

# *Shari'ah Governance Framework in Contemporary Islamic Banking Institutions*



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المعهد الدولي للاقتصاد الإسلامي  
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### TITLE OF THESIS:

### **"SHARIAH GOVERNANCE FRAMEWORK IN CONTEMPORARY ISLAMIC BANKING INSTITUTION"**

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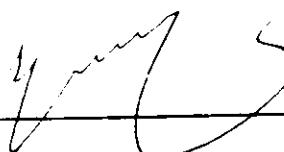
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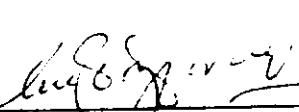
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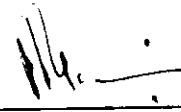
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بِسْمِ اللّٰهِ الرَّحْمٰنِ الرَّحِيْمِ

## **DECLARATION**

I, Muhammad Asghar Shahzad, hereby declare that this thesis, titled "*Shari'ah Governance Framework in Contemporary Islamic Banking Institutions*" has not been submitted for the award of any degree or diploma.

**(Muhammad Asghar Shahzad)**  
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## LIST OF ABBREVIATIONS

<b>AAOIFI</b>	Accounting and Auditing Organization for Islamic Financial Institutions
<b>BNM</b>	Bank Negara Malaysia
<b>BoD</b>	Board of Directors
<b>EM</b>	Executive Management
<b>EA</b>	External Auditors
<b>ESA</b>	External <i>Shari'ah</i> Auditors
<b>IBs</b>	Islamic Banks
<b>IBB</b>	Islamic Banking Branches
<b>IFSB</b>	Islamic Finance Services Board
<b>IFI</b>	Islamic Financial Institutions
<b>IIFS</b>	Institutions offering Islamic Financial Services
<b>RSBM</b>	Resident <i>Shari'ah</i> Board Member
<b>SA</b>	<i>Shari'ah</i> Audit
<b>SAB</b>	<i>Shari'ah</i> Advisory Board
<b>SBP</b>	State Bank of Pakistan
<b>SCD</b>	<i>Shari'ah</i> Compliance Department
<b>SG</b>	<i>Shari'ah</i> Governance
<b>SGF</b>	<i>Shari'ah</i> Governance Framework
<b>SR</b>	<i>Shari'ah</i> Review
<b>SSB</b>	<i>Shari'ah</i> Supervisory Board
<b>SSBM</b>	<i>Shari'ah</i> Supervisory Board Member

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## ABSTRACT

*Shari'ah* compliance is the backbone of Islamic banking & finance. It gives legitimacy to the practices of Islamic banking and finance and validates the profits. It also boosts the confidence of all stakeholders in that all the practices and activities of the bank are in compliance with the *Shari'ah*. The objective of this study is to analyze and evaluate the features of the *SGF* issued by SBP, BNM, AAOIFI, and IFSB. It also examines the role and responsibilities of the important organs of *Shari'ah Governance*. In the next part the study critically examined the competency, independence and appointment of *Shari'ah* Supervisory Board (*SSB*) in the light of existing *SGF* standards. The study also empirically investigates the impact of the essential components of *SG*, i.e., the Board of Directors (BoDs), executive management (EM), *SSB*, Residents *Shari'ah* Board and *Shari'ah* Audit (independent variables) on the enhancement of *SG* (dependent variable) of IBs. The study has used primary data of 500 respondents, a thorough survey of various fields, including *Shari'ah* Scholars, *Shari'ah* Board members, bankers, academia, *Shari'ah* auditors, auditors of reputed firms, and the general public. Multinomial logistic regression analysis is used by categorizing the level of *SG* into three, i.e., low, medium and high level. Data reliability and consistency is checked through Cronbach's alpha and heteroscedasticity. The study concludes that all the independent variables are presenting a strong association with a high level of performance of *SG* in relation to medium level except one variable 'Shari'ah review and audit.' This means that keeping all other independent variables constant if we increase the level of performance of *Shari'ah* review and audit for a high level of *SG*, it would decline by 1.48 units. The outcomes are empirically discussed in the context of coefficient and relative risk ratio. In other words, the efficiency of *SG* may be enhanced due to efficiency in independent variables. In the last chapter the study also compared the *SGF* issued by the SBP in 2015 and 2018 to investigate the improvements in *Shari'ah* compliance environment of IBs in Pakistan.

## Introduction

The Islamic finance industry is a rapidly growing industry all over the world; nowadays, IBs are working in many Muslim and non-Muslim countries. This industry was started in Pakistan since 1980. Interest (usury) is strictly prohibited in Islam. The Holy *Qur'ān* has declared war against Allah SWT and Prophet ﷺ against those who do not abstain from it. Modern banking interest is also a type of interest<sup>1</sup>. The contemporary Islamic banking system is an alternative to the conventional banking system. The conventional Banking is based on interest, while contemporary Islamic Banking is based on *Shari'ah* compliant products and services. The SSB supervises these products and services.<sup>2</sup>

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<sup>1</sup> Mr. Justice (R) Khalil-ur-Rehman Khan, 'The Supreme Court's Judgement on Riba' (Islamabad: Shari'ah Academy, International Islamic University, Islamabad, 2000); Justice Muhammad Taqi Usmani, 'Historical Judgement on Interest (Sood Per Tareekhi Faisla) Urdu' (Karachi: Maktaba Muarif ul Quran, Karachi, 2008); Dr. Muhammad Tahir Mansoori, 'Supreme Court's Judgment on Riba: A Shari'ah Appraisal', *Hamard Islamicus* XXIV, no. 3 (July-September) (2001): 15–52; Muhammad Ayub, *Understanding Islamic Finance* (Chichester, England: Jhon Wiley & Sons Ltd, 2007). Md. Akther Uddin, 'Principles of Islamic Finance: Prohibition of Riba, Gharar and Maysir', MPRA Paper No. 67711, posted 9. November 2015 09:32 UTC, 2015, <https://mpra.ub.uni-muenchen.de/67711/>; Yousuf Sultan, 'Riba , Gharar & Maysir : A Review from Classical Shari'ah and Contemporary Implications', Working Paper, 2016, [https://www.researchgate.net/publication/304660115\\_Riba\\_Gharar\\_Maysir\\_A\\_Review\\_from\\_Classical\\_Shari%27ah\\_and\\_contemporary\\_implications](https://www.researchgate.net/publication/304660115_Riba_Gharar_Maysir_A_Review_from_Classical_Shari%27ah_and_contemporary_implications).

<sup>2</sup> Muhammad Ayub et al., 'Enhancing the Competence and Effectiveness of Shari'ah Advisory Boards : Case of Islamic Banking Institutions in Pakistan', *Journal of Islamic Business and Management (JIBM)* 9, no. 1 (2019): 45–66; Muhammad Ayub, 'Focusing on Shari'ah Governance in Regulating the Islamic Banking Institutions', *Journal of Islamic Business and Management (JIBM)* 6, no. 2 (2016): 7–18; Muhammad Ayub, 'Strengths, Gaps and Issues in Shari'ah Governance Framework 2015 for IBIs in Pakistan', in *Research in Corporate and Shari'ah Governance in the Muslim World: Theory and Practice*, ed. Toseef Azid, Ali Abdullah Alnodel, and Muhamad Azeem Qureshi (Emerald Publishing Limited, 2019), 261–75, <https://doi.org/10.1108/978-1-78973-007-420191023>; Muhammad Asghar Shahzad and Dr. Habib ur Rehman, 'Shari'Ah Advisory in Islamic Bank's: An Analytical Study', *Fikr-O-Nazar; Islamic Research Institute; International Islamic University; Islamabad*. 54, no. 4 (2017): 111–42, <https://doi.org/10.2139/ssrn.2891044>; Muhammad Asghar Shahzad, Syed Kashif Saeed, and Asim

The compliance of products and services with *Shari'ah* principles is the essence of Islamic banking. The main difference between the conventional and Islamic banking is *Shari'ah* compliance of banking transaction with the *Shari'ah* rules. In order to ensure that the products and services of IFIs are complying with the *Shari'ah* rules and principles, every Islamic bank is required to appoint a board of *Shari'ah* scholars. The board supervises the IBs in product development and its implementation.<sup>3</sup> The SSB must be consists of qualified members in the field of Islamic commercial law (*Fiqh Mua'malat*). *These members* supervise the IBI's by providing appropriate *Shari'ah* decisions<sup>4</sup> on their transactions.<sup>5</sup>

The customers of IBs are concerned with *Shari'ah* compliance in their products and services. The strong SG environment in IBs will increase the confidence of their customers.

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Ehsan, 'Shari'ah Audit and Supervision in Shari'ah Governance Framework: Exploratory Study of Islamic Banks in Pakistan', *Business & Economic Review* 9, no. 1 (2017): 103–18, <https://doi.org/10.22547/BER/9.1.6>; Muhammad Asghar Shahzad, 'Book Review: Financial Institutions and Shariah Advisory Board, Need, Responsibilities and Rules: A Critical Review (Malyaati Adaray Aour Sharī'ah Advisory Board: Zaroorat, Zumidarian Aour Zawabat Tanqidi Jaiza)', *Quarterly Journal Fikr-O-Nazar; Islamic Research Institute; International Islamic University; Islamabad* 54, no. 1–2 (2016): 234–41.

<sup>3</sup> Ayub, 'Strengths, Gaps and Issues in Shari'ah Governance Framework 2015 for IBIs in Pakistan'; Ayub, 'Focusing on Shari'ah Governance in Regulating the Islamic Banking Institutions'; Shahzad and Rehman, 'Shari'Ah Advisory in Islamic Bank's: An Analytical Study'; Shahzad, Saeed, and Ehsan, 'Shari'ah Audit and Supervision in Shari'ah Governance Framework: Exploratory Study of Islamic Banks in Pakistan'.

<sup>4</sup> BNM. (2004). *Guidelines on the Governance of Shariah Committee for the IFIs*. Bank Negara Malaysia, ( the Central Bank of Malaysia), p6

<sup>5</sup> Muhammad Asghar Shahzad and Abdul Hameed, 'Islamic Banking Branches of Conventional Banks: An Analytical Review', *Pakistan Journal of Islamic Research* 19, no. 2 (2018): 43–65, <https://doi.org/https://ssrn.com/abstract=2876234>; SBP, 'Shari'ah Governance Framework for Islamic Banking Institutions', Islamic Banking Department State Bank of Pakistan (Karachi, 2018), <http://www.sbp.org.pk>; State Bank of Pakistan, 'Guidelines for Shariah Compliance in Islamic Banking Institutions', Islamic Banking Department, State Bank of Pakistan, Annexure 2 of IBD Circular No. 02 of 2008, 2008, [www.sbp.org.pk/ibd/2008/C2.htm](http://www.sbp.org.pk/ibd/2008/C2.htm).

Without proper *SG* mechanism, the bank will face *Shari'ah* non-compliance and reputational risks.<sup>6</sup>

### **Significance of the Study:**

The Central Banks of Pakistan, Malaysia and many other countries providing Islamic financial system has implemented numerous regulations regarding *Shari'ah* compliance in their IFI(s), besides Islamic Financial Services Board (IFSB) and “Accounting, Auditing Organization for Islamic Financial Institutions” (AAOIFI) have also issued standards and guidelines on *SG* for IFI(s). From the Pakistani perspective, the *SGF* issued by the SBP is an initiative to strengthen the *SG* system, but still, it has some weaknesses. These issues should be pointed out. The *SG* standards issued by AAOIFI and IFSB have been formulated from a global perspective for the whole Islamic finance industry. However, the *SGFs* issued by BNM and SBP are issued explicitly for their respective countries. It is imperative to compare these regulations in order to formulate a strong and uniform *SGF*.

### **Research Objective**

- To analyze and evaluate in a comparative perspective, the features of the *SGF* issued by SBP, BNM, AAOIFI, and IFSB.

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<sup>6</sup> Surianom Miskam, ‘Shariah Governance in Islamic Finance : The Effects of the Islamic Financial Services Act 2013’, *Proceeding of the World Conference on Integration of Knowledge, WCIK 2013, 25-26 November 2013, Langkawi, Malaysia*, no. November (2013): 455–63; Tadashi Mizushima, ‘Corporate Governance and Shariah Governance at Islamic Financial Institutions : Assessing from Current Practice in Malaysia’, *Reitaku Journal of Interdisciplinary Studies* 22, no. 1 (2013): 59–84.

- To examine the role and responsibilities of the BoDs, EM, *Shari'ah* Board, and *Shari'ah* Audit in the *SG* Principles.
- To critically examine the competency, independence, and appointment of the *SSB* in the light of existing *SGF*/Standards.
- To empirically examine the specific essential guidelines and policy recommendations that can be considered to enhance and improve the *SG* System.
- To undertake a comparative study of the *SGFs* of 2015 and 2018 in light of improvements in *Shari'ah* compliance environment of IBs in Pakistan.

## **Research Questions**

The study aims to respond and answer the following research questions;

- Is there any significant difference between the *SGF* of SBP, BNM, AAOIFI, and IFSB?
- What are the roles and responsibilities of the BoDs, EM, *Shari'ah* Board, and *Shari'ah* Audit in the light of *Shari'ah* governing principals?
- Do the *Shari'ah* Scholars, working with IBs, are competent enough to provide satisfactory answers to the issues of contemporary Islamic Banking & Finance?
- What is the procedure of determining the competency and selection of *Shari'ah* Board members in the light of the existing *SGF*/Standards?
- How active is the *SGF* issued by the SBP to ensure *Shari'ah* compliance in Islamic banking transactions?
- Do BoDs, EM, *SSB*, resident *Shari'ah* board member, and *Shari'ah* auditor contribute to strengthening the *SG*?

- Is there any significant difference between SBP's *SGFs* issued in 2015 and the framework issued in 2018 in the term of improvement of the *Shari'ah* compliance environment?

## **Research Methodology**

Most of the work in the research is qualitative. The study is library-based. However primary data has been collected through questioner from followings;

1. 'Ulamā' (*Shari'ah* Scholars) who are not associated with any IBI
2. 'Ulamā' (*Shari'ah* Scholars) associated with IBs as *SSB* members.
3. *Shari'ah* Audit Members of IBs
4. Auditors of reputed Audit firms (who normally conduct financial Audit of IBs)
5. Students/Scholars of Islamic Banking & Finance
6. General Public/Bank Clients

$$\text{Logit } (SG) = \beta_0 + (BOD) \cdot \beta_1 + (M) \cdot \beta_2 + (SSB) \cdot \beta_3 + (RSBM) \cdot \beta_4 + (SA) \cdot \beta_5$$

**BOD:** BoDs

**M:** Management

**SSB:** *SSB*

**RSBM:** Resident *Shari'ah* Board Member

**SA:** *Shari'ah* Audit

## **Limitations of the Study:**

This study is primarily focused on the *SGF* of Pakistan. However, the *SGF* of Pakistan and Malaysia was compared with the *SG* standards issued by AAOIFI and IFSB. In the second part, a survey was also conducted from the following respondents;

1. ‘Ulamā’ (*Shari’ah* Scholars) who are not associated with any IBI
2. ‘Ulamā’ (*Shari’ah* Scholars) associated with IBs as *SSB* members.
3. *Shari’ah* Audit Members of IBs
4. Auditors of reputed Audit firms (who usually conduct financial Audit of IBs)
5. Students/Scholars of Islamic Banking & Finance
6. General Public/Bank Clients

## **Chapter 1:**

### **Literature Review**

#### **Introduction**

This chapter provides a review of the available literature in the area of Islamic finance, particularly current literature on the *SG* in IFI(s). The field of *SG* is in its initial stage and, therefore, a limited study conducted in this area. The chapter begins with an introduction to *SG* followed by annotated literature review in the field of *SG* and role of BoDs, Senior Management, *Shari'ah* Board and *Shari'ah* Audit for robust *Shari'ah* compliance environment.

#### **1.1. *Shari'ah* Governance**

Grais, and Pellegrini, (2006), reviewed corporate governance challenges in Institutions offering Islamic Financial Services (IIFS) and suggested options to address solutions. First, they pointed out the need and importance of Corporate Governance in IFI(s), where it would need different treatment as compared to conventional Corporate Governance. In the contemporary Corporate Governance system, IIFS needs to ensure the reliability of its operations with the *Shari'ah* principles and protection of the financial benefits of stakeholders. The paper also elevated the issues relating to confidentiality, independence, competence, consistency, and disclosure in *SG*.

Chowdhury and Shaker (2015) discussed the current practices of *SG* in IBI(s) specifically in Malaysia. They pointed out the significant issues and challenges faced in the implementation of *SG*. The study also addressed the role of the *Shari'ah* board, and its

relation with the EM for the implementation of SG. The study is exploratory, where the authors reviewed the literature and *Shari'ah* based banking practices. The 'comparative study' method applied to understand the difference between the *Shari'ah* corporate governance used in conventional IFI and modern banking practices. They concluded that the reason for challenges facing SG practices is the lack of knowledge of Muslim scholars. They also highlighted some other relevant issues such as misinterpretation, illiterate human resources regarding *Shari'ah* based laws<sup>7</sup>.

Ahmed and Khatun (2013) examined the level of compliance of the AAOIFI governance standards in seventeen commercial banks operating their full-fledged IBBs, or windows in Bangladesh. They concluded that there is not a single bank that was fully complying with the AAOIFI governance standards. The full-fledged IBs were more compliant as compared to the IBBs of conventional banks. Though the *Shari'ah* audit is being practiced by the *Shari'ah* committee (SSCs).<sup>8</sup>

Hasan (2011), in his paper, explored the practices of SG, especially in Malaysia, GCC countries, and the UK. The study explored and analyzed the level of SG. The content analysis method has been used for analyzing and extracting the factual inputs and data of IFIs. The results of the study concluded that there are faintness, weakness, and inadequacies. In order to enhance and improve the present SG system. The study

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<sup>7</sup> Chowdhury Nazreen Tabassum and Shaker Fahim, 'Shariah Governance of Islamic Banks in Malaysia', *International Journal of Management Sciences and Business Research* 4, no. 10 (2015): 115–24.

<sup>8</sup> Mahmood Ahmed and Maksuda Khatun, 'The Compliance with Shariah Governance System of AAOIFI : A Study on Islamic Banks Bangladesh Introduction ':, *Journal of Islamic Economics, Banking and Finance* 9 (2013): 15, <https://doi.org/10.12816/0001617>.

recommended that it is crucial to have a comprehensive *SG* system through legislation or from regulators' side. The author recommended the valuable work of AAOIFI and IFSB regarding *SG* for the preparation of strong *SGF*.<sup>9</sup>

Omar et al. (2014) investigated the impact of the *SGF* after one year of implementation. Thus, this article focused on the advantages and limitations resulting from the implementation of the *SGF* of 2010. This research was based on primary data collected through questioner from the management of the IFIs, such as Islamic banker and Takaful operators, Member *Shari'ah* Committee, and *Shari'ah* Officers. Based on the analysis, the authors opinioned that IFIs well received the *SGF*, and these are more efficient after the adoption of *SGF* 2010.<sup>10</sup>

Sori et al. have discussed the level of commitment, requirements of the *SGF* by IFIs practicing in Malaysia. They highlighted the success factors and challenges faced by the IFIs after the implementation of *SGF*. The study is based on interviews of Sixteen *Shari'ah* committee members from 16 different IFIs for the effective implementation of this framework. The paper concluded that some *Shari'ah* committee members are of the view that they are not independent in their all decisions; however, other committee members do not focus on independence in their decision process.<sup>11</sup>

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<sup>9</sup> Zulkifli Hasan, 'Regulatory Framework of Shariah Governance System in Malaysia , GCC Countries and the UK', *Kyoto Bulletin of Islamic Area Studies* 3–2, no. March (2010): 82–115, <https://doi.org/10.1108/1753839111122195>.

<sup>10</sup> Muhammad Naim Omar et al., 'The Implementation of Shariah Governance Framework of 2010: Advantages and Constraints', *Australian Journal of Basic and Applied Sciences* 8, no. 13 (2014): 684–87.

<sup>11</sup> Zulkarnain Muhamad Sori, Shamsher Mohamad, and Mohamad Eskandar Shah Mohd Rashid, 'Shariah Committee Independence : An Insider ' s View', *NCEIF Quarterly Research Bulletin* 6 (2015): 1–8, <https://doi.org/10.2139/ssrn.2576539>.

Rahajeng (2013) has focused on the *SG* (*SG*) in Indonesia and tried to seek a model for corporate governance that is more relevant to IB&F. The paper was based on secondary data collected from annual reports of IBs. The paper assessed and analyzed the ‘operational activities’ of Indonesian IBs. The paper analyzed the level of *SG* in respect of SSB. The author concluded that the ‘stakeholder’s model’ is most appropriate for corporate governance. Moreover, the standardization of regulations at both the national & international levels is also necessary for his view.<sup>12</sup>

Hasan (2007) has presented an overview regarding the developments in the field of *SG* in IFIs in Malaysia with special reference to the legal framework of the *Shari’ah* supervisory Committee. He has concluded that the *Shari’ah* committee has a key role in IBIs and advising the BoDs on matters relating to *Shari’ah* in order to ensure operations comply with the injunctions of *Shari’ah*. He has also quoted the High Court’s Commercial bench (*Muamalah* Bench) amendment of section 16-B of the CBA 2003, which indicates that the *SG* guidelines provided by the government are more effective, detailed, and comprehensive. Regarding the harmonization of Islamic law, it is a new viable approach.<sup>13</sup>

Haqqi (2014) has discussed recent *SG* reforms and developments implemented or proposed in Malaysia. He has determined that the *SG* is the backbone of the regulatory and supervisory infrastructure in the Islamic financial industry. In order to have proper oversight mechanisms in the IFIs, the policymakers and thinkers need to ponder into the

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<sup>12</sup> Dian Kartika Rahajeng, ‘Sharia Governance: Sharia Supervisory Board Model of Islamic Banking and Finance in Indonesia’, *SSRN Electronic Journal*, no. 1 (2013), <https://doi.org/10.2139/ssrn.2366722>.

<sup>13</sup> Zulkifli Hasan, ‘Shariah Governance in the Islamic Financial Institutions in Malaysia’, *Global Conference on Business and Finance* 3, no. 5 (2007).

mechanism of the *SG* to provide oversight in the IF services in their country. He has stressed on regulators to play their role for the enforcement of *SG* and highlighted the need for the central *Shari'ah* committee.<sup>14</sup>

Miskam and Nasrul (2013) have examined the post-implementation effects of the Islamic Financial Services Act 2013<sup>15</sup>. *SG* provisions and their legal effects related to the stakeholders of IFIs after implementation. This paper also includes a comprehensive discussion on the “Central Bank of Malaysia Act 2009 for the establishment of *Shari'ah* Advisory Council, which plays an essential role in the governance of IFIs”.<sup>16</sup>

Minhas (2012) has explained the *SG*, its importance, and its role for strengthening *SG* in IFI(s). He is of the view that in order to enhance the trust and confidence of bank customers in Islamic banking products and services. It is necessary to implement a strong *SG* system in IBI's.<sup>17</sup>

Hamza (2013) deliberates on the effectiveness of *SG* and supervision models by comparing two modes of *SGF*, the first one is a centralized model of Malaysia, and second is a decentralized model of Gulf Corporation Council (GCC). He concluded that the

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<sup>14</sup> Abdurrahman Raden Aji Haqqi, ‘Shari'ah Governance in Islamic Financial Institution: An Appraisal’, *US-China Law Review* 11 (2014): 112–13, <https://doi.org/ISSN 1985-7497>.

<sup>15</sup> The Islamic Financial Services Act 2013 is a Malaysian laws which came into force on 30 June 2013, replacing the repealed Payment System Act 2003 (PSA)

<sup>16</sup> Miskam Surianom and Nasrul Muhammad Amrullah, ‘Shariah Governance in Islamic Finance: The Effects of the Islamic Financial Services Act 2013’, *Proceeding of the World Conference on Integration of Knowledge, WCIK 2013. 25-26 November 2013, Langkawi, Malaysia* 2013, no. November (2013): 98–106.

<sup>17</sup> Imran Hussain Minhas, ‘Shariah Governance Model and Its Four Basic Pillars’, *Islamic Finance News* 9, no. 15 (2012): 1–3.

Centralized *SG* system, in Malaysia, seems to be more beneficial to the Islamic finance industry in terms of effectiveness and credibility.<sup>18</sup>

Rahaman (2015) has examined the scope of the latest regulations on *SG* issued by BNM and compared it with international standards. The researcher analyzed the practice of compliance with the stipulated guidelines using the qualitative method of research. The practice of *SG* was examined by using the *SG* disclosure ratio on the items in the *Sharī'ah* Committee's report based on referred regulations. The author found that Malaysian regulations on *SG* of Islamic banking are more comprehensive than the international standard. However, only a few IBs comply with the guidelines, while the transition period for the compliance almost ends. Thus, he recommended for the authorities to ensure *SG* disclosure been fully complied by the concerned IBs. As a result, a proper and comprehensive *SG* in IBs in Malaysia could be achieved.<sup>19</sup>

Khan and Shah (2015) have critically analyzed the regulatory and supervisory frameworks for the dual banking systems of Pakistan, the Kingdom of Bahrain, Malaysia, and the UK. They discussed the core regulatory functions and found that controversial *Sharī'ah* issues among Islamic jurists and policymakers. The regulatory framework in each country developing in a certain way. The Malaysia and Kingdom of Bahrain have established their local governance system. The IBIs in the UK still fall under the

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<sup>18</sup> Hichem Hamza, 'Sharia Governance in Islamic Banks: Effectiveness and Supervision Model', *International Journal of Islamic and Middle Eastern Finance and Management* 6, no. 3 (2013): 226–37, <https://doi.org/10.1108/IMEFM-02-2013-0021>.

<sup>19</sup> Abd Rahaman Fatihah Binti, 'Shariah Compliance Disclosure', *Othman Yeop Abdullah Graduate School of Business, Universiti Utara Malaysia* (2015), <https://doi.org/10.1017/CBO9781107415324.004>.

conventional setup. Besides, in Pakistan, these institutions are jointly governed by a conventional regulatory framework and evolving regulatory system for IBI(s). However, the efficiency of the existing regulatory frameworks has never been fully tested by the nascent Islamic banking industry, which remains very conservative.<sup>20</sup>

Sarker (2012) has highlighted the role of central banks in regulating, supervising, guiding, and control of the IBIs for the development and smooth functioning of the sector from Bangladesh's perspective. The study has critically evaluated the regulations and role of the central bank of Bangladesh regarding regulation, supervision, and control of the Islamic banking industry. The author has also suggested some proposals for enhancement of the capacity of the Central bank in achieving its objectives.<sup>21</sup>

Kasim et al. (2013) compared *SG* guidelines provided by AAOIFI, IFSB, and BNM. "They discussed the important role of *SG* guidelines in the Islamic finance industry to ensure that the whole activities of financing activities are in line with the *Shari'ah*. Based on comparative analysis, they concluded that all the guidelines are not comprehensive enough, for instance, while IFSB defines *SG*, whereas AAOIFI and BNM did not discuss. Besides BNM discusses on the *Shari'ah* risk management and research functions, the other two guidelines are silent. Thus, they have suggested that one standardized and comprehensive guideline or framework and Comprehensive guideline or framework so that

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<sup>20</sup> Asad Khan and Abdul Qadir Shah, 'A Comparative Analysis of Regulatory and Supervisory Islamic Banking : Evidence from Pakistan , Malaysia , Bahrain , and the UK' 1, no. Autumn (2015): 37–60.

<sup>21</sup> Abdul Awwal Sarker, 'Regulation and Supervision of Islamic Banks and Financial Institutions: Bangladesh Perspective', *Thoughts on Economics* 22, no. 3 (2012): 59–97.

it will be an easy reference for the industrial players, regulators, *Shari'ah* advisors, and investors.”<sup>22</sup>

Hasan and Sabirzyanov (2015) have emphasized that *Shari'ah* compliance in Islamic finance is the core element, and SG is a key feature to ensure such adherence. Furthermore, they emphasized that the credibility and effectiveness of the SG system play an important role in creating public confidence regarding Islamic finance. The authors have also discussed Central *Shari'ah* Board and SSB and proposed an optimal SG model to strengthen the weak aspects of the existing models.<sup>23</sup>

## **1.2. Board of Directors**

The business of the corporations is being managed under the direction and supervision of the BoDs (BOD). The BOD delegates their powers to the chief executive officer, and to manage a business, the authority and responsibility transmit from the CEO to the senior and EM. The role of the BOD is supervisory nature; they supervise and monitor the performance of the management.<sup>24</sup>

Minhas (2012) has explained the SG, its importance, and methods for the strong SG system in IBIs. He has discussed the four pillars of SG, namely, Management, BoDs, SSB, and *Shari'ah* Audit. He considered Management and BoDs as the first pillar of SG and

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<sup>22</sup> Syed Ahmed Salman Nawal Kasim, Sheila Nu NuHtay, ‘Comparative Analysis on AAOIFI , IFSB and BNM Shari’ah Governance Faculty of Accountancy’, *International Journal of Business and Social Science* 4, no. 15 (2013): 220–27.

<sup>23</sup> Aznan Hasan and Ruslan Sabirzyanov, ‘Optimal Shari ’ Ah Governance Model in Islamic Finance’, *International Journal of Education and Research* 3, no. 4 (2015): 243–58.

<sup>24</sup> Syed Kashif Saeed and Umar Faiz, *Corporate Governance in Pakistan*, 1st ed. (Islamabad: Higher Education Commission, Government of Pakistan, 2018).

BoDs (BOD) comes first in the management. He is of the view that “the success of any organization, specifically the IFI, depends on the willingness of the management to adopt and implement Islamic principles in the organization. The provision of adequate resources, system procedures, infrastructure, and code of ethics for acceptance of business and its legitimacy according to *SG*, entirely depends on the management. Providing proper policies and systems will be inadequate if they are not implemented and supervised positively.”<sup>25</sup>

Kunhibava (2015) has evaluated the “Islamic Financial services Act 2013, Central Bank of Malaysia Act 2009” and *SGF*. After highlighting the role of the *Shari’ah* Advisory Council of Bank Negara Malaysia, he suggested amendment of section 57 of the Central Bank of Malaysia Act 2009. The enhanced role of supervising and rectifying *Shari’ah* non-compliance and the distinct burden and liability of the *Shari’ah* Committee. The author has also highlighted the role and responsibilities of the BoDs (BOD) in ensuring the true implementation of the *SGF*.<sup>26</sup>

Rahim et al. (2012) have reviewed the significance of governance in IFIs, where it is a unique feature from conventional corporate governance and highlights similarities between them. He also suggested *SG* criteria for IFIs that can attract potential and existing investors. This paper is a welcome addition to the literature of *SG*, which will lead to a better signal to investor’s investment decisions.<sup>27</sup>

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<sup>25</sup> Minhas, ‘Shariah Governance Model and Its Four Basic Pillars’.

<sup>26</sup> Sherin Kunhibava, ‘Legal Issues in Shariah Governance Industry in Malaysia’, *ISRA International Journal of Islamic Finance* 7, no. 2 (2015): 55–80.

<sup>27</sup> Memiyanty Abdul Rahim, Mohd Sirajuddin Siswadi Putera Mohamed Shith Shith, and Dr. Muhamad Rahimi Osman, ‘Attributes of Sound Shariah Corporate Governance Criteria from

### **1.3. Executive Management**

Chowdhury and Shaker (2015) highlighted the current practices of *SG* of IBI(s) in Malaysia. The paper pointed out the key challenges faced by applying *SG*. The study aims to address the relation of *Shari'ah* board and management in the implementation of the *Shari'ah*. The study is exploratory, where the authors reviewed the literature and *Shari'ah* based banking practices using comparative and analytical techniques to differentiate the *Shari'ah* based banking practices and corporate governance system applied by conventional FI(s). They are of the view that due to a shortage of experts and well-versed scholars, the *Shari'ah* based laws are being misinterpreted. They recommended that the management of IBs and financial institutions should be guided by revelation, whereas human natures guide conventional banks.<sup>28</sup>

Minhas (2012) has explained the *SG*, its importance, and methods for the strong *SG* system in IBIs. He has discussed the four pillars of *SG*, namely Management, BoDs, *SSB*, and *Shari'ah* Audit. He considered Management as the first pillar of *SG*, and the BoDs (BOD) comes first in the management. He is of the view that “the success of any organization, specifically the IFI, depends on the willingness of the management to adopt and implement Islamic principles in the organization. The provision of adequate resources, system procedures, infrastructure, and code of ethics for acceptance of business and its legitimacy, according to *SG*, entirely depends on the management. Providing proper

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Investor Persppective', *3rd International Conference On Business And Economic Research*, no. March (2012): 1557–64.

<sup>28</sup> Nazreen Tabassum and Fahim, 'Shariah Governance of Islamic Banks in Malaysia'.

policies and systems will be inadequate if they are not implemented and supervised positively.”<sup>29</sup>

#### **1.4. *Shari'ah* Board**

*SSB* is an independent group of experts in *fiqh al-mua'malāt*. They may also include expert members other than *fiqh al-mua'malāt* who must be experts in the field of Islamic economics, banking, law economics as technical members. The core responsibility of the board is to supervise the activities of the IFI and to ensure that their activities, products, and services are compliant with *Shari'ah* rules and principles. They issue fatawas and guide in *Shari'ah* rulings.<sup>30</sup>

Grais, and Pellegrini, (2006), has discussed the structure and process of *SSB* established within an IIFS for monitoring and evaluating *Shari'ah* compliance based on the World Bank’s working and Policy paper. They are of the view that competent, independent, and empowered *SSB* is essential to approve new *Shari'ah* compliant instruments. This paper has highlighted the issues in operations in ensuring *Shari'ah* compliance in IIFS and suggested that fatawas should be on standardized principles in order to harmonize the practices of IIFS.<sup>31</sup>

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<sup>29</sup> Minhas, ‘Shariah Governance Model and Its Four Basic Pillars’.

<sup>30</sup> Accounting and Auditing Organization for IFIs, (2015). Governance Standards for IFIs. In: Accounting and Auditing Organization for IFIs. Bahrain. Accounting and Auditing Organization for IFIs. P.O.Box 1176, Manama, Bahrain.

<sup>31</sup> Wafik Garis and Matteo Pellegrini, ‘Corporate Governance in Institutions Offering Islamic Financial Services’, *World Bank Policy Research Working Paper* October (2006): 1–46, <https://doi.org/http://dx.doi.org/10.1596/1813-9450-4052>.

Rammal (2010), in his paper while focusing on the Role of *SSBs* in Pakistan in the governance perspective. He investigated the issues relating to audit and governance in IFI's in Pakistan. He also examined the role and responsibilities of the *SSB* members using field-based case study method. He also used quantitative and qualitative methods through primary data and semi-structured face to face interviews. The study concluded that the Islamic finance industry is facing many issues related to *SG*, including the shortage of competent *Shari'ah* scholars world-wide. He also highlighted the issue of training of *Shari'ah* scholars in Pakistan, the too lengthy curricula of deeni madaris in Islamic Jurisprudence, i.e., *Shahadatul Almiya Fil Uloomal Arabia wal Islamia*. Due to these problems, the banks are hiring incompetent members for their *Shari'ah* boards, and due to shortage, one scholar is serving in many financial institutions as *Shari'ah* board members, which causes a conflict of interest.<sup>32</sup>

Karim (1990) asserted that the *Shari'ah* Committee needs to function as the external auditors in conventional corporations. The function of the *Shari'ah* Committee is to advise the chief executive officer or the BoDs on the *Shari'ah* matters. Therefore, the Islamicity of the ICBs would never be compromised as all stakeholders and shareholders have the rights and interests on governance mode and mechanisms shield (Iqbal & Mirakh, 2011).

Nurhastuty and Shaista (2012) theoretically examined the role of *SSB* in supervising IBIs, particularly the authority and responsibilities of the *SSB* members. The study also compared the role of *Shari'ah* board in Indonesia, Malaysia, and Brunei Darussalam. Based on the analysis, the authors suggested that both Indonesia and Malaysia are equally

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<sup>32</sup> Hussain G Rammal, 'Corporate Governance in the Islamic Banking System in Pakistan : The Role of the Shari'ah Supervisory Boards', no. March (2010): 1–249.

proportionate. However, the equality between responsibility and authority is the most important factor in supporting the *SSB* in supervising IBs. The paper suggests that the central bank of Indonesia needs to strengthen the *Shari'ah* board.<sup>33</sup>

Rahman and Bukair (2013) have empirically examined the influence of the *SSB* on corporate social responsibility (CSR) disclosure. Using content analysis, the descriptive statistics, a sample of fifty-three IBs operating in GCC countries during 2008 were used. The results expressed that the disclosure of CSR is increasing in the annual reports of IBs. The combination of *SSB* attributes has a significant positive influence on CSR disclosure. It means that in order to measure the level of CSR disclosure, the characteristics of the *SSB* are important factors.<sup>34</sup>

Rammal (2006) has discussed the role and functions of *SSB* in IFIs and recommended some more collective struggle among the central banks of Muslim countries and other regulatory organizations.<sup>35</sup>

Garas and Pierce (2010) examined the role of the council of *Shari'ah* scholars within and outside the central bank, i.e., *SSB*, *Shari'ah* Advisor, and *Shari'ah* consulting firms. The paper has also evaluated the functions of *SSB*, and lack of standardization among the

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<sup>33</sup> Nurhastuty Wardhany and Shaista Arshad, 'The Role of Shariah Board in Islamic Banks: A Case Study of Malaysia, Indonesia and Brunei Darussalam', *2nd ISRA Colloquium 'Islamic Finance Is a Challenging Economy: Moving Forward'*, no. November (2012): 1–26.

<sup>34</sup> Abdullah Awadh Bukair and Azhar Abdul-Rahman, 'The Influence of the Shariah Supervision Board on Corporate Social Responsibility Disclosure by Islamic Banks of Gulf Co-Operation Council Countries', *Asian Journal of Business and Accounting* 6, no. 2 (2013): 65–104, <https://doi.org/10.5296/jmr.v7i2.6989>.

<sup>35</sup> Hussain G. Rammal, 'The Importance of Shari'ah Supervision in Islamic Financial Institutions', *Corporate Ownership and Control* 3, no. 3 B (2006): 204–8.

IFIs concerning the position of the SSB within the corporate hierarchy was one of the important findings of the paper. Moreover, he also observed that the SSB is controlling the IFIs activities more than the other types of *Shari'ah* supervision, such as *Shari'ah* consulting firms and *Shari'ah* advisors.<sup>36</sup>

Al-Qattan (2008) has evaluated the regulations for the selection of the members of SSBs in the light of *Shari'ah* and governance standards issued by the AAOIFI that are related to the topic of the paper, as well as the author has also cited contributions of the contemporary scholars.<sup>37</sup>

Mohamad et al. (2015) have discussed the effectiveness of SSB/Committees in IB (s) in Malaysia, specifically, issues related to eligibility of SSB such as competency, independence, consistency and up to date knowledge and information, etc. in Malaysian perspective.<sup>38</sup>

Abdul Aziz (2013) identified challenges faced by the *Shari'ah* Committee that had decreased their capability and capacity to achieve their objectives. The paper has also recommended alternative measures on issues of the *Shari'ah* Committee and *Shari'ah* Auditors in bridging the public expectations.<sup>39</sup>

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<sup>36</sup> Samy Nathan Garas and Chris Pierce, 'Shari'a Supervision of Islamic Financial Institutions', *Journal of Financial Regulation and Compliance* 18, no. 4 (2010): 386–407, <https://doi.org/10.1108/13581981011093695>.

<sup>37</sup> Ali al-Qattan Muhammad Amin, 'Shari'ah Supervisory Boards : Selection of Their Members and Their Regulations', *7th Conference of the Shari'ah Board of Islamic Financial Institutions*, no. May (2008): 22–23.

<sup>38</sup> Shamsher Mohamad, Zulkarnain Muhamad Sori, and Eskandar Shah, 'Shariah Governance: Effectiveness of Shariah Committees in Islamic Banks in Malaysia', 2015, <https://doi.org/10.2139>.

<sup>39</sup> Ahmad Faizal Abdul Aziz, 'Shariah Governance Challenges Ahead', *International Centre for Education in Islamic Finance (INCEIF) Malaysia*, no. 47772 (2013): 1–26.

Ahmed, (2014) has discussed the use of traditional *Shari'ah* based contracts to structure in contemporary *Shari'ah* compliant modes of financing. In order to this, the product development process and the role of the *SSB* has been analyzed. The article highlighted the role of the *SSB* within a bank in ensuring compliance with *Shari'ah* in products and services.<sup>40</sup>

#### **1.4.1. Competency of SSB Member**

Amanullah (2015) analyzed the appointment criteria of SSBM. Though the study is comparative, however, the main objectives of the research are to highlight the guidelines of BNM and Bangladesh Bank on these criteria. Therefore, the author has compared and evaluated these criteria in light of *Shari'ah* guidelines as spelled out by contemporary Muslim jurists.<sup>41</sup>

Farook and Farooq (2013) examined the pertinent issues and laid out an outline regarding the qualification of *Shari'ah* scholars. In this conceptual paper, the authors emphasize the shortage of qualified *Shari'ah* Scholars in the Islamic finance industry<sup>42</sup>. The opinioned that due to the absence of standard qualification as per qualification for this

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<sup>40</sup> Habib Ahmed, 'Islamic Banking and Sharia Compliance:Product Development', *Journal of Islamic Finance*, Vol. 3 No. 2 (2014) 015 – 029. IIUM Institute of Islamic Banking and Finance ISSN 2289-2117 (O) / 2289-2109 (P) 3, no. 2 (2014): 15–29; Habib Ahmed, 'Maqasidid Al-Shariah and Islamic Financial Products :A Framework for Assessment', *International Journal* 3, no. 1 (2011): 149–60.

<sup>41</sup> Muhammad Amanullah, 'Criteria of Shari' ' Ah Supervisory Committee : A Comparative Study between Guidelines of Bangladesh Bank and Bank Negara Malaysia', *Intellectual Disclosure IIUM Press* 4878 (2015): 453–73.

<sup>42</sup> Sayd Zubair Farook and Mohammad Omar Farooq, 'Shariah Governance for Islamic Finance: Challenges and Pragmatic Solutions', *SSRN Electronic Journal*, 2011, <https://doi.org/http://ssrn.com/abstract=1813483>.

position, only a few top *Shari'ah* scholars are working in full concentration and devotion. The paper has also stressed the qualification and training of *Shari'ah* scholars in modern complex economics and the financial system. The authors have suggested some realistic solutions to overcome this challenge in the long-run, i.e., to design a comprehensive curriculum specifically for *Shari'ah* board members. In order to establish training & relevant educational programs, like other modern professional disciplines, a body should be formed to recognize, regularize, and certify *Shari'ah* practitioners' qualifications.<sup>43</sup>

Alman (2012) has explored the influence of the SSB's compositional characteristics on loan portfolio risk-taking of IBI (s). As such, they analyze to what degree the proper supervisory functions of a SSB affect the banks' risk-taking behavior using data of 2000 – 2010 of cross-country banks from the Middle East and Northern Africa as well as from Southeast Asia. "Based on the data, the author concluded that the loan portfolio risk-taking of IBs is positively influenced by the increasing size of the SSB. The membership of a reasonable number of top-ranked *Shari'ah* scholars with board mandates and when annual changes occur in the composition of a SSB. The author concluded that supervisory effectiveness and disciplining the power of individual bank SSBs towards the risk-taking in the loan portfolio of IBs decreases in a decentralized *Shari'ah*-compliant governance structure. The reverse causality analysis denotes that SSB factors affect primarily loan portfolio risk-taking, not the other way around."<sup>44</sup>

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<sup>43</sup> Mohammad Omar Farooq Farook, Sayd, 'Shari'ah Governance, Experties and Profession: Educational Challenges in Islamic Finance', *ISRA International Journal of Islamic Finance* 5, no. 1 (2013): 137–60.

<sup>44</sup> Mahir Alman, 'Shari'ah Supervisory Board Composition Effects On Islamic Banks ' Risk-Taking Behavior Shari ' Ah Supervisory Board Composition Effects On Islamic Banks ' Risk-Taking Behavior', *Journal of Banking and Regulation* 82, no.1 (2012): 1–43.

Kunhibava (2015) has evaluated the “Islamic Financial services Act 2013, Central Bank of Malaysia Act 2009” and *SGF*. After highlighting the role of the *Shari’ah* Advisory Council of BNM, he suggested the amendment of Section 57 of the Central Bank of Malaysia Act 2009. The enhanced role of supervising and rectifying *Shari’ah* non-compliance and the distinct burden and liability of the *Shari’ah* Committee. The author has also highlighted the role and responsibilities of the BoDs (BOD) in ensuring the true implementation of the *SGF*.

Toufik (2015) has explored the role of SSB in ensuring strong corporate governance and has used both primary and secondary data of IBs to discover the role of SSB. He concluded that IBs are succeeding in adapting corporate governance elements, i.e., accountability, trustworthiness, and transparency. However, the added value of the *Shari’ah* supervision to the corporate governance practices is just a moral commitment in the Islamic finance industry.<sup>45</sup>

Lahsasna (2011) has discussed fatawa and its methodology in Islamic finance to ensure a sound process of the promulgation of accurate resolutions which comply with the guidelines and rules as prescribed in Islamic Jurisprudence.<sup>46</sup>

Rammal and Parker (2010) have investigated the issues relating to appointment and training of the *Shari’ah* advisors in IFI. The paper stressed the erection of educational and

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<sup>45</sup> Bedj Toufik, ‘The Role of Shari’ah Supervisory Board in Ensuring Good Corporate Governance Practice in Islamic Banks.’, *International Journal of Contemporary Applied Sciences*. 2, no. 2 (2015): 109–18.

<sup>46</sup> Ahcene Lahsasna, ‘Fatwa and Its Shari’ah Methodology in Islamic Finance’, *Journal of Fatwa Management and Research (JFATWA)*, *World Fatwa Management and Research Institute (INFAD)*, Universiti Sains Islam Malaysia (USIM), 71800, Nilai, Negeri Sembilan, Malaysia 2 (2011): 133–79.

training institutes in the private and government sectors to produce skilled and professional human resources in the field of *Shari'ah* advisory.<sup>47</sup>

#### **1.4.2. Independence of *Shari'ah* Board Members**

Sori et al. (2015), in their paper on the *Shari'ah* committee's independence, have highlighted the independence of SSB in the SGF as an essential element for effective, reliable, and controlled SG system. The study also examined the independence of members *Shari'ah* committee in IFIs<sup>48</sup>.

Othman et al. (2013) have investigated the independence of the SSB and its efficiency of *Shari'ah* decisions. The main objective of this study was to measure the level of approvals for the resources effectiveness and human resources efficiency on the implementation of the SGF 2010 in Malaysia. The data collected through survey questioners from Islamic banking and takaful professionals. The study concluded that the independence of the *Shari'ah* committee leads to the efficiency of the *Shari'ah* committee's decisions during their meetings. In order to facilitate the *Shari'ah* committee decisions, they must be given required access to the official record, i.e., draft material, files, conversations, and all other confidential information related to their work, etc.<sup>49</sup>

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<sup>47</sup> H.G. Rammal and L.D. Parker, 'Audit and Governance in Islamic Banks: Selection and Training of Shariah Advisors', *Sixth Asia Pacific Interdisciplinary Research in Accounting Conference, Sydney.*, 2010, 1–39.

<sup>48</sup> Mohamad, Sori, and Shah, 'Shariah Governance: Effectiveness of Shariah Committees in Islamic Banks in Malaysia'.

<sup>49</sup> A A Othman et al., 'Shariah Governance for Islamic Financial Institutions in Malaysia on the Independency of Shariah Committee and Efficiency of Its Shariah Decisions', in *7th WSEAS International Conference on Management, Marketing and Finances*, 2013, 93–100.

## 1.5. *Shari'ah Audit*

Shafii et al. (2014) have conducted research using the quantitative approach in this study. They examined the perception of the undergraduate level students about *Shari'ah Audit* in IBs in Malaysia. The research was based on the research questionnaire. Findings suggested that there is a significant difference between students being studying to *Shari'ah Auditor's* course and those who have not.<sup>50</sup>

Rahman (2013), in his study on investigated the perception and practice of *Shari'ah Auditing* in Bangladeshi Banks using primary and secondary data, the researcher used frequency distribution method to analyze and interpret the views of the respondents. The questioner of this study all forms of Maysir and *Qimār* categorically among professional auditors, academicians, and *Shari'ah* scholars in Bangladesh. The researcher concluded in his findings that the *Shari'ah* scholars are quite satisfied. However, the other respondents, i.e., professionals, auditors, and academia, were not satisfied with the *Shari'ah* audit in IBs. Besides, the *Shari'ah* scholars are of the view that the *Shari'ah* auditors should conduct the internal *Shari'ah* audit under the supervision of the SSB. However, other respondents are of the view that it should be conducted independently.<sup>51</sup>

Kasim (2009) has examined the theoretical as well as practical aspects of *Shari'ah Auditing* in IFIs in Malaysia with the ultimate aim of identifying whether there is any gap

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<sup>50</sup> Zurina Shafii, Nor Aishah Mohd Ali, and Nawal Kasim, 'Shariah Audit in Islamic Banks: An Insight to the Future Shariah Auditor Labour Market in Malaysia', *Procedia - Social and Behavioral Sciences* 145 (2014): 158–72, <https://doi.org/10.1016/j.sbspro.2014.06.023>.

<sup>51</sup> Md. Jahidur Rahman, 'The Current Perception and Practice of Shari'ah Auditing in Bangladeshi Islamic Banks' (City University of Hong Kong (CityUHK) - Department of Accountancy, 2013).

between theory and practice. The study is based on surveys from different groups of respondents involved with *Shari'ah* Audit and compliance in the IFIs. The author is of the view that the concept of *Shari'ah* auditing should be expended. It is necessary to develop a reliable and effective *Shari'ah* auditing framework to ensure the *Shari'ah* compliance in IFI's<sup>52</sup>.

Mahzan (2012) has investigated the current practice of *Shari'ah* auditing among IFIs in Malaysia using interview methods. He conducted interviews of chief audit executives of IFIs. The paper discovered that the practices of *Shari'ah* audit are in the development stage and need improvement.<sup>53</sup>

Ahmad, and Al-Aidaros, (2015) the study evaluated the importance and independence of the *Shari'ah* members in Islamic Cooperative Banks in Malaysia using descriptive analysis through questionnaires. Based on results, 52% of *Shari'ah* auditors had total independence; however, 67% of *Shari'ah* auditors were free from the intervention of SSB. The auditors are of the view that there is a shortage of team members and also issues of human resources, i.e., non-experienced team members. In order to enhance the knowledge, the respondents were of the view that the auditors should improve their educational level and expertise.<sup>54</sup>

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<sup>52</sup> Nawal Kasim, 'Dynamics of Shariah Auditing In Islamic Institutions: A Study of The Malaysian Islamic Financial Sector', *PhD Dissertation*, (International Islamic University, Malaysia, 2009).

<sup>53</sup> Yazkhiruni Yahya and Nurmazilah Mahzan, 'The Role of Internal Auditing in Ensuring Governance in Islamic Financial Institutions ( IFI)', *3rd International Conference on Business and Economic Research and Economic Research*, no. March (2012): 1634–61.

<sup>54</sup> Mohd Rodzi Ahmad and Al-Hasan Al-Aidaros, 'The Need of Independent Shariah Members in Islamic Cooperative Banks: An Empirical Study of Professional Accountants in Malaysia', *International Review of Management and Business Research* 4, no. 1 (2015): 110–20.

Kasim et al. (2009) have explored the gap between “the desired” and “the actual” practice of *Shari’ah* auditing in IFIs in Malaysia empirically. The study found that there is a gap between both concepts, and the *Shari’ah* audit has not a severe impact on the Islamic financial industry in Malaysia.<sup>55</sup>

Yaacob and Donglah (2012) have researched the perspectives and awareness of the postgraduate students on the *Shari’ah* audit. The study is based on questioner filled by postgraduate students of two universities of Brunei Darussalam. Based on the results, the study founded that the respondents do not have a sufficient level of awareness and understanding of the *Shari’ah* audit. There are many misconceptions, and the concept of the *Shari’ah* audit is unclear. Besides, they felt that the IFI’s are not making efforts to promote the *Shari’ah* audit.<sup>56</sup>

Lahsasna et al. (2011) have conducted an exploratory study on *Shari’ah* Audit, evidence and methodology they have discussed a different aspect of *Shari’ah* auditing, starting from its definition, *Shari’ah* foundations, challenges, and methodology. They recommended that the regulatory authorities should make the practice of *Shari’ah* audit mandatory for the IFI’s. It will result certainly be the decisive point for the flight of *Shari’ah* audit and the industry as a whole in the right dimensions.<sup>57</sup>

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<sup>55</sup> Nawal Kasim, Shahul Hameed Mohamad Ibrahim, and Maliah Sulaiman, ‘Shariah Auditing in Islamic Financial Institutions: Exploring the Gap between the “Desired” and the “Actual”’, *Global Economy and Finance Journal* 2, no. 2 (2009): 127–37, <https://doi.org/1>.

<sup>56</sup> Hisham Yaacob and Nor Khadijah Donglah, ‘Shari’ah Audit in Islamic Financial Institutions: The Postgraduates’ Perspective’, *International Journal of Economics and Finance* 4, no. 12 (2012): 224–39, <https://doi.org/10.5539/ijef.v4n12p224>.

<sup>57</sup> Ahcene Lahsasna, Shahul Hameed Haji Mohamed Ibrahim, and Alhabshi Datuk Syed Othman, ‘Shariah Audit: Evidence & Methodology in Islamic Finance’, 2011, 1–24.

Shafii et al. (2013) have evaluated the impact of the *Shari'ah* audit function on the role of the *Shari'ah* Committee regarding the implementation of the SGF. The study used case study methods. The study was strengthened with interviews regarding the *Shari'ah* audit and its functions. This study also emphasized challenging and issues faced by the *Shari'ah* Committee of the selected establishment.<sup>58</sup>

Mulyany (2008) in her thesis on *Shari'ah* audit for IFI, perceptions of academia, audit professionals, and *Shari'ah* experts have discerned the perceptions of academicians of accounting discipline, auditors and *Shari'ah* scholars on *Shari'ah* auditing. The study focused on the fundamental issues of *Shari'ah* auditing for IFIs, which is based on literature and questionnaire<sup>59</sup>.

Shafii et al. (2010) have proposed *Shari'ah* compliance *Shari'ah* audit framework and audit program for IFIs after a thoughtful discussion on the need of *Shari'ah* audit and external *Shari'ah* audit. They concluded that non-compliance risk faced by the IFIs could be mitigated through the *Shari'ah* compliance Audit. *Shari'ah* committee is entirely dependent on the information provided by the *Shari'ah* audit team regarding their opinion on of IFI are complying with the *Shari'ah* rules.<sup>60</sup>

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<sup>58</sup> Zurina Shafii et al., 'Post Implementation of Shariah Governance Framework : The Impact of Shariah Audit Function Towards the Role of Shariah Committee', *Middle-East Journal of Scientific Research (Research in Contemporary Islamic Finance and Wealth Management)*: 13 (2013): 7–11, <https://doi.org/10.5829/idosi.mejsr.2013.13.1874>.

<sup>59</sup> Ratna Mulyanya, 'Shari'ah Audit for Islamic Financial Institutions, Perceptions of Accounting Academicians, Audit Practitioners, and Shari'ah Scholars', *MSc* (International Islamic University, Malaysia, 2008).

<sup>60</sup> Zurina Shafii, Salleh Supiah, and Shahwan Syahidawati, 'Management of Shariah Non-Compliance Audit Risk in the Islamic Financial Institutions via the Development of Shariah Compliance Audit Framework and Shariah Audit Programme', *Kyoto Bulletin Of Islamic Area Studies*, 2010, 14.

Zakari et al. (2015) reviewed the published studies on *Shari'ah* auditing since the inception of contemporary IFI's until 2014 to classify the essential trends, challenges, and issues in *Shari'ah* auditing. They have also proposed avenues of future research in this area.<sup>61</sup>

Ali et al. (2015) have discussed the competency of the *Shari'ah* auditors and *Shari'ah* audit framework in Malaysia. This study referred to a recent empirical study that concluded that most *Shari'ah* auditors are either trained in *Shari'ah* or auditing disciplines only. After a thoughtful discussion on the topic, they suggested that there is a need to draft the competency requirements of *Shari'ah* auditors on an urgent basis. The authors proposed a new model, “knowledge, skills, and other characteristics” (KSOC) for *Shari'ah* auditor's competency.<sup>62</sup>

Ali et al. (2016) have identified the required knowledge of *Shari'ah* auditors. This study adopted a multiple-case study that involves four different groups of IFI's. In total, thirty-one interviews were conducted from *Shari'ah* auditors and Head of *Shari'ah* audit department of the IFI's. They found that there are simple rules/ guidelines on hiring *Shari'ah* auditors in IFI's. There is no much difference between *Shari'ah* auditors and the

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<sup>61</sup> Maliah S. & Noraini M. A. Muntaka Alhaji Z., 'Shariah Auditing: A Review of Literature and Future Research Agenda', in *10th International on Islamic Economics and Finance*, 2015, 1–21.

<sup>62</sup> Nor Aishah Mohd Ali, Zakiah Muhammadun Mohamed, and Shahida Shahimi, 'Competency of Shariah Auditors in Malaysia : Issues and Challenges', *Journal of Islamic Finance* 4, no. 1 (2015): 22–30, <https://doi.org/10.12816/0024798>.

head of *Shari'ah* audit regarding the choice of knowledge except for the knowledge in Islamic banking and *fiqh al-mua'malāt*.<sup>63</sup>

Shafii et al. (2015) have identified the practices of *Shari'ah* auditing in GCC countries, Pakistan, Indonesia, and Sudan, where Islamic finance is being practiced. The authors have developed a *Shari'ah* audit model for the *Shari'ah* audit, which includes the internal and external *Shari'ah* audit function. The study also highlighted the scope of the *Shari'ah* audit. This study has qualitatively analyzed the guideline on SGF issued by BNM in 2010 and other guidelines of different institutions.<sup>64</sup>

Helal Uddin et al. (2013) have explored the basis of auditing from the traditional system as well as the Islamic perspective. In the first part, they have examined the developments and approaches established regarding auditing and pointed out some of its shortfalls from the *Shari'ah* point of view. In the second part, they have quantified the role of auditing in the Islamic framework.<sup>65</sup>

Shahzad et al. (2017) have investigated the *Shari'ah* audit mechanism and challenges faced by IFI's after the implementation of SGF issued by SBP. The authors suggested that, though *Shari'ah* audit is considered as a different activity as compared to the conventional audit. However, there is still a need for improvement regarding the

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<sup>63</sup> Nor Aishah Mohd Ali et al., 'Knowledge for Shari'ah Auditors' Competency in Islamic Financial Institutions', *International Journal of Trade, Economics and Finance* 7, no. 4 (2016): 113–20, <https://doi.org/10.18178/ijtef.2016.7.4.509>.

<sup>64</sup> Zurina Shafii, Ahmad Zainal Abidin, and Supiah Salleh, 'Integrated Internal-External Shariah Audit Model : A Proposal towards the Enhancement of Shariah Assurance Practices in Islamic Financial Institutions', 2015, 28.

<sup>65</sup> Md Hafij Ullah & Md Musharof Hossain Md Helal Uddin, 'An Overview on the Basics of Islamic Audit', *European Journal of Business and Management* 5, no. 28 (2013): 9–18.

training and development of audit staff of the audit firms to conduct external *Shari'ah* audit in IFIs.<sup>66</sup>

### ***1.6. Summary/Conclusion***

This chapter examines the current literature in the areas of SG in IFIs. Since 1970's when the Islamic financing was officially launched it has been observed that the Islamic finance industry is rapidly growing worldwide. The industry is facing competition from Islamic as well as conventional banks. The IFIs offering multiple products and services for the clients free from Ribā and all prohibited elements and are based on *Shari'ah* law. In order to govern the distinctive qualities of IFIs, different standard setting bodies were established including AAOIFI and IFSB. These bodies introduced new accounting, auditing and governance standards with the objective to standardize the Islamic finance practices. Similarly the central banks i.e. the SBP and the BNM has also issued SGFs to achieve these objectives.

There are different studies which addressed the different aspects of the important organs of the SG i.e BoDs, EM, *Shari'ah* Board and *Shari'ah* audit and review. As the Islamic finance literature is at its infancy stage of development. The focus of extant literature in this area is the features of the Islamic financial products, and strategies to attract more customers towards Islamic financial system however the areas of SG and its implementation in IFIs remain mostly unexplored with some limited studies focussing on the unique studies on supervisory requirements of such institutions. Thus there is need for

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<sup>66</sup> Shahzad, Saeed, and Ehsan, 'Shari'ah Audit and Supervision in Shari'ah Governance Framework: Exploratory Study of Islamic Banks in Pakistan'.

knowledge development addressing the different organs of SG empirically based on primary data from different stakeholders of Islamic finance industry. It is also important to comparatively analyze the different SG standards and frameworks issued by leading standard setting organizations and central bank of leading economys in Islamic finance i.e. Islamic Republic of Pakistan and Malaysia.

## Chapter 2:

### ***Shari'ah Guiding Principles in Shari'ah Governance***

#### **Introduction**

Governance is an essential part of every organization. The terms "governance" and "good governance" are frequently used in recent literature. The Concept of Governance has been defined as structures and processes that are designed to ensure accountability, transparency, responsiveness, the rule of law, stability, equity and inclusiveness, empowerment, and broad-based participation. In a broad sense, governance is about the culture and institutional environment in which citizens and stakeholders interact among themselves and participate in public affairs. It is more than the organs of the government. International agencies such as UNDP, the World Bank, the OECD Development Assistance Committee (DAC) and others define governance as the exercise of authority or power to manage a country's economic, political and administrative affairs.<sup>67</sup> In recent years several examples of poor governance issues have been publicized. To ensure transparent organizational practice, a robust governance system should be focused internationally. However, keeping in view the prevailing Islamic banking system globally, it is required to oversight the role and functions of IBIs in strong corporate and SG. This chapter will focus on the *Shari'ah* guiding principles relating to the role and responsibilities of the principal organs of the SG, i.e., BoDs, Management, Audit, and *Shari'ah* board in light of *Shari'ah* guiding principles.

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<sup>67</sup> International Bureau of Education, 'Concept of Governance', Concept of Governance, accessed 23 December 2019, <http://www.ibe.unesco.org/en/geqaf/technical-notes/concept-governance>.

## 2.1. Defining *Shari'ah*

الشريعة كل طريقة موضوعة بوضع الهي ثابت من نبي من الأنبياء، و يطلق كثيرا على الأحكام الجزئية التي يتهذب بها المكلف معاشا و معادا، سواء كانت منصوصة من الشارع أو

راجعة إليه: (كشاف اصطلاحات الفنون 1/1753)

*"Shari'ah mean the commands given by God to His servants, which have been brought by any of the Prophets. It is all the same whether they relate to the manner of action-and this is known as subsidiary and applied law-to which the science of Fiqh was developed, or they relate to the manner of belief, and this is known as the essentials and dogmatic for which the science of Kalam (Scholastic theology) was developed."*<sup>68</sup>

*Abd al-Rahman Shaykhz dah defined Shari'ah as;*

*Shari'ah is also called din and millah. These terms are identical in essence, but distinct in consideration of their individual mining. Shari'ah inasmuch as it is obeyed is called din; inasmuch as it is unified as called millah; and inasmuch as it is referred to, is call madhab, Din is*

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<sup>68</sup> Muhammad Ala Thanawi, 'Kashshaf Istilahat al-Funun', Calcutta, Asiatic Society of Bengal, 1862, Vol, I, p, 759

*attributed to God, millah to the Prophet, and Madhhab to a jurist (mujtahid)*<sup>69</sup>

*Professor Ahmad Hasan explains this definition as followings;*

“The scope of the *Shari'ah* is broader than that of Fiqh. It comprises beliefs ('*aqa'id*), rituals ('*ibadat*), civil and social transactions (*mua'malāt*), and ethics (*akhlaq*), while Fiqh comprises only rituals ('*ibadat*) and social transactions (*mu'amalat*). The *Shari'ah* is the textual law, while Fiqh is the derivative law. Hence there might be no disagreement in the *Shari'ah*, whereas there is disagreement in Fiqh since the jurists have derived it.”<sup>70</sup>

*Shari'ah* is generally used in the meaning of Islamic Law. In fiqh manuals, however, the term *al hukm al Shari* is used to denote the Islamic law. The term *Shari'ah* if used in the context of fiqh, then conveys the more general meaning than Islamic Law. Fiqh is used to be defined as the knowledge of the *shari ahkam* about conduct that has been derived from the specific evidence. In contrast, in *Shari'ah*, the *ahkam* relating to *i'tiqad* and morality are also included.<sup>71</sup>

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<sup>69</sup> Abd al-Rahman Shaykhzadah, 'Majma' al-Anhur fi Sharh Multaqā'l-abhur', Constantinople, 1327 A.H., Vol I, p 5-6

<sup>70</sup> Ahmad Hasan, *Principles of Islamic Jurisprudence*, 1st ed. (Islamabad, Pakistan: Islamic Research Institute, P.O. Box No. 1035, 1993). p1

<sup>71</sup> Hasan.

## 2.2. *Shari'ah* Principles of Governance Underlying Values

Islam has given guidelines for good governance to build a civilized society. These principals are based on the values of justice, equity, and devotion to Allah SWT.<sup>72</sup> There are mainly three specific *Shari'ah* principles relating to governance, i.e., Accountability (*Mas'ūliyyah*), Transparency (*Shafāfiyyah*), and Trust (*Amānah*).<sup>73</sup> These three principles of Islamic law are manifested in social practices. “Accountability, transparency, and good governance are mutually reinforcing concepts that assume wide currency today. Development of any kind cannot occur in the absence of a system that is accountable and transparent. It is worth noting that throughout Islamic history, the majority of Islamic scholars have opined in favor of transparency and accountability.”<sup>74</sup>

### 2.2.1. Accountability (*Mas'ūliyyah*)

Islamic law has a comprehensive system of accountability, which is based on the concept of ‘*hisba*,’ which means responsibility.<sup>75</sup> The word ‘*hisba*’ has been repeated more than eight in the Holy *Qur'ān*<sup>76</sup> in generic sense relating to the one’s obligations to God on

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<sup>72</sup> Prof A S Mikailu and Dr. Malami Muhammad Mishanu, ‘Islamic Value System, Accountability and Transparency in the Public Service’, *Journal of Management Studies, UDU Sokoto*, 2008.

<sup>73</sup> Mohammad Ayaz and Mohammad Tahir Mansoori, ‘Strengthening Corporate Governance Regime for Islamic Banks in Pakistan : Focusing on the Principles of Am Ana’, *Journal of Islamic Business and Management (JIBM)* 7, no. 2 (2017): 178–96.

<sup>74</sup> Mikailu and Mishanu, ‘Islamic Value System, Accountability and Transparency in the Public Service’.

<sup>75</sup> Taqī ad-Dīn Ahmad ibn Taymiyyah, *Al-Hisba Fi Al-Islam (The Hisba in Islam)*, ed. Dr. Hafiz Ikram ul Haq Yasin, 2nd ed. (Islamabad: Sharī'ah Academy, International Islamic University, Islamabad, 2015).

<sup>76</sup> Mikailu and Mishanu, ‘Islamic Value System, Accountability and Transparency in the Public Service’.- Askary S. and Clarke F. (1997), ‘Accounting in the Koranic Verses’, proceedings of International Conference, The Vehicle for Exploring and Implementing Shariah Islami ‘ah in Accounting, Commerce and Finance, Macarthur: University of Western Sydney

the Day of Judgement. It is the faith of every Muslim that he is accountable for all his activities. The Prophet (ﷺ) said, “Each one of you is a guardian, and each guardian is accountable to everything under his care.”<sup>77</sup>

The individuals appointed by the State to enforce the Islamic law are called *Muhtasib* in public as well as individual level. In order to enforce ‘hisba’ is considered that the *Muhtasib* is performing his duty promoting good and prohibiting evil (*al-amr bil-ma.ruf walnahy an al-munkar*).<sup>78</sup> There are different theories of Governance, i.e., accountability theory, agency theory, stakeholder theory, signalling theory, and economic theory. In accountability theory, the accountors (Agent/BOD/Managers) are required to provide information/report to the accountees (Stakeholders/users/society), the information can be financial or nonfinancial. In *Shari’ah* perspective, the agents have first responsibility towards Allah SWT then towards principal and society.<sup>79</sup>

### **2.2.2. Transparency (*Shafāfiyyah*)**

The term transparency is an antonym of concealment “al Kitman,” which means “a state of frankness and no undisclosed or suspicious matters.” The Islamic financial principles introduce structural strength, transparent information, disclosure, and strict compliance with the *Shari’ah* rules.<sup>80</sup> The implication of SG strictly prohibits unlawful

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<sup>77</sup> Muhammad ibn Ismail al-Bukhari, ‘Sahih al-Bukhari’, (1407/1987), 1st edition,, Beirut; Dar al-Qalam, Volume 2, Book 13, Number 18

<sup>78</sup> “Hisba” Encyclopedia of Islam and the Muslim World. . Encyclopedia.com. (February 9, 2019). <https://www.encyclopedia.com/religion/encyclopedias-almanacs-transcripts-and-maps/hisba>

<sup>79</sup> Sherif Ismail Abdel-Rahman El-Halaby, ‘Accountability Practices of Islamic Banks: A Stakeholders Pective’ (Graduate School of Management, United Kingdom, 2015).

<sup>80</sup> Mohd Izzat Amsyar Mohd Arif, Ruzian Markom, and Hisham Hanapi, ‘The Principles of Shariah Governance in Statutory Duties of Shariah Advisory Council in Malaysian Islamic Banking System: A Way Forward’, *International Journal of Business Marketing and Management (IJBMM)* 3, no. 2 (2018): 58–66.

sources of income, such as Ribā, gambling, uncertainty, etc. It adheres to the moral and ethical values by promoting the element of Amānah (trust), Adil (fairness), and transparent accountability.<sup>81</sup> The implementation of such practices also increases the level of satisfaction and standard of confidence in the products and services of IFI.

Allah SWT has divulged the concept of transparency in the following verse;

“Believers! Whenever you contract a debt from one another for a known term, commit it to write. Let a scribe write it down between you justly, and the scribe may not refuse to write it down according to what Allah has taught him, so let him write, and let the debtor dictate; and let him fear Allah, his Lord, and curtail no part of it. If the debtor be feebleminded, weak, or incapable of dictating, let his guardian dictate equitably, and call upon two of your men as witnesses; but if two men are not there, then let there be one man and two women as witnesses from among those acceptable to you so that if one of the two women should fail to remember, the other might remind her. Let not the witnesses refuse when they are summoned (to give evidence). Do not show slackness in writing down the transaction, whether small or large, along with the term of its payment. That is fairest in the sight of Allah; it is best for

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<sup>81</sup> Siti Noradibah Md Zain and Zurina Shafii, ‘The Impact of Shariah Governance to Financial and Non-Financial Performance in Islamic Financial Institutions: A Literature Survey’, *International Journal of Islamic Business* 3, no. 2 (2018): 27–40.

testimony and is more likely to exclude all doubts. If it is a matter of buying and selling on the spot, it is not blameworthy if you do not write it down; but do take witnesses when you settle commercial transactions with one another. Moreover, the scribe or the witness may be no harm. It will be sinful if you do so. Beware of the wrath of Allah. He teaches you the Right Way and has full knowledge of everything.”<sup>82</sup>

### 2.2.3. Trust (*Amānah*)

The term ‘Amānah’ is derived from an Arabic word *amn*, which means security, protection, safety, and shelter<sup>83</sup>. In addition to highly significant value, it is one of the sources of mutual trust in executing a claim in human mutual dealings. The Prophet Muhammad SAW said; One's faith is imperfect if he is dishonest”<sup>84</sup> The element of trust is an essential element of good governance; that why shareholders appoint BoD as their trustees under the Islamic principle of Amānah for the smooth running of a business. Similarly, the senior management is also bound to implement decisions and policies of the BoD; they are responsible for the management of the business in the light of the decision taken by the BoD. They are required to fulfill the requirement of competency and

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<sup>82</sup> Al-Quran, 2:282, for english translation Prof. Zafar Ishaq Ansari, “Towards Understanding the Quran”, Islamic Foundation UK, accessed on 25<sup>th</sup> February 2019, <http://www.islamicstudies.info>

<sup>83</sup> Sofiah Bt. Samsudin and Md. Sirajul Islam, ‘Value of Al- Amanah in Human ’ Life’, *International Journal of Scientific and Research Publications* 5, no. 4 (2015): 5–7.

<sup>84</sup> Ahmad Ibn Muhammad Ibn Hanbal, ‘Musnad Ahmad ibn Hanbal’, Vol 19, p 375, *Hadīth* No. 12383

qualification under some Fit and proper criteria; this is also a requirement of the Amānah in Islamic Law.<sup>85</sup>

### **2.3. Definition of Governance**

Governance means “Establishment of policies, and continuous monitoring of their proper implementation, by the members of the governing body of an organization. It includes the mechanisms required to balance the powers of the members (with the associated accountability), and their primary duty of enhancing the prosperity and viability of the organization.”<sup>86</sup>

SBP describes corporate governance in the following words;

*“Corporate Governance is the system by which business corporations are directed and controlled by structuring rights and responsibilities of different participants in the corporation, such as the board, managers, shareholders, and stakeholders. By doing this, it provides structure for setting corporate objectives and mustering resources to attain those goals without compromising fairness, ethics, transparency, and accountability”.*<sup>87</sup>

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<sup>85</sup> Ayaz and Mansoori, ‘Strengthening Corporate Governance Regime for Islamic Banks in Pakistan : Focusing on the Principles of Am Ana’.

<sup>86</sup> Dictionary, B. (2016, August 14). <http://www.businessdictionary.com>. Retrieved from Business Dictionary: <http://www.businessdictionary.com/definition/governance.html>

<sup>87</sup> State Bank of Pakistan, *Handbook of Corporate Governance*, retrieved on 2<sup>nd</sup> July 2018. [http://www.sbp.org.pk/about/corp\\_gov/](http://www.sbp.org.pk/about/corp_gov/)

## 2.4. *Definition of Shari'ah Compliance*

*Shari'ah* compliance is to abide by *Shari'ah* rules and principles, a believer who follows abide all the Ahkam of the *Qur'ān* and Sunnah is called a Muslim (complete submission to Allah). Mr. Hafij has defied *Shari'ah* compliance in the following words;

*"Shari'ah compliance means to abide by all the rules and regulations of Qur'ān and Sunnah, and the person who completely follows Islam is a Muslim."*<sup>88</sup>

*Shari'ah* compliance in financial matters means to follow the rules and principles of the *Qur'ān* and Sunnah<sup>89</sup> and to abstain from the prohibited elements as prescribed by the *Qur'ān* and Sunnah i.e., *Ribā*, *Gharar*, *Qimār* etc.

## 2.5. *Shari'ah Principles that Govern Shari'ah Compliance*

Before we discuss *Shari'ah*-governance, it is worth mentioning to highlight those *Shari'ah* principles which govern *Shari'ah* compliance in IBIs. Several elements make a transactions void,<sup>90</sup> that includes;

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<sup>88</sup> Ruma Khanam and Md. Hafij Ullah, 'Shari'ah Compliance in Islamic Banking', *International Journal of Islamic and Middle Eastern Finance and Management* 14, no. 6 (2014): 76–84, <https://doi.org/10.1108/imefm-06-2012-0051>; Umar A. Oseni, Abu Umar Faruq Ahmad, and M. Kabir Hassan, 'The Legal Implications of "Fatwā Shopping" in the Islamic Finance Industry: Problems, Perceptions and Prospects', *Arab Law Quarterly* 30, no. 2 (2016): 107–37, <https://doi.org/10.1163/15730255-12341319>.

<sup>89</sup> Government of Pakistan, 'The Constitution of the Islamic Republic of Pakistan' (2012). Section 227 (1)

<sup>90</sup> Muhammad Ayub, *Islami Maliyat (Islami Bankari: Usool Aour Tatbiq) Urdu*, 1st ed. (Islamabad: Riphah Centre of Islamic Business (RCIB), Riphah International University, 2010).

### 2.5.1. Prohibition of Ribā (Interest)

Ribā means an increase in the principal, stipulated in a loan transaction. So, anything chargeable in addition to the principal amount as a contractual obligation falls under the purview of Ribā.<sup>91</sup> In other words, Ribā means charging a predetermined additional amount on loan extended based on the length of the credit period. Certain quarters are of the view that Ribā, which is prohibited by revelations, is the Usury<sup>92</sup>. There are two types of Ribā, the first is Ribā ul *Qur'ān*, which is also known as Ribā al-jahiliyyah and second is Ribā ul *Hadīth* or Ribā al-fadal<sup>93</sup>. Imam Abubakr Al-Jassas defied Ribā al-jahiliyyah as “the Ribā of Jahiliyya is a loan given for stipulated period with a stipulated increase on the principal payable by the loanee.”<sup>94</sup>

Similarly, prohibitions of Ribā and warning against Ribā eaters can be found in *Hadīth*;

”عَنْ جَابِرِ، قَالَ: «لَعْنَ رَسُولِ اللَّهِ صَلَّى اللَّهُ عَلَيْهِ وَسَلَّمَ أَكْلُ الرِّبَا، وَمُؤْكِلُهُ، وَكَايِتُهُ، وَشَاهِدُهُ» ، وَقَالَ: «هُنْ سَوَاءٌ».<sup>95</sup>

*“This narration is from Jabir (RAA). He said that Allah's messenger SSWS cursed the persons who eat Ribā, gave Ribā, documented a Ribāwi deal, or stood witness to it. According to Jabir, this prophet SAAWS further said that all of the said persons were equal. Jabir said*

<sup>91</sup> Dr. Muhammad Tahir Mansoori, *Islamic Law of Contracts and Business Transactions* (Islamabad: Sharī'ah Academy, International Islamic University, Islamabad, 2011).

<sup>92</sup> Muhammad Hanif, *Islamic Banking: Theory and Practice* (Islamabad, 2014), <https://doi.org/rhttp://dx.doi.org/10.2139/ssrn.1731551>.

<sup>93</sup> Mansoori, *Islamic Law of Contracts and Business Transactions*.

<sup>94</sup> Abu Bakar Al-Jassas, ‘Akhkam al Quran’, Dar al-Kitab al-Arabi, Beritu.

<sup>95</sup> Abu al-Ḥusayn ‘Asakir ad-Din Muslim ibn al-Ḥajjaj ibn Muslim, ‘Sahih Muslim’, vol.3, p.1219, *hadīth* no. 1598, edited: Muhammad Fo'ad Abdul Baqi, Dar Ihya' Torath al-Arabi, Beruit.

*that Allah's Messenger ﷺ cursed the accepter of interest and its payer, and one who records it, and the two witnesses, and he said: They are all equal."*

"عَنْ أَبِي هُرَيْرَةَ، قَالَ: قَالَ رَسُولُ اللَّهِ صَلَّى اللَّهُ عَلَيْهِ وَسَلَّمَ: «الرِّبَا سَبْعُونَ حُوتًا، أَبْسَرُهَا أَنْ يَنْكِحَ الرَّجُلُ أُمَّةً.»<sup>96</sup>"

"This *Hadīth* is reported by Abu Horairah (RAA). According to him, the Prophet SAAWS said that the sin of Ribā equaled seventy sins with the slightest of them being equal, in despicability, to incest with one's mother. It was narrated from Abu Hurairah (RA) that the Messenger of Allah (صَلَّى اللَّهُ عَلَيْهِ وَآلِهِ وَسَلَّمَ) said: "There are seventy degrees of usury, the least of which is equivalent to a man having intercourse with his mother."

"عن عبيد الله بن أبي يزيد، سمع ابن عباس يقول: حدثني أسماء بن زيد، أن رسول الله صَلَّى اللَّهُ عَلَيْهِ وَآلِهِ وَسَلَّمَ قال: «لَا رِبَا إِلَّا فِي النَّسِيْنَ»<sup>97</sup>"

"According to obaidullah b Abu Yazid (RAA). He heard ibn abbas (RAA) saying that Osama b Zaid (RAA) told his as follows: "the Prophet SAAWS said that there was no Ribā except in lending" Usmah bin Zaid narrated that the Messenger of Allah (صَلَّى اللَّهُ عَلَيْهِ وَآلِهِ وَسَلَّمَ) said: "There is no Ribā except in credit."

<sup>96</sup> Abū 'Abdillāh Muḥammad ibn Yazīd Ibn Mājah, "Ibn Maja", vol. 2, p. 764, *hadīth* no. 2274, edited: Muhammad Fo'ad Abdul Baqi, Failal Isa al-babi al-Halabi.

<sup>97</sup> Abu 'Abd ar-Rahmān Aḥmad ibn Shu'ayb ibn Ali ibn Sīnān al-Nasa'i, "Sunan al-Nasai", vol. 7, p. 281, *hadīth* no. 4580, edited: Abudul fatah abu Ghodda, Maktab al-matbooat al-Islamiyah, Halb, 2nd ed. 1986

Arabs practiced the Ribā mentioned in the *Qur’ān* in the pre-Islamic period.<sup>98</sup> The interest being practiced in the modern banking system is the same, which is prohibited in the Holy *Qur’ān* and Sunnah of the Prophet ﷺ.<sup>99</sup> The Supreme Court’s Judgement on Ribā has decided that “Any additional amount over the principal in the contract of loan or debt is the Ribā prohibited by the Holy *Qur’ān* in several verses.”<sup>100</sup> The Islamic Fiqh Academy has passed a resolution that; “Any increase or interest on a debt which has matured, in return for an extension of the maturity date, in case the borrower is unable to pay and the increase (or interest) on loan at the inception of its agreement, are both forms of usury which are prohibited under *Shari’ah*.”<sup>101</sup> All transactions of IBs must be free of Ribā in any shape or kind.

### 2.5.2. Prohibition of *Gharar* (Uncertainty)

*Gharar* is an Arabic word which has a broad concept, literally means deceit, risk, fraud, uncertainty, or hazard that might lead to destruction or loss.<sup>102</sup> *Gharar* is one of an external prohibited attribute that invalidates the contracts. It includes many factors such as doubt, suspicion, uncertain conditions, and the absolute lack of knowledge about the transaction and in determinability of the fundamental elements of the subject matter.<sup>103</sup>

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<sup>98</sup> Mansoori, *Islamic Law of Contracts and Business Transactions*.

<sup>99</sup> Khan, ‘The Supreme Court’s Judgement on Riba’; Usmani, ‘Historical Judgement on Interest (Sood Per Tareekhi Faisla) Urdu’; Council of Islamic Ideology, ‘Report Interest Free Banking’ (Islamabad, 2003).

<sup>100</sup> Usmani, ‘Historical Judgement on Interest (Sood Per Tareekhi Faisla) Urdu’.

<sup>101</sup> Islamic Development Bank and Islamic Fiqh Academy, *Resolutions and Recommendations of the Council of the Islamic Fiqh Academy*, 1st (1421) (Jeddah: Islamic Research and Training Institute, Islamic Development Bank Jeddah, Kingdom of Saudi Arabia, 2000).

<sup>102</sup> Uddin, ‘Principles of Islamic Finance: Prohibition of Riba, Gharar and Maysir’.

<sup>103</sup> Mansoori, *Islamic Law of Contracts and Business Transactions*.

According to Imam Ibn-Hazam, “*Gharar* in sales occurred where the purchaser does not know what he has bought, and the seller does not know what he has sold.”<sup>104</sup>

There are two types of *Gharar*, first is *Gharar Yasir* (light *Gharar*) and the second is *Gharar Fahish* (excess *Gharar*). The holy *Qur’ān* has not explicitly prohibited *Gharar* however in Surah al Baqarah Allah SWT say “Eat not your property among yourselves unjustly by falsehood and deception, except it be a trade amongst you by mutual consent”<sup>105</sup> The Sunnah of the Prophet ﷺ forbidden dealing of contracts containing any form of *Gharar*;

عَنْ أَبِي هُرَيْرَةَ قَالَ نَهَى رَسُولُ اللَّهِ صَلَّى اللَّهُ عَلَيْهِ وَسَلَّمَ عَنْ بَيْعِ الْغَرَرِ وَبَيْعِ الْخَسَاءِ<sup>106</sup>

“*Narrated Abu Hurairah (RA): The Prophet (صَلَّى اللَّهُ عَلَيْهِ وَسَلَّمَ) forbade the type of sale which involves risk (or uncertainty) and a transaction determined by throwing stones.*”

The practice of *Gharar* relates to issues such as pricing, delivery, quantity, quality of assets that are transactional-based and would affect the quality of consent of the parties to a contract. In the modern financial system, the examples of *Gharar* are conventional insurance<sup>107</sup>, conventional futures.<sup>108</sup> “The prohibition of *Gharar* implies that the business partners must know exactly the details of the transaction which is being offered. Many

<sup>104</sup> Ibn Hazm, al-Muhallah, Dar al-Afaq al-Jadidah, vol. 8, pp343-389

<sup>105</sup> Al Quran, Al-Bakarah, 2:188;

<sup>106</sup> Abu 'Isa Muḥammad ibn 'Isa as-Sulami ad-Darir al-Bughi at-Tirmidhi, 'Jami' at-Tirmidhi', Abwab al-Buyu, *Hadīth* 1289,

<sup>107</sup> Mansoori, *Islamic Law of Contracts and Business Transactions*; Uddin, ‘Principles of Islamic Finance: Prohibition of Riba, *Gharar* and *Maysir*’.

<sup>108</sup> Md Akther Uddin, ‘Conventional Futures: Derivatives from Islamic Law of Contract Prospective’, Munich Personal RePEc Archive, 2016, <https://mpra.ub.uni-muenchen.de/70147/>.

contracts do not stipulate the exact nature, date, or value of what is received in exchange. Especially the case on financial markets, in general, future, forwards and other derivatives are seen as *gharar*, as there is no certainty that the object of the sale will exist at the time the trade is to be executed.”<sup>109</sup>

### 2.5.3. Prohibition of *Qimār* (Gambling)

Islam has prohibited all forms of Maysir and *Qimār* categorically. It comprises every form of an increase or money gaining of which depends entirely on luck on chance, for instance, acquiring income as an outcome of lottery or lucky draw. In other words, we can say maysir refers to the easy acquisition of wealth by chance whether or not it deprives the other's right. <sup>110</sup> In *Qur'ān* Allah SWT says;

يَسْأَلُوكُمْ عَنِ الْخَمْرِ وَالْمَنِيرِ ۖ قُلْ فِيهِمَا إِثْمٌ كَبِيرٌ وَمُنَافِعٌ لِلنَّاسِ وَإِثْمُهُمَا أَكْبَرٌ مِنْ نَفْعِهِمَا ۖ  
وَيَسْأَلُوكُمْ مَاذَا يُنْفِقُونَ قُلِ الْعَفْوُ ۖ كُلُّكُمْ يُبَيِّنُ اللَّهُ لَكُمُ الْأَيَّاتِ لَعَلَّكُمْ تَتَفَكَّرُونَ (219)

“They ask you about wine and gambling. Say, “In them is a great sin and [yet, some] benefit for people. However, their sin is greater than their benefit.” Moreover, they ask you what they should spend. Say, “The excess [beyond needs].” Thus Allah makes clear to you the verses [of revelation] that you might give thought”.

<sup>109</sup> Mahmoud A El-gamal, ‘An Economic Explication of the Prohibition of Gh Arar in Classical Islamic Jurisprudence’, in *4th International Conference on Islamic Economics to Be Held in Leicester, UK*, (Leicester, UK, 2001), 13–15.

<sup>110</sup> Uddin, ‘Conventional Futures: Derivatives from Islamic Law of Contract Prospective’.

<sup>111</sup> Al-Quran 2:219,

The relation between *gharar* and *maysir* is that *gharar* is general, and *maysir* is specific.<sup>112</sup> *Maysir* happens when the risk and uncertainty are shifted to one party from the other.<sup>113</sup>

## 2.6. Standard/BenchMark for *Shari'ah* Compliance

In light of the aforementioned discussion, it is concluded that in modern days, the IFIs should follow the *Shari'ah* guidelines in their complex routine transactions. These transactions must not involve any prohibited elements, i.e., *Ribā*, *gharar*, and *Qimār*. It is the responsibility of the *SSB* to ensure that the products and services of the financial institution are free from prohibited elements. Secondly, in the development of new products and services, the products and services must be keenly observed before launching in the market. Of course, the development of new products and services depends on *Ijtihād*. Therefore the difference of opinion among the *Shari'ah* board of different IBs on a specific product or service is indispensable. So, to avoid the controversy of views or at least to reduce the diversity and fanaticism of the schools of Islamic law, it is imperative to implement decisions of the institutions exercising collective *Ijtihād*. This will make products and services uniform and harmonization in the matters of IFIs.

No doubt, the problems of the modern era are far more complex than at the time of the Holy Prophet ﷺ. Therefore, Muslim societies rightly expect from 'Ulamā' to provide

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<sup>112</sup> Mawsua Fiqhiyyah, Ministry of Awqaf & Islamic Affairs – Kuwait, (2006).

<sup>113</sup> Muhammad Iman and Sastra Mihajat, 'Contemporary Practice of Riba, Gharar and Maysir in Islamic Banking and Finance', *International Journal of Islamic Management and Business* 2, no. 2 (2016): 1–19; Sultan, 'Ribā , Gharar & Maysir: A Review from Classical Shari'ah and Contemporary Implications'.

broad and pragmatic solutions to their problems.<sup>114</sup> That is why Allama Yusuf al-Qardawi stated that “the *Ijtihād* which we need in our era is Collective *Ijtihād* (al-*Ijtihād* al-Jamā‘ī)<sup>115</sup> The justification for collective *Ijtihād* comes from the verses of the *Qur’ān*. Allah SWT says, “And whose affairs are a matter of counsel”<sup>116</sup> similarly in another verse which guides regarding *shura* (consultation) “And consult with them upon the conduct of affairs.”<sup>117</sup> The collective *Ijtihād* was practiced on different occasions<sup>118</sup>. The decision regarding defense strategy inside Madina City or going outside during the battle of Uhud was finalized by mutual discussion.

Similarly, during the battle of Hunain, the decision regarding war prisoners of the Hawzin tribe was also a notable example of collective *Ijtihād*.<sup>119</sup>

The Collective *Ijtihād* was also practiced by the companions of the Holy Prophet (ﷺ); they resolve the most important and complicated matters through *Mushawirati Ijtihād*. There are several examples of collective *Ijtihād* during the era of the companions, i.e. the selection of the Caliph, etc. In modern days there are many institutions of collective *Ijtihād*

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<sup>114</sup> Nadirsyah Hosen, ‘Nahdlatul ‘Ulamā’ and Collective *Ijtihād*’, *New Zealand Journal of Asian Studies* 6, no. 1 (2004): 5–26.

<sup>115</sup> Yusuf al-Qardawi, ‘al-*Ijtihād* wa al-Tajdid baina al-Dawabit al-Syar’iyyah wa al-Hajat al-Mu’asirah,’ interview in al-‘Ummah, Qatar, 31 May 1984, p. 48.

<sup>116</sup> Al-Qur’ān, 42:38.

<sup>117</sup> Al-Qur’ān, 3:159

<sup>118</sup> Dr. Sajila Kausar, ‘Collective *Ijtihād* : History and Current Perspective’, *International Journal of Humanities & Social Sciences Studies* III, no. V (2017): 151–63.

<sup>119</sup> Abu Muhammad ‘Abd al-Malik bin Hisham, Al-Seerah al-Nabawiyyah (Egypt: Maktabah wa Matba‘ah Mustafa al-Babi al-Halabi wa Aouladuhu, 3<sup>rd</sup> Edition, 1375 A.H/1955 A.D) vol. 3-4, pp. 488-489.

working in different countries (Annexure VI). To uniform the practices of IFIs, it is imperative to strengthen these institutions and implement their decisions.

## **2.7. Definition of *Shari'ah Governance***

The IFSB has defined the SG as follow;

*“Shari'ah Governance System refers to the set of institutional and organizational arrangements through which an IIFS ensures that there is effective independent oversight of Shari'ah compliance over each of the following structures and processes: Issuance of relevant Shari'ah pronouncements/ resolutions, Dissemination of information on such Shari'ah pronouncements/resolutions to the operative personnel of the IIFS who monitor the day-to-day compliance with the Shari'ah pronouncements vis-à-vis every level of operations and each transaction, An internal Shari'ah compliance review/audit for verifying that Shari'ah compliance has been satisfied, during which any incident of noncompliance will be recorded and reported, and as far as possible, addressed and rectified An annual Shari'ah compliance review/audit for verifying that the internal Shari'ah compliance review/audit has been appropriately carried out and its findings have been duly noted by the Shari'ah board”<sup>120</sup>*

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<sup>120</sup> Islamic Financial Services Board, *Guiding Principles on Shari'ah Governance Systems for Institutions Offering Islamic Financial Services*, Islamic Financial Service Board, 2009.

## 2.8. *Shari'ah Governance* in IFIs

*Shari'ah Governance* is considered the most essential part of the governance system. Every organization is supposed to be regulated and supervised in with the light of various standards. Likewise, IFIs are also required to be supervised and monitored for the robust *SG* environment. To achieve this objective contemporary corporate governance rules are not applicable, because of the distinctive activities of the IFI(s) *SG* comes into operation.

The main objective of the *Shari'ah* is to ensure compliance of *Shari'ah* principles in the products, services, and operations of the IFIs. It also increases the confidence of IFI's customers with its disclosures, transparency, and proper oversight with intensifying professionalism.

## 2.9. Different Features of *Shari'ah Governance & Corporate Governance*

There is a difference between the components of corporate and *SG* in their roles and functions. The comparison of both governance systems concerning the governing body, control, and compliance is given below;

Functions	Typical Financial Institutions	Additions in IFI(s)
<b>Governance</b>	BoDs	<i>Shari'ah</i> Board
<b>Control</b>	Internal Auditors	ISRU (Internal <i>Shari'ah</i> Review Unit)
	External Auditors	External <i>Shari'ah</i> Review

<b>Compliance</b>	Regulatory and Financial compliance officers, unit or department	Internal <i>Shari'ah</i> compliance Unit (ISCU)
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Table 1: Different Features of *SG* & Corporate Governance

Source: IFSB (2009)

## 2.10. Components of *Shari'ah Governance*

There are four essential components of *SG*, i.e., Management, *Shari'ah* board, *Shari'ah* audit, and transparency & disclosure.<sup>121</sup> While the SBP *SGF* has mentioned the BoDs fourth component instead of transparency & disclosure.<sup>122</sup> A sound and practical *SGF* is only possible with the joint efforts of these components.

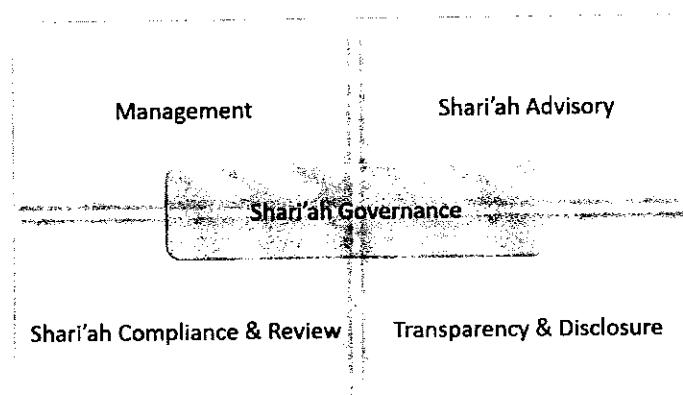


Figure 1 Components of *Shari'ah Governance*

<sup>121</sup> Minhas, 'Shariah Governance Model and Its Four Basic Pillars'.

<sup>122</sup> SBP, 'Shariah Governance Framework for Islamic Banking Institutions', Islamic Banking Department, State Bank of Pakistan, 2014, <http://www.sbp.org.pk/ibd/2015/C1.htm>; SBP, 'Shari'ah Governance Framework for Islamic Banking Institutions'.

## 2.11. *Shari'ah* Governing Rules Relating to BoDs (BOD)

The BOD are usually those individuals who either own a substantial number of shares in the company or supported by those who do.<sup>123</sup> They are elected to act as representatives of the shareholders to establish corporate management related policies and to make decisions on major company issues.<sup>124</sup> In light of the above definitions, it can be said that key players involved in corporate governance are shareholders, directors (BODs), and management. Shareholders are owners of the company, provide capital to the company, and appoint directors to protect their interests. The directors (as BODs) set the strategies as mentioned earlier and policies and establish the company's objectives. The management is responsible for the day-to-day operation of the company's business. According to the Organization for Economic Co-operation and Development (OECD) 2004:

*“The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board’s accountability to the company and the shareholders.”<sup>125</sup>*

According to the Organization for Economic Co-operation and Development (OECD) 2015;

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<sup>123</sup> Imran Ahsan Khan Nayzee, *Corporate Law*, 1st Editio (Rawalpindi - Pakistan: Federal Law House, 2014).

<sup>124</sup> <http://www.investopedia.com/terms/b/boardofdirectors.asp> reached on 27-8-2017, at 23:43

<sup>125</sup> OECD, ‘OECD Principles of Corporate Governance’, *OECD Publications Service* (Paris, France, 2004), [https://doi.org/10.1007/978-4-431-30920-8\\_10](https://doi.org/10.1007/978-4-431-30920-8_10). p 24, and

*“Monitoring of governance by the board also includes a continuous review of the internal structure of the company to ensure that there are clear lines OECD of accountability for management throughout the organization. In addition to requiring the monitoring and disclosure of corporate governance practices on a regular basis, a number of countries have moved to recommend or, indeed, mandate self-assessment by boards of their performance as well as performance reviews of individual board members and the CEO/Chairman.”*<sup>126</sup>

They implement the policies and strategies set up by the BODs. The board supervises such implementations by the management. This whole system is called corporate governance. In light of the OECD principle, the BoDs is the agents of the shareholders.

## **2.12. Responsibilities of the BoDs in IBI’s**

According to the law of agency, which governs the relationship between a company and its directors. The directors act on behalf of the company within the prescribed limits imposed by the memorandum and articles of the company. However, if an act goes beyond the memorandum and articles will be judged based on the doctrine of *ultra vires* and the

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<sup>126</sup> The Organisation for Economic Co-operation and Development, ‘Principles of Corporate Governance’, *The Organisation for Economic Co-Operation and Development* (Paris, France, 2015), <https://doi.org/10.1787/9789264015999-en>. p 61

doctrine of indoor management. The SBP determines the responsibilities of BOD regarding *SGF* in the following points:

1. “The BOD shall be ultimately responsible and accountable for ensuring full conformity of the IBI’s operations with *Shari’ah* principles. Like other risks faced by an IBI, the BOD needs to be fully aware of the risk of *Shari’ah* non-compliance and its potential implications on the reputation and business of the IBI. Towards this end, the BOD shall introduce an effective mechanism including diligent oversight on the functioning of the Framework and compliance with the fatawas, instructions, and guidelines of the *Shari’ah* Board”.<sup>127</sup>
2. “The BOD should also be fully aware of its fiduciary responsibility, particularly, towards Investment Account Holders (IAHs) /Profit and Loss Sharing depositors (PLS depositors) who accept risks that are almost similar to those of the shareholders but without having any voting rights and fora like Annual General Meetings (AGMs) to express their concerns on the IBI’s performance. The IAHs expect IBIs to not only exercise prudence in the deployment of their funds in different avenues but also to ensure *Shari’ah* conformity of returns to be earned and distributed to them. The BOD is thus expected to introduce the necessary mechanisms and risk management systems to safeguard the interests of IAHs/PLS depositors.”<sup>128</sup>

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<sup>127</sup> SBP, ‘Shariah Governance Framework for Islamic Banking Institutions’,

<sup>128</sup> SBP, ‘Shari’ah Governance Framework for Islamic Banking Institutions’.

3. “The BOD shall appoint a SB to perform such functions as stipulated under Para 3(B) of this Framework and shall cause to take appropriate measures for introducing and implementing an effective *Shari'ah* compliance framework. It shall also approve the Terms of Reference (TOR) of the SB and fix the remuneration of the SB members. In case of foreign banks having IBBs, the appointing authority shall be the Country Manager/CEO in Pakistan.”<sup>129</sup>
4. “The BOD shall meet the *Shari'ah* Board at least on a half-yearly basis to a) have a detailed briefing on the *Shari'ah* compliance environment, the issues/weaknesses (if any), and recommendations to improve *Shari'ah* compliance environment, and b) ensure timely and effective enforcement of the SB's decisions, fatawas, observations, and recommendations. However, one of the meetings between the SB and BOD, during a calendar year, maybe held through video conferencing.”<sup>130</sup>

#### ***2.12.1. Status of BoDs***

The status of BOD is as the agent of the company. Professor Imran Ahsan Khan Nyazee maintains in this respect that, in general terms, the BoDs are shareholders of the company. They are elected by the other shareholders to run the business of the corporation on their behalf. In partnership, the investors and owners are called partners; however, in the company, the investors are called shareholders or stockholders. They elect some shareholders to run their business

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<sup>129</sup> SBP.

<sup>130</sup> SBP.

smoothly. As the Company is a legal person and cannot act on its own, it has to work through natural persons. The company operates through its directors and other officials to whom authority is delegated. The position of the directors is, therefore, that of agents of the company on whose behalf they act.<sup>131</sup>

**According to Ferguson v. Wilson:**

*“The directors are merely agents of a company. The company itself cannot act in its own person. It can act only through directors, and the case is, as regards those directors, merely the ordinary case of principal and agent. Wherever an agent is liable, those directors would be liable; and where the liability is of the principal and principal only, the liability is the liability of the company.<sup>132</sup>”*

#### **2.12.2. Shari'ah Rules Relating to Agent (Wakil)**

“It is not out of place to define Contract of Agency before elaboration *Shari'ah* rules relating to Agent (Wakil). Hence, the contract of Agency can be defined as; *Wakalah is to substitute an agent for the principal to perform on behalf of that principal an act, which admits of representation. It creates a fiduciary relationship that exists between two persons, one of whom expressly or impliedly consents that another should act on his behalf. The one on whose behalf they*

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<sup>131</sup> Nayzee, *Corporate Law*. Page? And detailed information of the book?

<sup>132</sup> Ferguson v. Wilson (1866) LR 2 Ch. App. 77

*act is done the principal (asil), and the one who is to act is called agent (wakil)".<sup>133</sup>*

**According to AAOIFI *Shari'ah Standards*:**

*"Agency is the act of one party delegating the other to act on its behalf in what can be a subject matter of delegation, and it is, thus, permissible. Agency is basically a non-binding contact for both the parties thereto. However, it may sometimes become a binding contract.<sup>134</sup>"*

The condition of an agent is that he should possess the capacity of execution that requires sanity and ability of understanding and discrimination in the agent. Thus, it is not a requirement that the agent must necessarily be of age.<sup>135</sup> A person having an insufficient capacity of execution can act as an agent for another person. Hanbali and Shaf 'I jurists, however, postulate a full legal position for an agent. In their opinion, the general rule to be followed in this regard is that one, who does not have authority to dispose of a thing for him, is ineligible to be an agent for disposition of that thing for others.<sup>136</sup>

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<sup>133</sup> Zaydan, *al-Madkhal li Dirasah al-Shari'ah al-Islamiyyah*, p. 338

<sup>134</sup> AAOIFI, *Sharia'ah Standards, for Islamic Financial Institutions* (Manama, Bahrain: Accounting and Auditing Organisation for Islamic Financial Institutions, P.O. Box 1176, Manama, Bahrain, 2017). Shari'ah Standard No 23, section 2(1), p 610

<sup>135</sup> Mansoori, *Islamic Law of Contracts and Business Transactions*.

<sup>136</sup> Ibn Qudamah, *Al Mughni*, Vol. 5, pp. 79-8

### ***2.12.3. Agent's Duties Toward his Principal***

The agent is supposed to fulfill the following duties towards his Principal according to *Shari'ah*;

1. To perform the undertaking according to instructions, i.e., to observe all the conditions and restrictions laid down by the principal.<sup>137</sup>
2. To exercise due care and skills by the agent in the organization.
3. To carry out instructions personally, i.e., he is not allowed to entrust the task to another person.
4. Not to permit a conflict of interest to arise, i.e., he is not allowed to purchase for himself property, which he engaged in selling. The corollary to this case is that he must not sell his property to the principal without fully disclosing the facts.
5. Not to make a secret profit or misuse confidential information.

### ***2.13. Shari'ah Governing Rules relating to EM***

BoDs of the company appoint the team of EM under the chairmanship of Chief Executive officer (CEO). The EM is not concerned with the decision making; perhaps, they assist the CEO in the implementation of the policies issued by the BOD and operational management of the company. Their core responsibilities are to manage the business

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<sup>137</sup> Mansoori, p. 63

operation as a whole as well as monitoring of the financial matters and group business plans.<sup>138</sup>

### ***2.13.1. Status of Executive Management***

Executive Management means individuals who manage the business affairs of the company. They are not usually the owner of the company like BoDs; however, they work for the company against salary instead of dividend or profit, on the other hand, they are not liable for the loss. They follow the instructions and rules made by the BoDs. In other words, EM is the employees (*Ajīr*) of the company.<sup>139</sup>

There are many references on *Shari'ah* legitimacy of *Ijārah* Contract from the *Qur'ān*, Sunnah and *Ijmā'*

#### **The Holy *Qur'ān*:**

”فَإِنْ أَرْضَعْنَ لَكُمْ فَأَتَوْهُنَّ أَجُورَهُنَّ ۝ وَأَنْتُمْ رَايْنَكُمْ بِمَعْرُوفٍ ۝ وَإِنْ شَعَسْتُمْ فَسْتَرْضِعُ لَهُ أَخْرَىٰ“<sup>140</sup>

*Allah* says: “and if they suckle, you are (offspring) give them their recompense.”

In Surah Al-Qasas *Allah* SWT says;

”قَالَتْ إِحْدَاهُمَا يَا أَبَتِ اسْتَأْجِرْهُ ۝ إِنْ خَيْرٌ مِّنْ اسْتَأْجَرْتِ الْقَوْيِ الْأَمِينِ“<sup>141</sup>

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<sup>138</sup> Outotec, ‘Management duties and responsibilities’, [www.outotec.com](http://www.outotec.com) , retrieved on January 15 2019, <https://www.outotec.com/company/about-outotec/corporate-governance/management-duties-and-responsibilities/>

<sup>139</sup> Dr. Rafik Issa Beekun, *Islamic Business Ethics* (HErndon, USA: International Institute of Islamic Thought, PO Box 669, HErndon, VA 20170, 1997); Trevor. Gambling and Rifaat Ahmed. Abdel Karim, *Business and Accounting Ethics in Islam* (Mansell, 1991).

<sup>140</sup> Qur'an, 65:6

<sup>141</sup> Qur'an, 28:26

*Said one of the (damsels): "O my father: engage him on wages. Truly, the best of men for thee to employ is the man who is strong and trusty."*

### **The Sunnah:**

”فَلَمَّا رَأَى رَسُولَ اللَّهِ صَلَّى اللَّهُ عَلَيْهِ وَسَلَّمَ أَعْطَوْا الْأَجِيرَ أَجْرَهُ ، قَبْلَ أَنْ يَجْفَعَ عَرْقُهُ“<sup>142</sup>

*“Said the Prophet ﷺ. Give wages of the person hired before his sweat dries up.”*

In another *hadīth* the Prophet ﷺ guided about the wage of the employee;

نهى رسول الله صلى الله عليه وآله وسلم من استنجار الأجير حتى يبين له أجره<sup>143</sup>

*“If someone hires a person, let him inform him about the wage he is to receive.”*

#### **2.13.2. Conditions of *Ijārat al-Ashkhāṣ***

- 1) “In the contact of hiring services, the work required to be performed should be specifically fixed, such as the carriage of goods, or building houses, etc.”<sup>144</sup>
- 2) “Performance or work should not be prohibited in the *Shari‘ah*. ”<sup>145</sup>

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<sup>142</sup> Al-Amir al-San`aniy, Abu-Ibrahim Muhammad ibn Isma`il (died in AH 1182). Subul al-Salam Sharh Bulugh al-Maram min Adillat al-Ahkam. Volum 3. Beirut: Dar Ihya' al-Turath al-`Arabiyy, 4th Edition, Ah 1379, p 81; or Al-Qazwiniy, Abu-`Abdullah Muhammad ibn Yazid (died in AH 273). Sunan Ibn Majah. Vol, 3. Revised by Muhammad Fu'ad 'Abd al-Baqi. Beirut: Dar al-Fikr Publishers, p 510

<sup>143</sup> Al-Shawkaniy, Muhammad ibn 'Ali ibn Muhammad (died in AH 1255). Nayl al-Awtar min Ahadith Sayyid al-Akhyar Sharh Muntaqa al-Akhbar. Vol, 5. Beirut: Dar al-Jil Publishers, 1973. P. 292

<sup>144</sup> Dr. Muhammad Tahir Mansoori. (2011). Islamic Law of Contracts and Business Transactions, Edition 6<sup>th</sup>, Islamabad: Shari‘ah Academy, International Islamic University, p. 235

<sup>145</sup> Dr. Mansoori, p 236

- 3) “The service required to be rendered should not be a mandatory duty. It is, therefore, not allowed for a person to pray, to perform hajj, etc.”<sup>146</sup>
- 4) The contract of *Ijārah* should not comprise any condition according to which the wage might be paid from the article manufactured, or wrought upon the rental goods.
- 5) “*Ajīr* Mushtarak (Independent Contractor) such as tailor or shoemaker, will be held accountable for the loss of goods in his custody regardless of whether they are destroyed by his fault or without his fault. The ruling has been given by the *Fuqaha* on the grounds of public interest so that trustees and tradesmen exercise greater care in safeguarding people’s properties”.<sup>147</sup>

#### ***2.13.3. Ajīr’s (employee’s) Duties toward Principal (Employer)***

1. To perform the undertaking according to instructions, i.e., to observe all the conditions and restrictions laid down by the principal.<sup>148</sup>
2. To exercise due care and skills.
3. To carry out instructions personally, i.e., he is not allowed to entrust the task to another person.

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<sup>146</sup> As regards charging fee for teaching the Quran or the principles of faith, accepted rule of the Hanafi School is that no one is allowed to charge any fee for teaching these subjects because it is held to be a form of worship (*Ibadah*). This was the ruling of early jurists. The jurists of subsequent ages, when they saw that the people were reluctant to teach the Quran gave a fatwa in favor of charging fee for teaching the Quran. They considered it necessary in order to encourage the teaching of Islam.

<sup>147</sup> Kasani, *Badai al-Sanai*, Vol, 4, p 210

<sup>148</sup> Mansoori. *Islamic Law of Contracts and Business Transactions*, p. 63

4. Not to permit a conflict of interest to arise, i.e., he is not allowed to purchase for himself property, which he engaged in selling. The corollary to this case is that he must not sell his property to the principal without fully disclosing the facts.
5. Not to make a secret profit or misuse confidential information.

#### ***2.13.4. Shari'ah Governing Rules relating to Shari'ah Board***

*SSB* is an independent group of experts in the field of fiqh *al-mua'malāt*. They may also include expert members other than *fiqh al-mua'malāt* who must be experts in the field of Islamic economics, banking, law economics as technical members. The core responsibility of the board is to The *SSB* is supervise, the activities of the IFI, and to ensure that their actives, products, and services are compliant with *Shari'ah* rules and principles. They issue fatawas and guide in *Shari'ah* rulings.<sup>149</sup>

#### ***2.13.5. Status of SSB***

The *BoDs* appoints the *SSB* after approval from *SBP*<sup>150</sup>, and the *SSB* members report to the *BOD* instead of management, they act as agents of the *BoDs*, they are not like the regular employees of the bank. They provide *Shari'ah* guidelines on the matters presented to them and supervise them. They are responsible for the compliance of *Shari'ah* rules and principals in Islamic bank's products and services.

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<sup>149</sup> AAOIFI, *Accounting, Auditing and Governance Standards* (Accounting and Auditing Organization for Islamic Financial Institutions, Manama, Bahrain: Accounting and Auditing Organization for Islamic Financial Institutions. P.O.Box 1176, Manama, Bahrain., 2015).

<sup>150</sup> *SBP*, 'Shari'ah Governance Framework for Islamic Banking Institutions'.

## **2.14. Conclusion**

This chapter has addressed the *Shari'ah* guiding principles in SG. The chapter includes definitions of *Shari'ah* and *Shari'ah* principles of governance and its underlaying values i.e. Accountability (Mas'ūliyyah), transparency (Shafāfiyyah) and trust (Amānah). This chapter has also focused on the concept and different features of *Shari'ah* compliance and governance. In the last part the researcher has also explored the *Shari'ah* guiding principals related to the responsibilities of the main organs of SG i.e. BoDs, EM, *Shari'ah* board and *Shari'ah* auditors using Al-takyef al- Fiqhi. The objective of this analysis is to explore the status of these organs of SG whether these are Agent, employee or owner of the company? After exploaring their status the study has addressed their responsibilities in the light of *Shari'ah*.

## **Chapter 3:**

### ***Shari'ah Governance Frameworks: Comparative Study of SBP, BNM, AAOIFI, AND IFSB***

#### **Introduction**

*SG* is an essential part of the Islamic banking system. A sound and effective *Shari'ah* compliance environment is critically important for an IBs which is possible with a strong *SG* system. The central banks, regulators and standard-setting organizations have issued *SGFs* for IBIs. The BNM and the SBP have issued and implemented specific regulations for *SG* in IFIs. The IFSB (IFSB) and Accounting, Auditing Organization for IFI (AAOIFI) have also issued standards on *SG* in IFIs. In this chapter these *SG* regulations issued by SBP, BNM, AAOIFI, and IFSB will be comparative analysed.

#### **3.1. *Shari'ah Governance***

The *SG* is defined as a set of principles according to *Shari'ah*. The primary responsibility of the *SSB* is to ensure *Shari'ah* compliance in IFIs by providing guidelines, direction, reviewing the activities of the IFI. The *Shari'ah* supervisory members are appointed in the annual general meeting upon the recommendation of the BOD. The compliance with *Shari'ah* principles would enhance the level of confidence of the general public and the financial markets on the credibility of operations of the Islamic bank.<sup>151</sup>

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<sup>151</sup> Bank Negara Malaysia, 'Shariah Governance Framework for Islamic Financial Institutions', Islamic Banking and Takaful Department § (2009), <https://doi.org/10.1007/s13398-014-0173-7.2>.

### 3.2. *Shari'ah* Governance Framework by State Bank of Pakistan

Compliance with the principles of *Shari'ah*, according to the *Qur'an* and the Sunnah, is the essence of the Islamic banking industry. A sound and effective *Shari'ah* compliance framework is thus critically important to give confidence to the general public about *Shari'ah* conformity of IBIs products and services. To ensure the operation of the IFIs compliance with the rules and principles of *Shari'ah*, the SBP (SBP) issues regulations from time to time since the re-launch of Islamic Banking in Pakistan.<sup>152</sup>

In 2008 SBP issued *Shari'ah* Compliance guidelines for IBIs.<sup>153</sup> However, keeping in view the recent developments in the Islamic banking industry, a comprehensive *SGF* has been issued in 2014. The framework applies to all IBIs. The main objective of this *SGF* is to strengthen *Shari'ah* compliance in the IBIs and to define the role and responsibility of the BoDs, EM, SSB, *Shari'ah* Compliance Department (SCD) and internal and external auditors towards *Shari'ah* compliance.

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<sup>152</sup> IBD SBP, 'Islamic Banking Bulletin', Islamic Banking Department State Bank of Pakistan, 2019, <http://www.sbp.org.pk/ibd/bulletin/2019/Mar.pdf>; Muhammad Asghar Shahzad and Raees Khan, 'External *Shari'ah* Auditors in Islamic Banking and Finance Industry:', *The Pakistan Accountant, The Institute of Chartered Accountants of Pakistan*, 2019, <https://doi.org/https://ssrn.com/abstract=3478878>; Shahzad and Rehman, 'Shari'Ah Advisory in Islamic Bank's: An Analytical Study'.

<sup>153</sup> State Bank of Pakistan, 'Instructions for Shariah Compliance in Islamic Banking', Islamic Banking Department State Bank of Pakistan, Annexure 1 of IBD Circular No. 2 of 2008, 2008, <http://www.sbp.org.pk/ibd/2008/Annex-c2-1.pdf>.

### **3.3. AAOIFI *Shari'ah Governance* Standard**

The Accounting and Auditing Organization for IFIs is a Bahrain based standard setting organization which issues standards for IFI(s). The AAOIFI has so far issued following seven standards<sup>154</sup> on SG;

1. *SSB: Appointment, Composition, and Report*
2. *Shari'ah Review*
3. *Internal Shari'ah Review*
4. *Audit and Governance Committee for IFIs*
5. *Independence of SSBs*
6. *Statement on Governance Principles for IFIs*
7. *Corporate Social Responsibility Conduct and Disclosure for IFIs.*

### **3.4. IFSB *Shari'ah Governance* Guidelines**

The IFSB is an international standards-setting body that issues standards and guiding principles for IFIs. The objective is to strengthen governance structures and processes in the Islamic financial services industry. The IFSB Council, during its ninth meeting in Jeddah, approved the preparation of a set of comprehensive Guiding Principles

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<sup>154</sup> AAOIFI, 'Central Shari'ah Board', in *Accounting, Auditing and Governance Standards for Islamic Financial Institutions* (Manama, Bahrain,; Accounting and Auditing Organisation for Islamic Financial Institutions, P.O. Box 1176, Manama, Bahrain, 2013), 1–17.

on the *SG* system, which provides guidelines regarding *Shari'ah* audit/review process for compliance with *Shari'ah* rulings; and harmonization of the *SG* structures and procedures.

According to IFSB, the *SG* system is defined as “a set of institutional and organizational arrangement through which an IFI ensures that there is effective independent oversight of *Shari'ah* compliance over each of the following structures and process:<sup>155</sup>

- a) Issuance of relevant *Shari'ah* pronouncement or resolution. This refers to a juristic opinion on any matter about *Shari'ah* issues in Islamic finance given by the appropriately mandated *Shari'ah* board.<sup>156</sup>
- b) Dissemination of information on such *Shari'ah* pronouncement or resolutions to the operative personnel of the IFIs. Who monitors the day-to-day compliance with the *Shari'ah* resolutions vis-à-vis every level of operations and each transaction. However, this task would typically be done by the internal *Shari'ah* compliance department.<sup>157</sup>
- c) An internal *Shari'ah* compliance review or audit reports that if there is any incident of non-compliance, it should be recorded and addressed and rectified. Concerning this, IFSB-3 sets out that *Shari'ah* resolution issued by the *Shari'ah* boards should be strictly adhered to.<sup>158</sup>

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<sup>155</sup> Sana Maswadeh, ‘A Compliance of Islamic Banks with the Principles of Islamic Finance (Shariah): An Empirical Survey of the Jordanian Business Firms’, *International Journal of Accounting and Financial Reporting* 4, no. 1 (2014): 169, <https://doi.org/10.5296/ijafr.v4i1.5448>.

<sup>156</sup> Islamic Financial Services Board, *Guiding Principles on Shari'ah Governance Systems for Institutions Offering Islamic Financial Services*.

<sup>157</sup> Islamic Financial Services Board.

<sup>158</sup> Islamic Financial Services Board.

- d) An annual *Shari'ah* compliance review or audit to verify that internal *Shari'ah* compliance review or audit has been appropriately carried out and the *Shari'ah* boards have duly noted its findings.<sup>159</sup>

Furthermore, the IFSB explains the complements of the *SG* system in existing governance, compliance, and control functions in IFI(s). Regarding the *SG* aspect, IFI(s) should have *SSB* in addition to the BOD. The IFI should have both internal and external *Shari'ah* review units in addition to the conventional internal and external auditors for the control mechanism. In terms of compliance, IFI(s) should comply with *Shari'ah* in addition to compliance with the conventional regulatory and financial requirements.

### **3.5. Bank Negara Malaysia (BNM) *SGF***

The BNM claims to give great importance to the *Shari'ah* compliance in the overall Islamic financial system. This objective is being achieved through the two-tier *SG* structure comprising two components: First, the centralized *Shari'ah* advisory body at the Central Bank level, and the second is the internal *Shari'ah* Committee at every IFI level. The mandates of the *Shari'ah* Advisory Council is to ascertain the *Shari'ah* rules relating to the financial matter and to issue fatawas on it. The SAC also advises the Bank and the IFIs concerned on any *Shari'ah* issues relating to Islamic finance and business activities or transactions. The duties of the internal *Shari'ah* Committee at the industry level in advising respective IFIs are further deliberated in the Guidelines on the Governance of the *Shari'ah* Committee for the IFIs issued in 2004. The BNM has developed the *SGF* for IFIs, the main objective of which is to enhance the role of the *Shari'ah* board, the *Shari'ah* Committee,

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<sup>159</sup> Islamic Financial Services Board.

and the management concerning *Shari'ah* matters. The main objective of the *SGF* for the IFI(s) is to:

- a. Set out the expectations of the Bank on an IFI's *SG* structures, processes and arrangements to ensure that all its operations and business activities are in accordance with *Shari'ah*;
- b. Provide comprehensive guidance to the board, *Shari'ah* Committee and management of the IFI in discharging its duties in matters relating to *Shari'ah*; and
- c. Outline the functions relating to *Shari'ah* review, *Shari'ah* audit, *Shari'ah* risk management, and *Shari'ah* research.

The Framework applies to all IFI(s) regulated and supervised by the Bank. Any reference to 'IFI' for the Framework means:

- I. An Islamic bank licensed under the Islamic Banking Act 1983 (IBA);
- II. A takaful and re-takaful operator registered under the Takaful Act 1984;
- III. A financial institution licensed under the Banking and Financial Institutions Act 1989 (BAFIA) that participates in the Islamic Banking Scheme; and
- IV. A development financial institution prescribed under the Development Financial Institutions Act 2002 (DFIA) that participates in the Islamic Banking Scheme.

### 3.6. Comparative Analysis among SBP, BNM, AAOIFI and IFSB's SG Guidelines

Comparative Points	SBP	BNM	AAOIFI	IFSB
Appointing of SSB	“Every IBI (s) shall have a <i>Shari'ah</i> Board, comprising at least three <i>Shari'ah</i> Scholars appointed by the BoDs as per the Fit and Proper Criteria”. <sup>160</sup>	“A <i>Shari'ah</i> Committee with qualified members who can deliberate Islamic finance issues brought before them and provided sound <i>Shari'ah</i> decisions.” <sup>161</sup> He must have at least a bachelor's degree in	“Every IFI shall have a SSB to be appointed by the shareholders in their annual general meeting upon the recommendation of the BoDs taking into consideration the local legislation and regulations.” <sup>163</sup>	“The Institute offering Islamic Financial Services should establish or engage a reputable and credible <i>Shari'ah</i> board.” <sup>164</sup>

<sup>160</sup> SBP, ‘Shariah Governance Framework for Islamic Banking Institutions’,, 3(1)

<sup>161</sup> BNM, ‘Shariah Governance Framework for Islamic Financial Institutions’, *Federation of Malaysia EDICT OF GOVERNMENT 2 (2010): 1–48*, <https://doi.org/10.1007/s13398-014-0173-7.2>.

<sup>163</sup> AAOIFI. (2008). Governance Standards for IFIs. In *Accounting and Auditing Organization for IFIs*. Bahrain.: Accounting and Auditing Organization for IFIs. P.O.Box 1176, Manama, Bahrain.p4

<sup>164</sup> IFSB. (2009). GUIDING PRINCIPLES ON SHARI'AH GOVERNANCE SYSTEMS FOR INSTITUTIONS OFFERING ISLAMIC FINANCIAL SERVICES. ISLAMIC FINANCIAL SERVICES BOARD.p8

		<p><i>Shari'ah</i>, which includes study in Usul-Fiqh or Fiqh <i>Mua'malat</i> (from a recognized university.”<sup>162</sup></p>		
<b>Qualification and Experience of SSB Members</b>	<p>“<i>Shahadatul Almiya Fil Uloomal Arabia wal Islamia</i> with 70% and bachelor's degree with 2<sup>nd</sup> division or Postgraduate degree in <i>Shari'ah</i> or Uṣūluddin with minimum CGPA 3.00. The SB Chairperson shall have at least 05</p>	<p>“A <i>Shari'ah</i> Committee with qualified members who can deliberate Islamic finance issues brought before them and provided sound <i>Shari'ah</i> decisions. He must have at least a bachelor's degree in <i>Shari'ah</i>, which includes study in</p>	<p>“The SSB is an independent body of specialized jurists in <i>fiqh al-mua'malat</i>, however, the SSB may include a member other than those specialized in <i>fiqh al-mua'malat</i>, but who should be an expert in the field of IFIs with</p>	<p>“He or she must at least hold a bachelor's degree from a recognized university in the sciences of <i>Shari'ah</i>, including Islamic transaction/commencial law (Fiqh al-<i>Mua'malat</i>). The member of the <i>Shari'ah</i> board who has at least three years' experience of</p>

<sup>162</sup> Bank Negara Malaysia, Shariah Governance Framework for Islamic Financial Institutions.

	years' experience of working as <i>Shari'ah</i> Advisor or a member of <i>Shari'ah</i> Board of an IBI. The other <i>Shari'ah</i> Scholar members of the SB shall have at least 03 years' experience as <i>Shari'ah</i> Advisor/Member of SSB.” <sup>165</sup>	Usul-Fiqh (the origin of Islamic law) or <i>fiqh al-mua'malāt</i> (Islamic transaction/commercial law) from a recognized university.” <sup>166</sup>	knowledge of <i>fiqh al-mua'malāt</i> . ” <sup>167</sup>	making <i>Shari'ah</i> resolutions, or at least four years' post-qualification experience in teaching or research in Islamic finance, should be appointed as Chairman of the <i>Shari'ah</i> board” <sup>168</sup>
<b>Independence of <i>Shari'ah</i> Board</b>	“The appointment letter of each SB member shall clearly state the role and responsibilities of	“In order to make sound decisions on <i>Shari'ah</i> matters in an independent and objective manner,	“A SSB is an independent body of specialized jurists in <i>fiqh al-mua'malāt</i> , the board should not	“A <i>Shari'ah</i> board can only be deemed “independent” when none of its members has a

<sup>165</sup> SBP, ‘Shariah Governance Framework for Islamic Banking Institutions’, Annexure – A, 1, 2 (i)

<sup>166</sup> See BNM Guidelines for *Shari'ah* Governance, p6,

<sup>167</sup> See AAOIFI. (2008). Governance Standards for IFIs p4

<sup>168</sup> See IFSB, Guiding principles on *Shari'ah* Governance, p30

	<p>the SB and shall be duly accepted by him/her. In this regard, the <i>Shari'ah</i> board members will never involve or responsible for operational activities.”<sup>169</sup></p>	<p>the <i>Shari'ah</i> Committee will report directly to the <i>Shari'ah</i> Board.”<sup>170</sup></p>	<p>include the directors or shareholders of the IFIs. The SSB members should not be an employee of the same IFI. The SSB members should not involve in managerial or operational decisions of IFI.”<sup>171</sup></p>	<p>blood or intimate relationship with the IIFS, its related companies or its officers that could interfere, or be reasonably perceived to interfere, with the exercise of independent judgment in the best interests of the IIFS by the <i>Shari'ah</i> board.”<sup>172</sup></p>
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<sup>169</sup> See SBP. D (i)

<sup>170</sup> See BNM Guidelines for *Shari'ah* Governance, section III, p15

<sup>171</sup> See AAOIFI. (2008). Independence of *Shari'ah* Supervisory Board p44, para 7-8

<sup>172</sup> Islamic Financial Services Board, *Guiding Principles on Shari'ah Governance Systems for Institutions Offering Islamic Financial Services*; Muhammad Asghar Shahzad and Dr. Atiquzafar Khan, ‘*Shari'ah* Governance Framework in Islamic Financial Institutions: A Comparative Study of Pakistan and Malaysia’, in *MUST 1st International Conference on Business and Management Research (ICBMR-2015)* (Mirpur: Mirpur University of Science & Technology, Mirpur AJ&K, 2015), 2015; Shahzad and Rehman, ‘*Shari'ah* Advisory in Islamic Bank's: An Analytical Study’.

	reappointment.” <sup>181</sup>			
<b>Appointment of Shari'ah Advisor</b>	“The SB of an IBI shall in consultation with the management designate one of the SB members other than the Chairperson as RSBM to provide guidance/advice in day to day Shari'ah related operational matters.” <sup>182</sup>	“A Shari'ah Committee with qualified members who can deliberate Islamic finance issues brought before them and provided sound Shari'ah decisions. In this regard, every IFI is required to establish a Shari'ah Committee of which the majority shall	Not Applicable	“To support the Shari'ah board by appointing an Internal Shari'ah Compliance Unit or an individual Shari'ah Officer, whereby the Shari'ah board shall be able to mandate and delegate some of its functions to the ISCU.” <sup>184</sup>

<sup>181</sup> SBP, ‘Shari’ah Governance Framework for Islamic Banking Institutions’.

<sup>182</sup> SBP.

<sup>184</sup> Islamic Financial Services Board, *Guiding Principles on Shari'ah Governance Systems for Institutions Offering Islamic Financial Services.*

		comprise persons with appropriate qualifications and experience in <i>Shari'ah</i> .” <sup>183</sup>		
<b>Responsibilities of <i>Shari'ah</i> Advisor</b>	“Responsibilities of the RSBM/SA are to provide guidance on a day-to-day or routine <i>Shari'ah</i> related issues, post product approval, <i>Shari'ah</i> Training, Response to <i>Shari'ah</i> related queries, conduct <i>Shari'ah</i> review	“In order to ensure that the execution of business operations are in accordance with the <i>Shari'ah</i> , the committee will provide a guideline, conduct internal <i>Shari'ah</i> Review and <i>Shari'ah</i> audit regularly.” <sup>186</sup>	Not Applicable	“The <i>Shari'ah</i> board shall be empowered to reserve rights to delegate some of its functions to the ISCU or internal <i>Shari'ah</i> officers of the IIFS, i.e., product development and <i>Shari'ah</i> review.” <sup>187</sup>

<sup>183</sup> Bank Negara Malaysia, Shariah Governance Framework for Islamic Financial Institutions.

<sup>186</sup> Bank Negara Malaysia, Shariah Governance Framework for Islamic Financial Institutions.

<sup>187</sup> Islamic Financial Services Board, *Guiding Principles on Shari'ah Governance Systems for Institutions Offering Islamic Financial Services*.

	and submit a quarterly report to <i>Shari'ah</i> Board.” <sup>185</sup>			
<i>Shari'ah</i> Compliance Department	“Every IBI shall have a SCD supervised by full-time <i>Shari'ah</i> Advisor of IBI. The SCD will act as a Conduit between the SB and the management of the IBI. It shall also review agreements, contracts, manuals related to IBs products.” <sup>188</sup>	Not Applicable	Not Applicable	“The Internal <i>Shari'ah</i> Compliance Unit/ Department or <i>Shari'ah</i> Officer may be established/ appointed to ensure the <i>Shari'ah</i> compliance in IIFS.” <sup>189</sup>

<sup>185</sup> SBP, ‘*Shari'ah Governance Framework for Islamic Banking Institutions*’.

<sup>188</sup> SBP, ‘*Shari'ah Governance Framework for Islamic Banking Institutions*’.

<sup>189</sup> Islamic Financial Services Board, *Guiding Principles on Shari'ah Governance Systems for Institutions Offering Islamic Financial Services*.

<b><i>Shari'ah</i> Compliance Review</b>	<p>“The <i>Shari'ah</i> Compliance Department will conduct <i>Shari'ah</i> compliance review to ensure that all the organs of SG are operating effectively.”<sup>190</sup></p>	<p>“The SAC will conduct an internal <i>Shari'ah</i> review regularly, which is a review of processes as well as determining that such processes and outcomes satisfy the needs of <i>Shari'ah</i>.”<sup>191</sup></p>	<p>“The SSB will conduct <i>Shari'ah</i> review to ensure that the activities carried out by an IFI do not contravene the <i>Shari'ah</i> rules. The <i>Shari'ah</i> review will be carried out through, planning review procedures, executing review procedures and preparation and review of working papers, documenting</p>	<p>“While the ISCU is part of the IIFS's compliance team, the internal <i>Shari'ah</i> review/audit unit/ (ISRU) may be established to function in a similar manner to the IIFS's internal audit team. The major difference is that while the internal auditor will usually report to the Audit Committee, the ISRU shall report</p>

<sup>190</sup> SBP, ‘Shari'ah Governance Framework for Islamic Banking Institutions’.

<sup>191</sup> Bank Negara Malaysia, Shariah Governance Framework for Islamic Financial Institutions.

			conclusions and reports.” <sup>192</sup>	to the <i>Shari’ah</i> board” <sup>193</sup>
<b>Internal <i>Shari’ah</i> Audit Unit</b>	“Every IBI shall have an Internal <i>Shari’ah</i> Audit Unit (ISAU), which may be a part of the internal audit department or an independent unit depending on the size of the bank.” <sup>194</sup>	Not Applicable	“Internal <i>Shari’ah</i> review shall be carried out by an independent division/department or part of the internal audit department.” <sup>195</sup>	“The internal <i>Shari’ah</i> review/audit unit/department (ISRU) may be established to function in a similar manner to the IIFS’s internal audit team.” <sup>196</sup>
<b>Internal <i>Shari’ah</i> Audit</b>	“The Internal <i>Shari’ah</i> Audit Unit will conduct Internal <i>Shari’ah</i> Audit to ensure	“The SAC will also conduct a regular <i>Shari’ah</i> audit, at least on an annual basis,	“A comprehensive <i>Shari’ah</i> review will be conducted to examine and	“The ISRU ensures the <i>Shari’ah</i> compliance in IIFS and report to

<sup>192</sup> AAOIFI, *Accounting, Audit. Gov. Stand.*, *Shari’ah Review* p14-15

<sup>193</sup> Islamic Financial Services Board, *Guiding Principles on Shari’ah Governance Systems for Institutions Offering Islamic Financial Services.*

<sup>194</sup> SBP, ‘*Shari’ah Governance Framework for Islamic Banking Institutions*’.

<sup>195</sup> AAOIFI, *Accounting, Audit. Gov. Stand.*, *Internal Shari’ah Review* p20-28

<sup>196</sup> Islamic Financial Services Board, *Guiding Principles on Shari’ah Governance Systems for Institutions Offering Islamic Financial Services.*

	<p>the <i>Shari'ah</i> Compliance in IBI, and report shall be reviewed and approved by the SB.”<sup>197</sup></p>	<p>verifying that the IFI's functions and business operations comply with <i>Shari'ah</i>. ”<sup>198</sup></p>	<p>evaluate the extent of compliance with Islamic <i>Shari'ah</i> rules, principles, fatawas, and instructions issued by IFI's SSB.”<sup>199</sup></p>	<p>the <i>Shari'ah</i> Board.”<sup>200</sup></p>
<p><b>External <i>Shari'ah</i> Audit</b></p>	<p>“In order to have an independent assessment of SG and compliance environment of an IBI, the scope of external audit of IBIs shall also include an independent and objective</p>	<p>“The Bank may appoint or employ an external party or person to conduct a <i>Shari'ah</i> audit on the operations of the IFI if the Bank considers it is desirable or in the interest of the IFI</p>	<p>“The auditor is responsible for forming and expressing an opinion that the IFI is working according to <i>Shari'ah</i> rules and principles through audit evidence. The auditor shall</p>	<p>Not Applicable</p>

<sup>197</sup> SBP, ‘*Shari'ah Governance Framework for Islamic Banking Institutions*’.

<sup>198</sup> BNM, *Shari'ah Governance Framework*.

<sup>199</sup> AAOIFI, *Accounting, Audit. Gov. Stand.*, Internal *Shari'ah* Review p20-28

<sup>200</sup> Islamic Financial Services Board, *Guiding Principles on Shari'ah Governance Systems for Institutions Offering Islamic Financial Services*. p3

	<p>assessment of conformity of IBI's operations with <i>Shari'ah</i> rules and principles. The report of the external <i>Shari'ah</i> Audit shall be published in the annual report of the Islamic Bank.”<sup>201</sup></p>	<p>to do so, in which case the remuneration and expenses relating to the appointment shall be borne by the IFI.”<sup>202</sup></p>	<p>be knowledgeable about Islamic <i>Shari'ah</i> rules and principles. However, he would not possess the same level of knowledge as that of SSB member.”<sup>203</sup></p>	
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Table 2: Comparative Analysis among SBP, BNM, AAOIFI and IFSB's SG Guidelines

<sup>201</sup> SBP, 'Shari'ah Governance Framework for Islamic Banking Institutions'.

<sup>202</sup> Bank Negara Malaysia, Shariah Governance Framework for Islamic Financial Institutions., p25

<sup>203</sup> AAOIFI, 'Testing for Compliance with Shari'a Rules and Principles by an External Auditor', in *Accounting, Auditing and Governance Standards*, 2015th ed. (Manama, Bahrain: Accounting and Auditing Organisation for Islamic Financial Institutions, P.O. Box 1176, Manama, Bahrain, 2015), 859–67., p42

### **3.7. Analysis and Discussion**

It is not overstated if we had to say that there is no Islamic banking without strong *SG* practice, and there is no proper *SG* practice in without a competent and independent *SSB*.<sup>204</sup>

*SG* is a unique characteristic of the Islamic Banking industry.<sup>205</sup> The primary difference between Islamic and conventional Banking is Compliance with *Shari'ah* rules and principles. In the earlier section, different regulations and standards on *SG* issued by SBP, BNM, Accounting and Auditing Organization for IFIs, and IFSB have been comparatively analyzed. In this section, the compared points will be investigated.

#### **3.7.1. Appointment of *SSB***

The members of the *Shari'ah* board are individuals who have immense knowledge of both Islamic Jurisprudence and finance. Furthermore, in playing their role, *Shari'ah* Board members need to have a strong commitment to developing IFIs within the *Shari'ah* framework.<sup>206</sup> The Accounting and Auditing Organization for IFIs (AAOIFI) defines;

*"The SSB (SSB) should be an independent body of legal scholars specialized in Fiqh al-Mua'malat (Islamic commercial jurisprudence). SSB shall consist of at least*

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<sup>204</sup> Toufik, 'The Role of Shari'ah Supervisory Board in Ensuring Good Corporate Governance Practice in Islamic Banks.'

<sup>205</sup> Hasan Zulkifli, Bin, 'Shari'ah Governance in Islamic Financial Institutions in Malaysia, GCC Countries and the UK' (Durham University, UK, 2011); Shafii, Supiah, and Syahidawati, 'Management of Shariah Non-Compliance Audit Risk in the Islamic Financial Institutions via the Development of Shariah Compliance Audit Framework and Shariah Audit Programme'.

<sup>206</sup> Wardhani and Arshad, 'The Role of Shariah Board in Islamic Banks: A Case Study of Malaysia, Indonesia and Brunei Darussalam'.

*three members appointed by the shareholders in their annual general meeting upon the recommendation of the BoDs. However, the SSBs may include a member other than those specialized in *fiqh al-mua'malāt* but who should be an expert in the field of IFI (IFI) ”<sup>207</sup>*

Similarly, the International Islamic Fiqh Academy has also passed a resolution No. 177 (3/19) [Annexure VII] on Role of *Shari'ah* supervision in controlling Islamic banking business; Significance, conditions, etc.<sup>208</sup> It defines the *SSB* as under;

*“It is a group of three scholars or more, who are specialized in Islamic Jurisprudence (Jurisprudence of Islamic Financial transactions in particular), and are scholarly competent and well aware of practicing realities. This group assumes the tasks of issuing a fatwa, reviewing actual performance of the institution and ensure its compliance in all its dealings with the rules and principles of *Shari'ah*, and submitting a report to the general assembly. The decisions of the SSB are binding to the institution.”<sup>209</sup>*

They have unique responsibilities within IFIs, which include: to monitor the compliance of *Shari'ah* rules in all transactions, product development, and issuance of

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<sup>207</sup> AAOIFI, *Accounting, Audit. Gov. Stand.*

<sup>208</sup> The Resolution was passed in the 19<sup>th</sup> Session held in Sharjah (UAE) during the period 1-5 Jumada I, 1430 H (April 26-30, 2009)

<sup>209</sup> IIFA, ‘Role of *Shari'ah* Supervision in Controlling Islamic Banking Business; Significance, Conditions’ (2009).

Fatawas.<sup>210</sup> According to AAOIFI, the appointment of the *Shari'ah* board shall be made by the shareholders in the general meeting. This shows the distinctiveness of IFIs, where the shareholders play a role in appointing the *Shari'ah* board members.<sup>211</sup> However, the *SGF* under 'para 1(iii)' issued by the SBP stated that the BoDs would appoint *Shari'ah* board.<sup>212</sup>

### **3.7.2. Qualification and Experience of SSB Members**

The most critical organ of the *SG* structure of the banks is the *Shari'ah* Board.<sup>213</sup> The *Shari'ah* Advisory Board (SAB) member serves IBIs as mufti. His duties include issuing fatawa<sup>214</sup> relating to Islamic banking products.<sup>215</sup> According to AAOIFI *Shari'ah* Standard No. 29 "Stipulations and Ethics of Fatwa Stipulations and Ethics of Fatwa in the Institutional Framework in the Institutional Framework" states the conditions of a Mufti as under;

*"A board member shall be well versed in Fiqh (Islamic Jurisprudence), well informed of the contributions of diligent*

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<sup>210</sup> AAOIFI, *Accounting, Audit. Gov. Stand.*

<sup>211</sup> Zulkifli, Bin, 'Shari'ah Governance in Islamic Financial Institutions in Malaysia, GCC Countries and the UK'.

<sup>212</sup> SBP, 'Shariah Governance Framework for Islamic Banking Institutions',.

<sup>213</sup> Ayaz and Mansoori, 'Strengthening Corporate Governance Regime for Islamic Banks in Pakistan : Focusing on the Principles of Am Ana'.

<sup>214</sup> The term fatwa refers to a *Shari'ah* opinion presented to a person who seeks it with regard to an incidence that has already occurred (the Fatwa incidence) or is expected to occur. It does not refer to answering queries pertaining to hypothetical incidences. [AAOIFI *Shari'ah* Standard No. 29 "Stipulations and Ethics of Fatwa Stipulations and Ethics of Fatwa in the Institutional Framework in the Institutional Framework", Section 2/1]

<sup>215</sup> Lahasna, 'Fatwa and Its Shari'ah Methodology in Islamic Finance'; Shahzad and Rehman, 'Shari'Ah Advisory in Islamic Bank's: An Analytical Study'; SBP, 'Shariah Governance Framework for Islamic Banking Institutions';, Amanullah, 'Criteria of Sharī ' Ah Supervisory Committee : A Comparative Study between Guidelines of Bangladesh Bank and Bank Negara Malaysia'.

*Fiqh scholars, and well informed of the contributions of diligent Fiqh scholars, and has the ability to use the Shari'ah-accepted methods of deriving has the ability to use the Shari'ah-accepted methods of deriving reasonable rulings on emerging issues. He shall also be known for his reasonable rulings on emerging issues. He shall also be known for his discernment, cautiousness, and knowledge about the circumstances discernment, cautiousness, and knowledge about the circumstances and traditions of people and should always remain alert against the traditions of people and should always remain alert against the different means of human misbehavior. Competence in Fiqh is usually different means of human misbehavior. Competence in Fiqh is usually manifested by the vast reputation of the scholar or his distinguishable manifested by the vast reputation of the scholar or his distinguishable contributions, especially in the area of financial transactions performed contributions especially in the area of financial transactions performed by institutions.”<sup>216</sup>*

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<sup>216</sup> AAOIFI, *Sharia'ah Standards, for Islamic Financial Institutions*. Standard No. 29 “Stipulations and Ethics of Fatwa Stipulations and Ethics of Fatwa in the Institutional Framework in the Institutional Framework” Section 5.

The Section 3-A (i) of the SBP *SGF* obliges every IBI's to appoint a *Shari'ah* Board, as per fit and proper criteria (FAPC) as prescribed in the 'Annexure-A' of the *SGF*.<sup>217</sup> The FAPC of the SGF suggests minimum qualification as under;

1. *Shahadatul Almiya Fil Uloomal Arabia wal Islamia (Dars e Nizami)* "from any recognized Board of Madaris with minimum 70% marks and Bachelor's Degree with a minimum of 2<sup>nd</sup> Class."<sup>218</sup> Or
2. "Post Graduate Degree L.L.M from Faculty of *Shari'ah* (*Kuliyya tu Shari'ah*) or *Kuliyyah Uṣūluddin*, with a minimum GPA of 3.0 or equivalent from any recognized University"<sup>219</sup>.

Besides the minim qualification for the *Shari'ah* board member, it also requires experience in the field of *Ifta*, research or Islamic banking;

1. "The *Shari'ah* scholar members must have at least four years' experience of giving Fatawas (*Shari'ah* rulings) including the period of *Takhaṣuṣ fil Iftā*,<sup>220</sup> or at least five (5) years post qualification experience in teaching or Research and Development in Islamic Banking and Finance. Preference will be given to those who have a certificate in *Takhasus fil Fiqh/Takhaṣuṣ fil Iftā*".<sup>221</sup>

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<sup>217</sup> SBP, 'Shariah Governance Framework for Islamic Banking Institutions',.

<sup>218</sup> SBP, 'Shari'ah Governance Framework for Islamic Banking Institutions'.

<sup>219</sup> SBP.

<sup>220</sup> *Takhasus Fil Ifta* is a post graduate study that consists of minimum two years. It is an intensive course in the field of fiqh which requires a lot of mutala'ah (reading) and tahqeeq (research). Students are rigorously trained in the field of issuing fatwa. After completing this degree the candidate becomes a Mufti in Islamic Law who can issue fatawas (Shari'ah Pronouncements).

<sup>221</sup> SBP, 'Shari'ah Governance Framework for Islamic Banking Institutions'.

2. “Majority of *Shari’ah* scholar members of *Shari’ah* Board of an IBI, including RSBM, shall have at least three (3) years’ experience as *Shari’ah* Advisor or Member of *Shari’ah* Board (SB) of an Islamic Financial Institution (IFI) or deputy to a *Shari’ah* Advisor or member of the *Shari’ah* team of an IFI.”<sup>222</sup>

The AAOIFI, IFSB, and BNM do not have such strict criteria. According to these standards, the *SAB* member must have a bachelor’s degree in *Shari’ah*. The qualification criteria of *SSB* member are different in SGF issued by SBP from the BNM, IFSB, and AAOIFI’s SGF. The standards are different due to their own regional requirements. The other frameworks have set graduation in *Shari’ah*, and specifically, in fiqh ul, *Mu’āmalāt* there, on the other hand, the State bank has set “*Shahadatul Almiya Fil Uloomal Arabia wal Islamia*.”<sup>223</sup>

*Shari’ah* Board Members concerning their core responsibilities to provide *Shari’ah* guidance on the financial matters of IFI and also issue *Shari’ah* pronouncements they act as Mufti, which is an honorable and vital position in Islamic Law. After the Prophet (ﷺ), the issuance of *Shari’ah* rulings in the light of the *Qur’ān* and Sunnah of the Prophet (ﷺ) became the responsibility of his companions (*May Allah be pleased with them all*). After the companions of the Prophet (ﷺ), the responsibility of ifta was transferred to the students of companions and so on. Sincere religious scholars continue this pious work until our

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<sup>222</sup> SBP.

<sup>223</sup> Ayub et al., ‘Enhancing the Competence and Effectiveness of *Shari’ah* Advisory Boards : Case of Islamic Banking Institutions in Pakistan’; ‘Islamic Finance Education and Curricula of Deeni Madaris (Religious Seminaries): An Exploratory Study by Muhammad Asghar Shahzad, Habib Rehman, Syed Kashif Saeed, Asim Ehsan :: SSRN’, accessed 30 December 2019, [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3416852](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3416852).

time. According to the above-detailed explanation, ifta is very important and responsible job, who has no such attributes and qualities, should avoid and be aware of giving rulings about which he does not know, Allah says:

وَلَا تَقْرُبْ مَا لَيْسَ لَكَ بِهِ عِلْمٌ.<sup>224</sup>

*"And follow not (O man, i.e., say not, do not or witness not, etc.)  
that of which you do not know."*

Many verses in the Holy *Qur'ān* highlights the importance of fatwa. Some of these verses are mentioned below;

فَاسْأَلُوا أَهْلَ الْدِّيْنِ إِنْ كُنْتُمْ لَا تَعْلَمُونَ.<sup>225</sup>  
*"So ask of those who know [learned religious men], if you know not."*

يَسْأَلُونَكَ قُلِ اللَّهُ يُعْلِمُكُمْ فِي الْكَلَالَةِ<sup>226</sup>  
*"They ask you for a legal verdict. Say: "Allah directs (thus about Al-Kalalah (those who leave neither descendants nor ascendants as heirs)."*

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<sup>224</sup> Al-Isra' 17:36

<sup>225</sup> An-Nahl 16:43

<sup>226</sup> An-Nisa' 176

”وَلَا تَقُولُوا لِمَا تَصِيفُ أَسْتَثْكُمُ الْكَذِبَ هَذَا حَلَالٌ وَهَذَا حَرَامٌ لِتَفْتَرُوا عَلَى  
اللَّهِ الْكَذِبَ إِنَّ الَّذِينَ يَقْتُرُونَ عَلَى اللَّهِ الْكَذِبَ لَا يُفْلِحُونَ، مَنَّاعَ قَلِيلٌ وَلَهُمْ  
عَذَابٌ أَلِيمٌ.“<sup>227</sup>

*“Do not ascribe lies to Allah by decreeing with your tongues,  
"This is lawful, and that is unlawful" for those people who  
asccribe lies to Allah can never come to any good. (They should  
remember that) the pleasures of this world are transitory, and  
in the end, there is a painful torment for them.”*

A renowned scholar Ibn al-Salah says in the interpretation of this verse;

”شامل بمعناه من زاغ في فتواه، فقال في الحرام: هذا حلال، أو في  
الحلال: هذا حرام، أو نحو ذلك.“<sup>228</sup>

*The meaning of the verse applies to a jurist who deviates in his  
fatwa and declares lawful, which is unlawful or declares  
unlawful, which is lawful.*

Ifta (giving Fatwa) is an honorable position according to the saying of the Holy prophet ﷺ; the prophet ﷺ said;

<sup>227</sup>Al – Quran , 12:116

<sup>228</sup>Ibn al Ṣalāḥ, Uthmān ibn 'Abd al-Raḥmān al-Dīn al-Kurdī al-Shahrazūrī (1181 CE/577 AH – 1245/643), Adab al-Mufti wa al-Mustafti, Maktaba tul Uloom wal Hikam, Alam al Kutab, Beirut, 1<sup>st</sup> Edition (1987), p 85

”وَإِنَّ الْعَلَمَاءَ وَرَثَةُ الْأَئِمَّةِ وَإِنَّ الْأَئِمَّةَ لَمْ يُورِثُوا دِينَارًا وَلَا دِرْهَمًا  
وَرَثُوا الْعِلْمَ فَمَنْ أَحَدٌ بِحَظِّهِ وَافِرٌ.“<sup>229</sup>

*“The learned are the heirs of the Prophets who bequeath neither dinar nor dirham but only that of knowledge; and he who acquires it, has acquired an abundant portion.”*

In light of the above discussion, the *Shari'ah* board members are responsible for all of its decisions relating to Islamic banking transactions. The Board members must have a thorough knowledge and its impact on the economy. They must be qualified and certified in his field. According to the SBP's Fit and proper criteria a candidate having *Shahadatul Almiya Fil Uloomal Arabia wal Islamia* is not sufficient for the appointment as *Shari'ah* Supervisory board member. The syllabus of Dars e Nizami given in (Annexure-II) states that there is no direct relevant subject in the curriculum of *Shahadatul Almiya Fil Uloomal Arabia wal Islamia*<sup>230</sup>. Even though they know the *Qur'an* and Sunnah, but they are not aware of the complex banking transactions.

Secondly, if a person has LLM/MS in *Shari'ah*, he might be an expert in the field of *Shari'ah*; perhaps he is not fit for *Shari'ah* advisory in IBIs. The syllabus of the LLM/MS *Shari'ah* is given in Annexure IV, in which no subject is being taught, which is

<sup>229</sup> Abū-Dawūd As-Sigistānī, Sulāīmān Ibñ-al-As‘at, Sunān Abī-Dāud, Kitāb ul Ilm, Dar ul Risalah al alāmiyah, 1<sup>st</sup> edition 1430 A.H/2009, 5:485, Ḥadīth No. 3641

<sup>230</sup> Muhammad Asghar Shahzad et al., ‘Islamic Finance Education and Curricula of Deeni Madaris (Religious Seminaries): An Exploratory Study’, *Islamic Banking and Finance Review* 6 (28 February 2019): 59–79, <https://doi.org/https://doi.org/10.32350/ibfr.2019.06.04>; Muhammad Ayub, ‘Enhancing the Competence and Effectiveness of Sharī‘ah Advisory Boards: Case of Islamic Banking Institutions in Pakistan’, *Journal of Islamic Business and Management (JIBM)* 9, no. 1 (June 2019), <https://doi.org/10.26501/jibm/2019.0901-004>.

directly relevant to contemporary Islamic Banking. However, a person qualified from *Kuliyyah Uṣūluddin* might be an expert in the field of *Hadīth*, *Comparative Religions*, *Da'wah & Islamic Culture*, *'Aqīdah & Philosophy*, *Šīrah*, and *Islamic History*. However, he will not be consider as an expert in the field of Islamic commercial law.

It is pertinent to mention that in *Takhasus fil Fiqh/Takhaṣuṣ fil Iftā'* offered by renowned deeni Madaris does not focus on contemporary Islamic banking education, except International Islamic University in its LLM/MS Islamic Commercial law, *Jāmi'a tur Rāshīd* in its *Takhaṣuṣ fil Mu'āmalāt al Māliyyah*. These two are specialized degree programs for *Šarī'ah* scholars. However, *Jamia Darul Uloom Karachi*, which is offering selected *Šarī'ah* standard in the third year.<sup>231</sup> (Annexure-III – Syllabus of *Takhasus fil Fiqh/Takhaṣuṣ fil Iftā'*)

A person who does not have in-depth knowledge related to a transaction of how he can guide the others?

”عَنْ جُنْدِبِ ، قَالَ: قَالَ رَسُولُ اللَّهِ صَلَّى اللَّهُ عَلَيْهِ وَسَلَّمَ: مَنْ قَالَ: فِي

كِتَابِ اللَّهِ عَزَّ وَجَلَّ بِرَأْيِهِ فَأَصَابَ ، فَقَدْ أَخْطَأَ“<sup>232</sup>

*“It was narrated that Jundab said: "The Messenger of Allah said: 'Whoever speaks about the Book of Allah based on his own opinion, even if he is right, has Erred.'”*

<sup>231</sup> Ayub et al., 'Enhancing the Competence and Effectiveness of Shari'ah Advisory Boards : Case of Islamic Banking Institutions in Pakistan'.

<sup>232</sup> Abu Dawud Sulayman Ibn al-Ash'ath al-Azdi, (died in 275 AH) Sunan Abi Dawud, the book al Jihad, Darul Fikr, Damascus, vol. 3, p 320

The Messenger of Allah ﷺ said:

”مَنْ أَفْتَى بِفُتْيَا خَيْرٍ ثَبَّتِ فَإِنَّمَا إِنْثَمَ عَلَى مَنْ أَفْتَاهُ.“<sup>233</sup>

”Whoever is given a Fatwa that is not based on knowledge, his sin is borne by the one who gave the Fatwa.“

”عَنْ عَبْدِ الرَّحْمَنِ ابْنِ أَبِي لَيْلَى قَالَ أَدْرَكْتُ عَشْرِينَ وَمِنْهُ مِنَ الْأَنْصَارِ مِنْ أَصْنَابِ رَسُولِ اللَّهِ صَلَّى اللَّهُ عَلَيْهِ وَسَلَّمَ يُسْأَلُ أَحَدُهُمْ عَنِ الْمَسْأَلَةِ فَيُرْدَهَا هَذَا إِلَى هَذَا وَهَذَا إِلَى هَذَا حَتَّى تَرْجِعَ إِلَى الْأَوَّلِ.“<sup>234</sup>

”Abdurrahman ban Lila narrated that I had met 120 Ansari companions of the prophet when anyone asked about an issue he would be sent to another, and then he would be sent to another, and finally he would come back to the first one.“

”عَنْ ابْنِ مَسْعُودٍ وَابْنِ عَبَّاسٍ رَضِيَ اللَّهُ عَنْهُمْ مَنْ أَفْتَى فِي كُلِّ مَا يُسْأَلُ فَهُوَ مَجْنُونٌ.“<sup>235</sup>

”Ibn Masood and Ibn Abbas narrated that who issues fatwa in every question; he is mad.“

<sup>233</sup> Ibn Majah, Abu 'Abdullah Muhammad bin Yazid bin 'Abdullah Rab'i Al-Qazvini, Sunan Ibn Majah, Bab Ijtinab al-Ray Wa-al Qiyyas, Dar Ihya al-Kutab al Arabia, Hadith No. 53

<sup>234</sup> Al-Nawawiy, Abu-Zakariyya Yahya ibn Sharaf ibn Mirriy (died in AH 676). Adab al-Fatwa wa-al-Mufti, wa-al Mustafti, Darul Fikr, Damascus, 1st Edition (1408), p 14

<sup>235</sup> Al-Baghda diy, Ahmad ibn 'Ali ibn Thabit al-Khatib Abu-Bakr (died in AH 462). Al-Fiqh wa'l-Mutafaqqih. Beirut: Dar al-Kutub al-'Ilmiyyah, 2nd Edition, AH 1400/1980.

”وَعَنْ عَطَاءَ بْنِ السَّائِبِ التَّالِبِيِّ أَدْرَكْتُ أَقْوَامًا يَسْأَلُونَهُمْ عَنِ الشَّيْءِ  
فَيَتَكَلَّمُ وَهُوَ يَرْعَدُ.“<sup>236</sup>

*“Ata bin sayib narrated I have seen the people (jurists) whose hearts become full of fear and they were shivering when anyone asked about an issue.”*

”قَالَ مَالِكٌ قَالَ: أَخْبَرَنِي رَجُلٌ, أَنَّهُ دَخَلَ عَلَى رَبِيعَةَ, قَالَ: مَا يُتَكَبِّكُ  
وَارْتَاغُ لِبُكَائِهِ, قَالَ لَهُ: أَدْخَلْتُ عَلَيْكَ مُصِيبَةً؟ قَالَ: لَا, وَلَكِنْ «اسْتَفْتَيْ  
مِنْ لَا عِلْمَ لَهُ, وَظَهَرَ فِي الْإِسْلَامِ أَمْرٌ عَظِيمٌ» قَالَ: يَتَبَغِي لِإِمَامِ الْمُسْلِمِينَ  
أَنْ يَتَصَفَّحَ أَحْوَالَ الْمُفْتَنِينَ, فَمَنْ كَانَ يَصْنَعُ لِلْفَتُوْيِ أَقْرَهَ عَلَيْهَا, وَمَنْ لَمْ  
يَكُنْ مِنْ أَهْلِهَا مَنْعَةُ مِنْهَا.“<sup>237</sup>

*“Imam Malik said; a person narrated to me that he went to Rabia and asked why are you weeping? He was shivering due to weeping; he said to him weather any affliction came to you? He said; no, but an issue has been referred to a person who does not know, and it is an alarming thing which is emerged in Islam. I told that Muslim ruler might investigate in this regard, and he may appoint and forbid who is not capable of issuing a fatwa.”*

<sup>236</sup> Al-Nawawiy, Abu-Zakariyya Yahya ibn Sharaf ibn Mirriy (died in AH 676). *Adab al-Fatwa wa-al-Mufti, wa-al Mustafti*, Darul Fikr, Damascus, 1<sup>st</sup> Edition (1408), p 15

<sup>237</sup> Ahmed Ibn Hamdan, (D 695ah) *Sifat Al Fatwa* (Damascus, Mashroot al Maktab al Islami, 1380ah corresponding 1960), p11.

Keeping in view the above discussion, the *Shari'ah* board members are an essential part of the *SG* system. The members of the *Shari'ah* board must be competent enough to understand the modern complex Islamic banking transactions and to provide possible *Shari'ah* guidelines. The current qualification criteria for the appointment of *Shari'ah* board member according to SBP is not sufficient for this position. The SBP should revise the Fit and proper criteria. The selection of *Shari'ah* board members must be subject to the successful completion of a comprehensive training program<sup>238</sup> on Modern Banking and financial transactions.<sup>239</sup>

### **3.7.3. Independence of *Shari'ah* Board**

This position indicates that the *Shari'ah* board is independent of the BOD to enable them to provide advisory and supervisory functions without fear or favor.<sup>240</sup> The SBP has taken preliminary steps in this regard. To strengthen the *Shari'ah* compliance mechanism within IBIs the SBP initially issued “Guidelines for *Shari'ah* Compliance in IBIs” via circular IBD Circular No. 02 on 25 March 2008 according to this circular all IBs and windows were required to appoint a *Shari'ah* advisor by management;

“Appointment of *Shari'ah* Advisor, together with its terms and conditions shall be approved by the BoDs in case of domestic

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<sup>238</sup> Although the State Bank of Pakistan has implemented capacity building training programs for banking employees in 2018 which is a significant step. These training sessions are for the capacity building and of the short term. But at the time of appointment, the candidate should complete a comprehensive training program organized by the Institute of Bankers Pakistan.

<sup>239</sup> Ayub et al., ‘Enhancing the Competence and Effectiveness of *Shari'ah* Advisory Boards : Case of Islamic Banking Institutions in Pakistan’.

<sup>240</sup> Zulkifli, Bin, ‘*Shari'ah* Governance in Islamic Financial Institutions in Malaysia, GCC Countries and the UK’.

IBIs and in case of foreign banks having IBBs, *Shari'ah* advisor shall be appointed by the management.”<sup>241</sup>

The management may influence the *Shari'ah* Advisor for approval of some controversial products. Later the SBP issued the *SGF* in 2014, which ensured the independence to the *Shari'ah* board in issuing fatawa/pronouncements. According to this framework;

“Every IBI shall have an SB comprising at least three *Shari'ah* scholars appointed by the BOD<sup>242</sup> as per the Fit and Proper Criteria.”<sup>243</sup>

Besides this the *SGF* states regarding the independence of *SSB*;

*“The appointment letter of each SB member shall clearly state the role and responsibilities of the SB and shall be duly accepted by him/her. In this regard, the Shari'ah board members will never involve or responsible for operational activities.”*<sup>244</sup>

However, AAOIFI has described ‘independence’ in comparatively clear words that “A *SSB* is an independent body of specialized jurists in *fiqh al-mua'malāt*, the board should not include the directors or shareholders of the IFIs. The *SSB* members should not be an

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<sup>241</sup> State Bank of Pakistan, ‘Guidelines for Shariah Compliance in Islamic Banking Institutions’.

<sup>242</sup> Similarly, the Bank Negara Malaysia has also strengthened the independence with this rule mentioned in *Shari'ah* governance framework; “To make sound decisions on *Shari'ah* matters independently and objectively, the *Shari'ah* Committee will report directly to *Shari'ah* Board.”

<sup>243</sup> SBP, ‘Shariah Governance Framework for Islamic Banking Institutions’.

<sup>244</sup> SBP, ‘Shari'ah Governance Framework for Islamic Banking Institutions’.Section D (i)

employee of the same IFI. The SSB members should not involve in managerial or operational decisions of IFI.”<sup>245</sup>

“A *Shari'ah* board can only be deemed “independent” when none of its members has a blood or intimate relationship with the IIFS, its related companies or its officers that could interfere, or be reasonably perceived to interfere, with the exercise of independent Judgement in the best interests of the IIFS by the *Shari'ah* board”<sup>246</sup>

If the members of the *Shari'ah* board have any interest in the profit of the bank, their decisions could not be called impartial. In this regard, different scholars have suggested that the salaries of the *Shari'ah* board members must be issued from the central bank.<sup>247</sup> Shamsher and Sori state that; The *Shari'ah* Board committee to make objective decisions independently, which is without any fear (in the form of influence or coercion from the management) and favor of the IFI. The *Shari'ah* committees can only express opinions, or expert testimony but do not have the legal authority to force the management to follow-through with the opinion.<sup>248</sup>

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<sup>245</sup> AAOIFI, *Accounting, Audit. Gov. Stand.*

<sup>246</sup> Islamic Financial Services Board, *Guiding Principles on Shari'ah Governance Systems for Institutions Offering Islamic Financial Services.*

<sup>247</sup> Shahzad and Rehman, ‘*Shari'Ah Advisory in Islamic Bank's: An Analytical Study*'; Bashar Malkawi, ‘*A Bright Future: Towards an Enhanced Shariah Supervision in Islamic Finance*', no. JANUARY 2014 (2015): 1–12.

<sup>248</sup> Mohamad, Sori, and Shah, ‘*Shariah Governance: Effectiveness of Shariah Committees in Islamic Banks in Malaysia*'.

### **3.7.4. Responsibilities of SSB**

The most obvious purpose of *Shari'ah* supervision is to certify the Islamic banking customers regarding the Islamic financial products and services being offered to them are acceptable from the *Shari'ah* perspective. Such certifications are usually documented in a formal fatwa, may be thought of as a form of due diligence.<sup>249</sup> According to BNM the responsibilities of SSB/Committee is as follows;

“The *Shari'ah* Committee is expected to understand that in the course of discharging the duties and responsibilities as a *Shari'ah* Committee member, they are responsible and accountable for all *Shari'ah* decisions, opinions, and views provided by them.”<sup>250</sup>

### **3.7.5. Number of *Shari'ah* Board Members**

The members of the *Shari'ah* Board are appointed to supervise the IBI's activities. According to AAOIFI, SBP, BNM, and IFSB, the SSB should consist of at least three members. However, to ensure the right decisions, the SBP has extended the *Shari'ah* Board, that the board may also seek services of experts in the field of law, accounts, economics, and other professions to assist and advise the board. However, they will not have a voting right in the meeting<sup>251</sup>. Likewise, the AAOIFI states, “the SSB may seek the service of consultants who have expertise in business economics, law, accounting or others.”<sup>252</sup> The AAOIFI has not put any restrictions on the voting right of the members. Nevertheless, IFSB guidelines

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<sup>249</sup> Toufik, ‘The Role of Shari'ah Supervisory Board in Ensuring Good Corporate Governance Practice in Islamic Banks.’

<sup>250</sup> BNM, ‘Shariah Governance Framework for Islamic Financial Institutions’.

<sup>251</sup> SBP, ‘Shari'ah Governance Framework for Islamic Banking Institutions’.

<sup>252</sup> AAOIFI, *Accounting, Audit. Gov. Stand.*

identified that the board must be possibly trained in different schools of jurisprudence, have a mix of members with different lengths of experience, and where appropriate, comprise of different nationalities.<sup>253</sup> It is pertinent to mention that in Pakistan except for the SBP, no *Shari'ah* Board is having a diversity of different schools of thought. Usually, the *Shari'ah* board members from the same school of thought have teachers and students relation, and they do not disagree with the decisions of Sheikh.<sup>254</sup>

### **3.7.6. *Shari'ah* Compliance Department (SCD)**

The *Shari'ah* compliance department is the main department for an IBI, which is required to work under the supervision of the *Shari'ah* Board. However, administrative reporting of Head SCD shall be to the Chief Executive Officer of Islamic Bank and Chief Compliance Officer in the case of Islamic Banking Branches of Conventional Bank.<sup>255</sup> The IFSB added that the internal *Shari'ah* compliance unit/ department or *Shari'ah* Officer might be established/ appointed to ensure the *Shari'ah* compliance in IIFS.<sup>256</sup> According to the SGF of SBP, the *Shari'ah* compliance department will be responsible for the followings<sup>257</sup>:

1. Secretariat of *Shari'ah* Board
2. Conduit between Management and the *Shari'ah* Board
3. *Shari'ah* Compliance Review

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<sup>253</sup> Islamic Financial Services Board, *Guiding Principles on Shari'ah Governance Systems for Institutions Offering Islamic Financial Services*.

<sup>254</sup> Ayub, 'Focusing on Shari'ah Governance in Regulating the Islamic Banking Institutions'; Ayub, 'Strengths, Gaps and Issues in Shari'ah Governance Framework 2015 for IBIs in Pakistan'; Ayub et al., 'Enhancing the Competence and Effectiveness of Shari'ah Advisory Boards : Case of Islamic Banking Institutions in Pakistan'.

<sup>255</sup> SBP, 'Shari'ah Governance Framework for Islamic Banking Institutions'.

<sup>256</sup> Islamic Financial Services Board, *Guiding Principles on Shari'ah Governance Systems for Institutions Offering Islamic Financial Services*.

<sup>257</sup> SBP, 'Shari'ah Governance Framework for Islamic Banking Institutions'.

4. Enforcement of *Shari'ah* Audit Reports
5. Training on *Shari'ah* Compliance
6. Other Functions

Being an important pillar of the SG system, the members of this department performing the duties mentioned above must be qualified enough to perform the tasks mentioned above in a very appropriate manner. The SGF issued by SBP suggested the appointment of SCD members/employees as followings;

*“Every IBI shall have a SCD which may be headed by a RSBM or a suitably qualified, trained and experienced officer recommended by the SB. The SCD shall have dedicated and adequate staff as per the advice of the SB, so as to enable it to discharge its due responsibilities in a proper and timely manner. The SCD shall have at least one qualified Shari'ah expert (other than RSBM) who shall meet the criteria of “Academic Qualifications” as prescribed in Annexure-A of this Framework. Moreover, IBI's are encouraged to depute individuals with expertise and/or qualification in Shari'ah, Risk Management, Legal and Accounting to strengthen its Shari'ah compliance function.”*

The qualification for the member of SCD has be recommended the same as laid down for the SSB members. The qualifications criteria mentioned in the *Annexure-A* of SGF seems to be a medicine for every patient.

### **3.7.7. Internal *Shari'ah* Audit**

“Internal *Shari'ah* audit can be defined as a systematic process of obtaining and evaluating, the sufficient and reliable evidence by an internal *Shari'ah* auditor, as a basis to form an opinion, as to whether the operations and activities of the entity being audited is in compliance with established *Shari'ah* criteria and reporting the opinion thereon to the appropriate authority.”<sup>258</sup>

*SGF* issued by SBP states that “Every IBI shall have an Internal *Shari'ah* Audit Unit, which may be a part of internal audit department or an independent unit depending on the size of the bank.”<sup>259</sup> The AAOIFI and IFSB have a similar view regarding Internal *Shari'ah* review that, “it shall be carried out by an independent division/department or part of the internal audit department.”<sup>260</sup> The internal *Shari'ah* review/audit unit/ department (ISRU) may be established to function similarly to the IIFS’s internal audit team”.<sup>261</sup>

### **3.7.8. External *Shari'ah* Audit**

In this *SGF*, all IBIs were instructed to include external *Shari'ah* audit, but the *SGF* did not specify the qualification or experience of the external *Shari'ah* auditors.<sup>262</sup>

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<sup>258</sup> Wajdi Dusuki Asyraf, ‘Introduction to Shariah Audit Framework’, in *International Shariah Audit Conference*, 2011; Shahzad and Khan, ‘*Shari'ah* Governance Framework in Islamic Financial Institutions: A Comparative Study of Pakistan and Malaysia’; Shahzad, Saeed, and Ehsan, ‘*Shari'ah* Audit and Supervision in *Shari'ah* Governance Framework: Exploratory Study of Islamic Banks in Pakistan’.

<sup>259</sup> SBP, ‘*Shari'ah* Governance Framework for Islamic Banking Institutions’.

<sup>260</sup> AAOIFI, *Accounting, Audit. Gov. Stand.*, Internal *Shari'ah* Review p20-28

<sup>261</sup> Islamic Financial Services Board, *Guiding Principles on Shari'ah Governance Systems for Institutions Offering Islamic Financial Services*.

<sup>262</sup> Shahzad, Saeed, and Ehsan, ‘*Shari'ah* Audit and Supervision in *Shari'ah* Governance Framework: Exploratory Study of Islamic Banks in Pakistan’; Ayub et al., ‘Enhancing the Competence and Effectiveness of *Shari'ah* Advisory Boards : Case of Islamic Banking Institutions in Pakistan’; SBP, ‘*Shariah Governance Framework for Islamic Banking Institutions*’; Shahzad and Rehman, ‘*Shari'ah* Advisory in Islamic Bank’s: An Analytical Study’.

Later in 2018, the State Bank revised the *SGF*. Besides some other amendments in the *SGF*, an explanation was also given regarding external *Shari'ah Audit*.

To have an independent assessment of the *SG* and compliance environment of IBIs, the *SGF* 2018 bounded all IBIs to include an independent and objective evaluation of the conformity of IBI's operations with *Shari'ah* rules and principles. The audit firms will have to take appropriate measures to have the capacity concerning resources and methodology to conduct the *Shari'ah* audit of an IBI. It is entirely responsibility of the external audit firms to take appropriate measures for capacity building of their staff for conducting *Shari'ah* audit by providing them training in Islamic banking or by engaging *Shari'ah* scholar members in their audit team, but the *Shari'ah* scholar members must qualify according to fit and proper criteria (FAPC) prescribed by SBP for the appointment of *SSB* members.<sup>263</sup> The external *Shari'ah* auditor will follow the sequence provided below:

1. Essentials, Regulations, Instructions, and Guidelines issued by the SBP (SBP) including the *Shari'ah* Standards issued by Accounting and Auditing Organization for IFIs (AAOIFI), as adopted by SBP with suitable modifications, if any;<sup>264</sup>
2. The rulings of *Shari'ah* Board of SBP as notified by SBP;<sup>265</sup>
3. Requirements of the applicable Islamic Financial Accounting Standards as notified by the Securities and Exchange Commission of Pakistan (SECP) and as circulated by SBP;<sup>266</sup>

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<sup>263</sup> SBP, 'Shari'ah Governance Framework for Islamic Banking Institutions'.

<sup>264</sup> SBP.

<sup>265</sup> SBP.

<sup>266</sup> SBP.

4. Approvals and rulings are given by the SB of an IBI in line with the SBP directives, regulations, instructions, and guidelines issued by the decisions of the *Shari'ah* Advisory Committee of SBP.<sup>267</sup>

The main challenge to this industry is the lack of skillful and qualified human resources. Realizing the current curricula of reputed Accountancy Institutions who produce certified accountants and auditors lacks the topics related to Islamic banking products and services, moreover as suggested by the SBP the audit firms should hire *Shari'ah* scholars based on “*Shahadatul Almiya Fil Uloomal Arabia wal Islamia*” or *Takhasus fil Fiqh wal Ifta* or *Shari'ah* background.<sup>268</sup> These persons will not have accounting and auditing knowledge and experience as per FAPC.<sup>269</sup> However, the Accounting and Auditing Organization for IFIs has suggested a solution regarding the qualification of an external *Shari'ah* auditor;

*“The auditor shall be knowledgeable about Shari'a Rules and Principles. However, he would not possess the same level of knowledge as that of SSB members, and thus the auditor shall not be expected to provide an interpretation of these rules and principles.”<sup>270</sup>*

The nature of the job of an external *Shari'ah* auditor is very sensitive as compared to the financial audit. In the financial audit, the external auditor is responsible for

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<sup>267</sup> SBP.

<sup>268</sup> Ayub et al., ‘Enhancing the Competence and Effectiveness of *Shari'ah* Advisory Boards : Case of Islamic Banking Institutions in Pakistan’.

<sup>269</sup> SBP, ‘*Shari'ah* Governance Framework for Islamic Banking Institutions’.

<sup>270</sup> AAOIFI, ‘Testing for Compliance with Shari'a Rules and Principles by an External Auditor’.

obtaining reasonable assurance that the financial statements, taken as a whole, are free from material misstatement, whether caused by fraud or error. But in External *Shari'ah* audit, the auditor will be responsible for giving an opinion that the transactions and contracts comply with *Shari'ah* rules and principles, which increase the level of the confidence of banks customers. Keeping in view the nature of the job of an External *Shari'ah* auditor, the Accounting and Auditing Organization for IFIs, Bahrain is offering *Certified Shari'ah Auditor* Certification which is not sufficient. In Pakistan, it needs attention from the Accountancy bodies to produce qualified *Shari'ah* auditors in Pakistan.

As mentioned in the SGF:

“Institute of Chartered Accountants of Pakistan (ICAP) may develop comprehensive guidelines to conduct external *Shari'ah* Audit in consultation with external Audit firms.”<sup>271</sup>

Therefore, the SBP should review the qualification criteria (FAPC) for the *Shari'ah* auditors, and the Accountancy bodies, i.e., ICAP, ICMAP should organize training workshops, initiate certifications on *Shari'ah* Audit and issue manuals for the *Shari'ah* audit in collaboration with SBP, SECP and reputed *Shari'ah* bodies.

On the other hand, the BNM and IFSB have not discussed the concept of external *Shari'ah* audit according to BNM SGF;

*The functions of the Shari'ah audit shall be performed by the internal auditors who have acquired adequate Shari'ah knowledge. They may engage the expertise of Shari'ah officers. However, the Bank may*

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<sup>271</sup> SBP, ‘Shari'ah Governance Framework for Islamic Banking Institutions’.

*appoint or employ an external party or person to conduct a Sharī'ah audit on the operations of the IFI, if the Bank considers it is desirable or in the interest of the IFI to do so, in which case the remuneration and expenses relating to the appointment shall be borne by the IFI.*<sup>272</sup>

### **3.7.9. Board of Directors and Executive Management**

The role of EM is vital in the implementation of the *SGF* in true spirit. The *SGF* issued by the SBP has mentioned the role and responsibilities of the EM and BoDs. It is pertinent to mention that the *SGF* has also advised arranging Islamic banking and finance orientation training programs for EM and BoD for capacity development. These steps are very encouraging, but the *SGF* has oversight in the most critical factor which must be implemented.

As in Pakistan Bank and offering Islamic and conventional banking, Parallel and employees and EM are transferred between both Islamic to conventional and conventional to Islamic banking. A person who has served conventional banking for his whole carrier, he is being designated as Chief Executive Officer, Managing Director or any other key position of the Islamic banking division is not suitable for the process of the implementation of the *SG* system. A person having no prior experience has designated on a key position that will cause failure.

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<sup>272</sup> Bank Negara Malaysia, Shariah Governance Framework for Islamic Financial Institutions.

The State Bank may revise section 2 “Role of EM” with proper guidelines to appoint CEO, MD or any executive manager i.e. experience in Islamic banking industry and other important factors.

### **3.8. Conclusion**

SG is the backbone of Islamic banking system. A sound and effective *Shari'ah* compliance environment is critically important for the IFIs which can be possible with a strong *Shari'ah* compliance and governance system. The central banks, regulators and standard-setting organizations have issued SGFs for IBIs. The BNM and the SBP have issued and implemented specific regulations for SG in IFIs. The IFSB (IFSB) and Accounting, Auditing Organization for IFI (AAOIFI) have also issued standards on SG in IFIs. The main objective of this chapter is to comparatively analyze these SG regulations issued by SBP, BNM, AAOIFI, and IFSB. This chapter has focused on the appointment, qualification and experience of SSBM, independence of SB, responsibilities of SSB, Number of *Shari'ah* board members, duration of SSBM, Appointment of Resident *Shari'ah* board member/*Shari'ah* Advisor and its responsibilities, *Shari'ah* compliance department and *Shari'ah* Audit. After this comparative analysis it is concluded that the SGF is a robust SGF as compared to others but still there is still need for improvement in this SGF.

## **Chapter 4:**

### **Data and Methodology**

#### **Introduction:**

This study addresses various aspects of *SG*, which includes *Shari'ah* audit, supervision, and Role of different organs of governance for the implementation of *SG* in true spirit. The study is theoretical and analytical in nature, which placed the research study at a unique position in the Islamic finance literature; however, empirical research methods have also been used. The research objectives and research questions of the study are already mentioned in the previous section, which advocates the claim mentioned in the previous section.

This chapter explains the steps and procedures to collect data of any type and kind for the objectives and research questions mentioned in the previous section, i.e., Research objectives and research questions. In this chapter, a detailed overview of the processes regarding the data collection has discussed for this research study.

This chapter is mainly divided into two sections; the first section discusses the detailed procedure in the collection of data and later compiling and arranging the data in a way that fulfills the requirement of this research study. This section also highlights the sample of the study and logical grounds on which the sample is selected. The second section of this chapter explains thoroughly the methodology adopted for each research problem of the study.

#### **4.1. Data Collection**

In this section of the study, the data collection methods and procedures are mentioned in detail for each of the research objectives. Below is given the detailed research objectives of the study:

- To analyze and evaluate in a comparative perspective, the features of the *SGF* issued by SBP, BNM, AAOIFI, and IFSB.
- To examine the role and responsibilities of the BoDs, EM, *Shari'ah* Board, and *Shari'ah* Auditor in the *SG* Principles.
- To critically examine the competency, independence, and appointment of the *SSB* in the light of existing *SGF*/Standards.
- To empirically examine the specific essential guidelines and policy recommendations that can be considered to enhance and improve the *SG* System.
- To undertake a comparative study of the *SGFs* of 2015 and 2018 in light of improvements in *Shari'ah* compliance environment of IBs in Pakistan.

The first objective of the study discusses different approaches of IFIs towards *SG*. This research objective is explained or fulfilled theoretically, and the data for the theoretical discussion is taken from different standards-setting bodies and national level regulators of the banking industry. Data for this research objective is based on the standards, regulations, and guidelines set by the regulators and standards-setting bodies of IFIs regarding the *SGF* of IBs.

Standards issued by AAOIFI (Accounting and Auditing Organization for IFIs) on *SGF* for IBs are included in the data for this research objective. IFSB (IFSB), which is a

standards-setting autonomous body for IFIs, has issued a different set of standards about *SG*, and these are also included for theoretical analysis.

Similarly, *SGFs* issued by two central banks, i.e., SBP and BNM, have issued a different set of guidelines to the Islamic banking industry. These guidelines are part of the theoretical discussion for the first research objective of the study. All the data mentioned above for the first research objective of the study can easily be downloaded from the websites of these institutions and organizations.

The second objective of the study deals with the role and responsibilities of the BoDs, EM, *Shari'ah* Board, and *Shari'ah* Auditor to *Shari'ah* to enhance the *Shari'ah* compliance in IBs. This research objective is dealt with by two means; first, a comprehensive theoretical discussion is done which analyzes the duties, role, and responsibilities of *Shari'ah* board in the light of classical *fiqhi* literature and *fiqh ul Mu'amalat*.

This research objective is concerned with library research, and all the *fiqhi* literature can be taken from the library and the internet. The research objective is dealt with in another way in order to highlight the significance of the issue. For this purpose, the research objective is also included in the questionnaire (the details of the questionnaire are discussed later in the same section of the chapter) prepared for the full research study. The data obtained from the questionnaire is empirically analyzed in order to put more emphasis on the matter.

The fourth research objective deals with the characteristics and features of *Shari'ah* board members in the context of their level of independence, competence, transparency in

their matters, and confidentiality of their opinion and work. This section is dealt with via a questionnaire and a complete section included in the questionnaire for this part of the research objective. Data obtained from the questions are analyzed empirically with the help of statistical tools to give a clear picture of the attributed of *Shari'ah* board members and their significance.

The fifth research objective of the study is about the operational implementation of the *SGF* in IFIs. This objective is generally covering the whole research study, and if we explain the research study in a single sentence, then this research objective defines it exactly. So these research objectives cover all research objectives.

The sixth research objective of the research study is focused on the evaluation of the perception of specific respondents, i.e., IFIs of the questionnaire about the *Shari'ah* board's performance. This section defines the viewpoint of IFIs respondents of the sample of the study regarding the performance and efficiency of the *Shari'ah* board. This objective is relevant to the questionnaire, and the data of the perception of IFIs respondents is acquired through questions of perception in the questionnaire. The data for this section is obtained from the questionnaire and then analyzed with the help of statistical tools and also a descriptive analysis.

The next research objective discovers about the level of disclosure of *SG* practices in IFIs. This objective is also dealt with via primary data, and it deals with the analysis of the extent of *SG* practices being adopted by IFIs. Data obtained for this research objective from the questionnaire is arranged for empirical analysis.

The last objective of the study is concerned with the recommendation and conclusion by keeping in view the whole theoretical and empirical discussion done in all the research objectives. This is an overall conclusion of the results of the research study by combining theoretical discussion with empirical results.

This research study, as already mentioned, is a thorough study that presents complete theoretical aspects of *SG* and audit with endorsements from the empirical evaluation. The study has research questions that enhance the exposure and span of the research and covers a wide range of areas of *SG*. These research questions are mentioned below:

1. What are the various features and attributes of the *SGF* issued by SBP, BNM, AAOIFI, and IFSB?
2. What are the roles and responsibilities of, BoDs, EM, *Shari'ah* Board, and *Shari'ah* Audit in the light of *Shari'ah* governing principals?
3. What are the procedure of appointment and competency/qualification of *Shari'ah* Board members in the light of *Shari'ah* Law and existing *SGF/Standards*?
4. What are the measures taken to ensure the independence of *Shari'ah* board members prescribed under the guidelines of *Shari'ah* Law and existing *SGF/Standards*?
5. Do BoDs, EM, SSB, Resident *Shari'ah* advisor, and *Shari'ah* auditor contribute to the enhancement of *SG*?
6. Is there any significant difference in *SGFs* issued by the SBP during 2015 and 2018 for the improvement of the *Shari'ah* compliance environment?

Above are mentioned the research questions for this thesis, and these research questions differ in their domain, and because of this, these questions enhance the vibrancy of the research study. All these questions are incorporated into the questionnaire designed for this study, and research questions are broadened by asking every dimension of each aspect mentioned in every research question. Some research questions are exactly advocating the stance of research objectives, and the rest of the research questions are addition and enhancement to the research objectives.

First, three research questions ask about the role, responsibilities, and domain of *SSB* in the context of *SG*, the operational procedure of *SG* processes and evaluation of mechanism and system which ensures the independence, competence, transparency, and confidentiality in the affairs of *SG*.

Later the questions ask about the training and professional development of the *SAB* and also the examination of professional and academic qualification of *SAB*. Examination of *Shari'ah* review methodology of different aspects of IFIs and comparative analysis of auditing methodology of IBs in Pakistan and Malaysia.

These questions are incorporated into the questionnaire, which is explained in detail below. The issues and procedural activity of constructing the questionnaire and then finalizing it for the survey. Later the compiling of the data for the implementation of methodologies to be defined in the second section of this chapter.

#### **4.2. Justification for Designing a Questionnaire**

In order to conduct empirical research in this study, the first part is to collect data. The technique used to collect data for this study is the primary mean, i.e., structured questionnaire. The reason for selecting a questionnaire as a method of collecting data is because that research objectives and research questions of this study demand a new and novel set of data which is not already available in published form.

Secondly, the issues raised in this research study are unique and still unturned stones, so data for such objectives and questions are not available in published form.

#### **4.3. Questionnaire Designing**

Before collecting the data, the questionnaire is prepared (Annexure 1). Several questions are included in the questionnaire, which covers all the required details relevant to the research objectives and questions. The first section of the questionnaire includes the demographics information of the respondents. The items included in the first section to be responded by the respondents, i.e., demographics section are; name, age, gender, profession, professional designation, educational qualification, type of organization working in, accounting and auditing acquaintance level, the status of holding any *Shari'ah* certification and some structured open-ended questions. These open-ended questions are aimed to acquire opinions of respondents about the status of auditing structure in IFIs and relevant detail.

The second part of the questionnaire is concerned with SG. The questions which are included under this category are to inquire about SG as unique feature of IFIs, efficiency

of *SGF* that it can assure the *Shari'ah* compliance level of the IFIs, *SG* and profitability of IBs, importance and inevitability of *SG* for IBs, *Shari'ah* compliance assurance and *SG*, *SG* is integral part of corporate governance of IBs and the last question asks about practice of *SGF* is possible only if all the stakeholder of the IFIs work together to design.

The responses of the questions mentioned above are recorded on a five option scale known as the Likert scale. These questions are selected on the thorough review of IFI's literature and corporate governance literature. Corporate governance for financial institutions is a very advanced and well-developed field, and this field has developed and designed various standards for the financial institution. Designing a questionnaire for a field quite relevant to the domain of corporate governance helped excessively, as mentioned already, that IBs are underdeveloped in operational structure and theoretical fields relevant to operational aspects.

Questions in the questionnaire are all relevant to the research study, and the focus is to remain to the point in order to avoid the lack of importance of respondents when responding to questions. The difficulties and hindrances in developing a long and detailed questionnaire are, respondents get bored from the long surveys, and this reduces the number of responses and sometimes irresponsible responses.

These issues seriously and severely affect the analysis of the data as the results of the estimation may differ drastically, though the reality speaks differently. The solution to solve or reduce such problems is to make the questionnaire to the point, and the survey is to be conducted only to fulfill the exact requirements of the current research study.

Secondly, cross-check questions are added in the questionnaire in order to check the respondent's attention and understanding level.

The third part of the questionnaire is named "the BoDs", and in the different questions about the importance, relevance, efficacy, and responsibilities of the BoDs are asked. The questions which are asked in this section are; the responsibilities of BoDs (BOD) in context to accountable and answerable to every stakeholder of the banks, responsibility of BOD to ensure the implementation of *SG* in IFIs, awareness to the daily matters of the banks specifically the noncompliance risk of IFI, how the BOD and *Shari'ah* board can work in collaboration, independence of *Shari'ah* board and being top-notch of the Islamic bank, BODs should have well acquaintance of Islamic banking and finance. These meticulous questions are designed in the same manner similar to the second part of the questionnaire.

The fourth section of the questionnaire asks about the different duties and activities of the EM of an Islamic bank. In this section, questions are designed by surveying detailed Islamic financial literature and guidelines and standards issued by the SBP and other relevant institutions. Questions included in this section ask about; whether EM is responsible for implementation of *SGF*, the idea of zero-tolerance policy on *Shari'ah* noncompliance is impractical, responsibilities of EM include assurance of implementation of fatwas and other relevant matters, arranging different training programs, provision of detailed information to *SAB* in order to design a detailed framework, EM should be well equipped with the *Shari'ah* guidelines and serious actions against employees who fails to follow the guidelines of *SAB*.

Next section of questionnaire asks about *Shari'ah* board, status of *Shari'ah* board in an Islamic bank, importance and need of *Shari'ah* board in an Islamic bank, qualification of *Shari'ah* board members, *Shari'ah* board members' acquaintance with banking, finance and Islamic jurisprudence, level of independence of *Shari'ah* board in decision making, criteria of making decisions by *Shari'ah* board members, status of binding or non-binding nature of decision of *Shari'ah* board and frequent trainings of *Shari'ah* board members.

In the sixth part of the questionnaire, respondents were asked about the resident *Shari'ah* board members. The responsibilities of *Shari'ah* board members in the daily activities of an Islamic bank, the appointment status of resident *Shari'ah* board members, and the educational and professional qualification of resident *Shari'ah* board members. The perception and opinions were asked in these questions from the respondents.

Second last section of the questionnaire inquiries about the independence of the *Shari'ah* board and resident *Shari'ah* board members. This field is the burning issue of contemporary research when talking about operational, procedural guidelines of IBs and also when discussing the *Shari'ah* compliance risk for IBs. So in this section questions regarding *Shari'ah* board members' status of relationship and business relationship with the Islamic bank and its management. It uncovers and ensures transparency in the activities and responsibilities of the *Shari'ah* board and resident *Shari'ah* board members.

In this section, 'reporting status' of the above mentioned two departments in the hierarchy of Islamic bank's management, appointment criteria of *Shari'ah* board members and role of SBP in this regard and who should pay the remuneration to the *Shari'ah* board members and resident *Shari'ah* board members.

The last section of the questionnaire addresses the audit issues in IBs and precisely *Shari'ah* audit issues. *Shari'ah* review, internal and external *Shari'ah* audit, and its importance is discussed. The questions asked in this section focuses their interrogation on the points of responsibilities and duties of internal *Shari'ah* and external *Shari'ah* auditors, on what standards *Shari'ah* audit report shall be published, role and scope of *Shari'ah* audit, importance of *Shari'ah* audit if compared with financial audit for an Islamic bank, limitation of *Shari'ah* audit and auditors, qualification of *Shari'ah* auditors and training programs for *Shari'ah* auditors.

This comprehensive but short questionnaire ends by asking the consent of respondents, that if they are interested in being interviewed, keeping in view the responses of them. This concludes the questionnaire which has become a valuable contribution in the Islamic banking literature and also the data collected from these questionnaires is valuable and helpful to start a database which covers data for every aspect of IBs.

#### **4.4. Preparing for Launching the Survey**

After finalizing the questionnaire by surveying a meticulous Islamic financial literature specifically on *SG* and corporate governance. The questionnaire was first prepared in the English language and later translated into the Urdu language, as the widely spoken language in Pakistan is Urdu. Also, it is the national language of the country. For these reasons, it was necessary to prepare the questionnaire in the Urdu language too. The translation is done under the supervision and continuous assistance of experts of Urdu language, experts, and professionals of translation and people acquainted with the terminologies used in *SG*, IBs and other relevant aspects of this research study.

Later a pilot survey was conducted to finalize the questionnaire content, questions quality, relevancy, and quantity. The respondents of the pilot survey were Islamic financial experts, professionals, academicians, corporate governance professionals, auditors and experts and professionals of Islamic jurisprudence. So from academicians, only the teachers who were teaching Islamic banking, audit, and governance were selected. Auditors of IBs, EM, and BoDs of IBs and religious scholars (Muftis and Jurists) were selected.

The pilot survey was conducted by directly meeting with the selective respondents, and they were asked to put suggestions and guidelines to improve the questionnaire. The pilot survey was a very successful activity, as it collected the thought and opinions of various high ranked people of the Islamic financial industry. Necessary changes were made in the questionnaire with a detailed consultation of the supervisor after compiling the opinions and suggestions of the respondents. This eventually improved the overall picture of the questionnaire and enhanced its efficacy and relevancy of the questionnaire. A final draft of the questionnaire was prepared with questions in two languages, i.e., English and Urdu.

#### **4.5. Sample Size and Categories**

The survey was conducted through an online google form application, which improved the efficiency of the survey and provided easement too. Most parts of the survey were conducted through this source. A total of 250 questionnaires were conducted through a google form. Other means of conducting the survey were orthodox, i.e., by hand survey, and this means did 150 questionnaires. Personal contacts were used to complete the survey

and individually, the part which included the respondents from different specific professions, like, Muftis, ‘Ulamā’, and auditors and banking professionals were contacted via telephone and email. More than 100 questionnaires were conducted in this way.

The sample size for this research study is set as 500 respondents. This number is set after a detailed survey of the literature on categories of sample selection and also in consultation with academic people. This sample size is categorized into different categories which are mentioned below:

The first category of the respondents of this survey belongs to the profession of *Shari’ah*, and these are the *Shari’ah* scholars. These scholars should have at least a broad view of the knowledge of religious education and have at least completed Dars e Nizami. It is not necessary to have any professional experience for this category of the respondents, and only good acquaintance of Islamic jurisprudence specifically in fields of Fiq ul *Mu’amalāt* was needed. Another condition for this field of the sample is that these *Shari’ah* scholars should not be part of the management team of any Islamic bank or any other bank.

The next category of the survey is *SSB* members of IBs. The selection of this category is to examine and inquire about an inside opinion and view of the management team of IBs about the *SG* and other related aspects mentioned in the objectives and research questions for this study. It has already been mentioned in detail about the role of the *SSB* and their responsibilities too. So it is not necessary to repeat the introduction of *SSB* members.

The third category of respondents of this research study belongs to *Shari’ah* audit members of IBs. The responsibilities and functions of *Shari’ah* audit members are defined already and also asked in the questionnaire. This category is selected for the same reason

to have an inside view of the operations of IBs and to get professional responses, which would help to present a fair picture of operations and practices of IBs in the context of *SG* management.

The fourth kind of sample is Islamic banking and finance scholars and students of Islamic banking and finance. The scholars include academia and other advanced study level students. This category of the sample is selected for the reason to have a critical view of the operations and practices of IBs and specifically about *SG* practices of IBs.

Next is the general public and depositors of IBs, and the selection of this category is to evaluate the level of public awareness about the issues mentioned in the questionnaire and research objectives of this study. It is also to evaluate the perception of this category of sample about Islamic banking operations and precisely *SG* issues. The last category of the sample is auditors of reputed chartered auditors firms. This category is essential in the sense that it provides us with a bird view about the status and efficiency of *SG*. The auditors of chartered auditor firms are professionals and have advanced skills in corporate governance and auditing fields. Another reason for selecting this category is that these people are skilled in the fields of century-old practices. So their view and opinion about the *SG* and *Shari'ah* audit would be precious.

<b>Sample Category</b>	<b>Number of Samples</b>
<i>Shari'ah</i> Scholars	100
<i>SSB</i> Members of IBs	100
<i>Shari'ah</i> Audit Members of IBs	50

Scholars and Students of Islamic banking and finance	130
Depositors and General Public	100
Auditors of Reputable firms	20

*Table 3: Sample of Respondents*

A total of 560 respondents responded to this questionnaire by all three means, and 115 questionnaires were rejected due to various reasons. The reason involved in rejecting these questionnaires were, partially filled questionnaires, respondents did not have adequate knowledge of the *SG* aspects and irrelevant and illogical responses. So finalized many questionnaires to be selected for further analysis is 445.

In the end, the responses obtained from the detailed survey are compiled on the Microsoft Excel sheet for further analysis. The data is set by the requirements of the research objectives and research questions. Finalized data is now tested under different statistical tools and other analyses.

#### **4.6. Methodology**

This section addresses the processes and procedures for the execution of the data collected by different means in order to have the answers and solutions to the research questions and objectives of this research study. Every research question and objective demands a different set of data structures, and so is the case with methodology. In this section, all the execution policies and procedures shall be mentioned in detail, along with the reasons for adopting that specific methodology.

The reasons and logic behind structuring the research objectives and questions are already mentioned thoroughly in the first section of this chapter. It is evident from the first section of the chapter that there are a few objectives and research questions that require library research, as mentioned while explaining the reasons and logic of designing the questionnaire and research questions.

Empirical research is most relevant to the data which is collected through a questionnaire. There are various techniques and methods to conduct empirical research. However, every technique has unique prerequisite requirements for the data to fulfill in order to meet the standards required to execute that specific strategy.

In order to enhance the robustness of the results and outcomes of any empirical research, it is inevitable to analyze and exploit the data through some mathematical tools. Econometrics is aimed at providing mathematical implications of economic and finance thoughts. The widely used term in this regard is regression analysis, and it is the primary term too.

Regression analysis is a generic modeling technique that is focused on evaluating the relationship between dependent and independent variables of the research study. This process is used to analyze and forecast the causal relationship between the variables. The reason for using the regression analysis in the research studies is that this modeling technique provides a significant relationship between the dependent and independent variables. Secondly, it indicates the strength of the impact of independent variables on the dependent variable.

There are many techniques to execute the regression analysis, and linear regression and ordinary least square (OLS) are the methods categorized under parametric technique. Parametric methods of regression analysis follow typically distributed data and assume that the sample comes from a population. This type of regression analysis is supposed to fulfill more assumptions in the context of data distribution. The results obtained from this regression methodology are sturdy and robust, but it requires more assumptions too, so usually, the data obtained from the questionnaire are not normally distributed.

Another method of regression analysis is the nonparametric technique, and this technique is advantageous when the sample size is small. Fewer assumptions are taken care of this type of test for the data. Such a technique is considered to be specifically designed for the kinds of data that are categorized under the Likert scale. These types of tests are easier to apply than parametric tests, and also explanation and result interpretation is simple. However, nonparametric tests are considered less potent and strong in the context of results. Nonparametric tests are very appealing in the sense that they make fewer assumptions about the distribution of the data. Whereas, as the sample size gets larger and larger, non-parametric tests are as powerful as parametric tests.

#### **4.7. Logistic Regression**

The data collected for this research study is through primary means, i.e., questionnaire. Most of the responses of the questions are rated on a five-point Likert scale. It means that the outcomes of the questions are ordinal. The independent variables of this study are having the ordinal form of data. The independent variables of the research study are decided as Board of Directors (BOD), Management (M), *Sharī'ah* Supervisory Board

(SSB), Resident *Shari'ah* advisor (RSA) and *Shari'ah* Audit (SA). The questions relevant to these variables are asked in the questionnaire, and details are already mentioned in the previous section. The dependent variable in this study is *Shari'ah* governance. The expected outcome for the dependent variable is more than two, i.e., the SG's performance is high, medium or low.

Whenever the independent and dependent variables have outcomes in ordinal form, in such cases, a parametric model which is called Logistic regression is the best method to apply. The current research study has also used logistic regression analysis for the empirical and analytical evaluation of the data gathered through a questionnaire.

There are cases when the outcomes of the dependent variables are expected in a dichotomous nature, for example, studying the labor force participation of adult females as a function of the unemployment rate, wage rate, wealth level, and education. In this case, the person is either in the labor force or not and so the dependent variable takes only two outcomes, i.e., 1 if the person is in the labor force and 0 if he/she is not. It shows that the dependent variable has two possible outcomes, which is a case of dummy regression variable models.

There are several examples of dichotomous outcomes, and in these scenarios, the logit model is the best regression analysis to use. The logit model was first used in the 19<sup>th</sup> century for the explanation of the growth of populations and the course of autocatalytic chemical reactions or chain reactions (Cramer 2003).

In a simple logistic regression model, the dependent variable has a binary outcome. Therefore, a question arises that how can we deal with this situation with the help of a

linear equation. For example,  $p(x)$  is a function of  $x$ , in which every increment in the value of  $x$  would affect with the same or double or some specific proportion, and this will not give us the results in between '0' and '1'. This problem is solved by letting the  $\log p(x)$  is a linear function of  $x$ . This keeps the results in between '0' and '1,' but brings up another problem, and that is, logarithms are unbounded in one direction, but linear functions are not. This issue is resolved by logistic transformation, i.e.,  $\log p/1-p$ . It is called logistic regression (Long, 1997).

So the equation for the logistic regression is as follows:

$$\log \frac{p(x)}{1 - p(x)} = \beta_0 + x \cdot \beta$$

The logit model is a parametric regression test that asks data to follow lesser conditions, and the significance of the results are as strong as of any other parametric regression analysis. The estimation of the logit model is simple and easy to execute. There is another model of similar nature, and that is the probit model. The reason for not selecting probit regression is that Probit regressions use cumulative distribution function (CDF) or normal distribution function and disadvantage of using the normal distribution as a link for binary response model is that CDF does not have a closed-form. Logit regression analysis gives statistically sound results, and the results are easy to interpret and analyze.

A logistic regression model is a form of generalized linear models (GLM). General Linear models refer to a more significant section of models famed by McCullagh and Nelder (1982). It includes linear regression, ANOVA, Poisson regression, log-linear models, etc. and the table is given below explains the GLMs models:

Model	Random	Link	Systematic
<b>Linear Regression</b>	Normal	Identity	Continuous
<b>ANOVA</b>	Normal	Identity	Categorical
<b>ANCOVA</b>	Normal	Identity	Mixed
<b>Logistic Regression</b>	Binomial	Logit	Mixed
<b>Log-Linear</b>	Poisson	Log	Categorical
<b>Poisson Regression</b>	Poisson	Log	Mixed
<b>Multinomial response</b>	Multinomial	Generalized Logit	Mixed

Table 4: Generalized Linear Models (GLM) **Table source:** Agrestic (Ch. 4, 2013)

#### 4.7.1. Advantages of GLMs over Traditional OLS Regression

- “Under the GLMs models, it is not required to transform the response  $Y$  to have a normal distribution.
- The choice of the link is separate from the choice of the random component; thus, we have more flexibility in modeling.
- If the link produces additive effects, then we do not need a constant variance.
- The models are fitted via Maximum likelihood estimation, thus, optimal properties of the estimators.
- All the inference tools and model checking that we will discuss for log-linear and logistic regression models apply for other GLMs too, e.g., Wald and Likelihood ratio tests, Deviance, Residuals, Confidence Intervals, overdispersion.”

It is already mentioned that the logistic regression is used when dependent variable has two outcomes i.e., ‘yes or no’ or ‘male or female’ etc. But in the case of dependent

variable of current research study i.e., shariah governance, it has more than two outcomes and therefore, logistic regression may not be the suitable form of econometric model.

Therefore, in this research study, the multinomial logistic regression model is used (mentioned in detail in the next section of this chapter) to analyze the data gathered through the questionnaire empirically. The independent variables in this study are Board of directors (BOD), Management (M), *Shari'ah* Supervisory board (SSB), Resident *Shari'ah* advisor (RSA) and *Shari'ah* Auditor (SA). The questions relevant to these categories are asked in the questionnaire, and each variable is assigned a separate section, which includes a group of questions. The dependent variable in this research study is SG. The dependent variable of this study is supposed to examine the level of SG improved or enhanced because of independent variables in the study. The outcomes of the dependent variable will be the level of relevancy of independent variables in the enhancement of SG. This situation raises issues that logistic regression analysis only deals with the scenarios where the outcome of the dependent variable is in a binary manner, and this is the reason that the multinomial logistic regression model is used. The binary logistic regression model has the limitation that outcomes of the dependent variable are in binary i.e., two outcomes, for example, 'yes' or 'no.' Therefore, multinomial logistic regression is used, which generalized the model of the binary logistic regression model and mentioned below in detail.

#### **4.8. Multinomial Logistic Regression Model**

There is an extension or generalization of binary logistic regression in which more than two ordinal outcomes are taken into consideration, and this solves the problem

mentioned in the previous paragraph. It is called the multinomial logistic regression model, and in this model, nominal outcome variables in which the log odds of the outcomes are modeled as a linear combination of the predictor variables. Multinomial logistic regression is a generalization of logistic regression that is used to predict the probabilities of different possible outcomes of a categorically distributed dependent variable given a set of independent variables.

Multinomial logistic regression is also known by polytomous logistic regression, multiclass logistic regression, maximum entropy classifier, and the conditional maximum entropy model. The necessary procedure and setup are the same for the multinomial logistic regression model as in simple logistic regression. The only difference between both the models is that in the multinomial logistic regression model, the dependent variables are categorical rather than binary.

The equation for this research study in light of the logit regression model is as follows:

$$\text{Logit}(SG) = \beta_0 + \beta_1.(BOD) + \beta_2.(M) + \beta_3.(SSB) + \beta_4.(RSA) + \beta_5.(SA)$$

STATA 11.0 software is used to analyze the model mentioned above. The reason for selecting this software is because of its easement in operation and execution of the data. The command system of this software is easy and quick, and it has data compatibility with Microsoft Excel so that we can import the data from the excel sheets without any alteration in the sequence of the data. STATA has categorized the various regression analysis in the context of the data structure and sequence, which means that if the data sequence is known to the researcher, it would be quite easy for him/her to select the regression model to

implement on the data. The interpretation of the results is also comprehensive due to the detailed explanation of the results already mentioned by the Stata in the results sheet.

Along with the regression analysis, data gathered through the questionnaire is also explained in much detail, and for this purpose, descriptive analysis is used. The descriptive mentioning of the data details is followed by a theoretical explanation. Results of the regression model results also explained theoretically by mentioning the logics and grounds of the results in the context of Islamic banking practices and performance *SG* department in the banking institutes.<sup>273</sup>

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<sup>273</sup> Long, J. S. (1997) "Regression Models for Categorical and Limited Dependent Variables" Thousand Oaks, CA: Sage.

## **CHAPTER 5:**

### **RESULTS & DISCUSSION**

#### **Introduction**

This section's focuses on the comprehensive analysis of all the parameters and features examined in a questionnaire conducted for this research study. Detailed features and aspects mentioned in the questionnaire are discussed already in the previous section of the research study. In this section of the research study, outcomes, and responses received after conducting the questionnaire shall be evaluated by the following methodology adopted for this study. The methodology adopted for the analysis of questionnaire data is thoroughly mentioned in the previous section.

A questionnaire designed for this research study mainly consists of two sections. The first section asked the respondents about their demographic details. The purpose of asking these details is to get full acquaintance with the respondents of the survey, and it is because of the reason to show the strong background of respondents relevant to the knowledge required for responding to the survey. The details of demographic information have mentioned in this section by adopting a descriptive analysis technique, which is followed by theoretical discussion.

This part shall make a strong base for further discussion in this chapter, which is concerned with the analysis of the next sections of the questionnaire. The second general section of the questionnaire further divided into different sections, and every section contains various questions. These sections are considered as dependent and independent variables for this research study and shall be examined through detailed analysis. This data

obtained from this part of the questionnaire shall be examined by adopting a parametric technique that multinomial logistic regression. A detailed analysis of demographic information with descriptive analysis is mentioned in the below section.

### **5.1. Descriptive Analysis of Demographic Information**

A total of 560 respondents responded to the survey conducted for this research study, and 115 questionnaires were rejected due to various reasons. The reason involved in rejecting these questionnaires were, partially filled questionnaires, respondents did not have adequate knowledge of the *SG* aspects and irrelevant and illogical responses. So finalized the number of questionnaires to be selected for further analysis is 445. The data obtained through face to face conduction of surveys, via online and email, is compiled on MS Excel for making the information useful for analysis. There is a significant portion of data that was not in numerical form, and while compiling data on MS Excel, all the information was converted into a numerical form in order to have descriptive and econometric analysis possible.

The details asked in the demographic section of the questionnaire included information like, name of respondent, profession position held, organization with whom attached, contact details, designation at the organization, type of organization working with, any accounting or auditing qualification, and any *Shari'ah* certification completed. Contact details of the respondents shall be kept confidential and not disclosed in this research study, whereas, name of the respondents will be mentioned by mentioning their gender. The rest of the demographic information will be descriptively mentioned in this section. Each category of demographic information shall be mentioned separately, and

later, at the end of the discussion, concluding comments shall be presented in which information gathered shall be linked with the subsequent sections.

The first demographic information asked from the respondents was their names, and this information will be incorporated in this research study by mentioning the gender details of the respondents, which can easily be derived from the names of the respondents. Table 1 mentioned below describes the gender disparity among the respondents, which has many implications on its own. Most numbers of respondents were male in the survey, and it is because of various reasons.

Gender	No of Respondents
Male	415
Female	30
<b>Total Respondents</b>	<b>445</b>

Table 5: Gender Details of Respondents

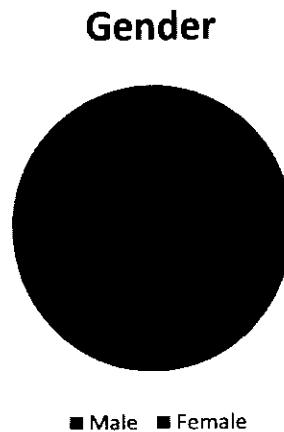


Figure 2: Gender Details of Respondents

The data mentioned in table 05 illustrates the gender disparity among the respondents of the survey conducted for this research study. The total number of respondents in the survey was 445, and from this total, only 30 respondents were female. A very high number of respondents were male in this survey, and it is because of various reasons. The first most reason is concerned with the limitation of this survey, which most of the survey was conducted in Pakistan only. The reason for mentioning this limitation is that Pakistan in specific is a dominant male society in which the majority of the professionals relevant to the survey sample were male.

There is another reason for this disparity in gender, and that is the Islamic finance studies are more concentrated by male sectors of the nation. The respondents for this survey were *SG* and audit specialists, and in this category, scholars from religious, educational institutes fall, and these are male. The author of this research study is male, and the social circle of the author is male dominant, which also contributed to this gender disparity. The female respondents mostly belong to other countries and attached to different professional sectors relevant to Islamic finance.

**Position Held/Designation:**

<b>Position</b>	<b>No of Respondents</b>
Students (Including Ph.D. scholars)	79
Academia (Teachers, Professors and Lecturers)	89
<i>SG</i> and audit	85
Islamic bankers	71

Researchers	25
Academia (Religious Institutions)	52
Administrative Jobs	44
<b>Total Respondents</b>	<b>445</b>

Table 6: Demographic details of Respondents

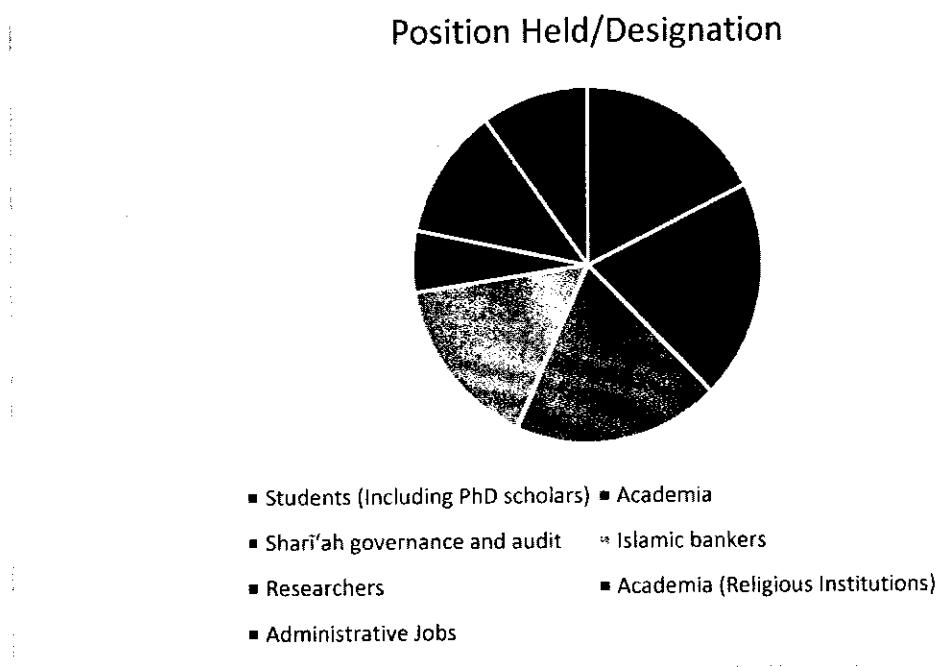


Figure 3: Demographic Details of Respondents

The following demographic information asked in the questionnaire is relevant to the professional position held by the respondents. The rationale of asking this category of information was to examine the professional status respondents of the survey, and by doing so, we can present our empirical results more confidently. The overall position of this category is dominant as most of the respondents are relevant to the topic and subject of the research study. This research thesis is concerned with *SG* and *Shari'ah* audit and so most

of the respondents hold professional positions that are supposed to be significant for this type of study.

In the questionnaire, respondents were asked to fill the professional position, and categories of professional positions were not already decided. The reason for doing so is to provide more liberty to the respondents while responding to this category. Therefore, the categories of professional positions were defined after the completion of the survey and based on data collected through a survey; seven different categories were defined. These categories are mentioned in table 02, and these are; students of different levels, and Ph.D. students of Islamic banking and finance are also included in this category. Academia includes all types of teachers irrespective of their level and institute, excluding religious sector academia. The teachers or academia of religious, educational institutes are categorized separately. Professional positions concerned with *SG* and audit are separately categorized, and staff of IBs is categorized in a different section. Administrative jobs in professional institutes and organizations of Islamic banking and financial institutions, whereas researchers who are not students and neither belong to the academic sector, are categorized in a separate category.

The number of respondents of different categories is almost of asymmetry. Academia other than religious, educational institutions is the biggest category in terms of number, which is 89 in number, and *SG* and audit are in the second position, as mentioned in table 02. This information has benefited the research study to build confidence in responses of the respondents as reliable and relevant, and the reason for this is that the respondents hold professional positions that are relevant to the research study.

**Type of Organization:**

<b>Type of Organization</b>	<b>No of Respondents</b>
Full-fledged local IFI	109
IBB of local conventional bank	21
Islamic window in a local conventional bank	16
Full-fledged foreign IFI	5
Islamic window in the foreign financial institution	2
Central Bank	11
Religious Institution	56
University /Research Institute	145
Business Man	24
Government/Private Employee	56
<b>Total No of Respondents</b>	<b>445</b>

Table 7: Type of Organization of the Respondents

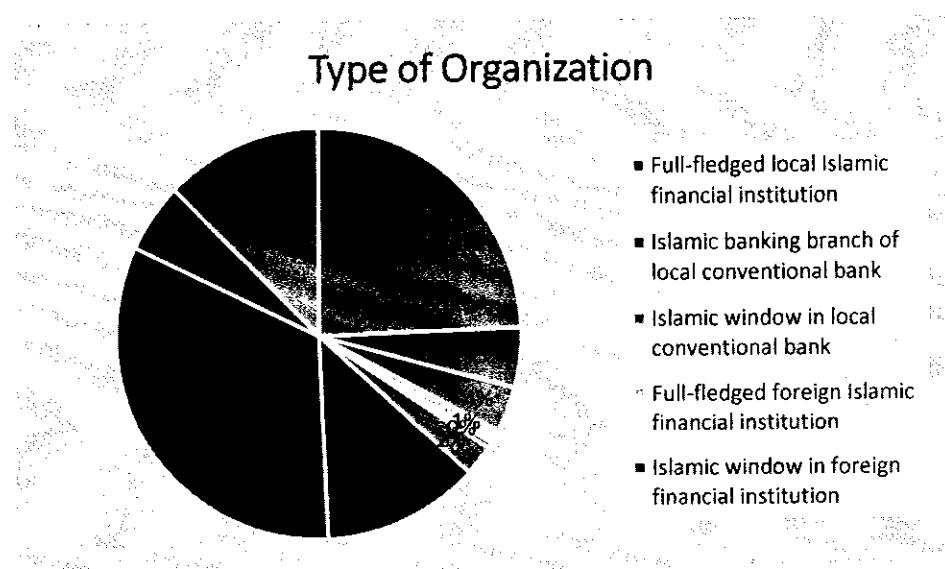


Figure 4 Type of Organization of the Respondents

The table mentioned above 05 is a descriptive picture of types of organization respondents of the survey. There is a total of 445 respondents in the survey, and after completion of the survey, respondents responded with a different list of organizations they affiliated with. Most respondents are attached to a university or research institute type of organization, which is 145 in number. The next category or sector to which most numbers of the respondents are professionally attached is full-fledged IBs of Pakistan. There are a few numbers of respondents who are related to different another type of financial institutions which are Islamic windows of conventional banks, Islamic branches of conventional banks, central bank and full-fledged foreign IBs.

The total number of respondents belong to these type of categories are 55 people, and this scenario has enhanced the diversification of respondents which has put a positive impact on responses. It is because of the reason that more diverse organizations and respondents incorporate this diversity and broad exposure in their perception while responding to the survey questions. The responses of these types of respondents provide a diverse view of a financial institution, which includes views and stance of a regulator of the financial market, i.e., central bank. The respondents from the central bank have provided an in-depth insight into the industry performance and factor, which would have an impact on the *SG* issues.

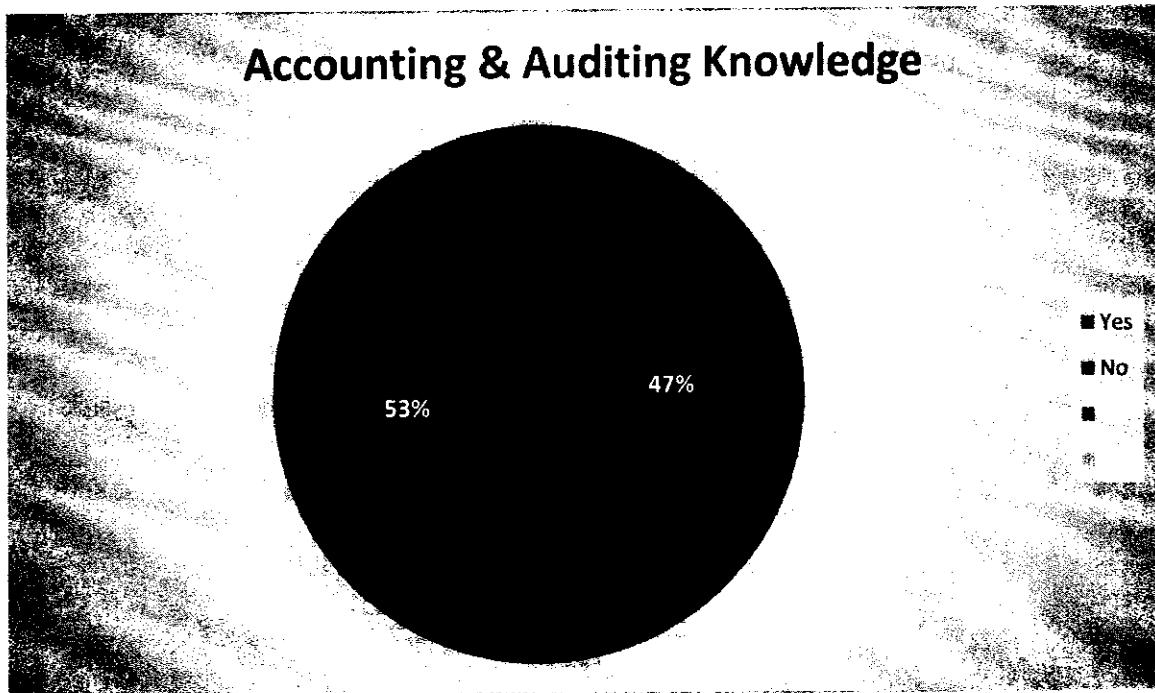
The respondents of IFIs, Islamic branches of conventional banks, and Islamic windows of conventional banks provide a viewpoint and issues related to *SG* management relevant to Islamic windows and branches of conventional banks. Hence, in this section, responses provided insight information and issues of the Islamic financial industry in the context of different perspectives. The most number of the respondents are from academia

or university level profession, which is providing strong theoretical aspects or stance regarding SG. Another sector of the respondents belongs to religious institutions, which have provided a pure *Shari'ah* perspective of SG issues.

#### **Accounting & Auditing Knowledge:**

<b>Accounting &amp; Auditing Knowledge</b>	<b>No of Respondents</b>
Yes	211
No	234
<b>Total Respondents</b>	<b>445</b>

*Table 8: Accounting & Auditing Knowledge of the Respondents*



*Figure 5: Accounting & Auditing Knowledge of the Respondents*

In this category, respondents were asked about their knowledge regarding accounting and auditing. The responses in this section are in yes, or no only, and no further information regarding this aspect is asked in the survey. The purpose of asking this type of question is to examine the acquaintance level of respondents of the survey. The intention of asking this question is to present the viewpoint of those who have knowledge of accounting and auditing matters and the stance of those respondents who do not have proper certification or degree of *Shari'ah* knowledge. Table 06 shows that almost half of the respondents do not know accounting and auditing, and the rest of the half does have. In this regard, a stance and perception of both sides of the coin are available in the questionnaire outcomes, which shall be presented in the next section.

***Shari'ah* Certification:**

<b><i>Shari'ah</i> Certification</b>	<b>No of Respondents</b>
Yes	244
No	201
<b>Total Respondents</b>	<b>445</b>

Table 9: *Shari'ah* Knowledge/Certification of the Respondents

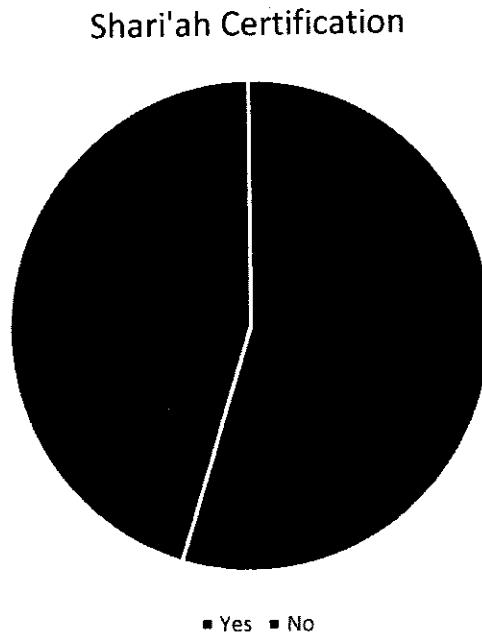


Figure 6: *Shari'ah Knowledge/Certification of the Respondents*

In this category or section of demographic information, respondents are asked about any *Shari'ah* certification they have or not. In this regard, respondents are asked to respond if they have any *Shari'ah* certification, and the objective of asking this question is to present the viewpoint of respondents of those who are *Shari'ah* certified and those who are not. This scheme of asking questions gives us a diverse viewpoint regarding *SG* aspects. The main theme or underlying intention in this question is to present the concern of both types of respondents on this critical matter of *SG*.

## 5.2. Implementation of Multinomial Logistic Regression:

In this section of the chapter, a detailed analysis and description of data results are extracted by applying the multinomial logistic regression model. A detailed explanation of the multinomial logistic regression model is already explained in earlier sections of the research study. The multinomial logistic regression model is an extension of binary logistic

regression in order to address the data which has more than two outcomes. The model is especially suitable for survey-based data in which cardinal form of data is obtained.

The survey conducted for this research study has asked various questions from the respondents, and outcomes of these responses are recorded on a five-point Likert scale. Therefore, for such type of survey, logistic data regression is the best parametric model, but binary logistic regression only accommodates two outcomes of the dependent variable. In order to solve this limitation, an extension of the logistic regression model is presented, which is called multinomial logistic regression. This model-dependent variable can have outcomes more than two, and this addresses the problems of binary logistic regression.

In this research study, a survey is conducted to examine the viewpoint of different sectors of the economy regarding *SG* for IBs. The survey contains one dependent variable which is *SG*, and independent variables are; BoDs, EM, *Shari'ah* board, resident *Shari'ah* board member, independence of *Shari'ah* board and *Shari'ah* review & audit. The objective of this survey is to examine the level of impact of independent variables on *SG* which dependent variable. In other words, the objective of this survey is to analyze the level of excellence brought in *SG* due to independent variables taken in this study.

The outcomes or level of excellence of *SG* is measured on three levels, which analyzes out of context of binary logistic regression. Therefore, multinomial logistic regression is used in this study. In the multinomial logistic regression model, data or outcomes are classified into different classes or categories or groups. In this research, study analysis or examination is done on level or categories of excellence of *SG*'s relationship

with independent variables of this study. The measure of efficiency or excellence of *SG* is done on three levels, with one being low and three being high.

### **5.2.1. Data Preparation for Estimation:**

In this section of the chapter, data gathered through a survey conducted for this research study shall be presented in a way to make it appropriate for the execution of multinomial logistic regression. It is mentioned in the last section that multinomial logistic regression is an extension of the binary logistic regression model in which if the research has more than two outcomes of the dependent variable. Binary logistic regression shall not cover the analysis. In order to cater to the need of more than two outcomes of the dependent variable in logistic regression, its extension, i.e., multinomial logistic regression, can be used.

Firstly, in this section, the description shall be done in which the raw data gathered through the conduction of the questionnaire for empirical analysis. The data was gathered through a questionnaire which has mainly two sections; first, demographic information of the respondents and the second section contains questions related to dependent and independent variables of the research study. The data gathered in the second section of the questionnaire under seven different heading, which later becomes dependent and independent variables for the research study. These headings later converted into a dependent variable (*SG*) and independent variables (BODs, EM, *Shari'ah* board, resident *Shari'ah* board member, Independence of Resident *Shari'ah* members, and *Shari'ah* review).

Each heading included various questions that address different aspects in order to make the variable more robust and comprehensive. These questions are also ranked on a five-point Likert scale, and in order to attain a single value for each variable, the simple average was taken of all the questions under each heading, which gives us a value for variables. This situation was done on MS Excel sheet, and values were rounded off to one point after the decimal. This technique gave us final data for independent variables for the research study. However, a further step was required for the finalization of data of the dependent variable of the research study.

The dependent variable was divided into three categories, i.e., one being a low level of performance and efficiency of *SG*, 2 being medium level, and three as a high level of performance of *SG*. These categories were extracted as follows; a simple average of the outcomes of questions asked under the heading of *SG* was done, which gave us a single value for the dependent variable. These values were later categorized into three sections, i.e., 1, 2, and 3, which means that average values range 1 to 1.5 falls in the first category, average values of 1.6 to 3.0 fall in the second category and third category contain average values range 3.1 to 5. This has finalized the data for the dependent variable as well and now the data will be exported to STATA for analysis of Multinomial logistic regression.

### **5.2.2. Data Reliability and Consistency Check:**

The purpose of this section is to provide details about the reliability and consistency of the data finalized for the execution of multinomial logistic regression. In order to examine the reliability and consistency of the data, Cronbach's alpha is used. Cronbach's alpha is used for the measurement of internal consistency which means an examination of

the level of relationship of a set of items. It is the coefficient of reliability or consistency of data finalized for the execution of multinomial logistic regression. The general formula for calculation of Cronbach's alpha is given below:

$$\alpha = \frac{Nc}{\gamma + (N - 1)c}$$

$N$  is equal to the number of items,  $c$  is the average inter-item covariance among the items, and  $\gamma$  equals the average variance. The value of the reliability coefficient or Cronbach's alpha of 0.70 or higher is considered acceptable for the analysis of data. The value of 0.70 and above is termed as good, 0.80 and above is better and, 0.90 and above is best, i.e., data sets and variables are reliable in the sense of their estimation and results in extraction.

In order to make the analysis more accurate and free from any errors, STATA is used for the analysis of Cronbach's alpha. Data for the dependent variable and independent variables exported to STATA and the results of Cronbach's alpha are mentioned below:

<b>Cronbach's Alpha</b>	
Average inter-item covariance:	.0882061
The number of items in the scale:	7
Scale reliability coefficient:	0.8478

Inter-item covariance (observations=445 in all pairs)

The table, as mentioned above, contains the results of Cronbach's alpha of seven variables (one dependent and six independent variables) is mentioned, and the scale reliability

coefficient states the value of 0.8478, which is above 0.70 and therefore, considered applicable for the estimation of data. The value of the result of Cronbach's alpha coefficient is 0.8478, which according to the range of values mentioned above depicts that, the data under consideration is termed as better in the context of its reliability. Therefore, the data can be used for further estimation in order to extract results in accordance with the guidelines and issues mentioned in the research objectives of the research study.

### 5.2.3. Heteroscedasticity Test:

The next step is to check the variance error in the independent variables, and for this purpose heteroscedasticity test of the independent variables shall be done. The procedures involved in the calculation of heteroscedasticity STATA software is used and in STATA. The Breusch-Pagan/Cook-Weisberg test for heteroscedasticity is executed. In this regard, first of all, linear regression is done on the software to examine the heteroscedasticity in the independent variables further. Below is given the results of the linear regression of six independent and one dependent variable:

Source	SS	Df	MS	Number of obs.		
Model	122.222437	6	20.3704062			445
Residual	137.305653	438	0.313483225	F(6, 438)		64.98
Total	259.52809	444	444.584522725	Prob > F		0.0000

R-squared	0.4709
Adj. R-squared	0.4637
Root MSE	0.5599

SG	Coeff.	Std. Err.	t	P> t	[95% Conf. Interval]	
<b>BOD</b>	0.4588382	0.650338	7.06	0.000	0.331021	0.5866554
<b>EM</b>	0.1499357	0.0834959	1.80	0.073	-0.0141668	0.3140381
<b>SB</b>	0.2011491	0.0728912	2.76	0.006	0.057889	0.3444092
<b>RSBM</b>	0.170596	0.0473337	0.36	0.719	-0.0759697	0.110089
<b>IRSBM</b>	0.0310187	0.0464277	0.67	0.504	-0.0602301	0.1222674

<b>SR</b>	0.0397778	0.0629135	0.63	0.528	-0.083872	0.1634276
<b>Cons</b>	-0.0598561	0.1007537	-0.59	0.553	-0.2578769	0.1381647

After calculating and executing simple regression, we now use command for the execution of heteroscedasticity by executing the Breusch-Pagan / Cook-Weisberg test for heteroscedasticity. Below is given the results extracted from the test:

**Variables:**

BOD	(BoDs)
EM	(EM)
SB	( <i>Shari'ah</i> Board)
RSBM	(Resident <i>Shari'ah</i> Board Member)
IR	(Internal Review)
SA	( <i>Shari'ah</i> Audit)

<b>Breusch-Pagan / Cook-Weisberg test for heteroscedasticity</b>	
Ho: Constant variance	
chi2(6)	12.51
Prob > chi2	0.0515

The null hypothesis in the above results states that data of six independent variables are homoscedastic and do not have heteroscedasticity. In order to not reject the null hypothesis, we need to have a p-value of more than 0.05. Therefore, the p-value of the data under examination of six independent variables is more than 0.05, and based on the results mentioned above; it can be concluded that the data under examination do not have heteroscedasticity. Therefore, we can proceed with multinomial logistic regression analysis without going through any further analyses.

### **5.3. Multinomial Logistic Regression Analysis:**

The analysis of multinomial logistic regression is done by using Stata software, which is chosen because of the reason this software is easy to use, and it gives effective and dynamic results. *SG*, which is the response variable or dependent variable in this research study, is treated as categorical with assumptions that level of *SG* has no natural ordering, and Stata is going to choose the referent group. The analysis and description of multinomial logistic regression for this research study shall be done in respect of two ways. The multinomial logistic regression coefficients and relative risk ratios. Below is mentioned the results of multinomial logistic regression coefficients which are followed by introductory details and then explanation or interpretation of results.

#### **5.3.1. Multinomial Logistic Regression Coefficient**

**Multinomial logistic regression      Number of obs. = 445**

**LR Chi<sup>2</sup> (12) = 191.79**

**Prob > Chi<sup>2</sup> = 0.0000**

**Log likelihood = -203.85527 Pseudo R<sup>2</sup> = 0.3199**

<b>SG</b>	<b>Coefficient</b>	<b>Std. Err.</b>
<i>I</i>		
<b>BoDs</b>	<b>-1.652607</b>	<b>.3608459</b>
<b>EM</b>	<b>-.6746596</b>	<b>.4252916</b>
<b><i>Shari'ah</i> Board</b>	<b>-.4997839</b>	<b>.3585548</b>

<b>Resident <i>Shari'ah</i> Board Member</b>	-.0268014	.2298313
<b>Independence</b>	-.0395304	.2322825
<b><i>Shari'ah</i> Review &amp; Audit</b>	-.0408589	.3136068
<b>_cons</b>	7.548813	.8616052
<b>2</b>	<b>Base Outcome</b>	
<b>3</b>		
<b>BoDs</b>	1.708592	.5279254
<b>EM</b>	.0991507	.7267883
<b><i>Shari'ah</i> Board</b>	1.390262	.859003
<b>Resident <i>Shari'ah</i> Board Member</b>	.4283506	.5955311
<b>Independence</b>	.4013879	.5073123
<b><i>Shari'ah</i> Review &amp; Audit</b>	-1.485787	.7605894
<b>_cons</b>	-8.998666	1.658651

Table 10: Results of Analysis through Multinomial Logistic Regression Coefficient

The above is mentioned a detailed analysis of data obtained through a survey for the examination of relationship and impact of independent variables (BoDs, EM, *Shari'ah* board, and resident *Shari'ah* board member, independence of *Shari'ah* board and *Shari'ah* review and audit) on performance or excellence of SG. At the start of the regression results, the iteration log is mentioned, which tells or explains log-likelihood at each iteration. The first iteration, which is 'iteration 0', is log-likelihood of the null or empty model, and then the predictor or independent variables are included in later iterations. It can be seen from

the iteration log that at each iteration, the log-likelihood decreases, and it is because the intention is to minimize the log-likelihood.

In the next level summary of the model and data is mentioned, which starts with log-likelihood, and it is the log-likelihood of the fitted model. Then comes the number of observations column which describes the details of data input in the model for analysis and case of this research analysis, the number of observations is 445. The next factor or aspect is the likelihood ratio (LR) chi-square test (LR Chi2 (12)) and this test is for both the levels of *SG* in respect to referent level i.e., low (1) concerning middle (2) and high (3) concerning middle. It tells that one of the predictors' (independent variable) regression coefficient is not equal to zero. The number in the parenthesis, which is 12, describes or represents a degree of freedom for chi-square distribution.

The next aspect or factor which is mentioned in the analysis chart is Prob>chi2, and it is the probability of getting LR test statistics. It is the probability of obtaining chi-square statistics, which is 191.79 when there is no effect of predictor or independent variables. The last aspect of this section is Pseudo R2, and it is known as McFadden's pseudo R squared and it is mentioned here because logistic regression does not have any equivalent to R squared calculated in OLS regression. The pseudo R square of logistic regression is not equivalent or similar to R square of OLS regression, and so it is recommended to not compare the values of pseudo R square in the context of R square of OLS regression.

*Shari'ah Governance* which is mentioned in the above estimation table is response or dependent variable in the study and under this section are mentioned two replicates of independent variables, which are estimated in context of low (1) level of *SG* relative to

medium (2) and high (3) level relative to medium (2). The medium level, which is represented by value 2, is taken as a base outcome in this model, and other both levels of  $SG$  are estimated about this base outcome. The multinomial logistic regression estimates  $k-1$  models, and  $k$  is a number of levels of the dependent variable and in the case of this research study, a number of outcomes are 3.

The next column of the estimation data mentions details of the logistic regression coefficient, and these are called estimated multinomial logistic regression coefficients. The results shall be interpreted based on these results in this section. As it is evident from the above discussion that parameter estimates are relative to the referent group or base outcome variable and therefore the interpretation for results of multinomial logistic regression coefficient would be that, a unit change in predictor variable, the logit of outcome, for example, 'a' relative to referent group or base outcome is expected to change by its respective parameter estimate given the variables in the model are held constant.

A similar sort of format is adopted, as mentioned above, for the interpretation of multinomial logistic regression coefficient results for this research study. In this study, the middle level of excellence and efficiency of  $SG$  is set as base outcome or referent group. We are starting the interpretation from a low level relative to the referent group, i.e., medium level in the context of the BoDs. In this regard, for a one-unit increase in the level of performance of the BoDs for the low level of  $SG$  relative to medium level keeping all other variables constant, the multinomial log-odds for the low level of  $SG$  to medium level would be expected to decrease by 1.65 units.

Similarly, on the same parameters and format, all other variables can be interpreted concerning the low level of *SG* relative to medium level. The second independent variable is EM and keeping all other variables constant if we do a one-unit increase in EM for the low level of *SG* relative to medium level, it would be expected to decline by 0.67 unit. Similar sort of results and trend is seen in other independent variables is seen when evaluating the low level of *SG* relative to medium level *SG*. The result for the independent variable of *Shari'ah* board in the context of the low level of *SG* relative to medium level, which is referent group, declines by 0.49, in the context of resident *Shari'ah* board member by 0.02.

In short, the results of the details, as mentioned above, can be summarized in another way, which states as the probability of occurrence of the low level of *SG* relative to medium level is less while seeing the results of all independent variables. It can be rephrased as the probability of occurrence of medium level of excellence of *SG* increases when one unit increase in the level of independent variables is initiated. Now below is mentioned the interpretation of results of the high level of performance or excellence of *SG*, which is ranked as 3, concerning base outcome or referent group, which is the medium level of excellence of *SG*.

In this section, the impact or level of relationship of independent variables on the high performance or excellence of *SG* when looking or analyzing about a medium level of *SG* is mentioned. A similar sort of format is adopted in the interpretation of results and outcomes of this category. The data of the regression coefficient in this category is giving us all positive values of independent variable except one which states that all independent

variable contributes positively in the enhancement of the high level of excellence or performance of *SG* when looking with the base outcome.

The independent variable, which is showing a negative trend in this category is *Shari'ah* review and audit. It means that keeping all other independent variables constant if we increase the level of performance of *Shari'ah* review and audit for a high level of *SG*, it will decline by 1.48 units. It can be concluded that independent variables contributed positively to achieving a high level of performance or excellence of *SG*. In other words, the probability occurrence of a high level of performance or excellence of *SG* relative to medium level (base outcome) is more. The overall conclusion of analysis and interpretation of the results of the multinomial logistic regression coefficient is that the independent variables of this study contribute positively to the enhancement of performance or excellence of overall *SG*.

#### **5.4. Relative Risk Ratios**

This is the second category or classification through which the data is analyzed in order to make the results and conclusions of the results more robust. The relative risk ratio or risk ratio, in general, elaborates on the strength of association among different variables. In this research study, the relative risk ratios shall present the level or strength of association of dependent variable (*SG*) and independent variables (BoDs, EM, *Shari'ah* board, and resident *Shari'ah* board member, independence of *Shari'ah* board and *Shari'ah* review and audit). A detailed overview of the results of relative risk ration is mentioned below, which are extracted through Stata, and these also come under the heading of multinomial logistic regression.

Multinomial logistic regression

Number of Obs = 445

LR Chi<sup>2</sup> (12) = 191.79

Prob > Chi<sup>2</sup> = 0.0000

Log likelihood = -203.85527

Pseudo R<sup>2</sup> = 0.3199

SG	RRR	Std. Err.
1		
<b>BoDs</b>	.1915499	.06912
<b>EM</b>	.5093298	.2166137
<b>Shari'ah Board</b>	.6066617	.2175215
<b>Resident Shari'ah Board Member</b>	.9735546	.2237533
<b>Independence</b>	.9612407	.2232794
<b>Shari'ah Review &amp; Audit</b>	.9599646	.3010515
2	Base Outcome	
3		
<b>BoDs</b>	5.521182	2.914772
<b>EM</b>	1.104233	.8025434
<b>Shari'ah Board</b>	4.015901	3.449671
<b>Resident Shari'ah Board Member</b>	1.534724	.913976

<b>Independence</b>	1.493897	.7578721
<b>Shari'ah Review &amp; Audit</b>	.2263242	.1721398

Table 11: Results of Analysis through Multinomial Logistic Regression Relative Risk Ratios

The results mentioned above are quite similar to the multinomial logistic regression coefficient with few differences. Initial details are all the same, but the only difference is the column of the relative risk ratio. The base outcome in this scenario is the medium level of performance of *SG*, whereas low level and high level of *SG* status are examined with a medium level. The results follow a similar sort of trend as they did in the multinomial logistic regression coefficient, but the interpretation of figures of relative risk ratio is different.

The relative risk ratios or risk ratios, in general, examine and elaborate on the level of association of dependent variables with independent variables. Looking at the results with a low level of *SG* relative to medium level of *SG*, the level of association of dependent variables and independent variables is less than 1. All the independent variables are presenting a similar sort of trend in this section, and therefore, this means that the strength of association of independent variables with a low level of performance or efficiency of *SG* is “less.” It also means that independent variables are not contributing to achieving the low performance of *SG*. So, low level of *SG* is less preferred over the medium level of *SG*, or chance of occurrence of medium level of *SG* increases as compared to a low level.

Similarly, the results of the high level of performance and excellence of *SG* and level of association of independent variables with a dependent variable to achieve this level in relation to medium level (base outcome), shows us a trend of a high level of association

among dependent variable with independent variables. All the independent variables are presenting a strong association with a high level of performance of *SG* with a medium level except one variable. The independent variable, which is showing a relatively weak association with a high level of *SG* efficiency in relation to base outcome is, *Shari'ah* review and audit.

The same variable was presenting out of the trend results in the multinomial logistic regression coefficient when all the independent variables were contributing positively to a high level of *SG* performance when looking in relation with a medium level of performance of *SG*. In general, the overall results of relative risk ratios predict that independent variables of this study have a direct and strong relationship with a high level of performance and efficiency of *SG*. Therefore, both sections of logistic regression results, i.e., multinomial logistic regression coefficient and relative risk ratio, illustrate the significance of independent variables, which are strongly related and significantly contributing to the enhancement and achievability of the efficient high-level position of *SG* in general.

It can be concluded from the overall survey data analysis that most of the respondents are male and have academic qualifications relevant to Islamic finance, audit, and corporate governance. The respondents are also holding reputed positions in the Islamic finance industry, academia, and religious academia, which make a very significant and valid portfolio of respondents for the survey designed for this study. Various

respondents are holding professional and academic positions regarding *Shari'ah* audit and governance and this factor enhanced the robustness of data gathered through a survey.<sup>274</sup>

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<sup>274</sup> Long, J. S. (1997) "Regression Models for Categorical and Limited Dependent Variables" Thousand Oaks, CA: Sage.

## Chapter 6:

### **Impact of *Shari'ah* Governance Framework on the Improvement of *Shari'ah* Compliance Environment in Islamic Banks during 2015-18**

#### **Introduction**

Compliance of Islamic banking products and services with the principles of *Shari'ah* is the essence and objective of the Islamic banking industry. To achieve these objectives, the SBP has taken significant steps. After re-launch the Islamic banking industry during 2001, the SBP established its Islamic Banking department for regulating IBs working in Pakistan.<sup>275</sup> The IBD-SBP issued a detailed *Shari'ah* compliance guideline for IBIs, which includes products of IBI (s) and other guidelines regarding the appointment of *Shari'ah* Advisor and Conduct of *Shari'ah* Audit<sup>276</sup>. During 2015 the IBD-SBP issued a detailed *SGF*, which was very comprehensive as compared to the previous guidelines. The objective of this chapter is to analyze the impact of post *SGF* on the improvement of the *Shari'ah* compliance environment in IBs.<sup>277</sup>

#### **6.1. Development of Islamic Banking in Pakistan**

Islamic banking is a rapidly growing industry globally. In Pakistan, this industry was established since it was relaunched in 2001 under the supervision of the SBP. The SBP

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<sup>275</sup> SBP, 'Strategic Plan for Islamic Banking Industry of Pakistan' (Karachi, 2013).

<sup>276</sup> State Bank of Pakistan, 'Guidelines for Shariah Compliance in Islamic Banking Institutions'.

<sup>277</sup> SBP, 'Shariah Governance Framework for Islamic Banking Institutions',.

started Islamic banking BPD Circular No. 01 dated 1<sup>st</sup> January 2003, according to this notification the SBP announced 'Policies for Promotion of Islamic Banking'<sup>278</sup> through;

1. Establishment of full-fledged Islamic bank(s) in the private sector;
2. setting up of subsidiaries for Islamic Banking by existing commercial banks; and
3. Allowing Stand-alone branches for Islamic banking in the existing commercial banks.<sup>279</sup>

Meezan Bank was granted the license as a full-fledged Islamic bank in 2002. It was the first full-fledged bank in Pakistan. Now four such banks are operating in Pakistan. Besides, 1211 Islamic branches of 16 conventional banks are working in the private and public sectors in Pakistan. In order to regulate the Islamic banking industry, Islamic Banking Department issues circulars, guidelines, and regulations.

Similarly, the IBD-SBP issued "Instructions and Guidelines for *Shari'ah* Compliance in IBIs" on 25<sup>th</sup> March 2008 via IBD Circular No.2 to harmonize the products and services and *Shari'ah* supervision in IBs working in Pakistan.<sup>280</sup>

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<sup>278</sup> Shahzad and Hameed, 'Islamic Banking Branches of Conventional Banks: An Analytical Review'.

<sup>279</sup> SBP, "Policies For Promotion Of Islamic Banking", January 1, 2003, retrieved on January 8 , 2019 <http://www.sbp.org.pk/bpd/2003/C1.htm>

<sup>280</sup> SBP, "Instructions and Guidelines for Shariah Compliance in IBIs", March 25, 2008, retrieved on January 8, 2019. <http://www.sbp.org.pk/ibd/2008/C4.htm>

## 6.2. Pre-Implementation of SGF

The SBP issued Instructions and Guidelines for *Shari'ah* Compliance in IBIs, according to this circular, all IBs working in Pakistan were required to:

1. Appoint a *Shari'ah* Advisor, according to Fit and Proper criteria notified by SBP, by the BoDs in case of domestic IBIs and by Management in case of foreign banks having IBBs with prior written approval from SBP.<sup>281</sup>
2. Submit information about *Shari'ah* Advisor to the IBD-SBP.<sup>282</sup>
3. The appointment of *Shari'ah* Advisor shall be for a renewable term of three years.

The termination of *Shari'ah* Advisor or his removal before the date of expiry of his term shall be with the approval of the authority. However, in case of resignation or termination of *Shari'ah* Advisor, the IBI will inform the SBP through a notification within 14 days of the date of resignation or termination.<sup>283</sup>

4. The *Shari'ah* Advisor will report to BoD in case of full-fledged Islamic Bank, while in case of IBB of a foreign bank, the *Shari'ah* Advisory will report to the CEO/Country Head of the bank.<sup>284</sup>
5. All fatawa and rulings of the *Shari'ah* Advisor in all financial matters shall be binding on the IBI.

According to these guidelines the *Shari'ah* Advisor was responsible for the followings;

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<sup>281</sup> State Bank of Pakistan, 'Instructions for Shariah Compliance in Islamic Banking'.

<sup>282</sup> State Bank of Pakistan.

<sup>283</sup> State Bank of Pakistan.

<sup>284</sup> State Bank of Pakistan; State Bank of Pakistan, 'Guidelines for Shariah Compliance in Islamic Banking Institutions'.

1. To Develop New Products, verification of new products, and related documentation in accordance with *Shari'ah* rules and principles.
2. To arrange Training sessions for Islamic Banking Staff.
3. To Review Islamic Bank's operations periodically.
4. To prepare a report to be published in the IBI's annual report

In light of these guidelines, it is clear that before the implementation of the *SGF*, the IBIs were required to appoint a *Shari'ah* Advisor who was responsible for *Shari'ah* compliance in the IBI. On the other hand, *Shari'ah* compliance of the IBs was also criticized in different ways, i.e., “Doller for Scholar.”<sup>285</sup> The scholars highlighted some issues regarding *Shari'ah* advisory, i.e., independence of *Shari'ah* Advisor, and it is not allowed for a mufti to get financial benefits for issuing fatawa.<sup>286</sup>

### **6.3. Post-Implementation of *SGF***

Keeping in view the developments taken place in the Islamic banking industry, the State bank issued a comprehensive *SGF* in pursuance to the previous guidelines via IBD Circular No. 03 of 2014 on 4<sup>th</sup> April 2014. The primary objective of the framework was to strengthen the overall *Shari'ah* compliance environment in the IBIs, which was

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<sup>285</sup> SPEARS, “Islamic Finance’s ‘Scholar Problem’: Why Are Shariah Scholars Paid So Much?”, April 26, 2012, retrieved on January 9, 2019, <https://www.spearwms.com/islamic-finances-scholar-problem-why-are-shariah-scholars-paid-so-much/>

<sup>286</sup> Shahzad, ‘Book Review: Financial Institutions and Shariah Advisory Board, Need, Responsibilities and Rules: A Critical Review (Malyaati Adaray Aour Sharī'ah Advisory Board: Zaroorat, Zumidarian Aour Zawabat Tanqidi Jaiza)’.

implemented from October 1, 2014.<sup>287</sup> The framework clearly defined the roles and responsibilities of different organs of IBI(s), including the BoDs, EM, *Shari'ah* Board, *Shari'ah* Compliance Department, Internal and External auditors towards *Shari'ah* compliance environment.<sup>288</sup>

#### **6.4. Essential Features of SGF**

The *SGF* was an uprising in *Shari'ah* compliance of IBIs. It was an extension in previous guidelines for *Shari'ah* compliance. It explicitly mentioned the role and responsibilities of the BoDs, Management, *Shari'ah* Board and *Shari'ah* audit, some essential features of the *SGF* are as follow;

##### **6.4.1. Role and Responsibilities of BOD and EM:**

1. The BoDs was held ultimately responsible and accountable for ensuring *Shari'ah* Compliance in the operations of IFIs. In order to this, the BOD should introduce an effective mechanism which including diligent oversight all the functioning of the said framework and compliance with the fatawa issued by *Shari'ah* Board, instructions, and guidelines.<sup>289</sup>
2. The BoDs should fully aware regarding their fiduciary responsibility particularly towards the Investment Account Holders/PLS depositors

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<sup>287</sup> SBP, 'Shari'ah Governance Framework for IBIs', Islamic banking department, State Bank of Pakistan, April 4, 2014 (Karachi 2014), retrieved on January 9, 2019. <http://www.sbp.org.pk/ibd/2014/C3.htm>

<sup>288</sup> SBP, 'Shariah Governance Framework for Islamic Banking Institutions',.

<sup>289</sup> SBP.

3. The appointment of the *Shari'ah* board was also the duty of the BoDs if the bank is domestic. However, in case the IBBs of conventional banks are operating, the Country Manager/CEO have to appoint the SSB.<sup>290</sup>
4. It orders to have detailed briefing regarding *Shari'ah* compliance in IBI, and the BoDs must have regular meetings with the SSB. This SGF made it compulsory for the BoD to meet SSB at least once on a half-yearly basis.<sup>291</sup>
5. The Senior/EM will be responsible and accountable for the implementation and enforcement of this framework and decisions of the *Shari'ah* board. If any employee failed to ensure *Shari'ah* Compliance, the EM would take appropriate action against him. The EM should ensure that the SSB must approve every document related to the products. Moreover, the EM should also ensure imparting and adequate training to their staff in coordination with the *Shari'ah* compliance department's training unit.<sup>292</sup>
6. In order to improve the understanding of Islamic banking and finance, some orientation programs for EM and BoD should be arranged.

In the guidelines issued on 25<sup>th</sup> March 2008, *Shari'ah* Advisor was responsible for the entire *Shari'ah* compliance mechanism in an IBI. However, after implementation of SG, BoD, and EM's role and responsibilities have been explicitly mentioned, and they are responsible for *Shari'ah* compliance.

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<sup>290</sup> SBP.

<sup>291</sup> SBP.

<sup>292</sup> SBP.

#### **6.4.2. Appointment of *SSB* and its Role and Responsibilities:**

Unlike previous guidelines, the SGF requires every IBI should appoint a *SSB* comprising at least three (3) *Shari'ah* scholars, which should be appointed by the BoDs as per FAP Criteria prescribed by State Bank. The appointment of the *SSB* members<sup>293</sup> should be subject to written clearance from SBP.

The *Shari'ah* board should be appointed for three (3) years and shall be eligible for re-appointment for the next term. It was also an essential point that *Shari'ah* board members except for Resident *Shari'ah* Board Member (RSBM), may work as SBM of up to three IBI(s) in Pakistan.

The termination of any SSBM shall be subject to prior approval from State Bank on sufficient reason provided by IBI(s), and the SSBM should be given the opportunity of being heard by the BoDs. Moreover, if any *Shari'ah* board member resigns earlier from the expiry of his/her term, he/she shall resign with reasons to the Board of Directors. In the case of IBB of the foreign bank, the resignation along with reason shall be submitted to Country Manager along with a copy to State bank.<sup>294</sup>

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<sup>293</sup> The IBI, may also seek services of experts i.e. lawyers, accountants, economists and such other professionals in consultation with *Shari'ah* board who will assist and advise the SBM(s) in their decisions, however these expert members shall not have voting right in meetings of the *Shari'ah* Board.

<sup>294</sup>. A casual vacancy arising on the SB caused by resignation, removal or termination or death of a member shall be filled by the BOD within three months from the date on which such vacancy was caused.

#### **6.4.3. Independence of *Shari'ah* Board (SB)**

The *Shari'ah* Board shall work and discharge its duties independently and objectively without any pressure and influence from the management and other members of the board.

#### **6.4.4. *Shari'ah* Compliance Department (SCD)**

Every IBI shall have an *Shari'ah* compliance Department (SCD) which may be headed by the RSBM or a suitably qualified, trained, and experienced officer recommended by the SB. The SCD shall work under the overall guidance and supervision of the SB, and its Head shall report to the SB, and his/her performance appraisal shall be finalized by SB. The SCD shall be responsible for (i) being Secretariat of the *Shari'ah* Board (ii) conduit between Management and the *Shari'ah* Board (iii) *Shari'ah* compliance review (iv) enforcement of *Shari'ah* audit reports (v) training on *Shari'ah* compliance and (vi) other functions such as preparation of a comprehensive procedure manual and website update to ensure dissemination of the desired information. The SCD shall submit a report regarding the status of compliance of audit observations to the SB for information periodically.

#### **6.4.5. Internal *Shari'ah* Audit**

Every IBI shall have an Internal *Shari'ah* Audit Unit (ISAU), which may be a part of the internal audit department or an independent unit, depending on the size of the IBI. The IBI shall ensure that staff of ISAU is adequately qualified and trained to perform their duties. Internal *Shari'ah* audit staff shall be dedicated to *Shari'ah* audit only; however, internal *Shari'ah* audit and regular audit of a branch or a function can be performed simultaneously. The final internal *Shari'ah* audit report shall be submitted to SB for consideration and for determining appropriate corrective action(s).

The final report, along with the enforcement/corrective actions determined by the SB, shall be sent to the Board Audit Committee (BAC) for information and ensuring compliance with SB directives on the report.

#### **6.4.6. External *Shari'ah* Audit**

In order to have an independent assessment of the *SG* and compliance environment of an IBI, the scope of external audit of IBIs shall also include an independent and objective assessment of the conformity of IBI's operations with *Shari'ah* rules and principles. The audit firms would need to take appropriate measures to have the capacity concerning resources and methodology to conduct the *Shari'ah* audit of an IBI. The external auditors shall prepare a report for the BOD while a copy of the report shall also be submitted to IBD-SBP.

All reports of internal *Shari'ah* audit and *Shari'ah* compliance reviews shall be submitted to the SB for consideration and prescribing appropriate enforcement action. The SB shall take up the unresolved issues with management and shall include all significant outstanding issues in its annual report on the *Shari'ah* compliance environment of the IBI.

### **6.5. Revised *SGF* 2018**

The *SGF* issued by the SBP in 2014 was an extension in previously issued guidelines on 25<sup>th</sup> March 2018. It was a revolution in the Islamic banking industry. However, there were some issues regarding product development and external *Shari'ah* audit in this

framework. The State Bank issued a revised *SGF* on June 07, 2018, via IBD Circular No. 01 of 2018<sup>295</sup>.

The revised *SGF* not only improved the previous version of the *SG* but also extended some clauses.

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<sup>295</sup> SBP, “Shari’ah Governance Framework (SGF) for IBIs (IBIs)”, June 07, 2018, retrieved on January 8 , 2019 <http://www.sbp.org.pk/ibd/2018/C1.htm>

## 6.6. Comparison between SGFs issued by SBP in 2014 and 2018

SGF ISSUED IN 2014	SGF ISSUED IN 2018
<b>1. Meetings of BoDs with <i>Shari'ah</i> Board</b>	Part “1 (V)” regarding the record of the meeting has been included as under;
N/A	<p>“The deliberations of the meeting between SB and BOD shall be properly recorded and duly confirmed by the BOD. A copy of the same shall be submitted to IBD-SBP within 15 days of the confirmation.”<sup>296</sup></p>
<b>2. Operational and Human Resource Issues in <i>Shari'ah</i> Non-Compliance</b>	In order to take strict measures against <i>Shari'ah</i> non-compliance a para has been included in section 2 (V) as follow; <p>“The EM shall take appropriate measures to address the operational and human resource issues that may result in <i>Shari'ah</i> non-compliance risk.”</p>
<b>3. Exposure of the <i>Shari'ah</i> Board Members</b>	
N/A	.” IBI shall provide exposure to the SB members concerning domestic and international

<sup>296</sup> SBP, ‘*Shari'ah Governance Framework for Islamic Banking Institutions*’. Section 1(V), p2

	developments in Islamic banking and finance. A yearly statement on the actions taken by the IBI shall be submitted to IBD-SBP by the 15th of January every following year.
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#### 4. Constitution of the *Shari'ah* Board (SB)

“Constitution of the SB and Appointment of SB Members. The appointment of the SB members shall be subject to prior written clearance of SBP. The IBIs already having a <i>Shari'ah</i> Board not cleared by SBP under SGF shall seek clearance from SBP about their existing SB within 45 days of notification of this Framework.” <sup>297</sup>  “The SB members shall be appointed for a term of three (3) years and shall be eligible for reappointment. The <i>Shari'ah</i> scholars working in IBIs as <i>Shari'ah</i> Advisors at the time of coming into force of this Framework may be reappointed as a member, RSBM, or Chairperson of SB, as	The following clauses have been amended or added in this section.  “Constitution of the SB and Appointment of SB Members” <sup>302</sup>  “The appointment of the SB members shall be subject to prior written clearance of SBP. The IBI all apply for SBP’s clearance after obtaining BOD’s approval.” <sup>303</sup>  “The SB members shall be appointed for a term of three (3) years. The SB members shall be eligible for reappointment with the approval of SBP. The three (3) years term of SB shall commence from the date of SBP’s clearance for appointment/reappointment.” <sup>304</sup>
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<sup>297</sup> SBP, ‘Shariah Governance Framework for Islamic Banking Institutions’.

<sup>302</sup> SBP, ‘Shari’ah Governance Framework for Islamic Banking Institutions’.

<sup>303</sup> SBP.

<sup>304</sup> SBP.

<p>the case may be, and their term shall start from the date of reappointment.”<sup>298</sup></p> <p>“Up to three years from the date of coming into force of this Framework, SB members, except RSBM, may serve on the SBs of up to three IBI in Pakistan.”<sup>299</sup></p> <p>“At least two months before the expiry of the term, members (including the Chairperson) of SB may be reappointed as a member of SB for another term, subject to prior written clearance of SBP and according to FAPC.”<sup>300</sup></p> <p>“A casual vacancy arising on the SB caused by resignation, removal, or termination or death of a member shall be filled by the BOD within three months from the date on which such vacancy was caused.”<sup>301</sup></p>	<p>“Up to three (3) years, i.e., June 2021, the SB members, except RSBM, may serve on the SBs of up to three IBI in Pakistan.”<sup>305</sup></p> <p>“At least two months before the expiry of the term of the SB, members (including the Chairperson) of SB may be reappointed as a member of SB for another term by the BOD, subject to afresh prior written clearance of SBP and according to FAPC.”<sup>306</sup></p> <p>“A casual vacancy arising on the SB caused by resignation, removal or termination or death of a member shall be filled by the BOD within three months from the date on which such vacancy was caused. However, the SB member appointed on casual vacancy shall hold the office until the expiry of the current term of the SB.”<sup>307</sup></p>
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## 5. Role of *Shari'ah* Board

<sup>298</sup> SBP.

<sup>299</sup> SBP.

<sup>300</sup> SBP.

<sup>301</sup> SBP.

<sup>305</sup> SBP.

<sup>306</sup> SBP.

<sup>307</sup> SBP.

<p>“The SB shall ensure that all the procedure manuals, product programs/structures, process flows, related agreements, marketing advertisements, sales illustrations, and brochures conform with the rules and principles of <i>Shari’ah</i>.”<sup>308</sup></p> <p>“All reports of internal <i>Shari’ah</i> audit and <i>Shari’ah</i> compliance reviews shall be submitted to the SB for consideration and prescribing appropriate enforcement action.”<sup>309</sup></p>	<p>The following clauses have been amended or added in this section.</p> <p>“The SB shall review and approve all the procedure manuals, product programs/structures, process flows, related agreements, advertisements, sales illustrations, and brochures so that they conform with the rules and principles of <i>Shari’ah</i>.”<sup>310</sup></p> <p>“All reports of internal <i>Shari’ah</i> audit, external <i>Shari’ah</i> audit, <i>Shari’ah</i> compliance reviews, and SBP <i>Shari’ah</i> compliance inspection shall be submitted to the SB for consideration and prescribing appropriate enforcement action. The report of the Internal <i>Shari’ah</i> Audit shall be finalized by the Internal <i>Shari’ah</i> Audit Unit/department (ISAU), and the final report shall be submitted to SB for prescribing appropriate enforcement/ corrective actions.”<sup>311</sup></p>
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<sup>308</sup> SBP, ‘Shariah Governance Framework for Islamic Banking Institutions’,.

<sup>309</sup> SBP.

<sup>310</sup> SBP, ‘Shari’ah Governance Framework for Islamic Banking Institutions’.

<sup>311</sup> SBP.

	<p>“The SB shall not delegate any of its roles and responsibilities prescribed in this framework to any other person or any of its members.”<sup>312</sup></p>
<b>6. <i>Shari’ah</i> Board Meetings, Quorum, Minutes</b>	
<p>“The SB shall, in addition to its meetings with the BOD, according to paragraph 1(iv) of this Framework, meet at least every quarter, and each member of the SB shall attend at least two-thirds of the meetings held during a calendar year. Further, in addition to the mandatory quarterly meeting, the Chairperson of the SB may convene SB’s meetings as and when he deems it necessary.”<sup>313</sup></p> <p>“All SB approvals taken through circulation shall be placed for ratification of the SB at its next meeting.”<sup>314</sup></p> <p>“The minutes of meetings of the SB shall be submitted to IBD-SBP within 45 days of the meeting for information and record. Further, the minutes shall be made</p>	<p>“The SB shall, in addition to its meetings with the BOD, according to paragraph 1(iv) of this Framework, meet at least quarterly, and each member of the SB shall attend at least two-thirds of the meetings held during a calendar year. Further, in addition to the mandatory quarterly meeting, the Chairperson of the SB may convene SB’s meetings as and when he deems it necessary.”<sup>316</sup></p> <p>“All SB approvals taken through circulation shall be placed for ratification of the SB at its next meeting. A resolution in writing signed by all SB members for the time being and shall be as valid and effective as if it had been ratified at an SB meeting. Proper documentary evidence of the SB approvals taken through</p>

<sup>312</sup> SBP.

<sup>313</sup> SBP, ‘Shariah Governance Framework for Islamic Banking Institutions’.,

<sup>314</sup> SBP.

<sup>316</sup> SBP, ‘Shari’ah Governance Framework for Islamic Banking Institutions’.

<p>available to the BOD, SBP inspection teams, internal auditors, and external auditors on request, enabling them to appreciate and understand the rationale and background of the SB rulings, decisions, and fatawa.”<sup>315</sup></p>	<p>circulation must be kept in record for audit &amp; inspection.”<sup>317</sup></p> <p>“For the implementation of the decisions of SB meeting before the confirmation of the minutes of the meeting, the approval/confirmation of the relevant resolution/decision for the specific agenda must be obtained from SB through written consent duly signed by the SB members or through email by the SB members. However, the same shall be ratified in the subsequent meeting of SB.”<sup>318</sup></p> <p>“The approved/confirmed minutes of meetings of the SB shall be submitted to IBD-SBP within 15 days of its approval/confirmation for information and record. Further, the minutes shall be made available to the BOD, SBP inspection teams, internal auditors, and external auditors on request, enabling them to appreciate and understand the rationale and</p>
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<sup>315</sup> SBP.

<sup>317</sup> SBP.

<sup>318</sup> SBP.

	background of the SB rulings, decisions, and fatawa.” <sup>319</sup>
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### **7. Resident *Shari'ah* Board Member (RSBM)**

“Respond to <i>Shari'ah</i> related queries of IBI’s clients regarding IBI’s products and services.” <sup>320</sup>	<p>“Moreover, RSBM shall not hold any administrative or full-time position with any organization/institution other than the IBI, where he is appointed as RSBM. SB shall ensure that engagements of the RSBM other than the IBI shall not be hinder his activities at the IBI.”<sup>321</sup></p> <p>“Review responses to <i>Shari'ah</i> related queries of IBI’s clients regarding IBI’s products and services as submitted by SCD.”<sup>322</sup></p>
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### **8. *Shari'ah* Compliance Department (SCD)**

“Further, the SCD shall work under the overall guidance and supervision of the SB, and its Head shall report to the SB, and his/her performance appraisal shall be finalized by SB.” <sup>323</sup>	<p>“The SCD shall have at least one qualified <i>Shari'ah</i> expert (other than RSBM) who shall meet the criteria of Academic Qualifications as prescribed in Annexure-A of this Framework. Moreover, IBI’s are encouraged to depute individuals with expertise or qualification in <i>Shari'ah</i>, Risk Management, Legal, and</p>
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<sup>319</sup> SBP.

<sup>320</sup> SBP, ‘Shariah Governance Framework for Islamic Banking Institutions’,

<sup>321</sup> SBP, ‘Shari’ah Governance Framework for Islamic Banking Institutions’.

<sup>322</sup> SBP.

<sup>323</sup> SBP, ‘Shariah Governance Framework for Islamic Banking Institutions’,

	<p>Accounting to strengthen its <i>Shari'ah</i> compliance function.”<sup>324</sup></p> <p>“The SCD shall work under the overall guidance and supervision of the SB, and its Head shall functionally report to the SB, and his/her performance appraisal shall be finalized by SB. However, administrative reporting of Head SCD shall be to the Chief Executive Officer of Islamic Bank and Chief Compliance Officer in the case of IBBs of Conventional Bank.”<sup>325</sup></p>
<p><b>9. Conduit between Management and the <i>Shari'ah</i> Board</b></p>	
N/A	<p>“The SCD shall not involve in any operational / business-related functions/activity, including product development.”<sup>326</sup></p> <p>“The SCD shall perform research and analysis on <i>Shari'ah</i> issues under the guidance of the RSBM/SB.”<sup>327</sup></p> <p>“The SCD shall be responsible for verifying the distribution of profit and loss to the depositors before its disbursement.”<sup>328</sup></p> <p>“The SCD shall prepare responses to <i>Shari'ah</i> related queries of IBI's clients regarding IBI's products and services after discussion with the relevant stakeholders and submit the same to RSBM for his advice/review/confirmation.”<sup>329</sup></p>

<sup>324</sup> SBP, ‘*Shari'ah Governance Framework for Islamic Banking Institutions*’.

<sup>325</sup> SBP.

<sup>326</sup> SBP.

<sup>327</sup> SBP.

<sup>328</sup> SBP.

<sup>329</sup> SBP.

<b>10. <i>Shari'ah</i> Compliance Review</b>	
“RSBM shall periodically submit a report to the SB on the overall <i>Shari'ah</i> compliance environment of the IBI, the ownership and commitment of the BOD and EM in building the necessary infrastructure for <i>Shari'ah</i> compliance together with identifying key areas of improvement.” <sup>330</sup>	“Head SCD shall periodically submit a report to the SB on the overall <i>Shari'ah</i> compliance environment of the IBI, the ownership and commitment of the BOD and EM in building the necessary infrastructure for <i>Shari'ah</i> compliance together with identifying key areas of improvement.” <sup>331</sup>
<b>11. Product Development Department</b>	
N/A	<p>In revised SGF section 6 has been included which describes that;</p> <p>“Every IBI shall have a Product Development (PD) Department /Unit, which may be part of the Business units or an independent department/unit. PD shall be responsible for research and development of new and innovative products and services, keeping in view the business needs of the IBI and considering international practices.”<sup>332</sup></p> <p>“The IBI shall ensure providing adequate qualified and trained staff to PD to perform its duties. The IBI shall be encouraged to engage at least two individuals, who shall meet the criteria of Academic Qualifications as prescribed in Annexure-A of this Framework. Thus the PD shall be able to seek guidance and support on</p>

<sup>330</sup> SBP, ‘Shariah Governance Framework for Islamic Banking Institutions’,

<sup>331</sup> SBP, ‘*Shari'ah* Governance Framework for Islamic Banking Institutions’.

<sup>332</sup> SBP.

	<i>Shari'ah</i> aspects of new products/ideas during the product development process.” <sup>333</sup>
<b>12. Internal <i>Shari'ah</i> Audit</b>	
“The IBI shall ensure that staff of ISAU is adequately qualified and trained to perform their duties. Internal <i>Shari'ah</i> audit staff shall be dedicated to <i>Shari'ah</i> audit only; however, Internal <i>Shari'ah</i> audit and regular audit of a branch or a function can be performed simultaneously.” <sup>334</sup>	“The Internal Audit Department or ISAU shall have dedicated and adequate staff as per the advice of the SB keeping in view the size of operations of the IBI, to enable it to discharge its due responsibilities in a proper and timely manner. The IBI shall ensure that staff of ISAU is adequately qualified (preferably having <i>Shari'ah</i> qualification) and trained to perform their duties. Internal <i>Shari'ah</i> audit staff shall be dedicated to <i>Shari'ah</i> audit only; however, Internal <i>Shari'ah</i> audit and regular audit of a branch or a function can be performed simultaneously. The IBI shall be encouraged to engage at least one individual in the Internal Audit Department or ISAU, who shall meet the criteria of Academic Qualification as prescribed in Annexure-A of this Framework.” <sup>335</sup>  “The Internal Audit Department or ISAU of the IBI shall conduct a post disbursement audit quarterly. The report of internal <i>Shari'ah</i> audit on profit and loss distribution shall be submitted to SB of the IBI.” <sup>336</sup>
<b>13. External <i>Shari'ah</i> Audit</b>	

<sup>333</sup> SBP.

<sup>334</sup> SBP, ‘Shariah Governance Framework for Islamic Banking Institutions’,

<sup>335</sup> SBP, ‘Shari’ah Governance Framework for Islamic Banking Institutions’.

<sup>336</sup> SBP.

N/A	<p>“The following instructions shall be adhered to while conducting external <i>Shari'ah</i> audit of the IBIs: SB members of IBI shall not be allowed to be engaged with any external audit firms.”<sup>337</sup></p> <p>“It will be the responsibility of the external Audit firms to take measures for capacity building of their staff for conducting <i>Shari'ah</i> audit and provide them with appropriate training. Moreover, external Audit firms shall prescribe FAPC for <i>Shari'ah</i> scholars to be engaged for external <i>Shari'ah</i> audit of IBIs. In this regard, FAPC for SB members as prescribed in Annexure- A of this Framework may be used as a guiding principle for the engagement of <i>Shari'ah</i> auditor. External Audit shall also include review and provide opinion on the bank’s pool management practices &amp; IT-based system. Specially computation and distribution of profit &amp; loss to the depositors, tagging, and movement of assets and allocation of income &amp; expenses, etc. The format of the external <i>Shari'ah</i> audit report for submission to BOD of an IBI and SBP (SBP) is enclosed as Annexure-C. Institute of Chartered Accountants of Pakistan (ICAP) may develop comprehensive guidelines to conduct external <i>Shari'ah</i> Audit in consultation with external Audit firms. A copy of the external <i>Shari'ah</i> audit report shall be submitted to IBD-SBP within 45 days of the</p>
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<sup>337</sup> SBP.

	date of the finalization of IBIs Audited Accounts. The IBIs shall not publish the External <i>Shari'ah</i> Audit report until further instructions.” <sup>338</sup>
<b>14. Competence of the Organs Dealing with SGF</b>	
“Similarly, members of the SB of an IBI shall also be required to undergo and attend training sessions and orientation programs related to the applicable legal and regulatory framework, banking, finance, treasury operations, etc. to improve their understanding of such matters in the context of an IBI.” <sup>339</sup>	“Similarly, members of the SB of an IBI shall also be required to undergo and attend training sessions and orientation programs related to the applicable legal and regulatory framework, banking, finance, treasury operations, etc. to improve their understanding of such matters in the context of an IBI. The IBI shall take appropriate measures to ensure that SB members are abreast with the developments internationally. For the said purpose, IBI's are encouraged to provide an opportunity to SB members to attend/participate in domestic and international forums.” <sup>340</sup>

Table 112: Comparison between *SGFs* issued by SBP in 2014 and 2018

## 6.7. Role of Central *Shari'ah* Advisory Board (SAB)

In modern days the IFIs are required to comply with the *Shari'ah* guidelines in their products and services strictly. These transactions must not involve any prohibited elements, i.e., *Ribā*, *gharar*, and *Qimār*. It is the responsibility of the *SSB* to ensure that the products and services of the financial institution are free from prohibited elements. They should also

<sup>338</sup> SBP.

<sup>339</sup> SBP, ‘Shariah Governance Framework for Islamic Banking Institutions’.

<sup>340</sup> SBP, ‘Shari'ah Governance Framework for Islamic Banking Institutions’.

keenly observe that the development of new products and services are aligned with the *Shari'ah* guiding principles.

The development of new products and services, it is a process of *Ijtihād*, which the *Shari'ah* board exercises. It has been observed that there is a difference of opinion among the *Shari'ah* boards of different IBs on a specific product or service.<sup>341</sup> In order to make products and services uniform and harmonization in the matters of IFIs, it is imperative to implement decisions of the institutions exercising collective *Ijtihād* to reduce the fanaticism of the schools of Islamic law. The Supreme Court of Pakistan ordered in its judgment on Ribā 2001, to establish some special departments within the SBP;

*“Shari'ah Board for scrutiny and evaluation of the Board's procedures and products and for guidance for successfully managing Islamic economics.”<sup>342</sup>*

“The Shariah Advisory Committee (SAC) of SBP (SBP) is an apex body that provides Shariah opinion and advice on *Shari'ah* related matters. The *Shari'ah* Advisory Committee consists of *Shari'ah* scholar members drawn from among Islamic scholars and Technical members, including accountant, lawyer, a senior official from SBP, and a specialist from other fields, i.e., Economics or Banking & Finance with good knowledge

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<sup>341</sup> Wardhani and Arshad, ‘The Role of Shariah Board in Islamic Banks: A Case Study of Malaysia, Indonesia and Brunei Darussalam’.

<sup>342</sup> PLD 2000 SC 225

Supreme Court of Pakistan, ‘Civil Shariat Review Petition No. 1 of 2000’, 2001, [www.supremecourt.gov.pk/web/user\\_files/File/JR\\_Detailed\\_Judgment\\_in\\_Riba\\_Case.pdf](http://www.supremecourt.gov.pk/web/user_files/File/JR_Detailed_Judgment_in_Riba_Case.pdf).

of Islamic finance and practices.” The SBP constituted its first *Shari’ah* Advisory Committee in 2004 consisting of followings<sup>343</sup>:

1. <b>Prof. Dr. Mahmood Ahmad Ghazi</b>	Chairman
2. <b>Dr. Imran Usmani</b>	<i>Shari’ah</i> Scholar
3. <b>Mr. Ebrahim Sidat</b>	Accountant
4. <b>Syed Riaz-ul-Hasan Gilani</b>	Lawyer
5. <b>Mr. Pervez Said</b>	Ex-officio Member/Secretary

In order to increase the harmonization and convergence in the financial transactions of the IFIs, the AAOIFI has also issued it’s a standard as Governance Standard No. 8 Central *Shari’ah* Boards.<sup>344</sup> The main objective of this standard is to iron out the situations of contradiction and differences between the Fatwas, rulings, decisions, and applications by such entity-level boards, allowing consistency in products and services offered by IFIs and the promotion of standardized practices.<sup>345</sup> The standard defines Central *SAB* as follow;

*“Central Shari’ah board – a broad-level board or similar body of specialized jurists in *Fiqh al-Mu’amalāt* (Islamic commercial jurisprudence) and experts in Islamic banking, finance, law, and accounting, etc. providing guidance and*

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<sup>343</sup> State Bank of Pakistan, ‘Shariah Advisory Committee’, accessed on 15<sup>th</sup> January 2019, <http://www.sbp.org.pk/IB/shariah.asp>

<sup>344</sup> Accounting and Auditing Organization for IFIs, ‘Governance Standard No. 8 Central *Shari’ah* Boards’, accessed on 2<sup>nd</sup> March 2019, <http://aaoifi.com/announcement/aaoifi-introduces-its-100th-standard-as-governance-standard-no-8-central-shariah-board-has-been-officially-issued/?lang=en>

<sup>345</sup> AAOIFI, ‘Central Shari’ah Board’.

*advice on Shari'ah matters, with limited supervision, that is established in a specific country or jurisdiction for providing uniformity and harmony in the products and practices concerning Islamic finance through Fatawa, rulings, and principles applicable on a broad base rather than a single institution. It has two basic types i.e., a national Shari'ah board and regulatory Shari'ah board.*<sup>346</sup>

The standard has also discussed the appointment of Central *Shari'ah* Board, qualification of its members, remuneration, expert members as well as their functioning. Keeping in view, this standard, which can be called as National *SAB*, is a supreme council of the *Shari'ah* scholars, which must also consist of members across the globe having exposure in the Islamic Banking industry.<sup>347</sup>

In Pakistan, the *Shari'ah* Advisory Committee also has the same objective as of Central *Shari'ah* board defined by the AAOIFI in its 8<sup>th</sup> Governance standard. However, the committee, unfortunately, could not serve the purpose of standardization of fatawa and uniformity of products and services. Even though the State Bank has implemented some AAOIFI *Shari'ah* standards but ideally Central *Shari'ah* board should have a leading role for the development of products and services, and the *Shari'ah* boards of the respective banks must comply the instructions of the central *Shari'ah* board. Besides, the Central *Shari'ah* board should also serve in conflict resolution, if any.

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<sup>346</sup> AAOIFI.

<sup>347</sup> AAOIFI.

## **CHAPTER 7:**

### **CONCLUSION & RECOMMENDATIONS**

*SG* is an essential part of the Islamic financial system. In the absence of proper *SG* system, the Islamic financial system will face *Shari'ah* non-compliance risk. The main difference of Islamic banking with conventional banking is the compliance of the Banking Transaction with *Shari'ah* rules and principles.

Keeping in view the importance of the *Shari'ah* compliance environment, the BNM and SBP have issued and implemented several regulations regarding *Shari'ah* Compliance in IFIs. On the other hand, the IFSB (IFSB) and Accounting, Auditing Organization for IFI (AAOIFI) have also issued standards on *SG* in IFIs.

In order to ensure that IFIs comply with the *Shari'ah* rules, banks are required to appoint a *SSB* (*SSB*) and *Shari'ah* Advisor/Resident *Shari'ah* Advisor. The *SSB* consists of *Shari'ah* (Islamic Law) scholars who are qualified from a Religious board. They ensure *Shari'ah* Compliance by supervision of new product, issuing guideline fatawas, and conduct internal *Shari'ah* audit.

In this study, the *SGF* issued by the BNM, SBP, AAOIFI, and IFSB has been compared and analyzed, in order to explore, whether the existing *SGF* provided in these countries is comprehensive and efficient enough to fulfill the requirements or it needs further enhancement. The study has suggested some improvements to formulate a comprehensive and sound *SGF* based on the empirical analysis through a questionnaire.

The study has examined the perception and viewpoint of different respondents, i.e., *Shari'ah* scholars, *SSB* members of IBs, *Shari'ah* audit members of IBs, scholars, and

students of Islamic banking and finance, general public and depositors of IBs and auditors of reputable firms. In order to examine perception, a detailed questionnaire was developed and conducted through online and other means. The details of the responses gathered through the survey are empirically analyzed to extract results.

Multinomial logistic regression analysis was used for empirical analysis of the data gathered through a questionnaire. Multinomial logistic regression analysis is a parametric approach that best suits the data gathered through a questionnaire for this research study. The results of the survey are categorized into three categories. The first category descriptively analyzed demographic details of the respondents in order to mention the importance and significance of the respondents. The second and third categories of results were concerned with the empirical examination of the data through multinomial logistic regression. Data gathered through the questionnaire was analyzed through multinomial logistic regression, and results are interpreted based on the coefficient of multinomial logistic regression and relative risk ratios.

The empirical result analyzed through multinomial logistic regression in the context of the coefficient of multinomial logistic regression state that the independent variables of the questionnaire strongly favor high-level performance and excellence of *SG* (dependent variable). These results and interpretations are mentioned in the context of the above group, which is the medium-level performance of *SG*. The results in the context of relative risk ratio elaborate about the level of association among dependent and independent variables and state that a high level of performance of *SG* is highly associated with the independent variable with the referent group. It means that the performance of independent variables is highly influenced and favorable in the high performance of *SG*.

*SG* is being practiced and implemented in almost all Islamic banking and financial institutions. However, their practices, rules, and regulations differ from country to country, i.e., Islamic banks (IBs) working in Pakistan irrespective of their origin are required to follow the *SGF* issued by the SBP. Similarly, IBs operating in Malaysia follow *SG* guidelines of the BNM. After comparing *SG* guidelines of the SBP, BNM, AAOIFI, and IFSB, it has been observed that the *SGF* issued by the SBP is more comprehensive as compared to the others. The *SGF* of SBP has described the roles and responsibilities of all the stakeholders, i.e., BOD, SM, SBM (s) and *Shari'ah* audit. However, still, there are some essential concerns of the *SGF* which need improvement for robust *SG* environment.

The *Shari'ah* board is the backbone of the *Shari'ah* compliance and governance system. The current educational system of deeni madaris does not fulfill the requirement of the position, as discussed in chapter four. Some specialized institutions must be established, or the existing institutions, i.e., the Center of Excellence's should be given the mandate to produce *Shari'ah* Advisors for the Islamic finance industry.

These institutions may introduce some degree programs, or like civil services, judicial services, and armed services every intake needs to pass a long course, this methodology may also be used in this regard.

The current Selection process of *Shari'ah* board members is also objectionable, this process should be changed, and a panel of the *Shari'ah* scholars should be created at the State Bank level. The *Shari'ah* scholars may apply for membership. However, the panel should have two levels, i.e., senior-level and journal level.

The senior members who have more than ten years of experience in related fields are not required to appear for the test or other processes; however, they may be asked to appear for an interview. After selection, they should be issued a membership card. While at junior-level, they need to apply for the membership, and their selection should be through a comprehensive selection process, i.e., shortlisting, test, group discussion, etc. and then the successful candidates may be called for interview. A candidate selected after the interview should be issued a membership card of the junior council.

It should be mandatory for all IBIs to appoint *Shari'ah* board members from this panel comprising two from the senior council and two from the junior council. The IBI should send remuneration to the panel, and the panel will distribute salaries of the *Shari'ah* scholars.

- i. Some orientation programs must be arranged for the BoDs, Senior Management, *Shari'ah* Board Members, and *Shari'ah* Auditors for capacity building.
- ii. The Criteria of appointment of *Shari'ah* board members should be reconsidered and revised.
- iii. The procedure of appointment of *Shari'ah* board members also needs some improvement; a panel of *Shari'ah* scholars may be created at the State Bank level. All the commercial banks should appoint their *Shari'ah* board members from this panel.
- iv. The SBP should pay the honorarium of the *Shari'ah* Board members by collecting it from respective IBs.
- v. *Shari'ah* Audit

vi. *Legal Practitioner Act should be followed for the appointment of Shari'ah Advisor.*

The SBP Should revise the qualification criteria for the appointment of external *Shari'ah* Auditor. The *SGF* issued by SBP in 2018 has described the qualification of an external *Shari'ah* auditor similar to the SSBM, which seems not appropriate. A *Shari'ah* scholar qualifying according to FAPC has knowledge of *Shari'ah* instead of Accounting and auditing. On the other side, the Auditor does not know about Islamic banking transactions. To fill this gape, the State Bank should revise these qualification criteria in consultation with reputed accountancy organizations.

EM of an IBI plays a significant role in the overall *Shari'ah* compliance environment of an IBI. It is imperative that EM must have experience in the field of Islamic Banking. It should be highly discouraged that a person who has no Islamic banking experience is appointed as Chief executive officer of the Islamic banking devision. The *SGF* should describe some basic guidelines in this regard.

The Central *Shari'ah* Board should actively perform its functions for the enhancement of the *SG* environment by regularization of uniform products and services. Currently, the role of central *Shari'ah* board at State banks level seems inative and symbolic. The State bank may adopt governance standard AAOIFI on central *Shari'ah* advisory in this regard.

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## **ANNEXURES**

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### 6.7.1. Annexure: I - Survey Questionnaire

## “*Shari’ah* Governance in Contemporary Islamic Banking Institutions”

### Part I: DEMOGRAPHIC DATA

Please tick [✓] or answer correspondingly on the items below as appropriate.

Name: \_\_\_\_\_  
Position: \_\_\_\_\_  
Organization: \_\_\_\_\_  
Contact No: \_\_\_\_\_

1. What is your designation?

<input type="checkbox"/> <i>Shari’ah</i> Advisor/Committee member	<input type="checkbox"/> External Auditor	<input type="checkbox"/> Central Bank Auditor/Inspector
<input type="checkbox"/> Internal Auditor	<input type="checkbox"/> Manager/Officer of <i>Shari’ah</i> Compliance Section of bank	<input type="checkbox"/> Ulama of Religious Institutions علماء المساجد
<input type="checkbox"/> Islamic Banking Scholar	<input type="checkbox"/> Bank’s Client	

2. What type of organization are you working with?

<input type="checkbox"/> Full-fledged local Islamic financial institution	<input type="checkbox"/> Islamic banking branch of local conventional bank	<input type="checkbox"/> Islamic window in local conventional bank
<input type="checkbox"/> Full-fledged foreign Islamic financial institution	<input type="checkbox"/> Islamic window in foreign financial institution	<input type="checkbox"/> Central Bank
<input type="checkbox"/> Religious Institution جامعة / دار علوم	<input type="checkbox"/> University/Research Institute	<input type="checkbox"/> Business Man
<input type="checkbox"/> Government/Private Employee	<input type="checkbox"/>	<input type="checkbox"/>

3. Do you have any accounting/auditing qualification?

Yes  No

If yes, please state: \_\_\_\_\_

4. Do you have any *Shari’ah* certification?  Yes  No

If yes, please state the level: \_\_\_\_\_

5. From your observation or experience or opinion, what is the current structure of auditing in Islamic Financial Institution you are involved with?

It is the same as the conventional auditing framework

It relies heavily on conventional auditing framework with few adjustments

Have its own brand-new framework of auditing in the Islamic perspective

Not aware of what framework they use


## Part II: *Shari'ah* Governance

Please tick [✓] the level to which you agree or disagree with the following statements.

	Strongly disagree	Disagree	Somewhat agree	Agree	Strongly agree
<i>Shari'ah</i> Governance is distinct feature of Islamic Financial Institutions					
<i>Shari'ah</i> Governance has to ensure that products of Islamic financial institution are <i>Shari'ah</i> compliant in letter and spirit.					
<i>Shari'ah</i> governance is directly proportionate to the profitability of IFI					
Without <i>Shari'ah</i> governance, the entire paradigm of Islamic Financial Institution becomes doubtful.					
Shariah compliance of Islamic financial products can't be fully ensured without strong <i>Shari'ah</i> Governance.					
<i>Shari'ah</i> governance is a crucial part of Corporate governance in Islamic Financial Institutions					
An effective <i>Shari'ah</i> Governance framework is only possible through joint efforts of <i>Shari'ah</i> Board, Board of Directors, Executive Management and <i>Shari'ah</i> Audit.					

## Part III: Board of Directors (BOD)

Please tick [✓] the level to which you agree or disagree with the following statements.

	Strongly disagree	Disagree	Somewhat agree	Agree	Strongly agree
Board of Directors are representative of the Shareholders and Investment Account holders, they are liable to all stakeholders they represent.					
Board of Directors are responsible for ensuring effective <i>Shari'ah</i> Governance in Islamic Financial Institutions					
Board of Directors should be fully aware about the <i>Shari'ah</i> noncompliance risk in IFI					
There should be any joint meetings of the BoD and the Shariah Board of an IFI					
To ensure the independence of <i>Shari'ah</i> Board it is important that salary and perks of the <i>Shari'ah</i> Board members are managed by any third party.					
To implement <i>Shari'ah</i> compliance in IFI, it is important that the Board of Directors must have knowledge about Islamic Banking & Finance. Therefore some training programs and orientation course must be arrange for BOD's					

## Part IV: Executive Management (EM)

Please tick [✓] the level to which you agree or disagree with the following statements.

	Strongly disagree	Disagree	Somewhat agree	Agree	Strongly agree
Executive Management is responsible for implementation of Shariah Governance Framework.					
The idea of zero tolerance policy on <i>Shari'ah</i> non-compliance is impractical.					
Executive Management should ensure that all financial products along with procedure manuals, related agreements, fatwas, and contracts etc are duly approved by the <i>Shari'ah</i> Board.					
Executive Management should arrange adequate training to their employees.					
To have any <i>Shari'ah</i> guideline from <i>Shari'ah</i> Board, the management should provide all the relevant information, and should not conceal anything they might know.					
The executive management must be fully equipped with					

<i>Shari'ah</i> knowledge related to Islamic Finance, therefore orientation programs must be arranged on regular basis for the executive management.					
EM must take appropriate action against employees who have failed to ensure compliance with the <i>Shari'ah</i> rules and principles.					

### Part V: *Shari'ah* Board

Please tick [√] the level to which you agree or disagree with the following statements.

	Strongly disagree	Disagree	Somewhat agree	Agree	Strongly agree
Every IFI shall have a <i>Shari'ah</i> Board comprising at least three <i>Shari'ah</i> scholars having related knowledge.					
<i>Shari'ah</i> Board members must have banking and finance knowledge / NIBAF certification of certain level.					
The <i>Shari'ah</i> Board must also have technical members having expertise in economics, Law and finance etc.					
To ensure the independence of <i>Shari'ah</i> Board, they must be appointed and terminated by the Board of Directors after prior approval by the SBP.					
Decisions in the Shariah Board meetings may be made on 'majority' principle.					
The <i>Shari'ah</i> scholars, individually, should have veto power in decision making at <i>Shari'ah</i> Board.					
The decisions, fatwas' of the <i>Shari'ah</i> Board must be binding on the IFI.					
There must be continued professional development (CPD) activities for <i>Shari'ah</i> Board Members.,					

### Part VI: Resident *Shari'ah* Board Member (RSBM)

Please tick [√] the level to which you agree or disagree with the following statements.

	Strongly disagree	Disagree	Somewhat agree	Agree	Strongly agree
To ensure <i>Shari'ah</i> compliance in day to day operations, the IFI must appoint a Resident <i>Shari'ah</i> Board Member (RSBM).					
The RSBM should on full time basis, he should not serve any other IFI, bank or non-bank as RSBM or <i>Shari'ah</i> Board Member.					
The RSBM should be expert in <i>Fiqh ul Muamlat</i> and contemporary financial transactions.					

### Part VII: Independence of *Shari'ah* Board/Resident *Shari'ah* Board Member (RSBM)

Please tick [√] the level to which you agree or disagree with the following statements.

	Strongly disagree	Disagree	Somewhat agree	Agree	Strongly agree
<i>Shari'ah</i> Board Members must not be shareholder, Ex-employee of the IFI nor should any close relative of the <i>Shari'ah</i> board members be the executive employee of the Islamic Financial Institution.					
The <i>Shari'ah</i> Board must report to the Board of Directors.					
There is need to be maintained a panel of certified <i>Shari'ah</i> Board members' at SBP level, from where RSBM or <i>Shari'ah</i> scholar members may be appointed.					
Remuneration of RSBM and <i>Shari'ah</i> Board Members should be issued by the State Bank of Pakistan by collecting from the respective Bank.					

**Part VIII: *Shari'ah Review/*  
Internal *Shari'ah Audit/External Shari'ah Audit***

Please tick [✓] the level to which you agree or disagree with the following statements.

	Strongly disagree	Disagree	Somewhat agree	Agree	Strongly agree
Shari'ah Board along with BoD must certify that an effective internal Shari'ah compliance control mechanism is in place in IFI and is being properly reviewed.					
A statement in the report, as required above that 'all operations of the bank are by and large Shariah Compliant' implies that there might be some products / operations could be doubtful.					
A broader scope of Shari'ah audit is necessary to safeguard the IFI's social acceptance by society					
The audit for <i>Shari'ah compliance</i> is more important than the financial statement audits in the IFIs because non-compliance would lead to haram income.					
The scope of <i>Shari'ah audit</i> is not limited to compliance with rules / procedures only.					
The <i>Shari'ah auditor</i> can only be a qualified accountant with some certification of Islamic finance knowledge and training.					
There must be some regular training sessions about Islamic Banking and Finance <i>Shari'ah</i> Auditors.					

If you have any other comments to add, apart from the above, please state in the space provided below:

3. Please state if you are willing to be interviewed for further clarification on certain issues in relation to the objective of the research.

Yes       No

4. If yes, please fill in your contact details or attach your business card in the space below:

**THANK YOU FOR YOUR COOPERATION**

## 6.7.2. Annexure: II - Subjects of Islamic Law and Islamic Jurisprudence

### *Shahadat Ul Alamiyyah*

Degree	Year	Wifaq ul Madaris Arabia	Wifaq ul Madaris Salafiyah	Rabita tul Madaris	Tanzeem ul Madaris	Wifaq ul Madaris Shia
Shahadatul Almiyyah	2 <sup>nd</sup> Year	There are no Fiqh/Usool al Fiqh Subjects in this class.	* Bidayatal-Mujtahid 4 Chapters Ijarah, Musharkah, Qiraz, * Al Wajiz fi usool al fiqh	There are no Fiqh/Usool al Fiqh Subjects in this class.	There are no Fiqh/Usool al Fiqh Subjects in this class.	* Fiqh Istidlali Vol. IV * Usool al fiqh lil Muzaffar Vol. II (Second half)
	1 <sup>st</sup> Year	* Hidayah Vol. III and IV	* Bidayatal-Mujtahid (Marriage and Divorce) * Al Wajiz fi usool al fiqh (from preamble to Ijma)	Hidayah Vol. IV ( <i>Kitab al Shuf'a</i> )	* Hidayah Vol. IV (Part 4) * Al Tozeeh (Preamble)	* Fiqh Istidlali Vol. III * Usool al fiqh lil Muzaffar Vol. II (first half)
Shahadatul Alla (B.A)	2 <sup>nd</sup> Year	Hidayah Vol. II Al Tozeeh (Preamble)	* Hidayah Vol. I (one fourth) * Usool al Shashi (till haroof al Maani)	* Hidayah Vol. III <i>Kitab al Bayu</i> * Al Tozeeh	* Hidayah Vol. III (Part 4) i.e. Adab al Qazi and Bayu. * Noor al Anwar	* Fiqh Istidlali Vol. II * Usool al fiqh lil Muzaffar Vol. II
	1 <sup>st</sup> Year	Hidayah Vol. I Husami (from preamble to Qiyas)	* Fiqh al Sunnah ( <i>Kitab al Nikah</i> ) * Usool al Shashi (till haroof al Maani)	* Hidayah Vol. I (Al-taharah – Al Nikah) & Hidayah Vol. II (Al-Nikah – Al-waqaf) * Husami	* Hidayah Vol. I * Husami (from preamble to Qiyas)	* Fiqh Istidlali Vol. I * Usool al fiqh lil Muzaffar Vol. I
Shahadatul Sanvia Khassa (F.A)	2 <sup>nd</sup> Year	Sharh Wiqayat last two volumes Noor al Anwar (from preamble to Qiyas)	* Fiqh al Sunnah (Prayer) * Usool al fiqh	* Sharh Wiqayat * Noor al Anwar	* Hidayah Vol. I * Noor al Anwar (Quran, Sunnah & Ijma)	* Fiqh Shra'e al Islam (al Ibadat) * Al Mojiz fi al Usool
	1 <sup>st</sup> Year	Kanz al-Daqa'iq (Except Inheritance) Usool al Shashi	* Fiqh al Sunnah ( <i>Taharah</i> )	* Kanz al-Daqa'iq * Usool al Shashi	* Qadri * Usool al Shashi	* Tozeeh al Masail (till kitab al ariya)
Shahadatul Sanvia Auma (Matriculation)	2 <sup>nd</sup> Year	Qadri	There are no Fiqh/Usool al Fiqh Subjects in this class.	* Qadri	Qanoon e Shariat (Prayer)	* Tozeeh al Masail (till kitab al Nikah)
	1 <sup>st</sup> Year	There are no Fiqh/Usool al Fiqh Subjects in this class.	There are no Fiqh/Usool al Fiqh Subjects in this class.	* Noor al Idah	There are no Fiqh/Usool al Fiqh Subjects in this class.	* Tozeeh al Masail (till kitab al salat)

**6.7.3. Annexure: III - Subjects of Islamic Law and Islamic Jurisprudence in  
Takhaṣuṣ fil Iftā'**

Year	Darul Uloom Karachi	Jamia Usmania Peshawar	Markaz Al Tarbiah	Jamia Tashim ul Quran Mardan	Markaz Taleem o Tahqiq Islamabad	Tanzeem al Madaris Ahl E Sunnat
1 <sup>st</sup> Year	<ul style="list-style-type: none"> <li>• Muqaddama al Durr al Mukhtar</li> <li>• <i>Uṣūl al Karkh</i></li> <li>• Provident Fund</li> <li>• Insurance and Takaful</li> </ul>	<ul style="list-style-type: none"> <li>• Usool al Fiqh (Hukam al shari, legal capacity)</li> <li>• Objectives of <i>Shari'ah</i></li> </ul>	<ul style="list-style-type: none"> <li>• Subul al salam</li> <li>• Al-Waraqat</li> </ul>	<ul style="list-style-type: none"> <li>• Al wajeez fi usool al fiqh</li> <li>• Al-Ashbah wa al-Naza'ir</li> </ul>	<ul style="list-style-type: none"> <li>• Usool al fiqh</li> <li>• Comparative study of fiqh</li> <li>• Objectives of <i>Shari'ah</i></li> </ul>	<ul style="list-style-type: none"> <li>• Al-Ashbah wa al-Naza'ir</li> <li>• al Durr al Mukhtar, (Al Nikah to Taaliq)</li> <li>• Fiqh al Muamlat<sup>1</sup>(Kitab al bayu to Al saraf)</li> </ul>
2 <sup>nd</sup> Year	<ul style="list-style-type: none"> <li>• Al-Ashbah wa al-Naza'ir</li> <li>• Al Durr al Mukhtar</li> <li>• Jawahar al Fiqh</li> <li>• Imdad al Ahkam</li> </ul>	<ul style="list-style-type: none"> <li>• Legal maxims</li> <li>• Islamic Banking</li> <li>• <i>Shari'ah</i> Standards</li> <li>• Comparative study of fiqh</li> </ul>	<i>Not Applicable</i>	<ul style="list-style-type: none"> <li>• Al-Ashbah wa al-Naza'ir</li> <li>• al Durr al Mukhtar</li> <li>• Legal maxims</li> </ul>	<ul style="list-style-type: none"> <li>• Extension lectures on, Islamic banking, takaful, 50 fatawa relating to financial matters.</li> </ul>	<ul style="list-style-type: none"> <li>• al Durr al Mukhtar, and Radd al Mukhtar</li> <li>• Bada'i al-sana'i Sanai (was ayah)</li> <li>• Al Durr al Mukhtar, (Kitab al waqaf to al Nazar wal Lams).</li> </ul>
3 <sup>rd</sup> Year	<ul style="list-style-type: none"> <li>• <i>Shari'ah</i> Standards</li> <li>• Constitution of Pakistan</li> <li>• Practice of 250 fatawa</li> </ul>	<i>Not Applicable</i>		<i>Not applicable</i>	<i>Not applicable</i>	<i>Not applicable</i>

#### 6.7.4. Annexure: IV - Revised Syllabus MS/LLM Islamic Commercial Law

Revised scheme of studies for  
**MS / LL.M. Islamic Commercial Law (ICL)**

##### 1<sup>st</sup> Semester

S #	Course Code	Title	CH
1.	MSL-401	Islamic Law of Commercial Transactions-1	03
2.	MSL-402	Property and Ownership in Islamic Law	03
3.	MSL-403	Law of Banking	03
4.	MSL-404	Research methodology	03
Total Credit Hours			12

##### 2<sup>nd</sup> Semester

S #	Course code	Title	CH
1.	MSL-405	Islamic Law of Commercial Transactions 2	03
2.	MSL-406	Shariah Maxims on Commercial Transactions	03
3.	MSL-407	International Trade and Finance	03
4.	MSL-408	Islamic Law of Banking and Insurance: Theory and Practice	03
Total Credit Hours			12

##### Research Work

S #	Course code	Title	CH
1.	MSL-415	Thesis	06

**6.7.5. Annexure: V - Revised Syllabus MS/LLM *Shari'ah***

**INTERNATIONAL ISLAMIC UNIVERSITY, ISLAMABAD  
FACULTY OF SHARIAH & LAW**

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**Scheme of Studies for  
MS/LL.M. Shariah (Islamic Law & Jurisprudence)**

S #	Subject	Description
1.	Name of Program for holders of M.A Islamic Studies/ other equivalent degree	MS Shariah (Islamic Law & Jurisprudence)
2.	Name of Program for Law Graduates	LL.M. Shariah (Islamic Law & Jurisprudence)
3.	Aims & Objectives	<ol style="list-style-type: none"> <li>1. Prepare scholars who have a grasp of Shariah / Islamic studies in general and a command over the area of specialization in particular.</li> <li>2. Establish a cadre of specialists and professionals in different fields of Shariah who can provide effective leadership in guiding in conducting quality research in various disciplines of Islamic law.</li> <li>3. The program is especially designed to provide opportunities of professional growth in development in the field of Shariah to the holders of relevant Islamic studies degrees from other Pakistani universities and <i>Madaris</i>.</li> <li>4. Enhance the capacity to understand comparative study of Shariah, different Islamic schools of law and western legal thought.</li> </ol>
5.	Duration	<ul style="list-style-type: none"> <li>• Course work 24 CH 2 Semesters</li> <li>• Research work 2 Semesters</li> </ul> <p>Program has to be completed within two to four years or as per HEC / IIU Rules.</p>
6.	Eligibility for Admission for MS Shariah (Islamic Law & Jurisprudence)	<ul style="list-style-type: none"> <li>• MA Islamic Studies (16 years education) or equivalent BS Islamic studies / BS Shariah (4 years program / BA (honors) Usul-ud-Din (4 years) with first division or CGPA 2.5/4. or as fixed by IIU from time to time.</li> <li>• Determination of eligibility as per approved criteria</li> <li>• GRE General Type Entry Test.</li> <li>• Interview</li> </ul>

7.	Eligibility for admission in LL.M. Shariah (Islamic Law & Jurisprudence)	LLB Shariah & Law with CGPA 2.5/4 / LLB (honors) with CGPA 2.5/4 / LLB with 50% marks or as fixed by IIU from time to time.
8.	Extra Courses & Languages Proficiency	The candidates coming from other institutions having deficiency in Arabic or English language will have to study the language courses in preparatory courses as per IIU policy.
9.	Research Work	Thesis equal to six credit hours to be completed in two semesters (extension will be allowed as per IIU rules)

#### Course Work for MS / LLM Shariah (Islamic Law & Jurisprudence)

S #	Subject	Courses	Credit Hours
1.	Total No. of courses included in course work	8 Courses	24 credit hours
2.	No. of courses in each semester	4 courses	12 credit hours
3.	Credit hours of each course	3 credit hours	
4.	No. of core courses	6 courses	18 credit hours
5.	No. of optional courses	2 courses (to be selected from list of optional courses by the dept.)	6 credit hours
6.	Total credit hours for Course Work		24 credit hours
7.	Total credit hours for Research Work (Thesis)		6 credit hours
8.	Total credit hours for Degree		30 credit hours
9.	Core course	6 courses (4 core courses will be offered in first semester, 2 core courses and 2 optional courses will be offered in 2 <sup>nd</sup> semester)	

#### Ω 1<sup>st</sup> Semester

S #	Course Code	Name of Course in English	Name of Course in Arabic
1.	MS-401	Research Methodology in Shariah	مناهج البحث في الشريعة
2.	MS-402	Islamic Jurisprudence	أصول الفقه
3.	MS-403	Family Laws in Contemporary Muslim World (Egypt, Morocco, Iran, Turkey)	قوانين الأسرة في العالم الإسلامي (مصر، المغرب، فلسطين، تركيا)
4.	MS-404	Constitutional Law & Administrative Law	القانون الدستوري والسياسة الشرعية

## 6.7.6. Annexure: VI - Institutions of Collective *Ijtihād* in Modern Days

### **AL-MAMLAKAT AL-ARAYBIYYAH AL-SA'UDIYAH**

- The Council of Senior Scholars of Saudi Arabia (Hay'at Kibar al-Ulama fi al-Mamlakat al-Araybiyyah al-Sa'udiyah).
- The Permanent Committee for Scientific Researches and Ifta (Al-Lujnah al-Da'imah lil-Bahuth al-Ilmiyyah wa al-Ifta).
- The General Commission for the Administration of Scientific Researches, Ifta and Missionary Works and Preaching (Al-R'iasat al-Aammah li Idarat al-Bahuth wa al-Ifta wa al-Dawah wa al-Irshad).
- International Islamic Fiqh Academy, Jeddah (Majma al-Fiqh al-Islami al-Dauli).
- The Islamic Fiqh Academy, Makkah Mukarramah (Majma al-Fiqh al-Islami).

### **EGYPT:**

- The Academy for Islamic Researches (Majma al-Bahuth al-Fiqhiyyah).
- The High Council for Islamic Affairs (al-Majlis al-A'la lil-Shaun al-Islamia).

### **KUWAIT:**

- The General Administration for Ifta (Kuwait).
- The Islamic Organization for Medical Researches (Al-Munazamah al-Islamia lil-Uloom al-Tibbiah).
- The Islamic Council for Fatwa and Shariah Supervisory in the Kuwaiti House of Finance (Hai'ah al-Fatwa wa al-Riqabah al-Shariah fi Bait al-Tamwil al-Kuwaiti).
- The International Shariah Council for Affairs Related to Zakat under the House of Zakat in Kuwait (al-Hai'ah al-Shariah al-Ilmiyyah lil-Zakat al-Tabi'at li Bait al-Zakat fi Daulat al-Kuwait).

### **SUDAN:**

- The Board for Ifta al-Shariah in Sudan (Majlis al-Ifta al-Shari'i fi al-Sudan).
- The Supreme Council of the Shariah Supervisory Board for Banking and Financial Institutions in Sudan (al-Hai'ah al-Ulya al-Shariah li al-Jihaz al-Masrafi wa al-Mu'assasah al-Malia fi Sudan).

### **JORDAN:**

- The National Academy for Research of Islamic Culture (Al-Majma al-Mulki li Bahuth al-Hadharat al-Islamiah).

### **MOROCCO:**

- The Academy of Ahl al-Bait (Majma Ahl al-Bait).

### **PAKISTAN:**

- The Council of Islamic Ideology (Islami Nazariati Council);
- Federal Shari'ah Court (Wifaqi Shar'i Adalat).

### **INDIA:**

- Islamic Fiqh Academy, India.
- Institution for legal discussions (Idarah Mubahith al-Fiqhiyyah).
- The Council for Shariah Researches (Majlis Tahqiqat-e-Shariah).
- The Fiqh Council (Majlis-e-Fiqhi)

### **EUROPE:**

- European Council for Fatwa and Research, Ireland (Al-Majlis al-Aurubi lil Ifta wa al-Bahuth).

### **UNITED KINGDOM:**

- Council for Shariah Researches (Majlis Tahqiqat-e-Shariah).

### **NORTH AMERICA:**

- Shar'i ah Scholars Association of North America (Majma Fuqaha al-Shariah).
- The Fiqh Council (Majlis-e-Fiqhi)

**6.7.7. Annexure: VII - Resolution of International Islamic Fiqh Academy on Role of *Shari'ah* supervision in controlling Islamic banking business;**

*In the Name of Allah the Most Gracious, the Most Merciful*

*All praise is to Allah, the Lord of all the worlds; and peace and blessings are to our Master Muhammad and His family and all His companions.*

**Resolution No. 177 (3/19)**

**On**

**Role of *Shari'ah* Supervision in Controlling Islamic Banking Business:  
Significance, Conditions and Modus Operandi**

The council of the International Islamic Fiqh Academy (IIFA) of the Organization of Islamic Cooperation (OIC), in its 19<sup>th</sup> Session held in Sharjah (U. A. E) during the period 1– 5 Jumada I, 1430H (April 26 – 30, 2009),

Having reviewed the research papers submitted to IIFA on "Role of *Shari'ah* Supervision in Controlling Islamic Banking Business: Significance, Conditions and Modus Operandi", and listened to discussions on the subject,

Resolved the following:

**Firstly:** *Shari'ah* supervision refers to the process of issuing *Shari'ah* opinions (*fatwas*) and rulings pertaining to the activity of the institution; monitoring their implementation; and ensuring their proper application.

**Secondly:** *Shari'ah* supervision has three main components:

**(1) *Shari'ah* Supervisory Board**

It is a group of three scholars or more, who are specialized in Islamic jurisprudence (jurisprudence of financial transactions in particular), and are scholarly competent and well aware of practicing realities. This group assumes the tasks of issuing *fatwa*; reviewing actual performance of the institution to ensure its compliance in all its dealings with the rules and principles of *Shari'ah*; and submitting a report to the general assembly. The decisions of the *Shari'ah* supervisory board are binding to the institution.

1/1 A *Shari'ah* supervisory board should be independent, and therefore the following has to be observed:

- (a) Appointment and termination of members of *Shari'ah* supervisor board as well as specification of the amounts of honoraria payable to them is the responsibility of the general assembly of the institution. Final endorsement of decisions in this regard should be sought from central *Shari'ah* supervisory body or any other competent authority.
- (b) A member of *Shari'ah* supervisory board should not be an executive director or hold any other staff position in the institution. He should also have no other type of work relationship with the institution, other than membership of *Shari'ah* supervisory board.
- (c) A member of *Shari'ah* supervisory board should not be a shareholder in the concerned institution.

1/2 Controls on *Ijtihad* (Interpretative Judgement) and *Shari'ah* Opinion (*Fatwa*) by *Shari'ah* Board:

- (a) Abidance by IIFA resolutions, with due consideration to resolutions of other bodies that assume the duty of collective *Ijtihad* (Interpretative Judgement), as far as resolutions of such bodies do not contradict with those of IIFA.
- (b) Avoidance of anomalous viewpoints, running after permits and prohibited devising, as indicated in IIFA Resolution No. 70 (1/8).
- (c) Observance of objectives of *Shari'ah* and final consequences of acts when formulating *Shari'ah* rulings.
- (d) Observance of what has been stated about *fatwa* in IIFA Resolution No. 135 (2/17).

**(2) Internal *Shari'ah* Control Department**

The department that apply necessary procedures to ensure proper implementation of decisions of *Shari'ah* board in all transactions performed by the institution. Such procedures include the following:

- (a) Review of manuals and procedures to ensure performance of operations according to *Shari'ah* rulings issued by *Shari'ah* supervisory board.
- (b) Qualifying staff of the institution to the extent that enables them to do their jobs properly from a *Shari'ah* and professional points of view.
- (c) Constitution of a team for internal *Shari'ah* audit. The team should have sufficient academic and practical competence, enjoy autonomy and report directly to a high-level authority within the organizational structure of the institution such as the audit committee or board of directors. Appointment and termination of team members should take place in coordination with the *Shari'ah* supervisory board of the institution.

**(3) Central *Shari'ah* Control**

A *Shari'ah* supervisory board at the level of state supervisory bodies. It has two main tasks including:

- (a) Supervising activities of the supervisory authority that report to it.
- (b) Ensuring effectiveness of *Shari'ah* supervision at the institutional level. This task involves auditing of the work of *Shari'ah* supervisory boards and internal control departments and setting of regulations and standards that govern *Shari'ah* control activities in the institutions including appointment, termination, competence, number and mandate of *Shari'ah* supervisory boards.

And recommends the following:

- (a) Supervisory authorities in each country should assume the duty of issuing regulations and rules to organize *Shari'ah* control activities and undertake necessary procedures to ensure independency of the *Shari'ah* supervision function.
- (b) IIFA Council recommends to Islamic rating agencies refraining from rating products that are prohibited by IIFA resolutions.

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