AN EMPIRICAL INVESTIGATION INTO THE ROLE, INDEPENDENCE AND EFFECTIVENESS OF SHARI'AH BOARDS IN THE MALAYSIAN ISLAMIC BANKING INDUSTRY

by

Ahmad Fahmi Sheikh Hassan

Master of Science in Accounting (International Islamic University of Malaysia)
Bachelor of Accounting (University Putra Malaysia)
Diploma in Social Science Research Method (Cardiff University)

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"In the name of Allah, the Most Gracious,
the Most Merciful"

To my wife and my children

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I give praise to Allah for, without His guidance and the strength and patience He has bestowed upon me, this study entitled '*An Empirical Investigation into the Role, Independence and Effectiveness of Shari'ah Boards in the Malaysian Islamic Banking Industry'* would not have been successfully completed.

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ABSTRACT

Islamic banks' operations are guided by the principles and values laid down in Islam (i.e., the Shari'ah). To ensure Shari'ah compliance on the operations of the bank and to inspire the confidence of shareholders and stakeholders, each Islamic bank is required to establish a Shari'ah board. This study empirically investigates the Shari'ah boards operating in the Malaysian Islamic banking industry and specifically examines the influence of the dual-layer Shari'ah governance system on Malaysian Islamic banking practices where, besides the regulated Shari'ah board, Shari'ah supervision at the highest level is undertaken by the Shari'ah Advisory Council (SAC) of the Central Bank of Malaysia. Two separate questionnaire surveys were distributed to banks offering Islamic banking in Malaysia. One was sent to the Shari'ah department of the Islamic banks and the second to the branch managers to assess the current practice and the expectations regarding how the issues investigated are being practised by the Shari'ah board. Furthermore, a series of in-depth interviews were undertaken with important stakeholders within the Malaysian Shari'ah governance framework.

Essentially, this study indicates that Shari'ah boards do in the main undertake a valuable Shari'ah advisory role and reveals the existence of an established structure for Shari'ah reviews. However, the Shari'ah reviews were found not to be effectively implemented by the Shari'ah boards thus raising concern regarding the quality of the Shari'ah reports issued by the boards highlighting both the importance and need for an external Shari'ah audit. In addition, the composition of the Shari'ah board members is revealed to have influence over the quality of Shari'ah decisions issued by the board. Moreover, the integrity of the Shari'ah board members, such as their ethical value, reputation and scholarly background, was found to be important in influencing its accountability and independence. Interestingly, Shari'ah boards were also perceived by branch managers of not providing the required level of involvement. The study also emphasises that branch managers felt the Shari'ah Advisory Council (SAC) to be the most important party within the Malaysian Shari'ah governance framework, and that the dual-layer Shari'ah governance system was viewed as having contributed to the standardisation of Islamic banking. Also, it appears that the role played by the Shari'ah Advisory Council (SAC) is not limiting creativity in developing Islamic banking products.

TABLE OF CONTENTS

LIST OF TABLES

LIST OF FIGURES AND CHART

GLOSSARY

Arabic Term		**Translation**
‘*urf*	:	Customary practice.
Al-ijarah thumma al-bay’	:	A contract of lease which subsequently followed by a sale contract.
bay’ al-‘inah	:	A back to back sale contract or a sale repurchase, usually sale is at a higher price while the buying back is at a lower price.
bay’ al-dayn	:	A contract of sale of debt.
bay’ al-salam	:	A sales contract where the price is paid in advance and the goods are delivered in the future.
bay’ bithaman ajil	:	A sales contract on a deferred payment basis.
daruriyyat	:	Essentials.
falah	:	Success.
fatwa	:	Shari’ah decision.
furu’	:	Branch cases in Islam.
gharar	:	Uncertainty.
hajiyyat	:	Complementary requirements.
hajj	:	Pilgrimage to Makkah; represent one of the basic tenets in Islam.
halal	:	Permissible according to the Islamic law.
haram	:	Prohibited according to the Islamic law.
harus	:	Permissible practice according to the Islamic law.
hibah	:	Reward.
hikmah	:	Rationale.
ibadat	:	Worship.

ibahah	:	Permissibility.
ijarah	:	A lease contract.
ijarah mawsufah fi al-zimmah	:	A lease contract of a specified future asset which is not in existence at the time of contract.
ijtihad	:	Legal opinion.
illah	:	The effective cause.
istihsan	:	Juristic preference.
khalifah	:	Vicegerent.
khilaf	:	Differences among the Shari'ah scholars.
madzahab	:	Islamic legal school.
makruh	:	Disapproved practice according to the Islamic law.
maqasid al-Shari'ah	:	Objectives of the Shari'ah.
maslahah mursalah	:	Unrestricted public interest.
maslahah	:	Benefits on different changed circumstances.
mua'malat	:	Matters pertaining to human relation in Islam.
mudharabah	:	It is a form of silent partnership between two parties where one provides the capital for a project and the other, *mudharib*, manages the project. Profits are distributed according to a predetermined ratio while losses are borne by the provider of the capital.
mudharib	:	Entrepreneur within the *mudharabah* contract.
mufti	:	A jurist who interprets Muslim religious law.
murabahah	:	A sales contract where goods are sold at a price which includes a profit margin agree by both parties.
musharakah	:	A partnership contract where partners contribute the capital for financing the project. All parties share profits on a pre-agreed ratio but losses are shared on the basis of equity participation.
musharakah mutanaqisah	:	A diminishing partnership contract where the partners usually enter into two types of contracts: a joint ownership contract and an *ijarah* (lease) contract in which the bank will gradually sell its shares to the client. In terms of distribution of profit and loss

		in *musharakah* type of financing, all profits generated will be shared among the partners in a proportion which is mutually agreed in the contract, while the losses will be shared in proportion to the partners' capital.
nisab	:	A threshold figure specified in Islamic law.
qard al-hasan	:	Charitable loan with no interest.
qiyas	:	Analogical reasoning.
riba	:	Usury or interest. In a commodity exchange *riba* denotes the disparity in the quantity or time of delivery. Technically, *riba* denotes any increase that must be paid by the borrower to the lender along with principal sum as a condition for the loan or loan extension.
ribawi	:	Usurious items.
s.a.w	:	Peace be upon him.
Shari'ah	:	Islamic law.
sunnah	:	The traditions of Prophet Muhammad s.a.w.; the recommended practice of Prophet Muhammad s.a.w.
tahsiniyyat	:	Desirables.
Takaful	:	Islamic insurance.
tawarruq	:	A sales contract where the financial institution will buy an asset and immediately sell it to a customer on a deferred payment basis. The customer then sells the same asset to a third party for immediate delivery and payment, the end result being that the customer receives a cash amount and has a deferred payment obligation for the marked-up price to the financial institution.
ummah	:	Nation.
usul-fiqh	:	The methodology of Islamic jurisprudence.
wadi'ah	:	Safekeeping of deposit by customers in financial institution.
wadi'ah yad dhamanah	*:*	Safekeeping of deposit by customers in financial institution where the deposit is guaranteed by the financial institution.
wajib	:	Obligatory practice according to the Islamic law.
zakat	:	Alms-giving; represent one of the five basic tenets in Islam.

ABBREVIATIONS

Abbreviations		Meaning
AAOIFI	:	Accounting and Auditing Organization for Islamic Financial Institutions
BNM	:	Bank Negara Malaysia
CEO	:	Chief Executive Officer
GPS1	:	Guidelines on the Governance of Shari'ah Committee for the Islamic Financial Institutions
IB	:	Islamic Banking
IFI	:	Islamic Financial Institution
IFSB	:	Islamic Financial Services Board
ISR	:	Internal Shari'ah Review
MIFC	:	Malaysian International Islamic Finance Centre
QS1	:	Questionnaire Survey 1
QS2	:	Questionnaire Survey 2
RM	:	Ringgit Malaysia
SC	:	Shari'ah Committee
SGF	:	Shari'ah Governance Framework

CHAPTER ONE: INTRODUCTION

1.1 Background to the Study

Good corporate governance might not be confined to a prescribed standardised set of Code of Practice that fits all but could rather be unique to the type of business operation (Prowse 1994; Mayer 2000; Monks and Minow 2001). It is well accepted that the corporate governance for financial institutions such as banks entail distinct features due to the opacity and regulatory nature of the industry and calls for a separate scope of analysis from its counterpart, i.e., non-financial corporations (Ciancanelli and Gonzalez 2001; Levine 2004; Andres and Vallelado 2008). As for Islamic financial institutions (IFIs), such as Islamic banks, their corporate governance features Shari'ah governance mechanisms, which ensures adherence to the Islamic Shari'ah principles in their business operations.

One of the Shari'ah governance mechanisms apparent in Islamic banks is the Shari'ah board.[1] It is argued that the Shari'ah board ensures the credibility of Islamic banks by ascertaining the Shari'ah compliance of the banks' operations (Briston and El-Ashker 1986; Tomkins and Karim 1987; Karim 1990a; Karim 1990b; Banaga et al. 1994; Rammal 2006; Ghayad 2008; Laldin 2008a). To strengthen further the Shari'ah governance mechanism in the Islamic banking operation, Malaysia, as well as several other countries, has established a centralised Shari'ah board at the national level. In this light, the present study empirically investigates the governance function of the Shari'ah board in the Malaysian Islamic banking industry. In particular, this study offers an examination of the influence of the dual-layer Shari'ah governance system on Malaysian Islamic banking practices.

The importance of a thorough evaluation of the governance mechanism within IFIs could be ascertained from the recent global financial crisis. It has emerged that the financial turmoil that began in 2007 affected various financial and economic activities worldwide including the failure of financial institutions due to the global impact of the financial crisis. The focus of the prevalent argument on what caused the crisis has been on the weaknesses of institutions'

[1] The term Shari'ah board is used interchangeably with Shari'ah Supervisory Board (SSB) and Shari'ah Committee (SC). The SSB refers to the designation of the Shari'ah board used by AAOIFI and IFSB in their standards, whilst the SC is the designation of Shari'ah Committee used in the Malaysian regulatory guidelines. Commonly, this Shari'ah governance authority is known as the Shari'ah board.

corporate governance and regulations, underlining that they proved to be insufficient (Kirkpatrick 2009). Importantly, the financial crisis calls for discussion about and the urgent evaluation of existing governance mechanisms that holds the financial institutions. Hence, investigation of the governance function of Shari'ah boards in the Islamic banking industry attempted in this study is deemed to be crucial.

1.2 Motivation and Rationale of the Study

This study investigates the governance function of the Shari'ah board in Islamic banks. A review of the literature indicates that there is a lack of extensive research in this area. The studies that are available tend to be limited in scope and provide only a narrow understanding of the issues surrounding the Shari'ah board. The main motivation for conducting this study is to address this gap by examining the crucial issues concerning the role, independence and effectiveness of the Shari'ah board. With regard to the development of the Shari'ah governance structure, Malaysia is recognised by many as having the most established regulatory and supervisory framework for the Islamic banking industry in the Islamic world. In addition, the Islamic banking industry in Malaysia also includes the range of fully-fledged Islamic banks as well as conventional banks offering an Islamic banking window. The competitive environment created by this dual banking system is argued to have resulted in the availability of a wide range of sophisticated products from banks offering Islamic banking operations (Bakar 2008a, pp. 69-70) of which the Shari'ah boards are involved. Hence, investigation of the Shari'ah board issues above for the Islamic banking industry in Malaysia would provide an indication of the present state of the Shari'ah governance of the Malaysian Islamic banking industry.

Additionally, Malaysia implements a dual-layer Shari'ah governance system for its Islamic banking industry. This is where, besides the regulated Shari'ah board, Shari'ah supervision at the highest level is undertaken by the Shari'ah Advisory Council (SAC) of the Central Bank of Malaysia (Bank Negara Malaysia (BNM)), which acts as the centralised Shari'ah board and the supreme authority governing the Islamic finance industry. One important task of the SAC is to attempt to standardise Islamic banking practices through coordination of the *fatwas*[2] and Islamic finance products and services (Grais and Pellegrini 2006; Laldin 2008a;

[2] Fatwa is the Arabic translation for 'Islamic verdict'. The term *fatwa* is used interchangeably with Shari'ah decisions throughout this thesis.

Shaffaii 2008). This is supported by Wilson (2009) who argued that consistencies in the IFIs are more likely in jurisdictions where there exists a centralised Shari'ah board. The fundamental issue to be addressed is whether the presence of a dual-layer Shari'ah governance system actually enhances the Shari'ah governance and, therefore, ensures the credibility of the Islamic banking industry. Hence, this study expands the understanding of the issues surrounding the Shari'ah boards that operate within a dual-layer Shari'ah governance system.

1.3 Aims and Objectives of the Study

The principal aim of this study is to evaluate the Shari'ah governance of the Malaysian Islamic banking industry by examining the role, independence and effectiveness of the Shari'ah board. Thus, the objectives of this study are:

a) To ascertain and evaluate the present role of the Shari'ah boards of Islamic banks in Malaysia in ensuring the credibility of the Islamic banking industry and in attending to the needs of the investors and stakeholders.
b) To evaluate the independence and effectiveness of the Shari'ah governance role of the Shari'ah board in the context of the Malaysian dual-layer Islamic banking Shari'ah governance system and to assess its influence on the coherence of Islamic banking practice.

Against the above research objectives, the following research questions have been formulated and will be addressed by the researcher:

a) What is the current role of the Shari'ah board members in the Islamic banking industry in Malaysia?
b) What are the perceptions of the stakeholders regarding the expected role of the Shari'ah board members in the Islamic banking industry in Malaysia?
c) How does the role played by the Shari'ah board and the SAC members influence the credibility of Islamic banks and safeguard the Shari'ah banking needs of investors and stakeholders?
d) How independent are Shari'ah board members in performing their functions? What are the factors that influence their independence?

e) What are the factors that influence the integrity of Shari'ah board members? To whom are they accountable?
f) How do the Shari'ah board members interact with other parties within the Shari'ah governance mechanisms of an Islamic bank?
g) What are the perceptions of the stakeholders regarding the effectiveness of a dual-layer Shari'ah governance system of Islamic banks, as they are implemented in Malaysia?
h) What are the perceptions of the stakeholders regarding the influence of the dual-layer Shari'ah governance system of Islamic banks in promoting coherence of the Islamic banking practice in Malaysia?
i) What is the extent of Shari'ah board members' involvement in the accounting aspects of Islamic banking operations?
j) How is the Shari'ah governance mechanism, as it is practiced in Malaysia, associated with the quality of an Islamic bank's Shari'ah report?

1.4 Scope of the Study

This research principally involves an examination of the role, independence and effectiveness of the Shari'ah board amongst participating banks in the Malaysian International Islamic Finance Centre (MIFC) of BNM. The MIFC makes apparent three main categories of Islamic banking operations: (1) local, fully-fledged Islamic banks; (2) international Islamic banks; and (3) other banks offering Islamic banking window.

1.5 Methodology

In order to accomplish the research objectives mentioned above, firstly, a review of the literature on the corporate governance of banks in general was undertaken and this was followed by a literature review of corporate governance of Islamic banks. In addition, this study also made a crucial review of the governance function of the Shari'ah board in Islamic banks. Important debates are discussed, as well as empirical research that specifically examined the role, independence and effectiveness of the Shari'ah board. With regard to the research design, a two-stage data collection procedure was undertaken. The first stage was the administration of questionnaire surveys, which were aimed at gaining a general picture of the issues under investigation. Two questionnaire surveys were undertaken and both were conducted between mid-January and the end of February 2010. To assess how the issues investigated are being practiced by the Shari'ah board, the first questionnaire survey was distributed to heads of Shari'ah departments of the banks offering Islamic banking products and services in Malaysia. Also, in order to determine how the issues investigated are expected to be practiced by the Shari'ah board, a second questionnaire survey was distributed to the branch managers of the banks under study. Furthermore, the second stage of the research was to undertake a series of in-depth interviews, which were conducted between March and the end of May 2010. At this stage, the researcher was interested in gaining further understanding of the results derived from the questionnaire surveys and to discover the 'social process' that is involved in the Shari'ah governance function of the Shari'ah board.

The two-stage research design and the use of both the quantitative and qualitative research instruments presented above highlights that this research is a 'sequential explanatory design', and employs a mixed-method research strategy, respectively. It is argued that the collection of data using this research design, which incorporates a mixed-method research strategy, would enhance the validity of the overall analysis and enable the building of a rounded and overall picture of the issues under investigation (Mason 1994). Hence, it is deemed that the research method used in this study would provide an in-depth review and broaden the understanding of the Shari'ah governance function of the Shari'ah board.

1.6 Contribution of the Study

In addition to implementation of best practice for effective corporate governance, an essential requirement for Islamic banks is the establishment of a Shari'ah governance mechanism that ensures the operations are Shari'ah compliant. The Shari'ah board, in this case, is the backbone and the Shari'ah governance authority of an Islamic bank. The current research also investigates issues surrounding the role of the Shari'ah board, which, in Malaysia, serves as a regulated Shari'ah governance authority. In addition, this research also offers an examination of Malaysian Shari'ah governance system for the operation of Islamic banking that is recognised by many to be the most established and comprehensive in the Islamic world.

Since the aim of this study is to evaluate the role, independence and effectiveness of the Shari'ah board, it is therefore hoped that it will contribute to a better understanding of the present Shari'ah governance function of the Shari'ah board. It is also hoped that it will provide evidence of the efficacy of the Shari'ah governance framework (SGF) in ensuring Shari'ah compliance and shed light on possible avenues for strengthening Shari'ah governance within the Islamic banking industry in Malaysia. It is, therefore, anticipated that this study will not only have policy implications for the Malaysian Islamic finance industry but will also be useful to other countries intending to develop the necessary regulatory infrastructure for their Islamic banking industry.

1.7 The Structure of the Thesis

This chapter has provided the background of the study, outlined the objectives and has briefly discussed the research methodology. Chapter Two provides the review of the literature on the corporate governance of the banks. This chapter highlights the three theories used in the current research as the theoretical framework for the study of corporate governance. These theories are the agency theory, the transaction cost theory and the stakeholders' theory. Several governance mechanisms for the banking industry have been discussed. In particular, this chapter emphasises that regulatory intervention, through policies, prudential standards and guidelines, is a crucial governance mechanism function of the regulators to protect the banking industry from possible financial failure, which may open up the possibility of systemic risk.

Chapter Three reviews the literature on the corporate governance of Islamic banks. Distinctly, this chapter discusses the principles governing Islamic banking practices, with Shari'ah compliance assurance as central and intrinsic to the governance mechanism implemented in the industry. Besides explaining the various Islamic financial contracts, this chapter also discusses the role of the regulatory bodies in promulgating standards and guidelines used in the IFIs and standardising the Islamic banking practices. As the background of the study is the Malaysian Islamic banking industry, this chapter also focuses on the Malaysian Islamic banking environment.

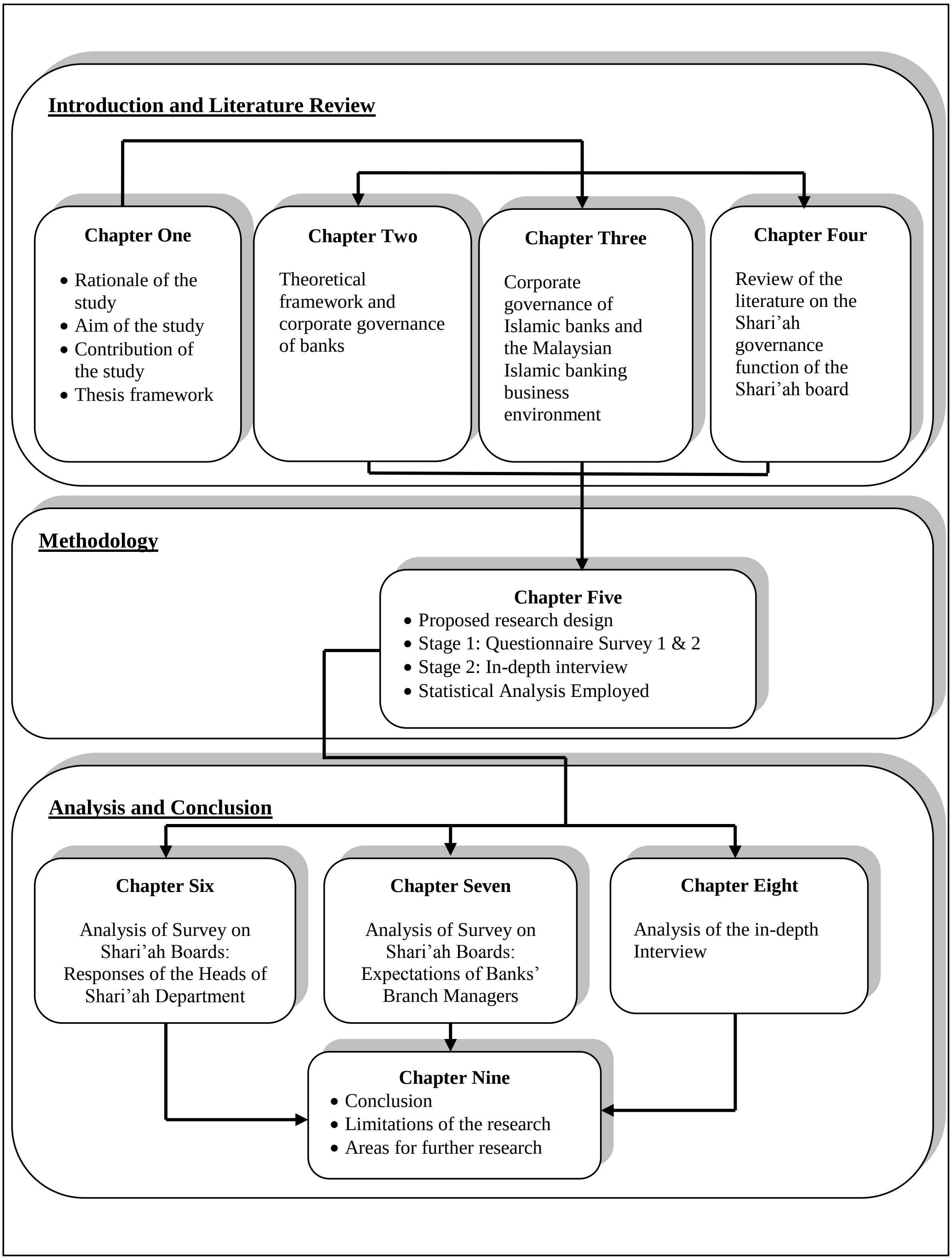
Chapter Four draws attention to the Shari'ah governance function of the Shari'ah board. In particular, this chapter discusses the two spheres of the Shari'ah board's role, i.e., Shari'ah advisory and Shari'ah review, the independence and the effectiveness of the Shari'ah board's governance function. Relevant standards and guidelines on these aspects of interest have also been highlighted. As the current research represents a study from the Malaysian perspective, discussion of the Malaysian Islamic banking regulatory framework and the relevant guidelines on the Shari'ah governance function of the Shari'ah board have been emphasised.

Chapter Five is concerned with the research methodology, describing the research objectives and the processes used in this study. It presents, in detail, the rationale for adopting a combination of methods and issues related to data collection. Regarding the questionnaire survey, the methods used to collect the data are presented, including the questionnaire design, pilot study and distribution procedures. As regards the in-depth interviews, negotiating access and interview strategies are discussed. The relevant analysis to be employed is also highlighted.

The results of the study are detailed in Chapters Six, Seven and Eight. Chapters Six and Seven focus on the results of the analysis of the questionnaires surveys with, respectively, the Shari'ah department and the branch managers of banks offering Islamic banking in Malaysia. Meanwhile, Chapter Eight presents the analysis of the in-depth interviews with the Shari'ah board members, heads of Shari'ah departments, Chief Executive Officer (CEOs) and senior executives of Islamic banks, the SAC of BNM and BNM officers. Chapter Nine presents a brief summary of the overall study and discusses its conclusions and implications for theory and practice. The limitations of the study are also highlighted and, additionally, a number of recommendations and suggestions for future research are proposed.

A framework for the thesis has been constructed to assist in navigating the various parts and chapters. This is displayed in Figure 1.1 below.

Figure 1.1: A Framework for the Thesis



CHAPTER TWO: THEORETICAL FRAMEWORK AND CORPORATE GOVERNANCE OF BANKS

2.1 Introduction

There has been a series of high profile failures from Enron, Parmalat and WorldCom through to Global Crossing and others, despite the presence of a code of good governance and its requirement for businesses to comply or explain their failure to do so. It is, therefore, argued that, given the need to restore public confidence in the corporate governance of organisations, policy makers will need to produce improved guidelines that will at least prevent similar scandals from recurring. Ideally, corporations, in pursuing their aims and objectives, ought to implement what is normally referred to when discussing corporate governance as the 'best practices', which lead to shareholders' and other stakeholders' rights being fulfilled. Hence, a good corporate governance mechanism for corporate success is deemed vital, and its importance cannot be underestimated. As for financial institutions, such as banks, their opaque and regulated nature represents additional dimensions that make their corporate governance different from their counterparts, i.e., non-financial corporations (Ciancanelli and Gonzalez 2001; Adams and Mehran 2003; Levine 2004; Hagendorff et al. 2007; Andres and Vallelado 2008; Mülbert 2009). This could be explained by the nature of the banking business, which collect funds from customers and then uses those funds; this makes it essential to embed a highly regulated governance feature that will uphold the integrity of the financial market and preserve the socio-economic well-being as a whole. On the other hand, one could anticipate that improper and weak governance in banks would lead to catastrophic consequences such as the destruction of the economy and reduced market confidence.

The failure of the banking business and the impact it has had on the economy could be understood from banks' and financial institutions' position in the financial system, which has been described as "a network of interdependent funds flows" by Ciancanelli and Gonzalez (2001p. 11). The present global financial crisis, which began in July 2007, has seen how the failure of financial institutions like Northern Rock of the United Kingdom, which received liquidity support from the Bank of England on 14 September 2007 and later was nationalised on 22 February 2008, and the bankruptcy of United States' Lehman Brothers on 14

September 2008, led to an acute phase of financial failures as witnessed by the subsequent failure of banks, mortgage lenders and insurance companies, the fall of the global stock market and the devaluation of local currencies. Hence, these developments explain the need for and the significance of effective corporate governance for financial institutions and the socio-economic implication such governance would bring.

This chapter is organised as follows. The next section, i.e. Section 2.2, discusses the theoretical framework of the study of corporate governance, with specific emphasis on the agency theory, the transaction cost theory and the stakeholder theory. This is followed by a literature review of the corporate governance of banks in Section 2.3. Then, an explanation of several international regulatory bodies governing the banking industry is offered in Section 2.4. Finally, Section 2.5 offers the summary of the chapter.

2.2 Corporate Governance Theories: The Agency Theory, the Transaction Cost Theory and the Stakeholder Theory Perspective

This section discusses the corporate governance theories underpinning the present study undertaken by the researcher: the agency theory, the transaction cost theory, and the stakeholder theory. An understanding of the theoretical explanation of corporate governance is deemed vital as it makes apparent the related parties' involvement within a business environment and the recognition of whose rights need to be addressed along with the identification of the governance mechanism required to ensure the attainment of that objective. The following paragraphs discuss these theories in more detail.

2.2.1 Agency Theory

Historically, the limitation of funding on the operation of family-owned traditional businesses leads owners to invite others into capital participation in what consequently evolves into a corporation. The emergence of corporate ownership through shareholding and the dispute that can develop over the separation of ownership and corporate control, as discussed by Berle and Means (1932), produces an important economic-based theoretical framework to the concept of corporate governance, i.e., agency theory. Jensen and Meckling (1976), proponents of the agency theory, define the agency relationship as a contractual relationship between the shareholder as the principal and the managers as the agent who are given some authority to perform services on behalf of the principal. One of the primary concerns over this contractual relationship is the conflict of interest between the two parties. The underlying assumption of this agency problem is that, because a management's pay-related benefits are based on the firm's performance, they tend to behave in a manner that would fulfil their self interests (see for example Guidry et al. 1998; Boatright 1999; Ryan and Schneider 2003; Kim and Mahoney 2005). Such behaviour amongst the management serves as an opportunity cost to the firm as it contradicts the long term wealth maximization aim of the shareholders (Demirag and Tylecote 1992). Although this contractual aim of enhancing the corporation value might appear to be implicit, the fiduciary duties that the management owes to the shareholders are deemed to be legally manifested as could be judged from legal prohibitions on activities such as managements' self-dealing, acceptance of bribes, private use of confidential information and the like.

There is a notion that the agency problem above is associated with information asymmetry between the shareholders and the managements (Agrawal and Knoeber 1996). Essentially, the separation of ownership and control concept explained by Berle and Means (1932) has introduced a new form of ownership in doing business, i.e., an ownership that is dispersed amongst the shareholders. This ownership structure gives rise to the challenge of how the shareholders could exercise monitoring and control of corporate management, which is often costly (Eisenhardt 1989). The dispute arises because the management has the upper hand regarding the information available to them, in that the latter is able to make some observations that the former are not in a position to make. This information advantage on the part of the management has been used to make decisions that best serve their interests, as may be reflected by the choices managers make regarding effort, risk exposure and time horizons (Jensen and Smith 1985). Thus, shareholders aspire to wealth maximization while managements incline towards opportunistic behaviours that satisfy their self interests.

Among the agency costs involved in aligning the interests of both parties are the introduction of incentive schemes and contracts for the management, and shareholders' use of voting rights in a way that might influence the direction of the firm (Pratt and Zeckhauser 1985). Through voting, shareholders could exert corporate governance on issues pertaining to corporation faith, such as liquidation and mergers, or even on matters that would enhance their ownership via the election of a board of directors that represents the shareholders' interests, besides monitoring the management. Nevertheless, for the minority shareholders, who are synonymous with the 'free rider' label in the corporate governance literature, the inferiority of their position in comparison with that of large investors and the intensified information asymmetry problem make mechanisms such as voting exercises ineffective at representing their rights and curbing expropriation by the management (Shleifer and Vishny 1997).

On the other hand, contracts are being used to establish the rights of the contracting parties (shareholders and managements) with performance measurement and pay-off being specified (Evan and Weir 1995). Some theorists describe two ways in which shareholders can improve the efficiency of contracts (see for example Ouchi 1978; Eisenhardt 1989). The first method is aimed at reducing the information asymmetry problem of the agent as well as imposing sanctions on an agent's deviated behaviour through a mechanism that would monitor agent behaviour so that it is in accordance with what is stipulated in the contract. Meanwhile, a management appraisal that is based on actual performance in comparison with expected outcome, as suggested by Jensen and Meckling (1976), represents the alternative.

2.2.2 Transaction Cost Theory

Similar to agency theory, transaction cost theory is another economic-based theory of organizational corporate governance that was expanded from the work of (Coase 1937) and a series of publications by Oliver Williamson. However, differences such as the fundamental theoretical assumption as to what constitutes a firm are noted. For example, Williamson (1998) argued that the theoretical proposition brought by agency theory considers a firm as a production function (as with price and output) between the principal and the agent as can be deduced from the phrase 'nexus for contracting relationship' used by Jensen and Meckling (1976, p. 311). In agency theory, the notion of governance lies in an *ex ante* efficient incentive alignment between both contracting parties in anticipation of risk aversion behaviour and the potential moral hazard of the agent. On the other hand, the firm as theoretically manifested in transaction cost theory is regarded as an organizational construction in which the efficient boundaries could be derived by aligning different transactions with governance structures (firm or market) in a discriminating mechanism (Williamson 1985, 1991b, 1998). This difference also highlights a clear distinction between the units of analysis used between agency theory and transaction cost theory whereby the former uses the individual agent and the latter uses transaction.

What makes up a transaction cost and what is its association with the governance structure underlying transaction cost theory are important points for discussion. Typically, transaction costs relate to all aspects of a transaction, including negotiating, monitoring, and enforcing the exchange. In a market organization, this would tend to encompass discovering what the relevant prices are, the costs associated with the terms of the trade and negotiating and concluding a separate contract for each exchange transaction. Alternatively, Coase (1937) argued that as the transaction cost of performing the activities in the market is substantial, a firm emerges and workers surrender the right to use their labour by contract. Besides economizing transaction costs, internalizing activities by the firm (which is also known as vertical integration) gives a different set of transaction costs which include coordinating purchases, production activities and the costs of motivating and monitoring the workforce.

In Williamson's work (see for example Williamson 1975; 1979, 1981) and in the light of the transaction cost description above, he suggested three generic governance structures, namely, the market, hierarchy (i.e., vertical integration), and hybrid (a combination of market and hierarchy). It is noteworthy that there are two factors considered as the postulates underpinning the theoretical idea behind transaction cost theory that produce ambiguity in the contracting process and which give rise to transaction costs: 'bounded rationality' and opportunism (Williamson 1975, 1985). The assumption of 'bounded rationality' or contractual incompleteness follows Simon's (1961, p. xxiv) interpretation of human action as 'intendedly rational, but only limitedly so', which describes the rationality of human behaviour as being limited by the ability to process information and, so exposes the contracting parties to certain risks. If, for example, circumstances change unexpectedly, not only will the original governing agreement no longer be effective, but this will also force the firm to be adaptive; failure do so imposes 'maladaptation costs' (Williamson 1991a). Meanwhile, opportunism is the assumption of human behaviour that is described as 'self-interest seeking with guile' (Williamson 1975). It is the perceived hazards of an agent that would attempt to organize transactions in their best interests, thereby adding to the existing contractual complications. As a result of assuming bounded rationality and opportunism, transaction cost theory focuses on how *ex ante* choices of governance structure could be exercised in order to safeguard against *ex post* hazards of opportunism (Williams 1993). Hence, similar to agency theory, transaction cost theory also seeks the best governance structure that would control the agents' opportunistic behaviour in pursuit of shareholders' profit maximization motive. As such, from the theoretical perspective, both agency theory and transaction cost theory have been regarded as complementary (Williamson 1998).

2.2.3 Stakeholder Theory

Many studies have argued about the narrow governance relationship underlying agency theory between the board of directors, the shareholders and the management in understanding the complexities within an organisation (see for example Eisenhardt 1989; Aguilera et al. 2008; Christopher 2010), and its inability to explain accurately the diversity of corporate governance arrangements in different institutional contexts (Aguilera and Jackson 2003; Filatotchev et al. 2008). Stakeholder theory, as a governance theory, refutes the claim of the limited impact of corporations' activities on shareholders. The essence of stakeholder theory is the exposition that the corporate governance and accountability of the management is wider than that offered by agency theory, i.e., shareholders, and is extended to incorporate other stakeholders. By broadening the corporate governance spectrum, stakeholder theory examines situations where management, in addition to shareholders, also pursue the interests of other stakeholders (Berry and Rondinelli 1998; Caldwell and Karri 2005; Solomon 2007; Collier 2008). In this regard, Freeman (1994, p. 46) offers clarity by defining stakeholders as 'any group of individuals who can affect or is affected by the achievement of the organization's objectives'. Meanwhile, Waddock et al. (2002) categorized stakeholders into primary stakeholders (such as the employees and customers of an organization) and secondary stakeholders (such as non-government organizations, activists, communities and governments).

In relation to agency theory, the theoretical exposition of corporate governance in stakeholder theory implicitly rejects the notion that shareholders' wealth maximization is the only aim of a corporation, as is claimed by agency theory. The management, as the agent within stakeholder theory, is argued to have the responsibility to select activities and direct resources to obtain benefits for all legitimate stakeholders (Donaldson and Preston 1995). This is supported by Carroll and Buchholtz (1999, p. 23) who asserted that 'the task of management is not only to deal with the various stakeholder groups in an ethical fashion but also to reconcile the conflicts of interests that occur between the organisation and the stakeholder groups'. Hence, the fiduciary duty of the management has to suit the interests of all parties under the ambit of stakeholder theory. In this respect, stakeholder theory has been considered as complementing agency theory with regard to corporate governance (Solomon 2007).

Besides the three theories mentioned above, there are other theoretical perspectives on corporate governance. These include resource dependency theory, managerial-class hegemony theory and stewardship theory. Resource dependency theory, for example, posits that the board of directors is valuable in facilitating, securing and easing the process of acquiring scarce and essential resources (Selznick 1949; Zald 1969; Pfeffer and Salancik 1978; Pennings 1980; Zahra and Pearce 1989; Boyd 1990; Kesner and Johnson 1990; Daily and Dalton 1993; Goodstein et al. 1994; Johnson et al. 1996; Kula 2005). Under this theory, the board of directors is viewed as the mechanism for reducing environmental uncertainty (Pfeffer 1972) where such uncertainty could affect an organization's control of resources and choice of strategies. Another role of the board of directors explained in resource dependency theory is reducing the transaction cost resulting from the inter-dependencies between the firm and various institutions within the environment (Williamson 1984). Meanwhile, managerial-class hegemony theory advocates that the board of directors is an ineffective mechanism of corporate governance, as the board plays only a passive role in strategy or directing the corporation; these activities are dominated by the management (Mace 1971; Lorsch and Maclver 1989). Under this theory, the role of the board of directors in the strategic management of the firm is said to be contingent upon the firm facing a crisis (Mace 1971; Clendenin 1972). Accordingly, managerial-class hegemony theory posits that the real responsibility of running and controlling an organisation is actually assumed by corporate management (Scott 1997).

Stewardship theory, on the other hand, holds a contrasting view to agency theory. Unlike agency theory, stewardship theory assumes that there is no conflict of interest resulting from the separation of ownership and that the goal of governance is basically to find mechanisms and structures that facilitate the most effective coordination between the management and the owners (Donaldson 1990; Davis et al. 1997). Furthermore, stewardship theory views people in an organization as collectivist and pro-organisational and not opportunist (Davis et al. 1997). With regard to transaction cost, it is expected that the transaction costs under stewardship theory will be lower as there is a reduced need for costs associated with incentives and the monitoring of behaviour (Davis et al. 1997).

In summary, this section offers insights into important governance elements embedded in corporate governance theories which are rooted in the separation of ownership and corporate control in a corporation. As highlighted in the beginning of this section, the theoretical perspectives of corporate governance underpinning the present study are agency theory, transaction cost theory, and stakeholder theory. As will be discussed later in Chapter Three, the liberal market policies that exist in the Malaysian Islamic banking industry have encouraged economic and market development and have created a competitive environment for the industry. In this regard, an economic-based corporate governance theory, such as the three selected theories mentioned, is deemed to be the pertinent type of theory for elucidating the corporate governance of banks and the corporate governance environment and circumstances in the Malaysian context. Additionally, in the context of the present study, the term 'corporate governance' takes the definition used by the Organisation for Economic Co-operation and Development (OECD)[3]: 'a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined' (OECD 2004).

The following section discusses corporate governance with a special focus on the banking industry. It highlights the governance issues surrounding certain corporate governance mechanisms of banks, as highlighted in the literature.

2.3 Corporate Governance of Banks

The governance attributes for non-financial institutions are similarly relevant when discussing the corporate governance of banks (Peni and Vähämaa 2011). Indeed, the banking institutions incorporate special features which continue to exert corporate governance challenges to a greater extent than do its counterparts, i.e. the non-financial institutions. For example, the information asymmetry problem is claimed to be heightened in banks (Furfine 2001), as could be evaluated by examining two factors. First, Levine (2004) asserted that the volatility of a bank's financial position and its quality are usually at the discretion and in the consciousness of the management, though not observable by the shareholders. The financial

[3] More discussion on OECD is given in Section 2.4.1 below.

intermediary role of the banks through the use of financial instruments has made liquidity one of the most important features associated with this industry. Yet, the risk quality and the nature of the business resulting from the transactions that take place within banks, as a whole, is deemed to be known only to the management. Secondly, Ciancanelli and Gonzalez (2001), in disagreement with the underlying assumption of a competitive market for non-financial corporations in agency theory, assert that the multi-contractual relationship that exists in banks expands the scope of information asymmetry beyond what is usually described between owners and managers to include depositors, borrowers and regulators. Hence, these arguments show how the agency problem poses more corporate governance challenges in the banking industry whilst indicating the hefty agency costs associated with the resulting divergence between the principal's and the agent's objectives. In addition, the contractual relationship that exists between the management and non-shareholders, such as in the case of bank depositors, could demand greater protection than that exists between the management and shareholders. In this regard, the government and the regulator are the two stakeholders that, although not directly involved in the contractual relationship as the agent or the principal, signify their important stakehold in banks' highly regulated environment.

In light of the above discussion, the shareholders and the stakeholders in the banking industry, in comparison with those in non-financial institutions, are deemed to face intensified difficulties associated with the monitoring and control of the management as a result of banks' unique characteristics, as noted earlier. The following subsections discuss the corporate governance issues surrounding certain corporate governance mechanisms of banks.

2.3.1 Issues Surrounding the Role of the Board in Banks

The corporate governance theories discussed in the preceding section have described how the agents carry a significant responsibility to execute a corporation's functions in fulfilling the rights of the shareholders as well as of the stakeholders. Commonly, the structure of a corporation, including banks, exhibits the distinctive designation of the board of directors that displays authority over the operation of the business through its decision-making capacity. The board also monitors the management, which is usually headed by the Chief Executive Officer (CEO), and how the management discharge their responsibility as the agent in the contractual relationship with the shareholders. There is an ongoing debate in the corporate governance literature over the negative impact of the duality issue of the CEO and chairman of the board. Fama and Jensen (1983) were amongst the earliest to argue that the CEO-chairman duality could result in a concentration of power, leading the board to be influenced by a single person. In such circumstances, they asserted that the board could be deprived of an effective monitoring role over the management of the corporation.

Recent research on bank governance, for example, Adams and Mehran (2008) and Andress and Vallelado (2008), advocates a large size of board of directors for banks. This presupposition was made after it was found that board size is positively associated with bank performance, which implies that a bigger board would allow for efficient monitoring and advising of managers, thereby creating value for shareholders. However, the finding of Andress and Vallelado (2008) also recommends exercising caution on the size of the board, suggesting it should not to be oversized and should be limited to 19 directors, after which an increase in the number of directors would diminish the bank's performance. More specifically, this result was obtained after controlling for several factors including the regulatory and institutional setting amongst the sample data used on banks from developed countries. Hence, the possibility that regulation and supervision differences among the countries studied would influence the results was addressed and it was concluded that a 'one-size-fits-all board' is implausible for banking corporations. Additionally, the finding regarding the drawbacks of an oversized board implies that disputes amongst the directors are likely to occur, as the authors suggest that coordination and communication difficulties are likely to arise within a bigger board.

Importantly, the board has to be independent to be effective in mitigating the opportunistic behaviour of the management (Fama and Jensen 1983). One way to promote independence is by maintaining an optimal balance between the inside and outside directors (Rutherford et al. 2007). Indeed, studies also indicate that the monitoring role of the outside directors is crucial, as without them, the inside executive directors are likely to manipulate their position in fulfilling their own self-interests (Morck et al. 1988). In the corporate governance of bank literature, Andress and Vallelado (2008) recommend the composition of the board be balanced between insiders and outsiders. Again, they found that directorships among outsiders in banks are positively associated with bank performance, but however, reach a peak after which performance is reduced if more outsiders are included in the board. Hence, although the presence of non-executive directors is meant to enhance the governance of the bank, the finding indicates that the effectiveness and efficiency of the board to execute control over management does not necessarily depend on the board being overloaded with outsiders. Apart from the right balance of the directorship, a study by Adams and Mehran (2008) also shed light on how outsiders' association with the bank could affect others' interpretation of the outsiders' performance. They pointed out that outsiders' lending relationship with their bank could jeopardise the directors' true independence and, thus, raises the concern of whether, under such circumstances, the outsiders would really perform in the best interests of either the shareholders or the stakeholders. Additionally, Adams and Mehran (2008) showed evidence of how the diverse directorships the board members hold could hinder effective corporate governance of the board. Factors such as the external directorship of the insiders and outsiders as well as interlocks amongst the bank's CEO or the board's chairman were found to be significantly negatively associated with the bank's performance.

Meanwhile, Prowse (1997) discussed the influence of regulatory intervention on the effectiveness of the governance mechanism of the board. He asserted that regulators have imposed certain restrictions on the operation of banks which consequently deflate the market's role in disciplining bank managers. One of the apparent regulatory restrictions discussed by the author is the likelihood of hostile takeovers amongst banks, which is deemed common in non-financial institutions. While such a restriction could be seen as an escape for the management from the likelihood of a management turnover threat, and, as a result would arguably escalate the agency problem discussed earlier, Prowse (1997) believes that, in such circumstances, regulators have taken over the role of the board by becoming the primary tool in disciplining the management. However, recent studies have challenged suggestions that regulation is a substitute for the firm's governance mechanism as suggested by Prowse (1997). For example, Hagendorff et al. (2010) studied the interaction of board monitoring with bank regulation amongst 204 US and European bidding banks in a merger and acquisition setting. Three board monitoring mechanisms were tested: board independence; board diversity (which includes occupational, age, tenure and expertise diversity), and CEO and chairman duality, in different regulatory regimes. Board independence and board diversity were found to be associated with higher bidder announcements in a strict regulatory regime (in the US and the UK), but they were irrelevant in a less strict regulatory environment (other European countries). These results led Hagendorff et al. (2010) to conclude that there exists a complementary relationship between regulation and some governance mechanisms (in this case, the board's monitoring role).

Meanwhile, Cornett et al. (2009) give insights into the impact of the corporate governance mechanism and the opportunistic behaviour of the management. Specifically, their study examines the relationship between board independence and CEO payment incentives and the effect on earnings and earnings management of 46 of the largest bank holding companies that had head-quarters in the US in the period 1994 to 2002. The results of their study reveal that an independent board is associated with loan losses and fewer recorded securities gains; hence, an independent board constrains earnings management. In addition, they found evidence that when the CEO payment incentive is high, managers record fewer loan loss provisions and more securities gains; hence, CEO payment incentives lead to earnings management. Accordingly, Cornett et al. (2009) suggest that any attempt to structure the corporate governance of banks should consider the collective effect on the action of the management of all the corporate governance mechanisms employed.

2.3.2 Issues Surrounding the Ownership of Banks

Several studies, such as Prowse (1997), Caprio et al. (2007), Leaven and Levine (2009) and Barry et al. (2011), discuss how the ownership structure of banks affects certain governance mechanisms of banks. Prowse (1997), in his empirical study on the determinants of the form of control change in US banks, found evidence that banks which encounter regulatory intervention exhibit poor bank performance and lower equity stakes of large shareholders. He argued that regulatory intervention has repercussions that result in the board being less motivated to impose disciplinary action on the management due to low directors' ownership. This finding, which measured ownership concentration based on shareholding of more than five percent from the total outstanding shares, lends support to the view that ownership concentration is associated with the monitoring incentives of the management and that the bank's board tends to be represented by large equity shareholders to ensure the bank's high performance. Alternatively, this evidence suggests that the banking industry could be deprived of an important governance mechanism that would reduce the agency problem in banks through the monitoring role played by large equity holders. It is worth noting that the significance of the large shareholders in exerting effective corporate governance through efforts such as pressuring or even removing management using their voting rights is also evident in the literature for non-financial firms (for example Shleifer and Vishny 1986). Notwithstanding regulators' policy in discouraging large equity stakes by shareholders in banks, as indicated by Prowse (1997), an analysis of 244 banks across 44 countries by Caprio et al. (2007), who used a stricter percentage of ownership control through the selection of at least 10 percent shareholders' voting rights, revealed that most publicly listed banks are concentrated and display a pattern of family-controlled ownership. Furthermore, in circumstances where the controlling owner holds greater cash-flow rights and where banks are operated in countries with only weak legal protection of shareholders, they found that concentrated ownership would increase the valuation of banks. Evidence provided by Caprio et al. (2007) implied the 'survival' of large equity shareholders, despite banks' highly regulated business environment, and simultaneously demonstrated its' potential role in the governance of banks.

On the other hand, Laeven and Levine (2009) provide an analysis of how a bank's ownership structure would influence shareholders' risk taking in the bank. Their findings revealed that large shareholders with high voting and cash-flow rights would be more inclined to indulge in higher risk taking than would debt holders and non-shareholders managers, although, in the short run, the ownership structure does not explain the fluctuation in bank risk. The perturbing implication is that large shareholders in the banking industry would use their control rights for their private benefit. For non-financial firms, Morck et al. (1988) found evidence that the firm's performance increases with an increase in ownership, after which it falls, as an increase in ownership implies that large shareholders play a significant role in reducing the agency problem but there is the concern that too much control in their hands could generate a hazardous impact due to the misallocation of benefits at the expense of minority shareholders. Nevertheless, Laeven and Levine (2009) and Caprio et al. (2007) share the same conclusion with evidence derived from studies of non-financial firms (for example Shleifer and Vishny 1997; La Porta et al. 2002b) in which a law that provides effective protection for shareholders would mitigate large shareholders' consumption of risk, thereby serving as legal protection for small shareholders. Although it is noted that a large stake of shares in the banking sector could be hampered by the presence of regulators where regulatory intervention is deemed to be common in banks, as indicated by Prowse (1997), the existence of shareholders' legal protection is seen as a possible governance mechanism solution that could curb the risk-taking behaviour of the (large) shareholders.

More recently, Barry et al. (2011) studied the association between the different levels of risk and profitability in privately owned and publicly held European commercial banks with five different ownership structures of banks: managers or directors, institutional investors, non-financial companies, individuals or families, and banks. Their findings revealed that different ownership structures demonstrate different risk-taking incentives, though this is true only for privately owned banks. For example, their findings indicated that ownership in the form of individuals, families, or banking institutions leads to a decrease in asset risk and default risk but no change in profitability. Meanwhile, both the institutional investor and non-financial companies indicated similar risk-return objectives, as their ownership does not result in changes in risk and profitability. They also observed that a higher level of involvement amongst individuals or families in countries which exhibit low shareholder protection law leads to lower risk-taking behaviour. For publicly held banks, Barry et al. (2011) indicated that market forces, such as minimum capital requirement, regulator supervision and disclosure requirement, imposed by Basel II[4] could result in constraint and so mitigate the risk-taking behaviour of the owner. This is because the ownership structure changes were revealed as not affecting the risk taking of the owners.

2.3.3 Issues Surrounding the Regulation in Banks

Generally, the intervention of external forces, called regulators, affects all sectors of the economy. As noted earlier, the specificities of the banking business result in characteristics unique to the industry, in which the opaque nature of the banking business is likely to present financial dealings and financial positions considered observable by the management but not observable to the shareholders or investors. Because investors are risking their wealth when consuming financial instruments from the bank, regulators usually intervene by imposing enforcement, requiring banks to provide adequate information so that investors make informed decisions. Moreover, the common notion found in the literature is that a bank's business performance has a significant impact in the form of either stability or otherwise, in the event of a bank's failure, the downfall of the economy, lending support for the claim regarding regulators' pursuit of public interest (Ciancanelli and Gonzalez 2001; Levine 2004). The regulation imposed on banks could see the intervention of government authorities, such as the central bank and other monetary or financial agencies. Meanwhile, in the international setting, global coordination efforts on banking have seen institutions such as the Bank for International Settlement, the International Monetary Fund, the World Bank, the

[4] More discussion on the Basel Committee on Banking Supervision and Basel II is provided in Section 2.4.2.

Basel Committee and the Organisation for Economic Co-Operation Development (OECD), which promote certain benchmarks on banking business practices, playing an important role. In either a domestic or an international setting, regulation efforts, such as the issuance of prudential standards and guidelines, and their importance in forcing banking institutions to implement and comply with them, signify the vital role played by the regulators in the industry. Among other instruments imposed or roles performed by the regulators in the banking system are the market restrictions on banking and financial activities, acting as a lender of last resort, offering a platform for deposit insurance, developing financial policies, and so on. However, the literature presents arguments both in favour and critical of the intervention of regulators in banks, as will be discussed below.

2.3.3.1 The Positive Impact of Regulation on the Corporate Governance of Banks

Arguably, one solution to the agency problem specifically relating to information asymmetry in the banking business works best with the intervention of external forces called regulators. As discussed in the preceding sections, there appears to be a multiple-contractual relationship between the shareholders, managers, depositors, borrowers and regulators. Hence, it could be argued that the information privilege the management holds would be likely to affect more contractual parties than would be affected in non-financial corporations. Several scholars are of the opinion that the information asymmetry problem coupled with the possibility of negative externalities that banks could produce, such as the contagion effect resulting from bank failures, requires outside forces to intervene on the grounds of economic stability and public welfare (Ciancanelli and Gonzalez 2001; Levine 2004). In order to achieve these aims, the regulators produce rules or ordinances, thus, simultaneously exhibiting the monitoring role of the regulators and that of the shareholders in controlling the management. In such a manner, the involvement of regulators in monitoring the agents could be viewed as a mechanism to control the misconduct or moral hazard behaviour of the agents. In addition, the implication of the regulators' intervention would be for the management to fulfil the interests of two parties, namely, the shareholders and the regulators, through the set of regulations applied to them.

Another important function of the regulators in the banking business is the role they play in controlling systemic risk. Systemic risk is the risk that could causes the contagion effect that spreads to the entire financial system, resulting in bank runs by depositors and possible macroeconomic implications, such as the collapse of the banking system and government monetary policy (Heffernan 2006). In such circumstances, regulators are said to have the upper hand in comparison with other parties on undertaking measurements including control over banks' new entries, takeovers and acquisitions (Macey and O'Hara 2003). Additionally, such an effort could be seen as a mechanism to control another potential moral hazard in the banking system by means of the market concentration of certain groups that have the potential to dominate the financial system. Evidence indicates that the power of the insiders to expropriate bank resources could be limited through a restriction on the range of activities in which banks participate (Boyd et al. 1998). There is also a view that regulation through efforts such as the enforcement of financial policies could serve as the 'last resort' in disciplining the management, since a market instrument that results in corporate control change fails to improve banks' poor performance (Prowse 1997, p. 515). Ciancanelli and Gonzalez (2001) are of the opinion that the best mechanisms imposed by the regulators to reduce or control the systemic risk of banks are via the lender of last resort and deposit insurance. They argue that the regulators' arrival on the banking scene and their concern about the soundness of the banking system through control of the market has offered the shareholders relief from having to bear the total risk of their investment.

To sum up, the range of the regulators' intervention in the banking industry varies and has different objectives. They could cover an impediment on bank ownership concentration through the requirement of regulatory approval as on the substantial purchase of banks' shares, a measurement seen to hinder the banks' control of power over the economy. Regulators could also limit banks' operation and investing activities, such as the hostile takeovers of banks and having ownership in nonbank firms, to limit the competition in banks. There are also common financial regulations by the regulators in the financial and banking industry, such as the mechanism of capital adequacy, liquidity requirements, control of interest rates and fees, obstructing a bank from engaging in non-lending activities and underwriting its equity to ensure stability in the banking business. Clearly, the regulators, through their intervention, have affected this industry in two ways: (1) the banking operations are being administered, and (2) intervention has limited the market competition that normally exists in non-financial corporations.

2.3.3.2 The Adverse Impact of Regulation on the Corporate Governance of Banks

Despite the supportive enforcement brought by the regulators, the literature also indicates that some of the instruments imposed by the regulators in the banking system appear to represent a drawback to the industry itself. Although it is acknowledged that the barrier on market concentration has been made through the intervention of the regulators by a market control mechanism, and in some instances, by government ownership of banks, it also gives rise to difficulties associated with the loss of market discipline on managers (Prowse 1997; Ciancanelli and Gonzalez 2001; La Porta et al. 2002; Macey and O'Hara 2003; Barth et al. 2004; Andres and Vallelado 2008). The requirement for market discipline is specific to the following banking operations: excessive risk-taking, such as results from demands for higher returns and the threat of deposit withdrawal by depositors (Berger 1991; Demirguc-Kunt and Huizinga 1999); or the deemed increase of the cost of funding due to a demand for higher yields by debt holders; or even shareholders threatening to sell their shares, which would lead to a reduction in share prices (Berger 1991). These are now being presented to the government as a consequence of its intervention through the regulations imposed on the industry. Hence, these findings indicate that the regulators' presence on the banking scene has set limits on the power of the market to discipline banks.

Another area of controversy regarding government intervention in banks relates to the issue of deposit insurance. Government initiatives to insure deposits, although effective in preventing bank runs, have been the subject of criticism of the adverse impact their loop hole has on the governance of banks. Macey and O'Hara (2003) and Prowse (1997), for example, explain that deposit insurance fosters a moral hazard through the risk taking of the shareholders at the expense of the deposit insurance fund and the taxpayers that replenish the fund, while another recent empirical finding by Laeven and Levine (2008) reveals that the risk taking behaviour created by deposit insurance is associated only with that of large equity holders.

Meanwhile, government ownership in banks, besides contributing to the loss of market discipline of bank managers, also institutes another setback associated with the supervision of banks. Initially, the government is positioned amongst the stakeholders who all share incentives to control managers. However, when a stakeholder, i.e., a regulator, becomes a shareholder in the bank, there arises a conflict that casts doubt on the efficiency of the supervision (La Porta et al. 2002). The foreseen weakness in the supervision, coupled with the increased information asymmetry as a result of the regulators' intervention in the banking system, would trigger questions about the realization of the regulators' role in curbing the moral hazard in the banking business (Ciancanelli and Gonzalez 2001). A further confusion that deepens the supervision crisis of the regulators is one such as that found by Boot and Thakor (1993), where regulators also indulge in activities that pursue their own interests. Studies have indicated the dilemma has given rise to a new agency problem and has become an opportunity cost to public welfare. Buchanan and Tullock (1962) asserted that governments, instead of maximizing the social welfare, make regulations that maximize their own welfare. Meanwhile, Rajan and Zingales (2003) discussed how political power might influence the credit flow of banks, as well as bankers capturing politician to serve the interests of banks. Later, Barth et al. (2004) found that the more extensive the power held by the regulators, the more likely it is that it will increase the national levels of corruption and become negatively associated with overall levels of bank development.

Based on the above arguments, and because the existence of powerful regulators (i.e., the existence of regulators as shareholders) might jeopardise the regulators' independence in their monitoring capacity, there have been studies such as that by Levine (2004) to express the need to reduce the political interference and increase the installation of independent monitoring and supervision of banks through an autonomous regulation, such as in the private empowerment of a regulatory agency. Several studies have found a positive correlation between private regulatory agency mechanisms and effective corporate governance. For example, Barth et al. (2004) found that enforcement through the disclosure of information and subsequent penalties are associated with banks' efficiency. Similarly, Beck et al. (2006) revealed that the private empowerment of banks through the enforcement of accurate information disclosure reduces corrupt ties with bank officials on credit applications. Meanwhile, Nier and Baumann (2006) offer insights on the influence of market discipline, disclosure and the risk-taking behaviour of banks. Using a cross-country panel data set from 1993 till 2000 that includes banks from 32 countries, their findings indicate that uninsured liabilities and greater information disclosure induce banks to hold larger capital buffers, but the effect of this is weakened by an extensive government safety net. Interbank competition was also revealed to increase the risk-taking behaviour of banks, with market discipline indicated as being more effective in controlling such incentives in countries where there is strong interbank competition. Hence, the findings derived from Nier and Baumann (2006) seem to call for increased disclosure combined with a low government safety net and greater interbank competition. More recently, Pasiouras et al. (2009) studied the impact of the regulatory environment on the cost and profit efficiencies of banks. Specifically, they examined Basel II requirements on minimum capital, supervisory authority and market discipline mechanisms. Their findings indicate that greater supervisory power and the requirement for disclosures and incentives that enhance market discipline influence a bank's cost and profit efficiency. Stricter capital requirement has been indicated as resulting in positive cost efficiency but negative profit efficiency. Meanwhile, restrictions on bank activities have a negative effect on cost efficiency but a positive effect on profit efficiency. In addition, Pasiouras et al.'s (2009) findings suggest that market discipline is associated with accurate and timely disclosure and accordingly helps private agents to monitor banks effectively. On the other hand, a powerful supervisor could set out the conditions for the enforcement of an accurate and timely disclosure for use by private agents in monitoring banks and, hence, enhance market discipline. However, increased disclosure requirements for banks have also been associated with inefficiencies. Duarte et al. (2008) revealed that such requirements resulted in additional costs for additional disclosures, maintaining investor relations departments, costs relating to time and effort in preparing formal disclosure documents, and the release of sensitive information to competitors.

2.4 International Regulatory Bodies

As stated earlier, the regulation of banks also takes place at the global level through the establishment of international standard setting bodies. These international regulatory bodies carry the responsibility for overseeing and promoting sound practices as well as introducing regulation through prudential standards for implementation in banks. Their significance could be judged from the need to ensure financial stability in the international financial system which otherwise could see potential contagion effect in the case of the failure of financial institutions, leading to a possible global economic crisis. In addition, these international regulatory bodies serve as a platform for international coordination and integration among supervisory authorities to arrive at agreement especially when considering the liberalization of a globalized financial system which witnesses the penetration of banks into other countries, such as the setting up of offshore branches or subsidiaries. Hence, this section discusses the role of international regulatory bodies that have a significant role in the governance of banks.

2.4.1 The Organisation for Economic Co-operation and Development

The Organisation for Economic Co-operation and Development (OECD), established in 1961, is the international organisation concerned primarily with economic growth and financial stability to help its member countries whilst it develops and oversees the strategic orientation of global relations through the establishment of OECD's Centre for Co-operation with Non-Members. OECD has been actively engaged in promoting the corporate governance agenda, as can be seen from the joint effort with other regulatory bodies on the establishment of global corporate governance forums and regional roundtables that promote an effective and continuing dialogue on the subject. Additionally, OECD has produced prudential standards to assist the governments of member and non-member countries to evaluate the legal, institutional and regulatory framework in developing and promoting good corporate governance in their respective countries. The OECD Principles of Corporate Governance, which was first released in May 1999 and later revised in 2004, is one example of such an effort; it has gained worldwide recognition as an international benchmark for sound corporate governance. The standards outlined in this governance framework recommendation have been used by governments, regulators, investors, corporations and stakeholders and have been adopted by the Financial Stability Forum as one of the Twelve Key Standards for Sound Financial Systems.

Apparently, the OECD Principles of Corporate Governance offers general principles of corporate governance for all corporations. Since the banking business entails unique features, as described earlier, guidelines on corporate governance for banking institutions require modifications that best suit the specificities of the industry. In this regard, the Basel Committee on Banking Supervision published guidance about governance in 1999 entitled 'Enhancing Corporate Governance for Banking Organisations', which was later revised in 2006 to assist banking supervisors in promoting the adoption of sound corporate governance practices by banking organisations in their countries. Interestingly, this guidance is drawn from the principles of corporate governance that were published by the OECD.

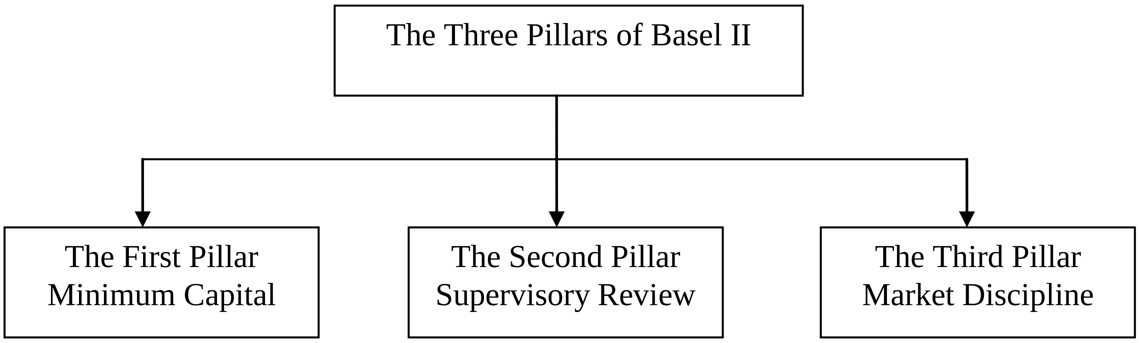
2.4.2 The Basel Committee on Banking Supervision

Another significant governance effort in the arena of banking is the prescriptive, regulatory approach and rule-based capital adequacy provision of the Basel Committee on Banking Supervision (BCBS). BCBS is the committee of Bank for International Settlements, an international organization that promotes financial and monetary cooperation and acts as a bank for the central banks. BCBS, created in 1974, serves as the forum to discuss banking supervisory matters amongst its membership countries, consisting of Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong, India, Italy, Indonesia, Japan, Korea, Luxembourg, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States.[5] It is actively engaged in producing prudential standards and guidelines on effective banking supervision, though they are broad and advisory in nature, for implementation recommendation and to be suited as deemed appropriate amongst its member countries as well as for supervisory authorities that are not directly participating. Primarily, the work of BCBS is executed through its four subcommittees: the Standards Implementation Group, the Policy Development Group, the Accounting Task Force, and the Basel Consultative Group.

In 1988, BCBS introduced the International Convergence of Capital Measurement and Capital Standards or what is commonly known as the Basel Capital Accord, a capital measurement system that provided the implementation of a credit risk measurement framework with a minimum capital standard of 8% by the end of 1992. Later, in June 2004, a revised framework to the Basel Capital Accord, Basel II, was published as a guideline that shifted from sole reliance on the capital adequacy ratio to an approach that ensures bank solvency based on its ‘three pillars’ concept. While emphasis on the minimum capital ratio remains, it is now calculated for credit risk through “risk bucketing” approaches and serves as the first pillar. Meanwhile, the second pillar deals with supervisory review of banks’ risk management systems and requires that major banks adopt comprehensive internal economic capital models, whereas the third pillar focuses on the enhancement of market discipline through improved disclosure standards and practices. Figure 2.1 below illustrates the three pillars encompassing Basel II.

[5] These are the membership countries as at 15th of September 2011.

Figure 2.1: The Three Pillars of Basel II



The work on Basel II has been continuously revised and, following the recent global economic crisis, BCBS has striven to incorporate more rigorous measures to enhance the three pillars detailed in the Basel II framework issued previously in 2004.[6] In response to the recent global financial crisis, the BCBS introduced Basel III in December 2010. While Basel III does not supplant the basic three pillars in Basel II, it does include a series of amendments to the latter. Basel III now requires banks to hold 4.5% of common equity (an increase from the existing 2% requirement in Basel II) and 6% of Tier 1 capital (an increase from the existing 4% requirement in Basel II) while the remaining ratio of total capital of 8% required in Basel II stays unchanged. In addition, Basel III introduces additional capital buffers: (1) a mandatory capital conservation buffer made up of common equity and amounting to 2.5%, and (2) a discretionary countercyclical buffer which allows regulators to require up to another 2.5% of capital made up of common equity during periods of high credit growth. Other changes imposed by Basel III include a minimum of 3% leverage ratio and two required liquidity ratios: (1) the liquidity coverage ratio, which requires a bank to hold sufficient high quality liquid assets to cover its total net cash flow over a 30-day stress period, and (2) the net stable funding ratio, which requires a bank to have stable funding to address funding needs over a stressed one-year period. Some aspects of Basel III are scheduled to be implemented by January 2013 while others will be phased in over several years.

[6] For the latest list of works by BCBS please refer to http://www.bis.org/list/bcbs/tid_22/index.htm.

2.4.3 International Accounting Standards Board

In 1973, the International Standards Committee (IASC) was the first international accounting standard setting body to be established following the proposals put forward by the Accountants International Study Group's (AISG) representatives from Canada, the United Kingdom, the United States, Australia, France, Germany, Japan, the Netherlands and Mexico. Later on, in 2001, it was reorganised into the International Accounting Standards Board (IASB) where 41 standards, known as the International Accounting Standards (IASs), previously issued by IASC were adopted. These accounting standards have undergone a number of changes from having been previously revised, superseded, or merged with other standards. Nonetheless, since IASB's inception in 2001, these standards have again been revised besides the issuance of a new series of standards called the International Financial Reporting Standards (IFRS).

Various international bodies including the World Bank, the United Nations, the International Monetary Fund (IMF), the G7 finance ministers, the International Organization of Securities Commissions (IOSCO), the OECD and BCBS have strongly advocated for the adoption of a single set of accounting standards to be practised worldwide. Particularly, the accounting harmonisation effort on the financial reporting for banks has seen how IASB has been collaborating with organisations like BCBS since 1977 and the European Economic Community[7] in the 1980s, who aimed at establishing the European Economic Community Bank Accounts Directive.

2.5 Summary

This chapter began with a review of three theories and their repercussions for the subject of corporate governance, namely, the agency theory, the transaction cost theory and the stakeholder theory. It appears that the principal and the agent are the two key roles that serve as the basis of a corporation's contractual relationship. However, the accountability spectrum of these theories differs from one to another with the stakeholder theory considering responsibility to extend beyond that of the shareholders. Despite this difference, agency problems, which exert a challenge to sound corporate governance in corporations, are not

[7] The European Economic Community, which was later transformed into European Community when the European Union was created in 1993, is described as becoming one of the EU's three pillars.

exclusive to any of the discussed theoretical explanations or any particular organisation. In addition, it has been made clear that the agency problems associated with the banking business are intensified due to the opaque nature and the multi-contractual relationships that exist within the industry. All in all, there is a need for a governance solution that will monitor and control the performance of the management through the establishment of a corporate governance mechanism that will ensure that the rights of both the shareholders and the stakeholders will be protected.

It is argued that the governance mechanisms for the banking industry are similar to those of non-financial firms. Nevertheless, this chapter has drawn attention to the grave implications of the systemic risk caused by financial failure, which sees the intervention of an external force called regulators. Hence, regulators represent one of the crucial governance mechanisms in banks' highly regulated business environment, although the literature presents both the positive and the adverse impact of regulators' intervention in the industry. Also discussed was the role of international regulatory bodies of certain international standard setting bodies whose continued development in the corporate governance of banks is well acknowledged globally, as could be judged from the nationwide acceptance of their prudential standards, guidelines, policies and the like.

CHAPTER THREE: CORPORATE GOVERNANCE OF ISLAMIC BANKS AND THE MALAYSIAN ISLAMIC BANKING BUSINESS ENVIRONMENT

3.1 Introduction

Over the last two decades, there has been a rapid expansion of Islamic banks in Islamic countries. The operation of these banks also presents as an example where faith is being integrated with banking. Its emergence, alongside the more established conventional interest-based banking, is meant to serve as an alternative financial system to a segment of society whose preference is for financial products and services which are consistent with Islamic principles. Moreover, Islamic finance has not only spark the interest of the adherents of Islam but is also becoming popular amongst many non-Muslims (Iqbal and Molyneux 2005). Currently, the Islamic finance industry is well accepted on the global platform and its significance has been mutually acknowledged with organisation like the World Bank declaring it a priority area (Parker 2011). Apparently, what is of crucial importance for an industry that is relatively young is a robust corporate governance framework that would ensure the soundness and stability of the industry by distinctly recognising the specificities of the Islamic banking operations.

Essentially, Islamic banks carry out the same functions as a conventional bank, however, they have a strict requirement for all their transactions to follow the principles which are laid down in Islam (Henry and Wilson 2004; Iqbal and Mirakhor 2007); this means that the integrity of the industry, and the confidence of its stakeholders, rests on the adherence to Islamic ethics and values which the bank represents. Accordingly, Islamic banks and the corporate governance they feature make a presence not by alienating itself within the existing financial system but, rather, by being distinctly comprehensive by integrating the regulation and requirement imposed by others and with that of Islam. It is for this reason that Islamic banks utilise the function of the Shari'ah board as an additional layer of governance which is responsible for ensuring that the Islamic banking operation comply with the requirements of Islam and, hence, gaining the confidence of the stakeholders (Briston and El-Ashker 1986;

Tomkins and Karim 1987; Karim 1990b; Karim 1990a; Banaga et al. 1994; Rammal 2006; Laldin 2008a).

The objective of this chapter is to introduce the unique features of corporate governance for Islamic banks. After the introduction, Section 3.2 provides a brief historical background of the Islamic banking industry. Next, in Section 3.3, the topic on corporate governance of Islamic banks is discussed by introducing Shari'ah, *mua'malat* (human relation), *maqasid al-Shari'ah* (objectives of the Shari'ah), the concept of accountability from the Islamic perspective, the basic principles on the operation of Islamic banking, the sources and the application of funds in Islamic banking operations. Meanwhile, Section 3.4 discusses the concept of Shari'ah compliance in corporate governance of Islamic banks. Since the interest of the present study is on the aspect of Shari'ah governance of the Malaysian Islamic banking business, Section 3.5 offers an explanation on the Islamic banking business environment in Malaysia. Finally, the last section, i.e. Section 3.6, is a summary.

3.2 Historical Background of Islamic Banks

The idea for banking on the basis of profit sharing rather than interest has emerged since late 1940s (Siddiqi 1976). The pioneering effort in bringing Islamic banking principles into practice emerged later, in 1963, with the development of the Mit Ghamer Saving Bank and the Nasser Social Bank in Egypt. However, the activities of these two banks were attuned to collecting small savings and making a direct investment in agricultural and industrial activities or to small local businesses; hence, they were more akin to a social bank. Twelve years later, the Organisation of Islamic Conference (OIC) inaugurated an inter-governmental Islamic bank, known as the Islamic Development Bank (IDB), which was established with the purpose of fostering economic development and social progress among member countries and their Muslim communities in accordance with the principles of Shari'ah. As the IDB was meant to be the financial backbone for the Muslim nations, it had no precedence for the procedures and the mode of financing that would be compatible with Shari'ah because the IDB, until 2003, did not have any formal Shari'ah board to supervise them. It was only in 1976 that the IDB made its first *murabahah* (mark-up financing) transactions with the government of Algeria.

Following the establishment of IDB, many commercial Islamic banks were established including: the Dubai Islamic Bank in the United Arab Emirates (1975), Faisal Islamic Bank of Sudan (1977), Kuwait Finance House (1977), Jordan Islamic Bank (1979), Dar al-Mal al-Islami (1981), Bank Islam Malaysia Berhad (1983). Islamic banking was then expanded to several other countries, including: Turkey, Pakistan and Bangladesh. During this period, the expansion that Islamic banks experienced was partly caused by the oil revenue boom which was experienced in the Gulf countries (Wilson 1995). Meanwhile, the alliance between Shari'ah scholars and bankers by means of formal appointment of a Shari'ah board that is responsible for looking into the Shari'ah aspects of Islamic bank activities first occurred in Faisal Islamic Bank of Egypt in 1976 (Kahf 2002). This practice was later continued along with the development of other Islamic banks and Islamic investment companies as a medium to gain the acceptance and legitimacy of investors and depositors (Kahf 2002).

Assisted by the Shari'ah board, Islamic banking in the modern world generally aims at applying the principles of Islamic finance in its financial and banking transactions. This has given rise to various Islamic financial contracts that are acceptable and consistent within the Shari'ah precept. At present, Islamic banking practices have been extended beyond the boundaries of Muslim countries and currently receive wide acceptance from both Muslims and non-Muslims alike (Iqbal and Molyneux 2005). Not surprisingly, the development of Islamic finance in Western countries signifies the respective government's recognition of the industry as a business opportunity (Wilson 2011).

3.3 Corporate Governance of Islamic Banks

The importance of best practice as a governance mechanism (such as has been discussed for corporate governance of banks in Chapter Two) is equally relevant when discussing its application for the Islamic banking industry. Nonetheless, the corporate governance of Islamic banks features characteristics which are unique to the specificities of the Islamic banking operation. At this point, it is appropriate to provide a brief introduction to aspects of the Shari'ah, which will be the subject of discussion in the next section.

3.3.1 Shari'ah

Islam as a monotheistic religion which typifies submission, surrender, obedience, as well as peace (Al-Faruqi 1982). The Islamic law, or Shari'ah, is a divinely revealed law which encompasses an all comprehensive and all embracing system that serves as the blueprint for human conduct. The adherents of Islam, called a Muslim, express his *tawheed* by submitting that there is no God except Allah and that the Prophet Muhammad (s.a.w.) is His messenger (Bilal 1994). In the Shari'ah, both the Qur'an and the *Sunnah* (the traditions of the Prophet Muhammad s.a.w.) serve as the ultimate, or primary, sources of the divine law, which are basically textual in character. Meanwhile, *ijtihad*, or legal reasoning, is the interpretation of the Shari'ah by the Muslim jurists who formulate a rule of law on the basis of evidence found from its ultimate sources, i.e. the Qur'an and the *Sunnah*. Because the incidents of human daily life are unlimited, judgment on matters that are considered as *furu'* (branch cases) and not specified in the Qur'an and Sunnah are derived through legal reasoning that is based on the spirit of wisdom and justice in Islam. Accordingly, this gives rise to the importance of subsidiary sources for *ijtihad* as the secondary divine Islamic knowledge in the development of Islamic legal theory. These secondary sources of the Shari'ah include: *qiyas* (analogical reasoning), *istihsan* (juristic preference), *maslahah mursalah* (unrestricted public interest), and '*urf* (customary practice).

The end result of the interpretation process is known as *fiqh*, or Islamic jurisprudence, and how both the Shari'ah and *fiqh* are appreciated can be derived from the words of Faruki (1962) cited in Bakar (2008b, p. 28) who asserted that *'the difference between Shari'ah and fiqh is between the divine law as it is and the divine law as human beings understand it'*. *Usul al-fiqh* or the Islamic legal theory, on the other hand, is the study of sources and principles upon which Islamic jurisprudence is based. Hence, *usul al-fiqh* is the methodology of Islamic jurisprudence whose aim is to provide a legitimate basis and proof for the Islamic legal rulings. These Islamic legal rulings can be assigned into one of the five main categories, which are: *wajib* (obligatory), *sunnah* (recommended), *haram* (prohibited), *makruh* (disapproved), and *harus* (permissible). Later, in the middle of the eight century, several Islamic legal schools, called *madzahib*[8], evolved. These legal schools basically correspond to the differences in conducting Islamic jurisprudence; however, they usually make decisions based on those matters which are considered as the details and not the principles of the

[8] *Madzahib* is the Arabic plural for *madzhab*.

Shari'ah application (Kamali 2008). Importantly, these differences, which are called *khilaf*, arise not because of disputes against the divine sources of Islamic knowledge but rather because of differences in the interpretation of the Qur'an and the *Sunnah* on the basis of local customary law. Named after the founding scholars, the surviving *madzahib* are the Hanafi, Maliki, Shafi'i and Hanbali. Since *ijtihad* is an important tool in formulating the *fiqh*, *khilaf* or differences among the Shari'ah scholars seems inevitable. *Khilaf* occurs in many spheres of the Shari'ah, including *mua'malat* which is the subject of discussion in the next section.

3.3.2 Mua'malat (Human Relations)

The Qur'an, the divine source of Islamic knowledge, was gradually revealed to Prophet Muhammad (s.a.w.) with attention first given on the aspect of *aqidah* (belief) which was then followed by the expositions of two broad sets of rules: *ibadat* (i.e. worship), and *mua'malat* (i.e. human relations) (Kamali 2003, p. 20). The general Shari'ah principles of the rulings of *ibadat* are that anything which is not validated by the Shari'ah is taken as prohibited, whereas the opposite is true for *mua'malat* in which everything is permitted except those explicitly forbidden by the Shari'ah. The exercise of *ijtihad* (legal reasoning) in coming out with the Shari'ah ruling on *mua'malat*, which constitute the *fiqh al-mua'malat*, has a great deal of significance in Islam.[9] This is given the fact that the divine revealed knowledge (i.e. the Qur'an and the *Sunnah*) are finite in text while the incidents of human life are indefinite in nature (as has been explained in the preceding section). However, the process for arriving at a new ruling requires an understanding of the effective cause (*illah*) and rationale (*hikmah*) of the original rulings and consideration of *maslahah* (benefits) on different changed circumstances (Kamali 2000, p. 78).

The use of *ijtihad* in the development of the contemporary Islamic banking and finance has been significantly acknowledged. Kamali (2000, pp. 69-70), for example, explained the basic rules for which the present Islamic financial product, such as futures and option should be founded is that all Islamic commercial laws should be accepted on the basis of permissibility

[9] The terms *mua'malat* and *fiqh al-mua'malat* encompass a wide range of human relationship issues and the respective Shari'ah rulings concerning these issues. For the purpose of this thesis, the terms *mua'malat* and *fiqh al-mua'malat* are confined to matters concerning commercial issues and Islamic commercial law respectively.

(*ibahah*) as long as they are not in contradiction to the principles of Shari'ah.[10] This rule provides the Islamic economic system with the *ijtihad* facility in meeting the financial needs of the Muslims in the modern world while remaining within the boundaries of the Shari'ah. Meanwhile, Ahmed (2006) observed that, as a result of Shari'ah board's exercise of *ijtihad*, the classical financial contract found in the Shari'ah (example of these financial contracts will be explained in Section 3.3.5.5 and 3.3.5.6) has been revamped, leading to the emergence of contemporary Islamic financial contracts whose nature can be explained by one of the following three categories: a classical contract with contemporary application; a hybrid of multiple classical contract resulting in new financial contract; and, a conventional product which has been made Shari'ah-compliant by removing its non-Shari'ah component.

Due to its importance (such as described above), *ijtihad* is believed to be a dynamic tool in the development of Islamic banking and finance. However, concern has also been raised over a liberal approach in undertaking *ijtihad* as having the potential of ruining the integrity and viability of the Islamic financial system (Bakar 2008b, pp. 39-42). In this regard, the exercise of *ijtihad* is believed to have a strong connotation with the *maqasid al-Shari'ah*, a topic which will be presented in the next section.

3.3.3 Maqasid al- Shari'ah (Objectives of the Shari'ah)

Maqasid al-Shari'ah, which literally means the objectives of Shari'ah, has had significant development in the formulation of its theory by al-Ghazali and later by al-Shatibi (Kamali 2008, p. 124). Al-Shatibi in his work *Al-Muwafaqat fi Usul al-Shari'ah* (The Congruences of the Sources of the Divine Law) has singled out *maslahah* (benefits) as the overriding overall *maqasid al-Shari'ah* (Kamali 2008, p. 32), a concept achieved by promoting essentials (*daruriyyat*), complementary requirements (*hajiyyat*), and desirables (*tahsiniyyat*). Meanwhile, the objectives pursued by the Shari'ah have been given a more precise clarification by Al-Ghazali as: faith; life; intellect; lineage; and, property. However, there is evolving evidence amongst the Shari'ah scholars as to other objectives which extends this existing list (Kamali 2008, pp. 124-126).

[10] Further discussion on the Shari'ah concepts applied in developing contemporary products such as Islamic futures and options can be found, for example, in Hassan, M. K. and Lewis, M. K. 2007. *Handbook of Islamic banking*. Cheltenham: Edward Elgar Publishing Limited.

The concept of *maqasid al-Shari'ah* (objectives of the Shari'ah) has been applied in the context of Islamic economic system and the operation of Islamic financial institutions (IFIs) in various dimensions. Siddiqi (2004), for example, asserts that the overall aim of the Islamic economic system is the realization of *maqasid al-Shari'ah*, which can be accomplished by allowing growth and justice. This is further supported by Kahf (2006) who asserted that the implications behind the *maqasid al-Shari'ah* on the prohibition of *riba*[11] in the Islamic financial system is to enable growth and to ensure that the transaction meets the objectives of what it is meant for.

On the other hand, Dusuki and Abozaid (2007) have analysed the challenges of the use of *daruriyyat* (essentials) in Islamic financial products. Indeed, *daruriyyat* as the underlying principle on the theory of *maslahah* (benefits), and its use in authorising Islamic financial products such as *bay' al-'inah*, has recently emerged as a delicate and controversial issue. It is worth noting that the general rule on the principal of *daruriyyat* is that dire necessity, or *darurrah* in Arabic, could lead to exceptions of things established as unlawful in the Shari'ah, which would then become unlawful again as the necessity ceases (Laldin 2006). Delicate as it is, Dusuki and Abozaid (2007) observed that failure to understand the concept of *maslahah*, and its inappropriate use in justifying *daruriyyat*, could lead to the authorisation of Islamic financial products whose form is Islamically permissible but whose substance is highly questionable because the economic outcome is tantamount to *riba*.

More recently, Ahmed (2011) used *maqasid al-Shari'ah* to develop a framework for classifying Islamic financial products. Asserting that *maqasid al-Shari'ah* is implied in the legal and social requirements, Ahmed ascertained the former using an analysis of the form and substance of an Islamic financial product and using the principle of *maslahah* in defining the latter into survival (*daruriyyat*), security (*hajiyyat*), and growth (*tahsiniyyat*) in three different market segments. Using this framework of analysis Ahmed asserts that an Islamic financial product whose form is legal but whose substance is questionable because it features an economic outcome similar to the practice of *riba* does not meet the social requirement and as such it is classified as a pseudo-Islamic product. Meanwhile, a product which satisfies the form and substance requirement but which does not meet the survival and security needs

[11] More discussion on *riba* is provided in Section 3.3.5.1.

adequately is classified as a Shari'ah-compliant product. A Shari'ah-based product, on the other hand, is an Islamic financial product which meets all legal requirements and satisfies all of societies needs (i.e. survival, security and growth).

3.3.4 Accountability from the Islamic Perspective

Affirming the *tawheed* concept (submission to the oneness of God) mentioned earlier, Muslim leaders and subordinates within an Islamic institution should render themselves as the *khalifah* (i.e. vicegerent) to Allah; thereby, signifying that all their activities are ultimately accountable to Allah (Abdul Rahman 1998; Bardai 2002). When the accountability and *khalifah* framework of Islam is translated into the practice of corporations various injunctions of the Shari'ah imply that all concerned parties within the organisation and its operation should exercise and promote basic Islamic values, such as: trustworthiness[12], justice[13], and transparency[14]. Additionally, the Islamic concepts of *adalah* (social justice) and *ihsan* (beneficence) also provide the rationale for corporations (such as an Islamic bank) to promote an ethical and socially oriented method of financing. On the basis of these financing principles, some writers have argued that it will be inappropriate for these corporations to aim at solely maximisation of profit (see for example Siddiqi 1992a, b; Abdul Rahman 1998). What is similarly essential is to endeavour for social optimality (Naqvi 1994; Abdul Rahman 1998; Iqbal and Mirakhor 2004; Yusof and Amin 2007; Asutay 2008). In fact, IFIs, such as Islamic banks, have been accorded a greater corporate social responsibility role, which can sometimes exceed the need to generate profits for the various stakeholders (Dusuki 2008).

In light of the above, the accountability spectrum and the fiduciary duty the management of an Islamic corporation has to the shareholders and all stakeholders must be attuned to the *tawheed*, *adalah* and *ihsan* concepts discussed above. Hence, corporations such as Islamic banks should assume the duties and liabilities of fulfilling the aims arising from the legal ownership of the shareholders while protecting the interests of other stakeholders. In addition, Islamic banks should observe the Islamic ethical values and precepts which are taught in

[12] Based on the Islamic revelation, for example, Qur'an (8: 27): "*O ye who believe! Betray not the trust of God and the Apostle, nor misappropriate knowingly things entrusted to you.*"

[13] Based on the Islamic revelation, for example, Qur'an (49: 9): *"Then make peace between them with justice, and be fair: for Allah loves those who are fair (and just)."*

[14] Based on the Islamic revelation, for example, Qur'an (2: 282): "*O you who believe! When ye deal with each other, in transactions involving future obligations in a fixed period of time, reduce them to writing. Let a scribe write down faithfully as between the parties.*"

Islam while simultaneously recognising their transcendental accountability to God (Abdul Rahman 1998; Abod 2002; Iqbal and Mirakhor 2004). Consequently, all concerned parties within an Islamic bank should be pragmatic and conceive the right consciousness on the responsibilities and accountabilities in their everyday Islamic banking operation. It is deemed that this human-God transcendental paradigm has a significant association with Islamic corporations (such as Islamic banks) which leads to the accomplishment of *maqasid al-Shari'ah* (objectives of the Shari'ah).

Given the ethical objectives of the establishment Islamic banks and the importance of stakeholders highlighted in the Islamic accountability framework discussed above, it seems appropriate to assert that Islam promotes a stakeholder-centric governing corporation. However, what is deemed to a significant difference between the interests and needs of the stakeholders of an Islamic bank from those of other corporations is the emphasis the stakeholders of an Islamic bank place on it complying to the Islamic Shari'ah. The Islamic banks, in this regard, are expected to face pressure from their stakeholders as they are held responsible for ensuring that the activities of Islamic bank are Shari'ah compliant. The topic of Shari'ah compliance, its significance and the consequences for not complying will be discussed further in Section 3.4 below.

3.3.5 The Principles of Islamic Finance

According to Khan and Mirakhor (1986, p. 36), the Islamic economic system defines a complete financial system and prescribes the specific patterns of economic behaviour for all individuals within an Islamic way of life. The principles governing the Islamic economic system are drawn from the Islamic Shari'ah and include: risk sharing, individual's rights and duties, property rights, and the sanctity of contracts (Iqbal 1997; Zaher and Kabir Hassan 2001). Within this boundary of Islamic Shari'ah financing lies the intrinsic principle which serves as the cornerstone and the nucleus of the Islamic economic system, i.e. the prohibition of *riba* (Iqbal 1997, p. 42). The establishment of Islamic banks represents a hallmark and institutionalisation which is a consequence of the realisation of an Islamic financial system. With Shari'ah compliance as the backbone to the Islamic finance system, IFIs such as Islamic banks provide the platform for Muslims to engage in their financial dealings based on the principles of Islamic financing as has been laid down in the Qur'an and the *Sunnah*. Indeed, the realisation of an inspired Islamic financial system (such Islamic banks) would protect the interest of all contracting parties and promote social harmony amongst stakeholders (Ahmad 2000; Warde 2000). These principles are discussed in further detail in the following sections.

3.3.5.1 Prohibition of Receipt and Payment of Riba

The prohibition on the receipt and payment of *riba* has been explicitly mentioned in many parts of the Qur'an and the sayings of the Prophet Muhammad (s.a.w.). For example, God says in the Qur'an *"Ye, who believe, fear God and leave up what remains of your demand for riba if you are indeed believers. If you do not do it, take a notice of war from God and his apostle, but if you turn back, you shall have your principal; deal not unjustly and not be dealt with unjustly"* (Quran, 2: 278-279). In another verse of the Qur'an, God says *"O, you who believe, devour not riba, doubling and redoubling, and keep your duty with Allah, that you may be successful"* (Qur'an, 3: 129). Similarly, there are numerous *ahadith*[15] pertaining the prohibition and condemnation of *riba*. For example, there is a *hadith* recorded on the authority of Jabir that the Prophet Muhammad (s.a.w.) cursed the receiver and the payer of *riba*, the one who records it, and the two witnesses to the transaction and said: *"They are all alike (in sin)"*.

In Arabic, *riba* literally means increase, growth, addition, or rise. From the Shari'ah perspective, the most precise and comprehensive meaning on what constitutes *riba* could be derived from the *hadith* reported on the authority of Ubadah bin Samith in which the Prophet Muhammad (s.a.w.) said: *"Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates and salt for salt, like for like, equal for equal, and hand-to-hand. If the commodities differ, then you (may) sell as you wish provided that (the exchange) is hand-to-hand"*. Hence, from the point of view of Islamic legal theory, the *hadith* introduces two elements of *riba*, which are: deferment in the time of exchange, and different counter values in the exchange of two similar *ribawi* or usurious items (the commodities mentioned in the *hadith*). The Shari'ah defines *riba* by virtue of deferment in the time of exchange as *riba al-nasiah*, and *riba* by virtue of excess in terms of the quantity of the counter values as *riba al-fadl*. In the light of the *hadith* mentioned, many Shari'ah scholars have also agreed that all commodities that are used as a medium of exchange are to be treated similarly as *ribawi*

[15] *Ahadith* is the Arabic plural for *hadith*. Meanwhile, *hadith* is the documented part of the *Sunnah* or tradition of Prophet Muhammad (s.a.w.)

items. It is against this brief background that transactions involving one or both of the *riba* types mentioned is prohibited in Islam, leaving writers (for example Mirza and Baydoun 2000; Bakar 2008c) to debate the elements of social injustice and misappropriation of other's assets as a result of engaging in *riba*.

Bakar (2008c, pp. 17-18) underlines that for a property to be Islamically lawful to be transferred to another, one of the following five conditions specified in the theory of transfer of property in Islamic commercial law has to be fulfilled:

(1) Property earned by one party as a result of individual's labour and entrepreneurship or natural resources or capital;
(2) Property whose title has been transferred by its owner as a result of a bilateral exchange;
(3) Property whose title has been transferred by its owner by virtue of remittance of rights of others in the owner's property;
(4) Property whose title has been transferred by virtue of donation and grant by the owner or donor; and,
(5) Property transferred following the law of inheritance.

According to Bakar, these conditions set forward the importance for both wealth creation and wealth transfer to be present from the point of view of Islamic commercial law. In addition, the conditions mentioned also make it significant for the commodity transaction in Islam to have the attributes of capital and effort, thus justifying profit derived with risk and liability.

While it has been described above that *riba* is prohibited, profit resulting from trading activity should not be mistakenly confused with the meaning of growth or increase carried by the term *riba*. The permissibility of trade and prohibition of *riba* have been clearly ordained by God when He says that *"God has permitted trading and forbidden riba"* (Qur'an, 2: 275). Indeed, the *Majallah al-Ahkam al-'Adliyyah* incorporated the principles associating profit with liability (Bakar 2008c, pp. 19-20). Hence, the injunctions of the Shari'ah and earlier Muslim civil law are evidence of the decree for benefits received by one or both contracting parties in a particular transaction with some degree of risk and liability to be lawful while lending activities without liability commensurate by the lender are considered to be unlawful. As will be discussed later in this chapter, the Islamic financial contracts found in the literature and available in the market feature both elements (i.e. profit with element of risk, as apparent in the case of *mudharabah* and *musharakah* in the light of their profit and sharing ratio feature). Importantly, this creates a distinction on the concept of 'predetermined' in finance between conventional and the Islamic practice. Based on the explanation given earlier, financial contracts in Islam make it evident that it is profit and sharing ratio that is predetermined but not the return itself (Ghayad 2008). At this juncture, it is important to explain how Islam regards the concept of time value of money generally applied in the book of finance, and how this concept is applied in the institutions offering Islamic banking and finance in the present day.

It has been explicitly mentioned in the *hadith* above that deferment in the time of exchange constitutes *riba*. Similarly, it has also been highlighted that Islam permits transactions arising from the engagement of capital and effort, and the profit that is derived from it, so long as it is justified with risk and liability. After clarifying this it is appropriate to make a distinction in that, while capital and effort are both accepted in Islam as a production factor, it is not accepted for time (Gambling and Karim 1991; Hamid et al. 1993; Khan 1994). Indeed, the acceptance of an increase in price for a deferred payment (such in an Islamic sales contract) is permitted because of the existence of the element of risk (Saadallah 1994; El-Gamal 2000). This element of risk has also been considered by Shari'ah scholars in the form of opportunity cost arising from the deferment on the receipt of payment, thus justifying a price increase as compensation to the traders and financial intermediaries (El-Gamal 2000, p. 34). These explanations shed light in justifying the legality of yield earned from both debt financing and equity financing offered by Islamic banking and finance operations, which basically feature transactions that is legal in its nature and which enjoins profit and loss sharing amongst contracting parties.

3.3.5.2 Prohibition of Gharar (Uncertainty)

Gharar could be briefly described as trading with excessive risk from an unknown factor or unpredictable outcome. Some examples of prohibited business transactions stem from the concept of *gharar* or uncertainty includes gambling, the purchase of unborn animals, or sales of assets before possession. Clearly, transactions involving *gharar* are highly risky and could lead to undesirable consequences. Hence, it can be understood that the prohibition behind the sale before possession is due to the risk that the seller may fail to deliver the object of transaction in the future. However, it is worth mentioning at this stage that the prohibition of *gharar* does not mean that Islamic financial contracts are free from risk and that the element of risk is not favoured in Islam. As will be explained later in Sections 3.3.5.5 and 3.3.5.6 below, the Islamic financial contract *mudharabah* and *musharakah* are both based on the profit and loss sharing mode of finance, thereby, signifying the risk engagement amongst the contracting parties. Indeed, it will be explained later that a forward sale contract called *bay' al-salam* features an element of uncertainty but is still regarded as permissible in Islam.

3.3.5.3 Zakat

Zakat is a term derived from the Arabic *zaka*, meaning 'pure', and it is an Islamic tax. As one of the five basic tenets of Islam, *zakat* is a compulsory levy and a mechanism for the redistribution of income and wealth to ensure that every Muslim is guaranteed a fair standard of living. The *zakat* should be paid to certain recipients specified in the Qur'an, which include: the poor and the needy, debtors in financial difficulty and not able to pay their debt, persons who have recently accepted Islam and are in need of basic necessities that would benefit from encouragement by Muslims, volunteers who have dedicated their effort and time in spreading the Muslim religion, and the people appointed to collect *zakat*. The generally accepted minimum amount of *zakat* is one fortieth (2.5 %) of Muslim's annual income in cash or kind from all forms of assessed wealth exceeding *nisab* (i.e. a threshold figure). It is in the light of promoting social justice that Islam also requires Islamic business organisations (such as Islamic banks) to make *zakat* payments annually on behalf of the shareholders and depositors as a result of the positive return of their contribution (Gambling and Karim 1991).

3.3.5.4 Nature of Business

Islamic banks, as with other Islamic corporation and individuals, are bound to carry out business activities that are consistent with the Shari'ah. In this regard, the Shari'ah clearly details which activities are not allowed in Islam because they violate the Shari'ah. To name a few, Islam prohibits the sales of alcohol, gambling, casino activities, pork production, and pornographic production. Consistent with the spirit of justice in Islam, businesses should also be fair to the other party and rule out unjust dealings and oppression, and deceit or fraud. To ensure that the business activities are consistent with the Shari'ah, banks offering Islamic banking operation have establish the Shari'ah board whose duties, among others, include ensuring Shari'ah compliance in all aspects of the banking operation.

3.3.5.5 The Sources of Funds for Islamic Banks

An interest-free bank receives its source of funds from the means of: shareholders equity, customers' deposits in current account, customers' deposits in savings account, and customers' deposits in general investment accounts, and customers' deposits in special investment accounts. The application of Islamic financial contracts in these sources of funds could be distinctly explained from the operation of a full-fledge Islamic bank and a bank operating in a dual platform with an Islamic window operation alongside their conventional banking. The Islamic bank can raise its initial paid-up capital using an Islamic equity-financing contract of *musharakah* among the initial shareholders, while a bank with an Islamic window operation could receive the paid-up capital from the main bank on the basis of either *mudharabah*, *musharakah* or *qard al-hasan*. In both banking operations the contribution could also come from customers' deposits in the Islamic contract of *wadi'ah yad dhamanah* through the saving and current accounts and the *mudharabah* contract for the investment account.

Basically, the Islamic contract of *wadi'ah* and *mudharabah* are contracts where money is deposited into the bank on the basis of safe custody, and profit and loss sharing. Because banks offering Islamic banking operations strictly adhere to the principles of Shari'ah, the concept of paying an interest on money deposited by the customers (as is similar to the conventional practices) is impermissible. This has caused the Islamic banking business to be open to challenges at being competitive with the conventional banking practice who promises a return for money deposited by the customers. In this regard, the banks offering Islamic banking operations award discretionary rewards called *hibah* to their depositors; however, there is no up-front promise on the *hibah* rate of return. Hence, this represents the underlying concept for the Islamic deposit contract *wadi'ah yad dhamanah* (safekeeping with guarantee), which is developed based on two separate concepts: *wadi'ah* (safe custody) and *dhaman* (surety). Meanwhile, deposit taking through the Islamic contract *mudharabah* (profit and loss sharing) could be made on the basis of either the General Investment Account or the Specific Investment Account. The distinction between the two investment accounts lies in the nature of the investment project and the ratio of profit distribution. In the general investment account the investment project is not defined and the profit distribution ratio is normally fixed. On the other hand, the investment project is specifically defined and the ratio for profit distribution is usually negotiated in the specific investment account. In addition, the *mudharabah* contract operates in the form of partnership where the investor or depositor is the capital provider and the bank acts as the entrepreneur *(mudharib)*. Any profit arising from the business venture will be shared between the parties based on a certain agreed ratio or percentage in advance, whereas a loss will result in the investor or depositor bearing all of the loss while the bank losses its effort and expected profit.

3.3.5.6 The Application of Funds for Islamic Banks

Banks offering Islamic banking operations provide financing to customers based on several Islamic banking contracts. One type of financing that is deemed heavily practiced because of its less risky features is the Islamic contract of *murabahah* (mark-up financing). To be acceptable from the Shari'ah perspective, the buyer in the contracting parties should know the cost and the seller should already possess the goods. In addition, both the seller and the buyer must agree on the price of the commodity, with a stated profit known to both parties. As the original *murabahah* in its simplest form is not practical as a financing instrument in banks, *murabahah* of a new form, which is called a *murabahah* purchase order, is developed. In this form of contract, the buyer specifies the goods to be acquired and the supplier. Accordingly, the bank would purchase the goods and resell them at a higher price to the customer, in which the total amount could be paid in cash or by instalment on a deferred term. Thus, the transaction include two sales transactions: the first is between the bank and the supplier, and the second is between the bank and the client. Usually, the buyer is also required to sign a commitment to buy the goods before the commencement of any transactions.

Bay' bithaman ajil (BBA) is another type of Islamic financing which is usually a financing facility for a longer term than the *murabahah* financing. The BBA is commonly used in Malaysia as the Islamic financing for purchasing or financing a house. Taking financing of a house as an example, the financer will purchase the house identified by the client, who will then resell it back to the client at the principal amount and at an agreed profit margin. The client would then have to make payment by instalment on the BBA financing based on a certain agreed period by the contracting parties. Similar to the *murabahah* financing above, the BBA financing also involves two sales transactions.

Meanwhile, *ijarah* or leasing is an alternative mode of financing to the *murabahah* and BBA above. Generally, *ijarah* involves a bank purchasing certain assets which are required by the client, who will then lease it to customers at an agreed charge or rent. The *ijarah* contract may contain a promise to transfer ownership of the assets from the lessor to the lessee. Financing using such a premise is completed through the *al-ijarah thumma al-bay'* (AITAB) contract. The underlying principles of AITAB contract lies in the leasing of a particular asset, which after meeting a certain period of time is followed by the sale of that asset at an agreed selling price.

Also generally practiced amongst Islamic banks is *qard al-hasan.* This Islamic contract represents a non-interest bearing loan which is intended to allow the borrower to use the loan for a period of time, which will then be repaid at the end of the period at same amount of money. However, banks are permitted to charge a minimum service fee to cover the cost of administration. In addition, the bank may also ask for collateral from the client to ensure that the loan granted is repaid.

On the other hand, *bay' al-salam* is a forward sale contract. This type of financing takes place when the buyer makes an immediate payment for an asset-to be delivered. The uncertainty element, or *gharar*, that constitutes *bay' al-salam,* although criticised by some Shari'ah scholars, is permitted by others on the basis of the economic benefits that would have been lost if the contract was not made available (El-Gamal 2001). This can be explained as in a case where the seller upon receipt of money from *bay' al-salam* financing would use it to produce the object of sale.

An Islamic financial contract on a sale of debt is called a *bay' al-dayn.* The debt in *bay' al-dayn* can either be at the price of an asset, or services, whose settlement is being deferred. In addition, the seller of the debt can be the creditor or the party who has the right over the debt; for example, one who has purchased the debt from the creditor. Another type of financing that is subject to much criticism is *bay' al-'inah* and *tawarruq. Bay' al-'inah* contract represents a sale-repurchase financing where an asset is first sold at a deferred price and then repurchased from the buyer with cash but at a lower price than the initial selling price. Almost similar to *bay' al-'inah* is the Islamic contract *tawarruq.* Distinctly categorised into real *tawarruq* and organized *tawarruq*, the real *tawarruq* is a transaction where a person buys a commodity from a bank on a deferred basis and then sells it to a different person or bank for cash. On the other hand, organised *tawarruq* is a transaction where the bank arranges to sell a commodity to a client by deferred payment, and then becomes an agent on behalf of the client to sell the commodity to a third party, whereupon, the institution pays the price to the client.

Some scholars argue that the Islamic banking industry should concentrate in financing with a profit and loss sharing feature, such as *mudharabah* and *musharakah* (see for example Ghayad 2008). In *mudharabah* financing, the bank will act as the principal who provides the funds to the entrepreneur (*mudharib*) in undertaking a business venture. Profits generated from the venture will be shared by both the bank and the *mudharib* according to the percentage specified in the contract. In contrast, any loss will be borne exclusively by the bank. On the other hand, *musharakah* financing represents a partnership or a joint venture arrangement. Hence, in this type of financing both the bank and the client jointly finance and manage the business venture. One type of *musharakah* that is currently practice in Islamic banks specifically for the purpose of house financing is in the form a diminishing partnership, which is an Islamic financing contract based on the concept *musharakah mutanaqisah*. In this type of financing, the partners usually enter into two types of contracts: a joint ownership contract and an *ijarah* (lease) contract in which the bank will gradually sell its shares to the client. In terms of distribution of profit and loss in *musharakah* type of financing, all profits generated will be shared among the partners in a proportion which is mutually agreed in the contract, while the losses will be shared in proportion to the partners' capital.

3.4 Shari'ah Compliance of Islamic Banks

Earlier, it was discussed that the main distinction between Islamic banks and conventional banks lies in the requirement for the operations of Islamic banks to be in accordance with the Islamic Shari'ah. This requirement provides the foundation for the operation of Islamic banks to be guided by the principles and values laid down in Islam, i.e. the Shari'ah (Siddiqi 1983; Ahmad 1984; Siddiqi 1985; Khan and Mirakhor 1986; Ahmad 2000; Siddiqui 2001). Furthermore, it has been argued that the integrity of an Islamic bank would be undermined, and stakeholders would lose confidence, if its operation are found to be non-compliant to the Shari'ah (Bhambra 2002). In this regard, the management of an Islamic bank should ensure that the principles of Islamic finance discussed in Section 3.3.5 above are implemented in its everyday banking business. Arguably, this responsibility on the part of the management of

Islamic banks has a strong connotation with the Islamic accountability framework discussed earlier in Section 3.3.4.

As the main objective of the establishment of an Islamic bank is the provision of financial activities that are Shari'ah compliant, the shareholders and stakeholders of an Islamic bank are expected to put pressure on the bank to accomplish this objective. The investment decision of the shareholders, for example, is deemed to be influenced by the assurance that the activities of the bank and the profit generated from them are Shari'ah compliant. In addition, institutional investors who usually hold a large stake in the shareholding of a corporation could exercise their voting power to decide on the policies and business operations that would provide a positive return on their investment while ensuring the ethical aspect of the Islamic banking operation remains intact. Meanwhile, to ensure that the credibility of the bank is preserved in accordance with the expectations of these shareholders, the board of directors would monitor the management and require the latter to report to them that the activities of the bank are Shari'ah compliant. These tasks are undertaken with the assistance of an external and independent Shari'ah board which comprises experts on Shari'ah and on *fiqh al-mua'malat*-related knowledge. The Shari'ah board advises the board of directors on the Shari'ah aspects of the Islamic banking operation and the latter carry out a Shari'ah compliance review of the bank. The conclusions drawn by the Shari'ah board based on the results of the Shari'ah compliance review are published in a Shari'ah report that is issued annually along with the financial statements of the bank. Hence, the Shari'ah boards of Islamic banks serve as an important governance mechanism because the assurance of the bank's level of Shari'ah compliance guarantees the credibility of these banks and instils confidence in the shareholders and stakeholders (Briston and El-Ashker 1986; Tomkins and Karim 1987; Karim 1990b; Karim 1990a; Banaga et al. 1994; Rammal 2006; Ghayad 2008; Laldin 2008a). Others also claim that the Shari'ah board has an implicit role of monitoring the behaviour of Islamic bank's management and to ensure the good image and reputation of the bank (see for example Ghayad 2008).[16]

In addition to the above, there are other stakeholders who address the need for the Islamic banking industry to comply with Shari'ah. The government, for example, provides the legislation through enactment of laws and the pronouncement of standards and guidelines on

[16] Further discussion on the roles and functions of the Shari'ah board in ensuring Shari'ah compliance and the issues surrounding its Shari'ah governance function is the focus of Chapter Four.

the operation of Islamic banks. These regulations are aimed at ensuring stability and maintaining the supervision that shall uphold the integrity of this banking industry. There are also other regulatory bodies who play an important role at the international level as the standard-setting and governing bodies for the Islamic banking industry. For instance, the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) and the Islamic Financial Services Board (IFSB) are actively engaged in the development of standards and guidelines for use in IFI, although the implementation of their standards is voluntary in nature.[17] Meanwhile, the Islamic International Rating Agency (IIRA) is the rating agency that provides a rating benchmark on the capital instruments and financial products issued by IFIs. Amongst others, the benchmarks put forward by IIRA are compliant to the Shari'ah standards produced by the AAOIFI. On the other hand, the International Islamic Financial Market (IIFM) is the market and global standardisation body that encourages self-regulation for the development of the Islamic capital and money markets. It focuses on the standardisation, documentation, and the related processes of Islamic financial products by issuing guidelines, best practices procedures, standardisation of financial contracts, market recommendations and infrastructure development. Another institution that supports the requirement for the operation of Islamic banks and financial institutions to maintain Shari'ah compliance is the Liquidity Management Centre (LMC). The LMC assists IFIs in managing their short-term liquidity by investing them in quality short and medium term financial instruments which are structured in accordance with the Shari'ah principles.

The above paragraphs have highlighted how Shari'ah compliance is an essential feature of the Islamic banking industry. Furthermore, the concept of Shari'ah compliance in Islamic banks could be concluded as being broad in scope, from ensuring the Islamic legality of the product and services which Islamic banks provide, to the profit that the banks make, and the moral and ethical behaviour of their employees. There are various governance mechanisms in place to ensure that the integrity of the industry is being upheld, including the establishment of regulatory bodies that serve as the key drivers for the advancement and sustenance of the industry. Hence, it should be fundamentally acknowledged that the Islamic banking industry

[17] The AAOIFI issues standards and guidelines for use by IFI while the IFSB issues standards, guidelines and technical notes for use by regulatory and supervisory agencies, as well as market players and professional institutions.

requires Shari'ah governance as an overarching body above the corporate governance which is usually discussed with regard to other corporations.

3.5 The Malaysian Islamic Banking Environment

Historically, the idea of establishing an Islamic financial institution evolved due to the rising need to collect and manage funds used by the Malaysian citizens to perform the *hajj*. This resulted in the establishment of Lembaga Urusan dan Tabung Haji (LUTH)[18] or The Pilgrim's Fund Board in 1969. Following the successful establishment of LUTH and other Islamic banks in the Muslim countries, the Malaysian government has built up the necessary foundation for the establishment of the nation first own Islamic bank. This includes the enactment of dedicated acts for the establishment and operation of Islamic banking (for example the Islamic Banking Act (IBA) 1983), *Takaful* or Islamic insurance (for example the Takaful Act 1984) and Shari'ah compliant government funding. In terms of the banking operations, the first fully-fledged Islamic bank was established and started operating in Malaysia in March 1983; it was incorporated as the Bank Islam Malaysia Berhad (BIMB). Unlike other banking institutions which are bounded by the Banks and Financial Institution Act (BAFIA) 1989, the BIMB is governed by IBA 1983, being monitored and regulated by the Bank Negara Malaysia (BNM).

Further progress to initiate market vibrancy of the Islamic financial system can be seen to include amendments to legislation. In 1993, the BNM introduced the Interest Free Banking Scheme, currently known as the Islamic Banking Scheme (IBS), which allows conventional banks to offer Islamic banking products and services without having to apply for an Islamic banking license. As a result, these commercial banks were given a platform to promote and offer Islamic banking products alongside their conventional banking system. In addition, the Islamic Interbank Money Market (IIMM) was introduced in 1994. It provides a ready source of short-term investment outlets based on Shari'ah principles, thus facilitating Islamic banking institutions and those participating in the IBS to solve their liquidity and investment problems. Malaysia also took another milestone in establishing an Islamic financial system

[18] With the effect of Act 535 of the Pilgrimage Fund Board Act 1995, the Board has been renamed to Lembaga Tabung Haji from August 28, 1997.

when it established the national Shari'ah Advisory Council (SAC) in May 1997. Comprised of qualified individuals with vast experience in the areas of Islamic economics and finance, the SAC as the Shari'ah apex body ascertains the Islamic law and issues rulings on Islamic financial business, it advises BNM on any Shari'ah issue relating to Islamic financial business or transactions of BNM, it advises IFIs or any other person on Islamic financial business pursuant, and it issues rulings following the pursuant from the request of courts and arbitrators (BNM 2010). In addition, Malaysia also offers 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 April 1999, the Kuala Lumpur Shari'ah Index (KLSI) was launched to assist local and foreign investors to invest in securities which are consistent with the Shari'ah. The KLSI acts as a benchmark to track the performance of Shari'ah compliant securities and it helps in making informed decisions.

Furthermore, since 2001, there has been an initiative towards strategic positioning and the international integration of the Malaysian Islamic finance sector. In March 2001, the BNM launched the Financial Sector Master Plan (FSMP), which incorporated a 10 years master plan for Islamic banking and a *Takaful* aiming at creating an efficient, progressive and comprehensive Islamic financial system. The FSMP also sought to open new markets and encourage the internationalisation of the Islamic finance sector. This enabled many global players to enter the Malaysian market. In 2002, Malaysia 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. In order to protect the legal rights of the contracting parties and to provide a quick settlement that shall increase investor confidence, Malaysia installed three dispute resolution mechanisms: (1) a dedicated high court[19], (2) the Kuala Lumpur Regional Centre for Arbitration[20], and (3) the Financial Mediation Bureau[21]. 2004 saw the liberalisation of the Malaysian Islamic banking market when BNM granted three new Islamic bank licences to foreign institutions.[22] Later, in December 2004, the BNM issued the Guidelines on the Governance of Shari'ah Committee

[19] BNM. 2010. *Annual Report 2010*. Bank Negara Malaysia.

[20] The Governor of BNM, Tan Sri Dr Zeti Akhtar has been quoted in Starbiz dated 26 August 2004 as saying that disputes involving Islamic banking and financial services could be referred to the arbitration centre for resolution to complement the court system.

[21] BNM. 2010. *Annual Report 2010*. Bank Negara Malaysia.

[22] The three foreign institutions that were granted Islamic banking license are all from middle-eastern countries, namely: Kuwait Finance House, Al-Rajhi Banking and Investment Corporation, and a consortium of IFI represented by Qatar Islamic Bank, RUSD Bank Inc and Global Investment House.

for the Islamic Financial Institutions, or the GPS1, to rationalise and streamline the functions and duties of the Shari'ah board in IFIs. This guideline, which became effective on the 1st of April 2005, represents the Malaysian Shari'ah Governance Framework (SGF) and complements the role of the SAC of BNM. Also in 2005, the BNM approved the Islamic banking subsidiary structure to replace the Islamic window structure.

In addition, the liberal economic policy of the government of Malaysia allowed foreign Islamic banks to operate in the country, including foreign international Islamic banks. To promote the country as a hub for international Islamic finance further, Malaysia launched the Malaysian International Islamic Finance Centre (MIFC) in August 2006. Specifically, MIFC initiatives consist of:

(1) Financial and market regulatory bodies;
(2) Government ministries and agencies;
(3) Financial institutions;
(4) Human capital development institutions; and,
(5) Professional services companies that are participating in the field of Islamic finance.[23]

Participating financial institutions in the MIFC initiative would benefit, among others, from new licenses for conducting foreign currency businesses, attractive tax incentives and facilitative immigration policies. In conjunction with the MIFC initiative, a new category of licenses, the international Islamic bank under the IBA 1983, were issued to 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 business of Islamic commercial banking, Islamic investment banking and other banking business as specified by BNM (2008). To date, the MIFC has listed the operation of 17 full-fledge Islamic banks, 5 international Islamic banks, and 15 conventional banks offering Islamic banking window.[24]

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[23] http://www.mifc.com/index.php?ch=menu_exp&pg=menu_exp_ovr.

[24] For an update on the list of banks offering Islamic banking services in Malaysia please visit http://www.mifc.com/index.php?ch=menu_know_ibt_ib&pg=menu_know_ibt_ib_list.

Another milestone in Malaysian comprehensive Islamic financial system is the enhancement of knowledge and expertise through BNM's establishment of institutions, such as: the Global University of Islamic finance (INCEIF) in 2006 and the International Shari'ah Research Academy for Islamic Finance (ISRA) in 2008. These two institutions represent BNM's significant role in establishing a human capital infrastructure and giving added value to existing institutions, such as: the Islamic Banking and Finance Institute Malaysia (IBFIM), Securities Industry Development Corporation (SIDC), International Centre for Leadership in Finance (ICLIF), Financial Sector Talent Enrichment Programme (FSTEP) and other institutions of higher learning. More recently, in October 2010, the BNM introduced the new SGF where the role of important parties within the IFIs in ensuring compliance has been enhanced. The new SGF, which took effect June 2011,[25] offers clarity on the accountability and responsibility of these parties, imposes new regulations on the appointment of Shari'ah board members, and requires IFIs to establish Shari'ah compliance and Shari'ah research function.

3.6 Summary

This chapter commenced by offering the distinction between Islamic banks and their conventional counterparts. It has been emphasised that, although Islamic banks carry the same financial intermediary function as conventional banks, the operation of Islamic banks is guided by the principles which are laid down in Islam. It was further highlighted that the Shari'ah is an all comprehensive and all embracing system for humankind not only on matters pertaining to *ibadat* (worship) but also on *mua'malat* (human relations). It has been made clear that since matters pertaining to Islamic commercial law, or *fiqh-mua'malat*, are founded on the basis of permissibility (*ibahah*), the Shari'ah allows the use of *ijtihad*, or legal reasoning by a Muslim jurist based on the interpretation of the revealed law, (i.e. the Qur'an and *Sunnah*). In this regard, the practice of contemporary Islamic banking and finance has been highlighted to have gained benefit from the exercise of *ijtihad*, which serves as a dynamic tool for the invention of Islamic financial products and the development of an Islamic economy. Essentially, the *ijtihad* facility should be exercised by ensuring that the *maqasid al-Shari'ah* (objectives of the Shari'ah) of the Islamic economy are accomplished by

[25] The new Shari'ah Governance Framework is effective from 1 January 2011 but IFI are given 6 months from the effective date to comply.

ascertaining what constitutes the *maslahah* (benefits) of the public while observing basic principles, such as: avoiding charging or receipt of *riba*, transactions that comprise element of *gharar* (uncertainty), and business activities which have been explicitly forbidden in Islam.

It is against these sets of rules that Islamic banks ensure that their operations are in compliance with the Shari'ah. Shari'ah compliance, to Islamic financial institutions such as Islamic banks, is not only fundamental but also crucial because its assurance will boost the confidence of the shareholders and other stakeholders. On the other hand, Shari'ah non-compliance will give an opposite effect to Islamic banks, which in accounting and finance terms, can be represented as Shari'ah non-compliance risk, fiduciary risk, and reputational risk, whilst also leading to the non-recognition of income. This provides justification that the central and intrinsic governance for the industry is a requirement for all its financial activities to be supervised and controlled in accordance with the rules of Islamic Shari'ah. To ensure good Islamic governance, that their activities are Shari'ah compliant, Islamic banks have established Shari'ah board comprised of experts in Shari'ah and other related fields, whose Shari'ah governance function is the focus of discussion in the next chapter.

CHAPTER FOUR: SHARI'AH GOVERNANCE FUNCTION OF SHARI'AH BOARDS IN ISLAMIC BANKS

4.1 Introduction

The Shari'ah compliance review of an Islamic bank's activities is considered to be a crucial governance mechanism to ensure the credibility and viability of the financial institutions because of the requirement for Islamic banks to adhere to the Islamic Shari'ah principles. For this reason, many banks offering Islamic banking products and services have established a Shari'ah board whose membership and hierarchical position in the bank is deemed to stand no comparison to other types of supervisory boards. The available literature presents a growing interest on the issue of Shari'ah governance function of the Shari'ah board in Islamic banks. For example, despite the esteem that is given to the highly authoritative governance function of the Shari'ah board, several studies have questioned their role and monitoring effectiveness (Kahf 2002; Khan 2007). In addition, a considerable amount of the previous studies have accounted for the dilemmas facing Islamic banks with respect to Shari'ah board's function (for example Grais and Pellegrini 2006; Rammal 2006; Siddiqi 2006; Khan 2007) and its association with Islamic banks' transparency in financial reporting (for example Karim 1996; Iqbal et al. 1998) and socio-economic consequences (for example Karim 1996). However, there seems to be a scarcity in the literature of research that provides empirical evidence on the Shari'ah governance functions of the Shari'ah board. Furthermore, empirical studies on this subject are limited in scope and provide only a general understanding on the issue. In this regard, an in-depth examination on the crucial aspect on the role, independence, and effectiveness of the Shari'ah board in a country such as Malaysia (where the Islamic banking industry exhibits a dual-layer Shari'ah governance system) seems to be warranted. Additionally, the scope of such a study provides an evaluation of the Shari'ah board where its governance function is demonstrated to be highly regulated.

In light of the above, this chapter aims to critically review the literature on the Shari'ah governance function of the Shari'ah board. Of importance and consistent with the objectives of this study, the issues on the role and independence of the Shari'ah board and their association with the effectiveness of the Shari'ah governance function of the board will be discussed. Relevant standards on the role and independence of the Shari'ah board as promulgated by the regulatory bodies governing Islamic Financial Institutions (IFIs) (namely Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and Islamic Financial Services Board (IFSB)) will be examined. In addition, the issue of the standardisation of Islamic banking practice and its association with the role of the Shari'ah board and the centralised Shari'ah board will be reviewed and addressed.

This chapter is organised into nine sections. The first section is this introduction. The next section, i.e. Section 4.2, will examine issues on the qualification, competency and appointment of the Shari'ah board members. Then, the role and independence of the Shari'ah board in the Islamic banking industry are discussed in Sections 4.3 and 4.4, respectively. This is followed by an examination on the role of centralised Shari'ah board in Section 4.5. Since the issue of the standardisation of Islamic banking practice is regarded as a major challenge for the industry, important debates surrounding this subject are provided in Section 4.6. Section 4.7 offers an explanation of the Shari'ah governance function of Shari'ah board and Shari'ah Advisory Council in the Malaysian Islamic banking industry. Section 4.8 examines the previous empirical studies of the Shari'ah governance function of the Shari'ah board. Finally, this chapter concludes with a summary in Section 4.9.

4.2 Qualification, Competency, and Appointment of the Shari'ah Board Members

As discussed earlier, amongst the salient features of Islamic banks is the requirement for the bank to operate in a manner consistent with the divine Islamic Shari'ah. To uphold this distinct feature the Islamic banks generally exhibit a Shari'ah governance mechanism through the establishment of a Shari'ah board. A clear definition on the qualification, appointment and scope of responsibilities of the Shari'ah board would normally be stipulated in the articles of association of the respective Islamic banks (Briston and El-Ashker 1986). Interestingly, the previous literature also presents a debate on whether the Shari'ah board should consist of members merely from Shari'ah qualification backgrounds or a mixture of members drawn from diverse backgrounds.

Arbouna (2007), for example, asserts that a possible Shari'ah conflict could cause the Islamic financial product to be invalid, albeit in the case of a financial product that is comprised of a hybrid contract, which could be identified by someone from a Shari'ah qualification background. Arguments such as those provided by Arbouna (2007) imply that the Shari'ah board of IFIs should be limited to experts from Shari'ah and *fiqh al-mua'malat* related knowledge. A preference for Shari'ah board members with these qualifications is believed to have a strong connotation with the expert's ability to relate the Shari'ah knowledge and *maqasid al-Shari'ah* (objectives of the Shari'ah) in the context of modern Islamic banking and finance. However, there are also some arguments that raise the question of the Shari'ah experts' ability to look at the macro perspective of Islamic banking and finance product development beyond their theoretical knowledge of Shari'ah. For example, Siddiqi (2006) argued that the training received by the Shari'ah experts does not provide them with an evaluation of Islamic banking product development beyond the technicalities of the Shari'ah. According to Siddiqi (2006), the Shari'ah experts did not look at the overall macroeconomic consequences, as in the case of the widespread Islamic financial product *tawarruq*. Siddiqi asserts that by approving *tawarruq* the *maqasid al-Shari'ah* could not be accomplished because the macroeconomic outcome from *tawarruq* would result in greater *mafasadah* (harms) than *maslahah* (benefits).

Meanwhile, there are other researchers who have advocated that the Shari'ah board should consist of members from various qualification backgrounds (for example Gambling et al. 1993; Grais and Pellegrini 2006; Ghayad 2008; Laldin 2008b). These researchers advise that Shari'ah board members should be well versed in both Islamic Shari'ah knowledge (particularly in the field of *fiqh al-mua'malat*) as well as in the subjects of accounting, finance, economics, and law. A Shari'ah board which is made of members who have various expertises is seen by these researchers to be more competent in handling various dynamic issues surrounding the contemporary Islamic banking business, although this could also trigger potential disputes and communication failure because of the different perspectives held by the Shari'ah board members (Grais and Pellegrini 2006). Ghayad (2008), for example, asserts that a Shari'ah board drawn from a mixture of qualification backgrounds would help to provide better oversights on Islamic banking and finance whose issues could be overlapping between Shari'ah and non-Shari'ah related matters.

In addition, the modern banking feature of Islamic banks has set another level of skills requirement from the Islamic scholars. Exposure in the banking industry, proficiency in the English and Arabic languages, being dynamistic and capable of synergising between the Shari'ah and legal aspects of financing are now regarded by many as the necessary skills to boost the industry and to be able to separate Islamic banks genuinely from the conventional banks (Laldin 2008a, b). Laldin (2008b) believes that a Shari'ah board of this type of membership, and who also receives good cooperation from various parties within the bank, will not only speed up but also ensure a better Shari'ah decision is made by this governance authority. As a matter of fact, the Islamic banking industry is not unusual in presently facing a shortage of competent scholars who are well versed in both the Islamic *fiqh al-mua'malat* and accounting and finance knowledge, the financial industry as a whole is experiencing a shortage of scholars who are able to supervise the activities of Islamic banks. As the Islamic banking industry keeps evolving, the Shari'ah board members should keep pace with its development by updating and strengthening their training and getting involved in continuous professional education (Grais and Pellegrini 2006; Siddiqi 2006).

Regardless of their qualification background, the ethical nature of this governance authority means that this institution should be comprised of members who have a good character and who uphold high ethical standards and noble characteristics such as trustworthiness, honesty, responsibility and accountability (Laldin 2008a). In this regard, the effectiveness of the Shari'ah board governance function could be viewed as dependent on the integrity of the board members because the Shari'ah board members of Islamic banks are commonly individuals who have a good reputation and significant role in their society (Ghayad 2008).

Meanwhile, the hierarchical position of the Shari'ah board in Islamic banks could be seen as a mechanism to instil the confidence of the public and the investor community in those Islamic banks which have a Shari'ah governance authority. The literature seems to promote the approach where the Shari'ah board members are appointed by the shareholders (see for example Karim 1990a; Rammal 2006; Laldin 2008b). Laldin (2008b) views that this appointment approach is meant to preserve the integrity of the Shari'ah board and to cater to any possible conflict of interest on the role of Shari'ah board in monitoring the Islamic bank's management side by side with that of the bank's corporate board. Additionally, the appointment of a Shari'ah board by shareholders is consistent with protecting the interest of shareholders within the principal-agent relationship (as discussed in Chapter Two). Although this would be the ideal approach for Shari'ah board members appointment, there are variations in terms of the appointment of Shari'ah board members across countries. For instance, Abdallah (1994), besides giving an example of the formation of a Shari'ah board as a board, also mentioned the existence of Islamic banks whose operation are supervised and monitored by only one Shari'ah scholar, as is the case in Sudan. Later, Khan (1997), who cited findings from the International Institute of Islamic Thought, stated that 58.4% of a corpus of members of Shari'ah board is elected by the board of directors. Furthermore, Khan argued that such an approach to the appointment of Shari'ah board members could give rise to a conflict of interest because the Shari'ah board members are positioned as being subordinate to the bank's board of directors.

The issue on appointment and composition of Shari'ah board members have been given attention by AAOIFI and IFSB. AAOIFI, in its *'Governance Standards for Islamic Financial Institutions No. 1 Shari'a Supervisory Board: Appointment, Composition and Report'* define the Shari'ah board as consisting of members with an expertise in the field of *fiqh al-mua'malat* (AAOIFI 1997 para. 3). However, they also suggest that Shari'ah board's membership could include experts from the field of business, accounting, economics, laws and others (AAOIFI 1997 para. 7). In addition, AAOIFI also made clear reference to the need for the appointment and remuneration of Shari'ah board members to be approved by the shareholders (AAOIFI 1997 para. 3). Moreover, the number of Shari'ah board members has been specified to be at least three persons (AAOIFI 1997 para. 7), thereby suggesting that it is up to the individual Islamic banks to appoint the number of Shari'ah board's membership depending on the services required. Meanwhile, the AAOIFI and IFSB have made recommendations for the establishment of certain 'fit and proper' criteria on the appointment of Shari'ah board members. This recommendation is part of AAOIFI's '*Governance Standard for Islamic Financial Institutions No. 6: Statement on Governance Principles for Islamic Financial Institutions'* (AAOIFI 2010b para. 45-46) and IFSB's '*Guiding Principles on Corporate Governance for Institutions Offering Only Islamic Financial Services'* (IFSB 2006 para. 53), respectively. In addition, the IFSB in its '*Guiding Principles on Shari'ah Governance System for Institutions offering Islamic Financial Services'* standard also clearly stipulates that banks offering Islamic banking products and services should ensure that the Shari'ah board is authorised with adequate power to undertake its roles and functions (IFSB 2009 principle 1.2).

As mentioned earlier, the Islamic banking industry is presently faced with a number of challenges concerning the shortage of competent scholars to undertake the Shari'ah board function. In order to cater for the need of this expertise, the Shari'ah scholars tend to serve as members of the Shari'ah board in a number of other Islamic banks, either in their respective country or they can even serve on Shari'ah boards across national boundaries. On the one hand, the cross board representation of the Shari'ah scholars could be seen to be advantageous because it assists the harmonisation effort of the Shari'ah interpretation of the Islamic banking and finance principles, and it can promote the standardisation of Islamic banking practices across national boundaries (Alhabshi and Bakar 2008; Wilson 2009). However, on the other hand, there are several negative aspects of the various placements of Shari'ah board members. The first concerns the point that the oversight function quality is likely to be compromised due to the time constraint of the Shari'ah scholars (Antonio 2008). Already, there is a contention that the Shari'ah board members would be conducting Shari'ah audit sampling instead of using a full Shari'ah audit of the operation of the Islamic banks (Karim 1990a). With more and more tasks being handed over to the Shari'ah board members due to various Shari'ah board sittings, the time spent on the Shari'ah compliance review can be expected to be excessively limited, hence, leading one to question the review quality or the amount of time spent by the Shari'ah board members in their duties. Another crucial implication which arises from the cross representation of Shari'ah board members is the risk of confidentiality of proprietary information exposure held by the Shari'ah board members, which arises as a result of the multiple associations that they have with the Islamic banks they serve (see for example Grais and Pellegrini 2006; Alhabshi and Bakar 2008). Equally, the various multiple placements of the Shari'ah board members could also affect the quality of Shari'ah board members' work considering their possible lack of rigorous training in accounting and auditing (Abdul Rahman 2008) which characterises the membership of this institution (as mentioned above).

4.3 The Role of Shari'ah Boards in the Islamic Banking Industry

The Islamic banking industry exhibits the importance of the governance role of Shari'ah boards. It can be argued that the boards' hierarchical position in Islamic banks is unique and has no parallel in other board models. Countries influenced by the Anglo-Saxon style of corporate governance, for example, practice a unitary board model whereas some European countries practice a two-tier board model comprising a supervisory board and the management board. Despite the differences in the board models, the aim of the board in the unitary board model as well as that of the supervisory board in the two-tier model are argued to be the same, i.e. overseeing the management of the corporation. The Shari'ah board of Islamic banks, on the other hand, is an additional governance structure, on top of the existing board of directors, responsible for overseeing the Shari'ah aspects of the Islamic banking operations. Indeed, the literature seems to establish a consensus that the Shari'ah board ensures the credibility of Islamic bank by ascertaining the Shari'ah compliance of the bank's operations (Briston and El-Ashker 1986; Tomkins and Karim 1987; Karim 1990a; Karim 1990b; Banaga et al. 1994; Rammal 2006; Ghayad 2008; Laldin 2008a). Briston and El-Ashker (1986) were among the first to establish the foundation of the roles and responsibilities of the Shari'ah board. Specifically, Briston and El-Ashker (1986) asserted that the Shari'ah board members are responsible to perform duties in the area of *ex ante* auditing and *ex post* auditing. *Ex ante* auditing means that the Shari'ah board members would have the Shari'ah advisory role to the board of directors to ensure that aspects of the institution's operation, contract of sale, and compliance procedure are consistent with the Shari'ah (Briston and El-Ashker 1986). Meanwhile, reviewing management of Islamic bank compliance to the Shari'ah procedures and highlighting this in the form of Shari'ah compliance report and ensuring proper administration of *zakat* (such as assisting the calculation on the payment of *zakat*) are illustrated by the authors as the *ex post* auditing required from the Shari'ah board.

The leading studies on the role and function of the Shari'ah board (such as Briston and El-Ashker (1986)) tend to indicate that the traditional role of the Shari'ah board is to: provide Shari'ah advice to the board of directors; develop Islamic banking products; review an Islamic bank's activities; work out the calculation and payment of *zakat*; and, report their Shari'ah compliance in the Shari'ah report. In addition, categorising the role of the Shari'ah board into Shari'ah advisory and Shari'ah review, as suggested by Briston and El-Ashker (1986), appears to be useful in providing a clear division on the two spheres of Shari'ah governance responsibilities of the Shari'ah board. Most of the later studies either advocate or expand the roles of the Shari'ah board that were described by Briston and El-Ashker (1986). The following sections will offer an explanation on the role of the Shari'ah board as found in the literature as well as those prescribed in AAOIFI governance standards and IFSB prudential standards.

4.3.1 Shari'ah Advisory Role of Shari'ah Boards

In essence, the literature on the Shari'ah governance of Islamic banks explains that the Shari'ah board would have the advisory role on the Shari'ah aspects of the Islamic banks' operations (see for example Tomkins and Karim 1987; Banaga et al. 1994; Haniffa and Hudaib 2007; Ghayad 2008). This Shari'ah advisory role of the Shari'ah board covers a number of Shari'ah matters, including: Islamic financial products and services (Briston and El-Ashker 1986; Banaga et al. 1994; Ahmed 2006; Alhabshi and Bakar 2008; Ahmed 2011); advising and designing operational procedures (Banaga et al. 1994; Alhabshi and Bakar 2008); advising and designing corporate strategic issues (Alhabshi and Bakar 2008); and, monitoring and ensuring good organisational image and reputation (Ghayad 2008). In addition, the Shari'ah board was also associated with giving legitimacy to the IFIs when the industry was first introduced to the Muslim society (Siddiqi 2006). Meanwhile, other researchers have also discussed the need for the Shari'ah board to balance meeting the shareholder's desire for profits and ensuring the Shari'ah compliance of the Islamic banks operations (Ghayad 2008; Ahmed 2011), although this task can frequently be challenging to the Shari'ah board. Ahmed (2011) asserts that the Shari'ah should prevail when a conflict between economic factors and Shari'ah principles arises when developing an Islamic financial product to be offered to consumers. The pervasive Shari'ah influence, which encompasses all aspects of Islamic banking operations, indicates an implicit task of the Shari'ah board to ensure that the application and implementation of the Shari'ah in Islamic banks remains dominant (Ahmed 2011). In the course of Islamic banking operations there might be some developments which make some of the earlier Shari'ah decisions made by the Shari'ah board inapplicable. In this regard, and in light of *maqasid al-Shari'ah* (objectives of the Shari'ah), Siddiqi (2006) asserts that the Shari'ah board can make corrective actions, which could mean issuing a new and more relevant Shari'ah decision. This presents an example where the Shari'ah advisory role of the Shari'ah board is to be considered as dynamic in nature and has to suit the developments of the Islamic banking industry.

Apart from the direct functional Shari'ah advisory of the Shari'ah board members discussed above, this Shari'ah governance authority also holds the responsibility to promote the Shari'ah based Islamic finance to the general public by educating them on the distinct features of the bank as well as to enjoin Muslim consumers to opt to the Islamic way of financing as a means of *ibadat* (worship) and achieving *falah* (success) (Laldin 2008a). In addition, the Shari'ah board will also need to respond to any queries given by the community, possibly on the operation of Islamic bank or on Islamic banking product related matters (Banaga et al. 1994). The present modern Islamic finance, within which the Islamic banks practice, continues to exert challenges on the role of the Shari'ah board members. In particular, the Shari'ah board members are expected to be actively engaged in shaping Islamic banks by developing modern Islamic financial products and services based on the interpretation of the Islamic Shari'ah principles (Tomkins and Karim 1987; Karim 1996; Laldin 2008a). Laldin (2008a) emphasises that the Shari'ah board, as well as the centralised Shari'ah board, are the apparent distinctive governance mechanism between Islamic banks and their counterparts (i.e. the conventional banks). In addition, Laldin (2008a) stresses that innovation on modern Islamic finance and services by Islamic banks should also be guided by the Shari'ah board based on the Shari'ah principles and they should not indiscriminately replicate the conventional banking operations. Of importance is the point that the Shari'ah board members should ascertain that the designed Islamic financial product and services will have the objective of delivering the benefit to the *ummah*[26] and not merely be a means to Shari'ah forbidden ends (Siddiqi 2006; Laldin 2008a). Clearly, the significance of the Shari'ah board stands no comparison with other organs within the bank and justifies the immense accountability that the Shari'ah scholars carry.

4.3.1.1 AAOIFI and IFSB Standards on the Shari'ah Advisory Role of Shari'ah Boards

AAOIFI, in its *'Governance Standards for Islamic Financial Institutions No. 1 Shari'a Supervisory Board: Appointment, Composition and Report'* broadly outlined that the Shari'ah board as the governance authority *"entrusted with the duty of directing, reviewing and supervising the activities of the Islamic financial institutions in order to ensure that they are in compliance with Islamic Shari'a Rules and Principles"* (AAOIFI 1997 para. 2). In addition, the AAOIFI's *'Governance Standards for Islamic Financial Institutions No. 2 Shari'a Review'*, although specifically designed for the Shari'ah review role of the Shari'ah board, also indicates the further scope of the Shari'ah advisory that is required from the Shari'ah board. The standard identifies that *"the SSB shall assist (the management) by providing guidance, advice, and training relating to compliance with the Shari'a"* (AAOIFI

[26] *Ummah* is the Arabic word meaning nation. In the context of the present study, the term *ummah* is meant to cater the interest of, but not limited to, the Muslim population.

1998 para. 5). Similar recommendations are given by IFSB in its *'Guiding Principles on Corporate Governance for Institutions Offering Only Islamic Financial Services'* for Islamic Financial Services to develop mechanism for obtaining rulings from Shari'ah scholars, applying *fatwa* and monitoring Shari'ah compliance on aspects including the *ex ante* and *ex post* of financial transactions and the operations of Islamic Financial Services (IFSB 2006 para. 47). Such a requirement implies that the Shari'ah board would use its capacity as the Shari'ah authority in the IFIs to ensure the IFI's management compliance with the *fatwa* and rulings issued by the Shari'ah board. In addition, these *fatwas* could range from various activities of the IFI, including its daily operational aspect, and in the development of products and services to be launched to consumers. Similarly

4.3.2 Shari'ah Review Role of Shari'ah Boards

It has been made clear in the previous section that one of the Shari'ah board members' roles is to review the Shari'ah compliance aspect of the Islamic banks' operation. Basically, this requires the Shari'ah board members to evaluate the implementation of the Shari'ah decisions made earlier at the Shari'ah advisory stage by the Islamic bank's management. Hence, this Shari'ah review role of the Shari'ah board could be regarded as significant and central within the Shari'ah governance mechanism of the Islamic banking industry because the essence for the establishment of this banking business is to assist the Muslims in adhering to their religious values (i.e. the Shari'ah) in their financial dealings (Karim 1990a). An important repercussion to such conformity is that the Shari'ah review by the Shari'ah board provides assurance to the investors and the stakeholders on Islamic banks' commitment in abiding to the Shari'ah (Alhabshi and Bakar 2008).

In simple terms, the Shari'ah board ensures that the profit earned by the bank conforms to the Shari'ah (Haniffa and Hudaib 2007; Ghayad 2008). However, the Shari'ah review task of the Shari'ah board is rather broad and complex. It is broad because it encompasses a wide range of Islamic banking activities that needs to be confirmed on its compliance to the Shari'ah. Meanwhile, the Shari'ah review is regarded as complex because it requires the involvement of various parties within the Islamic bank to ensure the task is executed successfully. Based on these explanations, it is imperative for the Shari'ah review mechanism to be appropriately established and effectively carried out. Alhabshi and Bakar (2008) make a distinction between two categories of Shari'ah review, which are: product review and institution review. The Islamic banking product review by the Shari'ah board should be carried out throughout the product's life cycle (Antonio 2008). This relates to the different stages of product development (i.e. product conception, product design, product documentation, and product testing) as well as to the product implementation and final product review stage (Alhabshi and Bakar 2008). The institution review, on the other hand, is statutory driven and holistic in nature because it includes a review of the Islamic banks operation, management, transactions and financial records. Alhabshi and Bakar (2008) argued that both the Shari'ah product review and the Shari'ah institution review would give a different kind of assurance to the investors and stakeholders. Since the emphasis and scope of the Shari'ah review in both categories are different, the assurance delivered and the likely perceived credibility imposed on these interested parties is a matter between the products and services of the institution itself.

Associated with the product review, many scholars have argued that the Islamic financial products and services that an Islamic bank offers should meet the *maqasid al-Shari'ah* (objectives of the Shari'ah) (for example Kamali 2000; Kahf 2006; Siddiqi 2006; Dusuki and Abozaid 2007; Dusuki 2010; Ahmed 2011). In light of *maqasid al-Shari'ah*, Ahmed (2011) also highlighted that the board of directors and top management as being the parties responsible in determining the type of Islamic financial products that would meet society's needs; however, it is the Shari'ah board's responsibility to ensure that the financial product is not pseudo-Islamic (i.e. an Islamic financial product whose form is Islamically permissible but whose substance is questionable and which features an economic outcome that is tantamount to *riba*). In addition, Siddiqi (2006) and Ahmed (2011) also indicated that the failure to evaluate the macro-economic consequences of *maqasid al-Shari'ah* could lead the Shari'ah board to authorise a financial product which is pseudo-Islamic in nature, such as the controversial Islamic product *tawarruq* which is argued would result in debt proliferation.

The challenge mentioned above on the Shari'ah board's ability to evaluate the *maqasid al-Shari'ah* at the macro level seem to be located in a chain of dilemma facing the Islamic banking industry. It was mentioned earlier that the industry is experiencing a shortfall in the number of competent scholars to hold governorship of the Shari'ah board. Another setback on the side of its development is that the Islamic banking industry has been associated with a lack of innovation of Islamic financial products and those products that it does offer tend to resembles those of a conventional bank (Laldin 2008b), an argument in which the Shari'ah board is deemed to share the responsibility. However, Siddiqi (2006) takes a different point of view. He asserts that emphasis loaded on to the Shari'ah board to strive for innovation in Islamic banking products has led to the initial *halal* assurance function that the board provides to the Islamic banking industry to be declined. Siddiqi (2006) identifies this development and the occurrence of Shari'ah board's failure to evaluate the macroeconomic consequences of Islamic banking product development and offering (such as in the case of *tawarruq*) as the 'malfunction of Shari'ah advisement' of the Shari'ah board.

Regarding the institution review, some scholars have argued for the Shari'ah board's involvement in the accounting aspects of Islamic banks; for example, by determining the formula on profit distribution to be shared between Islamic banks and the entrepreneur as in *mudharabah* financing (see for example Tomkins and Karim 1987; Karim 1990a; Abdallah 1994). In addition, the Shari'ah board also ascertains that the Islamic bank's profit has been earned lawfully according to the Shari'ah (see for example Haniffa and Hudaib 2007; Ghayad 2008). This would mean that the Shari'ah board would have to validate the Islamic financial contract transactions and the relevant documentations used by Islamic bank for that purpose. Some scholars have also highlighted that the Shari'ah board could also have an influence on the accounting policy of Islamic banks; such as, deciding whether to use accrual or cash accounting basis as in the case for *murabahah* financing (see for example Tomkins and Karim 1987; Karim 1990a; Abdallah 1994; Karim 1996). The Shari'ah board is also held responsible to produce an annual Shari'ah report on the Shari'ah compliance of Islamic bank (Briston and El-Ashker 1986; Tomkins and Karim 1987; Karim 1990a; Karim 1990b; Haniffa and Hudaib 2007). This report concludes the Shari'ah review task of the board in which the board members will express their opinion on the level of Shari'ah compliance in the operation of Islamic bank. Hence, this report provides reasonable assurance to the stakeholders on the ethicality of the Islamic bank's institution as well as assisting the investors in their investment decisions (see for example Briston and El-Ashker 1986; Tomkins and Karim 1987; Karim 1990b; Karim 1990a; Maali et al. 2006; Rammal 2006; Laldin 2008a).

The Shari'ah review task usually requires the cooperation between the Shari'ah board and other parties within an Islamic bank. Among the important parties involved in assisting the Shari'ah board in Shari'ah reviewing the activities of the bank is the internal Shari'ah compliance officer and the internal Shari'ah review officer.[27] Both the Shari'ah compliance officers and internal Shari'ah reviewer (ISR) are usually competent staff with a Shari'ah education background and who are regarded as an important internal Shari'ah control system within Islamic banks (Abdul Rahman 2008; Zaidi 2008). Zaidi (2008) considered them as the most essential element of Shari'ah compliance outside of the Shari'ah board. Their close ties with the management and the responsibilities they carry through which the Shari'ah board mirror Shari'ah compliance of the Islamic bank requires them to be competent, hold high integrity and independence (which is similar to the Shari'ah board). As such, the establishment of this internal Shari'ah control system within Islamic banks is seen as a self Shari'ah governance mechanism to facilitate the Shari'ah board in Shari'ah compliance aspect of this ethically established financial institution.

It is also imperative for the Shari'ah board to collaborate with the management, accountants and legal advisers when developing contracts on Islamic financial products and services and when preparing the relevant documentations to be used between the contracting parties (Banaga et al. 1994). Of importance is the point that the Shari'ah board should be given access to all financial records and documentation used between the contracting parties, and to validate these against the Shari'ah decisions made by the Shari'ah board if it is to execute the Shari'ah compliance review independently and effectively (Briston and El-Ashker 1986; Tomkins and Karim 1987). Equally important is that the Shari'ah board would have to organise periodical meetings amongst its members and to work closely with other parties (such as the board of directors, management, Shari'ah compliance officers, internal auditor, audit committee, external auditors and other concern parties) to evaluate and deliberate on any Shari'ah issues pertaining to the implementation of the Shari'ah decision made by the Shari'ah board (Banaga et al. 1994; Ghayad 2008). It is apparent that the Shari'ah review on the operation of Islamic banks would review the interrelated functions of the Shari'ah board, board of directors, Shari'ah compliance officers, ISR, audit committee and external auditor. Hence, it could be suggested that any failure on the part of these parties to carry out this task

[27] The IFSB differentiate between the role of internal Shari'ah compliance officer and the internal Shari'ah review officers IFSB. 2009. *Guiding Principles on Shari'ah Governance System for Institutions offering Islamic Financial Services.* Islamic Financial Services Board. The internal Shari'ah compliance officer is similar to Shari'ah officer as widely practice in the Malaysian Islamic banking industry; hence, these two terms are used interchangeably in this thesis. On the other hand the internal Shari'ah review officer refers to the internal officer who conduct internal Shari'ah audit on Islamic bank's activities.

can portray weak Shari'ah governance and would result in ineffective Shari'ah governance function of the Shari'ah board.

4.3.2.1 AAOIFI and IFSB Standards on the Shari'ah Review Role of Shari'ah Boards

In AAOIFI, the Shari'ah board's responsibilities concerning the Shari'ah review mainly refers to the *'Governance Standards for Islamic Financial Institutions No. 2 Shari'a Review'*, although issues on Shari'ah report and the elements to be included in the report are specified in *'Governance Standards for Islamic Financial Institutions No. 1 Shari'a Supervisory Board: Appointment, Composition and Report'*. In essence, the former standard deals with the requirement for Shari'ah board to execute Shari'ah review procedures and to conclude the Shari'ah compliance of IFI by documenting it in the form of a report. In order to carry out these functions, the standard provides clear provision for the Shari'ah board to have a complete access to records, transactions and information kept by the IFI, including acquiring them from the IFI's employees (AAOIFI 1998 para. 3). Amongst the Shari'ah review procedures required from the Shari'ah board are: ascertaining IFI's management awareness on and compliance procedures of the Shari'ah; reviewing documents and reports, including the IFI's policies, and deliberating on Shari'ah issues through interaction with concerned parties. The detailed Shari'ah review procedures expected from the Shari'ah board can be seen from the following excerpt of the standard (AAOIFI 1998 para. 12):

> *The SSB review procedures shall normally include:*
>
> - *Obtaining an understanding of the management's awareness, commitment and compliance control procedures for adherence to the Shari'a;*
> - *Reviewing of contracts, agreement, etc.;*
> - *Ascertaining whether transactions entered into during the year were for products authorised by the SSB;*
> - *Reviewing other information and reports such as circulars, minutes, operating and financial reports, policies and procedures, etc.;*
> - *Consultation/co-ordination with advisors such as external auditors; and*
> - *Discussing findings with an IFI's management.*

The AAOIFI and IFSB have responded to the need for a proper Shari'ah review framework for application in Islamic financial institutions with prescribed standards on this important issue. The AAOIFI's *'Governance Standards for Islamic Financial Institutions No. 3:*

Internal Shari'a Review' specifically deals with issues relating to internal Shari'ah review in IFI. Some of the important issues highlighted in the standard include: an independent attitude of the internal Shari'ah review officers when carrying out the Shari'ah review task, a step by step guide to undertake the task and the need to establish a good communication with other organs of the IFI such as the Shari'ah board, board of directors, internal auditor and external auditor (AAOIFI 2000). Meanwhile, the AAOIFI in its *'Governance Standards for Islamic Financial Institutions No. 4: Audit & Governance Committee for Islamic Financial Institutions'* requires that the audit and governance committee, amongst others, review the effectiveness of IFI's existing Shari'ah compliance monitoring system (para. 4) as well as to facilitate the Shari'ah review task conducted by the Shari'ah board and the internal auditor (para. 7). In addition, the AAOIFI require an external auditor to express their opinion as to whether the financial statements are prepared in accordance with the Shari'ah rules and principles (AAOIFI 1996 para. 17). This explains the need for an external auditor to work closely with parties such as the Shari'ah board and the officers in charge of the internal Shari'ah control system of the IFI. IFSB also gives similar recommendation for the audit committee of Islamic Financial Services to communicate and coordinate with both the Shari'ah board and a proposed Governance Committee (IFSB 2006).

In addition, the AAOIFI and IFSB require the Shari'ah board to issue a report on IFI's adherence to the Islamic Shari'ah rules and principles. Essential elements to be included in this compliance report have been specified in AAOIFI (1998 para. 10-25). Of importance is the point that this report should make apparent the scope of Shari'ah board's responsibilities, the Shari'ah review procedures undertaken, a clear statement on the examination of IFI's transactions, profit earned and the approval on IFI's calculation of *zakat* as well as declaring that the earnings realised from sources prohibited in Islam has been disposed of to charity causes. In addition, this report, as with the *fatwas* and rulings issued by Shari'ah board, are recommended to be published in the annual report of the respective IFI (AAOIFI 1998 para. 25-26; IFSB 2006 para. 49). It is also worth noting that while the Shari'ah board is responsible for forming and expressing an opinion on the extent of an Islamic bank's compliance with the Shari'ah, the responsibility for compliance rests with the management of the Islamic bank (AAOIFI 1998 para. 5).

Notwithstanding the above explanations, there are concerns as to the effectiveness of the Shari'ah review performed by the Shari'ah board members. One of the apparent issues on this subject is the structure for Shari'ah review in Islamic banks. The Shari'ah board's role, first, endorsing and, later, reviewing and giving assurance on Shari'ah compliance of the activities of Islamic banks highlights the absence of segregation of duties on the role of the Shari'ah board (Alhabshi and Bakar 2008; Antonio 2008). This conflict of interest on the Shari'ah governance function of the Shari'ah board can be confusing to regulators who are keen for Islamic banking and finance but sceptical about the modus operandi of this banking business (Antonio 2008). There are also criticisms on the practice of Islamic banks which raise the question of the implementation of Shari'ah review by the Shari'ah board. For example, a survey conducted by Alhabshi and Bakar (2008) revealed a significant decreasing role of the Shari'ah board members in performing Shari'ah review on Islamic financial product development, especially in areas deemed critical, specifically on product testing and product implementation. More recently Hasan (2011) has revealed that many Shari'ah boards did not undertake this function. Of the Shari'ah board in the IFIs studied by Hasan (2011), 58% delegate this task to the Shari'ah compliance unit.

Meanwhile, Abdul Rahman (2008) argued that, despite the deficiency in Shari'ah review described above, the Shari'ah board members report their Shari'ah opinion on an Islamic bank's full conformity with the Shari'ah. In such circumstances, the Shari'ah report is deemed to portray partial instead of complete assurance on the Shari'ah compliance of the Islamic bank's activities. Besides Abdul Rahman's (2008) criticism on the Shari'ah board's Shari'ah report, there are others who have questioned the Shari'ah board's responsibilities on the accounting aspects of Islamic banking operations, this includes: the lack of transparency on the calculation of profit sharing among investment holders (Grais and Pellegrini 2006), the details of the uses of funds which have not been declared to the depositors and investors of the bank (Grais and Pellegrini 2006; Maali et al. 2006), and the *fatwa* or resolutions issued by the Shari'ah board (Grais and Pellegrini 2006). Indeed, the annual report of some Islamic banks was revealed to have not included the Shari'ah report that was issued by the Shari'ah board (Grais and Pellegrini 2006).

Interestingly, the literature also presents evidence on arguments that view the Shari'ah review task of the Shari'ah board as not constituting Shari'ah audit (see for example Mohamed Ibrahim and Mulyany 2007; Abdul Rahman 2008). A study conducted by Mohamed Ibrahim and Mulyany (2007) revealed that the Shari'ah review task of the Shari'ah board is not perceived to include a Shari'ah audit. In addition, this study also indicates variations in terms of the scope and level of Shari'ah audit required on the operation of Islamic bank. Meanwhile, Abdul Rahman's (2008) criticism on the level of Shari'ah compliant assurance which was mentioned above contradicts with the role of the Shari'ah board because the board is arguably not required to conduct an audit. Furthermore, Abdul Rahman (2008) asserts that the complete assurance of Shari'ah compliance reported in the Shari'ah report mentioned above is in an overstatement on the part of the Shari'ah board considering that even a professional external auditor which is structurally more independent provides only a reasonable assurance on the true and fair presentation of the financial statement. Therefore, there is a call for Shari'ah audit to be conducted by an external Shari'ah audit in order to accomplish a more independent and quality Shari'ah compliance assurance (see for example Chapra and Ahmed 2002). However, Grais and Pellegrini (2006) believe that such a move would not improve the existing practice of Shari'ah compliance assurance as provided by the Shari'ah board with the assistance of the bank's ISR which is more familiar with the internal Shari'ah governance system of the bank. Similarly, the idea to overcome the challenge on the quality of Shari'ah compliance assurance through Shari'ah board rotation (similar to the suggestion forwarded for the practice of external auditors) was not welcomed. Grais and Pellegrini (2006) further assert that such a practice is inefficient and could cause problems with Shari'ah compliance verification, an issue deemed to have resulted from the exercise of *ijtihad* (which is the authority and prerogative of each Shari'ah scholar based on individual's Shari'ah knowledge depth and wisdom). In fact, Wilson (2009) observes instances where Shari'ah board members serve in a non-renewable term in their respective IFI. Such organisational behaviour was explained by Wilson (2009) as indicating IFI's preference to retain scholars with extensive experience and who have demonstrated integrity in their Shari'ah governance function.

Arguably, the shortcomings in the structure and implementation of Shari'ah review in Islamic banks mentioned above could run the risk of jeopardising the confidence of Islamic bank customers and other stakeholders. An apparent governance issue from these debates is the independence of the Shari'ah board, which will be discussed in the next section.

4.4 Independence of Shari'ah Boards

Another issue of importance when discussing the Shari'ah governance of Islamic banks is the independence of the Shari'ah board members. Similar to the external auditor of any organisations, the Shari'ah board is required to be independent in performing their task if the oversight function on the Islamic banks is to be effectively carried out. In this regard, Karim (1990a) provides a useful guide on the conceptual perception required on the independence of the Shari'ah board members. Karim (1990a) argued that the concept of independence on the Shari'ah board members should be viewed from the ethical perspective whereby the Islamic Shari'ah scholars are required to be committed to their moral beliefs and Islamic precepts, as reflected from their Shari'ah educational background, when performing their duties. In this regard, the independent concept of the Shari'ah board presents the religious commitment requirement of the Shari'ah board members and exposes their greater and ultimate transcendental accountability to God. Karim (1990a) also described how religious commitment as the independence feature of an ethically established institution (such as Islamic banks) could be significant in determining the publicly perceived credibility of the institution's operation. This is consistent with the belief that the Islamic banks' management is also keen to adhere to the Islamic Shari'ah in the operation of the bank because a reported violation of the Shari'ah by the Shari'ah board could be detrimental to the perceived credibility of the bank. A further crucial criteria for an independent function of the Shari'ah board members is to be free from the influence of economic interest or being pressurised by the Islamic banks' management (Karim 1990a).

An interesting debut on the independence of Shari'ah board is the absence of proper segregation of Shari'ah board duties pertaining to their product endorsement function and, later, when they perform Shari'ah review, as has been mentioned in the previous section. Also discussed was Abdul Rahman's (2008) argument on the Shari'ah compliance assurance in the Shari'ah report which was made by the Shari'ah board in the absence of an external Shari'ah auditor. These dilemmas do not only display the apparent loophole in the independence of the Shari'ah governance authority of Islamic banks, but they might also impair the Shari'ah opinion as expressed by the Shari'ah board members. In addition, since both stages are held responsible by the same monitoring body (i.e. the Shari'ah board), this brings forward a further concern on the monitoring effectiveness within Islamic bank's Shari'ah governance authority. Equally crucial is the need for Shari'ah board members to be able to attend general meetings, and gain accessibility and means to Islamic banks' documents and accounts when performing their duty as religious auditors as would external auditors when examining the financial statements of an organisation (Briston and El-Ashker 1986; Tomkins and Karim 1987; Gambling et al. 1993; Rammal 2006). Clearly, these requirements are vital for the Shari'ah board to produce a truthful and unbiased Shari'ah compliance report on the operation of the Islamic banks because if the operation of Islamic banks are found to be non-compliant to the Shari'ah then the integrity of the Islamic banking industry would be undermined and stakeholders would lose confidence (Bhambra 2002).

4.4.1 AAOIFI and IFSB Standards on the Independence of Shari'ah Boards

AAOIFI and IFSB raise the issue of the independence of the Shari'ah board by addressing aspects of Shari'ah board members' appointment, remuneration and the need for a clearly defined scope of duties. In relation to the Shari'ah board's terms of appointment, there are several factors which are considered by both the AAOIFI and IFSB as influencing the independence of the Shari'ah board. Among these it is suggested that the Shari'ah board members should not become involved in the managerial decisions of the IFI and that they or their family members should not be employed as a senior executive officer or have a substantial shareholding in the IFI (IFSB 2009 para. 41-45; AAOIFI 2010a para. 47, Appendix A). In addition, IFSB also made clear the need for the board of directors to be ultimately responsible for the appointment of Shari'ah board members and that this appointment should be made by the board of directors with approval from the shareholders in the general meeting (IFSB 2009). Indeed, the shareholders are seen as the ideal party to appoint Shari'ah board members because this approach is deemed to be consistent with the earlier discussion on the appointment of board of directors over the principal-agent relationship on the need for monitoring of the agents' activities. However, the apparent distinction of the Shari'ah board will be its specialisation on the Shari'ah compliance monitoring capacity. The IFSB (2009), under principle, 1.2 also clearly spells out recommendations for institutions such as Islamic banks to provide clear terms of reference regarding the responsibilities and mandated authority of the Shari'ah board. These terms of reference should also specify well-defined operating procedures, the line of reporting and the remuneration of Shari'ah board members (IFSB 2009 Appendix 1). Such initiatives, if taken, are deemed to be capable of enhancing the independence of the Shari'ah board in carrying out its duties.

Despite the explanation and recommendations of the AAOIFI and IFSB above, the literature presents a number of arguments that raise questions on the independence of Shari'ah boards. For example, the recruitment of Islamic scholars to serve on the Shari'ah governance authority in the Islamic banking industry has made a dramatic change in their lifestyle. From the social well-being perspective, these scholars are currently highly paid for their governance role (Kahf 2002; Siddiqi 2006). Additionally, the fact that the Shari'ah board members are being remunerated by the bank and at the same time carrying out the Shari'ah compliance monitoring role on the bank's activities points to the dual relationship of the Shari'ah board members and, hence, could jeopardise the independence of this Shari'ah governance authority (Grais and Pellegrini 2006; Rammal 2006; Khan 2007). Other criticisms go further by arguing that the Shari'ah board members would, in return for the monetary value they gain by sitting in the Shari'ah board, legitimise dubious operations (Rammal 2006) or provide an easy *fatwa* to the management of the Islamic banks (Grais and Pellegrini 2006), thus, becoming a window dresser to Islamic banks (Kahf 2002).

4.5 The Role of Centralised Shari'ah Board

Another Shari'ah governance model apparent in the Islamic banking industry is the establishment of a centralised Shari'ah board that co-exists with bank's in-house Shari'ah board. While the Shari'ah board is the Shari'ah governance authority in-charge of the Shari'ah governance at the bank's level, the centralised Shari'ah board is in-charge of the Shari'ah governance at the macro level, i.e. at the national level. The countries that exhibit a centralised Shari'ah board governing the Islamic banking industry are Jordan, Bahrain, Bangladesh, Brunei, Malaysia, Sudan, Kuwait, Qatar, Pakistan, and Indonesia. However, the authority of this centralised Shari'ah board and the mechanism of how this board would operate might not be identical amongst the countries mentioned (see, for example, Hasan 2009). For example, the centralised Shari'ah board for the Islamic banking industry in Malaysia is established at the level of the central bank, whose resolutions are binding and whose members are restricted from becoming a Shari'ah board member of IFI. Meanwhile, Kuwait has a Fatwa Board at the Ministry of Awqaf and Islamic Affairs which acts as the centralised Shari'ah board for the Islamic banking industry, and its members are not restricted from serving as a Shari'ah board member in any of the country's IFIs. Despite these differences, the central argument on the tasks of a centralised Shari'ah board is to attempt to standardise the Islamic banking practices through coordination of the *fatwas* and the Islamic financing products and services (Grais and Pellegrini 2006; Laldin 2008a; Shaffaii 2008).

One of the apparent features of the centralised Shari'ah board is its Shari'ah compliance facilitative feature (Shaffaii 2008). The centralised Shari'ah board, which is usually comprised of experts in the field of *fiqh al-mua'malat*, is deemed significant in assisting the related parties (i.e. the Islamic banks themselves, the regulators and the supervisors) in understanding the Shari'ah principles applied in the operation of Islamic banks, thus easing any possible regulatory conflicts amongst them. On the question of membership, Wilson (2009) asserts that a centralised Shari'ah board should also include experts from other fields (such as finance) because this will ensure that the *fiqh* scholars in the same board are aware of the financial consequences and will make better informed decisions and approvals on the Islamic financial contracts that could be complex in nature. However, he also agreed that the centralised Shari'ah board with limited knowledge in *fiqh* could dilute the influence of the Islamic jurisprudence. Nonetheless, the establishment of a centralised Shari'ah board could be seen as a regulator's intervention to further strengthen the Shari'ah governance of Islamic banks and as one measurement of mitigating possibilities of non-compliant Shari'ah risk. Such a move by the regulators signifies a positive contribution towards a standardised approach and pushes for acceptance of the Islamic banking practices at a global platform. It is also noteworthy that the setup of a centralised Shari'ah board as the governance mechanism for overseeing the national Islamic banking practices is also recommended by AAOIFI[28] and the Organisation of Islamic Conference's (OIC) Fiqh Academy[29].

The centralised Shari'ah board could also play an intermediary role in resolving any difference of opinions or any disputes that arise between the in-house Shari'ah board members of particular Islamic banks (Grais and Pellegrini 2006; Alhabshi and Bakar 2008;

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[28] AAOIFI, Certified Shari'a Advisor and Auditor (CSAA) textbook, p. 326.

[29] The International Council of Fiqh Academy in its Decision Number 177 (19/3) recommends the set up of a central Shari'ah authority to supervise the operations of Shari'ah board of all Islamic financial institutions in the country. Additionally, the resolution also includes a suggestion that the appointment and removal of the Shari'ah board should be done by the central Shari'ah authority and that the later should structure the function of, and audit the work done by, the former. It is also worth noting that many of the recommendations included in the resolutions, such as on the role of the Shari'ah board and the internal Shari'ah review process of Islamic financial institutions, are similar to those of AAOIFI. The resolution of the *fiqh* academy can be accessed at http://www.iefpedia.com/english/wp-content/uploads/2009/10/The-Role-of-Shariah-Supervision-in-Regulating-the-Operations-of-Islami-Banks.pdf

Laldin 2008a). Since there are likely to be differences in the *ijtihad* (legal reasoning) of the Shari'ah board on the operation of Islamic banks, these differences could be referred to the centralised Shari'ah board in order to arrive at an agreement between the Shari'ah board members. In this light, Wilson (2009) concludes that consistencies in the IFI are more likely in jurisdictions where there exists a centralised Shari'ah board. Hence, the Shari'ah reference role of the centralised Shari'ah governance authority is seen as crucial in harmonising the Islamic banking practices worldwide as well as in preserving the integrity of the Shari'ah board itself (Laldin 2008b).

The next section will discuss further one of the main challenges in the Islamic banking industry worldwide, which is the standardisation of Islamic banking practices.

4.6 Standardization of Islamic Banking Practices

It has been discussed earlier that the scope of the present modern Islamic banking operation requires the Shari'ah board members to use the *ijtihad* facility in coming up with their *fatwa* on its application in the Islamic banks. However, this provision opens room for differences of opinion amongst the scholars with regard to the permissibility on the operational or product innovation aspect of Islamic banks. Also deemed unavoidable because of the expansion of Islamic banks operation worldwide is the likelihood that the operation of Islamic banks will be influenced by the cultural background and the diversity provided by the different *madzahib*. Hence, differences in Islamic banking practices seem inevitable because they are the natural outcome of *ijtihad* (legal reasoning) by the Shari'ah body, who governs the industry, and the effect of the domestic condition and circumstances on Islamic banks (Laldin 2008b).

Apparently, the situations described above lead to a series of un-standardised Islamic banking practices across the globe. Several studies present an argument that a different verdict by the Shari'ah board members on similar practices impacts on the financial reporting of Islamic banks (Karim 1990b, 1996; see for example El-Gamal 1997; El-Hawary et al. 2007; Khan 2007). For instance, Karim (1996) asserts that the diverse recognition and measurement policies suggested by an individual Islamic bank's in-house Shari'ah board members could eventually make Islamic banks disclose differently from one another on the same issues.

Meanwhile, Karbhari et al. (2004) asserted that the lack of standardisation on the Islamic scholars' opinions on issues relating to the practice of Islamic banks has created tension between Islamic bank and the regulators, which has contributed to Al-Baraka's (the first Islamic bank in the UK) loss its bank license. Hence, standardisation and consistency can be considered as key elements for the penetration and establishment of Islamic banking products and practices, especially in the non-Islamic regulatory setting of Western countries. Additionally, it makes it obvious that standardisation is attributed to ease of regulatory control in terms of monitoring activities, examining fulfilment against certain authority's requirement, and enhanced comparability and transparency of the reporting practices by Islamic banks.

Shaffaii (2008) provides three examples which are regarded as the key drivers in standardising and harmonising the Shari'ah for Islamic banks. The first example could be considered as the market influence of disciplining the industry (a corporate governance mechanism which was mentioned in Chapter Two). Since there are many industry players in the market, the high competition in the market will force Islamic banks to standardise their practices to ensure their survival. Secondly, the establishment of IFI regulatory bodies such as AAOIFI and IFSB have been recognised for their outstanding effort in producing governance, reporting and Shari'ah standards for use in institutions like Islamic banks. Indeed, both institutions have worked on reconciling and harmonising the Shari'ah jurisdiction used in Islamic financial services through the set-up of their Shari'ah board and Shari'ah working group respectively. Thirdly, there has been an ongoing Shari'ah forums and discussion initiated by various parties, including reputable organisations (such as the Islamic Fiqh Academy of Organization of Islamic Countries (OIC) and Multaqa Dallah al-Barakah) and the more recent forums (such as Muzakarah Cendekiawan Shari'ah Nusantara (MCSN), a gathering of prominent Shari'ah scholars from the South East Asian region (ASEAN) comprising of countries from Malaysia, Indonesia, Brunei, Singapore and Thailand) which have aimed at becoming the platform to find a common ground for harmonising the application of the Shari'ah in the Islamic banking industry of the region.

In addition to those responsible organisations put forward by Shaffaii (2008) above, there are other initiatives towards standardising Islamic banking practice which can be judged by the objectives of the establishment of these respective bodies. They include the work done by the International Islamic Financial Market (IIFM), the Islamic International Rating Agency

(IIRA), monetary agencies and Islamic indices in the stock market. The role of the IIFM and IIRA in promoting standardization of Islamic banking practices has been highlighted in Section 3.4 of Chapter Three. Meanwhile, monetary authorities have also put their effort to ensuring uniformity and harmonisation of the Shari'ah interpretation by establishing a centralised Shari'ah board as well as the issuance of guidelines for implementation in IFIs such as Islamic banks. Over the past few decades a number of Islamic Market Indices have also been developed, such as the FTSE Global Islamic Index, Dow Jones Islamic Market Indexes, Malaysian Securities Commission's Islamic Capital Market (ICM), and the Jakarta Islamic Indexes. These indices provide investment opportunities by identifying and filtering out those companies whose operations are not consistent with the Shari'ah. Thus, companies who seek funds through investment in these indices would have to be abide by the Shari'ah guidelines which are issued by the respective indices' Shari'ah board.

At the other extreme, Zaidi (2008) pointed out that standardisation of the Shari'ah opinion would be contrary to the objective of the Shari'ah for several reasons. Firstly, he noted that in the event where rules are being imposed to force the Shari'ah to be standardised this would restrict the use of *ijtihad* (legal reasoning) which allows for the application of Shari'ah at different times and circumstances. Wilson (2009) shares the same concern when he asserts that standardisation would only slow the innovation of Islamic banking development. In addition to the first counter argument by Zaidi (2008), the standardisation of Shari'ah rulings could also result in the opinion of certain *madzhab* to take precedence over other *madzhab*. On the other hand, the Shari'ah principle of '*al-ijtihad la yanqudu bi al-ijtihad'* means that the interpretation of the Shari'ah by the scholars or the *ijtihad* cannot be nullified by another *ijtihad* (Laldin 2008b). Hence, when there are conflicting opinions on the permissibility of certain Islamic finance products by different Shari'ah scholars, this does not mean that Islamic banks should close their doors on the innovation of Islamic finance products and services.

Moreover, the Islamic banking industry operates under the ambit of the national Shari'ah governance framework (SGF). This SGF might comprise a centralised Shari'ah board acting as the supreme authority of the Islamic banking industry whose resolutions serve as the point of reference for Shari'ah boards of IFI within that national jurisdiction. As the highest Shari'ah authority in the SGF, the centralised Shari'ah board would issue certain Shari'ah resolutions by accommodating the local and cultural circumstances of the country. However, this resolution could be contrary to the resolutions of the centralised Shari'ah board of another country. This scenario makes it apparent that the flexibility given in Shari'ah itself serves as the contributing factor that makes the SGF of one country unique. This is also the reason for the prevalent differences on the opinion of the Shari'ah scholars on whether there should be a penalty imposed on a defaulting debtor (which is argued as being tantamount to *riba* or usury) and the permissibility of certain Islamic financial products in some countries while it is considered impermissible in others (such as the common use of *bay' bithaman ajil* in Malaysia as discussed in Chapter Three).

The above arguments provide some indication of the difficulty associated with standardising Islamic banking practices. Despite the emerging challenge of differences in Islamic banking practice, Grais and Pellegrini (2006) cited the findings of the Council for Islamic Banks and Financial Institutions (CIBAFI) (as reported in the proceedings of the Fourth Harvard University on Islamic Finance) in which out of 6000 *fatwas* sampled by CIBAFI, 90% were found to be consistent across banks. Thus, this finding shows an inclination on the consistency of Shari'ah interpretation used in Islamic banks by the scholars over the legal Shari'ah sources and implies that overall differences in Shari'ah opinion will be on broad and not specific matters, as has been suggested by Karim (1990b). Significant efforts on standardising Islamic banking practices have taken place, and many are still consistently working towards this goal.

4.7 Shari'ah Governance Function of Shari'ah Boards and Shari'ah Advisory Council in the Malaysian Islamic Banking Industry

It was been mentioned earlier that Malaysia is one of the countries which implements a dual-layer Shari'ah governance system in their Islamic banking industry. Every bank offering Islamic banking products and services in Malaysia has an in-house Shari'ah board, called Shari'ah Committee, who holds a non-executive role and who is the sole authority of Shari'ah matters in that particular bank. Meanwhile, another level of Shari'ah governance is undertaken at the central bank level by the centralised Shari'ah board, which is called the Shari'ah Advisory Council (SAC). The SAC acts as the sole authoritative body to advise the Bank Negara Malaysia (BNM) for Islamic banking and *Takaful* operations, hence, making apparent its role as a regulator and supervisor. As the Shari'ah apex body, the SAC has been authorised with mandated power on its Shari'ah governance role, as can be seen from the recent amendment to the Central Bank of Malaysia Act 2009 in which the Shari'ah resolutions issued by the SAC are binding to all Malaysian IFIs (BNM 2009). This enforcement demonstrates that the role of the regulators in ensuring that the governance system implemented in Islamic banking system is robust due to the strict requirement for the banks to adhere to the Shari'ah. It is also noteworthy that as a central Shari'ah reference the SAC could overcome or minimise inconsistencies in Islamic banking practices in Malaysia.

The regulatory setup for the Islamic banking industry in Malaysia seems to be partly consistent with the recommendation made by AAOIFI. For instance, under the provision of BNM's '*Guidelines on the Governance of Shariah Committee for Islamic Financial Institutions'* (or GPS1) the Islamic banks should establish a Shari'ah board of at least three members (BNM 2004). However, in practice, the approach of appointing Shari'ah board members appeared to be contrary to the AAOIFI's recommendation because the members to this Shari'ah governance authority are currently appointed by the bank's board of directors. Nevertheless, the GPS1 also highlights that the procedure of appointing Shari'ah board member is heightened by the requirement for this appointment to gain the approval of BNM. The GPS1 also limits the number of Shari'ah board members sitting in a bank to be not more than one. It has also been argued that a limitation imposed on Shari'ah board's membership, such as that required by the GPS1, can potentially protect the confidentiality of banking information and documents to rival institutions (Grais and Pellegrini 2006; Wilson 2009). In addition, the GPS1 includes guidelines on matters pertaining to the procedures, qualifications, composition, secretariat, disqualification, resignation and termination, restrictions, duties and responsibilities of the Shari'ah board members. Indeed, under the provision of Section 3 (5) (b) of the Malaysian Islamic Bank Act 1983, the BNM is required to disallow the grant of a license, and that the Minister shall not grant the license, unless they are satisfied that there is, in the articles of association of the bank concerned, provision for the establishment of a Shari'ah board (Malaysia 1983). Similarly, Section 124 of the Malaysian Banking and Financial Institutions Act (BAFIA) 1989 spells out the requirement for other banks (i.e. conventional banks) or licensed institutions offering Islamic banking business to be subject to the same enforcement of BNM in relation to the Islamic banking business, which necessitates the bank to establish a Shari'ah board and to work in consultation with the SAC (Malaysia 1989).

Clearly, under the Malaysian regulatory environment the establishment of a Shari'ah board is mandatory and the appointment of its members requires the approval of the regulator. Malaysia can also be seen to have taken an initiative to ensure the independence of the Shari'ah board since any concern on conflict of interest, or the capability of the Shari'ah board member in performing a Shari'ah governance function, can be addressed before the Shari'ah board member is formally appointed. Hence, this prevailing regulatory framework can be seen as a filtering mechanism on Shari'ah board's appointment and demonstrates the influence of the regulator in shaping the Shari'ah governance structure of the Islamic banking industry in Malaysia.

The GPS1 also outlines an important regulation on the Shari'ah board over its Shari'ah governance functions in Malaysian Islamic banks. In tandem with its Shari'ah advisory role, the guidelines states a provision for the Shari'ah board to advice the board of directors on Shari'ah matters and to report functionally to the board of directors. Also specified in GPS1 is the need for the Shari'ah board to establish auditing procedures by developing contracts on Islamic financial products and services to be launched to consumers, and to also endorse its related documentation. Also required from the Shari'ah board is endorsing the Shari'ah manual that is developed and used by the Islamic bank that the Shari'ah board serves, and to organise periodical Shari'ah meetings to discuss any issue involving operational or product matters of their respective bank. Moreover, the GPS1 also specifies the need for the Shari'ah board to validate the documentation used within the contracting parties and to ensure that there is a proper record of those documents for easy reference on Shari'ah decision to be made by the Shari'ah board. The Shari'ah compliance report on the Islamic bank's adherence to the Shari'ah represents another important task of the Shari'ah board which is set out in the guideline. In addition, the GPS1 also requires IFIs offering Islamic banking and *Takaful* to recruit a minimum of one Shari'ah compliance officer (who is called the Shari'ah officer) who will serve as the secretariat to the Shari'ah board.

4.8 Empirical Studies on the Shari'ah Governance Function of the Shari'ah Board

The preceding sections have thoroughly discussed the Shari'ah governance function of the Shari'ah board. These sections have highlighted a number of significant Shari'ah board issues found in the literature, including: its membership, its diverse scope of responsibilities, the accountability and independence of the Shari'ah board and the factors influencing these two attributes, as well as the standardisation of Islamic banking practice. In addition, the role of the Shari'ah board and the SAC in the context of Malaysian Islamic banking business has also been described. The interest of this current section is to examine prior empirical studies on these issues. As mentioned in the introduction of this chapter, empirical studies on the Shari'ah governance function of the Shari'ah board can be considered as still lacking and they leave much to be desired, although the few which are available such as Abumouamer (1989), Abdul Rahman et al. (2005), Al-Sadah (2007), Alhabshi and Bakar (2008), Faizullah (2009), Safieddine (2009), Hassan et al. (2010), Rammal (2010) and Hasan (2011) provide an indication of the extent of empirical work done on this subject.

Abumouamer's (1989) study on the Shari'ah governance function of the Shari'ah board is the earliest study to be found on this subject. Using a questionnaire survey and interview as his research instruments, Abumouamer (1989) studied the role of Shari'ah board members in fifteen Islamic banks and Islamic finance houses from different countries. His findings revealed that the majority of the Shari'ah board members perceived that they are independent and that they have a coordinated relationship with the management. The Shari'ah board was also indicated as receiving authority from the shareholders and a Shari'ah board whose remuneration is determined by the shareholders perceived that they are more independent. In addition, the Shari'ah board members who are placed on the management and the board of directors were found to have more access to financial books and documents than those Shari'ah board members who hold a non-executive role.

Meanwhile, there is no clear definition on the Shari'ah advisory role of the Shari'ah board as reported by Abumouamer (1989). On the other hand, the Shari'ah review role of the Shari'ah board, called 'Shari'ah auditing' by Abumouamer (1989) was categorised as: the pre-audit, during the work audit, and the post-audit. It was revealed that information for Shari'ah auditing was collected by asking the bank's staff (65.9%) or from financial books and documents (34.1%). Abumouamer (1989) also examined Shari'ah auditing on financial statements and the various accounts in an Islamic bank (e.g. investment account, deposit account and current account). This Shari'ah auditing was undertaken despite the fact that the Shari'ah board members were reported as mainly comprising of Shari'ah scholars who did not have the ability to audit accounting documents. Moreover, the Shari'ah board members were reported as mostly working part-time in the Islamic banks, and as such their time to conduct a post-audit after they had declared their *fatwa* was limited. Interestingly, Abumouamer (1989) also revealed that although clients tend to be unaware of a Shari'ah report issued by the Shari'ah board, they still have confidence in the activities of Islamic banks as being *halal* through the dependence on Islamic bank's management and publications.

On the other hand, Abdul Rahman et al. (2005) provide an empirical work on the independence of the Shari'ah board from the perspective of commercial bank managers who work in Islamic banks and Islamic banking divisions of conventional local commercial banks in Malaysia. The study by Abdul Rahman et al. (2005) employed a mail questionnaire survey which was distributed to two fully-fledged Islamic banks and ten conventional banks offering Islamic banking products and services. Investigation of the Shari'ah board's responsibilities was undertaken by briefly soliciting the perceptions of the respondents of the parties to whom the Shari'ah boards are responsible legally, as well as religiously and socially. Based on the descriptive analysis performed on the central tendencies of mean data aggregated, Abdul Rahman et al. (2005) concluded that the Shari'ah board' responsibilities were perceived by the respondents to be more important to depositors, shareholders, regulatory agencies, customers and the Muslim public than to creditors and managers. In addition, an analysis of the mean values revealed five factors which were able to increase the level of the Shari'ah board's independence. These five factors include the level of Shari'ah background and the reputation of the Shari'ah board members, which is consistent with the independence concepts that were forwarded by Karim (1990a). The respondents also indicate that the existence of institutions such as Shari'ah board, who are also members of the SAC and who take on a non-executive role, as other factors which are deemed crucial to increase the independence of the Shari'ah board members.

Meanwhile, Al-Sadah (2007) examined several issues on the corporate governance of Islamic banks through case studies of four Islamic banks in three different Gulf Cooperation Council (GCC) countries. Al-Sadah (2007) exposed that the Shari'ah board was mainly undertaking its Shari'ah advisory role and it relied on the ISR for the Shari'ah review function of the respective Islamic banks. In addition, he reported that all four of the Islamic banks studied reported no formal communication between the audit committee and the Shari'ah board. Indeed, a Shari'ah violation of an investment that is not compatible to the Shari'ah occurred in one of the Islamic banks and was reported by the Shari'ah board but was not mentioned in the external auditor's report. Interestingly, the same violation had been reported for four consecutive years and, despite the disclosure, the total deposit of the said bank showed an increasing trend during the same period. Al-Sadah (2007) associated the failure of such a revelation to the ineffective market discipline depicted by the passive role of the investment account holders through their unconcerned deposits in the respective Islamic bank. Meanwhile, Al-Sadah (2007) briefly draws attention to the independence issue of the Shari'ah board with regard to its remuneration. Al-Sadah (2007) reported that the Shari'ah board members in all four Islamic banks studied are appointed and remunerated based on the decision of the board of directors, which is in turn made upon the recommendation of the management. Al-Sadah (2007) argued that in these circumstances the independence and effectiveness of the Shari'ah board could be jeopardised because this Shari'ah governance authority could be subject to the influence of the management.

Another study on Shari'ah governance of IFIs is by Alhabshi and Bakar (2008). This study examined various governance issues on 67 IFIs mostly form Middle East and Southeast Asia countries including Malaysia and produce findings that reveal varying Shari'ah governance practices in the countries studied. The majority of the respondents in this study indicate the involvement of the Shari'ah board in its traditional role of formulating as well as adopting Shari'ah opinion and the exercise of Shari'ah compliance monitoring on the IFI's system, documents, and products. This finding corresponds to the evidence which shows that 95% of the respondents regarded the Shari'ah board as the highest decision making authority on Shari'ah matters. Majority of the respondents also felt that Shari'ah matters are reported to the Shari'ah board and that the Shari'ah board is a platform to resolve differences in Shari'ah matters. They also found that less than 50% of the respondents incorporate Shari'ah goals in the IFIs' vision, mission, and overall institutional goals. In addition, six different stages of product development were tested, which are: conception, design, documentation, testing, implementation and review. The highest involvement of the Shari'ah board in Islamic bank's product development based on these stages was reported from Bahrain and UAE. Meanwhile, countries like Malaysia, Qatar, and Sudan indicated a high level of Shari'ah board roles only in the conception, product design and product documentation stages.

Alhabshi and Bakar (2008) also observed a varying emphasis on the scope of the Shari'ah report prepared by the Shari'ah board. It was found that about 95% of the respondents reported on the Shari'ah compliance of the products offered by the Islamic banks. A lower percentage of respondents included emphasis on the reliance on an internal Shari'ah control system (76%), governance issues in the interest of investment account holders (71%), as well as other issues addressing the interest of stakeholders (68%). Meanwhile, the shareholders role in approving the Shari'ah report issued by the Shari'ah board seems to be weak in practice. Malaysia and Indonesia have both shown the lowest levels of involvement of shareholders in giving approval to the Shari'ah report, with a response rate lower than 40%. This is deemed to have resulted from the country specific mechanism on the appointment of the Shari'ah board members. In addition, evidence from all of the investigated countries indicated that the Shari'ah matters are deliberated by the Shari'ah board. However, there are differences in the concentration level on the deliberation by the Shari'ah board; for example, Islamic banks in Bahrain, Brunei, Jordan and Malaysia have reported a higher involvement of the Shari'ah board in this process when compared to other countries.

In addition, Alhabshi and Bakar (2008) found that the presence of the centralised Shari'ah board influenced the authority, appointment and Shari'ah reporting mechanism of the Shari'ah board. Such an inference is made on the basis that the final say on the appointment of the Shari'ah board rests on the centralised Shari'ah board whom the majority of the respondents considered as the highest authority in the Shari'ah governance of Islamic banks within the sovereigns. Their findings also revealed that the primary role of the centralised Shari'ah board was regarded as establishing the national SGF by 56% of the respondent, while another 49% regarded it to be formulating national policy and rulings for the Islamic financial industry.

Meanwhile, Faizullah's (2009) study pertaining to the role of the Shari'ah board relates to the reported questionnaire survey findings of ten IFIs in Bangladesh. He briefly reported that the main role of the Shari'ah board was: to give advice on all aspects of Shari'ah law (70%); advising on formulating products (40%); and, issuing Shari'ah certification (30%). He also briefly studied the Shari'ah board members involvement on the accounting aspects of the IFI's operation. These are issues pertaining to: the paying or receiving of interest (of which the Shari'ah boards are generally unaware); the segregation of funds (of which 40% believe that it is segregated); profit distribution (of which 80% believe that it is based on actual profit); and, loss distribution (of which 50% believe that it is based on actual loss). Faizullah (2009) also briefly indicated the independence of the Shari'ah board. In addition to revealing that the chairman of one bank was also the Shari'ah board member of that particular bank, Faizullah (2009) also reported that the Shari'ah board members mostly do not hold an executive position in the bank. In addition, he also found that 40% of the Shari'ah board members are also on the board of other IFIs and that the Shari'ah decision is made mainly based on a majority (80%).

In 2009, Safieddine examined the practices of IFIs from five GCC countries together with their implications in mitigating the agency problems, as well as their influence on the operations and performance of Islamic banks. In undertaking his study, Safieddine (2009) collected data from 40 IFIs using both a questionnaire survey and interviews with senior managers from 3 IFIs. He highlighted the issue of the independence of the Shari'ah board in its appointment mechanism (83% of the IFIs appointed their Shari'ah board through a general assembly), possible conflict of interest (the Shari'ah boards were reported as not holding executive position or owning any shares in their respective IFIs), its reporting line (73% of the IFIs reported that their Shari'ah board reports to the board of directors and the shareholders while the remaining 27% reported to the board of directors only), and its decision making (all of the IFIs reported that their decisions are approved by majority of the Shari'ah board members, and 85% of the IFIs reported that decisions made by the Shari'ah board is mandatory and binding). While these findings offer some insights into the independence of the Shari'ah board, other important aspects of the Shari'ah governance function of this governance authority were not included in Safieddine's (2009) study.

Later, Hassan et al. (2010) looked to the role of the Shari'ah board in Malaysian Islamic banking and *Takaful* industries by conducting interviews with 37 participants, which included: Shari'ah board members (23); Shari'ah officers (11), and regulators (3). This study indicated that the role of the Shari'ah board members were limited to: product approval (91.4%), as a decision making body (85.7%), and as researchers and experts in Islamic banking and finance (97%). In addition, they also report that the Shari'ah review task of the Shari'ah board was to: review any new products and their structures, concepts, and documentation; existing Shari'ah matters, and their implementation of Shari'ah decisions and resolutions; hold regular monthly meetings and ad-hoc meetings when necessary; and, to ensure that IFIs have their own Shari'ah manual. Furthermore, Hassan et al. (2010) reported that the Shari'ah decisions issued by the Shari'ah board members are binding to the IFIs and that if Shari'ah violations are found corrective actions should be taken to the extent of withholding or terminating the product if it cannot be rectified.

Additionally, Hassan et al. (2010) also revealed the importance of proper operative procedures, appropriate qualifications and relevant experience for Shari'ah board members as being amongst the factors influencing the effectiveness of this Shari'ah governance authority. Interestingly, their findings also reported that the amount of remuneration received by the Shari'ah board members influenced their effectiveness (76.5%) and that remuneration does not affect their independence (75%). Meanwhile, the effective structure of the Shari'ah board was indicated as comprising a combination of both Shari'ah and non-Shari'ah experts (71%), with between three to five expert members (79%). Factors that might impede the effectiveness of Shari'ah review function of the Shari'ah board were also indicated in their findings. These are:

1. Time constraint due to the part-time working nature of the Shari'ah board;
2. Incompetency (in knowledge and experience) of the Shari'ah board members;
3. Inadequate communication between Shari'ah board members with internal parties within the bank;
4. Shortage of human resources; and,
5. Interference from the board of directors.

Rammal's (2010) study on the role of the Shari'ah board for the Islamic banking industry in Pakistan used case studies of two fully-fledge Islamic banks and four banks offering Islamic window. It is argued that Rammal's (2010) study offers a narrow understanding on the Shari'ah governance function of the Shari'ah board. The diverse range of Shari'ah advisory and Shari'ah review role of the Shari'ah board was not ascertained. For instance, Rammal (2010) revealed that the roles and function of the Shari'ah board include developing Islamic banking products. If a new product is to be developed then this requires the approval of the Shari'ah board of the State Bank of Pakistan (SBP), which is noted as a mechanism to standardise Islamic banking products. However, Rammal (2010) did not specify the involvement of Shari'ah board members in the different stages of developing the product. Meanwhile, Rammal (2010) briefly described the structure of the Shari'ah review task of the Shari'ah board by differentiating it between Islamic banks and banks with an Islamic window. Rammal (2010) revealed that, unlike the case of banks with an Islamic window, the Shari'ah board members find it difficult to review Islamic banks because they have many branches across the country. This has resulted in the need for the Shari'ah review of Islamic banks to be undertaken by the Shari'ah board at the bank's headquarter due to time and cost constraints. In addition, Rammal (2010) also indicated that the role of Shari'ah board members are regarded as simple 'rubber stamping' because most of the decisions have already been made by the bank itself. Furthermore, the board members were argued by Rammal (2010) to be unlikely to reject the decisions made by the bank because they are compensated by the bank.

More recently, Hasan (2011) attempted to study aspects of Shari'ah governance in IFIs from the regulatory framework perspective. Insights on the Shari'ah governance function of the Shari'ah board offered by Hasan (2011) were derived from 31 IFIs, which were drawn from: Malaysia (17), UK (1) and GCC (13) countries. Hasan (2011) indicated that the majority of the Shari'ah board in the IFIs studied undertook a Shari'ah advisory and Shari'ah review role. However, it was noted that the Shari'ah advisory role of the Shari'ah board was not clearly defined. For example, the Shari'ah board's involvement in advising the board of directors or other parties within the bank, in designing the strategic issues of the bank, or in training the bank staff have not been ascertained. Also, there was no indication of whether the Shari'ah board members receive any assistance from relevant parties within the bank in order to undertake their Shari'ah advisory role.

In addition, it has been observed that Hasan (2011) also looked at the involvement of the Shari'ah board in developing Islamic banking products, in undertaking institution review (for example, the accounting aspects of the IFIs), the structure of Shari'ah review (for example, the operative procedures), and in the implementation of Shari'ah review (for example, the communication between the Shari'ah board and other parties within the bank and evaluation of IFI's Shari'ah governance system). However, the precise involvement of the Shari'ah board in different stages of product development, the commitments in innovating and standardising products, and in the operation of IFI and the role and influence of the centralised Shari'ah board are amongst the apparent loopholes which are identified in Hasan's (2011) study on the Shari'ah governance function of the Shari'ah board. Meanwhile, aspects of Shari'ah board member's independence were limited to the regulatory framework applied in the jurisdiction of the IFIs studied. This leaves important factors found in the literature and which were discussed in Section 4.4 not being identified by Hasan (2011) as influencing the independence of the Shari'ah board. Similarly, Hasan (2011) overlooks the importance of ascertaining factors influencing the accountability of the Shari’ah board members, although it is noted that he studied those parties to whom the board is deemed to be accountable. Also worth noting is that aspects of the Shari’ah board’s appointment and authority were studied by Hasan (2011). This includes establishing the existence of ‘fit and proper’ criteria for the appointment of the Shari’ah board, communication channel and an evaluation of the appointment and authority of the Shari’ah board members.

This section has thoroughly examined prior empirical studies on the Shari’ah governance function of Shari’ah board. Table 4.1 below provides a summary of this. It can be concluded that these studies are rather limited in scope principally because the Shari’ah governance function of the Shari’ah board in terms of its role, accountability, independence and effectiveness are rather broad (as reviewed in Sections 4.2 to 4.6 above). Similarly, studies that examine Shari’ah governance function of the Shari’ah board in its association with the centralised Shari’ah board are also limited. Hence, there is a gap in the literature that evaluates and provides an in-depth understanding on the Shari’ah governance function of the Shari’ah board in pace with the rapid development of the Islamic banking industry and with the increasing demand of the customers for these services.

Table 4.1: Summary of Empirical Studies relating to the Shari'ah Governance Function of Shari'ah Boards

Literature				Defining the Role of the Shari'ah Board	Defining Shari'ah Review Role of the Shari'ah Board		Defining Shari'ah Board's Accountability		Defining Shari'ah Board's Independence	
Author	**Sample Study Country / Countries**	**Research Method**	**Target Respondents**	**Ascertain the Diverse Shari'ah Advisory & Shari'ah Review Role**	**Ascertain the Structure for Shari'ah Review**	**Ascertain the Implementation of Shari'ah Review**	**Ascertain Factors Influencing Accountability**	**Ascertain Parties whom Shari'ah Board is Accountable**	**Ascertain Factors Influencing Independence**	**Ascertain the Nature of Appointment and Mandated Authority**
Hasan (2011)	Malaysia, GCC and UK	Questionnaire survey	IFIs	Limited	+	Limited	-	+	-	+
Hassan et al. (2010)	Malaysia	Interview	Shari'ah board members, Shari'ah officers & regulators	Limited	+	+	-	-	Limited	+
Rammal (2010)	Pakistan	Interview, secondary data	Managers of IFIs, Shari'ah board members, executives and researchers involved in Islamic banking industry (all interviews)	Limited	Limited	Limited	-	-	Limited	+
Safieddine (2009)	Saudi Arabia, Kuwait, Qatar, Bahrain & UAE	Questionnaire survey, interview	IFIs (questionnaire), Senior managers (interview)	-	-	-	-	-	-	+
Faizullah (2009)	Bangladesh	Questionnaire survey	IFIs	Limited	-	Limited	-	-	-	Limited

Note: + tested or studied, - not tested or not studied, Limited- limited in scope, not defined by the author(s)

Table 4.1: Summary of Empirical Studies on the Shari'ah Governance Function of the Shari'ah Board (*continued*)

Literature				Defining the Role of the Shari'ah Board	Defining Shari'ah Review Role of the Shari'ah Board		Defining Shari'ah Board's Accountability		Defining Shari'ah Board's Independence	
Author	**Sample Study Country / Countries**	**Research Method**	**Target Respondents**	**Ascertain the Diverse Shari'ah Advisory & Shari'ah Review Role**	**Ascertain the Structure for Shari'ah Review**	**Ascertain the Implementation of Shari'ah Review**	**Ascertain Factors Influencing Accountability**	**Ascertain Parties whom Shari'ah Board is Accountable**	**Ascertain Factors Influencing Independence**	**Ascertain the Nature of Appointment and Mandated Authority**
Alhabshi and Bakar (2008)	10 countries including Malaysia	Questionnaire survey, secondary data	IFIs	+	+	+	-	Limited	Limited	+
Al-Sadah (2007)	Kuwait, Bahrain & Qatar	Interview, secondary data,	Bank's Shari'ah officers, Shari'ah board members, external auditors	Limited	Limited	Limited	-	-	Limited	Limited
Abdul Rahman et. al (2005)	Malaysia	Questionnaire survey	Branch managers from local full-fledge Islamic banks & banks with Islamic window	-	Limited	-	-	+	+	Limited
Abumouamer (1989)	Including Kuwait, Qatar, Bahrain, Egypt, Luxembourg, Denmark, Sudan	Questionnaire survey, interview	Islamic banks (questionnaire); Shari'ah board members, board of directors, the management and clients of Islamic banks (interviews)	Limited	Limited	Limited	-	limited	Limited	limited

Note: + tested or studied, - not tested or not studied, Limited- limited in scope, not defined by the author(s)

4.9 Summary

This chapter has provided a literature review on the Shari'ah governance function of the Shari'ah board. Various issues concerning this governance mechanism offered by the Shari'ah board members (particularly on their role, independence and effectiveness) have been discussed. While there is a consensus in the literature that the Shari'ah board is held responsible for the oversight governance function of Islamic banks, the main responsibility of Shari'ah compliance lies with the management. However, these Shari'ah board members are expected to carry out their function independently and effectively. How these are perceived by the investors and the public community would determine the credibility of the Islamic banks and the Shari'ah board itself. In addition, the present modern Islamic banking operation demands that the Shari'ah scholars be dynamic in terms of innovating Islamic finance products and services that would satisfy the need of the present consumers. In doing so, the Shari'ah scholars have to ensure that the new finance instruments will be developed based on the guidelines and interpretations of the Shari'ah and they should not merely imitate the practices of conventional banks and financial institutions.

It has also been pointed that diverse Shari'ah interpretations by Shari'ah scholars have caused inconsistencies in the practice of Islamic banks as well as other associated difficulties with relevant parties, such as the regulators, investors, and the public. As argued in this chapter, a standardised Islamic banking practice is essential because it helps in the formation of efficient oversights, either by the Shari'ah board members or by the regulators who are not experts in the Shari'ah field. It also enhances the financial reporting quality of Islamic banks and it contributes to the confidence needed for the industry as a whole. This chapter has also discussed the reasons why the challenge towards standardisation effort persists. In addition, the role of the centralised Shari'ah board has also been examined in this chapter. Of importance is that this centralised Shari'ah board, in its regulatory and supervisory role, also carries a significant role in standardising the practice of Islamic banking within a particular jurisdiction.

It has been highlighted that the Malaysian regulatory environment presents that the Shari'ah board as a regulated Shari'ah governance authority. The GPS1, the guidelines on the Shari'ah governance function of the Shari'ah board issued by BNM, clearly stipulated that the establishment of a Shari'ah board is mandated and the appointment of its members requires the approval of the regulator. In addition, the GPS1 also clearly stipulated that Shari'ah board membership is limited to one local bank only, an initiative seen to ensure the independence of the Shari'ah board. Also included in the GPS1 are the specified roles and functions of the Shari'ah board. This chapter has also discussed previous empirical studies on the Shari'ah governance function of the Shari'ah board. It has been brought into attention that these previous studies have been limited in scope and restricted to investigation of several parties associated with the Shari'ah governance function of the Shari'ah board. Hence, there is a gap in the literature that provides an in-depth understanding on this subject.

CHAPTER FIVE: RESEARCH METHODOLOGY

5.1 Introduction

The preceding chapters have reviewed the literature on the pertinent issues underlying the present scope of this research. This chapter aims to discuss the purpose of this study, describing the selection of Islamic banks in Malaysia (which are the research subject) as well as detailing the methodology which was designed within the researcher's ontological and epistemological framework. The design of this study involved the use of data which was collected predominantly from primary sources through questionnaires and in-depth interviews. In addition, the researcher also used annual reports to find descriptive information about the institutions investigated and the participants involved; consequently, this chapter will also describe secondary data sources used in this study. Details of the research methods used in this study will be explained later in this chapter. Also included in this chapter is a discussion on the limitations of following the research method which is employed in this study.

5.2 Purpose of the Study

As mentioned at the outset of the previous chapter, there is a growing interest in the literature on the subject of Islamic banking and finance. However, the empirical literature which specialises in corporate governance of Islamic financial institutions (IFIs) tends to be very limited, which, in contrast to the more established conventional interest-based banking and finance, is comparatively well studied. Several empirical studies relevant to the present scope of research include: Abumouamer (1989), Abdul Rahman et al. (2005), Al-Sadah (2007), Alhabshi and Bakar (2008), Faizullah (2009), Safieddine (2009), Hassan et al. (2010), Rammal (2010) and Hasan (2011). These studies are an important source of knowledge on this subject and they have contributed to the development of empirical work in this area. Nonetheless, a critical review of these studies indicates that they are limited in scope and restricted to investigation of several parties associated with the Shari'ah governance function of the Shari'ah board. In order to explore beyond the surface understanding of the subject of Shari'ah governance in Islamic banks which has been provided by previous studies, the present research attempts to extend the breadth and depth on the fundamental issues concerning the role, independence, and effectiveness of the Shari'ah board in Islamic banks.

Furthermore, the Islamic finance industry has marked a steady progress. In 2007, the global annual growth of the industry was reported as 15-20% (McKinsey 2007). This indicates that Islamic finance is a fast developing industry and demonstrates an increase in the demanding needs of the investors and stakeholders. As such, investigations of the above subjects are deemed crucial because they would provide an indication of the present state of the Shari'ah governance of the Malaysian Islamic banking industry. It is believed that research on the subject of the Malaysian Islamic banking business would help to offer an evaluation of the Shari'ah governance for an industry which was developed more than 25 years ago.

Additionally, the regulatory set-up for the Islamic banking industry in Malaysia exhibits a dual-layer of Shari'ah governance (i.e. at both the banking level and the regulatory level) which falls under the authority of the Shari'ah board and the centralised Shari'ah board, which are the Shari'ah Advisory Council (SAC) of the Bank Negara Malaysia (BNM), respectively. Hence, by investigating the Shari'ah governance function of the Shari'ah board in the context of Malaysian dual-layer Shari'ah governance system, this study offers an assessment of both the Shari'ah board and the SAC of BNM. Drawing from this background, the researcher defines the research objectives of this study as follows:

a) To ascertain and evaluate the present role of the Shari'ah board of Islamic banks in Malaysia in ensuring the credibility of the Islamic banking industry and in attending to the needs of the investors and stakeholders.
b) To evaluate the independence and effectiveness of the Shari'ah governance role of the Shari'ah board in the context of the Malaysian dual-layer Islamic

banking Shari’ah governance system and to assess its influence on the coherence of Islamic banking practice.

Of interest, this study aims at meeting the research objectives above by addressing them to various stakeholders associated with the Shari’ah governance function of the Shari’ah board (as will be defined in Section 5.4 below). It is deemed that by expanding the research parameter such as attempted in this study would allow a holistic view on the Shari’ah board issues under investigation. In this regard, the following research questions have been formulated:

a) What is the current role of the Shari’ah board members in the Islamic banking industry in Malaysia?
b) What are the perceptions of the stakeholders regarding the expected role of the Shari’ah board members in the Islamic banking industry in Malaysia?
c) How does the role played by the Shari’ah board and the SAC members influence the credibility of Islamic banks and safeguard the Shari’ah banking needs of investors and stakeholders?
d) How independent are Shari’ah board members in performing their functions? What are the factors that influence their independence?
e) What are the factors that influence the integrity of Shari’ah board members? To whom are they accountable?
f) How do the Shari’ah board members interact with other parties within the Shari’ah governance mechanisms of an Islamic bank?
g) What are the perceptions of the stakeholders regarding the effectiveness of a dual-layer Shari’ah governance system of Islamic banks, as they are implemented in Malaysia?
h) What are the perceptions of the stakeholders regarding the influence of the dual-layer Shari’ah governance system of Islamic banks in promoting coherence of the Islamic banking practice in Malaysia?
i) What is the extent of Shari’ah board members’ involvement in the accounting aspects of Islamic banking operation?

j) How is the Shari'ah governance mechanism, as it is practiced in Malaysia, associated with the quality of an Islamic bank's Shari'ah report?

5.3 Study Population

The Islamic banking industry in Malaysia emerged as early as 1983. Since then, the number of banks offering Shari'ah finance and services has steadily increased. This occurred as a result of participation from a number of conventional banks who have established their own fully-fledged Islamic banking subsidiary, as well as those banks who offer an Islamic banking service in addition to their conventional banking activities. In addition, the liberal economic policy of the government of Malaysia has provided room for foreign Islamic banks to operate in the country, including foreign international Islamic banks. It was mentioned in Chapter Three, Malaysia has launched the Malaysian International Islamic Finance Centre (MIFC) as part of an initiative to promote the country as a hub for international Islamic finance. To date, the MIFC has listed the operation of 17 fully-fledged Islamic banks, 5 international Islamic banks, and 15 conventional banks offering Islamic banking window.

Since one of the areas of the present research is to examine the Shari'ah governance issues of the Shari'ah board members, the selection of the banks to be used as research subjects should be representative of the Shari'ah board's respective banking institution. In this regard, where several banks are from the same bank holding company, only one bank was selected to be used in this research whilst the remaining banks were excluded because they are also under the prerogative of the same Shari'ah board.[30] After a careful review of the list of all banks offering Islamic banking services in Malaysia it was found

[30] It is worth noting that the new Shari'ah governance framework for Islamic financial institutions which became effective 1st of January 2011stipulate clearly that a financial group could establish a single SC for the entire licensed institutions within that group. Hence, the BNM's consent for the establishment of single SC for the entire financial group give credence to the short listing procedure for the selection of bank represented by the SC used in this study.

that four pairs of banks were found to be subsidiaries of the same holding companies.[31] As such, instead of investigating all eight banks, only four banks were selected and included in this research. Consequently, there are a total of 32 banks that are considered relevant to the present research, ranging from fully-fledged Islamic banks to international Islamic banks and conventional banks offering Islamic banking window. Table 5.1 below displays the short-listed banks which represent the research subject of this study.

[31] The four pairs of banks are CIMB Islamic Bank and CIMB Investment Bank; Maybank Islamic Bank and Maybank Investment Bank; Alliance Islamic Bank and Alliance Investment Bank; and, AmIslamic Bank and AmInvestment Bank.

Table 5.1: List of Banks Included in the Present Research by Bank Types and Ownership

	List of Islamic Banks Operating in Malaysia	Fully-fledge Islamic Banks		Banks with Islamic Window	
		Domestic Banks	Foreign Banks	Domestic Banks	Foreign Banks
A. Fully-fledged Islamic Banks					
1	Affin Islamic Bank Berhad	✓			
2	Al Rajhi Banking & Investment Corporation		✓		
3	Alliance Islamic Bank Berhad	✓			
4	AmIslamic Bank Berhad	✓			
5	Asian Finance Bank Berhad		✓		
6	Bank Islam Malaysia Berhad	✓			
7	Bank Muamalat Malaysia Berhad	✓			
8	CIMB Islamic Bank Berhad	✓			
9	EONCAP Islamic Bank Berhad	✓			
10	Hong Leong Islamic Bank Berhad	✓			
11	HSBC Amanah Malaysia Berhad	✓			
12	Kuwait Finance House (Malaysia) Berhad		✓		
13	Maybank Islamic Berhad	✓			
14	OCBC Al-Amin Bank Berhad	✓			
15	Public Islamic Bank Berhad	✓			
16	RHB Islamic Bank Berhad	✓			
17	Standard Chartered Saadiq Berhad	✓			
B. International Islamic Banks					
1	Unicorn International Islamic Bank Malaysia		✓		
2	PT Bank Syariah Muamalat Indonesia, Tbk		✓		
3	Al Rajhi Bank KSA		✓		

Table 5.1 List of Banks Included in the Present Research by Bank Types and Ownership *(Continued)*

	List of Islamic Banks Operating in Malaysia	Fully-fledge Islamic Banks		Banks with Islamic Window	
		Domestic Banks	Foreign Banks	Domestic Banks	Foreign Banks
C. Banks Participating In Islamic Banking Scheme: Development Financial Institutions (DFIs) Offering Islamic Banking Services					
1	Bank Kerjasama Rakyat Malaysia Berhad	✓			
2	Bank Perusahaan Kecil & Sederhana Malaysia			✓	
3	Bank Pembangunan Malaysia Berhad			✓	
4	Export-Import Bank of Malaysia Berhad			✓	
5	Bank Pertanian Malaysia Berhad (Agrobank)			✓	
6	Bank Simpanan Nasional Berhad			✓	
Investment Banks					
1	KAF Investment Bank Berhad			✓	
2	MIDF Amanah Investment Bank Berhad			✓	
3	OSK Investment Bank Berhad			✓	
Commercial Banks					
1	Citibank Berhad				✓
2	The Royal Bank of Scotland Berhad				✓
3	Deutsche Bank (Malaysia) Berhad				✓

5.4 Research Design

This study is undertaken in the form of questionnaire surveys and in-depth interviews. This research design make apparent that this study benefits from a combination of quantitative and qualitative mixed method research strategies. Tashakori and Teddlie (2003) assert that research designed in the form of a mixed method approach is popular because it represents a more efficient way of answering research questions and means that the researcher can produce results that are stronger in inferences than that of a single method. Indeed, incorporating both quantitative and qualitative research methods can provide an overall picture of the issues under investigation because the use of one approach can explain and broaden the understanding on the results of the other approach (Mason 1994). The mixed method strategy used in this research follows what Creswell (2009) identified as 'sequential explanatory design', a two-stage research design that is characterised by the collection and analysis of quantitative data first which is followed by the collection and analysis of qualitative data. In addition, this study explores the Shari'ah governance function of the Shari'ah board in the Malaysian Islamic banking industry setting. Hence, this research is a study on the Shari'ah governance system of the Malaysian Islamic banking industry. Figure 5.1 below illustrates the mixed method strategy used by the researcher.

Figure 5.1: The Explanatory Sequential Mixed Method Strategy Used by the Researcher

Stage 1: Questionnaire Surveys (Mid January 2010 – February 2010)	Stage 2: In-depth Interviews (March 2010 - May 2010)
➢ **Questionnaire Survey 1:** Targeted Respondent Heads of Shari'ah departments ➢ **Questionnaire Survey 2:** Targeted respondent Branch managers of banks offering Islamic banking products and services	➢ **In-depth Interviews** ✓ Shari'ah board members ✓ Heads of Shari'ah departments ✓ CEO of Islamic banks ✓ Shari'ah Advisory Council members of Bank Negara Malaysia ✓ Bank Negara Malaysia officers

As illustrated in Figure 5.1 above, the research surveys constitute the first stage of the research design for this study. A survey research has the property of enabling the generalisation of the results to a population from a study on certain characteristics, attitude, and behaviour of a sample (Babbie 1990; Creswell 2009). In addition, survey research is considered to be the most prevalent and the most economic research technique in determining public policy that is often conducted by studying a sample of people about certain issues (Fowler 2002). Parallel with the survey research form which is used in the present study is the formulation of a descriptive inquiry nature of the research questions. It is worth noting that a descriptive research design attempts to answer who, what, when, and how questions (Zikmund 2000, p. 50; DeVaus 2001, p. 1). In the context of the present mixed method research strategy, the research survey was aimed at measuring the level of agreement and disagreement in order to build a general picture of the Shari'ah governance function of the Shari'ah board under investigation. Hence, the result produced from the research survey represents a reflection of the general population only and it offers one facet of understanding the overall issues surrounding the Shari'ah board. Additionally, the approach taken in this study (where investigation on the issues outlined in the research question has been conducted over different banks and various parties involved in the Shari'ah governance function of the Shari'ah board) makes it apparent that the present research is a cross-sectional study. A cross-sectional study has also been considered to be well suited for use in a descriptive study (Babbie 1990; DeVaus 2001). It is also predominantly used in the social sciences (Oppenheim 1992, p. 24; Nachmias and Nachmias 1996, p. 129) which benefit from its efficient way of collecting data and economical features (DeVaus 2001, p. 176).

For the purposes of this study, the researcher has selected the use of a self-administered questionnaire survey based on the argument that this research instrument is considered to be a practical and efficient way of data collection (Ary 1972). Besides the relatively low cost feature of a questionnaire survey, many have argued that its use would allow respondents time to reflect and consult on the issues raised (Oppenheim 1992; Fowler 2002). Moreover, a questionnaire survey also enables all research participants to be exposed to the same questions and so avoid any opportunity for the researcher to be biased (Oppenheim 1992). Prior studies on the Shari'ah governance function of the Shari'ah board have also recorded the use of questionnaire survey as the research instruments employed in their study (for example Abumouamer 1989; Abdul Rahman et al. 2005; Alhabshi and Bakar 2008; Faizullah 2009; Safieddine 2009; Hasan 2011). In this regard, from mid January 2010 until the end of February 2010 the researcher has distributed two sets of questionnaires which were aimed at two different types of targeted respondents. The first questionnaire survey (hereafter termed as Questionnaire Survey 1 or QS1) was targeted at the heads of Shari'ah departments of all 32 Malaysian banks offering Islamic banking services which are listed in Table 5.2. Concurrently, the researcher also distributed a second questionnaire survey (hereafter termed as Questionnaire Survey 2 or QS2) which was targeted at eliciting the opinion of the stakeholder, which in this survey is the branch managers of these 32 banks, on similar Shari'ah board issues with some modification tailored at meeting the Shari'ah governance exposure of this group of respondent. It may be argued that the use of questionnaire surveys would enable the researcher to make a reflection of the study population involved based on the counting and aggregation of the results produced; however, this generalisation only provides the researcher with the general picture and, therefore, it offers only one facet of understanding of the issues surrounding the Shari'ah governance function of the Shari'ah board.

Meanwhile, Figure 5.1 above illustrates that the second stage of the research design was conducted through the use of a series of qualitative in-depth interviews. The use of an interview as a qualitative research instrument has the advantage of eliciting the opinion of busy people who are used to making appointments and schedules (Fowler 2002). It also helps build up the kind of trust needed through interactive communication between the researcher and respondents, which could be essential in the case of investigation of sensitive issues (Fowler 2002). The use of an interview as a research instrument has also been documented in previous studies on Shari'ah governance function of the Shari'ah board Islamic banks (for example Abumouamer 1989; 2007; Safieddine 2009; Hassan et al. 2010; Rammal 2010). In the context of the present mixed method research strategy, the use of in-depth interview as the second stage of the research design is aimed at discovering what Mason (1994) termed the 'social process' that is involved in the Shari'ah governance function of the Shari'ah board. Indeed, using qualitative methods (such as an in-depth interview) allows the researcher to focus on the dynamics of the process; however, there is a requirement for the researcher to gauge deeper understanding of behaviour and meaning in the context of complex phenomena (Snape and Spencer 2003; Alvesson and Skoldberg 2009). In this regard, the second stage of the research design is aimed at understanding the complex process of the Shari'ah governance of the Shari'ah board in the context of dual-layer Shari'ah governance system which is implemented in Malaysia. The researcher conducted interviews between March and May 2010 with important and inter-related parties of the Shari'ah governance system for the Malaysian Islamic banking industry, they were asked about how they experience this process. These interviewees included: the Shari'ah board members; the stakeholders, as represented by the heads of Shari'ah departments and the banks' CEOs; and the regulators, as represented by the SAC of BNM and BNM officers.

From the explanation on the two-stage research design above, it is apparent that the two-stage research design aimed at two different level of understanding of the issues under investigation. First, the quantitative research surveys were aimed at enabling the researcher to gain a general picture on the role, independence and effectiveness of the Shari'ah board. Secondly, the qualitative in-depth interviews were distinctly aimed at discovering an understanding pertaining to the process involved on the issues under investigation from the experience of the parties concerned. Mason (1994, pp. 104-105) concluded that when the data from two-stage research design (such as the present study) is put together it would enhance the validity of the overall analysis and enable the building of a rounded and overall picture. It is worth noting, however, that integration of the data from the mixed method sources features some challenges, namely: a requirement for the researcher to gather an extensive amount of data for collection, and the intensive time spent and the skills required to analyse the different data nature of the inquiry. For the purposes of this study, the researcher has integrated the data from the two-stage research design following the suggestions as outlined by Mason (1994, p. 105) below:

a) Linking the data by following up similar themes in the different data sets; and,
b) Developing propositions and questions from a variety of angles to address a particular topic by using the data set.

The above discussion illustrates that this study has adopted a 'realism' perspective of knowledge which influences the selection of the research tools. An ontological view of the realist perspective acknowledges that reality exists in actuality and is independent from human perceptions (Williams and May 1996, p. 81). This knowledge perspective views that the task of the researcher is to *'uncover the structures of social relations in order to understand why we then have the policies and practices that we do'* (May 2001, p. 12). Knowledge in this perspective is, thus, seen as stratified and derived from an understanding of what lies behind people's actions. In addition, Wass and Wells (1994) have asserted that most research has used the realist perspective because it reconciles positivist and naturalist epistemologies and methods. Because realism recognises both the existence of actual reality and that its realities can be comprehended through the human mind, the selection of questionnaire survey and in-depth interview explained above is viewed as acceptable.

5.5 Research Method

This section discusses the research method, i.e., both the questionnaire survey and the in-depth interview, in further detail.

5.5.1 The Questionnaire Survey

Another important consideration of the research method of a particular study is the design of the research instrument which will be used for data collection. This section offers relevant discussion on the design and development of the questionnaire as one of the research instrument used in this study. It includes an explanation on the type of question, the language of the questionnaire, piloting of the questionnaire, and the questionnaire rationale and administration.

5.5.1.1 Questionnaire Design and Development

One of the challenges associated with the use of a questionnaire survey is the need to be especially careful when designing the questionnaire due to the fact that the respondent is left with absolute reliance on the questions already designed for them to respond (Fowler 2002). In the absence of someone for the respondents to refer to (such as an interviewer in an interview survey), they are made dependent on the quality of the questionnaire that has been designed and developed by the researcher. Hence, essential considerations underlying the characteristics and the features of a good questionnaire have been made to ensure that the use of questionnaire survey will achieve its objective in addressing the research questions of this study.

It is worth noting that the prime function of the questionnaire is to collect a measurement (Oppenheim, 1992, p. 100). Together with this facilitative nature of the questionnaire, the researcher will have to appropriately consider the design and development of the questionnaire. A useful guide to the construction of questionnaires is given by Evans (1984), who identified four important steps to be considered: firstly, there should be a clear definition of the purpose of the questionnaire; secondly, the researcher has to decide the data that is required from the questionnaire; thirdly, the component parts of the questionnaire need to be analysed; and finally, a series of questions should be structured in order to elicit the appropriate responds from the respondents. When structuring the questions Fowler (2002) suggest that respondents should be allowed to get started with relatively easy questions and the more sensitive and thoughtful questions should be kept for use in the middle or in the end. He also called for the design of the questionnaire to be laid out in a manner that is clear and uncluttered from the point of view of the respondents. Importantly, the features discussed will have to be incorporated within the sampling frame of the present research, which includes the banks listed in Table 5.1 above and the different parties involved in the Shari'ah governance function of the Shari'ah board that were mentioned earlier.

The purpose of the questionnaires used in this research is to address the research questions that are outlined in Section 5.2 above. Because this research is aimed at eliciting the opinion of the respondents on the role, independence and effectiveness of the Shari'ah board, the researcher has developed two sets of questionnaire (i.e. QS1 and QS2) for two targeted respondents: heads of Shari'ah departments[32] and bank's branch manager[33], respectively.

Both questionnaire surveys were designed and structured to address the research questions for this study based on: the role of the Shari'ah board, the accountability and independence of the Shari'ah board, and the nature of Shari'ah review in banks offering Islamic banking products and services. These three themes have been identified as the fundamental components underlying the scope of the present research corresponding to the role, independence and effectiveness of the Shari'ah board under investigation. Furthermore, the questions developed in these two sets of questionnaire surveys are formulated to elicit the opinions of the respondents on the matters described above, against the arguments put forward in the literature and the regulatory requirement prescribed in AAOIFI, IFSB as well as the '*Guidelines on the Governance of the Shariah Committee for the Islamic Financial Institutions*' or GPS1 issued by BNM. Hence, when developing the questions in both questionnaire surveys attention has been made to address the above themes that were found in the literature and which are given as requirements in the regulatory standards and guidelines. Because QS1 and QS2 involve different categories of targeted respondents, emphasis was also made to ensure that the questions addressed would cater for the different Shari'ah governance exposure of the respondents on the technicality aspect of the structure and implementation of the Shari'ah review function of the Shari'ah board. As such, some of the questions developed in QS1 have no matching question in QS2, and *vice versa*, because they are personalised to those targeted respondents. By designing the questionnaire in this approach the researcher aims at evaluating how the Shari'ah governance is being practiced, and is expected to be practiced, amongst the participating banks in the MIFC. A copy of both questionnaire surveys along with the covering letter to the research participants are attached in Appendix 1.

[32] QS1 was sent to the heads of Shari'ah department at the headquarters level amongst banks offering Islamic banking products and services

[33] QS2 was sent to the branch manager of banks offering Islamic banking products and services.

Generally, both questionnaire surveys contained four sections, of which three encompass the three themes mentioned above. The remaining section asked about the respondent's demographic details. When set out on a single sided A4 paper, both questionnaire surveys consisted of eight pages. A method of identification for the purpose of data analysis is essential to identify the 32 Malaysian banks included in this study (as listed in Table 5.1 above). Alphanumerical coding has been assigned to the questionnaire surveys for the purpose of identification. Additionally, the cover page of both questionnaire surveys also contained other essential information, such as the title of the research and the name and address of the researcher as well as the researcher's supervisor. Also included along with the questionnaire and the cover letter is the Cardiff Business School's standardised anonymous and consent letter to the research participants which gave an assurance that the privacy of the research participants and their respective organisations would remain confidential.

5.5.1.2 Types of Questions

Nachmias and Nachmias (1996) advised that when formulating the questions to be included in the questionnaire consideration should be given to its content, structure, format, and the sequence of the questions. In addition, the design of these questions should enable the respondents to respond in a minimum time, with a minimum effort, while not underestimating the need to uphold the quality of their answers. In general, this study has used closed-ended questions where alternative answers on the questions raised are given to the respondents. Fowler (2002) argued that, besides being more convenient to respondents, closed-ended types of questions would be appropriate for use when the research involves asking respondents a large number of item in a similar form. A survey in the form of closed-ended questions also have the characteristics of being more meaningful for analytical purposes in comparison to the array of answers provided from open-ended type of questions (DeVaus 1996; Fowler 2002). Nevertheless, questions designed as closed-ended also pose some challenges. For example, Oppenheim (1992) asserts that this type of question could result in the researcher loosing the respondent's sense of spontaneity and expressiveness. As such, he suggests that a space should be left in the questionnaire for respondents to include their further comments or opinions on the subject raised in the questionnaire, and this has been included in the questionnaire design of this research.

In addition, the researcher used an ordinal measure of collecting and analysing the data through the use of a Likert scale type of questions to elicit the opinion and attitude of the respondents on the issues under investigation. Amongst the various Likert scale measurements normally used in research projects, and which are implemented in the present study, are: the continuous scale, where respondents are asked on questions such as measuring between strongly agree to strongly disagree; and the categorical scale, which measures respondents' ranking on certain issues from highest to lowest importance and ranking by numbers. The use of both types of Likert scales in the present research are deemed suitable because it allows the researcher to make a relative measurement that is necessary on the relationship between the present practice of the interrelated parties on the Shari'ah governance function of the Shari'ah board with the issues on the role, independence and effectiveness of the Shari'ah board. This use of the Likert scale in measuring these attitudinal relationships is supported by Fowler (2002, p. 93) when he says that *'Only comparative statements (or statements about relationships) are justifiable when one is using ordinal measures.'* In this regard, both questionnaire surveys mainly consist of questions designed in the form of Likert scales. Generally, Section A, B and C in QS1 and QS2 comprise of questions which requires research participants to respond using the scale: (1) strongly disagree; (2) disagree; (3) uncertain; (4) agree and (5) strongly agree. Meanwhile, questions B1, B2 and B3 in Section B, in both questionnaire surveys, also contain questions that measure respondents' attitude using the scales: (1) very unimportant; (2) unimportant; (3) uncertain; (4) important and (5) very important. In question C3 of QS2 the research participants are required to rank the importance of the related parties in the Shari'ah governance of Islamic banks from 1 to 5.

Section D also constitutes part of both questionnaire surveys. This section requires the respondents to provide some of their demographic details, such as their gender, age range, qualification and aspects of training received. These questions have been designed in a manner that requires respondents to tick the alternative answers provided by the researcher.

5.5.1.3 Piloting the Questionnaire

Both questionnaires have undergone several stages of improvement before they were distributed to the targeted respondents. Firstly, the questionnaires were developed and refined with intense consultation with the researcher's principal supervisor. After the principal supervisor was satisfied with the content, wording and format of the questionnaires, the researcher took the initiative to send both questionnaire surveys to a qualified proof-reader. This was done to ensure that the quality and readability of the questionnaires is of the required standard. After the adjustment based on the proofreading exercise was made, the researcher conducted pilot testing to establish the content validity of the issues raised and to improve the structure and overall format of the questions in the questionnaire. According to Fowler (2002), the best way to pre-test a self-administered questionnaire is to conduct it in person with the targeted group of respondents. Consequently, in this study the researcher has approached eight individuals, of whom: three are PhD candidates in Islamic banking and finance; another three are academicians who teach this subject in Malaysian public universities (of which 1 has an experience working in an Islamic bank); and one person each came from the Shari'ah board members and Shari'ah department officer who serve in two different Malaysian Islamic banks. These different categories of people were chosen because they have knowledge and understanding of the Malaysian Islamic banking environment, hence, they were able to contribute and provide necessary input for the improvement of the questionnaires. During this exercise they were asked whether the instructions and questions are consistently clear and understandable. They were also asked to evaluate and make comments on the questionnaires as a whole and to indicate the time spent filling in the questionnaire.

The pilot testing of the questionnaires was found to be very beneficial indeed. In particular, the discussion and comments received from the practitioner (the Shari'ah board member and the Shari'ah department officer) were very useful and clarified further the Islamic banking practice in Malaysia. For example, the terminology 'Shari'ah Committee' (SC) used throughout QS1 and QS2 was indicated to be more suitable than the common 'Shari'ah board' term to refer to the authority in charge of individual bank's Shari'ah governance system in Malaysia because of the fact that the guidelines issued by the regulator (i.e. BNM, such as the GPS1) use the term SC to refer to this Shari'ah authority. Another example of the terminology changes which were made following the pilot test can be seen when referring the Shari'ah governance function of the Shari'ah board. The term 'Shari'ah review' instead of 'Shari'ah supervision' was suggested because of the possibility that the term 'supervision' in the latter could be mistakenly considered by the respondent to be the authority of the regulator and, hence, refer to that of the SAC of BNM. However, overall, no major amendment on the content of the questionnaires was required.

5.5.1.4 Questionnaire Rationale

As mentioned earlier, both questionnaire surveys attempt to measure the same three themes, which are: (1) the role of the Shari'ah board; (2) the accountability and independence of the Shari'ah board; and, (3) the nature of the Shari'ah review in banks offering Islamic banking products and services. Additionally, as discussed above, these questionnaires were targeted at two different respondents with the objective of capturing how these themes are being practiced (QS1) *vs*. how they are expected to be practiced (QS2). These three themes which correspond to Section A, Section B and Section C are identical in both questionnaires and carry similar content for ease of inference based on the themes identified when interpreting the results later. However, as mentioned earlier, several questions in these questionnaires have been specifically tailored to the different Shari'ah governance exposure of both targeted respondents. For instance, there is one additional question in Section A in QS1 which has no matching question in the same section of QS2. The main differences are in Section C where the questions are more technical in nature (pertaining to the structure and implementation aspect of Shari'ah review by the Shari'ah board). Hence, some of the questions in Section C have no matching questions in the other questionnaire because they have been personalised for each respondent group. However, these questions deal with the same subject and, therefore, enable the researcher to analyse the issue under investigation. Meanwhile, Section D consists of questions on the demographic details which allow the researcher to analyse the different background of the respondents. Again, it is stressed that the benchmark used when formulating the questions in QS1 and QS2 are based on the standards and guidelines issued by AAOIFI, IFSB and GPS1. The details of the questionnaires rationale are provided below.

Section A

This section was designed to elicit opinions of respondents on matters relating to the role of the Shari'ah board based on the previous literature as well as in the standards and guidelines of the regulator (AAOIFI's governance standards, IFSB prudential standards and GPS1 guidelines of BNM) which has been discussed in Chapter Four. As mentioned above, there is a pertinent question on this section for the QS1, which is question A1. This question asks the respondents (i.e. the heads of Shari'ah departments) to ascertain whether the standards and guidelines used by the Shari'ah board in their respective bank were consistent with AAOIFI, IFSB and the GPS1 by indicating them on a five-point Likert scale between 1 (strongly disagree) and 5 (strongly agree). The remaining questions on this section for the QS1 are matched with those in QS2 in which the respondents were required to indicate their agreement on a similar Likert scale on six different categorisations on the role of the Shari'ah board:

(1) Scope of Shari'ah advisory role;
(2) Corporate objectives of Islamic banks;
(3) Development of Islamic banking products and services;
(4) Accounting issues of banks;
(5) Relevant parties who assist the Shari'ah board; and,
(6) General commitments of the Shari'ah board.

Section B

This section relates on the important issue of accountability and independence of the Shari'ah board. Although the two might seem to be closely associated, the researcher has attempted to gauge the factors that influence accountability and independence separately because this could assist in ascertaining whether accountability could be a determining factor that influences the independence of the Shari'ah board.

Question 1

This question is concerned with eliciting the perception of the respondents on factors influencing the accountability of the Shari'ah board. In Chapter Four, it has been discussed how various studies have regarded the highly perceived ethical authority of the Shari'ah board to be associated with the ethical values, reputation and scholarly background of the Shari'ah board members (see for example Karim 1990a; Laldin 2008a). Furthermore, it has been argued that the stakeholders put reliance on the roles and function of the Shari'ah board to ascertain the Shari'ah compliance of Islamic bank's activities, especially in connection with Shari'ah board's role in producing annual Shari'ah compliance report (see for example Briston and El-Ashker 1986; Tomkins and Karim 1987; Karim 1990b; Karim 1990a; Rammal 2006; Laldin 2008a). Therefore, these factors have been listed as influencing Shari'ah board's accountability and were asked to the respondents on their importance based on a five-point Likert scale between 1 (very unimportant) and 5 (very important).

Question 2

As with Question 1 above, the ethical values, reputation and scholarly background of the Shari'ah board members can be argued as influencing Shari'ah board's independence. This is supported by Karim (1990a) who asserted that the independence of the Shari'ah board members should be viewed from the ethical perspective whereby the Shari'ah scholars are required to be committed to their moral beliefs and Islamic precepts, as reflected from their Shari'ah educational background. However, these three integrity factors could be further categorized as the ethical status (representing the ethical values and reputation of the Shari'ah scholars) and the scholarly background of the Shari'ah board members. As such, only these two factors were considered and forwarded to the respondents as possibly influencing the independence of Shari'ah board members. Meanwhile, the third factor considered is a clearly defined scope of Shari'ah board's responsibility. It has been mentioned in Chapter Four that Briston and El-Ashker (1986) suggest that a clearly defined scope of Shari'ah board's responsibility should be stipulated in the bank's article of association. In fact, the IFSB has also recommended a clear term of reference to be written in Shari'ah board members appointment letter (IFSB 2009 principle 1.2) while AAOIFI has specified it as one of the items suggested to be included in the Shari'ah report issued by the Shari'ah board (AAOIFI 1998 para. 10-25).

The fourth and fifth factors considered as influencing the independence of Shari'ah board relate to IFSB recommendations for the Shari'ah board member to be equipped with adequate power and for the top management to participate in the Shari'ah board's meeting (IFSB 2009) respectively. The need for the former could be understood as an important requisite for independent and effective Shari'ah governance function of the Shari'ah board in undertaking its roles and functions. On the other hand, the researcher has taken account the recommendation of the latter as positively influencing the independence of the Shari'ah board since any likelihood of information asymmetry on the Shari'ah decisions issued by this Shari'ah governance authority could be resolved. This possibility is upheld because the decisions issued by the Shari'ah board could be directly communicated to the top management, thus strengthen the Shari'ah governance of the bank and install the independence of the Shari'ah board.

The above five factors were considered based on their possible positive influence on the independence of the Shari'ah board. However, the literature also presents arguments on factors that have an opposite effect on the independence of the Shari'ah board. In Chapter Four, the factors highlighted as negatively influencing independence of Shari'ah board members are relating to remuneration (see for example Grais and Pellegrini 2006; Rammal 2006; Khan 2007) and various placements of the Shari'ah board (Alhabshi and Bakar 2008). Hence, these two represent the sixth and the seventh factor negatively associated and detrimental on the independence of the Shari'ah board. While the

Malaysian Islamic banking environment restricted Shari'ah board members sitting in local bank to be not more than one (as has been highlighted in Section 4.7 of Chapter Four), this study consider possibility of additional Shari'ah board membership in other industry (for example *Takaful* companies) as the factor likely influencing the independence of the Shari'ah board member.

All in all, seven factors deemed to have influence on the independence of Shari'ah board were outlined and the respondents were asked for their thoughts on their importance, based on a five-point Likert scale (i.e. between 1 (very unimportant) and 5 (very important)).

Question 3

This question asks the respondents who they feel the Shari'ah board should be accountable. It has been discussed throughout Chapters Three and Four that the assurance on the bank's level of Shari'ah compliance that Shari'ah board provides ensures the credibility of Islamic banks and instils the confidence of the shareholders and stakeholders (see for example Briston and El-Ashker 1986; Tomkins and Karim 1987; Karim 1990b; Karim 1990a; Banaga et al. 1994; Rammal 2006; Ghayad 2008; Laldin 2008a). On the other hand, the integrity of the Islamic banking industry would be undermined, and stakeholders would lose confidence, if the operation of Islamic banks are found to be non-compliant to the Shari'ah (Bhambra 2002). In addition, GPS1 has clearly stipulated that the Shari'ah board will report functionally to the board of directors while the recent amendment to the Central Bank of Malaysia Act 2009 specifies that the Shari'ah resolutions issued by the SAC as binding to all Malaysian Islamic financial institutions. In this regard, the relevant parties whom the Shari'ah board is deemed accountable are the: (1) shareholders; (2) consumers; (3) boards of directors; (4) public; and, (5) SAC of BNM. Similarly, the respondents were asked to indicate the level of importance they placed on these five identified parties based on a five-point Likert scale (i.e. between 1 (very unimportant) and 5 (very important)).

Question 4

In this question the respondents were asked to indicate their agreement based on a five-point Likert scale (i.e. between 1 (strongly disagree) and 5 (strongly agree)) on six different natures of Shari'ah board appointment and mandated authority. Firstly, the respondents were asked to consider whether the appointment of the Shari'ah board members is made based on certain 'fit and proper' qualification criteria as recommended by AAOIFI (2010b para. 45-46) and IFSB (2006 para. 53). The IFSB also gives caution on the perceived lack of independence if the Shari'ah board or its family members have an intimate relationship with a senior executive employee, or if any of them are holding a substantial shareholding in the bank where the Shari'ah board is serving (IFSB 2009 para. 42); therefore, this question was also posed to the respondents.

The respondents were then asked on their agreement about whether the Shari'ah board members are subject to any assessment by the bank the Shari'ah board is serving or by the BNM. This is because the nature of Shari'ah board's appointment in the Malaysian Islamic banking environment initially requires the Shari'ah board to be appointed by the respective bank's board of directors but subject to the approval of the BNM at the later stage. This is followed by a question on whether adequate power has been mandated to the Shari'ah board in performing its role (IFSB 2009 principle 1.2), which is deemed important when evaluating the independence of the Shari'ah board. The IFSB also stressed the importance of avoiding any kind of conflict of interest on the role of the Shari'ah board and it requires the settlement of possible conflicts among the Shari'ah board members, or between the Shari'ah board members and the management (see IFSB 2009). Hence, the respondents were asked about the existence of a reporting channel for settlement of such a conflict.

Finally, the respondents were asked if the nature of Shari'ah board's mandated authority made it clear that there should be a proper segregation of Shari'ah board duties (e.g. product endorsement) and later when carrying out the Shari'ah compliance review function. This is in line with the argument raised by Alhabshi and Bakar (2008) on the apparent loophole on the independence of the Shari'ah board with regard to the absence of segregation between the two Shari'ah board duties.

Section C

This section of the questionnaire aims to elicit the perceptions of the respondents pertaining to the nature of the Shari'ah review undertaken by the Shari'ah board based on the structure of the Shari'ah review and on the implementation of the Shari'ah review. As mentioned earlier, the questions in this section are tailored to meet the different Shari'ah governance exposures of the two different groups of respondents. Hence, explanations on the rationale of the questions included in this section are provided based on each of the questions included in individual questionnaire.

Question 1 in Questionnaire Survey 1 (QS1)

In this question, respondents were asked to indicate their agreement based on a five-point Likert scale (between 1 (strongly disagree) and 5 (strongly agree)) on several structures of the Shari'ah review. Chapter Four discussed that the literature suggests that the role of Shari'ah board is to ensure the credibility of Islamic banks by ascertaining the Shari'ah compliance of the bank's operations (see for example Briston and El-Ashker 1986; Tomkins and Karim 1987; Karim 1990b; Karim 1990a; Banaga et al. 1994; Rammal 2006; Laldin 2008a). In light of this, the respondents were asked whether they regarded the Shari'ah board as the sole authority of the Shari'ah review system of individual banks that offer Islamic banking products and services. Next, the respondents were asked about the existence of a prescribed operative procedure for the Shari'ah board to perform its role and function as suggested by IFSB (IFSB 2009 principle 1.2)

In addition, Chapter Four also explained that several studies have advocated that the membership of the Shari'ah board should include experts from various fields (such as accountants, lawyers and economics) and should not be merely limited to experts in Shari'ah or *fiqh al-mua'malat* (Gambling et al. 1993; Grais and Pellegrini 2006; Laldin 2008b). Indeed, a similar recommendation has also been forwarded by AAOIFI (AAOIFI 1997 para. 7). Hence, the respondents were asked whether the membership of their

Shari'ah board consists of various experts. The next question related to the existence of an effective communication channel for the Shari'ah board to deliberate Shari'ah issues. It is argued that in order for the Shari'ah board to perform its role and functions effectively the Shari'ah board would have to work closely with various parties to evaluate and deliberate any Shari'ah issues pertaining to the implementation of the Shari'ah decision made by the Shari'ah board (Banaga et al. 1994). Similar importance has been laid down by the AAOIFI (AAOIFI 1998 para. 12).

Meanwhile, the Malaysian Islamic banking environment exhibits the regulatory role of the SAC as the national centralised Shari'ah board. Indeed, recently the SAC has been authorised with mandated power whereby the Shari'ah resolutions issued by the institution will be binding to all Malaysian Islamic financial institutions (BNM 2009). Hence, in this study a question has been posed to the respondents to evaluate whether adequate and apparent guidelines have been issued by this supreme Shari'ah authority for use in the Islamic banking industry.

Question 1 in Questionnaire Survey 2 (QS2)

Similarly to question 1 in QS1, the branch managers were asked to indicate their agreement based on a five-point Likert scale, of between 1 (strongly disagree) and 5 (strongly agree), on the same subject (i.e. the structures of the Shari'ah review). Among the five questions asked of these respondents two are similar to that in QS1. These questions are asked to find out if they consider that the Shari'ah board is the sole authority on the Shari'ah review system within the individual banks that offer Islamic banking services. The respondents are then asked if adequate and apparent guidelines should be issued by the SAC for use in the Islamic banking industry in Malaysia. The issue raised in these two questions challenges the branch manager to evaluate the general structure of Shari'ah review mechanism on the part of the Shari'ah board at the level of individual banks and the SAC at the regulator's level. These questions relate to the general Shari'ah governance structure.

The remaining three questions require the branch managers to make an assessment of the dual-layer Shari'ah governance system applied in the Islamic banking industry in Malaysia. First, the branch managers were asked the question whether the Shari'ah reference role of the SAC as the supreme authority on the Shari'ah governance system in Malaysia enhances the standardisation of Islamic banking practices. This question evaluates the claim that such a centralised Shari'ah body promotes standardisation through coordination of *fatwa* and the Islamic banking products and services offered at the national level (Grais and Pellegrini 2006; Laldin 2008a; Shaffaii 2008). Their experience at the operational level means that the branch managers could provide feedback on this question by reflecting on the Islamic banking products and services available in the market, including those offered by their own bank. In association with the Shari'ah reference role of the SAC, the branch managers were then asked whether the dual-layer Shari'ah governance system in Malaysia is effective in ensuring the stability of the Islamic banking industry. It has been discussed in Chapter Two that the opacity feature of the banking business requires the intervention of the regulator in pursuit of public interest to promote stability and prevent any downfall in the economy (Ciancanelli and Gonzalez 2001; Levine 2004). Hence, this question aims to explore whether the intervention of the regulator through the establishment of a dual-layer Shari'ah governance mechanism promotes stability in the Islamic banking industry in Malaysia.

Finally, the branch managers were asked to consider whether the dual-layer Shari'ah governance system is capable of harmonising Islamic banking practices in Malaysia and across national boundaries. It has been discussed in Chapter Four that a lack of standardisation in Islamic banking practices could be detrimental to the growth of Islamic banking and finance (see for example Karbhari et al. 2004). In addition, Chapter Four also highlighted that one important task of the centralised Shari'ah board is to attempt to standardise Islamic banking practices through coordination of the *fatwas* and Islamic finance products and services (Grais and Pellegrini 2006; Laldin 2008a; Shaffaii 2008). In this regard, efforts such as the establishment of dual-layers of Shari'ah governance system could be seen as harmonising Islamic banking practices both domestically and internationally. Hence, this question asked the branch managers to evaluate whether the dual-layer Shari'ah governance system currently implemented in Malaysia and the role played by the SAC have contributed towards harmonising Islamic banking practice in Malaysia and achieved standardization at the international level.

Question 2 in Questionnaire Survey 1 (QS1)

This question relates to several aspects of the implementation of Shari'ah review by the Shari'ah board. The respondents were asked to consider their agreement on a similar five-point Likert scale. Since the Shari'ah board is held to be the sole authority on the Shari'ah governance mechanism of individual Islamic banks (as mentioned above) it would be interesting to find out whether the Shari'ah board also has the full authority to stop the bank from undertaking non-Shari'ah compliant activities. Hence, this question aims to explore the quality of the decision making process and review function by the Shari'ah board. It is also equally important to the purposes of this study to learn whether the Shari'ah board has been given ample time for making certain decisions. It has been mentioned in Chapter Four that the Shari'ah review role of the Shari'ah board could be regarded as significant and central within the Shari'ah governance mechanism of the Islamic banking industry. This is due to the fact that the essence for the establishment of this banking business is to assist the Muslims in adhering to their religious values in their financial dealings (Karim 1990a). However, as the Shari'ah review requires Shari'ah board members to evaluate the implementation of array of Shari'ah decisions at the Shari'ah advisory stage by the Islamic bank's management, it is expected that the board would have to be diligent to ensure effective implementation of the Shari'ah review. In addition, Chapter Four has described how the Shari'ah board is expected to organise periodical meetings with relevant parties within the bank (Banaga et al. 1994; BNM 2004). Hence, the question on whether the board has been given ample time in its decision making process and review function could also be reflected in the frequency of these meetings or in similar sittings.

In addition to the two questions above, it is important to find out from the respondents whether the Shari'ah board gets the necessary professional advice in performing its function. It has been mentioned earlier that the Shari'ah board is expected to work closely with various parties within the Islamic banks (Banaga et al. 1994; AAOIFI 1998 para. 12); hence, this question aims to assess the contribution of other parties in the Shari'ah decisions issued by the board. It is also interesting to learn whether the Shari'ah board receives direct access to relevant, accurate, adequate and timely information so that it can effectively carry out its functions as has been clearly stipulated by AAOIFI (AAOIFI 1998 para. 3) as well as the GPS1 (BNM 2004 para. 21); therefore, this question was also posed to the respondents.

Next, the respondents were asked whether they consider that the part-time working nature of the Shari'ah board members hinders the effectiveness of the Shari'ah review function. This question challenges the respondents to evaluate the quality of the Shari'ah review function of the Shari'ah board and the nature of Shari'ah board's engagement in the bank. The rational for this question is based on the argument that the non-executive role and part-time engagement of the Shari'ah board's could results in a compromise of the oversight quality function of the Shari'ah board.

To evaluate the cooperation of important parties within the Shari'ah governance framework (SGF) in the Malaysian Islamic banking industry as a whole, the respondents were asked whether there has been active communication and consultation between the Shari'ah board, the bank, and the SAC of BNM. The response to this question can imply the effectiveness of the existing dual-layer Shari'ah governance system that is put in place for the Malaysian Islamic banking industry.

Question 2 in Questionnaire Survey 2 (QS2)

There are six issues on the implementation of Shari'ah review which were raised in this question. The branch managers were required to indicate their agreement based on a five-point Likert scale. Two of the questions posed to the respondents in QS2 is similar to Question 2 of QS1 in that the branch managers were asked whether they think that the Shari'ah board has the authority to stop banks from undertaking non-Shari'ah compliant transactions and if the part-time working nature of the Shari'ah board hinders the effectiveness of the Shari'ah review function of the Shari'ah board. The rationale of these questions is to ascertain how the branch mangers perceive the implementation of the Shari'ah review from their operational point of view and it challenges them to evaluate the power authorised to the Shari'ah board and the working nature engagement of Shari'ah board and their association with the quality of Shari'ah review function undertaken by the board.

Additionally, there are two more questions on the function of the Shari'ah board which have been issued to the branch managers. In one of the questions the branch managers are required to consider whether the Shari'ah compliance activities of the bank have been adequately reflected in the Shari'ah report issued by the Shari'ah board. It has been discussed in Chapter Four that the Shari'ah report issued by the Shari'ah board would provide the necessary assurance in determining the ethicality of the banking institution and assisting the investors and stakeholders to make their investment decision (see for example Briston and El-Ashker 1986; Tomkins and Karim 1987; Karim 1990b; Karim 1990a; Rammal 2006; Laldin 2008a). Hence, by asking this question the researcher is able to discover whether the branch managers consider the Shari'ah report produced by the banks can achieve its said objective. The other question requires the branch managers to ascertain whether the Shari'ah board has satisfactorily disclosed the bank's accounting issues. This question reflects once again on how the branch managers perceive the quality of the Shari'ah reporting by the Shari'ah board; however, this time the question is asked in terms of the accounting aspect of the bank to which the Shari'ah board is made responsible (as has been highlighted and discussed in Chapter Four). Finally, the branch managers were asked whether the SAC should adopt rigorous procedures to examine and endorse the application of the Islamic financial products which are submitted by the bank. By asking this question the researcher aims to explore how the branch managers perceive the effectiveness of the SAC institution in overseeing the national Islamic banking practices and in mitigating possible non-Shari'ah compliance risk within the Islamic banking industry.

Question 3 in Questionnaire Survey 2 (QS2)

This question is unique to QS2. The branch managers were asked to rank in order of importance from 1 to 5 on the function of several parties whose involvement in the Shari'ah governance of banks offering Islamic banking services has been discussed in Chapter Four. These parties are: the SAC of BNM, the Shari'ah board, the Shari'ah department officer of banks, the board of directors and the management. By asking this question the researcher is able to evaluate how the branch managers perceive the role and significance of each party in the overall framework of the Shari'ah governance in Islamic banks.

Section D

Both questionnaire surveys contain Section D, which has been designed to ascertain the background of the respondents and the characteristics of their banking institution. Information derived from this section would explain the individual as well as the organisational behaviour towards the Shari'ah governance implementation within banks offering Islamic banking products and services.

5.5.1.5 Questionnaire Administration

The researcher self-administered the questionnaire surveys by distributing the questionnaires through both the mail, and the delivery and collection method, between mid-January 2010 until the end of February 2010. Fowler (2002) recommended that these methods are relatively low in cost, require minimal staff and facilities, and they also give respondents the time required to provide thoughtful answers. Considering the constraint on funds and time faced by the researcher in this study, these administration procedures were carried out with the agreement of the researcher's principal supervisor. In addition, the researcher developed an access strategy so that the questionnaire could reach the targeted respondents in order to gain the highest possible response rate. This enabled the researcher to gain assistance from the responsible authorities for the Islamic banking industry in Malaysia. On QS1, the researcher received the assistance of the Association of Islamic Banking Institution Malaysia (AIBIM) to get the contact details of the head of

Shari'ah department of those banks offering Islamic banking products and services. Once this information had been gathered QS1 was directly mailed to the respondents. However, a small number of targeted banks in QS1 are not members of the AIBIM, hence; the researcher went to those banks which are conveniently located in Kuala Lumpur, the capital, to deliver the questionnaire personally. At the bank, the researcher approached the head of the Shari'ah department, explained the purpose of the research and handed over the questionnaire to be filled by the respondent for later collection. In total, all 32 banks (which represent the total population of participating banks in the MIFC) were approached and QS1 was successfully distributed.

Meanwhile, QS2 (which is targeted at the branch managers of banks offering Islamic banking products and services) was distributed at the same time as the QS1 (as illustrated in Figure 5.1 above). An analysis was carried out to ascertain the number of branches available for each of the thirty-two banks mentioned above, together with its distribution in the thirteen states and three federal territories that constitute Malaysia. It was found that some full-fledged Islamic banks are well established with operations scattered all over the country, while others (particularly banks which operate as an Islamic window) have only few or merely minimal numbers of branches. Indeed, it was revealed that some full-fledge Islamic banks (Islamic banking subsidiary) operated in a dual platform alongside its conventional banking system. This observation is not unusual because many of the fully-fledged Islamic banks are still relatively new and they operate as a subsidiary to its conventional parent bank, hence, they either share a similar platform for their Islamic banking operation or they have limited numbers of dedicated Islamic banking branches.

It was also found that two foreign banks are from the same parent bank but operate under a separate license from the BNM (i.e. Al Rajhi Banking & Investment Corporation (Malaysia) Bhd and Al Rajhi Bank KSA). The latter, who holds an international bank license, operates at the former's headquarters, which has a license to operate as a foreign Malaysian publicly listed bank. Thus, at the same premises, the two banks are operating together with two different licenses from the BNM and, therefore, they qualified as one bank for the purpose of QS2. As a result, the total number of different banks to be considered for distribution of QS2 by mail has been short listed to 31 banks. The selection for the branches from these thirty-one banks is based on the number of branches available for each bank and it was capped to a maximum of sixteen to represent the location for each of the thirteen states and three federal territories that constitute Malaysia. In order to meet the capped number of 16 branches, all of the dedicated Islamic banking branches were chosen first and then the balance was randomly selected, subject to branch availability of each bank, based on the remaining locations within Malaysia. The branch location for each bank was determined from the bank's website and with consultation with the respective bank's officer at the headquarters level.

The respondents of both questionnaire surveys were given two weeks to complete and return the questionnaire. Then, the non-respondents were identified and they were followed-up through phone calls which were used as a gentle reminder with due care and diligence on the importance of their feedbacks for the success of the research project. Where there had been non-receipt of QS2 the researcher once again sent the questionnaire together with a personalised cover letter and preaddressed return envelope. After one week another followed-up was made to the non-respondents through phone calls stressing the importance of the respondents' participation as mentioned before. In total the researcher concluded the administration of the questionnaires in six weeks after they started (i.e. the end of February 2010) for both questionnaire surveys.

One of the important considerations to be made when conducting a questionnaire survey, such as the present research, is the number of responses received by the researcher to make a meaningful interpretation when analysing the data. Nachmias and Nachmias (1996, p. 226) advise that the general response rate for a mail questionnaire survey is between 20% and 40%. Nevertheless, the drop-off method of distributing the questionnaire (QS1), in addition to the follow-up measurement taken explained above, helped to ensure that the response rates of the present research was well above 20%. In summary, twenty-four out of thirty-two questionnaires were returned and a usable response of QS1 was received, indicating a response rate of 75%. Further analysis based on the ownership of the banks represented by the heads of Shari'ah departments revealed that 19 banks are domestic banks while the remaining 5 banks are foreign banks operating as Malaysian public listed companies. Also, categorisation of the responses by the types of banks indicates that fourteen banks are fully-fledged Islamic banks while another ten are banks with Islamic windows. Table 5.2 and Table 5.3 below provide details on the response from the QS1 survey by the types of banks and ownership and by total assets categorizations respectively.

Table 5.2: Analysis Showing the Responses from Questionnaire Survey 1

Types of Bank	Ownership					
	Domestic		Foreign		Total	
	No	*%*	*No*	*%*	*No*	*%*
Full-fledge Islamic Banks	11	78.6	3	21.4	14	100.0
Banks with Islamic Window	8	80.0	2	20.0	10	100.0
Total	19	79.2	5	20.8	24	100.0

Table 5.3: Analysis Showing the Total Assets of Banks Participating in Questionnaire Survey 1

Type of Bank	Total Asset by Category							
	Small (Less than RM1,000 million assets)		Medium (between RM1,000 million to RM10,000 million assets)		Large (More than RM10,000 million assets)		Total	
	No	*%*	*No*	*%*	*No*	*%*	*No*	*%*
Full-fledge Islamic Bank	0	.0	6	42.9	8	57.1	14	100.0
Bank with Islamic Window	4	44.4	6	60.0	0	.0	10	100.0
Total	4	17.4	12	50.0	8	34.8	24	100.0

Meanwhile, a total of 350 QS2 have been distributed from which 79 were returned with 1 unanswered. Thus, the response rate based on the usable returned and completed QS2 is 22.3%. Table 5.4 below summarizes the sample size of QS2 distribution and its response rate.

Table 5.4: Sample Size of Questionnaire Survey 2 and Analysis of Responses

	Banking Institutions	No of Questionnaire Survey 2 Distributed			Usable Returned and Completed	
		Dedicated Islamic Bank Branch	Dual Platform Branch	Total	No	%
1	Affin Islamic Bank Bhd	5	11	16	3	18.75
2	Al Rajhi Banking & Investment Corporation (Malaysia) Bhd	16	-	16	1	6.25
3	Alliance Islamic Bank Bhd	8	8	16	1	6.25
4	AmIslamic Bank Bhd	2	14	16	-	-
5	Asian Finance Bank Bhd	2	-	2	-	-
6	Bank Islam Malaysia Bhd	16	-	16	10	62.5
7	Bank Muamalat Malaysia Bhd	16	-	16	11	68.75
8	CIMB Islamic Bank Bhd	-	16	16	6	37.5
9	EONCAP Islamic Bank Bhd	5	11	16	1	6.25
10	Hong Leong Islamic Bank Bhd	-	16	16	1	6.25
11	HSBC Amanah Malaysia Bhd	4	12	16	-	-
12	Kuwait Finance House (Malaysia) Bhd	8	-	8	3	18.75
13	Maybank Islamic Bhd	12	4	16	4	25
14	OCBC Al-Amin Bank Bhd	6	10	16	-	-
15	Public Islamic Bank Bhd	-	16	16	2	12.5
16	RHB Islamic Bank Bhd	16	-	16	-	-
17	Standard Chartered Saadiq Bhd	1	15	16	-	-
18	Unicorn International Islamic Bank Malaysia Bhd	1	-	1	-	-
19	PT Bank Syariah Muamalat Indonesia, Tbk	1	-	1	-	-
20	Bank Kerjasama Rakyat Malaysia Bhd	16	-	16	12	75
21	Bank Perusahaan Kecil & Sederhana Malaysia Bhd (SME Bank)	-	16	16	5	41.67
22	Bank Pembangunan Malaysia Bhd	-	1	1	-	-

Table 5.4: Sample Size of Questionnaire Survey 2 and Analysis of Responses (*Continued*)

	Banking Institutions	No of Questionnaire Survey 2 Distributed			Usable Returned and Completed	
		Dedicated Islamic Bank Branch	Dual Platform Branch	Total	No	%
23	Export-Import Bank of Malaysia Bhd	-	3	3	-	-
24	Bank Pertanian Malaysia Bhd (Agrobank)	-	16	16	8	50
25	Bank Simpanan Nasional Bhd	-	16	16	7	43.75
26	KAF Investment Bank Bhd	-	1	1	-	-
27	MIDF Amanah Investment Bank Bhd	-	6	6	1	6.25
28	OSK Investment Bank Bhd	-	16	16	3	18.75
29	Citibank Bhd	-	5	5	-	-
30	The Royal Bank of Scotland Bhd	-	1	1	-	-
31	Deutsche Bank (Malaysia) Bhd	-	1	1	-	-
TOTAL		**135**	**215**	**350**	**78**	**22.3**

5.5.1.6 Statistical Analysis Techniques Employed

The next step after the data collection process is to analyse and interpret the data. Statistical packages have generally been used as a major tool for analytical purposes in social science research because they offer various statistical analysis techniques for use in questionnaire survey data. There are three main purposes for using statistical analysis, as noted by Kerlinger (1986):

(1) To reduce large quantities of data to a manageable and understandable form;

(2) To assist the study of the population and samples; and,

(3) To assist in making reliable inferences.

As noted earlier, this research investigates the Shari'ah governance function of the Shari'ah board amongst the banks participated in the MIFC, hence, the design of this research feature a cross-sectional study. Nachmias and Nachmias (1996, p. 129) assert that the statistical analysis which is used in research design tests the kinds of relationship between variables. Meanwhile, DeVaus (1996) cautions that there are three factors of how data are analysed:

(1) The number of variables examined at a time;

(2) The level of measurement of variables; and,

(3) The used of the data whether for descriptive or inferential purposes.

Two main analytical steps were conducted in the present research project. Firstly, the researcher has undertaken a descriptive analysis of each variable. DeVaus (1996) claims that descriptive analysis is ideally suited for a cross-sectional survey design and involves establishing the counts of a particular opinion among the respondents. There are two methods of descriptive analysis referred by Zikmund (2000) which have been used in this research: using tabulation to summarize data and using measures of central tendency (i.e. mean, median or mode). Zikmund (2000) also asserts that the use of counts and percentages when summarizing the data in the former could be extremely useful when comparing trends. Secondly, the researcher analyse the result of each variable by using organisations variables. This would allow the researcher to test any statistically significant differences between subgroups within the control variable. The control variables used in this study are similar to the control variables used in previous studies on Islamic banking, for example, total assets to measure the size of the banks (see for example Safieddine 2009); types of banks, i.e. full-fledge Islamic banks or bank with Islamic windows (see for example Hamim et al. 2008); and, ownership of banks, i.e. domestic or foreign banks (see for example Hamim et al. 2008). In addition, the researcher includes the number of years banks have been offering Islamic banking products and services as additional control variable to be used in this study. Data pertaining to the first three control variables were derived from the annual reports and website of the respective banks whereas data for the last control variable were gathered from QS1.[34]

In addition, a decision has to be made between using a parametric or non-parametric statistical test when analysing control variables. The selection of the appropriate statistical test to use depends on the conditions of the data available. Siegel and Castellan (1988, p. 34) identifies that the conditions that must be satisfied to use parametric test are: the observation must be independent; the observation must be drawn from normally distributed populations; the populations must have the same variance if there are two groups; and, the variables must measured on at least an interval scale. On the other hand, Siegel and Castellan (1988) asserts that a non-parametric statistical test is based on general conditions and does not specifically require any form of distribution of scores in the population. Moreover, there is no requirement for the data to meet the assumption of normality and homogeneity of variance nor the measurement need to be on an interval scale as argued by Berenson et al. (2002). The present study used the ordinal scale to gauge respondents' attitudes and opinions, although this scale is recognised to be weaker than an interval scale. Besides being more appropriate for a small sample size, Berenson et al. (2002) also claims that non-parametric methods can be almost or equally as powerful as the parametric test when the assumptions of the latter are not met and it can be more powerful when the assumptions of the parametric procedures are not met.

[34] The total assets value of the sample banks was derived from the latest annual report published at the time of data collection. Similarly, data pertaining to the type and ownership of bank are based on the respective bank's website at the time of data collection, hence presented the status quo of the bank at that time.

The discussion above has led the researcher to employ the non-parametric test in this study when analysing the questionnaires surveys data as it was clearly preferable. The relevant non-parametric techniques which were used for the analyses of the control data were the Mann-Whitney U and Kruskal-Wallis H test. In addition, the researcher also performed cross-tabulation to present the result of the analysis by control variables because it is the simplest and most frequently used method of demonstrating the presence or absence of a relationship (Bryman and Cramer, 1990; Zikmund 2000). Also, the statistical analysis by control variables was conducted based on the five-point Likert scale, but for presentational purposes the responses would be collapsed into three categories.

5.5.2 The In-depth Interview

As mentioned earlier, the in-depth interview which was conducted in this research forms the second stage of the research design. An interview is defined as a verbal interaction that is purposeful and directed in which *'one person takes responsibility for the development of the conversation'* (Molyneaux and Lane 1982, p. 1). In addition, an interview makes it possible for us to know what the interviewee knows (i.e. knowledge or information), discover what the interviewee likes or dislikes (i.e. values and preferences), and to discover what the interviewee thinks (i.e. attitudes and beliefs) (Gorden 1975, p. 39). Meanwhile, in-depth interviewing is a qualitative research technique that involves conducting intensive individual interviews. More precisely, an in-depth interview is a detailed investigation of an individual's personal perspective where in-depth understanding within the context of personal experience on delicate, complex system and process can be explored at a detailed level (Lewis 2009, pp. 57-61).

In this study, a series of in-depth interviews took place between March and May 2010 with individuals deemed important within the Malaysian Islamic banking industry's SGF. Basically, the researcher has conducted interviews with the Shari'ah board members, heads of Shari'ah departments, the SAC of BNM, and the managers from the Department of Islamic Banking and *Takaful* of BNM (Jabatan Perbankan Islam and *Takaful* or JPIT).

This jointly constructed discourse effort emulates elite interviewing because the interviewees represent the major players of the Islamic banking business and they are considered to be directly associated with the function of Shari'ah board under investigation. Such features of elite interviewing would enable the researcher to gain the insights from the individuals concerned, which will help to produce an explanation of the subject of interest (Richards 1996). Elite interviewing exemplifies issues of power relations in which the interviewee attempts to dominate the interview most of the time (Richard 1996). The appropriate format or approach for the conduct of these types of interview would be 'facilitative and neutral' (Rapley 2007). This approach requires the interviewer to carefully construct the wording when questioning and probing so as to indicate the neutral position of the interviewer.

The interview approach used in this study is the semi-structured interview where the participants were given some degree of freedom to explain their thoughts and experiences without following sequenced questions and predetermined specific answer categories. The absence of sequenced pre-designed questions makes the semi-structured interview more like a guided conversation; however, a list of possible questions to be asked is normally specified. May (2001) pointed that these sets of specified questions in semi-structured interview allow participants to speak out or answer freely on the issues forwarded and subsequently enables the researcher to form standardisation and comparability analysis between the samples of the study. Nevertheless, although this type of interview allows respondents some degree of freedom to answer the questions, there is still a possibility that some issues listed in the series of questions might have been tackled and, thus, would be left behind. Moreover, Wengraf (2001, p. 5) asserts that the demand for the interviewer to have no preconceived expectations of what could be the response of the participants in a semi-structured interview may require the interviewer to modify the procedures of the interview in response to the participant's replies to the initially prepared questions.

The participants in the interview were asked three main types of question: open-ended questions, fixed alternative and funnel questions, and probing questions. During the conversation open-ended questions were used to start a new topic and they provided an opportunity for the participants to freely reveal their thoughts so that the feedback given was not biased in a certain direction. Meanwhile, the fixed alternative questions were used to confirm the questionnaire's findings, whereas probing questions benefits the researcher in discovering the motivation and reasons behind certain responses. The questions were discussed with the researcher's primary supervisor and a Shari'ah board member for approval and possible amendment in order to ensure that the interview questions were understandable and unambiguous.

Table 5.5 below reports that interviews with participants from banks offering Islamic banking products and services comprise of 23 interview sessions with the Shari'ah board members, 5 interviews sessions with the CEOs of Islamic banks, 3 interview sessions with the senior executives of banks (2 are from the same bank) and 7 interview sessions with the heads of Shari'ah departments. From these interview sessions, the researcher managed to cover 25 banks, i.e., more than 78% of the 32 banks in the MIFC sample. In addition, eight interview sessions were held between the researcher and regulators as shown in Table 5.6 below. These represent 4 interviews sessions with the SAC members[35], 1 interview session with ex-SAC member and 2 interviews sessions with the JPIT managers. It is also worth noting that the researcher believes that the interview sessions with the ex-SAC member can provide invaluable insights on the different phases of the development of national SGF for the Malaysian Islamic banking industry, as well as enriching the understanding of the role and functions of the SAC. All in all, the researcher held discussions on the issues surrounding the governance function of the Shari'ah board with 46 interview participants who hold a significant role in the SGF of the Malaysian Islamic banking industry. It is believed that an interview of this intensity would provide the researcher with in-depth understanding of the social process involved in the Shari'ah governance function of the Shari'ah board.

[35] The SAC members participated in this study were the current SAC members for the term 2008/2010. In November 2010, after this research had been completed, the BNM announced the new membership of the SAC for the term 2010-2013.

Table 5.5: Analysis of the Respondents of the In-depth Interviews amongst Banks Participating in the Malaysian Islamic Finance Centre (MIFC)

Banking Institutions/ Institutions	Shari'ah Board Members Interviewed	Head of Shari'ah Department Interviewed	CEO/ Senior Executives (SE) Interviewed
A. Full-fledge Islamic Banks (IB)			
IB1	2	1	2 (both SE)
IB2	1	1	1 (CEO)
IB3	1	1	1 (CEO)
IB4	1	-	2 (CEO & SE)
IB5	1	-	1 (CEO)
IB6	1	-	-
IB7	1	-	-
IB8	1	-	1 (CEO)
IB9	1	-	-
IB10	1	-	-
IB11	1	1	-
IB12	1	-	-
IB13	1	-	-
IB14	-	1	-
IB15	1	1	-
1B16	1	1	-
B. Development Financial Institutions Offering Islamic Banking Services (DFI)			
DFI1	1	-	-
DFI2	1	1	-
DFI3	1	-	-
DFI4	1	-	-
DFI5	1	-	-
C. Investment Banks (Inv.B.)			
Inv.B.1	1	-	-
D. Commercial Banks (Comm.B.)			
Comm.B.1	1	-	-

Table 5.6: Analysis of the Respondents of the In-depth Interviews amongst Regulatory Authorities

Regulatory Authorities:	Interview Participants
Shari'ah Advisory Council (SAC) of Bank Negara Malaysia	SAC 1 SAC 2 SAC 3 SAC 4 Ex-SAC
Department of Islamic Banking and Takaful (or JPIT) of Bank Negara Malaysia	JPIT 1 JPIT 2

The researcher also analysed the qualification background of certain groups of interview participants, namely the Shari'ah board members, who are mainly academics in Malaysian universities, and the SAC members. Specifically, the researcher identified the qualification background by ascertaining the first degree obtained by these interview participants. Information pertaining to this qualification was gathered from the annual reports and websites of financial institutions and other affiliations where the interview participants are attached, as well as from the interview sessions held. However, as there are many degrees offered in the field of Shari'ah (for example degree in Shari'ah; *Usuluddin*; *Fiqh* and *Usul-fiqh*, Qur'an and *Sunnah*) the degrees have all been clustered as Shari'ah. The researcher also ascertained whether the interview participants hold a higher degree qualification, using a similar approach as for the first degree. This qualification background was used to describe the qualification and expertise of the interview participants when reporting analysis of the interviews later.[36]

[36] The interview participants were classified as Shari'ah experts or non-Shari'ah experts mainly based on their higher degree qualification background. Classification as Shari'ah experts were made based on

It is worth noting that each interview commenced with a brief explanation about the objectives of the research and the interviewees were assured of the complete confidentiality of their responses. In addition, the interviewees were asked general questions about their employment, such as their position in the organisation and the length of time in that position. These questions helped to start the interview in a relaxed mood and it established rapport before discussion moved on to more detailed and serious issues. Generally, the questions brought into discussion followed a specific order, however, on several interviews the order depended on the emerging issues raised by the interviewees. Since the issues on Shari'ah governance of Islamic banks and the role and function of the Shari'ah board are deemed to be important many interviewees appeared to be interested and enjoyed expressing their opinion on the issues raised during the interview. Most of the interviews lasted about an hour, while a few lasted about forty-five minutes. The interview questions to all respondent groups for this in-depth interview are provided in Appendix 2.

Meanwhile, the selection of the interviewees was generally based on convenience sampling. In this regard, the selection of interview participants was made based on the first to agree for the interview once the invitation has been offered by the researcher. For instance, an invitation for an interview to the Shari'ah board members and the CEO was made on a bank by bank basis amongst all those banks who participated in the MIFC (i.e. the study population). The approach taken by the researcher was to first contact these respondents by telephone, whereupon, the study on Shari'ah governance function of the Shari'ah board undertaken by the researcher was explained and a request for interview participation was made. This would normally be followed up by an email which includes an attached covering letter explaining the objective of the study and a letter from International Shari'ah Research Academy (ISRA') which is the Shari'ah research entity of the regulator (i.e. BNM) indicating support for the research. When the Shari'ah board member, or the CEO, expressed their unwillingness to be interviewed the researcher contacted the next member within the bank's Shari'ah board or the CEO of the following

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qualification background in the field of Shari'ah and Shari'ah law. Interview participants holding other than these two fields were reported as non-Shari'ah experts.

bank and this process continued to all 32 banks in the MIFC sample. However, due to the researcher's limitation of time and funding, the selection of the Shari'ah board and the CEO for the in-depth interview was limited to those who are based in Malaysia.

5.5.2.1 Analysis of the Interview Data

The in-depth interview was meant to provide the researcher with an in-depth understanding of the 'social process' involved in the Shari'ah governance function of the Shari'ah board, which when integrated with the findings of the questionnaire surveys would provide a rounded and overall picture of the issues under investigation. This requires the researcher to make a critical and in-depth assessment of the participants' comments in relation to the general understanding of the issues under investigation, as provided by the questionnaire surveys findings. The first step of analysing the data from the in-depth interviews was to transcribe the interview in order to enable the researcher to analyse the data thoroughly. An important step following this is to read through all transcribed interviews in order to obtain general ideas of what the interviewees are saying and to reflect on its meaning before coding the textual data. Rossman and Rallis (1998, p. 171) define coding as the process of organising the material into chunks or segments of text before bringing meaning to information. Consequently, the researcher began to collect text data by segmenting sentences or paragraphs, which were then labelled using a specific term to generate themes. Boyatzis (1998) identified two ways of generating themes: firstly, inductively from the raw information; and secondly, deductively from theory and prior research. Following the latter method, the main themes for interview data analysis are similar to the issues investigated in the questionnaire survey, which include: the role of the Shari'ah board, the accountability and independence of the Shari'ah board, the structure of Shari'ah review for the Shari'ah board, and the implementation of Shari'ah review by the Shari'ah board. However, coding into themes in such a pre-structured manner where the themes have been predetermined prior to data analysis raises a risk that the conclusions are being drawn too early. As a measurement to reduce this risk, the researcher in this study identified possible emerging themes as a result of using coding techniques, as suggested by Creswell (2009, pp. 186-187), which includes: codes that are surprising and not anticipated; codes that are unusual; and, codes that address a larger theoretical perspective in the research.

In this study, the researcher decided to use Atlas.ti version 6.2 software to analyse the interview data. Atlas.ti is a computer software and one of the Computer Assisted Qualitative Data Analysis Software (CAQDAS) available for analysing qualitative data. Analysis of qualitative data through the use of CAQDAS is the intellectual task of the researcher because the software itself could not function on its own unless instructed by the researcher (Hwang 2008; Konopásek 2008). Moreover, using qualitative data analysis software such as Atlas.ti also brings the benefit of easier management and coding of the data (Wickham and Woods 2005; Konopásek 2008). The researcher has obtained the necessary skills (up to the advanced level) on how to use the software after attending several training workshops which are offered by the university.

Basically, the transcribed interviews and the memos on thoughts developed throughout the study serve as the Primary Documents (PD). This PD has to be assigned in a single platform known as ‘hermeneutic unit’. After the PD has been assigned, the next step is to extract segments of the PD into pieces of information, known as a ‘quotation’, which are deemed important and relevant to the topic under investigation. Atlas.ti makes the separation of quotations from the original source (PD) as ‘self-contained objects’ for ease of analysis by the researcher; however, it is not difficult to trace them back to their original reference (Konopásek 2008). The quotations were then linked into certain codes developed by the researcher so that the quotations extracted earlier would have some meaning and relevance. In this regard, Bogdan and Biklen (1982, pp. 166-172) offer some useful advice on how to develop code names when analysing qualitative data, the code names they suggest include: setting and context codes, codes based on perspective held by subjects, codes based on subjects’ way of thinking about people and objects, process codes, activity codes, strategy codes, relationship and social structure codes, and pre-assigned coding schemes. Moreover, Atlas.ti provides the users with a comment tool that can be attached in many parts of Atlas.ti’s analytical object, including: the PDs, codes, quotations, memos and network view. It serves as a useful tool for the researcher in expressing a personal explanation, description, or idea of the analytical object in a more conventional way.

In addition, Konopásek (2008) suggests that relevant information could be judged by ascertaining quotations, codes, memos and networks in which the researcher has included personal attachment or which possesses a certain quality. Examples of this include codes which are attached with researcher's comments, quotations that are linked to multiple codes or to other quotations, as well as codes that are associated with higher quotations. Based on this relevant information, the researcher can then make a continual reflection on the meaning brought from interviewees' responses for each theme and then compare these with the responses from all groups of respondent and with the information gleaned from the literature and theory. Meanwhile, Miles and Huberman (1994, p. 243) have emphasised the importance of displaying data from the original source when presenting the results of qualitative data. Following this recommendation, the researcher used a quotation which also mentioned the type of respondents and the organisation that they belong to. The researcher has also undertaken methods of drawing a conclusion which was suggested by Miles and Huberman (1994, p. 253), which includes noting patterns, contrasting, comparing, and clustering of the facts within the themes developed to provide a deeper understanding of the results found in the questionnaire survey. The mapping or networking tools offered in CAQDAS, such as Atlas.ti, could also facilitate the researcher in developing the structure and logical writing up of the results on the interview analysis (Wickham and Woods 2005). In this regard, the researcher has used the family code and super family code facilities in Atlas.ti in order to generate the networking view which then becomes the basis of the arguments of the findings and presentation structure for the writing-up of the thesis.

The findings from the in-depth interview are presented in Chapter Eight in the form of a narrative passage, which includes interpretations and quotes. Where necessary the qualification of the interviewee participants, the size of the banking institutions and the ownership of the bank was also mentioned in order to emphasise the facts given by the interviewee participants on the topic under discussion.

5.6 Summary

In this chapter the research objectives, the rationale for the choice of cross-sectional survey design, the questionnaire method, and the interview approach have been critically described. The research objectives outlined earlier in this chapter attempt to assess the Shari'ah governance function of the Shari'ah board for the Malaysian Islamic banking industry in two main ways. First are those questions which relate to the role and functions of the Shari'ah board in ensuring the credibility of banks offering Islamic banking products and services, and in attending the need of the investors and stakeholders. Second are those questions which investigate the Malaysian dual-layer Shari'ah governance system in promoting stability and coherence in Islamic banking practices (as reflected in questions about the accountability and independence of the Shari'ah board and the structure and implementation of Shari'ah review systems within these banks). The process of implementing the questionnaire survey and the in-depth interview as the two research instruments used in meeting these research objectives has been described. The researcher has also demonstrated the measurement taken to ensure that the research design and the data collection methods match the purposes of the study. This chapter has also described the types of statistical analysis undertaken to analyse the questionnaire data, and how the use of CAQDAS, in this case Atlas.ti software program, assists the researcher in analysing the interview data.

Chapter Six and Seven offer discussion on the questionnaire survey findings whilst Chapter Eight presents analysis of the in-depth interview findings.

CHAPTER SIX: ANALYSIS OF THE SURVEY ON SHARI'AH BOARDS: RESPONSES OF THE HEADS OF SHARI'AH DEPARTMENTS

6.1 Introduction

This chapter discusses the overall responses to the first questionnaire survey, Questionnaire Survey 1 (QS1), distributed and undertaken to elicit opinions of the heads of Shari'ah departments amongst 32 banks in the Malaysian International Islamic Finance Centre (MIFC) of Bank Negara Malaysia (BNM). The aim of the questionnaire was to elicit the respondents' opinions on three themes regarding the Shari'ah governance function of the Shari'ah board: (1) its role, (2) its accountability and independence, and (3) the nature of the Shari'ah review in banks offering Islamic banking products and services. This chapter contains six sections. In Section 6.2, the backgrounds of the respondents and the characteristics of the banks offering Islamic banking business are provided. The details of the analyses and the discussion of the findings pertaining to these three themes are presented in sections 6.3, 6.4 and 6.5 respectively. Finally, section 6.6 provides the summary.

6.2 Profile of Respondents and Characteristics of Banks

It was mentioned in Chapter Four that the Shari'ah department of banks that offer Islamic banking products and services plays a vital role in assisting the Shari'ah board. The close Shari'ah governance ties between the Shari'ah department and the Shari'ah board provided the researcher with insights into the issues under investigation. This is evident from the guidelines issued by BNM, namely, '*Guidelines on the Governance of the Shariah Committee for Islamic Financial Institutions'* (or GPS1) which make clear the role of the Shari'ah department officer as the secretariat to the Shari'ah board (BNM 2004). An important repercussion of the significant role played by the Shari'ah department officers would be the requirement for the Shari'ah officer to have the required knowledge and competency to carry out his or her duties. Hence, the discussion below offers analyses on the background of the heads of Shari'ah departments participating in this research.

6.2.1 Gender and Age Range of Heads of Shari'ah Departments

Among the 24 heads of Shari'ah departments who responded to the questionnaire, 21 are male whereas 3 are female. Furthermore, the age range of these Shari'ah officers was almost equally distributed between the different age categories. There are 9 officers each in the range of 25-34 years old and 35-44 years old while the remaining 6 are in the range of 45-54 years old. Table 6.2.1 below shows the analysis of the background of the heads of Shari'ah departments by gender and age range.

Table 6.2.1: Analysis Showing Gender and Age Range of Heads of Shari'ah Departments

Head of Shari'ah Department's Gender	Age Range of Heads of Shari'ah Departments			
	25-34	35-44	45-54	Total
Male	8	7	6	21
Female	1	2	0	3
Total	9	9	6	24

6.2.2 Experience of Heads of Shari'ah Departments

Table 6.2.2 below shows the analysis of the respondents' experience in the Islamic banking industry and the distribution of the number of years all the banks in the sample have offered Islamic banking products and services. Table 6.2.2 shows the similarity between the number of years of working experience amongst the heads of Shari'ah departments and the number of years the bank has offered Islamic banking products and services. It was found that 13 heads of Shari'ah departments fall into the category of 0 to 5 years experience of working in the Islamic banking industry. They represent the majority whereas almost half of that number fall into the categories where the Islamic banking working experience attained ranges from 6-10 years (5 persons) and 15 years and above (6 persons).

Interestingly, the table also presents evidence that the frequency of banks in each category of the number of years banks have been offering Islamic banking products and services is similar to the frequency of respondents for each experience range. These findings might be attributed to the fact that many of the long-established conventional banks have taken the initiative to participate in the MIFC scheme, launched by the Malaysian government in year 2006, by setting up an Islamic banking subsidiary. In addition, since the GPS1 mandated that each bank that offers Islamic banking products and services should have at least one Shari'ah officer (BNM 2004), these newly established Islamic banking subsidiaries began the task of recruiting these Shari'ah officers. Another observation that could be made is that majority of these heads of Shari'ah departments are from the newly established Islamic banking subsidiaries.

Table 6.2.2: Analysis Showing Experience of Heads of Shari'ah Departments and the Number of Years Banks have been Offering Islamic Banking (IB)

Number of Years Offering IB	Experience in Islamic Banking Industry									
	0-5 years		6-10 years		11-15 years		16 years and above		Total	
	No.	%	No.	%	No.	%	No.	%	No.	%
0-5 years	8	61.5	2	15.3	0	0	3	23.2	13	100.0
6-10 years	3	60.0	2	40.0	0	0	0	0	5	100.0
11-15 years	0	0	0	0	0	0	0	0	0	100.0
16 years and above	2	33.3	1	16.7	0	0	3	50.0	6	100.0
Total	13	54.2	5	20.8	0	0	6	25.0	24	100.0

6.2.3 Training Received by the Heads of Shari’ah Departments

One indicator that could be used to measure the effectiveness of the Shari’ah governance mechanism is the training exposure received by the heads of Shari’ah departments. As argued earlier, the requirement for these officers to work closely with the Shari’ah board in ensuring that the activities of the bank are Shari’ah compliant requires them to acquire a certain level of competency. Thus, the GPS1 emphasizes that the Shari’ah officer should be ‘preferably a person with knowledge in Shari’ah’ (BNM 2004), although this is not mandatory. Nevertheless, knowledge and skills in accountancy, finance or management are deemed relevant for the efficiency and competency of a Shari’ah officer. Table 6.2.3 below presents the findings on the aspects of training received by the heads of Shari’ah departments.

Table 6.2.3: Analysis Showing Aspects of Training Received by Heads of Shari’ah Departments

Training Received by Heads of Shari’ah Departments	**No**	**%**
Shari'ah	1	4.2
Fiqh al-mua'malat	1	4.2
Combination of Shari'ah and *fiqh al-mua'malat*	13	54.1
Management	1	4.2
Accounting and Finance	1	4.2
Combination of Shari'ah or *fiqh al-mua'malat* with other non-Islamic field(s)	5	20.8
Others	2	8.3
Total	24	100.0

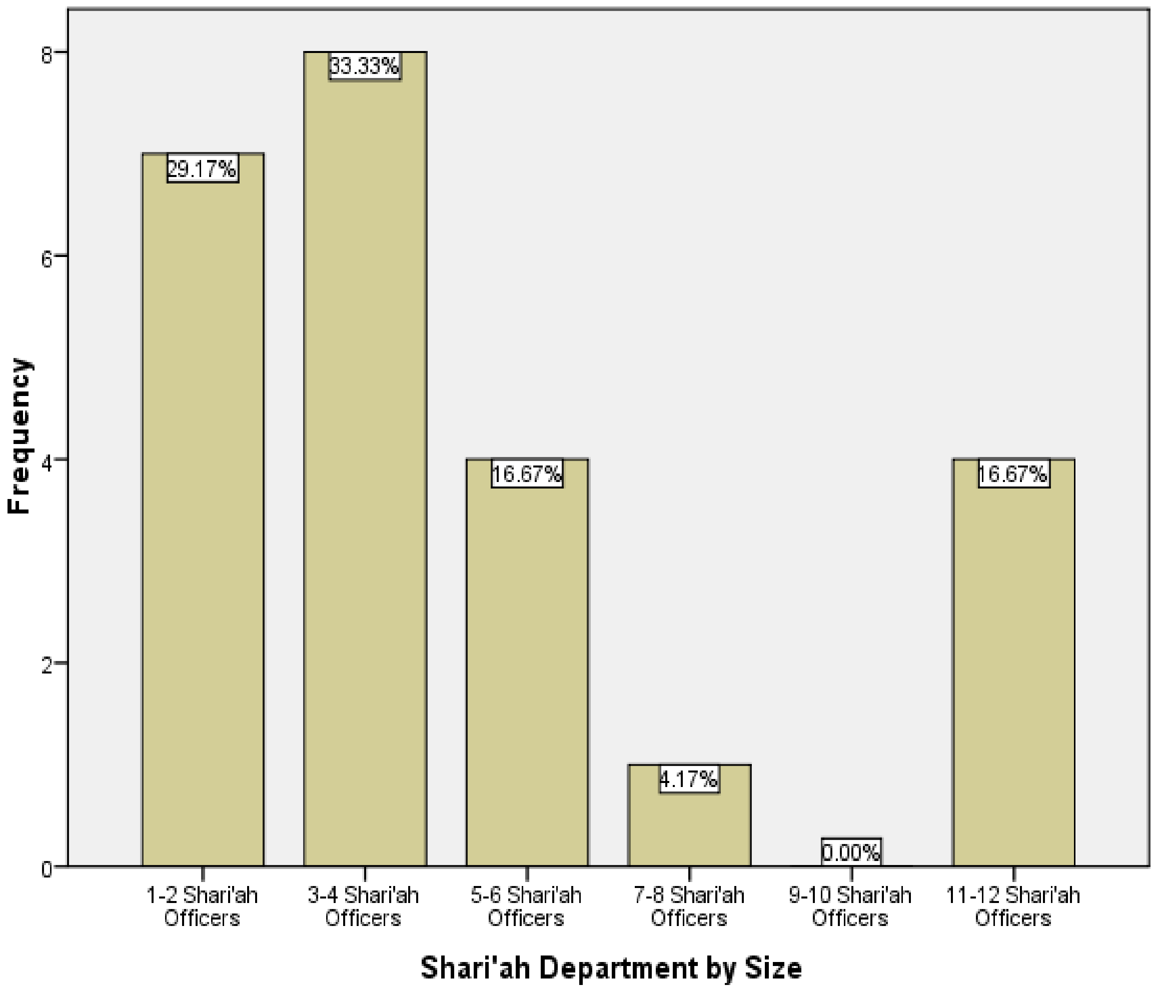
As can be clearly seen from the above table, more than half of the heads of Shari’ah departments (13 persons) claimed to have knowledge of both Shari’ah and *fiqh al-*

mua'malat. Meanwhile, a further five heads of Shari'ah departments had a combination of knowledge in either Shari'ah or *fiqh al-mua'malat* with other non-Islamic field(s). Emphasis on training in Shari'ah or/and *fiqh al-mua'malat* amongst the heads of Shari'ah departments could be expected, as knowledge of these two fields is deemed essential and represents the principles underlying the ethical operation of institutions offering Islamic banking and finance. These two knowledge types, combined with other aspects of training, would be a valuable addition to their respective banks, as other skills are also commonly essential for the smooth operation of banks. On the other hand, the fact that there is one person each for training in the field of management and accounting and finance while two or more heads of Shari'ah departments have training in other fields reflects the GPS1's non-mandatory requirement for Shari'ah officers to have the knowledge of Shari'ah.

6.2.4 Size of Shari'ah Departments

Another concern regarding the effectiveness of the Shari'ah governance mechanism amongst banks that offer Islamic banking products and services is the number of Shari'ah officers within the Shari'ah department. With this in mind, the researcher analyzed the size of Shari'ah departments by categorizing them according to the number of officers recruited by the bank. Chart 6.1 below shows the distribution of the number of Shari'ah officers in the Shari'ah departments run by the 24 respondents. As illustrated in the chart, most of the banks have a small number of officers in their Shari'ah department. Eight heads of Shari'ah departments indicated that the number of Shari'ah officers in their Shari'ah department falls into the category of 3-4 officers whereas another seven heads of Shari'ah departments indicated that the number of Shari'ah officers falls into the category of 1-2 officers. There are also four heads of Shari'ah departments indicated that the number of Shari'ah officers in their Shari'ah department falls into the category of 5-6 officers. In short, in 19 of the banks, the Shari'ah department comprises 6 or fewer Shari'ah officers. On the other hand, a small number of banks were revealed to have a sizable Shari'ah department. From the chart below it is evident that only 1 head of Shari'ah department belonged to the category of a Shari'ah department with 7-8 officers while another 4 heads of Shari'ah departments belonged to the category of 11-12 Shari'ah officers.

Chart 6.1: Number of Shari'ah Officers in Shari'ah Department of Banks Offering Islamic Banking



The above findings also provide an important indication of the effectiveness of the Shari'ah governance mechanism of the banks. As the Shari'ah officers serve as the secretariat to the Shari'ah board, the role and functions of the Shari'ah board would function more smoothly if assisted by a sizable Shari'ah department. Hence, the more Shari'ah officers that are recruited by the bank, the more intensive the Shari'ah governance mechanism of the respective bank is expected to be. However, it is argued that the need for a higher number of Shari’ah officers is dependent on how extensive the Islamic banking and finance operation actually is. Therefore, banks that provide a variety of Islamic banking products and services and that have a wide operation that spans the domestic as well as the international market are expected to require a higher number of Shari’ah officers in their Shari’ah department. This requirement could be explained by the need to assist the Shari’ah board in its Shari’ah advisory and Shari’ah review function. As the secretariat to the Shari’ah board, the Shari’ah officer could act as an intermediary in communicating the Shari’ah decisions issued by the Shari’ah board to other relevant parties within the bank, for example to the management or board of directors. Other ways in which Shari’ah officers could provide assistance to the Shari’ah board are by conducting or joining in with the research activities of the Shari’ah board and by preparing the necessary documentation for new Islamic banking products or services developed by the bank. Similarly, Shari’ah officers are expected to assist the Shari’ah board in ensuring that the Shari’ah decisions made by the latter are being implemented by the management of the bank. In addition, if there are any issues stemming from the bank’s network operation, the Shari’ah officers would bring this matter to the attention of the Shari’ah board for deliberation by them. On the other hand, if the Islamic banking products and services that are offered and the operation of the bank are relatively limited, there is no need for a higher number of Shari’ah officers and therefore, the number of officers should not be the basis for the evaluation of the bank’s Shari’ah governance mechanism.

6.2.4.1 Size of Shari'ah Departments by the Type of Bank

Table 6.2.4 shows the size of Shari’ah department by the types of bank represented by the respondents. As is evident from the table, 14 of the banks (58.3% of the total banks represented by the respondents) surveyed in this study are full-fledged Islamic banks while the remaining 10 banks (41.7% of the total banks represented by the respondents) are banks with an Islamic window. In addition, it was found that, amongst the fully-fledged Islamic banks, there was a wide range in the size of the Shari’ah department. From the total of 14 full-fledged Islamic banks, 1 bank was reported to have between 1 to

2 Shari'ah officer(s), 5 banks had 3 to 4 Shari'ah officers, 4 banks had 5 to 6 Shari'ah officers and another 4 banks had 11 to 12 Shari'ah officers. On the other hand, most of the banks with an Islamic window had only a small Shari'ah department. From the total of 10 banks operating as an Islamic window, 6 banks had 1 to 2 Shari'ah officer(s), 3 banks had 3 to 4 Shari'ah officers and 1 bank had 7 to 8 Shari'ah officers.

Thus, the fact that banks operate as full-fledged Islamic banks does not necessarily imply that the Shari'ah department of these banks will be large. Evidence from this study indicates that the size of Shari'ah department of the full-fledged Islamic banks varies from small to large with the number of Shari'ah officers ranging from 1 to 12. On the other hand, almost all banks with an Islamic window have a small Shari'ah department with the number of Shari'ah officers ranging from 1 to 4. This could be because the banking operations of these banks are dominated by the interest-based banking activities whereas the Islamic banking operation constitutes a smaller part of the banking operation.

Table 6.2.4: Analysis of Size of Shari'ah Departments by Type of Bank

Type of Bank	Size of Shari'ah Departments							
	1-2 Shari'ah Officers	3-4 Shari'ah Officers	5-6 Shari'ah Officers	7-8 Shari'ah Officers	9-10 Shari'ah Officers	11-12 Shari'ah Officers	Total	
							No.	%
Full-fledged Islamic Banks	1	5	4	0	0	4	14	58.3
Bank with Islamic Window	6	3	0	1	0	0	10	41.7
Total	7	8	4	1	0	4	24	100.0

6.2.4.2 Size of Shari'ah Departments by Total Assets

It is equally important to discover whether the size of the Shari'ah department is influenced by the size of the bank. Thus, this study uses total assets as the proxy to measure bank size. Table 6.2.5 provides an analysis of the size of Shari'ah department by total assets. As is evident from the table, the size of Shari'ah department varies with bank size. All 4 small banks appeared to have small Shari'ah departments with 1 to 2 Shari'ah officer(s), while the size of the Shari'ah department in banks in the medium category varied. Amongst the 12 banks in this category, 3 banks had 1 to 2 Shari'ah officers, 6 banks had 3 to 4 Shari'ah officers, 2 banks had 5 to 6 Shari'ah officers and 1 bank had 7 to 8 Shari'ah officers. Hence, it appears that medium-sized banks have a Shari'ah department in the middle of the size range except for 3 banks which had a small number of Shari'ah officers and thus meet the requirement of GPS1 (at least one Shari'ah officer is required) whereas the remaining banks tend to be concentrated in the mid range of the category for Shari'ah department size. On the other hand, large banks appeared to have large Shari'ah departments. Amongst all 8 large banks, half had 11 to 12 Shari'ah officers with another 2 banks each in the categories of 3 to 4 Shari'ah officers and 5 to 6 Shari'ah officers.

Table 6.2.5: Analysis of Size of Shari'ah Departments by Total Assets

Total Assets	Size of Shari'ah Departments													
	1-2 Shari'ah Officers		3-4 Shari'ah Officers		5-6 Shari'ah Officers		7-8 Shari'ah Officers		9-10 Shari'ah Officers		11-12 Shari'ah Officers		Total	
	No.	%	No.	%	No.	%	No.	%	No.	%	No.	%	No.	%
Small	4	100.0	0	0	0	0	0	0	0	0	0	0	4	100.0
Medium	3	25.0	6	50.0	2	16.7	1	8.3	0	0	0	0	12	100.0
Large	0	0	2	25.0	2	25.0	0	0	0	0	4	50.0	8	100.0
Total	7	29.1	8	33.3	4	16.7	1	4.2	0	0	4	16.7	24	100.0

Small: Less than RM1,000 million assets
Medium: between RM1,000 million to RM10,000 million assets
Large: More than RM10,000 million assets

The above findings suggest that the size of Shari'ah department depends on the size of the bank, with small banks having small Shari'ah departments whereas large banks have large Shari'ah departments. This association between bank size and Shari'ah department size could be explained in the light of the Islamic banking business operation. The larger the bank size, the more extensive the Islamic banking business operation is expected to be and, therefore, more Shari'ah officers are required to assist the Shari'ah governance function of the Shari'ah board. Conversely, it could be expected that the Islamic banking business operation of small banks would be less extensive and, therefore, there would not be the same need for a big number of Shari'ah officers. Hence, banks offering Islamic banking products and services should determine the size of Shari'ah department required based on the evaluation of their Islamic banking operation, although the requirement imposed by the regulator is for each bank to have at least one Shari'ah officer.

6.3 The Role of Shari'ah Boards

The main aim of this section is to analyse the important issue surrounding the role of the Shari'ah board amongst participating banks in the MIFC. For this purpose, this section is divided into seven subsections. First, a brief overview of the standards and guidelines used by the Shari'ah board is provided. This is followed by an analysis and discussion of the scope and role of the Shari'ah board. Third, an analysis is provided regarding the involvement of the Shari'ah board in advising and designing the corporate objectives of the banks. Fourth, there is an analysis of the involvement of the Shari'ah board in the development of Islamic banking products and services. The next section analyses the involvement of the Shari'ah board in the accounting issues of the bank. This is followed by a subsection which analyses the relevant parties that assist the Shari'ah governance function of the Shari'ah board. Finally, an analysis of the Shari'ah governance commitment undertaken by the Shari'ah board is provided.

6.3.1 Standards and Guidelines Used by Shari'ah Boards

Chapter Two discussed how the opaque nature of banking has made it one of the most highly regulated industries. As mentioned in Chapter Four, several authorities in the Islamic banking institutions have produced standards and guidelines for use in the industry, including bodies such as the AAOIFI, IFSB and, in the case of the Malaysian Islamic banking industry, the guidelines issued by the BNM. In this research, the heads of Shari'ah departments were asked to indicate on a five-point Likert scale their agreement on the guidelines and standards used by the Shari'ah boards in their respective banks. The results are highlighted in Table 6.3.1 below.

Table 6.3.1: Analysis Showing the Standards and Guidelines Used by Shari'ah Boards

Standards and Guidelines Used by Shari'ah Boards	Disagree		Uncertain		Agree		Total	
	No	*%*	*No*	*%*	*No*	*%*	*No*	*%*
AAOIFI	2	8.3	9	37.5	13	54.2	24	100
IFSB	0	0	6	25	18	75	24	100
GPS1	0	0	0	0	24	100	24	100

It is apparent from the table that the heads of Shari'ah departments indicated both agreement and disagreement on the use of AAOIFI's governance standard. For example, about 54.2% of the heads of Shari'ah departments agreed that the Shari'ah governance standard is consistent with AAOIFI's governance standard whereas another 8.3% disagreed on the use of the same standards. Meanwhile, about 75% of the heads of Shari'ah departments agreed that the Shari'ah board in their respective bank used the prudential standard issued by IFSB while another 25% were uncertain. In addition, all heads of Shari'ah departments expressed their agreement with the Shari'ah boards' use of GPS1 guidelines issued by the BNM.

The above results could be explained in two ways. First, that there is no mandatory requirement amongst banks offering Islamic banking products and services to follow the standards issued by the AAOIFI and IFSB has resulted in emphasis for adherence by these banks being given less consideration even by banks operating in Malaysia. However, the fact that some banks were reported to be using these standards could be attributed to the nature of their business, as they might also operate in foreign countries, and thus be required to consider the use of accepted international standards in the industry. Alternatively, this could be the result of banks whose Shari'ah board members are from those Middle Eastern countries that recognized these international standards and decided to implement them while simultaneously fulfilling the requirement of GPS1. Evidently, the use of these two standards amongst Malaysian banks that offer Islamic banking products and services is entirely on a voluntary basis. Participating banks in the MIFC may or may not consider the use of standards set out by these authority bodies. In addition, the reported adherence to GPS1 guidelines by the Shari'ah board reflects the mandatory requirement issued by the regulator that is directly in charge of the Islamic banking industry for participating banks in the MIFC to follow these guidelines. Hence, none of the heads of Shari'ah departments reported their agreement with using GPS1 as the Shari'ah governance guideline to any degree less than the agree category.

6.3.2 The Scope and Role of Shari'ah Boards

One of the crucial pieces of information required in evaluating the Shari'ah governance mechanism amongst the banks participating in the MIFC pertains to the scope and role of the Shari'ah board. Thus, the respondents were invited to indicate their agreement based on a five-point Likert scale between strongly disagree (1) and strongly agree (5). The analysis of the findings is reported in Table 6.3.2 below.

Table 6.3.2: Analysis Showing the Scope and Role of Shari'ah Boards

The Scope and Role of Shari'ah Boards	Disagree		Uncertain		Agree		Total		Overall	
	No	*%*	*No*	*%*	*No*	*%*	*No*	*%*	*Mean*	*Rank*
Advise board of directors on Shari'ah matters	0	.0	2	8.3	22	91.7	24	100.0	4.54	2
Assist other parties on Shari'ah matters	1	4.2	0	.0	23	95.8	24	100.0	4.50	3
Advise Shari'ah department officers on scope of Shari'ah review	2	8.3	2	8.3	20	83.3	24	100.0	4.38	4
Provide training for Shari'ah department officers	7	29.2	5	20.8	12	50.0	24	100.0	3.25	6
Report to Shari'ah Advisory Council on Shari'ah matters	3	12.5	4	16.7	17	70.8	24	100.0	3.83	5
Prepare Shari'ah compliance manual	11	45.8	5	20.8	8	33.3	24	100.0	2.92	7
Endorse Shari'ah compliance manual	1	4.2	1	4.2	22	91.7	24	100.0	4.58	1

The table reveals that the majority of the respondents agreed that the Shari'ah board in their respective banks had undertaken the listed scope of Shari'ah advisory role. It is evident from the table that endorsing the Shari'ah compliance manual prepared by the management of the bank is ranked in first place with a mean score of 4.58, with 92% of the respondents indicating their agreement. Meanwhile, advising the board of directors on Shari'ah matters is ranked second with a mean score of 4.54 and with 92% of the respondents indicating their agreement. In addition, assisting other parties on Shari'ah matters and advising Shari'ah department officers on the scope of the Shari'ah review are ranked in third and fourth place respectively, with corresponding mean scores of 4.50 and 4.38 and with 96% and 83% of the respondents expressing their agreement. As is apparent from the table, the mean score of these 4 elements of the Shari'ah advisory are not substantially different and, thus, show there is almost equal emphasis on the scope of Shari'ah advisory given by the Shari'ah board. That the scope of the Shari'ah advisory ranked second, third and fourth clearly indicates the direct advisory role of the Shari'ah board. Indeed, endorsing the Shari'ah compliance manual, which is ranked in first place, could also be similarly interpreted as agreeing with the advisory role of the Shari'ah board. This is due to the fact that, in this case, the Shari'ah board is required only to provide their approval of the Shari'ah manual already prepared by the management and, hence, could be considered as advisory in nature. As was discussed in Section 4.3.1 of Chapter Four, the literature has described advising on Shari'ah matters as one of the *ex ante* auditing functions of the Shari'ah board.

Meanwhile, reporting to the SAC on Shari'ah matters, providing training for Shari'ah department officers and preparing the Shari'ah compliance manual were ranked fifth, sixth and seventh respectively. Although respondents expressed some level of agreement with these three elements of the Shari'ah advisory, they were also highly weighted in the uncertainty and disagreement categories by some respondents. For example, when it comes to reporting to SAC on Shari'ah matters, 13% of the respondents expressed their disagreement while another 17% indicated uncertainty on whether this element of the Shari'ah advisory is being undertaken by their respective Shari'ah boards. It was mentioned in Chapter Four that the SAC serves as the regulator and the supreme authority on the Shari'ah governance system in the Malaysian Islamic banking industry. However, it is argued that the interaction between this authority and the Islamic banking institutions is merely on matters pertaining to the appointment of Shari'ah boards and giving approval to products and services these banks propose offering to the consumers. As a result, the respondents might find that the interaction between these two parties is confined to the said matters and it is not considered that further involvement is required from the Shari'ah board.

On the other hand, 29% of the respondents expressed their disagreement with the Shari'ah board providing training for the Shari'ah department officers while another 21% reported feeling uncertainty. These findings may be attributable to the fact that the

Shari'ah officers possess the required knowledge in the field of Shari'ah or *fiqh al-mua'malat* as reflected by the training received by the majority of the heads of Shari'ah departments, as shown in Table 6.2.3 above. It might also be due to this reason that the majority of the respondents (46% indicating disagreement and another 21% indicating uncertainty) rejected considering preparing the Shari'ah compliance manual as coming within the scope of Shari'ah advisory and as something that should be undertaken by the Shari'ah board, as this could be done by the management with the assistance of Shari'ah department officers who are knowledgeable in these two fields.

In addition, analysis by all the control variables produced no significant difference in response, and thus, is not reported here.

6.3.3 Involvement of Shari'ah Boards in the Corporate Objectives of the Banks

This study also examined the involvement of Shari'ah boards in advising and designing the corporate objectives of the banks by including other corporate objectives tested by Alhabshi and Bakar (2008) and discussed in Chapter Four, namely, the bank's objectives, the bank's corporate brand value, and the bank's long term strategic direction. Initial analysis of the findings of Shari'ah board involvement in the corporate objectives of the banks revealed that the responses provided by the heads of Shari'ah departments fall into all categories of agreement. Table 6.3.3 provides a detailed analysis of the results.

As is evident from Table 6.3.3, the majority of the respondents indicated that they disagreed with the involvement of the Shari'ah board in advising or designing the corporate objectives of their respective banks. Meanwhile, the percentages of the responses indicated that agreement falls below 40% across all listed corporate objectives. A similar low emphasis on a bank's strategic issues by the Shari'ah board was reported by Alhabshi and Bakar (2008). Alternatively, these results show that a bank's corporate objectives are mostly designed by the board of directors without the participation of Shari'ah board members. Although Section 6.3.2 revealed that Shari'ah board members were given priority in advising the board of directors on Shari'ah aspects (ranked second), strategic issues such as the corporate objectives listed above do not seem to have been given emphasis by Shari'ah board members. Additionally, this also indicates that Shari'ah board members' roles and functions tend to be limited to the traditional role pertaining to product and service development issues. When analyses by all control variables were conducted, they did not produce significant results and, thus, are not reported here.

Table 6.3.3: Analysis Showing Involvement of Shari'ah Boards in the Corporate Objectives of the Banks

Involvement of Shari'ah Boards in the Corporate Objectives of the Banks	Disagree		Uncertain		Agree		Total	
	No	***%***	***No***	***%***	***No***	***%***	***Mean***	***Rank***
The bank's mission	12	50.0	3	12.5	9	37.5	2.79	3
The bank's vision	12	50.0	4	16.7	8	33.3	2.75	6
The bank's goal	12	50.0	4	16.7	8	33.3	2.79	3
The bank's objective	11	45.8	4	16.7	9	37.5	2.88	2
The bank's corporate brand value	10	41.7	7	29.2	7	29.2	2.79	3
The bank's long-term strategic direction	9	37.5	7	29.2	8	33.3	3.00	1

6.3.4 Involvement of Shari'ah Boards in the Development of Islamic Banking Products and Services

In Chapter Four, it was discussed how developing Islamic banking products and services based on Shari'ah principles is integral to the function of the Shari'ah board. To ascertain the involvement of Shari'ah board members in this important role, the heads of Shari'ah departments were invited to indicate their stage of agreement on eight different stages of developing Shari'ah products and services. The findings of this analysis are presented in Table 6.3.4.

As is evident from the table, there are certain stages of development of Islamic banking product and services that seem to be given importance by Shari'ah board members as indicated by none or almost non-disagreement by the respondents. It was reported that none of the respondents disagreed with the involvement of Shari'ah board members during the conception stage and legal documentation stage whereas only one respondent disagreed with involvement during the review stage. As such, these three stages of development of products and services seem to receive full commitment by Shari'ah board members and highlight the crucial stages which require scholarly attention by Shari'ah board members. On the other hand, evidence of disagreement on other stages of development of products and services is surprising and raises concerns about the lack of attention by this Shari'ah governance authority. For example, respondents indicated high disagreement with the involvement of Shari'ah board members in the pricing, testing and marketing stages. Alternatively, these findings seem to indicate that these three stages of product development are being carried out by the management of the bank and not by Shari'ah board members. Earlier findings, which reveal that most of the heads of Shari'ah departments are trained in the field of Shari'ah or *fiqh al-mua'malat*, might suggest that Shari'ah board members relieve themselves from such responsibilities and delegate the responsibility to the secretariat (heads of Shari'ah departments) for further action.

Table 6.3.4: Analysis Showing Involvement of Shari'ah Boards in the Development of Islamic Banking Products and Services

Involvement of Shari'ah Boards in the Development of Islamic Banking Products and Services	Disagree		Uncertain		Agree		Total	
	No	***%***	***No***	***%***	***No***	***%***	***Mean***	***Rank***
Conception stage	0	.0	2	8.3	22	91.7	4.29	1
Design stage	5	20.8	6	25.0	13	54.2	3.42	4
Pricing stage	13	54.2	5	20.8	6	25.0	2.63	7
Legal Documentation stage	0	.0	4	16.7	20	83.3	4.21	2
Testing stage	17	70.8	5	20.8	2	8.3	2.17	8
Marketing stage	11	45.8	3	12.5	10	41.7	3.04	6
Implementation stage	7	29.2	7	29.2	10	41.7	3.08	5
Review stage	1	4.2	4	16.7	19	79.2	4.04	3

Moreover, the above results strengthen earlier findings that Shari'ah board members tend to confine themselves to their traditional role by only specifying the Shari'ah concepts to be applied to the products and services and drafting the contracts in the legal documentation stage, but not dealing with technical issues, such as pricing, testing, marketing or even designing those products and services.

In addition, analyses by control variables produced significantly different results for types of banks and bank's total assets. Table 6.3.5 below reports that analyses of responses by the types of banks provide significantly different results for the implementation stage with the p value of 0.026. The reported mean values in the table also show that the proportion of respondents from the full-fledged Islamic banks indicating their agreement on the involvement of the Shari'ah board during the implementation stage is higher than that from banks with an Islamic window. Hence, this finding indicates that Shari'ah board members from full-fledged Islamic banks give more emphasis than do their counterparts to ensuring that the products and services developed are implemented in accordance with decisions made in the earlier development stages.

Meanwhile, the analysis of responses by total assets reported in Table 6.3.6 indicated that the distribution of responses pertaining to the design stage and the pricing stage are significantly different with p values of 0.037 and 0.019 respectively. As is clearly indicated from the reported mean values in the table, the proportion of respondents from small banks indicating their agreement with the involvement of the Shari'ah board in both the design and the pricing stage is higher than the proportion of respondents from the medium and large banks. The design and pricing stages can be considered as important stages in developing Islamic banking products and services after ascertaining the Shari'ah concepts to be applied at the conception stage. Essentially, the bank would have to design the product according to the concept laid down in Shari'ah to ensure its legitimacy from the Islamic point of view as a mechanism to distinguish it from the products offered by the conventional banks. Equally important is ensuring that Islamic banking products and services offered by banks should not be seen as exploiting the consumers due to the unreasonable pricing offered to them. Because of these deemed Shari'ah concerns, the small banks reported a high involvement of Shari'ah board members during these two stages of product development. Furthermore, these significantly different results reported for small banks refer to banks with an Islamic window whose Shari'ah department has 1 to 2 officers only. This is due to the fact that banks with small total assets feature the characteristics of offering Islamic banking as an Islamic window (refer to Table 5.3) and of having 1 to 2 Shari'ah officers (refer to Table 6.2.5). In such circumstances, where the capacity of Shari'ah officers is regarded as weak, the involvement of Shari'ah board members during these stages seems inevitable. The utilization of the Shari'ah board during these stages could also be seen as a strategy for banks with an Islamic window to keep up with their counterparts, i.e., the full-fledged Islamic banks. On the other hand, the low responses from banks in the medium and large asset categories might be because Shari'ah board members have relieved themselves from such responsibilities, as these two categories of bank have the capability to undertake that task, as is shown by the high number of Shari'ah officers in the Shari'ah department (see Table 6.2.5).

Table 6.3.5: Analysis Showing Involvement of Shari'ah Boards in the Development of Islamic Banking Products and Services by Type of Bank

Involvement of Shari'ah Boards in the Development of Islamic Banking Products and Services	Full-fledged Islamic Banks				Banks with an Islamic Window				Sig.
	Disagree	*Uncertain*	*Agree*	*Mean*	*Disagree*	*Uncertain*	*Agree*	*Mean*	
	%	*%*	*%*		*%*	*%*	*%*		
Conception stage	.0	14.3	85.7	4.21	.0	.0	100.0	4.40	-
Design stage	28.6	28.6	42.9	3.21	10.0	20.0	70.0	3.70	-
Pricing stage	50.0	21.4	28.6	2.64	60.0	20.0	20.0	2.60	-
Legal documentation stage	.0	21.4	78.6	4.14	.0	10.0	90.0	4.30	-
Testing stage	57.1	28.6	14.3	2.43	90.0	10.0	.0	1.80	-
Marketing stage	28.6	14.3	57.1	3.43	70.0	10.0	20.0	2.50	-
Implementation stage	14.3	28.6	57.1	3.57	50.0	30.0	20.0	2.40	*0.026
Review stage	.0	14.3	85.7	4.21	10.0	20.0	70.0	3.80	-

*Indicates distribution of responses between the two categories of bank types is statistically significantly different using the Mann Whitney U test

Table 6.3.6: Analysis Showing Involvement of Shari'ah Boards in the Development of Islamic Banking Products and Services by Total Assets

Involvement of Shari'ah Boards in the Development of Islamic Banking Products and Services	Total Assets by Category												Sig
	Small (Less than RM1,000 million assets)				Medium (RM1,000 million to RM10,000 million assets)				Large (More than RM10,000 million assets)				
	Disagree	*Uncertain*	*Agree*	*Total*	*Disagree*	*Uncertain*	*Agree*	*Total*	*Disagree*	*Uncertain*	*Agree*	*Total*	
	%	*%*	*%*	*Mean*	*%*	*%*	*%*	*Mean*	*%*	*%*	*%*	*Mean*	
Conception stage	0	0	100.0	4.25	0	18.2	81.8	4.17	0	0	100.0	4.5	-
Design stage	0	0	100.0	4.25	27.3	45.5	27.3	2.92	12.5	12.5	75.0	3.75	*0.037
Pricing stage	25.0	25.0	50.0	3.5	81.8	18.2	0	2.00	25.0	25.0	50.0	3.13	*0.019
Legal documentation stage	0	0	100.0	4.25	0	18.2	81.8	4.25	0	25.0	75.0	4.13	-
Testing stage	100.0	0	0	1.75	72.7	27.3	0	2.00	50.0	25.0	25.0	2.63	-
Marketing stage	75.0	0	25.0	2.75	45.5	18.2	36.4	2.83	25.0	12.5	62.5	3.5	-
Implementation stage	50.0	25.0	25.0	2.5	36.4	27.3	36.4	2.75	0	37.5	62.5	3.88	-
Review stage	0	0	100.0	4.25	0	27.3	72.7	3.83	0	12.5	87.5	4.25	-

*Indicates distribution of responses between the three categories of total assets is statistically significantly different using the Kruskal-Wallis H test

6.3.5 Involvement of Shari'ah Boards in the Accounting Issues

It was highlighted in Chapter Four that the role and function of Shari'ah board members' include issues relating to the accounting aspects of the Islamic banking operation. In this regard, the heads of Shari'ah departments were invited to indicate their agreement with the involvement of the Shari'ah board of their respective banks in important accounting issues pertaining to the Islamic banking operation. The findings from the analyses are provided in Table 6.3.7 below.

Table 6.3.7: Analysis Showing Involvement of Shari'ah Boards in the Accounting Issues of the Bank

Involvement of Shari'ah Boards in the Accounting Issues	Disagree		Uncertain		Agree		Overall	
	No	***%***	***No***	***%***	***No***	***%***	***Mean***	***Rank***
Determine profit distribution formula	9	37.5	7	29.2	8	33.3	3.00	7
Approve calculation & distribution of *zakat*	2	8.3	2	8.3	20	83.3	4.12	2
Approve accounting policy	7	29.2	8	33.3	9	37.5	3.25	6
Validate documents in contracts	0	.0	4	16.7	20	83.3	4.37	1
Validate transaction records	5	20.8	6	25.0	13	54.2	3.42	5
Issue Shari'ah report	5	20.8	6	25.0	13	54.2	3.54	4
Endorse annual report	3	12.5	3	12.5	18	75.0	4.12	2

As is evident from the table, involvement by Shari'ah board members was highest for accounting issues pertaining to validating the documentation on Islamic financing contracts, with a reported mean value of 4.37. Indeed, validating the documentation on Islamic financing contracts would correspond to the vital stage of ensuring the source documents detailing business transactions between the bank and its customers accurately stipulated the terms and conditions underlying the Islamic financial contract in accordance with the Shari'ah concept applied. Another example where validating documents in Islamic financial contracts is deemed important by the Shari'ah board is ensuring that ownership of assets has been rightly assigned between the contracting parties. It is argued that the issue of asset ownership has important repercussions for the transaction's legality from an Islamic point of view, which will determine whether the bank could recognize the income derived from the transaction.

Meanwhile, accounting issues pertaining to approving the calculation and distribution of *zakat* and endorsing the annual report both scored a mean value of 4.12 and shared the second position. It is worth noting that *zakat* has direct links with the Islamic Shari'ah as it is one of the pillars of Islam. Therefore, the high Shari'ah board involvement in the issue of *zakat* is seen as ensuring that this important Islamic practice on the part of the bank on behalf of the shareholders is appropriately upheld. On the other hand, the high Shari'ah board involvement on endorsing the annual report could be associated with the need to ensure that any income derived from non-Shari'ah activities has been appropriately channelled to charity organisations and not recognized as profit to the bank and, therefore, only the bank's legitimate profit is reported.

The next accounting issue deemed important to Shari'ah board members is producing the Shari'ah compliance report, which had a mean score of 3.54. This is followed by validating transaction records (mean value of 3.42), approving accounting policy (mean value of 3.25) and, finally, determining the profit distribution formula (mean value of 3.00). It can be seen from Table 6.3.7 that respondents showed surprisingly high levels of disagreement with Shari'ah board involvement in these four accounting issues. For example, 20.8% of the respondents indicated their disagreement with the Shari'ah board's involvement in producing the Shari'ah compliance report despite its significance in giving assurance of the ethicality of the Islamic banking operation and in assisting the decision making of the investors (see for example Briston and El-Ashker 1986; Tomkins and Karim 1987; Karim 1990b; Karim 1990a; Rammal 2006; Laldin 2008a). A similar percentage of disagreement was reported for the Shari'ah board's involvement in validating transaction records although such auditing practices are deemed to have an importance similar to that of validating the documentary records discussed above, albeit more specifically regarding the accounting transactions between the bank and its customers. Approving accounting policy and determining the formula for profit distribution were both responded to with higher levels of disagreement by the respondents (29.2% and 37.5% respectively). This is despite the call for the Shari'ah board's involvement in such issues (see for example Tomkins and Karim 1987; Karim 1990a; Abdallah 1994; Karim 1996) and the recommendation put forward by AAOIFI.

The above findings provide evidence of minimal and selective involvement of the Shari'ah board in the accounting-related issues of Islamic banking activities. Shari'ah board members seem to show particular concern for accounting issues relating to validating the documentation of Islamic banking contracts, approving the calculation and distribution of *zakat* and endorsing the annual report. On the other hand, other accounting issues seem to be given less emphasis, as they might be delegated to the Shari'ah officers in the bank or handled at the discretion of the management. These findings could have resulted from the lack of accounting skills amongst Shari'ah board members. The fact that the standards and guidelines issued by the regulators (for example, AAOIFI and BNM) emphasised the need for experts in the Islamic commercial law or *fiqh al-mua'malat* to hold membership in this Shari'ah governance authority has resulted in there being a lack of appropriately qualified people in the accounting aspects of Islamic banking operations.

Additionally, analyses using the control variables did not product significant differences in responses regarding the involvement of the Shari'ah board in the accounting issues of the bank, and thus they are not reported here.

6.3.6 Relevant Parties Assisting the Shari'ah Governance Function of Shari'ah Boards

The Shari'ah board is the Shari'ah governance mechanism that is external to the bank and is responsible for overseeing the Shari'ah aspects of the Islamic banking operation. It was discussed in Chapter Four that in performing its roles and functions, the Shari'ah board should receive assistance from several relevant parties within the bank. In this regard, the respondents were invited to indicate their agreement with the relevant parties whom they perceive provide assistance on the important role and functions of this Shari'ah governance authority. Table 6.3.8 below presents the analysis of the findings.

Table 6.3.8: Analysis Showing the Relevant Parties Assisting Shari'ah Boards

Relevant Parties Assisting Shari'ah Boards	Disagree		Uncertain		Agree		Total		Overall	
	No	*%*	*No*	*%*	*No*	*%*	*No*	*%*	*Mean*	*Rank*
Shari'ah department	0	.0	1	4.2	23	95.8	24	100.0	4.71	1
Audit committee	6	25.0	9	37.5	9	37.5	24	100.0	3.13	7
Internal auditor	4	16.7	8	33.3	12	50.0	24	100.0	3.42	4
External auditor	7	29.2	9	37.5	8	33.3	24	100.0	3.00	8
Board of directors	4	16.7	3	12.5	17	70.8	24	100.0	3.63	3
Management	2	8.3	0	.0	22	91.7	24	100.0	4.29	2
'Shared services'	6	25.0	8	33.3	10	41.7	24	100.0	3.17	6
Consultants	7	29.2	6	25.0	11	45.8	24	100.0	3.21	5

It can be observed from the table that the Shari'ah department officers provide the highest assistance to the Shari'ah board, with a reported mean value of 4.71. The second highest assistance was reported to be from the management, as indicated by a mean value of 4.29. In order of highest assistance received, this is followed by the board of directors (mean value of 3.63), internal auditor (mean value of 3.42), consultants (mean value of 3.21), shared services (mean value of 3.17), audit committee (mean value of 3.13) and external auditor (mean value of 3.00).

The above results provide evidence of the crucial role of the Shari'ah department officers and the management in assisting Shari'ah board members to execute their ethical role in ensuring the Shari'ah adherence of banks offering Islamic banking activities. In other words, the support from these two parties is regarded as essential in order for Shari'ah board members to perform their role and functions. These findings could also shed light on the effectiveness of the Shari'ah governance mechanism amongst banks participating in the MIFC. Since the assistance of the Shari'ah department officers has been found to be crucial, the size of the department could reflect the effectiveness of the Shari'ah governance mechanism within each bank that offers Islamic banking products and services. The larger the size of the Shari'ah department, in terms of the number of Shari'ah officers, the more effective the Shari'ah governance mechanism is expected to be. However, it is important for Shari'ah board members to draw a line regarding the involvement of the Shari'ah department officers and the management so that the Shari'ah decisions made by them are not be influenced by an over reliance on the latter.

Table 6.3.8 also reveals the importance of the board of directors to the Shari'ah governance of Islamic banks. Indeed, this finding on the support of the board of directors to the Shari'ah board could highlight the effectiveness of the Shari'ah governance mechanism among the participating members of the MIFC. This is because the results seem not to indicate any communication gap that might hinder the Shari'ah board from providing Shari'ah advice to the board of directors. As such, the agency cost and opportunistic behaviour of the management, discussed under the agency theory, can be checked by these two governance mechanisms, i.e., the board of directors and the Shari'ah board.

Meanwhile, other parties, namely, the internal auditor, consultants, shared services, audit committee and external auditor, scored 50% or below in terms of the assistance they provide to the role and function of the Shari'ah board. These results indicate that the support for the Shari'ah governance function of the Shari'ah board appeared to be incomprehensive and was limited to internal parties which have a direct association with the role of the Shari'ah board, as was discussed above regarding the Shari'ah department officers, the management, and the board of directors. A similar communication gap between the Shari'ah board and the audit committee, internal auditor and external auditor was reported by Alhabshi and Bakar (2008) in the various countries that offer Islamic banking that they surveyed, including Malaysia. As such, it seems that when the support of other relevant parties in the Shari'ah governance mechanism of the Islamic banking operation is studied across the Islamic banking operations in Malaysia, the involvement of these supporting parties appears to be weak and insufficient.

When analysis by control variables was conducted, no significant results were produced except for the control variable total assets. Analysis by total assets using the Kruskal-Wallis H test produced a significant result for the external auditor, with a p value of 0.015, as indicated in the test statistic results in Table 6.3.9 below. This finding indicates that the assistance of the external auditor is more apparent for large banks than for medium or small banks. Indeed, the AAOIFI in its governance standard recommends that the Shari'ah board coordinates and consults with the external auditor during the important stage of the Shari'ah review (AAOIFI 1998 para. 12). Hence, the cooperation which is evident between the Shari'ah board and the external auditor could suggest that a proper governance mechanism has been established, albeit for large-sized Islamic banking institutions only.

Table 6.3.9: Analysis Showing the Relevant Parties Assisting Shari'ah Boards by Total Assets

Relevant Parties Assisting Shari'ah Boards	Total Assets by Category												Sig.
	Small (Less than RM1,000 million assets)				Medium (between RM1,000 million to RM10,000 million assets)				Large (More than RM10,000 million assets)				
	Disagree	*Uncertain*	*Agree*	*Total*	*Disagree*	*Uncertain*	*Agree*	*Total*	*Disagree*	*Uncertain*	*Agree*	*Total*	
	%	*%*	*%*	*Mean*	*%*	*%*	*%*	*Mean*	*%*	*%*	*%*	*Mean*	
Shari'ah department	.0	.0	100.0	4.25	.0	8.3	91.7	4.75	.0	.0	100.0	4.88	-
Audit committee	50.0	25.0	25.0	2.50	33.3	50.0	16.7	2.92	.0	25.0	75.0	3.75	-
Internal auditor	25.0	25.0	50.0	3.00	25.0	41.7	33.3	3.17	.0	25.0	75.0	4.00	-
External auditor	50.0	50.0	.0	2.25	41.7	41.7	16.7	2.75	.0	25.0	75.0	3.75	*.015
Board of directors	25.0	.0	75.0	3.25	25.0	16.7	58.3	3.50	.0	12.5	87.5	4.00	-
Management	.0	.0	100.0	4.25	16.7	.0	83.3	4.00	.0	.0	100.0	4.75	-
'Shared services'	25.0	.0	75.0	3.25	41.7	41.7	16.7	2.75	.0	37.5	62.5	3.75	-
Consultants	50.0	25.0	25.0	2.50	33.3	33.3	33.3	3.17	12.5	12.5	75.0	3.63	-

*Indicates distribution of responses is statistically different between the three category of total assets using the Kruskal-Wallis H test

6.3.7 Commitments of Shari'ah Board Members

This study also evaluates the Shari'ah board members' commitments to strengthening the Shari'ah governance of their respective banks as has been recommended by the regulatory bodies, namely, AAOIFI and IFSB. Respondents were invited to indicate their agreement on a five-point Likert scale ranging from 1 (strongly disagree) to 5 (strongly agree). Table 6.3.10 and Table 6.3.11 below present an analysis of the findings.

As is evident in Table 6.3.10, most of the respondents indicated agreement with Shari'ah board members' commitment to strengthening the Shari'ah governance practice of their respective banks, although there is also some evidence of disagreement and uncertainty in their responses. The percentage of the agreement response is highest for Shari'ah board members' commitment to engaging themselves in workshops and meetings of scholars of *fiqh al-mua'malat* to promote consistency in Islamic banking products and services, with a mean value of 4.21; 83.3% of the respondents reported their agreement with Shari'ah board members undertaking this commitment. Such practices indicate the prevailing concern amongst Shari'ah board members of banks participating in the MIFC about standardizing Islamic banking products and services. The fact that there are many banks participating in the MIFC increases the possibility of there being diverse Islamic banking products and services that could trigger difficulties associated with a lack of standardization and consistency. However, the results derived from this study indicate a positive concerted mechanism under the ambit of a dual-layer Shari'ah governance system implemented in Malaysia towards the harmonization of Islamic banking practices. In addition, this governance commitment could be a platform for banks new to the Islamic banking industry as well as for new Shari'ah board members to be on a par with other established banks by giving and sharing relevant knowledge pertaining to contemporary Islamic financing products and services and the issues surrounding them.

The following concern amongst Shari'ah board members as indicated by the mean value of responses received pertains to undertaking commitments regarding (1) analysing whether Islamic banking products and services would deliver benefit to the *ummah* before they are launched (mean value of 4.13), and (2) enhancing Shari'ah review skills by attending appropriate training for the Shari'ah board's continuous professional development (mean value of 4.04). These two commitments were reported as having an equal percentage of agreement, i.e., 79.2%, for Shari'ah board members' involvement in undertaking such responsibilities. Laldin (2008a) asserts that Shari'ah board members should ascertain that the design of the Islamic banking products and services would deliver benefit to the *ummah* and not merely be a means to achieve ends forbidden by Shari'ah. This study provides evidence that Laldin's (2008a) concern for quality Islamic banking products and services has been on the agenda amongst Shari'ah board members of the Malaysian Islamic banking industry. Shari'ah board members also seem to give equal importance to enhancing their Shari'ah review skills by attending the necessary training. It was mentioned in Chapter Four that the modern Islamic banking business calls for Shari'ah board members to be well versed in the Islamic *fiqh al-mua'malat* and accounting and finance knowledge (Gambling et al. 1993; Grais and Pellegrini 2006; Laldin 2008b). It has been recognized that the Islamic banking industry is facing challenges regarding the shortage of competent scholars who possess the expertise to lead as the Shari'ah governance authority within banks that offer Islamic banking products and services. However, the development indicated by this study is that Shari'ah board members taking seriously their role in empowering their Shari'ah review skills represents constructive evidence regarding Shari'ah board members' initiative to enhance their competency level.

Next, Shari'ah board members' commitment to (1) engaging in the innovation of Islamic banking products and services, and (2) responding to the questions pertaining to pronouncements and resolutions issued by the Shari'ah board through discussion with the shareholders and the public, were both revealed to have a similar mean value of 3.50 and, therefore, are deemed to be given equal importance by Shari'ah boards. Table 6.3.10 presents evidence that 62.5% of the respondents indicated their agreement with Shari'ah board members' former commitment while 54.2% indicated their agreement with Shari'ah board members' latter commitment. It was discussed earlier that Shari'ah board members are responsible for developing contracts on Islamic financial products and services based on Shari'ah principles. Such a responsibility requires Shari'ah board members to consult and deliberate the Shari'ah issues with various parties within the bank. The finding of this study illustrates that the majority of Shari'ah board members give a positive commitment to making Islamic banking more progressive through efforts at innovation and through streamlining the concepts required for this purpose with other relevant parties within the bank. However, there are few banks whose Shari'ah board members were indicated not to be involved in such a commitment. Table 6.3.10 shows that one quarter of the respondents (25%), which corresponds to six banks, indicated their disagreement with their respective Shari'ah board members undertaking the innovation commitment mentioned. Hence, it could be suggested that although Shari'ah board members in the majority of the banks showed an interest in applying Shari'ah concepts in search of new Islamic banking products and services, as indicated by their commitment to innovation, there are banks which might be lagging behind, presumably due to the conservative ideology of Shari'ah board members who refuse to expand beyond the traditional Islamic finance contracts.

Finally, the Shari'ah board's commitments to publishing to the public their Shari'ah resolutions and rulings and the mechanics of Shari'ah compliance as applied in their Islamic bank reported the lowest mean value of 2.83. Indeed, Table 6.3.10 shows that 50.0% of the respondents indicated their disagreement with the Shari'ah board's commitment to this task. In Chapter Four, it was discussed that Shari'ah board members hold a social responsibility by educating the public about the features of Islamic banking and enjoining Muslims to subscribe to this form of banking as it is in keeping with the injunctions of the Shari'ah (Laldin 2008a). Similarly, AAOIFI has put forward its recommendation for the pronouncements and resolutions of Shari'ah board members to be disclosed in the Shari'ah report they issue to enhance the transparency of the Islamic banking practices in the bank (see for example AAOIFI 1998 para. 25-26). The finding of this study on this issue might indicate Shari'ah boards' difficulties in undertaking this commitment at the expense of stakeholders' interests. Alternatively, this finding could also raise the concern of whether the Shari'ah board or the management of the bank are being transparent on the Shari'ah issues surrounding the Islamic banking practices of the bank. Notwithstanding these possibilities, there is a need for the policy maker to develop a mechanism that could enhance the transparency of the Islamic banking practices, which would further increase the confidence of the stakeholders in this banking industry.

Analyses by control variables did not produce significant differences except when analysed by the number of years banks have been offering Islamic banking products and services. As is evident from Table 6.3.11, the Kruskal Wallis H test produced a significant result for Shari'ah board members' commitment to engaging in workshops and meetings of scholars of *fiqh al-mua'malat* to promote consistency in Islamic banking products and services for banks who have been offering Islamic banking business between 6-10 years, with a p value of 0.026. Specifically, this Islamic banking experience category refers to five banks, who all shared the same responses of strong agreement, as can be observed from the mean value of 5 in Table 6.3.11. In other words, all the respondents in this category of Islamic banking business experience recognized that the Shari'ah board members of their respective banks gave full commitment to workshops and meetings to promote consistency in Islamic banking practices. Additionally, this particular range of Islamic banking business experience could be considered as one stage between the early and the established level of experience. It can be suggested that in the early stage of Islamic bank's establishment, the Shari'ah board, together with the management of the bank, would be focusing on developing the Islamic financial products and services to be offered to the customers. At the other extreme, banks in the 'established' stage might find it challenging to innovate and introduce new Islamic financial products and services to the market. Hence, the period between 6-10 years after the establishment of the bank could be suggested as the stage where Shari'ah board members would attempt to find their footing within the industry by aligning the products and services offered by their respective banks with that of other banks through engagement in workshops and meetings of scholars of *fiqh al-mua'malat* in search of consistency of Islamic banking practices across the industry.

Table 6.3.10: Analysis Showing Commitments of Shari'ah Board Members

Commitments of Shari'ah Board Members	Disagree		Uncertain		Agree		Total		Overall
	No	***%***	***No***	***%***	***No***	***%***	***No***	***%***	***Mean***
Publish resolutions to the public	12	50.0	4	16.7	8	33.3	24	100.0	2.83
Engage in innovation of IB products & services	6	25.0	3	12.5	15	62.5	24	100.0	3.50
Engage in effort on promoting consistency of IB products & services	1	4.2	3	12.5	20	83.3	24	100.0	4.21
Analyze how IB products & services would benefit *ummah* before they are launched	0	.0	5	20.8	19	79.2	24	100.0	4.13
Enhance Shari'ah review skills by attending training	1	4.2	4	16.7	19	79.2	24	100.0	4.04
Respond to questions through discussions with the shareholders & the public	4	16.7	7	29.2	13	54.2	24	100.0	3.50

Table 6.3.11: Analysis Showing Commitments of Shari'ah Board Members by the Number of Years Banks have been Offering Islamic Banking (IB)

Commitments of Shari'ah Board Members	Number of Years Bank have been Offering IB									
	0-5 Years		6-10 Years		11-15 Years		16 Years and above		Overall	
	No	*Mean*	*No*	*Mean*	*No*	*Mean*	*No*	*Mean*	*Total*	*Sig.*
Publish resolutions to the public	13	2.7	5	3.2	0	0.0	6	2.8	24	-
Engage in innovation of IB products & services	13	3.5	5	3.8	0	0.0	6	3.3	24	-
Promote consistency of IB products & services	13	3.8	5	5.0	0	0.0	6	4.3	24	*0.026
Analyze how IB products & Services would benefit *ummah* before they are launched	13	4.2	5	4.2	0	0.0	6	4.0	24	-
Enhance Shari'ah review skills by attending training	13	3.8	5	4.4	0	0.0	6	4.3	24	-
Respond to questions through discussions with the shareholders & the public	13	3.2	5	4.2	0	0.0	6	3.7	24	-

* Indicates distribution of responses is statistically different between the four categories of number of years banks offer Islamic banking products and services using the Kruskal-Wallis H test

6.4 Accountability and Independence of Shari'ah Boards

This section analyzes frequently debated issues surrounding the Shari'ah governance function of the Shari'ah board, namely, the accountability and independence of the Shari'ah board. In this section, there are four subsections on the issues of the accountability and independence of the Shari'ah board. The first two subsections cover an analysis of the factors influencing the Shari'ah board's accountability and independence respectively. These are followed by a subsection on the analysis of the relevant parties to whom Shari'ah board members are deemed accountable. The last part covers an analysis of the nature of Shari'ah board appointments and mandated authority.

6.4.1 Factors Influencing Accountability

The respondents were invited to provide their feedback on the ethical issues pertaining to the accountability of Shari'ah board members. They were asked to indicate the level of importance on a scale that ranged from very unimportant (1) to very important (5) on five crucial factors that are believed to influence the accountability of Shari'ah board members. Table 6.4.1 provides an analysis of the findings on the level of importance of the factors influencing the accountability of Shari'ah board members.

It can be observed from Table 6.4.1 below that none of the respondents provided feedback in the 'unimportant' category. Thus, all the factors listed as influencing the accountability of Shari'ah board members are deemed relevant and important. An analysis based on the mean value of the responses revealed that the Shari'ah board's ethical value and the Shari'ah board's reputation shared the highest mean value of 4.75 and were similarly ranked first as the factors influencing the Shari'ah board's accountability. In order of importance, this is followed by the Shari'ah board's scholarly background, with a mean score value of 4.71 (ranked third); the requirement for the Shari'ah board to ensure the Shari'ah compliance of the bank, with a mean score value of 4.63 (ranked fourth); and the stakeholders' reliance on the Shari'ah review of the Shari'ah board factors, with a mean score value of 4.50 (ranked fifth).

Table 6.4.1: Analysis Showing the Importance of the Factors Influencing Accountability of Shari'ah Boards Members

Factors Influencing Accountability of Shari'ah Board Members	Unimportant		Uncertain		Important		Total		Overall	
	No	*%*	*No*	*%*	*No*	*%*	*No*	*%*	*Mean*	*Rank*
Shari'ah board's ethical value	0	.0	0	.0	24	100.0	24	100.0	4.75	1
Shari'ah board's scholarly background	0	.0	0	.0	24	100.0	24	100.0	4.71	3
Shari'ah board's reputation	0	.0	1	4.2	23	95.8	24	100.0	4.75	1
Stakeholders' reliance on Shari'ah board	0	.0	2	8.3	22	91.7	24	100.0	4.50	5
Shari'ah board's requirement to ensure Shari'ah compliance	0	.0	2	8.3	22	91.7	24	100.0	4.63	4

When the first three factors considered as most important by respondents, i.e., the Shari'ah board's ethical value, the Shari'ah board's reputation, and the scholarly background of the Shari'ah board, were further analysed, it seemed that they represented the factors pertaining to the personal integrity of individual members of the Shari'ah board. On the other hand, the last two factors, i.e., the requirement for the Shari'ah board to ensure the Shari'ah compliance of the bank and the stakeholders' reliance on the Shari'ah review of the Shari'ah board, could be considered as factors pertaining to the fiduciary duties of Shari'ah board members. Hence, it seems that the respondents believed that personal integrity rather than fiduciary duties is the most important factor influencing the accountability of Shari'ah board members. Indeed, the importance of good personal integrity and its association with high accountability amongst Shari'ah board members is consistent with the arguments raised by various studies (see for example Karim 1990a; Kahf 2002; Laldin 2008a), as was discussed in Chapter Four.

The only control variable that was found to produce significantly different results is total assets. As is evident from Table 6.4.2 below, the Kruskal-Wallis H test results are significantly different for the Shari'ah board's ethical value factor, with a p value of 0.033. It can be seen from Table 6.4.2 that the mean values for banks in the medium-sized and large categories are 4.9 and 4.8 respectively. These mean values are relatively higher than the mean value for banks in the small category, i.e., 4.3. In other words, the respondents in the medium-sized and large banks felt more strongly that the Shari'ah board's ethical value was a very important factor in influencing the Shari'ah board's accountability than did respondents in small banks. This suggests that as the size of the banks increases, so does the importance of Shari'ah board members being faithful to their ethical values when undertaking their roles and functions. This finding illustrates how the integrity of the Shari'ah governance authority is crucial for the success of financial institutions whose establishment and operations are based on ethical values. In addition, this finding lends support to the need for Shari'ah boards, as the Shari'ah governance authority, to be regulated in order for this alternative ethical banking to avoid a financial crisis similar to that suffered by the western financial system, as a result of proper monitoring and regulation from the authority.

Table 6.4.2: Analysis Showing the Factors Influencing Accountability of Shari'ah Board Members by Total Assets

Factors Influencing Accountability of Shari'ah Board Members	Total Assets by Category												Sig.
	Small (Less than RM1,000 million assets)				Medium (between RM1,000 million to RM10,000 million assets)				Large (More than RM10,000 million assets)				
	Unimportant	*Uncertain*	*Important*	*Total*	*Unimportant*	*Uncertain*	*Important*	*Total*	*Unimportant*	*Uncertain*	*Important*	*Total*	
	%	*%*	*%*	*Mean*	*%*	*%*	*%*	*Mean*	*%*	*%*	*%*	*Mean*	
Shari'ah board's ethical value	.0	.0	100.0	4.30	.0	.0	100.0	4.90	.0	.0	100.0	4.80	*0.033
Shari'ah board's scholarly background	.0	.0	100.0	4.50	.0	.0	100.0	4.70	.0	.0	100.0	4.80	-
Shari'ah board's reputation	.0	25.0	75.0	4.30	.0	.0	100.0	4.80	.0	.0	100.0	4.90	-
Stakeholders' reliance on Shari'ah board	.0	.0	100.0	4.30	.0	8.3	91.7	4.60	.0	12.5	87.5	4.40	-
Shari'ah board's requirement to ensure Shari'ah compliance	.0	.0	100.0	4.80	.0	8.3	91.7	4.60	.0	12.5	87.5	4.50	-
* Indicates distribution of responses is statistically different between the three categories of total assets using the Kruskal-Wallis H test													

6.4.2 Factors Influencing Independence

It was discussed in Chapter Four that Shari'ah board members are expected to be independent if the oversight function on the Islamic banks is to be effectively carried out. In this regard, this study investigated the factors considered important by the respondents as influencing the independence of Shari'ah board members. Table 6.4.3 and Table 6.4.4 below provide an analysis of the findings on the subject of Shari'ah boards' independence.

Table 6.4.3: Analysis Showing the Importance of the Factors Influencing Independence of Shari'ah Board Members

Factors Influencing Independence of Shari'ah Board Members	Unimportant		Uncertain		Important		Total		Overall	
	No	*%*	*No*	*%*	*No*	*%*	*No*	*%*	*Mean*	*Rank*
A clearly defined scope of responsibility	0	.0	0	.0	24	100.0	24	100.0	4.71	1
The remuneration received	5	20.8	4	16.7	15	62.5	24	100.0	3.5	7
The scholarly background	0	.0	1	4.2	23	95.8	24	100.0	4.58	3
The perceived high ethical status	0	.0	1	4.2	23	95.8	24	100.0	4.63	2
Adequate powers being mandated	0	.0	1	4.2	23	95.8	24	100.0	4.5	4
Participation of top management in the Shari'ah board's meeting	5	20.8	2	8.3	17	70.8	24	100.0	3.83	6
Involvement of the Shari'ah board as Shari'ah board members in other industries	3	12.5	4	16.7	17	70.8	24	100.0	3.87	5

In Table 6.4.3, the feedback on the respondents' perceived importance of factors identified as influencing the independence of Shari'ah board members is given. The table also presents the mean value of the responses for each identified factor; this was then used as a basis to rank them in order of importance. Several observations could be made from the analysis shown in Table 6.4.3. First, there are four factors with mean values exceeding 4.0, indicating that they were perceived as being very important in influencing the independence of Shari'ah board members. In order of importance, these factors are the Shari'ah board's clearly defined scope of responsibilities (mean value of 4.71), the perceived high ethical status of the Shari'ah board (mean value of 4.63), the scholarly background of the Shari'ah board (mean value of 4.58), and adequate powers being mandated to the Shari'ah board (mean value of 4.50). Second, the table also highlights that none of the respondents perceived any of these four factors as unimportant, albeit there is some evidence of respondents indicating uncertainty about their influence on the independence of Shari'ah board members. This implies that these factors are crucial in determining the independence of Shari'ah board members and that their non-observance could lead to questions being raised about the independence of this Shari'ah governance authority. Third, the three remaining identified factors received mixed feedback from respondents regarding their perceived importance in influencing the independence of Shari'ah board members. The involvement of Shari'ah board members in the Shari'ah Committee in other industries (mean value of 3.87), the participation of top management in the Shari'ah board's meetings (mean value of 3.83), and the remuneration received by the Shari'ah board (mean value of 3.50) were ranked fifth, sixth and seventh respectively in importance as influencing the independence of Shari'ah board members. Nevertheless, these factors were not perceived as being of absolute importance, as they were also regarded by some respondents as unimportant, as is seen in Table 6.4.3.

The existence of a clearly defined scope of responsibilities, which is ranked first in importance and regarded as important by all respondents, would serve as a term of reference and a guideline for Shari'ah boards when undertaking their roles and functions. It can also be used to specify the accountability of Shari'ah boards as well as other relevant parties within the Shari'ah governance framework (SGF) thereby enabling them to become liable for the success of each party's task accomplishment. Indeed, the need for a clearly defined scope of responsibilities as a mechanism to ensure the independence of the Shari'ah board is consistent with the requirement put forward by the regulatory bodies of the Islamic banking industry (AAOIFI 1997, 1998; BNM 2004; IFSB 2009). A clearly defined scope of responsibilities might have been undermined in previous studies investigating the factors influencing the independence of Shari'ah board members; however, it is highlighted as an important factor in this study. It would also be intriguing to find out whether the banks as well as Shari'ah board members themselves are being transparent in disclosing the responsibilities of the Shari'ah board to the stakeholders of the Islamic banking industry. This finding suggests that, in the absence of this important independence tool, it would be difficult to hold the Shari'ah board accountable for any negligence or breach of duty on their part.

Meanwhile, the perceived high ethical status of Shari'ah board members and the scholarly background of Shari'ah board members, which were ranked second and third respectively, reflect the importance of the personal integrity of Shari'ah board members in the independence of their Shari'ah governance function. In influencing the independence of Shari'ah board members, both factors were perceived as important by 95.8% of the respondents. Additionally, it is worth noting that Abdul Rahman et al. (2005) found these two factors as highly important in increasing the independence of Shari'ah board members. It was mentioned in Chapter Four that Karim (1990a) asserted that the independence of the Shari'ah board should be viewed from the ethical perspective whereby Shari'ah board members are expected to be committed to their moral beliefs and Islamic precepts as reflected in their educational background. Hence, the evidence found on these two factors supports the argument put forward by Karim (1990a) in which it is important for Shari'ah board members to present a good character and to practice their faith in accordance with their Shari'ah educational background and high ethical position, as how they are perceived determines their independence. These findings also highlight the importance of establishing a mechanism whereby a continuous performance appraisal of Shari'ah board members could be conducted which would be used in determining their contract renewal. It is also high time for the regulators to establish certain guidelines that would serve as a code of conduct for Shari'ah board members similar to those available to other professionals, such as accountants.

On the other hand, adequate powers being mandated to Shari'ah board members, which is ranked fourth, was similarly perceived as important by 95.8%. Indeed, the importance perceived by the respondents on this issue is consistent with the recommendation forwarded by IFSB (IFSB 2009 principle 1.2). However, it would be is interesting to find out whether the considerably high percentage of importance given by the respondents to this factor is an indication that the present level of authority awarded to Shari'ah board members is not sufficient for them to carry out their Shari'ah governance function. If this were the case, it would mean that there is a gap between the roles and functions of Shari'ah board members as stipulated in the present guidelines issued by the regulator (for example, the GPS1 issued by BNM) and the present governance role carried out by Shari'ah board members. In such circumstances, the policy maker would have to review the existing guidelines and make the necessary amendments in order to ensure that the present scope of the Shari'ah governance function of Shari'ah boards has been taken into account and stipulated in the guidelines.

Although the factors that ranked fifth, sixth and seventh, i.e., involvement of the Shari'ah board as the Shari'ah Committee in other industries, the participation of top management in the Shari'ah board's meeting, and the remuneration received by the Shari'ah board, received a mixed perception of their importance from the respondents, this also highlights several issues. For example, the factor of the involvement of Shari'ah board members in Shari'ah Committees in other industries was perceived by 70.8% of the respondents as important in influencing the independence of Shari'ah board members. In Chapter Four, it was discussed that a lack of competent scholars has resulted in Shari'ah scholars holding Shari'ah board membership in various banks, which could potentially lead to problems associated with Shari'ah review quality (see for example Antonio 2008) and the independence of Shari'ah board members (see for example Grais and Pellegrini 2006; Alhabshi and Bakar 2008). In order to tackle the placement of Shari'ah board members in multiple banks, the Malaysian regulator has imposed limitations on the membership of the Shari'ah board to only one bank within the same industry (BNM 2004). However, the evidence derived from this study suggests that the representation of Shari'ah board members even from a different industry (for example, the *Takaful* or Islamic insurance industry) is important in influencing the independence of Shari'ah board members. Hence, the present restriction imposed by BNM for Shari'ah board members to hold a position in just one bank within the same industry but not in another industry seems to have the potential of jeopardising the independence of Shari'ah board members. Although this finding calls for the regulator to review existing policy regarding the membership of the scholars in the Shari'ah board within the same or different industries, it also highlights the need to produce more competent scholars to serve the Islamic financial services industry as a whole.

Meanwhile, the factor of the participation of the top management in the Shari'ah board's meeting was similarly perceived as important by 70.8% of the respondents. Thus, most of the respondents perceived that the synergy that could result from the participation of the top management in the Shari'ah board's meeting, which is also amongst recommendations made by the IFSB (please refer to IFSB 2009), as important in influencing the independence of Shari'ah board members. Nevertheless, there is also evidence to the contrary, as indicated in Table 6.4.3, where 20.8% of the respondents regarded it as unimportant and negatively influence the independence of the Shari'ah board members.

Finally, the factor of the remuneration received by Shari'ah board members was perceived as important by 62.5% of the respondents. This finding indicates that most of the respondents perceived that the remuneration received by Shari'ah board members could compromise this Shari'ah governance authority's independence; this view is consistent with the debate discussed in Chapter Four (see for example Grais and Pellegrini 2006; Rammal 2006; Khan 2007). However, some of the evidence in this study refutes such claims, as is reflected by a total of 20.8% of the total number of respondents (by combining the 12.5% of respondents who perceived it as unimportant and another 8.3% who perceived it as very unimportant) who considered this factor as unimportant in influencing the independence of Shari'ah board members. In such circumstances, the ethical value and the scholarly background of Shari'ah board members would ensure their resistance to the monetary influence and would uphold the integrity and guarantee the effective and independent function of Shari'ah board members.

Meanwhile, analyses by control variables were also conducted but produced significantly different results only for the control variable total assets. Table 6.4.4 below presents the analysis of the factors influencing the independence of Shari'ah board members by the three categories of total assets when tested using the Kruskal-Wallis H test. As can be seen from the table, amongst all the factors identified, the only factor that is significantly different across the three categories of total assets is the Shari'ah board's clearly defined scope of responsibilities, with a p value of 0.037. The respondents from medium-sized and large banks thought it of high importance that a clearly defined scope of responsibilities would influence the independence of Shari'ah board members, with mean values of 4.92 and 4.63 respectively. On the other hand, respondents from small banks, in comparison to those from medium-sized and large banks, perceived a lower importance for this factor's ability to influence the independence of Shari'ah board members. It can be suggested that the high importance given to the factor in discussion amongst bigger banks is a result of the implementation of good governance practice that has witnessed the positive effect on Shari'ah board members' independence after investing in mechanisms such as a precise Shari'ah manual, seeking the consultation of external experts, as well as support from all relevant parties within the bank for the governance function of Shari'ah board members. In contrast, small banks, while perceiving that a clearly defined scope of responsibilities could enhance the independence of Shari'ah board members, might not see this as the dominant factor due to possible constraints on making investments of the type discussed for their counterparts. As a result, Shari'ah board members might have multiple tasks regarding their roles and functions whilst at the same time preserving and ensuring their independence.

Table 6.4.4: Analysis Showing the Factors Influencing Independence of Shari'ah Board Members by Total Assets

Factors Influencing Independence of Shari'ah Boards Members	Total Assets by Category												Sig.
	Small (Less than RM1,000 million assets)				Medium (between RM1,000 million to RM10,000 million assets)				Large (More than RM10,000 million assets)				
	Unimportant	*Uncertain*	*Important*	*Total*	*Unimportant*	*Uncertain*	*Important*	*Total*	*Unimportant*	*Uncertain*	*Important*	*Total*	
	%	*%*	*%*	*Mean*	*%*	*%*	*%*	*Mean*	*%*	*%*	*%*	*Mean*	
A clearly defined scope of responsibility	.0	.0	100.0	4.25	.0	.0%	100.0	4.92	.0	.0	100.0	4.63	*0.037
The remuneration received	50.0	25.0	25.0	2.50	16.7	16.7%	66.7	3.67	12.5	12.5	75.0	3.75	-
The scholarly background	.0	.0	100.0	4.50	.0	.0%	100.0	4.67	.0	12.5	87.5	4.50	-
The perceived high ethical status	.0	.0	100.0	4.50	.0	.0%	100.0	4.83	.0	12.5	87.5	4.38	-
Adequate powers being mandated	.0	.0	100.0	4.50	.0	8.3%	91.7	4.50	.0	.0	100.0	4.50	-
Participation of top management in the Shari'ah board 's meeting	25.0	25.0	50.0	3.50	25.0	.0%	75.0	3.83	12.5	12.5	75.0	4.00	-
Involvement of the Shari'ah board as Shari'ah board members in other industries	25.0	25.0	50.0	3.25	8.3	16.7%	75.0	4.08	12.5	12.5	75.0	3.88	-

* Indicates the distribution of responses is statistically different between the three categories of total assets using the Kruskal-Wallis H test

6.4.3 Relevant Parties to which Shari'ah Boards are Accountable

The esteem and high ethical status of Shari'ah boards is linked with their role in ensuring that the operation of banks offering Islamic financial services is in accordance with the Islamic Shari'ah. As such, the role and function of Shari'ah boards is of great importance to the stakeholders of these banks. In this study, the respondents were invited to indicate the importance they perceived of the identified parties to whom they consider Shari'ah boards to be accountable based on a scale ranging from very unimportant (1) to very important (5). Table 6.4.5 below shows the analysis of the findings.

Table 6.4.5: Analysis Showing the Parties to which Shari'ah Boards are Accountable

Parties Shari'ah Boards are Accountable	Unimportant		Uncertain		Important		Total		Overall	
	No	%	No	%	No	%	No	%	Mean	Rank
Bank's shareholders	0	.0	0	.0	24	100.0	24	100.0	4.5	3
Bank's consumers	1	4.2	1	4.2	22	91.7	24	100.0	4.46	4
Bank's board of directors	0	.0	0	.0	24	100.0	24	100.0	4.63	1
Public	1	4.2	1	4.2	22	91.7	24	100.0	4.42	5
Shari'ah Advisory Council of BNM	0	.0	0	.0	24	100.0	24	100.0	4.63	1

As is shown in Table 6.4.5, most of the respondents perceived as important that the identified parties to whom Shari'ah boards are accountable. Based on the responses given, a mean value was calculated for each identified party and a ranking given to indicate each party's importance. It is evident from the table that both the bank's board of directors and the SAC of BNM scored the highest mean value (4.63) and secured the first rank. Both parties were unanimously perceived as important by all respondents. While both the bank's board of directors and the SAC of BNM are from two different organizations, they are undeniably important parties within the SGF of banks offering Islamic banking activities. It was discussed in Chapter Four that the board of directors are the party within the bank to whom Shari'ah boards are held accountable to provide Shari'ah advice (Briston and El-Ashker 1986; Tomkins and Karim 1987; Banaga et al. 1994; Haniffa and Hudaib 2007), as the former is responsible for the policy making of the bank. In addition to the Shari'ah advisory role, GPS1 also stipulates that Shari'ah boards are required to report directly to their respective board of directors (BNM 2004). Hence, the perceived high importance given to Shari'ah boards' accountability to the board of directors reflects the functional accountability of Shari'ah boards and is to be expected.

Meanwhile, the SAC of BNM is the regulator and the supreme authority on Shari'ah governance in the Malaysian Islamic banking industry. Its authority over all Malaysian Islamic financial institutions (IFIs) is reflected in the recent amendment of the Central Bank of Malaysia's Act 2009 whereby all resolutions made by the SAC are binding to the industry (BNM 2009), as was discussed in Chapter Four. Indeed, the GPS1 clearly stipulated that Shari'ah boards are required to assist the SAC regarding advice, for example, by supporting the SAC with relevant Shari'ah jurisprudential literature from established sources when seeking approval for the launch of new Islamic banking products and services (BNM 2004). In this regard, the perceived high importance given to the SAC as the party to whom Shari'ah boards are accountable could be described as confined to the regulator-regulatee relationship.

After the board of directors and the SAC of BNM, the respondents perceived that the bank's shareholders come next in importance as the party to whom Shari'ah boards are accountable, with a mean score of 4.50. In Chapter Four it was discussed that Shari'ah boards are expected to perform in the best interest of the shareholders, as it is suggested that the former be appointed by the latter (see for example Karim 1990a; Rammal 2006; Laldin 2008b). Indeed, matters such as the appointment, remuneration and issuance of

Shari'ah reports of Shari'ah boards have been recommended by AAOIFI to be subject to the shareholders' approval (AAOIFI 1997 para. 3). However, Malaysia diverges on this issue, as the appointment and remuneration of Shari'ah board members are the prerogative of the board of directors of the IFIs, although subject to approval from the BNM (BNM 2004). Similarly, the reporting structure of Shari'ah boards has been clearly stipulated in GPS1 as being direct to the board of directors of their respective IFIs (BNM 2004). It is due to this regulatory requirement, perhaps, that the respondents perceived that it is more important that Shari'ah boards are held accountable to the board of directors than to the bank's shareholders.

In order of importance, the following parties to whom Shari'ah board members are perceived accountable are the bank's consumers and the public with mean score values of 4.46 and 4.42 respectively. Clearly, these two parties represent other important stakeholders regarding the roles and functions of Shari'ah board members. However, the perceived reduced importance given to these two parties revealed in this study could be the result of the apparently reduced direct functional association between Shari'ah board members and these two parties. Additionally, the bank's consumers and the public are both the end users of Islamic banking products and services. Although Shari'ah board members are responsible for ensuring the confidence of the consumers and the public in the operation of banks offering Islamic banking products and services, the Shari'ah board members' functional accountability to these two parties is, arguably, less than their accountability to the board of directors, the SAC of BNM and the bank's shareholders.

Analyses by control variables did not produce significantly different results and, thus, are not reported here.

6.4.4 The Appointment and Mandated Authority of Shari'ah Board Members

This study also investigates important issues surrounding the nature of the appointment and mandated authority of Shari'ah boards. The respondents were invited to indicate their agreement with selected features surrounding these issues based on a scale that ranged from strongly disagree (1) to strongly agree (5). Table 6.4.6 presents the analysis of the findings.

Table 6.4.6: Analysis Showing the Nature of the Appointment and Mandated Authority of Shari'ah Board Members

Nature of Appointment and Mandated Authority of Shari'ah Board Members	Disagree		Uncertain		Agree		Total		Overall
	No	*%*	*No*	*%*	*No*	*%*	*No*	*%*	*Mean*
Appointment of Shari'ah board is based on fit and proper criteria	0	.0	0	.0	24	100.0	24	100.0	4.58
No conflict on the appointment of Shari'ah board	0	.0	0	.0	24	100.0	24	100.0	4.54
Shari'ah board is subject to assessment by the bank or BNM	0	.0	0	.0	24	100.0	24	100.0	4.63
Adequate powers have been mandated to Shari'ah board	2	8.3	1	4.2	21	87.5	24	100.0	4.29
Existence of reporting channel on conflicts with Shari'ah board, board of directors or management	3	12.5	3	12.5	18	75.0	24	100.0	3.83
Proper segregation of Shari'ah board duties	3	12.5	1	4.2	20	83.3	24	100.0	4.00

On the question of whether the appointment of Shari'ah board members is made based on certain 'fit and proper' qualification criteria, Table 6.4.6 shows that all the respondents unanimously indicated their agreement that this feature be exercised in their respective banks. The consensus in the literatures seems to suggest that the Shari'ah board should comprise experts from the field of *fiqh al-mua'malat* as well as from accounting and finance (see for example Gambling et al. 1993; AAOIFI 1997; Grais and Pellegrini 2006; Laldin 2008b). In addition, the importance for IFIs, such as banks offering Islamic banking products and services, to establish ‘fit and proper’ qualification criteria has been laid down by IFSB (see IFSB 2006 para. 52-53). Hence, the findings of this study indicate that such an important appointment mechanism is being well exercised across all the participating banks in the MIFC.

Next, the respondents were asked whether assurance has been made that the appointment of Shari’ah board members is free from any conflict of interest, such as being substantial shareholders or having an intimate relationship with an employee of the bank the board serves. Similarly, all respondents indicated their agreement that this requirement be taken into account when appointing Shari’ah board members. Earlier, it was mentioned that it is recommended that Shari’ah board members be appointed by the bank’s shareholders (see for example Karim 1990a; AAOIFI 1997; Rammal 2006; Laldin 2008b). Such an appointment mechanism is seen as a way to cater for any possible conflict of interest on the role of Shari’ah board members in supervising and monitoring the Islamic banks’ management in conjunction with that of the bank’s board of directors. However, the Malaysian Islamic banking business environment diverges in the way that Shari’ah board members are appointed by the bank’s board of directors, but the method is still subject to the approval of the regulator, i.e., BNM. Although such an appointment mechanism seems to indicate that Shari’ah board members in the Malaysian Islamic banking industry are deprived of the benefit of shareholders’ endorsement to counter the principal-agent conflict, the findings of this study suggest otherwise. With the assurance indicated in this study that there is no conflict of interest in the appointment of Shari’ah board members, it is expected that Shari’ah board members would perform their roles and functions in the best interests of the shareholders. In fact, this appointment filtering mechanism at the bank level is followed by another filtering mechanism in which the choice of Shari’ah board members by the bank’s board of directors is subject to the approval of BNM. Hence, the need to ensure that Shari’ah board members would serve in the best interests of shareholders is dealt with despite Shari’ah board members not being appointed by the shareholders.

Another question of interest is whether Shari'ah board members are subject to any assessment by the bank or BNM. As shown in Table 6.4.6, all the respondents indicated their agreement with the existence of such a performance appraisal. This finding clearly indicates that Shari'ah board members in the Malaysian Islamic banking industry are not immune from performance evaluation and could simultaneously provide evidence to counter criticism, such that they lack of independence (Grais and Pellegrini 2006; Rammal 2006; Khan 2007), legitimize dubious operations (Grais and Pellegrini 2006; Rammal 2006) and are merely window dressing for Islamic banks (Kahf 2002). Additionally, it reflects the effectiveness of the dual-layer Shari'ah governance system implemented in Malaysia whereby the existence of such a check and balance mechanism on the important role of Shari'ah board members would ensure that this Shari'ah governance authority would serve in the best interests of all the stakeholders involved.

The respondents were also asked whether they perceived that Shari'ah board members have been mandated with adequate powers to perform the role of the board. On this issue, the results shown in Table 6.4.6 reveal that 87.5% of the total respondents indicated their agreement with such mandated authority being given to Shari'ah board members. While it can be said that the vast majority of Shari'ah board members are given the authority to carry out their roles and functions, there is also some evidence to the contrary, as can be observed with about 12.5% of the respondents. Alternatively, evidence of the lack of power to exercise their roles and functions could possibility indicate that Shari'ah board members are unable to perform their perceived high ethical function with absolute independence. In such circumstances, the agency problem faced by corporations such as Islamic banks is unlikely to be eased even with the existence of an additional layer in the role of Shari'ah governance as played by Shari'ah board members.

The respondents were also asked about the existence of a reporting channel for Shari'ah board members in the event of any conflict arising between Shari'ah board members and the board of directors or the management of the bank. Such a reporting mechanism is deemed crucial, as it would enhance the independence and effective function of the Shari'ah board. Indeed, this question has relevance, as it is consistent with the requirement put forward by IFSB that any conflict of interest on the role of the Shari'ah board among Shari'ah board members themselves or between Shari'ah board members and the management should be avoided and resolved (IFSB 2009). In response, Table 6.4.6 reveals that 75.0% of the respondents indicated their agreement whereas 12.5% indicated their disagreement. Evidence for the existence of such a mechanism could reflect the mechanism developed by the banks to ensure that Shari'ah board members undertake their roles and functions effectively. Nevertheless, evidence to the contrary makes apparent that possible disputes between all the important parties within the SGF occur at the cost of other stakeholders.

One of the issues discussed in Chapter Four surrounding the appointment of Shari'ah board members is the absence of any proper segregation of Shari'ah board members' duties pertaining to their product endorsement function and later when performing the Shari'ah compliance review, as highlighted by Alhabshi and Bakar (2008). Arguably, if the same monitoring body, i.e., the Shari'ah board, was responsible for these two functions, there would be concerns regarding the independence of Shari'ah board members and the effectiveness of the Shari'ah compliance review. The findings of this study reveal that 83.3% of the respondents indicated their agreement whereas 12.5% indicated otherwise regarding the existence of such an appointment mechanism. Hence, it can be said that the vast majority of the banks ensure that there is no duplication of Shari'ah board duties that would jeopardise the independence of this Shari'ah governance authority. On the contrary, evidence in the negative could have a detrimental effect on Shari'ah board members' independence, as highlighted by Alhabshi and Bakar's (2008) argument above.

In addition, analyses by control variables did not produce significantly different results and, hence, are not reported here.

6.5 The Nature of the Shari'ah Review by Shari'ah Boards

One of the important roles of the Shari'ah board which has also been the focus of this study is the Shari'ah review function. This study has examined further the issue of the Shari'ah review by looking into aspects of the structure and implementation of the Shari'ah review by the Shari'ah board. For this purpose, the following paragraphs offer analyses and discussions of the two aforementioned aspects of the Shari'ah review.

6.5.1 Structure of the Shari'ah Review for Shari'ah Boards

This study investigates important issues surrounding the structure of the Shari'ah review for Shari'ah boards. The respondents were invited to indicate their agreement with several crucial issues on this subject based on a scale that ranged from strongly disagree (1) to strongly agree (5). Table 6.5.1 below provides an analysis of the results.

Table 6.5.1: Analysis Showing the Structure of Shari'ah Review for Shari'ah Boards

Structure of the Shari'ah Review for Shari'ah Boards	Disagree		Uncertain		Agree		Total		Overall
	No	*%*	*No*	*%*	*No*	*%*	*No*	*%*	*Mean*
Shari'ah board is individual bank's sole authority in Shari'ah review	3	12.50	1	4.20	20	83.30	24	100	4.17
Shari'ah board is prescribed with operative procedure on its role & function	2	8.30	1	4.20	21	87.50	24	100	4.13
Shari'ah board membership comprises various experts	11	45.80	2	8.30	11	45.80	24	100	3.08
Existence of effective communication channel to deliberate Shari'ah review issues	2	8.30	2	8.30	20	83.30	24	100	4.13
Adequate & apparent guidelines have been issued by Shari'ah Advisory Council of BNM	5	20.80	0	0.00	19	79.20	24	100	3.92

First, the respondents were asked whether they perceived the Shari'ah board to be the sole authority on the Shari'ah review system within individual banks offering Islamic banking services; 83.3% of the respondents indicated their agreement whereas 12.5% disagreed about the position of Shari'ah boards as the sole authority in the Shari'ah review system, as indicated in Table 6.5.1. Hence, the vast majority of the respondents perceived the Shari'ah board to be the sole authority in the Shari'ah review system, consistent with its role in ensuring the credibility of Islamic banks by ascertaining the Shari'ah compliance of the bank's operations, as discussed in Chapter Four (see for example Briston and El-Ashker 1986; Tomkins and Karim 1987; Karim 1990b; Karim 1990a; Banaga et al. 1994; Rammal 2006; Laldin 2008a). Nevertheless, the fact that 12.5% of the respondents disagreed with this hierarchical position of the Shari'ah board raises concerns on whether the Shari'ah board members in those banks (three banks) delegate some of their functions to other parties within the bank, such as to the bank's Shari'ah department officers. Interpreted differently, this result could also mean that the Shari'ah board members were unable to execute their function in absolute independence from the management of the bank. In such circumstances, the banks would be exposed to Shari'ah risk as an important component within the Shari'ah governance system, i.e., Shari'ah board members would be unable to carry out their role and function in ensuring the Shari'ah compliance of the operations of the banks they represent.

Next, the respondents were asked whether the Shari'ah board had been prescribed the appropriate operative procedures on its roles and functions by the bank. Evidence from Table 6.5.1 indicates that 87.5% of the respondents agreed whereas another 8.3% disagreed. It is worth noting that GPS1 requires IFIs, such as banks offering Islamic banking services, to produce a Shari'ah compliance manual which is subject to endorsement by the Shari'ah board (BNM 2004), as was discussed in Chapter Four. This Shari'ah compliance manual should include, amongst other things, the operative procedures for the relevant parties within the bank, including those for the Shari'ah board. Indeed, a similar requirement was put forward by the IFSB (IFSB 2009 principle 1.2). As such, the finding of this study indicates that the participating banks in the MIFC have established a proper structure for the Shari'ah review in terms of the operative procedure of the Shari'ah board's role and function, although respondents from a few banks indicated otherwise.

The following question related to whether membership of the Shari'ah board in the respondents' respective banks comprised various experts, the importance of which was discussed in Chapter Four (see for example Gambling et al. 1993; AAOIFI 1997; Grais and Pellegrini 2006; Laldin 2008b). The findings of this study reveal that there were equal percentages of respondents (45.8%) whose Shari'ah board in their respective banks comprised various experts and those which comprised Shari'ah scholars only. Hence, this study provides evidence that the suggestion that Shari'ah boards should comprise various experts has gained acceptance amongst the participating banks in the MIFC. However, it should be noted that the present lack of competent Shari'ah scholars combined with the requirement laid down by GPS1 that each scholar can become a Shari'ah board member of only one financial institution within the same industry could have resulted in the trend of Shari'ah boards that include various experts, as found in this study. Evidently, membership of Shari'ah boards that comprise Shari'ah experts only seems prevalent, as indicated by the equivalent numbers of banks whose Shari'ah board membership comprises various experts. These findings suggest that the acceptance amongst banks offering Islamic banking services for membership of the Shari'ah board to comprise various experts is on a par with those banks that are being conservative by appointing only Shari'ah scholars as Shari'ah board members.

In addition, the respondents were asked about the existence of an effective communication channel to deliberate Shari'ah review issues. It was discussed in Chapter Four that this communication channel is an important governance mechanism for Shari'ah board members to deliberate Shari'ah concerns on the operation of Islamic banks with all parties within the SGF. Evidence from this study revealed that 83.30% of the respondents indicated their agreement whereas only 8.30% indicated their disagreement on the existence of such a governance mechanism on Shari'ah review for the Shari'ah board. Such a high percentage of agreement amongst the respondents reflects the commitment of banks offering Islamic banking products and services to establishing the infrastructure necessary to uphold the Shari'ah governance of this ethical banking operation.

Finally, the respondents were also asked whether they perceived that there are adequate and apparent guidelines on the pronouncements and resolutions of the SAC of BNM issued for use in the Islamic banking industry; 79.2% of the respondents indicated their agreement whereas another 20.8% indicated the contrary, as shown in Table 6.5.1 above. Although more than three quarter of the respondents agreed on the existence of such guidelines by the SAC of BNM a considerable number of respondents perceived it to be otherwise. This revelation challenges the role of the SAC, especially when an earlier finding, as indicated in Table 6.4.5 above, shows that the SAC was ranked first in importance as the party to whom Shari'ah board members were perceived to be accountable. Furthermore, the new amendment to the Central Bank of Malaysia Act 2009 clarified the issue of the mandated powers authorized to the SAC whereby the Shari'ah resolutions issued by the institution are binding upon all Malaysian IFIs (BNM 2009). One would argue that with the lack of adequate and apparent guidelines from the SAC, there is a communication gap between the important and interrelated parties within the Malaysian SGF that serves as a loophole on the effectiveness of the dual-layer Shari'ah governance system practiced in Malaysia.

In addition, analyses by control variables did not produce significantly different results, and, thus, are not reported here.

6.5.2 Implementation of the Shari'ah Review by Shari'ah Boards

Another issue investigated in this study pertains to the implementation of the Shari'ah review by the Shari'ah board. Thus, the respondents were invited to indicate their agreement based on the scale between strongly disagree (1) and strongly agree (5). Table 6.5.2 and Table 6.5.3 present analyses of the findings.

Table 6.5.2: Analysis Showing the Features on Implementation of the Shari'ah Review by Shari'ah Boards

Implementation of the Shari'ah Review by Shari'ah Boards	Disagree		Uncertain		Agree		Total		Overall
	No	***%***	***No***	***%***	***No***	***%***	***No***	***%***	***Mean***
Shari'ah board has full authority to stop non-Shari'ah compliance transactions	3	12.5	4	16.7	17	70.8	24	100.0	3.96
Shari'ah board is given ample time for decision making & Shari'ah review	2	8.3	2	8.3	20	83.3	24	100.0	4.17
Shari'ah board gets professional advice to support its function	0	.0	3	12.5	21	87.5	24	100.0	4.29
Shari'ah board has direct access to relevant, accurate, adequate & timely info	2	8.3	1	4.2	21	87.5	24	100.0	4.21
Working part time does not hinder effective Shari'ah review by the Shari'ah board	5	20.8	3	12.5	16	66.7	24	100.0	3.63
Existence of active communication & consultation between Shari'ah board, bank & Shari'ah Advisory Council	3	12.5	8	33.3	13	54.2	24	100.0	3.58

The respondents were first asked whether they perceived that the Shari'ah board has the full authority to stop the bank from undertaking non-Shari'ah compliant transactions. As is evident in Table 6.5.2 above, 70.8% of the respondents indicated their agreement whereas only 12.5% were in disagreement that such authority has been given to Shari'ah board members. Apparently, the feedback was unexpected, as there are some indications that the respondents did not perceive the Shari'ah board to be the sole authority on the Shari'ah governance mechanism of banks offering Islamic banking services and, thus, as having the full authority to stop banks from undertaking transactions that are not consistent with the Shari'ah. In other words, the respondents indicated that even if the bank were known to be indulging in activities which are against the Shari'ah, the Shari'ah board has no authority to stop the bank from proceeding. These findings highlight a severe lack of independence on the part of Shari'ah board members to perform their roles and functions due to the fact that they seem to be under the control of other parties within the bank. This finding, although it refers to a small number of banks (three banks), triggers concerns about the opportunistic behaviour of the management in the light of the agency problem and the crucial ethical role of the Shari'ah board in overcoming this problem and protecting the interests of shareholders and other stakeholders as promoted in the stakeholder theory.

Another question that was posed to the respondents was whether they perceived that the Shari'ah board is given ample time for decision making and for the Shari'ah review. Table 6.5.2 indicates that 83.3% of the respondents were in agreement whereas only 8.3% were in disagreement. Hence, this finding indicates that the vast majority of the respondents were in agreement that Shari'ah board members are given the required amount of time to perform their function. However, there is some evidence to the contrary, which corresponds to two banks where the respondents considered that their respective Shari'ah board members are not given adequate time to complete their tasks within the given time period. It is argued that the nature of the banking business, which requires fast decision making, could have resulted in these respondents perceiving that Shari'ah board members are unable to meet the deadline in making their Shari'ah decisions. Moreover, the fact that Shari'ah board members work part time in the bank could have contributed to this result. Nevertheless, this does not seems to be common, as the majority of respondents perceived that Shari'ah board members are given ample time for the said purpose.

Apart from the consideration on the amount of time given to Shari'ah board members, another question posed to the respondents regarding the issue of the implementation of Shari'ah review was whether the Shari'ah board gets professional advice to support its functions, such as on legal, accounting and finance aspects. It was mentioned in Chapter Four that Shari'ah boards are expected to work closely with various parties within the Islamic banks (Banaga et al. 1994; AAOIFI 1998 para. 12). Such a requirement is deemed essential in order for Shari'ah board members to gain clarity on all aspects of the bank's operation, which is vital if an objective Shari'ah decision is to be made. The findings of this study reveal that 87.5% of the respondents indicated their agreement and there was no evidence to the contrary, as shown in Table 6.5.2. These findings demonstrate that the necessary professional support is given to Shari'ah board members, as was perceived by the vast majority of the respondents. It also highlights the existence of an established communication and cooperation between all interrelated parties within the bank in ensuring the successful implementation of Shari'ah governance amongst banks offering Islamic banking products and services.

Also investigated was the important issue of whether the Shari'ah board members have direct access to relevant, accurate, adequate and timely information when performing their Shari'ah review function. It was found that 87.5% of the respondents indicated their agreement whereas 8.3% were in disagreement on the provision of such information quality, as indicated in Table 6.5.2. It was discussed in Chapter Four that the financial institution represented by Shari'ah board members is required to provide the latter with information that has the characteristics mentioned (AAOIFI 1998 para. 3; BNM 2004 para. 21). Although the vast majority of the respondents provided positive responses to this question, there were responses in the negative (two banks), which presents a setback for the banks' compliance with the regulatory requirement and raises concerns on whether the Shari'ah governance authority is able to perform its function independently and effectively. In addition, accessibility to such information has an apparent repercussion on the transparency on the part of financial institution and objective Shari'ah opinion by Shari'ah board members. The question that could be asked is what could the regulator do, in this case the BNM, to ensure compliance with the requirements of the guidelines issued and the action taken for non-compliance.

Another issue of frequent debate is on the part-time working nature of Shari'ah board members. The respondents were invited to indicate whether they perceived that working part time does not hinder the production of an effective Shari'ah review by the Shari'ah board. As indicated in Table 6.5.2, 66.7% of the respondents reported their agreement whereas 20.8% reported their disagreement. These findings reveal that most of the respondents perceived that working part time does not hinder Shari'ah board members from performing their roles and functions effectively. It also implies that the part-time status and the non-executive role of Shari'ah board members were considered acceptable. However, the fact that 20.8% of the respondents took a negative view of this points to the inappropriateness of Shari'ah board members working part time to perform their highly important roles and functions.

Finally, the respondents were asked whether there is active communication and consultation between the Shari'ah board, the bank and the SAC of BNM. The responses, as shown in Table 6.5.2, indicate that 54.2% of the respondents were in agreement whereas 12.5% were in disagreement. As can be seen from the table, these findings show that slightly more than half of the total number of respondents were in agreement on the presence of active communication and consultation between these three important parties whilst other respondents were either uncertain or in disagreement. Such a proportion does not seem to be the level deemed satisfactory and might suggest that communication between these three related parties tends to be limited to aspects of product approval and Shari'ah board members' appointment, as was discussed earlier. Furthermore, the fact that Malaysia implements a dual-layer Shari'ah governance system in its Islamic banking industry signifies the potential for closing the gap between the industries and minimizing the inconsistencies in Islamic banking practices. Therefore, the regulator has to utilize the mechanisms in the existing SGF to bring the Islamic banking industry into further growth and development.

Table 6.5.3: Analysis Showing the Features of Implementation of the Shari'ah Review by Shari'ah Boards by Total Assets

Implementation of the Shari'ah Review by Shari'ah Boards	Total Assets by Category												Sig.
	Small (Less than RM1,000 million assets)				Medium (between RM1,000 million to RM10,000 million assets)				Large (More than RM10,000 million assets)				
	Disagree %	*Uncertain %*	*Agree %*	*Overall Mean*	*Disagree %*	*Uncertain %*	*Agree %*	*Overall Mean*	*Disagree %*	*Uncertain %*	*Agree %*	*Overall Mean*	
Shari'ah board has full authority to stop non-Shari'ah compliance transactions	.0	25.0	75.0	4.00	25.0	16.7	58.3	3.67	.0	12.5	87.5	4.38	-
Shari'ah board is given ample time for decision making & Shari'ah review	.0	.0	100.0	4.25	16.7	16.7	66.7	4.00	.0	.0	100.0	4.38	-
Shari'ah board gets professional advice to support its function	.0	.0	100.0	4.25	.0	25.0	75.0	4.25	.0	.0	100.0	4.38	-
Shari'ah board has access to relevant, accurate adequate & timely info	.0	.0	100.0	4.25	16.7	8.3	75.0	4.08	.0	.0	100.0	4.38	-
Working part time does not hinder effective Shari'ah review by Shari'ah board	.0	.0	100.0	4.50	41.7	16.7	41.7	3.00	.0	12.5	87.5	4.13	*0.024
Existence of active communication & consultation between Shari'ah board , bank & Shari'ah Advisory Council of BNM	25.0	50.0	25.0	3.00	8.3	41.7	50.0	3.58	12.5	12.5	75.0	3.88	-

Additionally, the only control variable that produced significantly different results was total assets regarding the factor of respondents' perception that working part time does not hinder the Shari'ah board in producing an effective Shari'ah review. Table 6.5.3 above presents evidence that this factor was significantly different, with a p value of 0.024 when tested using the Kruskal-Wallis H test, with the relatively smaller mean value of 3.00 for the medium-sized banks compared to that for the small and large banks, which had mean values of 4.50 and 4.13 respectively. These findings reveal that the respondents from the medium-sized banks were uncertain whether working part time does not hinder the production of an effective Shari'ah review while their counterparts from the other two categories perceived to be the case. Interpreted differently, these findings suggest that Shari'ah board members in small and large banks were perceived by the respondents to perform their crucial non-executive Shari'ah roles and functions at the expected level despite the fact that board members are attached to the banks on a part-time basis. Meanwhile, the respondents from the medium-sized banks doubted the ability of their respective Shari'ah board members to perform their high ethical and crucial Shari'ah roles and functions as a result of being attached on a part-time basis.

6.6 Conclusion

This chapter discussed the findings from Questionnaire Survey 1 (QS1) derived from 24 heads of Shari'ah departments of banks offering Islamic banking and services in the MIFC. This position in these banks was found to be dominated by males, largely equipped with knowledge of Shari'ah and *fiqh al-mua'malat* and with some also having knowledge in non-Islamic fields, such as management, accounting and finance. In addition, the size of Shari'ah department seems to be influenced by the type of its operation and size with full-fledged Islamic banks and large banks appearing to have more Shari'ah officers in the Shari'ah department. Moreover, slightly more than half of the heads of Shari'ah departments were found to have between 0-5 years working experience in the Islamic banking arena. These heads of Shari'ah departments were invited to provide their feedback on three significant issues surrounding the governance function of the Shari'ah board: (1) the role of the Shari'ah board, (2) the accountability and independence of the Shari'ah board, and (3) the nature of Shari'ah review by the Shari'ah board.

The banking business, including the Islamic banking industry, seems to be continually highly governed and regulated by the government. One significant implication of this is that the mandatory regulatory standards and guidelines prevail over the recommended ones, as in the case of GPS1, i.e., where the guidelines on the governance of the Shari'ah board issued by BNM seem to prevail over AAOIFI and IFSB standards, which are basically best recommended governance practice for the Islamic banking industry. Hence, the clarity and comprehensiveness of GPS1, to a certain extent, reflects how robustly the Shari'ah governance system is applied across the participating banks in the MIFC. Although these banks would generally implement a Shari'ah governance system to fulfil the requirement of GPS1, any additional measures taken that are consistent with AAOIFI and IFSB (but not required by GPS1) would indicate additional initiatives by the bank to enhance its Shari'ah governance mechanism.

The results of QS1 indicate that the Shari'ah board generally emphasises the Shari'ah advisory role particularly in endorsing the Shari'ah compliance manual prepared by the management and in advising the board of directors and other parties as well as advising the Shari'ah department officers on the scope of the Shari'ah review. However, the Shari'ah boards do not seem inclined to get involved further in areas such as designing or providing training on the Shari'ah governance system for implementation in the bank. Similarly, this study indicates the passive involvement of Shari'ah boards in the bank's strategic issues, as most of the heads of Shari'ah departments responded negatively regarding the involvement of the Shari'ah board in advising and designing the corporate objectives of the banks. These findings demonstrate that the scope of Shari'ah advisory undertaken by Shari'ah boards has not progressed beyond its traditional Shari'ah advisory role and tends to be limited to traditional product and development issues.

In fact, when Shari'ah boards' involvement in developing Islamic banking products and services was explored further, it seems they give priority to the conception, legal documentation and the review stages. Technical aspects of products and services development, e.g., the pricing, testing, marketing and designing of Islamic banking products and services, were given less attention, as these issues might have been delegated to the Shari'ah department for further action. Nevertheless, the design and pricing stages were found to be significantly different in small banks. In explaining these significant results and their association with bank size, relevant findings in this study indicate that small banks have fewer Shari'ah officers, suggesting that Shari'ah board members might have an intensive role in these two product and service development stages and are fully occupied due to their insights and hence their involvement. Meanwhile, the low emphasis given by the Shari'ah boards on other stages of product and service development also demonstrates the delegation of authority to and the important role of the Shari'ah department officers and other relevant parties within the bank.

Minimal and selective involvement amongst Shari'ah board members on accounting related issues was evident. Generally, the Shari'ah board seems to be emphasising accounting issues which have direct Shari'ah concerns relating to the Islamic banking business. These were found to be issues pertaining to (1) validating documents in contracts, (2) approving the calculation and distribution of *zakat*, and (3) endorsing the bank's annual report. Interestingly, accounting issues such as issuing a Shari'ah report, which is closely associated with the role and function of the Shari'ah board and which is deemed crucial for the ethical and investment decision of the stakeholders, was not indicated as being in Shari'ah boards' top accounting involvement category. In such circumstances, the Shari'ah department officers would be the party deemed to be in charge of preparing the Shari'ah report, which would, however, be given to the Shari'ah board for approval and sign-off later. This delegation of duties to the Shari'ah department officers or other relevant parties can be assumed for accounting issues which were indicated to receive similar low attention from the Shari'ah board. They include accounting issues pertaining to validating transaction records, approving the accounting policy to be applied by the bank and determining the formula for profit distribution.

Hence, it could be said that the involvement of the Shari'ah board in the accounting issues of banks offering Islamic banking products and services leaves much to be desired. In order for Shari'ah board members to be cleared from the negative perception of being labelled window dressing or offering a rubber stamp to Islamic banks, the Shari'ah board is expected to be more vigilant by giving serious attention to and being more involved in the accounting issues surrounding the Islamic banking operation.

The above claim about Shari'ah boards' delegation of duties could be supported by related evidence derived from this study in which Shari'ah boards were found to receive high assistance from banks' Shari'ah department officers, management and boards of directors. It is argued that the part-time attachment nature of Shari'ah boards has shown the importance of this Shari'ah governance authority gaining the necessary assistance, particularly from Shari'ah department officers. However, it should be noted that over-reliance on these parties could result in the Shari'ah decisions made by the Shari'ah board being influenced and, this would be detrimental to Shari'ah boards' independence. Meanwhile, assistance and support from other parties are still wanting, e.g., from the audit committee, internal auditor and external auditor. However, evidence indicates that assistance from the external auditor was more apparent for large banks than for small and medium-sized banks. This revelation reflects the more comprehensive governance mechanism within large banks as they were benefiting from more cooperation between both financial auditors and the Shari'ah board.

Additionally, a positive attitude towards consistency in Islamic financing products and services was evident as Shari'ah board members gave importance to engaging themselves in workshops and meetings of scholars of *fiqh al-mua'malat*. This reflects the prevailing concern amongst Shari'ah board members to standardize Islamic financing products and services under the ambit of the dual-layer of the Shari'ah governance system implemented in Malaysia. Alternatively, meeting in such a platform could offer banks new to the Islamic banking industry the opportunity to be on a par with mature Islamic banks in the market. Indeed, new Shari'ah board members in the industry could also develop skills and knowledge learnt from the more experienced members who attend such platforms. It was also found that this commitment by Shari'ah board members is significant for banks with between 6-10 years of establishment. It is deemed that this period after establishment is crucial to the Shari'ah board members as they would attempt to streamline the products and services offered by their banks with that of other banks within the industry.

Following the above commitment, Shari'ah board members seem to be giving priority to (1) analysing whether Islamic banking products and services would deliver benefit to the *ummah* before they are launched, and (2) enhancing Shari'ah review skills by attending appropriate training for Shari'ah board member's continuous professional development. These findings indicate Shari'ah board members' stakeholder-centric behaviour and commitment to enhancing their Shari'ah review skills especially when they are commonly deemed to be specialized in a particular field of knowledge.

Some respondents also indicated some areas where Shari'ah board members demonstrate no commitment: (1) actively engaging in the innovation of Islamic banking products and services through discussion with the management, accountants, lawyers and other concerned parties; (2) responding to any questions pertaining to pronouncements and resolutions issued by the Shari'ah board through discussion with the shareholders or the public or a similar forum; and (3) publishing for the public the Shari'ah board's Shari'ah resolutions and rulings and the mechanics of Shari'ah compliance applied in the Islamic bank. It appears that these findings highlight the weak motivation amongst some Shari'ah board members to progress beyond the present emphasis on debt-based financing product features offered by the majority of banks in the Islamic banking industry and the lack of transparency on the resolutions issued by this Shari'ah governance authority for use in this sphere of Islamic banking operations. It also calls for further guidelines by the regulator on enhancing the transparency of the Shari'ah board's roles and functions, which could improve stakeholders' confidence.

Another interesting finding derived from this study is the importance and influence of the Shari'ah board members' principles and how others perceive that the Shari'ah board has accountability. It was found that the Shari'ah board's ethical values and reputation were both ranked first, followed by the Shari'ah board's scholarly background as important factors influencing the accountability of Shari'ah board members. Meanwhile, factors that relate to the Shari'ah board's fiduciary duties, e.g., the requirement for the Shari'ah board to ensure the Shari'ah compliance of the bank as well as stakeholders' reliance on the Shari'ah review done by the Shari'ah board, were perceived to be less important in influencing the Shari'ah board's accountability. It was also discovered that the ranked first factor, i.e., the Shari'ah board's ethical values, was significantly different, with medium-sized banks indicating higher importance than large and small sized bank categories, however, with large banks following closely their medium-sized counterparts regarding the importance given to this issue. It is argued that, as the size of the banks increases, the more important it is for Shari'ah board members to uphold their ethical values when performing their roles and functions. This finding illustrates how the integrity of the Shari'ah governance authority is crucial for the success of financial institutions whose establishment and operations are based on ethical values.

It is worth noting that the issue of independence of Shari'ah board members is usually associated with the remuneration received by them, as is frequently discussed in the literature. However, this study indicates factors associated with a clearly defined scope of responsibilities and, again, the integrity of the Shari'ah board members as the two most crucial factors in influencing the independence of this Shari'ah governance authority. Indeed, the factor of the Shari'ah board's clearly defined scope of responsibilities was found to be significantly different for medium-sized and large banks. A possible explanation for this could be the positive impact from investment in mechanisms such as a precise Shari'ah manual, seeking consultation with external experts, and having support from all relevant parties within the bank on the governance function of the Shari'ah board. Overall, the factors influencing the independence of the Shari'ah board, in order of importance, could be listed as follows: (1) the Shari'ah board's clearly defined scope of responsibilities, (2) the perceived high ethical status of the Shari'ah board, (3) the scholarly background of the Shari'ah board members, (4) adequate powers being mandated to the Shari'ah board, (5) the involvement of Shari'ah board members in

Shari'ah Committees in other industries, (6) the participation of top management in the Shari'ah board's meetings, and finally, (7) the remuneration received by the Shari'ah board.

Interestingly, some of the above findings shed light on the implications that the existing Shari'ah governance policy has for banks offering Islamic banking operations in Malaysia. For example, as was highlighted in Chapter Four, amongst the guidelines stipulated in GPS1 is the requirement for each scholar to be limited to one Shari'ah board membership in institutions within the same industry. However, this study provides evidence that even the involvement of Shari'ah board members with Shari'ah boards in other industries influences the independence of Shari'ah board members. Similarly, the recommendation put forward by the IFSB for top management to participate in the Shari'ah board's meetings was also indicated to have a negative influence on the independence of Shari'ah board members. Hence, these findings have policy implications and call for the regulator to revisit the existing SGF used in the industry.

On the question about the relevant parties to whom Shari'ah boards are deemed accountable, the respondents indicated this to be, first, the board of directors and the SAC of BNM. It is argued that the fact that GPS1 makes it clear that Shari'ah board members should be appointed by and report to the board of directors and that the SAC of the BNM is the regulator and supreme Shari'ah authority have contributed to such results. After these two parties, the respondents indicated the importance of Shari'ah boards' accountability to the shareholders, to the bank's customers and, finally, to the public. Clearly, these results demonstrate the nature of Shari'ah board members' roles and functions as being regulator-centric and not shareholder-centric.

This study also examined several features of the nature of Shari'ah board appointment and mandated authority. It was found that all of the banks represented by the respondents had established fit and proper qualification criteria for the appointment of Shari'ah board members. Evidence also indicated that the appointment of Shari'ah board members is made after ascertaining that they are free from any conflict of interest that could raise questions about their independence. It was also revealed that Shari'ah board members are subject to certain performance assessments by the bank or the BNM. Hence, this study reports robust features of Shari'ah board appointment under the ambit of the dual Shari'ah governance system in Malaysia that would ensure the independent and effective Shari'ah governance function of Shari'ah board members.

On the other hand, there seem to be some flaws in Shari'ah boards' mandated authority. This is due to some evidence indicating that Shari'ah board members are not given adequate powers to undertake their roles and functions, although the vast majority of the respondents indicated otherwise. Similarly, evidence for the existence of a reporting channel for any possible conflict that might arise between Shari'ah board members and the board of directors or the management of the bank seems weak. Moreover, problems associated with the absence of any segregation of Shari'ah board duties that would ensure effective Shari'ah governance, as observed by Alhabshi and Bakar (2008), seems to prevail. Although these problems refer to a handful of banks offering Islamic banking products and services, the apparent cause that contributes to such practices is deemed to be the absence of a clearly mandated requirement from the regulators on the implementation of a governance mechanism that would ensure and make transparent the Shari'ah board's mandated authority.

Another debate surrounding the issue of Shari'ah governance which has also been of interest in this study is about the structure and implementation of the Shari'ah review by the Shari'ah board. On several questions pertaining to the structure of the Shari'ah review by the Shari'ah board, most of the respondents expressed their agreement, although a minority indicated otherwise. This includes whether the respondents consider that the Shari'ah board is the sole authority in the Shari'ah review and whether the Shari'ah board has been prescribed appropriate operative procedures by the bank for its roles and functions. The fact that the majority of the respondents agreed on the Shari'ah review structure regarding these two issues indicates an established attitude amongst the relevant parties within the SGF that the Shari'ah board is the highest Shari'ah authority whose needs for an effective Shari'ah governance function should be supported. However, the concern that arises is that a minority of respondents did not agree with the views expressed; this reveals a possible governance crisis within the banks they represent. For example, if the Shari'ah board is not perceived as the sole Shari'ah governance authority, this could imply that the Shari'ah board has delegated some of its crucial duties to other parties within the bank, possibly the Shari'ah department officers. Alternatively, disagreement on the view indicated the possibility of a much worse scenario, where the Shari'ah board was unable to perform its function effectively due to a lack of independence. Similarly, the absence of any prescribed appropriate operative procedure by the bank on the Shari'ah board's roles and functions would imply an ineffective Shari'ah governance mechanism. This diluted evidence from a minority of the respondents should be taken seriously by the regulator and the board of directors of the respective banks regarding the need for clear guidelines on these issues and for the urgent remedy of the Shari'ah risk that comes from within.

There are other issues on the structure of the Shari'ah review which require equal attention. For example, the responses to the questionnaire indicated that the number of banks whose Shari'ah board's membership comprises various experts was found to be the same as the number of banks whose Shari'ah board's membership comprises Shari'ah scholars only. Although the lack of competent scholars in *fiqh al-mua'malat* and the limit imposed by the regulator for each scholar to hold only one Shari'ah board membership within the same industry, as discussed in Chapter Four, is acknowledged, further investigation should be made regarding the increase in the number of non-Shari'ah scholars holding Shari'ah board membership in an industry the essence of whose business operation is based on the Shari'ah principles and whose Shari'ah board membership depends on Shari'ah scholars. Furthermore, there seems to be evidence of a lack of adequate and apparent guidelines on the pronouncement and resolutions of the SAC for use in the industry as perceived by a considerable number of respondents. Further investigation in this area is also deemed essential, as it is unclear whether this finding stems from a communication gap between the important and related parties within the Malaysian SGF, and, hence, highlights the lack of transparency on the role of the SAC, or is simply because of the lack of such guidelines. Despite all these assumptions, clearly this finding presents a setback for the potential of the dual-layer Shari'ah governance to exert effective Shari'ah governance over the Islamic banking industry against its more established interest-based banking industry.

Meanwhile, there are also several interesting findings on the aspect of the implementation of the Shari'ah review by the Shari'ah board. For example, the view that the Shari'ah board has the full authority to stop banks from undertaking Shari'ah non-compliant transactions was not unanimously agreed on by the respondents. While this is deemed to have grave repercussions for the independence of Shari'ah board members, it also provides room for the management of the bank to engage in opportunist behaviour. In addition, the vast majority of the respondents perceived that the Shari'ah board is given ample time for decision making and for the Shari'ah review, although there is some evidence of respondents indicating otherwise. It is expected that the dynamism of the bank combined with the nature of the banking business, which requires fast decision making, has resulted in respondents indicating that the Shari'ah board does not have ample time. However, it is argued that the management should provide an adequate time frame for the Shari'ah board to undertake its function effectively and efficiently.

This study also reveals findings that most respondents thought that the Shari'ah board has direct access to relevant, accurate, adequate and timely information, with some evidence indicating otherwise. It was discussed in Chapter Four that such a requirement was clearly stipulated in the standards and guidelines issued by the regulators, i.e., AAOIFI, IFSB and GPS1. Hence, negative responses regarding the quality of such information given to the Shari'ah board clearly indicate a violation of the regulatory requirements, and this raises the concern of whether the Shari'ah board is able to undertake its roles and functions independently and effectively. Again, this non-compliance refers to a small number of banks, but has an apparent repercussion for the transparency of these financial institutions and the objective Shari'ah opinion of Shari'ah board members. Similarly intriguing is the fact that a considerable number of respondents disagreed on the view that working part-time does not hinder the Shari'ah board in producing an effective Shari'ah review. This finding is significantly different, with a lower mean value of 3.00 (uncertain) for Shari'ah board members from medium-sized banks. As such, this revelation highlights possible constraints faced by the respondents on the fulfilment of the work load given to the Shari'ah board in banks which are in the 'emerging and expanding' category. In other words, the respondents in the medium-sized banks did not actually foresee that the part-time working attachment could hinder the effectiveness of the Shari'ah review by the Shari'ah board.

To add to the dilemma, only slightly more than half of the respondents were in agreement on the existence of active communication and consultation among the Shari'ah board, the bank, and the SAC of BNM. The remainder of the respondents were either uncertain or in disagreement on the more effective synergy that could have taken place between these important parties within the Malaysian SGF. This, however, is not the level deemed satisfactory, and it points to weak control and monitoring by the regulator. It was suggested that the communication and consultation among the three parties does not seem to exceed beyond the procedural issue relating to Shari'ah board members' appointment and the approval of Islamic banking products and services.

Despite all the deficiencies in the implementation of the Shari'ah review mentioned above, this study discovered that the Shari'ah board gets professional advice to support its function. This revelation by the vast majority of the respondents indicated good communication and cooperation among all interrelated parties within the SGF. The existence of such support should be the focal point for the Shari'ah board to meet the aspirations of the stakeholders in effectively carrying out its ethical Shari'ah governance function and for the Islamic banking industry, in general, to progress further.

Overall, the findings of QS1 seem to indicate that the Shari'ah board has not progressed beyond its traditional Shari'ah advisory role, with issues on the accountability and independence of Shari'ah board members being perceived to be highly reliant on the integrity of the Shari'ah board members themselves. Some of the findings of this study raise concerns about the lack of emphasis, if not neglect, by important parties within the SGF, including that of the SAC of BNM, crucial aspects of Shari'ah governance that hinder the effective governance function of the Shari'ah board and the Malaysian dual-layer Shari’ah governance system in general. The next chapter discusses all the issues under investigation, but from the perspective of the branch managers of banks offering Islamic banking services.

CHAPTER SEVEN: ANALYSIS OF THE SURVEY ON SHARI'AH BOARDS: EXPECTATIONS OF BANKS' BRANCH MANAGERS

7.1 Introduction

This chapter discusses the overall responses to the second questionnaire survey, Questionnaire Survey 2 (QS2). QS2 was distributed and undertaken to elicit the opinion of the branch managers of banks offering Islamic banking products and services in the Malaysian International Islamic Finance Centre (MIFC) of Bank Negara Malaysia (BNM). Similar to Questionnaire Survey 1 (QS1), QS2 aimed to elicit the opinion of the respondents regarding three themes regarding the Shari'ah governance of the Shari'ah board: (1) its role, (2) accountability and independence, and (3) the nature of the Shari'ah review in banks offering Islamic banking products and services. This chapter contains six sections. In section 7.2, the backgrounds of the respondents and the characteristics of the banks offering Islamic banking business are provided. The details of the analyses and the discussion of the findings pertaining to the three themes mentioned above are presented in Section 7.3, Section 7.4 and Section 7.5. Finally, Section 7.6 offers the summary.

7.2 Profile of Respondents and Characteristics of Banks

This section offers an overview of the background of the branch managers whose expectations were sought of the Shari'ah board's role, accountability, and independence and the nature of Shari'ah review. In addition, this section provides an analysis of the characteristics of the banks represented by the branch managers. By distributing the questionnaire to the branch managers, the researcher aimed to compare how the issues investigated in the three themes that constituted the questionnaire survey (both QS1 and QS2) are actually being practised (according to responses by the heads of Shari'ah departments as discussed in Chapter Six) and are expected to be practised by the branch managers, which is the focus of the present chapter.

7.2.1 Gender and Age Range of Branch Managers

Table 7.2.1 below provides an analysis of the background of the branch managers by gender and age range. It is evident from the table that amongst the 78 branch managers who responded to the questionnaire, 54 are male whereas another 24 are female. In addition, it was revealed that the age of the branch managers seems to be concentrated in the range of 35 to 44 years, with 44 branch managers, while there are 11 branch managers in the age range of 25 to 34 years, 22 branch managers in the age range of 45 to 54 years and 1 branch manager in the age range of 55 to 64 years.

Table 7.2.1: Analysis Showing Branch Managers' Gender and Age Range

Branch Managers' Gender	Branch Managers' Age Range									
	25-34 years		35-44 years		45-54 years		55-64 years		Total	
	No.	%	No.	%	No.	%	No.	%	No.	%
Male	8	14.8	28	51.9	17	31.5	1	1.8	54	100.0
Female	3	12.5	16	66.7	5	20.8	0	0	24	100.0
Total	11	14.1	44	56.4	22	28.2	1	1.3	78	100.0

7.2.2 Experience and Level of Education of Branch Managers

Another important demographic detail that was collected in this study and that could be used to explore the quality of the judgments made by the branch managers on the issues under investigation pertains to their level of experience and education. In this regard, Table 7.2.2 shows an analysis of the years of working experience and the level of education attained by the branch managers. As indicated in the table, the majority of the branch managers have more than five years working experience. This level of experience seems reasonable for one holding a position as the branch manager of a particular bank and considered as possessing the required skills and knowledge of a banking operation including that of Islamic banking activities. The second highest range of years of experience attained by the branch managers is between 1 to 3 years (21 branch managers) and followed by 3 to 5 years (17 branch managers) and, finally, less than 1 year (7 branch managers).

Table 7.2.2: Analysis Showing Level of Experience as Branch Manager and the Level of Education

Experience as Branch Manager	Level of Education						Total
	High School Dip.	Bachelor's Degree	Master's Degree	Prof. Cert.	High School Dip. & Prof. Cert.	Master's Degree & Prof. Cert.	
	No.	*No.*	*No.*	*No.*	*No.*	*No.*	*No.*
Less than 1 year	3	4	0	0	0	0	7
1 to 3 years	4	12	4	0	0	1	21
3 to 5 years	3	11	2	1	0	0	17
More than 5 years	3	22	5	1	1	0	32
Total	13	49	11	2	1	1	77

Meanwhile, the bachelor's degree seems to be the most common level of education attained by these branch managers, as 49 out of the 77 responses received indicated this level of education[37]. Besides the bachelor's degree, other branch managers seem to have attained education at the high school diploma level (13 branch managers), followed by

[37] 1 branch manager did not respond to the question on the level of education and this was regarded as missing data by the researcher.

the master's degree level (11 branch managers), professional certificate level (2 branch managers), a combination of high school diploma and professional certificate (1 branch manager) and a combination of master's degree and professional certificate (1 branch manager).

7.2.3 Training Received by the Branch Managers

In analysing the quality of opinion issued by the branch managers in QS2, the researcher also collected details of the aspects of training received by these respondents the findings of which are presented in Table 7.2.3 below.

Table 7.2.3: Analysis Showing Aspects of Training Received by Branch Managers

Fields of Training Received by Branch Managers	No	%
Shari'ah	3	4.1
Fiqh al-mua'malat	1	1.4
Combination of Shari'ah and *fiqh al-mua'malat*	2	2.7
Management	15	20.5
Accounting and Finance	17	23.3
Combination of Shari'ah or/and *fiqh al-mua'malat* with other non-Islamic field(s)	16	21.9
Economics	7	9.6
Others	1	1.4
Combination of non-Islamic Fields	11	15.1
Total	73	100.0

As can be clearly seen from the table, most of the branch managers have been trained in three fields, i.e., accounting and finance (17 branch managers), a combination of Shari'ah or/and *fiqh al-mua'malat* with other non-Islamic fields (16 branch managers), and management (15 branch managers). The high concentration of training received by the branch managers in these fields is not surprising, as these fields are deemed highly relevant and provide the required skills in managing financial institutions such as banks. Furthermore, the high number of scores for training in the field of a combination of Shari'ah or/and *fiqh al-mua'malat* with other non-Islamic fields makes it apparent that this study is investigating financial institutions that practise Islamic banking and finance operations. On the other hand, there are also high scores amongst the branch managers who have undertaken training in a combination of other non-Islamic fields (11 branch managers) while other individual fields, such as economics, Shari'ah, *fiqh al-mua'malat* and others, seem to be less apparent with a score of fewer than 10 branch managers. Meanwhile, five branch managers did not respond to the question regarding the qualification attained and this was regarded as missing data by the researcher.

Hence, it can be said that the branch managers were highly trained to exercise the role of branch manager of a bank. Indeed, the branch managers who had training either in Shari'ah or *fiqh al-mua'malat,* which is the Islamic principal underlying the operation of the Islamic banking business, constituted more than 20% of the total number of branch managers participating in QS2 (after taking into account 3 branch managers who had undertaken training in Shari'ah, 1 branch manager with training in *fiqh al-mua'malat,* 2 branch managers with training in a combination of both Shari'ah and *fiqh al-mua'malat,* as well as 16 branch managers with training in a combination of Shari'ah or/and f*iqh al-mua'malat* with other non-Islamic field(s)). This finding could suggest that the branch managers are highly knowledgeable about Islamic banking operations and the differences between conventional banking and Islamic banking. More importantly, it also hints that the branch managers are highly likely to be aware of the existence and Shari'ah governance function of the Shari'ah board.

7.2.4.1 Branch Managers by the Type and Ownership of Banks

Table 7.2.4 presents an analysis of the representativeness of the branch managers by the type and ownership of banks. As is evident from the table, the majority of the branch managers are from domestic and full-fledged Islamic banks. Briefly, 55 out of the 78 branch managers who participated in QS2 are from full-fledged Islamic banks whereas the remaining 23 are from the banks with an Islamic window. Meanwhile, the branch managers from domestic banks constitute 74 out of the total of 78 branch managers (94.9%) whereas only 4 branch managers are from foreign banks (5.1%).

Table 7.2.4: Analysis Showing Branch Managers by the Type and Ownership of Bank

Type of Bank	Ownership of Bank					
	Domestic		Foreign		Total	
	No	*%*	*No*	*%*	*No*	*%*
Full-fledged Islamic Bank	51	92.7	4	7.3	55	100.0
Bank with Islamic Window	23	100.0	0	.0	23	100.0
Total	74	94.9	4	5.1	78	100.0

Whilst the statistics given above indicate some representativeness of branch managers from both types of bank, i.e. full-fledged Islamic banks and banks with an Islamic window, there is an apparent lack of representatives from foreign banks. A possible explanation for this could be the limited number of branches of foreign banks' networks operating in the country. Hence, it can be said that, mainly, the responses received in QS2 were from branch managers from domestic banks which are more likely to be influenced by the domestic guidelines issued by BNM than by international guidelines, e.g., the AAOIFI governance standards or the IFSB prudential standards.

7.2.4.2 Branch Managers by Bank's Total Assets Categorization

Similar to QS1, in QS2, total assets was used as a proxy to measure size when analysing the representativeness of the branch managers by bank size. Table 7.2.5 presents an analysis of the representativeness of the branch managers by bank's total assets categorization. As is evident from the table, the majority of the branch managers represented large banks with total assets worth more than RM10, 000 million. They account for 47 out of the total number of 78 branch managers (60.3%) who participated in QS2. Meanwhile, the second highest representation amongst the branch managers was from the medium-sized category, with total assets worth between RM1, 000 million to RM10, 000 million, which accounts for 27 branch managers (34.6%). Finally, banks in the small size categorization, with total assets worth less than RM1, 000 million were represented by 4 branch managers (5.1%).

Table 7.2.5: Analysis Showing Branch Managers by Total Assets

Branch Managers by Bank's Total Assets Categorization	No.	Percentage (%)
Small (less than RM1,000 million assets)	4	5.1
Medium (between RM1,000 million to RM10,000 million assets)	27	34.6
Large (more than RM10,000 million assets)	47	60.3
Total	78	100.0

Considering the fact that the large and medium-sized banks were represented by most of the branch managers in QS2 and account for 94.9% of the entire branch manager sample, it could be said that the operations of the banks represented in QS2 are deemed to be extensive. Accordingly, it is expected that such a business operation environment would incline the branch managers to consider a rigorous Shari'ah governance mechanism to be implemented on the Islamic banking operation, which includes the important roles and functions of the Shari'ah board.

7.3 Branch Managers' Expectation on the Role of the Shari'ah Board

The aim of this section is to analyse how the branch managers perceived the expected role of the Shari'ah board amongst participating banks in the MIFC. Hence, the findings in this section would be explained in the light of analysing the differences between the actual Shari'ah governance roles and functions of the Shari'ah board as revealed in QS1 with the expectations of the stakeholders represented by the branch managers in QS2 on the same subject. As was mentioned in Chapter Five, Section A of QS2 contained six questions parallel to those of Section A in QS1. Hence, this section discusses the six questions in the six following subsections. First, an analysis and discussion of the branch managers' expectations of the scope of the Shari'ah advisory by the Shari'ah board will be provided. Second, an analysis regarding the branch managers' expectations regarding the involvement of the Shari'ah board in advising and designing the corporate objectives of the banks will be discussed. Third, an analysis of the branch managers' expectations of the involvement of the Shari'ah board in developing Islamic banking products and services will be offered. The next section presents an analysis of the branch managers' expectations of the involvement of the Shari'ah board in the accounting issues of the bank. This is followed by a subsection which analyzes the branch managers' expectations regarding the relevant parties that assist in the Shari'ah governance function of the Shari'ah board. Finally, an analysis of the branch managers' expectations regarding the Shari'ah governance commitment of the Shari'ah board is provided.

7.3.1 Expectations of Branch Managers on the Scope and Role of Shari'ah Boards

The branch managers were invited to indicate their agreement on the expected scope of the Shari'ah advisory by the Shari'ah board. Table 7.3.1 displays an analysis of branch managers' expectations of the scope of the Shari'ah advisory by the Shari'ah board including a ranking based on the mean value of these respondents' levels of agreement as expressed on a 5-point Likert scale between strongly disagree (1) and strongly agree (5). Interestingly, the ranking of the branch managers' expectations regarding the scope of the Shari'ah advisory by the Shari'ah board, when analysed with a parallel ranking made in

QS1, seems to show that the rank of certain elements of the Shari'ah board's Shari'ah advisory does not correspond to their rank in QS1. This highlights the disparity between the stakeholders' expectations of the scope of the Shari'ah board's Shari'ah advisory and how certain elements are actually implemented by the Shari'ah board. For example, advising the board of directors on Shari'ah matters is ranked first, with a mean value score of 4.64 and with 96.2% of the branch managers indicating their agreement while this is ranked second based on the responses provided by the heads of Shari'ah departments. After the board of directors, the branch managers seem to consider that the next priority for the Shari'ah board regarding the Shari'ah advisory is to advise the Shari'ah department on the scope of the Shari'ah review; this had a mean value score of 4.49 and was ranked second while it was ranked fourth in QS1. Meanwhile, unlike the heads of Shari'ah departments, preparing a Shari'ah compliance manual and endorsing the Shari'ah compliance manual were both closely ranked in third and fourth place respectively, with corresponding mean values of 4.47 and 4.44. These two elements of the Shari'ah advisory were, on the other hand, ranked last, i.e., seventh and first respectively in QS1 by the heads of Shari'ah departments. It is argued that the branch managers consider both preparing and endorsing the Shari'ah compliance manual to be the prerogative of the Shari'ah board and not of some other parties, as the responses by the heads of Shari'ah departments might have indicated. Meanwhile, reporting to the SAC on Shari'ah matters, assisting other parties on Shari'ah matters and providing training to Shari'ah department officers were ranked fifth, sixth and seventh respectively, with their corresponding mean values of 4.42, 4.36 and 4.33. In contrast, in QS1, reporting to the SAC on Shari'ah matters was similarly ranked fifth whilst assisting other parties on Shari'ah matters and providing training to Shari'ah department officers were ranked third and sixth respectively.

Table 7.3.1: Analysis Showing Expectation of Branch Managers on the Scope and Role of Shari'ah Boards

The Scope and Role of Shari'ah Boards	Disagree		Uncertain		Agree		Total		Overall	
	No.	*%*	*No.*	*%*	*No.*	*%*	*No.*	*%*	*Mean*	*Rank*
Advise board of directors on Shari'ah matters	0	0.0	3	3.8	75	96.2	78	100.0	4.64	1
Assist other parties on Shari'ah matters	0	0.0	8	10.3	70	89.7	78	100.0	4.36	6
Advise Shari'ah department officers on scope of Shari'ah review	0	0.0	4	5.1	74	94.9	78	100.0	4.49	2
Provide training to Shari'ah department officers	0	0.0	9	11.5	69	88.5	78	100.0	4.33	7
Report to Shari'ah Advisory Council on Shari'ah matters	1	1.3	5	6.4	72	92.3	78	100.0	4.42	5
Prepare Shari'ah compliance manual	1	1.3	5	6.4	72	92.3	78	100.0	4.47	3
Endorse Shari'ah compliance manual	1	1.3	8	10.3	69	88.5	78	100.0	4.44	4

Table 7.3.2: Test Statistics on Differences in Responses between Heads of Shari'ah Departments (Table 6.3.2) and Branch Managers (Table 7.3.1) on the Scope and Role of Shari'ah Boards

Test Statistics	Advise Board of Directors on Shari'ah Matters	Assist Other Parties on Shari'ah Matters	Advise Shari'ah Department Officers on Scope of Shari'ah Review	Provide Training to Shari'ah Department Officers	Report to Shari'ah Advisory Council on Shari'ah Matters	Prepare Shari'ah Compliance Manual	Endorse Shari'ah Compliance Manual
Mann-Whitney U	873.500	772.000	876.000	438.000	641.000	290.000	807.000
Wilcoxon W	1173.500	3853.000	3957.000	738.000	941.000	590.000	3888.000
Z	-.598	-1.442	-.539	-4.210	-2.552	-5.475	-1.167
Asymp. Sig. (2-tailed)	.550	.149	.590	.000	.011	.000	.243

The above findings from QS2 seem to indicate that the branch managers' expectations of the scope of the Shari'ah board's Shari'ah advisory are not limited to the commonly prescribed Shari'ah advisory role. Instead, the branch managers seem to consider the expected elements of Shari'ah advisory by the Shari'ah board to be procedural in nature and not limited to Shari'ah advice only. This can be deduced from the fact that, after the elements of advising the board of directors and Shari'ah department officers, the branch managers also emphasised preparing and endorsing the Shari'ah manual which, as a whole, signifies the expected need for the Shari'ah board to put Shari'ah advice and the Shari'ah governance mechanism in order. On the other hand, the results highlighted in section 6.3.2 of Chapter Six about QS1 revealed evidence that the Shari'ah board seem to emphasise giving Shari'ah advice only. Hence, there seems to be a disparity between the actual and the expected scope of the Shari'ah board's Shari'ah advisory as revealed from evidence obtained in both QS1 and QS2.

Meanwhile, when the responses from the branch managers and the heads of Shari'ah departments were analysed using the Mann Whitney U test, significant differences in the responses pertaining to three elements of the Shari'ah advisory were found, as shown in Table 7.3.2. These are providing training to the Shari'ah department officers, preparing the Shari'ah compliance manual and reporting to the SAC of BNM on Shari'ah matters. Both of the first two elements of the Shari'ah advisory have a p value of almost 0.000, which shows highly significant differences between the two groups of respondents, with the heads of Shari'ah departments indicating a lower level of agreement than the branch managers, as can be seen from the disparity in their corresponding mean values reported in Table 6.3.2 and Table 7.3.1 respectively. Similarly, opinions on reporting to the SAC on Shari'ah matters are significantly different, with a p value of 0.011 and with the heads of Shari'ah departments indicating a lower level of agreement than the branch managers. These results show the significant gap in the Shari'ah governance practices in terms of the low involvement of the Shari'ah board in these three elements of the Shari'ah advisory and the high expectation for them to be undertaken by the Shari'ah board as perceived by the branch managers.

In addition, analysis using the Mann Whitney U test also produced significant differences in response to the listed elements of the Shari'ah advisory by the types of banks. As is evident from Table 7.3.3 below, opinions on advising the board of directors are significantly different, with a p value of almost 0.000 and with the branch managers from the full-fledged Islamic banks indicating a higher level of agreement than the branch managers from banks with an Islamic window. Earlier, in Table 7.3.1, it was reported that the branch managers regarded advising the board of directors on Shari'ah matters as the Shari'ah board's top priority, as reflected by its first ranking position. In this regard, the reported significant difference the finding revealed regarding this element of the Shari'ah advisory suggests that the branch managers from the full-fledged Islamic banks regarded advising the board of directors on Shari'ah matters as the utmost priority of the Shari'ah board more than did the branch managers of banks with an Islamic window. Such a claim is made in consideration of the difference in how extensive the Islamic banking operations of these two types of banks are. The branch managers from the full-fledged Islamic banks, whose Islamic banking operation is deemed to be more extensive, seem to place more emphasis on the need for the Shari'ah board to undertake its Shari'ah advisory role to the board of directors. As they are operating Islamic banking to full capacity, the branch managers from the full-fledged Islamic banks expressed such a need regarding the Shari'ah advisory role of the Shari'ah board given that the board of directors are the bank's policy and decision makers and the Shari'ah board is the authority responsible for ensuring that the Islamic banking operation is Shari'ah compliant.

Moreover, analysis of the branch managers' expectations about the elements of the Shari'ah board's Shari'ah advisory by bank size also produced significantly different results using the Kruskal Wallis H test. Table 7.3.4 shows that opinion about advising the board of directors on Shari'ah matters differs significantly across the three categories of banks. As is evident from the table, the mean value reported for branch managers from the large banks indicated a higher level of agreement than for those from the small and medium-sized banks. Similar to the above explanation regarding full-fledged Islamic banks, the Islamic banking operations in large banks are expected to be more extensive than those in small and medium-sized banks. This could have resulted in the branch managers from large banks placing more emphasis on the need for the Shari'ah board to provide Shari'ah advice to the board of directors than would their counterparts from small and medium banks.

Meanwhile, another control variable, namely, the number of years the banks have been offering Islamic banking products and services, also produced significantly different results using the Kruskal-Wallis H test. As reported in Table 7.3.5, the expected scope of the Shari'ah advisory by the Shari'ah board was significantly different regarding advising the board of directors on Shari'ah matters (p value of 0.037), providing training to Shari'ah department officers (p value of 0.033), reporting to the SAC of BNM on Shari'ah matters (p value of 0.043) and endorsing the Shari'ah compliance manual produced by the management (p value of 0.037). The table also shows that the mean values are higher for banks whose experience in offering Islamic banking products and services ranges in the category of 11 to 15 years on three significantly different expected elements of the Shari'ah advisory: advising the board of directors on Shari'ah matters, reporting to the SAC on Shari'ah matters, and endorsing the Shari'ah compliance manual prepared by the management. However, the mean values are higher for the category 6 to 10 years experience in offering Islamic banking products and services regarding the expected element of Shari'ah advisory listed as providing training to the Shari'ah department officers.

Arguably, both the 6 to 10 and the 11 to 15 years banking experience in offering Islamic banking products and services categories could be regarded as the mid range of Islamic banking experience, considering the length of time that the Malaysian Islamic banking industry has been established. Hence, the significant differences reported reflect how the branch managers from these two Islamic banking experience categories considered four expected elements of the Shari'ah advisory by the Shari'ah board to be more crucial than other elements of the Shari'ah advisory during these stages of Islamic banking experience. As such, the reported three elements of the Shari'ah advisory found to be significantly different in the category of 11 to 15 years of Islamic banking experience suggest that they are considered to be more pertinent to be undertaken by the Shari'ah board as the bank goes through the higher cycle of Islamic banking experience. On the other hand, the branch managers represented from the 6 to 10 years of Islamic banking experience considered providing training to the Shari'ah department officers to be more pertinent to be undertaken by the Shari'ah board as the bank starts into the mid category of Islamic banking experience or development.

Table 7.3.3: Analysis Showing Expectation of Branch Managers on the Scope and Role of Shari'ah Boards by the Type of Bank

The Scope of Shari'ah Board Role	Type of Bank								Sig.
	Full-fledged Islamic Banks				Bank with Islamic Window				
	Disagree	Uncertain	Agree	Overall	Disagree	Uncertain	Agree	Overall	
	%	*%*	*%*	***Mean***	*%*	*%*	*%*	***Mean***	
Advise board of directors on Shari'ah matters	.0	1.8	98.2	4.78	.0	8.7	91.3	4.3	*0.000
Assist other parties on Shari'ah matters	.0	9.1	90.9	4.4	.0	13.0	87.0	4.26	-
Advise Shari'ah department officers on scope of Shari'ah Review	.0	3.6	96.4	4.56	.0	8.7	91.3	4.3	-
Provide training to Shari'ah department officers	.0	9.1	90.9	4.4	.0	17.4	82.6	4.17	-
Report to Shari'ah Advisory Council on Shari'ah Matters	.0	5.5	94.5	4.51	4.3	8.7	87.0	4.22	-
Prepare Shari'ah compliance manual	.0	5.5	94.5	4.49	4.3	8.7	87.0	4.43	-
Endorse Shari'ah compliance manual	1.8	9.1	89.1	4.49	.0	13.0	87.0	4.3	

* Indicates distribution of responses is significantly different (using the Mann Whitney U test)

Table 7.3.4: Analysis Showing Expectation of Branch Managers on the Scope and Role of Shari'ah Boards by Total Assets

The Scope and Role of Shari'ah Boards	Total Assets by Category												Sig
	Small (Less than RM1,000 million assets)				Medium (between RM1,000 million to RM10,000 million assets)				Large (More than RM10,000 million assets)				
	Disagree	Uncertain	Agree	Overall	Disagree	Uncertain	Agree	Overall	Disagree	Uncertain	Agree	Overall	
	%	*%*	*%*	*Mean*	*%*	*%*	*%*	*Mean*	*%*	*%*	*%*	*Mean*	
Advise board of directors on Shari'ah matters	0	0	100	4.25	0	11.1	88.9	4.44	0	0	100	4.79	*0.017
Assist other parties on Shari'ah matters	0	0	100	4.5	0	14.8	85.2	4.19	0	8.5	91.5	4.45	-
Advise Shari'ah department officers on scope of Shari'ah review	0	0	100	4.25	0	11.1	88.9	4.33	0	2.1	97.9	4.6	-
Provide training to Shari'ah department officers	0	25	75	4	0	18.5	81.5	4.22	0	6.4	93.6	4.43	-
Report to Shari'ah Advisory Council on Shari'ah matters	25	0	75	4	0	14.8	85.2	4.26	0	2.1	97.9	4.55	-
Prepare Shari'ah compliance manual	25	0	75	4	0	11.1	88.9	4.48	0	4.3	95.7	4.51	-
Endorse Shari'ah compliance manual	0	0	100	4.5	0	14.8	85.2	4.33	2.1	8.5	89.4	4.49	-

*Indicates distribution of responses between the three categories of total assets is statistically significantly different using the Kruskal-Wallis H test

Table 7.3.5: Analysis Showing Expectation of Branch Managers on the Scope and Role of Shari'ah Boards by the Number of Years Banks have been offering Islamic Banking (IB)

The Scope and Role of Shari'ah Boards	Number of Years Banks have been Offering IB								Sig.
	0-5 Years		6-10 Years		11-15 Years		16 Years and above		
	Overall		Overall		Overall		Overall		
	No	***Mean***	***No***	***Mean***	***No***	***Mean***	***No***	***Mean***	
Advise board of directors on Shari'ah matters	19	4.58	22	4.91	1	5.00	36	4.50	*0.037
Assist other parties on Shari'ah matters	19	4.26	22	4.45	1	4.00	36	4.36	-
Advise Shari'ah department officers on scope of Shari'ah review	19	4.53	22	4.73	1	5.00	36	4.31	-
Provide training to Shari'ah department officers	19	4.26	22	4.68	1	4.00	36	4.17	*0.033
Report to Shari'ah Advisory Council on Shari'ah matters	19	4.16	22	4.73	1	5.00	36	4.36	*0.043
Prepare Shari'ah compliance manual	19	4.53	22	4.55	1	4.00	36	4.42	-
Endorse Shari'ah compliance manual	19	4.63	22	4.64	1	5.00	36	4.19	*0.037

* Indicates the distribution is significantly different between the four categories of years banks offer Islamic banking products and services (using the Kruskal-Wallis H test)

7.3.2 Expectations of Branch Managers on Involvement of Shari’ah Boards in the Corporate Objectives of the Banks

This section deals with investigating the perception of the branch managers on the expected involvement of the Shari’ah board in advising and designing the corporate objectives of the banks. In this regard, the branch managers were invited to indicate their agreement based on a five-point Likert scale between strongly disagree (1) and strongly agree (5). Table 7.3.6 shows the analysis of the findings.

Table 7.3.6: Analysis Showing Expectations of Branch Managers on Involvement of Shari’ah Boards in the Corporate Objectives of the Banks

Involvement of Shari’ah Boards in the Corporate Objectives of the Banks	Disagree		Uncertain		Agree		Overall	
	No	***%***	***No***	***%***	***No***	***%***	***Mean***	***Rank***
The bank's mission	3	3.8	11	14.1	64	82.1	4.27	2
The bank's vision	4	5.1	11	14.1	63	80.8	4.24	3
The bank's goal	4	5.1	8	10.3	66	84.6	4.23	4
The bank's objectives	3	3.8	8	10.3	67	85.9	4.29	1
The bank's corporate brand value	5	6.4	12	15.4	61	78.2	4.10	6
The bank's long-term strategic direction	5	6.4	7	9.0	66	84.6	4.18	5

As is evident from Table 7.3.6, almost all corporate objectives were given an indication of a more than 80% level of agreement for the Shari’ah board to be involved in advising or designing the corporate objectives of their respective banks, although some responses indicated disagreement. In addition, the table also reports the mean values across all the corporate objectives of the banks based on the responses provided by the branch managers. The table above indicates that element of the bank's objectives is ranked first, as it has the highest mean value (4.29). Meanwhile, the bank's mission is ranked second, with a mean value of 4.27. On the other hand, the bank's vision is ranked third with a mean value of 4.24. The following ranking position of the remaining corporate objectives and their corresponding mean values are as follows: the bank's goal (4.23), the bank's long-term strategic direction (4.18), and the bank's corporate brand value (4.10).

There seems to be some disparity between the actual and the expected involvement of the Shari'ah board in advising and designing the corporate objectives of the banks as reported by the heads of Shari'ah departments in QS1 (Table 6.3.3) and by the branch managers in QS2 (Table 7.3.6). First of all, the vast majority of the heads of Shari'ah departments in QS1 indicated that the Shari'ah board was not actually involved in the corporate objectives of their respective banks whereas the branch managers thought otherwise. A reference to Table 6.3.3 of QS1 shows that the mean values of responses made by the heads of Shari'ah departments were 3.0 and under, thus indicating uncertainty to disagreement. On the other hand, the reported mean values for the branch managers in Table 7.3.6 of QS2 are above 4.0, thus indicating agreement to strong agreement on the expected involvement of the Shari'ah board. In addition, the responses of the heads of Shari'ah departments (QS1) and the branch managers (QS2) are significantly different for all listed corporate objectives, with a p value of almost 0.000, as shown in Table 7.3.7 below. These findings show a large gap in the lack of implementation of Shari'ah governance by the Shari'ah board and how the stakeholders see the required role of the Shari'ah board in matters pertaining to the corporate objectives of banks offering Islamic banking products and services. It also gives an insight into what the stakeholders, under the stakeholder theory spectrum discussed in Chapter Two, have indicated to be their interests and which are perceived to be highly important for the Shari'ah boards to fulfil.

Table 7.3.7: Test Statistics on Differences in Responses between Heads of Shari'ah Departments (Table 6.3.3) and Branch Managers (Table 7.3.6) on Involvement of Shari'ah Boards in the Corporate Objectives of the Banks

Test Statistics	The Bank's Mission	The Bank's Vision	The Bank's Goal	The Bank's Objectives	The Bank's Corporate Brand Value	The Bank's Long-term Strategic Direction
Mann-Whitney U	346.000	339.000	373.000	374.000	383.500	443.000
Wilcoxon W	646.000	639.000	673.000	674.000	683.500	743.000
Z	-4.905	-4.950	-4.678	-4.694	-4.548	-4.098
Asymp. Sig. (2-tailed)	.000	.000	.000	.000	.000	.000

Second, there also seems to be disparity in terms of the priority actually given by the Shari'ah board and that which the Shari'ah board is expected to give regarding involvement in the corporate objectives of the bank. For example, amongst the Shari'ah boards involved in advising and designing the corporate objectives of the banks, priority seems to be given to the bank's long-term strategic direction, as this was ranked first, as reported in Table 6.3.3. This was followed by the bank's objectives (ranked second), the bank's mission, the bank's goal, and the bank's corporate brand value (ranked equal third), and finally the bank's vision (ranked sixth). However, there are differences regarding the corporate objectives which the branch managers thought the Shari'ah board should make being involved in a priority. For example, unlike the bank's long-term direction in QS1, the branch managers thought that the Shari'ah board should give top priority to the bank's objectives. These findings show how the branch managers thought the bank's objectives which, as they are the essence of the Islamic banking business, should be accorded top priority by the Shari'ah board. Meanwhile, unlike the priority given by the Shari'ah board to the bank's long-term strategic direction (ranked first in Table 6.3.3), this was not seen by the branch managers as being more crucial than other corporate objectives (as it was ranked fifth) regarding the involvement of the Shari'ah board. A possible explanation for this difference is that the branch managers might not consider the bank's long-term strategic direction as more fundamental than other listed corporate objectives to which the Shari'ah board should give priority.

In addition, analyses by control variables produced significantly different results for types of banks, total assets and the number of years the bank has been offering Islamic banking products and services. The analyses of the findings by these control variables are reported below in Tables 7.3.8, 7.3.9 and 7.3.10 respectively.

As is evident in Table 7.3.8, analysis by the types of banks produced significantly different results for three corporate objectives. These corporate objectives and their corresponding p values are the bank's mission (p value of 0.023), the bank's vision (p value of 0.027), and the bank's objectives (p value of 0.043). The table also shows there was a higher level of agreement regarding these three corporate objectives for full-fledged Islamic banks than for the banks with an Islamic window. A reference to Table 7.3.6 above indicates that these three corporate objectives represent the first three top corporate objectives in which the branch managers expected the Shari'ah board to be involved. Hence, it can be said that expectation of the branch managers in the full-fledged Islamic banks for the Shari'ah board to be involved in these three corporate objectives is more pertinent than that of branch managers from banks with an Islamic window. Given that the operations of full-fledged Islamic banks are expected to be generally more extensive than those of banks with an Islamic window, these significantly different findings between the two types of bank seem to be justified.

Meanwhile, analysis by the total assets categorization produced significantly different results for the bank's mission and the bank's vision, as indicated in Table 7.3.9 below. These two corporate objectives indicated a higher level of agreement for large banks in comparison to the other two categories of bank size, with the bank's mission having a p value of 0.023 and the bank's vision having a p value of 0.031. These findings suggest that the branch managers from large banks think that the Shari'ah board's role in advising and designing the bank's mission and vision more pertinent than do the branch managers from the small and medium banks. Generally, the bank's mission and vision define how the bank would pursue its strategic planning on matters pertaining to the fundamental purpose of its existence and its intended future state respectively. Arguably, large banks are deemed to be more determined and focused on achieving such targets and, therefore, consider the Shari'ah board's involvement in terms of advising and designing Islamic banking aspirations to be more crucial than do small or medium-sized banks.

On the other hand, Table 7.3.10 below presents evidence that the corporate objectives which was ranked first as the expected top priority for the involvement of the Shari'ah board, i.e., the bank's objectives, is the only factor that produces significantly different results when analysed by the number of years the bank has been offering Islamic banking products and services. The table reports that banks with 11-15 years of Islamic banking experience indicated a higher level of agreement than did banks from other experience categorizations, with a p value of 0.035. As described earlier, the 11-15 years of Islamic banking experience represents the upper mid range before the bank reaches the Islamic banking maturity level. Hence, the significantly different findings on the bank's objectives amongst branch managers from this level of Islamic banking experience show the importance these managers give to the need for the Shari'ah board to be involved in ensuring that the bank does not fail to achieve its corporate objectives.

Table 7.3.8: Analysis Showing Expectations of Branch Managers on Involvement of Shari'ah Boards in the Corporate Objectives of the Bank by Type of Bank

Involvement of Shari'ah Boards on the Corporate Objectives of the Banks	Type of Bank								Sig.
	Full-fledged Islamic Banks				Bank with Islamic Window				
	Disagree	Uncertain	Agree	Overall	Disagree	Uncertain	Agree	Overall	
	%	*%*	*%*	*Mean*	*%*	*%*	*%*	*Mean*	
The bank's mission	5.5	7.3	87.3	4.38	.0	30.4	69.6	4.00	*0.023
The bank's vision	5.5	9.1	85.5	4.36	4.3	26.1	69.6	3.96	*0.027
The bank's goal	7.3	5.5	87.3	4.31	.0	21.7	78.3	4.04	-
The bank's objectives	5.5	5.5	89.1	4.38	.0	21.7	78.3	4.09	*0.043
The bank's corporate brand value	7.3	14.5	78.2	4.16	4.3	17.4	78.3	3.96	-
The bank's long-term strategic direction	9.1	7.3	83.6	4.22	.0	13.0	87.0	4.09	-

* Indicates distribution of responses is significantly different between the two categories of bank types using the Mann Whitney U test.

Table 7.3.9: Analysis Showing the Expectations of Branch Managers on Involvement of Shari'ah Boards in the Corporate Objectives of the Bank by Total Assets Categorization

Involvement of Shari'ah Boards on the Corporate Objectives of the Bank	Total Assets by Category												Sig.
	Small (Less than RM1,000 million assets)				Medium (between RM1,000 million to RM10,000 million assets)				Large (More than RM10,000 million assets)				
	Disagree	Uncertain	Agree	Overall	Disagree	Uncertain	Agree	Overall	Disagree	Uncertain	Agree	Overall	
	%	*%*	*%*	*Mean*	*%*	*%*	*%*	*Mean*	*%*	*%*	*%*	*Mean*	
The bank's mission	.0	75.0	25.0	3.25	.0	18.5	81.5	4.26	6.4	6.4	87.2	4.36	*0.023
The bank's vision	.0	75.0	25.0	3.25	3.7	14.8	81.5	4.22	6.4	8.5	85.1	4.34	*0.031
The bank's goal	.0	50.0	50.0	3.50	.0	14.8	85.2	4.26	8.5	4.3	87.2	4.28	-
The bank's objectives	.0	50.0	50.0	3.50	.0	14.8	85.2	4.30	6.4	4.3	89.4	4.36	-
The bank's corporate brand value	25.0	25.0	50.0	3.00	.0	22.2	77.8	4.15	8.5	10.6	80.9	4.17	-
The bank's long-term strategic direction	.0	25.0	75.0	3.75	.0	11.1	88.9	4.22	10.6	6.4	83.0	4.19	-

* Indicates distribution of responses is significantly different between the three categories of total assets using the Kruskal-Wallis H test.

Table 7.3.10: Analysis Showing Expectations of Branch Managers on Involvement of Shari'ah Boards in the Corporate Objectives of the Bank by the Number of Years the Banks have been Offering Islamic Banking (IB)

Involvement of Shari'ah Boards on the Corporate Objectives of the Banks	Number of Years Banks have been offering IB								Sig.
	0-5 Years		6-10 Years		11-15 years		16 Years and above		
	Total		Total		Total		Total		
	Count	Mean	Count	Mean	Count	Mean	Count	Mean	
The bank's mission	19	4.05	22	4.55	1	5.00	36	4.19	-
The bank's vision	19	4.11	22	4.55	1	5.00	36	4.11	-
The bank's goal	19	4.00	22	4.50	1	5.00	36	4.17	-
The bank's objectives	19	4.11	22	4.59	1	5.00	36	4.19	*0.035
The bank's corporate brand value	19	3.89	22	4.41	1	4.00	36	4.03	-
The bank's long-term strategic direction	19	4.21	22	4.36	1	4.00	36	4.06	-

* Indicate the distribution is significantly different (using the Kruskal Wallis H test)

7.3.3 Expectations of Branch Managers on Involvement of Shari'ah Boards in the Development of Islamic Banking Products and Services

This section is concerned with how the Shari'ah board is expected to be involved in the development of Islamic banking products and services from the point of view of the branch managers. Thus, the branch managers were invited to indicate their agreement based on a five-point Likert scale between strongly disagree (1) and strongly agree (5) on their expectations regarding the Shari'ah board's involvement in the development of selected Islamic banking products and services. Table 7.3.11 below displays the analysis of the findings, including the ranking made based on the mean values of the responses provided by the branch managers.

As is evident from the table, all stages of Islamic banking products and services development reported mean values of higher than 3.0, which indicates that the branch managers agree and strongly agree about their expectations regarding the Shari'ah board's involvement. Based on these mean values, the branch managers seem to give priority to the Shari'ah board's involvement in the conception stage, which has the highest mean value (4.47) and secures the first rank. In order of importance, this is followed by the legal documentation stage (mean value of 4.35), review stage (mean value of 4.26), design stage (mean value of 4.04), implementation stage (mean value of 3.97), testing stage (mean value of 3.65), pricing stage (mean value of 3.62) and finally, marketing stage (mean value of 3.47).

An analysis of the comparison between the results for the expected involvement of the Shari'ah board in this subject as reported in Table 7.3.11 and those of Shari'ah boards' actual practice, as reported in Table 6.3.4 of Chapter Six, reveals minor differences in terms of the priority indicated by the two parties. For example, the stages of products and services development that were ranked first, second, third, fourth, fifth and seventh were the same for both the expected and the actual practice of the Shari'ah board. The only differences between the two were indicated for the stages of development ranked in the sixth and eighth positions. Based on Table 7.3.11, the testing stage and marketing stage correspond to positions six and eight respectively for the expected involvement of the

Table 7.3.11: Analysis Showing Expectations of Branch Managers on Involvement of Shari'ah Boards in the Development of Islamic Banking Products and Services

Involvement of Shari'ah Boards in the Development of Islamic Banking Products and Services	Disagree		Uncertain		Agree		Total		Overall	
	No	*%*	*No*	*%*	*No*	*%*	*No*	*%*	*Mean*	*Rank*
Conception stage	1	1.3	5	6.4	72	92.3	78	100.0	4.47	1
Design stage	6	7.7	8	10.3	64	82.1	78	100.0	4.04	4
Pricing stage	14	17.9	16	20.5	48	61.5	78	100.0	3.62	7
Legal documentation stage	2	2.6	3	3.8	73	93.6	78	100.0	4.35	2
Testing stage	10	12.8	18	23.1	50	64.1	78	100.0	3.65	6
Marketing stage	16	20.5	20	25.6	42	53.8	78	100.0	3.47	8
Implementation stage	10	12.8	7	9	61	78.2	78	100.0	3.97	5
Review stage	1	1.3	5	6.4	72	92.3	78	100.0	4.26	3

Table 7.3.12: Test Statistics on Differences in Responses between Heads of Shari'ah Departments (Table 6.3.4) and Branch Managers (Table 7.3.11) on the Involvement of Shari'ah Boards in the Development of Islamic Banking Products and Services

Test Statistics	Conception Level	Design Level	Pricing Level	Legal Documentation Level	Testing Level	Marketing Level	Implementation Level	Review Level
Mann-Whitney U	771.00	616.50	489.50	832.50	250.00	762.50	524.00	834.50
Wilcoxon W	1071.000	916.500	789.500	1132.500	550.000	1062.500	824.000	1134.500
Z	-1.460	-2.726	-3.664	-.909	-5.666	-1.418	-3.427	-.896
Asymp. Sig. (2-tailed)	.144	.006	.000	.363	.000	.156	.001	.370

Shari'ah board whereas similar positions on the Shari'ah board's actual practice were indicated in Table 6.3.4 as the marketing and testing stages. Although these two stages of products and services development were not given the top priority, their corresponding ranking positions indicate how the two parties differ regarding which is more important. In this regard, the Shari'ah board seems to give more importance to marketing than to testing the products whereas the branch managers consider the testing more important than the marketing of Islamic banking products and services.

In addition, an analysis of the differences between the responses given by the two parties regarding the actual and expected involvement of the Shari'ah board in the development of Islamic banking products and services produced significantly different results using the Mann Whitney U test. Table 7.3.12 indicates the stage of development of products and services and their corresponding p values. As shown in the table, four stages of products and services development are significantly different: design stage (p value of 0.006), pricing stage (p value of almost 0.000), testing stage (p value of almost 0.000), and implementation stage (p value of 0.001). A cross-examination of the mean values reported in Table 6.3.4 and Table 7.3.11 indicated that the mean values on the four factors found to be significantly different are higher for the responses from the branch managers (in QS2 pertaining to the expected involvement of the Shari'ah board) than those of the heads of Shari'ah departments (in QS1 pertaining to the actual involvement of the Shari'ah board). As such, it can be said that the branch managers' view of the need for the Shari'ah board to be involved in these four stages of products and services development is greater than the Shari'ah board's actual involvement.

Meanwhile, analysis by the control variable types of banks using the Mann Whitney U test produced significantly different results for both design and legal documentation stages, as reported in Table 7.3.13 below. These stages of products and services development have a p value of 0.034 and 0.016 respectively, with the mean values for branch managers from the full-fledged Islamic banks being reportedly higher than those of banks with an Islamic window. These results indicate that the branch managers from the full-fledged Islamic banks gave more importance to the need for the Shari'ah board to be involved in these two stages of products and services development than do the branch managers from banks with an Islamic window. The importance given to these two stages of product development might highlight the branch managers' scepticism about the lack of emphasis given by the Shari'ah board to these stages of developing Islamic financing products and services.

On the other hand, Table 7.3.14 reports that analysis by the control variable 'the number of year banks have been offering Islamic banking products and services' using the Kruskal-Wallis H test also produced significantly different results for the legal documentation stage. As is evident from the table, the legal documentation stage had a p value of 0.010 with banks with 11-15 years of Islamic banking experience indicating a higher stage of agreement than other Islamic banking experience categorizations.

Table 7.3.13: Analysis Showing Expectations of Branch Managers on Involvement of Shari'ah Boards in the Development of Islamic Banking Products and Services by Type of Bank

Involvement of Shari'ah Boards in the Development of Islamic Banking Products and Services	Type of Bank								Sig.
	Full-fledged Islamic Banks				Bank with Islamic Window				
	Disagree	Uncertain	Agree	Overall	Disagree	Uncertain	Agree	Overall	
	%	*%*	*%*	*Mean*	*%*	*%*	*%*	*Mean*	
Conception stage	.0	7.3	92.7	4.53	4.3	4.3	91.3	4.35	-
Design stage	7.3	9.1	83.6	4.15	8.7	13.0	78.3	3.78	*0.034
Pricing stage	14.5	25.5	60.0	3.62	26.1	8.7	65.2	3.61	-
Legal documentation stage	1.8	3.6	94.5	4.45	4.3	4.3	91.3	4.09	*0.016
Testing stage	12.7	25.5	61.8	3.64	13.0	17.4	69.6	3.70	-
Marketing stage	18.2	29.1	52.7	3.51	26.1	17.4	56.5	3.39	-
Implementation stage	14.5	12.7	72.7	3.91	8.7	.0	91.3	4.13	-
Review stage	1.8	9.1	89.1	4.29	.0	.0	100.0	4.17	-

* Indicates distribution of responses is significantly different between the two categories of bank types using the Mann Whitney U test

Table 7.3.14: Analysis Showing Expectations of Branch Managers on Involvement of Shari'ah Boards in the Development of Islamic Banking Products and Services by the Number of Years the Banks have been Offering Islamic Banking (IB)

Involvement of Shari'ah Boards in the Development of Islamic Banking Products and Services	Number of Years Banks have been offering IB								Sig.
	0-5 Years		6-10 Years		11-15 Years		16 Years and above		
	Overall		Overall		Overall		Overall		
	No	*Mean*	*No*	*Mean*	*No*	*Mean*	*No*	*Mean*	
Conception stage	19	4.32	22	4.59	1	5.00	36	4.47	-
Design stage	19	3.84	22	4.27	1	4.00	36	4.00	-
Pricing stage	19	3.42	22	3.45	1	3.00	36	3.83	-
Legal documentation stage	19	4.05	22	4.68	1	5.00	36	4.28	*0.010
Testing stage	19	3.58	22	3.45	1	2.00	36	3.86	-
Marketing stage	19	3.16	22	3.45	1	2.00	36	3.69	-
Implementation stage	19	3.84	22	3.91	1	2.00	36	4.14	-
Review stage	19	4.05	22	4.36	1	4.00	36	4.31	-

* Indicates the distribution is significantly different between the four categories of years bank offers Islamic banking products and services using the Kruskal-Wallis H test

7.3.4 Expectations of Branch Managers on Involvement of Shari'ah Boards in the Accounting Issues

The aim of this section is to analyse the branch managers' expectations regarding the involvement of the Shari'ah board in the accounting issues of the bank. In this regard, the branch managers were invited to indicate their agreement based on a five-point Likert scale between strongly disagree (1) and strongly agree (5) on their expectations regarding the Shari'ah board's involvement in the development of selected Islamic banking products and services. Analysis of the findings is reported in Table 7.3.15 below.

Table 7.3.15 below reveals that, although the vast majority of the branch managers indicated agreement on the expected involvement of the Shari'ah board across all selected accounting issues (more than 70%), there were also responses in disagreement regarding the Shari'ah board undertaking such a role. The table also displays the mean values of the responses provided by the branch managers, which were used as an indication of the priority given by these respondents. As revealed in the table, the branch managers seem to give top priority to the Shari'ah board undertaking the role of approving the calculation and distribution of *zakat* (mean value of 4.35). The accounting issue that comes second in priority pertains to validating the documentation on Islamic financing contracts (mean value of 4.24). This is followed by issuing the Shari'ah report in third position (mean value of 4.22), approving accounting policy in fourth position (mean value of 4.09), determining profit distribution formula in fifth position (mean value of 3.99), endorsing the annual report in sixth position (mean value of 3.95) and finally, validating Islamic banking transaction records in seventh position (mean value of 3.82).

Analysis of the differences in the responses provided by the heads of Shari'ah departments and the branch managers regarding the actual and expected involvement of the Shari'ah board in the accounting issues of the bank produced significantly different results on three accounting issues using the Mann Whitney U test. As is evident in Table 7.3.16, these accounting issues and their corresponding p values are as follows: determining the profit distribution formula (p value of almost 0.000), approving the

Table 7.3.15: Analysis Showing Expectations of Branch Managers on Involvement of Shari'ah Boards in the Accounting Issues of the Bank

Involvement of Shari'ah Boards in the Accounting Issues of the Bank	Disagree		Uncertain		Agree		Overall	
	No	***%***	***No***	***%***	***No***	***%***	***Mean***	***Rank***
Determine profit distribution formula	8	10.3	11	14.1	59	75.6	3.99	5
Approve calculation & distribution of *zakat*	2	2.6	7	9.0	69	88.5	4.35	1
Approve accounting policy	5	6.4	11	14.1	62	79.5	4.09	4
Validate documents in contracts	5	6.4	7	9.0	66	84.6	4.24	2
Validate transaction records	10	12.8	11	14. 1	57	73.1	3.82	7
Issue Shari'ah report	4	5.1	5	6.4	69	88.5	4.22	3
Endorse annual report	8	10.3	12	15.4	58	74.4	3.95	6

Table 7.3.16: Test Statistics on Differences in Responses between Heads of Shari'ah Departments (Table 6.3.7) and Branch Managers (Table 7.3.15) on involvement of Shari'ah Boards in the Accounting Issues of the Bank

Test Statistics	Determine Profit Distribution Formula	Approve Calculation & Distribution of *Zakat*	Approve Accounting Policy	Validate Transaction Records	Validate Documents in Contracts	Issue Shari'ah Report	Endorse Annual Report
Mann-Whitney U	495.500	847.000	579.500	879.000	747.000	657.000	819.000
Wilcoxon W	795.500	1147.000	879.500	3960.000	1047.000	957.000	3900.000
Z	-3.625	-.771	-2.952	-.492	-1.585	-2.367	-.977
Asymp. Sig. (2-tailed)	.000	.441	.003	.623	.113	.018	.329

accounting policy (p value of 0.003), and issuing the Shari'ah report (p value of 0.018). Moreover, a cross-examination of the responses provided by the two groups of respondents reported in Table 6.3.7 (of QS1) and Table 7.3.15 (of QS2) revealed that the responses of the branch managers regarding these three accounting issues indicated higher mean values than those of the heads of Shari'ah departments. These findings clearly indicate that there is a significant gap between the actual and the expected level of Shari'ah board involvement regarding the three accounting issues mentioned. Thus, it can be said that the branch managers regarded these three accounting issues as important, and hence, expected the level of involvement of the Shari'ah board to be greater than that already undertaken.

In terms of the importance established by the two groups of respondents on the actual and expected involvement of the Shari'ah board in bank's accounting issues as indicated by the ranking positions in Table 6.3.7 and Table 7.3.15, only slight variations between the two can be observed. For example, Table 6..3.7 reported that the Shari'ah board seems to give most importance to validating the documentation on Islamic financing contracts whereas the branch managers seem to perceive matters pertaining to approving the calculation and distribution of *zakat* to be more important (ranked first in Table 7.3.15). Nevertheless, the differences between the two issues do not seem to have any major implications, as the ranking of both accounting issues differs by one ranking position, i.e., approving the calculation and distribution of *zakat*, which branch managers ranked as first in importance, was ranked second in importance as regards the Shari'ah board's actual practice as reported in Table 6.3.7. Similarly, all of the remaining accounting issues, although they do not have parallel positions between the expected and actual practice of the Shari'ah board, were revealed to have differences in ranking of one or two positions only.

Meanwhile, analysis by the control variable 'bank ownership' produced significantly different results using Mann Whitney U test. Table 7.3.17 below shows that validating Islamic banking transaction records was significantly different, with a p value of 0.039 and with the branch managers from foreign banks indicating greater expected involvement of the Shari'ah board than did the branch managers from domestic banks. This result shows that the branch managers from the foreign banks give more importance to the Shari'ah board undertaking validation of Islamic banking transaction records than do the branch managers from the domestic banks. This finding could demonstrate that these branch managers are sceptical about the present level of Shari'ah boards' involvement during the important stage of validating Islamic banking transactions.

Similarly, analysis by the control variable total assets produced significantly different results using the Kruskal-Wallis H test. Respondents from large banks indicated a greater expected involvement of the Shari'ah board in undertaking approval of the calculation and distribution of *zakat* than did those from other banks, with a p value of 0.044, as shown in Table 7.3.18. Earlier, it was discussed that this accounting issue was given the top priority on the expected involvement of the Shari'ah board based on the first ranking position as reported in Table 7.3.15. Hence, this significantly different finding indicates that this emphasis was more pertinent amongst the branch managers from the large banks than those from the small or medium-sized banks.

Another control variable that produced significantly different results using the Kruskal-Wallis H test was 'the number of years the bank has offered Islamic banking products and services'. Table 7.3.19 below shows that two accounting issues were found to be significantly different: approving the calculation and distribution of *zakat* and validating the documentation on Islamic banking contracts. The responses for these two accounting issues were indicated to be higher for banks with 11-15 years of Islamic banking experience than for other categorizations of Islamic banking experience. Hence, it seems that the branch managers from this Islamic banking experience categorization consistently contradict other branch managers in giving emphasis to the Shari'ah board undertaking involvement in these accounting issues, which are also counted amongst the two accounting issues ranked as most important (ranked first and second in Table 7.3.15).

Table 7.3.17: Analysis Showing Expectation of Branch Managers on Involvement of Shari'ah Boards in the Accounting Issues of the Bank by Bank Ownership

Involvement of Shari'ah Boards in the Accounting Issues of the Bank	Ownership of Bank								Sig.
	Domestic Banks				Foreign Banks				
	Disagree	Uncertain	Agree	Overall	Disagree	Uncertain	Agree	Overall	
	%	*%*	*%*	*Mean*	*%*	*%*	*%*	*Mean*	
Determine profit distribution formula	9.5	14.9	75.7	4.00	25.0	.0	75.0	3.75	-
Approve calculation & distribution of *zakat*	2.7	9.5	87.8	4.32	.0	.0	100.0	4.75	-
Approve accounting policy	6.8	14.9	78.4	4.07	.0	.0	100.0	4.50	-
Validate documents in contracts	6.8	9.5	83.8	4.20	.0	.0	100.0	5.00	-
Validate transaction records	13.5	14.9	71.6	3.77	.0	.0	100.0	4.75	*0.039
Issue Shari'ah report	5.4	6.8	87.8	4.20	.0	.0	100.0	4.50	-
Endorse annual report	10.8	14.9	74.3	3.95	.0	25.0	75.0	4.00	-

* Indicates distribution of responses is significantly different between the two categories of bank ownership using the Mann Whitney U test

Table 7.3.18: Analysis Showing Expectations of Branch Managers on Involvement of Shari'ah Boards in the Accounting Issues of the Bank by Total Assets Categorization

Involvement of Shari'ah Boards in the Accounting Issues of the Bank	Total Assets by Category												Sig.
	Small (Less than RM1,000 million assets)				Medium (between RM1,000 million to RM10,000 million assets)				Large (More than RM10,000 million assets)				
	Disagree	Uncertain	Agree	Overall	Disagree	Uncertain	Agree	Overall	Disagree	Uncertain	Agree	Overall	
	%	*%*	*%*	*Mean*	*%*	*%*	*%*	*Mean*	*%*	*%*	*%*	*Mean*	
Determine profit distribution formula	25.0	.0	75.0	3.75	3.7	18.5	77.8	4.04	12.8	12.8	74.5	3.98	-
Approve calculation & distribution of *zakat*	.0	25.0	75.0	4.00	3.7	7.4	88.9	4.15	2.1	8.5	89.4	4.49	0.044
Approve accounting policy	.0	.0	100.0	4.25	7.4	18.5	74.1	3.93	6.4	12.8	80.9	4.17	-
Validate documents in contracts	.0	.0	100.0	4.25	7.4	18.5	74.1	3.96	6.4	4.3	89.4	4.40	-
Validate transaction records	25.0	.0	75.0	3.75	11.1	22.2	66.7	3.70	12.8	10.6	76.6	3.89	-
Issue Shari'ah report	.0	.0	100.0	4.25	.0	7.4	92.6	4.22	8.5	6.4	85.1	4.21	-
Endorse annual report	25.0%	.0%	75.0%	3.75	3.7%	14.8%	81.5%	4.15	12.8%	17.0%	70.2%	3.85	-

* Indicates the distribution is significantly different between the three categories of total assets using the Kruskal-Wallis H test

Table 7.3.19: Analysis Showing Expectations of Branch Managers on Involvement of Shari'ah Boards in the Accounting Issues of the Bank by the Number of Years Banks have been Offering Islamic Banking (IB)

Involvement of Shari'ah Boards in the Accounting Issues of the Bank	**Number of Years Banks have been Offering IB**								**Sig.**
	0-5 Years		**6-10 Years**		**11-15 Years**		**16 Years & above**		
	Overall		**Overall**		**Overall**		**Overall**		
	No	***Mean***	***No***	***Mean***	***No***	***Mean***	***No***	***Mean***	
Determine profit distribution formula	19	3.84	22	3.68	1	3.00	36	4.28	-
Approve calculation & distribution of *zakat*	19	3.95	22	4.55	1	5.00	36	4.42	*0.022
Approve accounting policy	19	3.84	22	4.36	1	3.00	36	4.08	-
Validate documents in contracts	19	3.84	22	4.68	1	5.00	36	4.17	*0.012
Validate transaction records	19	3.58	22	4.05	1	4.00	36	3.81	-
Issue Shari'ah report	19	4.42	22	4.45	1	4.00	36	3.97	-
Endorse annual report	19	4.00	22	3.82	1	5.00	36	3.97	-
* Indicates the distribution is significantly different (using the Kruskal-Wallis H test)									

7.3.5 Expectations of Branch Managers on the Relevant Parties Assisting the Shari'ah Governance Function of Shari'ah Boards

In this section, the branch managers were asked who amongst the relevant parties they expect to assist the Shari'ah board in performing its roles and functions. Thus, they were invited to indicate their agreement based on a five-point Likert scale between strongly disagree (1) and strongly agree (5) on their expectations regarding the relevant parties who should provide assistance to the Shari'ah board. Analysis of the findings is reported in Table 7.3.20 below.

Table 7.3.20: Analysis Showing Expectations of Branch Managers on the Relevant Parties Assisting Shari'ah Boards

Relevant Parties Assisting Shari'ah Boards	Disagree		Uncertain		Agree		Total		Overall	
	No	***%***	***No***	***%***	***No***	***%***	***No***	***%***	***Mean***	***Rank***
Shari'ah department	0	.0	4	5.1	74	94.9	78	100.0	4.62	1
Audit committee	6	7.7	14	17.9	58	74.4	78	100.0	3.95	3
Internal auditor	5	6.4	15	19.2	58	74.4	78	100.0	3.91	4
External auditor	10	12.8	21	26.9	47	60.3	78	100.0	3.58	6
Board of directors	9	11.5	15	19.2	54	69.2	78	100.0	3.86	5
Management	3	3.8	6	7.7	69	88.5	78	100.0	4.23	2
'Shared services'	9	11.5	28	35.9	41	52.6	78	100.0	3.55	7
Consultants	13	16.7	24	30.8	41	52.6	78	100.0	3.47	8

As can be observed from Table 7.3.20, the vast majority of the branch managers expressed agreement with the relevant parties providing assistance to the Shari'ah board. However, except for Shari'ah department officers, there were objections amongst some of the branch managers regarding the need for these relevant parties to assist the Shari'ah board. For instance, Table 7.3.20 indicates that the relevant parties shown to have received objections to their assisting the Shari'ah board were the consultants, the external auditor, and shared services as well as the board of directors. Nonetheless, Table 7.3.20 reveals Shari'ah department officers to be the most important party expected to assist Shari'ah board members in undertaking their roles and functions, and this corresponds to the highest assistance actually received by the Shari'ah board (similarly ranked first) as reported in Table 6.3.8 of Chapter Six. Such consistency underlines the crucial role of the Shari'ah department officers within the Shari'ah governance mechanism of banks offering Islamic banking products and services.

In addition, both Table 6.3.8 and Table 7.3.20 make it apparent that the management and the internal auditor were consistently ranked second and fourth as the relevant parties to assist the Shari'ah board based on the responses given by the two groups of respondents.

Other than these three parties, both tables reported differences in the importance attributed to the relevant parties as can be seen by the differences in their ranking positions, including that of the board of directors. Interestingly, Table 6.3.8 indicates that the board of directors is ranked third whereas Table 7.3.20 ranks these directors fifth, i.e., below the position of the audit committee and the internal auditor. This suggests that the branch managers consider the latter two as more important in assisting the Shari'ah governance function of the Shari'ah board. One possible explanation for the assumed superiority of these two parties over the board of directors is deemed to be their auditing role, which would complement the *ex ante* audit and *ex post* audit function of the Shari'ah board.

Meanwhile, Table 7.3.21 below reports that the analysis of the differences in the responses provided by the two groups of respondents produced significantly different findings using the Mann Whitney U test for three relevant parties: the audit committee (p value of 0.001), internal auditor (p value of 0.044) and external auditor (p value of 0.012) were found to produce significantly different responses from the branch managers, achieving a higher mean value than with the heads of Shari'ah departments. These findings reveal the existence of a significant gap between the actual and expected assistance these three parties provide to the Shari'ah board. The results derived from this analysis seem to indicate that the branch managers expected that the audit committee, internal auditor and external auditor would provide greater assistance to the Shari'ah board than they actually contribute.

On the other hand, analysis by the control variable types of banks on the relevant parties who should assist the Shari'ah board produced a significantly different result for Shari'ah department officers, with a p value of 0.001 using the Mann Whitney U test. As is evident in Table 7.3.22 below, the branch managers from the full-fledged Islamic banks expected greater assistance from the Shari'ah department officers than did the branch managers from the banks with an Islamic window. It is suggested that the nature of Islamic banking operations in full-fledged Islamic banks, which are deemed to be more extensive than that of the banks with Islamic windows, contributed to this result.

Similarly, Shari'ah department officers were the only relevant party found to be significantly different when an analysis of differences was conducted by the control variable total assets, with a p value of 0.019 using the Kruskal-Wallis H test. Table 7.3.23 below reports that the mean value of the responses was highest for the branch managers from large banks, indicating that greater assistance from Shari'ah department officers was expected amongst branch managers from this bank size than amongst other categorizations of bank size. As suggested above, the prospect of Islamic banking operations being more extensive is also deemed to be a contributing factor for why branch managers from large banks expect greater assistance from the Shari'ah department officers than do branch managers from other sized banks.

Table 7.3.21: Test Statistics on Differences in Responses between Heads of Shari'ah Departments (Table 6.3.8) and Branch Managers (Table 7.3.20) on the Relevant Parties Assisting Shari'ah Boards

Test Statistics	Shari'ah Department	Audit Committee	Internal Auditor	External Auditor	Board of Directors	Management	'Shared Services'	Consultants
Mann-Whitney U	859.000	527.500	697.000	636.000	846.500	829.500	759.000	821.000
Wilcoxon W	3940.000	827.500	997.000	936.000	1146.500	3910.500	1059.000	1121.000
Z	-.749	-3.391	-2.011	-2.507	-.748	-.928	-1.466	-.946
Asymp. Sig. (2-tailed)	.454	.001	.044	.012	.454	.353	.143	.344

Table 7.3.22: Analysis Showing Expectations of Branch Managers on the Relevant Parties Assisting Shari'ah Boards by Type of Bank

Relevant Parties Assisting Shari'ah Boards	Type of Bank								Sig.
	Full-fledged Islamic Banks				Bank with an Islamic Window				
	Disagree	Uncertain	Agree	Overall	Disagree	Uncertain	Agree	Overall	
	%	%	%	*Mean*	%	%	%	*Mean*	
Shari'ah department	.0	3.6	96.4	4.75	.0	8.7	91.3	4.30	*0.001
Audit committee	7.3	20.0	72.7	3.95	8.7	13.0	78.3	3.96	-
Internal auditor	7.3	20.0	72.7	3.91	4.3	17.4	78.3	3.91	-
External auditor	10.9	30.9	58.2	3.55	17.4	17.4	65.2	3.65	-
Board of directors	12.7	21.8	65.5	3.80	8.7	13.0	78.3	4.00	-
Management	5.5	9.1	85.5	4.20	.0	4.3	95.7	4.30	-
'Shared services'	14.5	38.2	47.3	3.45	4.3	30.4	65.2	3.78	-
Consultants	14.5	36.4	49.1	3.44	21.7	17.4	60.9	3.57	-

* Indicates distribution of responses is significantly different between the two categories of bank types using the Mann Whitney U test

Table 7.3.23: Analysis Showing Expectations of Branch Managers on the Relevant Parties Assisting Shari'ah Boards by the Total Assets

Relevant Parties Assisting Shari'ah Boards	Total Assets by Category												Sig.
	Small (Less than RM1,000 million assets)				Medium (between RM1,000 million to RM10,000 million assets)				Large (More than RM10,000 million assets)				
	Disagree	Uncertain	Agree	Overall	Disagree	Uncertain	Agree	Overall	Disagree	Uncertain	Agree	Overall	
	%	*%*	*%*	***Mean***	*%*	*%*	*%*	***Mean***	*%*	*%*	*%*	***Mean***	
Shari'ah department	.0	.0	100.0	4.25	.0	7.4	92.6	4.44	.0	4.3	95.7	4.74	*0.019
Audit committee	.0	.0	100.0	4.25	7.4	18.5	74.1	3.85	8.5	19.1	72.3	3.98	-
Internal auditor	.0	25.0	75.0	4.00	3.7	22.2	74.1	3.81	8.5	17.0	74.5	3.96	-
External auditor	25.0	.0	75.0	3.75	11.1	33.3	55.6	3.56	12.8	25.5	61.7	3.57	-
Board of directors	.0	.0	100.0	4.00	7.4	18.5	74.1	3.96	14.9	21.3	63.8	3.79	-
Management	.0	.0	100.0	4.25	.0	7.4	92.6	4.30	6.4	8.5	85.1	4.19	-
'Shared services'	25.0	.0	75.0	3.50	.0	37.0	63.0	3.85	17.0	38.3	44.7	3.38	-
Consultants	50.0	.0	50.0	3.00	18.5	25.9	55.6	3.56	12.8	36.2	51.1	3.47	-

* Indicates the distribution is significantly different between the three categories of total assets using the Kruskal-Wallis H test

7.3.6 Expectations of Branch Managers on Commitments of Shari'ah Board Members

The branch managers were also invited to indicate their agreement on a five-point Likert scale ranging from 1 (strongly disagree) to 5 (strongly agree) regarding their expectations on whether Shari'ah board members should undertake selected commitments similar to those which were posed to the heads of Shari'ah departments, as discussed in section 6.3.7 of Chapter Six. Table 7.3.24 below reports the analysis of the findings.

Generally, the vast majority of the branch managers expressed their agreement that the Shari'ah board should undertake the selected commitments, although a small number of them (a maximum of two branch managers) also indicated disagreement, as revealed in Table 7.3.24. In addition, the table shows that the mean values of the responses are higher than 4.00, indicating that the branch managers agree to strongly agree that the Shari'ah board should undertake these commitments. When the mean value for each commitment in Table 7.3.24 was compared with its corresponding mean value in Table 6.3.10, it was found that the mean value reported in the former was higher. Moreover, an analysis of the difference in responses provided by the two groups of respondents produced significantly different results using the Mann Whitney U test. Table 7.3.25 below shows four of the selected commitments to be significantly different: publish resolutions to the public (p value of almost 0.000), engage in innovation of Islamic banking products and services (p value of almost 0.000), analyze how Islamic banking products and services would benefit *ummah* before they are launched (p value of 0.042), and responding to questions through discussions with the shareholders and the public (p value of 0.005).

Further examination of Table 6.3.10 and Table 7.3.24 reveals that the mean values reported for each commitment showed a consistent pattern both for the expected and the actual commitments undertaken by the Shari'ah board in terms of their positions. For example, Table 7.3.24 reveals that the highest mean value was reported for branch managers' expectations regarding commitments pertaining to Shari'ah board members engaging in workshops and meetings of scholars of *fiqh al-mua'malat* to promote consistency in Islamic banking products and services. Apparently, this same commitment gains the highest mean value, as reported in Table 6.3.10. Indeed, other commitments reported in the two tables were also revealed to be consistent in their respective mean value positions. Thus, both parties seem to be aware of and to recognize the importance of these commitments, which Shari'ah board members fulfil in accordance with their priority as suggested by their mean value position. Hence, these findings provide a positive indication of the success of the dual-layer Shari'ah governance system implemented in Malaysia in addressing this agenda.

Meanwhile, analysis by the control variable types of banks produced significantly different results using the Mann Whitney U test. Table 7.3.26 below reports that the commitment pertaining to publishing resolutions to the public was significantly different, with a p value of 0.022 and with the branch managers from the full-fledged Islamic banks indicating higher expectations regarding Shari'ah board members' commitment than do the branch managers from banks with an Islamic window, as revealed by the higher mean value of the former compared to the latter.

In addition, analysis by the control variable 'the number of years the bank has been offering Islamic banking products and services' also produced significantly different results using the Kruskal-Wallis H test. As is evident in Table 7.3.27 below, the two commitments found to be significantly different are engaging in workshops and meetings of scholars of *fiqh al-mua'malat* to promote consistency in Islamic banking products and services (p value of 0.004) and analysing whether Islamic banking products and services would deliver any benefit to the *ummah* before they are launched (p value of 0.005). Apparently, based on the highest mean value reported, the branch managers of banks with 11-15 years of Islamic banking experience indicated a higher expectation for these two commitments to be undertaken by the Shari'ah board than did branch managers from other Islamic banking experience categorizations.

Table 7.3.24: Analysis Showing Expectations of Branch Managers on Commitments of the Shari'ah Boards

Shari'ah Board Members' Commitment	Disagree		Uncertain		Agree		Total		Overall
	No	*%*	*No*	*%*	*No*	*%*	*No*	*%*	*Mean*
Publish resolutions to the public	2	2.60	5	6.40	71	91.00	78	100.00	4.32
Engage in innovation of IB products & services	2	2.60	6	7.70	70	89.70	78	100.00	4.35
Engage in effort to promoting consistency of IB products & services	1	1.30	4	5.10	73	93.60	78	100.00	4.47
Analyze how IB products & services would benefit *ummah* before they are launched	1	1.30	6	7.70	71	91.00	78	100.00	4.45
Enhance Shari'ah review skills by attending training	0	0.00	6	7.70	72	92.30	78	100.00	4.4
Respond to questions through discussions with the shareholders & the public	2	2.60	12	15.40	64	82.10	78	100.00	4.15

Table 7.3.25: Test Statistics on Differences in Responses between Heads of Shari'ah Departments (Table 6.3.10) and Branch Managers (Table 7.3.24) on Commitments of the Shari'ah Board

Test Statistics	Publish Resolutions to the Public	Engage in Innovation of IB products & Services	Promote Consistency of IB products & Services	Analyze how IB Products & Services would Benefit *Ummah* Before They are Launched	Enhance Shari'ah Review Skills by Attending Training	Respond to Questions through Discussions with the Shareholders & the Public
Mann-Whitney U	339.500	527.500	810.500	703.000	746.500	603.000
Wilcoxon W	639.500	827.500	1110.500	1003.000	1046.500	903.000
Z	-5.011	-3.488	-1.110	-2.032	-1.649	-2.806
Asymp. Sig. (2-tailed)	.000	.000	.267	.042	.099	.005

Table 7.3.26: Analysis Showing Expectations of Branch Managers on Commitments of the Shari'ah Board by Type of Bank

Shari'ah Board Members' Commitment	Type of Bank								Sig.
	Full-fledged Islamic Banks				Bank with an Islamic Window				
	Disagree	Uncertain	Agree	Overall	Disagree	Uncertain	Agree	Overall	
	%	*%*	*%*	*Mean*	*%*	*%*	*%*	*Mean*	
Publish resolutions to the public	1.8	1.8	96.4	4.47	4.3	17.4	78.3	3.96	*0.022
Engage in innovation of IB products & services	1.8	7.3	90.9	4.40	4.3	8.7	87.0	4.22	-
Engage in effort on promoting consistency of IB products & services	.0	5.5	94.5	4.56	4.3	4.3	91.3	4.26	-
Analyze how IB products & services would benefit *ummah* before they are launched	.0	7.3	92.7	4.55	4.3	8.7	87.0	4.22	-
Enhance Shari'ah review skills by attending training	.0	9.1	90.9	4.44	.0	4.3	95.7	4.30	-
Respond to questions through discussions with the shareholders & the public	1.8	14.5	83.6	4.25	4.3	17.4	78.3	3.91	-

* Indicates distribution of responses is significantly different between the two categories of bank types using the Mann Whitney U test.

Table 7.3.27: Analysis Showing Expectations of Branch Managers on Commitments of the Shari'ah Board by the Number of Years Banks have been Offering Islamic Banking (IB)

Shari'ah Board Members' Commitment	Number of Years Banks have been Offering IB								Sig.
	0-5 Years		6-10 Years		11-15 Years		16 Years & above		
	Overall		Overall		Overall		Overall		
	No	*Mean*	*No*	*Mean*	*No*	*Mean*	*No*	*Mean*	
Publish resolutions to the public	19	4.11	22	4.45	1	5.00	36	4.33	-
Engage in innovation of IB products & services	19	4.11	22	4.64	1	5.00	36	4.28	-
Promote consistency of IB products & services	19	4.37	22	4.86	1	5.00	36	4.28	*0.004
Analyze how IB products & services would benefit *ummah* before they are launched	19	4.05	22	4.77	1	5.00	36	4.44	*0.005
Enhance Shari'ah review skills by attending training	19	4.32	22	4.68	1	5.00	36	4.25	-
Respond to questions through discussions with the shareholders & the public	19	3.95	22	4.45	1	4.00	36	4.08	-
* Indicates distribution of responses is statistically different between the four categories of years banks have been offering banking products and services using the Kruskal-Wallis H test									

7.4 Expectation of Branch Managers on the Accountability and Independence of Shari'ah Boards

This section investigates the branch managers' expectations regarding the issue of accountability and independence of the Shari'ah board. It offers the researcher an understanding of these two important issues from the perspective of the stakeholder, which in this case is the branch manager of banks offering Islamic banking products and services. Similar to section 6.4 of Chapter Six, this section comprises four relevant subsections: in the first two subsections an analysis of the expected factors influencing the Shari'ah board's accountability and independence respectively are provided and these are followed by a subsection on the analysis of the expected relevant parties to whom Shari'ah board members are deemed accountable and, finally, an analysis of the expected nature of Shari'ah board appointment and mandated authority.

7.4.1 Expectations of Branch Managers on Factors Influencing Accountability

The branch managers were invited to indicate the level of importance based on scale between very unimportant (1) to very important (5) on 5 crucial factors that are believe to influence the accountability of Shari'ah board members. Table 7.4.1 below provides analysis of the findings on the level of importance on the factors influencing the accountability of Shari'ah board members.

As can be observed from Table 7.4.1 below, the vast majority of the branch managers provided feedback in the important category, although evidence also indicates that one branch manager responded in the negative to both of the listed factors that are deemed to influence the accountability of the Shari'ah board. Analysis based on the mean value of the responses provided revealed that the Shari'ah board's ethical value had the highest mean value of 4.69 and, therefore, was considered by the branch managers to be the most important factor influencing the Shari'ah board's accountability. The Shari'ah board's ethical value was similarly ranked first in importance by the heads of Shari'ah departments as influencing the Shari'ah board's accountability, as reported in Table

6.4.1.The factor that comes next in importance to the branch managers appears to be inconsistent with that cited by the heads of Shari'ah departments. As is evident in Table 7.4.1, the requirement for the Shari'ah board to ensure the Shari'ah compliance of the bank was ranked second in importance, with a mean value of 4.68. It is worth remembering that, in addition to giving the position of most important factor, like the branch managers, to the Shari'ah board's ethical value, the heads of Shari'ah departments also perceived that the Shari'ah board's reputation, which scored the same mean value of 4.75, was ranked equal first, as reported in Table 6.4.1. This means that the heads of Shari'ah departments give equal weight to the Shari'ah board's ethical value and the Shari'ah board's reputation, considering them the two most important factors influencing the accountability of the Shari'ah board. The branch managers, however, considered the Shari'ah board's reputation, which scored a mean value of 4.51, to be fourth in importance after the Shari'ah board's scholarly background, which scored a mean value of 4.53. Finally, the stakeholders' reliance on the Shari'ah board was considered by both the branch managers and the heads of Shari'ah departments to be the least important factor, with the responses from the former group having a mean value score of 4.23.

Meanwhile, an analysis of the differences in the responses provided by the branch managers and the heads of Shari'ah departments did not produce significantly different results, and, thus, is not reported here. However, analysis by the control variable 'the number of year bank has been offering Islamic banking products and services' produced significantly different results using the Kruskal-Wallis H test. Table 7.4.2 below shows two factors were found to be significantly different; their respective p values are as follows: the Shari'ah board's ethical value has a p value of 0.036 and the Shari'ah board's scholarly background has a p value of 0.034. As is evident in the table, branch managers from banks with 11-15 years of Islamic banking experience accorded greater importance to these two significance factors than did branch managers from banks of other Islamic banking experience categorizations.

Analyses by other control variables did not produce significantly different results and, thus, are not reported here.

Table 7.4.1: Analysis Showing Expectations of Branch Managers on Factors Influencing Accountability of Shari'ah Boards Members

Factors Influencing Accountability of Shari'ah Boards Members	Unimportant		Uncertain		Important		Overall	
	No	*%*	*No*	*%*	*No*	*%*	*Mean*	*Rank*
Shari'ah board's ethical value	0	.0	3	3.8	75	96.2	4.69	1
Shari'ah board's scholarly background	1	1.3	6	7.7	71	91.0	4.53	3
Shari'ah board's reputation	0	.0	7	9.0	71	91.0	4.51	4
Stakeholders' reliance to Shari'ah board	1	1.3	14	17.9	63	80.8	4.23	5
Shari'ah board's requirement to ensure Shari'ah compliance	0	.0	1	1.3	77	98.7	4.68	2

Table 7.4.2: Analysis Showing Expectations of Branch Managers on Factors Influencing Accountability of Shari'ah Board Members by the Number of Years Banks have been Offering Islamic Banking (IB)

Factors Influencing Accountability of Shari'ah Board Members	Number of Years Banks have been Offering IB								Sig.
	0-5 years		6-10 Years		11-15 years		16 Years & Above		
	Overall		Overall		Overall		Overall		
	No	*Mean*	*No*	*Mean*	*No*	*Mean*	*No*	*Mean*	
Shari'ah board's ethical value	19	4.58	22	4.95	1	5.00	36	4.58	*0.036
Shari'ah board's scholarly background	19	4.32	22	4.86	1	5.00	36	4.42	*0.034
Shari'ah board's reputation	19	4.42	22	4.77	1	5.00	36	4.39	-
Stakeholders' reliance to Shari'ah board	19	4.16	22	4.36	1	4.00	36	4.19	-
Shari'ah board's requirement to ensure Shari'ah compliance	19	4.58	22	4.86	1	4.00	36	4.64	-
* Indicates distribution of responses is statistically different between the four categories of number of years banks have been offering banking products and services using the Kruskal-Wallis H test									

7.4.2 Expectations of Branch Managers on Factors Influencing Independence

Besides the issue of accountability discussed above, the branch managers were also invited to indicate their perception of the level of importance based on a five-point Likert scale from very unimportant (1) to very important (5) on seven crucial factors thought to influence the independence of Shari'ah board members. An analysis of the findings on the level of importance as perceived by the branch managers is provided in Table 7.4.3 below.

Table 7.4.3: Analysis Showing Expectations of Branch Managers on Factors Influencing Independence of Shari'ah Boards Members

Factors Influencing Independence of Shari'ah Board Members	Unimportant		Uncertain		Important		Total		Overall	
	No	*%*	*No*	*%*	*No*	*%*	*No*	*%*	*Mean*	*Rank*
A clearly defined scope of responsibility	0	0	3	3.8	75	96.2	78	100	4.51	1
The remuneration received	15	19.2	22	28.2	41	52.6	78	100	3.41	7
The scholarly background	1	1.3	7	9	70	89.7	78	100	4.40	3
The perceived high ethical status	0	0	7	9	71	91	78	100	4.45	2
Adequate powers being mandated	0	0	6	7.7	72	92.3	78	100	4.36	4
Participation of the top management in the Shari'ah board's meetings	1	1.3	13	16.7	64	82.1	78	100	4.12	6
Involvement of Shari'ah board members in Shari'ah boards in other industries	3	3.8	8	10.3	67	85.9	78	100	4.22	5

In Table 7.4.3, the responses of the branch managers are provided including the corresponding mean values of the responses regarding all the factors as well as their importance ranking based on the mean values derived. The responses reported in this table reveal that the perceived importance given by the branch managers of all factors influencing the independence of Shari'ah board members seems to be consistent with that of the heads of Shari'ah departments, as the ranking order in Table 7.4.3 is similar to that in Table 6.4.3. In addition, the branch managers seem to give more weight to the importance of these factors, which results in the mean values reported in Table 7.4.3 being generally higher than the responses of the heads of Shari'ah departments, as reported in Table 6.4.3. However, no significantly different results were found when an analysis was conducted of the differences between the responses of the two groups of respondents, and, hence this is not reported here.

The Shari'ah board's clearly defined scope of responsibilities was similarly ranked first as a factor influencing the independence of the Shari'ah board. Indeed, the importance given in the responses of 96.2% of the total number of branch managers regarding this factor stresses its importance to the independence of the Shari'ah board as the foundation for establishing the board's accountability. Meanwhile, Shari'ah board members' integrity were emphasised as an important factor which influences the independence of Shari'ah board members. The perceived high ethical status of Shari'ah board members and their scholarly background were ranked second and third in importance, where 91.0% and 89.7% of the total number of branch managers respectively perceived them as being important in influencing the independence of the Shari'ah board. In addition to being consistent with the findings of Abdul Rahman et al. (2005) and supporting the Shari'ah board's ethical requirement argument made by Karim (1990a), the responses regarding the last two factors also similarly highlight the need for a code of conduct for Shari'ah board members.

On the other hand, Table 7.4.3 also indicates that the factors of adequate powers being mandated to Shari'ah board members, the involvement of the Shari'ah board members as the Shari'ah board in other industries, the participation of top management in the Shari'ah board's meeting and the remuneration received by the Shari'ah board were ranked fourth, fifth, sixth and seventh respectively in importance in influencing the independence of the

Shari'ah board. As can be seen from the table, the factor of adequate powers being mandated to Shari'ah board members was perceived as important by 92.3% of the respondents. Meanwhile, the last three ranking positions, while recording high percentages for their perceived importance, also show responses in the negative. Of the total number of branch managers 3.8% considered as unimportant the involvement of Shari'ah board members in Shari'ah Committees in other industries; the participation of top management in the Shari'ah board's meetings recorded 1.3%, and the remuneration received by the Shari'ah board recorded 19.2%

Analysis by other control variables did not produce significantly different results except for the control variables bank ownership and the number of years the bank has been offering Islamic banking products and services. Table 7.4.4 below indicates that the factor of the Shari'ah board being mandated with adequate powers was significantly different using the Mann Whitney U test, with a p value of 0.045. As is evident from the table, the branch managers from foreign banks gave greater importance to this factor influencing the independence of the Shari'ah board than did branch managers from the domestic banks. This finding demonstrates how branch managers from foreign banks emphasize the need for the Shari'ah board, as the Shari'ah governance authority of banks offering Islamic banking business, to be mandated with adequate powers. Hence, such mandated powers would allow this authority to exercise its roles and functions independently in the best interests of the stakeholders without coming under pressure from the management or other parties.

On the other hand, Table 7.4.5 below indicates that the factor of the scholarly background of the Shari'ah board was significantly different when tested using the Kruskal-Wallis H test, with a p value of 0.044. As is evident from the table, the branch managers from banks with 11-15 years of Islamic banking experience gave greater importance to this factor than did branch managers from other Islamic banking experience categorizations.

Table 7.4.4: Analysis Showing Expectations of Branch Managers on Factors Influencing Independence of Shari'ah Boards Members by Bank Ownership

Factors Influencing Independence of Shari'ah Board Members	Ownership of Bank								Sig.
	Domestic				Foreign				
	Unimportant	Uncertain	Important	Total	Unimportant	Uncertain	Important	Overall	
	%	%	%	%	%	%	%	*Mean*	
A clearly defined scope of responsibility	.0	4.1	95.9	4.51	.0	.0	100.0	4.50	-
The remuneration received	18.9	29.7	51.4	3.41	25.0	.0	75.0	3.50	-
The scholarly background	1.4	9.5	89.2	4.39	.0	.0	100.0	4.50	-
The perceived high ethical status	.0	9.5	90.5	4.42	.0	.0	100.0	5.00	-
Adequate powers being mandated	.0	8.1	91.9	4.32	.0	.0	100.0	5.00	*0.045
Participation of top management in Shari'ah board's meeting	1.4	17.6	81.1	4.11	.0	.0	100.0	4.25	-
Involvement of Shari'ah board members in Shari'ah boards in other industries	2.7	10.8	86.5	4.24	25.0	.0	75.0	3.75	-

* Indicates distribution of responses is significantly different between the two categories of bank ownership using the Mann Whitney U test

Table 7.4.5: Analysis Showing Expectations of Branch Managers on Factors Influencing Independence of Shari'ah Board Members by the Number of Years Banks have been Offering Islamic Banking (IB)

Factors Influencing Independence of Shari'ah Board Members	**Number of Years Banks have been Offering IB**								**Sig.**
	0-5 Years		**6-10 Years**		**11-15 Years**		**16 Years & Above**		
	Overall		**Overall**		**Overall**		**Overall**		
	No	***Mean***	***No***	***Mean***	***No***	***Mean***	***No***	***Mean***	
A clearly defined scope of responsibility	19	4.47	22	4.68	1	5.00	36	4.42	-
The remuneration received	19	3.16	22	3.36	1	2.00	36	3.61	-
The scholarly background	19	4.21	22	4.73	1	5.00	36	4.28	*0.044
The perceived high ethical status	19	4.42	22	4.64	1	5.00	36	4.33	-
Adequate powers being mandated	19	4.32	22	4.55	1	5.00	36	4.25	-
Participation of top management in Shari'ah board's meeting	19	4.05	22	4.27	1	4.00	36	4.06	-
Involvement of Shari'ah board members in Shari'ah boards in other industries	19	4.05	22	4.41	1	4.00	36	4.19	-

* Indicates the distribution is significantly different between the four categories of number of years the bank has offered Islamic banking products and services using the Kruskal-Wallis H test.

7.4.3 Expectations of Branch Managers on Relevant Parties to whom Shari'ah Board Members are Accountable

When undertaking their Shari'ah governance roles and functions, the Shari'ah board receives assistance from several parties within the bank. This study invited the branch managers to indicate the importance they perceived as having the relevant parties, similar to those in section 6.43 of Chapter Six, to whom the Shari'ah board are deemed accountable based on a five-point Likert scale from very unimportant (1) to very important (5). Table 7.4.6 below shows analysis of the findings.

Table 7.4.6: Analysis Showing the Parties to whom the Branch Managers Perceived Shari'ah Board Members to be Accountable

Parties Shari'ah Board Members are Accountable	Unimportant		Uncertain		Important		Total		Overall	
	No	*%*	*No*	*%*	*No*	*%*	*No*	*%*	*Mean*	*Rank*
Bank's shareholders	7	9.00	7	9.00	64	82.10	78	100	4.15	5
Bank's consumers	5	6.40	5	6.40	68	87.20	78	100	4.19	4
Bank's board of directors	4	5.10	8	10.30	66	84.60	78	100	4.21	3
Public	1	1.30	8	10.30	69	88.50	78	100	4.41	2
SAC BNM	1	1.30	6	7.70	71	91.00	78	100	4.46	1

Table 7.4.7: Test Statistics on Differences in the Responses between Heads of Shari'ah Departments (Table 6.4.5) and Branch Managers (Table 7.4.6) on Parties to whom Shari'ah Board Members are Perceived to be Accountable

Test Statistics	Bank's Shareholders	Bank's Consumers	Bank's Board of Directors	Public	SAC BNM
Mann-Whitney U	804.000	769.000	681.000	923.000	847.500
Wilcoxon W	3885.000	3850.000	3762.000	4004.000	3928.500
Z	-1.138	-1.448	-2.212	-.115	-.800
Asymp. Sig. (2-tailed)	.255	.148	.027	.909	.424

As can be seen from Table 7.4.6 above, the vast majority of the branch managers regarded as important all the selected relevant parties to whom the Shari'ah board is deemed to be accountable. However, there is also some evidence which shows that some perceived these relevant parties to be unimportant, particularly the bank's shareholders (9.00%), the bank's consumers (6.40%) and the bank's board of directors (5.10%). Additionally, the mean values calculated in accordance with the responses shown in this table were used to develop ranking positions regarding parties to whom the Shari'ah board is deemed to be accountable. As is evident from the table, the branch managers recognized the SAC of BNM as the most important party to whom the Shari'ah board is accountable. As with the heads of Shari'ah departments, the SAC was ranked first, with a reported mean value of 4.46 and with 91.00% of the total number of branch managers perceiving it as important. It is worth noting that Table 6.4.5 of Chapter Six reported that the responses from the heads of Shari'ah departments similarly ranked the SAC first, though it shared the position with the bank's board of directors.

On the other hand, the bank's board of directors was ranked by the branch managers as third in importance after the public. The public, which was ranked second in importance, was considered important by 88.50% whereas the bank's board of directors, which comes next, was considered important by 84.60%. Moreover, contrary to the responses of the heads of Shari'ah departments, the bank's board of directors was also perceived as unimportant by the branch managers, as mentioned earlier. Indeed, the bank's board of directors is the only relevant party that was found to be significantly different when analyses of the differences in the responses of the branch managers and the heads of Shari'ah departments were conducted using the Mann Whitney U test. The statistical summary reported in Table 7.4.7 shows that the bank's board of directors is significantly different, with a p value of 0.027 while analyses of the comparison between the reported mean values in Table 6.4.5 and Table 7.4.6 indicates that the heads of Shari'ah departments perceived the bank's board of directors as being more important than did the branch managers. The difference in importance shown by the position of the public and the board of directors might reflect the nature of Islamic banking exposure between these two groups of respondents. As the secretariat to the Shari'ah board and being accountable to the board of directors themselves, the heads of Shari'ah departments recognize the board of directors as being the more important party to whom the Shari'ah board is accountable than the public. This is due to the fact GPS1 clearly states that the Shari'ah board reports to the board of directors (BNM 2004), as the latter is responsible for the policy and decision making of the bank. However, the branch managers as the front line managers might perceive the role of the Shari'ah board to have greater importance to the public as the reason for the former's establishment is to cater to the need for an alternative banking which is consistent with the Islamic principles of Muslims as a whole.

Meanwhile, the bank's consumers were consistently ranked fourth with responses similar to those of the heads of Shari'ah departments, as reported in Table 6.4.5. As shown in Table 7.4.6, 87.20% of the total number of branch managers perceived the bank's consumers as being important whereas 6.40% considered this party as unimportant. Surprisingly, there seems to be a discrepancy in the perceived importance of the bank's shareholders by both the heads of Shari'ah departments and the branch managers, as the former ranked it third in importance whereas that same party was ranked last in importance by the latter. Evidence in Table 7.4.6 indicates that the bank's shareholders were considered important by 82.10% of the total number of branch managers while 9.00% consider the party unimportant. The fact that the importance of the bank's shareholders was ranked last seems to indicate that the branch managers consider the fiduciary duties of the Shari'ah board in ensuring that the activities of the bank are in compliance with Shari'ah to be relevant and important to the parties concerned in accordance with their position as shown in Table 7.4.6.

In addition, analyses by other control variables produced no significantly different results and, thus, are not reported here.

7.4.4 Expectations of Branch Managers Relating to the Appointment and Mandated Authority of Shari'ah Board Members

Table 7.4.8 below presents an analysis of the selected feature on the issues of Shari'ah board members' appointment and mandated authority where the branch managers have indicated their agreement based on a five-point Likert scale between strongly disagree (1) and strongly agree (5).

As is evident in Table 7.4.8 below, 93.6% of the branch managers indicated their agreement with the appointment of the Shari'ah board being based on certain 'fit and proper' qualification criteria while 1.3% disagreed and another 5.1% were indifferent about such an appointment mechanism. Although the responses of the branch managers were not in absolute agreement, as compared to the responses of the heads of Shari'ah departments reported in Table 6.4.6, the mean value of the responses of the former (4.46) was almost the same as those of the latter (4.58). Thus, both groups of respondents can be said to demonstrate a common agreement regarding Shari'ah board members being appointed in accordance with certain 'fit and proper' qualification criteria; this was indicated by both groups as being skewed towards the strongly agree perception.

Another question posed to the branch managers was regarding the requirement that there should be no conflict of interest on the appointment of Shari'ah board members, such as them being substantial shareholders or having an intimate relationship with an employee of the bank the board serves. While the vast majority of the branch managers seem to agree on these appointment criteria, there was also some evidence which indicated otherwise. Table 7.4.8 reports that 87.2% of the branch managers responded that they agreed whereas 2.6% disagreed and another 10.3% were indifferent to such requirements. Unlike the responses of the heads of Shari'ah departments, the evidence seems to demonstrate a division among the perceptions of the branch managers. Nevertheless, the overall mean value of the responses of the former, (4.54), as reported in Table 6.4.6 is very nearly the same as that reported for the latter in Table 7.4.8 (4.41).

Table 7.4.8: Analysis Showing Expectations of Branch Managers Relating to the Appointment and Mandated Authority of Shari'ah Board Members

Nature of Shari'ah Board Members Appointment and Mandated Authority	Disagree		Uncertain		Agree		Total		Overall
	No	*%*	*No*	*%*	*No*	*%*	*No*	*%*	*Mean*
Appointment of Shari'ah board is based on fit and proper criteria	1	1.3	4	5.1	73	93.6	78	100	4.46
No conflict surrounding the appointment of Shari'ah board	2	2.6	8	10.3	68	87.2	78	100	4.41
Shari'ah board is subject to assessment by the bank or BNM	3	3.8	6	7.7	69	88.5	78	100	4.21
Adequate power has been mandated to Shari'ah board	0	0	8	10.3	70	89.7	78	100	4.37
Reporting channel exists to report conflicts	2	2.6	9	11.5	67	85.9	78	100	4.32
Proper segregation of Shari'ah board duties exists	0	0	12	15.4	66	84.6	78	100	4.28

Table 7.4.9: Test Statistics on Differences in Responses between Heads of Shari'ah Departments (Table 6.4.6) and Branch Managers (Table 7.4.8) on the Appointment and Mandated Authority of Shari'ah Board Members

Test Statistics	Appointment of the Shari'ah board is based on 'Fit and Proper' Criteria	No Conflict on the Appointment of the Shari'ah Board	The Shari'ah Board is Subject to Assessment by the Bank or BNM	Adequate Power has been Mandated to the Shari'ah Board	Channels Exist to Report Conflicts	Proper Segregation of Shari'ah Board Duties Exists
Mann-Whitney U	881	902	658.5	898.5	746.5	863
Wilcoxon W	3962	3983	3739.5	3979.5	1046.5	1163
Z	-0.496	-0.303	-2.434	-0.327	-1.621	-0.625
Asymp. Sig. (2-tailed)	0.62	0.762	0.015	0.743	0.105	0.532

Meanwhile, 88.5% of the branch managers agreed while 3.8% disagreed and another 7.7% were indifferent on the question of whether the Shari'ah board should be subject to assessment by the bank or BNM, as reported in Table 7.4.8 below. As with the above issue, these results of the branch managers differ from those of the heads of Shari'ah departments, with the latter demonstrating absolute agreement, as shown in Table 6.4.6. In terms of the mean values of the responses of both groups of respondents, Table 7.4.8 reports it as being 4.21 for the branch managers whereas Table 6.4.6 reports it as being 4.63 for the heads of Shari'ah departments. It is worth noting that this is the only question which produced significantly different results when an analysis of the differences in the responses of both groups of respondents were conducted using the Mann Whitney U test. Table 7.4.9 above indicates that the issue of the need for the Shari'ah board to be assessed by the bank or BNM gave a significantly different result, with a p value of 0.015. The mean values of the two groups of respondents mentioned earlier seem to indicate that the heads of Shari'ah departments had a higher level of agreement than did the branch managers. This suggests that the implementations of the assessment of Shari'ah board members by the bank or BNM were at a higher level than the branch managers desired. It also demonstrates that the mechanism for the appointment of the Shari'ah board is far more rigorous than expected and that the quality of the Shari'ah board's Shari'ah governance has been emphasized in the Malaysian Shari'ah governance framework (SGF).

On the other hand, 89.7% of the branch managers agreed while another 10.3% were indifferent on the need for Shari'ah board members to be mandated with adequate power, as shown in Table 7.4.8 above. While there was no disagreement reported in the responses of the branch managers, this was not the case for the heads of Shari'ah departments. Table 6.4.6 reported that 8.3% of the heads of Shari'ah departments indicated their disagreement while another 4.2% were indifferent when responding to the same question. Nevertheless, the mean value of the responses of the branch managers and the heads of Shari'ah departments were 4.37 and 4.29 respectively, which could be considered as being very similar.

Next, when asked to indicate their agreement on the need for a reporting channel in order for Shari'ah board members to report any conflict that might arise between Shari'ah board members and the board of directors or with the management of the bank, 85.9% of the branch managers agreed while 2.6% disagreed and another 11.5% were indifferent. A similar division on the perception amongst the heads of Shari'ah departments was also revealed. As reported in Table 6.4.6, 75.0% of the heads of Shari'ah departments indicated their agreement while disagreement and uncertainty each accounted for 12.5% of the responses. Although the mean value of the responses reported for the branch managers is relatively higher (4.32) than that of the heads of Shari'ah departments (3.83), this is not significantly different, as indicated earlier. Nevertheless, it suggests that the branch managers, generally, were more in favour of the existence of such a reporting mechanism to resolve possible conflicts between important parties within the SGF.

Finally, 84.6% of the branch managers agreed while another 15.4% were indifferent on the question of whether there should be a proper segregation of Shari'ah board duties. However, amongst the heads of Shari'ah departments, 83.3% agreed, 12.5% disagreed and 4.2% responded with indifference. In addition, the responses of the branch managers produced a mean value of 4.28 while the mean value was slightly lower for the heads of Shari'ah departments (4.00). This suggests that the branch managers give more importance to a proper segregation of Shari'ah board duties consistent with the argument proposed by Alhabshi and Bakar (2008) than is actually exercised, as indicated in the responses of the heads of Shari'ah departments. Nevertheless, the responses of the two groups of respondents regarding this question were not significantly different.

In addition, an analysis by the control variables types of banks, total assets and number of years the bank has been offering Islamic banking products and services on the responses of the branch managers produced significantly different results. On the control variable types of banks, Table 7.4.10 below shows that three aspects of Shari'ah board's appointment and mandated authority were found to be significantly different using the Mann Whitney U test. First, the requirement that there be no conflict of interest in the appointment of the Shari'ah board was significantly different, with a p value of 0.031.

The table shows that the branch managers from the full-fledged Islamic banks indicated a higher level of agreement (mean value of 4.55) than did the branch managers from banks with an Islamic window (mean value of 4.09). Second, the issue of the need for Shari'ah board members to be assessed by the bank or BNM was significantly different, with a p value of 0.002. As is evident from the table, the branch managers from the full-fledged Islamic banks indicated a higher level of expectation (mean of 4.40) than did the branch managers from banks with an Islamic window (mean of 3.74). Next, the requirement for a channel for the Shari'ah board to report possible conflicts between Shari'ah board members and the board of directors or the management also gave a significantly different result, with a p value of 0.029. Similarly, the branch managers from the full-fledged Islamic banks indicated a higher level of agreement (mean value of 4.45) than did branch managers from banks with an Islamic window (mean value of 4.00).

Meanwhile, Table 7.4.11 below shows the results when an analysis by the control variable total assets was conducted. As is evident from the table, the only significantly different result derived using the Kruskal-Wallis H test was regarding the issue of Shari'ah board members being subject to assessment by the bank or BNM, with a p value of 0.015. The table indicates that the branch managers from large banks indicated a higher level of agreement than did the branch managers from the small and medium-sized banks.

On the other hand, Table 7.4.12 below presents the findings of the analysis by the control variable the number of years the bank has offered Islamic banking products and services. As shown in the table, the issue regarding the need to ensure that there is no conflict surrounding the appointment of the Shari'ah board, and Shari'ah board members being subject to assessment by the bank or BNM, were found to be significantly different using the Kruskal-Wallis H test, with p values of 0.005 and 0.003 respectively. Regarding both issues, the branch managers of banks with 11 to 15 years of Islamic banking experience indicated a higher level of agreement than did branch managers from other categories of Islamic banking experience.

Table 7.4.10: Analysis Showing Expectations of Branch Managers Relating to the Appointment and Mandated Authority of Shari'ah Board Members by the Type of Bank

Nature of the Shari'ah Board Members Appointment and Mandated Authority	Type of Bank								Sig.
	Full-fledged Islamic Banks				Banks with an Islamic Window				
	Disagree	Uncertain	Agree	Total	Disagree	Uncertain	Agree	Total	
	%	*%*	*%*	*Mean*	*%*	*%*	*%*	*Mean*	
Appointment of Shari'ah board is based on fit and proper criteria	1.8	3.6	94.5	4.53	.0	8.7	91.3	4.30	-
No conflict on the appointment of Shari'ah board	.0	9.1	90.9	4.55	8.7	13.0	78.3	4.09	*0.031
Shari'ah board is subject to assessment by the bank or BNM	.0	7.3	92.7	4.40	13.0	8.7	78.3	3.74	*0.002
Adequate power has been mandated to Shari'ah board	.0	10.9	89.1	4.42	.0	8.7	91.3	4.26	-
Reporting channel exists to report conflicts	.0	10.9	89.1	4.45	8.7	13.0	78.3	4.00	*0.029
Proper segregation of Shari'ah board duties exists	.0	16.4	83.6	4.33	.0	13.0	87.0	4.17	-

* Indicates distribution of responses is significantly different between the two categories of bank types using the Mann Whitney U test

Table 7.4.11: Analysis Showing Expectations of Branch Managers Relating to the Appointment and Mandated Authority of Shari'ah Board Members by Total Assets

Nature of Shari'ah Board Members Appointment and Mandated Authority	Total Assets by Category												Sig.
	Small (Less than RM1,000 million assets)				Medium (between RM1,000 million to RM10,000 million assets)				Large (More than RM10,000 million assets)				
	Disagree	Uncertain	Agree	Overall	Disagree	Uncertain	Agree	Overall	Disagree	Uncertain	Agree	Overall	
	%	%	%	*Mean*	%	%	%	*Mean*	%	%	%	*Mean*	
Appointment of Shari'ah board is based on fit and proper criteria	.0	.0	100.0	4.00	.0	7.4	92.6	4.44	2.1	4.3	93.6	4.51	-
No conflict on the appointment of Shari'ah board	.0	25.0	75.0	4.00	7.4	11.1	81.5	4.26	.0	8.5	91.5	4.53	-
Shari'ah board is subject to assessment by the bank or BNM	.0	.0	100.0	4.00	11.1	11.1	77.8	3.85	.0	6.4	93.6	4.43	*0.015
Adequate power has been mandated to Shari'ah board	.0	.0	100.0	4.25	.0	7.4	92.6	4.33	.0	12.8	87.2	4.40	-
Reporting channel exists to report conflicts with Shari'ah board, Board of directors or Management	25.0	.0	75.0	3.75	3.7	11.1	85.2	4.15	.0	12.8	87.2	4.47	-
Proper segregation of Shari'ah board duties exists	.0	.0	100.0	4.25	.0	11.1	88.9	4.26	.0	19.1	80.9	4.30	-

* Indicates the distribution is significantly different between the three categories of total assets using the Kruskal-Wallis H test

Table 7.4.12: Analysis Showing Expectations of Branch Managers Relating to the Appointment and Mandated Authority of Shari'ah Board Members by the Number of Years Banks have been Offering Islamic Banking (IB)

Nature of Shari'ah Board Members Appointment and Mandated Authority	Number of Years Banks have been Offering IB								Sig.
	0-5 Years		6-10 Years		11-15 Years		16 Years & Above		
	Overall		Overall		Overall		Overall		
	No	*Mean*	*No*	*Mean*	*No*	*Mean*	*No*	*Mean*	
Appointment of Shari'ah board is based on fit and proper criteria	19	4.22	22	4.59	1	5.00	36	4.39	-
No conflict on the appointment of Shari'ah board	19	4.32	22	4.86	1	5.00	36	4.17	*0.005
Shari'ah board is subject to assessment by the bank or BNM	19	3.84	22	4.64	1	5.00	36	4.11	*0.003
Adequate power has been mandated to Shari'ah board	19	4.47	22	4.55	1	5.00	36	4.19	-
Reporting channel exist to report conflicts	19	4.32	22	4.50	1	5.00	36	4.22	-
Proper segregation of Shari'ah board duties exist	19	4.42	22	4.50	1	5.00	36	4.08	-
* Indicates the distribution is significantly different between the four categories of years bank offers Islamic banking products and services using the Kruskal-Wallis H test									

7.5 Perceptions of Branch Managers Regarding the Nature of the Shari'ah Review by Shari'ah Boards

This section deals with important issues surrounding the perceptions of the branch managers regarding the Shari'ah review function of the Shari'ah board. It is worth remembering that the questions raised on these issues correspond to Section C of QS2 and most of the questions are unique to the branch managers. Thus, comparison of the responses of the branch managers with those of the heads of Shari'ah departments is limited to questions that are similar to both groups of respondents. However, the scope of the Shari'ah review the researcher wished to investigate with the branch managers remains the same, i.e., the structure and implementation of the Shari'ah review by the Shari'ah board. The next subsections offer analyses and discussions of these two aspects of the Shari'ah review regarding the responses of the branch managers.

7.5.1 Perceptions of Branch Managers Regarding the Structure of the Shari'ah Review

The branch managers were invited to indicate their agreement based on a five-point Likert scale between strongly disagree (1) and strongly agree (2) on several crucial issues on this subject. Table 7.5.1 below provides an analysis of the results.

The branch managers were first asked whether they perceived the Shari'ah board as being the sole authority on the Shari'ah review system within individual banks offering Islamic banking services. It is worth noting that the same question was also posed to the heads of Shari'ah departments. From the results, it seems that both groups of respondents gave responses of a similar pattern in which responses in all categories of agreement were evident. Table 7.5.1 shows that 74.4% of the branch managers agreed while 16.7% disagreed and another 9% were indifferent. In contrast, Table 6.5.1 reports that the responses of the heads of Shari'ah departments showed that 83.3% agreed, 12.5% disagreed and another 4.2% were indifferent. Additionally, the mean value of the responses of the branch managers and the heads of Shari'ah departments are 3.9 and 4.17 respectively and so do not differ much from one another. Thus, it can be said that there is no apparent gap between the expectations of the branch managers for the Shari'ah board to be considered as the sole authority in the Shari'ah review and what was actually being exercised by Shari'ah board members as indicated in the responses of the heads of Shari'ah departments. In addition, there were responses of disagreement from the branch managers just as there were from the heads of Shari'ah departments. In Section 6.5.1 of Chapter Six, it was discussed that the perception of disagreement produced by the heads of Shari'ah regarding this question might suggest that Shari'ah board members have delegated some of their functions to other parties within the bank. Similarly, disagreement amongst the branch managers on this issue could indicate that the these branch managers were not in favour of the governance mechanism in which Shari'ah board members act as the sole authority on the Shari'ah review system of the bank. Although these indications of disagreement represents a minority view among both the branch managers and the heads of Shari'ah departments, it also suggests that it would not be possible for Shari'ah board members to be totally in charge when undertaking the Shari'ah review system. It seems that the Shari'ah board would need to entrust other parties within the bank to cooperate with them in performing such an important role.

Viewing the same issue from a slightly different perspective, the branch managers were asked whether adequate and apparent guidelines on the pronouncements and resolutions should be issued by the SAC of BNM for use in the Islamic banking industry. In response, 84.6% of the branch managers agreed whereas another 15.4% were indifferent. Table 7.5.1 also reports that the mean value of the responses to this question is 4.14, an indication of strong agreement. A similar question was posed to the heads of Shari'ah departments. Table 6.5.1 reported that 79.2% of this group of respondents agreed while 20.8% disagreed and the mean value was 3.92. Hence, it can be said that the branch managers place greater importance on the role of the SAC to provide an established constitution to which the Shari'ah board can refer when undertaking their Shari'ah review function. It is worth noting that the high expectation expressed by the branch managers for the SAC of BNM to provide the necessary Shari'ah governance guidelines has a true basis. As the bank's branch managers, their responses reflect the confidence they place in and, therefore, the reliance the industry places on this institution, which acts as the supreme authority of the Shari'ah governance system of all Islamic financial institutions (IFIs) in Malaysia including Islamic banks. Indeed, such authority was further emphasized when the recent Central Bank of Malaysia Act 2009 clearly stipulated the mandated power of the SAC in which the Shari'ah resolutions issued by the SAC are binding to all Malaysian IFIs (BNM 2009).

Table 7.5.1: Analysis Showing Perceptions of Branch Managers Regarding the Structure of the Shari'ah Review for Shari'ah Boards

Structure of the Shari'ah Review for Shari'ah Boards	Disagree		Uncertain		Agree		Total		Overall
	No	*%*	*No*	*%*	*No*	*%*	*No*	*%*	*Mean*
Shari'ah board is individual banks' sole authority in Shari'ah review	13	16.7	7	9	58	74.4	78	100	3.9
Adequate & apparent guidelines should be issued by Shari'ah Advisory Council of BNM	0	0	12	15.4	66	84.6	78	100	4.14
Shari'ah Advisory Council enhances standardization of IB practices	0	0	8	10.3	70	89.7	78	100	4.26
Dual-layer Shari'ah governance system in Malaysia effective in ensuring stability of IB industry	0	0	18	23.1	60	76.9	78	100	4.06
Dual-layer Shari'ah governance system harmonizes IB practices in Malaysia and across countries	0	0	19	24.4	59	75.6	78	100	4.06

Next, Table 7.5.1 presents evidence that 89.7% of the branch managers agreed whereas another 10.3% were indifferent when asked whether the role of the SAC enhances the standardization of Islamic banking practices. These responses by the branch managers represent the stakeholders' perception; the vast majority seem to provide support for the ability of the supreme authority in the SGF to curb the problem facing the Islamic banking business, i.e., inconsistencies in Islamic banking practices. Hence, the dual-layer

Shari'ah governance system implemented in Malaysia, with the SAC as the regulator overseeing the Shari'ah governance implementation of the participating IFIs, evidently contributes to minimizing inconsistencies in Malaysian Islamic banking practices. This revelation signifies that a central Shari'ah governance authority such as the SAC is crucial to bridge the gap resulting from differences in Shari'ah opinion issued by the respective Shari'ah boards of individual banks offering Islamic banking products and services.

The branch managers were also asked to indicate their level of agreement with whether the dual-layer Shari'ah governance system implemented in Malaysia is effective in ensuring the stability of the Islamic banking industry. In response, 76.9% of the branch managers agreed while another 23.1% were indifferent, as shown in Table 7.5.1. With the percentage of agreement slightly above three quarters of the total number of branch managers and most of the remaining quarter being uncertain, the table indicates that the mean value of the branch managers' responses is just above 4.00, i.e., 4.06, an indication of overall agreement. Thus, the vast majority of the branch managers perceived that the dual-layer Shari'ah governance system implemented in Malaysia has managed to ensure the stability of the Islamic banking industry. This finding provides further evidence regarding the advantages of the dual-layer Shari'ah governance system; the branch managers perceive it as promoting the stability of the Islamic banking industry which has, to date, been in place in the Malaysian business scene for almost 20 years.

The last question posed to the branch managers on the structure of the Shari'ah review was regarding whether these respondents perceived that the dual-layer Shari'ah governance system as being capable of harmonizing Islamic bank practices in Malaysia and across national boundaries. The response received was similar to the response pattern in the preceding question in which almost three quarter of the branch managers indicated their agreement (75.6%) while almost another quarter were indifferent (24.4%). Indeed, the mean value of the responses reported for this question was similar to the mean value reported for the preceding question, i.e., 4.06. As such, the branch managers seem to indicate that, to some extent, the dual-layers of Shari'ah governance system have realized their potential in harmonizing the Islamic banking practices in Malaysia and across national boundaries.

Meanwhile, analysis by the control variable types of banks produced significantly different findings using the Mann Whitney U test. As shown in Table 7.5.2 below, the mean value of the responses to the question on whether adequate and apparent guidelines on the pronouncements and resolutions of the Shari'ah Advisory Council of BNM should be issued for use in the Islamic banking industry was significantly different, with a p value of 0.044. Furthermore, the branch managers from the full-fledged Islamic banks indicated a higher level of agreement than the branch managers from banks with an Islamic window, as the reported mean value for the former (4.24) is higher than that of the latter (3.91). In addition, an analysis by the control variable total assets also produced significantly different results using the Kruskal-Wallis H test. Table 7.5.3 below presents evidence that responses regarding whether adequate and apparent guidelines on the pronouncements and resolutions of the SAC of BNM should be issued for use in the Islamic banking industry are similarly significantly different with a p value of 0.027. Also, the branch managers from the large banks indicated a higher level of agreement (mean value of 4.30) than did branch managers from other bank size categorizations.

The significantly different results from both the control variables above suggest that the branch managers from large full-fledged Islamic banks place greater emphasis on the need for such guidelines by the SAC as the basis for Islamic banking practices in Malaysia. This demonstrates that branch managers from banks whose Islamic banking activities are extensive, as is the case with full-fledged Islamic banks and large banks, regard the proper installation of the Shari'ah governance mechanism as a crucially important directive from the SAC. Hence, the SAC, which acts as the supreme authority for the Islamic banking industry, has to ensure that clear and transparent guidelines will be issued for use in this emerging industry.

Table 7.5.2: Analysis Showing Perceptions of Branch Managers on the Structure of Shari'ah Review for Shari'ah Boards by the Type of Bank

Structure of the Shari'ah Review for Shari'ah Boards	Type of Bank								Sig.
	Full-fledged Islamic Banks				Banks with an Islamic Window				
	Disagree	Uncertain	Agree	Overall	Disagree	Uncertain	Agree	Overall	
	%	*%*	*%*	*Mean*	*%*	*%*	*%*	*Mean*	
Shari'ah board is individual banks' sole authority in Shari'ah review	16.4	7.3	76.4	3.93	17.4	13.0	69.6	3.83	-
Adequate & apparent guidelines should be issued by Shari'ah Advisory Council of BNM	.0	12.7	87.3	4.24	.0	21.7	78.3	3.91	*0.044
Shari'ah Advisory Council enhances standardization of IB practices	.0	10.9	89.1	4.29	.0	8.7	91.3	4.17	-
Dual-layer Shari'ah governance system in Malaysia effective in ensuring stability of IB industry	.0	21.8	78.2	4.15	.0	26.1	73.9	3.87	-
Dual-layer Shari'ah governance system harmonizes IB practices in Malaysia and across countries	.0	23.6	76.4	4.15	.0	26.1	73.9	3.87	-

* Indicates distribution of responses is significantly different between the two categories of bank types using the Mann Whitney U test

Table 7.5.3: Analysis Showing Perceptions of Branch Managers Regarding the Structure of Shari'ah Review for Shari'ah Boards by Total Assets

Structure of the Shari'ah Review for Shari'ah Boards	Total Assets by Category												Sig.
	Small (Less than RM1,000 million assets)				Medium (between RM1,000 million to RM10,000 million assets)				Large (More than RM10,000 million assets)				
	Disagree	Uncertain	Agree	Overall	Disagree	Uncertain	Agree	Overall	Disagree	Uncertain	Agree	Overall	
	%	*%*	*%*	*Mean*	*%*	*%*	*%*	*Mean*	*%*	*%*	*%*	*Mean*	
Shari'ah board is individual bank's sole authority in Shari'ah review	50.0	.0	50.0	3.25	11.1	11.1	77.8	3.96	17.0	8.5	74.5	3.91	-
Adequate & apparent guidelines should be issued by Shari'ah Advisory Council of BNM	.0	25.0	75.0	3.75	.0	22.2	77.8	3.93	.0	10.6	89.4	4.30	*0.027
Shari'ah Advisory Council enhances standardization of IB practices	.0	.0	100.0	4.00	.0	14.8	85.2	4.15	.0	8.5	91.5	4.34	-
Dual-layer Shari'ah Governance System in Malaysia effective in ensuring stability of IB industry	.0	.0	100.0	4.00	.0	22.2	77.8	4.04	.0	25.5	74.5	4.09	-
Dual-layer Shari'ah governance system harmonizes IB practices in Malaysia and across countries	.0	.0	100.0	4.00	.0	22.2	77.8	4.07	.0	27.7	72.3	4.06	-
* Indicates the distribution is significantly different between the three categories of total assets using the Kruskal-Wallis H test													

7.5.2 Perceptions of Branch Managers Regarding the Implementation of the Shari’ah Review

This study also invited the branch managers to indicate their agreement on issues regarding the implementation of the Shari’ah review by the Shari’ah board. Thus, the respondents were invited to indicate their agreement based on a five-point Likert scale between strongly disagree (1) and strongly agree (5). Table 7.5.4 below shows analysis of the findings.

Table 7.5.4: Analysis Showing Perceptions of Branch Managers Regarding the Implementation of the Shari'ah Review

Implementation of the Shari'ah Review	Disagree		Uncertain		Agree		Total		Overall
	No	*%*	*No*	*%*	*No*	*%*	*No*	*%*	*Mean*
Shari’ah board has full authority to stop non-Shari'ah compliance transactions	7	9.0	11	14.1	60	76.9	78	100.0	4.14
Shari’ah Advisory Council should adopt rigorous procedures to examine & endorse application of IB industry	0	.0	11	14.1	67	85.9	78	100.0	4.10
Working part time does not hinder effective Shari'ah review by the Shari’ah board	10	12.8	16	20.5	52	66.7	78	100.0	3.73
Shari'ah compliance is adequately reflected in Shari'ah report by Shari’ah board	3	3.8	16	20.5	59	75.6	78	100.0	3.94
Shari'ah report by Shari’ah board satisfactorily discloses accounting issues of IB	5	6.4	19	24.4	54	69.2	78	100.0	3.79

The first question posed to the branch managers was regarding whether they thought that the Shari'ah board should have the full authority to stop banks from undertaking non-Shari'ah compliant transactions. Table 7.5.4 above shows that 76.9% of the total number of branch managers agreed while 9.0% disagreed and another 14.1% were indifferent. Hence, it can be said that the vast majority of the branch managers seem to support the argument for the Shari'ah board to have full authority to stop banks from undertaking non-Shari'ah compliant transactions. Indeed, this was also the extent of the authority exercised by the Shari'ah board as indicated by the responses derived from the heads of Shari'ah departments when a similar question was posed to them. In response to the same question, Table 6.5.2 of Chapter Six shows that 70.8% of the heads of Shari'ah departments indicated their agreement while 12.5% were in disagreement and another 16.7% were indifferent. A comparison of the percentages from the two groups of respondents does not reveal any major differences. Moreover, the mean values of the responses from these two groups of respondents were relatively close (3.96 in QS1 and 4.14 in QS2).

The following question was about whether the branch managers thought the SAC of BNM should adopt rigorous procedures to examine and endorse Islamic financial products submitted by banks offering Islamic banking services. In response, Table 7.5.4 above reports that 85.9% of the branch managers agreed while another 14.1% were indifferent. With a mean value of 4.10, it can be said that the vast majority of the branch managers agreed for such a rigorous mechanism from the SAC of BNM. It has been mentioned before that an individual bank offering Islamic banking services which seeks to launch new products or services to its customers is required to secure the approval of the SAC. Hence, noting that the SAC has the authority to determine which Islamic financial products and services are to be made available in the market, this finding suggests that this authoritative body has ensured the installation of such rigorous procedures.

Meanwhile, another question similar to one posed to the heads of Shari'ah departments was posed to the branch managers regarding whether the latter consider that Shari'ah board members working part time in banks does not hinder their production of an effective Shari'ah review of the operation of banks offering Islamic banking services. Table 7.5.4 shows that 66.7% of the branch managers agreed while 12.8% disagreed and another 20.5% were indifferent. It seems that the view of the branch managers that the Shari'ah board members' part time status does not hinder their production of an effective Shari'ah review was at almost the same level as for the heads of Shari'ah departments who, to the same question, responded with 66.6% in agreement and 20.8% in disagreement with another 12.5% being indifferent. Additionally, the mean values of the responses of the branch managers and the heads of Shari'ah departments was 3.73 and 3.63 respectively. These mean values show that both groups of respondents have a moderate view that the part time working nature of the Shari'ah board does not hinder the production of an effective Shari'ah review.

Regarding the quality of the Shari'ah report, the branch managers were invited to indicate whether they thought that the Shari'ah compliance of the bank is adequately reflected in the Shari'ah report issued by the Shari'ah board. From Table 7.5.4, it can be seen that 75.6% of the branch managers expressed their agreement while 3.8% disagreed and another 20.5% were indifferent. In Chapter Four, it was discussed that the Shari'ah report serves as the capstone where the Shari'ah board summarizes and discloses its roles and functions with the emphasis on disclosing the Shari'ah compliance of the bank's activities to the users of the report. Hence, with a reported mean value of 3.94, as shown in Table 7.5.4, the branch managers indicated that they generally perceived that the Shari'ah report issued by the Shari'ah board met its objective in disclosing the information regarding the Shari'ah compliance of the activities of the bank they represented.

In addition to the question about Shari'ah compliance above, the branch managers were also asked to indicate whether the Shari'ah report satisfactorily discloses the accounting issues of the bank. In response, 69.2% of the branch managers indicated their agreement while 6.4% disagreed and another 24.4% were indifferent. It was discussed in Chapter Four that the Shari'ah report should include a clear statement about the examination of

IFI's transactions, the profit earned and the approval of the IFI's calculation of *zakat* as well as declaring that the earnings realized from sources prohibited in Islam have been disposed of to charitable causes (AAOIFI 1998 para. 10-25). With a mean value of 3.79 as well as almost a quarter of the total number of branch managers indicating either uncertainty or disagreement, it seems that these respondents were moderately satisfied that the accounting issues were disclosed in the Shari'ah report by the Shari'ah board.

Meanwhile, the only control variable that produced significantly different results was types of banks. Table 7.5.5 below reveals that the question of whether the SAC of BNM should adopt rigorous procedures to examine and endorse the application of Islamic financial products submitted by banks offering Islamic banking services was found to be significantly different using the Mann Whitney U test, with a p value of 0.029. As shown in the table, the branch managers from the full-fledged Islamic banks indicated a higher level of agreement than did the branch managers (mean value of 4.20) from the banks with an Islamic window (mean value of 3.87). Hence, it can be said that, as the Islamic banking operations of full-fledged Islamic banks are relatively more extensive, the branch managers from these banks perceived that rigorous procedures from the SAC on the examination and endorsement of new applications of Islamic banking products by banks as being more important than did branch managers from banks with an Islamic window.

Table 7.5.5: Analysis Showing Perceptions of Branch Managers Regarding the Implementation of the Shari'ah Review by the Type of Bank

Implementation of Shari'ah Review	Type of Bank								Sig.
	Full-fledged Islamic Banks				Banks with an Islamic Window				
	Disagree	Uncertain	Agree	Overall	Disagree	Uncertain	Agree	Overall	
	%	*%*	*%*	*Mean*	*%*	*%*	*%*	*Mean*	
Shari’ah board has full authority to stop non-Shari'ah compliance transactions	7.3	12.7	80.0	4.20	13.0	17.4	69.6	4.00	-
Shari’ah Advisory Council should adopt rigorous procedures to examine & endorse application of IB industry	.0	10.9	89.1	4.20	.0	21.7	78.3	3.87	*0.029
Working part time does not hinder effective Shari'ah review by the Shari’ah board	16.4	16.4	67.3	3.73	4.3	30.4	65.2	3.74	-
Shari'ah compliance is adequately reflected in Shari'ah report by Shari’ah board	5.5	16.4	78.2	4.02	.0	30.4	69.6	3.74	-
Shari'ah report by Shari’ah board satisfactorily discloses accounting issues of IB	7.3	23.6	69.1	3.84	4.3	26.1	69.6	3.70	-

* Indicates distribution of responses is significantly different between the two categories of bank types using the Mann Whitney U test

7.5.3 The Branch Managers' Perceptions of Relevant Stakeholders within the Shari'ah Governance Framework

The Shari'ah governance of banks offering Islamic banking activities sees the involvement of interrelated parties within the bank and the regulator. Thus, the branch managers were invited to rank between 1 (very unimportant) to 5 (very important) on the relevant stakeholders in the SGF for the Islamic banking industry according to their degree of importance. These parties are the SAC of BNM, the Shari'ah board, the Shari'ah department of the bank, the board of directors, and the management of the bank. Table 7.5.6 below presents an analysis of the results.

Table 7.5.6: The Branch Managers' Perceptions of Relevant Stakeholders within the Shari'ah Governance Framework

Important Parties Within the Shari'ah Governance Framework	**Unimportant**		**Uncertain**		**Important**		**Total**		**Overall**
	No	***%***	***No***	***%***	***No***	***%***	***No***	***%***	***Mean***
Shari'ah Advisory Council of BNM	9	11.5	8	10.3	61	78.2	78	100	4.14
Shari'ah board	11	14.1	6	7.7	61	78.2	78	100	4.12
Shari'ah department	7	8.9	13	16.7	58	74.4	78	100	4.10
Board of directors	9	11.5	15	19.3	54	69.2	78	100	3.81
Management	12	15.4	12	15.4	54	69.2	78	100	3.78

As is evident from Table 7.5.6 above, the SAC of BNM is ranked first as the most important party within the SGF, with a mean value of 4.14. It is suggested that this finding reflects the importance the branch managers give to the position of the SAC as the supreme authority over the Malaysian SGF for the Islamic finance services industry. Indeed, it has been discussed before that many aspects of the Islamic banking operations are subject to the authority of the SAC, including the appointment of Shari'ah board members and the endorsement of Islamic financial products and services to be launched to customers. More crucially, the resolutions issued by the SAC are binding to all Malaysian IFIs (BNM 2009). Hence, the utmost importance given to the SAC by the branch managers shows the former's vital role in the Malaysian Islamic financial services' SGF.

The Shari'ah board of individual banks was revealed as the second most important party within the SGF after the SAC of BNM, scoring the second highest mean value of 4.12, as reported in Table 7.5.6. Throughout the discussion on the Shari'ah governance of banks offering Islamic banking services, it has been emphasised that the Shari'ah board ensures the credibility of an Islamic bank by ascertaining the Shari'ah compliance of the bank's operations (see for example Briston and El-Ashker 1986; Tomkins and Karim 1987; Karim 1990b; Karim 1990a; Banaga et al. 1994; Rammal 2006; Laldin 2008a). Its position as next after the SAC of BNM demonstrates how the branch managers conceded to the fact that the Shari'ah board is under the domination of the SAC.

With a reported mean value of 4.10, as shown in Table 7.5.6, the Shari'ah department of the bank was perceived by the branch managers as ranking third in importance within the SGF for banks offering Islamic banking services. It was mentioned in Chapter Four that GPS1 clearly states that the Shari'ah officer serves as the secretariat to the Shari'ah board. Amongst the crucial roles of the Shari'ah department officers is helping to organize the Shari'ah issues for action by the Shari'ah board. Besides this, the Shari'ah department also acts as the intermediary with other interrelated parties within the bank to ensure that the Shari'ah decisions made by the Shari'ah board are being communicated to and implemented by these parties. Thus, it is apparent that the authority of the Shari'ah board is superior to the Shari'ah department, and, hence, the former has been positioned one rank higher in importance than the latter by the branch managers.

Meanwhile, the bank's board of directors ranks fourth in importance within the SGF. As is apparent in Table 7.5.6, the mean value of the branch managers' responses was 3.81. Despite the Shari'ah board being accountable to the board of directors (BNM 2004), the latter was perceived as important by the branch managers after the Shari'ah board and the Shari'ah department. The fact that the Shari'ah department was perceived by the branch managers to have greater importance than the board of directors identifies the former as the internal party deemed to be the most important within the SGF. Alternatively, this finding suggests that the role of the board of directors is less significant than the Shari'ah board and the Shari'ah department officers regarding the SGF of banks offering Islamic banking services. This could be attributed to the fact that the board of directors is bound to implement the Shari'ah decisions made by the Shari'ah board in which the Shari'ah department officers, as the secretariat to the Shari'ah board and equipped with the necessary knowledge and experience in Islamic banking, also serve as the intermediaries between these two parties.

Table 7.5.6 also reports that the mean value of the responses of the branch managers regarding the management was 3.78. This makes the management of the bank the least important amongst all the selected parties within the SGF. Although the management is responsible for the implementation of Shari'ah decisions issued by the Shari'ah board, this study suggests that the management comes last and next only after the Shari'ah department officers and the board of directors in its importance with respect to the SGF. The above explanation regarding the significance of the Shari'ah department over the board of directors in terms of the SGF can also be used to explain the rank of the management. Furthermore, in the light of the principal-agent relationship discussed in Chapter Two, one function of the board of directors is to monitor the management, due to the information asymmetry problem experienced by the latter, in order to protect the interests of the shareholders. The same applies when discussing corporations, such as Islamic banks whose activities are restricted to compliance with the Islamic Shari'ah. Hence, this finding reflects that the board of directors were perceived by the branch managers as being more important than the management in terms of the SGF, as the former protects the Shari'ah legitimacy needs of the shareholders.

7.6 Conclusion

This chapter provides discussions on analyses of the Questionnaire Survey 2 (QS2) findings from 78 branch managers of banks offering Islamic banking services in the MIFC. The findings in QS2 shed light on the interest of the stakeholders under the spectrum of stakeholder theory regarding the three significant issues surrounding the governance function of the Shari'ah board: (1) the role of the Shari'ah board, (2) the accountability and independence of the Shari'ah board, and (3) the nature of the Shari'ah review by the Shari'ah board. In essence, the findings derived from QS2 were interpreted as the branch managers' anticipation of how the issues under investigation should be carried out. These findings were then analysed and contrasted with the responses by the heads of Shari'ah departments in Questionnaire Survey 1 (QS1). Meanwhile, regarding the background of the branch managers who participated in QS2, 55 (70.5%) were from full-fledged Islamic banks while another 23 (29.5%) were from banks with an Islamic window. On the other hand, examining the composition of the sample of branch managers on the basis of the bank's ownership indicates that 74 (94.9%) of the branch managers were from domestic banks while another 4 (5.1%) branch managers were from foreign banks. Mostly males, these branch managers generally had plenty of experience as branch managers since only a small number of branch managers (seven) were found to have less than one year's experience. Moreover, 60.3% of the branch managers were found to be from large banks while 34.6% and 5.1% were from medium and small-sized banks respectively. In addition, being designated as the bank's branch manager, most of them were trained, especially in the field of accounting and finance (17 branch managers), a combination of Shari'ah and/or *fiqh al-mua'malat* with other non-Islamic field(s) (16 branch managers) and management (15 branch managers).

The results regarding the scope of Shari'ah advisory by the Shari'ah board showed that the branch managers expected priority to be given to the Shari'ah board's Shari'ah advisory role similar to the results derived from QS1. However, the branch managers seemed to emphasise a different element of the Shari'ah board's Shari'ah advisory role. There are differences between what the heads of department considered the top three most important roles and those that the branch managers considered important. The heads of Shari'ah departments, in QS1, indicated that the Shari'ah board gave priority to endorsing the Shari'ah compliance manual, advising the board of directors on Shari'ah matters and assisting other parties on Shari'ah matters. Meanwhile, the branch managers, in QS2, focused on advising the board of directors on Shari'ah matters, advising the Shari'ah department officers on the scope of the Shari'ah review and preparing the Shari'ah compliance manual. These contrasting results suggest that the branch managers called on the Shari'ah board to undertake a Shari'ah advisory role essentially to those whose Shari'ah governance function is fundamental and to equip the structure of Shari'ah governance by preparing the Shari'ah compliance manual. Such emphases are expected to have resulted from a pragmatic approach, as the branch managers themselves are dealing with day-to-day banking business operations. Moreover, an analysis of the differences in the responses in QS1 and QS2 on the scope of the Shari'ah advisory by the Shari'ah board revealed three elements of the Shari'ah advisory to be significantly different, with the branch managers giving them greater emphasis: providing training to the Shari'ah department officers, preparing the Shari'ah compliance manual and reporting to the SAC of BNM on Shari'ah matters. In addition, the branch managers did not seem inclined to accept the involvement of the Shari'ah board in areas such as designing or providing training on the Shari'ah governance system for implementation in the bank.

Despite the passive involvement of the Shari'ah board in the bank's strategic issues revealed in QS1, the branch managers indicated high expectations regarding the involvement of the Shari'ah board in advising and designing the corporate objectives of the bank. Indeed, all the listed corporate objectives were significantly different when an analysis of the differences was conducted on the responses of the branch managers and those of the heads of Shari'ah departments. Amongst the corporate objectives to which the branch managers gave great importance regarding the Shari'ah board's involvement were the bank's objectives, the bank's mission and the bank's vision.

Meanwhile, both the heads of Shari'ah departments and the branch managers were consistent regarding the role of the Shari'ah board in developing Islamic banking products and services. This is because the importance exercised by the Shari'ah board in their involvement at different stages of developing Islamic banking products and services as indicated by the former were found to conform with the importance expected from the Shari'ah board as laid down by the latter. Despite this similarity, there were some evident gaps indicated on the level of importance given by these respondents, particularly in four different stages of development of Islamic banking and services which were found to be significantly different and to which the branch managers gave greater importance, namely, design stage, pricing stage, testing stage, and implementation stage. This suggests that the Shari'ah board had exercised low involvement in the development of these stages of Islamic banking products and services and should attempt to increase that involvement in order to meet the branch managers' expectations. On the other hand, the branch managers from the full-fledged Islamic banks indicated higher expectations regarding the involvement of the Shari'ah board, specifically on the design and legal documentation stage than did the branch managers from banks with an Islamic window, which is deemed to correspond to how extensive the Islamic banking operations were in these banks. Evidently, this shows the gap in the importance perceived by the branch managers of these two types of bank. Also, the branch managers from banks with 11-15 years of experience of the Islamic banking business showed significantly different results for expectations of the Shari'ah board's involvement in the legal documentation stage.

On the bank's accounting issues, there seems to be a slight variance in the priority given between the expected and the actual involvement of the Shari'ah board, as indicated by the branch managers and the heads of Shari'ah departments respectively. For example, approving the calculation and distribution of *zakat* was ranked first as an accounting issue, where the involvement of the Shari'ah board was expected by the branch managers while this same issue was ranked second in importance where the Shari'ah board was actually involved, based on the responses of the heads of Shari'ah departments. Similarly, the ranking positions pertaining to other bank's accounting issues, which signify the perceived importance of Shari'ah board involvement, showed no great difference between the branch managers and the heads of Shari'ah departments. However, differences were apparent regarding the degree of importance given, as was indicated by the significantly different results in the responses of both groups of respondents. These accounting issues, where the expectation the branch managers had of the Shari'ah board's involvement was higher than the Shari'ah board's actual involvement, as indicated by the heads of Shari'ah departments, were as follows: determining the profit distribution formula, approving the accounting policy, and issuing Shari'ah report. In addition, other significantly different results were derived for validating Islamic banking transaction records, validating documentation on Islamic banking contracts, and approving the calculation and distribution of *zakat*. For instance, validating Islamic banking transaction records was significantly different, with branch managers from foreign banks indicating a higher expectation than the branch managers from the domestic banks. Meanwhile, approving the calculation and distribution of *zakat* showed a significant difference, with the branch managers from large banks indicating a higher expectation than the branch managers from the small and medium-sized banks. Also, approving the calculation and distribution of *zakat* and validating documentation of Islamic banking contracts were both significantly different for branch managers whose banks had 11 to 15 years experience of Islamic banking business in contrast to other categorizations of Islamic banking business experience.

Similar to the heads of Shari'ah departments, the branch managers also recognized the significant role of the Shari'ah department officers. The Shari'ah department was ranked in the first position of relevant parties whom the branch managers expected to assist the Shari'ah board; this is similar to the highest assistance received by the Shari'ah board, as indicated by the heads of Shari'ah departments. In addition, when analyses of differences by control variables were conducted, it was found that the views of branch managers from the full-fledged Islamic banks and from large banks were significantly different thereby indicating that more importance was given by them than was given by the branch managers from other categorizations. This demonstrates that the support from the Shari'ah department in banks whose Islamic banking activities are deemed extensive is characterised by the branch managers in these findings as apparently eminent. Meanwhile, the ranking positions indicate that the branch managers seem to have a higher expectation of, and hence give more importance to parties such as the audit committee, internal auditor and external auditor to provide assistance than these parties actually contribute, as indicated by the heads of Shari'ah departments. Indeed, analysis of the differences in the responses provided in QS1 and QS2 revealed that these three relevant parties were significantly different, with the branch managers' expectations regarding assistance being greater than the actual assistance offered by these parties.

QS2 of this study also evaluated branch managers' perception of the Shari'ah board's involvement in several commitments aimed at strengthening the Shari'ah governance of the Islamic banking industry. Although there was some evidence of disagreement, the branch managers generally indicated high agreement with Shari'ah board members undertaking these commitments. Indeed, analysis of the differences in the responses received in QS1 and QS2 shows that many of these commitments were significantly different, with the branch managers indicating higher agreement than the heads of Shari'ah departments. Two of the commitments to which the branch managers gave apparent importance were Shari'ah board members engaging in workshops and meetings of scholars of *fiqh al-mua'malat* to promote consistency in Islamic banking products and services as well as analysing whether Islamic banking products and services would deliver benefit to the *ummah* before they are launched. Similarly, section 6.3.7 of Chapter Six pointed out that Shari'ah board members were highly committed to these two issues. In addition, significantly different results were obtained when analyses by control variables were conducted. Firstly, analysis by the types of banks produced a significantly different result for commitment regarding publishing the Shari'ah board's Shari'ah resolutions and rulings as well as for the mechanics of Shari'ah compliance as applied in Islamic banks' dealings with the public, with the branch managers from the full-fledged Islamic banks indicating higher agreement than the branch managers from banks with an Islamic window. Secondly, analysis by the number of years the bank has offered Islamic banking products and services produced significantly different results, with branch managers of banks with 11 to 15 years experience of Islamic banking business indicating higher agreement than others regarding two commitments: (1) actively engaging in meetings of the scholars of *fiqh al-mua'malat* to promote consistency in Islamic banking products and services, and (2) adequately analysing whether Islamic banking products and services would deliver benefit to the *ummah* before they are launched.

Another section of QS2 was dedicated to determining the branch managers' perception of issues pertaining to the accountability and independence of the Shari'ah board. On the question concerning factors influencing the accountability of the Shari'ah board, the responses of the branch managers, in order of importance, were (1) the ethical values of the Shari'ah board, (2) Shari'ah board's requirement to ensure the Shari'ah compliance of the bank, (3) the scholarly background of the Shari'ah board, (4) the Shari'ah board's reputation, and (5) the stakeholders' reliance on the Shari'ah board's Shari'ah review. It is worth noting that the factors that ranked first and last corresponded to similar positions in the responses of the heads of Shari'ah departments in QS1. Hence, these similarities give compelling evidence of the factors deemed most crucial as well as least influential regarding the accountability of the Shari'ah board. Of particular importance is the result on the significant influence of the ethical values of the Shari'ah board, which underlines how the integrity of this Shari'ah governance authority is crucial for the success of the Islamic banking industry, as discussed in Chapter Six. Meanwhile, there were inconsistencies between the ranking positions of the remaining factors as derived from the responses in QS1 and QS2. On the other hand, the ethical values and the scholarly background of the Shari'ah board were significantly different when analysis by the number of years the bank has offered Islamic banking products and services was conducted. It was apparent that the branch managers from banks with 11 to 15 years experience of Islamic banking business gave greater importance to this than did branch managers from other Islamic banking business experience categorizations.

The branch managers were also asked about the factors influencing Shari'ah board members' independence. Interestingly, the branch managers' perceived importance of all factors influencing the independence of the Shari'ah board seems to be consistent with that of the heads of Shari'ah departments in QS1. This is due to the fact that the ranking order derived in

QS2 was similarly positioned in QS1. In order of importance, these factors were: (1) a clearly defined scope of responsibility, (2) the perceived high ethical status of the Shari'ah board, (3) the scholarly background of the Shari'ah board, (4) adequate powers being mandated to the Shari'ah board, (5) involvement of the Shari'ah board members' in Shari'ah board in other industries, (6) the participation of top management in the Shari'ah board's meeting, and (7) the remuneration received by the Shari'ah board. In addition, analysis by bank ownership produced significantly different results for the factor on adequate powers being mandated to the Shari'ah board, with the branch managers from foreign banks indicating higher importance than the branch managers from domestic banks. Also, the factor on the scholarly background of the Shari'ah board members was significantly different when analysed by the number of years the bank has been offering Islamic banking products and services, with the branch managers from banks with 11 to 15 years of Islamic banking business experience indicated higher importance than branch managers from other Islamic banking business experience categorizations.

On the question about the relevant parties to whom the Shari'ah Board is deemed accountable, similar to the heads of Shari'ah departments in QS1, the branch managers gave highest importance to the role of the SAC of BNM. It is apparent that the branch managers also gave credence to the role of the SAC as the supreme authority in the Malaysian Islamic banking industry, which implied their supposition that the Shari'ah board should be subject to the regulations and resolutions issued by the SAC. However, the branch managers then took a holistic view by citing the general aim of the Shari'ah governance function of the Shari'ah board, and indicated that the public was next in importance. It appears that the board of directors, who GPS1 clearly indicated as the party to which the Shari'ah board is accountable (BNM 2004), and who in QS1, ranked joint first with the SAC as the party perceived to have the highest importance, was given less importance by the branch managers. This is due to the fact that the board of directors was ranked third in importance by the branch managers as the party to whom the Shari'ah board is accountable. Indeed, the board of directors was the only party found to be significantly different when an analysis was conducted of the responses in QS1 and QS2, with the heads of Shari'ah departments indicating higher importance than did the branch managers. Meanwhile, the bank's consumers and the bank's shareholders were revealed as the parties considered fourth and last in importance by the branch managers.

To ascertain the Shari'ah board's accountability and independence, the branch managers were also asked about their perception of several features regarding the nature of the Shari'ah board's appointment and mandated authority. The responses on most of the features listed indicated reported mean values which signified almost similar levels of agreement with the heads of Shari'ah departments in QS1. These features were (1) the need to establish 'fit and proper' qualification criteria for the appointment of Shari'ah board members, (2) the appointment of Shari'ah board members is free from any conflict of interest, (3) adequate powers being mandated to the Shari'ah board to perform its role, (4) the existence of a reporting channel for Shari'ah board members to report possible conflict that might arise between Shari'ah board members and the board of directors or the management of the bank, and (5) the existence of proper segregation of Shari'ah board duties. Analysis of the differences between the responses in QS1 and QS2 found only one significantly different result, which corresponds to the feature of Shari'ah board members being subject to certain assessments by the bank or the BNM. It emerged that the heads of Shari'ah departments indicated higher agreement for the Shari'ah board to possess this feature than did the branch managers.

In addition, there were also several significantly different results derived from analyses by control variables which were conducted regarding features on the nature of the Shari'ah board's appointment and mandated authority. Analysis by the types of banks produced significantly different results, with branch managers from full-fledged Islamic banks indicating higher agreement than those from banks with an Islamic window for features of (1) no conflict of interest on the appointment of Shari'ah board, (2) Shari'ah board members are subject to assessment by the bank or BNM, and (3) the existence of a reporting channel to report conflicts between the Shari'ah board and the board of directors or the management. Meanwhile, the second commitment was also significantly different for branch managers from large banks compared to those from small and medium-sized banks. On the other hand, analysis by the number of years the bank has been offering Islamic banking products and services produced significantly different results for the first and the second commitment amongst branch managers from banks with a mid range of Islamic banking business experience in comparison to bank managers from other experience categorizations.

This study was also interested in examining the branch managers' perceptions on the nature of the Shari'ah review in banks offering Islamic banking and services. Similar to QS1, the branch managers were asked about the structure and implementation of the Shari'ah review by the Shari'ah board. Basically, there was no indication of disagreement from the branch managers on all the structures of the Shari'ah review except on one particular question. This particular question, which was subject to considerable amount of disagreement amongst the branch managers, was on the issue of whether these respondents thought that the Shari'ah board was the sole authority in the Shari'ah review. Indeed, this negative reply came as a surprise, as the Shari'ah board was deemed to be the bank's sole authority in the Shari'ah review. It is worth noting that in QS1, the heads of Shari'ah departments similarly responded to this question in the negative, though to a smaller extent. Furthermore, it was highlighted that this negative response of the heads of Shari'ah departments could suggest that the Shari'ah board had delegated some of its crucial duties to other parties within the bank. Alternatively, the negative response of the heads of Shari'ah departments hinted at a possible Shari'ah governance crisis in which the Shari'ah board might not able to function independently. It appears that indicating that the Shari'ah board is unable to execute its function independently, as has been pointed out when discussing the responses of the heads of Shari'ah departments, is not justified. The fact that the branch managers were also opposing the view of the Shari'ah board as the sole authority in Shari'ah review signifies that the Shari'ah board could not be the only authority executing the Shari'ah review. This demonstrates the need for internal party(ies) within the bank to assist the Shari'ah review function of the Shari'ah board, which is highly likely to become the role of the Shari'ah department officers.

Meanwhile, other features on the structure of Shari'ah review received responses indicating agreement by the branch managers. For example, the question on whether adequate and apparent guidelines on the pronouncements and resolutions should be issued by the SAC of BNM for use in the Islamic banking industry, which was similarly asked to the heads of Shari'ah departments, was responded favourably by most of the branch managers; this was particularly evident for those from full-fledged Islamic banks and large banks. On another question regarding the SAC, slightly more than 90% of the branch managers responded in agreement regarding the capability of the SAC to enhance the standardization of Islamic banking practices. These two findings regarding the SAC demonstrate the important role of this governing authority in the overall structure of the Shari'ah review for banks offering Islamic banking products and services. They also lend support to arguments advocating the establishment of a central or national Shari'ah board as the supreme Shari'ah reference institution for IFIs such as Islamic banks. In the meantime, the branch managers were also asked two questions regarding the dual-layer Shari'ah governance system, which received positive responses and thus, consolidated earlier findings on the SAC. Specifically, these questions were whether the branch managers perceived that (1) the dual-layer Shari'ah governance system implemented in Malaysia is effective in ensuring the stability of the Islamic banking industry, and (2) the dual-layer Shari'ah governance system is capable of harmonizing Islamic bank practices in Malaysia and across national boundaries. In both questions, slightly more than three quarter of the respondents indicated agreement.

On the implementation aspects of the Shari'ah review, the responses indicated some division amongst the branch managers regarding their agreement on several questions. For example, almost 10% of the branch managers were in disagreement that the Shari'ah board should have the full authority to stop banks from undertaking Shari'ah non-compliant transactions, although three quarters thought otherwise. Interestingly, this evidence of disagreement, although not substantial, seems to suggest that the respective branch managers believe that the Shari'ah board should not assume full authority over the Shari'ah governance of banks offering Islamic banking products and services. Interpreted differently, these branch managers were inferring that the Shari'ah board should not retain the final say on everyday Islamic banking operations. It is worth noting that the heads of Shari'ah departments were asked a similar question in QS1, in which evidence of disagreement was also reported. These indications of disagreement from both groups of respondents are intriguing and depart from the general consensus on the absolute and unchallenged authority of the Shari'ah board.

Meanwhile, the branch managers seem to have high expectations regarding the role of the SAC, specifically regarding adopting rigorous procedures to examine and endorse Islamic financial products submitted by banks offering Islamic banking services. This is due to the fact that this is the only question where the branch managers did not respond in the negative and it was evidently significant for branch managers from the full-fledged Islamic banks. In addition, similar to QS1, the branch managers were asked whether working part time does not hinder the production by Shari'ah board members of an effective Shari'ah review of the operations of banks offering Islamic banking services. Apparently, the responses received were very similar to those in QS1 where, despite the fact that the branch managers have a moderate view of the effect of part-time status of the Shari'ah board members, a considerable number of the branch managers were also evidently in disagreement. Hence, the part-time

status of the Shari'ah board remains in the spotlight due to its implications for the quality of the Shari'ah review by this Shari'ah governance authority.
On the other hand, the branch managers seem to indicate their satisfaction on the level of Shari'ah compliance disclosure shown within the Shari'ah report of the bank the Shari'ah board represented. The evidence showed slightly more than three quarters of the branch managers indicated their agreement while only a few did not. The branch managers also expressed a similar satisfaction that the Shari'ah board discloses the accounting issues of the bank, as reflected in their responses, which were very similar to those to the preceding question. These findings illustrate the quality of the Shari'ah report in which the Shari'ah board concludes its Shari'ah review function as perceived by the branch managers.

This study also revealed the parties whom the branch managers perceived as important in the Shari'ah governance of banks offering Islamic banking services. It appears that the SAC of BNM was considered as the most important party, which indicates its role as the supreme authority in the Malaysian Islamic banking industry. This is followed by the Shari'ah board as the Shari'ah governance authority in charge at the bank level. Next, in order of importance, were the Shari'ah department officers, the board of directors and the management of the bank.

Overall, the findings of QS2 reveal how the issues under investigation, i.e., (1) the role of the Shari'ah board, (2) the accountability and independence of the Shari'ah board, and (3) the nature of the Shari'ah review in banks offering Islamic banking products and services, were expected to be exercised or undertaken by the Shari'ah board from the branch managers point of view. Evidently, some of the results derived clearly indicated the branch managers' departure from the results obtained in QS1. This means that some aspects of the issues investigated were perceived differently and, hence, signify the branch managers' deviation from how they were actually exercised by the Shari'ah board, as indicated in QS1. In other cases, there are similarities in the perceptions of both groups of respondents which, on the other hand, gave credence to the responses derived earlier in QS1. In particular, the branch managers seem to recognize clearly the role of the SAC, and the dual-layer Shari'ah governance system implemented in Malaysia was positively appraised. In an attempt to provide further evidence concerning these tentative findings, a series of in-depth interviews have been undertaken. An outline of the responses from these interviews is provided in the next chapter.

CHAPTER EIGHT: ANALYSIS OF IN-DEPTH INTERVIEWS

8.1 Introduction

The results from both questionnaires provide a valuable insight into the issues surrounding the role of the Shari'ah board, in terms of Islamic banking practice amongst the banks offering Islamic banking products and services, and expectations of it from the perspective of the branch managers. In an attempt to gain an understanding of the Shari'ah governance processes of the Shari'ah board, a series of in-depth interviews were undertaken with the Shari'ah board members[38] and relevant parties in the Shari'ah governance framework (SGF). These were, namely, the heads of Shari'ah Departments, the Chief Executive Officer (CEO) and senior executives of Islamic banks, the Shari'ah Advisory Council (SAC) of Bank Negara Malaysia (BNM) and the BNM officers. In addition, similar to the questionnaire surveys, these in-depth interviews focused on the issues relating to the role, independence and effectiveness of the Shari'ah board. Details of the interview schedules were provided in Table 5.5 in Chapter Five.

8.2 Perceptions on the Shari'ah Governance and Its Implementation

It has been discussed throughout this thesis that the unique distinction of the Islamic banking industry lies in the requirement for the market players within it to ensure that their business operations adhere to the Shari'ah law. In this regard, it is crucial for banks offering Islamic banking products and services to establish Shari'ah governance mechanisms that uphold the Shari'ah law, as this would establish the credibility of its banking business. From the series of in-depth interviews undertaken, it seems that the participants place a great deal of importance on the Shari'ah governance of the Islamic banking industry. As the Shari'ah is very much integral to Islamic banks and because these banks' activities have to adhere to the Shari'ah, the interviews revealed the use of an expression that described the intimate association between the Shari'ah and the Islamic banks' activities. For example, the CEOs of two Islamic banks described their banking operations by labelling them as 'faith banking', in appreciation

[38] The Shari'ah Committee (SC) is the term widely used in Malaysia to refer to the Shari'ah board. This is consistent with the designation used in the Malaysian regulatory guidelines such as the guidelines issued by the BNM. Hence, during the interview sessions most of the participants designated the Shari'ah board as Shari'ah Committee.

of Shari'ah governance. It is assumed that, with such statements given by their respective banks, these top managers would be determined to ensure adequate and proper Shari'ah governance mechanisms. This could include securing the effectiveness of the role and function of the Shari'ah board.

Meanwhile, a CEO of a large-sized Islamic bank indicated that the role of Islamic banks is similar to the conventional bank, except for the fact that Islamic banks are required to operate in accordance with the Shari'ah and to serve as an alternative banking choice to customers. Arguing on the distinction requirement for the Islamic banking operation to be Shari'ah compliant and to meet the Shari'ah banking needs of the customers, the CEO remarked:

> "Islamic finance is simply intermediating between the 'haves' and the 'have nots', meaning the distribution of wealth to ensure that the economic activity is authored. Whether it is conventional or Islamic, the work is the same. I can intermediate by way of debt financing or equity financing but, in Islamic finance, I do it in a Shari'ah compliant manner, for both debt and equity."

Meanwhile, interview participants also indicated the importance of Shari'ah governance by explaining the implication of Shari'ah non-compliance to the bank. It has been mentioned in Chapter Four that the responsibility to ensure that the operation of Islamic banks is Shari'ah compliant lies in the hand of the banks' management. In this light and, with the view that Shari'ah non-compliance would result in negative repercussions on the banks' wellbeing, the CEO of a medium-sized Islamic bank remarked on the risk associated as:

> "Mitigating Shari'ah non-compliance is very important. It is your credibility, your integrity, your 'everything'. You cannot run an Islamic bank knowing that there are areas that are Shari'ah non-compliant. That's why I am saying, as far as the management is concerned, whatever we do, we ensure Shari'ah compliance"

Nevertheless, interviews held with the Shari'ah board members revealed that some of them expressed concerns about the dedication of the management in adhering to the Shari'ah. Rather, the management was seen by some of the Shari'ah board members as indulging in opportunistic behaviour to fulfil their own self-interests, a concept that has been discussed in Chapter Two. Meanwhile, others see the management's involvement in Shari'ah banking as a business opportunity for widening the market share of its banking operation. Regarding the first concern, the Shari'ah board of one Islamic bank remarked:

> "The *fatwa* issued by the SC concerns the product structure, the legal documentation and anything related to its operation. However, sometimes the bank does not say everything about the Shari'ah, either purposely or unintentionally. They might consider the matter as insignificant when, actually, the *fatwa* involves our understanding of the subject matter."

On the other hand, the concerns that the management may lack dedication to the Shari'ah and consider Islamic banking to be purely a business opportunity is expressed by the Shari'ah board of another Islamic bank, who remarked:

> "The management does not really want the Shari'ah. They just adhere to it because there is a demand from the customers for Islamic products. In my view they do not actually appreciate the real spirit of the Shari'ah."

In light of the above, it is apparent that the important parties within banks offering Islamic banking products and services seem to recognise Shari'ah governance as important in ensuring the viability of the Islamic banking industry. Despite this outlook, the above findings also revealed that the Shari'ah board was being pessimistic about the bank management's inclinations towards Shari'ah governance; this was due to the possibility of self-interested, opportunistic behaviour by the management. Hence, it is expected that the findings from the following sections could be explained based on the above behavioural approaches of the participants towards Shari'ah governance.

8.3 The Role of Shari'ah Boards

This section deals with the discussion of the role of the Shari'ah board within the SGF. The in-depth interviews held with the participants revealed emerging issues relating to the role of the Shari'ah board, which are discussed in the following sub-sections.

8.3.1 Qualifications of the Shari'ah Board Members

It has been discussed in Chapter Four that the governance standards and the guidelines issued by the BNM, i.e. '*Guidelines on the Governance of the Shariah Committee for the Islamic Financial Institutions*' or GPS1, clearly stipulate that membership of the Shari'ah board is not restricted only to individuals experienced in the field of Islamic commercial law, or *fiqh al-*

mua'malat, but also includes those from the fields of law, accountancy, economics and others. Ideally, the Shari'ah board should comprise of members who hold a Shari'ah qualification and are well-versed in banking operations (Gambling et al. 1993; Grais and Pellegrini 2006; Laldin 2008b). It became apparent from discussion with the participants that such diverse appointment qualifications seems to have influenced the role and function of the Shari'ah board and contributed to the development of the Islamic banking industry. The importance of diverse expertise in the Shari'ah board has been pointed out by the Shari'ah board chairman of an Islamic bank, who is a non-Shari'ah expert, as follows:

> "Shari'ah is a dynamic discipline. When it comes to *mua'malat,* the Shari'ah principles state that it is something which is open to interpretation and, thus, open to dispute. I mean everything is allowed. '*Al-aslu fil uqud al-ibahah*'- everything is considered permissible, unless there is clear evidence in the Qur'an or in the *hadith* that prohibits such transactions. Moreover, mostly the banks are not just applying *murabahah* as the standalone contract, rather it is combined with many other contracts, together with many added principles, which require clear parameters and clear understanding of what the Shari'ah requirements and guidelines are. Fundamentally, this works very well when you have a composition of the Shari'ah board consisting of individuals from different backgrounds."

The Shari'ah board chairman of a conventional bank offering Islamic banking window shared a similar sentiment about the importance of diverse expertise amongst the Shari'ah board members by associating this with the ability of the Shari'ah board to explore new concepts beyond classical Islamic financial products, such as *mudharabah* and *murabahah,* which dominate the current Islamic banking markets. The Shari'ah board chairman who is a non-Shari'ah expert remarked:

> "Sometimes the SC is too purely Shari'ah, being made up of all those with classical views, who cannot go a step beyond classical Islamic financial products. They do not even consider the contemporary issues in *fiqh al-mua'malat*. This is possibly the reason why the SC limits itself in such a way that they only follow existing products in the market."

In addition, the discussions with the interview participants make it apparent that the appointment of Shari'ah board members is tailored strategically to the bank's business mission. As the Shari'ah board holds the Shari'ah advisory role, the bank seeks the appointment of Shari'ah board members who are able to advise the bank in all spectra of banking business activities. For example, the CEO of a large-sized Islamic bank, in support of the Shari'ah board membership being comprised of various experts, remarked:

> "When it is in terms of who we appoint, it is subject to what we need. We essentially need people who are able to advise us on all aspects of the business in relation to Shari'ah. For example, you cannot have someone who is simply au fait with commercial types of activities and not the law. So, you need to have different people, with different focuses, in their own fields."

The interview also made apparent the concern of the participants that, although the Shari'ah board may be comprised of scholars from a diverse background, it is crucial for the Shari'ah decisions to be issued by Shari'ah experts. However, an important requisite for successful implementation of such a mechanism means that the cooperation and consolidation between the Shari'ah experts and the non-Shari'ah experts amongst the Shari'ah board members are essential. The Shari'ah board chairman of a conventional bank offering Islamic banking window, who comes from a Shari'ah background, highlighted this point and remarked:

> "I always emphasise that one who wants to become a Shari'ah advisor has to possess the necessary skills and sufficient knowledge in Shari'ah. If one does not have sufficient knowledge in the Shari'ah how would one be able to give a Shari'ah opinion or decision, even if one possesses a banking qualification?"

Interestingly, the concept of Shari'ah board membership comprising of diverse expertise does not seem to be appealing to some Shari'ah board members, particularly amongst the Shari'ah experts, as well as the banks' Shari'ah officers. They seem to advocate that Shari'ah board membership should be composed of Shari'ah experts only, due to concerns about the quality of the *fatwa* or Shari'ah decisions issued. For instance, the methodology of deriving Islamic jurisdiction involves the use of classical Islamic manuscripts, which are written in Arabic. In this regard, individuals with a Shari'ah background are likely to have proficiency in Arabic; hence, they would be able to make reference to these manuscripts for their Shari'ah decisions. The Shari'ah board member of an Islamic bank, whose bank's headquarters is in the Middle East, remarked:

> "The SC really needs to communicate with the people in the bank's headquarters and the documents are either in Arabic or English. Secondly, we have to understand the Shari'ah issue and do research, which means we need to know Arabic, as we have to refer to classical manuscripts. To me, if asked about the SC, they have to be from the field of Shari'ah. Even from degree level, the SC candidate should have studied in the field of Shari'ah and they must know Arabic."

It became apparent from the discussions held with the participants that, notwithstanding the stance expressed above for the Shari'ah board to comprise of Shari'ah experts only, these Shari'ah experts recognised the importance of experts from other fields, however, as they could contribute to the Shari'ah governance role of the Shari'ah board by offering a different approach. One of the recommendations put forward was for the non-Shari'ah experts to contribute by acting as consultants to the Shari'ah board. Emphasising that the Shari'ah board should comprise of Shari'ah experts only, while recognising the importance of expertise from other fields, the Shari'ah board member above remarked:

> "To me, some people's claims about the Shari'ah experts not knowing everything are undeniable. What I mean is that, in *majmak fiqh* (*fiqh* league), for example, besides the Shari'ah experts there are also experts from other fields. This means that one commission or committee, comprising of experts in certain fields, could be specifically established and, so, could be appointed as consultants to the bank."

The head of Shari'ah department of an Islamic bank shared a similar sentiment, arguing that it would be unbefitting for a non-Shari'ah expert to authorise Shari'ah rulings for Islamic banking operations. The head of Shari'ah department remarked:

> "When this happens, it is like asking a fireman to carry out surgery in a hospital, which, at the end of the day, he does not know how to do. Similarly, if you ask the Shari'ah people to do the treasury or accounting work, they will tend to make mistakes. Therefore, we still need expertise from other fields. The Shari'ah people still need experts in accounting, risk management, treasury and law; however, they should work within their own specialisation. For example, the legal expert should specialise in clause provision, on how to draft legal documentation, while the accountant specialises in the accounting treatment."

From the above arguments, it could be said that the Shari'ah board member is suggesting that experienced outsiders, having a background with no Shari'ah qualifications, could be appointed as consultants to the bank. However, for them to become a Shari'ah board member would be inappropriate, as issuing a *fatwa* is too great a responsibility. Furthermore, the concern expressed about the Shari'ah boards' membership above is related to the ability of the Shari'ah board to undertake its roles and functions and, notably, the quality of Shari'ah decisions it issues. It was discussed in Chapter Four that the Shari'ah board members are perceived to be people of high ethical standards (Karim 1990a; Laldin 2008b). More crucial is the fact that the bank is held accountable for implementing Shari'ah decisions issued by this Shari'ah governance authority. This explanation sheds light on the authoritative qualified party within the Shari'ah board deemed to be most appropriate in issuing the *fatwa,* or Shari'ah ruling, for the Islamic banking industry. In other words, the quality of the *fatwa* or Shari'ah decision issued by Shari'ah boards is depended on the membership of the board. The implication of the type of Shari'ah board membership on the quality of *fatwa* it issues has been pointed by the Shari'ah board chairman of an investment bank offering Islamic banking, who remarked:

> "Imagine if the SC was comprised of only one Shari'ah expert and the other two were experts from a non-Shari'ah background, it would definitely not be giving a Shari'ah viewpoint. Therefore, the non-Shari'ah experts can sit in the SC meetings but only as additional members to the minimum requirement of three. The three must be strictly from a Shari'ah background."

It is apparent from the above argument that the view of the majority of the Shari'ah board members could not be considered as a Shari'ah view if the majority of its board members was comprised of non-Shari'ah experts. Additionally, the Shari'ah board chairman of the investment bank above seems to advocate the idea that the inclusion of non-Shari'ah experts as Shari'ah board members should constitute a subset of a larger Shari'ah board member pool comprised of Shari'ah experts. Moreover, the Shari'ah board chairman also recommended that the number of Shari'ah board members should be expanded beyond the minimum requirement of three members, as laid down by BNM in its GPS1.

8.3.2 The Importance of Relevant Experience

In addition to the qualifications of the Shari'ah board members, the interview also makes apparent another important requirement for a quality Shari'ah decision. The interview participants emphasised that the quality of the decisions made by the Shari'ah board was associated with the ability of its members to expand their paradigm beyond their theoretical framework. In the case where the Shari'ah board members are comprised of three members, with one being a Shari'ah expert and the remaining two being non-Shari'ah experts, a manager from the Department of Islamic Banking and *Takaful* of BNM remarked:

> "Even if one of the members is from the Shari'ah background his *tassawur* (understanding of the subject matter) might still be right or wrong. On the other hand, the *tassawur* of the other two Shari'ah board members, although they aren't from a Shari'ah background, might be right."

Another important criterion in the appointment of the Shari'ah board, which became apparent from the discussions with the participants, is the experience of the Shari'ah board candidates. In support of the Shari'ah board members comprising of Shari'ah experts, the head of the Shari'ah department of a development financial institution offering Islamic banking highlighted a requirement for quality *fatwa* in the appointment of Shari'ah board members being from amongst Shari'ah experts with relevant banking experience. The head of the Shari'ah department remarked:

> "Being simply a university academic would not make much of a contribution whereas knowing both the banking practice and the *fiqh* would enable much more accurate conclusions. Also, knowing the current issues in *mua'malat* by, for example, being involved in consultancy work and participating in seminars on Shari'ah banking is important."

A senior executive of a large-sized Islamic bank similarly put forward the need for adequate banking experience as a requisite for a Shari'ah board member in contributing to the Shari'ah governance of the bank, remarking:

> "Theory is not something which is dynamic. Only things that are practiced are dynamic. I see Shari'ah board members without much banking experience finding it difficult to understand and, sometimes, hardly even participating. I see it as there being no contribution from them."

Hence, the Shari'ah board members are expected to understand business dynamism by being able to handle banking business issues and to be proactive in assisting the business development process. In this regard, the CEO of a medium-sized Islamic bank clarified how an inspiring Shari'ah board member, combined with relevant experience, could alleviate some of the challenges faced by the Islamic banking industry. The CEO remarked:

> "If you look at the Islamic banks in general, the level of product innovation is lacking. The level of compliance to the requirements of the Shari'ah is also lacking. In order for you to raise that bar higher, not only must the management of the Islamic bank want to do it, but you must also have the assistance of your Shari'ah Committee. Crucially, the Shari'ah Committee members should also understand the industry issues and then they can make their decisions in line with, or by taking into consideration, these issues."

The above discussions point to how the management of banks offering Islamic banking products and services perceived relevant experience as crucial for scholars to hold governorship on the Shari'ah board. Indeed, the importance of relevant experience amongst the Shari'ah board members, highlighted by the interview participants above, might explain the reason why banks participating in the MIFC were indicated as having developed a pattern of having a Shari'ah board comprised of diverse experts. This is as indicated in Section 6.5.1 of Chapter Six on the structure of Shari'ah review for Shari'ah board in Questionnaire Survey 1 (QS1).

8.3.3 Image Building and Standardisation of Islamic Banking Practice

It became apparent from the discussions with the participants that the Shari'ah board is regarded as the insurer of the banks' ethical operation and its establishment is seen as carrying the image of the bank's commitment. On this, the CEO of a large-sized Islamic bank remarked:

> "I think image plays a key part. We have marketed the fact that we are a pure Shari'ah committee bank and we hold Shari'ah's high principles in our day to day activities."

In addition, the interviews disclosed that the image-building element mentioned above is allied with the appointment of prominent international figures for the banks' commercial reasons. For example, the interview participants discussed that the appointment of several international figures as Shari'ah board members was intended as a marketing tool to capture the market share in those different jurisdictions. In this regard, the domain of profit maximisation amongst the management seems to remain intact, even in matters such as the appointment of Shari'ah board members. The CEO of another large-sized Islamic bank provides evidence in this light, remarking:

> "I'm now looking for someone who is based in Indonesia, because I have a keen interest in expanding my business in Indonesia. There are many qualified people in Indonesia that I can tap into as SC members. So, I will not necessarily bring that person in due to their Shari'ah qualification, but because there are other commercial reasons behind the selection of SC members."

The interview also revealed that the appointment of a prominent international figure as a Shari'ah board member could result in the bank gaining the advantage of minimising the gap in terms of product offering, as well as allowing domestic products and services to penetrate different national jurisdictions. The Shari'ah board member of a similar Islamic bank to the one run by the CEO above remarked:

> "The appointment of an international figure as an SC member is very good because, by this appointment, we can understand the problems faced by the international Islamic banking industry. These people know what the international perspective is and they might tell us not to offer some of the existing Malaysian products. At the end, what we want is to minimise the gap between the boundaries."

On a similar note, a senior executive of a large-sized Islamic bank also pointed out that the bank had taken the initiative to appoint a prominent international figure as the Shari'ah board member in order to consolidate the bank's mission of becoming the leading Islamic bank in the world. This is clearly indicated below:

> "Our vision stated that we want to become the world leader in Islamic banking. One of the missions in accomplishing this vision is to develop and innovate products based on a globally accepted concept. As such, the bank must develop the appropriate infrastructure to assist in the accomplishment of this. An element of this is the SC, which is why the SC now has additional 'blood' whose views and experiences are from the Middle East."

Hence, it became apparent from discussions with the participants that the Shari'ah board members, though responsible for ensuring the ethical aspect of the banking operation by the Shari'ah compliance assurance they provided, also generated goodwill for the financial institutions on the basis that their appointment gives additional benefits to the business. However, a precaution, related to the business motive behind the appointment of Shari'ah board members mentioned above, is for them to remain vigilant against the possible opportunistic behaviour of the management when undertaking their Shari'ah governance function.

8.3.4 Shari'ah Advisory Role of Shari'ah Boards

Despite the existence of a prescribed general scope of the Shari'ah board's role, stipulated in the GPS1 and AAOIFI standard, the interviews held with the participants revealed that the level of Shari'ah board members' involvement in undertaking these roles appeared to vary from one bank to another. Among the factors contributing to the differences in Shari'ah board members' levels of involvement are: the ability of the Shari'ah board member to undertake the task, as reflected by the composition of the Shari'ah board, the capacity of the Shari'ah department in assisting the Shari'ah board and the rigour of the Shari'ah governance mechanism developed by the bank. The types of banks, either a fully-fledged Islamic bank or a conventional bank offering Islamic banking window, and the specification of the scope of the Shari'ah boards' roles and functions, as prescribed in the banks' Shari'ah manual also play a part. The following sub-sections discuss further results from the in-depth interviews.

8.3.4.1 Dynamism of the Shari'ah Boards' Shari'ah Decisions

Consistent with the findings in QS1, the in-depth interviews revealed that the Shari'ah board was mainly advising on matters relating to approving the Islamic banking products to be offered to the customers. As has been discussed in Chapter Four, the dual-layer Shari'ah governance system implemented in the Malaysian Islamic banking industry implies that banks wanting to offer Islamic banking products have to firstly seek approval from their respective Shari'ah boards. If the boards give their approval this would have to be followed with agreement from the SAC of BNM. In approving the Islamic banking products, the Shari'ah board would have to take into consideration many issues before any Shari'ah decision could be made. It would have to be made in accordance with the Shari'ah principles laid down in the *Qur'an* and *hadith*, as well as the *ijtihad* (legal opinion) of the Muslim jurists, who would issue their argument based on the principles deduced from the Shari'ah. Interestingly, the in-depth interviews also revealed that the Shari'ah board placed importance on the bank's dynamism for Shari'ah decision considerations. For instance, in the case where there is no other Islamic banking product alternative, the Shari'ah board chairman of an Islamic bank issued a decision to endorse a particular product, on evaluation of the bank's financial health, in spite of it being controversial. The Shari'ah board chairman remarked:

> "When we talk about liquidity, it is a something that can cost the bank severely in terms of its solvency level. In one situation, the bank needed to enter into a transaction or else it would have a liquidity risk problem. So, in that case, the Shari'ah board allowed the bank to use a particular controversial product."

As clearly indicated in the above, an important facet in Shari'ah decision making is for the Shari'ah board to draw a line encircling the principles of the Shari'ah and the justification of need should be based on the fulfilment of *maqasid al-Shari'ah* (objectives of the Shari'ah), i.e., in the public interest. It has been discussed in Chapter Three that, in determining the public interest, judgement has to be made based on whether the subject matter is considered as *daruriyyat* (the essentials), *hajiyyat* (the complimentary requirements) or *tahsiniyyat* (the desirables). The in-depth interviews revealed that the Shari'ah board is usually confronted with the need to base its judgement on the three aforementioned concepts when issuing Shari'ah decisions. Included in the domain of protecting the public interest, instances are revealed where the Shari'ah board carefully examined the underlying contract on the Islamic banking products offered to the customers and its related legal documentation to ensure that any possibility of customer exploitation would be avoided and their rights protected. However, the ability of the Shari'ah board members to assess and to make a distinction on what constitutes public interest is argued to be delicate and can only be appreciated by one who is knowledgeable in the Shari'ah. In this regard, the Shari'ah board member of an Islamic bank, who is also a Shari'ah expert, remarked:

> "Many people talk about *maqasid* (objective of the Shari'ah) but they do not understand what it means. The economist talks about it but, when we analysed what he said, he cannot differentiate between *daruriyyat* (the essentials) and *maslahah* (public interest). Sometimes they claim that they are securing the interests of the Islamic banking industry, but shareholders' or investors' interests are not the same as the public interest."

As such, the above remark gives rise to concerns about the *fatwa* quality issued by the Shari'ah board and the issues revolving around the fitness of the Shari'ah board members to issue the *fatwa,* as discussed in section 8.3.1 above. Additionally, the in-depth interviews also revealed that the majority of the Shari'ah board members and the SAC of BNM members, generally, do not limit themselves to opinions deduced from the Shafi'i[39] Islamic legal school when issuing Shari'ah decisions, but rather are open to interpretations from all Islamic legal schools. The participants emphasise the fact that matters of *fiqh al-mua'malat,* in modern applications such as in Islamic banks, are concerned with meeting the *maslahah* (public interest) and that confining themselves to one particular Islamic legal school would not resolve the issue at stake and face the risk of limiting the potential of the Islamic banking industry.

8.3.4.2 Accounting and Finance Influence in the Product Approval Decisions of the Shari'ah Board

Another important finding revealed from the in-depth interviews is the diverse level of the Shari'ah boards' involvement in developing Islamic banking products and services. It is apparent from the discussions with the Shari'ah board members that aspects of product concept, its design, the legal documentation and marketing level are the stages of product development where the Shari'ah board members are commonly involved. At the concept level, the Shari'ah board members are presented with the challenge of developing classical Shari'ah financial products with modern Islamic banking features that will ultimately meet the demands of current customers. It was revealed that, most of the time, the Shari'ah board members were presented with a challenge to devise a product that does not feature straightforwardly classical Shari'ah elements or, as they are more commonly known, 'plain vanilla' products, such as *mudharabah* and *murabahah*. Rather, the Shari'ah board members would have to apply several Shari'ah principles to devise a particular Islamic financial contract or, as it is more commonly known, the 'hybrid' product that will result in the economic effects demanded by the customers. Hence, it is apparent that the design of modern Islamic banking products entails not only the necessary Shari'ah knowledge but also includes, for example, knowledge in the accounting and finance fields.

The accounting concerns in designing Islamic banking products also expands beyond determining the financial impact that would produce the required economic effect to also include issues pertaining to the sequence of the transactions, the nature of the assets involved

[39] It is worth noting that the Muslim majority in Malaysia practice the Shafi'i Islamic legal school of Islamic thought.

and the transfer of risks and ownership between the seller and the buyer. In this regard, the Shari'ah board chairman of an Islamic bank remarked:

> "We don't only look at the structure. The management can present to the SC beautifully and justify all the principles. However, the most important thing is what is next. What is the underlying contract? Is there a real transfer of ownership? Are there real assets involved? Is it a valued asset? How does the issue of delivery take place? All these are Shari'ah issues that need to be addressed for each particular contract."

In another instance, the Shari'ah board chairman above expressed how accounting can be an important tool in justifying the management's accounting treatment choice for a particular Islamic financial contract. Quoting an example of an Islamic financial contract on *ijarah mawsufah fi al-zimmah,* or 'forward lease', the Shari'ah board chairman explains that the Shari'ah allows for the lessor (the bank) to charge rental in advance as income even though lessee's usufruct will only be transferred later. Although the recognition of this rental as income, which will then be portrayed as profit in the bank's financial statement, seems to be biased towards the management's compensation plan, the accounting system could be adjusted to change this to a liability. Therefore, the income collected would be returned in total to the customer if the usufruct could not ultimately be transferred. Explaining that the Shari'ah allows rental in advance on this contract to be recognised as income, the Shari'ah board chairman remarked:

> "Whether you want to recognise the income now or later, or you want to take it as liability, it is something that is, for me, Shari'ah compatible, as long as the principles are clear. I am sure this can be done through accounting and if the accounting can be done, from the Shari'ah point of view, there is no problem. This is one case where, if there is a contradiction between the Shari'ah and accounting, the Shari'ah will prevail."

The above argument highlighted some of the Shari'ah boards' accounting concerns when designing Islamic banking products. Issues such as those mentioned above on the transfer of ownership and the existence of real assets ('form over substance') are deemed fundamental when ascertaining the legitimacy of an Islamic financial contract. Indeed, it has been described in the above that accounting plays an important role in justifying the management's choice of accounting treatment of a particular Islamic financial contract. Importantly, the above explanation of *ijarah mawsufah fi al-zimmah,* provides one example of how an Islamic financial contract could give rise to accounting implications encompassing aspects of recognition, measurement and disclosure of accounting information in the financial statement. In the case of the above, it was indicated that any fault in the implementation of the Islamic banking product could result in the transaction being Shari'ah non-compliant, meaning that the profit derived from that transaction would be considered as impermissible.

8.3.4.3 Catering for the Financial Needs of Muslims and Protecting the Customers

The in-depth interviews also revealed that the Shari'ah board would have to accommodate the dynamism of business operation whilst ensuring that the Shari'ah decisions it issues would protect the public interest. For instance, in the case where the customers are unable to repay financing instalments due to personal reasons, such as job loss, the Shari'ah board could authorize a moratorium, which in a conventional bank would result in the customer being penalised with interest charges. In another instance, the Shari'ah board member of an Islamic bank showed tolerance by authorising customer financing involving a non-permissible source of funds as encouragement for participation in Islamic banking operation, with the aim of purifying the customer's income. The Shari'ah board member remarked:

> "One Malay[40] customer wanted to invest with his *non-halal* gaming house income. For me, I allowed it because the small proportion of the *non-halal* income, when pooled with the bigger proportion, became between 10% and 20% of the fund, so the whole fund become *halal* again. The aim of this was to give him his returns with *halal* income and to encourage him to invest in an Islamic bank, rather than to go to a non-Islamic or conventional bank."

Furthermore, the discussions with the interview participants also made apparent the concerns of the Shari'ah board in protecting the customers, as well as the banks' staff, from receiving or providing misleading information. A mechanism to ensure such protection was disclosed during the interviews, where the Shari'ah board has established the product's operational framework that serves as the Shari'ah compliance manual for the bank and will be used at a later stage for Shari'ah review and audit. This revelation highlights the importance of the operational aspects of the Islamic financial products and, thus, the significance of the implementation stage, after the product has been approved. This is because the operational issues will be continuous, whereas the Shari'ah board will only deal with the product

[40] Malay is the Muslim ethnic majority in Malaysia.

approval once. Additionally, this finding also sheds light on the reason why the direct involvement of Shari'ah boards during the implementation stage was indicated to be low in QS1 (as reported in Section 6.3.4 of Chapter Six), as the boards have already developed a mechanism, such as the aforementioned product's operational framework, to be carried out by the management of the bank. Meanwhile, the Shari'ah boards' involvement in reviewing the operational aspects of the product and the Shari'ah governance mechanisms established by the bank to ensure that the operation of the product is Shari'ah compliant is explained in the section on the Shari'ah boards' role in the Shari'ah review below.

8.3.4.4 Other Shari'ah Advisory Roles of Shari'ah Boards

The interviews also disclosed that the Shari'ah boards' Shari'ah advisory role advances beyond banking product matters. For example, it has been revealed that the Shari'ah board also provides lectures and training to the banks' staff, as well as to the high-level management. Besides this, the Shari'ah board members also expressed that their board received great respect from the board of directors and that they were also consulted on matters such as the selection of the bank's CEO and new Shari'ah board members.

8.3.5 Shari'ah Review Role of Shari'ah Boards

One of the critical aspects of the Shari'ah governance mechanism of the Islamic banking operation is the requirement for the Shari'ah board to ensure the implementation of the Shari'ah decisions it makes, i.e., the Shari'ah review. The following subsections provide further understandings on the implementation of Shari'ah review amongst the participants.

8.3.5.1 The Shari'ah Review Approach

As mentioned before, one of the regulatory requirements stipulated in the GPS1 for the Shari'ah governance of banks offering Islamic banking services is for these banks to appoint Shari'ah officers to act as the secretariat to the Shari'ah board. In this regard, the discussions held with the interview participants revealed that the Shari'ah board mainly appeared to depend on the assistance of the Shari'ah department when assuming its role in Shari'ah review. For example, the Shari'ah board member of an Islamic bank remarked:

> “We have not been directly involved with Shari’ah review. We are given certain indications that the Shari’ah officers have actually prepared the financial report. From that, we understand the various Shari’ah products and others that are available. Because the Shari’ah review is basically just endorsing what they have done, they will come to us and request endorsement that the whole exercise is Shari’ah compliant.”

In fact, the interviews also disclosed instances where the Shari’ah board members considered that the Shari’ah review was not within their jurisdiction. Instead, the Shari’ah board members had entrusted the responsibility for the Shari’ah compliance review to the Shari’ah department officers of the bank. For example, the Shari’ah board member of a development financial institution offering Islamic banking remarked:

> “We, the SC members, are not involved in the Shari’ah review. We merely give our approval and the Shari’ah officers proceed with its implementation. They do not report to us and we do not ask any questions. We ask the Shari’ah officers to carry out the implementation of the Shari’ah decisions and we trust them.”

Furthermore, the interviews also highlighted instances where the bank’s Shari’ah compliance manual specified that the Shari’ah department officers, instead of the Shari’ah board, were the party responsible for undertaking the Shari’ah review task. In such circumstance, the Shari’ah board is merely responsible for approving the Shari’ah review burden of the Shari’ah department officers, as a means to satisfy the GPS1 requirement of the Shari’ah board’s Shari’ah review role. Indicating that the Shari’ah review is not the sole authority of the Shari’ah board, the head of the Shari’ah department of an Islamic bank remarked:

> “In our bank, the SC delegates the Shari’ah review function to the Shari’ah department. The SC just double-checks the review and provides the sign-off. Therefore, most of the SC work is performed by the Shari’ah department.”

The discussions held with the participants also make it apparent that the Shari’ah review exercise of the Shari’ah board is deemed to be more significant for non fully-fledged Islamic banks. This is due to the fact that the Islamic banking operations of these banks are either (1) an Islamic banking subsidiary to a conventional parent bank, or (2) operating on a dual platform alongside the conventional banking (Islamic window). As such, there is a possibility that handling of the funds of these banks will be comingled with those from the conventional banking operations. Also likely is that the documentation process of the Islamic banking operation will tend to replicate those of the conventional banking practice. Explaining this fact, the Shari'ah board chairman of an Islamic bank, whose parent company is a conventional bank, remarked:

> "We give our approval on all the instruments at the early stage but, operation-wise, we do not know whether the management implement them or not. Our parent bank, for example, is a conventional bank and that is quite a problem. Once, I checked one of the forms and it still had written the term 'interest' on it because they simply change it from 'loan' to 'finance' and 'interest' to 'profit'."

Evidence on the lack of Shari'ah board's involvement in the Shari'ah review exercise provided in the above example is argued as being because the GPS1 is silent on the procedures of how Shari'ah review is to be carried out. This has resulted in banks having the discretion to define their own Shari'ah governance mechanism, which is usually tailored to the size and nature of their banking operation. The interview disclosed an instance where an Islamic bank, which is a subsidiary to a conventional parent bank, established a Shari'ah compliance unit that monitors the operation of the Islamic bank and its links with other banks within the group as a whole. The CEO of this large-sized Islamic bank remarked:

> "We internalise Shari'ah compliance responsibility to each individual banker within the group. Our compliance framework clearly requires each division essentially to confirm that they are Shari'ah compliant. This has to be verified on a sampling basis by the Group Compliance department and, finally, reported to the SC on periodic basis. Therefore, the SC role is very much in relation to broad policies and the direction of the business. We leave the day-to-day issues to the management."

However, the discussions with the participants also made it apparent that there are banks whose internal Shari'ah governance mechanism is robust. For instance, the internal Shari'ah governance mechanism of a pioneer fully-fledged Islamic bank is structured as two platforms, in which one acts as the filtering mechanism before proceeding to the other. The manner in which this internal Shari'ah governance mechanism operates is that the higher level platform is exclusively comprised of Shari'ah board members, while the lower level platform is comprised of the internal Shari'ah officers combined with representatives amongst the Shari'ah board members. Describing this internal Shari'ah governance structure, the Shari'ah board member of this Islamic bank remarked:

> "Our Shari'ah Committee Review is established to review and detail the Shari'ah aspects from the beginning. This includes examining the documentation of any financial contracts prepared, word by word. If the committee is satisfied then this will be given the go-ahead and will proceed to the Shari'ah Supervisory Council. There the decision will be finalised and approval will be granted."

The above discussions provide evidence of the state of the Shari'ah review practice in the interview participants' respective banks. In addition, the interviews disclosed that the internal Shari'ah governance mechanism of the bank, such as provided by its Shari'ah department officers, plays a significant role in assisting the Shari'ah boards' Shari'ah review function. In fact, there were circumstances where the Shari'ah board was highlighted as merely depending on the Shari'ah department to ensure implementation of Shari'ah decisions issued by the board and, hence, the bank's overall Shari'ah compliance. This revelation could shed light on why a minority of the respondents in both questionnaire surveys (heads of Shari'ah departments in QS1 and branch managers in QS2 (Questionnaire Survey 2), as reported in Section 6.5.1 of Chapter Six and Section 7.5.1 of Chapter Seven respectively) responded with disagreement when asked whether they perceived the Shari'ah board as being the sole authority on the Shari'ah review system within individual banks offering Islamic banking services. The next subsection examines further the Shari'ah review of banks offering Islamic banking products and services on issues pertaining to previous Shari'ah decisions and *zakat*.

8.3.5.2 Review of Previous Shari'ah Decisions and Zakat

In addition to sound internal Shari'ah governance structures, the robustness of the Shari'ah governance mechanism is also apparent from the extensiveness of the Shari'ah review scope it practices. Indicating that the bank's Shari'ah review also covers decisions made over a decade ago, the Shari'ah board member of the Islamic bank with two Shari'ah governance structures, mentioned above, remarked:

> "We instructed the Shari'ah department officers to perform Shari'ah compliance reviews, including those of past decisions, because we were afraid that the decisions might have gone outside of the Shari'ah. When we first established the bank we might have made decisions in a situation that were seemingly Shari'ah compliant at that point in time, so, we wanted to check if there was anything that we had mistakenly decided."

If past Shari'ah decisions were indeed decided mistakenly by the Shari'ah board members, this could mean that the accounting information presented in the bank's historical financial statements would have to be adjusted. Hence, the emerging issue arising from the above is the question of whether the Shari'ah decisions made by the Shari'ah board can be challenged. Interestingly, this issue also opens a new dimension of Shari'ah audit, i.e., whether the Shari'ah board has accurately concluded Shari'ah decisions. Explaining this, the head of the Shari'ah department of an Islamic bank remarked:

> "Sometimes the SC gives a ruling on financial aspects of the bank without full understanding of the matter. Sometimes, they feel that the business is too difficult to handle and this will worsen if the SC members are old and do not understand business operations. They give their approval merely based on the explanations provided by the business."

The interviews also disclosed circumstances where a change in Shari'ah ruling by the Shari'ah authority, on certain Islamic financial contracts, could raise possible accounting implications. As the Islamic financial contract involves decisions made based on the *ijtihad* of the scholars and because Islamic banking and finance is a relatively new and emerging industry, it is possible that the permissibility of Islamic financial contracts will experience a change over time. In this light, the head of the Shari'ah department above remarked:

> "When the SAC approved *bay' al-'inah* back in the 1980s, the justification given was because, at that juncture, the *bay' al-'inah* contract could be considered as *darurrah* (essential). However, at present, there are lots of other alternatives but the bank still keeps going with *bay' al-'inah*. Therefore, the auditor would have to ask, 'is this valid? Should this be automatically 'null and void'? Should we declare that this contract be terminated?"

Besides the complicated accounting implications and avenues for Shari'ah audit above, the interview also disclosed the Shari'ah boards' role on matters pertaining to *zakat*. It became apparent that the management's acceptance of the Shari'ah boards' concern about *zakat* varies. For example, the interview disclosed instances where the Shari'ah board of an Islamic bank was consulted to give an opinion as to whether the bank should offer *zakat* and to whom it should be given. Meanwhile, the Shari'ah board of another Islamic bank gets involved to the extent of confirming the calculation of *zakat* by the bank. However, the management refused to accept the Shari'ah board's recommendation for the *zakat* to be calculated based on the method proposed by AAOIFI. The Shari'ah board remarked:

> “We found that the management was not at ease when we asked them to calculate *zakat* using AAOIFI’s calculation method because this would result in much higher *zakat* being paid than with the calculation method by the Selangor *zakat* authority (a Malaysian State Islamic authority). So, we resolved this by using the calculation method issued by the Selangor *zakat* authority and not AAOIFI.”

On the other hand, the interview also revealed an instance where the management refused to accept the Shari’ah board’s advice on *zakat* payment, despite the GPS1 clearly having mandated the management to comply with the Shari’ah decisions issued by the Shari’ah board. The Shari’ah board chairman of an Islamic bank remarked:

> “I have been emphasising corporation *zakat* for three or four years, since I’ve been with this bank, but this has never been accepted. It does not matter whether the *zakat* is on behalf of the shareholders or the bank’s customers; it is an Islamic bank and is, therefore, liable to pay corporation *zakat*.”

The next subsection looks at an inter-related issue, i.e., the decisiveness of the Shari’ah board’s Shari’ah review decision

8.3.5.3 The Decisiveness of Shari’ah Board’s Shari’ah Review Decision

The discussion held with the interview participants also revealed that it would be premature to conclude the Shari’ah decisions issued by the Shari’ah board without further investigation. For example, as a result of reviewing the operation of banks offering Islamic banking products, the Shari’ah board might come out with the verdict that the bank is being Shari’ah non-compliant due to breach of Shari’ah principles in the activities of the bank. However, this decision is inconclusive until the Shari’ah board gains clarification, from the respective parties, on the reasons behind the decision of Shari’ah non-compliance. The head of the Shari’ah department of an Islamic bank remarked:

> “The SC only approves the Shari’ah reviews undertaken by the Shari’ah department. When we find Shari’ah non-compliance issues we will list down all the issues, prepare the report and arrange an exit meeting with the respective departments. We will ask the department why it has resulted in Shari’ah non-compliance and, after gathering feedback, we might drop several issues which we had initially misunderstood.”

Similarly, the interviews also disclosed the fact that the management could not carry out all of the Shari'ah decisions issued by the Shari'ah board immediately. Hence, evidence of Islamic banking practices contrary to the decisions initially issued by the Shari'ah board would not necessarily mean management's opposition to the Shari'ah board but could be because of possible constraints that caused its implementation to be delayed. The head of the Shari'ah department of another Islamic bank remarked:

> "If the SC issues a decision to stop a particular financial contract this cannot be in effect immediately. It does not mean that the management does not abide by the SC decisions, but because there might be some constraint. For example, the system might not be ready. So, it is necessary to give period of grace."

It is apparent from the above discussions that a conclusive Shari'ah compliance decision would require the Shari'ah board to gain sufficient information and carry out sufficient deliberation on how Shari'ah issues are being implemented with all concerned parties in the bank. In addition, the fact that the banks' Shari'ah officers play a significant role in the Shari'ah review exercise and, hence, signify the inter-dependence of the Shari'ah board with the function of the former, would suggest the prerequisite mentioned as being more crucial.

8.3.5.4 Disposal of Profits from Shari'ah Non-Compliant Activities

The Shari'ah review role of Shari'ah boards also has important implications for the Shari'ah governance of banks offering Islamic banking products and services. As has been discussed in Chapter Four, the Shari'ah board will manifest the conclusion of its Shari'ah review task in the Shari'ah report, which is usually included in the banks' annual report, prepared every financial year end. Hence, the bank would want to ensure that its operations are in accordance to the Shari'ah decisions issued by the Shari'ah board, as a report of Shari'ah non-compliance issued by this governance authority would have a negative implication for the bank. However, if the Shari'ah review task has identified that any of the bank's revenue is derived from activities regarded as Shari'ah non-compliant, this non-compliance will have to be reported in the Shari'ah report and the Shari'ah board is required to instruct the disposal of the profit for charity causes and to disclose this fact in the bank's Shari'ah report (AAOIFI 1998). Explaining the effect if certain conditions of the Islamic financial contract are not followed, the Shari'ah board member of an Islamic bank remarked:

> “If the Islamic financial contract conditions are not followed, we need to carry out a review. This means that, in terms of profit, we cannot take that profit and the money gained through that kind of process cannot be considered as income. In the accounting statement, it is just revenue and not profit and we need to channel it to charitable bodies.”

This section has provided the explanation of the Shari’ah advisory and Shari’ah review process undertaken by the Shari’ah board and other relevant parties within the bank. It also provides an indication of the effectiveness level of the Shari’ah review task entrusted to the Shari’ah board. The next section offers the interview findings that explore the effectiveness of the Shari’ah governance role of the Shari’ah board in further detail.

8.4 The Effectiveness of the Shari’ah Boards’ Shari’ah Governance Function

This section discusses the effectiveness of the Shari’ah governance role of the Shari’ah board. While the previous sections have provided an explanation concerning issues that indicate the effectiveness of Shari’ah board, this section attempts to identify further factors derived from the interviews held with the participants that might support or impair the Shari’ah governance function of the Shari’ah board.

8.4.1 Factors that Support the Shari’ah Governance Role of Shari’ah Boards

This subsection looks at factors that support the Shari’ah governance role of the Shari’ah board.

8.4.1.1 Accountability Driven Paradigm

The results of QS1 and QS2, reported in Chapters Six and Seven respectively, revealed that both the heads of the Shari’ah departments and branch managers perceived the integrity factor, such as the ethical value of the Shari’ah board members, as important in influencing the accountability of the Shari’ah board. In relation to this, and as the salient feature of the Islamic financial institutions (IFIs) is the requirement to adhere to the principles of the Shari’ah, the accountability dimension that better reflects the parties in the SGF is perceived to be ‘ethical accountability’. The interview sessions held with the participants clearly indicated the perceived ethical accountability they hold in preserving the Shari’ah aspects of the Islamic banking industry. For example, the Shari'ah board member of an Islamic bank remarked:

> "As SC member, our accountability is first and foremost to Allah. People like us have one leg in Hell and the other leg in Heaven. If we make an incorrect decision or a decision for our own interest, this will bring about certain severe consequences. If this is your primary concern, you are not afraid that your tenure will not be renewed."

In addition, the regulatory settings within which the Islamic banking industry resides also made apparent the accountability of the Shari'ah board from the regulatory perspective. It has been discussed in Chapter Four that the new amendment to the Central Bank of Malaysia Act 2009 has made it clear that the resolutions and pronouncements of the SAC should be binding on all interested parties, including the Shari'ah board. This, ultimately, makes clear the Shari'ah reference role of the SAC in matters pertaining to the Shari'ah governance of the IFIs, including that of the Islamic banking industry. In this regard, the Shari'ah board member of another Islamic bank remarked:

> "Being a Muslim professional, we are answerable to God. Of course, we also exist in a regulatory framework and we are bound by the regulations saying that we are accountable to the SAC of Bank Negara. This has been stated clearly in the recent amendment to the Central Bank Act."

Moreover, the interviews held with the participants also indicated that the Islamic banking industry has a higher level of regulatory requirement on the part of the management, which stems from the aforementioned ethical accountability concept. This is because the Islamic banking industry does not just comply with policies that apply to conventional banks but also, arguably, a higher standard of requirements that are imposed by the Shari'ah system's regulatory requirements, which allow for additional protection for the customers who opt for this form of alternative banking. Comparing the governance between conventional banking and Islamic banking, a senior executive of an Islamic bank remarked:

> "You don't necessarily see the Shari'ah requirement as a burden. It is just additional 'value-add' and additional quality control in the overall banking process. It will create a greater level of assurance on the part of customers, stakeholders and shareholders that things are being carried out in accordance with what is required. Of course, it means that we have to ensure that we are always dotting the 'i's' and crossing the 't's'."

From the above discussions, it is apparent that the existence of a clear accountability paradigm amongst all relevant parties within the SGF is crucial for the effective Shari'ah governance function of the Shari'ah board. Arguably, this accountability paradigm will be the foundation on which additional values for the effectiveness of the Shari'ah board role should be built. It will also serve as an important filtering mechanism without which the industry players will devote themselves to the pursuit of profit at the expense of Islamic banks' ethical establishment objectives, and hence will act in a manner that is contrary to the stakeholder-centric governing feature of the industry. More importantly, this accountability factor will be the focal point for all relevant parties to provide ongoing support to the role of the Shari'ah board.

8.4.1.2 Support from Relevant Parties with Islamic Banking Experience

The SGF encompasses the significant role of many of the relevant parties responsible in ensuring the Shari'ah compliance of the Islamic banking operation. Besides the Shari'ah board, other parties that are deemed crucial in the Shari'ah governance of Islamic banks are the Shari'ah department officers, the management, the board of directors, the audit committee, the risk management committee, the internal and external auditor. The interviews held with the participants revealed that these parties would contribute to the role of the Shari'ah board and, hence, strengthen the Shari'ah governance of the bank if they are equipped with relevant experience in the field of Islamic banking. For example, a manager from the Department of Islamic Banking and *Takaful* of the BNM disclosed that designating inexperienced Shari'ah officers as the secretariat to the Shari'ah board could result in Shari'ah issues not being deliberated adequately and, ultimately, risk the potential of Shari'ah non-compliance. The manager remarked:

> "The Shari'ah issues in banking and finance are not stand-alone issues. They do not arise from something which is known and which could be understood from the beginning. They need deliberation, as only then would the Shari'ah issues emerge. So, if the banks do not have the right Shari'ah officers and do not deliberate the issues adequately, they would tend to overlook this matter."

Besides the Shari'ah officers, another party highlighted by the interview participants as deemed better able to contribute to the Shari'ah governance role of the Shari'ah board, if equipped with relevant and adequate Islamic banking experience, is the management. It has been mentioned in Chapter Four, that the SGF signifies that the management is held responsible for the implementation of the Shari'ah decisions issued by the Shari'ah board. Hence, in addition to the requirement for the management to possess high aspirations for the advancement of the Islamic banking industry and a clear accountability paradigm, as discussed before it is argued that the management better able to fulfil the responsibilities mentioned if they have relevant experience in Islamic banking. The Shari'ah board chairman of an investment bank offering Islamic banking remarked:

> "Although the bank is owned by non-Muslims they are concerned with the operation of Islamic banking. We have three officers who are highly capable in managing our Islamic banking operation. This is crucial as, if they do not brief us or raise the Shari'ah issues with us, we could be making misleading decisions."

In addition, the interviews also disclosed the practice of some banks who hired an external consultant to improve the Shari'ah governance of the bank and to assist the Shari'ah governance role of the Shari'ah board. Amongst the jurisdictions of this consultant revealed were using the consultant's expertise to improve the Shari'ah compliance manual of the bank, undertaking Shari'ah research into the Islamic banking products to be offered to customers, as well as vetting the product proposal by the bank. Arguing that the assistance of this external consultant would enhance the effectiveness and efficiency of the Shari'ah board, the Shari'ah board chairman of another Islamic bank remarked:

> "After the consultant has done the vetting, the issue would be brought to the SC. This will make the SC's work easy so that they would not spend as much time discussing all the details. Therefore, I, as the chairman, would first ask the consultant whether they had a look at the matters. If they said, 'yes', then the SC would provide the approval or else the SC would not proceed."

It was mentioned previously that one of the current challenges facing the Islamic banking industry is to find scholars who are well versed in the Shari'ah and have accounting and finance related knowledge. The above discussions seem to indicate that this dilemma could be eased if the financial institution supplemented the Shari'ah governance role of the Shari'ah board with the necessary functional support, in the form of a team with relevant experience in the field of Islamic banking. Such an alliance is argued as able to merge the theoretical perspective of the Shari'ah board and the practical experience of the supporting parties, which would ultimately exert effective Shari'ah governance mechanisms within the bank. However, the interview also disclosed that IFIs face similar challenges in appointing competent and experienced staff to assume the role of Shari'ah officers in the bank. In light of this, the CEO of a medium-sized Islamic bank remarked:

> "Many Islamic banks, especially the subsidiaries within the group, are really product engines. Basically, the marketing is done by the conventional side of the banks. Meanwhile, Islamic banking is growing rapidly and is pushing out many products to the market. *Musharakah mutanaqisah*, for example, is a new product and not many people are conversant with it. Typically, what you find is that the conversant people, who do know this product, tend to move from one place to another."

Hence, the interviews highlighted that the infrastructure for Shari'ah governance, demonstrated by the presence of a competent and dedicated internal Shari'ah officer team, would enhance the effectiveness of the Shari'ah board, which is the backbone of the Shari'ah governance of IFIs.

8.4.1.3 Holistic Approach to Shari'ah Governance

The Islamic banking industry exhibits pertinent concerns in relation to Shari'ah as the intrinsic value governing all aspects of the Islamic banking operation, empowered by the Shari'ah governance role of the Shari'ah board. As such, it is crucial for all parties within the bank to inspire mutual interest in developing and operating the bank in a manner consistent with principles of Shari'ah. Arguably, this would essentially require application of the Shari'ah in the operational frameworks of banks offering Islamic banking products and services encompassing all aspects of the banking activities and which meet the demanding needs of the customers. The interviews held with the participants revealed that some banks have taken the initiative to build up the Shari'ah knowledge of their employees, including amongst non-Muslims, via training and certification. Such investment in Shari'ah knowledge acquisition is deemed able to enhance the bank employees' awareness on matters such as a basic understanding of the Shari'ah and, simultaneously, pave the way for appreciation of Shari'ah compliance as the underlying ethical value governing the Islamic banking operation. Explaining the motive behind the Shari'ah training provided to the bank's employees, the CEO of a medium-sized Islamic bank remarked:

> "I make sure that my product developers and marketing people understand basic Shari'ah so that when they interact with the SC members it is a meaningful discussion. If the SC members mention certain concepts, my product developer also understands these concepts and so the gap between the SC members and the practitioners becomes very, very small."

The above remark highlighted the importance of the concern that the Shari'ah should not just be the domain of Shari'ah scholars or certain departments, for example, Shari'ah departments only. Indeed, exposing Shari'ah knowledge and instilling the importance of Shari'ah compliance amongst all levels of bank employees is deemed to result in the gap between Shari'ah board members and bank employees being minimised. In addition, interviews held with the participants revealed instances, in the case where the Islamic banking operates under the ambit of the conventional banking of its parent company, where the Shari'ah has influenced the modus operandi of the conventional banking system as well. In this light, the CEO of a large-sized Islamic bank remarked:

> "The approach in Islamic finance has been assimilated into the conventional business of our bank holding. Our conventional business has adopted the Islamic banks approach to liquidation exercises, in terms of negotiating on how we can help the customers to meet their obligation rather than simply going in and selling the house just because they are not able to pay for three months."

Additionally, the discussions held with the participants make apparent how the banks' management, particularly those with countrywide branch networks, have made concerted efforts in organising visits and lectures for the employees to ensure that the operation of the bank and aspirations of the employees are in tandem with the Shari'ah decisions issued by the Shari'ah board. It was highlighted that, during such efforts, the management emphasised that the marketing of Islamic financial products is conducted by articulating correct information, as any misleading information given could affect the Shari'ah compliancy of the products. Hence, the holistic approach demonstrated through the operational framework of accountability and good business practice, consistent with the Shari'ah, lends support to the Shari'ah governance function of the Shari'ah board.

Despite the above, the interview also draws attention to an interesting revelation. It became apparent from discussion with the participants that another challenge facing the Islamic banking industry is the fact that the banks' operation seems to be in the shadow of conventional banking. The interviews highlighted the difficulties faced by the management and the SAC of BNM in producing Islamic financial products without referring to the *modus operandi* of conventional banking practice. Mandatory requirements for Islamic financial contracts to be legally well covered and the expectation of consumers for these contracts to have similar economic effects and benefits as the conventional ones represent examples highlighted as contributing to the conventional banking frame of reference for Islamic products. In this light, the CEO of a large-sized Islamic bank remarked:

> "The pressure from society causes you to move towards conventional types of products, or ones that look as if they are conventional but are not. Firstly, this is because of regulatory pressure. The Regulator wants your products to be well covered legally and from a security viewpoint. Secondly, it is because of the customer. They want the upsides and not the downsides in that they want to gain profit but they do not want to incur losses. Thirdly, it is down to the readiness of bankers to do all this."

The above remark seems to indicate that the practice of Islamic banks tends to be influenced by the more established conventional banking practice. The pressures highlighted in the CEO's remark above demonstrate the direct evidence of the market forces determining the functioning of Islamic banks. Furthermore, the inclination of the concerned parties mentioned in the above also appear to be contrary to the entrepreneurship attributes and the profit and loss sharing principles underlying Islamic financial contracts, such as *mudharabah* and *musharakah,* as discussed in Section 3.3.5.5 and Section 3.3.5.6 of Chapter Three. Hence, it can be argued that the conventional banking mindset seems to be prevalent amongst the regulators, customers and operators of banks offering Islamic banking products and services. The interview also disclosed that producing Islamic financial contracts with conventional features could be a complicated task for the Shari'ah board and the product developers within the bank, as well as for the SAC of BNM, as the results must be Shari'ah compliant. A member of the SAC of BNM remarked:

> "To replicate a conventional product because of market attitude wanting a product similar to a conventional one, but Shari'ah compliant, is a challenge. Some of the conventional products are too conventional and could not be replicated Islamically in a way that would be satisfactory to the Shari'ah Committee and to the market players. It is as if you want to have *halal* meat but you want it to have a flavour like a *non-halal* food product. If it is *halal*

> and it is chicken it should taste like chicken, not taste like pork, for example. So, it is matter of market perception, expectations and appetite."

Hence, it is apparent that the Malaysian business environment demonstrates a holistic Shari'ah approach to its Islamic banking industry, with the Shari'ah board and all concerned parties endeavouring to implement and apply the Shari'ah to ensure that the Islamic ethical values of the industry remain intact. However, the evidence derived from the interview also indicates that the Islamic banking industry in Malaysia tend to be driven by the market forces and operates under the shadow of conventional banking practices.

8.4.1.4 Concerted Shari'ah Governance Mechanisms

Depending on the size and nature of the business, banks establish their own Shari'ah governance mechanism, with the Shari'ah board serving as the highest Shari'ah authority. It became apparent from the discussions held with the participants that the governance mechanisms established by the banks has a direct influence on the function of the Shari'ah board. It is argued that support of the management by the role of the Shari'ah board would improve Shari'ah governance by fostering appreciation of the Shari'ah and its motivation to ensure Shari'ah compliance. It could be expected that such concerted efforts would result in all involved parties within the banks having the same concerns as the Shari'ah board in ensuring that the banks' activities are in accordance with Shari'ah principles, which is the focal point underlying the establishment of the Shari'ah board. Illustrating the Shari'ah governance mechanism of the bank, a senior executive of a large-sized Islamic bank remarked:

> "There is a Shari'ah compliance risk unit within the Shari'ah department and a formalised Shari'ah audit within the internal audit department. Two of our SC members sit on the board's Risk Committee and two board members sit on the SC as permanent invitees. One is the chairman of the board's Risk Committee, because he takes care of the risk, and the other is the chairman of the Audit Committee, because any of the Shari'ah non-compliance issues would go the audit department. When they all sit for meetings, you can see the cross-participation between the parties."

Meanwhile, the interviews also disclosed an instance where the bank supported the function of the Shari'ah board by establishing various checkpoints within the bank as a filtering mechanism in ensuring Shari'ah compliance. These checkpoints also serve as the feedback mechanism that receives and provides operational information amongst all concerned parties within the SGF. Explaining this, the CEO of a medium-sized Islamic bank remarked:

> "We have an operational risk framework and various checkpoints within the bank holding where Shari'ah risk is treated almost like a subset of the operational risk. Every month a form from these checkpoints has to be filled in and this form is electronically captured on the central database and reported to an operational risk management committee, who sit every month. There, our Shari'ah compliance framework will be rolled up. The bank has this procedure in almost all the touch points within the bank."

In addition, the interviews also made apparent the situation where a Shari'ah board member is appointed as a member of the bank's board of directors. This appointment, besides, presents another example of the bank's appreciation of the role of the Shari'ah board and also paves the way for bridging the gap that is frequently debated between the board of directors and the Shari'ah board, the two important parties within the SGF. It has been argued that the gap between the board of directors and the Shari'ah board could result in the former authorising decisions and policies that might discount the Shari'ah concerns of the latter. Analysing their ability to participate in the decision-making process and performance monitoring at banks' highest level, the appointment of Shari'ah board members onto the board of directors of the bank could be seen as enhancing the effectiveness of the Shari'ah board.

8.4.1.5 Efficient Regulatory Framework for Islamic Banking

It has been discussed in Chapter Four that the Malaysian business environment exhibits a regulatory framework in support of the Islamic banking industry with the establishment of several enactments, such as the Islamic Banking Act of 1983, and incentives promoting the industry, such as the MIFC. Malaysia also serves as one of the countries that regulates the role of Shari'ah board members through the introduction of BNM's guidelines, as in the GPS1, which specifies important regulations of the role of this Shari'ah governance authority. The discussion with the interview participants makes it apparent that the role of the Shari'ah board has achieved significant improvements through the Malaysian authority's regulatory support, since the establishment of the first Islamic bank in 1983. In this regard, a SAC member of BNM remarked:

> "When we started with Islamic banking, the Shari'ah advisors were not familiar with financial markets and the financial markets were also not familiar with Shari'ah issues. However, as the market grows, you can see that Shari'ah advisors are better versed with how the financial market works. Similarly, bankers also have more experience with the Shari'ah advisors. They know what the Shari'ah issues are."

Arguably, the above remark presents the learning curve amongst the market players in the Islamic banking industry. As is evident from the above, during the early stages of the establishment of Islamic banking there were divergences apparent amongst the Shari'ah board members and the industry practitioners. Hence, the implication of such circumstances relates to the view of the accuracy of the Shari'ah pass decisions issued by the Shari'ah board. This is due to the possibility that the Shari'ah board might misunderstand some of the financial issues as the Islamic bankers might think that there are no Shari'ah issues in the prevailing matter, when actually there are. Moreover, Shari'ah board members also issue their decisions based on what is presented to them and as a result, the Shari'ah board might not have been able to see the whole picture of the Islamic banking operation, as it might not have been presented to them. However, as the industry progressed, the SAC of BNM remarked that there existed a better understanding of the Islamic banking issues, resulting in an improved Shari'ah governance of the industry.

In addition, the regulatory environment in Malaysia has experienced recent amendments to the Central Bank of Malaysia Act 2009, which gives a mandate to the Shari'ah resolutions and pronouncements issued by the SAC of BNM to be binding on the court and arbitrators. Accordingly, the strongest possible effect to this legislation is that 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 decisions on any decisions related to Islamic finance. The profound effect of such a requirement is that there will be consistency in the country's legislation and in the interpretation of the Shari'ah with regard to the Islamic banking products approved for marketing, as well as the products' basic Shari'ah parameters. Hence, the Malaysian Islamic banking regulatory framework provides the necessary regulatory support for the operation of the Islamic banking industry and strengthens the Shari'ah governance function of the Shari'ah board. Another SAC member of BNM, who has evaluated the Islamic banking regulatory framework to this effect, remarked:

> "Islamic finance is now recognised as a financial system in Malaysia. It means that it is there in the Act now that Islamic finance is a system whereas before the Act did not recognise Islamic finance as a system. The implication is that anyone, or any government, who comes after this cannot say that they do not want Islamic finance. Islamic finance is here to stay."

Moreover, the interview also disclosed the importance laid down by the regulator in giving priority to, and ensuring the provision of, the infrastructure required to support the operation of the Islamic banking industry. Explaining the industry's unique Shari'ah governance feature, which serves an additional layer of governance that is overarching to the regulatory framework of the industry, a manager from the Department of Islamic Banking and *Takaful* of BNM remarked:

> "As much as we can we have to ensure that we are very serious in developing the infrastructure for Islamic finance. Under the current governance, you have Shari'ah governance and you have corporate governance as a subset of it. That means Shari'ah is overarching. Our approach is that we are really serious in ensuring Shari'ah compliance."

The interview also revealed recognition of the Shari'ah board members' views on the regulator's role in resolving issues of main concern to the Islamic banking industry. Explaining the implications of the amendment to the Central Bank of Malaysia Act 2009 on the Islamic banking practice, the Shari'ah board chairman of an Islamic bank remarked:

> "I felt that the SAC had been mandated with immense authority. The SC, in any banks offering Islamic banking, could not disagree with the SAC of Bank Negara (BNM), whereas in the past this was allowed, as the nature of Shari'ah is based on *ijtihad* therefore, you could have narrow differences here and there. However, now, if you have differences with the SAC of Bank Negara (BNM), you will be fined."

In addition, the interviews disclosed that the participants view the repercussions, resulting from failure to comply with the regulations imposed by the authority, as a mechanism to strengthen the Shari'ah governance of the Islamic banking industry. In light of this, the Shari'ah board member of another Islamic bank remarked:

> "Islamic banking under the Bank Negara (BNM) is among the most well-regulated and the Bank Negara is the strictest regulator in the world. This is partly because of the political will and the awareness of the regulators. If there are any Shari'ah issues, or if certain minimum requirements of Shari'ah compliancy are not adhered to, the regulator will not continue the Islamic financial institution's license."

On the other hand, the interviews also raised an emerging issue pertaining to the dual-layer Shari'ah governance system for the Islamic banking industry implemented in Malaysia. The discussions with the participants revealed that the requirement for financial institutions offering Islamic banking products to seek approval from both the in-house Shari'ah board and, later, the SAC of BNM has been criticised as this impedes the fast decision-making required by businesses. More crucially, as the number of financial institutions participating in the MIFC keeps increasing, the product approval process and the deliberation of Shari'ah issues relating to the banking products, and how these are implemented, are expected to take much longer. In such circumstances, the interviews make apparent the need for the SAC of BNM to focus on issues concerning the industry at large and the industry itself should be given the flexibility to relax the rigidity on the need to present issues seeking approval in front of the SAC of BNM. The Shari'ah board chairman of a conventional bank offering Islamic banking window highlighted this requirement and remarked:

> "Why don't the SAC provide the industry with more Shari'ah parameters and guidelines? Any issues raised could also be discussed at the national level and then forwarded to the 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?"

In summary, the interviews with the participants indicated that the Malaysian Islamic banking regulatory framework enhances the effectiveness of the Shari'ah governance function of the Shari'ah board. It is evident that the Islamic banking industry has secured a place within the Malaysian business regulatory framework and the legislative and regulatory infrastructure that has been addressed provides the impetus required in Shari'ah governance towards the advancement of the industry, driven by the Shari'ah governance role of the Shari'ah board.

8.4.2 Factors that Limit the Shari'ah governance role of Shari'ah Boards

This subsection looks at the factors that limit the Shari'ah governance role of the Shari'ah board.

8.4.2.1 The Drawback of the Functional Independence of Shari'ah Boards

The issue of Shari'ah board independence is one of particular concern because stakeholders rely on the function of the Shari'ah board in ensuring that the operation of Islamic banks is compliant with the Shari'ah. The above discussion on Shari'ah board members' transcendental accountability to God, for example, could suggest that this Shari'ah governance authority would undertake its roles and functions with utmost responsibility and independence. Similarly, the regulatory framework set out in the GPS1 stipulates that a Shari'ah board member is limited to holding Shari'ah board membership in only one industry. However, besides the perceived accountability paradigm of the Shari'ah board and the structural independence provided by the regulatory framework, several operational issues have arisen in different aspects of the Shari'ah boards' independence. Arguably, the Shari'ah boards' heavy reliance on the function of the Shari'ah officers when undertaking Shari'ah review, as discussed in Section 8.3.5 above, posed a threat to the independence of the Shari'ah board. The Shari'ah board member of an Islamic bank remarked:

> "The independence of the SC is actually on the issuance of the *fatwa*. The manner in which the *fatwa* is issued should not be because it is being requested, or the SC is being pressurised, by the bank. Independence is about it being the SC's own decision."

In addition, the interviews also revealed situations where the Shari'ah board was asked by the management to explain their Shari'ah concerns on matters relating to the financial products per se, although the Shari'ah board was endeavouring to ensure that all aspects of the banking activities complied with the Shari'ah. The Shari'ah board member above remarked:

> "I see the bigger issue of the independence of the Shari'ah board is in the willingness of the management to comply with the Shari'ah itself. Sometimes the management do not really want to listen. They ask the SC to give their concerns on product matters only and not to get involved in other banking activities. The management once questioned us, asking 'Is your jurisdiction on products only or for all the bank's activities?' The management is not happy if we say it is for all banking activities."

Moreover, the interviews also disclosed instances where the top management's participation in Shari'ah boards meetings could result in the board's Shari'ah decisions being influenced by the former, despite the argument that such an exercise would provide the platform to deliberate Shari'ah issues in greater depth amongst the parties concerned with the SGF. This revelation sheds light on the results from QS1, where a minority of the heads of Shari'ah departments responded that participation of top management was unimportant in influencing the independence of the Shari'ah board members (as reported in Section 6.4.2 of Chapter Six). Explaining the complications over the issue of the Shari'ah board's independence from the conduct of the Shari'ah board meeting in his bank, the head of the Shari'ah department of a development financial institution offering Islamic banking, remarked:

> "When the top management joins the meeting they influence lots of the Shari'ah decisions made by the SC. Things that at first were not permissible can suddenly become permissible. When the SC tried to say something, the management would interrupt, saying 'No. It should be like this…'"

Another set of circumstances where the independence of the Shari'ah board is at stake is when the Shari'ah board itself does not undertake its roles and functions as professionally as it should, while the management attempts to justify profit as a means to an end in its operation at every possibility, regardless of Shari'ah permissibility concerns. For example, the head of the Shari'ah department of an Islamic bank remarked:

> "Businesses will try to find a thousand and one excuses for a Shari'ah non-compliant business to keep going. The bank will find as many views as possible to say that things can be approved and they can be done. When they talk about business, it is just about money to the bank. This has reached the point where the Shari'ah department found a Shari'ah non-compliance issue but the SC merely commented that it might have overlooked it and did not dare to say 'stop'."

On the other hand, the interviews also disclosed the participants' concerns about the hierarchical position of the Shari'ah board, in which it is made accountable to the board of directors of the bank. It has been explained in Chapter Four that the Malaysian Islamic banking regulatory framework, as stipulated in GPS1, exhibits that the procedure of the appointment of the Shari'ah board is within the authority of the banks' board of directors. Similarly, the GPS1 also clearly stated the Shari'ah board as being responsible for reporting directly to the board of directors. Such regulatory frameworks reflect the hierarchical position of the Shari'ah board as being directly subordinate to the board of directors. This appointment and reporting approach, however, appeared to be contrary to AAOIFI's recommendation for Shari'ah board members to be appointed by, and report to, the banks' shareholders during the Annual General Meeting. This contradictory approach between the Malaysian regulatory requirement and AAOIFI's recommendation has raised concerns about the independence of the Shari'ah board members. This is especially intriguing considering both the board of directors and the Shari'ah board are the banks' decision makers, however, with different concerns and coming from different hierarchical positions. Explaining the concerns about the Shari'ah board's independence when the board of directors, which is at a higher hierarchical position but is required to seek approval from the Shari'ah board, which is subordinate to it, the head of the Shari'ah department of an Islamic bank remarked:

> "In the Middle East, the SC reports to the General Assembly whereas, in Malaysia, it reports to the board (board of directors). Therefore, the board, as and when necessary, might ask the SC's view on a particular issue. If the board says that there is no need to ask the SC, this means that the SC cannot influence the board's decision."

The above remark highlighted the hierarchical position of the Shari'ah board, which evidently is not at the same level as the board of directors. As indicated in the head of the Shari'ah department's remark above, the independence of the Shari'ah board has been jeopardised due to the gap resulting from the different hierarchical positions of the two authorities. Emphasising that a better approach to the appointment of the Shari'ah board is when the shareholders appoint the Shari'ah board member, as this would instil accountability and independence from the board of directors and the Shari'ah board respectively, a Shari'ah board chairman of an Islamic bank remarked:

> "A good model is where the SC is appointed and answerable to the shareholders. This is because the SC is protecting the shareholders, the stakeholders and the customers, who want assurance from the SC that the products are Shari'ah compliant."

The above discussions signify emerging dimensions for consideration when interpreting factors that influence the independence of the Shari'ah board. Their significance in impairing the effectiveness of the Shari'ah board in undertaking its roles and functions are deemed equally important with the more established argument of the Shari'ah board being influenced because of material gain.

8.4.2.2 Ineffective Shari'ah Governance Functions of Shari'ah Boards

Despite the perception of the role of the Shari'ah board being held in high esteem, the interviews also disclosed the concerns raised by the participants about the ineffective

Shari'ah governance function of some of the Shari'ah board members. For example, the interviews revealed that some Shari'ah board members were not being professional in undertaking their function to the meet the expectations of the parties within the bank. This is because some of the Shari'ah board members were seen as unable to actively participate in Shari'ah boards meetings due to lack of understanding of the issues raised and not being well prepared enough to attend. As a result, the Shari'ah board was viewed as not contributing to the bank and, therefore, the risk was posed that these parties would not view the Shari'ah aspects of the banks' operation as being a matter of importance. Explaining this in light of the ineffective Shari'ah governance by the Shari'ah board, the head of the Shari'ah department of a development financial institution offering Islamic banking, remarked:

> "Actually, it is the Shari'ah department that does all the work. The SC merely gives its approval based on research done by the Shari'ah department, without any supporting source justifying its approval. For example, there is no *Qur'anic* verse, *hadith* or stories of the companion to the prophet to strengthen the SC's decision."

Another concern raised by the interview participants is the lack of incentive amongst the Shari'ah board members to carry out their responsibilities beyond their traditional and confined role in Islamic banking product matters, though the management is very determined to ensure Shari'ah compliance in the whole of the Islamic banking operation. Such conduct amongst the Shari'ah board members could have a detrimental effect on the Shari'ah governance of the bank as matters contributing to Shari'ah compliance encompass a wide range of the Islamic banking operation, as has been discussed throughout the role of the Shari'ah board. In this regard, the CEO of a medium-sized Islamic bank remarked:

> "Maybe the Shari'ah advisors are too focused on looking at the products that I think they forget that their role is very much more important than that. Actually, they have to look at the overall view, including the audited accounts. When they sign them off and say that they are Shari'ah compliance it means that they are endorsing the entire operation, A to Z, as being Shari'ah compliant. I think this is something to which they are not fully alert."

Furthermore, the interviews also disclosed the concerns of the management on the possibility of Shari'ah non-compliance risk due to the lack of interest and indifferent attitudes amongst the Shari'ah board members in probing further the reports tabled to them by the Shari'ah department. The CEO above continues by highlighting the low accountability of the Shari'ah board and remarked:

> "When the SC endorsed the Shari'ah report were they actually confirming that it is all Shari'ah compliant? Does the SC ask all the relevant questions? Have the management given the SC enough information? I would like to know if the SC knows what they are getting themselves into when they sign off the Shari'ah report."

In addition, it has been discussed above that the management considers appointing Shari'ah scholars who are high dignitaries, such as the *muftis*, and foreign Shari'ah scholars as being driven by commercial reasons and image building for the Islamic banking institutions. However, interviews held with the participants revealed that Shari'ah scholars having such attributes, although prominent, were unable to contribute effectively to the Shari'ah governance of the bank, as they did not have enough time to undertake their responsibilities. Hence, it appears that the selection of such Shari'ah board members could equally be detrimental to the effectiveness of the Shari'ah governance function of the Shari'ah board. In this light, the Shari'ah board chairman of an Islamic bank, who is also a high dignitary Shari'ah scholar in Malaysia, remarked:

> "Because of my responsibilities, I did not have much time. I depended on the other three SC members, who are academicians and carry out research. Therefore, when I attended the SC meeting, I would just read the documents and sometimes I did not even understand them. I would ask, 'Who is going to present?' and the top management would present. Then I would ask the other three SC members, 'What is your opinion?' If all three were in agreement, then I would take that up as the Shari'ah decision."

It is worth noting that the results from both questionnaire surveys indicate that a considerable number of respondents were not in agreement when asked whether working part-time is not a hindrance to effective Shari'ah review by the Shari'ah board (as reported in both Section 6.5.2 of Chapter Six and Section 7.5.2 of Chapter Seven). Indeed, the part-time working nature of the Shari'ah board was further disclosed by interview participants as the main obstacle and was why this Shari'ah authority has been criticised, as has been described above. The part-time working attachment of the Shari'ah board to the bank, although it serves as a mechanism to instil independence from the board, could actually be a setback. This is because they are not able to assume their role beyond what is perceived as the minimum required from them, which corresponds to the confined role of approving Islamic banking products to be offered to the customers. In this regard, the Shari'ah board of an Islamic bank remarked:

> "As for now, the role of the SC is limited to giving approval; in terms of supervision, that is still beyond our function. If the regulator put that as our function, it would be almost impossible because we only serve on a part-time basis, unless we are a fulltime SC member."

Similarly, the head of the Shari'ah department of an Islamic bank highlighted the inability of the Shari'ah board to keep pace with the fast decision making requirements of the business. The head of the Shari'ah department remarked:

> "Our SC only serves part-time. Sometimes, we send them our advertisement materials or collateral, which have already been vetted and ascertained as being Shari'ah compliant, and we ask for their email approval. For things as simple as that you still need to allow time to get their reply as it may take a week or two weeks."

More damagingly, the time limitation factor was revealed as affecting key governance aspects that are vital in determining the Shari'ah compliance of the banking institution. For example, the interviews disclosed that the Shari'ah board did not access the banks' relevant documents as part of the Shari'ah review process before concluding the Shari'ah compliance of the Islamic banking activities, despite the authority mandated to them and the willingness of the bank to cooperate. Explaining about the review of business documents practiced by the Shari'ah board, the head of the Shari'ah department of another Islamic bank remarked:

> "If we go back to the theory, of course they can review the documents but, implementation-wise, they do not have the time, though they have the power. Maybe, the SC does not want to get itself into trouble as whatever the business is proposing has caused them a headache. So, what more about looking at these documents."

The interviews also explain the ineffective Shari'ah governance function of the Shari'ah board from a different perspective. The discussions held with the participants revealed that a Shari'ah board member, as an Islamic religiously conscious person, might be carried away with the *husnul-zan* character (good expectation of others), in which others expected them to undertake their tasks ethically and with full responsibility. However, such practice could undermine the effectiveness of the Shari'ah governance function of the Shari'ah board, in the manner that the Shari'ah board has not undertaken a critical Shari'ah review of the banking business operation. A manager in the Department of Islamic Banking and *Takaful* of BNM remarked:

> "These Shari'ah scholars usually have *husnul-zan*, (a good expectation of others). When they behave like this they cannot be a filtering mechanism. That is why behaving with *husnul-zan* also has its own implications. By right, the SC should counter-argue, to question and cross examine the bank in return."

Indeed, the interviews revealed that the problem of the ineffective Shari'ah governance function of the Shari'ah board is also perturbing the higher Shari'ah authority, i.e., the SAC of BNM, who regarded some Shari'ah board members as not being keen to assume the Shari'ah board role, as their appointment was merely to fill the Islamic banks' Shari'ah board membership. A member of the SAC of BNM remarked:

> "There are SC members who have knowledge but do not have the courage. They do not make the effort to learn, to improve themselves. Therefore, these people are there just to fill the seat, to make up the quorum. The bank also does not have a choice as they have just grabbed the Shari'ah scholar since they fulfil the criteria."

It is apparent from the above that the ineffective Shari'ah governance function of the Shari'ah board is a drawback to the overall strength of the Islamic banking institution in ensuring that its operation is Shari'ah compliant. Indeed, the failure of the Shari'ah board members to undertake their roles and functions effectively could present a denial to the responsibilities entrusted upon them and hamper the development of a promising industry against its more established counterpart, i.e., conventional banking.

8.4.2.3 Inadequate Regulatory Support and the Ineffective Function of Designated Institutions

The Islamic banking business, like any banking business, is a highly regulated industry. In such circumstances, the regulator should provide the necessary infrastructure for the effective governance function of the Shari'ah board, as well as the concerned parties within the SGF. As discussed in Chapter Two, amongst its regulatory intervention in the banking business is the provision of the necessary legislation and imposition of certain enforcement within the industry. In this regard, it is argued that the Shari'ah board is able to undertake its roles and functions effectively if the environment within the business it represents exhibits regulatory support for the conducive operation of the business and the smooth functioning of the Shari'ah board. However, the interviews held with the participants revealed that regulatory support in critical areas of the Shari'ah boards' function seems to be inadequate. For example, the interviews disclosed the Shari'ah boards' concern over the opportunistic behaviour of the banks' management and the absence of Shari'ah audit enforcement. The Shari'ah board member of an Islamic bank remarked:

> "The problem with our industry is that, if the Bank Negara does not come out with the regulation, the management does not consider it an important one. They do not consider Shari'ah compliance audit as important whereas, if the bank is found to be Shari'ah non-compliant, it will affect the industry, the whole industry."

Indeed, the interviews disclosed that most banks offering Islamic banking products and services underwent minimal or no Shari'ah board involvement in Shari'ah auditing of the operation. In fact, the interviews revealed that banks who perform audits undertake them using methods discretionary to the bank. Explaining this, the Shari'ah board chairman of an investment bank offering Islamic banking remarked:

> "Until now, there is no agreed-upon standard on how to conduct a Shari'ah audit. Even the Bank Negara (BNM) has not got a standard of its own, we are still looking for it. Internally, we do our own auditing. However, the question on which standard to follow would be better if it was answered by the Bank Negara."

Meanwhile, in an effort to support the Islamic banking industry, several institutions have also been setup to promote research, education and training in the fields of Islamic banking and finance, as well as for the *Takaful* industry. Institutions of this kind are the INCEIF (International Centre for Education in Islamic Finance), ISRA (International Shari'ah Research Academy for Islamic Finance), IBFIM (Islamic Banking and Finance Institute Malaysia) and AIBIM (Association of Islamic Banking Institutions Malaysia). Their presence should be seen as a positive effort in strengthening the Islamic banking industry, which is still considered in its infancy in comparison to the more established conventional banking industry. Indeed, the training and exposure in the field of Shari'ah and banking that these institutions provide could be seen as enhancing the level of Shari'ah governance amongst banks offering Islamic banking products and services, hence elevating the effectiveness of the

Shari'ah board role. Despite these assumptions, several interviews held with the participants expressed their disappointment in the functions of the institutions mentioned. For example, the Shari'ah board chairman of an Islamic bank remarked:

> "There should be a change in paradigm so that Bank Negara would consider taking those who really have potential and who are still young so that these people could be trained, becoming proficient, and could make an impact on the people at the lower level. At first, I thought ISRA would be the one who would gather the people for that purpose. Similarly, we also have IBFIM but it does not work either. These institutions are becoming a new business, which is why we see they are busy producing degrees, including those for overseas students. They do organise a forum here and there, but nothing material happens."

In addition, the interviews also disclosed the participants' concerns about the lack of leadership in the circle of Islamic scholars, especially amongst the SAC of BNM, who acts as the supreme authority and the Shari'ah reference role for the Islamic banking industry. Arguing on the basis that the SAC is comprised of members with diverse expertise, mostly aged scholars, and the lack of research conducted by them, the interview participants revealed their scepticism about the ability of this Shari'ah governance authority to influence the Islamic banking industry and its practice. This concern, as well as the lack of regulatory enforcement in critical areas, as discussed above for Shari'ah audit, could not only lead to possible morally hazardous behaviour of the management, but could also risk the potential of Shari'ah non-compliance in the bank.

8.4.2.4 The Absence of Shari'ah Audit and its Implication on the Shari'ah Report

It has been mentioned before that one of the important instruments in the Shari'ah governance mechanism of an Islamic banking institution is the bank's Shari'ah compliance manual. This Shari'ah governance instrument serves as the operational framework, which specifies on matters, including those ranging from product structuring to product offering and the responsibilities of the different parties within the bank from the aspect of its Shari'ah governance. In addition, this operational framework could be used as the Shari'ah review procedure for the implementation of Shari'ah decisions issued by the Shari'ah board and as the guidelines for auditing purposes. Interestingly, the in-depth interviews also made it apparent that some participants were unclear as to what constituted a Shari'ah review as required in the GPS1. Similarly, the participants found that the distinction between Shari'ah review and Shari'ah audit was ambiguous and they were confused as to which of the two falls under the jurisdiction of the Shari'ah board. For instance, the head of the Shari'ah department of an Islamic bank remarked:

> "Is Shari'ah review the same as auditing or is it just to ensure that Shari'ah decisions issued by the SC are being implemented? So far, the regulator has used these terms interchangeably. If Shari'ah review means the same as auditing, it ties back to another issue. They, the SC, are the ones who approve the Shari'ah decisions so how could they, at the same time, do the auditing?"

Additionally, it was discussed earlier in Chapter Four that what constitutes a Shari'ah review cannot be confined to Islamic banking product matters only. Ideally, the Shari'ah board should undertake a holistic Shari'ah review evaluation of all aspects of the Islamic banking operation. However, the associated challenge with this task is the question of whether the Shari'ah board, whose membership is usually comprised of scholars who are well versed in a particular field only, is capable of undertaking such responsibilities. Interestingly, this issue of competency of the Shari'ah board in undertaking Shari'ah review relates to another emerging issue. The interviews held with the participants revealed that, because of the Shari'ah board members inability to undertake aspects of Shari'ah review, the Shari'ah report issued by the Shari'ah board is indicated as providing only partial Shari'ah compliance assurance to its users. Explaining in light of this, the Shari'ah board member of an Islamic bank remarked:

> "There might be something that the bank did not refer to us, for example, on the accounting or the systems side. I also understand that, if I were to log into the system, I would not be able to command as well because I do not know about the system. As a result, the SC only endorses whatever matters that have come to us as being Shari'ah compliant."

Indeed, the fact that the Shari'ah review task of the Islamic banking institution is mainly undertaken by the Shari'ah officers of the bank and the Shari'ah board only provides an overview of the results, as discussed in Section 8.3.5 above, aggravated the question over the quality of the Shari'ah report aforementioned. The Shari'ah officers' role, in respect of the Shari'ah review task, and the close ties between Shari'ah review and the Shari'ah report that is issued by the Shari'ah board means that it could be viewed as a Shari'ah report prepared by the Shari'ah officers but, however, approved by the Shari'ah board. Hence, these arguments give rise to another fundamental issue on the need for an independent party to undertake Shari'ah audit to assess the Shari'ah compliance of the Islamic banking operations. Equally intriguing is the question of whether the Shari'ah report issued by the Shari'ah board is truly independent and, thus, whether the Shari'ah board could be considered as the appropriate party to issue such a report. In this regard, an ex-SAC of BNM remarked:

> "Although the bank is an Islamic bank and the customers are confident because of the existence of the SC, however, the SC only goes through Shari'ah review. If the SC is expected to give its approval only, then it means audit would not have a place, as whatever is being tabled in the SC's meeting would be approved straight away. So, there must be some other party who carries out the audit work."

It is apparent from the above discussions that the current SGF gives rise to occurrences of the Shari'ah boards' over-reliance on the Shari'ah officers' function concerning the Shari'ah compliance review task and, thus, poses questions about the effectiveness of Shari'ah boards' role. Associated with this problem is the question of the quality of the Shari'ah board report and the Shari'ah compliance assurance it gives to the users. The interview sessions held with the participants indicate the need to revamp the mechanism for Shari'ah review as well as to ensure immediate implementation of Shari'ah audits in the Islamic banking industry.

8.5 The Impact of the Dual-Layer Shari'ah Governance System on Standardisation of Malaysian Islamic Banking Practices

It has been discussed previously that the dual-layer Shari'ah governance system implemented in the Malaysian Islamic banking industry features the Shari'ah governance authority role of the Shari'ah board and that of the SAC of BNM. With the SAC as the Shari'ah apex body and the provision for this authority to act as the Shari'ah reference role, resulting from the amendment to the Central Bank of Malaysia Act 2009, the mechanism for the Shari'ah governance system implemented in Malaysia is deemed able to minimise inconsistencies with regard to the Shari'ah application of the Islamic banking products. The results from QS2 indicated that the vast majority of the branch managers perceived that the role played by the SAC enhances the standardisation of Islamic banking practices in Malaysia. Moreover, the branch managers also perceived that the dual-layer Shari'ah governance system in Malaysia was effective in ensuring the stability of the Islamic banking industry and in harmonising the Islamic banking practice in Malaysia and across national boundaries. The discussions held with interview participants emphasised further the contribution of the SAC and the dual-layer Shari'ah governance system to the Islamic banking industry in Malaysia.

The interview disclosed that the elements of the Shari'ah that are open to differences in interpretation are limited, whereas the basics and fundamentals are commonly agreed upon. Notwithstanding differences in these limited matters, the Shari'ah scholars would generally aim at issuing their *fatwa* based on what is more convenient and in the best interest of the Muslims. In this light, a SAC member of BNM remarked:

> "The Shari'ah has some fixed elements and some flexible elements. Obviously, we cannot change the fact that *riba* (interest) is *haram* (impermissible) and *gharar* (uncertainty) should be avoided. However, based on circumstances and needs, certain things can be changed. I think all the Shari'ah advisors would want to make the industry flexible as this is the *sunnah* (practice) of Prophet Muhammad. Where the prophet is given a choice between two things, he would choose the easier of the two so that it would be easy for the *ummah* (nation), as Islam comes to bring benefits and *rahmah* (mercy) and not hardship to the people."

Indeed, the interviews make apparent that, in the case of the Islamic banking industry, standardisation of the Shari'ah, as within the conscience of Islam, benefits the Muslims and removes prejudice amongst the nations in the country. This is despite the fact that there are differences in opinions about the interpretation of the Shari'ah amongst the four main Islamic legal schools, i.e., the Shafi'i; Hanafi; Maliki and Hanbali, as well as amongst contemporary Islamic scholars. In this regard, another member of the SAC of BNM remarked:

> "I believe that Islam recognises a State as an entity. Currently, the Bank Negara (BNM) has the final say. If Bank Negara says 'No' then it is not approved; there is only one voice in Malaysia."

Meanwhile, the discussions with the participants also make it apparent how the Shari'ah pronouncements by the SAC of BNM are issued. The interviews disclosed that the AAOIFI's Shari'ah standards serve as the first point of reference for the SAC. These AAOIFI standards will later be determined for their application to suit Malaysian circumstances, as the Malaysian Islamic banking market might have different peculiar needs, circumstances, different laws and different customs that should be looked at. In this light, a SAC member of BNM 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 will deliberate on that and apply it to the Malaysian scenario. Then we will see whether to apply the AAOIFI decision or go for a different opinion, depending on the strengths of the arguments and various policy considerations."

Indeed, the interviews held with majority of the SAC of BNM members disclosed that the pronouncements issued by the SAC were also made with reference to the Shari'ah decisions issued by several other bodies, including the OIC's (Organization of Islamic Cooperation) Fiqh Academy and Dar al Barakah (resulting from the Multaqa Dallah al-Barakah forum). Such associations were emphasised by the interview participants as marking the Malaysian regulator's effort in standardising the Shari'ah with the international Muslim community and as a basis for producing Islamic banking products that are globally accepted. In addition, these SAC members also revealed initiatives taken by the BNM to standardise Islamic banking practices in the regions close to Malaysia. It has been disclosed that ISRA, under the patronage of BNM, has organised several annual gatherings of Muzakarah Cendekiawan Shari'ah Nusantara (MCSN), whose objective has been mentioned before, in Section 4.6 of Chapter Four.

In addition, discussions with the interview participants also make apparent the standardisation of Islamic banking practice at the national level. For example, the interviews disclosed the contribution of the Association of Islamic Banking Institutions Malaysia (AIBIM) in promoting consistency amongst banks in Malaysia by issuing a standardised Master Agreement for interbank transactions, such as the Interbank Murabahah Master Agreement (IMMA), the Corporate Murabahah Master Agreement (CMMA) and the Wakalah Placement Agreement (WPA) for Interbank and Corporate. Similarly, the SAC of BNM has developed a series of Shari'ah parameters, known as the Shari'ah Parameter Reference, aimed at promoting operational efficiency and best practices amongst industry players in the country. These Shari'ah parameters comprise of a minimum standard guidance on applying the respective Shari'ah contracts in Islamic finance contracts, which has been prepared by gaining feedback from the industry players.[41] The significance of the Shari'ah parameters in harmonising Malaysian Islamic banking practices has been highlighted by the Shari'ah board chairman of an Islamic bank, who remarked:

> "On basic elementary matters, the Bank Negara (BNM) has developed Shari'ah parameters. In doing so, the Bank Negara referred to the banks and, accordingly, the Shari'ah parameters were designed. I believe that this is a good move towards ensuring efficient Islamic banking practices in the future."

Notwithstanding the above, the interviews also disclosed some of the dilemmas faced by the Malaysian regulator. The fact that some of the pronouncements issued by the SAC are not consistent with the Shari'ah standards issued by Shari'ah bodies, such as AAOIFI and the OIC's Fiqh Academy, has resulted in Malaysia being labelled as liberal in its Islamic banking operation. Such a perception is made due to circumstances where the permissibility of certain Islamic banking products authorised by the SAC of BNM are considered as actually being impermissible, especially by Shari'ah scholars from the Middle Eastern countries. It has been mentioned in Chapter Four that some of the Islamic banking products approved by the SAC, such as *bay' bithaman ajil* and *bay' al-'inah*, are seen as controversial as these products are not approved in the Middle Eastern market by their respective Shari'ah scholars. However, the interviews make apparent the justifications for permissibility of these two products. A member of the SAC of BNM 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 (one of the Islamic legal schools). We take the position that should we continue to be in vice, in *riba*, when actually, with *bay' al-'inah* it is more *a'haf* (permissible, though controversial)? So, we ask ourselves, which one should we choose? Do we choose to be in major elements of sin or lesser ones and we decided to choose the lesser ones."

Meanwhile, the interviews also make apparent an interesting revelation. The decree on *bay' bithaman ajil* and *bay' al-'inah* resulted in them being given the mandate but, in order to promote consistency with the international Islamic banking practice, they are not preferred by the SAC and, hence, by the BNM. In addition, the Malaysian authority has taken the position that the market players should consider these Islamic financial contracts as the last resort of

[41] List of all Shari'ah Parameter References developed by Bank Negara Malaysia can be found at http://www.mifc.com/index.php?ch=menu_know_principal&pg=menu_know_principals_intro.

Islamic banking products offered to the customers. Besides their controversial nature, other reasons why the BNM would be keen not to favour them is due to the availability of other Islamic financial contracts, such as *murabahah, musharakah mutanaqisah* and others. However, the interviews disclosed the concerns amongst the regulators that *bay' bithaman ajil* and *bay' al-'inah* have became the default financial contracts amongst the Islamic banking market players. A member of the SAC of BNM remarked:

> "Some people say we are liberal. I will say that, before any decision is made, there is a thorough study of the particular issue. We might prefer certain views to others and, in certain circumstances, the bank can go for the exception but the bank is given a time limit for that. However, sometimes the exception has become the default."

Another significant revelation derived from the interviews is that the existence of the SAC, the supreme Shari'ah authority that monitors and controls application of the Shari'ah across the Malaysian Islamic banking industry, is perceived by the participants as not limiting the creativity and flexibility of the industry. This is due to the fact that the Shari'ah board 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*), although they are permitted by the SAC. Indeed, the Shari'ah board and all concerned parties within the bank could be more creative by innovating contemporary Islamic banking products based on globally accepted Islamic financial contracts. Alternatively, the interviews revealed that the lack of regulation at the international level has contributed to conflicting views amongst the Shari'ah scholars on the operation of Islamic banking activities and associated difficulties in cross-border transactions. The CEO of a large-sized Islamic bank remarked:

> "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. I cannot do business in the GCC, not because I don't have the product, but because I'm not confident about doing business there. Any Tom, Dick and 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 there, it is *non-halal*, but a few months later it becomes *halal*."

In conclusion, the discussions with the interview participants revealed their support for a dual-layer Shari'ah governance system as contributing to standardisation and consistency in

Islamic banking practices in Malaysia, although there are apparent challenges towards this effort.

8.6 Conclusion

Overall, the interview results presented above have provided an in-depth understanding of the role, independence and Shari'ah review effectiveness of the Shari'ah board issues investigated in this study. It became apparent from the discussions with the participants that the parties concerned within the SGF placed high importance on Shari'ah governance as the mechanism to ensure the Shari'ah compliance of the Islamic banking operation, however, with evidence of business connotations amongst the management, as indicated in the selection of Shari'ah board members. The appointment of Shari'ah board members has been discussed as having a direct association with the Shari'ah boards' roles and functions. Interesting findings also emerged regarding the appointment of the Shari'ah board members as to whether the Shari'ah board membership should only be comprised of Shari'ah scholars or those with diverse qualifications. The arguments about the Shari'ah board membership led to further debate on its association with the quality of the Shari'ah decisions issued by this Shari'ah governance authority.

It has also been highlighted that the Shari'ah board remains dominated within its Shari'ah advisory role to the extent that some Shari'ah board members consider the Shari'ah review task as the sole purview of the Shari'ah officers and that the Shari'ah board only provides approval to the Shari'ah review carried out by these officers. Although this poses a question on the functional independence of the Shari'ah board, this study also revealed the challenges faced by the Shari'ah board, in contributing beyond its Shari'ah advisory capacity, as mainly due to its part-time attachment to the bank. In addition, the interviews held with the participants also revealed the Shari'ah review effectiveness of the Shari'ah board by discussing the factors that support, as well as limit, the Shari'ah governance function of the Shari'ah board. The factors revealed as supporting the role and function of the Shari'ah board are the accountability driven paradigm, the support from relevant parties with Islamic banking experience, the holistic approach to Shari'ah governance, concerted Shari'ah governance mechanisms and the efficient regulatory framework for Islamic banking. On the other hand, the factors revealed as limiting the Shari'ah governance role of the Shari'ah board are the drawbacks of the functional independence of the Shari'ah board, its ineffective Shari'ah governance function, inadequate regulatory support, the ineffective functions of designated institutions and the absence of Shari'ah audit and its implications for the Shari'ah board's Shari'ah report. Finally, this chapter ends with the apparent support of the interview participants for the role of dual-layer Shari'ah governance system in standardising the Islamic banking practice in Malaysia.

CHAPTER NINE: SUMMARY AND CONCLUSIONS

9.1 Summary and Review of Findings

Chapter One of this thesis outlined the rationale and objectives of this study. Chapter Two discussed the corporate governance of banks and explained selected theoretical frameworks on the subject of corporate governance. Because the failure of the banking system could lead to the downfall of the economy, Chapter Two also discussed the important role of the regulator and specifically looked into the function of several international regulatory bodies in promoting best practices through the issuance of policies, standards and guidelines for use in the industry.

Chapter Three, meanwhile, focused on the corporate governance of Islamic banks. The significance of *ijtihad* (legal reasoning) as the dynamic tool for the development of Islamic banking and finance has been discussed and a detailed explanation on the Islamic principles of the Shari'ah, which governs the operation of Islamic banks, has been provided. In essence, the Islamic Shari'ah prohibits transactions involving interest and investment into activities that feature the characteristics of being uncertain, or *gharar*, besides others that have been clearly laid down in the Shari'ah as impermissible, such as alcohol, gambling, casino activities, pork production, pornographic production, etc. In addition, this chapter also drew attention to two important concepts influencing the Islamic banking practice, namely accountability and the *maqasid al-Shari'ah* (objectives of the Shari'ah). As a matter of interest, the diverse classical Islamic financial contracts deduced from the Shari'ah have been highlighted and the issue of Shari'ah compliance of Islamic banks has been explained. Additionally, as this study discusses the Shari'ah governance system implemented in the Malaysian Islamic banking industry, this chapter also throws light on the Malaysian Islamic banking environment.

The emphasis of Chapter Four is on the Shari'ah governance function of the Shari'ah board, whose establishment stems from the requirement for the board to ensure that the operations of the Islamic bank are Shari'ah compliant. The role of the Shari'ah board has been discussed individually as the Shari'ah advisory role and the Shari'ah review role. Accordingly, relevant regulatory standards and guidelines on the two spheres of the Shari'ah boards' role have been detailed. Besides critically reviewing the research surrounding the issues of the role of the Shari'ah board, this chapter also provides a brief overview of the Shari'ah governance system for the Islamic banking industry in Malaysia. It has been explained that the Shari'ah governance framework (SGF) for Malaysian Islamic banking exhibits a dual-layer Shari'ah governance system where, besides the Shari'ah board, Shari'ah supervision is also undertaken at the Bank Negara Malaysia (BNM) level by the Shari'ah Advisory Council (SAC), who act as the supreme Shari'ah authority, governing the whole Islamic banking industry. Hence, the bureaucracy presented by the Malaysian Islamic banking SGF requires approval at two stages, firstly, by the bank's Shari'ah board and, subsequently, by the SAC of the BNM.

It is against this background that this study has explored the role, independence and effectiveness of the Shari'ah boards' Shari'ah governance function, in the context of Malaysian SGF, by adopting a mixed strategy approach to data collection; the methodology adopted for this strategy is presented in Chapter Five. The quantitative approach, through questionnaire surveys, represents the first stage of data enquiry, aimed at establishing a general understanding of the Shari'ah governance function of the Shari'ah board. Two sets of questionnaire surveys were undertaken: (1) questionnaire survey 1- QS1; and (2) questionnaire survey 2- QS2. QS1 is aimed at assessing the Shari'ah governance functions of the Shari'ah board from the perspective of the banks' head of Shari'ah departments. Acting as the Shari'ah boards' secretariat, it is expected that the responses from the heads of Shari'ah departments would provide useful insights into the level of Shari'ah boards' involvement in Shari'ah governance of the bank and other important issues relevant to the Shari'ah boards' roles and functions. Meanwhile, QS2 is aimed at obtaining the perceptions of the banks' branch managers on how the same issues presented in QS1 are expected to be undertaken by the Shari'ah board. In order to make a meaningful analysis of comparison between the two questionnaire surveys' findings, the content of QS2 comprises similar questions to those in QS1, however, with some alterations tailored to the differences in the Shari'ah governance exposure in the two respondents' groups. In the second stage of data enquiry, in-depth interviews were conducted with concerned parties within the SGF, i.e. the Shari'ah board members, heads of Shari'ah departments, CEOs and senior executives of Islamic banks, the SAC of BNM and BNM officers. These series of in-depth interviews were aimed at gaining further understanding of the results derived from the questionnaire surveys and discovering the ‘social process’ that is involved in the Shari’ah governance function of the Shari’ah board. Hence, by incorporating both the quantitative and qualitative research approach, this study is deemed able to provide an overall picture of the Shari’ah boards’ issues under investigation. The data analysis and findings of the two questionnaire surveys are presented in Chapters Six and Seven, while Chapter Eight presents the results of the in-depth interview.

Chapters Six and Seven analysed and discussed the responses to QS1 and QS2 respectively. In QS1, the perceptions of 24 heads of Shari’ah departments, who responded to a series of questions on the issues studied, were analysed based on overall analysis and by control variables (types of banks, ownership of banks, size and the number of years experience of the Islamic banking operation). Meanwhile, QS2 analysed the responses of 78 branch managers, who participated in the survey, in the same manner as QS1.

The QS1 in Chapter Six revealed that the vast majority of banks in the Malaysian International Islamic Finance Centre (MIFC) were adopting the mandatory guidelines issued by the BNM, i.e., the ‘*Guidelines on the Governance of the Shariah Committee for Islamic Financial Institutions’* or GPS1, as against AAOIFI’s recommended governance standards and that the heads of Shari’ah departments were mainly from the Shari’ah and *fiqh al-mua’malat* background. These two findings placed significance on the nature of the Islamic banking operation being, in a way, consistent with the Malaysian regulatory requirement. In fact, the finding on the qualification background of the heads of Shari’ah departments had the impression of having the same Shari’ah concerns with the Shari’ah board, thus could be relied upon by the board and, indeed, by the banks’ management. The fact that the Shari’ah boards were found to be mainly involved in endorsing the Shari’ah compliance manual, advising the board of directors as well as advising the Shari’ah officers, signifies the concern and the limited Shari’ah advisory role of the Shari’ah board. Indeed, Shari’ah boards’ involvement in developing Islamic banking products and services tends to be limited to crucial areas where Shari’ah concern may arise, namely the conception, the legal documentation and the review levels. In terms of accounting-related issues in the Islamic banking operation, the Shari’ah boards were found to give minimal and selective involvement, particularly in validating documents in contracts, approving calculation and distribution of *zakat* and endorsing the banks’ annual reports. Interestingly, issuing Shari’ah report, as a function closely associated to the Shari’ah boards’ role in articulating the banks’ Shari’ah compliance, was not indicated as the Shari’ah boards’ top accounting involvement.

The impression from the above findings was that the Shari'ah boards in Malaysian MIFC had not advanced beyond areas of Shari'ah concern associated with approval of Islamic banking products and the need to ensure that the income generated and reported in the banks' annual reports is from Shari'ah compliant activities. The explanation for this limitation rests in the revelation that the Shari'ah boards receive the greatest assistance from the Shari'ah department officers. This, combined with the fact above that the heads of Shari'ah departments are mainly knowledgeable in Shari'ah and *fiqh al-mua'malat*, gives the opportunity for the Shari'ah boards to delegate conveniently the task entrusted with them to the Shari'ah officers of the bank. After the Shari'ah department officers, the relevant parties who had given most assistance to the Shari'ah boards were indicated as the management, followed by the board of directors. In addition, evidence of assistance from external auditors was significantly apparent for large-sized banks, hence revealing implementation of a more comprehensive Shari'ah governance mechanism than in their counterparts, i.e. the small and medium-sized banks.

In relation to the Shari'ah boards' commitments, the Shari'ah governance authority has given priority to efforts towards standardising Islamic banking practices by engaging in workshops and meetings of scholars of *fiqh al-mua'malat*, with apparent emphasis given by the Shari'ah boards on banks in the mid range of the establishments. This is followed by commitments to: (1) analysing whether Islamic banking products and services would deliver benefit to the *ummah* before they are launched and (2) enhancing Shari'ah review skills by attending appropriate training. Meanwhile, evidence also indicates weak inspiration amongst the Shari'ah boards in innovating Islamic banking products and their dilemma in revealing important Shari'ah decisions pertaining to the Islamic banking operation. This is because some of them were not involved in: (1) publishing the Shari'ah board's Shari'ah resolutions and rulings and the mechanics of Shari'ah compliance applied in the Islamic banks; (2) responding to any questions pertaining to pronouncements and resolutions issued by the Shari'ah board through discussion with the shareholders or the public; and (3) efforts in innovation of Islamic banking products and services through discussion with relevant parties within the bank.

Regarding accountability and independence, issues on how the Shari'ah boards can be influenced by the two elements, as well as their reflection in the nature of the Shari'ah boards' appointment and mandated authority, were investigated. Overall, factors referring to the integrity of the Shari'ah board members were given more importance than the Shari'ah boards' fiduciary duties in influencing its accountability and independence. For example, Shari'ah board members' ethical value and reputation were both revealed most and equally important as factors influencing the accountability of this Shari'ah governance authority. This is followed by the Shari'ah boards' Shari'ah scholarly background, making all three elements representative of the Shari'ah boards' integrity. Next, are the factors relating to the Shari'ah boards' fiduciary duties, which, in order of importance, are the requirement for Shari'ah boards to ensure Shari'ah compliance and, subsequently, the stakeholders' reliance on the Shari'ah review done by the Shari'ah boards. Similarly, integrity factors have high importance in influencing the independence of the Shari'ah board. The factor perceived as most important is the Shari'ah board members' clearly defined scope of responsibilities, followed by the integrity attributes of the Shari'ah board members, i.e., the perceived high ethical status and the scholarly background of the Shari'ah board members. Next, in order of importance, are: adequate powers being mandated to the Shari'ah board; involvement of Shari'ah board in the same way as the Shari'ah board in other industries; participation of top management in Shari'ah board meetings; and, finally, the remuneration received by the Shari'ah board. These findings are also worth considering from the regulatory point of view. Although the factors pertaining to the involvement of the Shari'ah board being the same as the Shari'ah board in other industries and the participation of top management in Shari'ah board meetings were given less importance they, nevertheless, call for a review of the relevant regulatory guidelines, as both are generally practiced in banks offering Islamic banking operations.

In addition, the parties to whom the Shari'ah board is perceived as being most accountable are the board of directors and the SAC of BNM, where the response was that both were equal in importance. Evidently, these two main parties form the reporting line of the Shari'ah board, as depicted by the SGF of the Malaysian Islamic banking operation. After these two parties, next in importance are the shareholders, followed by the banks' consumers and, finally, the public.

On the nature of the Shari'ah board members' appointment and mandated authority, it was revealed that the appointment of Shari'ah board members is made based on 'fit and proper' criteria and after ascertaining that there is no conflict of interest in their appointment. In addition, the Shari'ah board members were indicated as being subject to certain performance assessments by the bank or the BNM. However, several findings relating to the Shari'ah boards' mandated authority require attention. For example, there are indications that the Shari'ah board members were not given adequate power and there was an absence of a reporting channel to address conflict between important Shari'ah governance parties within the bank, as well as an absence of segregation of the Shari'ah boards' duties. Hence, although regulations relating to the Shari'ah boards' appointment seem to have been addressed, it leaves the allowance of the Shari'ah boards' authority to report possible disputes in its Shari'ah governance role as questionable.

Regarding the structure and implementation of Shari'ah review by the Shari'ah board, the overall impression provided from the answers by the respondents are that both have been properly and adequately satisfied by the banks. For example, the responses derived indicated an established perception amongst the respondents on the Shari'ah boards that they were the sole authority for the Shari'ah review and that this Shari'ah governance authority has been prescribed with the appropriate operative procedure in its roles and functions by the bank. However, the answers amongst the minority of the respondents sparked a concern of possible governance crisis. This is due to the evidence from a small minority of the respondents, who dismissed the claim that the Shari'ah boards are the sole authority in the Shari'ah review exercise and who reported the absence of the aforementioned procedure. Also relevant is the fact that there is equal number of banks whose Shari'ah board comprised of Shari'ah scholars only as those comprising of diverse expertise. The increase in non-Shari'ah scholars' participation as Shari'ah board members, although it signalled an apparent challenge facing the Islamic banking industry relating to the lack of competent Shari'ah scholars, also calls for an investigation into the possible implications of such an uprising. Meanwhile, another division amongst the perceptions of the heads of Shari'ah departments is regarding the existence of an adequate and obvious guideline on the pronouncements and resolutions of SAC for use in the industry. While the respondents largely agreed on the establishment of such guidelines from the SAC, a small number of respondents indicated otherwise. In short, the findings of this study reported an established structure for the execution of Shari'ah review by the Shari'ah board, which also sheds light on the effectiveness of the Shari'ah review function of the Shari'ah board. However, there is also evidence highlighting concerns about the Shari'ah boards' independence and possible compromises on the quality of the Shari'ah decisions issued by the Shari'ah board, although these views were only represented by a minority of respondents.

On the implementation side, the general perception from the respondents' answers was that the Shari'ah boards effectively carried out the Shari'ah review function; however, apparent challenges were noted, with evidence from the small minority indicating complications in the execution of this crucial task. For example, the respondents generally perceived that the Shari'ah boards have been given full authority to stop Shari'ah non-compliant transactions. In addition, ample time for decision making and carrying out their Shari'ah review function was indicated as having been provided. Moreover, the Shari'ah boards have generally been perceived as having access to the required information and were furnished with the existence of active communication and consultation between the Shari'ah board and the SAC of BNM. Disturbingly, this study also witnessed evidence that dismissed all the features mentioned. Moreover, although this contrary evidence represents only a small portion of the respondents, they raise concerns about the independence of the Shari'ah board and call for further investigation into these matters. In addition, this study also discovered that the Shari'ah board receives the professional advice required to support the implementation of its Shari'ah review function.

Interestingly, this study also highlighted evidence on a known challenge to the function of the Shari'ah board, which is detrimental to Shari'ah governance but remains unresolved, i.e., the part-time working nature of the Shari'ah board. It appeared that a considerable number of respondents refute the claim that Shari'ah boards' part-time working nature does not hinder the Shari'ah review effectiveness of the Shari'ah board. This revelation is alarming and imposed questions about the effectiveness of the Shari'ah boards' Shari'ah governance function. An important issue that emerged is about the quality of Shari'ah compliance assurance that the Shari'ah boards provide to the users of the Shari'ah report. Despite the revelation of the above findings on the infrastructure support and the provision of the authority required, this study indicated that the Shari'ah boards were unable to contribute an effective amount of time for reviewing the implementation of Shari'ah decisions made previously by the Shari'ah board. Hence, this study suggests that the part-time working nature of the Shari'ah board and its effective Shari'ah review could not possibly be attuned and emphasises the call for Shari'ah audit by an independent Shari'ah auditor, similar to the external financial auditor.

The QS2 of Chapter Seven, on the other hand, revealed that most of the branch managers are trained in the field of accounting and finance, as well as a combination of Shari'ah and *fiqh* *al-mua'malat* with other non-Islamic field(s). These training backgrounds reflect the relevance of the responses provided for discussion and for comparison with decisions derived from QS1 of Chapter Six. The responses provided indicated that the branch managers placed similar highest expectations on the Shari'ah advisory capacity of the Shari'ah board; however, this was with emphasis on advising the board of directors, advising Shari'ah department officers on the scope of the Shari'ah review and preparing the Shari'ah compliance manual. These contrasting emphases demonstrate the pragmatic approach of the branch managers resulting from dealing with the day-to-day banking business operation. The branch managers also expressed their expectations on the Shari'ah boards' involvement in advising and designing the corporate objectives of the bank and highlighted the areas of primary concern to them as being the banks' objectives, mission and vision.

In relation to the Shari'ah boards' involvement in developing Islamic banking products and services, the results revealed consistency in priority areas between what is expected by the branch managers and what is actually being exercised by the Shari'ah board. These refer, in order of importance, to the conception, the legal documentation, the review, the design, the implementation and the pricing levels. However, results also indicated that the branch managers expected greater involvement by the Shari'ah board, especially in the design, the pricing, the testing and the implementation levels. Also revealed was the greater emphasis for the Shari'ah boards' involvement in the design and implementation levels amongst the branch managers from full-fledged Islamic banks, as compared with Islamic window banks, and for the implementation level for those from the mid range Islamic banking experience, as compared with other levels of Islamic banking operation experience.

Regarding involvement in the accounting issues of the bank, priority areas expected by the branch managers from the Shari'ah boards are relatively similar. Apparent emphases highlighted were the branch managers' concerns about the Shari'ah boards' higher involvement in determining the profit distribution formula, approving accounting policy and issuing Shari'ah reports. In addition, branch managers from foreign banks had greater concerns about the Shari'ah boards' involvement in validating Islamic banking transaction records than those in domestic banks. Moreover, the branch managers from the large-sized banks also placed greater concern on issues pertaining to approving the calculation and distribution of *zakat* from the small and medium-sized banks. This same accounting issue, as well as another pertinent to validating documents in Islamic banking contracts, were also of higher concern amongst those from the mid range Islamic banking experience, in comparison to their counterparts.

The results in QS2 also indicated similar recognition of the role of Shari'ah department officers as the party perceived as most important in assisting the role of the Shari'ah board; however, this apparently received more emphasis amongst branch managers from the fully-fledged Islamic banks, as compared with those from Islamic window banks. Also revealed was the greater importance placed on the role of audit committee, internal auditor and external auditor to assist the Shari'ah board than these parties actually provided. The impression from QS2 on commitments to strengthen the Shari'ah governance of the banks was that the Shari'ah boards were not giving the level of involvement expected from them. For example, branch managers showed greater concern for the Shari'ah boards' commitments on: (1) publically publishing Shari'ah resolutions and rulings and the mechanics of Shari'ah compliance applied in the Islamic bank; (2) engaging in innovation of Islamic banking products and services through discussions with concerned parties within the bank and (3) analysing how Islamic banking products and services would benefit the *ummah* before they are lunched. In addition, the first commitment mentioned was given more emphasis by the branch managers from fully-fledged Islamic banks as against those from Islamic window banks. Meanwhile, the third and further commitment, to actively engage actively in workshops and meetings of the scholars of *fiqh al-mua'malat* to promote consistency in Islamic banking products and services, were both given more emphasis by branch managers from the mid range of Islamic banking experience, when compared with its counterparts.

Regarding the factors influencing the Shari'ah boards' accountability and independence, it was revealed that the branch managers emphasise the integrity of the Shari'ah board members in a similar way to the heads of Shari'ah departments. Interestingly, the factor of the Shari'ah boards' requirement to ensure Shari'ah compliance, which represents one of the Shari'ah boards' fiduciary duties, was placed second among the factors influencing accountability of the Shari'ah board members. While the branch managers reiterated the importance of integrity factors, this study also indicates that the branch managers additionally place importance on the accomplishment of the Shari'ah boards' role in providing Shari'ah compliance assurance as influencing the accountability of the Shari'ah governance authority. In addition, the factors of the ethical value and the scholarly background of the Shari'ah board were given more importance by branch managers amongst banks from the mid range of

Islamic banking experience when compared with its counterparts. Meanwhile, on factors influencing the Shari'ah board members' independence, the overall results were that the branch managers place similar importance with the heads of Shari'ah departments, as these factors were positioned in the same way as in QS1. However, it was revealed that the branch managers from the foreign banks placed more importance on adequate power being mandated to the Shari'ah board than those in domestic banks. In addition, the scholarly background of the Shari'ah board was revealed to have more importance amongst branch managers from banks in the mid range of Islamic banking experience as compared with their counterparts.

Meanwhile, the parties to whom the branch managers deem the Shari'ah boards accountable were slightly different from those perceived by the heads of Shari'ah departments; however, this was with apparent importance given by the branch managers on the need to secure public interest. This is because, although both respondents agreed on the SAC of BNM as being the most important party deemed accountable by the Shari'ah boards, the branch managers expressed concern that next most important is the public and that this is followed by the board of directors. In contrast, the heads of Shari'ah department were more concerned with the board of directors, as they shared the same position with the SAC of BNM as the most important party deemed accountable, while the public was perceived as being least important. On the other hand, the banks' consumers and shareholders were perceived as least important by the branch managers.

In addition, investigation into the nature of the Shari'ah board members' appointment and mandated authority, as a reflection of the accountability and independence of the Shari'ah board members, revealed almost identical emphasis given by the two respondent groups. Nevertheless, the heads of Shari'ah departments made a higher claim for the Shari'ah board members to be subjected to assessment by the bank or the BNM than was expected by the branch managers. Moreover, the features of (1) no conflict of interest in the appointment of the Shari'ah board; (2) Shari'ah board members being subject to assessment by the bank or BNM, and (3) the existence of reporting channels to report conflicts with the Shari'ah board, board of directors or the management were apparently more important amongst the branch managers from fully-fledged Islamic banks than to those from Islamic window banks. Furthermore, the second feature was also given more importance amongst those from large-sized banks when compared to those from small and medium-sized banks. In addition, the first and the second feature were given more importance by branch managers from the mid range Islamic banking experience when compared to its counterparts.

Regarding the structure of Shari'ah review, the general impression of the perceptions of the branch managers was the support on the establishment of all the structures featured. For example, most of the branch managers indicated their agreement for the Shari'ah boards to be the sole authority in the Shari'ah review task; however, there was evidence from a minority of the respondents dismissing such a call. Indeed, this is the only feature in the structure of Shari'ah review where the branch managers expressed their disagreement. In addition, the branch managers also emphasised the need for the SAC of BNM to carry out the Shari'ah reference role for the Islamic banking industry and for adequate and explicit guidelines for use in the industry to be provided by this supreme authority. In fact, the call for these guidelines has been given greater emphasis amongst branch managers from the fully-fledged and large-sized Islamic banks. Moreover, these branch managers also perceived that the dual-layer of Shari'ah governance system implemented in Malaysia is effective in ensuring the stability of the Islamic banking industry operation and is capable of harmonising Islamic banking practice.

Meanwhile, on the topic of the implementation of Shari'ah review, the responses received from the branch managers generally supported all the investigated features, although there is evidence indicating division of perceptions amongst these respondents. For example, the branch managers call for the Shari'ah board to be given full authority to stop banks from undertaking Shari'ah non-compliant transactions, although a small minority of the branch managers also reportedly dismissed such a notion. In addition, the branch managers also called for the SAC to adopt rigorous procedures to examine and endorse Islamic financial products submitted by banks offering Islamic banking products. Indeed, this is the only one of the Shari'ah boards' Shari'ah review implementation features where there is no dismissal amongst the branch managers and where those from the fully-fledged Islamic banks placed greater emphasis. Furthermore, there was also a division of perceptions amongst the branch managers on the notion of whether working part-time hinders the effectiveness of the Shari'ah board. Nevertheless, this dismissal represents only the small minority of the branch managers, whereas the larger sample considered it in the affirmative. Moreover, the QS2 also revealed that the branch managers mainly perceived that the Shari'ah compliance and accounting issues have been adequately disclosed in the Shari'ah report, although the minority of respondents presented evidence to the contrary.

Meanwhile, on the ranking of importance amongst the parties concerned with the Shari'ah governance of banks offering Islamic banking services, the responses provided by the branch managers revealed in first place the SAC of BNM. Relevant parties from within the bank follow, starting primarily with the Shari'ah board and then the Shari'ah department officers. Subsequently, the board of directors follow in the ranking and, finally, the management.

In relation to the in-depth interview, the responses were presented and discussed in Chapter Eight. Overall, the interview results provided an in-depth understanding of the role, independence and the effectiveness of the Shari'ah board's Shari'ah governance function issues investigated.

It became apparent from the discussion with the participants that the concerned parties within the SGF placed high importance on Shari'ah governance as the mechanism to ensure the Shari'ah compliance of the Islamic banking operations, however with evidence of a business connotation amongst the management, as indicated in the selection of Shari'ah board members. It emerged that the appointment of Shari'ah board members has direct association with the board's roles and functions. The interview revealed the apparent division amongst the participants on the qualifications of the Shari'ah board members on whether the board should comprise of only Shari'ah scholars or should have a membership of scholars with diverse qualifications. Moreover, associated with this qualification is the interview participants' argument of its unique contribution to the Shari'ah governance, which qualifications from another background would not be able to match. For example, the proponents of the Shari'ah board with diverse qualifications justified this based on the Shari'ah being dynamic and matters such as *mua'malat,* and its application in modern banking, is open to interpretation. Hence, diverse qualifications amongst the Shari'ah board members is associated with the ability to innovate Islamic banking products, which is usually complicated and hybrid in nature, with various Islamic financial contracts being linked together. In addition, the participants also revealed the need for the Shari'ah board to advise the bank on its Shari'ah advisory capacity in all spectrums of the banks' activities; hence, the argument was made for the Shari'ah board not to be limited to Shari'ah scholars only.

On the other hand, the proponents of the Shari'ah board comprising only of Shari'ah scholars are basically the Shari'ah scholars amongst the Shari'ah boards themselves and the banks' heads of Shari'ah departments. Their arguments are on the basis that the Shari'ah scholars usually master the Arabic language and, hence, are able to read the classical Arabic manuscripts for research purposes; understand *maqasid al-Shari'ah* (objectives of the Shari'ah) better; and, therefore, arrive at solid Shari'ah decisions. As such, it is apparent that they defend the view that Shari'ah decisions are the prerogative of Shari'ah scholars and place their justification on the implication that the qualifications of Shari'ah board members have an impact on the quality of Shari'ah decisions made. Nonetheless, it was revealed that this group of interview participants recognised the need for non-Shari'ah experts; however, this was in their designation as consultants to the Shari'ah board and not as the Shari'ah board itself. Others who relaxed the rigidity on the Shari'ah board membership compromised by agreeing to the inclusion of non-Shari'ah scholars but, however, were of the opinion that the majority of the Shari'ah board members should be amongst the Shari'ah scholars.

The interview also revealed the importance of relevant Islamic banking experience amongst the Shari'ah board members. It became apparent from the interviews with the BNM officers and heads of Shari'ah departments that a requisite for quality Shari'ah decisions is the need for Shari'ah board members to expand their view beyond theoretical framework, without which the Shari'ah board is perceived to be unable to contribute to the Shari'ah governance of the bank. Indeed, the management of the banks perceive the Shari'ah board members who possess relevant experience as being able to alleviate challenges associated with innovation of Islamic banking products and increasing the level of Shari'ah compliance of the banking operation.

In addition, the interview also indicated that the appointment of Shari'ah board members has an image-building and commercial reasoning facet for the banks. This is apparent from the appointment of Shari'ah board members amongst local Shari'ah dignitaries and prominent international figures. Besides establishing the image as insurer of the banks' ethical operations, the appointment of these Shari'ah board members also has been highlighted as having an aim of tapping their knowledge in relation to Islamic banking product offering and penetration into the international financial market.

Regarding the Shari'ah advisory role, the Shari'ah boards have been revealed as being involved in mainly, but not limited to, issues surrounding Islamic banking products to be offered to customers. It has become apparent that, in approving Islamic banking products, justification for the Shari'ah decisions issued by the Shari'ah board is made not merely on the principles laid down in the Qur'an and *hadith*, but also by giving consideration to the needs of the Muslims and by making evaluations of the dynamism of the banking operation. A typical example of this condition was revealed as the approval of controversial Islamic banking products due to the absence of alternative Islamic banking products. Also highlighted by the participants was the accounting and finance concerns during the design and implementation stages of developing Islamic banking products. Among other factors, this included the accounting implications brought by the sequence of transactions, the nature of assets involved and the transfer of risks and ownership between the contracting parties. Indeed, it has been revealed that accounting is an important tool in justifying the legality of the timing choice for income recognition, by the management, from the Shari'ah perspective.

Meanwhile, the interview makes it apparent that the Shari'ah boards' involvement in the Shari'ah review function is minimal and inconclusive. Although the Shari'ah board members interviewed concurred with the importance of Shari'ah review, with more apparent emphasis given by the Shari'ah boards whose parent bank is a conventional bank, it has been indicated that the Shari'ah officers of the bank are primarily undertaking the Shari'ah review function of the Shari'ah board. Explanation for such lack of commitment amongst the Shari'ah board was highlighted as being due to time limitation factors resulting from the Shari'ah boards' part-time attachment to the bank and an absence of clear guidelines from the regulator on the mechanism for implementation of the Shari'ah review. The latter has resulted in banks developing a Shari'ah compliance manual, which specifies that the Shari'ah review task is to be undertaken by the Shari'ah officers and the Shari'ah boards only provide their approval.

In addition, the interview also makes apparent a new avenue of Shari'ah review. The Shari'ah board members and the Shari'ah officers interviewed revealed that Shari'ah review of previous Shari'ah decisions issued by the Shari'ah board also took place in their respective banks. If the previous Shari'ah decision was indeed mistakenly concluded and, if a change of Shari'ah ruling is made by the Shari'ah board, the emerging issue that arises is whether the Shari'ah decisions issued by the Shari'ah board can be challenged. Interestingly, these issues also open a new dimension on Shari'ah audit, such as whether Shari'ah decisions issued by the Shari'ah board have been accurately concluded and what the accounting implications are of such review exercises on the banks' reported income. Also discovered was the issue of the decisiveness of the Shari'ah review decisions made by the Shari'ah board. The interview participants highlighted the need for Shari'ah boards to gain clarification from all relevant parties within the bank, as to the possibility of Shari'ah non-compliance findings by the Shari'ah boards, before this Shari'ah governance authority could reach any verdict.

It has also been discussed in Chapter Eight that the interview makes apparent factors contributing to as well as, conversely, hindering the effectiveness of the Shari'ah boards' Shari'ah governance function. The discussion with interview participants highlighted a clear accountability paradigm amongst the concerned parties within the bank, the support of relevant parties with experience in Islamic banking, the holistic approach to Shari'ah governance, the concerted Shari'ah governance mechanism and efficient regulatory framework as factors contributing to the effectiveness of the Shari'ah boards' Shari'ah governance function. On the other hand, the factors that hinder the effectiveness of the Shari'ah boards' Shari'ah governance function, highlighted in the interviews, were the drawbacks of the functional independence of the Shari'ah board and Shari'ah governance tasks being undertaken ineffectively by the Shari'ah board. Additional factors were inadequate regulatory support, ineffective functioning of designated institutions and, finally, the absence of Shari'ah audit and its concern about the quality of the Shari'ah reports.

With regard to the dual-layer Shari'ah governance system, the discussion held with the SAC members and the BNM officers makes it apparent that the SAC of BNM, as the Shari'ah apex body and the Shari'ah reference for the Malaysian Islamic banking industry, issue their Shari'ah resolutions by first making reference to Shari'ah standards issued by international regulatory and Shari'ah reference bodies, such as AAOIFI, OIC's Fiqh Academy and Dar al Barakah (resulting from Multaqa Dallah al-Barakah forum). However, these interview participants revealed that the SAC does not restrict itself to these Shari'ah standards. In addition, the interview makes apparent the initiative by the BNM and other concerned parties to standardise Islamic banking practice at the national, as well as at the regional, level. Examples of effort at the national level are: establishing Shari'ah parameters in Islamic banking products and a standardised master agreement for interbank transactions while, at the regional level, it is the annual gathering of prominent Shari'ah scholars from the south-east Asian countries.

The interview with the SAC members also highlighted that the council does not limit itself to interpretations of the Shari'ah based on the Shafi'i's school of Islamic thought, despite the majority of the Muslims in Malaysia subscribing to them. Such apparent flexibility of approach undertaken by the SAC was meant to ensure that banks could offer Islamic banking products and services that would cater for the financial needs of the Muslims and for the Muslims to commit themselves to a banking system that is consistent with the Shari'ah. The discussions held with the Shari'ah board, SAC and BNM officers also made apparent their dismissal of the thought that the dual-layer Shari'ah governance system implemented in Malaysia would tend to limit the creativity and innovation of Islamic banking products. This is because, although the SAC takes a flexible approach in issuing its Shari'ah resolutions, the Shari'ah board at the bank level could be more stringent by opting to refuse controversial Islamic banking products permitted by the SAC. Indeed, the Shari'ah board could issue new Islamic banking products that, after being scrutinised and permitted by the SAC, would be able to launch it to their customers.

9.2 Theoretical Implications and Recommendation for Practice

At the heart of Islamic banking objectives, it appears that the relevant theoretical framework underlying the operation of Islamic banks is the stakeholder theory. Further, when the concept of Islamic accountability is put together into this theoretical framework, the stakeholders are deemed to be ultimately interested in ascertaining the realization of an Islamic banking operation and the provision of its products and services that are Shari'ah compliant. In this regard, the Shari'ah boards play a significant role in the SGF of the Islamic banking industry as the external and independent party responsible for providing the Shari'ah compliance assurance required by the stakeholders. However, there is some flaw on the task of providing that assurance, as demonstrated through the Shari'ah review role of these Shari'ah boards. This study revealed that, in most cases, the Shari'ah review is undertaken by the banks' Shari'ah department officers, and its results are then presented to the Shari'ah board for approval. Furthermore, there is some evidence indicating that there is no due diligence on the part of Shari'ah board members when undertaking this task. Hence, the effectiveness of the Shari'ah board in carrying out this crucial Shari'ah review task does not seem to get enhanced under the Malaysian dual-layer Shari'ah governance system, although this study reported the existence of an established structure for the Shari'ah review. Nonetheless, the governance alliance promoted by the dual-layer Shari'ah governance system between that of the Shari'ah boards and the SAC of BNM has demonstrated an advance in Islamic banking practices that is standardized.

Additionally, this study discovered that the appointment of Shari'ah board members had an image building facet as well as to serve the business motives of Islamic banks. This, combined with the drawback of the governance function of the Shari'ah board addressed above, added to the potential for this Shari'ah authority to be used as the vehicle for serving the opportunistic behaviour of the management. Meanwhile, the pressure imposed by the market and the regulator for Islamic banks to feature products and services that would safeguard investment of the investors and depositors points to the fact that the operation of Islamic banks does not advance beyond ensuring a positive return to these parties. These facts seem to have let the Islamic banking industry emphasis shift from a stakeholders' to an agency theoretical framework of operation as the interests of shareholders and depositors remain the focal point of the operation of Islamic banks.

Meanwhile, the apparent loophole in the Shari'ah review function of the Shari'ah board mentioned above jeopardises the independence of this Shari'ah governance authority, and hence compromises the credibility of the Shari'ah report issued by the Shari'ah board. It is therefore suggested that until, and unless, Shari'ah audit is taken up by an external and independent Shari'ah auditor other than the Shari'ah board, the present role and function of the Shari'ah board will be merely to rubber stamping the work already undertaken by the banks' internal Shari'ah governance mechanisms. In this regard, it is recommended that Shari'ah audit should be conducted by external Shari'ah auditors, similar to auditing of financial statements. Accordingly, this means that the Shari'ah report issued by the Shari'ah board should be regarded as similar to the director's report in other corporations. In addition, verification of the true and fair presentation of this Shari'ah report, similar to that undertaken by the external auditor of financial statements prepared by the management, is deemed crucial. This implies that the Shari'ah compliance assurance, that the shareholders and stakeholders seek to find, would be attained from external verification of the Shari'ah report instead of the Shari'ah board's report itself. All in all, this would enhance the credibility of the Shari'ah report. However, an important repercussion from the above recommendation is the requirement for regulatory guidelines on the Shari'ah audit framework for both the internal and external Shari'ah auditor which currently do not exist.

This study has also introduced possible avenues regarding Shari'ah boards' Shari'ah governance function, where the Shari'ah audit could be carried out, including the auditing of the Shari'ah decisions of the Shari'ah board. Implementation of the latter offers a new dimension to Shari'ah audit, where external Shari'ah auditors are given the authority to question the accuracy of decisions made by the Shari'ah board, hence assigning accountability to the Shari'ah board for the decisions it makes. While it has been discussed throughout the thesis that Shari'ah decisions are the sole authority and prerogative of each Shari'ah scholar, evidence derived from this study has made apparent the radical need for this esteemed Shari'ah governance authority to be held accountable for any of its malfunctions. Interpreted differently, this recommendation and the recommendation for verification of Shari'ah reports by an external Shari'ah auditor mentioned above, implies the importance of establishing classification of Shari'ah decisions, issued by the Shari'ah board, into those derived from deep Shari'ah knowledge and the wisdom of the Shari'ah board members, which should not be questioned, and those that could be challenged. Not least in importance are the calls for audit firms to take up the challenge in establishing or strengthening their Shari'ah audit capacity by focusing on a relatively young but promising sector, i.e., Islamic financial institutions, including Islamic banks, and by developing the talent pool and the competency required for the task.

In addition, the regulator, in this case BNM, should consider enhancing the independence of Shari'ah board members by mandating a shift in the approach to Shari'ah board members' appointments. Consistent with AAOIFI's governance standard, the Shari'ah board members are recommended to be appointed by the shareholders instead of the board of directors. This appointment mechanism would ensure that the Shari'ah board is made accountable and has a reporting line to the shareholders. In addition, the trend of the present Shari'ah boards' membership seems to indicate that banks recruit Shari'ah board members based on their experience in the operation of Islamic banking, but not on their Shari'ah expertise in Islamic finance, hence having possible implications on the quality of Shari'ah decisions issued by the Shari'ah board, as has been discussed previously. It remain to be seen whether the requirement set in the new SGF, which became effective on 1st January 2011, for Shari'ah board members to number a minimum of 5, with at least 3 from a Shari'ah background, will enhance the Shari'ah governance of the Islamic financial institutions. In ensuring the quality of Shari'ah decisions, it is recommended that, besides ensuring that the majority of the

Shari’ah board membership is from the Shari’ah background, the Shari’ah boards’ chairman position should also be entrusted to a Shari’ah board member from the same background.

Given the prosperous growth of the Islamic banking market share, it seems that the industry has the prospect of becoming more established in the mainstream banking system, while more conventional banks are expected to integrate Islamic banking operations. Hence, it is expected that the Shari’ah governance function of the Shari’ah board will become more crucial and, aligned with the above recommendation, its role will firmly emphasise on the Shari’ah advisory capacity, while assurance of Shari’ah compliance rests with the external Shari’ah auditor. Meanwhile, the role of the central Shari'ah advisory board, such as the SAC, is becoming more essential for standardising Islamic banking practices. In the light of fast decision-making requirements by businesses such as banks, standardisation mechanisms, such as the existing Shari’ah parameter developed by the SAC of BNM or the Master Agreement by AIBIM, are recommended to be expanded to include other Islamic banking products and operations.

9.3 Limitations and Scope for Further Research

This study is a two-stage research design in which the aim of the in-depth interview conducted at the second stage was not intended to check the validity of the questionnaire survey findings in the first stage. It was, rather, to provide a deeper understanding of the process involved in the issues surrounding the Shari’ah governance function of the Shari’ah board under investigation. In addition, the in-depth interviews with Shari’ah board members, heads of Shari’ah departments, the CEOs and senior executives of banks were conducted based on convenience sampling and, thus, limited only to several banks participating in the MIFC. Although these methodological concerns limit the generalisability of the findings, it is argued that the findings derived from the two-stage design of this study enhance the validity of the overall analysis by producing a more complete picture of the Shari’ah governance function of the Shari’ah board.

Secondly, the scope of the current study is confined to the operation of banks encompassing Islamic banking activities, although some of these banks are also involved in Shari’ah-compliant investment in the Malaysian Islamic capital market, which is subject to the

Securities Commission's guidelines. Hence, reference to the guidelines on the Shari'ah governance function of the Shari'ah boards used for the questionnaire survey and in-depth interview are limited to those issued by BNM. In order to arrive at a more comprehensive evaluation of the Shari'ah governance function of the Shari'ah board, it is recommended that future research should expand the current study by also examining issues investigated in this study taking into account the regulatory framework and guidelines of the Securities Commission. Indeed, such a study could provide a more comprehensive assessment of the dual-layer Shari'ah governance system, as the Malaysian Islamic capital market similarly operates a dual-layer Shari'ah governance system, under the auspices of the SAC of the Securities Commission, as the supreme Shari'ah authority governing the Malaysian Islamic capital market industry.

Thirdly, the two questionnaire surveys were designed to gain a general understanding of the Shari'ah board issues under investigation. Because the Shari'ah boards' roles and functions are influenced by the nature of the Islamic banking operation, several control variables have been used to analyse the data for this study, namely factors attributing to the banks' size, type, ownership and Islamic banking experience. However, the fact that the respondents' exposure to the Shari'ah governance function of the Shari'ah board varies could result in the perceptions cast on the issues highlighted in the questionnaire being prematurely concluded. For example, in the case of QS2, the Shari'ah governance exposure of a branch manager from a standalone, fully-fledged Islamic bank is assumed to be more extensive than that of a branch manager from another fully-fledged Islamic bank whose parent bank operates a dual banking system, i.e., both conventional and Islamic banking. This limitation, although it affected the aim of the current questionnaire survey, offers further investigation into variations in the Islamic banking operation segments for future research.

Finally, this study highlights that the Shari'ah review of banks offering Islamic banking in Malaysia was found not to have been effectively undertaken by Shari'ah boards and that the Shari'ah report issued by the board was reported to have nearly depended on investigations by the bank's Shari'ah department officers. This shows that the Shari'ah department officers play a vital role in the Shari'ah governance of the Islamic banking industry in Malaysia. However, since the focus of the present study is to purely investigate aspects of the governance function of the Shari'ah board there are, nevertheless, other aspects surrounding the role of Shari'ah department officers such as their independence and effectiveness which could be part of the future research agenda. In addition, this study examined the governance function of Shari'ah boards in the context of the dual-layer Shari'ah governance system practiced in Malaysia which is recognised to be the most established and comprehensive in the Islamic world. Future research could extend the findings of this study by investigating the dual-layer Shari'ah governance system practiced in other countries thus providing valuable insights into practices elsewhere in the Islamic world.

Despite its many caveats, the current study establishes evidence on the role, independence and effectiveness of the Shari'ah board's Shari'ah governance function in the context of the Malaysian dual-layer Shari'ah governance system for the Islamic banking industry. It contributes to the existing literature by providing rich empirical data relating to all concerned parties within the SGF and other stakeholders, hence it stands out beyond the surface understanding of the issues investigated.

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APPENDICES

Appendix 1

Cardiff Business School
Director Professor R Mansfield MA PhD (Cantab)
Deputy Director (Research)
Professor Michael I Reed BSc (Econ) (Wales) PhD (Wales)

Ysgol Fusnes Caerdydd
Cyfarwyddwr Yr Athro R Mansfield MA PhD (Cantab)
Dirprwy Gyfarwyddwr (Ymchwil)
Yr Athro Michael I Reed BSc (Econ) (Wales) PhD (Wales)

CARDIFF UNIVERSITY
PRIFYSGOL CAERDYDD

Cardiff University
Aberconway Building
Colum Drive
Cardiff CF10 3EU
Wales UK

Tel *Ffôn* +44(0)29 2087 6
Fax *Ffacs* +44(0)29 2087 4
www.cardiff.ac.uk/

Prifysgol Caerdydd
Adeilad Aberconway
Colum Drive
Caerdydd CF10 3EU
Cymru Y Deyrnas Gyfunol

7 January 2010

Dear Sir/Madam,

I am a full time PhD researcher at the Cardiff Business School, Cardiff University, United Kingdom. I am currently undertaking a research project on the Shari'ah governance of the Islamic banking industry in Malaysia under the supervision of Dr Yusuf Karbhari. Our main objective is to analyse the Shari'ah governance function of the Shari'ah Committee of banks offering Islamic banking products and services.

We would be very grateful if you could spare some of your valuable time to fill in the attached questionnaire and to return it back to us using the self-addressed envelope provided by the 28th of January 2010. Your participation in this research will provide invaluable input for the development of the Islamic banking industry in Malaysia and vital for the success of this study.

You can be assured that all information provided will be treated in the strictest of confidence and will be used for academic purpose only. If you would like to have a summary of the report I will be happy to forward you a copy.

Your cooperation is very much appreciated.

Thank you

Yours sincerely

Ahmad Fahmi Sheikh Hassan
Principal Researcher
Accounting and Finance Section,
Cardiff Business School
Cardiff University
Aberconway Building, Colum Drive,
Cardiff CF10 3EU
UK
Email: sheikhhassanAF@cardiff.ac.uk
Mobile Malaysia - 017-3414158
Mobile UK - +44(0) 7545 962529

ISRA الأكاديمية العالمية للبحوث الشرعية
International Shari'ah Research Academy for Islamic Finance

5 March 2010

Dear Sir/Madam,

TO WHOM IT MAY CONCERN

Academic Research on the Shari'ah Governance within the Malaysian Islamic Banking Industry

Encik Ahmad Fahmi Sheikh Hassan is conducting his PhD research on the Shari'ah governance of banks that offers Islamic banking services in Malaysia. For the purpose of this research, he will be distributing questionnaires and conducting interview sessions with the management of the banks to gain insights on the topic above.

I would appreciate if you could render the necessary assistance to enable him to complete the project. Your participation in this research would provide invaluable input for further development of the Islamic banking industry in Malaysia and would be vital for the success of this study.

Yours Sincerely,

Assoc. Prof. Dr. Asyraf Wajdi Dato' Dusuki
Head, Research Affairs
International Shari`ah Research Academy for Islamic Finance (ISRA)

INTERNATIONAL SHARI`AH RESEARCH ACADEMY FOR ISLAMIC FINANCE
ISRA@INCEIF (718736-K)
2ND FLOOR ANNEXE BLOCK, MENARA TUN RAZAK, JALAN RAJA LAUT, 50350 KUALA LUMPUR, MALAYSIA
TEL: +603 2781 4000 FAX: +603 2692 4094
E.MAIL: info@isra.my Website: www.isra.my

A Research Survey on the Shari'ah Board of the Malaysian Islamic Banking Industry

General Instructions and Information

1. Please answer the questions in each section by placing a tick in the appropriate box or by circling the appropriate number.
2. You can be assured that the details you provide will be treated in the STRICTEST OF CONFIDENCE. Any disclosure of results will be done in aggregate form and individual Islamic banks or organisations will not be identified.

Principal Researcher:
Ahmad Fahmi Sheikh Hassan
Lecturer in Accounting
Department of Accounting and Finance
Faculty of Economics and Management
University Putra Malaysia
sheikhhassanAF@cardiff.ac.uk

Under supervision of:
Dr Yusuf Karbhari
Cardiff Business School
Cardiff University
Wales, UK

Questionnaire to the Heads of Shari'ah Department (QS1):

Section A: The Role of the Shari'ah Committee (SC)

Please indicate the extent to which you agree or disagree with the following roles of the SC in banks offering Islamic banking services and the associated procedures used in performing these roles by placing a circle in the appropriate box based on the scale from 1 to 5 where:

1	2	3	4	5
Strongly Disagree (SD)	Disagree (D)	Uncertain (U)	Agree (A)	Strongly Agree (SA)

1. In my view, the procedures used by the SC are consistent with the following standards and guidelines:

Guidelines on the role of SCs	SD	D	U	A	SA
a) Governance standards issued by the AAOIFI	1	2	3	4	5
b) Prudential standards issued by the IFSB	1	2	3	4	5
c) Guidelines on the governance of the Shari'ah Committee for Islamic Financial Institutions issued by Bank Negara Malaysia (BNM/ GPS 1)	1	2	3	4	5

2. The role of the SC in your bank could be defined as including the following:

The Role and Scope of the SC	SD	D	U	A	SA
a) Advise the Board of Directors on Shari'ah matters	1	2	3	4	5
b) Assist other parties on Shari'ah matters[1]	1	2	3	4	5
c) Advise the Shari'ah Department officer on the scope of Shari'ah review required	1	2	3	4	5
d) Provide training to the Shari'ah Department officers to ensure effective Shari'ah review by the latter	1	2	3	4	5
e) Report to the Shari'ah Advisory Council of Bank Negara Malaysia on Shari'ah matters.	1	2	3	4	5
f) Prepare the Shari'ah compliance manual to be used in the Islamic bank	1	2	3	4	5
g) Endorse the Shari'ah compliance manual prepared by the management of the bank	1	2	3	4	5

[1] For example, having discussions with legal advisers and accountants when developing an Islamic bank's products and services or assisting external auditors during auditing periods

3. The SC in your bank is involved in advising and designing the following corporate objectives of the bank by incorporating Shari’ah values or ensuring its compatibility with the Islamic Shari’ah:

Corporate Objectives of Islamic Banks	SD	D	U	A	SA
a) The bank’s mission	1	2	3	4	5
b) The bank’s vision	1	2	3	4	5
c) The bank’s goals	1	2	3	4	5
d) The bank’s objectives	1	2	3	4	5
e) The bank’s corporate brand value	1	2	3	4	5
f) The bank’s long-term strategic direction	1	2	3	4	5

4. The SC in your bank is involved in the following stages of developing the Islamic banking products and services:

Development of Islamic Banking Products and Services	SD	D	U	A	SA
a) Conception level[2]	1	2	3	4	5
b) Design level[3]	1	2	3	4	5
c) Pricing level	1	2	3	4	5
d) Legal documentation level	1	2	3	4	5
e) Testing level[4]	1	2	3	4	5
f) Marketing level	1	2	3	4	5
g) Implementation level	1	2	3	4	5
h) Review level	1	2	3	4	5

5. The SC in your bank is involved in the following important accounting issues:

Accounting Issues of Banks	SD	D	U	A	SA
a) Determining the formula for profit distribution	1	2	3	4	5
b) Approve the calculation and distribution of *zakat*	1	2	3	4	5
c) Approve the accounting policy to be applied	1	2	3	4	5
d) Validating documentation used on Islamic financing contracts	1	2	3	4	5
e) Validating the Islamic banking transaction records	1	2	3	4	5
f) Issuing the Shari’ah compliance report of the bank	1	2	3	4	5
g) Endorsing the annual report prepared by the management of the bank	1	2	3	4	5

[2] For example, arriving at an agreement on the concept of the Islamic banking products or services based on the Shari’ah principles

[3] For example, designing the product or service to be launched to consumers based on initial agreement on its concepts

[4] For example, computer programming (or IT) testing and simulation of the Islamic banking products and services.

6. When performing its roles and duties, the SC in your bank receives assistance from the following relevant parties:

Relevant Parties who Assist SC	SD	D	U	A	SA
a) Shari'ah Department	1	2	3	4	5
b) Audit Committee	1	2	3	4	5
c) Internal auditor	1	2	3	4	5
d) External auditor	1	2	3	4	5
e) Board of Directors	1	2	3	4	5
f) The management	1	2	3	4	5
g) 'Shared services'[5]	1	2	3	4	5
h) Consultants	1	2	3	4	5

7. The SC in your bank undertakes the following commitments:

General Commitment	SD	D	U	A	SA
a) Publishing the SC's Shari'ah resolutions and rulings and the mechanics of Shari'ah compliance applied in the Islamic bank to the public	1	2	3	4	5
b) Actively engaging in innovation of the Islamic banking products and services through discussion with the management, accountants, lawyers and other concerned parties to fulfil the more demanding needs of consumers	1	2	3	4	5
c) Actively engaging in workshops and meetings of the *ulamma* of *fiqh almua'malat* to present and debate existing and new Shari'ah resolutions in order to promote consistency in Islamic banking products and services	1	2	3	4	5
d) Adequately analysing whether Islamic banking products and services would deliver benefit to the *ummah* before they are launched	1	2	3	4	5
e) Enhancing Shari'ah review skills by attending appropriate training for SC's continuous professional development.	1	2	3	4	5
f) Responding to any questions pertaining to pronouncements and resolutions issued by the SC through discussion with the shareholders or the public in a general assembly or similar forum	1	2	3	4	5

[5] For example, oversight committee such as auditors and support services such as accountants

Section B: Accountability and Independence of the Shari'ah Committee (SC)

Please indicate below the level of importance of the factors that influence the accountability and independence of the SC in banks offering Islamic banking services.

1. In my view, the accountability of the SC members is influenced by the following factors:

	Very Unimportant	Unimportant	Uncertain	Important	Very Important
a) The ethical values of the SC	1	2	3	4	5
b) The scholarly background of the SC	1	2	3	4	5
c) The reputation of the SC	1	2	3	4	5
d) Stakeholders' reliance on Shari'ah review of the SC	1	2	3	4	5
e) The requirement for the SC to ensure the Shari'ah compliance of the bank	1	2	3	4	5

2. In my view, the independence of the SC members is influenced by the following factor(s):

	Very Unimportant	Unimportant	Uncertain	Important	Very Important
a) A clearly defined scope of responsibilities	1	2	3	4	5
b) The remuneration received by the SC	1	2	3	4	5
c) The scholarly background of the SC	1	2	3	4	5
d) The perceived high ethical status of the SC	1	2	3	4	5
e) Adequate powers being mandated to the SC	1	2	3	4	5
f) Participation of top management in SC's meeting	1	2	3	4	5
g) Involvement of SC as Shari'ah committee in other industry	1	2	3	4	5

Please indicate below the level of importance concerning the parties to whom the SC members are accountable.

3. In my view, the SC members are accountable to the following parties:

	Very Unimportant	Unimportant	Uncertain	Important	Very Important
a) The bank's shareholders	1	2	3	4	5
b) The bank's consumers	1	2	3	4	5
c) The bank's Board of Directors	1	2	3	4	5
d) The public	1	2	3	4	5
e) Shari'ah Advisory Council of Bank Negara Malaysia	1	2	3	4	5

Please indicate the extent to which you agree or disagree with the following aspects of SC members' appointment and the SC's mandated authority in performing their Shari'ah review role in banks offering Islamic banking services by placing a circle in the appropriate box based on the scale from 1 to 5 where:

1	2	3	4	5
Strongly Disagree (SD)	Disagree (D)	Uncertain (U)	Agree (A)	Strongly Agree (SA)

4. The SC members in your bank possess the following appointment and Shari'ah review features:

Nature of SC Appointment and Mandated Authority	SD	D	U	A	SA
a) The appointment of SC members is made based on certain 'fit and proper' qualification criteria	1	2	3	4	5
b) There is no conflict of interest on the appointment of SC members[6]	1	2	3	4	5
c) The SC members are subject to certain assessment by the bank or the Bank Negara Malaysia	1	2	3	4	5
d) Adequate power has been mandated to the SC to perform its role	1	2	3	4	5
e) There is a reporting channel for SC members if any conflict arises between the SC members and the Board of Directors or the management of the bank	1	2	3	4	5
f) There is proper segregation of SC duties, as in giving endorsement to an Islamic banking product and the Shari'ah compliance review of the product	1	2	3	4	5

[6] Such as being substantial shareholders or having an intimate relationship with an employee of the bank it serves

Section C: The Nature of Shari’ah Review by the Shari’ah Committee (SC)

Please indicate the extent to which you agree or disagree with the following nature of the SC’s Shari’ah governance function by placing a circle in the appropriate box based on the scale from 1 to 5 where:

1	2	3	4	5
Strongly Disagree (SD)	Disagree (D)	Uncertain (U)	Agree (A)	Strongly Agree (SA)

1. The structure for Shari’ah review by the SC in your bank could be described as include the following features:

The Structure for Shari’ah Review by the SC	SD	D	U	A	SA
a) The SC is the sole authority on the Shari’ah review system within individual bank that offers Islamic banking services	1	2	3	4	5
b) The SC has been prescribed the appropriate operative procedures on its roles and functions by the bank	1	2	3	4	5
c) The membership of the SC comprises various experts such as Shari’ah scholars, accountants, lawyers, etc.	1	2	3	4	5
d) There are effective communication channels to deliberate Shari’ah review issues in banks offering Islamic banking services	1	2	3	4	5
e) Adequate and apparent guidelines on the pronouncements and resolutions of the Shari’ah Advisory Council of Bank Negara Malaysia has been issued for use in Islamic banking industry.	1	2	3	4	5

2. The implementation of Shari’ah review by the SC in your bank could be described as include the following features:

The Implementation of Shari’ah Review by the SC	SD	D	U	A	SA
a) The SC has the full authority to stop banks from undertaking non-Shari’ah compliant transactions	1	2	3	4	5
b) The SC has been given ample time in their decision making process and review function	1	2	3	4	5
c) The SC gets professional advice to support its functions such as on legal, accounting and finance aspects	1	2	3	4	5
d) The SC has direct access to relevant, accurate, adequate and timely information	1	2	3	4	5
e) The fact that SC members work part time in banks does not hinder effective Shari’ah review of the operation of banks offering Islamic banking services.	1	2	3	4	5
f) There has been active communication and consultation between the SC and the bank with the Shari’ah Advisory Council of Bank Negara Malaysia.	1	2	3	4	5

Section D: Demographic information about you.

Please tick (✓) where appropriate:

1. What is your gender?

☐ Male ☐ Female

2. Which of these age ranges do you fall into?

☐ 25-34 ☐ 35-44

☐ 45-54 ☐ 55-64

☐ 65 and above

3. How long have your been in the Islamic banking industry?

☐ 0-5 years ☐ 6-10 years

☐ 11-15 years ☐ 16 years and above

4. How long have your banking institution been offering Islamic banking products and services?

☐ 0-5 years ☐ 6-10 years

☐ 11-15 years ☐ 16 years and above

5. What is the highest level of education that you have achieved?

☐ High school diploma ☐ Bachelor's degree

☐ Master's degree ☐ PhD

☐ Professional certificate ☐ Other

6. Which aspect of training have you attained?

☐ Shari'ah ☐ *Fiqh almua'malat*

☐ Management ☐ Accounting and Finance

☐ Economics ☐ Law

☐ Others, please specify ....

7. Which other organisational bodies are you affiliated to?

☐ Bank Negara Malaysia ☐ AAOIFI

☐ IFSB ☐ Malaysian Accounting Standard Board

☐ None of the above

8. Is any of your Shari'ah Board Committee simultaneously a member of any other Islamic bank's Shari'ah Board Committee abroad?

☐ Yes ☐ No

GENERAL INFORMATION:

Islamic Bank's/Organisation's Name: ___________________________

Approximate numbers of internal Shari'ah audit/Shari'ah Department staff:______________

What is your job title and department?
Job title :
Department :

Would you be willing, if necessary, to grant an interview?

☐ Yes ☐ No

If the answer is Yes, please provide your name, contact number and address:

Name :
Contact Number :
Contact Address :
Email Address :

If there is anything else you want to add or comment that you think may help us to understand the Shari'ah governance in Malaysian banks that offer Islamic banking services, please include them in the spaces provided below:

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THANK YOU FOR YOUR COOPERATION

Questionnaire to the Banks' Branch Managers (QS2):

Section A: Perceptions on the Role of Shari'ah Committee (SC)

Please indicate the extent to which you agree or disagree with the following role of the SC in banks offering Islamic banking services and the associated procedures used in performing these roles by placing a circle in the appropriate box based on the scale from 1 to 5 where:

1	2	3	4	5
Strongly Disagree (SD)	Disagree (D)	Uncertain (U)	Agree (A)	Strongly Agree (SA)

1. In my view, the role of the SC should be defined as including the following:

The Role and Scope of the SC	SD	D	U	A	SA
a) Advise the Board of Directors on Shari'ah matters	1	2	3	4	5
b) Assist other parties on Shari'ah matters[1]	1	2	3	4	5
c) Advise the Shari'ah Department officer on the scope of Shari'ah review required	1	2	3	4	5
d) Provide training to the Shari'ah Department officer to ensure effective Shari'ah review by the latter	1	2	3	4	5
e) Report to the Shari'ah Advisory Council of Bank Negara Malaysia on Shari'ah matters.	1	2	3	4	5
f) Prepare the Shari'ah compliance manual to be used in the Islamic bank	1	2	3	4	5
g) Endorse the Shari'ah compliance manual prepared by the management of the bank	1	2	3	4	5

2. In my view, the SC should be involved in advising and designing the following corporate objectives of the bank by incorporating Shari'ah values or ensuring its compatibility with the Islamic Shari'ah:

Corporate Objectives of Islamic Banks	SD	D	U	A	SA
a) The bank's mission	1	2	3	4	5
b) The bank's vision	1	2	3	4	5
c) The bank's goals	1	2	3	4	5
d) The bank's objectives	1	2	3	4	5
e) The bank's corporate brand value	1	2	3	4	5
f) The bank's long-term strategic direction	1	2	3	4	5

[1] For example, having discussions with legal advisers and accountants when developing an Islamic banking products and services or assisting external auditors during auditing periods

3. In my view, the SC should be involved in the following stages of developing Islamic banking products and services:

Development of Islamic Banking Products and Services	SD	D	U	A	SA
a) Conception level[2]	1	2	3	4	5
b) Design level[3]	1	2	3	4	5
c) Pricing Level	1	2	3	4	5
d) Legal Documentation level	1	2	3	4	5
e) Testing level[4]	1	2	3	4	5
f) Marketing level	1	2	3	4	5
g) Implementation level	1	2	3	4	5
h) Review level	1	2	3	4	5

4 In my view, the SC should be involved in the following important accounting issues:

Accounting Issues of Banks	SD	D	U	A	SA
a) Determining the formula for profit distribution	1	2	3	4	5
b) Approving calculation and distribution of *zakat* by Islamic banks	1	2	3	4	5
c) Approve the accounting policy to be applied	1	2	3	4	5
d) Validating documentation on Islamic financing contracts	1	2	3	4	5
e) Validating the Islamic banking transaction records	1	2	3	4	5
f) Issuing the Shari'ah compliance report of the Islamic bank	1	2	3	4	5
g) Endorsing the annual report prepared by the management	1	2	3	4	5

[2] For example, arriving at an agreement on the concept of the Islamic banking products or services based on the Shari'ah principles.
[3] For example, designing the product or service to be launched to consumers based on initial agreement on its concepts.
[4] For example, computer programming (or IT) testing and simulation of the Islamic banking products and services.

5. In my view, the SC receives assistance from the following relevant parties when performing its roles and duties:

Relevant Parties who Assist SC	SD	D	U	A	SA
a) Shari'ah Department	1	2	3	4	5
b) Audit Committee	1	2	3	4	5
c) Internal auditor	1	2	3	4	5
d) External auditor	1	2	3	4	5
e) Board of Directors	1	2	3	4	5
f) The management	1	2	3	4	5
g) 'Shared services'[5]	1	2	3	4	5
h) Consultants	1	2	3	4	5

6. In my view, the SC should undertake the following commitments:

General Commitment	SD	D	U	A	SA
a) Publishing the SC's Shari'ah resolutions and rulings as well as the mechanics of Shari'ah compliance applied in the Islamic bank to the public	1	2	3	4	5
b) Actively engaging in innovation of the Islamic banking products and services to fulfil the more demanding needs of consumers	1	2	3	4	5
c) Actively engaging in meetings of the *ulamma* of *fiqh almua'malat* to promote consistency in Islamic banking products and services	1	2	3	4	5
d) Adequately analysing whether Islamic banking products and services would deliver benefit to the *ummah* before they are launched	1	2	3	4	5
e) Enhancing Shari'ah review skills by attending appropriate training for SC's continuous professional development.	1	2	3	4	5
f) Responding to questions pertaining to pronouncements and resolutions issued by the SC through discussion with the shareholders or the public	1	2	3	4	5

[5] For example, oversight committee such as auditors and support services such as accountants

Section B: Accountability and Independence of the Shari'ah Committee (SC)

Please indicate below the level of importance of the factors that influence the independence and accountability of the SC in banks offering Islamic banking services.

1. In my view, the accountability of the SC members is influenced by the following factors:

	Very Unimportant	Unimportant	Uncertain	Important	Very Important
a) The ethical values of the SC	1	2	3	4	5
b) The scholarly background of the SC	1	2	3	4	5
c) The reputation of the SC	1	2	3	4	5
d) Stakeholders' reliance on the Shari'ah review of the SC	1	2	3	4	5
e) The requirement for the SC to ensure the Shari'ah compliance of the bank	1	2	3	4	5

2 In my view, the independence of the SC members is influenced by the following factor(s):

	Very Unimportant	Unimportant	Uncertain	Important	Very Important
a) A clearly defined scope of responsibilities	1	2	3	4	5
b) The remuneration received by the SC	1	2	3	4	5
c) The scholarly background of the SC	1	2	3	4	5
d) The perceived high ethical status of the SC	1	2	3	4	5
e) Adequate powers being mandated to the SC	1	2	3	4	5
f) Participation of top management in SC's meeting	1	2	3	4	5
g) Involvement of SC as Shari'ah committee in other industry	1	2	3	4	5

Please indicate below the level of importance of the parties to whom the SC members are accountable.

3. In my view, the SC members should be accountable to the following parties:

	Very Unimportant	Unimportant	Uncertain	Important	Very Important
a) The bank's shareholders	1	2	3	4	5
b) The bank's consumers	1	2	3	4	5
c) The bank's Board of Directors	1	2	3	4	5
d) The public	1	2	3	4	5
e) Shari'ah Advisory Council of Bank Negara Malaysia	1	2	3	4	5

Please indicate the extent to which you agree or disagree with the following aspects of SC members' appointment and the SC's mandated authority in performing their Shari'ah review role in Islamic banks by placing a circle in the appropriate box based on the scale from 1 to 5 where:

1	2	3	4	5
Strongly Disagree (SD)	Disagree (D)	Uncertain (U)	Agree (A)	Strongly Agree (SA)

4. In my view, the SC members should possess the following appointment and Shari'ah review features:

Nature of SC Appointment and Mandated Authority	SD	D	U	A	SA
a) The appointment of SC members is made based on certain 'fit and proper' qualification criteria	1	2	3	4	5
b) There is no conflict of interest on the appointment of SC members[6]	1	2	3	4	5
c) The SC members are subject to certain assessment by the bank or the Bank Negara Malaysia	1	2	3	4	5
d) Adequate power has been mandated to the SC to perform its role	1	2	3	4	5
e) There is a reporting channel for SC members if any conflict arises between the SC members and the Board of Directors or management of the bank	1	2	3	4	5
f) There is proper segregation of SC duties, as in giving endorsement to an Islamic banking product and the Shari'ah compliance review of the product	1	2	3	4	5

[6] Such as being substantial shareholders or having an intimate relationship with an employee of an Islamic bank it serves

Section C: Perceptions of the Nature of Shari'ah Review in Banks Offering Islamic Banking Services

Please indicate the extent to which you agree or disagree with the following aspects of Shari'ah review by placing a circle in the appropriate box based on the scale from 1 to 5 where:

1	2	3	4	5
Strongly Disagree (SD)	Disagree (D)	Uncertain (U)	Agree (A)	Strongly Agree (SA)

1. In my view, the structure of Shari'ah review mechanism of banks offering Islamic banking services in Malaysia demonstrates the following features:

The Structure of Shari'ah Review Mechanism	SD	D	U	A	SA
a) The SC should be the sole authority on the Shari'ah review within individual bank that offers Islamic banking services	1	2	3	4	5
b) Adequate and apparent guidelines on the pronouncements and resolutions of the Shari'ah Advisory Council of Bank Negara Malaysia should be issued for use in Islamic banking industry	1	2	3	4	5
c) The Shari'ah reference role of the Shari'ah Advisory Council of Bank Negara Malaysia enhances the standardization of Islamic banking practices	1	2	3	4	5
d) The two layers of the Shari'ah governance system implemented in Malaysia are effective in ensuring the stability of the Islamic banking industry	1	2	3	4	5
e) The two layers of the Shari'ah governance system are capable of harmonising Islamic banking practices in Malaysia and across national boundaries	1	2	3	4	5

2. In my view, the implementation of Shari'ah review mechanism of banks offering Islamic banking services in Malaysia demonstrates the following features:

The Implementation of Shari'ah Review Mechanism	SD	D	U	A	SA
a) The SC should have the authority to stop banks from undertaking non-Shari'ah compliant transactions	1	2	3	4	5
b) The Shari'ah Advisory Council of Bank Negara Malaysia should adopt rigorous procedures to examine and endorse the application of Islamic financial products submitted by banks offering Islamic banking services	1	2	3	4	5
c) The fact that SC members work part time in banks does not hinder effective Shari'ah review of the operation of banks offering Islamic banking services.	1	2	3	4	5
d) The Shari'ah compliance of the banks is adequately reflected in the Shari'ah report issued by the SC	1	2	3	4	5
e) The Shari'ah report by the SC satisfactorily disclose accounting issues of banks offering Islamic banking services	1	2	3	4	5

Please rank the degree of importance you attach to the following parties in the Shari'ah governance of banks offering Islamic banking services, where 1 is very unimportant and 5 is very important.

3. How do you regard the importance of the following parties in the Shari'ah governance of banks offering Islamic banking services?

Parties involve in the Shari'ah Governance of Banking Institutions	**Please rank (1-5) in order of importance**				
a) Shari'ah Advisory Council of Bank Negara Malaysia	1	2	3	4	5
b) Shari'ah Committee of the bank	1	2	3	4	5
c) Shari'ah Department of the bank	1	2	3	4	5
d) Board of Directors of the bank	1	2	3	4	5
e) Management of the bank	1	2	3	4	5

Section D: Demographic information about you.

Please tick (✓) where appropriate:

1. What is your gender?

☐ Male ☐ Female

2. Which of these age ranges do you fall into?

☐ 25-34 ☐ 35-44
☐ 45-54 ☐ 55-64
☐ 65 and above

3. What is the highest level of education that you have achieved?

☐ High school diploma ☐ Bachelor's degree
☐ Master's degree ☐ PhD
☐ Professional certificate

4. Which aspects of training have you attained?

☐ Shari'ah ☐ *Fiqh almua'malat*
☐ Management ☐ Accounting and Finance
☐ Economics ☐ Law
☐ Others, please specify _______________

5. How long have you been the depositor or customer of this bank?

☐ Less than 1 year ☐ 1 to 2 years
☐ 3 to 4 years ☐ 5 years and above

GENERAL INFORMATION:

Islamic Bank's/Organisation's Name: ___________________________

Approximate number of internal Shari'ah audit/Shari'ah Department staff:_______________

What is your job title and department?

Job title :

Department :

Would you be willing, if necessary, to grant an interview?

☐ Yes ☐ No

If the answer is Yes, please provide your name, contact number and address:

Name :
Contact Number :
Contact Address :
Email Address :

If there is anything else you want to add or comment that you think may help us to understand the Shari'ah governance in Malaysian banks that offer Islamic banking services, please include them in the spaces provided below:

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THANK YOU FOR YOUR COOPERATION

Appendix 2

A Study on the Shari'ah Governance Function of the Shari'ah Committee in the Malaysian Islamic Banking Industry

Interview Memoirs

Introduction
Thanks for time
Mention nature and relevance of research
Assure interviewee of absolute confidentiality

Background Information
Organisation name:
Name of participant: Position:
No. of years in the organisation:

Interview Questions to the Shari'ah Committee members:-

1. How many Shari'ah Committee members are there in your bank/Islamic bank?
2. What are the criteria and mechanism on the appointment of the Shari'ah Committee in your bank/Islamic Bank?
3. What is the current role of the Shari'ah Committee in your bank/Islamic bank?
4. How does the Shari'ah Committee preserve its integrity and independence whilst performing the Shari'ah supervision function in your bank/Islamic bank?
5. What are the Shari'ah governance mechanisms in your bank/Islamic bank?
6. What are the guidelines used for Shari'ah governance mechanisms in your bank/Islamic bank?
7. How does the Shari'ah Committee interact with other parties within your bank/Islamic bank?
8. How does the Shari'ah Committee seek balance between the profit maximization motive of the management to the bank/Islamic banks and Shari'ah compliance?
9. How does the Shari'ah Committee resolve possible conflict with the Board of Directors or the management of your bank/Islamic bank?
10. What are the mechanisms of Shari'ah compliance review in your bank/Islamic bank?
11. How does the Shari'ah Committee of your bank/Islamic bank interact with the Shari'ah Advisory Council?
12. What are the reporting process of Shari'ah Committee of your bank/Islamic bank?

Interview Questions to the Shari'ah Department Officers:-

1. How many Shari'ah Officers and Shari'ah Committee members are there in your bank/Islamic bank?

2. What are the criteria and mechanism on the appointment of the Shari'ah Committee Members in your bank/Islamic Bank?
3. What is the current role of the Shari'ah Committee in your bank/Islamic bank?
4. What are the Shari'ah governance mechanisms in your bank/Islamic bank?
5. What are the guidelines used for Shari'ah governance mechanisms in your bank/Islamic bank?
6. How does the Shari'ah Committee member interact with other parties within your bank/Islamic bank?
7. How does the Shari'ah Committee resolve possible conflict with the board of directors or the management of your bank/Islamic bank?
8. What are the mechanisms of Shari'ah compliance review in your bank/Islamic bank?
9. How does the Shari'ah Committee of your bank/Islamic bank interact with the Shari'ah Advisory Council?
10. What is the reporting process of Shari'ah Committee of your bank/Islamic bank?

Interview Questions to the CEO of Islamic Banks:-

1. How important is the role of Shari'ah Committee members to Islamic Bank?

2. How do you perceive about the dynamism of Islamic banks and the importance of the Shari'ah governance mechanism in Islamic banking operation?
3. What are the criteria and mechanism on the appointment of Shari'ah Committee members in Islamic Bank? Is there any preference on the criteria of a person to become a Shari'ah Committee member of your Islamic bank?
4. What is the current role of Shari'ah Committee members to Islamic Bank?
5. How is the Shari'ah Committee members associated with Islamic Bank's customers and depositors?
6. How is the management involved in the Shari'ah governance of Islamic Bank?
7. How will the recent Prudential Shari'ah Governance Framework announced by Bank Negara Malaysia influence Islamic Bank?
8. How crucial is the Shari'ah non-compliance risk to Islamic Bank?

Interview Questions to the Bank Negara Malaysia Officers

1. When was the Shari'ah secretariat of the Jabatan Perbankan Islam dan Takaful, Bank Negara Malaysia been established?
2. What is the motive of the establishment of the Shari'ah secretariat of the Jabatan Perbankan Islam dan Takaful, Bank Negara Malaysia?
3. How many staffs are there in the Shari'ah secretariat of the Jabatan Perbankan Islam dan Takaful, Bank Negara Malaysia?
4. What is the qualification background of the Shari'ah secretariat staffs from the Jabatan Perbankan Islam dan Takaful, Bank Negara Malaysia?
5. How does the Shari'ah secretariat of the Jabatan Perbankan Islam dan Takaful, Bank Negara Malaysia associated with the Shari'ah Advisory Council of Bank Negara Malaysia?
6. How does the Shari'ah secretariat of the Jabatan Perbankan Islam dan Takaful, Bank Negara Malaysia associated with the banks offering Islamic banking services in Malaysia?
7. What is the relationship between the Shari'ah secretariat with other parties within the Jabatan Perbankan Islam dan Takaful, Bank Negara Malaysia?
8. How is the role of the Shari'ah Advisory Council of Bank Negara Malaysia significant to the regulators?
9. How does the dual-layer Shari'ah governance of Islamic banks as practice in Malaysia help to promote stability and coherent in the Islamic banking industry?
10. What are the role of the regulators in harmonizing the Islamic banking practice between Islamic banks in Malaysia and other countries?
11. What are the channel of communication between the regulator and Islamic banks?
12. What are the mechanisms taken to mitigate the Shari'ah non-compliance risk arising from Islamic banks' operation?
13. How crucial is Shari'ah non-compliance risk of Islamic banks?
14. How important is the Shari'ah Advisory Council and Shari'ah Committee to be regulated?
15. How do the standards and guidelines promulgated by AAOIFI and IFSB influence the Shari'ah governance of Islamic banks in Malaysia?
16. What are the mechanisms taken to enhance the transparency and disclosure amongst Islamic banks in Malaysia?

17. What is the general evaluation on the implementation of Shari'ah governance framework amongst the banks that offer Islamic banking services in Malaysia?
18. What is the general evaluation on the function of Shari'ah Committee members of banks that offer Islamic banking services in Malaysia?

Interview Questions to the Shari'ah Advisory Council of Bank Negara Malaysia

1. What is the current role of the Shari'ah Advisory Council of Bank Negara Malaysia?
2. What is the mechanism for the Shari'ah Advisory Council to come out with a Shari'ah resolution?
3. How do the standards and guidelines promulgated by AAOIFI and IFSB influence the Shari'ah governance of banks offering Islamic banking services in Malaysia?
4. How does the Shari'ah Advisory Council interact with banks offering Islamic banking services in Malaysia?
5. How does the Shari'ah Advisory Council interact with the regulators on Shari'ah governance issue of Islamic banks?
6. What is your opinion on the present function of the Shari'ah Committee members of banks offering Islamic banking services?
7. What is your opinion on the present dual-layer Shari'ah governance system for the Islamic banking industry as practice in Malaysia?
8. What are the challenges facing the Shari'ah Advisory Council members?
9. How does the new Central Bank Act of Malaysia 2009 influence the Shari'ah governance practice of the Islamic financial institutions?
10. How does the role of the Shari'ah Advisory Council promote to the growth and prospects of the Islamic banking industry in Malaysia?