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An Analytical Commentary on Shariah Governance in Islamic Financial Institutions Across Multiple Countries.

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ABSTRACT

This commentary provides a comprehensive overview of Shariah governance in Islamic financial institutions (IFIs). This piece draws on a literature review of various relevant studies and their key findings and observations. It emphasises the importance of implementing a robust Shariah governance framework in IFIs and argues that the current Shariah governance frameworks are complicated, resulting in each country adopting a different approach. The commentary highlights that the existence of different Shariah governance approaches can lead to inconsistencies in Shariah rulings, potentially undermining the credibility of IFIs and eroding consumer confidence.

Additionally, the study reveals that certain IFIs have failed due to a deficient Shariah governance system. However, the commentary argues that the collapse of an institution does not necessarily indicate a weak Shariah governance framework. The framework itself remains robust, but the problem lies in how the Shariah supervisory board (SSB) interprets and makes decisions. As a result, a standardised Shariah governance framework could help address some of the inconsistencies contributing to these issues. This commentary is valuable for both academics and non-academics who are interested in understanding Shariah governance.

Introduction

Since the global financial crisis of 2008, there has been a growing interest in Islamic finance, mainly because Islamic banks appeared to have been less affected by the crisis than their conventional counterparts (AlAbbad et al., 2021; Louhichi et al., 2020; Berger et al., 2019; Johnes et al., 2014; Beck et al., 2013). But what exactly is an Islamic bank? It is a financial institution that offers similar services to those of a conventional bank, but with a fundamental requirement that its operations comply with Islamic laws known as 'Shariah'.

There are several Shariah laws, including the prohibition of charging interest or conducting business dealings involving alcohol and gambling, among others. Although it originated in predominantly Muslim countries, Islamic finance is now a global phenomenon (see Figure 1), with a growing number of non-Muslim countries embracing it. As a result, western economies have made significant efforts to include financial

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products and services that comply with Islamic principles. International commercial banks, such as HSBC and Standard Chartered, have established Islamic branches, also known as Islamic windows, to offer financial products and services that comply with Islamic rules, reflecting the potential for growth in the sector. However, it can be argued that the significant growth is probably due to the increasing demand from those who are sensitive to religion, not necessarily of the Muslim faith, but willing to do business with firms that comply with Islamic principles. In other words, Islamic finance operates on principles that appeal to consumers of all faiths, such as ethical investment and risk-sharing. This is why it has gained popularity (AlAbbad et al., 2021; Saiti et al., 2019).

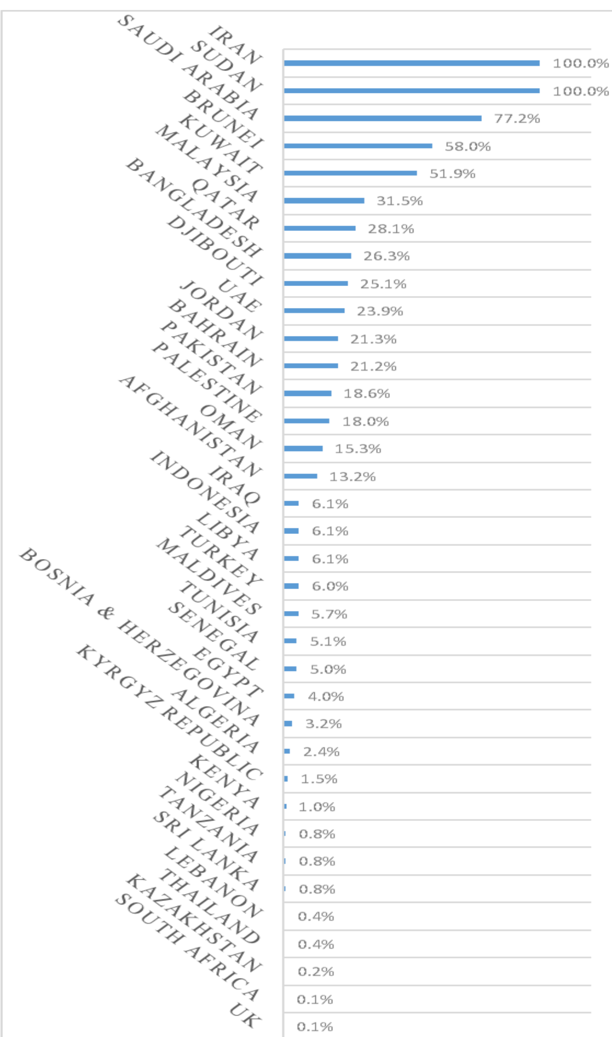

Figure 1: Islamic Banking Share in Total Banking Assets by Jurisdiction (2021). Source: Islamic Financial Services Board Stability Report (2022)

As shown in Figure 1, Sudan and Iran lead the way in Islamic banking with a share of 100% based on total assets. This suggests that all banking operations in these countries adhere to Islamic principles, without any conventional banking counterpart. Saudi Arabia and Brunei follow with shares of 77% and 58%, respectively. Meanwhile, the UK and South Africa have the lowest share at 0.1%.

Corporate governance has received considerable attention across different sectors in developed and developing countries due to scandals and corporate failures such as Enron and WorldCom (Dalwai et al., 2015; Johnes et al., 2014). The impressive performance of IFIs during the 2008 financial crisis, along with their intact reputation, has attracted the interest of academic researchers; industry practitioners; standard setters; and other stakeholders in studying the corporate governance practices of IFIs and uncovering their secrets (Aribi et al., 2019; Elamer et al., 2019; Safiullah and Shamsuddin, 2019; Farag et al., 2018; Platonova et al., 2018; Mollah and Zaman, 2015; Johnes et al., 2014; Beck et al., 2013).

However, it can be argued that the failures of established IFIs, such as the Islamic Bank of South Africa in 1997, Ihlas Finance House of Turkey in 2001, Bank Islam Malaysia Berhad in 2005, and Dubai Islamic Bank between 2004 to 2007, have increased the interest in the governance structure to ensure the industry's sustainability (Ginena, 2014). From an Islamic perspective, although the prudent administration of corporate governance practices can be essential for industry growth, implementing these practices without considering Shariah laws can have a negative effect and hinder its promising growth (Muneeza & Hassan, 2014).
The remainder of the discussion will briefly cover the corporate and Shariah governance of IFIs. Subsequently, it will elaborate on the importance of establishing a strong framework for Shariah governance. To conclude, a summary of the key points will be provided.

Corporate and Shariah Governance of IFIs

Shariah governance is particular to Islamic corporations, and researchers use the term to refer to Islamic corporate governance (Fatmawati et al., 2022; Jan et al., 2021; Azid et al., 2019). In the literature, like any other concept in management and social sciences, there is no globally accepted definition of corporate governance. The definition depends on the goal it is designed to achieve in different contexts and jurisdictions (Dogarawa, 2021). Although there are common concepts mentioned in each definition, it cannot be stated that one definition is superior to the other. However, this commentary will consider two definitions that seem crucial and central to corporate governance issues. The first definition is from the Cadbury Report; corporate governance was defined as 'the way in which companies are governed and controlled' (1992, p.15). The second definition is from the Basel Committee for Banking Supervision (BCBS, 1999), which defined corporate governance as the method through which the board and senior management monitor all business activities. This, in turn, impacts the way stakeholder interests, corporate objectives, and daily business are set.

From these two definitions, it can be concluded that corporate governance is about the relationships that are defined by structures and methods. Additionally, these relationships involve different or contrasting interests among stakeholders. For example, shareholders are interested in the survival and sustainability of the company, followed by profit-making that will lead to high dividend declarations. Managers' main interest is to remain in the company, get promotions, and receive huge salaries, indicating an agency conflict between managers and owners. There is also the interest of employees in receiving huge salaries and being promoted through the ranks to the highest position in the institution. While there is also the public interest, the institution's activities should not infringe on their rights. In other words, there should not be a situation of harm or spillage that could harm the environment and affect the local residents' employment (Dogarawa, 2021).

Therefore, corporate governance is a means to reduce inefficiencies and a method of monitoring performance and mitigating agency problems between owners and managers. It improves shareholder value and accounts for the other stakeholders' interests by efficiently utilising society's resources. A sound corporate governance framework is considered essential for establishing a harmonious relationship among concerned parties, promoting prudent and transparent management practices, and protecting stakeholders' interests. It also ensures the proper discharge of corporate social responsibility and promotes a sound, stable, and competitive financial industry. The six principles provided by the Organisation for Economic Co-operation and Development (OECD) for a sound corporate governance framework include establishing an effective governance framework, ensuring equitable treatment of shareholders and key ownership functions, considering institutional investors, stock markets, and other intermediaries, acknowledging the role of stakeholders, promoting disclosure and transparency, and defining the board's responsibilities.

Corporate governance objectives for both conventional and IFIs are similar as they aim to provide efficient and effective management, adequate disclosure, and long-term corporate stability. However, Shariah governance is a crucial component of Islamic finance and is intertwined with corporate governance in IFIs. Compliance with Shariah laws, is fundamental for IFIs, which must include and observe Shariah governance by ensuring strict compliance with Shariah in all activities at all stakeholder levels, including management, the board, employees, and regulatory authorities. Shariah governance is not included in the conventional corporate governance framework, but it was introduced to complement universal standards of corporate governance and streamline non-adaptable standards (Dogarawa, 2021).

There are currently no universally agreed-upon definitions of Shariah governance, but the definition provided by the Islamic Financial Services Board

(IFSB) is the most commonly referenced in existing literature. Other standard-setting bodies (such as the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI)) have also embraced the IFSB's definition. The IFSB defined Shariah governance as follows:

> A set of organizational arrangements whereby the actions of the management of Islamic financial institutions are aligned, as far as possible, with the interests of its stakeholders; provision of proper incentives for the organs of governance such as the board of directors, Shariah board, and management to pursue objectives that are in the interests of the stakeholders and facilitate effective monitoring, thereby encouraging Islamic financial institutions to use resources more efficiently; and compliance with Islamic Shariah rules and principles (2006, p. 27).

The definition provided by the IFSB outlines the main framework of Shariah governance. Specifically, it highlights the central element of the corporate governance framework alongside the necessity of Shariah compliance. From the definition, the first part clarifies the objective of corporate governance as a set of relationships among corporation stakeholders. In contrast, the second part confirms the need to ensure that all Shariah compliance requirements are met for stakeholders' assurance. The second part makes it clear that the framework of Shariah governance is unique to Islamic corporations. Furthermore, Shariah governance is distinct as it operates a multi-layer governance structure to monitor and oversee the Shariah compliance of IFIs. IFIs must have an additional governance layer, namely the Shariah Supervisory Board (SSB). The SSB comprises Shariah scholars in Islamic jurisprudence (Fiqh) and some finance-related background. The existence of this board is a vital confirmation of the IFIs' attempt to ensure that all operations adhere to Shariah principles.

The fundamental components of a robust Shariah governance framework are established by the AAOIFI governance standards and the Exposure Draft of IFSB Guiding Principles on Shariah Governance System. These components encompass the overarching approach to Shariah governance, regulatory structure, the Shariah board's responsibilities, their competence and independence, disclosure and transparency, operating procedures, and the Shariah board's evaluation. Despite this, the implementation of the Shariah governance framework can be a complex matter, resulting in different approaches being adopted by every country (Fatmawati et al., 2022; Hasan, 2011). Thus, the effectiveness of Shariah governance is reliant on the legal framework of each country.

The regulatory structure of Shariah governance around the world can be classified into three main types: centralised, *laissez-faire,* and hybrid (see Table 1). In the centralised model, the SSB is located within the central bank and is responsible for issuing all Shariah-related guidelines for IFIs. This approach is considered to be the most reliable and robust. In contrast, the *laissez-faire* or self-regulated approach to Shariah governance is developed by the SSB of each IFI and has minimal interference from regulators. While this model allows IFIs and their institutional SSBs to ensure Shariah compliance in their business functions, products, and services, the lack of a central regulatory authority can lead to concerns about the quality of Shariah compliance, services, and *fatwa* (Shariah opinions) resolutions among IFIs due to the diverse interpretations and rulings of Shariah principles.

Finally, the hybrid model of Shariah governance requires IFIs to report to a central regulatory body and ensure Shariah compliance at the institutional level. For instance, in the United Arab Emirates, IFIs are required to report to the 'UAE's National Council of the Shariah Supervisory Committees of IFIs' for any Shariah compliance concerns.

Table 1: Shariah governance Models

	Centralised	**Laissez-faire**	**Hybrid**
Central Bank	Centralised SSB	None	Centralised SSB
IFIs	SSB at IFIs	SSB at IFIs	SSB at IFIs
Shariah opinions	At the central bank, the SSB is responsible for issuing all rulings and opinions.	The SSB of the IFIs is responsible for issuing all Shariah opinions.	While the SSB of IFIs is responsible for issuing Shariah opinions, they are also required to report their activities to the central regulatory body
Countries	Malaysia, Sudan, Brunei, Indonesia, and Iran	Saudi Arabia, Kuwait, Qatar, UK, Germany, France, South Korea, Hong Kong, and Japan	United Arab Emirates and Pakistan

Source: Noordin and Kassim (2019)

Several researchers have raised concerns about the potential negative effects of having different approaches to Shariah governance, including inconsistent Shariah rulings, which can harm consumer confidence in the credibility of IFIs (Fatmawati et al., 2022; Shahzad Virk et al., 2022; Aribi et al., 2019; Nawaz and Virk, 2019; Platonova et al., 2018; Muneeza and Hassan, 2014). To address this issue, some scholars have called for the development of a global Shariah governance framework. Such a framework could include the establishment of an international Shariah board or a uniform code that countries can adopt, particularly those without local laws related to Shariah.

The development of a universal Shariah governance framework is a realistic possibility, especially if the main standard-setting bodies for IFIs, both at the national level (such as the Central Banks of Pakistan, Bahrain, and Malaysia) and internationally (such as the AAOIFI and IFSB), collaborate on this effort. By pooling their expertise and resources, these organisations could work together to create a comprehensive and globally accepted framework for Shariah governance in the IFI sector.

Institutionalising Efficient Shariah Governance.

Establishing an effective institutional framework for Shariah governance is essential to ensure the sustainability of IFIs. To achieve this, it's crucial to implement robust Shariah governance and corporate governance mechanisms. Such measures not only increase the legitimacy and confidence of these institutions, but also minimise the risk of non-compliance with Shariah principles, prevent institutional failure, and encourage innovation and ethical practices (Dogarawa, 2021).

Despite the fact that the existing Shariah governance systems have caused several IFIs, such as Bank Islam Malaysia Berhad, Ihlas Finance House of Turkey, and Islamic Bank Limited of South Africa, to fail (Aslam & Haron, 2021; Abd Razak, 2018), this doesn't necessarily indicate an inherent flaw in the Shariah governance framework itself. Rather, the issue lies in how decisions and interpretations are made by the SSB. Therefore, it is crucial to develop a comprehensive and uniform Shariah governance framework that covers all relevant Islamic concepts for IFIs.

Establishing robust Shariah governance mechanisms in institutions offers numerous benefits, such as boosting legitimacy and confidence among stakeholders, attracting more customers, and promoting sustainability (Dogarawa, 2021). When an institution's management is accountable to Allah (God) and conducts business affairs with transparency, fairness, and consciousness, pursuing what is legitimate within the rule of law leads to innovation and increased responsiveness to stakeholders. This approach eliminates any possibility of cutting corners and instead promotes transparency and ethical practices. Additionally, Shariah governance ensures that the IFI complies with Shariah principles in all aspects of its operations, from product development to investment decisions.

According to the literature, compliance with Shariah principles is at the heart of Shariah governance. It means following the guidelines and rules of Shariah law. Importantly, just because a financial institution has 'Islamic' in its name doesn't automatically make it Shariah-compliant. What matters is its actions and operations, not its name. This principle is consistent with the general principle in Islamic law that substance is more important than form (Dogarawa, 2021). For example, the Kuwait Finance House and Liquidity Management Centre are both Shariah-compliant institutions, even though they don't have 'Islamic' in their names. IFIs must design all their products and services in accordance with Shariah principles to ensure a high level of compliance. Failure to do so can damage the institution's reputation and expose it to Shariah risk. A robust Shariah governance system is critical for the Islamic finance industry to grow and achieve global stability.

Moreover, the absence of effective Shariah governance can give rise to Shariah risk, creating an uncertain governance system for IFIs. Shariah risk arises when institutions fail to comply with Shariah principles in their transactions or do not adhere to the rulings approved by the SSB. While there are other typical risks, such as market, liquidity, and credit risks, Shariah risk requires greater attention from IFIs. This is because it has the potential to trigger a chain reaction and lead to additional issues for the institution. To mitigate the impact of Shariah risk, a uniform and standardised framework is essential, as emphasised in the literature (Fatmawati et al., 2022; Shahzad Virk et al., 2022; Aribi et al., 2019; Nawaz & Virk, 2019).

A robust Shariah governance system can also increase the confidence of stakeholders, both Muslim and non-Muslims. According to AlAbbad et al. (2021), the success of Islamic banking is not solely dependent on Muslim countries, making it even more vital to establish a robust Shariah governance system for global growth. Among the stakeholders of IFIs, Investment Account Holders (IAH) play a significant role in mudarabah contracts, and maintaining their trust is essential. A weak system can undermine the industry's credibility and result in the failure of institutions.

Finally, the failures of established IFIs, including Bank Islam Malaysia Berhad, Ihlas Finance House of Turkey, and Islamic Bank Limited (IBL) of South Africa, have increased interest in implementing efficient Shariah governance. These failures serve as a reminder that even institutions with ethical and business practices are not invincible to crises. For example, Ihlas Finance House's bankruptcy in Turkey in 2001 was attributed to inadequate internal and external corporate governance mechanisms (Aslam & Haron, 2021; Abd Razak, 2018). The failure of IBL was attributed to several factors, including non-compliance with Shariah principles regarding its products and the role of the South African central bank. The non-compliance raises questions about the effectiveness of the SSB at IBL. Although the SSB did raise several non-compliance issues from time to time and even withheld Shariah approval in 1993, IBL prioritised financial performance over Shariah compliance, despite signals from the SSB. These incidents highlight the importance of having strong and effective Shariah governance and corporate governance mechanisms to ensure the sustainability of IFIs.

Summary and Conclusion

This commentary discusses the Shariah governance in IFIs, which is essential for their success and sustainability. The key highlights of this commentary are as follows:

- Shariah governance varies depending on the legal framework of the country and can be categorised into three types: centralised, laissez-faire, and hybrid. Countries such as Malaysia and Sudan follow the centralised model, while the Gulf Cooperation Council (GCC) countries and non-Islamic countries such as the UK and Hong Kong follow the laissez-faire model. Pakistan and the UAE follow the hybrid model.

- The existence of multiple Shariah governance approaches can lead to discrepancies in Shariah rulings. As such, it is imperative to establish a unified, global Shariah governance framework that harmonises these approaches.
- A sound Shariah governance system is critical to achieving and maintaining Shariah compliance, minimising Shariah risk, and ensuring the long-term sustainability of the Islamic finance industry.

The importance of Shariah governance in IFIs cannot be overstated. As discussed in this commentary, failures of established IFIs due to inadequate Shariah governance mechanisms highlight the need for a comprehensive and uniform Shariah governance framework that covers all relevant Islamic concepts. To ensure the sustainability of IFIs, strong and effective Shariah governance and corporate governance mechanisms must be in place. It is crucial that researchers and non-professionals alike continue to deepen their understanding of Islamic finance practices, including Shariah governance, to promote the success and sustainability of IFIs.

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