the members of the public regardless of its religious backgrounds. Evidently, we have witnessed the emergence and rapid developments of the IFIs with constant growth over the last few decades. The assets of IFIs have grown exponentially and reached double-digit rates during the past decade, from about USD200 billion in 2003 to USD1.6 trillion at the end of 2012⁵¹ and USD1.88 trillion at the end of 2015.⁵² The amount of full-fledged Islamic banks, subsidiaries and windows is worth approximately USD1.5 trillion as at the end of 2015.⁵³ As discussed in the earlier chapters, the IFIs have not merely shown strength in growth, but have also proved to be resilient against the global financial instability throughout the last decade.⁵⁴

Eventually, this expanding market has turned its attention to the UK, especially the London financial market. The depth and breadth of London's capital markets play the role of access to a wide pool of investors and secondary market liquidity. Apart from that, London is also the home for countless numbers of legal firms, accounting and business consultation companies, and many others. The fact that the UK hosts more than 60 courses relating to Islamic finance has made the UK the largest provider of Islamic finance academic courses, which has made a good example for the Islamic financial players to reach out. Back in the 1980s, the London Metal Exchange used to apply a significant volume of commodity *murabahah* to give liquidity to Middle East companies and other investors that now have the potential to foster the development of a wholesale market in the UK.⁵⁵ Nowadays, business parties from the Middle East are more likely to invest in the UK as a result.⁵⁶ We could see the use of a sizable amount of Islamic financing schemes to invest in major infrastructure projects all over the UK. For instance, development finance for The Shard, Battersea Power Station regeneration, London Gateway, the Olympic Village and the redevelopment of Chelsea Barracks.⁵⁷

⁵¹ IFSB, (Islamic Financial Services Industry Stability Report 2013) 7.

⁵² IFSB, (Islamic Financial Services Industry Stability Report 2016) 7.

⁵³ *ibid* 9

⁵⁴ Feisal Khan, 'How Islamic is Islamic Banking?' (2010) 76 *Journal of Economic Behaviour & Organization* 805; Hussein Elasrag, 'Corporate Governance in Islamic Finance: Basic Concepts and Issues' <<http://ssrn.com/abstract=2442014>> accessed 6 August 2016.

⁵⁵ FSA (Islamic Finance in the UK: Regulation and Challenges 2007) 6.

⁵⁶ This could be credited to the existence of multiple wholesale Islamic investment institutions in the UK, such as the Rasmala plc and BLME. Other than that, giant Islamic investment groups like Masraf Al Rayan are also getting involved in retail financial services.

⁵⁷ TheCityUK (Global Trend in Islamic Finance) (n 1).

The astonishing growth of the Islamic financial market is also aided by its *sukuk* market. By the end of 2016, the accumulative value of *sukuk* or Islamic bond issuance was estimated to be USD 856, 718 million.⁵⁸ Despite experiencing a decrease in terms of annual issuance between 2012 and 2015, the *sukuk* market is believed to maintain its positive momentum over the upcoming years. This is due to the increase of total international *sukuk* in 2016, which stood at USD 31.56 billion, an expansion of USD 10.68 billion from USD 20.88 billion in 2015.⁵⁹ This expanding market makes an impact in the UK is proven by the issuance of the first UK sovereign *sukuk* in 2014. Due to the strong demand, the UK marked a more active involvement in early 2018, through Al Rayan Bank plc, the first UK bank to issue a *sukuk*.⁶⁰ UK participation in the *sukuk* market is economically strategic. The UK gilt market's reputation for huge numbers in value could mean it becomes a sought-after destination by fresh Muslim investors if it could only open its window for the *Shariah*-compliant bond package.⁶¹

Other than that, the increasing number of Muslims in the Western region has also significantly impacted on the UK financial market. In 2011, the Muslim community grew up to 2.7 million, consisting of 5% of the UK's total population, a 48% of increase since 2001.⁶² This number escalated to 3 million in 2014 and is constantly enlarging in the more recent years due to the 50% of birth rate. Bear in mind that this excludes non-permanent Muslim residents like asylum seekers, foreign students, business communities and tourists. The domestic increment of the Muslim population with a growing wealth, has pressed the demand for a more comprehensive range of Islamic retail financial products and services. The fact that Muslim customers are reluctant to use interest-based finance due to their religious beliefs, a concept thoroughly discussed in the previous chapters, has made Islamic finance a new core of the UK financial market.⁶³ The UK government has sought to take strategy to broaden the range for regulated mortgage products and HPP as the answer to the said demand.

⁵⁸ International Islamic Financial Market, (A Comprehensive Study of the Global Sukuk Market 2017) 2.

⁵⁹ *ibid* 5.

⁶⁰ <<https://www.sukuk.com/sukuk-new-profile/hm-treasury-uk-sovereign-sukuk-plc-2057/>> accessed 14 March 2018.

⁶¹ The UK debt portfolio gross value is up to 1,600 billion pound; see <https://www.dmo.gov.uk/media/15606/apr-jun18.pdf> accessed 15 September 2018.

⁶² See also the report published by the Muslim Council of Britain; MCB, (British Muslims in Numbers 2015).

⁶³ See also Abdul Karim Al-Dohni, 'The Emergence of Islamic Banking in the UK: A Comparative Study with Muslim Countries' (2008) 22 Arab Law Quarterly 180.

8.3.2 Legal Flexibilities

Due to its secular background, the English legal system is flexible in many ways, including in adopting new features to catch up with the latest market trends. Perhaps the best example to demonstrate such a notion is by looking at legal developments pertaining to Islamic finance in the UK itself. Since 2003, we could see numerous amendments made by the UK government as supportive measures to make the English legal and regulatory regime more conducive for the IFIs to tap into and flourish. The approach is simply to give the Islamic finance a level playing field with their conventional counterparts. Apart from that, a clear message was delivered by the relevant case laws, as seen in *Beximco v Shamil*, which established that an English court should not interpret *Shariah* rulings provided by the *Shariah* committees of the respective banks, which is also sensible as the official judiciary approach in this matter. As far as this research is concerned, this is a great opportunity for the IFIs to posit themselves as qualified players to compete with other well-established counterparts.

One of the peculiarities of the UK legal framework is the self-regulation approach. By virtue of this, rather than looking for a way to control how *Shariah* committees execute their duties, the IFIs have the advantage to turn the tables and make it an instrument to gain customers confidence. Under the corporate governance purview, the board is responsible to ensure that good governance practices are adopted by the institutions. Good governance is when a business entity is operated, regulated and controlled by well-designed risk management policies, processes, corporate regulations, rules and laws that lead the entity to achieve its ultimate goals.⁶⁴ In this case, having independent *Shariah* experts, a clearly stated *Shariah* governance framework, adopting the requirements proposed by international and national standard-setters or coming up with clear explanations in the case of non-compliance, are amongst the practices that are reckoned as good governance practices, as far as this research is concerned.

8.3.3 Economic Uncertainties

In a nutshell, economic growth has not been invariably on the uptrend but rather fluctuating between periods of expansion and contraction due to multiple variables. In this sense, the government holds the upper hand in power to ensure mitigation plans are in place to protect the economy domestically from potential turbulences. As for the UK, there are two recent events that have made significant impacts on its financial ecosystem, the 2007 financial crisis and Brexit.

⁶⁴ Imran Minhas, 'Shariah Governance Model (SGM) and Its Four Pillars' (2012) Journal of Islamic Banking and Finance 30, 31.

During the 2007 crisis, the UK financial institutions were not immune from turmoil. 'The Run on the Rock' expression was a notorious moment in the history of the crisis at Northern Rock, a 'too big to fail' bank in the UK, set up in Victorian times, that experienced liquidity problems as a result of the crisis. The failure of Northern Rock, amongst others was attributed to the lack of supervision from the relevant authorities. As mentioned in the report, the FSA did not supervise Northern Rock properly, and the procedures available were inadequate to supervise a bank whose business grew so rapidly. Apparently, the authority did not seem to have carried out the task with the skill and diligence one might have expected.⁶⁵ The Banking Act 2009 was the most important legislative response owing to the lessons learned from the crisis. The act contains several provisions for checks and balances to oversee any potential concerns within the institutions.⁶⁶ From the *Shariah* governance viewpoint, the origin of that crisis could be pinned down to excessive risk, reckless lending and speculative trading supported by an interest-based financial system, a notion believed to be remedied by *Shariah*-compliant financial arrangements.⁶⁷

After the 2007 financial crisis, the UK is experiencing another economic uncertainty surrounding Brexit, the decision to leave European Union (EU), the world's largest trade and economic association. The EU has a membership of 28 countries from the European continent. In terms of economic and finance, the EU has provided the UK with frictionless access to a vast market at a low cost and vice versa. It is done by having Euro as a single currency of trade and lowering controls on border access for the member countries. The EU is the UK's major trading partner, accounting for 44% of exports and 53% of imported of goods and services in 2015.⁶⁸ In the same year, the UK exported 223 billion and imported 291 billion pounds sterling of goods and services to the EU.⁶⁹ The main issue is the future of this trade is unclear until the procedure of leaving the EU procedure is concluded, a two-year process following the initiation of article 50 in 2017.

As a result of Brexit, it is believed that the UK economy will lose its perks as an EU member and be treated as if it is a total stranger to the market despite long trade histories.⁷⁰ One of the significant facts under consideration here is the

⁶⁵ HM Treasury (The Run on the Rock) 34.

⁶⁶ International Bar Association (A Survey of Current Regulatory Trends) 63.

⁶⁷ Al-Dohni, 'The Quest for a Better Legal and Regulatory Framework for Islamic Banking' (n 7) 23.

⁶⁸ House of Commons Library, In Brief: UK-EU Economic Relations (Briefing paper no 06091, 13 June 2016) 3.

⁶⁹ *ibid* 5.

⁷⁰ Chris Giles, 'What has EU Done for the UK' <<https://www.ft.com/content/202a60c0-cfd8-11e5-831d-09f7778e7377>> accessed 30 May 2018.

impact of Brexit on the UK's financial industry. After Brexit, the UK is potentially to lose liquidities benefiting from the EU financial subsidiaries. In addition, those financial institutions were one of the reasons why the UK is preferable as the doorway to access the EU's financial market. This economic privilege, enjoyed by the UK for years in the past is now faces an indefinite future. As phrased in the HM Treasury analysis, the UK would be permanently poorer after leaving the EU, and alternative plans need to be tabled in the nearest time possible.⁷¹ This is not a rocket science to comprehend. Whether it is to stimulate inward or outward flows, UK trades and investment must be more diversified than it used to be. Therefore, alternative prospects for financial subsidiaries are to be encouraged to operate in order to bring back inward investments to replace liquidity loophole caused by Brexit.

Despite the fact that the UK will probably suffer severe economic stress, post-Brexit also means that the UK will have more liberty to go after new strategic partners. There is no more EU or non-EU treatments for potential foreign direct investments. One of the markets that has received less attentions from the UK government is the Gulf Cooperation Council (GCC) countries.⁷² With a bilateral trade worth 30 billion pound in 2015, the GCC is not to be sidelined without any consideration. Gulf countries offer a sizeable amount of petrol-cash with a Muslim-dominated market, and Brexit actually offers a golden opportunity for the UK to secure free trade deals with the respective market.⁷³ Arguably, Islamic finance is a crucial tool to attract the attentions and trigger new prospects for inward cash flow to the UK economy. Other than the GCC, the Commonwealth countries are also an alternative not to be taken for granted. Some Commonwealth members such as Malaysia and Pakistan are major players in Islamic finance globally. They might not have significant economic capabilities to offer, but the fact that those countries are rich with experts in Islamic finance and their legal origin are close to the English legal system, is a promising source of knowledge and legal transplant ideas if the UK is to move forwards at a faster pace in Islamic finance.

⁷¹ HM Treasury, 'The Long-term Economic Impact of EU Membership and the Alternatives' (Report Presented to Parliament by the Chancellor of Exchequer by Command of Her Majesty in April 2016), 8.

⁷² The Gulf Cooperation Council consist of six gulf Arab countries: Saudi Arabia, Kuwait, United Arab Emirates, Qatar, Bahrain and Oman. It is one of the economic associations similar to the EU that exist around the globe.

⁷³ <www.cityam.com/250987/britain-has-golden-opportunity-leapfrog-eu-and-secure-free> accessed 23 February 2018

8.4 Islamic Finance in the UK: Remarks and Observations

After exploring what the UK financial system has to offer in terms of its regulatory regime and what has been shown by its growth and market progress, this part of the present chapter will extensively analyse the aforementioned legal and market highlights in order to point out remarks and observations relevant to the topics. The objective is to raise problematic issues in the implementation of *Shariah* governance system under English jurisdiction and offer relevant insights for refinements. It is done whether by offering relevant explanations applying the principles underlined by this research, highlighting related regulations or provide insightful recommendations.

First and foremost, as repeatedly mentioned on many occasions, English Common Law is a secular-based law. Although historically it is part of a Christian teaching, those days have been left far behind as witnessed through its long regulatory experience.⁷⁴ On the contrary, IFIs are offering products and services that are fabricated to comply with *Shariah* law, a religious teaching. Therefore, as the way to facilitate Islamic finance in the UK, the attempt to adopt religious notion into this regulation system, if any, is fairly challenging, perhaps impossible to some extent. This is the important point that needs to be grasped and accepted by the stakeholders of the IFIs. In saying that, any legal reform to secure a level playing field for the IFIs to operate supposedly more on deregulation of the law that grants a privilege to interest-based financing. The goal is to broaden the room for other types of financial models under a shadow, including the interest-free model, to surface without eminent threats.⁷⁵ As discussed in Chapter 6, Islamic finance is a system derived from the belief that wealth must be managed in the way approved by God as its sole owner. This individual religious belief is viewed as the right to freedom of thought, conscience and religion, guaranteed by Article 9 of the European Convention on Human Rights (ECHR).⁷⁶ From this point of view, the IFIs possessed neither an advantage nor disadvantage. However, this religious belief is at liberty to be manifested in democratic ways without disregarding the protected rights and freedom of others. Leading from this, the market plays an impactful role where it is sensitive and cautious when dealing with customers' trends. If demands for *Shariah*-compliant products and services escalate, the market will respond accordingly. This trend on many occasions will be followed by regulatory reform, especially if there are legal obstacles whereby the IFIs are supposed to take this as an important note.

⁷⁴ *Bowman v Secular Society Limited* [1917] A.C 406.

⁷⁵ Shadow banking is a banking system offering financial products and services outside the regulated mode.

⁷⁶ European Court of Human Rights, European Convention on Human Rights, Article 9.

In this regard, the feature required by the IFIs in terms of English regulatory regime is the liberty to operate in the way they believe the best way of doing business. From this point of view, the deregulation of interest-based law should not be perceived as an endeavour to uphold the conception of the rule of *Shariah* law. It is simply a legal liberation process to accommodate new financial market trends. This is due to the fact that any financial transaction is to be enacted as licit until proven otherwise by *Shariah* law.⁷⁷ In other words, everything which is not forbidden is allowed. The illicitness of a financial product is only apparent when it is involved with *riba*, *gharar* and other prohibited activities.⁷⁸ Furthermore, as for *akhlak* based ethics, the local legal propensity is already supportive rather than combative against this religious-origin best of practice. The existing corporate governance codes, despite the absence of the *Shariah* governance emphasis, encourage self-regulation and improvements to secure stakeholders' rights. The question of the most concerned is on legal loopholes caused by the IFIs' financial mode of product structuring and contractual relationship. The IFIs are notoriously applying mix-matching method to construe their products. This has caused the IFIs and the customers a great deal of inefficiencies, such as double taxation on a single product, unclear legal protection and unenforceable agreement in the eyes of judiciary.

Secondly, the absence of a national authority to oversee the *Shariah* compliance process exercised by the IFIs represent a lack of 'check and balance' to supervise the institutional *Shariah* committees.⁷⁹ Earlier in this research, it is observed that the central bank *Shariah* committee undertakes the functions of the highest supervisory authority as a 'check and balance' mechanism in *Shariah*-related matters. Since the UK government is looking at this particular issue from a secular point of view, the absence of such a governance supervision mechanism is rather not an overarching concern. However, the gravity of this governance loophole is fairly substantial, as far as the stakeholders may concern. Without central authority, institutional *Shariah* committees operate with no central supervision to hold them responsible for any malpractice or mismanagement in the *Shariah* compliance process, which is likely to rise *Shariah*'s systemic risk. It is worth noting that being responsible to God in ensuring *Shariah* compliance does not mean that the *Shariah* committee is out of human reach. The fact that the *Shariah* committee members are the subject to duty of loyalty to the institutions, has puts their credibility under judgement by stakeholders in many ways. Therefore, an

⁷⁷ This is based on the maxim, 'a thing shall remain as it was originally', meaning, if it was originally permissible, it will remain permissible until proven otherwise; Al-Majalla Al-Ahkam Al-Adliyyah, Part II. Maxims of Islamic Jurisprudence, no. 5.

⁷⁸ For further discussions, refer to Chapter 5 on *Shariah* Compliance.

⁷⁹ The accountability of *Shariah* governance elements is not only to the stakeholders, as listed traditionally, but include accountability to the Divine as the Islamic law-maker or *Shariah* itself. Refer to Chapter 3 for further discussion on *Shariah* governance definition.

independent supervision body is a crucial governance organ in this regard from a *Shariah* governance perspective, especially to ensure accountability.

Perhaps the relevant question here is, what is the best solution within reach considering the nature of the UK's regulatory and market? To answer that is by looking at the underlying principle of the *Shariah* governance supervision mechanism. It is rather straightforward, which is to ensure there is effective independent oversight of *Shariah* compliance.⁸⁰ The governance structure is flexible depending on the local legal propensity and market practices. By considering all the relevant standards and market experience, two possible choices are available. The first is forming a central *Shariah* supervisory body as a subsidiary of Bank of England as frequently seen in other jurisdictions, and second is appointing an independent institution with relevant expertise to exercise timely evaluations. As for the former, the suggested supervisory body would be regulated with the power similar to the PRA and the FCA. It could also be carried out by either, or the FCA in particular, through a designated committee with specific duties. Most importantly, the person drawn to be in charge must be sufficiently qualified.⁸¹ The latter option, however, is brought about by considering the latest market development of the *Shariah* consultation firms. It is observed that the numbers of *Shariah* firms providing *Shariah* legal expertise to the IFIs is increasing globally. Most of these firms are run by *Shariah* experts with in-depth knowledge and experience in Islamic finance in multiple jurisdictions. Their functions are similar to external auditors who carry out the task independently.⁸² This independent body is an ad-hoc authority, which is still under the flagship of a decentralised *Shariah* advisory system, which is a more sensible model under suggestion.⁸³

Thirdly, other than the aforementioned issues, the absence of a central *Shariah* supervision mechanism could cause *fatwa* inconsistency, hence *Shariah* opinion contradictions and unintegrated product arrangements. It is to some extent has the potential to affect the validity of the contracts construed by the IFIs. To exemplify the magnitude of this particular remark is by looking at the *Shariah* perimeters on product requirements. Some authority such as Bank Negara Malaysia (BNM), considers *bay' al-'inah* as a *Shariah*-compliant instrument, implementing the opinion of the Shafie legal school. The respective instrument,

⁸⁰ IFSB, (IFSB-10) (n 47).

⁸¹ The required qualifications are similar to the membership of the *Shariah* committee.

⁸² Karim Ginena and Azhar Hamid, *Foundations of Shari'ah Governance of Islamic Banks: The Role of Sharia Supervisory Boards, Internal Audit and Advisory Firms* (John Wiley and Sons 2015) 363.

⁸³ Mushtak Parket, *Practices of Shariah Governance in the Islamic Capital Market in ISRA & Thomson Reuters (Islamic Commercial Law Report 2017) 56-59.*

however, is conferred as not a *Shariah*-compliant by other jurisdictions, especially Middle Eastern countries based on the majority of other *Shariah* legal schools.⁸⁴ As a result, a particular scheme may be granted *Shariah* compliance under Malaysian jurisdiction but conferred as otherwise by another. Therefore, *bay al-'inah* was widely used by Malaysian authorities in their *sukuk* structure and at the same time criticised by others. Since the UK's financial market is in fact a meeting place of the IFIs that originated from countless jurisdictions, the absence of such a single code for the IFIs to make reference would be damaging. In addition to that, the UK experience of disputes related to Islamic finance could also be considered as a good example.

The solution for this particular issue is in the hands of the government, as policy maker to choose its preferred *Shariah* legal framework. As mentioned in Chapter 7, one of rationales of regulating Islamic finance is to ease *Shariah* legal contradictions. It is in the government's power to remove undesirable legal opinions and endorse a desired framework. The UK regulatory regime might be a secular-based, but it does not mean it cannot seek for consultation from *Shariah* experts to determine the best solution to such a matter. Other than that, incorporating the available international *Shariah* standards published by multilateral bodies such as IFSB and AAOIFI is another imaginable option. Whether it is to be adopted as an advisable standards as in 'comply or explain' or to be incorporated into the existing regulations, it is a choice for the UK government to make a sensible decision.

Fourthly, missing the referred *Shariah* governance code could also cause a conflict of duty for the institutional *Shariah* committee members. This is due to the fact that there is no restriction on a *Shariah* expert being appointed to sit on more than one *Shariah* committee within the same industry at the same time. Thus far, it has depended on the IFIs' initiative to structuralise their *Shariah* governance, which is mainly reflects the original jurisdictions of their parent companies. As observed, due to this non-appearance, the UK IFIs have so far never put a high regard on this particular matter. Based on the table-9, five out five IFIs under observation have experts who are the members of multiple institutional *Shariah* committees at the same time.⁸⁵ Some of the experts are even sitting together as members of more than one *Shariah* committees simultaneously. This is also as a result of the fact that the UK is a global hub for financial subsidiaries. Parent companies might not be originated from the same jurisdiction, where as far as they are concerned, this is not an issue. Other than

⁸⁴ Saiful Azhar Rosly and Moh Sanusi, 'Some Issues of Bay' al-'Inah in Malaysian Islamic Financial Markets' (2001) 16 (3) Arab Law Quarterly 262.

⁸⁵ So far there are five full-fledged Islamic banks in the UK and by considering their corporate structures, financial institutions offering Islamic window are not included.

that, if there is no limitation from the related jurisdictions where the parent companies originally come from, this sort of issue is rather irrelevant from their perspective. For whatever reasons imaginable, since *Shariah* experts are carrying out fiduciary duty delegated by the board, the duty to avoid conflict of interest is extremely crucial to highlight.

No.	Bank	Shariah Committee Members
1	Bank of London and The Middle East ⁸⁶	Dr Abdul Aziz Khalifa al-Qassar Dr Essam Khalaf Enezi Dr Mohammad Daud Bakar
2	Gatehouse Bank	Mufti Muhammad Nurullah Shikder Sheikh Nizam Muhammad Saleh Yaqoobi Dr Abdul Aziz Khalifa al-Qassar Dr Essam Khalaf Enezi
3	QIB (UK) plc	Sheikh Walid bin Hadi Dr Abdul Sattar Abu Ghuddah Dr Mohamad Ahmaine
4	Al-Rayan Bank ⁸⁷	Dr Abdul Sattar Abu Ghuddah Sheikh Nizam Muhammad Saleh Yaqoobi Mufti Abdul Qadir Barkatulla Dr Samir Alamad
5	ADIB (UK) Ltd	Sheikh Muhammad Taqi Uthmani Prof Jasem Ali Salem Al Shamsi Sheikh Issam Mohammed Ishaq Sheikh Nizam Muhammad Saleh Yaqoobi Dr Muhamed Elqari

Table 9: *Shariah* Experts in the UK Full-fledged Islamic Banks⁸⁸

To ease possible conflict, it is sensible to apply the virtues of the relevant provisions from Companies Act 2006.⁸⁹ In a due manner, it is the duty of the members who by any way, directly or indirectly, have a conflict of interest on a certain arrangement or transaction, for the reason that he/she is the member of

⁸⁶ <<https://www.blme.com/about-blme/investor-relations/corporate-governance/sharia-a-supervisory-board/>> accessed 2 March 2018

⁸⁷ Former Islamic Bank of Britain, the first established Islamic Bank in Britain in 2009

⁸⁸ This is based on the latest annual reports of the banks.

⁸⁹ Companies Act 2006, s 175.

the *Shariah* committees of the contracting parties, to make reasonable declaration. The fact that the *Shariah* committee has no direct involvement with business strategy does not mean it does not have consequential impact on the situation. The dealing parties might have different choices of *Shariah* instruments at hand be up to their proportionalities. Any choices of possible instruments to be deployed are submissive to the institutional practices and business strategies. A certain product structure might be exploited so it could be advantageous to a certain party and detrimental to another if not delivered in a proper manner, regardless of its *Shariah*-compliant nature. To exemplify the magnitude of this case, the *Dana Gas v Dana Gas* case in English court is worthy of an investigation.⁹⁰ The case thus far might not cause by the present of the same expert within the involving institutions but a slightly reckless judgement, like 'fatwa shopping' on the related *Shariah* matters can adversely affect the whole arrangement or transaction, as it could be invalidated.

Fifthly, diverse composition of the board members with relevant skills, experience and knowledge is considered as one of the factors for effectiveness. It helps the institutions to have a dynamic business approach in order to follow market trends. The *Shariah* committee is no different in this regard. However, since the authority has never put any emphasis on such a matter, the composition of the *Shariah* committee members of the existing IFIs in the UK suggests that they have a little option of experts. This is due to the fact that the IFIs operating in the UK are mostly owned by Middle Eastern parent companies as shown in the table-10. As observed, Middle Eastern IFIs have the tendency to elect those who are respected and well-recognised as experts in *Shariah* or Islamic studies as their *Shariah* committee members and give little attention to other relevant fields of expertise. This pattern affects the composition of *Shariah* committees. However, such a management strategy is rather on the basis of market practice, which puts a high regard on the *Shariah* background person to sit at such a position. Additionally, the Middle Eastern region is also rich with talents in Islamic studies who are eligible to take other management positions within the institutions. Other than that, as mentioned by the IFSB-10, in the case of the IFIs include experts from other professions as their *Shariah* committee members, they must ensure that those members must not hold the right to vote on *Shariah* issues, the number of the *Shariah* experts must be the majority of the quorum and the present of those experts as consultants should not delude the value of the decision made by the *Shariah* experts.⁹¹

⁹⁰ *Dana Gas PJSC v Dana Gas SUKUK Ltd* [2017] EWHC 2928.

⁹¹ IFSB (IFSB-10) (n 47) 26.

Bank	Parent Bank/Company	Country of Origin
Bank of London and The Middle East	Originally sponsored by Boubyan Bank, Kuwait	Kuwait
Gatehouse Bank	Independent	England
QIB (UK) Plc	Qatar Islamic Bank	Qatar
Al-Rayan Bank ⁹²	Masraf Al Rayan	Qatar
ADIB (UK) Ltd	Abu Dhabi Islamic Bank	United Arab Emirates

Table 10: UK's Islamic Bank Ownerships⁹³

Arguably, this is not really the case if the IFIs are to operate in the UK market. The market puts a high regard on a dynamic board's composition as well as its committees, with a balance of skills, experience and knowledge, to discharge their duty effectively and avoid problems arising from 'groupthink'.⁹⁴ Since a *Shariah* committee is exercising a part of the board's duty on *Shariah* matters due diligence, the same principle is applicable, as far as the UK's market is concerned. Furthermore, the UK market trend is more challenging owing to its location as one of the world's largest financial hubs. Therefore, it is imperative for the IFIs not to take this sort of remark for granted, if they are to have a brighter future and compete with other giant financial institutions, which mostly do not offer Islamic finance. Other than a sensible business strategy to enhance market confidence, the dynamic composition of the *Shariah* committee is also substantial for the IFIs in order to encourage constructive debate between the members on the issues at hand and seek expert consultation to comprehend local market practices, based on the maxim, 'local custom is an arbitrage'.⁹⁵ This is due to the fact that *Shariah*-related decisions are not merely religious verdicts, but rather rulings with a real impact on institutions with millions in investment value.

Sixthly, the present implementation of the *Shariah* governance system has also brought about the question of how independent a *Shariah* member is. We have discussed the fiduciary duty of the *Shariah* committee which also consists of the duty of loyalty and duty of care as if they were board members.⁹⁶ We also have put emphasis on the structural arrangement viewpoint that the duty carried out

⁹² Former Islamic Bank of Britain, the first established Islamic Bank in Britain, incorporated in 2009.

⁹³ This is based on the available reports, prospectuses and official websites of the banks.

⁹⁴ FRC (n 44) 2.

⁹⁵ Muhammad Akram Laldin and Munzir Kahf, 'Islamic Banks: The Rise of a New Power Alliance of Wealth and *Shariah* Scholarship' in Clement M Henry and Rodney Wilson (eds), *The Politics of Islamic Finance* (Edinburgh University 2004) 17-36.

⁹⁶ For further discussions, refer to Chapter 6 on the fiduciary duty of *Shariah* committee.

by the *Shariah* committee is delegated by the board as the source of power. Therefore, perhaps a relevant question here is to what extent is the *Shariah* committee independent from the influence of the board? Under a jurisdiction where there is no emphasis on such a matter as required by IFSB-10 *Shariah* governance code, the integrity and credibility of the *Shariah* committee seems to be compromised under the governance purview. Independent oversight is a crucial element of the *Shariah* compliance process to ensure objective judgement on *Shariah*-related matters at hand.

To some extent, the fact that the *Shariah* committee members are taking the functions of non-executive directors, as asserted by Al-Dohni, is the key to resolving the issue at hand. As non-executive members, they do not have any interest over the corporate internal affairs but rather merely what the *Shariah* perspective is on the matters submitted to them. Perhaps, the issue of the utmost concern here is the absence of a transparent standard operational procedure for *Shariah* committees. Therefore, as one of the self-regulation parameters, the authority might need to make *Shariah* committee statements on the *Shariah* compliance process as a required standard.

Seventhly, as observed, none of the UK's IFIs, have made explicit declarations on their internal *Shariah* compliance structures to carry out day-to-day functions. As drawn by the standards, the internal *Shariah* department or at least an *internal Shariah* officer is considered as one of the operating procedures for the *Shariah* committee to work as the secretariat of the committee. Having an officer to monitor the day-to-day process is rather crucial as a *Shariah* governance support system. Other than monitoring the implementation of the endorsed *fatwa*, it can assist the IFIs to address *Shariah* non-compliance and report it to the relevant governance organs for them to take action of rectification accordingly.⁹⁷ There are no explicit indicators on the present of in house *Shariah* department. None of the corresponding banks seen in the table-10 above enclose *Shariah* risk in their annual reports. The non-existence of such a report is presumable due to the absence of an internal *Shariah* compliance mechanism. It does not, however, mean that such a process does not take place. This is due to the fact that 4 out of 5 of the banks are owned by full-fledged IFIs with solid internal *Shariah* compliance mechanisms in place.

Eighth, the UK financial institutions are given the chance to adopt International Reporting Standards (IFRS) or UK Generally Accepted Accounting Principles

⁹⁷ IFSB (IFSB-10) (n 47) 3.

(UK GAAP).⁹⁸ Thus far, there is no concern of any sort regarding special attention on *Shariah* compliance accounting and auditing standards. The absence of such a standard, designed to cater to Islamic finance characteristics is potentially to ignore the AAOIFI code of conducts. This is on the account of conventional banking largely relies on contractual liability to recover monies exchanged as loan and deposit, together with an interest margin for the lender. Meanwhile, the IFIs require physical assets or trading transactions and are more familiar with profit lost sharing business preposition.⁹⁹ The IFIs are prohibited from getting involve with non-compliant activities and any non-complaint revenues must be channelled in a proper manner as required by AAOIFI standards. How the IFIs manage non-compliance assets and cash flow is crucial in this sense. On top of that, the multilayer contracting arrangements are due to be scrutinised diligently in terms of accounting reports. Steps taken and parties relevant to the transactions must be audited to ensure their existence and functions under the circumstances.

Therefore, without having an explicit accounting standard to be complied to by the IFIs, the UK IFIs especially those offering Islamic financial windows, are at risk of *Shariah* non-compliance, as far as this research is concerned. One of the issues under discussion is the separation of the *Shariah*-compliant and *Shariah* non-compliant revenues. Other than having a clear report on a distinguishable accounting, the rectification procedure of the *Shariah* non-compliant revenue also needs to be well reported and audited. The solution, however, does not need a significant change to the accounting regime. It is argued that IFRS could properly reflect the *Shariah* compliance accounting requirements without compromising *Shariah* principles.¹⁰⁰ Furthermore, the *Shariah* Accounting Standards endorsed by the AAOIFI adopt the IFRS accounting standards.¹⁰¹ Most importantly, there must be a framework to ensure sensible and appropriate explanations disclosed by the institutions in their financial reporting regarding *Shariah*-related matters.

8.5 Conclusion

To conclude, there are three points standing as the beacons of the chapter. First, *Shariah* governance is not a total stranger to the UK corporate governance system. Owing to the nature of both, the *Shariah*-compliant financing and the UK

⁹⁸ To be exact, the Companies Act 2006 state the accepted accounting standard is in accordance with the International Accounting Standard (IAS), and the UK GAAP is a statutory terms in the UK Taxes Acts; Companies Act 2006, s 386.

⁹⁹ PricewaterhouseCoopers (Open to Comparison, Islamic Finance and IFRS) 3.

¹⁰⁰ *ibid* 4

¹⁰¹ AAOIFI, Auditing Standard No. (1): objective and Principles of Auditing in AAOIFI (eds) *Accounting, Auditing and Governance Standards* (Almainan Publication and Distribution, Manama 2015) 816.

market practices, which are rather flexible and dynamic, adopting *Shariah* governance system into the UK IFIs is not wishful thinking. The UK legal flexibility is the tipping point of this endeavour. However, such a reform should take into account local legal and market practices, which do not regard religious tenets as a compass for business arrangements. Having said that, the IFIs should be more creative and adaptive, which at some point might mean operating with a different *Shariah* compliance process, depending on the jurisdiction. It is essential for the *Shariah* governance arrangement to be more diverse without jeopardising the underlying principles while complying with the local legal requirements. At any rate, the IFIs must ensure that their *Shariah* governance systems are fully functioning at their full potential.

Secondly, in order to allow *Shariah* governance to hit a bigger punch onto the UK financial markets, the aspects of the above remarks and observations are not to be taken for granted. Regardless of the *Shariah* supervision model, the UK government needs to publish its own *Shariah* governance code in order to ensure a robust *Shariah* compliance process is in place. By looking at the remarks above, this code should be compatible with both, the governance aspects of the IFIs and local market practice, respectively. This could be the answer to the mentioned ambiguities regarding the *Shariah* compliance process within the UK's IFIs. Local stakeholder sentiment is the key element in formulating the respective *Shariah* governance code. The emphasised corporate governance concerns could be the starting point to addressing the sentiment. The idea whether to have a designated central body or an independent ad-hoc body to timely oversee *Shariah* compliance process within the institutions depends on the government to make a sensible decision. It is not an attempt to undermine the existing system, but merely to empower the *Shariah* governance functions.

Thirdly, the Muslim population in the UK is growing; however, it remains as a small portion of Islamic finance users. The fact that Muslims represent merely 5% of the total population makes the local Islamic financial market rather share a minimal size of the economic slices. Let alone the readiness of the Muslim communities to accept a *Shariah*-compliant financial system from a non-Islamic government. This situation can improve only if the UK's IFIs are ready to put a focus on tackling the customer confidence using a *Shariah* compliance flagship. The aim is to draw the attention, and hence the confidence of Muslim customers who are reluctant to use conventional financing in order to make Islamic finance a trusted alternative. On top of that, the UK government also should also take an action to educate members of the public to increase awareness about the *Shariah*-compliant finance. However, it should consider a rebranding strategy in order to ensure higher market penetration.

Chapter 9

Conclusion

9.1 Introduction

This chapter is the final chapter of this research. It will summarise areas that have been the focal point of the discussions thoroughly put forward by this research, discuss the research originality and contributions as well the recommendations as far as this research is concerned. The summary provides responses to the research questions asked in Chapter 1. Note that, under research recommendations, there are suggestions for possible further research that are meant to be the most useful contribution of this research. Last but not least, primary take-home points will be mentioned as the overall conclusion at the end of the chapter.

9.2 Research Originality

The originality of this research can be seen in four dimensions. First, this research offered an in-depth philosophical explication of the *Shariah* governance as a subject matter. It drew the worldview surrounding *Shariah* compliance, a notorious idea of the Islamic financial market. Since technical and applicable approaches are more likely the trend in the area, this research is one of the first attempts to posit a philosophical approach into the *Shariah* governance corpus. Second, it also offered a comprehensive combination of multiple disciplines of knowledge in a single discussion. Legal studies, Islamic finance and corporate governance are intermingled. As a result, every discussion has formulated a new and stand-alone understanding of the subject at hand. The discovered themes thus far might not be as well-developed as their conventional counterparts, but it is undeniably shedding light on the relevant grey areas. Third, the fact that this research chose the UK as the case study is unique. Most of the *Shariah* governance issues happen to take place in Muslim-dominated jurisdictions, as far as this research is concerned. Given the fact that the UK is the host of many corporate governance standards since the 1990s and Islamic finance has been operating within the market since its first appearance in the 1970s, research on the applicability of *Shariah* governance should not be abandoned. If the UK experience is to be accounted for, *Shariah* governance could potentially expand if it manages to catch the eye of the right party. Fourth, this research is also original in terms of its high regard of the fundamental aspects of *Shariah* governance. Most standard-setters such as the IFBS and the AAOIFI focus on managerial and organisational aspects to ensure *Shariah* compliance. Likewise, the majority, if not all, of the researchers have done no less. As repeatedly emphasised, the virtues of such are equally consequent, as far as this research is concerned.

9.3 Research Findings

The findings of this research are in response to the research questions, arisen from the research statement in Chapter 1. They are as below.

9.3.1 *Shariah* Governance Definition, Characteristics and its Relationship to Conventional Corporate Governance

Regarding this, this research defined the word '*Shariah*' and 'governance' discretely to hint at the similarities as well as the dissimilarities of *Shariah* governance as opposed to conventional corporate governance. *Shariah* as a fundamental conception in the Islamic worldview is defined through its features that are closely related to governing the Islamic finance. Frequently, it is conceivable as the Islamic law, but it is also in fact connoted by the scholars as the teaching of Islam as a whole. Both comprehensions make irrevocable impacts on the IFIs' operating systems. Whether it is a law or a holistic teaching, it is the concept fully upheld by the IFIs' systemic and operational arrangements. As a result, the existence of the *Shariah* governance is a distinctive element of the IFIs as a way to ensure *Shariah* compliance at all costs.

As a set of laws, *Shariah* upholds the balance between rigidity and flexibility as its characteristic. In many cases, the fundamental aspect of each chapters of the law will be rigid, as in the prohibition of *riba*. As repeatedly mentioned, it is perhaps that this is the most controversial element within the discussions of Islamic finance. Other than that, *Shariah* law is flexible, namely in prescribing legal approaches to tackle innovative financial expansions as long as *riba* is not involved. In this respect, one of the primary objectives of *Shariah* under spotlight is to preserve the wealth and prevent it from any harm. The way to achieve this might be dissimilar to conventional approaches. However, the essential idea is that it is not to restrain the potential of the financial market, but to facilitate an alternative to the existing system. As far as the stakeholders are concerned, this could be another choice that the Islamic financial industry has to offer and they are free to make a choice.

In defining the word 'governance', this research embraced the approach of the mainstream schools of thought on viewing what corporate governance truly is. This is to emphasise that *Shariah* governance is not to deviate from the course of what are already established. It is somehow a contribution from the Islamic financial industry towards the betterment of the corporate governance corpus. Similar to the conventional corporate governance, the *Shariah* governance system is highly concerned with accountability, transparency, enhancing stakeholders' confidence and so forth. To make it more sensible, this research offered an explication of the objectives of the Islamic firms. As observed, it is still

about increasing firms' value, but on its own terms. Instead of focusing only on shareholder wealth maximisation, the installation of the *Shariah* governance principles refines the respective notion by diverting it to an alternative, which looks to optimising the firms' value. It might similar to the former conception but optimising as far as this research is concerned denotes a new paradigm of the firm's existence. Due to this, there is no ingenuity in increasing the value of the wealth to the maximum if such an action could jeopardise the stakeholders. The wealth is only optimised if it is beneficial to the stakeholders because that is what preserving wealth is truly about.

Following the comprehension of the both terminologies is, what is the definition established by the *Shariah* governance standard-setters. As mentioned by the IFSB, *Shariah* governance is a system through which there is an independent mechanism to ensure *Shariah* compliance. The primary concern is how the governance constituents of the IFIs execute their functions since they play a pivotal role to give assurance to the stakeholders that the IFIs are operating in accordance with *Shariah* precepts. With this notion, a *Shariah* committee, which is consisted of a group of *Shariah* experts, was introduced to IFIs' organisational structures. As an advisory board, the *Shariah* committee, with the assistance of the internal *Shariah* department, will evaluate the products and services before their execution in case of any non-compliant aspects to the preceding *Shariah* rulings. The existence of such a committee is a crucial evidence of the IFI's endeavour to ensure the adherence of their products and services to *Shariah* law.

Looking at the relationship of the *Shariah* governance to the conventional corporate governance, it could be concluded that neither concept is alien to the other. By observing the standards published by the IFSB, AAOIFI and BNM, *Shariah* governance turned out to be well integrated within the existing corporate governance system. In this vein, *Shariah* governance functions as an additional system to empower what is already there to support Islamic finance's peculiarities. Seemingly, *Shariah* governance has also managed to widen the horizon of the corporate governance comprehension namely in its ethical division. As far as this research is concerned, it is an interesting development of our modern world, which is far more complicated than the year when the debates on corporate governance first took place.

9.3.2 Conventional Corporate Governance Theories under *Shariah* Purview

To explain this, this research has chosen two widely recognised theories in corporate governance: the shareholder wealth maximisation theory, and the stakeholder theory. There are many other theories available, but since the two theories are classically debated and their fundamental elements are already well

disposed and adopted by several multilateral standard-setters such as the OECD, it is worth utilising them as the points of reference for this research to illustrate the underlying principles of *Shariah* governance.

Islam is tolerant of ideas and innovations. In fact the very fabric of its teaching puts a high regard on knowledge and scholarship. Muslims are urged to explore the universe in order to understand what is happening around them and to make their lives easier through science and technology. As in economics, what makes humans prosper is welcomed and well-accepted. This is the general approach taken by Islamic scholars when dealing with theories originating from the non-Islamic world. This intellectual discourse is the culture of Islamic scholarship for more than a thousand years. The approach is, everything is permissible or licit until it is proven as non-permissible or illicit by the Islamic sources. That is the exact method taken by this research when dealing with corporate governance theories.

By and large, those theories have been developed to ensure economic prosperity and wealth is well-generated and preserved. As shown, it should be understood that not all of the conventional corporate governance theories should be eliminated from the equation. The dialogues on the respective narratives have procured many aspects, some of which are acceptable and some of which are not. Some are fundamental and some are rather supplemental. More importantly, this research has located the dialogue of the *Shariah* governance within the breadth of corporate governance discourse. From the beginning of this research, we have seen many aspects of *Shariah* governance, either in conjunction with conventional corporate governance or otherwise. There are three angles of explanation chosen to explicate the timeless principles, and three mechanisms to be utilised as the way to bring those principles into action.

As commonly happens in the debates between corporate governance schools, *Shariah* governance has provided the viewpoints that make it peculiar. This is unavoidable since the installation of the *Shariah* compliance concept into a corporation makes an impact on how the business should be understood. It includes how it views wealth and the ways of generating it and maximising its value. As we can see in the counterbalances, the most prominent point, amongst others, is how the IFIs, under the *Shariah* purview, perceive the managers, wealth and business ethics. Firstly, as the managers ought to act with good faith on the wealth trusted to them, the shareholders should also see the managers as trustworthy. This heart-to-heart communication is actually denying the fundamental convictions of conventional corporate governance theory, wherein managers are perceived as untrustworthy. However, it does not necessarily mean that all the controls put by the shareholders to oversee the managers due

to that mistrust are inappropriate at all. That is to say, those controls can function as the last resort in the case of a breach of trust. It also widens the narrative of who matters most in the managers' decisions and actions: the shareholders or the stakeholders. Secondly, increasing wealth especially through shareholders' wealth maximisation is not the most fundamental issue in business as wealth ownership is diversely viewed. It is rather how the generated wealth is going to make an impact to the stakeholders. From this standpoint, the stakeholder theory seems to have a closer ground to *Shariah*. This is due to the fact that, as stakeholder theory appreciates multiple stakeholders who should benefit from the wealth, *Shariah* is no different. The debate might come by discussing the actions and the inactions of the managers; the outcome however is undeniably about how they manage the wealth. This is where the third aspect comes in, the business ethics. Islam, as a religion with a very tight relationship to ethics, makes a stand against the separation theory. In this respect, the stakeholder theory as excavated here is appreciating ethics as fundamentally consequential in business decisions and actions. However, this does not mean that there is no rooms for improvement available from the *Shariah* perspective.

9.3.3 *Shariah* Governance Principles

The third finding exposed that there are three dimensional principles that underlie the *Shariah* governance system: the worldview, the legal approach and the ethics. The comprehension of these timeless principles works as the pillars to envisage the duty held by *Shariah* governance constituents. It provides the fundamentals that could induce a new way of thinking to the governance system, especially catering the IFIs' characteristics. These principles are formulated from a vast literature developed by the scholars from the Islamic sources, the Quran and the Hadith.

The first principle emphasises how the faith in Allah as the only God under the unity of God conception (*tawhid*), gives an impact on the Muslims' daily lives, including their business decisions and actions. Most importantly, this worldview describes the conception of wealth ownership where humans as the vicegerents of God are not the sole owners of the earth but the agents with power delegated by God to manage it on His behalf. Becoming conscious of this, humans would see themselves as utilisers and managers of the resources, rather than as manipulators or exploiters. The resources are not the objective, but the tools to achieve the objective, which is to seek equilibrium in the economic ecosystem. In terms of business management of the IFIs, according to this worldview, the IFIs should firstly never deem the managers as untrustworthy and waste their labour production talents. Secondly, the IFIs should also be delicate and creative in business strategies, as they are the passionate vicegerents of God managing the available resources entrusted to humans. Thirdly, the IFIs should serve as economic agents to achieve economic equilibrium through wealth-sharing and

balance ownership. The last point, but not the least, is the IFIs should promote this notion to their conventional counterparts and find a way to merge the both systems for everybody's benefit.

The worldview of *Shariah* governance is believed to be what is capable of making the firms to see the natural resources in a different manner as opposed to the classical economic theories. It might seem non-substantial, in a way, as faith is an individual, internal affair. However, when it comes to institutional applications, this faith is not merely individual any longer, but a responsibility upheld by those who have the power. It is imperative to understand here that this worldview is not what dictates the institutions but an understanding possessed by the institutions of the way of thinking of the Muslim customers in the market. It is for this reason, the IFIs are needed, to ensure a resilient *Shariah* compliance process is in place, since it is a direct impact of the indicated worldview.

The second principle of the discussion is being *Shariah*-compliant. As the crux of the research, this research supplies the demand for the matter under the discussion. Since *Shariah* is not a written law in most jurisdictions, *Shariah*-compliance is conceptualised in a way it could bring about the essence of the law as derived from the Islamic texts. It is a set of laws regulated by the *Shariah* scholars, from the Quran and Sunnah, through a cautious jurisprudence and implemented by the government in power. In a financial sense, *Shariah*-compliant means that the institutions are following the standards derived from the sources of *Shariah* in financial activities. In this respect, in many cases the most controversial component is the prohibition of *riba*. On this score, this research chose to address a technical approach to understanding the issue of *riba*. Based on the discussion, despite being complicated, *riba* can be addressed structurally, whereby instead of looking at it as a sacred religious verdict, it is in fact economically sensible. If interest is not the heartbeat of our modern economic systems, *riba* might not an issue at all, as far as this research is concerned. This is due to the fact *gharar* (uncertainty) and non-permissible activities, no matter how diverse they are, based on jurisdictions, are common issues that exist in finance. Above all, a learn off argument here is, *Shariah*-compliant is actually a propagation of an alternative economic approach, formulated from a religious teaching. Whether it is going to be taken as a belief ones must adhere to or as nothing of concern, *Shariah*-compliance prevail as a successful propeller of the Islamic financial industry. Market penetration of this industry thus far might be a tiny fraction of the whole system, but the potential is undeniable nonetheless. Therefore, this research stands as a gateway to comprehending the issue in hand so that when it is time, those who may be concerned, namely regulators could find themselves in the right place regardless of their religious purview.

The third principle involves the Islamic conception of *akhlaq* as the depiction of ethics. Islam as a religion never fails to prove ethics as its fundamental element. However, as disclosed, it is not the only feature of Islam. It is a supplementary element of Islam as a whole, which comes after righteous belief and compliance to the rules depicted by the texts. Perhaps one of the most intriguing parts is the intertwining concept of morality and law in Islam. Ethics is the propellant of legal compliance which makes legal actions only as the last resort as far as Islam is concerned. The important point here is how *akhlaq* serves as a unification tool of humans' diverse interpretations of the best of conduct to overcome moral hazard. By sidelining the false understanding on what is 'good' or 'best', as probably defined by humans' multicultural backgrounds, *akhlaq* upholds intercultural goodness. That is the reason why, similar to the conventional counterpart, *Shariah* governance addresses accountability, transparency, risk mitigation, customer confidence and so on. This is what brings together Muslims from all over the globe, including when it comes to business matters. Note that this threefold fundamental truth is the basis that forms the counterbalances as discussed. It is also the articulation of *Shariah* governance principles, formulated from genuine Islamic texts, using well-recognised methodological approaches.

9.3.4 *Shariah* Governance Mechanisms

After excavating the timeless principles of *Shariah* governance, this research addressed the fourth finding that depicted *Shariah* governance mechanisms to ensure applicability of the respective principles. Frequently, the available discussions on *Shariah* governance are philosophical and theoretical and less attentions is given to its mechanisms of implementation. As demonstrated, the mechanisms to implement the principles of *Shariah* governance are dynamic and flexible, depending on the market and jurisdiction. In this regard, this research proposed three sensible mechanisms, which are the governing law, the supervision and the audit.

As far as this research is concerned, having governing law that appreciates *Shariah*-compliant requirements is a prerequisite to a resilient *Shariah* governance system, owing to the fact that it is the *raison d'être* of *Shariah* governance. There are inexorable needs for a conducive legal environment for the Islamic financial market to flourish in. As we can see, regulating Islamic finance is to justify *Shariah* compliance in the relevant jurisdiction, mitigate the risk, protect the customers, and codify the implementation of *Shariah*-compliance. Not to mention that it is believed an agile and responsive regulatory ecosystem can assist the IFIs to thrive to their full potential while minimising the risks embarked on by the customers. All those are the key factors that are believed to be consequential if Islamic finance is to expand and reach its full potential and ensure stability and prosperity to the market. More importantly, the governing law must also reflect the virtues as promulgated in *Shariah* law. This

is to avoid rule-based *Shariah*-compliance without a consideration of the underlying virtues.

On top of that, the present legal mechanism that values *Shariah* compliance is extravagant if its implementation is not supervised in a proper manner. In fact, this has been the focal point of *Shariah* governance standard-setters such as the IFSB from the beginning. *Shariah* supervision carried out by *Shariah* committee is the key to *Shariah* compliance. Since *Shariah* compliance is in its infancy, there are many features unknown to the stakeholders, including, to name some, the managers, the customers and legal practitioners. Furthermore, the governing law might be the mechanism to define what *Shariah*-compliance is, but the real deal is the supervision mechanism available as a profoundly fundamental tool to uphold the rule of law. As for this reason, setting up a robust *Shariah* supervision mechanism is a demand to the corporations in general and the IFIs in particular. To explain what this is truly about, this research described how close this role is to the fiduciary duty of the relevant governance constituents. As deeply explored, the *Shariah* committee plays the role of due diligence to ensure not only the prescribed conventional corporate governance standards but also *Shariah* governance standards are fully complied with by the institutions. *Ijtihad* as the centre of this due diligence process is crucial in ensuring adherence to *Shariah* law. It is for this reason, IFIs are in need of *Shariah* experts. Nevertheless, the supervision functions of the *Shariah* governance still to be oversight by another layer of the check-and-balance mechanism, which is the *Shariah* audit.

Apart from the two mechanisms above, the audit in *Shariah*-compliant processes serves as the third mechanism of defence in the *Shariah*-compliant saga. It functions as a mechanism to double check, not only the IFIs' accounting system but also the *Shariah*-compliant process. The objective is to gain and enhance stakeholders' confidence, especially that of Muslim costumers who see *Shariah*-compliant assurance done by the *Shariah* committee as their way to be released from the burden of doing so on their own. In terms of its structural arrangement, the *Shariah* audit resembles the conventional model yet deploys specific additional tasks. To demonstrate how this should be done, the Malaysian *Shariah* governance framework was chosen. Similar to the conventional corporate governance audit mechanism, the *Shariah* audit has to be internal and external. The scope, however, is concentrated on the *Shariah*-compliant process. It is an additional feature of the existing audit system, which puts more focus on accounting, whereas in this relationship, the *Shariah* audit is somehow interrelated to such. To reiterate, in a way, *Shariah* governance mechanisms are structurally similar to the conventional counterpart. Owing to its unique principles, *Shariah* governance mechanisms work as forces to provide constructive support to the IFIs towards achieving their organisational objective, which to optimise the firm's value and ascertain its sustainability.

9.3.5 Jurisdictional Compatibility

The fifth finding exhibited the compatibility of *Shariah* governance to be adopted by the institutions regardless of their jurisdictions. As observed, this research excavated the possibilities of adopting the *Shariah* governance system into the UK IFIs. The fact that this research is constructed based on existing practices of the IFIs is sufficient as an answer. However, this research underscored the importance of preserving the comprehension of *Shariah* governance from its core principles, where such a knowledge could widen the horizon of the policy-makers, regardless of their legal approach. Furthermore, it could stand as a solid evidence, manifesting how an in-depth understanding of a particular matter could give more flexibility and bring less rigidity to the written standards when it comes to the implementation since one size does not fit all. Above all this research might be looking at the UK market, but the compatibility issue is not restricted to such. Other markets, especially, the Muslim-dominated markets, are also within the scope.

Starting by addressing the positive developments with regard to the UK Islamic financial market and relevant legal aspects, we can see that *Shariah* governance is truly a big deal, even in the UK. However, there are many challenges and issues that could hinder the process should it be overcome by the IFIs. Thus far, the finding showed that the UK is adopting decentralised approach where *Shariah* governance is left to the institutions to make it happen. Due to the fact that the UK IFIs are mostly foreign-based institutions, the existing practices are akin to their home market norms. Perhaps the biggest issue here is the Islamic financial market penetration is still small in size to put a significant pressure to the policy makers to look at it with a decisive manner. As depicted, there are significant factors to be put under consideration for the UK policy-makers to be more decisive. For the time being, the demand might still considerably small, but the fact that the fraction is growing is not to be abandoned unobserved. Either way, there will be a time when the UK Islamic financial industry has a bigger and more indicative market penetration. Furthermore, the UK policy-makers are interested in making the UK a global Islamic finance facilitator by providing alternative dispute resolution. In achieving that, they have to be well-prompted with relevant data and sufficient knowledge of the matter in hand.

9.4 Recommendations

Throughout the three years of research, there are a few recommendations worth mentioning here. To make it easy to understand, it will be divided into three segments, as below.

9.4.1 Academia

Recommendations relevant to academia are surely on possible future researches on the subject under the discussion. First, research on the principles of *Shariah* governance is still in its infancy. The attempt taken by this research to fill up the gaps in fact only represents a tiny part of the whole area. Alternative conceptualisations to contemplate *Shariah* governance are welcomed so this research field could have a well-rounded aspect of discussions in the future. The approach suggested by this research, which is to integrate *Shariah* governance into conventional corporate governance is believed will be able to generate more upcoming researches, especially in the ways to understand the existing market phenomenal. Second, since this research adopted doctrinal study that collects the data from documents, not from fieldwork, research to compare market practices based on provided principles is required. In this regard, a relevant question here is 'are the IFIs' stakeholders aware of those principles?'. Third, if we look at the conventional corporate governance corpus, demonstrations to exhibit practices in multiple jurisdictions are common. The fact that *Shariah* governance also possessed diverse models adopted by different jurisdictions, means a similar demonstration is possible. This means, there is a great potential for researches in newly explored markets. Japan's financial market, for instance, as one of the major markets discussed in corporate governance corpus, is exploring the possibility of offering green banking and taking part in the international Islamic financial market. *Shariah* governance is an unavoidable issue for them to tackle in the near future.

Other than addressing possible future research, academics are entailed to obtain a sufficient cross-field knowledge with regard to *Shariah* governance. As learnt by this research, experts are truly in need of looking at the *Shariah* governance issue through a principle base lens. To do so, they must be competent in legal studies, namely in corporate law and Islamic studies, especially in Islamic finance and corporate governance, collectively. Similarly to the conventional counterpart, the knowledge development for this area is time-consuming. Therefore, the effort must begin from now. Perhaps a designated subject committed to *Shariah* governance should be taught by universities or even academic centres with specific attention given over to this corpus is a sensible idea, as far as this research is concerned.

9.4.2 Policy Makers

Policy makers relevant under discussion are the standard-setters, especially the IFSB and the AAOIFI, and the central banks which Islamic finance is operating under their jurisdictions. Those are the authorities close to *Shariah* governance.

As for standard-setters, whether explicitly or implicitly they ought to adopt a principle-based approach within their *Shariah* governance standards. This research has relentlessly demonstrated the magnitude of this approach. As revealed, existing *Shariah* governance standard-setters are akin to the stakeholder theory and when it comes to *Shariah* governance standard, a rule-based approach is favourable. Despite 'one does not fit all' is applied, a rule-based approach which comes in detail on how to behave seems to take place in most part of the standards and frameworks published. To ensure long term resiliency, the IFSB and the AAOIFI, for instance, are recommended to modify the approach. This is to give room to stakeholders to comprehend the *Shariah* governance issues that have arisen in hand. It is believed, the principle-based model could provide them with the background of a certain standard, so they would obtain the bigger picture of such. To exemplify is by looking at how shareholder value maximisation and value optimisation justify managers' decisions and actions. In the case where shareholders are the sole subject under managers consideration, any consequences enjoyed or suffered by other stakeholders are not of concern. As long as the shareholders are satisfied and there is no breach of law, other matters are not an issue, and the managers mostly enjoy a great compensation as a result. This is where self-dealing could be happening. Under *Shariah* governance principles, the shareholders are not who or what matter most. Regarding this, the institutions, the customers, the employees, even nature, to name some, are the real subject matters in the boardroom. The value of wealth generated by the institution should not be calculated solely on an accounting basis, but non-accounting aspects should also be appreciated as well. Most importantly, decisions and actions that could preserve the institution in the longest run in order to bring goodness to the stakeholders as a whole are what truly matter. Therefore, *Shariah* governance of the future should go beyond *Shariah*-compliant procedural periphery, as far as the standard-setters should concerned.

As for the central banks, there are two market dynamics available, Muslim-dominated jurisdictions and non-Muslim dominated. In Muslim-dominated jurisdictions, *Shariah*-compliance might well be a great deal to uphold. However, as demonstrated, the Islamic financial system is sophisticated and complicated thus understanding it could be trouble. Therefore, an attempt to increase awareness amongst the stakeholders should be initiated. This is due to the fact that customer demand for *Shariah*-compliant products over merely religious sentiment would open the market to the risk of manipulation as far as this research is concerned. In this respect, ignorance and negligence are no longer a choice. It is also holding the key for the IFIs to go beyond *Shariah* compliance, which is *Shariah*-based. It is not wishful thinking to hope for an emergence of a market that functions based fully on Islamic teaching as a result of collective understanding and corporative initiation propelled by the stakeholders as an

ummah, not merely fractions of members of a community with different agendas and interests.

As for non-Muslim-dominated jurisdictions, the objective is to facilitate *Shariah*-compliant products and services, so they could be offered by financial institutions at will. In this respect, facilitating *Shariah* compliance does not mean a dictation of *Shariah* law as some might perceive. It is an appreciation of market diversity within the free market system that also supports value optimisation and ascertains firm sustainability. As reported, the Islamic financial market has shown tremendous growth. From about USD200 billion in 2003 to USD1.6 trillion at the end of 2012, the market had achieved USD1.89 trillion at the end of 2016 and USD 2 trillion in 2017. More importantly, Islamic finance is no longer operating remotely in Muslim dominated jurisdictions, where it has triggered global demand including markets outside the Muslims region. Rather than a religious imposition, non-Muslim demand for *Shariah*-compliant products is considerable as a positive market push instead. As a result, policy-makers in non-Muslim-dominated markets such as in the UK have shown their interest to take part and supply the demand in kind. In their way to ensure righteous actions and strategies are in place, a deep understanding of the *Shariah* governance is a great advantage. They may begin with the most fundamental and controversial aspect of Islamic finance, which is the prohibition of *riba*, then moving towards other areas that are flexible to the market, proportionately. In this case, when interest charge is only a matter of choice for financial institutions whether to take it or not, other challenges are not an issue anymore. As we can see in the UK cases, issues such as double taxation are fairly minor and resolvable when interest-free based products are already legalised. Furthermore, the notion under a secular-based legal system that looks at religion as a personal choice is to some extent a great opportunity for the IFIs. Above all, this is merely a financial alternative for the customers to freely go for it or not. If not Islamic finance, other types of financial systems might as well emerge and spread all over the systems.

9.4.3 Financial Institution Practitioners

Islamic financial institutions are the hosts of the subject matter of this research. In fact, they are the centre of discussion. In this respect, these are a few sensible recommendations for them.

First, members of *Shariah* committee are to improve their understanding of the *Shariah* governance system. As discussed, their roles are not merely to issue *Shariah* verdicts on *Shariah*-related matters, but also to act as fiduciaries of the stakeholders. This conception urges them to master other issues surrounding the products or services respectively and to put a thorough analysis to the affected stakeholders. This is why the impact of the IFIs business decisions and actions

are also believed to be under *Shariah* committee's boardroom concern. Ignoring this would just spread an impression that *Shariah* compliance is merely a dictation of *Shariah* financial law, and the *Shariah* committee is the one and only all-knowing committee on such a matter. Efforts to enhance stakeholders' confidence in *Shariah* compliance must be initiated. In this respect, better transparency of *Shariah* compliance processes and well-regulated external *Shariah* audits, amongst others, are sensible means to highlight as target areas of improvement.

Second, as for the external *Shariah* audit, senior *Shariah* experts are the most eligible group of experts to begin with as external *Shariah* auditors. This is due to the fact that the *Shariah* audit is one of the latest features of *Shariah* governance mechanisms. It is believed that their invaluable experience is extremely fit for purpose as auditors of the *Shariah*-compliant process. If this is not to be done, there will be a paradoxical situation where inexperienced auditors will be auditing the work of more experience experts. This situation will jeopardise the integrity of the respective IFIs and could be detrimental to the industry as a whole. Other than that, training and educating new generations of *Shariah* experts is to be escalated to supply the demand of the market for *Shariah* advisors, *Shariah* auditors, *Shariah* officers and other positions relevant in *Shariah* governance.

Third, members of IFIs' boards of directors are to put stakeholders into consideration in their boardroom because they are not merely shareholders' proxies. It is important to emphasise here that they are also accountable to the stakeholders. It is not because it makes sense, but is securely plugged in to their subconscious mind as Muslims. They believe that they are accountable to God, as in the Unity of God, in every decisions and actions they take. It is through this concept, the board should act accordingly with *Shariah* requirements, even when black letter *Shariah* law is in absent. Other than that, moral consideration should also be well represented in business strategies. No matter how easy it is to say and how hard it is to comply with, the IFIs should take the role of changing the mindset of business entities as a whole. Whether it is going to be a success or not is not our concern because this is the never-ending course promulgated by Islamic finance founders decades ago.

Fourth, improvement of the managers' knowledge of *Shariah* governance principles is a must. In other words, IFIs' managements ought to acquire this new dimension of corporate governance for the sake of their institutions. If not all, most managers are already well aware of corporate governance special treatment needed by their institutions. Regarding this, IFIs as financial institutions ought not to take similar approaches as the conventional institutions. They are not to view IFIs as merely money generators towards shareholder value

maximisation. IFI corporate strategies must take into-account the impacts of their decisions and actions on the stakeholders and *ummah* as a whole. Therefore, the IFIs' economic equilibrium, if not totally, is differently defined as opposed to the conventional counterpart. Wealth optimisation is perceived as prioritising the benefit of wealth to the stakeholders rather than looking at its numerical indication. Apart from annual increase in terms of revenue, the valuation should consider how it has increased stakeholders' value at the same time. In other words, Islamic finance is not merely a brand, but it is a set of financial systems that offers alternative financing which is believed to be better than the conventional counterpart.

9.5 Overall Conclusion

This research has examined the principles of *Shariah* governance. This has been done by looking at the relevant extent literature in legal studies, Islamic studies and corporate governance. Regarding this, there are three points to be reiterated as take-home notes. First and foremost, the main objective of *Shariah* governance as observed is to optimise the value and to ascertain the sustainability of the institutions in a way that complies with *Shariah* law. In doing so, *Shariah* governance is not to contradict the mainstream approach as generally taken by corporate governance system. It offers an alternative for involving constituents to adopt it in their governance systems. To ensure that to happen, experts are to look at the common grounds of the both systems before proposing the solutions for any diversified areas. Second, the principles of *Shariah* governance stand on the epistemological worldview as in the unity of God, *Shariah*-compliant and *akhlak*-based ethical codes. Belief in the unity of God is the key propulsion that has built up the way of the IFIs business direction. From such a worldview, IFIs are contemplating wealth as a tool rather than a final objective. This is what allows them to go beyond shareholder value maximisation and even the stakeholders' interest, where they give consideration to other aspects that are also matter in their decisions and actions. Under this, the agents are the most trustworthy partners of the shareholders. In this relationship, necessary controls function as the last resort, especially in the case of breach of trust, not as the tools to dictate or control the agents so they would work solely for the shareholders' best interest. The key performance index of the agents is not merely on the annual financial increment, where how the generated wealth makes impacts to those who are at stake is also essential. To ensure those fundamentals are well upheld involves a *Shariah*-compliant process. In this regard, the IFIs, propelled by self-awareness, have been willingly upholding the responsibility to supply the demand in kind. This is the very factor that has brought *Shariah*-compliant products and services to its success as seen today. Well-regulated or not, the IFIs have penetrated the market, regardless. Third, there are three mechanisms consequential to *Shariah* governance: the governing law, the supervision and the audit. However, more research should be initiated to

investigate other mechanisms that might as well exist and be effective in supporting *Shariah* governance. Further research on the mentioned mechanisms is also welcomed to find answers within grey areas unattended by this research. This is just a beginning from which *Shariah* governance is yet to reach its full capacity. It is also imperative to note here that *Shariah* governance is not a peculiarity that could only operate within Muslim-dominated jurisdictions, but could operate within other jurisdictions as well. It is to this account, that IFIs should not restrict themselves but expand and make new discoveries about the potential of the *Shariah* governance in the future so this corpus of knowledge could reach new levels of exploration in the future.

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