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**Central Bank Regulation, Religious Governance and Standardisation:
Evidence from Malaysian Islamic Banks**

by

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Central Bank Regulation, Religious Governance and Standardisation: Evidence from Malaysian Islamic Banks

Abstract

This study explores the *modus operandi* and regulatory influence of the pioneering Malaysian dual-layer governance system where, besides an Islamic bank's in-house religious board, supervision is undertaken by the country's Central Bank via its own Shariah Advisory Council (SAC). Data was collected by means of in-depth interviews with SAC members, Central Bank compliance officers, Bank Chairmen and members of Shariah boards, CEO's and other senior executives. We find that the procedures asserted by this over-arching governance structure contributes to standardising practice without hampering creativity when innovating new Shariah compliant financial products. Considerable bureaucracy is reported to exist due to the current approval process impeding efficient decision-making. In particular, the SAC is found to be decisive in resolving disputes from the widespread use of the 'legal reasoning' (or Ijtihad) principle exercised by boards providing the much needed confidence and market discipline required by stakeholders. Finally, we highlight how this form of banking operates best when left to a country's own governance framework rather than imposing international regulation for this nascent industry.

Keywords: religious boards, legal reasoning, Islamic finance, governance, standardisation, Malaysia.

1. Introduction

Over the last few decades, the Islamic banking and finance industry has not only flourished in Islamic countries but has steadily gained prominence worldwide with global assets reaching USD 1.6 trillion in 2017 (IFSB, 2018). Concomitant with this growth is the increase in the diverse number of academic studies that have researched this alternative form of finance. Prior studies have predominantly focussed on examining operational performance of Islamic banks (Beck et al., 2012; Gheeraert, 2014; How et al., 2005; Nawaz, 2017) or issues related to ethics (Aribi and Gao, 2011; Haniffa and Hudaib, 2007; Ullah et al., 2016) and corporate social responsibility (Hisham et al., 2014). Several studies also make a limited but worthwhile contribution to the literature on corporate governance frameworks in such institutions (Abu-Tapanjeh 2009; Bakar, 2012; Garas and Pierce, 2010; Karbhari et al., 2018; Safieddine, 2009). Other researchers have highlighted the debate surrounding the need for suitable mechanisms to be implemented in these institutions (see for example Archer et al., 1998; Grais and Pellegrini, 2006; Kamla and Rammal, 2013; Karim, 1990a; 1990b; 2001; Khan, 2007). Prior research has also focussed on disclosure and social reporting of Islamic banks (Belal et al., 2015; Darus et al., 2014; Marsidi et al., 2017; 2018) and on the impact of corruption on Islamic banks profitability (Arshad and Rizvi, 2013). However, these studies provide little or no evidence on the important relationship between a central governance framework and the crucial issues of standardisation and innovation in the Islamic finance industry.

Given that the difference between conventional and Islamic finance is the latter's strict adherence to the principles and values embedded in religious doctrine. Therefore, the supervision and management of complex religious compliance would require an equally complex and rigorous set of governance structures to ensure that products and operations

provided by Islamic financial institutions (IFIs) conform to religious law in order to provide the much needed societal legitimacy which stakeholders and constituents seek. Generally, this ecclesiastically driven form of governance can be observed at two distinct levels. First, at the organizational level an IFI should have appropriate internal processes to ensure that religious requirements are fulfilled. A key organ of the organizational governance framework is, therefore, the Sharia Supervisory Board (SSB) which comprises of religious scholars who are responsible for ensuring integrity and credibility of the institution by determining the extent of religious compliance of the bank's operations (Banaga et al., 1994; Karim, 1990a; 1990b; Tomkins and Karim, 1987). In the context of regulation, whilst undertaking this governance role, the SSBs may, from time to time, be required to produce religious rulings or edicts (i.e., *fatwa*'s) by interpreting different legal religious sources. Therefore, the likelihood of generating conflicting opinions very much exists. In reality, the variations in opinions within one jurisdiction can raise religious compliance and reputation risks that can cause instability in banks (Qattan, 2006). It is also fair to add that as the industry expands globally, the likelihood of conflicting religious rules increase, leading to undermining of consumer confidence (Grais and Pellegrini, 2006). Therefore, this calls into question the need for harmonizing rulings at the national level to safeguard religious compliance and reduce legal and reputational risks.

In the absence of a national regulatory framework, problems in religious governance at the organizational level can become manifestly obvious. Hence, a second effective mechanism to circumvent possible risk is by establishing an over-arching central religious governing authority (supervised by a Central Bank) which could play an influential role in the supervision and monitoring of the Islamic financial sector in individual Islamic jurisdictions. This additional dual governance approach is unique and is implemented in countries such as Malaysia, Bahrain, Bangladesh, Brunei, Indonesia, Sudan, Kuwait, Pakistan, Qatar and the

UAE. A key responsibility of this central body is to attempt effective regulation and standardisation of banking practices through coordination of religious edicts (otherwise known as *fatwas*)¹ relating to financial products and services (Graiss and Pellegrini, 2006). The central governing body would also be required to perform an intermediary role in resolving potential differences of opinion and disputes that arise between the in-house SSB members of an Islamic bank. Such a central body would also be required to play a pivotal role in assisting both banks as well as regulators (i.e., Central Banks) to better understand the religious principles applied in the operational context of Islamic banks to reduce any possible regulatory and religious conflict.

Besides the above governance mechanisms, a variety of international regulatory mechanisms already exist to support the Islamic finance industry. One such organisation is the Bahraini headquartered Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)² which issues religious standards on accounting, auditing, ethics and governance. A further influential organisation is the Malaysian based Islamic Financial Services Board (IFSB), which issues standards for the effective supervision and regulation of the global Islamic finance industry. Despite the determined efforts of these two organisations, challenges still remain in the work of these regulatory bodies, especially in relation to enforcement of standards in various other jurisdictions. This is because related governments have failed to make such standards mandatory.³ Frankly, substantial differences exist in the approach adopted by regulators in Muslim countries in setting up a locally based governance framework which would ensure the successful operation of the Islamic finance industry.

Although the *modus operandi* of a Centralised governing board is regulatory intervention, strengthening governance and to mitigate possibilities of Shariah non-compliant risk, a move by regulators to establish such a board in the first place indicates a positive attempt towards standardisation of banking practices. The case of Malaysia is particularly interesting and

worthy of academic pursuit because since 1997, the country was the first to implement a pioneering dual-layer religious governance system. Every bank offering Islamic banking products and services has a internal but part-time SSB, which plays a non-executive role and has sole authority on religious matters. In the Malaysian setting, this governance process is supplemented at the central bank level by the use of an over-arching in-house Shariah Advisory Council (SAC).⁴ The role and function of the SAC is to act as the sole authority that advises the Central Bank of Malaysia (*Bank Negara Malaysia*: BNM) on Islamic finance matters, thus making visible its role as both a regulator and a supervisor. To affirm its authority, the SAC is authorised with mandated power on its Shariah governance role in the amendment to the Central Bank of Malaysia Act 2009 in which the resolutions issued by the SAC are binding on all Malaysian IFIs (BNM, 2009). This enforcement demonstrates the key role of the regulator to ensure that a robust and strict governance system is both implemented and adhered to. It could further be argued that the central reference role of the SAC could play a major role in minimising potential inconsistencies in banking practice.

Therefore, the key objective of this study is to explore the extent to which the Malaysian central governance system (i.e., the SAC) is perceived to have supported the standardisation of Islamic banking practice. Our choice of Malaysia as a basis for study is motivated by the fact that Malaysia is perceived to operate the most developed religious governance and regulatory system in the Islamic world. Thus, this research sheds important light on the extent to which Malaysia, as a leader in Islamic finance, has been successful in operating a central governance system of its Islamic finance industry. The study provides early empirical evidence and contributes to prior literature in the following ways. First, we consider the impact of regulation on innovation and standardisation of products and services in Islamic banks. Second, we use interview data to provide explanations and interpretations of senior industry players to determine the major challenges to governance faced by this alternative

and distinct banking industry. Finally, to the best of our knowledge, no prior research has been undertaken which has investigated the dynamics of religious regulation between a central national body (such as the Malaysian SAC) and the intricate governance relationship with individual in-house SSB.

The remainder of this paper is structured as follows. Section 2 discusses the issue and challenges of standardisation of Islamic banking practices. Section 3 provides a synopsis of the current Malaysian Islamic banking, governance and regulatory environment. Whilst, Section 4 reports the research methodology adopted and data collection methods, Section 5 presents a discussion of the study's findings. The conclusion is provided in Section 6 along with a brief discussion of the policy implications of the study.

2. Governance and standardisation of Islamic banking: issues and challenges

A lack of standardisation leads to confusion about what Islamic banking really is and could potentially be an obstacle to its eventual expansion (Iqbal and Mirakhor, 1999; Khan, 2007). It has been argued that the accounting standards for IFIs issued by the AAOIFI have not been accepted or even recognised by many Islamic countries (see for example ACCA 2010) for a plethora of reasons. For example, in the financial reporting area, the lack of uniformity in accounting standards have resulted in different interpretations by users of financial reports, poor accounting quality and the prospect of promoting earnings management (Barth et al., 2008; Doukakis, 2010; Jeanjean and Stolowy, 2008). The benefits of standardisation are clarity, coherence, assists regulation of Islamic banking activities and leads to greater competition with their conventional counterparts (Karbhari et al., 2004). However, as the key feature of an Islamic banking operation is the provision of products and services that are religiously compliant, a heavy burden is placed on religious scholars to provide interpretations of the Shariah (Islamic Religious Code) for use in modern Islamic finance.

Generally, scholars who serve on SSB are perceived to be individuals with religious and ethical commitment, have a credible Islamic educational background and are generally well versed and respected as ethically minded. From a religio-legal perspective, a key feature of these boards is that board members have the flexibility to exercise the provision of ‘legal reasoning’, otherwise known as *Ijtihad*⁵, in generating religious edicts (*fatwas*) and arriving at rulings related to religious regulatory compliance. However, this provision creates room for differences of opinion amongst scholars with regards to the permissibility and legitimacy of product innovation methods and procedures. Further complications arise due to the four very different Islamic Schools of Jurisprudence that influences the cultural background of different Islamic societies around the world. Thus, as the Islamic banking industry expands globally, its operations are likely to be affected by this cultural sentiment.⁶ For this reason, Khan (2007) maintains that differences in banking practices are inevitable, and they rightly highlight that this is due to the natural outcome of legal reasoning (*ijtihad*) by the religious body who ultimately governs the industry thereby affecting the domestic condition of Islamic banks. For example, conflicting views exist amongst Shariah scholars on whether a penalty should be imposed on a defaulting debtor (which is argued as being synonymous to interest or usury). It is commonly accepted that whilst certain Islamic financial products are permissible in some countries, they may be impermissible in others, such as a sales contract on a deferred payment basis (known as *bay’ bithaman ajil*) whose use is widely prevalent in Malaysia but its application is widely criticised by experts from Middle Eastern countries.

The differences in legal reasoning as in the example cited above have, undeniably, contributed to a lack of standardisation in Islamic banking practice. Such inconsistencies have previously been highlighted by researchers such as Karim (1996), who emphasised that the wide-ranging recognition and measurement policies suggested by individual Islamic banks’ in-house SSB members could eventually make Islamic banks disclose differently from

one another on the same issues. Karbhari et al. (2004) also assert that the lack of standardisation on scholars' opinions on matters relating to the practice of Islamic banks creates unwanted tension between banks and their regulators. The authors highlight that this tension was a significant factor which led to the demise of the first Islamic bank in the United Kingdom (Al-Barakah Bank), which lost its banking license in 1993, thus providing evidence of a factor that would be detrimental to the growth of the Islamic banking industry. As such, diverse Shariah legal rulings on Islamic banking practice are expected to be associated with monitoring difficulty by authorities who do not have the required religious expertise, thereby causing instability in the governance framework of the industry. It is also likely that diversity in interpretation of the Shariah could result in loss of market discipline, leading to moral hazard behaviour by which Islamic banks would be selective on the application of Shariah in ways that would suit their interests alone (e.g., Karim, 1996; Khan, 2007; Ullah et al., 2016).

Furthermore, Ahmed (2011) identified two interrelated areas of concern related to religious governance that rely on SSBs at the organizational levels. First, the selection of Shariah scholars and the structure and functions of SSBs are determined at the organizational level. As religious governance and supervision becomes a sub-system of the overall governance system of a bank, there is possibility that SSB members are selected to serve the interests of only shareholders, and not all of the stakeholders. A critical issue in religious governance in Islamic banks is the use of control and authority by the board of directors (BOD) and senior management to serve their needs. After all, it is the BOD and senior management of Islamic banks that decide on who can sit on the SSB and it is bank's management that remunerates SSB members which can itself lead to conflict of interests and possible compromise in independence. Indeed, selecting SSB members who are more inclined to fulfil the economic objectives of Islamic banks can create incentives for *'fatwa*

shopping’ and limit and compromise the role of SSBs (Grais and Pellegrini, 2006; Ullah et al., 2016).

The second area of concern relates to the clearance of new products that dilute Islamic requirements. As the approach of the industry has been predominantly to design products based on conventional products as benchmarks, cases can arise when there may be trade-offs between religious requirements and economic factors. If the SSB is accommodating, economic factors may well be given preference at the cost of religious principles. This may result in opting for controversial Islamic products even when Shariah compliant alternatives are available. Therefore, this raises questions about the objectivity of Shariah scholars in SSBs as Kahf (2004) rightly points out that ‘many of them are now accused of being bankers’ window dressers and of over-stretching the rules of religion to provide easy *fatwas* for the new breed of bankers’.

The above arguments indicate that issues of standardisation and legal-religious consistency are key elements for greater growth and market penetration of Islamic banking products and practices, especially in the non-Islamic regulatory setting of Western countries. It also becomes obvious that standardisation is attributed to the ease of regulatory control in terms of monitoring activities, examining fulfilment against certain established criteria and enhances comparability and transparency of reporting practices of Islamic banks. One such example of this effect is that civil courts of law, which are not bound by the Shariah, would be more likely to ‘recognise’ banking products if Islamic banks were standardized (Grais and Pellegrini, 2006). Interpreted differently, this means that standardisation could be seen as providing the infrastructure required for regulatory bodies to establish well-defined regulatory guidelines, which would assist in the formulation of regulatory judgment on Islamic banking practice. Due to the importance of this issue, Khan (2007) suggested the coordination of a universal standardised approach that could be used as a guideline for the

Islamic finance industry. However, our view is that harmonization would prove to be difficult due to the many cultural and complex jurisprudential differences.

Other than concerns of objectivity and conflict of interests at the organizational level, Ahmed (2011) identifies other reasons that may necessitate regulatory intervention. One key reason for regulatory oversight of the Shariah governance process is to protect the rights of other stakeholders, who expect the industry to conduct all its operations in a compliant manner. Shariah governance, from the regulators perspective, considers the interests of all stakeholders, including depositors, whose interests may not always be recognized at bank level. Furthermore, leaving governance at the bank level can generate different risks that can adversely affect the stability and growth of the industry. Qattan (2006) points out that religious non-compliance can be a reason for reputational risk that can trigger bank failure and cause systemic risk and instability. The same can happen if the perception of stakeholders about Islamic products become negative causing a serious loss of trust and credibility. Another risk that may require regulatory attention is the legal risks arising from diverse edicts (*fatwas*) issued by various SSBs within the same country let alone across jurisdictions. As SSB produce rulings by interpreting different legal sources, the likelihood of generating conflicting opinions exist. With the expansion of the industry, the possibility of conflicting edicts will undermine the customer confidence in the industry (Grais and Pellegrini, 2006). This calls for maintaining credibility of the religious edicts issued within a jurisdiction by harmonizing the religious rulings at the national level.

The above discussion indicates that appropriate regulatory measures may be required to improve governance for the industry. A key regulatory measure is to establish a central supervisory body (i.e., Shariah Advisory Council) at the regulatory level to accomplish the broader requirements of the industry. Other than minimizing the reputation and legal risks, establishing a central authority can provide oversight of religious matters of the Islamic

financial sector. Also, since members of the SAC are independent from Islamic banks, they are expected to be free from all conflicting interests. This body can also help reduce legal risks by endorsing all new products entering the market and at the same time identifying the permissible modes of financing and investment.

Interestingly, countries that implement a dual-layer (or centralised) religious governance system are perceived to have a competitive edge in terms of enjoying standardized Islamic banking practices. This arises because differences that exist in the provision of legal reasoning (*ijtihad*) afforded to SSB can be referred to the SAC to enable agreement amongst banks' SSB members. Hence, the role of the SAC is seen as crucial in standardizing Islamic banking practices as well as preserving the integrity of SSBs. Nonetheless, the mechanism for governance created by this dual-layer system is not without criticism. For instance, there has been a focal argument that the SAC and the standardisation of Islamic banking practice that it facilitates are seen as eliminating the diversity of Shariah interpretation by scholars, thus restricting the creativity and innovation of Islamic banking products.⁷

The ideal regulatory environment related to governance is one that balances mitigation of religious risks and demands for innovation. A good example of a robust Shariah governance regime in operation is that applied in Malaysia. Other than having guidelines for governance at the bank level, Malaysia has a national Shariah Advisory Council (SAC) housed at the central bank that also has the task of both reviewing and approving new products introduced into the market. The country is at the forefront of pioneering new and innovative Islamic finance under a robust Shariah regulatory regime that provides checks and balances to the industry.

3. Background to governance and regulation of Malaysian Islamic finance.

In the Malaysian context, the idea of establishing an IFI arose due to the need to collect and manage funds used by Malaysian citizens to plan and perform pilgrimage (i.e., the Haj) to Mecca. This initiative resulted in the establishment of The Pilgrim's Fund Board in 1969 (known in the Malay language as the *Lembaga Urusan dan Tabung Haji* (LUTH)). Following the successful establishment of the LUTH and other Islamic banks in Muslim countries, such as Dubai, Sudan, Kuwait and Jordan, the Malaysian government established its first Islamic bank in March 1983, which became known as Bank Islam Malaysia Berhad (BIMB). Demonstrating its seriousness and to assist the implementation of Islamic banking, the Islamic Banking Act (IBA) 1983 was enacted. In 1984, further legislation was introduced to promote the industry, such as the *Takaful* Act (or Islamic Insurance Act). Unlike their conventional banking counterparts, Islamic banks were specifically required to be governed by the IBA 1983 and were to be specifically monitored and regulated by the Malaysian Central Bank (BNM).

Additional progress was made when various schemes were introduced and amendments made to earlier legislation. For instance, in 1993, the BNM introduced the Interest Free Banking Scheme, currently known as the Islamic Banking Scheme (IBS), which allowed conventional banks to offer Islamic banking products and services without having to apply for an Islamic banking license. Consequently, commercial banks were allowed to offer Islamic banking products alongside their day-to-day conventional banking activities. In particular, the Islamic Interbank Money Market (IIMM) was launched in 1994 and provided a ready source of short-term investment outlets based on Religious principles, thus helping Islamic banking institutions and those participating in Islamic Banking to solve their liquidity and investment problems. Malaysia also took a quantum leap in its quest for standardisation when it established the National Shariah Advisory Council (SAC) in May 1997. The

prescribed role of the SAC is to (1) advise the BNM on any Shariah issue relating to Islamic financial business or transactions, (2) advise IFIs or any other person or organisation on Islamic financial business and (3) issue rulings pursuant from the request of courts and arbitrators (BNM, 1997). The Malaysian government also established a holistic set of Islamic capital market infrastructure to complement the role of the Islamic banking system and the Islamic financial markets as a whole. In addition, in April 1999, the Kuala Lumpur Shariah Index (KLSI) was launched to assist local and foreign investors to invest in securities that are consistent with the Islamic tenets. The KLSI acts as a benchmark to track the performance of Shariah compliant securities and assists in making informed judgements.

In pursuit of standardisation, the Government, in 2002, hosted the establishment of the IFSB, an international regulatory standard-setting body that is responsible for ensuring the soundness and stability of the Islamic finance industry. To ensure greater investor confidence, the BNM established three dispute resolution mechanisms: (1) a dedicated high court, (2) the Kuala Lumpur Regional Centre for Arbitration and (3) the Financial Mediation Bureau. To attract foreign Islamic banks and to liberalize Islamic banking, the BNM granted three new Islamic bank licences to foreign institutions in 2004.⁸ Later, in December 2004, the BNM issued its Guidelines on the Governance of Committees for Islamic Financial Institutions. These guidelines became effective on 1st April 2005 and were aimed to streamline the function, role and duties of religious boards in IFIs. They included guidelines on matters relating to the procedures, qualifications, composition, disqualification, resignation and restrictions of board members. Many of these guidelines are similar to those of AAOIFI's requirements, although in some others they are unique to BNM. For example, similar to the requirement set out in AAOIFI (1997), BNM mandated each Malaysian IFI to have a minimum of three SSB members. BNM also emphasised that SSB members should comprise of expert in the field of fiqh al-mua'malat as well as experts from the field of

business, accounting, economics and law. In October 2010, the BNM introduced its new Shariah Governance Framework (SGF), setting out the roles of different stakeholders operating with IFIs to ensure greater compliance. The SGF took effect in June 2011, and offered substantial clarity on the accountability and responsibility arrangements of these parties, imposed new regulations on the appointment of SSB members with a minimum number members set out at five and required IFIs to establish religious compliance as well as a research function. In June 2013, the Islamic Financial Services Act (IFSA) was implemented as a governance mechanism to ensure end-to-end Shariah compliance in all aspects of regulation and supervision including licensing IFIs to winding up. Following this Act, all IFIs were required to ensure that their aims, operations and activities are in compliance with Shariah. Amongst the guidelines provided under IFSA 2013, banks were required to apply directly to BNM on the establishment of their SSBs to advise and oversee all operations and activities and to confirm that activities comply with Islamic law. In the event of non-compliance, SSB members could be liable to imprisonment for a term not exceeding eight years or a fine not exceeding twenty-five million ringgits or both.

To broaden its sphere of influence, the BNM further established the Malaysian International Islamic Finance Centre (MIFC) in August 2006. Foreign Islamic banks were granted licenses to operate and incentives provided which included granting new licenses for conducting foreign currency businesses, and attractive tax and flexible immigration policies afforded to participating institutions. In conjunction with the MIFC initiative, a new category of license, namely International Islamic Bank status, was issued under the aegis of the IBA 1983 to allow qualifying foreign and Malaysian financial institutions to conduct business in international currencies in 2006. Approval for the setting up of an International Currency Business Unit (ICBU) within these financial institutions was awarded in the same year. With regard to the licensed international Islamic banks, these financial institutions are allowed to

undertake a wide range of Islamic commercial banking, Islamic investment banking and other banking business as specified by the BNM (2008). To date, the MIFC has 28 local and international Islamic banks listed under its auspices.

4. Data Collection and Methodology

To undertake empirical examination, several key issues relevant to standardisation of Islamic banking were identified and assessed to allow full understanding of the subject matter. These include issues on (i) the Shariah; (ii) the religious decision making process of BNM's SAC and individual SSB; (iii) the role of the SAC as the highest authority in the Islamic banking industry; and (iv); the standardisation process of Islamic banking and its implications. We conducted 24 semi-structured interviews with key players operating in the Malaysian religious governance framework. Our interviewees included regulators, SSB members and bankers across all Islamic banks operating under the aegis of the MIFC. In total, we interviewed five SAC members of the Central Bank (BNM), two senior officials of the BNM's Department of Islamic Banking, Chairmen of five separate SSBs, six influential SSB members of different banks, two Heads of Shariah Departments, three senior executives of Islamic banks and a Chief Executive Officer (CEO) of a separate large Islamic bank.⁹ Our interviews lasted approximately 90 minutes in length. Our approach was to engage in elite interviewing, our respondents had to be senior individuals with extensive knowledge and experience of banking regulation and governance. The benefit of undertaking unstructured interviews with senior BNM officials and established practitioners allowed a greater insight to be gained into the governance problems and challenges facing the industry. Our interviewees were given complete freedom to explain their thoughts and experiences without following sequenced questions and predetermined specific answer categories. The interviews were undertaken in the expectation that respondents' experience in the field would provide

valuable understanding into the main issues under study. We analyzed our data using the latest Atlas.ti software. This software is a Computer Assisted Qualitative Data Analysis Software (CAQDAS) available for analysing qualitative data that brings the benefit of assisting theme development and easier management and coding of data.

5. Results and analysis

5.1 Impact of regulation on innovation and standardisation

This study provides evidence that over the last decade the Malaysian Islamic finance industry had experienced substantial innovation of Islamic financial contracts resulting from a challenging process that is dependent on the use of legal reasoning (*ijtihad*) by SSB. Such a provision is permitted, given that the Shariah is regarded as a dynamic discipline, as reflected in matters concerning Islamic commercial activity (i.e., known as *mua' malat*) that are open to interpretation by Islamic scholars. The consensus amongst our respondents is that the general rule on Islamic commercial activity is that everything is considered permissible unless there is clear evidence in Islamic teaching that prohibits such transactions. The overwhelming majority of our interviewees highlighted that elements of the Islamic faith that are open to differences in interpretation are limited, whereas the basics and fundamentals are commonly agreed upon. Notwithstanding differences in limited matters, religious scholars would generally aim at issuing edicts (i.e., *fatwas*) on Islamic finance products based on what is deemed to be more convenient and what serves the best interest of the community in terms of necessity. Explaining this, a senior member of the SAC of the Malaysian Central Bank (BNM) explained:

“The Islamic faith prescribes some fixed elements and some flexible elements. Obviously, we cannot change the fact that interest (*riba*) is not permissible (*haram*) and uncertainty (*gharar*) should be avoided. However, based on circumstances and needs, certain things can be legally changed. I believe that all religious advisors would want to make the industry as flexible as

possible. After all, Islam prescribes that which is easy as long as it does not contravene its core values.”

Based on Islamic finance foundations, contemporary financial contracts that are currently available in the market have been developed using a single classical contract such as the *mudharabah* (a form of partnership that is based on profit and loss sharing) or *murabahah* (a sales contract where goods are sold at a mark-up price) but also a hybrid classical contract that forms a new financial contract and a conventional product that has been made Shariah-compliant by removing its non-Shariah component. Such difference in the range of financial contracts arises because of the Islamic faith not imposing strict rigidity on commercial activities.

However, the so-called flexibility provided by Islam on commercial matters and the resulting interpretation by scholars (i.e. the legal reasoning or *ijtihad* facility) inevitably results in differences of opinion amongst SSB members in individual Islamic banks. The issue arising is that consensus of opinion amongst members of the same religious board is indispensable, as their decision would determine whether management of the bank could proceed with its proposed business agenda. Hence, any differences amongst SSB members would have to be resolved through means of debate and discussion between board members themselves, as uniformity in Shariah resolution is a requirement mandated by BNM (BNM, 2004). Highlighting the concern for a unified decision, the Chairman of a SSB from a small-sized conventional bank offering Islamic banking remarked:

“When documents relating to Islamic banking practices and products are presented to me, I might consider the proposals forwarded by management as invalid, whereas other religious board members might consider them otherwise. We thus bring this matter into the meeting and have an extensive debate and discussion over the issue. If other board members convince me that the proposal is Shariah compliant, then I would accept their opinion as long as it is religiously acceptable.”

Besides the ‘debate and decide’ mechanism for resolving religious differences of opinion, the central governance system was highlighted by nearly all of our respondents to play a

crucial role in providing the necessary infrastructure required for bringing consistency to Islamic banking practice at the national level. Our respondents were generally satisfied with the Islamic banking system operating in Malaysia through its dual-layer governance system and the effective role played by the SAC, which helped create the required market discipline called for by market players. This sentiment was clearly expressed by a SSB member of a medium-sized fully-fledged Islamic bank as follows:

“It is not denied that to some extent the BNM allows flexibility through the exercise of legal reasoning (*ijtihad*) amongst Shariah board (SSB) members. However, the market players are complaining. They ask, ‘why are we not competing on a level playing field?’ This is where the BNM, through its SAC (SAC) and the standardisation effort it assumes, plays a significant role in assisting the development of the Islamic banking market.”

The regulatory environment brought about by recent amendments to the Central Bank of Malaysia Act 2009 provided a clear mandate for resolutions issued by the SAC to be binding on courts and arbitrators. Accordingly, the Act makes it mandatory for the judge to refer to the written rulings of the SAC, to the extent that the court has to refer to the SAC’s resolutions on any decisions related to Islamic finance. The effect of such a requirement is profound in that consistency will ensue in the country’s legislation and in the interpretation of the Shariah with regard to Islamic banking products that are approved to be marketed to consumers. This development is seen as providing the necessary regulatory support for the operation of the Islamic banking industry and thus strengthening the governance function of Religious boards.

The recognition of Islamic finance in Malaysia and the regulatory framework adopted by the SAC as the over-arching governance body and the first point of reference was regarded by our interviewees to have substantial authority in maintaining integrity and consistency of industry practice. Also, the vast majority of our participants made it clear that standardisation on matters concerning the Islamic banking industry within a nation is paramount and should be seen as standardisation of Islamic rituals (such as the fixing of the Islamic date for the

fasting month (Ramadhan) and the Eid celebration) in importance. Such uniformity was revealed to be beneficial as it would aid the removal of prejudice. A requisite for this to be implemented successfully is believed by our respondents to be the enforcement of an authoritative body such as the BNM. A second SAC member echoing a similar sentiment remarked:

“I believe that Islam recognises a State as an entity. Currently, the Central Bank (BNM) has the final say. If the Central Bank says ‘No’ then it is not approved.....Quite frankly, there should be only one voice in Malaysia and that is of the Central Bank.”

Consequently, industry market players, including religious boards, referred to the resolutions issued by the SAC. For example, the Chairman of a SSB of a large fully-fledged Islamic bank highlighted the absolute authority of the SAC by stating:

“When we want to develop certain financial products, we first ascertain whether the SAC has produced any resolutions relevant to our proposal. If the resolutions exist, we would simply use it as the basis of our decision.”

When attention is turned to accounting and the utilization of AAOIFI standards, our interviewees were generally of the view that AAOIFI’s religious standards serve as the first source of reference for the SAC. However, AAOIFI standards were assessed for their applicability to Malaysian circumstances, as the Malaysian Islamic banking market might have very different needs, circumstances, laws and customs that should be taken into consideration. With this in mind, another SAC member remarked:

“We refer to the reasons or the grounds for the decisions made by AAOIFI because their standards include the *mustanad* (sources on how and why the rulings are derived). We deliberately do that and apply it to the Malaysian context. Then we determine whether to apply the AAOIFI decision or go for a different approach, but this all depends on the strength of the argument as well as various policy considerations.”

All in all, the views expressed by almost all of our interviewees from the SAC and the senior officials from the Department of Islamic Banking disclosed that the pronouncements issued by the SAC were also made with reference to decisions issued by several other bodies, including the OIC’s (Organization of Islamic Cooperation) *Fiqh* (Islamic

Jurisprudence) Academy. Such associations were emphasised by interview participants as marking the Malaysian regulator's attempt at standardizing Shariah precepts with other Islamic jurisdictions as a basis for the innovation of Islamic banking products that can be globally accepted. In addition, these SAC members also revealed initiatives taken by the BNM to enhance understanding of the global Islamic banking practices through avenues such as the International Shariah Scholars' Forum and by engaging in annual events organised amongst scholars from other countries in South East Asia such as Indonesia and Brunei.

5.2 Governance and Regulation Challenges

In the main, our study revealed frustrations amongst SAC participants as they felt they were labelled as being 'liberal' in their attitude towards Islamic finance. Perhaps, the reason for this belief by outsiders was that some pronouncements issued by the SAC were inconsistent with Shariah standards issued by other bodies, such as the AAOIFI and the OIC's *Fiqh Academy*. Such perceptions exist due to situations where the permissibility of certain Islamic banking products (authorised by the SAC of the BNM) were considered to be impermissible, especially by Middle Eastern conservative scholars. Such situations arise as a result of the development of some Islamic banking products that were approved by the SAC, such as a sale on a deferred payment basis (otherwise known as *bay' bithaman ajil*) and a back-to-back sale or a sale repurchase contract (*i.e.*, *bay' al-'inah*). However, our participants made clear the justification for allowing the permissibility of these two products. For instance, a SAC member of the Central Bank remarked:

"We were criticised for approving *bay' bithaman ajil* and *bay al-'inah*. However, we argued that we implement them because there are references based on the Shafi'i School of Jurisprudence. We take the position that should we continue to be non-compliant when actually, with *bay al-'inah*, it is permissible, though it is controversial?"

Despite the flexibility exercised by the SAC, our respondents revealed that SSBs could be more stringent by opting to refuse management proposals to develop Islamic

banking products based on controversial contracts (as in *bay' bithaman ajil* and *bay al-'inah*) stated above, though they might be permitted by the SAC. Thus, differences and tensions amongst IFIs in Malaysia may still persist, as a particular IFI, through approval of its SSB, may opt to market these controversial products whereas such products are criticized by the board of other IFIs who strictly disapprove of them.

The situation cited above has two potential implications. First, although disagreements on Islamic financial contracts amongst SSBs across Malaysian IFIs remain possible, these disagreements occur on financial contracts that were decreed by the SAC, i.e. the SAC. Approval of such mandate allows the financial market and consumers to remain confident in the Malaysian Islamic banking environment. In this regard, a senior official at the Department of Islamic banking and Takaful of the BNM remarked:

“Because of the various interpretations amongst Shariah boards (SSB) in the industry, the role of the SAC in centralizing the Shariah resolutions is crucial. In this way, stakeholders will have greater confidence because Shariah compliance is guaranteed at both the bank and the National level.”

Another senior official from the same department of the BNM expressed a similar sentiment and argued that the establishment of the SAC had, by and large, allowed disputes to be resolved amongst the key players in the Islamic banking industry. However, institutions in other countries that do not have the benefit of a centralised religious board could well be deprived, with controversies remaining. This respondent expressed his views thus:

“In Malaysia, we have the SAC of the Central Bank who oversee the Islamic banking industry at the macro level. In all honesty, I believe that our industry is much more organized and we do tend to be consistent. In other countries, the Islamic banking industry is still uncertain on certain issues, as the Shariah board of a particular bank claims that the Islamic financial products they endorse are valid whilst financial products of others are not.”

Second, SSB members who hold strict and conservative views on Islamic banking tolerate controversial Islamic financial contracts will eventually exercise creativity by innovating products that are based on globally accepted Islamic contracts. Explaining the ‘healthy’

outcome of differences of opinion amongst boards in Malaysia, a board member of a fully-fledged bank remarked:

“Disagreements amongst Shariah boards (SSBs) within the national jurisdiction do not hold back Islamic banking from prospering. You may have Bank A that produces an Islamic financial product that Bank B says does not comply with the Shariah: Bank B would now have to produce another innovated product into the market. So, instead of one, now you have two products in the market.”

Nevertheless, some of our respondents revealed concerns regarding implementation of the dual-layer governance system in Malaysia. For instance, the two Heads of Shariah Departments were critical of the mechanism adopted by the BNM, and hence the SAC, in handling emerging issues arising from the banking industry. In the words of the Head of the Shariah Department of a medium-sized fully-fledged Islamic bank:

“The way that the Central Bank (BNM) reacts to any issues or complaints in the market is not proactive as it tends to prefer a fire-fighting approach. It is only when there is an issue that the Central Bank gets involved and takes action by calling all the market players and gathering information from them.”

The Head of a Department from a further medium-sized fully-fledged Islamic bank supported this view in light of the resolutions issued by the SAC, albeit with possible justification with regard to the seemingly phlegmatic approach of the SAC. This is reflected in the following comment:

“Frankly speaking, the rulings and pronouncements of the SAC are not enough. However, I think that is the intention of the BNM. If every responsibility is given to the SAC, then the religious board at the bank level would be irrelevant.”

In addition, the requirement for financial institutions offering Islamic banking products to seek approval from the in-house SSB and also later from the SAC was criticised, as it was seen as an impediment to efficient decision-making required by businesses. More crucially, as the number of IFIs increase, the product approval process and the deliberation of Shariah issues relating to banking products, and how these are to be implemented, are expected to take much longer. In such circumstances, there is an obvious need for the SAC to first focus

on issues concerning the industry at large, and second, allow industry itself the flexibility to relax its rigidity on the need to present issues that need approval. To meet this request, the SAC has developed a series of Shariah parameters aimed at promoting operational efficiency and best practice amongst industry players. These parameters prescribe minimum guidance on applying the Shariah contracts in Islamic finance, which have been prepared by gaining feedback from industry players. However, these religious parameters still prove to be inadequate. Confirming this, the Chairman of a SSB from a conventional bank offering Islamic banking was somewhat scathing and remarked:

“The SAC should provide industry with more Shariah parameters and guidelines. Issues raised could certainly be discussed at the national level and then forwarded to industry. So, rather than asking the industry to come to the Central Bank (BNM) and present in front of the SAC, why doesn’t the SAC just give the industry its approval?”

Specifically focussing on the controversial Islamic financial contracts of a sale on a deferred payment basis contract (*bay’ bithaman ajil*) and a back-to-back sale or a sale repurchase contract (*bay al-’inah*) discussed earlier, our interviewees stated that although they had the mandate, these contracts were not preferred by the RCSB.¹⁰ In fact, the overwhelming belief was that the SAC had taken the view that it is market players who should consider these Islamic financial contracts as a last resort to be offered to customers. Besides the controversial nature, the reason why the BNM were keen not to favour the two products was the availability of other Islamic financial contracts, such as a sales contract where goods are sold at a mark-up price (otherwise known as a *murabahah* contract) or a diminishing partnership contract (known as a *musharakah mutanaqisah*). However, the officials participating in this study disclosed to us the concerns amongst the regulators that *bay’ bithaman ajil* and *bay al-’inah* have become default financial contracts amongst the Islamic banking market players. A member of the SAC remarked:

“Some people accuse us of being liberal. What I can say is that before we make a decision, a thorough and comprehensive study is undertaken on the particular issue. We might prefer certain views to others and, in some circumstances, the bank can opt for the exception rather

than the rule, but the bank is given a time limit for that. However, sometimes the exception has become the rule by default.”

The view expressed by the SAC member quoted above appears to be more complicated than it first seems. Our interviewees revealed that in actual practice, the choice of a financial contract, although potentially controversial, might not be something that is decided on the basis of an IFI’s choice. A senior executive of a fully-fledged Islamic bank remarked:

“Once we were entering into an agreement on an Islamic financial syndicate with another Islamic bank. Our syndicate partner proposed *bay al-’inah* as the medium for the syndicate. At first, this proposal was declined, because our Shariah board (SSB) vehemently disapproved. However, as our syndicate partner insisted on *bay al-’inah*, we did finally agree to its use.”

This disclosure on the use of a controversial Islamic financial contract is interesting. This is because the determination of certain IFIs to proceed with a contentious financial contract which is known to produce an economic effect similar to a conventional financial product is an exposition that the Islamic banking industry tends to be market-driven, thus taking advantage of the flexibility of legal reasoning (*Ijtihad*) permitted by the Islamic faith.

Our interviewees also revealed the lack of regulation at the international level to have contributed to conflicting views amongst religious scholars on the operations of Islamic banking activities and the associated difficulties related to cross-border transactions. For instance, several of our board members and executives interviewed expressed frustration regarding international operations. The CEO of a large fully-fledged Islamic bank revealed his discontent by stating:

“All the Islamic finance problems you find today are caused by the GCC (the Gulf Cooperation Council). I am not being biased because I have operations in the GCC. Quite frankly, I cannot do business in the GCC, not because I don’t have the product, but because I personally am not that confident about doing business there. Any Tom, Dick or Harry can just come and say that your product is not right and my experience tells me that....every time I come out with a new product in the GCC, it is labelled impermissible (*non-halal*), but a few months later it becomes permissible (*halal*).”

The above remark demonstrates how a Malaysian Islamic banking product from a particular legal jurisdiction and approved by its higher SAC could still be opposed when

undergoing a cross-border transaction if it is deemed unacceptable according to the resolutions of a Shariah authority in another jurisdiction. Finally, although the findings of our study extols the virtues of a centralised board such as the SAC in Malaysia, several of our high ranking participants from the BNM itself (from the Department of Islamic Banking and Takaful) along with several SAC members interviewed had disagreed with the assertion that establishment of a global SSB would provide benefit to the Islamic finance industry. For instance, a SAC member made his view clear by commenting:

“I totally disagree to having an international centralised Shariah board with the idea of standardising Islamic banking products and practises globally. This is simply because we should allow the Islamic banking industry to progress in accordance with each country’s level of Islamic banking acceptance and stage of development rather than merely imposing rules on them.”

The above statement demonstrates that Islamic banking tends to operate best when it is left to a country’s own national Shariah governance framework. In the Malaysian case, our study participants perceived the industry to be enjoying the privileges of consistency in Islamic banking practice due to the dual-layer Shariah governance system. It may well be that as the Islamic banking Industry matures globally, this will necessitate the establishment of a global SAC (consisting of jurists from all of the four Islamic Schools of Jurisprudence) to lay down the law for all jurisdictions and effectively contribute to the standardisation of Islamic banking practice. Nevertheless, it must be remembered that any resolutions issued under this governance system might still be in dispute when cross-border transactions take place. We therefore highlight that although there are conflicting opinions on the permissibility of certain Islamic finance products by different Shariah scholars, this does not mean that Islamic banks should close their door to the innovation of Islamic finance products and services.

6. Conclusion

A robust governance framework is critical in ensuring religious compliance in the Islamic financial industry. The likelihood of producing diverse rulings (i.e., *fatwas*) and products that can lead to non-shariah compliance and reputational risks is higher in countries that do not have a central religious supervisory board similar to the Malaysian SAC. This study finds that one of the major problems in standardizing Islamic banking practice is that substantial reliance is placed on religious scholars for their expertise. Also, the disparities in religious decisions amongst Shariah scholars serving on SSBs of individual banks are the natural outcome of the exercise of ‘religio-legal reasoning’ (*ijtihad*) facility. Our study provides evidence that it is this freedom to exercise the ‘religio-legal reasoning’ provision that gives rise to the dichotomy in standardizing Islamic banking practices whether nationally or internationally. However, the resulting complexity does not change the fact that standardisation of Islamic banking is associated with ease of regulatory control and promotes confidence amongst industry players and other key stakeholders.

Our findings also indicate that the governance partnership endorsed by the Malaysian dual-layer Shariah governance system and the intricate relationship between individual SSB of banks and a national SAC, has improved and advanced standardisation of practice. The regulatory infrastructure and the mandated authority of the SAC are found to have contributed to the positioning of itself as an over-arching governance body ultimately responsible for regulatory affairs and pivotal in standardising Islamic banking practice. Furthermore, the SAC was found to be decisive in resolving disputes arising from the power to exercise legal reasoning (*ijtihad*) by individual SSB thus providing the much-needed confidence sought by stakeholders.

Overall, the standardisation effort brought about by the dual-layer governance system implemented in Malaysia is shown not to have impeded creativity in the innovation of new Islamic banking products. Rather, this governance mechanism facilitates openness for

industry players to further benefit from the potential of Islamic finance. Taking advantage of the regulatory framework, Islamic banks can broaden its product offering in their quest to attract and meet different customer needs and be at par with their conventional counterparts. New industry players would also feel confident in establishing themselves in the Islamic banking industry as the dual-layer governance system features governance commitment at both the regulatory and industry level whilst recognizing the importance of product innovation. Yet, challenges remain for this dual-layer governance system as to how its approval process could be made more effective to meet the rapid decision-making requirement sought by Islamic banks business in Malaysia.

Finally, given the demand for Islamic banking and finance and the need to standardise practices, it would be worthwhile for future researchers to investigate whether the experiences of other countries operating a dual-layer religious governance system have been similar to Malaysia. This would provide a much broader understanding of the attempts being made by regulators to standardise and harmonise Islamic banking practices globally. Future studies should also consider undertaking comparative evaluation aimed to evaluate the effectiveness of governance and regulatory mechanisms since evidence provided in this particular study indicates that major inconsistencies remain.

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¹ *Fatwa* is the Arabic translation for 'religious edict'. The term *fatwa* is used interchangeably with Shariah decisions throughout this paper.

² AAOIFI is supported by nearly 200 members from 40 countries, including Central Banks, Islamic Financial Institutions and other participants from Industry. AAOIFI has issued a total of 88 standards comprising 26 accountability standards, 5 auditing standards, 7 governance standards, 2 ethics standards and 48 Religious standards (AAOIFI, 2015) To date, AAOIFI standards have been adopted in 7 countries but are only mandatory in Bahrain and Qatar.

³ Examples of jurisdictions where AAOIFI standards are made mandatory are Bahrain, Dubai International Financial Centre, Jordan, Sudan, Syria and Qatar. .

⁴ Currently, there are eleven members of the Shariah Advisory Council (SAC) of Malaysia's Central Bank (BNM). These SAC members are drawn from practitioners, jurists, Shariah scholars and academics.

⁵ *Ijtihad*, or legal reasoning, is the interpretation of the Shariah by jurists who formulate a rule of law on the basis of evidence found from its ultimate source, the Qur'an and the *Sunnah* (Practice of the Prophet).

⁶ The four different Schools of Islamic Jurisprudence here refer to the Shafe'i, Hanafi, Maliki and Hanbali.

⁷ In a paper by a prominent scholar entitled 'Governance Standards and Protocols on the Religious Decision Making Process' presented at the round table meeting between the Securities Commission of Malaysia and the Oxford Centre for Islamic Studies (OCIS), the Religious scholars argued that issuance of a *fatwa* should not be centralized, indicating that such effort could result in the lack of innovation of Islamic financial products. Parker, M. (2010).

⁸ The three foreign institutions that were granted an Islamic banking license were all from middle-eastern countries, namely: Kuwait Finance House (Kuwait), Al-Rajhi Banking and Investment Corporation (Saudi Arabia) and a consortium led by the Qatar Islamic Bank.

⁹ We examined the size and type of banks of the banking institutions represented by our interview participants from the industry. In this study, the size of banks is defined and categorised by total assets where: small (is less

than RM1,000 million assets); medium (between RM1,000 million to RM10,000 million assets); and, large (more than RM10,000 million assets). Meanwhile, the type of banks is differentiated between fully-fledged Islamic banks and conventional banks that operate Islamic windows.

¹⁰ The SAC, in its Shariah resolutions issued by the BNM, makes clear provision that IFIs should limit the use of controversial products such as *bay' al-'inah*. BNM. Shariah resolution in Islamic finance. http://www.bnm.gov.my/index.php?ch=en_reference&pg=en_reference_index&ac=584&lang=en. (Accessed 19 April 2018)