Ensuring Shariah Compliance in Islamic Financial Institutions as an Essential Interest of Shareholders

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Abstract

Islamic financial institutions are committed to conduct their business in compliance with the rules of Islamic Shariah. In order to ensure their Shariah compliance and win the trust of their shareholders and other stakeholders they usually implement a special type of corporate governance called ‘Shariah corporate governance’. The key feature of this governance policy is the appointment of a Shariah supervisory board in the internal structure of the institution. IFIs around the world operate under three main regulatory and supervisory systems of Shariah corporate governance. Some countries apply a centralised system, while others implement a decentralised system, yet others completely lack this regulation and supervision.

Nevertheless, with all the measures taken by the IFIs and jurisdictions, Shariah corporate governance still encounters some problems that might jeopardise its effectiveness in achieving its objective of ensuring proper Shariah compliance in IFIs. Therefore, this thesis argues that shareholders of IFIs – as the third main pillar of corporate governance alongside the institution and the authority – need to play their role as stewards and actively engage with their investee IFIs. It is believed that Shariah compliance is an important interest to these shareholders, and therefore they are expected to defend this interest.

It is essential that shareholders of IFIs are equipped with specific rights in Shariah corporate governance especially toward the SSB and the IFI’s Shariah compliance in order to engage more with their institutions. Also, their activism needs to be encouraged and guided with some regulatory rules. In this context it is important for shareholders, especially institutional shareholders, to utilise their power and use all possible means to ensure the delivery of a proper Islamic business by the institutions they invest with. There is no doubt that shareholders might face some obstacles to their activism, however this should not stop them from practising their stewardship role.
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<td>AAOIFI</td>
<td>Accounting and Auditing Organization for Islamic Financial Institutions</td>
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<td>AGM</td>
<td>Annual General Meeting</td>
</tr>
<tr>
<td>AoA</td>
<td>Articles of Association</td>
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<td>AUB</td>
<td>Ahli United Bank</td>
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<tr>
<td>BAFIA</td>
<td>Banking and Financial Institutions Act (Malaysia)</td>
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<tr>
<td>BBA</td>
<td>British Bankers Association</td>
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<tr>
<td>BCBS</td>
<td>Basel Committee on Banking Supervision</td>
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<td>BLME</td>
<td>Bank of London and the Middle East</td>
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<td>BoE</td>
<td>Bank of England</td>
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<tr>
<td>BoD</td>
<td>Board of Directors</td>
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<td>BNM</td>
<td>Bank Negara Malaysia</td>
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<td>CBK</td>
<td>Central Bank of Kuwait</td>
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<td>CII</td>
<td>Council of Institutional Investors (US)</td>
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<td>CSB</td>
<td>Central Shariah Board</td>
</tr>
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<td>CSR</td>
<td>Corporate Social Responsibility</td>
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<td>CPIFR</td>
<td>Core Principles for Islamic Finance Regulation</td>
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<td>ESG</td>
<td>Environmental, social and governance factors</td>
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<td>FCA</td>
<td>Financial Conduct Authority (UK)</td>
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<td>FRC</td>
<td>Financial Reporting Council (UK)</td>
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<tr>
<td>FSA</td>
<td>Financial Services Authority (UK)</td>
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<td>KFH</td>
<td>Kuwait Finance House</td>
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<td>MCII</td>
<td>Malaysian Code for Institutional Investors</td>
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<td>Acronym</td>
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<td>MSWG</td>
<td>Minority Shareholder Watchdog Group (Malaysia)</td>
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<td>OECD</td>
<td>Organisation for Economic Co-operation and Development</td>
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<td>PBUH</td>
<td>Peace be upon him</td>
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<td>PLS</td>
<td>Profit and loss sharing</td>
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<td>SAC</td>
<td>Shariah Advisory Council (Malaysia)</td>
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<tr>
<td>SCG</td>
<td>Shariah Corporate Governance</td>
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<tr>
<td>SSB</td>
<td>Shariah Supervisory Board</td>
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<tr>
<td>UKCGC</td>
<td>UK Corporate Governance Code</td>
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<tr>
<td>UKSC</td>
<td>UK Stewardship Code</td>
</tr>
</tbody>
</table>
List of Arabic Terms

Adl Just
Fiqh Islamic jurisprudence - the human attempt to understand divine law (Shariah).
Al-Hisbah An Islamic institution that used to regulate the markets in Islamic countries
Allah Almighty God
Al-mu’allafati Non-Muslims whose hearts are to be softened or reconciled
Qolbohom with Islam
Fatwa Shariah ruling
Fiqh Al- Islamic commercial jurisprudence
Muamalat
Ghalat Mistake
Gharar Speculation or uncertainty
Ghubn Inequality
Halal Permissible/ in compliant with Shariah rules.
Haram Prohibited
Hijab Headscarf
Ijarah Leasing
Ijmaa Consensus
Ijtihad Human intellectual effort or diligence
Ikhtilaf Divergence or lack of agreement
Ikrah Duress
Khilafah Vicegerency/trusteeship
Madh’hab Doctrine
Makruh Disliked/ hateful
Maqasid Al- The objectives of Shariah
Shariah
Maslahah Public interest
Maysir Gambling
Mudarabah Passive partnership
Mufti Shariah scholar who is eligible to provide Shariah rulings
<table>
<thead>
<tr>
<th>Term</th>
<th>Description</th>
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<tr>
<td>Mukallaf</td>
<td>Responsible</td>
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<tr>
<td>Murabahah</td>
<td>Sales contract at a profit mark-up/passive partnership</td>
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<tr>
<td>Musharakah</td>
<td>Active partnership</td>
</tr>
<tr>
<td>Mustafati</td>
<td>The person who seeks the <em>fatwa</em></td>
</tr>
<tr>
<td>Qiyas</td>
<td>Analogic reasoning</td>
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<tr>
<td>Quran</td>
<td>The book of Islamic revelation; scripture</td>
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<tr>
<td>Rahn</td>
<td>Pledge agreement</td>
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<tr>
<td>Riba</td>
<td>Usury</td>
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<tr>
<td>Sadaqah</td>
<td>Charity</td>
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<td>Shurah</td>
<td>Consultation</td>
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<td>Sukuk</td>
<td>Asset-backed Bonds</td>
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<td>Sunnah</td>
<td>Acts and sayings of Prophet Mohammed</td>
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<td>Taghrir</td>
<td>Deception</td>
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<td>Takaful</td>
<td>Mutual</td>
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<td>Tawhid</td>
<td>Oneness of God</td>
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<td>Tawwaruq</td>
<td>Subtitle asset backing a loan</td>
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<tr>
<td>Urf</td>
<td>Custom</td>
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<tr>
<td>Usul Al-Fiqh</td>
<td>The roots of Islamic jurisprudence</td>
</tr>
<tr>
<td>Wakalah</td>
<td>Fiduciary relationship</td>
</tr>
<tr>
<td>Zakat</td>
<td>Required almsgiving that is one of the five pillars of Islam</td>
</tr>
<tr>
<td>Zakat oroudh al-tijarah</td>
<td>Almsgiving required to pay on business money</td>
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Mission Capital plc v Sinclair and another [2008] EWHC 1339 (Ch)
Franbar Holdings Ltd v Patel and Others [2008] EWHC 1534 (Ch)
Flanagan v Liontrust Investment Partners LLP [2015] EWHC 2171 (Ch)
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Welton v. Saffery [1897] A.C. 299
Russell v Northern Bank Development Corp Ltd [1992] 1 W.L.R. 588 HL
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Bahrain Corporate Governance Code 2018

**Germany**
German Corporate Governance Code 2017

**Sudan**
Sudan Constitution 2005

**Japan**
Japan’s Corporate Governance Code 2018

**Saudi Arabia**
Basic Law of Governance 1992

**EU**
Regulation (EC) No 593/2008 of the European Parliament and the Council of 17 June 2008 on the law applicable to contractual obligations (Rome I)

**Conventions**

Chapter One: Introduction to Thesis

1.1 Statement of the problem:

Islamic financial institutions (IFIs), such as Islamic banks, *takaful* (mutual) insurance companies and Islamic investment companies, have a similar purpose to conventional financial institutions except that they work in compliance with Islamic Shariah rules in all their activities. Shariah imposes some restrictions and prohibitions on business transactions, for example, a prohibition on *maisir* (gambling), *gharar* (speculation or uncertainty), and the most influential one for banks, the prohibition on collecting interest which is considered as *riba* (usury) in Shariah. The key principle of Islamic banking is profit sharing and loss bearing with the fund suppliers. All these prohibitions and others have excluded Islamic banking from the conventional banking system. Alternative banking contracts, transactions and products have been put in place to conform with Islamic Shariah rules. Among these products and transactions are *Mudarabah* (passive partnership), *Musharakah* (active partnership), *Murabahah* (sales contract at a profit mark-up), *Ijarah* (leasing), *Tawwaruq* (subtitle asset backing a loan) and *Sukuk* (asset-backed bonds).

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1 Shahzad Qadri, ‘Islamic Banking’ (2008) 17 Business Law Today 59
2 Interest is defined as ‘any excess of money paid by the borrower to the lender over and above the principal amount for the use of the lender’s liquid money over a certain period of time’. Imtiaz Pervez, ‘Islamic Finance’ (1990) 5 Arab Law Quarterly 259, 263
5 Nasser Suleiman, ‘Corporate Governance in Islamic Banks’ (2000) 22 Society and Economy in Central and Eastern Europe 98
6 The substantives details of Islamic transactions and products are beyond the scope of this thesis and therefore will not be addressed. For more, please see Munawar Iqbal, ‘Development, History and Prospects of Islamic Banking’ in Mohamed Ariff and Munawar Iqbal (eds), *The Foundations of Islamic Banking* (Edward Elger 2011) 68; Awais Anwar, ‘Emerging markets: the importance of Islamic finance to the UK economy’ [2014] Journal of International Banking Law and Regulation 360
Shariah compliance is the most distinctive feature of IFIs. They endeavour to highlight the quality and solidity of their Shariah compliance in order to prove their credibility and win the trust of shareholders, customers and the public. Failure to achieve an appropriate level of Shariah compliance would affect the trust of those stakeholders who might then be discouraged from dealing with them, which is detrimental to their growth and development. Ensuring proper Shariah compliance is not just important to the IFIs, but also to the jurisdiction within which they operate. Financial institutions, including Islamic ones, play a pivotal role in a modern economy. They provide a number of essential services and functions for both private and public sectors in the country, and in the process they have an impact on the country’s wider economy. Hence, national authorities usually subject financial institutions to strict regulations and supervision so as to eliminate any obstacle that might jeopardise their stability. Therefore, ensuring proper Shariah compliance in IFIs is believed to be just as important to national authorities as much as it is important to these institutions themselves.

Shariah compliance is also of great interest to shareholders of the IFIs. It is acknowledged that many investors buy into companies for the purpose of maximising their shares’ value. However, a number of investors still have other non-economic interests that are equally important to them, for example the shareholders’ interest in an institution’s social, environmental, educational and religious responsibilities and corporate governance practices. In this context, it is envisaged that investors, or at least a number of them, join an IFI not for the sole purpose of getting a return on their investment but also to get it in a Shariah compliant way. In this regard, Shariah compliance is seen as an important factor for their investment and they need to be assured of its efficiency and maintenance throughout the time of their shareholding.

But how can Shariah compliance in IFIs be achieved and ensured? It is agreed among writers, policy makers and legislators that the answer is through the

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implementation of Shariah Corporate Governance (SCG).\textsuperscript{10} SCG is a special type of corporate governance that aligns with the IFIs’ special characteristics and the nature of their business.\textsuperscript{11} It can be seen that IFIs are keen to implement this policy whether in adherence to a legal obligation or through individual commitment. The main distinctive features of this policy are the appointment of a Shariah Supervisory Board (SSB) in the institution’s internal structure and the management of Shariah non-compliance risks.\textsuperscript{12}

However, although implementing a SCG system is meant to ensure the institution’s Shariah compliance, a number of problems are still seen in this system that might dilute its effectiveness. Some of these flaws are inherent in the governance of the SSB, such as the lack of enforceability of SSB opinions, conflicts of interest, divergence between Shariah rulings, and the remuneration and multiple memberships of the SSB members. These problems are seen to affect the SSB members’ independence, objectivity, confidentiality and productivity and, by extension, their competence to supervise the IFI’s Shariah compliance. Other problems are related to the governance of the IFI’s Shariah financial obligations, namely, the IFI’s obligation to pay zakat (almsgiving) and its obligation to purify Shariah non-compliant income. These problems also affect the efficiency of the SCG system and, overall, the quality of the IFI’s Shariah compliance.\textsuperscript{13} This highlights the importance of monitoring the implementation of SCG in order to ensure its effectiveness and robustness to achieve Shariah compliance in IFIs. This supervision is usually conducted by the national financial supervisor in the country – whether the central bank or any other body – as part of its duty to supervise financial institutions, which usually referred to as ‘prudential supervision’.

Prudential supervision is an important aspect of corporate governance regulation.\textsuperscript{14} Due to the special nature of SCG and its aim in achieving Shariah


\textsuperscript{11} Nasser Suleiman, ‘Corporate Governance in Islamic Banks’ (2000) 22 Society and Economy in Central and Eastern Europe 98, 99

\textsuperscript{12} SCG and its main features are addressed in detail later in this chapter and in Chapter Two.

\textsuperscript{13} Problems of SCG are addressed in detail in Chapter Two.

compliance in IFIs, it requires a special national supervision that focuses on the efficiency of Shariah compliance in IFIs, which is distinct from conventional prudential supervision. Imposing this type of national supervision helps to protect the credibility of Islamic finance as a whole and the interest of IFIs’ shareholders. However, national Shariah supervision is not implemented in all jurisdictions hosting IFIs. Even in jurisdictions where this supervision is applied, it comes with different levels of effectiveness. In this context, there are three main systems for SCG regulation and national supervision: centralised, decentralised, and self-regulated. The effectiveness of these systems varies in terms of ensuring Shariah compliance in IFIs due to big differences in the national regulation and supervision of SCG between the countries concerned. Hence, this adds another challenge for SCG to ensure Shariah compliance in IFIs.

SCG, its supervisory models and problems have been identified and discussed in a number of publications and solutions have been presented to address such problems, mainly through strengthening legislation and national supervision. This

15 SCG regulatory and supervisory models and their effectiveness in ensuring Shariah compliance in IFIs are addressed in detail in Chapter Three.


might help in avoiding some of the problems of SCG but not entirely eliminate them, especially when the system itself is flawed. The problems therefore remain unsolved, highlighting the need for another supporting solution. This need for a solution to the

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There are also four PhD theses that address SCG as the mechanism used by IFIs to ensure their Shariah compliance and the problems related to this system. See Anwar Al-Sadah, ‘Corporate Governance of Islamic Banks, Its Characteristics and Effects on Stakeholders and the Role of Islamic Banks Supervisors’ (PhD Thesis, Surrey University 2007); Hasan Zulkifli, ‘Shariah Governance in Islamic Financial Institutions in Malaysia, GCC Countries and the UK’ (PhD Thesis, Durham University 2011); Ahmad Hassan, ‘An Empirical Investigation into the Role, Independence and Effectiveness of Shariah Boards in the Malaysian Islamic Banking Industry’ (PhD Thesis, Cardiff University 2012); Ghalib Albulooshi, ‘Sharia Assurance in Islamic Financial and Banking Industry’ (PhD thesis, Bristol University 2015).
problems of SCG provides the rationale for this thesis. In this regard, the thesis argues that shareholders, as the third main pillar of corporate governance alongside the institution and the authority, need to play an active role and engage with their investee IFIs in order to enhance the practices of SCG, which will result in achieving a better level of Shariah compliance in such institutions in return.

Shareholders in an IFI, as owners, have a responsibility to observe Shariah compliance in IFIs. However, it is impractical to expect all shareholders to engage at the same level in developing SCG and supervising its implementation in their institution. Some are more effective than others in this process. In this context, the thesis argues that institutional and large shareholders of IFIs are the most effective shareholders that can make a difference and enhance SCG. This is for three main reasons: (a) their ability to effect change in SCG due to their large ownership; (b) their interest in Shariah compliance that is seen in the factors behind investing in IFIs; and (c) their rights in SCG which provide the tools for their activism. Moreover, having a stewardship code is also important to encourage and guide shareholders through their activism. Once all the aforementioned factors exist, shareholders interested in Shariah compliance (Shariah shareholders) are expected to engage actively with their investee IFIs, aiming to enhance their SCG policy using some quiet, formal and collective methods. There is no doubt that Shariah shareholders will face some obstacles in the path of their activism, however this should not stop them from practising their role as stewards.

1.2 Research questions:

The principal aim of this thesis is to provide means for shareholders’ protection with regard to their right of adequate Shariah compliance in IFIs. This protection should be assured by the collective work of the IFI, the national supervisor and shareholders. In this regard, the thesis attempts to give evidence that shareholders’ involvement is an essential element in achieving the objectives of SCG, alongside the internal supervision performed by the SSB and the external supervision performed by the national supervisor. Therefore, the research question, which reflects these issues,

17 Siti Obid and Babak Naysary, ‘Toward a Comprehensive Theoretical Framework for Shariah Governance in Islamic Financial Institutions’ in Tina Harrison and Esam Ibrahim (eds), Islamic Finance (Palgrave Macmillan 2016) 17
18 Shareholders of IFIs, their interest in Shariah compliance and rights in SCG are addressed in detail in Chapter Four.
19 Shareholders’ methods of engagement are addressed in detail in Chapter Five.
is as follows: to what extent can shareholders’ active involvement be effective in enhancing SCG practices in IFIs? The research question is then divided into a number of component questions, all of which will be covered as part of this thesis. The questions are:

1- What are the problems of SCG that challenge its effectiveness and from where do these problems originate?
2- How far is SCG regulated and supervised in practice and how effective is this supervision in helping IFIs to achieve their objective of full Shariah compliance?
3- How far does engagement of shareholders form a potential solution to reduce the current problems of SCG?
4- To what extent can shareholders be active and improve SCG in Islamic finance in practice?

1.3 Research scope:

The general fields of this thesis are Islamic finance, banking law, comparative corporate governance and company law; more specifically, the study analyses the standards of SCG and their practices in IFIs as well as the regulatory and supervisory systems of SCG in some selected leading jurisdictions in Islamic finance, namely: Malaysia, Kuwait and the UK. Bear in mind that compliance with Shariah rules is the most important purpose of these institutions. This thesis’s scope is therefore bounded by four main limits:

1.3.1 The relevant entity:

The study focuses on IFIs (mainly Islamic banks) and excludes the other types of companies that operate in compliance with Shariah rules. This is due to the important role these institutions play in the Islamic economy and their effect on the global economy at large. Banks are the most significant of these institutions, but the term includes insurance companies, mutual funds, investment companies and others.20

20 Samy Garas, ‘The Control of the Shari’a Supervisory Board in the Islamic Financial Institutions’ (2012) 5 International Journal of Islamic and Middle Eastern Finance and Management 8. It is worth mentioning that IFIs are different from religious corporations as the latter are non-profit entities and are established for religious purposes only. In some countries such as the US and the UK religious corporations have their own acts, specific internal structure and courts. Zoe Robinson, ‘What is a Religious Institution?’ (2014) 55 Boston College Law Review 181, 234
1.3.2 The madh'hab (doctrine) of Shariah relevant to the study:

With regard the matters related to Shariah rules and their interpretation, this study relies on the Sunni doctrine of Islamic Shariah and excludes the other doctrines. The Sunni doctrine is the dominant doctrine in the Islamic nation.\(^21\) There are four major schools of thoughts under the Sunni doctrine: Hanafi, Maliki, Shafi’ei and Hanbali.\(^22\) These schools were formed in the ninth to mid-tenth centuries and were named after the leading scholar in their developmental period.\(^23\) Each school has developed a number of legal rules and a particular jurisprudential methodology based on the leading scholar’s approach, but all four schools agree on the sources of Shariah.\(^24\)

1.3.3 The jurisdictions relevant to the study:

The thesis does not have a specific geographical scope and examines Islamic finance and the SCG framework in general. However, three jurisdictions, namely Malaysia, Kuwait and the UK, are added as reference points and representatives of Islamic finance, as they are leading jurisdictions in this industry and apply different approaches to SCG: Malaysia (in Asia) represents an Islamic jurisdiction with a centralised SCG system; Kuwait (in the Gulf region) represents an Islamic jurisdiction with a decentralised SCG system; and the UK (in the West) represents a non-Islamic jurisdiction with a minority Muslim population where SCG is self-regulated by individual IFIs due to the absence of national regulation and supervision of SCG in that country.\(^25\)

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\(^{25}\) **Malaysia** is the most contributor of Islamic finance assets in leading country in Asia which embraces 24.4% of the total Islamic financial assets. **Kuwait** is one of the Gulf Cooperation Council countries (GCC), which is the largest domicile for Islamic financial assets in the world, accounting for 42% of
1.3.4 The international organisations and standards relevant to the study:

Different international organisations in the global financial sector seek to ensure financial stability by addressing different issues, including corporate governance, banking supervision, regulation, and other standards and guidelines.26 This thesis, however, focuses on the guidelines of four key bodies in international banking regulation and Islamic finance, namely the Organisation for Economic Co-operation and Development (OECD)27, the Basel Committee on Banking Supervision (BCBS)28, the Islamic Financial Services Board (IFSB)29, and the Accounting and

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26 Iris Chiu and Joanna Wilson, Banking Law and Regulation (Oxford University Press 2019) 192
27 The OECD is an international organisation that provides a forum for governments to share experiences and find solutions to common problems. Its focus is on the global economy, trade and investments. It sets international standards on a wide range of issues including corporate governance. Its main objective is to improve the economic well-being of people worldwide. The OECD corporate governance principles were first released in 1999, revised in 2004 and later updated in 2015. The OECD principles of corporate governance are globally recognised and they serve as a platform for setting and evaluating corporate governance policies. According to the OECD, the principles ‘have been adopted as one of the Financial Stability Board’s (FSB) key standards for sound financial systems serving FS3, G20 and OECD members, they have also been used by the World Bank Group in more than 60 country reviews worldwide and they serve as the basis for the Guidelines on corporate governance of banks issued by the Basel Committee’. OECD, G20/OECD Principles of Corporate Governance (OECD 2015) 3. For more about the OECD and to view its principles please visit <http://www.oecd.org/> accessed 16 December 2019.
28 The BCBS is a standard-setting body that provides a forum for cooperation on banking supervisory issues. Its key objective is to enhance the regulations, supervision and practice of banks around the world. For more about the BCBS please visit <http://www.bis.org/bcbs/> accessed 16 December 2019. It is known for its guidelines on the effective supervision of banks. In this regard, it has issued three series of measures (Basel I, II and III) known as ‘the Basel Accords’. They are mainly concerned with setting measures for capital adequacy and risk control and are seen as the minimum standards for sound prudential supervision for banks across the globe. For more about Basel Accords please see Iris Chiu and Joanna Wilson, Banking Law and Regulation (Oxford University Press 2019) chs 8 and 9. Although the initial focus of the BCBS standards is banking supervision of compliance with the capital adequacy requirements, it is also interested in in supervising aspects of corporate governance. The BCBS published its initial corporate governance guidance for banking organisations in 1999 and revised it in 2006 and 2010, respectively. In 2015 the BCBS released its latest corporate governance
Auditing Organization for Islamic Financial Institutions (AAOIFI). In 2018, the IFSB and the AAOIFI signed a memorandum of association to facilitate the joint cooperation between both organisations in order to undertake technical activities to develop the Islamic finance sector at large. It should be noted that none of these principles for banks to replace the 2010 guidance. The BCBS principles are all available online on its website http://www.bis.org/bcbs/ accessed 16 December 2019. Although the BCBS draws its corporate governance guidelines from the OECD principles, its main objective, however, is to emphasise the board of directors’ (BoD) collective oversight and risk governance responsibilities. In addition, it determines the roles and duties of the BoD, senior management and control functions, and stresses the strengthening of bank checks and balances. BCBS, Guidelines Corporate Governance Principles for Banks (Bank for International Settlements 2015) 3

The IFSB is a standard-setting organisation that sets guidelines for Islamic banks, capital markets and the insurance sector. Regarding SCG, this organisation has issued three main documents: (a) the ‘Guiding Principles on Corporate Governance for Institutions offering only Islamic Financial Services’ (IFSB-3) in 2006, (b) the ‘Guiding Principles on Shariah Governance Systems for Institutions offering Islamic Financial Services’ (IFSB-10) in 2009, and (c) the ‘Core Principles for Islamic Finance Regulation; Banking Segment’ (IFSB-17) in 2015. For more about the IFSB and its standards, please visit <https://www.ifsb.org/index.php> accessed 16 December 2019. It has also issued risk management standards for IFIs in 2005 under the name ‘Guiding Principles of Risk Management for Institutions (other than Insurance Institutions) Offering Only Islamic Financial Services’ (IFSB-1). As of 2019, the IFSB has 179 members from regulatory and supervisory authorities, international inter-governmental organisations, financial institutions and professional firms as well as self-regulatory organisations operating in 57 jurisdictions. Please see the IFSB List of Members <https://www.ifsb.org/membership.php> accessed 16 December 2019

The AAOIFI is also an Islamic international body that sets accounting, auditing and Shariah standards for IFIs and the Islamic financial industry as a whole. This organisation issued seven documents comprising governance, accounting and auditing standards for Islamic financial institutions in 2010. In addition, it issued Shariah standards for IFIs the same year. The AAOIFI is supported by a number of institutional members from 45 countries, including central banks, Islamic financial institutions, regulatory authorities, financial institutions, accounting and auditing firms, and legal firms. See About AAOIFI at <http://aaoifi.com/about-aaoifi/?lang=en> accessed 16 December 2019. Also, according to the organisation’s website, the AAOIFI Shariah standards have been made part of mandatory regulatory requirements in a number of countries, including Bahrain, Qatar and the UAE, while in other countries, such as Kuwait, the Standards have been recommended as guidelines. See Adoption of AAOIFI Standards <http://aaoifi.com/adoption-of-aaoifi-standards/?lang=en> accessed 16 December 2019. See also Adel Sarea, ‘The Level of Compliance with AAOIFI Accounting Standards: Evidence from Bahrain’ (2012) 8 International Management Review 27; Frederick Perry, ‘The Corporate Governance of Islamic Banks: A Better Way of Doing Business’ (2010) 19 Michigan State Journal of International Law 251, 267. It should be noted that the AAOIFI has its own Shariah board to guide it through its Shariah related matters. For more see Shari’ah Board at <http://aaoifi.com/shariah-board/?lang=en> accessed 16 December 2019. In 2019, the AAOIFI officially issued its eighth document, including a governance standard for the central Shariah board. For see AAOIFI, ‘AAOIFI Introduces its 100th Standard as Governance Standard No. 8 ‘Central Shari’ah Board’ Has Been officially Issued’ (AAOIFI, 2018) <http://aaoifi.com/announcement/aaofi-introduces-its-100th-standard-as-governance-standard-no-8-central-shariah-board-has-been-officially-issued/?lang=en> accessed 30 December 2019.

Areas of co-operation include: (a) development and revision of prudential, Shariah, accounting and governance standards on areas of mutual interest, (b) promote the implementation of prudential, Shariah, accounting and governance standards to facilitate the development of the Islamic financial services industry, and (c) enhance awareness through knowledge sharing and organisation of executive programs, workshops, conferences, seminars etc’. For more about the memorandum of association between the IFSB and the AAOIFI and the areas of co-operation please see IFSB, ‘Islamic Finance Standard-Setting Bodies IFSB and AAOIFI Join Forces to Strengthen the Development and Resilience of the Islamic Financial Services Industry’ (IFSB, October 2018) <https://www.ifsb.org/presse_full.php?id=449&submit=more> accessed 16 December 2019.
organisations has any legal authority in any jurisdiction and their guidelines come in the form of recommended standards for best practice, yet they are widely adopted.

1.4 Originality:

This thesis aims to investigate the effectiveness of SCG to ensure Shariah compliance as an essential interest of shareholders in IFIs and identify the means they have to protect this interest. Several aspects have been identified that might contribute to the dilution of the IFI’s overall Shariah compliance and by extension affect the shareholders’ right to a proper Shariah compliant business. Some are related to the internal governance system and others related to national supervision.

There is significant literature on SCG in IFIs in general and the role of the SSB in ensuring the IFI’s Shariah compliance.\textsuperscript{32} Also, a number of scholarly works have dealt with SCG from the institution’s perspective and its SSB.\textsuperscript{33} However, there is no study that discusses the shareholders of IFIs within SCG who are interested in the institution’s Shariah compliance and the role they can play in the promotion of good SCG and Shariah compliance in IFIs.

Shariah governance of IFIs in Islamic jurisdictions, including the national laws and regulations, have been examined and analysed in a few studies.\textsuperscript{34} However, there is little discussion of the governance of IFIs that operate within a non-Islamic jurisdiction and the obstacles they face in implementing and ensuring Shariah compliance for their shareholders. Also, no study has been found that addresses in detail SCG in Kuwait and its supervisory system. In addition, there is no research that deals with the shareholders of IFIs, whether in an Islamic or non-Islamic jurisdiction, and their activism in SCG. This study, therefore, sheds light on SCG in IFIs in Islamic and non-Islamic jurisdictions by studying the way SCG is implemented in Malaysia, Kuwait and the UK and the means available for shareholders to ensure Shariah compliance in these jurisdictions.

It is against this background that this thesis seeks to contribute to the available knowledge by providing a comprehensive study of SCG and shareholders’ activism in promoting good SCG. To achieve that objective, the aspects that compromise Shariah compliance in IFIs and therefore the shareholders’ interest will be discussed.

\textsuperscript{32} See (n16)
\textsuperscript{33} See (n16)
\textsuperscript{34} See (n16)
Subsequently, some workable solutions and recommendations for more effective Shariah assurance controls through shareholder involvement will be presented. As there are limited studies in the research areas mentioned, this study will be a primary source for further studies on the topic of the role of shareholders in SCG to ensure Shariah compliance in IFIs, and at the same time paves the way for future researchers.

1.5 Methodology:

This thesis primarily undertakes an examination of the way in which some problems related to SCG and its main players might affect the extent of Shariah compliance in IFIs. The methodologies chosen for this research are a critical literature review and a comparative analysis. The research uses multiple methods through collecting and analysing qualitative data and few basic quantitative data in order to understand the research problems. The chosen approach enhances validity and reliability because it makes allowance for triangulation.35

The research is literature-based, which involves the use of both primary and secondary research methods, data collections and analysis of documentary sources available in the public domain. Different methods are used in the collection and analysis of data and the investigation of research issues. The research methodology is used in relation to five regimes: (a) the international corporate governance frameworks, (b) Islamic Shariah, (c) Malaysia, (d) Kuwait, and (e) the UK. The legal organisation at the level of the IFIs is also examined when needed.

In terms of the international legal system, the methods employed are based upon legal analysis of key provisions that govern corporate governance. In this regard, the international corporate governance standards and regulatory rules set by different international organisations for Islamic and conventional financial institutions, namely the OECD, BCBS, IFSB and AAOIFI form a main source of primary data in this research. Academic publications that discuss these standards are also reviewed closely.

The methodology of this study in terms of Islamic Shariah involves the review of both classical and modern texts. Since the original language of Islamic Shariah and its sources is Arabic, the study relies mainly on Arabic references to obtain the

information related to Shariah but without ignoring the translated English version of these sources if available.

Concerning Shariah rules and principles, the study relies on the main Islamic Shariah sources, Quran, Sunnah and Fiqh. The Holy Quran is referred to with the assistance of the translation undertaken by Saheeh International. As for Sunnah, the study relies on the six major hadith books known as ‘The Accurate Six’. The field of Islamic Fiqh that deals with commercial and business transactions, namely Fiqh Al-Muamalat, forms a major source for this research. In this context, the researcher mainly focuses on the work of early Muslim scholars, due to the fact that modern scholars usually rely on their opinions in their modern work, as they are regarded as primary sources in Fiqh. However, the opinion of modern scholars and the more recent works are also examined, especially in the case of disagreement or if the subject matter is contemporary and has not been addressed in the classical work. In this regard, decisions of well-known and highly respected scholars and Islamic institutions in the Islamic world will be referenced. In cases where different jurisprudential opinions exist between the different scholars, and where too many different views exist making it prohibitive to present them all, this study will employ a selective approach based on the most dominant opinions in the subject matter.

With regard to the legal systems of Malaysia, Kuwait and the UK, the research depends mainly on primary sources, such as the country’s legislation, regulations, rulebooks, guidelines and court decisions. The use of the UK legal system in this study serves to provide a broader understanding of the legal environments where IFIs operate as well as the obstacles they face in terms of ensuring their Shariah

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36 The Holy Quran is ‘the book of Islamic revelation; scripture’. Sunnah is the ‘established custom, normative precedent, conduct, and cumulative tradition, typically based on Muhammad’s example. The actions and sayings of Muhammad are believed to complement the divinely revealed message of the Quran, constituting a source for establishing norms for Muslim conduct and making it a primary source of Islamic law’. Fiqh is ‘the human attempt to understand divine law (Shariah)’. See John Esposito, The Oxford Dictionary of Islam (Oxford University Press 2003) chs Quran, Sunnah and Fiqh
37 Saheeh International (tr), The Qur’an (3rd edn, Al-Muntada Al-Islamy Trust 2010)
38 Muhammad Bukhari, Sahih Bukhari (Muhammad Khan tr, Darussalam 1997); Hafiz At-Tirmidhi, Jami Al-Tirmidhi (Abu Kallyl tr, Darussalam 2007); Mohammed Al-Qazwini, Sunan Ibn Majah (Nasiudin Al-Kattab tr, Darussalam 2007); Muslim Ibn Al-Hajjaj, Sahih Muslim (Nasiruddin Al-Khattab tr, Darussalam 2007); Hafiz An-Nasai, Sunan An-Nasai (Nasiruddin al-Kattab tr, Darussalam 2008); Sulaiman Al-Sijistani, Sunan Abu Dawud (Yaser Qadhi tr, Darussalam, 2008)
39 For example, the International Islamic Fiqh Academy and the General Presidency for the Departments of Scientific Research and Ifta. For more about the two bodies please see <http://www.iifa-afi.org/> and <https://www.alifta.gov.sa/Ar/Pages/default.aspx> both accessed 16 December 2019
compliance in a non-Islamic jurisdiction without any governmental Shariah supervision.

Individual IFIs in the selected jurisdictions and other jurisdictions are also examined in order to understand the implementation of SCG in practice and the extent of adherence to Shariah rules. With regard to the data related to the IFIs’ SCG and Shariah compliance, the research depends mainly on the institutions’ articles of association (AoA), annual reports, governance policies and regulatory documents, and reports published on their websites.

Secondary data is collected by exploring published academic and professional written works related to the research fields. This includes critically reviewing books, journal articles, conference papers, working papers, research papers, empirical investigations and other studies accessible on the Internet. The process of data collection required visits to libraries, Islamic centres and other information centres in the UK and in an Arab country (usually Kuwait) for viewing the Arabic references.

1.6 Limitations of the research:

Some limitations have arisen in the course of completing this study. The main limitation lies in its descriptive nature, which requires a large amount of information and analytical data. Unfortunately, the primary and secondary sources of the information needed for this research are limited or hard to obtain. The available literature on SCG is general and does not provide in-depth data on the system and its related problems. The other main limitation is the lack of the court cases and arbitral decisions in the field of SCG and Shariah shareholder activism in all the jurisdictions studied in this research. No case has been found that raises a Shariah compliance issue in IFIs by shareholders. This, however, could be interpreted in several ways: (a) shareholders do not experience any problems; (b) shareholders are insufficiently aware of their rights and obligations; (c) shareholders do not have the rights they need; (d) the concerns of shareholders are raised and settled quietly inside the IFIs. This therefore emphasises the importance of this thesis and the need to highlight the rights shareholders should have in SCG.40

The researcher has faced another challenge in the terms of reading and interpreting in Islamic Shariah. Due to the fact that corporate governance is a

40 The rights of shareholders in SCG are discussed in detail in Chapter Four.
contemporary matter, there are no direct rules in the primary Shariah sources or in the classical Shariah texts that govern the relevant practices. Therefore, in order to compensate for the lack of specialised studies on the topic of corporate governance in the Islamic legal system, the researcher relied on the main principles of the core sources of Islamic Shariah, the *Quran* and *Sunnah* in particular, as well as the views of the classical and modern scholars. However, another problem arose at this point, which is the multiple interpretations and diversity in opinions between scholars. To overcome this, the researcher depended on the most reliable scholarly opinions that are mostly agreed upon among the most respected Shariah scholars and Shariah councils.

1.7 Islamic Shariah: clarification of key terms

It has been observed in Islamic literature that there is disagreement among writers on the term used to describe the Islamic legal system. Some writers use the term ‘Islamic Shariah’, others use the term ‘Islamic law’, yet others use both terms interchangeably. In order to decide what is the correct term to use in this study, the researcher undertook an initial investigation.

To know whether there is any difference between the two terms, it is necessary to determine the meaning of ‘Shariah’ first. Shariah is an Arabic term, which literally means the path or way to follow. The root of this meaning is found in the *Quran* where *Allah* Almighty has directed people to follow the appointed way of living He laid down for them. Arab linguists agree that the term ‘law’ or ‘qanon’ is alien to Arabic and was developed later due to the influence of the Syriac language. The word ‘qanon’ was commonly used in the Ottoman era to refer to state secular rules in order to differentiate between them and Islamic Shariah rules. Then it found its way into Arab countries’ legal systems, mostly to refer to rules issued by the state and not those addressed in Shariah.

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42 ‘Allah’ is the term used by Muslims to refer to God. See John Esposito, *The Oxford Dictionary of Islam* (Oxford University Press 2003) ch Allah. The terms ‘Allah’ and ‘God’ are used interchangeably in this thesis.
44 Jamaluddin Ibn Mandhoor, *Lisan Al-Arab*, vol13 (Dar Sader 2003) 349
45 Omar Al-Ashqar, *Al-Shariah Al-Elahiyya la Al-Qawanin Al-Jahiliyya* (Dar Al-Da’a’awa 1983) 21
46 Omar Al-Ashqar, *Al-Shariah Al-Elahiyya la Al-Qawanin Al-Jahiliyya* (Dar Al-Da’a’awa 1983) 23
Arab Muslim scholars have preserved the term ‘Islamic Shariah’ and use it in their writings to this day. There is almost complete uniformity among them on using the term ‘Islamic Shariah’ and not ‘Islamic law’, and whenever they use the term ‘law’ they refer to secular laws. In contrast, the term ‘Islamic law’ is widely used in Islamic English literature to refer to the Islamic system as a whole, although the concept of law is viewed differently by the Western legal system and the Islamic system.\(^{47}\) Law is usually described as ‘the enforceable body of rules that govern any society’.\(^{48}\) The concept of Shariah differs from the concept of law in some aspects as follows:

1- With regard the term’s scope; Shariah is wider than the common meaning of law. It regulates all aspects of human life, from when to clip their finger-nails, and how to shower, to how to rule a country. It covers devotions, rituals, morals, transactions, penalties and more.\(^{49}\) It is not directed at a specific country or people but at all humankind. It tells Muslims not only what is prohibited and permissible, but also what is detested, obligatory and preferred.\(^{50}\) It not only regulates the relationship between individuals but also between them and God. Basically, Shariah serves two panels: secular and religious. Hicks claims that the Western law model does not fit all systems of law.\(^{51}\) Other Western philosophers still disagree; Posner states that law is an interdisciplinary field and Kantorowicz explains that the usual definition of ‘law’ found in books is far too narrow to include all aspects of this ancient concept.\(^{52}\) Kantorowicz adds that ‘law’ embodies ethical, religious and ritual ideas and is never restricted to rules issued by the state or to its enforceable

\(^{48}\) See ‘law’ in Jonathan Law and Elizabeth Martin (eds), A Dictionary of Law (Oxford University Press 2013)
\(^{51}\) Stephen Hicks, ‘The Fuqaha and Islamic Law’ (1982) 30 American Journal of Comparative Law 1, 12
character. Even if it is agreed that the term ‘law’ covers more than just practical rules, the next point illustrates the difference further.

2- In term of the source or lawgiver; Shariah was revealed by God, while law is man-made. Muslims believe that God is the sole legislator and that Shariah – His revelation – is perfect, complete and no man can add to it or change it.

3- In term of immutability; the basic rules of Shariah are fixed while the rules of law are changeable. After the death of the Prophet Muhammad peace be upon him (PBUH) there were no further addition to Shariah rules. Accordingly, the divine rules of Shariah are immutable and no man can add to them or change them.

4- In term of validity; Muslims believe that Shariah has absolute validity for all times and every place, while law is set for a specific society.

Therefore, for the above reasons, the term ‘Islamic law’ is not commensurate with the Islamic system as a whole and the term ‘Shariah’ is more accurate. In addition, there is no need to use the term ‘law’ when the term ‘Shariah’ is available, especially since it is a well-known term in English.

From reading in Islamic English literature, it can be said that the use of the term ‘Islamic law’ by English writers reflects the practical rules only and excludes the other aspects of life covered by Shariah. The reason behind this could be to parallel the term Shariah with the modern usage of the term ‘law’ and perhaps to make it easier for non-Arabic speakers to understand. However, the major drawback in this approach is that devotions or acts of worship and practical legal rules in Shariah are

53 Herman Kantorowicz, The Definition of Law (Cambridge University Press 1958) 12-13
55 Allah Almighty says in the Holy Quran, ‘This day I have perfected for you your religion and completed My favor upon you and have approved for you Islam as religion’. The Holy Quran, Surah Al-Ma’idah, Chapter 5, Verse 3. Saheeh International (tr), The Qur’an (3rd edn, Al-Muntada Al-Islami 2010) 142. See also Omar Al-Ashqar, Al-Shariah Al-Elahtiyya la Al-Qawanin Al-Jahiliyya (Dar Al-Da’awa 1983) 24
56 According to Muslims’ beliefs, ‘Muhammad was God’s Messenger sent to proclaim in Arabic the same revelation that had been proclaimed by earlier Jewish and Christian prophets, first to the Arabs and then to all people.’ See John Esposito, The Oxford Dictionary of Islam (Oxford University Press 2003) ch Muhammad
57 Mashood Baderin, ‘Understanding Islamic Law in Theory and Practice’ (2009) 9 Legal Information Management 186, 188
58 Mustafa Al-Zarqa, Al-Madkhal Al-Fiqhy Al-Aam, vol 1 (Dar Al-Qalam 1998) 47. See also Nasim Razi, ‘Quranic Legislation in Modern Context’ (2011) 8 Pakistan Journal of Islamic Research 17, 19
intertwined and it is not always easy to distinguish between them.\textsuperscript{59} For example, in Shariah there is a worldly punishment for not praying or not fasting, which are acts of worship.\textsuperscript{60} On the other hand, Muslims worship God through the worldly transactions, such as fair trade\textsuperscript{61}, fulfilment of contracts \textsuperscript{62}and payment of wages.\textsuperscript{63}

A second issue that needed to be clarified here revolves around whether to include \textit{Fiqh} (Islamic jurisprudence) under the term Shariah, along with the \textit{Quran} and \textit{Sunnah}, or to consider it as a separate source. This uncertainty arose because there is divergence between Muslim writers on this matter. Both Arabic and English Islamic literature express differing views. Before clarifying whether Shariah is only contained in the \textit{Quran} and \textit{Sunnah} or whether \textit{Fiqh} is also included under this term, it is important to explore the sources of Shariah.

Islamic Shariah is mainly originated from two primary sources\textsuperscript{64}: the Holy \textit{Quran} that constitutes the divine revelations, and the \textit{Sunnah} that constitutes the acts and sayings of the Prophet Muhammad (PBUH). In the lifetime of Prophet Muhammad (PBUH), he acted as a point of reference in the application of the \textit{Qur'anic} rules and his decision was final and binding.\textsuperscript{65} However, after his death, divine revelation ceased but the interpretation and implementation of the Islamic divine rules needed to continue. This resulted in the development of new supplementary sources based on \textit{Ijithad} (human intellect effort or diligence) using two

\begin{itemize}
  \item \textsuperscript{60} According to the majority opinion of Muslim scholars, a Muslim who willingly abandons obligatory prayers completely out of disbelief should be punished. For more details see Ministry of Trust and Islamic Affairs, \textit{Al-Mawso‘ah Al-Fiqhiyyah}, vol 27 (Dar Al-Safwa 1992) 53. Also see Zain Addin Ibn Rajab, \textit{Jami‘ Al-Omloon wa Al-Hikam} (Darussalam 2004) 149. In addition, the country ruler has the right to punish a Muslim for breaking fast in the holy month of Ramadan as he sees fits. For more see Muhammad Al-Maliki, \textit{Al-Qawaneen Al-Fiqhiyyah fi Talkhis Madh‘hab Al-Malikiya} (Dar Ibn Hazm 2013) 233. Also see Ministry of Trust and Islamic Affairs, \textit{Al-Mawso‘ah Al-Fiqhiyyah}, vol 28 (Dar Al-Safwa 1993) 75
  \item \textsuperscript{61} Prophet Muhammad (PBUH) said, ‘The seller and the buyer have the right to keep or return goods as long as they have not parted or till they part; and if both the parties spoke the truth and described the defects and qualities (of the goods), then they would be blessed in their transaction, and if they told lies or hid something, then the blessings of their transaction would be lost.’ Muhammad Al-Bukhar, \textit{Sahih Al-Bukhairi}, vol 3 (Muhammad Khan tr, Darussalam 1997) Hadith 2079
  \item \textsuperscript{63} Prophet Muhammad (PBUH) said, ‘Give the worker his wages before his sweat dries.’ Muhammad Ibn Majah Al-Qazwini, \textit{Sunan Ibn Majah}, vol 3 (Nasiusdin al-Kattab tr, Darussalam, 2007) Hadith 2443
  \item \textsuperscript{64} See Irshad Abdal-Haq, ‘Islamic Law - An Overview of Its Origin and Elements’ (2002) 7 The Journal of Islamic Law and Culture 27, 33
  \item \textsuperscript{65} Mashood Baderin, ‘Understanding Islamic Law in Theory and Practice’ (2009) 9 Legal Information Management 186, 188
\end{itemize}
methods, namely *Ijmaa* (consensus) and *Qiyas* (analogical reasoning).\(^{66}\) The supplementary sources are collectively referred to as *Fiqh* (Islamic jurisprudence).\(^{67}\)

In clarifying this matter, four different perspectives are found in Islamic literature:

**First perspective:** Shariah is contained in the *Quran* and *Sunnah* only, and *Fiqh* is a separate section of the Islamic system.\(^{68}\) This opinion is based on the fact that the primary sources are divine revelation whereas *Fiqh* is the product of human effort.

**Second perspective:** *Fiqh* is an integral part of Shariah as the rules reached through human intellectual effort are either derived from the *Quran* and *Sunnah* or associated to them.\(^{69}\)

**Third perspective:** Shariah is viewed from two different angles: broad and narrow. The broad meaning comprises all texts addressed in the Holy *Quran* and *Sunnah*, whether legal, moral or ideological. The narrow meaning excludes the morals and devotions and focuses only on the practical legal rules in *Quran* and *Sunnah*. This group considers *Fiqh* as the science concerned with the interpretation of the practical legal rules only. Therefore, they fit *Fiqh* in the narrow meaning of Shariah but not the broad.\(^{70}\)

**Fourth perspective:** Shariah is viewed in three different contexts: (a) In the general religious sense, it means the Muslim way of life where the term covers law and non-law provisions; (b) in the general legal sense, it is seen as the Islamic legal system which covers the practical rules in the *Quran*, *Sunnah* and *Fiqh*; finally, (c) in a specific context, Shariah is restricted to the divine sources, the *Quran* and *Sunnah*. In this context, Shariah is different to *Fiqh*.\(^{71}\)

Given the above illustration, it can be seen that there is no certain answer whether *Fiqh* is part of the term ‘Shariah’ or not. Therefore, for the purpose of this study, the term ‘Islamic Shariah’ or ‘Shariah’ is used as a general term that refers to

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\(^{66}\) These sources are agreed upon by the majority of Sunni Muslim scholars. See Farooq Hassan, ‘The sources of Islamic Law’ (1982) 76 American Society of International Law Proceedings 65, 66-76


\(^{71}\) Mashood Baderin, ‘Understanding Islamic Law in Theory and Practice’ (2009) 9 Legal Information Management 186, 187
all sources primary and supplementary. As for the details, the researcher will specify the source from which the evidence is derived is Quran, Sunnah or Fiqh.\footnote{Having said that, it is important to mention that in the context of Islamic finance and SCG, there are specific Shariah standards followed by IFIs which form the basis on which the extent of their Shariah compliance is determined. In this regard, Shariah standards for Islamic finance might differ from one jurisdiction to another. The IFSB defines them as the rules determined by the IFI’s SSB or the CSB. While the AAOIFI defines them in the following hierarchy: (a) Shariah standards issued by the AAOIFI; (b) regulations issued by the national authority; (c) the rulings of the centralised Shariah board (CSB); (d) the standards of the AAOIFI; and (e) the rulings of the IFI’s SSB. See IFSB, ‘Guiding Principles of Risk Management for Institutions (Other than Insurance Institutions) Offering Only Islamic Financial Services’ (2005) IFSB Paper no IFSB-1, 26 <https://www.ifsb.org/published.php> accessed 26 December 2019; AAOIFI, Governance Standard No. 9, Shari’ah Compliance Function (2018) AAOIFI Paper no GSIFI 9, 7-8 <http://aaoifi.com/gsifi-9-shariah-compliance-function/?lang=en> accessed 26 December 2019.}

\section*{1.8 The thesis theoretical framework:}

The thesis is based on SCG as the policy used by IFIs to implement and supervise their business compliance to Shariah rules. Therefore, the theoretical framework of the thesis requires examining the existing corporate governance models and the theoretical frameworks behind these models to decide whether or not SCG falls into any of them. This examination is essential to allow a better understanding of the arguments that follow when considering the substantive issue of shareholder active engagement in SCG.

\subsection*{1.8.1 Corporate governance:}

\subsubsection*{1.8.1.1 Introduction to corporate governance:}

After the successive disasters of the collapse of giant corporations in several economically developed countries, such as Barings Bank in the UK, Enron in the US, Royal Bank of Scotland, Parmalat in Italy and others in the mid 1990s and 2000s, the whole world has recognised the need to find an optimal system to operate and control companies in order to prevent such collapses happening again and to restore investors’ confidence in the market.\footnote{Christine Mallin, \textit{Corporate Governance} (5\textsuperscript{th} edn, Oxford University Press 2016) 1-8} All attention has been drawn to corporate governance as the best route to achieving better corporate practice, and questions have been raised about the adequacy of regulations.\footnote{Heidi Meier and Natalie Meier, ‘Corporate Governance: An examination of U.S. and European Models’ (2013) 9 Corporate Board: Role, Duties & Composition 6, 7} In current days, it is no longer debatable that corporate governance plays an essential role in business corporations...
and the global economy as a whole.\textsuperscript{75} It is the mechanism used for enhancing a company’s performance and protecting shareholders’ and other stakeholders’ interests through helping the executive management and board of directors (BoD) to exercise their duties and responsibilities efficiently.

There is no universal consensus on the definition of corporate governance. Economists and social scientists define it in a broad sense while policy makers, managers and lawyers view it in a narrower context, all based on their perspective as to what objective the corporate governance system should serve.\textsuperscript{76} This variation is mainly based on the model of corporate governance and the concerned parties that require initial focus.\textsuperscript{77} In addition, the divergence of laws and regulations between countries and different cultural practices have had their effect on the contrasting understandings of corporate governance.\textsuperscript{78} The most widely used and forthright definition of corporate governance is provided by Sir Adrian Cadbury, the chairman of the Cadbury Committee in the UK, as ‘a system by which companies are directed and controlled’.\textsuperscript{79} On an international level, the OECD views corporate governance as,

'[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.'\textsuperscript{80}

Corporate governance mechanisms are generally shaped by two types of regulations: compulsory and voluntary. Compulsory regulations include laws issued by the country, such as the company law and central bank law, which govern, among other things, the creation and basic structure of the company, as well as the rights and duties of the directors, managers and shareholders. Voluntary regulation is left to the company, where it has discretion to set its own internal corporate governance policy,
including the board composition, incentive schemes and contractual arrangements. This is what distinguishes corporate governance as it not only addresses the relevant legal provisions but also extends to encouraging self-regulation. For example, the EU corporate governance framework is a mixture of legislative rules and compliance with standards bodies’ recommendations. Another example can be seen in the UK corporate governance code, which applies a ‘comply-or-explain’ method of enforcement. Under this method, a listed company is required to disclose whether or not it has complied with the code and the reasons for any non-compliance.

Corporate governance determines the corporation’s accountability towards its shareholders and society in general and controls management performance. It is a mechanism that sets out certain rules to ensure the corporation’s transparency, reliability and accountability. In general, corporate governance is a conglomeration of rules and stratagems, which control and monitor the behaviour of an organisation and ensures that shareholders, creditors, investors, customers and other stakeholders are protected against any form of exploitation by applying transparency, disclosure of information and accountability criteria. The impact of corporate governance is not limited to corporations but extends to include the whole of society.

1.8.1.2 Theories of corporate governance:

There are two main theories of corporate governance: the shareholder-centred theory and the stakeholder-centred theory. These theories established the two dominant models of corporate governance around the world: the Anglo-American model (shareholder), which is mainly followed by the Anglo-Saxon countries such as the US, UK and Australia, and the European-Continental model (stakeholder), which is mainly followed by Germany, other European countries and Japan. The

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81 Jeswald Salacuse, ‘Corporate Governance in the New Century’ (2004) 69 Company Lawyer 1, 6
82 John Farrar, ‘Corporate Governance’ (1998) 10 Bond Law Review 139, 141
84 Derek French, Mayson, French & Ryan on Company Law (35th edn, Oxford University Press 2018) 344. The comply-or-explain method is explained in more detail in chapters 3 and 5.
85 Thomas Clarke and Douglas Branson, ‘Introduction: Corporate Governance – An Emerging Discipline?’ in Thomas Clarke and Douglas Branson (eds), The SAGE Handbook of Corporate Governance (SAGE Publications 2012) 2
shareholder model is known to focus on maximising shareholder value while the stakeholder model has a wider focus that includes the other types of stakeholders, such as the employees, suppliers, clients and the whole of society.\textsuperscript{87} These models and the theories behind them are illustrated below.

A. The shareholder theory: the product of the agency problem

The agency problem in companies stems from the separation of ownership and control, which was the basis for a considerable amount of discussion on how to protect the interest of owners (as principals) from potential exploitation by managers (as agents).\textsuperscript{88} This idea was first highlighted by Berle and Means more than 80 years ago in their classical work *The Modern Corporations and Private Property*, which established the theoretical framework for modern corporate governance.\textsuperscript{89} In this work, they rejected the classical model of an entrepreneur who single-mindedly operates his own firm and highlighted the concept of the modern company.\textsuperscript{90} Under this modern view, ownership of companies becomes impersonal due to the fact that shares are scattered among a large number of investors, which usually results in placing ultimate control in the hands of the managers.\textsuperscript{91} Jensen and Meckling further elaborate the proposition that the company is a nexus of contracts between individuals who have conflicting objectives.\textsuperscript{92} In a similar way, Fama describes the company as, ‘A set of contracts covering the way inputs are joined to create outputs and the way receipts from outputs are shared among inputs’.\textsuperscript{93} This perception helps to understand the facts that control can be held by someone else in the company other than the shareholders, and that shareholders do not have to play the role of the owner-entrepreneur.\textsuperscript{94} Therefore, as articulated by Eastbrook and Fischel, when a company

\textsuperscript{88} Santosh Pande and Valeed Ansari, ‘A Theoretical Framework for Corporate Governance’, (2014) 7 Indian Journal of Corporate Governance 56, 57
\textsuperscript{89} Santosh Pande and Valeed Ansari, ‘A Theoretical Framework for Corporate Governance’ (2014) 7 Indian Journal of Corporate Governance 56, 57
is treated as a complex of contracts, people cannot foresee the future sufficiently well to cover all the contingencies, and this is why these contracts are found to create fiduciary duties.95

Because of this problem in designing the contract, the manager and the investor have to allocate what is called ‘residual control rights’.96 But where the investors are not qualified or informed enough to deal with the situations that arise and because the managers have better information, the managers acquire fundamental residual control rights, including a discretion to allocate the funds.97 Therefore, managers may be in a position to pursue their own interests rather than to act in the interest of the company and its shareholders.

But how is the agency problem related to the shareholder model of corporate governance? Corporate governance was presented as a mechanism that helps to deal with the agency problem in a way that diminishes the potential exploitation of shareholders by managers (agency cost). Under this model, corporate governance was seen as, ‘The way in which suppliers of finance to corporations assure themselves of getting a return on their investment’.98 Hence, as stated by Magnier, ‘Governance policies advocating shareholder supremacy in corporate decision-making was legitimized’.99 This is also known as the theory of ‘shareholder primacy’, which puts shareholders in the top position relative to the rest of stakeholders.100 According to the view explained by this model, managers of the company (as agents) have a fiduciary duty to advance the interest of shareholders (as principals) in taking decisions. This view was famously argued by Friedman in 1970. In his view, executives have a sole responsibility to serve the company’s owners and make them more money without taking into consideration the interest of other stakeholders.101

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99 Véronique Magnier, *Comparative Corporate Governance; Legal Perspectives* (Edward Elgar Publishing 2017) 18
100 Craig Smith and David Rönnegard, ‘Shareholder Primacy, Corporate Social Responsibility, and the Role of Business Schools’ (2014) 125 Journal Business Ethics 463, 463
101 Friedman said, ‘There is one and only one social responsibility of business — to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game.’ Milton Friedman, ‘The Social Responsibility of Business is to Increase its Profits’ (The New York
This model of corporate governance was developed to cater for companies with dispersed ownership, as viewed by Berle and Means. Therefore, it can be seen clearly in countries with Anglo-American legal systems, mainly the UK\textsuperscript{102} and the US, where listed companies with publicly traded shares are widespread and most shares are held by financial intermediaries as agents of their beneficiaries.\textsuperscript{103} Because of this low concentration in ownership, most shareholders lack significant control powers, which leaves the managers with greater power to make decisions. As explained above, this creates a potential conflict of interests between managers and shareholders where managers could act in their own best interest instead of that of the shareholders. In addition, due to the dispersed ownership of shares, shareholders can easily sell their shares and exit the company whenever they receive unsatisfactory information about the company, which indicates that shareholders in countries with an Anglo-American legal system have low personal attachment to their companies.\textsuperscript{104} Nevertheless, a number of writers, especially in the US, argue that the company’s ownership has evolved in recent years away from the image of Berle and Means such that majority of corporations are now held by a small number of major shareholders whether individuals or institutions.\textsuperscript{105}

\textsuperscript{102}This is seen clearly from the general duty placed by the UK Companies Act 2006 (s 172(1)) on directors to promote the success of the company ‘for the benefit of its members’. Nevertheless, there is more to say about the model followed by the UK corporate governance, especially with the embedment of the concept of "enlightened shareholders value”. See Chapter 3 for more details about the UK corporate governance system.


The shareholder model looks to solve the problems arising from the dispersed ownership by relying on a number of external and internal mechanisms. These include: (a) the force of market competition that drives managers to run the company efficiently to avoid their replacement; (b) the managerial labour market that forces managers to act for the success of the company to leverage their human capital rental rates; and (c) managers’ reward strategies that tie their monetary returns to those of the shareholders.\(^\text{106}\) However, Shleifer and Vishny observe that these mechanisms might minimise but do not eliminate the conflict of interests between managers and shareholders; in addition, intensive monitoring is still required.\(^\text{107}\) Also, these mechanisms have some gaps, where they become inefficient to prevent one-off fraudulent conversion.\(^\text{108}\)

Therefore, countries with a shareholder model apply legal controls to protect the interests of shareholders and ensure that directors and managers do not abuse their powers. A legal system with a shareholder-centred view of corporate governance usually emphasises directors’ duties toward shareholders and provides the latter with several rights to force directors to have regard to their interest. This only privileges shareholders, not other stakeholders. For example, the UK Companies Act puts into legislative form the fiduciary and common law duties of directors, other statutory provisions to guard against self-dealing by directors, and stipulate civil and criminal sanctions for breach of these provisions.\(^\text{109}\) In addition, the Act confers on shareholders with a statutory right to dismiss directors with a simple majority (s168) and minority shareholders have the right to challenge directors in courts for any unfairly prejudicial conduct regarding their interest (s994). This is in addition to issuing a code of corporate governance that provides a framework for best practice to companies. It could come in the form of legislation that is compulsory for companies, as in the case in the US, or in the form of soft law, as is the case in the UK.


\(^{109}\) See the UK Companies Act 2006, Part 10, Chapter 2 (UK)

Non-executive directors are independent directors whose role is to supervise and control the executive directors by providing constructive challenge to them.\footnote{John Birds and others, Boyle & Birds’ Company Law (9th edn, Jordan Publishing Limited 2014) 364; Brenda Hannigan, Company Law (4th edn, Oxford University Press 2016) 135} Under this structure, executive directors act as managers and non-executive directors are not involved in the day-to-day running of the company, however, they can still take the initiative in management decisions.\footnote{Klaus Hopt and Patrick Leyens, ‘Board Models in Europe: Recent Developments of Internal Corporate Governance Structures in Germany, the United Kingdom, France, and Italy’ (2004) ECGI Working Paper Series in Law, Working Paper 18/2004, 11 <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=487944> accessed 16 December 2019} A number of writers believe that the appointment of independent, non-executive directors in the board is essential as it helps in ensuring that the board acts in the best interest of shareholders.\footnote{See Eilis Ferran, Company Law and Corporate Finance (Oxford University Press 1999) 217-223; Malla Bhasa, “Understanding the Corporate Governance Quadrilateral” (2004) 4 Corporate Governance: The International Journal of Business in Society 7, 10; John Birds and others, Boyle & Birds’ Company Law (9th edn, Jordan Publishing Limited 2014) 364. The importance of the non-executive directors is also highlighted by Provision no 13 of the UK Corporate Governance Code 2018.} Nevertheless, French still believes otherwise, as it is unrealistic to expect non-executive directors who do not devote their whole working time to the company and receive a relatively small fee, to discipline powerful managing directors.\footnote{Derek French, Mayson, French & Ryan on Company Law (35th edn, Oxford University Press 2018) 344}

The unitary board structure has a number of advantages. Due to the fact that executives and non-executives are bound to meet together in one board, this supports a higher flow of information, faster decision making, and better communication and
involvement in business between the members.\textsuperscript{117} Nevertheless, this structure might affect the directors’ independence, as the close relationships between the members might affect the supervisory function of the non-executive directors over the executives.\textsuperscript{118}

Finally, if the protection of investors is not strong enough when they are so dispersed, then perhaps the control rights of investors will be more effective if they become concentrated. Institutional investors – mainly banks, insurance companies, public pension funds and mutual funds – are very powerful and professional shareholders and their power comes from the proportion of their shareholdings.\textsuperscript{119} Where shareholders become large they have substantial ownership stakes, and this gives them the incentive to evaluate the governance system in the company professionally and exercise their monitoring role over the management.\textsuperscript{120} Nevertheless, even when shareholders are concentrated, the problems of corporate governance still exist. This is due to the fact that ‘Shareholders are not cohesively organised to enable them to use their potential collective weight to bring the managers to account,’ as articulated by Birds and others.\textsuperscript{121} Also, there are always costs for this concentrated ownership that should not be ignored; the most obvious drawback is that while they look after their own interests they might harm the other stakeholders and other investors in the company.\textsuperscript{122}

\textbf{B. The stakeholder theory: development of the agency theory}

The other dominant corporate governance model is the stakeholder model, which is based on stakeholder theory. This theory, in contrast to shareholder theory,
extends the focus to include the interest of other categories of stakeholders. The term ‘stakeholder’ refers to ‘All persons, groups or organizations that have an impact on the company’s activity or are influenced by the company’. The term includes shareholders, employees, suppliers, creditors, customers and society in large.

At the same time that Berle and Means presented their view of modern corporations and the agency problem and asserted the need for a strict fiduciary duty of management towards shareholders, Dodd started a debate with them arguing that management should also be held accountable to the other stakeholders and society on the ground that public companies are distinct from their shareholders and subject to the principles of citizenship. Under this perspective, Dodd views a company ‘As an institution directed by persons who are primarily fiduciaries for the institution rather than for its members’. Thus, managers can take into consideration the corporate social responsibilities toward all stakeholders without being guilty of committing a breach of trust. This view was the breakthrough to the stakeholder and corporate social responsibility theories.

Following this inception, the early 1970s witnessed the emergence of a new model in the US promoting the pluralist role of managers. The stakeholder theory was developed then by Freeman. According to him, in order for modern companies to cope with ongoing changes in business, they need a new system, and in developing this new system, managers need to take into consideration the demands of all groups of stakeholders and corporate social and environmental responsibility.

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123 Nicolae Borlea and Monica-Violeta Achim, ‘Theories of Corporate Governance’ (2013) 23 Economics Series 117, 121
125 SAGE, SAGE Brief Guide to Corporate Social Responsibility: Berle-Dodd Debate (SAGE Publications 2012) 2; Véronique Magnier, Comparative Corporate Governance; Legal Perspectives (Edward Elgar Publishing 2017) 27
126 Merrick Dodd, ‘For Whom Are Corporate Managers Trustees?’ (1932) 45 Harvard Law Review, 1145, 1162-1163
127 Merrick Dodd, ‘For Whom Are Corporate Managers Trustees?’ (1932) 45 Harvard Law Review, 1145, 1161
129 Véronique Magnier, Comparative Corporate Governance; Legal Perspectives (Edward Elgar Publishing 2017) 28
130 Edward Freeman, Strategic Management: A Stakeholder Approach (Cambridge University Press 2010) 8
Nowadays, the stakeholder model can be seen in a number of European continental countries, most clearly in Germany and also in Japan.\textsuperscript{131} It is worth noting that countries applying the stakeholder model usually have a small number of public listed companies and that ownership is concentrated, in contrast to the countries applying the shareholders model.\textsuperscript{132} For example, Germany has fewer than 800 public companies, most of which have a single shareholder owning more than a quarter of voting shares.\textsuperscript{133} Due to this concentration in ownership, the problems of agency occur less frequently in these countries, as shareholders can use their power to control management.\textsuperscript{134} However, it might happen between the controlling and minority shareholders or between different stakeholders.\textsuperscript{135}

One of the major features of this system is its dual board structure, which includes a managerial board of executive members and a supervisory board composed of non-executive members that represents both shareholders and employees.\textsuperscript{136} As such, German corporations, for example, involve workers in decision making through allowing them to have a representative member in the supervisory board.\textsuperscript{137} Similarly,
Japan applies a system of employee promotion to the BoD.\textsuperscript{138} The German system also gives regard to creditors, as banks representatives are usually found in the supervisory board of companies of which they are major creditors.\textsuperscript{139}

Owing to the fact that the stakeholder model employs a supervisory board, a question arises as to the role of that board in the governance of the company. The main role of the supervisory board is the appointment, removal and supervision of the management board.\textsuperscript{140} In conducting their supervision, they can bring actions against members of the management board, such as taking legal action in courts if they breach their duties, especially their duty of care. In its mandate, the supervisory board controls the management and not the company, as they cannot directly become involved in managing the company.\textsuperscript{141}

Like the appointment of the non-executive directors in the shareholder model, members of the supervisory board in the stakeholder model are appointed by shareholders in the AGM.\textsuperscript{142} However, the main difference between the two types of directors is that non-executive directors in the shareholder model have the same powers as the executive directors on the board and can get involved in the managerial decisions without being restricted to post-decision approval as is the case for the supervisory board in the stakeholder model.\textsuperscript{143}

\textsuperscript{140} David Block and Anne-Marie Gerstner, ‘One-Tier vs. Two-Tier Board Structure: A Comparison Between the United States and Germany’ (2016) Comparative Corporate Governance and Financial Regulation Paper 1, 23
\textsuperscript{141} David Block and Anne-Marie Gerstner, ‘One-Tier vs. Two-Tier Board Structure: A Comparison Between the United States and Germany’ (2016) Comparative Corporate Governance and Financial Regulation Paper 1, 24
It is worth mentioning that the dual board, like the unitary board, has some independence issues related to the appointment of supervisory members and the existence of mutual business relationships with the management. For example, in some public companies the members of the supervisory board are chosen by the management and it is very common to include former managers and representatives of business partners in this appointment.\textsuperscript{144} In addition, separation between management and supervision might cause a problem of information asymmetry. This remoteness might reduce the supervisors’ ability to gain the needed business information to exert effective supervision.\textsuperscript{145}

Despite the apparent differences between the shareholder and stakeholder models, Shleifer and Vishny observe that, ‘Corporate governance systems of the US, Germany and Japan have more in common than is typically thought, namely a combination of large investors and a legal system that protects investor rights’.\textsuperscript{146} Having said that, Ahmad and Omar assert that the stakeholder model is getting more attention across the world due to its wider perspective in including the interests of all stakeholders.\textsuperscript{147} It is worth mentioning that, in 2019, the Business Roundtable in the US issued a new statement that redefines the purpose of corporations to include the interests of all stakeholders.\textsuperscript{148}

C. Corporate social responsibility and sustainability:

As seen from the previous illustration, corporate governance started as a system that aimed to maximise shareholder value, then it developed to include the interests of other stakeholders to form the two main models of corporate governance. Today, all companies are expected to meet the standards of citizenship through


\textsuperscript{147} Shabir Ahmad and Rosmini Omar, ‘Basic Corporate Governance Models: A Systematic Review’ (2016) 58 International Journal of Law and Management 73, 78

observing what is known as ‘corporate social responsibility (CSR)’ and ‘sustainability’ which embrace profit, people and planet.

CSR is a broad concept that requires companies to respect the needs and values of the whole society within which they operate. As Godiwalla says, ‘Today organizations are seen as integral parts of a society and they must conduct themselves with the higher standards of legality, ethics, decency and corporate citizenship.’ CSR refers to the ‘Policies and practices of corporations that reflect business responsibility for some of the wider societal good’. As reported by Carrel, four kinds of responsibilities (economic, legal, ethical, and philanthropic) shape the total CSR. He presents them in the structure of a pyramid where the economic responsibility of a company forms the foundation, at the same time it should obey the law, next it needs to be ethical as to do what is right and fair to all stakeholders, and finally it should act as a good citizen by contributing financial and human resources to the community and improving quality of life.

This does not imply that making profit and maximising shareholder value is not important. This remains a key concern to any company that wishes to stay attractive to investors. However, other interests must be considered as well as making profit. A sustainable corporation is not oblivious of its responsibilities toward shareholders and stakeholders, however, it employs a governance system that aims to improve its economic, social and ecological performance all together. This approach is known as ‘enlightened shareholder value’, which is defined by Millon as, ‘The idea that corporations should pursue shareholder wealth with a long-run

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149 Daniela Salvioni and Francesca Gennari, ‘Corporate Governance, Ownership and Sustainability’ (2016) 13 Corporate Ownership & Control 604, 604
154 Véronique Magnier, Comparative Corporate Governance; Legal Perspectives (Edward Elgar Publishing 2017) 31
155 Daniela Salvioni and Francesca Gennari, ‘Corporate Governance, Ownership and Sustainability’ (2016) 13 Corporate Ownership & Control 604, 605
orientation that seeks sustainable growth and profits based on responsible attention to the full range of relevant stakeholders interests’. 156

Accordingly, it can be seen that some companies promote their social activities and make them known to investors and the public through their websites and public relations, so as to highlight that they operate in compliance with sustainable good governance. 157 Observing CSR and sustainability tends to influence corporate governance activities. Jamali, Safieddine and Rabbath examined the relationship between corporate governance and CSR. In their work they presented three models that depict this relationship, namely: (a) corporate governance as a pillar of CSR, which requires an effective corporate governance system to support solid CSR activities; (b) CSR as an attribute of corporate governance, which requires widening the scope of corporate governance to incorporate non-financial activities; and (c) corporate governance and CSR as coexisting components of the same continuum, where poor corporate governance equals poor CSR. 158 Therefore, ‘The company requires a policy grounded on stakeholder engagement, high ethical standards, fairness, transparency and accountability’. 159 In terms of determining the responsibilities of the BoD, the OECD affirms that it is accountable to the company and shareholders and should act in their best interests; but it should also give regard to the interests of other stakeholders and observe environmental and social standards. 160

Observing CSR also requires additional information disclosure. Companies are recommended to ‘disclose policies and performance relating to business ethics, the environment and, where material to the company, social issues, human rights and other public policy commitments’. 161 Some companies now issue a sustainability


158 For more please see Dima Jamali, Asem Safieddine and Myriam Rabbath, ‘Corporate Governance and Corporate Social Responsibility Synergies and Interrelationships’ (2008) 16 Corporate Governance 443, 447-448

159 Daniela Salvioni and Francesca Gennari, ‘Corporate Governance, Ownership and Sustainability’ (2016) 13 Corporate Ownership & Control 604, 605

160 OECD, G20/OECD Principles of Corporate Governance (OECD 2015) 51

161 OECD, G20/OECD Principles of Corporate Governance (OECD 2015) 43
report highlighting their integrity, values, environmental and social impact, sustainable development and other different components of CSR.\textsuperscript{162}

As established earlier, the type of ownership affects the system of corporate governance. Similarly, the ownership structure can also affect CSR. In this context, it is seen that large shareholders are more interested in CSR than small shareholders. Oh explains that corporate social actions are seen as an investment, therefore major shareholders will be keen to get involved in the corporation’s decisions related to social investments.\textsuperscript{163} Here, major shareholders, such as long-term investors who have less ability to exit without a loss, will be concerned with CSR in their investee companies because it may impact financial performance over time.\textsuperscript{164}

With regard to the means of enforcement, CSR can be enforced either legally or via publicity. Some jurisdictions require companies to disclose their CSR activities, as is the case in the UK.\textsuperscript{165} Other countries go further and subject companies that do not take their CSR seriously to legal sanctions.\textsuperscript{166} Moreover, even if CSR is not legally enforced, corporations need to adhere to it voluntarily or otherwise it will compromise their reputation. According to Godiwalla, CSR is linked to the success of corporations as it is related to gaining the trust of the society, and without that trust, corporations may lose their business.\textsuperscript{167}

Finally, due to the fact that it is a developing approach, CSR has some specific shortcomings. For example, according to Magnier: the CSR concept is ambiguous and needs specification; it adds to BoD accountability in a way that puts a burden on them to find the balance between all relevant interests, which requires boards to be efficient

\textsuperscript{164} See Richard Johnson and Daniel Greening, ‘The Effects of Corporate Governance and Institutional Ownership Types on Corporate Social Performance’ (1999) 42 The Academy of Management Journal 564, 573
\textsuperscript{165} Daniela Salvioni and Francesca Gennari, ‘Corporate Governance, Ownership and Sustainability’ (2016) 13 Corporate Ownership & Control 604, 605
in many ways; also observing CSR might conflict with the traditional goal of profit maximisation.\textsuperscript{168}

### 1.8.2 Shariah corporate governance:

From the previous illustration, it can be seen that having different models of corporate governance results from many influential factors that have their effect on each model’s scope and concerns. The main variables by which a corporate governance model is defined and formed are the board structure, the existence of non-executive directors, the representation of other stakeholders on the board, and the most protected party. In addition, the legal system of the country has its effect on selecting the suitable model. For example, when the law provides a high level of shareholder protection, the shareholder model is usually preferred. The questions arise here: What is the theory behind SCG? Does it fit in any of the previous models? Or is it a distinct model? Before answering these questions, it is essential to define SCG.

#### 1.8.2.1 Definition of Shariah corporate governance:

It is acknowledged that corporate governance policy provides ‘the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined’.\textsuperscript{169} Therefore, IFIs, as companies offering Islamic compliant business, implement a policy of corporate governance with a distinctive internal structure and governance strategy so as to cater for their special objectives and nature of business.\textsuperscript{170} It is believed that this policy is one of the elements behind the success of Islamic finance nowadays.\textsuperscript{171} This policy is referred to as ‘Shariah corporate governance’. The most formal definition of SCG is provided by the IFSB as:

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\text{[A] set of institutional and organizational arrangements through which IFIs ensure that there is effective independent oversight of Shariah compliance over the issuance of relevant Shariah pronouncements, dissemination of information on such Shariah pronouncements and an}
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\textsuperscript{168} Véronique Magnier, Comparative Corporate Governance; Legal Perspectives (Edward Elgar Publishing 2017) 33-38
\textsuperscript{169} OECD, \textit{G20/OECD Principles of Corporate Governance} (OECD 2015) 9
\textsuperscript{170} Nasser Suleiman, ‘Corporate Governance in Islamic Banks’ (2000) 22 Society and Economy in Central and Eastern Europe 98, 99
Another definition is given by Haqqi as ‘a set of organisational arrangements through which Islamic financial institutions ensure effective oversight, responsibility and accountability of the board of directors, management and Shariah committee’. The main distinctive feature of this governance system is the SSB, which is added to the IFI’s internal structure in order to monitor and ensure its Shariah compliance.

Accordingly, SCG can be described as a group of guiding principles through which an effective supervision is imposed over the institution to monitor its compliance with Shariah. In addition, it ensures the effectiveness and accountability of the BoD, management and SSB towards shareholders with regard to the institution’s Shariah related matters. SCG is seen as the proposed mechanism for IFIs to assure their shareholders and other stakeholders that they operate in compliance with Shariah. It is a special type of governance as it is concerned with regulating and monitoring the Shariah elements of a financial institution.

1.8.2.2 The theory behind Shariah corporate governance:

A. Shariah corporate governance v shareholder model:

SCG does not fit under the shareholder model, simply because it has a different purpose and concerns. Although IFIs are profitable entities, profit maximisation is not their sole objective. They are not meant to make money ‘in any way and as much as possible’. According to Mohammed and Muhammed, ‘The agency theory does not adhere to the principles and character of Islamic law because the maximisation of the shareholders’ profit is never the only target of the agency

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One main objective of IFIs is to comply with the rules of Shariah and this affects their way of making money. Most notably, they will not deal with interest even if interest financially benefits the institution and maximises shareholder value.\(^\text{177}\)

This is not to say that profit maximisation is not an essential interest under SCG. On the contrary, Islamic finance is an Islamic alternative to conventional banking and IFIs have to compete in the financial sector or otherwise they will be abandoned. Also, making profits out of property is encouraged in Shariah as part of *Maqasid Al-Shariah* (objectives of Shariah). Shariah is based on five objectives: protecting religion, life, intellect, offspring and property, and anything that secures them is beneficial to society.\(^\text{178}\) One of the ways of protecting property is by maximising it using different means, such as investing and doing business with others. However, this maximisation is only allowed if it complies with Shariah rules and principles.\(^\text{179}\)

From the shareholders’ side, it is believed that their purpose in joining IFIs is not merely to maximise the value of their shares and profits but to do so in a particular way, i.e. under the umbrella of Shariah rules.\(^\text{180}\) In theory, it is unacceptable to the IFIs’ shareholders who are interested in Shariah compliance to be part of an institution that is only driven by the need to make money with no real care for the profit source. They are willing to deal with Islamic institutions, even if they are not as successful as the conventional ones and have fewer opportunities to prosper in a very competitive and demanding industry. Shareholders in IFIs are meant to be not only interested in the returns on their investments but also in following Shariah rules in business.\(^\text{181}\)

Also, SCG is expected to give regard to every interest that is affected by the institution and not just the shareholders in application of the *Maqasid Al-Shariah*

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\(^\text{176}\) Sulaiman Mohammed and Joriah Muhammed, ‘The Relationship Between Agency Theory, Stakeholder Theory and Shariah Supervisory Board in Islamic Banking’ (2017) 33 Humanomics 75, 76
\(^\text{180}\) Osama Shibani and Christina De Fuentes, ‘Differences and similarities between corporate governance principles in Islamic banks and Conventional banks’ (2017) 42 Research in International Business and Finance 1005, 1006
\(^\text{181}\) The interest of the IFIs’ shareholders in Shariah compliance is discussed further in Chapter Four.
(objectives of Shariah) as well. According to Bedoui and Mansour, the *Maqasid Al-Shariah* reflect Islam’s vision of justice and equitability, which aims to 'spread ethical values in order to establish justice, eliminate prejudice and alleviate hardship by the promotion of cooperation and mutual support within the family and society in general'. Therefore, IFIs should not be restricted to financial performance but must include all the dimensions of the *Maqasid Al-Shariah*. This paves the way to review the applicability of stakeholder theory as a ground for SCG, which is addressed in the following point.

**B. Shariah corporate governance v stakeholder model:**

A number of writers agree that SCG is a stakeholder-centred model in which the governance structure and style equitably protect the interests of all stakeholders whether they hold equity or not. According to Iqbal and Mirakhor, the objectives of Islamic economic system ‘do not violate property rights of any party whether it interacts with the firm directly or indirectly. In pursuit of these goals, firm honors its obligations to explicit and implicit contractual agreements without impinging on the social order’. They explain that the foundation of the stakeholder model is based on two fundamental concepts of the Islamic economic system: (a) the Islamic principles of property rights, and (b) commitment to explicit and implicit contractual agreements which govern the economic and social behavior of individuals, society and state. In terms of the rights of ownership, they explain that God is the sole owner of property and man is His trustee in managing this property in accordance with His rules. On the other hand, the social interest and the collective dimension of human life requires finding a balance between all agents who have a claim to property rights, namely the individual, society and state. With regard to contractual agreements, all economic relationships between different interested agents are governed by contracts, whether directly or indirectly, and while each party is expected to fulfil their obligation, they

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should not come into conflict with each other.\textsuperscript{187} In a similar context, Aldohni asserts that Shariah governance is an implementation of the concept of \textit{Khilafah}\textsuperscript{188} (vicegerency/trusteeship) in Shariah. He explains that under this concept, a human is a vicergerent of God and while they are encouraged to benefit themselves, they need to recognise that earth is for the benefit of all humans.\textsuperscript{189} Accordingly, this creates a brotherhood bond between people, which prevents an individual from achieving their own interest at the expense of another’s all in order to please God.\textsuperscript{190}

Hasan also agrees with the above view. He states that SCG is based on the ground of \textit{Tawhid} (oneness of God) and \textit{Shurah} (consultation).\textsuperscript{191} This means that all parties involved in the governance of an Islamic corporation are accountable to God and they manage their interrelated interests via the \textit{Shurah} process.\textsuperscript{192} In this system: the SSB has a duty to advise and supervise the institution and ensure the compliance of its business with Shariah rules; the BoD oversees overall business activities on behalf of shareholders; the managers have a fiduciary duty to run the institution as a trust for all stakeholders; the other stakeholders have a duty to fulfil their contractual agreements; and finally the country has a duty to provide external regulation and enforcement.\textsuperscript{193}

Abu-Tapanjah is also inclined to considering SCG as a stakeholder-oriented and socially responsible model. He states that Islamic economics is a social discipline that produces a just, honest, fair and balanced society, as envisioned by Islamic ethical values and rules.\textsuperscript{194} He gives evidence that IFIs do not get involved in illegal

\begin{thebibliography}{99}
\bibitem{188} Allah Almighty says, ‘And it is He who has made you successors upon the earth’. The Holy Quran, \textit{Surah Al-An’am}, Chapter 6, Verse 165. Saheeh International (tr), \textit{The Qur’an} (3rd edn, Al-Muntada Al-Islamy Trust 2010) 202
\bibitem{189} Abdul Karim Aldohni, ‘Islamic Financial Institutions and Corporate Sustainability: A Study of Oman, Dubai and Malaysia’ in Beate Sjåfjell and Christopher Bruner (eds), \textit{The Cambridge Handbook of Corporate Law, Corporate Governance and Sustainability} (Cambridge University Press 2019) 494-495
\bibitem{190} Abdul Karim Aldohni, ‘Islamic Financial Institutions and Corporate Sustainability: A Study of Oman, Dubai and Malaysia’ in Beate Sjåfjell and Christopher Bruner (eds), \textit{The Cambridge Handbook of Corporate Law, Corporate Governance and Sustainability} (Cambridge University Press 2019) 494
\bibitem{191} Zulkifli Hasan, ‘Corporate Governance: Western and Islamic Perspectives’ (2009) 5 International Review of Business Research Papers 277
\bibitem{192} Zulkifli Hasan, ‘Corporate Governance: Western and Islamic Perspectives’ (2009) 5 International Review of Business Research Papers 277, 286
\bibitem{193} Zulkifli Hasan, ‘Corporate Governance: Western and Islamic Perspectives’ (2009) 5 International Review of Business Research Papers 277, 286
\bibitem{194} Abdussalam Abu-Tapanjah, ‘Corporate governance from the Islamic perspective: A comparative analysis with OECD principles’ (2009) 20 Critical Perspectives on Accounting 556, 557
\end{thebibliography}
activities, which are detrimental to social and environmental well-being. Due to the fact that Shariah encourages business people to be fair, just and honest, they should act in accordance with good morals and not deceive or exploit their fellows. Thus, they should not use their business for the sole purpose of making personal profits but rather with a view to the interests of other stakeholders and society, conforming to the divine norms and rules.

Finally, Mansour and Bhatti also support this view. They state that the theoretical model behind SCG and the practical implications confirm that the model is concerned with maximising the joint interests of all stakeholders, in which it preserves their various interests, solves agency conflicts and disclosure requirements, and improves profitability.

**C. Distinct model: a faith-based model**

SCG clearly shares some of the characteristics of the stakeholder model and the approach of CSR, for it does not focus solely on the interests of shareholders but also considers the interests of other stakeholders and society, as explained above in a number of academic publications. However, SCG also differs significantly in other aspects from the stakeholder model as prescribed by Western literature, mainly in terms of: (a) the source of responsibility; (b) the scope of the relevant interests; and (c) the firm’s internal structure due to being influenced by religion as explained below.

**a. Difference in the source of responsibility:**

There is a significant difference between being ethical and being religious. Ethics and values should not be confused with religious obligations. What is considered to be socially responsible in society might not be accepted in religion. Therefore, because IFIs are religiously oriented, they should not follow any act that...
contradicts the rules of Shariah, even if it is accepted as ethical from another perspective or seems to be of beneficial to society.

Ethics is defined as, ‘The study of the concepts involved in practical reasoning: good, right, duty, obligation, virtue, freedom, rationality, choice’.^{199} Ethics, morality and values are different from divine rules in terms of being culturally bound and prone to alter with changes in time, place and circumstances. As seen earlier in the context of defining Shariah, the latter includes devotions, rituals, morals, ethics, transactions, penalties and more, and in this realm there are obligations and prohibitions as well as recommended, detested and permitted acts.^{200} It was also seen that the basic rules of Shariah, driven by the \textit{Quran} and \textit{Sunnah}, are fixed and cannot be altered or changed by man.^{201} For example, in Shariah it will never be over time that consuming pork or alcohol becomes optional for Muslims or that taking interest becomes permissible. This is in contrast to values and ethics that can be changed with changes in time, place and circumstances. What is considered to be unethical or immoral today might become normal behaviour in the future and vice versa, even within an Islamic society. For example, women driving in Saudi Arabia used to be banned for many years due to cultural issues, but in 2018 this ban was lifted with a change in societal perspective and needs.^{202}

In the context of Islamic finance, in order for IFIs to achieve Shariah compliance they need to avoid dealing with investors whose nature of business contradicts Shariah rules, such as those who deal with alcoholic beverages, gambling or tobacco as well as conventional banks and insurance companies.^{203} Here, someone might attribute this investment ban to being socially responsible and hence confuse Shariah compliance with CSR. However, this argument is not quite correct for the reasons given below.

^{200} See 1.7 Islamic Shariah: clarification of key terms in this chapter.
^{201} See 1.7 Islamic Shariah: clarification of key terms in this chapter.
It is acknowledged that avoiding a whole line of industries, such as those involved in alcohol, tobacco, war support or slavery, is expected among companies that are considered socially responsible. It is also acknowledged that this social responsibility has a religious root. Religious investors such as the Quakers and Methodists were the first to raise the idea of social responsibility in investing, refusing to deal with companies engaged in profiting from products designed to kill or enslave humans because it is against their beliefs. According to Schueth, ‘The deepest religious origins of socially responsible investing can still be seen in the widespread avoidance of ‘sin stocks’ by the majority of socially conscious investors in the US – those companies in the alcohol, tobacco and gaming industries’. Glac also states that, ‘The avoidance of certain companies was more a rejection of whole lines of business that were at odds with personal beliefs …. socially responsible investing was more about ensuring a ‘good use’ of money in accordance with a belief system’. Moreover, in the context of Islamic finance literature, Chowdhury and Masih argue that there are similarities between Shariah compliance and social responsibility. They state that, ‘Islamic finance and social responsibility investment share several commonalities including that they are focused principally on individuals using their money in a manner that conforms to their morals and beliefs’.

There is no doubt that IFIs should not invest in enterprises that deal with alcoholic drinks, tobacco or gambling due to the fact that these activities and products are all prohibited in Shariah, which brings them closer to socially responsible institutions. However, it should be noted that there are two major differences between being Shariah compliant and being a socially responsible company. First, being Shariah compliant not only requires IFIs to avoid investing in Shariah non-compliant

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companies, but also forbids them to allow such companies to finance them.\textsuperscript{209} Second, being Shariah compliant covers a wider range of undesired businesses. There are businesses that are Shariah non-compliant while they may be considered to be socially responsible, most importantly, conventional banks, insurance companies and other financial institutions that deal with interest.\textsuperscript{210} A system can be moral but not necessarily religious.\textsuperscript{211} A socially responsible financial investment is still considered as Shariah non-compliant because it deals with interest, which highlights the big difference between religious obligations imposed by Shariah and ethics as envisioned in the conventional perspective. In short, conducting business in accordance with religious rules should not be confused with ethics.

b. Difference in the scope of the relevant interests:

Mansour and Bhatti begin their article by saying that SCG is ‘A part of the mechanisms that aim at improving the performance of corporations, financial institutions, and the well-being of the poor class of society in a globalized setting to eliminate poverty’.\textsuperscript{212} This statement is not entirely correct for the following reasons: It is acknowledged that IFIs do not merely aim to maximise shareholder value but also give regard to the interests of other stakeholders. However, this approach does not fully reflect the Western concept of CSR as it is influenced by religion. In this context, Islamic finance might not be seen always as socially responsible from the Western perspective, especially in non-Muslim jurisdictions, which highlights the difference between being socially responsible and being religiously oriented.

Although it is permissible in Shariah to give regard to all people regardless of their sex, religion or background, however, Muslims always have priority. This impacts the IFIs choices in a manner that compromises their role as being responsible

\textsuperscript{209} This point is explained further in 5.5.1.1 Non-Shariah compliant investors in Chapter Five.


\textsuperscript{211} Abdul Karim Aldohni, ‘Morality and Religion: Complementing or Complicating Corporate Governance’ (2014) 3 Journal of Religion and Business Ethics 1, 6. See in general, E. D. Klemke, ‘On the Alleged Inseparability of Morality and Religion’ (1975) 11 Religious Studies 37. In this article Klemke declares in Page 45: ‘I accept the view that morality is a necessary condition for religion. But deny the converse: that religion is a necessary condition for morality’.

\textsuperscript{212} Walid Mansour and Ishaq Bhatti, ‘The New Paradigm of Islamic Corporate Governance’ (2018) 44 Managerial Finance 513, 513
citizens, especially in non-Muslim jurisdictions. To elaborate, being Shariah compliant affects all of the IFIs’ relationships; they all should be to the extent permitted by Shariah whether they are seen as socially responsible or not. For example, in terms of the employment of people, being socially responsible requires the company to acknowledge all segments of society without discrimination. However, because IFIs are religiously driven, their capacity to employ people is restricted to the limits set by Shariah. As such, in terms of appointing Shariah scholars to the SSB, non-Muslims cannot be appointed even if they have profound knowledge in Shariah and *Fiqh Al-Muamalat*, because being Muslim is one of the competence requirements in Shariah for being a *mufti* (Shariah scholar who is eligible to provide Shariah rulings). Also, IFIs are not expected to employ any member from the LGBT group due to religious observations. Moreover, they are usually reluctant to employ women who do not wear a *hijab* (headscarf) in observance to the Islamic dress code.

Another example in terms of community service: it is acknowledged that being socially responsible requires a firm to participate in achieving social wellbeing and fighting poverty through engaging in charitable activities. In this regard IFIs will not be seen as fully responsible in non-Muslim jurisdictions as their *zakat* and charity fund distribution is restricted by religious rules. The majority of Muslim scholars agree that *zakat* money can only be given to poor Muslims. This is in contrast to

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213 Knowledge alone is not enough to allow a person to be involved in issuing Shariah rulings, there are other competence requirements. Most importantly, *mufti* has to be Muslim, *mukallaf* (responsible) and *adl* (just). Yahya Addin Al-Nawawi, *Adab Al-Fatwa wa Al-Mufti wa Al-Mustafti* (Dar Al-Fikr Publishing 1988) 19-20. This issue is discussed further in chapter 2 in the context of explaining the SSB competency under C. Qualifications and competency.

214 It must be noted, however, that this could be illegal in some countries as is the case in the UK based on the Equality Act 2010. Nevertheless, other countries might allow some exceptions with regard to religious organisations. For example, the Employment Non-Discrimination Act 2013 in the US, which was issued especially to prohibit employment discrimination on the bases of sexual orientation and gender identity, exempts religious organisations from this prohibition. See Employment Non-Discrimination Act 2013, Section 6 (US)


216 This is based on Prophet Muhammad (PBUH) saying, ‘Invite the people to testify that none has the right to be worshipped but Allah and I am Allah’s Messenger, … then teach them that Allah has made it obligatory for them to pay the Zakat from their property and it is to be taken from the wealthy among them and given to the poor’. Muslim scholars agree that this verse orders the wealthy Muslim to pay their *zakat* to the poor Muslim. In this regard, Ibn Al-Munthir said ‘there is a consensus among the people of knowledge that *zakat* should not be given to non-Muslims’ expect to *al-mi’allahati*
giving *sadaqah* (charity) to any needy and poor regardless of their religion or beliefs, which also includes animals. In short, there is divergence in defining the concept of social responsibility between Islamic and Western perspectives, which shows that social responsibility of IFIs is religiously based and driven.

c. **Difference in the company’s internal structure:**

In terms of the board structure, there is no specification in the SCG model, it can be a unitary board or a two-tiered board as the two structures do not contradict Shariah rules. However, the distinction is found in the appointment of a SSB in the institution’s internal structure. Due to the fact that the appointment of a SSB does not contradict Shariah but on the contrary helps IFIs to achieve Shariah compliance, it is the most essential element of this model, as will be seen in the following chapter.

Given the board structure followed by the conventional models of corporate governance, it is seen that the shareholder model requires a unitary board that does not accommodate a separate supervisory board; it therefore cannot be compared to the SSB. On the other hand, the stakeholder model requires a two-tier board - a management board and a supervisory board - and therefore one might argue that this supervisory board is similar to the SSB. Perry, for example, states that, ‘The Islamic bank is similar to the German corporation in its governance model’.

However, it is worth saying that the two board structures might look the same but in fact there are major differences between them. Although they both require an independent and separate supervisory board, there are still major differences in their

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*qolobo hom* (non-Muslims whose hearts are to be softened or reconciled with Islam). See Atiyya Saqr, *Mawsou’ at Ahsan Al-Kalm fe Al-Fatawi wa Al-Ahkam*, vol 4 (Wahba Publishing 2011) 587. Zakat as a financial obligation on IFIs and its expenditures will be discussed in detail in chapter 2 under 2.3.6.1 The IFI’s obligation to pay *zakat*. 217 This is based on Allah Almighty saying, ‘Allah does not forbid you from those who do not fight you because of religion and do not expel you from your homes – from being righteous toward them and acting justly toward them. Indeed, Allah loves those who act justly,’ The Holy Quran, *Surah Al-Mumtahinah*, Chapter 60, verse 8. Saheeh International (tr), *The Qur’an* (3rd edn, Al-Muntada Al-Islamy Trust 2010) 818. See also Atiyya Saqr, *Mawsou’ at Ahsan Al-Kalm fe Al-Fatawi wa Al-Ahkam*, vol 4 (Wahba Publishing 2011) 587. As for animal, ‘When the companions of Prophet Muhammad (PBUH) asked Him is there for us a reward even for (serving) animals?, He replied yes, there is a reward for service to every living animal.’ Muslim Ibn Al-Hajjaj, *Sahih Muslim*, vol 6 (Nasiruddin Al-Khattab tr, Darussalam 2007) Hadith 2244

218 Osama Shibani and Christina De Fuentes, ‘Differences and Similarities Between Corporate Governance Principles in Islamic Banks and Conventional Banks’ (2017) 42 Research in International Business and Finance 1005, 1006

functions and duties. First, the supervisory board is composed of financial or economic professional experts who are non-executive directors, while the SSB is composed of religious scholars. Second, although both boards monitor the institution’s corporate governance policy and provide opinions, advice and recommendations, the opinion of the supervisory board members is usually advisory to the institution, while the opinion of the SSB should be compulsory and adhered to by the institution, as will be seen later in Chapter Two. The supervisory board supervises and affects the company’s financial matters only, while the SSB supervises the company’s Shariah-related matters and by extension affects its financial decisions. Finally, the SSB members depend on divine rules in providing their opinions, while the supervisory board members depend on their professional experience and other man-made rules in reaching their opinions. Thus, the functional roles of the IFIs are applied via Shariah rules.

The OECD states that board structures vary between countries: some have two-tier boards, others have unitary boards, yet in others ‘there is also an additional statutory body for audit purposes’. This statement shows that there is no fixed board structure for all companies. Although there are two dominant board structures (unitary and two-tier), some other countries still apply a different structure that includes an additional statutory body for audit purposes. This is the case for the SCG board structure. It includes an additional board for Shariah audit purposes, which can be statutory or self-regulated.

From the previous analysis it is seen that SCG does not fit squarely in any of the existing corporate governance models but it is a distinctive model that is religiously oriented or faith-based. One main objective of this model is to comply with the rules of Shariah and this objective in fact impacts the institution’s other objectives. As articulated by Aldohni, when religion is introduced into the business, it

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221 Jeswald Salacuse, ‘Corporate Governance in the New Century’ (2004) 69 Company Lawyer 1, 11
223 Osama Shibani and Christina De Fuentes, ‘Differences and similarities between corporate governance principles in Islamic banks and Conventional banks’ (2017) 42 Research in International Business and Finance 1005, 1006
224 OECD, G20/OECD Principles of Corporate Governance (OECD 2015) 51
carries ‘the governance complexities that religious values bring’. Shariah compliance affects the IFIs’ corporate governance model in a way that makes it different from the other models. Most importantly, it affects the duties of the BoD by adding an additional duty to observe the rules of Shariah in business and as a result the long-term value of the company is a function of its Shariah compliance. Also, it affects the company’s risk profile by exposing the company to an additional layer of risk (Shariah non-compliance risks). In addition, it expands the company’s extent of information disclosure by requiring the company to disclose Shariah compliance information. Finally, it affects the company’s internal corporate structure by adding a new organ (the SSB) with distinctive functions. This view is supported by a number of writers in the field of SCG. Obid and Naysary believe that, despite the similarities between the existing models and SCG, the adoption of a single model is insufficient, especially with regard to Shariah governance. Similarly, Haridan, Hassan, and Karbhari observe that, ‘Due to the wide spectrum of Islamic bank accountability, the Shariah broadens the concept of stakeholder interest and business legitimacy to include socio-religious compliance and ethics in the governance system of this alternative banking industry’. Abd Aziz and Abd Ghadas also confirm the unsuitability of the conventional corporate governance framework for SCG ‘because the apex of shari’ah corporate governance is to obey God’.

This is not to say that SCG is alien to the conventional models of corporate governance as it usually employs some of their practices, especially in terms of regulating the IFIs’ economic aspects. However, the model is visibly different in order to cater for the institutions’ nature of business, special objectives and needs. According to Ahmad and Omar, ‘The Islamic model adapts stakeholder (Continental European) model, incorporates the best practices of the Anglo-Saxon and blends with

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225 Abdul Karim Aldohni, ‘Morality and Religion: Complementing or Complicating Corporate Governance’ (2014) 3 Journal of Religion and Business Ethics 1, 12
226 Osama Shibani and Christina De Fuentes, ‘Differences and similarities between corporate governance principles in Islamic banks and Conventional banks’ (2017) 42 Research in International Business and Finance 1005, 1006
Shari’ah principles to facilitate the Islamic concept of governance’.\textsuperscript{230} Confirming this view, the IFSB states that the SCG framework issued by them is a modified version of the universally accepted international conventional framework.\textsuperscript{231} By adopting the basic standards of either or both models and customising them to fit its special needs, SCG is seen as a distinct model.

This model is suitable for faith-based institutions. It is not restricted to IFIs but any other institution that has a similar objective. In this context, the most similar institutions to IFIs are the profit-making financial institutions that invest in compliance with religious rules, such as Catholic funds. The most noticeable example of these funds is Ave Mary Mutual Funds. These funds implement a screening process in order to eliminate any investment that contradicts Catholic values. In addition, they have a Catholic Advisory Board that is comprised of religious scholars who monitor the institution’s screening process. They present themselves as institutions that provide an opportunity for investors to do business that aligns with their religious beliefs.\textsuperscript{232}

Accordingly, the final finding of this section is that SCG does not fit squarely in any of the existing models of corporate governance because it has different influential factors, scope and concerns and therefore no overarching theoretical framework can be adopted. Hence, in the context of demonstrating the SCG of IFIs, the thesis depends on the corporate governance standards issued by the relevant Islamic international standard-setting organisations, namely, the AAOIFI and IFSB. This is based on the fact that these standards are the most authoritative international guiding principles for IFIs and are adopted by many of them in practice.\textsuperscript{233} However, they cannot be studied in isolation from the conventional standards issued by the OECD and BCBS, especially since they are originally built on them but refined to cover the specificities of Islamic institutions. However, all these standards will be filtered according to the rules of Shariah as the common rules for IFIs.

\textsuperscript{230} Shabir Ahmad and Rosmini Omar, ‘Basic Corporate Governance Models: A Systematic Review’ (2016) 58 International Journal of Law and Management 73, 76


\textsuperscript{232} For more please visit the Ave Mary Mutual Funds website <https://avemariafunds.com/> accessed 30 December 2019. Luther King Capital Management Aquinas is another example of funds that operate in compliance with the church principles. For more please see <http://www.aquinASFunds.com/> accessed 30 December 2019.

\textsuperscript{233} See (n29) and (n30)
1.9 Chapters outline:

The argument in this thesis goes through several stages that are built on one another, creating a coherent discussion that ends with the final conclusion of the research. The starting point is an exploration of the current SCG framework and the problems of the system that reduce its effectiveness as ground for the research questions. The second stage requires examining the different regulatory and supervisory systems of SCG and their effectiveness in ensuring Shariah compliance in IFIs. The third stage then provides the reasons for choosing shareholder engagement as a solution that helps to improve the effectiveness of SCG and overcome its problems. The final stage provides the means of shareholder activism to improve the current SCG framework and overall Shariah compliance in Islamic finance. This argument progression is presented in six chapters. This structure has been chosen carefully in order to answer the thesis’s key questions, fulfil its objectives and support its main argument.

Chapter One is the introductory chapter that starts with identifying the research problems, questions, scope, originality, methodology, limitation and clarification of key terms. It then addresses the thesis’s theoretical framework and ends by illustrating the chapters’ outline.

Chapter Two explores SCG as the mechanism used by IFIs to ensure their Shariah compliance. In this context, SCG policy is thoroughly examined, including the governance of the SSB and the management of the Shariah non-compliance risk as the main characteristics of this policy. The chapter then presents and troubleshoots the problems related to that system that might hinder its effectiveness. This chapter attempts to answer the research questions: ‘What are the problems of SCG that challenge its effectiveness and from where do these problems originate?’

Chapter Three examines the regulatory and supervisory systems of SCG. In this context, it explores three different jurisdictions: Malaysia, Kuwait and the UK, which apply different legal systems and different levels of SCG regulation and supervision. This examination is essential in order to understand the effectiveness of the available legal systems in ensuring Shariah compliance in IFIs. This also helps to understand the scope for shareholders’ engagement in each system. This chapter then attempts to answer the research question: ‘How far is SCG regulated and supervised in practice and how effective is this supervision in helping IFIs’ to achieve their objective of a full Shariah compliance?’
Chapter Four addresses the reasons behind choosing shareholders from among the rest of the stakeholders to help in solving the problems of SCG. In this context, the chapter examines the shareholders’ ownership structure and power, interest in Shariah compliance and their fundamental rights in SCG in theory and in the three countries covered by the research. This chapter aims to answer the research question: ‘How far does engagement of shareholders form a potential solution to reduce the current problems of SCG?’

Chapter Five builds on the examination conducted in Chapter Four as it highlights the practical means available to Shariah shareholders to improve the practices of SCG and overall Shariah compliance in Islamic finance. This chapter aims to answer the research question: ‘To what extent can shareholders be active and improve SCG in Islamic finance in practice?’

Chapter Six is the concluding chapter of the thesis. This chapter provides a brief summary of the argument in the preceding chapters and the way it developed up to this chapter. This leads to the final part of the thesis which provides the final recommendations as to how SCG and Shariah compliance in IFIs can be improved with the help of Shariah shareholders.
Chapter Two: Shariah Corporate Governance Standards, Compliance and Challenges

2.1 Introduction:

As mentioned in the introductory chapter, IFIs implement a SCG policy to ensure their Shariah compliance. The main feature of this policy is the SSB that is meant to provide an effective oversight of Shariah compliance. The governance of this body is an essential part of SCG. In addition, this policy is also characterised by addressing the Shariah non-compliance risk, which is unique to IFIs. Nevertheless, SCG suffers from a number of issues, mainly related to the governance of the SSB. These issues might challenge the effectiveness of this body and the governance policy that is built thereon. The policy also encounters some issues related to the IFI’s Shariah financial obligations. Therefore, this chapter attempts to answer the research questions, ‘what are the problems of SCG that challenge its effectiveness and from where do these problems originate?’

Against this backdrop, the chapter is divided into two main sections. The first section addresses the main characteristics of SCG, which are (a) the SSB, and (b) Shariah non-compliance risk. The second section explains and addresses the problems of SCG. In this regard, six problems are highlighted: (1) the binding force of the SSB’s opinions; (2) the conflicts of interest of SSB members; (3) the divergence of Shariah rulings; (4) the remuneration of SSB members; (5) the multiple memberships of SSB members; and (6) problems related to the governance of the IFI’s Shariah financial obligations.

2.2 The main characteristics of Shariah corporate governance:

2.2.1 The Shariah Supervisory Board:

First, it must be noted that there are several types of Shariah boards in Islamic finance: internal, external and international. The internal SSB is the board appointed in the internal governance structure of IFIs at the micro level. The external SSB is not part of the IFI and can be divided into two further types:

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234 Bashar Malkawi, ‘Shar'i'ah Board in the Governance Structure of Islamic Financial Institutions’ (2013) 61 The American Journal of Comparative Law 539, 525-555; Osama Shibani and Christina De Fuentes, ‘Differences and Similarities Between Corporate Governance Principles in Islamic Banks and Conventional Banks’ (2017) 42 Research in International Business and Finance 1005, 1006
centralised/national Shariah board at the macro level and advisory Shariah firms. Neither are part of any IFIs, but they might have a relationship with the internal SSB, depending on the country’s legal system. An international SSB is the board of an Islamic international organisation, such as the Shariah board of the AAOIFI. This thesis is mainly interested in the internal SSB, however, it also refers to the other boards. Therefore, this point addresses the internal SSB in detail in terms of its definition, justification, the governance rules of its members, their roles and duties – including the conduct of an internal Shariah review and the issuance of an annual Shariah report, and finally the ethical criteria of the SSB’s members.

2.2.1.1 Definition of the SSB and its justification:

The appointment of a supervisory board of Shariah experts (or at least a Shariah scholar, depending on the institution’s size), acting as consultants to guide the IFI on its Shariah-related matters is an essential element of SCG. Several studies give evidence that the presence of a SSB and its supervisory role increases the efficiency of the IFIs’ performance. Therefore, it can be seen that the national laws of some jurisdictions emphasise the necessity of this body and legally require IFIs to include it in their internal structure, as is the case in the Gulf countries (GCC), Malaysia. The AAOIFI defines the SSB as,

[A]n independent body of specialised jurists in fiqh al-muamalat (Islamic commercial jurisprudence). However, the Shariah supervisory board may include a member other than

235 For more about the AAOIFI Shariah board please visit <http://aaoifi.com/composition-3/?lang=en> accessed 30 December 2019
those specialised in *fiqh al-muamalat*, but who should be an expert in the field of Islamic financial institutions and with knowledge of *fiqh al-muamalat*.239

Malkawi explains that the SSB is an independent body of Shariah scholars who are experts in *Fiqh Al-Muamalat* and are vested with the duty of reviewing and supervising all the institution’s activities to ensure their Shariah compliance.240 In conducting their duties, SSB members need an efficient governance system and framework that determines their full mandate and ensures their independence and effectiveness.241

Despite the fact that some of the IFIs nowadays tend to procure Shariah consulting services from external Shariah firms, these firms do not replace the need for a proper Shariah panel in the institutions’ internal structure.242 The need for appointing this board finds its justification in two aspects: financial and theological. From the financial aspect, Islamic institutions strive to fulfil an appropriate level of Shariah compliance in order to attract investors and customers who are interested in Islamic business. Failure to achieve this objective would affect the trust of those stakeholders and might result in withdrawal of funds, loss of income or voiding of contracts, which would be detrimental to the institution.243 Also, it might affect public confidence in Islamic banking system as a whole and exposes IFIs to incredibility risk.244 Therefore, it can be seen that the appointment of a SSB in IFIs is used as a marketing factor in the field of Islamic finance.245

On the other hand, the theological justification for this board is found in the Islamic rule that forbids any Muslim to do a certain matter without knowing the ruling

239 AAOIFI, *Accounting, Auditing and Governance Standards* (AAOIFI 1997), Chapter Governance Standard for Islamic Financial Institutions No. 1 Sharia’ah Supervisory Board: Appointment, Composition and Report, 4
241 Bashar Malkawi, ‘Shari’ah Board in the Governance Structure of Islamic Financial Institutions’ (2013) 61 The American Journal of Comparative Law 539, 544
244 Hichem Hamza, ‘Sharia Governance in Islamic Banks: Effectiveness and Supervision Model’ (2013) 6 International Journal of Islamic and Middle Eastern Finance and Management 226, 227
of Shariah about it. All Muslims’ activities must be subject to the commands and principles of Shariah and work within its limits. Therefore, due to the fact that conducting a Shariah-compliant business and dealing with money requires a certain level of knowledge of Islamic Shariah rules, especially *Fiqh Al-Muamalat*, IFIs tend to appoint a SSB comprised of Shariah scholars as part of their fiduciary duty towards the institution’s shareholders. The founders of an Islamic institution are accountable first to God then to shareholders, other stakeholders and to society at large. Therefore, each IFI should adhere to the rules of Shariah, and to achieve that effectively, its activities should be placed under Shariah compliance supervision. According to Alman, one of the distinctive characteristics of IFIs is that their internal corporate structure includes a SSB in addition to the usual board structure of conventional banks. In a similar context, Perry states that, ‘The Islamic bank in essence has two boards: the one required by secular law, and the one required by religious law’.

### 2.2.1.2 Governance of the SSB:

#### A. Appointment:

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246 According to Shariah rules, common people are obliged to ask Shariah scholars if they do not know the rule of a certain matter. Allah says in the Holy *Quran*, *Surah Al-Nahl*, Chapter 16, Verse 43 and again in *Surah Al-Anbya*, Chapter 21, Verse 7, ‘So ask the people of the message if you do not know.’ Saheeh International (tr), *The Qur’an* (3rd edn, Al-Muntada Al-Islamy Trust 2010) 375 and 456. Prophet Muhammad (PBUH) says about people who acted without knowledge ‘could they not ask when they did not know? The cure for ignorance is inquiry’. Sulaiman Al-Sijistani, *Sunan Abi Dawud*, vol 1 (Yaser Qadhi tr, Darussalam 2008) Hadith 336. Caliph Omar Ibn Al-Khattab (the second Caliph in the time of Rashidun Caliphate) used to expel any trader from the market who did not know the rules of trade in Islam to avoid dealing with *riba* (usury). Muhammad Al-Kattany, *Nizam Al-Hokoma Al-Nabawiyyah*, vol 2 (2nd edn, Dar Al-Arqam 1996) 17. Al-Nawawi also said, ‘It is compulsory to know the ruling of Shariah. If a common person cannot find a scholar to ask he should travel in the quest of one no matter how far he can go.’ Yahya Addin Al-Nawawi, *Al-Majmou*, vol 1 (Maktabat Al-Irshad 1980) 91. This is because if a person committed something blindly, he might fall in the forbidden. Ministry of Trust and Islamic Affairs, *Al-Mawso'ah Al-Fiqhiyyah*, vol 32 (Dar Al-Safwa 1995) 46

247 Muhammad Usmani, *An Introduction to Islamic Finance* (Idaratu Al-Ma’arif 1998) 10

248 Hussain Ramnal, The Importance of Shariah Supervision in Islamic Financial Institutions (2006) 3 Corporate Ownership and Control 204, 205

249 Aishath Muneeza and Rusni Hassan, ‘Shari’ah Corporate Governance: The Need for a Special Governance Code’ (2014) 14 Corporate Governance 120, 129-123


On the international level, the IFSB recommends that the SSB members shall be appointed by the BoD after getting approvals from the shareholders in the AGM.\textsuperscript{252} The AAOIFI also indicates that the appointment is to be made by the shareholders in the AGM upon the recommendation of the BoD.\textsuperscript{253} In practice, the SSB members are usually appointed by the shareholders in the AGM upon the nomination of the BoD or by the sole authority of the BoD, and in some rare cases by the management.\textsuperscript{254} For example, in Kuwait and Qatar, members of the SSB of IFIs are to be appointed by the shareholders upon the nomination of the BoD.\textsuperscript{255} In contrast, the law in Malaysia requires the appointment to be done by the BoD.\textsuperscript{256}

It is worth mentioning that some countries require IFIs to obtain a prior approval from a designated authority for appointing the SSB members. For example, IFIs in the UAE should get a prior approval from the Higher Shariah Authority for the SSB appointment.\textsuperscript{257} In Qatar, Islamic banks should obtain a no-objection from the Central Bank.\textsuperscript{258} Similarly, the IFIs in Malaysia need to get the prior written approval from the Central Bank.\textsuperscript{259} It should be noted that Malaysia also requires a prior written approval from the Central Bank before terminating the appointment of a SSB member.\textsuperscript{260}

**B. Composition:**

The size of the SSB differs from one IFI to another, depending on its size and the complexity of its business. However, the study by Almutairi and Quttainah reveals
hand, from Malaysia, Hong Leong Islamic Bank and Bank Islam have five SSB members, while Affin Islamic Bank Berhad has six members. 269

In this context, a question might arise concerning the constitution of the SSB: should it be limited to Shariah scholars or can it also include other professionals? According to Ayub, ‘Most Shariah boards comprise only Shariah scholars with understanding of banking and finance. Experts from other disciplines are co-opted for technical help as and when required’. 270 Almutairi and Quttainah support the idea of including other professionals in the SSB, as this encourages the board’s diversity and increases its efficiency. 271 The AAOIFI and IFSB explain that the SSB members, in performing their duties, can seek help from other experts from different disciplines who are not specialised in Islamic jurisprudence but have knowledge of Shariah and Islamic finance, such as lawyers, accountants or economists. 272 However, the IFSB emphasises that those professionals should not outnumber or outvote Shariah scholars and not interfere by any means in Shariah-related matters. 273 This is mainly due to the fact that Shariah rulings cannot be issued by anyone but a qualified Shariah scholar who has specific qualifications, as will be explained in the next point.

In addition, the IFSB recommends having Shariah members with different lengths of experience and different nationalities. 274 This could help in overcoming any shortage in senior Shariah scholars and give other scholars the opportunity to acquire experience. Also, it helps to add balance to the board between experience and fresh

270 Muhammad Ayub, Understanding Islamic Finance (John Wiley & Sons Ltd 2007) 472
ideas. In addition, having members from different nationalities could help in exposing the board to the benefit of the experience of other countries.

C. Qualifications and competency:

In performing their duties, SSB members review all the IFI’s activities and provide a Shariah opinion on their compliance with the rules of Islamic Shariah. This opinion, once it has been issued through appropriate processes, takes the form of a *fatwa* (Shariah ruling). Therefore, the ideal qualification for SSB members is to have a profound knowledge of Shariah rules, especially *Fiqh Al-Muamalat*; in addition, they need to have knowledge in modern finance and economy. If there are no scholars that combine knowledge of Shariah and economy, experts in Islamic finance, economy and legal studies who are prepared to help the SSB by providing their consultancy services are essential. Qatar Corporate Governance Principles for Banks recognise this need and state that the SSB may be assisted by any external experts in Islamic financial institutions activities. Moreover, it is evident that Shariah scholars with a higher academic education provide better Shariah supervision and increase the IFI’s performance.

The IFSB sets standards for the minimum competence requirements for the members of the SSB related to their academic background and knowledge. In

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277 Ghada Ben Zeineb and Sami Mensi, ‘Corporate Governance, Risk and Efficiency: Evidence from GCC Islamic Banks’ (2018) 44 Managerial Finance 551, 553


279 Corporate Governance Principles for Banks 2015, Annex 2, Section 1 (Qatar)


281 They should at least hold a bachelor’s degree in science of Shariah including *Fiqh Al-Muamalat*, strong skills in *Usul Al-Fiqh* (the roots of Islamic jurisprudence) that deals with methodologies through which practical legal rules are derived from the primary sources, and have a good knowledge of written Arabic. See IFSB, ‘Guiding Principles on Shariah Governance Systems for Institutions Offering
In addition, the SSB member must be honest, have integrity and a good reputation.\textsuperscript{282} According to early Muslim scholars, the main competence requirements for a Shariah scholar to be eligible to provide \textit{fatwa} are to be Muslim, \textit{mukallaf} (responsible) and \textit{adl} (just).\textsuperscript{283} In addition, they should be trustworthy, well mannered, sound minded and not affected by enmity or a relationship.\textsuperscript{284}

In general, the IFSB recommends that all persons should satisfy a specific ‘fit and proper’ criteria developed and accepted by the IFI before being appointed as a member of the SSB. It is important for members of the SSB to remain fit and proper for the whole appointment period and the IFI is encouraged to help them in this process. For this purpose, the IFSB recommends that each IFI to facilitate ongoing professional development for SSB members and develop a process for the formal assessment of the effectiveness and achievements of the SSB as a whole as well as each member of the board.\textsuperscript{285}

Some countries have addressed the qualifications of the SSB members in their national laws. For example, the Central Bank of Kuwait sets specific ‘fit and proper’ criteria for Shariah advisors, which entail a specific academic background, length of experience and other reputation and integrity requirements.\textsuperscript{286} Similarly, Malaysia provides specific qualification and disqualification requirements for SSB members that determine the required level of their knowledge, experience and reputation.\textsuperscript{287}

\textbf{2.2.1.3 Roles and duties of the SSB:}

The role of the SSB might differ from one institution to another based on the institution’s size, the complexity of their business and the extent of their Shariah

\begin{itemize}
\item \textsuperscript{282}Islamic Financial Services’ (2009) IFSB Paper no IFSB-10, Appendix 4 <https://www.ifsb.org/published.php> accessed 27 December 2019
\item \textsuperscript{283}Azhar Abdul Rahman and Abdullah Bukair, ‘The Influence of the Shariah Supervision Board on Corporate Social Responsibility Disclosure by Islamic Banks of Gulf Co-Operation Council Countries’ (2013) 6 Asian Journal of Business and Accounting 65, 77
\item \textsuperscript{284}Yahya Addin Al-Nawawi, \textit{Adab Al-Fatwa wa Al-Mufti wa Al-Mustafti} (Dar Al-Fikr Publishing 1988) 19-20
\item \textsuperscript{285}Ahmad Al-Hanbaly, \textit{Sifat Al-Fatwa wa Al-Mufti wa Al-Mustafti} (4th edn, Al-Maktab Al-Islami 1984) 4 and 14
\item \textsuperscript{287}Instructions on Shariah Supervisory Governance for Kuwaiti Islamic Banks 2016, Chapter 3, Principle 3.
\item \textsuperscript{287}Guidelines on the Governance of Shariah Committee for the Islamic Financial Institutions (BNM/RH/GL/012-1), Sections 11,12,13,16 and 17 (Malaysia)
\end{itemize}
compliance. However, the SSB mainly exercises a role at three stages: (1) the advisory stage, where the members give their Shariah ruling on whether a certain matter is Shariah-compliant or not; (2) the supervisory stage, where they supervise the implementation of their Shariah rulings; and (3) the audit stage, where they inspect all the IFI’s activities and issue a report on its Shariah compliance.

Garas explains that the SSB is involved before authorising a transaction as an ex-ante audit to prevent any incident of Shariah non-compliance. Then it reviews the process of implementing the transaction to ensure its proper execution as a remedial audit. Finally, it reviews the transaction after its issuance to ensure its compliance with the SSB’s Shariah rulings as a complementary audit. The SSB is mainly responsible for certifying the transactions, services and products issued by an IFI from the Shariah perspective. It provides consultations and monitors the work of the BoD, management and the other departments in the institution in order to ensure the proper implementation of its decisions.

Provisions governing the roles, duties and responsibilities of the SSB are usually found in the national laws regulating SCG, in the IFI’s AoA, and in its corporate governance policy and annual report. The international Islamic frameworks also address these roles. Overall, after reviewing the national laws, Islamic banks’ annual reports and the guidelines of the IFSB and AAOIFI, it can be said that the main role of the SSB is to review and approve the permissibility of all transactions, services, products, contracts and documentations of an IFI. This covers the ex-ante

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288 Zulkifli Hasan, *Shariah Governance in Islamic Banks* (Edinburgh University Press 2012) 66
292 Samy Garas, ‘The Control of the Shari’a Supervisory Board in the Islamic Financial Institutions’ (2012) 5 International Journal of Islamic and Middle Eastern Finance and Management 8, 9-10
and ex-post issue of their rulings. In the performance of this duty, SSB members basically examine the deliberating matter brought to their attention by the institution and provide their ruling on whether or not it complies with the rules of Islamic Shariah. If the matter is permissible, then they certify it; if not, they state their observations and, if possible, provide alternative remedial solutions in the light of Shariah rules. After issuing a Shariah ruling, the SSB supervises its application and implementation. In addition, they review and approve the IFI’s policies, codes and guidelines in relation to Shariah matters. Moreover, the SSB has the duty of performing an annual Shariah audit and issuing a report on the extent of the institution’s compliance with Shariah rules, to be presented in the AGM. In performing this task, they report any incident of Shariah non-compliance committed by the IFI.

There are other functions for the SSB, which involve: supervising the internal Shariah unit and any other Shariah personnel; advising and assisting the other parties serving the IFI – such as auditors, accountants and legal consultants – whenever their help is needed on Shariah-related matters; and supervising any Shariah-related activity held in the IFI, such as conferences, symposia and training schemes. Finally, the SSB also reviews and supervises the process of calculating and distributing the IFI’s zakat and other charity funds, and the disposal of any declared non-Shariah-compliant income.

Shariah members are expected to meet a number of times during the financial year to perform their above-mentioned duties. They are also expected to answer questions from the institution and its shareholders about their rulings and how they

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AAOIFI 1997, Chapters Governance Standard for Islamic Financial Institutions No. 1 Shari’a Supervisory Board: Appointment, Composition and Report - Governance Standard for Islamic Financial Institutions No. 2 Shari’a Review - Governance Standard for Islamic Financial Institutions No. 3 Internal Shari’a Review


reached their decisions. In theory, Shariah scholars are expected to perform all these duties personally and to participate in each of them with adequate time and effort. In reality, depending on the size and complexity of the institution, the SSB has affiliated Shariah units to help its members to perform their duties.

It is important to highlight the fact that the SSB does not take financial decisions or even guide management decisions in financial matters. Rather, it provides its opinion on the permissibility of an activity in the light of Shariah rules and, if possible, provides alternative solutions in the case of non-Shariah-compliant activity. Having said that, it is still possible that the opinion of the SSB indirectly influences the IFI’s financial decisions – at least in terms of determining the financial transactions in which an IFI is allowed to participate.

2.2.1.4 Shariah review and report:

Due to the distinctive characteristics of an IFI, it is required to perform a Shariah audit and reporting process in addition to the normal financial audit. The main purpose of Shariah auditing is to ensure that an IFI adheres to its Shariah compliance objective and works to fulfil its fiduciary duty towards its shareholders in this regard. Experts believe it is necessary that IFIs undergo a thorough Shariah audit and reporting process. The main purpose of Shariah auditing is to ensure that an IFI adheres to its Shariah compliance objective and works to fulfil its fiduciary duty towards its shareholders in this regard.

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296 It is acknowledged that the SSB is the cornerstone of Shariah governance in the IFI. Nevertheless, there are other recognised supporting units in the internal structure. The IFSB framework endorses two separate units: the internal Shariah compliance unit (ISCU) and the internal Shariah review unit (ISRU). See IFSB, ‘Guiding Principles on Shariah Governance Systems for Institutions Offering Islamic Financial Services’ (2009) IFSB Paper no IFSB-10, 3 <https://www.ifsb.org/published.php> accessed 27 December 2019. The AAOIFI is less clear on this division. It recognises the need for an independent internal unit or at least part of the internal audit department for the purpose of conducting an internal Shariah review. See AAOIFI, Accounting, Auditing and Governance Standards (AAOIFI 1997), Chapter Governance Standard for Islamic Financial Institutions No. 3 Internal Shari’a Review.
inspection at least once a year. The AAOIFI and IFSB recommend that each IFI should perform two levels of Shariah auditing – a periodic internal Shariah review and an annual Shariah review – in order to monitor its Shariah compliance.

A. Internal Shariah review:

Internal auditing is a monitoring mechanism that plays an essential role in the corporate governance system. An IFI, like any other financial institution, needs to perform an internal audit as part of its governance policy, however, this audit is not only needed for the financial aspects of the IFI’s activities but also for its Shariah compliance. Therefore, a periodic internal Shariah review is required in order to monitor the IFI’s compliance with Shariah rules. These reviews are expected to evaluate the Shariah compliance of an IFI on a continuous basis and should cover all its operations. In most cases, conducting a Shariah review usually requires assistance from other parties within the IFI.

These reviews are usually carried out by a Shariah review unit or Shariah officers in the internal structure of the IFIs. The reviewers are operatives of the IFI who are expected to monitor the day-to-day implementation of the SSB’s Shariah


Muhammad Ayub, Understanding Islamic Finance (John Wiley & Sons Ltd 2007) 473


Ghada Ben Zeineb and Sami Mensi, ‘Corporate Governance, Risk and Efficiency: Evidence from GCC Islamic Banks’ (2018) 44 Managerial Finance 551, 553
rulings, instructions and advice. In performing their duties, the reviewers need to record any violations of or incidents of non-compliance with Shariah rules and provide a report with their findings to the BoD, copying in the SSB and management. It is then the management’s responsibility to address the reviewers’ remarks, rectify any issues of non-compliance and prevent their recurrence in the future. Zaidi asserts that the Shariah review unit is the most important body outside the SSB that plays a role in the IFI’s Shariah governance. Hence, the reviewers should fulfil specific knowledge, independence and integrity requirements and should have a direct relationship with the SSB and management and be able to access all the information relevant to their duty.

Due to the importance of the internal Shariah review, Islamic countries usually regulate it in their national laws. The Malaysian Shariah Governance Framework describes the internal Shariah review as, ‘A function that conducts regular assessment on the compliance of the operations, business, affairs and activities of the IFI with Shariah requirements’. The Central Bank of Kuwait and the Central Bank of Qatar also emphasise the importance of the internal Shariah audit. According to their instructions, each Islamic bank should appoint an internal unit that follows and reports to the SSB, in order to perform an internal Shariah audit to ensure that the bank is following the decisions and instructions of the SSB.

B. Annual Shariah audit and report:

The internal Shariah review alone is insufficient to fulfil Shariah compliance check in an IFI. An annual Shariah audit followed by a report is still needed. The main objective of the Shariah auditing and reporting is to give the opportunity to IFIs to prove to their shareholders and the public that they work in compliance with

308 Osama Shibani and Christina De Fuentes, ‘Differences and Similarities Between Corporate Governance Principles in Islamic Banks and Conventional Banks’ (2017) 42 Research in International Business and Finance 1005, 1008
310 Jamal Zaidi, ‘Sharia Harmonization, Regulation and Supervision’ (The AAOIFI-World Bank Islamic Banking and Finance Conference, Manama, 10-11 November 2012) 6
311 Shariah Governance 2019 (BNM/RH/PD 028-100), Section 18(1) (Malaysia)
312 Instructions on Shariah Supervisory Governance for Kuwaiti Islamic Banks 2016, Chapter 4, Corporate Governance Principles for Banks 2015, Annex 2, Section 7 (Qatar)
Shariah rules. According to the AAOIFI, the annual Shariah audit should include the IFI’s documents, products, services, transactions, reports and all its other activities. The IFSB recommends that this task can be assigned either to the SSB after receiving feedback from the internal Shariah unit or to an accredited external Shariah firm or auditor. The body that carries out the Shariah review should record all its findings and conclusions on the extent of the IFI’s compliance with Shariah rules during the whole financial year and prepare a report to be produced for the shareholders in the AGM.

The Malaysian Shariah Governance Framework regards the Shariah audit as an essential part of the overall internal audit function in an IFI alongside the Shariah review. The Central Bank of Kuwait and the Central Bank of Qatar also require SSBs of Islamic banks to issue an annual report on the extent of the bank’s Shariah compliance, which should be attached to the bank’s annual report. In practice, although the majority of IFIs are committed to issuing an annual Shariah report, there are still a number of IFIs that do not make this disclosure. According to the survey conducted by Grais and Pellegrini, 9 out of 13 IFIs are committed to issuing an annual Shariah report. Another explanatory study conducted by Maali confirmed the same finding, as 72% of the investigated banks provided a Shariah report. The annual Shariah audit and report are very important as they inform shareholders, other stakeholders and the public about the extent of the IFIs’ Shariah compliance.

314 AAOIFI, Accounting, Auditing and Governance Standards (AAOIFI 1997), Chapter Governance Standard for Islamic Financial Institutions No. 2 Shari’a Review, 14
316 AAOIFI, Accounting, Auditing and Governance Standards (AAOIFI 1997), Chapter Governance Standard for Islamic Financial Institutions No. 2 Shari’a Review, 15
317 Shariah Governance 2019 (BNM/RH/PD 028-100), Section 19 (Malaysia)
318 Instructions on Shariah Supervisory Governance for Kuwaiti Islamic Banks 2016, Chapter 3, Principle 1, Section 3 (Fifth). Corporate Governance Principles for Banks 2015, Annex 2, Section 5 (Qatar)
320 Bassam Maali, Peter Casson and Christopher Napier, ‘Social Reporting by Islamic Bank’ (2006) 42 ABACUS 266, 285
2.2.1.5 The ethical criteria of the SSB members:

In conducting their duties, SSB members should observe some ethical requirements. Mainly, they should have independence and objectivity, preserve the confidentiality of the information acquired and be consistent in their Shariah opinions.

A. Independence:

SSB independence and objectivity are essential elements as they help to win shareholders and public trust in IFIs and the whole Islamic finance sector. The significant supervisory responsibility of SSB members is to be independent and objective, hence, any situations that might influence their judgments should be avoided. The measures to ensure the SSB’s independence usually set some restrictions on the SSB members, such as a restriction on being an employee of the same IFI, or a significant shareholder, or a member of the BoD therein, or a close relative to any of these. Also there are usually prohibitions related to receiving any type of return other than the usual remuneration from the institution. The governance committee in each IFI is the body responsible for the implementation of the institution’s governance policy and this should include monitoring the effectiveness of the SSB members. National corporate governance guidelines also set down the procedures that should be followed by an IFI if any independence issue occurs.

The IFSB and AAOIFI have both dealt with the matter of related party transactions in the context of addressing SSB independence. The frameworks
provide a non-exhaustive list of relationships that might affect the SSB members’ independence and they urge SSB members to avoid having such relationships. However, the frameworks differ on managing this issue. The IFSB requires the SSB member to disclose any unavoidable relationship or conflict of interest issue in writing to the institution, therefore being banned from participating in any relevant decision. The AAOIFI, on the other hand, requires each SSB member to continuously assess their relations with the IFI and to take a position on any situation that might risk their independence, and try to resolve it or report it to the SSB and provide solutions on how to resolve it. It is noted that both frameworks apply a self-assessment criterion for detecting any conflicting relationship, but in terms of resolving the issue, the IFSB applies a stricter rule. While the IFSB prohibits the member from participating in managing the issue, the AAOIFI gives him the option to resolve it himself or raise it to the SSB and propose solutions on how to resolve it. However, if the issue still exists after the internal review by the SSB, the member concerned should resign and shareholders should be informed. In practice, the most detailed and clear national regulation of SSB members’ independence is given by the instructions issued by the Central Bank of Kuwait.

B. Confidentiality:

Members of the SSB are usually given the authority to access all the IFI’s information without any restrictions, to facilitate performing the Shariah review and

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Chapter Governance Standard for Islamic Financial Institutions No. 5 Independence of Shari’a Supervisory Board


327 AAOIFI, Accounting, Auditing and Governance Standards (AAOIFI 1997), Chapter Governance Standard for Islamic Financial Institutions No. 5 Independence of Shari’a Supervisory Board, 45


329 AAOIFI, Accounting, Auditing and Governance Standards (AAOIFI 1997), Chapter Governance Standard for Islamic Financial Institutions No. 5 Independence of Shari’a Supervisory Board, 45

330 Instructions on Shariah Supervisory Governance for Kuwaiti Islamic Banks 2016, Chapter 3, Principle 2
audit as well as their other duties. During this process, they will come across sensitive and confidential information related to the institution’s practices. It is part of their professional ethics to deal with such information with appropriate vigilance and not to use it in any way that might harm the institution; above all, they must not disclose this information to the institution’s competitors and the public.\textsuperscript{331} This criterion is stressed by the Central Bank of Kuwait, which provides some examples of the confidential information that should not be disclosed by a SSB member.\textsuperscript{332} Similarly, the Malaysian Shariah Governance Framework asserts the duty of SSB members to keep the information obtained during the course of their work confidential at all times and not to misuse it in any way.\textsuperscript{333}

C. Consistency:

The main duty of SSB members is to issue Shariah rulings on an IFI’s activities. Therefore, SSB members are expected to reach consensus on their decisions, which helps create efficient Shariah governance.\textsuperscript{334} They are also expected to be consistent in their own decisions, especially if they are members in multiple IFIs.\textsuperscript{335} This issue is highlighted in the Kuwait Central Bank instructions, which emphasise the need to reach consensus on the SSB’s decisions.\textsuperscript{336} The IFSB also explains that there are procedures for issuing, amending or withdrawing \textit{fatwas} that need to be observed and followed by the SSB.\textsuperscript{337} In this context, the Malaysian Shariah Governance Framework states that a SSB is expected to develop a structured process in arriving at Shariah decisions in order to ensure their decisions’ credibility.\textsuperscript{338} Consistency is also demanded among all SSBs as this helps to promote

\begin{footnotesize}
\begin{enumerate}
\item Instructions on Shariah Supervisory Governance for Kuwaiti Islamic Banks 2016, Chapter 3, Principle 4
\item Shariah Governance 2019 (BNM/RH/PD 028-100), Section 12.6 (Malaysia)
\item Rezaul Miajee, ‘Shariah Governance: Perspective of Islamic Finance’ (2018) 1 International Journal of Shari'ah and Corporate Governance Research 1, 2
\item Instructions on Shariah Supervisory Governance for Kuwaiti Islamic Banks 2016, Chapter 3, Principle 5
\item Shariah Governance 2019 (BNM/RH/PD 028-100), Section 10.10 (Malaysia)
\end{enumerate}
\end{footnotesize}
trust in the Islamic finance sector at large. Without this consistency, investors and consumers might become uncertain as to whether a service, product or transaction is Shariah-compliant.339

2.2.1.6 Legal status of SSB members:

SSB members are not employees of the institution and are free to provide their services to more than one institution simultaneously. They are paid for their services and their relationship with the institution is created by an agreement.340 They are independent individuals who do not practise executive duties and are not expected to monitor the institution’s Shariah related matters on a day-to-day basis as this is the job of the Shariah internal unit, as explained above.341 The SSB members are distinguished by two things: (a) they only oversee the Shariah related matters of the institution, and (b) their opinion is usually binding on the institution. This brings up the question of what is the legal status of a SSB member? Answering this question helps to understand the SSB members’ liability, which will be discussed in detail in Chapter Four under the shareholders’ right to take legal proceedings against the SSB members.

Rider presented the idea of considering SSB members as ‘shadow directors’342 due to the fact that the BoD is accustomed to act in accordance with their advice.343 Aldohni, on the other hand, suggested that SSB members should be treated as non-executive directors due to the similarity in the supervisory roles of both

341 See A. Internal Shariah review of 2.2.1.4 Shariah review and report in this chapter.
342 Section 251 of the UK Companies Act 2006 defines a ‘shadow directors’ as ‘A person in accordance with whose directions or instructions the directors of the company are accustomed to act’. However, the Section also states that: ‘A person is not to be regarded as a shadow director by reason only that the directors act on advice given by him in a professional capacity’. In this context, Rider explains that the individual must be in a position of dominance and not be appointed in a specific position in the company. Barry Rider, ‘Corporate Governance for Institutions Offering Islamic Financial Services’ in Craig Nethercott and David Eisenberg (eds) Islamic Finance: Law and Practice (Oxford University Press 2012) 169
343 Barry Rider, ‘Corporate Governance for Institutions Offering Islamic Financial Services’ in Craig Nethercott and David Eisenberg (eds) Islamic Finance: Law and Practice (Oxford University Press 2012) 168-169
professions. The outcome, in both arguments, is that SSB members ‘will be governed by the system of directors’ duties’.

SSB members are not employees of the IFI and do not exercise any executive responsibilities for running its business. Therefore, they cannot be seen as executive directors or managers or compared with them. However, SSB members share some similarities with the non-executive directors in the shareholder model, as described in Chapter One. Non-executive directors, like SSB members, are independent individuals, not employees of the company but appointed through a letter of appointment, and are allowed to sit on multiple boards at the same time. Also, they do not have executive responsibilities and are not expected to be involved in the day-to-day running of the company. They are appointed by the institution and receive remuneration for their services.

Nevertheless, there are still some considerable differences between SSB members and non-executive directors that might exclude the possibility of sharing similar liability. Some differences between SSB members and non-executive directors were illustrated in the introductory chapter to clarify the differences between the board structure in SCG and the supervisory board in the stakeholder model. Here, other differences will be explained that have an effect on determining their liability.

First, non-executive directors have different tasks from the SSB members. They are expected to monitor the executive directors, mainly to oversee their pay, appoint or remove the chief executive, and assess the strategy and performance of the company, while SSB members guide and oversee the company’s compliance with Shariah rules. Second, non-executive directors are expected to act in the interest of the company’s shareholders, while the SSB members enforce the rules of Shariah.

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345 Abdul Karim Aldohni, ‘Morality and Religion: Complementing or Complicating Corporate Governance’ (2014) 3 Journal of Religion and Business Ethics 1, 11
346 See A. The shareholder theory: the product of the agency problem in Chapter One.
347 Sally Wheeler, ‘Non-Executive Directors and Corporate Governance’ (2009) 60 Northern Ireland Legal Quarterly 51, 56
349 See c. Difference in the firm’s internal structure in Chapter One.
350 Sally Wheeler, ‘Non-Executive Directors and Corporate Governance’ (2009) 60 Northern Ireland Legal Quarterly 51, 56
whether or not they benefit shareholders. Third, non-executive directors practise directorship and have the same liability as executive directors, while SSB members, although they can be invited to attend the BoD meetings, do not hold a position on that board and do not share the same liability as the directors. Having said that, the most significant similarity between SSB members and directors is that they both serve in a fiduciary capacity, as will be explained below.

‘In determining whether a relationship is fiduciary, the substance of the relationship must be examined in light of its commercial context and the entirety of the obligations undertaken’. 351 Examples of fiduciaries include partners (to their fellow partners), solicitors and other professional advisers (to their clients), trustees (to beneficiaries), agents (to principals) and directors (to their companies). 352

Guiding the institution in Shariah related matters and monitoring its Shariah compliance is supposed to be the duty of the shareholders as owners of the institution, but because it is not possible for them to perform this duty they appoint Shariah experts and give them some power and authority to perform this duty efficiently. Moreover, as seen above, SSB members are not employees, they are paid for their services and their relationship with the institution is created by an agreement, therefore the relationship between them and the institution is fiduciary. Velasco defines a fiduciary as, ‘An expert who can be expected to do a better job than the entrustor or beneficiary could do for himself’. 353 Miller also said, ‘Where we rely on another person to represent us or to take care of our person or property, we do so within a fiduciary relationship’. 354 The fiduciary relationship (wakalah in Arabic) is also regulated in Shariah and defined in a similar manner as well. 355 SSB members are appointed by shareholders to oversee their institution’s Shariah compliance. In that, they provide professional services to the institution and owe its shareholders a

355 Ministry of Trust and Islamic Affairs, Al-Mawso’ah Al-Fiqhiiyyah, vol 45 (Al-Muqahwy 2006) 5
fiduciary duty. Hasan confirms this assumption by stating the ‘Shariah board has fiduciary duty towards all stakeholders in IFIs’.356

After exploring the SSB, its governance and the legal status of its members as the body that should be appointed by an IFI to ensure its Shariah compliance, the following point examines the institution’s duty to manage Shariah non-compliance risk as another distinct feature of its SCG.

2.2.2 Management of Shariah non-compliance risk:

Management of risk is an essential part of any corporate governance policy. According to the OECD, it is the duty of the BoD to oversee the company’s risk management, which involves ‘specifying the types and degree of risk that a company is willing to accept in pursuit of its goals, and how it will manage the risks it creates through its operations and relationships’.357 An IFI, like any other financial institution, is exposed to a number of risks that should be overseen and managed. However, by its special nature, Islamic finance is exposed to an additional type of risk that is unique to its business, which is Shariah non-compliance risk or Shariah risk.358

The IFSB addresses six categories of risks for IFIs: credit risk, equity investment risk, market risk, liquidity risk, rate of return risk and operational risk.359 The operational risk is one of the main risks in a bank’s risk management programme and the most related to the institution’s internal governance.360 In the governance of an IFI, the operational risk is mainly related to Shariah non-compliance risk.361

356 Zulkifli Hasan, Shariah Governance in Islamic Banks (Edinburgh University Press 2012) 62
357 OECD, G20/OECD Principles of Corporate Governance (OECD 2015) 53-54
359 It is worth mentioning that the IFSB risk management principles complement the Basel Principles for the Sound Management of Operational Risk in order to cater for the specificities of IFIs. IFSB, ‘Guiding Principles of Risk Management for Institutions (Other than Insurance Institutions) Offering Only Islamic Financial Services’ (2005) IFSB Paper no IFSB-1, 3 <https://www.ifsb.org/published.php> accessed 26 December 2019
360 Operational risk is defined as ‘the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events’. BCBS, ‘International Convergence of Capital Measurement and Capital Standards: A Revised Framework Comprehensive Version’ (BIS, 2006) 144 <https://www.bis.org/publ/bcbs128.htm> accessed 30 December 2019
A number of definitions found in the literature describe Shariah non-compliance risk. They all confirm the fact that it arises from a failure to comply with Shariah rules. Archer and Haron define it as,

[T]he risk of non-compliance resulting from a failure of an Islamic bank’s internal systems and personnel that should ensure its compliance with the Shariah rules and principles determined by its Shariah board or the relevant body in the jurisdiction in which the Islamic bank operates.\textsuperscript{362}

Balz refers to it as, ‘The chance that an Islamic financing transaction is challenged on grounds that it does not comply with Islamic law’.\textsuperscript{363} While Ginena chooses to define it as, ‘The risk of financial losses that an IFI may experience as a result of non-compliance with Shariah precepts in activities, as ascertained by the SSB or the pertinent authority in the relevant jurisdiction’.\textsuperscript{364}

Management of Shariah non-compliance risk is very important to any IFI in order to ensure its credibility, survival and development in the financial sector. Shariah non-compliance practices could be detrimental to Islamic finance as they could tarnish the trust of investors, customers, depositors and the public in IFIs.\textsuperscript{365} According to Ayub, ‘Ensuring Shariah compliance is the most important job in Islamic banking. Any failure in this regard may cause systemic risk for Islamic banking and income loss for any bank’.\textsuperscript{366} Hamza warns that Shariah risk can cause many losses to the IFI, as investors might cancel their investment contracts and withdraw their money, causing a drop in the institution’s profit and performance.\textsuperscript{367} A similar conclusion was reached by Ali on the likely impact of poor Shariah compliance on the stability of IFIs: he states, ‘Non-compliance can prompt excessive deposit withdrawals and cause even a financially sound institution to fail’.\textsuperscript{368} This is

\textsuperscript{362} Simon Archer and Abdullah Haron, ‘Operational Risk Exposures of Islamic Banks’ in Simon Archer and Rifaat Abdel Karim (eds), \textit{Islamic Finance: The Regulatory Challenge} (John Wiley & Sons 2007) 124

\textsuperscript{363} Kilian Balz, ‘Shari’ah risk? How Islamic Finance has Transformed Islamic Contract Law’ (2008) 9 Islamic Legal Studies Program Harvard Law School, Occasional Publications 1, 23

\textsuperscript{364} Karim Ginena, ‘Shariah Risk and Corporate Governance of Islamic Banks’ (2014) 14 Corporate Governance 86, 90

\textsuperscript{365} Rohaida Basiruddin and Habib Ahmed, ‘The Role of Corporate Governance on Shariah Non-compliant Risk: Evidence from Southeast Asia’ [2019] Corporate Governance 1, 8

\textsuperscript{366} Muhammad Ayub, \textit{Understanding Islamic Finance} (John Wiley & Sons Ltd 2007) 363

\textsuperscript{367} Hichem Hamza, ‘Sharia Governance in Islamic Banks: Effectiveness and Supervision Model’ (2013) 6 International Journal of Islamic and Middle Eastern Finance and Management 226, 227


supported by the result of the empirical investigation conducted by Chapra and Ahmed, which indicated that depositors of Islamic banks would withdraw their deposits and move to different banks if their Islamic banks fail to comply with Shariah in business.\textsuperscript{369} Furthermore, the inadequacy of Shariah non-compliance risk management exposes IFIs to other serious risks, such as legal, compliance, reputational and credit risks, as explained below.

A. Legal risk:

Legal risk is a form of operational risk and is defined by the Basel Committee as, ‘Exposure to fines, penalties, punitive damages resulting from supervisory actions and private settlements.’\textsuperscript{370} It can also be defined as, ‘The possibility that lawsuits, adverse judgments or contracts that turn out to be unenforceable can disrupt or adversely affect the operations or condition of the bank’.\textsuperscript{371} This risk can also be associated with the legal uncertainty, which results from unclear documentation or conflicting legal interpretations.\textsuperscript{372} This may pose a challenge to IFIs in countries where Shariah is not the basis for their legislation due to the diverse interpretations of its rules.\textsuperscript{373}

IFIs state in their AoA their nature as Shariah-compliant companies and many shareholders, investors, customers, depositors and other stakeholders deal with them on that basis. Therefore, failing to fulfil Shariah compliance as included in an IFI’s AoA might result in the institution’s liability. Any affected party may sue an IFI for any non-Shariah-compliant activity or inefficient level of Shariah compliance in general. Accordingly, an IFI may become subject to lawsuits resulting from the failure to observe Shariah compliance as described by its AoA, or even for failure to

\textsuperscript{371} BCBS, ‘Customer Due Diligence for Banks’ (BIS, 2001) 4 <https://www.bis.org/publ/bcbs85.htm> 30 December 2019
\textsuperscript{372} For more please see Abdul Karim Aldohni, ‘The Quest for a Better Legal and Regulatory Framework for Islamic Banking’ (2015) 17 Ecclesiastical Law Journal 15, 32-33
\textsuperscript{373} This issue will be explained and discussed in detail in Chapter Five.
practise due diligence to achieve Shariah compliance, which illustrates how Shariah risk might lead to legal risk.  

B. Compliance risk:

Compliance risk is similar to legal risk as they both arise from failing to adhere to legal obligations. However, compliance risk is related to failure to meet legal requirements as prescribed by national laws and regulations. The Basel Committee defines compliance risk as,

\[ \text{The risk of legal or regulatory sanctions, material financial loss, or loss to reputation a bank may suffer as a result of its failure to comply with laws, regulations, rules, related self-regulatory organisation standards, and codes of conduct applicable to its banking activities.} \]

In this situation, any IFI that fails to comply with the rules set by the national regulator with regard to SCG might be subject to legal sanctions. A clear example is seen in Malaysia, where the Islamic Financial Service Act of 2013 sets a duty on each IFI to ensure compliance with Shariah. Also, it requires any IFI, in the case of conducting a Shariah non-compliant activity, to inform the Central Bank immediately, cease from carry on doing such activity and submit a report to the Central Bank within a specific period of time, including a plan on the rectification of non-compliance. Moreover, the Act imposes legal sanctions for non-compliance with the aforementioned provisions that include imprisonment or a large fine or both.

C. Reputational risk:

Reputational risk is defined as,

\[ \text{The risk arising from negative perception on the part of customers, counterparties, shareholders, investors, debt-holders, market analysts, other relevant parties or regulators that can adversely affect a bank’s ability to maintain existing, or establish new, business relationships and continued access to sources of funding.} \]

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374 Karim Ginena, ‘Shariah Risk and Corporate Governance of Islamic Banks’ (2014) 14 Corporate Governance 86, 91
375 BCBS, ‘Compliance and the Compliance Function in Banks’ (BIS, 2005) 7 <https://www.bis.org/publ/bcbs113.htm> accessed 30 December 2019
376 Islamic Financial Service Act of 2013, Section 28 (Malaysia)
377 Islamic Financial Service Act of 2013, Section 28 (Malaysia)
378 Islamic Financial Service Act of 2013, Section 28 (Malaysia)
379 BCBS, ‘Enhancements to the Basel II Framework’ (BIS, 2009) 19 <https://www.bis.org/publ/bcbs157.htm> 30 December 2019. It is also defined as ‘the potential that adverse publicity regarding a bank’s business practices and associations, whether accurate or not, will cause a loss of confidence in the integrity of the institution’. BCBS, ‘Customer Due Diligence for Banks’ (BIS, 2001) 4 <https://www.bis.org/publ/bcbs85.htm> 30 December 2019
Shariah compliance is an important factor for investing and dealing with IFIs. Accordingly, in order to attract investors, depositors, customers and other stakeholders it is very crucial for IFIs to keep their Shariah compliance at a satisfactory level. If Shariah compliance is jeopardised, IFIs are exposed to losing their credibility and the trust of their stakeholders. Reputational risk can be the result of issuing/adopting odd or contravening Shariah opinions. It can also arise from poor communication and disclosure of information.

D. Credit risk:

Credit risk is one of the main risk categories in any bank’s risk profile. It is defined as, ‘The potential that a bank borrower or counterparty will fail to meet its obligations in accordance with agreed terms’. In Islamic finance, the Shariah compliance of an IFI’s products and services depends mainly on the validity of its contracts. The contracts will be valid and effective if their essential elements are compliant with Shariah rules. As such, contracts should not include any prohibitive elements, such as interest, Ikrah (duress), ghalat (mistake), ghubn (inequality), taghrir (deception) or illegal products or services. If these requirements are not fully met, contracts will be void and this will expose the IFI to credit risk as customers might breach their contracts in the belief that the terms they agreed on are not being fulfilled by the institution.

Examples of incidents that affect the extent of the IFI’s Shariah compliance include using their financing facility for non-Shariah-compliant purposes in executing a Tawarruq (subtitle asset backing a loan) contract, or providing a capital guarantee to the capital provider in the Mudarabah (passive partnership) contract, or using a conventional insurance panel for a car financing facility in an Ijarah (leasing) contract.

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381 BCBS, ‘Principles for the Management of Credit Risk’ (BIS, 2000) 1 [https://www.bis.org/publ/bcbs75.htm] accessed 30 December 2019


383 Karim Ginena, ‘Shariah Risk and Corporate Governance of Islamic Banks’ (2014) 14 Corporate Governance 86, 90
The SSB is the main organ of governance responsible for identifying and addressing Shariah-related risks. Hence it is important that SSB members are highly qualified, have the required experience and in general meet the ‘fit and proper’ criteria set by the institution. Also it is important that SSB members carefully consider the Shariah rulings they adopt and are ready to provide a justification for their decision to shareholders and to the public. Nevertheless, part of Shariah risk can be posed by the SSB members, as will be seen later in this chapter, and the IFI should take that into consideration as well.

For the above-mentioned reasons, Shariah non-compliance risk is considered one of the most important risk categories in an IFI’s risk profile. Therefore, each IFI is expected to have a comprehensive risk management and reporting process that caters for its distinctive risk profile and at the same time complies with Shariah rules as part of its SCG. National laws of some Islamic countries have acknowledged the necessity for Shariah non-compliance risk management in IFIs. According to the Malaysian Shariah Governance Framework, it is important to identify, assess, measure, monitor and report the Shariah non-compliance risks inherent in the IFI’s operations and activities. The Kuwait Central Bank’s Instructions on Shariah Governance also instructs Islamic banks to have a policy and a department for Shariah non-compliance risk management and confirms the BoD’s responsibility in this regard.

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388 Shariah Governance 2019 (BNM/RH/PD 028-100), Section 17 (Malaysia)
389 Instructions on Shariah Supervisory Governance for Kuwaiti Islamic Banks 2016, Chapter 2, Section 3
After illustrating the two main characteristics of SCG in IFIs, the SSB and Shariah non-compliance risk, the following section tackles the challenges facing this system that might threaten its effectiveness.

2.3 Problems of Shariah corporate governance:

A number of previous studies have tackled some of the challenges facing SCG that might limit the functions of the SSB and hence affect the extent of the IFI’s Shariah compliance.\textsuperscript{390} After all, the SSB is the body that provides assurance to shareholders, other stakeholders and the public that an IFI is Shariah-compliant. The most important problems that are said to affect the effectiveness of a SSB are: (a) the binding force of the SSB’s opinions; (b) the conflicts of interest of SSB members; (c) the divergence of Shariah rulings; (d) the remuneration of SSB members; and (e) their multiple memberships. Not all of these problems have been given proper attention in the literature. Therefore, this section sheds light on these problems and their effect on SSBs and their mandate to supervise Shariah compliance in IFIs. The section also sheds the light on some problems related to the governance of the IFIs’ Shariah financial obligations that are seen as another weakness of SCG.

2.3.1 The binding force of the SSB’s opinions:

It is acknowledged that the SSB plays the main role in ensuring the IFI’s Shariah compliance. The question, however, is whether the SSB’s decisions are binding on the IFI or merely advisory. First, it is important to explore the perspective of Shariah on the enforceability of Shariah rulings. Under Islamic Shariah,\textit{ fatwa} in principle does not have binding force in relation to the person who seeks it.\textsuperscript{391} This main rule, however, has some exceptions where it becomes compulsory to follow a \textit{fatwa}: (a) if there is no other Shariah scholar able to provide \textit{fatwas}; (b) if all scholars agree on that opinion; (c) if the \textit{fatwa} endorses a consensus opinion\textsuperscript{392}; (d) if the scholar who issued the \textit{fatwa} is the most knowledgeable and trustworthy; (e) if the person who sought the \textit{fatwa} commits themself to follow it; and (f) if that person

\textsuperscript{390} See (n16)
\textsuperscript{391} Ahmad Al-Hanbaly, \textit{Sifat Al-Fatwa wa Al-Mufti wa Al-Mustafti} (Al-Maktab Al-Islami 1960) 81; Yahya Addin Al-Nawawi, \textit{Adab Al-Fatwa wa Al-Mufti wa Al-Mustafti} (Dar Al-Fikr Publishing 1988) 20; Ministry of Trust and Islamic Affairs, \textit{Al-Mawsou‘ ah Al-Fiqhiyyah}, vol 32 (Dar Al-Safwa 1995) 49
\textsuperscript{392} Consensus or \textit{Ijma'a} refers to the agreement by Muslim scholars on a religious matter. Muhammad Al-Ghazaly, \textit{Al-Mustasfa min Ilm Al-Usool}, vol 2 (Al-Resalah Organisation 1997) 249
wholeheartedly believes that it is a correct opinion. Therefore, although some might argue that fatwas do not have binding force and that there is a diversity of Shariah opinions in the field of Islamic financial industry for IFIs to follow, it can be said that, in Shariah, fatwas issued by the SSB are still binding on the IFI because they fall into one or more of the cases of mandatory fatwa mentioned above. Especially if all the members of the SSB have agreed on an opinion or if the IFI has committed itself to adhere to its SSB decisions or when national law confers this force on them. Recognising the binding nature of SSB’s opinions is important in order to ensure the IFI’s adherence to its decisions, which contributes to the institution’s Shariah compliance in return. If an opinion of the SSB is advisory, there is a chance that it might get ignored by the BoD, which could have a negative influence on the IFI’s Shariah compliance. This threat was evident in the survey conducted by Dawud on the enforceability of Shariah rulings. The result showed that only 59.6% of IFIs consider Shariah rulings as binding, 20% consider them as merely advisory, while the rest did not respond. Therefore, national laws need to require IFIs to adhere to their SSB’s opinions and not to leave it to the BoD’s discretion.

It is worth mentioning that conferring binding force on the opinions of the SSB is stressed by the Islamic international organisations. The AAOIFI states that, ‘The fatwas, and rulings of the Shari’a supervisory board shall be binding on the Islamic financial institution’. Similarly, the IFSB affirms the necessity for an IFI to strictly adhere to the fatwas issued by its SSB and not to search for fatwas of other Shariah scholars to suit its interests ‘fatwa shopping’. If the binding force of Shariah rulings is not addressed in the national law, it is important for each individual IFI to commit itself to follow the opinions of its SSB by including a certain clause on this matter in its AoA.

393 Ahmad Al-Hanbaly, Sifat Al-Fatwa wa Al-Mufti wa Al-Mustafti (Al-Maktab Al-Islami 1960) 82; Yahya Addin Al-Nawawi, Adab Al-Fatwa wa Al-Mufti wa Al-Mustafti (Dar Al-Fikr Publishing 1988) 80-81; Ministry of Trust and Islamic Affairs, Al-Mawsou’ah Al-Fiqhiyyah, vol 32 (Dar Al-Safwa 1995) 49-50
394 Bashar Malkawi, ‘Shari’ah Board in the Governance Structure of Islamic Financial Institutions’ (2013) 61 The American Journal of Comparative Law 539, 572
396 AAOIFI, Accounting, Auditing and Governance Standards (AAOIFI 1997), Chapter Governance Standard for Islamic Financial Institutions No. 1 Shari’a Supervisory Board: Appointment, Composition and Report, 4
2.3.2 The conflicts of interest of SSB members:

First, it is worthwhile to indicate that relationships, friendship or hostility are not supposed to have any effect on a Shariah scholar when issuing fatwas. Therefore, in Islamic jurisprudence, it is permissible for a mufti (Shariah scholar who is eligible to provide Shariah rulings) to provide their opinion to their parents, children, friends, partners or even enemies and can also depend on their own fatwa. This is for two reasons: first, a mufti is like a narrator who tells the ruling of Shariah in a specific or general matter, and second, fatwa in principle is not compulsory.

Nevertheless, Islamic jurisprudence instructs that a mufti should not favour themself or anyone else in their fatwa and gives an illustration where a mufti provides a fatwa to their relative on the permissibility of doing something and prohibits the same thing to others. If such a thing happens, their fairness and objectivity will be undermined and therefore their opinion will not be taken into consideration. This does not mean that a Shariah scholar cannot change their opinion as a fatwa is subject to change, due to change in time, place, public interest, necessity, mistakes and other reasons.

Accordingly, it can be said that SSB members are not in a position to favour their interests over the shareholders’ as they are supposed to provide their opinion without regard to any interest but God’s. In this context, Hussain Hamid Hassan (an eminent scholar and chairman of many Islamic financial institutions) describes SSB members as, ‘The most worthy of confidence and trust, for they are leaders and role models. They explain the rule of Allah in the issues presented to them, and their fatwas are not considered the property of the mustafti (the person who seeks the fatwa) who asks them’. However, when the IFI is bound to follow the fatwas of its SSB, the second reason for for considering Shariah scholars to be beyond suspicion is

398 Yahya Addin Al-Nawawi, Al-Majmou, vol 1 (Maktabat Al-Irshad 1980) 74; Ministry of Trust and Islamic Affairs, Al-Mawso’ah Al-Fiqhiyyah, vol 32 (Dar Al-Safwa 1995) 31
399 Ministry of Trust and Islamic Affairs, Al-Mawso’ah Al-Fiqhiyyah, vol 32 (Dar Al-Safwa 1995) 31
400 Ministry of Trust and Islamic Affairs, Al-Mawso’ah Al-Fiqhiyyah, vol 32 (Dar Al-Safwa 1995) 31
401 Ministry of Trust and Islamic Affairs, Al-Mawso’ah Al-Fiqhiyyah, vol 32 (Dar Al-Safwa 1995) 31
402 For more see Ibn Al-Qayyim Al-Jouziyyah, I’laam Al-Muwaaqi’een an Rab Al-Alameen, vol 4 (Dar Ibn Al-jouzy Publishing 2002) 337
negated. In addition, as seen above, Islamic jurisprudence clarifies that unfair prejudice on the part of a *mufti* might happen. In the end, Shariah scholars are not infallible and are subject to human mistakes.

The independence of SSB members might be compromised by some practices. For example, their independence could be affected by the method of their appointment due to the fact that they are appointed or nominated by the BoD, which might raise a chance that they become loyal to the BoD at the expense of the institution’s Shariah compliance. The remuneration received by SSB members is usually fixed by the BoD and this could raise the same concern. Moreover, while performing their Shariah supervision, it is very likely that SSB members will refuse to certify a certain transaction or product due to being non-Shariah compliant that could be seen as affecting the IFI’s financial performance, and hence the management might try to influence the SSB members to let them be more flexible in applying Shariah rules. According to Aldohni, although SSB members have no executive powers, they can still exert influence over the management, and that although directors must comply with the SSB’s decisions, they still have powers over their appointment and dismissal. Also, it is argued that SSB members sometimes are not diligently performing their fiduciary duty of supervising Shariah compliance, as they rely heavily on the outcome and results presented to them by the internal Shariah unit or officers, which compromises their independence.

In general, it is recommended to impose some restrictions on SSB memberships to manage conflicts of interest between Shariah scholars and the IFI without diminishing their revered position. The law should set some rules to ensure

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SSB members’ independence thereby contributing to the proper application of Shariah rules within the institution. The independence measures should aim to set down boundaries between the SSB, the management and the BoD, and find solutions to any possible independence impairment or conflicts of interest.

2.3.3 Divergence of Shariah rulings:

Diversity in Shariah rulings among SSBs of different IFIs means a SSB of an individual IFI might issue a Shariah ruling on a certain matter and a SSB of another IFI might issue a different Shariah ruling on the same matter. According to McMillen, this diversity can occur due to different interpretations of Shariah rules given by different Shariah schools of thought, which might result in one IFI accepting a certain product or service and another rejecting it. A number of writers believe that diversity in Shariah rulings for similar practices causes confusion among the IFIs’ investors and customers, which not only affects individual institutions but also the whole Islamic finance sector. Hamza describes this issue as ‘one of the greatest challenges to be raised by Islamic finance’; Abd Jabbar calls it ‘a grave problem in Islamic finance’; and Hasan states that it ‘affects the Islamic finance image’. Before we agree or disagree with the opinion that divergence of Shariah rulings forms a challenge for SCG, it is important to understand the perspective of Shariah about this. In this regard, the meaning of divergence in Shariah rulings, the reasons behind this divergence, its limits and controls and then its impact on IFIs will be explored below.

2.3.3.1 What is divergence in Shariah rulings?

The literal meaning of Ikhtilaf in the Arabic language is ‘lack of agreement’ and that is the same meaning used by Shariah scholars to describe divergence between Shariah opinions. Ikhtilaf in Shariah is permissible and there is considerable evidence

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410 Hichem Hamza, ‘Sharia Governance in Islamic Banks: Effectiveness and Supervision Model’ (2013) 6 International Journal of Islamic and Middle Eastern Finance and Management 226, 230
as to its permissibility. However, it is important to understand that not every disagreement between two opinions is considered a genuine disagreement. There are some cases where two opinions look as if they disagree but in fact they are similar: for example, where there is divergence in the words used by scholars to express their opinions. If one scholar interprets the phrase ‘the right path’ in Surah Al-Fatiha as the Quran while another interprets it as Islam, this is not a genuine disagreement because the Quran in fact is the core of Islam. Also, the disagreement of a scholar is not considered if it is not based on proper ijtihad (human intellectual effort or diligence) and solid evidence. Scholars describe this opinion as a product of following inclination, whim or desire and Muslims should not follow it. A genuine disagreement exists, however, when there are two contrasting Shariah opinions both based on valid and clear evidence. A clear example in the financial context is seen in the disagreement between the Islamic schools of thought about the validity of a rahn agreement (pledge agreement) if it contains a corrupt condition: scholars from the Maliki school rules that the whole contract is defective, while other scholars from the Hanafi and the Hanbali schools ruled that the defect is limited to the condition and does not extend to the whole contract that stays valid. Nevertheless, there are limits and controls in order for this disagreement to be acceptable.

2.3.3.2 Limits and controls on divergence in Shariah rulings:

There are things that are not open for disagreement between Muslim scholars. For example, Shariah does not allow diverse opinions about the basics of Islam that

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413 For example, ‘Narrated Ibn Umar: when the Prophet (PBUH) returned from the battle of Al-Ahzab (The confederates), he said to us, "None should offer the ‘Asr prayer but at Bani Quraiza.” The Asr prayer became due for some of them on the way. Some of them decided not to offer the Salat but at Bani Quraiza while others decided to offer the Salat on the spot and said that the intention of the Prophet (PBUH) was not what the former party had understood. And when that was told to the Prophet (PBUH) he did not blame anyone of them.’ Muhammad Bukhari, Sahih Al- Bukhari, vol 2 (Muhammad Khan tr, Darussalam 1997) Hadith 946. According to Al-Asqalany, evidence on the permissibility of ikhtilaf in secondary matters can be derived from this Hadith and that each opinion is correct. Ahmad Al-Asqalany, Fat’h Al-Bary, vol 7 (Al-Maktabah Al-Salafiyyah) 409

414 Imam Al-Shatibi has counted the cases of non-genuine disagreement and limited them to ten types. For more please see Ministry of Trust and Islamic Affairs, Al-Mawso’ah Al-Fiqhiyyah, vol 7 (2nd edn, That Al-Salasil 1986) 292


416 Ministry of Trust and Islamic Affairs, Al-Mawso’ah Al-Fiqhiyyah, vol 2 (That Al-Salasil 1983) 292

are substantiated by conclusive evidence, such as the existence of God and His oneness.\textsuperscript{418} Imam Al-Shafi’\textacute{e} said, ‘What Allah has given evidence about, in His book or over the tongue of His Messenger, is not subject for disagreement to those who are aware of the evidence. Other than that is open for diverse interpretation’.\textsuperscript{419} Therefore, disagreement is only allowed in the secondary matters that do not have clear evidence in Shariah and this is where \textit{ijtihad} has found its way as the secondary source of Shariah.\textsuperscript{420} In this regard, it is acceptable that two or more Shariah scholars have different opinions about the same matter or even a single scholar changes or retrieves their opinion.

In order to decide whether a disagreement is genuine, the evidence and proof of the disagreeing scholars need to be examined. If the contrary opinion is based on considerable evidence from the sources of Shariah then it is considered genuine. The strength of evidence presented in the opinion is what matters and not the person who provides it. According to Imam Ezz Addin Al-Salmy, ‘The criterion in the case of disagreement is the evidence, the opinion of the disagreeing person is weak and far from right if his presented evidence is not considered legitimate in Shariah and therefore his opinion should be disregarded’.\textsuperscript{421} Imam Taj Addin Al-Subky states that the evidence is strong if it draws the attention of knowledgeable scholars and ends the argument in respect to that evidence, even if the level of the disagreeing scholar in Shariah and \textit{ijtihad} knowledge is lower than the one he disagrees with.\textsuperscript{422} Due to these limits and controls, Imam Al-Shatiby states that most disagreements between knowledgeable Shariah scholars are genuine.\textsuperscript{423}

The most obvious evidence for the validity of a Shariah opinion is when most Muslim scholars agree on its validity. In this context, the odd opinion of a single or few scholars opposition to the majority of scholars is disregarded and excluded.\textsuperscript{424} In modern days, to escape the problem of divergence in Shariah opinions, Muslim scholars in different countries tend to establish councils of the most respected and

\textsuperscript{418} Ismael Al-Ajlouny, \textit{Kashf Al-Khafa\textacute{a} wa Muzil Al-Ilbas amma Ishnahara min Al-Ahadith ala Alsinat Al-Nas} (Maktabat Al-Quds 1932) 65
\textsuperscript{419} Muhammad Al-Shafi’\textacute{e}, \textit{Al-Risalah} (Mustafa Al-Halaby and sons Publishers 1938)
\textsuperscript{420} Ibrahim Al-Shatiby, \textit{Al-Mu\textsuperscript{\textacute{u}}wafaqat fi Usul Al-Shariah}, vol 5 (Dar Ibn Affan Publishers 1997) 65
\textsuperscript{421} Ezz Addin Al-Salmy, \textit{Qawa\textacute{e}d Al-Ahkam fi Masaleh Al-Anam}, vol 1 (Maktabat Al-Koliyat Al-Azhariyya 1991) 253
\textsuperscript{422} Jalaluddin Al-Syouti, \textit{Al-Ashbah wa Al-Naza\textacute{e}r} (Dar Al-Kotob Al-Elmiyyah 1983) 112-113
\textsuperscript{423} Ibrahim Al-Shatiby, \textit{Al-Mu\textsuperscript{\textacute{u}}wafaqat fi Usul Al-Shariah}, vol 1 (Dar Ibn Affan Publishers 1997) 164
\textsuperscript{424} Bearing in mind the criterion mentioned above about the strength of the evidence presented by the disagreeing scholar. Ibrahim Al-Shatiby, \textit{Al-Mu\textsuperscript{\textacute{u}}wafaqat fi Usul Al-Shariah}, vol 5 (Dar Ibn Affan Publishers 1997) 140
knowledgeable Muslim scholars to issue general Shariah rulings that they all agree upon. The most important on international level are the International Islamic Fiqh Academy\textsuperscript{425}, Islamic Fiqh Council\textsuperscript{426} and the European Council for Fatwa and Research\textsuperscript{427}, and on the regional level, the General Presidency for the Departments of Scientific Research and Ifta in Saudi Arabia\textsuperscript{428}, and Al-Azhar Al-Sharif in Egypt\textsuperscript{429}. Most Muslims trust and follow the opinions of these councils due to the reputation of their Shariah scholars and because they issue their Shariah opinions collectively.

For new and contemporary matters, Muslims these days usually rely on the fatwa issued by the aforementioned Islamic councils and disregard odd opinions. In this context, if the majority of Muslim scholars state that a certain matter is prohibited and a single scholar thinks otherwise, common Muslims should follow the opinion of the group and ignore the odd opinion. For example, and most related to Islamic finance, the fatwa of Ali Gomaa that conventional banks’ interest is not riba but profits and therefore permissible\textsuperscript{430} in contrary to the opinion of the majority of Muslim scholars.\textsuperscript{431}

2.3.3.3 Reasons for divergence in Shariah rulings:

Divergence between Shariah rulings mainly happens for five reasons: (a) a deliberate legal lacuna in Islamic Shariah; (b) urf (custom) in Shariah; (c) the amenability of Shariah texts to diverse interpretation; (d) the rule of necessity in Shariah; and (e) the amenability of Shariah rulings to change according to time, place and circumstances.

A. The deliberate legal lacuna in Shariah:

\begin{footnotesize}
\begin{enumerate}
\item The International Islamic Fiqh Academy was established by the Organisation of Islamic Cooperation. For more please visit \texttt{<http://www.iifa-aifi.org/>} accessed 30 December 2019
\item Islamic Fiqh Council was established by the Muslim World League. For more please visit \texttt{<http://ar.themwl.org/>} accessed 30 December 2019
\item For more about the European Council for Fatwa and Research please visit \texttt{<https://www.e-cfr.org/>} accessed 30 December 2019
\item The General Presidency for the Departments of Scientific Research and Ifta serves as the national Shariah board in Saudi Arabia. It consists of the most senior scholars. The Committee members are: Abdul-Aziz Abdullah ibn Baz, Abdullah ibn Qa’ud, Abdullah ibn Ghudayyan and Abdul-Razzaq Afify. For more please visit \texttt{<https://www.alifta.gov.sa/Ar/Pages/default.aspx>} accessed 30 December 2019
\item For more about Al-Azhar Al-Sharif please visit \texttt{<http://www.azhar.eg/>} accessed 30 December 2019
\item Ali Gomma, ‘Banks’ Interests are Permissible and There is No Doubt About It’ (YouTube, 24 February 2015) \texttt{<https://www.youtube.com/watch?v=i7iHxUNlAtY>} accessed 19 December 2019
\item See (n3)
\end{enumerate}
\end{footnotesize}
There are things that have been left without direct regulation in Shariah or without sufficient detailed regulation. Scholars say that the aim of this lacuna is to add some flexibility to Shariah by allowing people to set down rules that suit their changing circumstances, which makes Shariah applicable for all times and places. As such, a number of issues are left to be dealt with by Muslim scholars using *ijtihad* and here is where divergence in opinions might happen, as explained above.

**B. Urf (custom) in Shariah:**

In the context of Shariah, *urf* (custom) is defined as, ‘A matter well known and followed by people whether it is a saying, an act or an abandonment. However, in order for *urf* to be considered valid and therefore accepted in Shariah, it should not negate any of Shariah known rules and principles’. There are some definitive indicators for the acceptance of *urf* in Shariah. For example, in the determination of the allowance that should be paid by a father to his baby’s mother, Allah says, ‘Upon the father is the mothers’ provision and their clothing according to what is acceptable’. And as to the money a man should pay to his divorced wife: ‘And for divorced women is a provision according to what is acceptable – a duty upon the righteous’.

*Urf* is resorted to in the case of the absence of religious texts regulating a subject matter. Scholars say that valid *urf* should be considered in both legislating and judging.

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432 Prophet Muhammad (PBUH) said, ‘Verily Allah Almighty has laid down religious obligations, so do not neglect them; and He has set limits, so do not overstep them; and He has forbidden some things, so do not violate them; and He has remained silent about some things, out of compassion for you, not forgetfulness; so do not seek after them.’ Yahya Addin Al-Nawawi, *The Forty Hadiths of Imam Al-Nawawi* (Mahmoud Makkok tr, Garnet Publishing 2017) Hadith 30

433 Allah Almighty says over the tongue of Archangel Gabriel, ‘And we [angels] descend not except by the order of your Lord. To Him belongs that before us and that behind us and what is in between. And never is your Lord forgetful.’ Holly Quran, *Surah Maryam*, Chapter 19, Verse 64. Saheeh International (tr), *The Qur’an* (3rd edn, Al-Muntada Al-Islami 2010) 433


435 Abdul Wahab Khalaf, *Elm Usul Al-Fiqh* (8th edn, Maktabat Al-Da`wa Al-Islamiyyah 1956) 89. For more about *urf* in Shariah please see Hafiz Abdul Ghani, ‘Conditions of a Valid Custom in Islamic and Common Laws’ (2012) 3 International Journal of Business and Social Science 306


438 Abdulwahab Khalaf, *Elm Usul Al-Fiqh* (8th edn, Maktabat Al-Da`wa Al-Islamiyyah 1956) 61
fact that urf changes according to time and place.\textsuperscript{439} What is accepted to be urf in a society or in a specific time might not be accepted in another society or another time.

C. The amenability of Shariah texts to diverse interpretations:

One of the main reasons for diverse rulings between Shariah scholars is that not all the texts of the Quran and Sunnah have the same level of certainty and clarity in meaning. Some of them are absolute upon which everyone agrees on, and others are uncertain and allow for multiple interpretations, which demand that scholars search for their connotations and here is where the divergence happens.\textsuperscript{440} A clear example of this matter is the disagreement between scholars in determining the time a divorced woman should spend before she can get married again as they disagree in interpreting the word ‘period’ in Surah Al-Baqarah – as to whether it is the menstrual period, or the purification from the menstrual period.\textsuperscript{441}

D. The rule of necessity in Shariah:

Another reason for divergence between Shariah rulings is that Shariah takes into account the necessity and different circumstances between people. The necessity rule in Shariah, whenever its conditions exist, exempts the person who committed a prohibited matter from punishment hereafter.\textsuperscript{442} For example, eating pork is prohibited in Shariah, however, if due to some exceptional circumstances a Muslim had to eat it, they will be excused.\textsuperscript{443} Determining whether the conditions of the necessity rule exist and therefore permit the act could vary between one scholar and another and here is where divergence in opinions could happen.

E. The amenability of Shariah rulings to change with changes in time, place and circumstances:

\textsuperscript{439} Yusuf Al-Qaradawi, Awamil Al-Si‘ah wa Al-Murounah fi Al-Shariah Al-Islamiyah (The Supreme Consultative Committee on the Implementation of the Provisions of Muslim Shariah Law 2002) 38
\textsuperscript{440} Ali Al-Khaffif, Asbab Ikhtilaf Al-Fuqaha‘a (Dar Al-Fikr Al-Araby 1996) 106
\textsuperscript{441} The Holy Quran, Surah Al-Baqarah, chapter 2, Verse 228. Saheeh International (tr), The Qur’an (3rd edn, Al-Muntada Al-Islami 2010) 47. See also Hamad Al-Sa‘edy, Asbab Ikhtilaf Al-Fuqaha‘a fi Aal-Farouq Al-Fiqhiyyah (Islamic University 2011) 84
\textsuperscript{443} Allah said in the Holy Quran, Surah Al-Baqarah, Chapter 2, Verse 173, ‘He has only forbidden to you dead animals, blood, the flesh of swine, and that which has been dedicated to other than Allah. But whoever is forced [by necessity], neither desiring [it] nor transgressing [its limit], there is no sin upon him. Indeed, Allah is Forgiving and Merciful.’ Saheeh International (tr), The Qur’an (3rd edn, Al-Muntada Al-Islami 2010) 34
Shariah rulings are prone to change according to changes in time, place and circumstances as a matter of flexibility in Shariah, and this might result in issuing different Shariah rulings on a similar matter.\textsuperscript{444} A striking example to illustrate this diversity is when Prophet Muhammad (PBUH) prohibited a young man from kissing his wife while fasting and at the same time allowed an old man to do so in a similar situation. The Prophet justified this contradiction by stating that ‘the old man can hold himself’.\textsuperscript{445} This diversity illustrates the fact that different circumstances can lead to different Shariah rulings.

The previous explanation clarifies the main reasons behind diversity in Shariah rulings between scholars in the Muslim nation and they are the same reasons behind diversity in Shariah rulings in Islamic finance. For example, a new product or a service can be suggested by an IFI that has not been previously addressed in Shariah; the SSB of one IFI might find the new product or service permissible while another IFI finds it prohibited, each based on evidence from Shariah. Diversity could also happen between different countries. A product might be found permissible in one country due to its customs while in another country it is questionable. Also, a SSB might issue a Shariah ruling on a certain matter at one time and later change its opinion. An example of diversity in Shariah rulings among different SSBs is the International Fiqh Academy’s opinion on the impermissibility of Tawarruq (subtitle asset backing a loan), although it is widely used in the Middle East.\textsuperscript{446} Another example of diversity between different jurisdictions is the Malaysian version of Murabaha (passive partnership) and Bai Bithaman Ajil Sukuk. Although these bonds have been certified in Malaysia by the Malaysian Shariah Advisory Council at the Central Bank level, their usage has not been accepted elsewhere. Other scholars

\textsuperscript{444} For more about Shariah rulings applicability to change please see Ibn Al-Qayyim Al-Jouziyyah, \textit{I\’laam Al-Muwaggi\’een an Rab Al-Alameen}, vol 4 (Dar Ibn Al-jouzy Publishing 2002) 337

\textsuperscript{445} ‘Abdulla Bin Omar narrated: we were with the Prophet (PBUH) and a young man came and said “oh Messenger of Allah, can I kiss while fasting?” He said “no”. Then an old man came and said “can I kiss while fasting?” He said “yes”. We looked at each other. The Prophet said “I know why you looked at each other. The old man can hold himself”. Ministry of Trust and Islamic Affairs, \textit{Al-Mawso\’ah Al-Fiqhiyyah}, vol 13 (2nd edn, That Al-Salasil 1988) 135. To illustrate further, in Shariah, intercourse between a husband and wife is forbidden during fasting. When the Prophet (PBUH) said ‘the old man can hold himself’ he was implying that an old man is more likely able to hold his sexual desire than a young man. Imam Malik has also mentioned this distinction and the diversity in ruling. Malik Bin Anas, \textit{Muwatta Malik}, vol 2 (Mustafa Bab Al-Halaby1985) 293

consider them a legal trick to turn around the practice of usury because of the government guarantee on the capital invested.447

Going back to the concern as to whether this diversity negatively challenges SCG and Islamic finance at large, there is no doubt that standardisation of Shariah rulings between different SSBs around the world is positive and if achieved it would be an advantage to Islamic finance. However, if this harmony has not been achieved or has not been achieved fully, it should not be seen as a definite disadvantage that obstructs the development of IFIs and Islamic finance. This is especially the case since divergence is not likely to happen over the basic rules of Shariah. When divergence in Shariah rulings happens between scholars, it should not be to the extent that allows enmity or division between Muslims. Al-Shatiby states that any disagreement that causes enmity between people is not part of Islam and it should not be followed.448 Moreover, diversity among Shariah scholars is not major due to the limits and controls illustrated above. Flexibility in Shariah allows scholars to use *ijithad* to set down rules that suit the circumstances of each country based on the basic rules and principles of Shariah. In this regard, if divergence happens between SSBs, it ‘does not alter the fact the there is only one Shariah’ 449, as scholars would not violate the basic rules of Shariah. Having a CSB at the central bank’s level to supervise the implementation of Shariah rules and solve any disagreement between SSBs would help in reaching a level of harmonisation among the different SSBs in a single country.450 However, this would not be very effective in eliminating the divergence in Shariah rulings between different countries, which should not be seen as a major issue due to the fact that real divergence is acceptable in Shariah.

Finally, it is also worth mentioning that the divergence problem in Islamic

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448 Allah says in the Holy Quran, Surah Al-An’am Chapter 6 Verse 159, ‘Indeed, those who have divided their religion and become sects - you, [O Muhammad], are not [associated] with them in anything.’ Saheeh International (tr), The Qur’an (3rd edn, Al-Muntada Al-Islami 2010) 201. See also Abi Is’haq Al-Shatiby, Al-Mu’waafaqat fi Usul Al-Shariah, vol 4 (Dar Ibn Affan Publishers 1997) 134

449 Muhammad Kamali, ‘The Scope of Diversity and Ikhtilaf (Jurisprudential Disagreement) in the Shariah’ (1998) 37 Islamic Studies 315, 316

finance can also appear in somewhere else other than in SSB Shariah opinions. Jurisdictions hosting IFIs, especially those that are interested in implementing a suitable regulatory system that caters for their specificity, try to adhere to the international conventional regulatory and supervisory standards, such as those issued by the OECD and BCBS, and at the same time align them with the needs of IFIs. This deviating implementation – or enhanced implemented from the perspective of Islamic finance – requires discretion by regulators in forming the suitable standards and therefore the outcome might differ from one jurisdiction to another. This is also should not be seen as a critical problem as it is acknowledged that it is not possible to have a single model for all jurisdictions. However, adopting the international standards issued by the Islamic organisations, such as the IFSB and AAOIFI that already align the conventional standards to the IFIs’ needs in their frameworks, might help in dealing with this issue.

2.3.4 The remuneration of SSB members:

SSB members receive annual remuneration from IFIs for their services. Table One in Appendix Two gives examples of remuneration received by SSB members in Islamic banks in different countries. A questionnaire conducted by Garas for the purpose of comparing the remuneration of SSB and BoD members in the GCC countries revealed that the remuneration of members of the SSB is lower than the remuneration of the BoD members in almost 60% of IFIs, while 14.5% of the SSB members receive a higher remuneration than BoD members and over 15% of the SSB members receive an amount equal to the BoD members.\(^{451}\) Hence, it is believed that the remuneration of SSB members should be given as much attention in regulations as that given to the remuneration of directors and executives – especially given that they receive an equivalent or even a higher amount in some IFIs. However, from studying the international and national regulations of some Islamic countries, it can be said that the remuneration of SSB members has not been given the required attention.

The AAOIFI framework only encourages IFIs to set an appropriate governance structure in relation to the remuneration policies for the BoD, SSB and management, and states that these policies should be developed on an independent

\(^{451}\) The questionnaire was sent to all the IFIs in the GCC countries and the data has been collected in 2009. The missing answers were 10.5%. Samy Garas, ‘The Conflicts of Interest Inside the Shari’a Supervisory Board’ (2012) 5 International Journal of Islamic and Middle Eastern Finance and Management 88, 95
and transparent basis.\textsuperscript{452} In addition, in the context of addressing the SSB members’ objectivity and independence, the AAOIFI warns against paying bonus payments to Shariah members based on the institution’s performance.\textsuperscript{453} It also states that if the total remuneration for SSB members represents a large proportion of the institution’s recurring fees, this could raise an independence issue.\textsuperscript{454} The IFSB, on the other hand, has not tackled the subject, except for asserting that the remuneration should be established from the outset.\textsuperscript{455}

On a national level, the Malaysian Guidelines on the Governance of the Shariah Committee explain that SSB members’ remuneration should be determined by the BoD and shall be commensurate with and reflect the roles and functions of the SSB.\textsuperscript{456} The Central Bank of Kuwait has regulated the issue in more detail: it states that the remuneration is to be suggested by the remuneration committee and approved by the shareholders at the AGM, or they can delegate this issue to the BoD.\textsuperscript{457} The remuneration should be commensurate with the duties and responsibilities of the SSB members. In addition, it should not be conditional on achieving a particular result or a benefit to the institution.\textsuperscript{458} The Qatar Corporate Governance Principles for Banks also state that the remuneration of the SSB members should be decided by the shareholders or they may delegate the matter to the BoD.\textsuperscript{459} However, none of the aforementioned countries imposes a legal requirement on IFIs to disclose the remuneration received by their SSB members in the annual report.

There are a number of international principles and supervisory guidelines on compensation that help financial institutions when setting their remuneration policy for the BoD members, key executives and all staff: most importantly, the FSF

\begin{itemize}
\item \textsuperscript{452} AAOIFI, \emph{Accounting, Auditing and Governance Standards} (AAOIFI 1997), Chapter Governance Standard for Islamic Financial Institutions No. 6 Statement on Governance Principles for Islamic Financial Institutions, 60
\item \textsuperscript{453} AAOIFI, \emph{Accounting, Auditing and Governance Standards} (AAOIFI 1997), Chapter Governance Standard for Islamic Financial Institutions No. 5 Independence of Shari’a Supervisory Board, 47
\item \textsuperscript{454} AAOIFI, \emph{Accounting, Auditing and Governance Standards} (AAOIFI 1997), Chapter Governance Standard for Islamic Financial Institutions No. 5 Independence of Shari’a Supervisory Board, 47
\item \textsuperscript{456} Guidelines on the Governance of Shariah Committee for the Islamic Financial Institutions (BNM/RH/GL/012-1), Section 21(g) (Malaysia)
\item \textsuperscript{457} Instructions on Shariah Supervisory Governance for Kuwaiti Islamic Banks 2016, Chapter 3, Principle 1, Section 1(A)(5)
\item \textsuperscript{458} Instructions on Shariah Supervisory Governance for Kuwaiti Islamic Banks 2016, Chapter 3, Principle 2, Section 6
\item \textsuperscript{459} Corporate Governance Principles for Banks 2015, Annex 2, Section 3 (Qatar)
\end{itemize}
Principles for Sound Compensation Practices and the International Corporate Governance Network (ICGN) Guidance on Non-Executive Director Remuneration.460 However, all these principles and guidelines are not applicable to SSB members as they are intended for BoD members, key executives, non-executive directors and all staff. Nevertheless, IFIs can still benefit from these international standards with regard to setting SSB remuneration policy, taking into account the specific characteristics of SSBs and the institution’s Shariah compliance.

In general, SSB members: are not employees of the IFI; their decision is binding on the institution; they provide their opinion based on divine rules and therefore do not primarily take into account the interests of the institution or its shareholders; no financial benefit should be expected because of them; and they add a layer of risk to the institution’s risk profile. In addition, receiving remuneration from the institution for supervisory services might raise an independence issue. Therefore, proper and specific remuneration principles are required for SSB members that take into consideration these characteristics and the nature of their duty. The Basel Report on the Range of Methodologies for Risk and Performance Alignment of Remuneration states that any remuneration policy should be aligned with the institution’s specific characteristics and nature.461 The remuneration policy for the SSB should meet the international requirements of sound remuneration and also be Shariah-compliant. Therefore, before providing the standards for the SSB members’ remuneration, a Shariah perspective on the right of Shariah scholars to receive remuneration for their duty, and the risk they impose on the institution needs to be understood.

2.3.4.1 Shariah perspective on the right of Shariah scholars to receive remuneration:

There is no straightforward rule in the Quran or Sunnah that addresses the right of mufti to a receive return for providing fatwa. However, Fiqh have addressed this matter. First, it is important to point out that there is an agreement among Muslim scholars on the religious nature of a mufti’s duty and that it is of priority for them to

donate their work freely and not to take any payment in return. This is because providing fatwa is a work that should be sincere, to get closer to God and to report on Him and His Messenger Muhammad (PBUH).

However, if the scholar is in need and there are other qualified scholars, it is agreed among scholars that it is permissible for them to receive wages from the authority only and not from the mustafti. Nevertheless, there are two situations addressed by a few early individual scholars that permit receiving money from the mustafti. The first situation is where the authority does not pay the scholars, yet the people of a country need a scholar to provide them with fatwas, so in return they give them a livelihood from their own money. The second situation is when a mustafti asks for a written fatwa, which is an additional act to a verbal fatwa. In this instance, if a person asks for a written fatwa then a mufti is allowed to take money from them for their handwriting but not for the fatwa itself. Nonetheless, a number of scholars still disagree; they believe a mufti should not receive a return from the mustafti, whether for a verbal or a written fatwa. Ibn Othaimeen (a Shariah scholar) also agrees that

463 There are different views among the Islamic schools of thoughts about the rule on receiving return for teaching people the principles and rules of Shariah and directing them through their right application. The Al-Hanafi doctrine believes in the prohibition of receiving return, because teaching people their religion is regarded as an act of worship that should meant to be sincere to God and hence should not be paid for. Al-Shafi’i and Al-Maliki schools view the matter from a different angle. They trust the permissibility of receiving return, however, the return is not for the act itself but for the benefit received by others on its basis. The Al-Hanbali school looks at the financial status of the scholar. It sees the permissibility of receiving return if the scholar is in need of money only. It reached this opinion by reasoning the scholar to the orphan’s guardian who should refrain from taking fee if he is self-sufficient. These opinions are reported by Ibn Taymiya. Taqi Addin Ibn Taymiya, Majmou’ Al-Fatwai, vol 30 (Majma’a Al-Malik Fahad 2004) 113; Taqi Addin Ibn Taymiya, Mawsu’at Al-Ijma (Dar Al-Bayan Al-Haditha 1999) 407
465 They are Al-Khateeb from Al-Shafi’i doctrine and Al-Saymari from Al-Hanbali doctrine. Al-Khateeb Al-Baghdady, Al-Fuqeh wa Al-Mutafaqiq, vol 2 (2nd ed, Dar Ibn Al-Jawzi 2000) 347. See also Ahmad Ibn Hamdan Al-Hanbaly, Sifat Al-Fatwa wa Al-Mufti wa Al-Mustafti, (Al-Maktab Al-Islami 1960) 35. Al-Khateeb added, to stop this from happening, the authority should take the lead and bear the responsibility for paying the mufti. He based his opinion on the ground that Caliph Omar Ibn Al-Khattab used to give every person in the same position an annual amount of money. Yahya Addin Al-Nawawi, Al-Majmou, vol 1 (Maktabat Al-Irshad 1980) 80
466 This is the opinion of Abo Hatim Al-Qazwiniy from Al-Shafi’i doctrine. He said, ‘a scholar might say I am obliged to provide a verbal fatwa but not a written one’. Yahya Addin Al-Nawawi, Al-Majmou, vol 1 (Maktabat Al-Irshad 1980) 80
467 Ibn Al-Qayyim believes that even a written fatwa should also be provided for free for the sake of God, however, a mufti is not obliged to provide the pen and paper. Ibn Al-Qayyim Al-Jouziyyah, I’laam Al-Muwagqi’een an Rab Al-Alameen, vol 6 (Dar Ibn Al-jouzy 2002) 158. Al-Bahoty states that a
any act meant to bring a person closer to God should not be subjected to lease.\textsuperscript{468} However, he believes that if work that is intended to be sincere to God has at the same time extended to benefit people, then the person is allowed to be paid for it, not for the worship but for the benefit received by others.\textsuperscript{469}

In summary, there is an agreement among Muslim scholars on the preference for donating freely the work of providing \textit{fatwa} in principle. If the scholar asks for a return for this act, there is controversy about whether they can receive it from the person who seeks it and there is a controversy as to whether they can receive it if they are not in need. However, it is permissible for a scholar to receive payment for providing services or activities other than \textit{fatwa} from the person they are serving. Also, it is permissible to receive payment from the authority with some conditions.

\textbf{2.3.4.2 Risk associated with SSB members:}

In performing their job, SSB members not only serve the IFI but they also pose some operational and reputational risks, such as \textit{fatwa} risk and leak of information. The IFSB acknowledges some of these risks and mentions that in the case of sensitive or confidential information leakage, an IFI should have in place appropriate risk management to limit the damage.\textsuperscript{470}

\textit{Fatwa} risk could be associated with issuing an unclear \textit{fatwa} or a \textit{fatwa} that is difficult for ordinary people to understand.\textsuperscript{471} Part of \textit{fatwa} risk is the risk of \textit{fatwa} rejection as well. In this case, SSB members are considered, by other Shariah scholars, investors, stakeholders or consumers, not qualified to issue a \textit{fatwa} on a specific product, service or transaction.\textsuperscript{472} Examples of \textit{fatwa} risk posed by SSB


\textsuperscript{468} Muhammad Ibn Othaimeen, \textit{Al-Sharh Al-Muntii’e ala Zad Al-Mustaqaqi’e} (Dar Ibn Al-Jawzi 2005)

\textsuperscript{469} Muhammad Ibn Othaimeen, \textit{Al-Sharh Al-Muntii’e ala Zad Al-Mustaqaqi’e} (Dar Ibn Al-Jawzi 2005)


\textsuperscript{470} Yusuf DeLorenzo, ‘Shari’ah Compliance Risk’ (2007) 7 Chicago Journal of International Law 397, 400

\textsuperscript{471} For more about \textit{fatwa} rejection and its reasons please see Yusuf DeLorenzo, ‘Shari’ah Compliance Risk’ (2007) 7 Chicago Journal of International Law 397, 401-402
members include the issuance of the Goldman Sachs proposed *Sukuk*. There was controversy as to the permissibility of these *Sukuk* and uncertainty as to whether they had received approval from Shariah scholars. Because of this, the *Sukuk* was never issued.\(^\text{473}\) Another example is the Islamic Total Return Swap. It was a product that allowed the investor to invest in a Shariah-compliant asset, but then the return swapped to another asset that might be non-Shariah-compliant. This created suspicion about its Shariah legitimacy, which resulted in its slow fade from the market.\(^\text{474}\) Moreover, withdrawal of a *fatwa* is another *fatwa* risk posed by SSB members. In this context, Shamsher recalls an incident that happened in 2007, when a well-known Shariah scholar declared the non-compliance of 85% of the existing *sukuk* and then revoked his statement without providing any official reason.\(^\text{475}\)

### 2.3.4.3 Standards for SSB remuneration:

From the foregoing discussion, the following points present the standards for best practices for SSB members’ remuneration in IFIs.

**First:** IFIs are encouraged to benefit from the conventional international standards for setting their remuneration policies. However, they should take into consideration the specificity of SSB members. Hence, the remuneration of the SSB members needs to be an essential element of any IFI remuneration policy. The policy needs to explain the nature of the SSB members’ duties, their appointment contract and the criteria for the determination of their remuneration. In addition, all information should be clear, well documented and transparent.

**Second:** Being Islamic in nature, IFIs should take into consideration the rules of Shariah with regard to their remuneration policies. Although the main duty of SSB members is to provide *fatwa* on the institution’s practice, they still do other services such as the annual Shariah review and report. Therefore, even if there is any suspicion about their right to be paid for providing *fatwa*, they are allowed to be paid for their

\(^{473}\) Tadashi Mizushima, ‘Corporate Governance and Shariah Governance at Islamic Financial Institutions: Assessing from Current Practice in Malaysia’ (2014) 22 Reitaku Journal of Interdisciplinary Studies 80

\(^{474}\) Tadashi Mizushima, ‘Corporate Governance and Shariah Governance at Islamic Financial Institutions: Assessing from Current Practice in Malaysia’ (2014) 22 Reitaku Journal of Interdisciplinary Studies 59, 80 and 81

other services. In other words, it is better to exclude providing *fatwa* as a factor in the calculation of remuneration when determining a SSB member’s remuneration, since it is a mere religious act that, according to the opinion of the majority of Muslim scholars, should not be remunerated. Therefore, the remuneration of SSB members can be determined using other factors, such as the non-religious duties and responsibilities, professional experience and level of education.

Although receiving remuneration for their services seems to be fair and allowed according to some credited opinions, Shariah scholars should not exaggerate in the amount taken to protect their integrity and piety. Guiding the institution to be Shariah-compliant is a religious manner and should not be taken as a commercial business. This highlights the difference between a Shariah scholar and other consultants such as lawyers, accountants or medical doctors. Moreover, receiving remuneration from the institution at all is controversial, as it is in the position of the *mustafti*. The remuneration might affect the scholar’s independence and objectivity because they might prioritise the institution’s interest over the right application of Shariah rules in order to keep the remuneration. Shamsher states that just by receiving remuneration from the institution, there exists a potential conflict of interests, which might result in legitimising an unlawful operation. 476 Using a similar argument, Warde recalled the debate that happened in Egypt in the late 1980s about the *fatwas* for sale or tailor-made *fatwas*, as some argued that private Shariah scholars were ready to offer *fatwas* to legitimate dubious practices on the weakest of religious grounds in exchange for money and that some of them were receiving very large amounts of remuneration. 477

**Third:** The nature of SSB members’ responsibilities requires their remuneration to be fixed. This is because they are not expected to promote the institution’s business or raise its profitability. Remuneration is not supposed to affect the performance of SSB members with regard to providing their Shariah-related opinion. They should provide their opinion regardless of the institution’s short or long term interests. The only thing they should take into consideration when performing

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their duty is their accountability to God and the right application of Shariah rules. Also, fixed remuneration is more appropriate as it can reflect professional experience, level of education and the degree of seniority.478

**Fourth:** It can be seen that SSB members impose some risk on the IFI, and the international standards stress the importance of aligning the remuneration with the individual appetite for risk. The Basel Report on the Range of Methodologies for Risk and Performance Alignment of Remuneration provides that,

[S]ome form of risk adjustment is needed as remuneration is often awarded before the final outcome of an activity is known. Risks taken need to be estimated (ex-ante) and risk outcomes observed (ex-post), and both ex-ante estimates and ex-post outcomes should affect payoffs.479

However, IFIs should take into consideration Shariah rules and should not apply any international standard that might affect their Shariah compliance. Therefore, their consideration of risk should not be done in a manner that contradicts Shariah rules. This means that the risk posed by a SSB member should not affect their payment unless their actions caused actual harm to the IFI, as estimated/predicted risk falls under *maisir* (gambling), which is prohibited in Shariah.480

**Fifth:** As transparency is the key tool for the adequate implementation of the principles of good corporate governance, each IFI is expected to disclose clear, comprehensive and timely information related to the SSB members’ remuneration. The annual report should include all information related to the remuneration of SSB members and their performance. This should mainly include a general overview of the work done by the SSB during the financial year, the certified and rejected transactions, the number of meetings attended by each member, and the amount received by each member.

Standard 15 of the Implementation Standards of the Financial Stability Forum Principles for Sound Compensation Practices asserts the duty of each institution to disclose an annual report on remuneration to the public on a timely basis.481 It is

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480 Shariah considers speculation as a way of gambling and therefore prohibits it. Allah says in the Holy Quran Chapter 5 Verse 90, ‘O you who have believed, indeed, intoxicants, gambling, … are but defilement from the work of Satan, so avoid it that you may be successful.’ Saheeh International (tr), *The Qur’an* (3rd edn, Al-Muntada Al-Islamy Trust 2010) 162
worth mentioning that, according to the Basel Pillar 3 Disclosure Requirements for Banks, banks are requested to disclose qualitative and quantitative information about their remuneration practices and policies covering some areas in addition to the disclosure requirements of Standard 15. The OECD also explains that companies are expected to disclose all information related to remuneration, not just collectively but on an individual basis. This information is of concern to shareholders as it helps to assess the cost and benefit of remuneration plans and their contribution to the company’s performance. Unfortunately, few IFIs apply good practice with regard to the SSB members’ remuneration. Some IFIs fail to include any information related to the SSB members’ remuneration in their annual report, as is the case with KFH, Al-Rajhi Bank in Saudi Arabia and Qatar Islamic Bank. Other IFIs give a little information about the SSB members’ remuneration – mostly the amount paid for the SSB members without specifying the remuneration criteria and strategy, as is the case with Boubyan Bank in Kuwait and Bahrain Islamic Bank.

### 2.3.5 Multiple memberships of SSB members:

It is noticeable in the field of Islamic banking that Shariah scholars sit on multiple SSBs in different IFIs. Khorshid claims that there is no reliable criteria for appointing Shariah scholars and that they are not selected according to their qualifications. Appointment depends on other factors that include: how active and popular the scholar is in the financial sector; who holds the most positions on Shariah

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482 BCBS, ‘Pillar 3 Disclosure Requirements – Consolidated and Enhanced Framework’ (BIS, 2017), Section 1.6 Disclosure Requirements for Remuneration and Part 13 Remuneration <https://www.bis.org/bcbs/publ/d400.htm> accessed 30 December 2019

483 OECD, G20/OECD Principles of Corporate Governance (OECD 2015) 44

484 OECD, G20/OECD Principles of Corporate Governance (OECD 2015) 44


486 By the end of 2014, the number of Shariah scholars in the Islamic finance sector reached 952, covering 652 IFIs in 46 countries. Most of these scholars have multiple memberships. See Muhammad M and others, Islamic Commercial Law Report 2016: An Annual Publication Assessing The Key Issues And Trends In Islamic Commercial Law For The Broader Islamic Finance Industry (ISRA and Thomson Reuters, 2016) 29 <https://ifikr.isra.my/library/viewer2/10355> accessed 19 December 2019

boards; or who has the most influence on investors. Due to this system the Islamic financial sector is dominated and controlled by only a handful of Shariah scholars.

Research conducted by Funds@Work in 2011 revealed that only 10 scholars hold positions on 450 boards, which represents approximately 40% of all Shariah boards around the world. The top 3 scholars alone altogether hold 241 positions between them on SSBs (85, 85 and 71). This is in addition to the positions they hold in standard setting bodies, unions, foundations, governmental entities and consulting firms. These are all additional occupations to their original jobs. Later in 2014, it was reported that the top 10 shariah scholars hold board memberships in 652 IFIs.

The SSB of Al Rajhi Bank in Saudi Arabia had 38 meetings in 2018, while the SSB of KFH had 46 meetings. In Pakistan, the SSB of Meezan Bank met 5 times, while the SSB of Hong Leong Islamic Bank in Malaysia met 10 times. Therefore, the average number of meetings per year for each SSB is around 24. Hence, even if a scholar is a member of only 10 SSBs (and not 70 or 80 as appeared from the research above), they should be responsible for attending 240 meetings per year.

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489 For more details please see Murat Unal, ‘The Small World of Islamic Finance: Shariah Scholars and Governance - A Network Analytic Perspective, v. 6.0’ (Funds@Work, 19 January 2011) 13 <https://zulkiflihasan.files.wordpress.com/2011/02/sharia-network_by_funds_at_work_ag.pdf> accessed 19 December 2019

490 For more details, see Murat Unal, ‘The Small World of Islamic Finance: Shariah Scholars and Governance - A Network Analytic Perspective, v. 6.0’ (Funds@Work, 19 January 2011) 5 <https://zulkiflihasan.files.wordpress.com/2011/02/sharia-network_by_funds_at_work_ag.pdf> accessed 19 December 2019

491 For more details, see Murat Unal, ‘The Small World of Islamic Finance: Shariah Scholars and Governance - A Network Analytic Perspective, v. 6.0’ (Funds@Work, 19 January 2011) 4 <https://zulkiflihasan.files.wordpress.com/2011/02/sharia-network_by_funds_at_work_ag.pdf> accessed 19 December 2019


year at a rate of at least 4 meetings per week in different countries, where they need to approve a number of transactions and activities for several IFIs. This would be physically and mentally exhausting, and appears impossible – even using modern technologies.

It is believed that if the issue of Shariah scholars’ multiple memberships is left unregulated, it could have a negative effect on the IFIs and the whole Islamic finance sector for several reasons. Most importantly, it overloads Shariah scholars with increased responsibilities for managing the Shariah related matters of several institutions, which leads to their inability to give sufficient time to each board and hence failure to perform their duties efficiently.\(^{497}\) Also, it concentrates and increases the authority, influence and wealth of a few selected scholars, which might raise the chance of abuse of power. Being a member in more than one board in the same industry increases the chance of a conflict of interest and breach of confidentiality.\(^{498}\)

In addition, this approach is not commensurate with the flexible and highly mobile nature of the business environment, which requires SSB members to be available whenever a Shariah opinion is needed. Finally, it disheartens other Shariah scholars and reduces their motivation, as they will not be given the opportunity to prove themselves or develop their experience. Shamsher has tackled the same issue. He mentions that multiple appointments in SSBs is a common practice in many IFIs in the Middle East and that the IFIs race to appoint the most popular, knowledgeable and lenient scholars, which increases the chance of ‘fatwa shopping’.\(^{499}\) Garas states that there is a shortage of Shariah scholars and this is the reason behind the fact that some

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sit in a number of SSBs, which might lead to a conflict of interests and a chance of a breach of confidentiality.\textsuperscript{500}

It should be recognised that the role of SSB members is not limited to the IFIs they serve; their duty and commitment extend to encompass the whole Islamic financial sector. They should strive to develop this sector and overcome any obstacle in the way of its prosperity and growth. Arshad states that SSB members need to perform their duties and responsibilities in an effective way and commit themselves strongly to develop IFIs and their SCG.\textsuperscript{501} The success of SCG depends primarily on them, and therefore, the shortage of qualified Shariah scholars should not be used in any way to hinder this success.

On a national level, some countries, such as Malaysia and Kuwait, regulate the issue of Shariah scholars being members of multiple SSBs, but many others ignore it. It is unfortunate to see that IFIs do not acknowledge the harmful impact of this issue. Rather they encourage it by competing to appoint a group of well-known, selected scholars and use this appointment as a tool to market and praise their Shariah compliance. Having said that, it is still believed by some writers that multiple memberships have some positive effects on the performance of SSBs. According to Grassa, sitting on a number of boards allows Shariah scholars to have access to more transactions and operations, which will contribute to developing their experience and the Islamic finance sector in general.\textsuperscript{502} This opinion is supported by Nomran, Haron and Hassans’s study, which examined a number of SSBs in Malaysia. The result revealed a positive impact of Shariah scholars’ cross-memberships on the boards’ effectiveness.\textsuperscript{503} Abdul Rahman and Bukair also believe that cross-memberships are a positive matter as they enhance information exchange and disclosure.\textsuperscript{504} Nevertheless, multiple memberships of Shariah members in IFIs requires proper regulation.

\textsuperscript{500} Samy Garas, ‘The Conflicts of Interest Inside the Shari’a Supervisory Board’ (2012) 5 International Journal of Islamic and Middle Eastern Finance and Management 88, 90
\textsuperscript{501} Nurhashtuty Wardhany and Shaista Arshad, ‘The Role of Shariah Board in Islamic Banks: A Case Study of Malaysia, Indonesia and Brunei Darussalam’ (2\textsuperscript{nd} ISRA Colloquium, Kuala Lumpur, 2012) 2 <https://www.researchgate.net/publication/276418060_THE_ROLE_OF_SHARIAH_BOARD_IN_ISLAMIC_BANKS_A_CASE_STUDY_OF_MALAYSIA_INDONESIA_AND_BRUNEI_DARUSSALAM> accessed 17 December 2019
\textsuperscript{502} Rihab Grassa, ‘Corporate governance and credit rating in Islamic banks: Does Shariah governance matters?’ (2013) 19 Journal of Management and Governance 1, 15
\textsuperscript{503} Naji Nomran, Razali Haron, and Rusni Hassan, ‘Shari’ah Supervisory Board Characteristics Effects on Islamic Banks’ Performance: Evidence from Malaysia’ (2018) 36 International Journal of Bank Marketing 290, 299
\textsuperscript{504} Azhar Abdul Rahman and Abdullah Bukair, ‘The Influence of the Shari’ah Supervision Board on Corporate Social Responsibility Disclosure by Islamic Banks of Gulf Co-Operation Council Countries, (2013) 6 Asian Journal of Business and Accounting 65, 76
Therefore, the best standards for regulation seem to be as follows:

**First:** to limit the chances of conflicts of interest and increase their productivity, the members of SSBs should not serve more than one local SSB of the same industry and no more than a limited number of boards internationally.\(^{505}\)

**Second:** to ensure the independence of SSB members, the appointment should be for one financial year, which is renewable for a limited number of consecutive years in a single institution, so as to allow rotation.\(^{506}\)

**Third:** to prevent sham membership, the Shariah member should be required to attend each and every meeting of the SSB either in person or by using remote communication, such as conference call or video call.

**Fourth:** to be able to evaluate the performance of SSB members, the IFI should disclose the number of meetings attended and missed by each SSB member. Moreover, as a means of managing conflicts of interest and confidentiality issues, the number of boards served by each SSB members should also be disclosed.

**Fifth:** with regard to the shortage in qualified Shariah scholars that is seen to be one of the reasons for the problem of multiple memberships of SSBs, it is noticed that female Shariah scholars are not given the opportunity to serve on SSBs, especially in the GCC countries, which would contribute to solving the problem of multiple memberships or at least reducing it. It is surprising to see that women are entirely absent from SSBs in the GCC countries, especially given that there is no prohibition, whether in Shariah or secular law, that prevents them from being appointed. It is noticeable that Malaysia does not suffer from the problem of multiple memberships to the same extent as the GCC countries, even though the Malaysian SSBs mostly contain more than three members. This could be due to the fact that women are able to hold positions on the Malaysian SSBs. Therefore, female membership in SSBs should be supported so that they can achieve adequate experience. IFIs can start by appointing a female Shariah scholar on top of the required number of Shariah scholars on a SSB to provide them with the opportunity to

\(^{505}\) The IFSB observes that ‘it may be acceptable for a Shariah scholar to become a member of the Shariah board for IIFS operating in different segments of the IFSI or in different jurisdictions’. IFSB, ‘Guiding Principles on Shariah Governance Systems for Institutions Offering Islamic Financial Services’ (2009) IFSB Paper no IFSB-10, Footnote 16 <https://www.ifsb.org/published.php> accessed 27 December 2019

\(^{506}\) The AAOIFI suggests an orderly rotation of SSB members every five years. AAOIFI, *Accounting, Auditing and Governance Standards* (AAOIFI 1997), Chapter Governance Standard for Islamic Financial Institutions No. 5 Independence of Shari’a Supervisory Board, 48
earn experience. With time, women will gain the needed experience and the IFIs can go back to appointing the usual number including women. They can use the same system for junior Shariah scholars.

The final problem affecting SCG relates to the IFI’s Shariah financial obligations, namely the obligation to pay zakat and the obligation to purify the non-Shariah-compliant income. These two obligations are essential elements of any IFI’s Shariah compliance and should be properly regulated.

2.3.6 Problems related to the governance of the IFI’s Shariah financial obligations:

In order for an IFI to fulfil its Shariah compliance, it should follow the rules of Shariah with regard to money, most related to Islamic finance, the obligation to pay zakat and to discard any prohibited money that is earned from Shariah non-compliant sources, which is known in Islamic finance as ‘purification of income’. However, in performing these obligations, most IFIs fail in some governance issues.

2.3.6.1 The IFI’s obligation to pay zakat:

_Zakat_ is one of the five pillars of Islam. Every Muslim should give away a percentage of their money every year if they have a certain amount of money that has stayed in their property for a whole year. Muslims are not free to pay zakat the way they see fit, since Shariah has specified appropriate zakat expenditures and has confined them to eight directions. In order to make it easy for people to pay their

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507 Prophet Muhammad (PBUH) said ‘(The superstructure of) al-Islam is raised on five pillars, testifying that there is no god but Allah, that Muhammad is His bondsman and messenger, and the establishment of prayer, payment of _zakat_, pilgrimage to the House and the fast of Ramadan’. Muslim Ibn al-Hajjaj, *Sahih Muslim*, vol 1 (Nasiruddin al-Khattab tr, Darussalam 2007) Hadith 16

508 Ministry of Trust and Islamic Affairs, _Al-Mawso’ah Al-Fiqhiyyah_, vol 23 (2nd edn, That Al-Salasil 1992) 236

509 Allah says in the Holy Quran, *Surah At-Tawbah*, Chapter 9, Verse 60, ‘Zakah expenditures are only for the poor and for the needy and for those employed to collect [zakah] and for bringing hearts together [for Islam] and for freeing captives [or slaves] and for those in debt and for the cause of Allah and for the [stranded] traveller - an obligation [imposed] by Allah.’ Saheeh International (tr), _The Qur’an_ (3rd edn, Al-Muntada Al-Islamy Trust 2010) 266. For more please see Ali Al-Mawardy, _Al-Ahkam As-Sultaniyyah_ (Dar Al-Hadith 2006) 195. See also Muhammad Al-Hanbaly, _Al-Ahkam As-Sultaniyyah_ (Dar Al-Kotob Al-Ilimiyah 2000) 132
**zakat**, Islamic countries usually establish a public treasury for zakat ‘The House of Zakat’ that receives zakat money and pays it out through legitimate channels.510

Zakat is not a matter of charity or tax, rather it is a compulsory giving ordered directly by God and on account of His own rights in people’s money.511 The purpose of requiring zakat is to purify the heart from stinginess and greediness, to generate affection between people and to help people in need.512 However, it should be clarified that there are some conditions that need to be met before paying zakat becomes obligatory on an individual Muslim. Muslim scholars agree that zakat is obligatory on the adult, sane, free Muslim - whether a man or a woman - and when their property reaches a certain threshold.513

In terms of business, the Muslim trader is also required to pay zakat on their business money. This type of zakat is called (zakat oroudh al-tijarah) in Fiqh Al-Muamalat and there are a number of texts in the Quran and Sunnah on this obligation.514 Under this category, people are required to pay zakat on any monetary or non-monetary property that they intend to grow and profit from through investment, such as real estate, livestock, agricultural farms and crops, gold and silver.515 Modern scholars have also included shares and bonds under this category.516

Although zakat is a religious obligation on humans, a company owned by Muslims also pays zakat on its money as a separate legal entity. IFIs pay zakat every year on their monetary and non-monetary assets, such as shares, cash, statutory and

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510 This is what Islamic jurisdictions are accustomed to do since ancient times. Yousef Al-Qaradawi, *Fiqh Az-Zakat*, vol 1 (2nd edn, Al-Risalah Organisation 1973) 757
general reserves, subsidiaries and portfolios, as part of their Shariah compliance. The calculation and distribution of zakat is usually done by or under the supervision of the SSB according to the rules of Shariah and following the instructions of the country. A reference to zakat payment, how it has been calculated and certification of its Shariah compliance, is usually mentioned in the annual report along with further details on the amount paid in the financial statements. For example, in the Shariah report of Bahrain Islamic Bank for 2018, the SSB has included a certification that ‘zakat was calculated according to the provisions and principles of Islamic Shariah, by the net invested assets method’, followed by a clarification of the sources and uses of the zakat fund in the financial statements. 517 Similarly, the SSB of Hong Leong in Malaysia has included a statement in its Shariah report for 2018 that the bank fulfilled its obligation to pay the zakat for its business to the State zakat authorities in compliance with Shariah rules. 518

Therefore, zakat is an obligation that is adhered to by IFIs in order to comply with Shariah. However, a problem is detected with the governance of zakat payment in IFIs. Many IFIs only include a statement in the annual report that the IFI has paid zakat along with the amount paid. In terms of information disclosure as a main principle of corporate governance, this seems to be insufficient. Moreover, IFIs need to clarify the fund expenditures. Especially that some Islamic banks collect zakat and donations from others to be channelled to charities. For example, Warba Bank in Kuwait mentioned in its annual report for 2018 that it has adhered to the obligation of zakat and disclosed how it was calculated and the amount paid, but was not fully transparent with the money expenditures, and the same issue is seen with Al-Rajhi Bank in Saudi Arabia. 519 A few IFIs deal with this issue in a more transparent manner. For example, Al-Rayan Bank in the UK collects zakat and charitable payments from Muslims and clearly states on its website that the money collected is used to support the National Zakat Foundation, which is a registered charity that aims

to help local, deserving recipients.\textsuperscript{520} Similarly, Bank Islam in Malaysia provides detailed information on zakat expenditures, naming every place where zakat has been distributed.\textsuperscript{521} This may be due to the different laws and regulations between different countries.

Certainly, it is essential that IFIs be vigilant and transparent in distributing charity and zakat funds in compliance with the International Standards on Combating Money Laundering and the Financing of Terrorism and Proliferation issued by the Financial Action Task Force.\textsuperscript{522} These standards aim to protect the integrity of the whole global financial system, and in this regard, Standard 8 sheds light on the non-profit organisations that are involved in raising or distributing money for charitable or religious purposes or other good works, which can be vulnerable to terrorist-financing abuse. Aldohni has highlighted the danger of the underground banking, which can ‘offer a clandestine conduit for moving finance to terrorist groups without any trace’.\textsuperscript{523} For this reason, it is important for IFIs to be transparent in distributing their zakat funds and other charitable donations. People need to be assured that IFIs are exercising a legitimate Islamic business, especially in countries where national supervision is absent.

\textbf{2.3.6.2 The IFI’s obligation to purify its Shariah non-compliant income:}

Shariah compliance is the main objective of IFIs and therefore they endeavour to do halal (permissible) business and earn halal income. Nevertheless, no matter how strong the precautions are taken by IFIs to achieve full Shariah compliance, there is always a possibility that they fall into unavoidable non Shariah-compliant practices, whether directly or indirectly. This can happen through their dealings with other companies that do not pay proper attention to Islamic rules, especially with regard to the IFI’s investment in stocks. Therefore, contemporary scholars have come up with a

\textsuperscript{520} For more details please see <https://www.alrayanbank.co.uk/other-products/zakat/> accessed 30 December 2019
\textsuperscript{523} Abdul Karim Aldohni, ‘The Emergence of Islamic Banking in the UK: A Comparative Study with Muslim Countries’ (2008) 22 Arab Law Quarterly 180, 193
solution to this problem by requiring the IFIs to conduct a ‘purification of income’.\textsuperscript{524} To illustrate, Shariah-compliant companies need to ‘deduct from the returns on the investments the earnings emanating from any unacceptable source from the Shariah point of view’.\textsuperscript{525}

A number of Islamic market indices have developed purification criteria for investment in stocks in order to be compliant with Shariah rules, such as the Dow Jones Islamic Index, Al-Meezan Islamic Investment Index and the Malaysian Islamic Index.\textsuperscript{526} For example, under Shariah screening criteria issued by Al-Meezan Investment Management, the ratio of non-compliant income to total revenue should be less than 5\% and this amount should be cleansed out as charity.\textsuperscript{527}

It is the duty of the SSB in the IFI to certify that the purification process has been conducted and that any income from a Shariah non-compliant source has been cleaned. In this regard, the amount paid out and the reason for this payment should be specified and appear in the annual report of the IFIs.\textsuperscript{528} Unfortunately, like the problem with the governance of zakat payments, not every IFI provides sufficient details on its purification process. For example, the SSB of KFH merely certifies in its 2018 Shariah report that the income received from Shariah non-compliant sources has been cleansed and donated to charity without determining the amount paid to charity or the channels used.\textsuperscript{529} Therefore, as with the zakat payment recommendations, each IFI should specify the percentage of income that has been given away as income purification and the way this money has been spent.

\textsuperscript{524} Rohaida Basiruddin and Habib Ahmed, ‘The Role of Corporate Governance on Shariah Non-compliant Risk: Evidence from Southeast Asia’ [2019] Corporate Governance: International Journal of Business in Society 1, 4
\textsuperscript{525} Muhammad Ayub, \textit{Understanding Islamic Finance} (John Wiley & Sons Ltd 2007) 202
\textsuperscript{526} Muhammad Ayub, \textit{Understanding Islamic Finance} (John Wiley & Sons Ltd 2007) 461-462
\textsuperscript{528} For example, Meezan Bank in Pakistan states in its 2018 Annual Report, ‘During the year an amount of Rs 36.92 Million was transferred to the Charity Payable Account. This includes Rs 1.15 Million to eliminate the non-compliant income portion identified during Shariah audit, Rs 3.39 Million to purify the dividend income earned from the investment made in the Shariah-compliant stocks by the Bank’. The Annual Report has also included a statement of uses of charity fund, which clarifies the amount paid for each distributed channel, such as education, health, and community development, but without giving details on the actual outlets. Meezan Bank, ‘Annual Report 2018’ (2018) 136 and 142 <https://www.meezanbank.com/wp-content/themes/mbl/downloads/annualreport2018.pdf> accessed 20 December 2019
It is worth mentioning that paying zakat and the purification of income are two different ways of giving: (a) zakat is directly commanded by God while purification is a method developed by Shariah scholars; (b) zakat is a pillar of Islam while purification is a way to follow the rules of Islam; (c) zakat is for self-disciplining and community help while purification is a way to get rid of haram (prohibited) money; (d) zakat is compulsory and purification is taken so as not to consume Shariah non-compliant money. However, they both coincide in respect of the fact that they are not the same as charity or a donation and they are both required from IFIs in order to be Shariah-compliant.

2.4 Conclusion:

This chapter examined SCG as the policy used by IFIs to ensure their Shariah compliance, and the problems of this policy that might weaken its effectiveness. It was seen that each IFI is required to appoint a SSB of specialised Shariah scholars in the institution’s internal structure in order to guide it through its Shariah-related matters and supervise its Shariah compliance. This body is subject to several rules and requirements under SCG, which regulate its appointment, composition and qualifications. The policy also determines the SSB’s roles and duties in general and its supervisory duty to conduct an internal Shariah review and issue an annual Shariah compliance report. Moreover, it highlights the ethical criteria to be used to ensure SSB members’ independence, confidentiality and consistency. Nevertheless, SCG is still prone to some problems that, if not managed properly, might result in reducing the extent of the IFI’s Shariah compliance.

First, in terms of the binding force of the SSB opinions, it is very important that they should be obligatory for IFIs, and that they cannot disregard their implementation. This can be achieved either by placing a legal obligation on IFIs under national law or by self-commitment through acknowledging this obligation in their AoA. If SSB opinions are merely advisory to the IFI, shareholders and other stakeholders will be skeptical as to the efficiency of its Shariah compliance and this might lead to loss of trust in its credibility.

Second, it is very important for IFIs to manage the conflict of interests related to SSB members in order to protect their independence and objectivity. The appointment system of Shariah scholars, the fact that they receive remuneration from the institution and the possibility that their opinion might affect the institution’s
financial decisions could all lead the management to try to interfere in their work. This might impair their independence and, by extension, their effective supervision of the institution’s Shariah compliance. Therefore, it is essential that each IFI sets down strict rules to manage any conflict of interests that might arise in the relations between the institution and SSB members.

Third, the other issue tackled in SCG is the divergence in Shariah rulings among SSBs of different IFIs, which might result in accepting a product or service in one institution and rejecting the same product or service in another. Some writers believe that this is a serious problem that affects not just an individual IFI but the whole Islamic finance sector. Exploring the Shariah perspective on divergence in Shariah rulings, it is seen that divergence is regulated and restricted by Shariah and that only real divergence is taken into account. It is not a reprehensible matter or otherwise Shariah would have rejected it. It can only be harmful if Shariah scholars do not follow the rules on divergence by Shariah.

Fourth, the remuneration of SSB members is another problem highlighted. It can be seen that Shariah scholars in IFIs receive remuneration for their services that is sometimes equivalent to, or even exceeds, the amount received by executives, and this causes similar governance issues without being regulated similarly. If Shariah scholars’ remuneration is left without proper regulation, it could affect their independence, which may affect the quality of their work. Therefore, the principles governing Shariah scholars’ remuneration should be an essential part in the IFI’s remuneration policy along with the criteria for determination of that remuneration. The amount paid should not be excessive, especially since Shariah has reservations about Shariah scholars’ right to receive money for providing fatwa. In order to ensure their objectivity, the remuneration should be fixed and not based on performance. All the related information should be transparent to shareholders.

Fifth, the multiple memberships of Shariah scholars in SSBs is another detected problem. It can be seen that individual Shariah scholars serve on a number of IFIs, either in one country or in several countries. This practice could raise a productivity problem and present a threat to confidentiality. Therefore, each IFI should take this matter into consideration and manage it effectively. In this regard, it is recommended that SSB membership should be regulated by restricting the number of boards served by a single Shariah scholar and their membership period.
Finally, paying zakat and income purifications are two financial obligations set by Shariah that should be adhered to by each IFI in order to be Shariah compliant. In this regard, IFIs should be transparent and provide sufficient information on the process of zakat payment and income purification in terms of clarifying the amount paid and the way the money is spent in the annual report.

After addressing SCG and highlighting the problems of its implementation in IFIs, the next stage of this research is to examine the regulatory and supervisory systems for SCG implemented in different countries. This examination is essential to understand the effectiveness of each system in ensuring Shariah compliance in IFIs. It also helps to understand the need for shareholders’ active engagement in each country and the scope for their engagement.
Chapter Three: The Regulatory and Supervisory Framework of Shariah Corporate Governance; A Cross Country Comparison of the Systems in Malaysia, Kuwait and the UK

3.1 Introduction:

Financial institutions are substantially different from other companies due to the nature of their business and functions. Therefore they require stringent prudential regulation and good corporate governance. As highlighted by Tarullo, ‘A special corporate governance measures are needed as part of an effective prudential regulatory system’. The previous chapter demonstrated how the nature of IFIs affects their corporate governance policy: special requirements exist to help in achieving their objective of being Shariah compliant. This chapter, on the other hand, highlights how Shariah requirements affect the financial regulation and national supervision in the countries where IFIs exist.

Due to the distinctive features of IFIs and the special nature of their work, they require special national supervision. This special supervision aims to monitor the implementation of SCG in IFIs and the extent of their Shariah compliance. That being so, this chapter focuses on the role of the national supervisor in SCG. It attempts to answer the research questions: ‘how far is SCG regulated and supervised in practice and how effective is this supervision in helping IFIs achieve their objective of full Shariah compliance?’ Answering this question helps to understand the different regulatory systems where shareholders are expected to be active and the scope for their activism, which will be discussed in the following chapters. Against this backdrop, the rest of the chapter is arranged as follows:

It starts with an overview of prudential supervision as the main supervision for financial institutions in general and then illustrates Shariah supervision as the special type of supervision for IFIs. This section ends by highlighting the differences between the two types of supervision. The chapter then addresses Shariah supervision as a religious obligation on supervisors from the perspective of Shariah. This explains the

role of an Islamic government under Shariah with regard to the implementation of Shariah rules within its jurisdiction. The following section illustrates the international regulatory and supervisory principles of Islamic finance. In this regard, it focuses on the supervisory standards issued by the Islamic international organisations: the IFSB and the AAOIFI – the only international supervisory standards for Islamic finance.

Thereafter, the chapter examines the different regulatory and supervisory frameworks of SCG. First, it gives an overview of the different supervisory systems in Islamic finance and highlights the views of scholars as to the system that best serves Shariah governance and compliance in IFIs. Then it goes on to examine the different systems in practice in order to evaluate the effectiveness of each system in helping IFIs to reach full Shariah compliance. In this regard, the chapter sheds light on the systems followed by three leading countries in Islamic finance: Malaysia, Kuwait and the UK. In the light of this examination, the importance and scope of shareholders’ intervention will be determined for each system.

3.2 Shariah supervision as distinct from prudential supervision:

This section addresses the meaning of national Shariah supervision and the way it differs from prudential supervision, in order to understand the role played by the national supervisor in SCG.

3.2.1 Prudential supervision:

The stability and soundness of the financial sector is a significant element for any country that works towards maintaining the credibility of its financial system and seeks to thrive in the global capital markets. Therefore, each country is keen to establish a strong system to supervise all players in the financial sector. ‘Prudential supervision’ is the term used to describe national supervision of financial institutions. It broadly revolves around overseeing banks’ compliance with the rules and regulations of the banking sector for the purpose of maintaining the stability, safety and soundness of the whole country’s financial system.532 Its main duty is to enhance the safety and soundness of all kinds of financial institutions and to work to reduce the damage they might cause to the financial system of the whole country. This

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includes providing protection to vulnerable parties in this system, such as shareholders, depositors, insurance policyholders and other consumers.\footnote{Examples of national supervisors in the finance sector include, the Prudential Regulation Authority (PRA) in the UK, which is part of the Bank of England, and the Federal Reserve in the US. For more about these authorities and their objectives please visit their websites at <https://www.bankofengland.co.uk/prudential-regulation> and <http://www.federalreserve.gov/> both accessed in 30 December 2019. As for Europe, prudential supervision is carried out by the European Central Bank and other bodies, such as the European Supervisory Authorities (ESAs), especially the European Banking Authority (EBA). These authorities provide prudential supervision across the whole European banking sector. For more, please see the European Central Bank banking supervision website <www.eba.europa.eu/> accessed in 30 December 2019} Prudential supervision has two supervisory dimensions: macro-prudential and micro-prudential. The House of Lords, in its report on the future of EU financial regulation and supervision, explains the difference between the two types of supervision as,

\[ \text{Macro-prudential supervision is the analysis of trends and imbalances in the financial system and the detection of systemic risks that these trends may pose to financial institutions and the economy. The focus of macroprudential supervision is the safety and soundness of individual financial institutions as well as consumer protection.} \right. \]

The main focus of prudential regulation and supervision for financial institutions is to ensure the financial institutions’ compliance with capital adequacy requirements and risk control. This is seen clearly in the supervisory requirements of the Basel Committee imbedded in the Basel Accords I, II and III as the most authoritative standards for banking supervision across the globe. However, it should be highlighted that supervision of aspects of corporate governance is also an essential part of the supervisory regulation.

As Mülbert notes, corporate governance deals with ‘the different internal and external mechanisms that ensure that all decisions taken by the directors and top management are in line with the objective(s) of a company and its shareholders, respectively’.\footnote{Peter Mülbert, ‘Corporate Governance of Banks’ (2009) 10 European Business Organization Law Review 411, 413} These mechanisms of corporate governance include board structure, transparency, remuneration, risk management, relationships between the firm and its shareholders and other stakeholders. All require efficient supervision from the national supervisor to ensure that financial institutions implement a good policy of corporate governance. The supervisor’s perspective on banks’ corporate governance is addressed by the Basel Committee in its guidelines \textit{Corporate Governance...}
Principles for Banks 2015. The guidelines consist of 13 corporate governance principles where the role of supervisors comes under principle number 13. This Principle provides that the main responsibility of the national supervisor is to set out a regulatory and corporate framework for best practice and require the banks to strengthen their corporate governance policies. Furthermore, the supervisor should regularly check and evaluate the corporate governance policies implemented by banks and make sure they put in place appropriate mechanisms, measures and criteria to address all relevant aspects of corporate governance. It is the duty of the supervisor to determine whether a bank has a sound and effective corporate governance policy. In addition, the supervisor should be able to require improvements and remedial actions by the bank whenever it notices deficiencies or governance failure, and to impose sanctions where necessary.

Prudential supervision at the national level is usually performed by the country’s central bank or a body related to it. The European Central Bank confirms that central banks in many jurisdictions are known for carrying out supervisory functions over the financial sector efficiently. However, this supervisory function can be practised by another body separated from the central bank, such as a regulatory body or a supervisory body. Also, the national supervisor can be single or more than one body, as is the case for the UK in the wake of the financial crisis. However, as emphasised by the House of Lords, ‘If different supervisors carry out these functions they must work together to provide mechanisms to counteract macro-prudential risks at a micro-prudential level’.

According to Principle 13, ‘Supervisors should provide guidance for and supervise corporate governance at banks, including through comprehensive evaluations and regular interaction with boards and senior management, should require improvement and remedial action as necessary, and should share information on corporate governance with other supervisors’.

For more details see BCBS, Guidelines Corporate Governance Principles for Banks (Bank for International Settlements 2015), Principle 13
The Financial Services Authority (FSA) was the sole supervisory body for the financial sector in the UK, however, post the financial crisis, this body was replaced by two separate regulatory bodies: the Financial Conduct Authority (FCA), and the Prudential Regulation Authority (PRA). The UK financial system will be examined in more detail later in this chapter. See 3.6.3 The UK.

HL Deb 17 June 2009, vol I: Report, col 28
supervision and its importance in the financial sector, a question arises as to its important and effectiveness in the field of Islamic finance and the distinction between it and the national Shariah compliance supervision which is discussed next.

3.2.2 National Shariah supervision:

As seen above, the prudential supervision of financial institutions is mainly concerned with the financial aspects of the supervisee institutions and the risks they may pose to the financial sector. This supervision also provides protection of the interests of vulnerable parties dealing with the financial institutions, such as the shareholders and other stakeholders. IFIs, like their conventional counterpart, are also subject to this form of supervision. However, due to their Shariah-compliant nature, they require an additional level of supervision related to this special feature.

First, it should be noted that although Shariah compliance is not a financial aspect of IFIs, it still has a strong effect on their financial stability. As highlighted in Chapter Two, failure to achieve a proper level of Shariah compliance might affect the trust of investors and customers in IFIs and exposes IFIs to a credibility risk and other types of risks, which in return, will have a negative impact on the financial stability of the Islamic finance sector as a whole.\textsuperscript{543} Therefore, Shariah compliance is deemed to be important to regulators as much as it is important to individual IFIs. As such, supervising Shariah compliance and the implementation of SCG is just as important as enforcing prudential supervision in the Islamic finance sector.

National Shariah supervision is meant to provide assurance that IFIs follow the rules of Shariah or have in place proper measures to ensure their Shariah compliance. It also helps in protecting the interests of shareholders and other stakeholders in IFIs, who have trusted that they operate as proper Islamic businesses. It is also usually exercised by the same body that undertakes prudential supervision.\textsuperscript{544}

The main difference, however, between prudential supervision and national Shariah supervision is the focus of the supervision. While prudential supervision focuses on the financial aspects of financial institutions, mainly the financial institutions’ adherence to the capital adequacy requirements, Shariah supervision focuses on the IFIs’ adherence to Shariah rules and the rules of SCG.

\textsuperscript{543} See 2.2.2 Management of Shariah non-compliance risks in Chapter Two.
\textsuperscript{544} Alejandro López Mejía and others, \textit{Regulation and Supervision of Islamic Banks} (IMF, 2014) 13
The distinction between prudential supervision and national Shariah supervision can also be seen from a different angle. As seen above, prudential supervision has two distinct dimensions: micro-prudential that focuses on supervising the practices of individual financial institutions, and macro-prudential that focuses on the safety and soundness of the whole financial system.\(^{545}\) In countries where Shariah governance is regulated, the two supervisory dimensions come in two different levels of intensity, represented in the centralised and decentralised supervisory systems of SCG. Micro-prudential regulation focuses on compliance with Shariah in the individual institutions. This type of supervision is mostly performed in collaboration between the national supervisor and the SSBs in the individual institutions. On the other hand, macro-prudential regulation focuses on the Islamic financial sector at large so as to achieve standardisation and an effective level of Shariah compliance among all IFIs in the country. This type of supervision is solely carried out by the national supervisor. The main example of this supervision is through enforcing standardised Shariah rulings by the national supervisor, to be followed by all IFIs. In the end, similarly to prudential supervision, both supervisions complement each other and play an important role in the supervisory regulation of SCG.

The last distinction between prudential supervision and Shariah supervision is related to the effect of supervision on the shareholders’ interests. As highlighted by Tarullo, applying the measures used for macro-prudential regulation, which takes into consideration the interest of the whole economy and the public, might conflict with maximising shareholder value as the traditional goal of shareholders theory.\(^{546}\) This concern is not valid in the case of SCG, since it is a faith-based model distinct from the conventional models of corporate governance, as discussed in Chapter One.\(^{547}\) SCG has a different interest from the initial focus of the shareholder model - which is shared by all the players in the Islamic finance – that is Shariah compliance.

\(^{545}\) It should be noted that SCG and supervision is not legally regulated in all and every jurisdiction hosting IFIs, as is the case in non-Islamic countries in general and some Islamic countries. For example, there is no specific regulation for IFIs in Saudi Arabia and its legislations that govern the financial sector are applied in both conventional and Islamic financial institutions without any discrimination. For more about the system in Saudi Arabia please see Zulkifli Hasan, ‘Regulatory Framework of Shari’ah Governance System in Malaysia, GCC Countries and the UK’ (2010) 3-2 Kyoto Bulletin of Islamic Area Studies 82, 97.


\(^{547}\) See 1.8.2.2 The theory behind Shariah corporate governance in Chapter One.
Finally, one might consider that it would make more sense to address the macro-prudential before the micro-prudential as it is the broader type of supervision. This is quite right in terms of prudential supervision. However, in terms of Shariah compliance supervision, the case is different. The micro-prudential represented in Shariah supervision in the individual IFIs is addressed first in Chapter Two due to its importance and prevalence in the field of Islamic finance in comparison to national Shariah supervision. SCG is not regulated in all jurisdictions where IFIs operate, but all IFIs still implement it regardless. Also, national Shariah supervision is fairly new while SCG is as old as Islamic finance. In the end, national Shariah supervision is a special type of prudential supervision; unlike conventional supervision, it is not involved with the financial aspects of IFIs. Therefore, national Shariah supervision can be described as the measures taken by the national supervisor to ensure that IFIs comply with the rules of Shariah and/or – depending on the system followed by the country – ensure their implementation of proper SCG policy.

3.3 National Shariah supervision as a religious obligation under Shariah:

In Islamic Shariah, following Shariah rules and restrictions is of high priority and takes precedence over economic interests. As mentioned in Chapter One, Islamic Shariah is based on five objectives (Maqasid AlShariah): protecting religion, life, intellect, offspring and property, and anything that secures them is beneficial to society. These objectives are not randomly ordered but in accordance with their importance and priority of protection. Al-Bouti explains that religion is the base of the rest of the objectives and protecting its rules has priority in the case of conflict with the other objectives. Therefore, Islamic countries have a religious obligation to monitor the application of Islamic rules and to secure and protect the objectives of Shariah in a Muslim society.

548 For example, in Kuwait, the first Islamic bank was established in 1977, however, national SCG was not clearly regulated and supervised by the Central Bank until 2016. Similarly, in Malaysia, the first Islamic bank was established in 1983, while SCG was not clearly regulated until the 2000s. Above that, Islamic finance has been around in the UK for more than 30 years and SCG and supervision is not regulated until today. This will be seen clearly when examining the regulatory systems of Malaysia, Kuwait and the UK later in this chapter. See 3.6 Cross-country comparison: Malaysia, Kuwait and the UK

549 Maqasid AlShariah were mentioned first in Chapter One (A. Shariah corporate governance vs shareholder model) in order to illustrate that protecting property is one of the five objectives of Shariah. They are mentioned in here in order to understand the way they are ordered.


551 Muhammad Al-Bouti, Thawabit Al-Maslaha fi Al-Shariah Al-Islamiyyah (Al-Risalah Organisation 1973) 85
The regulatory and supervisory role of Islamic governments can be traced back to the *hisbah* system in Islamic history. Under this system, a governmental institution used to perform many duties in the markets, such as checking weights, enforcing contracts and prohibiting unlawful trade practices. The obligation on an Islamic government to implement Shariah rules and supervise its application in the country stems from the general obligation on Muslims to enjoy the right and forbid the wrong. Although this obligation is not compulsory on all Muslims, it is compulsory on a State authority. According to Khan, an Islamic government has a number of obligations with regard to regulating the financial sector. This includes creating a mechanism that enables financial institutions to practise their business on an interest-free basis; providing a legal basis for an Islamic alternative banking system; and creating a commission of Shariah scholars, economists and financiers to interpret standards for Islamic business.

Therefore, it is seen that Shariah places an obligation on the government in an Islamic country to supervise the implementation of Shariah in its jurisdiction, which confirms that Islamic governments have a religious as well as economic obligation to supervise Shariah compliance in IFIs operating within their jurisdiction. These religious and economic aspects of Shariah supervision are also seen in SCG as a policy that serves to fulfil Shariah compliance as well as corporate governance requirements in Islamic finance, as explained in Chapter One.

However, in modern days, the full application of Shariah rules in many

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554 ‘Amr bi al-Maruf wa’l-Nahy an al-Munkar (enjoining the right/honorable and forbidding the wrong/dishonourable) used in the *Quran* nine times, referring to the collective duty of the Muslim community to encourage righteous behavior and discourage immorality, as recognized by reason and the Islamic moral and legal system’. John Esposito, *The Oxford Dictionary of Islam* (Oxford University Press 2003) ch *Amr bi al-Maruf wa’l-Nahy an al-Munkar*


557 See 1.8.2 Shariah corporate governance in Chapter One.
Islamic jurisdictions has retreated to be replaced with secular rules, especially in the financial sector where conventional financial institutions prevail. Therefore, it is observed that Islamic countries are not paying great attention to their religious obligation to applying Shariah rules. Nevertheless, the obligation on Islamic countries to supervise Shariah compliance in IFIs can at least be seen from the perspective of their duty to protect the interest of the IFIs’ shareholders and other stakeholders who choose to deal with these institutions for their Shariah compliance. This is also the same reason that should encourage non-Islamic jurisdictions to supervise Shariah compliance in IFIs that operate within their jurisdiction.

3.4 International standards of national Shariah supervision and the governance of the centralised Shariah board:

This point addresses the IFSB principles for banking supervision and the AAOIFI governance standard for the centralised Shariah board (CSB) as the only international standards that regulate national supervision of the IFIs’ Shariah compliance.

3.4.1 The IFSB regulatory principles for banking supervision:

As seen above in the context of addressing national Shariah supervision, the main difference between this supervision and prudential supervision is the focus on Shariah compliance. The national supervisor needs to determine that IFIs adequately address the specificities of Islamic banking, which includes, among other things, full compliance with Shariah rules and the rules of SCG.558 In 2015, the IFSB issued a regulatory and supervisory framework especially to provide guiding principles for the supervisory authorities in the Islamic financial industry under the name of ‘Core Principles for Islamic Finance Regulation (CPIFR)’.559 The principles are essentially built on the supervisory standards of the BCBS and refined to cover the specificities of Islamic banking.560 The main goal of these principles is to help jurisdictions where

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IFI is present to assess their regulatory and supervisory policies.\(^{561}\)

Principle 16 of the CPIFR, determines the main obligations of the national supervisor as: (a) ensuring that IFIs are under a legal obligation to offer Shariah-compliant products and services; (b) verifying that an IFI has a proper corporate governance structure and policy to ensure its Shariah compliance and that it is not allowed to represent itself as Islamic without such policy; (c) ensuring that the SSB of an IFI plays its oversight role with adequate capability to provide objective opinions in Shariah-related matters; (d) ensuring that SSB members fulfil acceptable fit and proper criteria and that an IFI facilitates their continuous professional development, in addition to having in place a formal assessment for their effectiveness as a board and as individuals; (e) determining that an IFI adheres to Shariah standards or rulings as determined by the authority; (f) ensuring that an IFI has a proper mechanism for obtaining Shariah rulings from Shariah scholars, implementing them and monitoring its compliance to them; (g) ensuring that the SSB members are provided with the information needed for their mandate and have access to the institution’s internal units; and (h) determining that an IFI has an adequate SCG policy that reflects internal and annual Shariah review.

The IFSB believes that these obligations need to be followed by the national supervisor in every jurisdiction where IFIs operate, as part of its legal framework.\(^{562}\)

Following the rules of the CPIFR is meant to fulfil the Basel regulatory and supervisory requirements and at the same time give regard to the specificity of IFIs and their Shariah compliance in terms of supervision. They will help jurisdictions hosting IFIs to assess the adequacy and effectiveness of their regulatory systems in supervising the Islamic finance sector.

Having said that, the CPIFR standards still have some shortcomings. First, the use of the term ‘the supervisory authority’ to refer to the body responsible for supervising IFIs is not very accurate and can cause confusion – especially given that the supervisor varies from one country to another and can be more than a single body in some cases, as explained earlier. Also, the most common body – the central bank – is usually independent. It would have been more appropriate if the standards had used the term ‘the national supervisor’ or ‘the supervisory body’ in general. Moreover, the


standards are somewhat ambiguous in determining the supervisor’s obligations, as they do not distinguish between the centralised and decentralised system of Shariah supervision, which also leads to the CPIFR’s main downfall. They have failed to highlight the role of the CSB in Shariah compliance supervision, which is one main tool used by some jurisdictions in Islamic finance to supervise SCG in IFIs, such as Malaysia and the UAE.\textsuperscript{563} The AAOIFI, on the other hand, has tried to fill this gap in the international standards by issuing a standard for the governance of the CSB, which is addressed in detail in the following point.

3.4.2 The AAOIFI governance standard for the central Shariah board:

In 2018, the AAOIFI issued a standard for the governance of the CSB under the name ‘GSIFI 8 Central Shari’ah Board’ that provides the main governance principles of that board.\textsuperscript{564} The main aim of this standard is to achieve a high level of standardisation among SSBs in different IFIs in order to eliminate the inconsistency and divergence in Shariah rulings and their application in such institutions. The standard also presents an approach at a country’s level for regulating Islamic finance as a whole; in this regard, the AAOIFI expects different CSBs around the world to adopt its Shariah standards for the purpose of standardisation.\textsuperscript{565} It is worth mentioning that this standard is the first and only international standard that provides governance guidelines for the CSB.

The Standard defines the CSB as,

[A] broad level board or similar body of specialized jurists in \textit{Fiq\h al-Muamalat} (Islamic commercial jurisprudence) and experts in Islamic banking, finance, economics, law, accounting, etc. providing guidance and advice on Shari’ah matters, with limited supervision, that is established in a specific country or jurisdiction for providing uniformity and harmony in the products and practices with regard to Islamic finance through Fatwas, rulings and guidelines. The CSB’s decisions are applicable on a broader base in the jurisdiction rather

\textsuperscript{563} In Malaysia, the Shariah Advisory Council (SAC) is the CSB that was established by the Central Bank. See the Central Bank of Malaysia Act 2009, Section 51. In the UAE, the Higher Shariah Authority which was established in 2018 on the Central Bank’s level is the centralised body. Decree Federal Law no 14 of 2018 Regarding the Central Bank and Organisation of Financial Institutions and Activities, Section 17 (UAE)


\textsuperscript{565} See AAOIFI, ‘AAOIFI Introduces its 100th Standard as Governance Standard No. 8 ‘Central Shari’ah Board’ Has Been officially Issued’ (AAOIFI, 2018) <http://aaoifi.com/announcement/aaofi-introduces-its-100th-standard-as-governance-standard-no-8-central-shariah-board-has-been-officially-issued/?lang=en> accessed 30 December 2019
than a single institution.\footnote{AAOIFI, ‘Governance Standard for Islamic Financial Institutions No. 8: Central Shari’ah Board’ (2018) AAOIFI Paper no GSIFI 8, Section 5(b) \url{http://aaoifi.com/gsifi-8-central-shariah-board/?lang=en} accessed 26 December 2019}

With regard to the governance rules of this board, they are not very different from those regulating the SSBs explained in the previous chapter. However, in terms of the CSB’s appointment and remuneration, it is noted that this standard provides slightly better governance: the remuneration should be fixed and paid by the national authority. Moreover, in contrast to the rules of SSB remuneration, the standard determines a sound basis on which the remuneration of the CSB members should be fixed that helps to maintain the members’ independence, objectivity and productivity, namely on a retainer basis, a time basis or an attendance to meetings basis, or a combination thereof.\footnote{AAOIFI, ‘Governance Standard for Islamic Financial Institutions No. 8: Central Shari’ah Board’ (2018) AAOIFI Paper no GSIFI 8, Section 10 \url{http://aaoifi.com/gsifi-8-central-shariah-board/?lang=en} accessed 26 December 2019} In addition, it emphasises the need to disclose the remuneration publicly as a matter of promoting transparency and information disclosure, which is often missing in terms of the remuneration of the SSB members.

According to the standard, the appointment of the CSB’s members, whether initially or subsequently, should be done by the authority. Furthermore, the standard also states that the authority needs to define the appointment terms of reference, including the time commitment expected from each member. A board’s term is recommended to be three to five years, while implementing a proper rotational policy. As for their removal, the standard determines the sole situations in which a member can be removed by the authority, namely if they committed professional misconduct, breached a term of reference or missed a number of meetings. Restricting the removal of the CSB members in certain situations is seen as a positive approach as it helps to minimise the authority’s discretion in removing the board’s members. For any other removal ground, the authority or any other concerned party may resort to the court.

In terms of the board’s composition, the standard recommends that it should comprise of at least five members – including Shariah scholars and other professional experts. However, in the case of a Shariah ruling, the opinion of the Shariah scholars prevails. Another positive aspect of this standard is that it requires diversity to be observed in the appointment of the CSB members, in terms of nationality, school of thought and experience. It would be even better if diversity in gender was also
included in order to encourage the appointment of women in the CSBs.

Nevertheless, despite the positive recommendations and good governance guidelines, several aspects of the standard can still be criticised. First, the standard rules are not very effective in ensuring the CSB’s members independence and objectivity. In contrast to the SSB’s rules, the standard does not specify the relationship between the CSB’s members and the national supervisor and whether, with their appointment, they become employees of the national supervisor or just free agents who provide consultancy to the supervisory body. In this regard, it is believed that being a member of this board should be considered as employment rather than just the hiring of consultancy services. This is to restrict the members’ ability to serve as Shariah scholars on different SSBs inside IFIs in order to protect their independence, objectivity and supervisory duty. In addition, the authority should prohibit CSB’s members from providing any verbal or written Shariah consultancy, paid or unpaid, other than that sought via the official, formal channel. Nevertheless, it is noticeable that the AAOIFI standard does not support this idea as it mentions that, in terms of appointing the CSB members for the first time, it is permissible to appoint Shariah scholars who serve on SSBs with IFIs, provided they do not exceed one-third of the members, which raises an obvious case of conflict of interests.568

Second, this standard also has a drawback in terms of enforcing the AAOIFI standards on CSBs of different countries. To clarify, the standard first acknowledges that the main function of the CSB is to harmonise Islamic finance practices. However, in terms of determining the means for this harmonisation, it clearly states that this can only be reached through the adoption of the AAOIFI Shariah standards or other widely accepted Shariah standards as long as they do not conflict with the AAOIFI standards. Thus, from this approach, it is noted that the AAOIFI through this standard tries to impose its Shariah rulings and standards on the different countries, which leads to the loss of their advisory nature. Moreover, adherence to the AAOIFI Shariah standards means that the AAOIFI Shariah Board is a superior authority to the CSB in the adopting country, thus restricting its ability to issue Shariah rulings that differ from those of the AAOIFI Shariah Board. It is understood that the AAOIFI is trying to harmonise the practices in the Islamic finance sector at large, but this should not be

to the extent that a jurisdiction loses its authority to implement Shariah rules and supervise the IFIs on its territory in the way that it sees fit. Supporting the idea of establishing a CSB and providing rules for its governance is different from imposing certain Shariah rules to govern the practices of the IFIs. Recommended governance rules can be accepted by jurisdictions but forcing substantive rules on them might be seen as interfering in the country’s legal system.

The severity of this issue is increased by the fact that the CSB’s functions can become compulsory in nature. To illustrate, according to the AAOIFI standard, the CSB has the authority to issue *fatwas* in its area of work and to provide advisory opinions and guidance to regulators and courts on any issue related to Islamic finance. 569 These functions are ‘passive’, i.e. the board does not provide an opinion unless requested by the authority, regulators or the court. However, the authority of the CSB becomes ‘proactive’ in some situations that are determined by its sole judgement. Namely, if the CSB concludes that: (a) a major incident of non-Shariah compliance has occurred; (b) it is believed that a non-compliance matter is known or approved by the BoD; or (c) unless a proactive step is taken, the interests of the larger stakeholders will be harmed. 570 Although the ‘proactive’ concept is slightly ambiguous, it indicates that the CSB is allowed directly to control a situation related to its functions rather than react to it. However, it is important to notice that this power of the CSB is not risky unless the country decides to adhere to the AAOIFI Shariah rulings, whereby the AAOIFI Shariah board will be the controller.

Third, another drawback of the AAOIFI standard is that it gives the CSB wide functions, which distracts it from its initial objective. In this regard, in terms of determining the CSB’s functions, the standard does not restrict its authority to supervising SSBs and Shariah compliance in IFIs but also confers on it other regulatory and supervisory functions in the country. For example, according to the standard, the CSB has the authority to adopt *fatwas* for the jurisdiction in general, provide Shariah consultation with regard to the country’s laws and adopt a code of


ethics.\textsuperscript{571} This, of course, provides the CSB with authority far beyond supervising Shariah compliance and harmonising the Islamic financial practices in the country. With these functions, the CSB becomes a general Shariah board in the country with the function of supervising SSBs, which leads to the loss of its specificity and professionalism.

To sum up, this governance standard has positive sides and provides good governance rules for any country that chooses to appoint a CSB, but it has some shortcomings that need to be taken into consideration. First, the independence of the CSB’s members needs to be protected in a better way, especially in terms of preventing them from serving the CSB and other SSBs simultaneously. Second, if the standard is adopted applying a literal interpretation, there is a possibility that the AAOIFI will be able to control the IFIs in the country and probably influence its whole regulatory system – especially given that the AAOIFI, as an international professional organisation, has its own Shariah board that issues \textit{fatwas} on all issues related to the IFIs’ practice. In addition, it issues international Shariah rules, regulatory standards, governance frameworks, codes of ethics and other regulations for IFIs. Finally, the duty of a CSB should be limited to supervising the SSBs and the level of Shariah compliance in IFIs without being distracted by other functions.

3.5 Overview of the different supervisory systems in Islamic finance:

The International Monetary Fund conducted a survey in 2014 to ‘document the international experiences and country practices related to legal and prudential frameworks governing Islamic banking activities’.\textsuperscript{572} The survey showed that the prudential supervision framework is implemented in the jurisdictions’ regulatory systems in three ways, either by: (1) adopting the BCBS framework only and, therefore, the distinctive characteristics of the Islamic banks are not taken into account; or (2) applying the BCBS standards along with the IFSB prudential supervisions principles; or (3) setting a separate regulatory framework specifically for supervising Islamic banks.\textsuperscript{573} In addition, the survey revealed that there are two

\textsuperscript{573} Inwon Song and Carel Oosthuizen, Islamic Banking Regulation and Supervision: Survey Results
models of supervision for IFIs in different jurisdictions. In a number of jurisdictions, a single supervisory body supervises all financial institutions, Islamic and conventional, and a single framework is applied to all. In other jurisdictions, a separate supervisory unit within a single supervisory body is in charge of supervising the IFIs and a separate framework is applied to them.\(^\text{574}\) Basically, in jurisdictions where Islamic Shariah is not the basis to all their laws, the supervisory body does not provide IFIs with special supervision that aligns with their specificities but rather it supervises them from a secular perspective. On the other hand, in jurisdictions where Shariah is the default source of their legislation, the supervisory body monitors Shariah compliance in IFIs.\(^\text{575}\)

The supervisory systems followed by the leading jurisdictions in Islamic finance have been the subject of a few studies, but each study has classified them in a different way. Hasan divides the models of Shariah supervision into five categories: (1) reactive, as in a non-Muslim country where there is no Shariah compliance supervision; (2) passive, as in Saudi Arabia where a Muslim country does not offer any national Shariah oversight of the IFIs and their Shariah governance is by self-initiated; (3) minimalist, where there is a limited degree of national intervention in the IFIs’ Shariah governance, as in Kuwait and Qatar; (4) proactive, where there are strong national Shariah regulations and supervision, as in Malaysia; and finally (5) interventionist, as in Pakistan where there is a third party that has the authority and the final say in the Shariah-related matters in IFIs.\(^\text{576}\)

Hamza, on the other hand, combines them into two main approaches in Islamic jurisdictions: decentralised and centralised.\(^\text{577}\) IFIs in the decentralised model have their own independent SSB, while the centralised model requires SSBs to follow Shariah rulings and decisions of the CSB. As for non-Islamic jurisdictions where IFIs

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577 Hichem Hamza, ‘Sharia Governance in Islamic banks: Effectiveness and Supervision Model’ (2013) 3 International Journal of Islamic and Middle Eastern Finance and Management 226, 231
operate, Shariah governance depends on the SSB in individual institutions without any national Shariah compliance supervision.

Finally, Hasan and Sabirzyanov assert that Shariah governance practices vary between countries, however, they can be combined in three models: (1) a centralised model, where the country has a CSB and its decisions are binding to the IFIs, as is the case in Malaysia and Pakistan; (2) a self-regulated model, as is the case in the GCC countries and Muslim-minority countries, such as the UK, where the country does not have a CSB and each IFI has its own SSB; and (3) a hybrid model, which is unique to Bahrain, where the country has a CSB at the central bank level but the board has only an advisory and supervisory function with regard to the IFIs’ adherence to the central bank’s Islamic finance rules. Hence, in this model, SSBs also depend on their own Shariah rulings.\textsuperscript{578}

Despite the minor differences in categorising the existing models of Shariah supervision across several jurisdictions, it is agreed among writers that there are three levels of intensity: strict, lenient and absent. This is based on the scope of their regulation of SCG and the degree of national supervision of Shariah compliance in IFIs in each country. These levels of intensity then produce the main three models of SCG: centralised, decentralised and self-regulated.

\subsection*{3.5.1 The centralised system:}

Under this approach, the national supervisory body undertakes strict supervision of SCG and Shariah compliance in IFIs. The country establishes special rules within its national laws for IFIs with regard to their SCG and Shariah compliance to cater for their specificity. Some rules are mandatory and others are advisory. In other words, the law provides a comprehensive SCG framework for IFIs.

Under this system, each IFI is required by law to follow a specific internal structure, which includes the appointment of a SSB and other requirements. The most distinctive feature of this system is the CSB at the central bank level, each SSB being obliged by law to follow the decisions and Shariah rulings of that board and to secure their implementation in their institution. IFIs under this system are not entirely free to design their own SCG and their SSBs are not free to issue independent Shariah rulings, which enforces strong national Shariah supervision over the IFIs’ SCG and

\textsuperscript{578} Aznan Hasan and Ruslan Sabirzyanov, ‘Optimal Shariah Governance Model in Islamic Finance Regulation’ (2015) 3 International Journal of Education and Research 243, 244-248
Shariah compliance in the country.

3.5.2 The decentralised system:

Under this approach, like to the centralised approach, the country imposes some mandatory and advisory rules with regard SCG in IFIs. Nevertheless, the main difference is the intensity of the national supervision of the SSBs in IFIs. In this system, SSBs are more independent and do not work under strict supervision of the national authority. The country does not have a CSB on the national supervisor’s level, but might have a general national fatwa board that is responsible for providing fatwas to any person, including IFIs when needed. Hence, Shariah compliance in IFIs, in principle, is implemented and monitored by the SSBs, but they have the option to seek the opinion of the general national fatwa board. Once the opinion of the national fatwa board is sought by an IFI, it is compulsory to follow it. Therefore, national Shariah supervision of SCG and Shariah compliance still exists but is not as strict as the centralised model.

3.5.3 The self-regulated system:

Under this system, SCG is not nationally regulated or supervised in any respect and IFIs voluntarily implement their SCG policy and conclusively supervise their own Shariah compliance. Therefore, SCG in this system is described as ‘self-regulated’. IFIs operating under this supervisory system follow the Shariah rulings of their SSBs and might also voluntarily apply the Shariah standards of a particular Islamic jurisdiction or those issued by an international Shariah board, such as the AAOIFI Shariah board, in order to ensure their Shariah compliance. As for the rules of SCG, they usually adhere to the international standards of the Islamic international organisations, mainly the IFSB and the AAOIFI.

3.5.4 Which system best serves Shariah governance and compliance in IFIs?

Many writers agree that the centralised approach provides standardisation and harmonisation of practices in Islamic finance as it promotes consistency in Shariah interpretation and certainty of rulings, which reduces divergences between different
IFIs (at least in a particular country). 579 According to Hamza, centralisation has the ability to strengthen the position and independence of SSBs and makes it possible to manage conflicts of interests. 580 This should help in reducing the Shariah non-compliance risk and in return boost the investors’ confidence in the institution. Centralisation also helps to reduce fatwa shopping, especially when the appointment of SSB members requires prior approval from the authority. 581 According to Wilson, without standardisation, stakeholders might shop for the least restrictive Shariah ruling and institutions will get the fatwas that best help their business. 582

Nevertheless, this approach also has some disadvantages. Hasan and Sabirzyanov state that the centralised approach limits the independence of ijtihad for the SSBs members as they are required to follow the rulings made by the centralised board and are not able to have a different opinion. 583 In addition, Wilson argues that if the authority is too involved in IFIs Shariah compliance, people might think that the SSBs are politicised. 584 The authority might also be biased towards a particular school of thought or religious group and imposing its opinions on SSBs, which would result in streaming IFIs in a particular intellectual direction. Another disadvantage to the centralised approach is that it requires specific rules and legislations to regulate Islamic finance and the centralised board mandate, which is not possible in all jurisdictions where IFIs operate. 585

The decentralised approach, on the other hand, allows more flexibility for IFIs


580 Hichem Hamza, ‘Sharia Governance in Islamic Banks: Effectiveness and Supervision Model’ (2013) 6 International Journal of Islamic and Middle Eastern Finance and Management 226, 236


under less control of the authority. Countries applying this approach do not impose rigorous and strict national supervision over the SSBs, which gives them extra space for *ijithad*. However, this might result in inconsistency in Shariah rulings among individual SSBs, which could confuse investors and consumers. Nevertheless, according to Hamza, there is some uniformity in the Shariah opinions of SSBs in the GCC countries due to the fact that most Shariah scholars are members in multiple SSBs in these countries.

The self-regulating approach also lacks standardisation and this variation might reduce certainty in the products of Islamic finance and cause confusion among investors. However, Hasan and Sabirzyanov confirm that, in terms of flexibility and ability to keep pace with the fast-moving nature of the financial sector, this approach prevails over the centralised system. IFIs can practise their business in any country, even those that lack special provisions for Islamic finance. In addition, not requiring approval from the authority would help IFIs to issue new products faster and compete with conventional institutions. Nevertheless, it is argued that countries without national supervision are not interested in the IFIs’ Shariah compliance as much as in their financial stability, due to the secular approach followed by the country, as is the case in non-Muslim jurisdictions.

It can be seen from this review that there is no consensus among writers on the ideal Shariah supervisory approach. Hasan and Sabirzyanov believe that each approach has some advantages and disadvantages, while Hassan has the view that each approach has its own strengths and is the result of the legal framework and social needs of the respective country. To provide a better assessment of the effectiveness

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589 Amin states that it can be deduced, following a religious neutrality approach, that the UK government does not have interest in whether an IFI is Shariah compliant or not. Mohammad Amin, ‘The United Kingdom’s Approach to the Regulation of Islamic Finance’ (Mohammad Amin, 9 November 2009) <http://www.mohammedamin.com/Islamic_finance/UK_approach_to_regulating_Islamic_finance.html> accessed 21 December 2019

of the aforementioned systems, a deeper investigation of selected systems will be pursued. Therefore, the systems implemented in Malaysia (the centralised system), Kuwait (the decentralised system) and the UK (the self-regulated system) will be examined in detail in the following section. This examination is essential as it forms an important bridge into the chapters that address the shareholders of IFIs and their active engagement as the solution proposed by this thesis for enhancing SCG alongside the efforts of the IFIs and the national authorities in each jurisdiction. The examination, in particular, will help to determine the scope for shareholders’ activism under the different SCG systems applied in Malaysia, Kuwait and the UK.

3.6 The regulatory and supervisory framework for IFIs in Malaysia, Kuwait and the UK:

3.6.1 Malaysia:

   Malaysia applies a dual legal system that enforces the rules of common law as well as the rules of Shariah.591 This integration has helped in imposing Shariah rules in the country’s Islamic banking and finance system.592 Since the emergence of the Islamic finance industry, Malaysia has been keen to develop a robust SCG framework for IFIs as to ensure their proper Shariah compliance.593 According to the survey conducted by Hasan, which examined the approach followed by Malaysia, GCC countries and the UK in regulating SCG, Malaysia was classified as a pronounced regulator and came out on top among the countries examined.594

3.6.1.1 The first initiative for regulating Islamic finance in Malaysia:

   The first initiative for regulating Islamic finance in Malaysia was the Islamic Banking Act (IBA) in 1983, which required the licensing of Islamic banks to provide Islamic services and the appointment of a Shariah board in the bank to oversee its

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592 Zulkifli Hasan, ‘Regulatory Framework of Shari’ah Governance System in Malaysia, GCC Countries and the UK (2010) 3-2 Kyoto Bulletin of Islamic Area Studies 82, 84
Shariah compliance.\textsuperscript{595} The IBA granted the Central Bank (Bank Negara Malaysia (BNM)) the power to supervise all Islamic banks in Malaysia and any branch opened by a Malaysian Islamic bank outside Malaysia.\textsuperscript{596} In the same year the first Islamic bank in Malaysia was established.\textsuperscript{597} Later, in 1989, the Banking and Financial Institutions Act (BAFIA), which deals with conventional banking, allowed conventional banks and financial institutions through an Islamic window to carry out Islamic business, provided that they do so in compliance with the rules of Shariah and appoint a SSB.\textsuperscript{598}

Besides these two main laws, the Central Bank Act 1958 played a major role in terms of supervising the implementation of the practices of Islamic banks in Malaysia, especially in terms of having a national Shariah council at the Central Bank level to oversee the implementation of Shariah rules in Islamic banks, namely the Shariah Advisory Council (SAC).\textsuperscript{599} The IBA and the BAFIA have both instructed Islamic banks to seek the advice of the SAC, but it is noteworthy that the latter has made it compulsory for Islamic banks to comply with the opinion of the SAC, while the former adopted a less clear position.\textsuperscript{600} At this time, it was not apparent whether Malaysia applied a centralised or decentralised model in regulating SCG, as the law did not clearly specify the powers of the SAC.

The IBA was the first law that exclusively governed Islamic banking, however, the legislation was general and brief.\textsuperscript{601} It merely permitted the establishment and operation of Islamic banks in Malaysia.\textsuperscript{602} The BAFIA, on the other hand, mainly regulates conventional institutions and added a small section for

\begin{itemize}
\item \textsuperscript{595} Islamic Banking Act 1983, Sections 3 and 5 (Malaysia). See also Mohamad Laldin, ‘Islamic Financial System: the Malaysian Experience and the Way Forward’ (2008) 24 Humanomics 217, 218
\item \textsuperscript{596} Islamic Banking Act 1983, Section 31 (Malaysia)
\item \textsuperscript{597} Norhashimah Yasin, ‘Legal Aspects of Islamic Banking: Malaysian Experience’ in Salman Ali and Ausaf Ahmad (eds), \textit{Islamic Banking and Finance: Fundamentals and Contemporary Issues} (Islamic Development Bank 2007) 215
\item \textsuperscript{599} The SAC was first established under subsection 16B (1) of the Central Bank of Malaysia Act 1958. For more information about the SAC please visit it website at \texttt{http://www.sacbnm.org/} accessed 30 December 2019.
\item \textsuperscript{600} Islamic Banking Act 1983, Section 13(A) (Malaysia). Banking and Financial Institutions Act, Section 124 (3) (Malaysia)
\item \textsuperscript{601} The IBA was repealed by the Islamic Financial Services Act 2013, as will be seen later in this section.
\item \textsuperscript{602} Norhashimah Yasin, ‘Legal Aspects of Islamic Banking: Malaysian Experience’ in Salman Ali and Ausaf Ahmad (eds), \textit{Islamic Banking and Finance: Fundamentals and Contemporary Issues} (Islamic Development Bank 2007) 217
\end{itemize}
Islamic windows. The nature and scope of Shariah governance in this period was simple and limited to approval of the activities of IFIs without any further requirements for corporate governance, such as Shariah audit and review. Therefore, there was still a need for a detailed and complete legislation to govern Islamic business and a comprehensive framework to regulate SCG in IFIs.

3.6.1.2 The Guidelines on the Governance of Shariah Committee for the Islamic Financial Institutions 2005:

BNM, as the body supervising financial institutions, issues guidelines to regulate the practices of these institutions whenever required. The IBA and BAFIA have both made these guidelines compulsory for all financial institutions. In 2005, BNM issued the most important guidelines that constituted a significant development in SCG in Malaysia: the Guidelines on the Governance of Shariah Committee for the Islamic Financial Institutions. The Guidelines place an obligation on every Islamic bank to appoint a SSB. They also determine the way of appointing the members of the SSB, their number, qualification, disqualification, duties, responsibilities and restrictions. Most importantly, the Guidelines state that the SSB members are to be appointed by the BoD and upon written prior approval from the BNM. In addition, the Guidelines set two main restrictions on the appointment of Shariah scholars in IFIs: (a) an IFI is not allowed to appoint any member of the SAC, and (b) an IFI should not appoint a scholar who is a member in another IFI of the same industry. These were the first mandatory rules of SCG in Malaysia and the start of stricter rules.

3.6.1.3 The new Central Bank Act 2009:

In 2009, a new Central Bank Act was issued that effected a major change in

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604 Islamic Banking Act, Section 53 (Malaysia), Banking and Financial Institutions Act, Section 116 (Malaysia)
605 Guidelines on the Governance of Shariah Committee for the Islamic Financial Institutions (BNM/RH/GL/012-1), Section 5 (Malaysia)
606 Guidelines on the Governance of Shariah Committee for the Islamic Financial Institutions (BNM/RH/GL/012-1), Sections 11 to 20 (Malaysia)
607 Guidelines on the Governance of Shariah Committee for the Islamic Financial Institutions (BNM/RH/GL/012-1), Section 8 (Malaysia)
608 Guidelines on the Governance of Shariah Committee for the Islamic Financial Institutions (BNM/RH/GL/012-1), Section 19 (Malaysia)
Malaysian Islamic finance regulation. First the Act officially declared existence of a dual financial system in Malaysia (conventional and Islamic), and second it confirmed the status of the SAC as the authority for the ascertainment of Islamic law for the purposes of Islamic financial business in the country. The Act conferred on the SAC a statutory power to monitor all business and activities conducted by IFIs to ensure their compliance with Shariah rules. In this regard, it provided that Shariah rulings issued by the SAC shall be respected by all IFIs, as well as by arbitrators and courts in the case of any legal proceeding in relation to Islamic finance. In addition, a ruling of the SAC prevails over any other ruling given by a SSB of an IFI in the case of any inconsistency. With the conferral of these powers on the SAC, it can be said here that Malaysia clearly shifted toward applying a centralised model of SCG. Under this system, the SAC acts as the sole supervisory body that issues Shariah rulings for IFIs and the SSBs play a supplementary role in supervising Shariah compliance in IFIs as internal Shariah auditors.

3.6.1.4 Shariah governance framework for Islamic financial institutions 2010:

In 2010, a year after the changes to the Central Bank of Malaysia Act, the BNM issued a SCG framework for Islamic financial institutions. The main objective of this framework was to ensure proper compliance with Shariah rules by all IFIs through implementing a strong SCG policy. The framework embraced the main principles of SCG: the requirements of Shariah governance; the accountability of the board, SSB and management; the independence, competency and confidentiality of SSBs; and finally, Shariah audit and review. This framework was replaced with a newer version in 2019, as will be seen below.

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610 See Central Bank of Malaysia Act 2009, Sections 24 and 51
612 See Central Bank of Malaysia Act 2009, Section 57
613 See Central Bank of Malaysia Act 2009, Section 58
614 Fulya Apaydin, ‘Regulating Islamic Banks in Authoritarian Settings: Malaysia and the United Arab Emirates in Comparative Perspective’ (2018) 12 Regulation & Governance, 466, 475
615 Shariah Governance Framework for Islamic Financial Institutions 2010 (BNM/RH/GL_012_3) (Malaysia)
616 See Shariah Governance Framework for Islamic Financial Institutions 2010 (BNM/RH/GL_012_3), Section 2 (Malaysia)
617 See Shariah Governance Framework for Islamic Financial Institutions 2010 (BNM/RH/GL_012_3), Section 6 onwards (Malaysia)
3.6.1.5 The Islamic Financial Services Act 2013:

SCG in Malaysia reached a high level of efficiency by issuing the comprehensive Islamic Financial Services Act (IFSA) in 2013, which repealed the IBA 1983. This Act has been described as ‘the culmination efforts of the legal framework of IFIs in Malaysia, in particular in the aspect of Shariah compliance’. It deals with the main aspects of SCG and Shariah compliance as well as Shariah standards in the field of Islamic finance. It emphasises the power of the Central Bank, its supervisory role and prudential responsibility to promote financial stability and compliance with Shariah. This distinction in the supervisory functions of the Central Bank clarifies the difference between prudential supervision and Shariah supervision as discussed earlier in this chapter.

In terms of Shariah compliance, the IFSA stresses the duty of an IFI to ensure compliance with Shariah. In this regard, it defines Shariah compliance as, ‘A compliance with any ruling of the Shariah Advisory Council in respect of any particular aim and operation, business, affair or activity’. To provide a strong assurance of Shariah compliance in IFIs, the Act enforces a strong sanction for undertaking any non-Shariah activity, with a maximum period of imprisonment of eight years or a fine with a maximum amount of twenty-five million ringgit (around 4.7 million pounds) or both.

Regarding SCG, the IFSA obliges all IFIs to appoint a SSB. It also determines the terms for appointing the SSB members, their duties and grounds for disqualification. In this context, it confirms the BoD’s duty to appoint SSB members upon the prior approval of the Central Bank. Furthermore, the IFSA does not ignore the other aspects of conventional corporate governance, such as those related to the BoD, transparency requirements and financial auditors.

The Act has not stopped at introducing a statutory framework for SCG but

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618 See Islamic Financial Services Acts 2013, Section 2 (Repealed Acts) (Malaysia)
620 The power, responsibilities and role of the Central Bank are highlighted in different sections of the Islamic Financial Services Act 2013 (Malaysia). See for example, Sections 6, 7, 29 and 56 to 61 of the Act.
621 See Islamic Financial Services Act 2013, Section 28 (Malaysia)
622 See Islamic Financial Services Act 2013, Section 28(5) (Malaysia)
623 See Islamic Financial Services Act 2013, Section 30 (Malaysia)
624 See Islamic Financial Services Act 2013, Sections 31 to 33 (Malaysia)
625 See Islamic Financial Services Act 2013, Section 31 (Malaysia)
626 See Islamic Financial Services Act 2013, Sections 62 to 82 (Malaysia)
extends to regulating Shariah standards for IFIs. Section 29 of this Act gives the power to the BNM, in accordance with the advice or ruling of the SAC, to specify standards on Shariah matters related to the business of IFIs and to give effect to the rulings of the SAC.627 Following this provision, the BNM together with the SAC, the International Shariah Research Academy and other industry players work together to issue Shariah standards to serve as substantial rules for Islamic finance.628 It should be noted that any Shariah standards issued by the BNM pursuant to the above provision have statutory force and need to be followed by all IFIs.629

3.6.1.6 The new Shariah Governance Framework 2019:

The most recent development in the Malaysian SCG happened in 2019 when the BNM issued a new SCG framework to replace the 2010 version.630 The new SCG framework is comprehensive and detailed. It includes a number of obligations that result in enforcement action for non-compliance and other recommended guidelines whose adoption is encouraged.631 This framework includes a number of essential new features. For example, it addresses Shariah non-compliance risk and its management; it deals with Shariah committee composition and meetings in more details; and it adds the cultural aspect to Shariah compliance, which reflects the behaviour of compliance with Shariah in the institution’s business.632 More importantly, to strengthen Shariah compliance, this framework has changed the Shariah functions of Shariah compliance established in the 2010 framework to control functions that consist of Shariah review, Shariah audit and Shariah risk management.633

627 See Islamic Financial Services Act 2013, Section 29 (Malaysia)
629 See Islamic Financial Services Act 2013, Section 29(3) (Malaysia)
630 The new Shariah governance framework 2019 supersedes the 2010 framework and will be effective on April 2020. See Shariah Governance 2019 (BNM/RH/PD 028-100), Section 4 (Malaysia)
631 See Shariah Governance 2019 (BNM/RH/PD 028-100), Section 5 (Malaysia)
632 See Shariah Governance 2019 (BNM/RH/PD 028-100), Section 11, 13, 17 and 20 (Malaysia)
3.6.1.7 The effectiveness of the Malaysian system in achieving Shariah compliance in IFIs and scope for shareholder engagement:

It is evident from the previous overview of the Malaysian regulatory and supervisory system that it has a comprehensive SCG framework for IFIs with centralised supervision. The SAC is the centralised body responsible for ensuring Shariah compliance in Islamic finance in Malaysia, which is mandated to issue publicly standardised Shariah rulings for all IFIs and the capital market. Therefore, the advantages and disadvantages of the centralised system explained earlier apply to the Malaysian system in general. In particular, the system is useful for achieving standardisation and harmonisation of practices in the whole Islamic finance sector of the country and overcomes the problem of risks to SSB members’ independence and possible conflicts of interest. This system, however, can be time-consuming and could cause delay in a very dynamic environment, especially when a new Shariah ruling is required. Obliging all IFIs in the country to refer to the centralised board for a Shariah ruling and then to wait until the ruling comes back before acting might take a long time that cannot be afforded by institutions working to compete in Islamic finance on both national and international levels.

Remarkably, the Malaysian centralised system has found a way of managing the issue of *ijtihad* limitation, which is a potential disadvantage of the centralised system, since it has not entirely deprived SSB members of the possibility of issuing Shariah opinions. SSB members are still able to provide their opinion in two particular cases: (a) if the IFI requires a Shariah ruling from the SAC, and (b) if the

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636 See above at 3.5.4 Which system best serves Shariah governance and compliance in IFIs?

637 Fulya Apaydin, ‘Regulating Islamic Banks in Authoritarian Settings: Malaysia and the United Arab Emirates in Comparative Perspective’ (2018) 12 Regulation & Governance 466, 477

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IFI submits an application to the Central Bank for approval to issue a new product.\textsuperscript{638} This opens the way for SSBs’ members to study Shariah-related matters in the IFIs they are serving and submit their opinion to the centralised board, which is expected to take this opinion into consideration before issuing its final ruling. Moreover, the Malaysian system has also overcome the problem of politicising the IFIs - another potential disadvantage of the centralised system - by ensuring the independence of the SAC. Even courts and arbitrators cannot interfere with or contradict the rulings given by the SAC. According to Apaydin, the SAC is fairly independent, and since its inception, has not suffered from any political meddling.\textsuperscript{639}

Therefore, the main concern of this research is whether the centralised system enforced by Malaysia overcomes the problems of SCG and ensures Shariah compliance in IFIs, which then helps to determine the scope for shareholders’ engagement in this regard. It should be acknowledged first that answering this question depends on the definition of Shariah compliance in Malaysia and not anywhere else. As seen above, Shariah compliance in Malaysia is viewed as compliance with the rulings of the SAC and any IFI acts that infringe these rulings will be considered Shariah non-compliant and will be subject to strong sanctions. Therefore, the answer is ‘yes’, the centralised system in Malaysia does help IFIs to overcome the problems of SCG and achieve Shariah compliance, even if another jurisdiction takes a different approach and applies different Shariah rulings and standards. As noted in Chapter Two, divergence in Shariah rulings and differences in the interpretation of Shariah principles is permissible in Shariah and might be especially likely to occur with new and modern issues and between different societies due to ijtihad.\textsuperscript{640} The system has also managed the problem of Shariah scholars’ multiple memberships in SSBs by restricting a Shariah member to a single SSB in a similar industry.\textsuperscript{641} Moreover, the effectiveness of the Malaysian centralised system has been increased through the strengthened enforcement provisions stated in the law. As seen above, the IFSA has empowered the Central Bank to initiate criminal actions

\textsuperscript{638} See Guidelines on the Governance of Shariah Committee for the Islamic Financial Institutions (BNM/RH/GL/012-1), Section 20(f) (Malaysia)
\textsuperscript{639} For more about the independence of the SAC please see Fulya Apaydin, ‘Regulating Islamic Banks in Authoritarian Settings: Malaysia and the United Arab Emirates in Comparative Perspective’ (2018) 12 Regulation & Governance 466, 468-477
\textsuperscript{640} See 2.3.3 Divergence of Shariah rulings in Chapter Two.
\textsuperscript{641} Guidelines on the Governance of Shariah Committee for the Islamic Financial Institutions (BNM/RH/GL/012-1), Section 19 (Malaysia)
in court against any IFI that practises a Shariah non-compliant activity.\textsuperscript{642} Moreover, as articulated by Yussof, the Central Bank of Malaysia can also ‘issue directions of compliance or accept legally enforceable undertakings that commit financial institutions to take specific actions to address identified risks’.\textsuperscript{643} Therefore, it can be said that the scope for shareholders’ engagement with regard to SCG in Malaysia is narrow. This outcome, however, does not mean that shareholders in IFIs in Malaysia should rely entirely on the national system to protect their interest in complete Shariah compliance. Their engagement is still needed to ensure the IFIs’ proper adherence to the rules of SCG set by the country.

3.6.2 Kuwait:

Kuwait, like Malaysia, implements a mixed regulatory system that combines secular rules with the rules of Shariah. This is evident from Article 2 of Kuwait’s constitution, which considers Shariah as (a main source of legislation) and not (the main source of legislation).\textsuperscript{644} This distinction means that although lawmakers are directed to follow the rules of Shariah, it is still open to them to establish rules from different sources. Indeed, the Kuwaiti legal system does not fully adhere to Shariah rules in all its legislation, especially in regulating criminal penalties, insurance and loans.\textsuperscript{645}

IFIs in Kuwait are governed by several pieces of legislation. The first of these is Law no 1 of 2016 on the Promulgation of the Companies Law (Kuwait Companies Law), which regulates the practice of companies in general, including IFIs. It has only one article (Article 15) that specifically relates to IFIs. This Article establishes a general rule for all IFIs, that each should have its own Shariah board consisting of no less than three members who are to be appointed by the shareholders. If a disagreement occurs between the SSB members then the matter may be referred to the national \textit{fatwa} board in the Ministry of \textit{Awqaf} (trusts) and Islamic Affairs. This referral is optional but if it happens then the decision of the national \textit{fatwa} board is


\textsuperscript{644} Article 2 of Kuwait Constitution, ‘The religion of the State is Islam, and the Islamic Shariah shall be a main source of legislation.’ It is worth mentioning that the Explanatory Memorandum of Kuwait Constitution has interpreted ‘Shariah’ as the rules of Islamic jurisprudence.

\textsuperscript{645} The Explanatory Memorandum of Kuwait Constitution, Article 2
binding and final.\textsuperscript{646} It is worth noting that, in order to ensure Shariah compliance in Islamic finance, Article 15 excludes IFIs from following the rules of mortgage and insurance contracts set by other laws (specifically the Civil Law and Commercial Law) – as they do not comply with the rules of Shariah – and allows them to form their own contracts in compliance with Shariah rules.

More specific and detailed rules regulating IFIs are found in Law no 32 of 1968 Concerning Currency, the Central Bank of Kuwait and the Organisation of Banking Business as amended in 2003 (Kuwait Central Bank Law), and Law No. 7 of 2010 regarding the Establishment of the Capital Markets Authority and Regulating Securities Activities as amended in 2015 (Capital Markets Authority Law). According to the Kuwait Central Bank Law, the Central Bank is the supervisory body responsible for regulating and supervising the practice of Islamic banks following a decentralised system. On the other hand, according to the Capital Markets Authority Law, the Capital Markets Authority is the supervisory body responsible for regulating and supervising the practice of licensed and listed Islamic companies, excluding banks, following a centralised system.\textsuperscript{647} Hence, Kuwait applies a dual supervisory system that distinguishes between Islamic banks and other IFIs. Nevertheless, considering that the centralised system has been examined in Malaysia, the centralised system of Kuwait will not be addressed here; instead this point will focus on the Kuwaiti decentralised system for Islamic banks as another system of SCG.

3.6.2.1 Law no 32 of 1968 Concerning Currency, the Central Bank of Kuwait and the Organisation of Banking Business as amended in 2003 (Kuwait Central Bank Law):

\textsuperscript{646} Law no 1 of 2016 on the Promulgation of the Companies Law, Articles 208-211
\textsuperscript{647} See Law no 32 of 1968 Concerning Currency, the Central Bank of Kuwait and the Organisation of Banking Business, Article 10. Article 2.2.1 of Module 5 of the Capital Markets Authority Executive Bylaws expressly excludes Islamic banks from supervision of the Capital Markets Authority with regard to their Shariah compliance. Moreover, Article 1.3 of Module 15 of the Capital Markets Authority Executive Bylaws related to Corporate Governance also expressly excludes banks, whether Islamic or conventional, from adhering to the corporate governance principles issued by the Capital Markets Authority. On the other hand, IFIs other than Islamic banks are excluded from the supervision of the Central Bank, unless the IFI is a subsidiary company of an Islamic bank, where it is then considered as an Islamic bank. Law no 32 of 1968 Concerning Currency, the Central Bank of Kuwait and the Organisation of Banking Business, Articles 55 and 87
The Central Bank of Kuwait (CBK) is the national body responsible for supervising conventional and Islamic banks in Kuwait. The CBK Law has a whole section for Islamic banks that was added in 2003. The Law includes rules regulating the practice of Islamic banks in general with a few rules related to their SCG. With regard to the national supervision of Shariah compliance in Islamic banks, there is no CSB at the Central Bank level to act as a higher supervisory board. However, Shariah supervision is not entirely absent. Article 39 of the CBK Law adopts the rule set by Article 15 of the Companies Law mentioned above. It states that if a disagreement occurs between the SSB members in an Islamic bank, the matter may be referred to the national fatwa board, which is part of the Ministry of Awqaf (trusts) and Islamic Affairs and whose decision is final and binding on the bank. This means that the Central Bank does not interfere with the work of the SSBs or their Shariah rulings in Islamic banks and that the referral is optional. However, if it happens, the decision of the national fatwa board must be respected. According to Hassan, ‘The referral is not compulsory. If such referral is made, they will embark into the advisory role as requested’. This illustrates the fact that Islamic banks in Kuwait operate under a decentralised supervisory system with regard to their Shariah compliance. It should be noted that the rules stated in the section regulating the practice of Islamic banks and their SCG are all mandatory. The section also includes a number of sanctions that can be imposed on Islamic banks in the case of non-compliance to its rules, which range from issuing a warning to withdrawing the licence of the bank violating the rules.

3.6.2.2 Rules and regulations of corporate governance in Kuwaiti banks:

In 2004, the Central Bank issued corporate governance instructions for banks inspired by the OECD principles. It replaced them with new instructions in 2012.

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649 Law no 32 of 1968 Concerning Currency, the Central Bank of Kuwait and the Organisation of Banking Business, Sections 86 to 100
650 Law no 32 of 1968 Concerning Currency, the Central Bank of Kuwait and the Organisation of Banking Business, Article 93
652 Law no 32 of 1968 Concerning Currency, the Central Bank of Kuwait and the Organisation of Banking Business, Article 85
These instructions contain nine principles of corporate governance, which relate to the BoD and its members, conflicts of interest, executive management, risk management, remuneration, transparency and disclosure, bank structure; shareholder rights, and stakeholder rights.653 The 2012 rules of corporate governance were recently amended by the CBK in September 2019. The most significant change is the legal requirement to appoint non-executive directors to the BoD and board committees, and to enhance the independence of the boards.654 However, these rules only provide general principles of corporate governance and are directed to all banks without any specificity to Islamic banks or their Shariah compliance.

3.6.2.3 Instructions Regarding Shariah Supervision Governance in Kuwait Islamic Banks 2016:

A major development in the area of SCG happened in late 2016. That year, CBK issued SCG rules for Islamic banks inspired by the guidelines of the IFSB and AAOIFI, named ‘Instructions Regarding Shariah Supervision Governance in Kuwait Islamic Banks 2016’. Like the rules stated in the Kuwait Central Bank Law, these Instructions are binding for all Islamic banks and the same aforementioned sanctions can be imposed on any Islamic bank in the case of non-compliance.

The Instructions determine the minimum requirements of SCG that should be followed by all Islamic banks in Kuwait. Mainly they emphasise: (a) the ultimate responsibility of the BoD to adhere to Shariah rules in all the bank’s activities and to implement a suitable SCG policy; (b) the necessity of appointing a SSB in the bank’s internal structure, whose decisions are binding on the bank; (c) the necessity of conducting a periodic internal Shariah audit and an annual external Shariah review, both according to the decisions of the SSB; (d) the necessity to have in place a suitable policy for managing Shariah non-compliance risk; and finally (e) the responsibility of the SSB to issue an annual Shariah report on the extent of the bank’s Shariah compliance, to be presented in the AGM.655

In terms of Shariah compliance supervision, the Central Bank, through these Instructions, enforces a new system that includes an internal and external Shariah audit to ensure Shariah compliance in Islamic banks. This system requires each

653 See Rules and Regulations of Corporate Governance in Kuwaiti Banks 2012
654 See Rules and Regulations of Corporate Governance in Kuwaiti Banks 2019
655 See Instructions on Shariah Supervisory Governance for Kuwaiti Islamic Banks 2016, Chapter 2 and Chapter 3, Principle 1
Islamic bank to appoint a SSB, a Shariah unit to satisfy the internal audit and an external Shariah firm to satisfy the external audit, each with specific governance rules and a mandate as explained below.

A. The SSB:

The Instructions established several rules to regulate the governance of the SSB in Islamic banks, relating to their competency, independence, confidentiality and productivity. In this regard, each Islamic bank is required to have at least three Shariah scholars in the SSB appointed by shareholders.\(^{656}\) They need to satisfy specific minimum competency requirements and academic qualifications.\(^{657}\) A single Shariah scholar is not allowed to serve more than three local Islamic banks.\(^{658}\) They also set specific duties for the SSB with regard to supervising Shariah compliance in Islamic banks.\(^{659}\)

To ensure the SSB members’ independence, the Instructions first define the purpose of independence as ‘to allow the SSB to issue Shariah rulings according to the rules of diligence without any external influences to promote the shareholders and other stakeholders trust in the correct application of Shariah rules’.\(^{660}\) The Instructions then set examples of some prohibited practices for the Shariah member, such as they should not be closely related to a member of the BoD or management and they should not be an employee of the bank they serve or a major shareholder.\(^{661}\) Nevertheless, the Instructions clearly state that these are only examples and Islamic banks can still consider a Shariah advisor to be independent in spite of falling in one of these.\(^{662}\)

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\(^{656}\) See Instructions on Shariah Supervisory Governance for Kuwaiti Islamic Banks 2016, Chapter 3, Principle 1, Section 3(First)(Third)

\(^{657}\) See Instructions on Shariah Supervisory Governance for Kuwaiti Islamic Banks 2016, Chapter 3, Principle 3

\(^{658}\) See Instructions on Shariah Supervisory Governance for Kuwaiti Islamic Banks 2016, Chapter 3, Principle 1, Section 3(Second)

\(^{659}\) The duties are: (a) to issue a Shariah opinion on every Shariah-related matter brought to their attention; (b) to review all the bank’s contracts, transactions, services and activities to ensure their Shariah compliance; (c) to detect and register any non-Shariah-compliant activity committed by the bank and provide an alternative Shariah-compliant remedy; (d) calculate zakat according to Shariah rules; and (e) to issue an annual Shariah report on the bank’s extent of Shariah compliance to be presented to shareholders in the AGM. See Instructions on Shariah Supervisory Governance for Kuwaiti Islamic Banks 2016, Chapter 3, Principle 1, Section 3(Fifth)

\(^{660}\) Instructions on Shariah Supervisory Governance for Kuwaiti Islamic Banks 2016, Chapter 3, Principle 2

\(^{661}\) Instructions on Shariah Supervisory Governance for Kuwaiti Islamic Banks 2016, Chapter 3, Principle 2

\(^{662}\) Instructions on Shariah Supervisory Governance for Kuwaiti Islamic Banks 2016, Chapter 3, Principle 2
However, in this case the Islamic bank should disclose and clarify this issue to the shareholders.\textsuperscript{663} The SSB member also has a responsibility to inform the Islamic bank of any case of unavoidable conflict of interests and then should refrain from taking any decision related to this conflict.\textsuperscript{664}

Moreover, to ensure that SSB members take the necessary effort and care in reaching their Shariah rulings, the Instructions have emphasised their personal responsibility towards the BoD and shareholders in this regard.\textsuperscript{665} Finally, to ensure the Islamic banks’ adherence to the Shariah rulings and decisions issued by their SSBs, the Instructions have granted them with mandatory force.\textsuperscript{666}

**B. The internal Shariah unit:**

Additionally to appointing a SSB, each Islamic bank is required to appoint an internal unit, independent from the executive management, that is responsible for doing an internal Shariah audit under the supervision of the SSB and the BoD.\textsuperscript{667} This unit should periodically report to the SSB on its audit.\textsuperscript{668} The Instructions also include rules to ensure the independence and objectivity of this unit from the executive management and to facilitate its work in terms of information access.\textsuperscript{669} The objectives of this unit are: (a) to ensure the bank’s full adherence to its SSB decisions; (b) to ensure the suitability of the internal supervisory system to achieve Shariah compliance as the bank’s higher objective; and (c) to detect any deviation that may impair the achievement of this objective.\textsuperscript{670}

**C. The external Shariah firm:**

\textsuperscript{663} Instructions on Shariah Supervisory Governance for Kuwaiti Islamic Banks 2016, Chapter 3, Principle 2
\textsuperscript{664} Instructions on Shariah Supervisory Governance for Kuwaiti Islamic Banks 2016, Chapter 3, Principle 2
\textsuperscript{665} Instructions on Shariah Supervisory Governance for Kuwaiti Islamic Banks 2016, Chapter 4, Principle 1, Section 3(1)
\textsuperscript{666} Instructions on Shariah Supervisory Governance for Kuwaiti Islamic Banks 2016, Chapter 4, Principle 1, Section 3(Sixth)(7)
\textsuperscript{667} See Instructions on Shariah Supervisory Governance for Kuwaiti Islamic Banks 2016, Chapter 4, Section 1(First) and (Second)
\textsuperscript{668} See Instructions on Shariah Supervisory Governance for Kuwaiti Islamic Banks 2016, Chapter 4, Section 1(Third)
\textsuperscript{669} See Instructions on Shariah Supervisory Governance for Kuwaiti Islamic Banks 2016, Chapter 4, Section 1(Third)
\textsuperscript{670} See Instructions on Shariah Supervisory Governance for Kuwaiti Islamic Banks 2016, Chapter 4, Section 1(Fifth)
The supervisory system of SCG in Kuwait is not content with the internal Shariah audit; it also includes an external Shariah audit. This is intended to provide an independent and external check of the Islamic banks’ Shariah compliance, since the system does not include a CSB. To satisfy the external Shariah audit, each Islamic bank is required to appoint an external independent Shariah auditing firm to examine the compliance of the bank’s activities to the decisions and rulings of its SSB, and to issue a report on its findings to be presented to the shareholders in the AGM. The Instructions state that the external firm is to be appointed by the shareholders in the AGM upon the recommendation of the BoD. In addition, they set a number of conditions and restrictions for the external Shariah firm to ensure its credibility and independence. This includes the requirement that the external Shariah firm should not provide Shariah opinions to the Islamic bank that appoints it as its external Shariah auditor. Moreover, the firm should be approved by the Ministry of Trade and Industry. It should not work for the Islamic bank under audit nor receive any monetary or non-monetary benefits from the bank, apart from the remuneration set at the AGM.

3.6.2.4 The effectiveness of the Kuwaiti system in achieving the objective of Shariah compliance in IFIs and scope for shareholder engagement:

The main conclusions to be drawn from the above illustration of the Kuwaiti supervisory and regulatory system of SCG is that SCG is regulated in Kuwait and the national supervision of the Islamic banks’ Shariah compliance is performed under a decentralised system. Therefore, the general advantages and disadvantages of the decentralised system identified earlier apply to the Kuwaiti system. In particular, the system allows Shariah scholars sitting on SSBs to issue their own Shariah opinions and implement them in the IFIs, which opens the way for *ijtihad*. This

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671 See Instructions on Shariah Supervisory Governance for Kuwaiti Islamic Banks 2016, Chapter 4, Section 2(First)
672 See Instructions on Shariah Supervisory Governance for Kuwaiti Islamic Banks 2016, Chapter 4, Section 2(First)
673 See Instructions on Shariah Supervisory Governance for Kuwaiti Islamic Banks 2016, Chapter 4, Section 2(Second) and (Third)
674 See Instructions on Shariah Supervisory Governance for Kuwaiti Islamic Banks 2016, Chapter 4, Section 2(Second)
675 See Instructions on Shariah Supervisory Governance for Kuwaiti Islamic Banks 2016, Chapter 4, Section 2(Twelfth)
676 See Instructions on Shariah Supervisory Governance for Kuwaiti Islamic Banks 2016, Chapter 4, Section 2(Twelfth)
677 See above at 3.5.4 Which system best serves Shariah governance and compliance in IFIs?
system also allows Islamic banks to keep pace with the fast development in the field of Islamic finance by not requiring the SSBs to refer to another body for Shariah rulings, in contrast to the centralised system. However, on the other hand, this flexibility might cause inconsistency in Shariah opinions between different Islamic banks in Kuwait. Nevertheless, this is unlikely to happen in a single jurisdiction, as explained in the previous chapter.678

The main positive aspect of the national Shariah supervisory system in Kuwait is the binding nature of the rules regulating SCG in Islamic banks, thus providing strong national supervision of SCG. This national supervision, however, does not extend to include the quality and appropriateness of Shariah rulings in Islamic banks: these have been left to the SSB in each Islamic bank. This illustrates the main difference between the centralised system in Malaysia and the decentralised system in Kuwait. However, it must be said that in terms of helping Islamic banks to reach an efficient level of Shariah compliance, the decentralised system might not be less effective than the centralised system if proper supervision of the quality of Shariah scholars appointed in the individual SSBs is exercised. Quality can be ensured through setting requirements for the SSB members’ qualifications, competency, independence and objectivity, as well as ensuring the binding force of their Shariah opinions, which is ensured – to some extent – by the Kuwaiti system as seen above. Having said that, there are still some problems related to the system implemented in Kuwait that might affect its effectiveness, as explained below.

First, it is worth mentioning that the national fatwa board of the Ministry of Trust and Islamic Affairs, to which members of a SSB resort in the case of disagreement, is a public authority that was established to serve any person who is in need of a general Shariah ruling in the country, whether an individual or a company, in all matters.679 They are not necessarily experts in Fiqh Al-Muamalat and Islamic finance, which raises the question of their ability and effectiveness to provide a specialised Shariah opinion for Islamic banks when they refer to them for an opinion.

Second, it is a good development that the CBK has issued SCG instructions for Islamic banks in 2016, after years of having a legal lacuna in this area. However, the system still has major weaknesses:

678 See 2.3.3 Divergence of Shariah rulings in Chapter Two.
679 For more about the national fatwa board of the Ministry of Trust and Islamic Affairs please visit <http://site.islam.gov.kw/eftaa/Pages/aboutmanagement.aspx> accessed 30 December 2019
(a) By contrast with Malaysia, the concept of ‘Shariah compliance’ is not defined properly and clearly in the Instructions, which might cause confusion in determining the rules that should be followed by Islamic banks, and their level of compliance by their SSBs. The Instructions define Islamic Shariah rules as, ‘A set of rules and provisions that are enforced by Islam in order to achieve its reform objectives in society’. This definition is very vague and does not provide any specific meaning for the rules that should be adhered to by Islamic banks. This is mainly a result of the lack of clear Shariah standards for Islamic finance in the Kuwaiti legal system, which might cause a problem for SSB members, courts and anyone who deals with Islamic banks.

(b) The independence of SSB members is not adequately ensured. First, the Instructions determines cases that might raise conflicts of interest with regard to SSB members and then they give the Islamic bank the right to ignore such conflicts of interest. Second, the SSB members are appointed and remunerated by the BoD. However, the requirement for shareholders’ approval reduces the severity of this issue, depending on the shareholders’ level of engagement.

(c) The system can also be criticised for not properly managing the issue of Shariah scholars’ multiple memberships in SSBs. In this regard, (1) the system allows a Shariah scholar to serve three banks simultaneously, which raises confidentiality and independence issues, and (2) it only imposes restrictions on banks and not the other IFIs, which means that a single Shariah scholar can serve three banks and sit on an an unlimited number of SSBs in other IFIs in Kuwait.

(d) The way external Shariah firms have been included in the supervisory system of Islamic banks will not help in ensuring Shariah compliance in Islamic banks but might cause more problems. The major problem with the duty of external Shariah firms is that they do not supervise the SSBs and the correct application of Shariah rules but merely monitor the Islamic banks’ adherence to their SSB rulings, which means that their supervisory job only replicates the job of the SSB. This double system does not really assist Islamic Banks to reach a better level of Shariah compliance: rather, it complicates the process and creates further problems for the following reasons.681

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680 See Instructions on Shariah Supervisory Governance for Kuwaiti Islamic Banks 2016, Chapter One
681 See Dana Alduaij, ‘Governance of Shariah Supervision .. Yes .. and No’ (Al-Qabas Newspaper, 2017)
- The main purpose of Shariah supervision is to monitor the correct application of Shariah rules and the authenticity of fatwas. Applying inaccurate fatwas will result in conducting a non-Shariah-compliant business.

- This system increases the Islamic bank’s supervisory costs without good cause through requiring the bank to pay Shariah auditing fees to two supervisory bodies for similar functions.

- It exacerbates the problem of the shortage of specialist Shariah scholars in Islamic finance, as it requires that the Shariah scholars sitting on the SSB are different to those who do the external auditing. This could encourage circumvention of the law by establishing Shariah firms with different names but using the same Shariah scholars.

- It is considered good practice to require prior approval from the authority before appointing the external Shariah firm. However, the approval is required from the Ministry of Trade and Industry and not the Ministry of Awqaf and Islamic Affairs or the Central Bank. This means in effect that the authority only checks the firm’s licence to practice its business and not the expertise of its Shariah members, which does not really help in trusting these firms and their judgement.

Overall, given the regulatory and supervisory requirements for SCG in Kuwait, it can be said that the decentralised system, like the centralised system, is effective in helping Islamic banks to achieve Shariah compliance if a proper attention is paid in choosing the SSB members as well as supervising their work inside the Islamic bank. However, this supervision should not solely be required from the BoD; shareholders should also actively engage. This is particularly true given that the law has invested them with some rights that increase their duties towards their investee Islamic banks, such as approving appointments to the SSB and the remuneration of members, as well as the confirmation of appointment in cases of conflicts of interest. Therefore, shareholders in Kuwait have a wider scope for their activism in comparison to the shareholders in Malaysia under the centralised system.

%D8%AD%D9%88%D9%83%D9%85%D8%A9-%D8%A7%D9%84%D8%B1%D9%82%D8%A7%D8%A8%D8%A9-%D8%A7%D9%84%D8%B4%D8%B1%D8%B9%D9%8A%D8%A9-%D9%86%D8%B9%D9%85-%D9%88%D9%84%D8%A9-%D8%A7>D accessed 30 December 2019
682 Shareholders’ rights in Kuwait will be explained in detail in the following chapter.
3.6.3 The UK:

The UK applies a single regulatory and supervisory regime, which subjects all financial institutions (Islamic included) to the same laws and standards regardless of their country of origin, specialised sector or religious principles. HM Treasury is the governmental authority governing the financial and economic policy of the UK, and the Bank of England (BoE) is the Central Bank of the country.

3.6.3.1 The main aspects of the UK regulatory and supervisory framework for financial institutions:

The primary piece of legislation governing the UK financial system is the Financial Services and Markets Act 2000 (FSMA). According to Section II of the FSMA (as amended by the Financial Services Act 2012), the UK financial system includes financial markets and exchanges. Regulated activities include accepting deposits, insurance and other investment activities. After the financial crisis in 2008, the UK financial regulatory system went through a number of reforms. The core of these reforms was the replacement of the principal financial regulator (the Financial Services Authority (FSA)) with a system consisting of two bodies: the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA), the latter being part of the BoE. Both bodies share the responsibility of regulating and supervising the financial system in the UK. Lovegrove and Prettejohn have clarified the difference between the two authorities: the PRA is the prudential regulator of UK deposit-taking institutions, insurance companies and certain large investment firms, while the FCA is the prudential regulator for UK retail and...


685 The list of regulated activities is established by the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001) This list is updated by the FCA periodically to add new activities. The list of regulated activities as of 2019 can be found on the FCA website. See Financial Conduct Authority, ‘List of Financial Activities we Regulate’ (Financial Conduct Authority, 2019) <https://www.fca.org.uk/firms/authorisation/how-to-apply/activities> accessed 30 December 2019.

whole financial markets.\textsuperscript{687} It was the Financial Services Act 2012 that introduced these reforms to the regulatory structure of the financial system, and that determines the powers, duties, objectives and supervisory role of the FCA and PRA.

Other laws related to the UK financial system are the Bank of England Act 1998 and the Banking Act 2009. The Bank of England Act 1998 establishes the constitution, regulation, financial arrangements and monetary policy of the BoE.\textsuperscript{688} The Banking Act 2009 was intended to improve the stability of the UK financial system by strengthening depositor protection.\textsuperscript{689} Among other things, it introduced a special resolution regime to deal with banks in financial difficulties and gave power to the BoE, Treasury and FSA – before it was eliminated in 2012 – in the operation of this regime.\textsuperscript{690} In 2016, the Bank of England and Financial Services Act reformed the governance of the BoE and the financial services sector in general. Most significantly, the Act has established a Prudential Regulation Committee (PRC) in the BoE to replace the PRA, which ends the PRA’s status as the BoE’s subsidiary.\textsuperscript{691}

\textbf{3.6.3.2 The UK Corporate Governance Code:}

The first principles of corporate governance were issued in the 1990s as the UK Combined Code, which encompassed the recommendations of the four committees on corporate governance: Cadbury, Greenbury, Hampel and Turnbull.\textsuperscript{692} The Combined Code was updated several times in the 2000s until it was entirely

\textsuperscript{687} Simon Lovegrove and Jack Prettejohn, ‘United Kingdom’ in Peter Hsu and Rashid Bahar (eds), \textit{Banking Regulation} (5th edn, Global Legal Group 2018) 314

\textsuperscript{688} See the Bank of England Act 1998, Part I and Part II


\textsuperscript{690} See Banking Act 2009, Part I (UK)


replaced by the UK Corporate Governance Code (UKCGC) in 2010, which was issued by the Financial Reporting Council (FRC). The UKCGC is regularly updated to follow the development in areas of corporate governance. The most recent version of the UKCGC was published in 2018. A number of guidance notes have been issued by the FRC to support the application of the UKCGC’s principles.

The UKCGC consists of principles in five main areas: (1) the board leadership and company purpose; (2) division of responsibilities; (3) composition, succession and evaluation; (4) audit, risk and internal control; and finally (5) remuneration. In terms of the UKCGC’s binding force, it is a form of soft law and implements a ‘comply-or-explain’ approach. Under this approach, companies, in essence, are required to apply the main principles and report to shareholders on this application, however, they can choose not to comply with the rules on the condition that an explanation is given to shareholders as to the reasons for this departure.

This is to open the way for companies to use other means to achieve good corporate governance. In 2009, doubts were raised by the European Commission as to the effectiveness of this approach and the monitoring of the explanations given by companies. The European Commission’s Green Paper highlighted the fact that the weakness of the method lies in the quality of the explanations published by companies departing from the recommendations of the UKCGC. This is based on a study conducted in 2009 on the monitoring and enforcement systems used in relation to

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696 The ‘comply or explain’ approach has been applied by the UK Corporate Governance Code from the beginning. The 2018 version explicitly states, ‘the Code does not set out a rigid set of rules; instead it offers flexibility through the application of Principles and through ‘comply or explain’ Provisions and supporting guidance’. The UK Corporate Governance Code 2018, 1

697 Demetra Arsalidou, Rethinking corporate governance in financial institutions (2016 Routledge) 173

698 Christine Mallin, Corporate Governance (5th edn, Oxford University Press 2016)

Member States’ corporate governance codes.\textsuperscript{700} The study found that the quality of the explanations given is rather low: ‘only 39% of all explanations on the reference corporate governance code are classified as sufficiently informative’.\textsuperscript{701} These doubts were refuted in 2012 by the FRC, confirming that this approach was supported by both companies and shareholders, and if used properly, it can deliver a better level of transparency and confidence than formal regulation.\textsuperscript{702} The FRC highlighted three key elements that should be taken into consideration by companies to ensure better explanation. They should: (a) set the context and historical background as well as giving a convincing rationale for their decision; (b) describe mitigating action to address any additional risk that might be posed because of the deviation from the Code; and (c) include information as to whether the deviation is limited in time and, if so, when they intend to return.\textsuperscript{703}

As mentioned in Chapter One, the UK follows a shareholder model in relation to corporate governance which prioritises the interests of shareholders.\textsuperscript{704} However, it should be made clear that, although the UK corporate governance system adopts the basics of the shareholder model in principle, it implements an ‘enlightened shareholder value’ approach as dictated by the UK Companies Act 2006, which requires boards to pursue a sustainable business.\textsuperscript{705} Also, s.172(1) of the UK


\textsuperscript{702} According to the FRC Report, low quality explanations are only indicated in a minority of cases. This is based on a survey conducted by Grant Thornton which found that 50% of FTSE 350 companies are fully compliant with the UK Corporate Governance Code, two-thirds of companies (around 116 companies) that chose not to comply with the Code provide detailed explanations, and one-third (around 58 companies) explain with less detail. No single company failed to provide any explanation for its departure from the Code. See Financial Reporting Council, ‘What Constitutes an Explanation Under ‘Comply or Explain’?: Report of Discussions Between Companies and Investors’ (Financial Reporting Council February 2012) 1 <https://www.frc.org.uk/getattachment/a39aa822-ae3c-4ddf-b869-db8f2f1e1b61/what-constitutes-an-explanation-under-comply-or-explain.pdf> accessed 22 December 2019


\textsuperscript{704} See A. The shareholder theory: the product of the agency problem of 1.8.1.2 in Chapter One.

Companies Act 2006 illustrates that a director has a duty to promote the success of a company and, in doing so, should have regard to the interests of other stakeholders, including: employees, suppliers, customers and the community. Therefore, it might be argued that the UK implements a hybrid shareholder corporate governance model that also caters for stakeholders.\(^7\) Moreover, the most recent reform of the UKCGC in 2018 clearly emphasises the need to give regard to the views of shareholders and wider stakeholders.\(^8\)

### 3.6.3.3 The effectiveness of the UK system in achieving the objective of Shariah compliance in IFIs and scope for shareholder engagement:

It is clear from the previous illustration of the UK financial system and corporate governance that SCG is not regulated or supervised in the UK. Therefore, IFIs in the UK lack a very important layer of Shariah governance, i.e. the national supervision of their Shariah compliance and the rules that ensure this compliance. In the UK, there is no CSB or any national rules that regulate IFIs’ SCG. The FCA and the PRA do not impose any regulatory requirements with regard IFIs’ Shariah governance – not even the necessity to appoint a SSB in the IFI’s internal structure. Therefore, SCG in the UK is entirely absent and this absence in regulation causes some problems to both the IFIs and the regulator in the UK.

In 2007, the FSA (which was the UK financial regulator at that time) highlighted a number of concerns regarding Islamic finance in the UK that might hinder the development of this sector in the future. Some of these concerns include: (a) the lack of Shariah standards, which could result in a product being considered as Shariah compliant by one IFI and not compliant by another; (b) the multiple memberships of Shariah scholars and the conflicts of interest arising from this issue; (c) the difficulty in accepting Shariah rules as the applicable law in English courts; (d) uncertainty in defining the position of SSB members and whether they have an


\(^8\) See the UK Corporate Governance Code 2018, 1
executive or a merely advisory role, and thus, whether they should be included under the category of the FSA Approved Persons rules; and finally, (e) uncertainty in defining the Islamic finance products as bank regulated activities due to the fact that their underlying structure is different from their conventional counterpart, and thus, there might be a difficulty in accepting them under the Regulated Activities Order. These concerns were raised more than ten years ago when Islamic finance was still in its infancy in the UK, but none of them has been radically solved – mainly due to the lack of regulation of SCG and lack of nationally accepted Islamic finance rules derived from Shariah.

In the absence of legislative regulation of Islamic finance and SCG, the question arises as to how IFIs in the UK ensure their Shariah compliance. In fact, they self-regulate their SCG and they depend solely on the work of their SSBs to ensure their Shariah compliance. To better understand the practical application of SCG in IFIs in the UK, the governance policy of some fully-fledged Islamic banks in the UK and the way they ensure their Shariah compliance is inspected below.

A. Al-Rayan Bank:

Al-Rayan Bank, established in 2004, is the first wholly Shariah-compliant retail bank in the UK. With regard to its corporate governance, the bank is committed to implementing a good policy that helps it to achieve its objectives and provide the necessary oversight of its performance. This policy requires the appointment of three committees that deal with the financial aspects of the bank: the remuneration and nomination committee; the audit committee; and the risk, compliance and credit committee. Moreover, the policy includes the appointment of a separate independent SSB that is comprised of Shariah scholars and experts in the interpretation of Shariah rules and their application within modern Islamic finance, and the appointment of a Shariah compliance officer trained to the standards of the AAOIFI. Both appointments are intended to ensure that all the bank’s activities,

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products and services are Shariah compliant. The bank follows the recommendations of the international organisations AAOIFI and IFSB in the number of Shariah scholars appointed to the SSB by appointing no less than three scholars. The SSB is responsible for providing guidance and Shariah rulings for the bank on Shariah-related matters, ensuring that all its financial and operational activities are Shariah compliant, and for issuing an annual Shariah compliance report on the extent of the bank’s Shariah compliance. The management, on the other hand, is responsible for implementing the decisions of the SSB.

The bank’s obligation to comply with Shariah rules is stated in its AoA. The AoA restrict this obligation, however: compliance with Shariah is required on condition that it does not conflict with the applicable laws of the land. This is in contrast to Kuwait and Malaysia, where the practice of IFIs and their SCG is regulated and IFIs are subject to the other related secular laws as long as they do not contradict the rules of Shariah. Moreover, it is noticed that the AoA have failed to define ‘Shariah’ in the ‘defined terms’ section, which might cause confusion about the rules followed by the bank and its standards for Shariah compliance.

In the UK, the absence of regulation and the financial regulatory system’s inability to take adequate account of the specificity of Islamic finance expose IFIs to problems related to their Shariah compliance. A clear example is provided by the Al-Rayan Bank’s AoA, illustrating the negative impact of subjecting IFIs to the conventional rules without considering their specificity. According to the AoA,

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714 According to Al-Rayan Bank’s AoA, ‘The company is a Sharia’a compliant bank which operates according to the Sharia’a guidelines. The Sharia’a will govern these articles as long as they do not conflict with the applicable laws of the land’. Al-Rayan Bank, ‘Articles of Association of Islamic Bank of Britain PLC’ (2011), Preliminary <https://www.alrayanbank.co.uk/media/85386/articles-of-association-10-2011.pdf> accessed 30 December 2019
Although utilizing the company funds to make good any principal loss of any profit sharing account holder will not be in accordance with Islamic principles governing these accounts, the SSB has allowed this condition to comply with current banking regulations until such time that these regulations are amended, or the company given an exemption by the Financial Services Authority.\footnote{Al-Rayan Bank, ‘Articles of Association of Islamic Bank of Britain PLC’ (2011), Article 86(2) <https://www.alrayanbank.co.uk/media/85386/articles-of-association-10-2011.pdf> accessed 30 December 2019}

However, the positive factor that helps Islamic finance to be established, remain and prosper in all environments is the flexibility of Shariah, which makes it applicable for all times, places and circumstances. As explained in Chapter Two, Shariah takes into account the element of necessity, that permits the commission of a prohibited act whenever the conditions of necessity exist.\footnote{See (d) The rule of necessity in Shariah in 2.3.3.3 Reasons of divergence in Shariah rulings in Chapter Two.} As seen in the case of the Al-Rayan Bank, Shariah scholars sitting on the bank’s SSB decided that the conditions of the necessity rule exist (because of the legal obligation to comply with the land’s laws), and therefore, they issued their Shariah ruling on the permissibility of a Shariah non-compliant issue accordingly.\footnote{According to Ibn Al-Qayyim, Shariah ruling is subjected to change due to change in time, place, public interest, necessity, mistakes and other reasons. For more see Ibn Al-Qayyim Al-Jouziyyah, ‘I’laam Al-muwaqqi’een an Rab Al-alameen’ vol 4 (Dar Ibn Al-Jouzy Publishing 2002) 337} This is also a good example of the obligation of IFIs to purify their fund in expiation for any unavoidable Shariah non-compliant activity discussed in Chapter Two.\footnote{See 2.3.6.2 The IFI’s obligation to purify its Shariah non-compliant income in Chapter Two.} Al-Rayan Bank confirms that they purify their fund by giving any money in the profit stabilisation reserve to charity.\footnote{Al-Rayan Bank, ‘Articles of Association of Islamic Bank of Britain PLC’ (2011), Article 104(b) <https://www.alrayanbank.co.uk/media/85386/articles-of-association-10-2011.pdf> accessed 30 December 2019}

B. Other banks:

The BLME and Gatehouse Bank are other Shariah-compliant banks in the UK. They are very similar in their internal structure and governance rules, possibly because they are both owned by Kuwaiti investors. Each bank has an independent SSB of three scholars in its internal structure, which has the responsibility to carry out the general duties of a SSB.\footnote{BLME: Article 115 of BLME AoA allows the appointment of three to five scholars, however, currently it only has three scholars. BLME, ‘Articles of Association of Bank of London and The Middle East’ (2016), Article 115 <https://beta.companieshouse.gov.uk/company/05897786/filing-history?page=2>, and See the BLME, ‘Sharia’a Supervisory Board’ <https://www.blme.com/about-us/investors/corporate-governance/sharia-a-supervisory-board/> both accessed 30 December 2019. Gatehouse: see Gatehousebank, ‘Our Shariah Supervisory Board’ <https://gatehousebank.com/about-us/shariah-supervisory-board/> accessed 30 December 2019} In contrast to Al-Rayan Bank, the BLME and
Gatehouse Bank provide a definition of the term ‘Shariah’ in their AoA as, ‘The rules, principles, parameters of Islamic law as interpreted by the SSB’.\(^{721}\) This definition, however, is still not clear in determining the rules followed by the bank. It also confers on SSB scholars in these banks a vast discretion in determining these rules and the level of their Shariah compliance, which can be confusing to anyone who deals with them. Moreover, it is noticeable that the SSB in the BLME and the Gatehouse Bank have significant power and discretion in performing its duties. According to their AoA, there is no obligation on the SSB to meet. Also, they can regulate the conduct of their duties as they see fit.\(^{722}\)

It is interesting to see that the BLME states in its AoA that the Bank shall not at any time or in any circumstances act in conflict with Shariah, as determined by its SSB: it does not make this obligation subject to the condition that it does not involve any violation to the applicable laws of the land, like Al-Rayan Bank.\(^{723}\) However, this will not make any difference in practice as Shariah compliance in the BLME is determined by its SSB, which would most likely resort to the rule of necessity where a Shariah rule cannot be applied due to a legal restriction.

From this, it can be said that IFIs in the UK apply a SCG policy, but this application is self-regulated without any legal obligation or national supervision. A self-regulatory approach for IFIs in the UK is supported by Aldohni.\(^{724}\) He stresses that self-regulation is common in the financial industry for several reasons including its ability to address the cultural differences. However, in this context, he calls for the establishment of a code of practice or guidance for IFIs in the UK with the help of a self-regulatory agency – namely the British Bankers Association (BBA) – in order to harmonise the practices of the Islamic finance industry in the UK and pave the way


\(^{724}\) See Abdul Karim Aldohni, ‘Soft Law, Self-Regulation and Cultural Sensitivity: The Case of Regulating Islamic Banking in the UK’ (2014) 15 Journal of Banking Regulation 164
for its enforcement by the regulator. The BBA has expressed their willingness to help,725 but no such code has been issued yet.

Currently, the obligation of IFIs in the UK to follow Shariah rules in their business, and their objective of being fully Shariah compliant, arise from including this obligation in their AoA. Under the UK Companies Act, the AoA are legally binding on the IFI and its members.726 The obligation to follow Shariah rules is included in the IFIs’ AoA from the standpoint of freedom of contract, given the fact that the AoA document is a contract between a company and its shareholders. However, that freedom of contract is not absolute; the agreement should not infringe any mandatory rules. Therefore, the IFIs’ compliance with Shariah rules is accepted as long as it does not conflict with the laws in the UK. As seen from the case of Al-Rayan Bank, this can cause problems for the IFIs operating in the UK that affect their Shariah compliance, but this issue can be compensated to some extent.

Due to the lack of guidance and standards of SCG in the UK, IFIs usually resort to the international standards issued by international organisations, such as the AAOIFI and the IFSB. However, the implementation of these standards and the quality of Shariah rulings is still not supervised nationally. The UK legal system does not place any obligation on the IFIs to appoint a SSB, or to set minimum qualification requirements for Shariah scholars sitting on that board, or to set a strategy for resolving any case of disagreement among them, or any other matter related to the governance of the SSB as this body is alien to the laws in the UK. This, in extension, affects the rights of shareholders toward this body, as will be seen in the next chapter. Neither the FCA nor the PRA is in a position to supervise or assess the quality of the SCG policy implemented by the IFIs and, therefore, the role that should be played by the national supervisor in SCG is entirely absent in the UK. As already established, national supervision is a key element in corporate governance and its absence reduces its effectiveness as well as the protection of shareholders’ interests. Accordingly, shareholders in IFIs in the UK should help to compensate for this supervisory shortfall and play an active role in protecting their interest in a full Shariah compliance in their investee IFIs. The scope for their activism is considerable in comparison to the scope for activism of shareholders in Kuwait and Malaysia.

726 See Companies Act 2006, Section 33(a) (UK)
3.7 Conclusion:

This chapter examined the national supervision in SCG as the role played by the national supervisor to ensure Shariah compliance in IFIs. This supervision, although usually performed by the same supervisory body and having the macro and micro supervisory dimensions, is different from prudential supervision. The main difference lies in the focus of supervision; while prudential supervision focuses on the financial aspects of financial institutions, Shariah supervision focuses on the IFIs’ adherence to Shariah rules and the rules of SCG. The international organisations have realised the importance of this supervision in Islamic finance and issued standards for supervisors in this regard. The IFSB issued core principles for Islamic finance regulation and the AAOIFI issued a standard for the governance of the CSB. They complement each other and, despite their shortcomings, provide good guidance for supervisors in all jurisdictions hosting IFIs.

Shariah national supervision usually operates at one of three levels, based on the scope of regulating SCG and intensity of the national supervision on Shariah compliance in IFIs in the country: strict, lenient and absent. These then form the main three models of SCG: centralised, decentralised and self-regulated. To achieve a better understanding of the different supervisory systems of SCG, a deeper investigation was applied to them in practice. The supervisory and regulatory systems of three leading countries in Islamic finance were investigated: Malaysia, applying a centralised system; Kuwait, applying a decentralised system; and the UK, where the system is self-regulated.

This investigation provided a better understanding of the different systems and their points of strength and weakness in ensuring Shariah compliance in IFIs operating within their jurisdictions and, therefore, gave a clear idea of the need for shareholders to engage actively in ensuring Shariah compliance in their investee IFIs and the necessary level of their engagement. In Malaysia, SCG is highly regulated and Shariah compliance in IFIs is strictly supervised by the national regulator, which helps IFIs to achieve a high level of Shariah compliance, as defined by the country. Therefore, the conclusion must be reached that the shareholders’ interest in Shariah compliance in Malaysia is highly protected and the scope for their engagement is narrow. This outcome, however, does not suggest that shareholders in Malaysia should rely entirely on the system to protect their interest in a Shariah-compliant business. It only implies that the scope for their activism is not wide.
SCG in Kuwait is also regulated but the national supervision of Shariah compliance in IFIs is less intense than the Malaysian supervision. Also, the regulatory system of SCG suffers from some defects, which might undermine its effectiveness in helping IFIs to achieve a proper Shariah compliance. Therefore, the conclusion can be reached that the shareholders’ interest in Shariah compliance in Kuwait is also protected but not to its highest level and therefore the scope for their engagement is wider than for those in Malaysia.

On the other hand, SCG in the UK is not regulated and national supervision over Shariah compliance in IFIs is absent. Therefore, IFIs in the UK self-apply SCG and self-supervise their Shariah compliance. Moreover, IFIs are subject to the same supervisory and regulatory rules as the conventional institutions with very few exceptions. This single system for all could negatively affect Shariah compliance in IFIs. Thus, the conclusion can be reached that the interest of shareholders in Shariah compliance in the UK is not properly protected and the scope for their active engagement is the widest among the three countries.

After discussing SCG and highlighting its problems in Chapter Two and the different national regulatory and supervisory systems in this chapter, it is clear now that Shariah compliance in IFIs is not adequately protected in all jurisdictions where IFIs exist and additional efforts need to be applied. Hence, this thesis suggests that shareholders, as the third pillar of any corporate governance model alongside the company and the jurisdiction, need to play an active role in SCG to protect their interest in Shariah compliance. Therefore, the following chapter explores shareholders of IFIs, their interest in Shariah compliance and their rights and powers in SCG as a prelude to investigating the role they can play in improving SCG in their investee IFIs, which will be discussed after in Chapter Five.
Chapter Four: Shareholders of IFIs and their Rights and Powers in Shariah Corporate Governance

4.1 Introduction:

It was seen in Chapter Two that for an IFI to ensure its Shariah compliance, it implements a SCG policy, especially through the appointment of a SSB. However, the implemented policy has some problems that weaken its effectiveness. Chapter Three then demonstrated that SCG regulation and supervision among jurisdictions comes in three different levels: strong, lenient and absent. Therefore, not every country provides adequate protection for Shariah compliance in IFIs. This calls for another supporting solution alongside the measures taken by the IFI and the national jurisdiction to strengthen SCG in Islamic finance. In this regard, this thesis argues that shareholders – as the third main pillar of corporate governance alongside the company and the national supervisor – need to play an active role and engage with their investee IFIs to enhance the practices of SCG and reduce its shortcomings. Therefore, this chapter addresses shareholders of IFIs: the reasons behind choosing them to strengthen SCG and their rights in SCG. This chapter attempts to answer the research question: ‘how far does engagement of shareholders form a potential solution to reduce the current problems of SCG?’

Against this backdrop, the chapter is divided into two main sections: theoretical and practical. The theoretical section explores (a) the ownership structure of IFIs, illustrating the power of shareholders to effect change in SCG; (b) the interest of shareholders in Shariah compliance; and (c) the rights of shareholders in SCG. The practical section of this chapter investigates shareholders of IFIs and their rights in Malaysia, Kuwait and the UK, as the three jurisdictions covered by the study. This investigation helps to explain the ownership structure of IFIs in these countries and whether or not the necessary rights of shareholders in SCG are recognised there in reality.

4.2 The ownership structure of IFIs and its effect on shareholders’ power:

4.2.1 Overview of shareholders’ ownership and power:

It is acknowledged, based on the doctrine of private property, that equity holdings confer ownership rights in the firm, and thus, shareholders are collectively
seen as the companies’ owners. However, as Ireland articulates, with the rise of a company as a separate legal person, and with it being possible to hold shares free of any further obligation to the company, it is no longer argued that the shareholders are the genuine owners of the corporate assets. As a result, shareholders find themselves being described as ‘absentee owners’, where their position as owners is questioned, as well as their claim to corporate returns. Many shareholders treat their shareholding as a mere investment, focusing on the return they get for their shares and relying on the managers to run the company. Shleifer and Vinish explain that investors, unlike the highly-trained employees and managers, usually have little ability to help the company. Once they have contributed the capital, their investment is sunk, and nobody needs them anymore, especially not the managers.

Shareholders have legal interests in the enterprise while managers have legal powers over it. As a result, the shareholders have become the mere suppliers of the capital without making any further substantial contribution to the enterprise afterward. Nevertheless, this does not deny shareholders their ownership and its associated rights. Even if an owner remains completely absent in respect of their enterprise, they would still be an owner. Cziraki, Renneboog and Szilagyi assert that, ‘Shareholders are the ultimate owners of public companies and should, therefore, have the final say in decisions such as corporate restructuring, changes in top management, payout policy, or governance structures’. Shareholders are seen as a company’s legitimate owners on the ground that they hold shares. This share ownership confers on them powers of control over the company and the option to exit the corporation through their own will. The vital issue, however, is not whether shareholders own the company – it is whether they can influence the company's direction and corporate governance.

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732 Peter Cziraki, Luc Renneboog and Peter Szilagyi, ‘Shareholder Activism through Proxy Proposals: The European Perspective’ (2010) 16 European Financial Management 738
733 Virgile Chassagnon and Xavier Hollandts, ‘Who are the Owners of the Firm: Shareholders, Employees or No One?’ (2014) 10 Journal of Institutional Economics 47, 48–51
As seen in Chapter One in the context of addressing the shareholder model of corporate governance, dispersed ownership or low concentration in ownership leads to shareholders losing the power to control managers in public companies (the agency problem), which reduces the protection of shareholders’ interests.\(^{734}\) This highlights the fact that the number of shares held by shareholders determines the extent of their power to influence corporate decisions.\(^{735}\) Therefore, in the opposite situation, shareholders with concentrated ownership will be more effective in monitoring a company’s performance and be able to influence its corporate governance.\(^{736}\) According to Gillan and Starks, large shareholders, through the strength of their equity holding, have the power and ability to participate in decision-making and influence the company’s strategic direction.\(^{737}\)

When shareholdings become large, there becomes an incentive to evaluate the governance system in the company professionally and practise their monitoring role over the management well, as it is most likely that the returns they get from monitoring will cover the costs.\(^{738}\) They also have substantial access to firm information that gives them the incentive to engage and cast an informed vote.\(^{739}\) Hence, with a large shareholding, shareholders have the strength and ability to act and the motivation to do so.\(^{740}\) Holderness and Sheehan’s study confirms the impact of major shareholders on managerial and board turnover, with many examples from public companies that prove their active role in selecting members of the top management and the BoD.\(^{741}\) They also highlight the role of major shareholders in influencing the company’s investment policy, to repel any mismanagement or

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\(^{734}\) See A. The shareholder theory: the product of the agency problem in 1.8.1.2 Theories of corporate governance in Chapter One.

\(^{735}\) Kerrie Warring, *Shareholder Responsibilities and the Investing Public* (The Institute of Chartered Accountants 2006) 12

\(^{736}\) Shleifer and Vishny highlight the role of shareholders in corporate governance, which can be effective through implementing two approaches: first, to provide legal protection against managers’ expropriation. Second, through concentrated ownership. Andrei Shleifer and Robert Vishny, ‘A Survey of Corporate Governance’ (1997) 2 The Journal of Finance 737, 739


\(^{740}\) Paul Laux and James Markham, ‘Shareholders in Corporate Governance’ in Alexander Kostyuk, Udo Braendle and Rodolfo Apreda (eds) *Corporate Governance* (Virtus Interpress 2007) 100

exploitation practice in the company’s investment.\textsuperscript{742}

Institutional shareholders in particular, such as insurance companies, public pension funds, mutual funds and banks, are powerful and professional shareholders, and their power comes from the size of their shareholdings.\textsuperscript{743} They are expected to be more vigilant and active shareholders who work towards the improvement of their investee companies for two reasons. First, they are not principal investors but invest on behalf of beneficiaries, and they have a fiduciary duty towards them. Second, given the large number of shares they hold, it is not easy to sell their shares and exit from corporations that have problems; instead, they usually use their powers and voting rights to engage actively in their improvement.\textsuperscript{744} The Cadbury Report emphasises the power of institutional shareholders and encourages them to use their voting rights as a tool to influence the governance of their investee companies.\textsuperscript{745}

Similarly, The Hampel Committee reports that,

[Where an institution is committed, explicitly or defacto, to retaining a substantial holding in a company, it shares the board’s interest in improving the company’s performance. As a result, some institutions now take a more active interest in corporate governance.\textsuperscript{746}]

Nevertheless, not all writers agree on the active engagement of large investors and on the efficiency of the role they play in enhancing corporate governance and imposing positive changes on corporations. Critics argue that there is a chance that large shareholders pursue their own interests at the expense of other shareholders, especially in countries with weak legal shareholder protection or in companies with poor performance.\textsuperscript{747} For example, they can divert corporate resources from other shareholders for their personal interest.\textsuperscript{748} Therefore, corporate laws try to limit the

\begin{itemize}
\item \textsuperscript{743} Paul Laux and James Markham, ‘Shareholders in Corporate Governance’, in Alexander Kostyuk, Udo Braendle and Rodolfio Apreda (eds) \textit{Corporate Governance} (Virtus Interpress 2007)
\item \textsuperscript{744} Marina Welker and David Wood, ‘Shareholder Activism and Alienation’ (2011) 52 Current Anthropology 57, 62
\item \textsuperscript{745} The report states that ‘given the weight of their votes, the way in which institutional shareholders use their power to influence the standards of corporate governance is of fundamental importance. Their readiness to do this turns on the degree to which they see it as their responsibility as owners, and in the interest of those whose money they are investing, to bring about changes in companies when necessary, rather than selling their shares’. See Adrian Cadbury and others, \textit{The Financial Aspects of Corporate Governance} (The Cadbury Report, GEE Publishing Ltd 1992) para 6.10
\item \textsuperscript{746} Ronnie Hampel and others, \textit{Committee on Corporate Governance: Final Report} (The Hampel Report, GEE Publishing Ltd 1998) para 5.3
\end{itemize}
controller’s ability to extract private benefits that are reaped at the expense of the corporation. The main point to be made here, however, is that large shareholders are more effective in enforcing changes to their companies as they have the power and ability to do so. The following point then sheds light on the shareholders of IFIs and their ownership structure to see whether they have the necessary power to enhance SCG in their IFIs.

4.2.2 Shareholders of IFIs and their ownership structure:

Shareholders provide one of the basic sources of funds to the company. They are ‘both partners with voting rights, who can take part in collective decisions concerning the company, and owners of equity securities, who are entitled to profit from selling them on’. In general, a shareholder can be any local or foreign individual or institution that buys securities of a company. Questions arise here: are shareholders of IFIs different than those of conventional financial institutions? Are they all Muslims? What type of ownership structure do IFIs usually have? Are there large shareholders or an ultimate controller?

What mainly distinguishes an IFI from its conventional counterpart is the Shariah compliance feature and the effects of this on its activities and corporate governance policy, as seen in Chapter Two. Due to this feature, IFIs mostly attract Muslim investors and clients, especially since dealing with a conventional institution on an interest basis is prohibited in Shariah. In other words, in a country where there are Islamic and conventional banks, Muslims in principle have no choice but to deal with Islamic banks. Besides, IFIs are usually concentrated in Islamic jurisdictions where Muslims make up the vast majority of the population. Therefore, it is envisioned that a significant number of IFIs’ shareholders are Muslims. Nevertheless, the fact that a bank is Islamic does not mean all its shareholders or customers have to

> accessed 23 December 2019
751 According to La Porta, Lopez and Shleifer, a company has an ultimate controller if its direct and indirect voting rights exceed 20% as this is usually enough to have control over the firm. Rafael La Porta, Florencio Lopez-de-Silanes and Andrei Shleifer, ‘Corporate Ownership Around the World’ (1999) 54 The Journal of Finance 471, 476–477
752 See (n3)
be Muslims. Unlike religious corporations, IFIs, although they work in compliance with Shariah rules, are not merely religious; rather, they are profitable commercial institutions that operate in accordance with religious rules. Accordingly, IFIs in the UK, as a secular country, have shareholders, other stakeholders and customers from all faith backgrounds.

With regard to the ownership structure of Islamic banks, Zouari and Taktak’s empirical study reveals that 70% of the banks’ equity is dominated by the top five shareholders. As for the controlling shareholder’s identity, the study showed that the majority of Islamic banks are institutionally owned, followed by state ownership and then family. This is confirmed by the study conducted by Srairi, which gives evidence that the ownership structure of IFIs is usually concentrated and they are mostly controlled by institutions. Therefore, it can be said tentatively here that Islamic banks often have a concentrated ownership structure with an ultimate controller and that they are mainly owned by institutions and large companies.

Concentrated ownership and institutional shareholding in IFIs provide the first justification for choosing shareholders to help in enhancing SCG. However, having a substantial shareholding only is not enough on its own to motivate shareholders to engage with their IFI and work to strengthen its SCG. Additionally, they need to be interested in Shariah compliance, especially since this feature is not a financial aspect of the company, which is a key interest of all shareholders. Therefore, the following point provides evidence that Shariah compliance is a vital interest of

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753 See 1.3.1 The entity interested by the study in Chapter One.

754 In 2013 a survey was conducted by 2Europe (on behalf of Al-Rayan Bank in the UK) to study the customers of Islamic banks in the UK and their impression toward Islamic finance. The survey revealed that one-third of the respondents were non-Muslim and the majority of those believed that Islamic finance is relevant to all faiths. For more, please see Islamic Bank of Britain Plc, ‘Majority of Non-Muslim UK Consumers believe that Islamic Finance is Relevant to All Faiths’ (Al-Rayan Bank, 7 February 2014) <http://www.alrayanbank.co.uk/useful-info-tools/about-us/latest-news/jan-dec-2014/majority-of-non-muslim-uk-consumers-believe-that-islamic-finance-is-relevant-to-all-faiths/> accessed 23 December 2019


758 This conclusion is confirmed later in the practical section of this chapter that addresses the ownership structure of IFIs in Malaysia, Kuwait and the UK. See 4.5 Shareholders of IFIs in Malaysia, Kuwait and the UK in this chapter.
shareholders in IFIs, which highlights the second reason for choosing them as a supporting solution for SCG problems.

4.3 Shareholders’ interest in Shariah compliance in IFIs:

According to Shleifer and Vishny, there are several reasons why investors finance a company: its good reputation; excessive investor optimism, where investors get very excited about short-term capital gains; or to get control rights in exchange.\(^759\)

Technically, shareholders hope to receive a return on the capital they have supplied during the tenure of their holding.\(^760\) They also expect to secure a return of that capital by reselling their security to somebody else.\(^761\) The capital from the enterprise perspective is permanent, but from the capital suppliers’ view it should be recoverable at some point. Especially since they are usually the residual claimants for the company’s profits, therefore, it is in their best interest to maximise the profits. In short, investors usually buy into companies to maximise the value of their shares and get easy money.

This idea also applies to the shareholders of IFIs. It is acknowledged that they buy into the IFI to make money. This is for the fact that IFIs have proved their efficiency in the global capital markets and have shown good great stability in financial crises.\(^762\) According to Hasan and Dridi, factors related to the practice of Islamic banks helped to limit the adverse effect of the financial crisis on their profitability.\(^763\) This is also attributed to having lower credit risk in comparison to conventional banks, especially in Islamic countries.\(^764\) Furthermore, the Islamic

\(^764\) For more, please see Pejman Abedifar, Philip Molyneux and Amine Tarazi, ‘Risk in Islamic
banking market is growing on an annual basis and is likely to grow more in the future. These financial factors would most likely attract investors to buy into Islamic banks and fund them, which reflects the traditional ‘maximising shareholder value’ role of a public company and its managers, as explained in Chapter One.

Nevertheless, the history of the development of corporate governance shows that this traditional interest in the company has changed to include other non-financial interests, such as corporate citizenship and its social, environmental, educational or religious responsibility. Many companies are now keen to operate in compliance with sustainable good governance and promote their socially-responsible business on their websites and through public relations channels. Some companies also promote their religious or faith background. For example, Forever 21 Clothing prints the biblical verse John 3:16 on each of its shopping bags and some products. Similarly, In-N-Out Burger prints some biblical verses, such as Revelation 3:20, John 3:16 and Matthew 6:19, on their cups, containers and wrappers. In the finance sector, some funds do business in compliance with religious rules and values, such as the Ave Maria Mutual Funds and Luther King Capital Management Aquinas, which work in accordance with Catholic values and principles.

Thus, it is believed that many investors have an interest in these non-financial aspects of companies, which encourage them to finance them.

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Greg Rung, Travis Hollingsworth and Rico Brandenburg, Building 150 Financial Institutions by 2020 (Oliver Wyman 2011) 3. See also 1.1 An overview of Islamic finance in Appendix One.

See A. The shareholder theory: the product of the agency problem in 1.8.1.2 Theories of corporate governance in Chapter One.

See B. The stakeholder theory: development of the agency theory in 1.8.1.2 Theories of corporate governance in Chapter One.

See C. Corporate social responsibility and sustainability in 1.8.1.2 Theories of corporate governance in Chapter One.

See D. The agency theory: a summary of the various theories of corporate governance in 1.8.1.2 Theories of corporate governance in Chapter One.


For more, please visit the Ave Maria Mutual Funds website at <https://avemariafunds.com/> and the Luther King Capital Management Aquinas website at <http://www.aquinasfunds.com/> both accessed 30 December 2019

Masih state that, ‘The last decade witnessed a tremendous growth in socially responsible investment, where investors combine their financial objectives with their concerns about social, environmental, ethical and/or corporate governance issues in their investment selection’. Glac also observes that some people are interested in such investments because it allows them to make money in accordance with their faith.

Muslim investors, in particular, have religious reasons behind buying into IFIs. As mentioned above, dealing with interest is prohibited in Shariah, therefore, devoted Muslims have limited investment opportunities in the field of financial institutions. If they decide to invest their money in banks, they have no choice but to buy into those that follow the rules of Islamic Shariah. In this context, they may prefer to invest in an Islamic institution, even if it does not perform as well as a conventional institution, to meet their religious obligations. In addition, they tend to invest in IFIs to help the entire Muslim nation as a higher cause. To illustrate, supporting and funding Islamic institutions assists in their development and continued ability to compete in the market, which would fulfil Muslims’ need for an alternative banking services solution. Muslims are aware of each other’s need for an alternative banking solution, hence, they would work to support the whole Islamic finance sector to help this industry to survive in compliance with Shariah teachings. Therefore, investors, or at least a number of them, join IFIs for a religious reason. They do not merely wish to get a return on their investment, but also to get it in a way that is Shariah compliant. Moreover, since poor Shariah compliance could cause several financial risks to an IFI that might threaten its financial stability, as seen in Chapter Two, shareholders will be interested in this feature for an economic reason as well.

In addition, some investors are interested in the IFIs’ Shariah compliance for legal reasons. An Islamic company, in general, has restricted investment

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775 Allah Almighty says in the Holy Quran, Surah Al-Ma'idah, Chapter 5, Verse 2, ‘And cooperate in righteousness and piety, but do not cooperate in sin and aggression.’ Saheeh International (tr), The Qur’an (3rd edn, Al-Muntada Al-Islamy Trust 2010) 141.

776 See the effect of non-Shariah compliance risks on IFIs in 2.2.2 Management of Shariah non-compliance risks in Chapter Two.
opportunities. Due to the objective of practising Shariah-compliant business set out in the company’s AoA, it is constrained to invest only in a business that complies with Shariah rules; in this regard, directors have a fiduciary duty toward shareholders to achieve this objective. Therefore, Islamic companies tend to buy into each other due to the nature of their business. These investor companies, as shareholders, need to be reassured that the financial institutions they invest in are Shariah-compliant. Another legal reason behind the shareholders’ interest in Shariah compliance is seen in the legal sanctions that might be served to their investee IFIs if they deviate from being Shariah compliant, which would affect their stability, as seen from the Malaysian and Kuwaiti regulations in Chapter Three.

Therefore, from the previous explanation, it can be said that Shariah compliance is an essential factor for shareholders of IFIs for several reasons. First, Shariah compliance is important to some of the shareholders for religious reasons: (a) they have the need to employ their money in a manner that is closely aligned with their religious values and priorities; and (b) they feel the need to use their investment capital to encourage the development of IFIs and Islamic finance sector in general, in order to support the Islamic nation at large. Second, Shariah compliance is important to other shareholders for financial reasons. Empirically, Shariah compliance helped IFIs to override the financial crisis. Also, it helps them to reduce non-Shariah-compliance risk and credit risk, therefore, poor Shariah compliance negatively affects the performance of IFIs and impairs their financial returns. Third, Shariah compliance is essential to some other shareholders for legal reasons. Due to legal investment restrictions and the directors’ fiduciary duty, Islamic companies have to invest in Shariah-compliant businesses. Shareholders also want their investee companies avoid legal penalties. In conclusion, shareholders of IFIs are interested in Shariah compliance and they need to be assured of its efficiency and maintenance throughout the time of their shareholding, which provides the second reason – alongside their power of control – for choosing them to enhance SCG.

777 AoA form a contract between the company and its shareholders that is binding to all parties. According to Hannigan, ‘The contract derives its binding force not from a bargain struck between parties but from the terms of the statute.’ Brenda Hannigan, Company Law (4th edn, Oxford University Press 2016) 104. See also Len Sealy and Sarah Worthington, Sealy’s Cases and Materials in Company Law (Oxford University Press 2010) 24

778 See Islamic Financial Services Act, Section (28)(5) (Malaysia); Law no 32 of 1968 Concerning Currency, the Central Bank of Kuwait and the Organisation of Banking Business, Article 93
After explaining the first and second reasons for focusing on shareholders, the following point addresses the fundamental rights of shareholders in SCG, which are needed for their active engagement with their investee IFIs.

4.4 The rights of shareholders in Shariah corporate governance:

The rights of shareholders largely depend on the laws and legal systems of the jurisdictions where the companies operate.\(^{779}\) According to La Porta and others, the legal rules of each country and their enforcement are essential determinants of what rights shareholders have and how well these rights are protected.\(^{780}\) The general rights of shareholders, although they vary in the level of enforcement, are usually recognised by the national laws and regulations in most jurisdictions around the world. It is acknowledged that the more rights given to shareholders and the better means for their enforcement, the better shareholder protection and engagement becomes. In this context, it is essential to implement a corporate governance policy in any company as it plays an important role in safeguarding shareholders’ rights.

The OECD highlights the protection of shareholders’ rights and the power of shareholders to influence corporations. It addresses the fundamental accepted rights of shareholders, which should be acknowledged for shareholders in any jurisdiction. This includes the right to: get relevant information; participate effectively and vote in general meetings; consult with each other about their rights; enjoy fair and equitable treatment; benefit from proper management of conflicts of interest; have protection for minority shareholders; and obtain effective redress for violation of all these rights.\(^{781}\) However, although it is recommended that the standards of the OECD concerning shareholders’ rights be endorsed by IFIs, specific principles that cater for their specificity are still needed. In other words, due to the fact that IFIs follow the rules of Islamic Shariah in their business and add a SSB to their internal structure, rights of shareholders should be recognised in respect of these unique characteristics.

The international Islamic frameworks or written works do not expressly address the rights of shareholders in SCG. Therefore, the rights mentioned in the OECD framework of corporate governance will be treated as a benchmark to illustrate

\(^{779}\) Paul Laux and James Markham, ‘Shareholders in Corporate Governance’ in Alexander Kostyuk, Udo Braendle and Rodolfo Apreda (eds) Corporate Governance (Virtus Interpress 2007) 96


\(^{781}\) OECD, G20/OECD Principles of Corporate Governance (OECD 2015) 19 onwards
the rights of shareholders in SCG. However, they will be modified to fit the IFIs’ requirements and their special governance. Moreover, some additional rights are added to cater for shareholders’ needs in IFIs. Hence, the following points present the rights that need to be attributed to shareholders in IFIs in any jurisdiction, in order to encourage their active engagement in SCG.

4.4.1 The right of information related to the IFI’s Shariah compliance:

It is acknowledged that shareholders of any company have the right to information pertaining to the company’s practice and activities. 782 This is a fundamental right of shareholders as it is the foundation for their other rights. It is of particular importance to shareholders in order to enable them to engage in the corporation actively and practise their rights on an informed basis. 783 This right is usually granted to shareholders by mandatory rules in the country and, therefore, in principle, companies have no discretion in providing the information. 784 Thus every shareholder is entitled to receive information from the company irrespective of the number of shares or voting rights held. 785 Refusing to provide any information could be accepted only on the ground that this disclosure will cause harm to the company. 786

The type of information to be disclosed is usually determined by the materiality concept, which should include but not be limited to the company’s

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783 OECD, G20/OECD Principles of Corporate Governance (OECD 2015) 42
784 Andres Vutt and Margit Vutt, ‘Shareholders’ Individual Information Right: Prerequisites and Boundaries’ (2015) 23 Juridica International 60, 61
786 Andres Vutt and Margit Vutt, ‘Shareholders’ Individual Information Right: Prerequisites and Boundaries’ (2015) 23 Juridica International 60, 65. In the UK, information that should be disclosed by companies to public without delay, including substantial transactions, related party transactions, fundamental changes of business, changes to significant shareholders. See London Stock Exchange, ‘AIM Rules for Companies’ (London Stock Exchange Group 2018), Part 2 Rules 11(e) Part 1, 11-15. However, there is information that the company is excused from disclosing immediately due to their confidential nature. For example, the company is permitted to delay the disclosure of price-sensitive information ‘if it is an impending development or a matter in the course of negotiation provided such information is kept confidential’. See London Stock Exchange, ‘AIM Rules for Companies’ (London Stock Exchange Group 2018) Part 2, Rules 11(e). Also, the EU Market Abuse Regulation allows a delayed disclosure of inside information if ‘immediate disclosure is likely to prejudice the legitimate interests of the issuer’. See Regulation (EU) No 596/2014 Of the European Parliament and of the Council of 16 April 2014 on market abuse (market abuse regulation) and repealing Directive 2003/6/EC of the European Parliament and of the Council and Commission Directives 2003/124/EC, 2003/125/EC and 2004/72/EC, Article 17(4)
financial situation, performance, ownership and governance. The Basel Committee also stresses the importance of disclosure of information for banks in particular. The Basel Pillar 3 disclosure requirements provide particular standards for disclosure of information that are observed by most banks around the world. Each bank endeavours to satisfy these requirements and to show their commitment to them in order to strengthen and promote their corporate governance policy. However, the Basel disclosure requirements mostly focus on capital and risk management.

Given the fact that Shariah compliance is the main distinctive feature of IFIs, the concept of materiality for these institutions should include an additional layer of information which is Shariah related. As such, shareholders need to be informed of the policy of SCG implemented by the IFI and the reasons for its preference and validity, to fulfil their interests. In this regard, it is insufficient to state that an IFI follows the recommendations of the AAOIFI or the IFSB; rather, the institution should provide detailed information on its implemented policy. As the SSB is a distinctive organ in an IFI’s governance structure, shareholders need to be provided with all information related to that body and every individual member. In this context, the AAOIFI has listed ‘the roles and responsibilities of the SSB’ as information of interest to the equity holders. Also, shareholders should be informed of the extent of an IFI’s Shariah compliance throughout the financial year by presenting a Shariah compliance report to shareholders in the AGM and making it available on the institution’s website.

This draws attention to whether the SSB fatwas are considered as material information that needs to be disclosed to shareholders. In other words, is it essential for shareholders to know about the fatwas issued by the SSB to provide an informed decision? As mentioned above, companies, in principle, should not withhold information unless its disclosure might cause harm to the company. Disclosure is

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787 The OECD defines the material information as ‘information whose omission or misstatement could influence the economic decisions taken by users of information. Material information can also be defined as information that a reasonable investor would consider important in making an investment or voting decision’. OECD, G20/OECD Principles of Corporate Governance (OECD 2015) 41

788 Pillar 3 disclosure requirements 2015 requirements were enhanced in 2016 and issued in 2017 to build on the 2015 framework. BCBS, ‘Pillar 3 Disclosure Requirements – Consolidated and Enhanced Framework’ (BIS, 2017) <https://www.bis.org/bcbs/publ/d400.htm> accessed 30 December 2019

789 Siti Obid and Babak Naysary, ‘Toward a Comprehensive Theoretical Framework for Shariah Governance in Islamic Financial Institutions’ in Tina Harrison and Esam Ibrahim (eds), Islamic Finance (Palgrave Macmillan 2016) 15-16

790 AAOIFI, Accounting, Auditing and Governance Standards (AAOIFI 1997), Chapter Governance Standard for Islamic Financial Institutions No. 6 Statement on Governance Principles for Islamic Financial Institutions, 65
considered harmful if it leads, for example, to leakage of classified information and investment strategies.\textsuperscript{791} In this context, disclosing fatwas issued by a SSB in an IFI is not expected to cause harm to the institution because fatwas are not usually confidential information. A fatwa is an opinion of a qualified Shariah scholar about a Shariah ruling in a particular matter supported by evidence from Shariah.\textsuperscript{792} This means that Shariah scholars are only reporting on Shariah, which should be or best to be known by everyone. Also, Shariah scholars often answer publicly any questions raised to them in order to benefit others and spread Shariah knowledge.\textsuperscript{793} The international Islamic organisations IFSB and AAOIFI agree that fatwas of SSBs are not confidential information and that the public has the right to view them and ask for further explanations regarding their adoption, applicability or abandonment.\textsuperscript{794} Moreover, IFIs tend to publish the fatwas of their SSBs on their websites for marketing purposes and to provide evidence for concerned parties that their services, products and activities are all Shariah compliant.\textsuperscript{795}

Shareholders need to be informed of the fatwas issued by the SSB in order to ensure that the directors are performing their fiduciary duty of running the business in a Shariah-compliant way. Moreover, informing shareholders about the fatwas is important whenever needed to provide an informed voting decision, as is the case in mergers and acquisitions or other significant investment opportunities or major changes to be assured of their permissibility. However, it should be acknowledged that in the latter situations, it might be acceptable for an IFI to keep the related fatwa confidential until the matter is presented to shareholders in the AGM, to avoid any chance of information leakage.


\textsuperscript{792} Ahmad Al-Hanbaly, \textit{Sifat Al-Fatwa wa Al-Mufti wa Al-Mustafii} (Al-Maktab Al-Islami 1960) 4. See also Ministry of Trust and Islamic Affairs, \textit{Al-Mawso’ah Al-Fiqhiyyah}, vol 32 (Dar Al-Safwa 1995) 20

\textsuperscript{793} For example, it is often seen that Shariah scholars answer questions in public and through means of communication (TV, radio, social media, etc.). Also, many fatwas can be found in books and online.


\textsuperscript{795} For example, see the fatwas issued by the SSB of Al-Rayan Bank in the UK on the Bank’s website. Al-Rayan Bank, ‘Sharia Compliance’ <https://www.alrayanbank.co.uk/useful-info-tools/islamic-finance/sharia-compliance/> accessed 30 December 2019.
Accordingly, under the right of information in SCG, shareholders of IFIs need to be given timely and regular information related to the institution’s SCG policy, including but not limited to information related to the work of the SSB as a body and each of its individual members; the extent of the IFI’s Shariah compliance; the fatwas issued by the SSB; the institution’s policy for managing non-Shariah compliance risk, as well as clarifying any Shariah non-compliance incidents that happened throughout the financial year and explaining how they were handled. Moreover, each IFI needs to disclose complete details on its Shariah financial obligations in the annual report. This should include stating the amount paid each year for zakat, charity and income purification, and how it has been calculated and given away.

4.4.2 The right toward zakat of shareholders:

As shown in Chapter Two, a Muslim trader is required to pay zakat on their business, including investing in shares. It was also seen that IFIs pay annual zakat in adherence to this obligation. However, is paying zakat on shares owned by shareholders in an IFI obligatory for the institution or the shareholders as owners? To answer this question, we need to distinguish between the person required by Shariah to pay zakat and the person who pays it.

Muslim scholars agree that it is the responsibility of shareholders to pay zakat on their shares in principle. However, the International Islamic Fiqh Academy has decided that it is also permissible for companies with shares to pay zakat on behalf of shareholders in four cases: (a) if it is addressed in the company’s AoA; (b) it is agreed upon in the general meeting; (c) if it is legally required from the company by the national law; or (d) if the shareholders authorise the company to pay their zakat.

Traditionally, many IFIs pay zakat on behalf of shareholders every financial year and a reference to this payment appears in the annual report as a notification. For example, Al-Rajhi Bank in Saudi Arabia clearly states in its annual report that, ‘The due Zakat amounts scheduled to be paid by shareholders are calculated and the Bank pays such amounts to competent parties’. This means that shareholders are no longer required to pay zakat on their shares. Any IFI that decides not to pay zakat on

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796 See 2.3.6.1 The IFI’s obligation to pay zakat in Chapter Two.

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behalf of shareholders also notifies them of this decision. For example, Bahrain Islamic Bank states in its annual report that, ‘The shareholders should pay their portion of Zakat on their shares’. This requires each shareholder to pay zakat on their shares individually. It is important to notify shareholders about whether the IFI is going to pay their zakat or not. This is to avoid double payment of zakat if they do pay it on dividends or to let shareholders know that they should pay zakat on their shares if the IFI does not.

Paying zakat for shareholders is a good practice of IFIs that helps shareholders fulfil their religious obligation. Nevertheless, there are a few problems that arise when IFIs pay zakat on behalf of shareholders. First, shareholders in IFIs can be Muslims and non-Muslims and zakat is only obligatory for Muslims. Therefore, non-Muslims are not required to pay zakat, even if they invest their money in an Islamic business. When IFIs pay zakat for shareholders, they usually pay it collectively. Accordingly, a non-Muslim shareholder will have to surrender a percentage of their money when there is no obligation to do so. Second, not all shareholders own the number of shares required to pay zakat. In Shariah, if one person mixes their money with others, none is required to pay zakat unless their share reaches the threshold of zakat giving. Finally, in Shariah, paying debts is prioritised over paying zakat because the right of people precedes the right of God. So a debtor is not required to pay zakat unless they pay out their due debts first. Therefore, if a shareholder is in debt and the company pays zakat on their shares, this could cause them a financial problem as they might need the zakat money to pay their debts, unless they can pay them from another source of money.

In the light of these considerations, it can be said that paying zakat for shareholders is not basically a right of shareholders or even an obligation of the IFIs toward them. Instead, it is a service provided by an IFI to its shareholders, especially when it has the qualification and means to do this task. However, shareholders have a right to be informed whether their zakat is going to be paid by the IFI or not and the

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800 Yousef Al-Qaradawi, Fiqh Az-Zakat, vol 1(2ed. edn, Al-Risalah Organisation 1973) 95. See also Ministry of Trust and Islamic Affairs, Al-Mawso’ah Al-Fiqhiyyah, vol 32 (Dar Al-Safwa 1995) 233
801 This is the opinion of the majority of Muslim scholars. Ministry of Trust and Islamic Affairs, Al-Mawso’ah Al-Fiqhiyyah, vol 32 (Dar Al-Safwa 1995) 235
802 This is the opinion of the majority of scholars. Muhammad Al-Shanqety, Sharh Zad Al-Mustaqni’e (Book of Zakat, Bayn Al-Sharhain University 2014) 13
calculation of this zakat. This should be seen as a right of shareholders in SCG because most IFIs are accustomed to assuming this responsibility towards shareholders, which could be considered as a customary obligation in the field of Islamic finance with time. In this regard, if an IFI does not pay zakat on behalf of shareholders and does not expressly inform them of its decision, a shareholder might be able to make a claim on the basis that this has been an accepted practice among IFIs. To avoid misunderstanding, each IFI needs to inform shareholders every financial year about whether it is going to pay their zakat or not.

4.4.3 The right to appoint and remove SSB members:

Shareholders are entitled to some control rights, most importantly the right to vote in the AGM, which gives them some control over the corporation.803 This voting right grants the shareholders with several powers, such as the power to elect and remove directors, to amend the AoA, and to approve significant changes to the corporation.804 According to the Cadbury report, shareholders as owners elect the directors to run the corporation on their behalf, the directors report to the shareholders on their stewardship and the shareholders appoint the auditors to check on the directors’ financial statements.805 A similar system applies in SCG, but additionally, the IFI has a SSB. Although SSB members do not interfere in managing the institution, their decisions concerning Shariah-related matters are mostly adhered to by the institution to ensure its Shariah compliance.806 Moreover, their work is not limited to issuing an opinion on the permissibility of the institution's activities, but they also provide alternative solutions in the case of any Shariah-non-compliant activity. In other words, they approve all the IFI’s activities and in so doing, they not only influence the institution’s Shariah compliance, but also its investment decisions. That being so, shareholders of an IFI should be entitled to elect and remove members of the SSB in the AGM as an aspect of their control rights. Each Shariah scholar should be subjected to a separate vote on an individual basis, and shareholders should

803 Sola Canizares, ‘The Rights of Shareholders’ (1953) 2 International and Comparative Law Quarterly 564, 568
805 Adrian Cadbury and others, The Financial Aspects of Corporate Governance (The Cadbury Report, GEE Publishing Ltd 1992), 47
806 See 2.3.1 Enforceability force of Shariah rulings in Chapter Two.
be permitted to vote either for or against a scholar or abstain, and the same system should apply for their removal or replacement. This would allow shareholders to supervise and approve the BoD selections to ensure the competence of Shariah scholars.

This right is closely related to the shareholders’ right of information. For shareholders to provide an informed decision with regard to electing SSB members, they need to be provided with the experience and background of the candidates. They also need to be informed about their activities throughout the financial year, such as their meetings attendance record, how many transactions have they certified or refused, the quality of their reporting to the BoD and their other duties, in order to be able to make an informed decision on whether to reappoint or remove them. Also, it is always recommended to apply appointment criteria and a screening process for Shariah members that should be transparent to shareholders. 807

4.4.4 The right to discuss and approve the SSB members’ remuneration:

It is regarded as good governance practice to entitle shareholders to discuss and express their opinion on specific financial decisions in the company, including the remuneration of the directors and key executives. 808 Especially given that the remuneration systems and faulty incentives of directors and executives of financial institutions are seen as one of the main reasons behind the 2007–2008 financial crisis. 809 Therefore, a number of countries have moved towards imposing stronger supervision. One way is through the implementation of the ‘say on pay’ rules that allows shareholders to vote on the remuneration of directors. For example, in 2013, the UK made some changes to the directors’ remuneration policy: it now entitles


808 OECD, G20/OECD Principles of Corporate Governance (OECD 2015) 22

shareholders to have a binding vote on directors’ remuneration.\footnote{810}{Enterprise and Regulatory Reform Act 2013, Section 79 to 82 (UK). See also Aidan O’Dwyer, ‘Corporate Governance After the Financial Crisis: The Role of Shareholders in Monitoring the Activities of the Board’ (2014) 5 Aberdeen Student Law Review 112. 125} Similarly, in the US, after the passing of the Dodd–Frank Wall Street Reform and Consumer Protection Act 2010, the shareholders’ opinion on the executives’ compensation has to be heard in the AGM in all public companies in the US.\footnote{811}{The vote should be taken no less than once every three years. See Dodd–Frank Wall Street Reform and Consumer Protection Act (Public Law 111–203—July 21, 2010), Section 951} Moreover, even if there is no legislation in the country conferring this right on shareholders, companies voluntarily oblige themselves as a matter of corporate governance good practice. This is what happens in Canada.\footnote{812}{‘In Canada, say-on-pay votes are not required, but 80 percent of the largest companies have adopted the practice voluntarily or as a result of pressure from investors.’ Yvan Allaire and Francois Dauphin, ‘Should Say-on-Pay Votes Be Binding?’ (The CLS Blue Sky Blog, September 2016) \url{http://clsbluesky.law.columbia.edu/2016/09/13/should-say-on-pay-votes-be-binding/}, accessed 23 December 2019}

Chapter Two explained that SSB members in IFIs receive remuneration that can be equivalent to or even higher than the remuneration received by directors.\footnote{813}{See 2.3.4 SSB remuneration in Chapter two.} It was also noted that this remuneration policies currently lack transparency and have not been given proper attention in the SCG policy of IFIs, even though it is believed that they might affect the SSB members’ independence and objectivity. It is then essential to allow shareholders in IFIs to discuss and approve SSB pay at the outset and every few years, in the same way that they have this right in relation to the remuneration of directors and key executives. They also need to be made aware of the related information, such as the remuneration criteria and strategy, especially given that there is a religious reservation on the right of Shariah scholars to receive payment for providing Shariah rulings.\footnote{814}{See 2.3.4.1 Shariah perspective on the right of Shariah scholars to receive remuneration in Chapter Two.}

4.4.5 The right to authorise an IFI’s philanthropy:

As seen in Chapter Two, for an IFI to be Shariah compliant, it has to pay zakat and purify its income. It was also seen that this process creates a major governance issue relating to transparency and disclosure of information about money expenditures. This raises the question whether shareholders need to discuss and approve the IFI’s payment of zakat, purification of income and charity. As to zakat and income purification, shareholders do not have a say on their payment by the IFI,
as they are religious obligations. However, there is an issue as to whether they need to authorise the IFI’s charitable activities, or what is known as ‘corporate philanthropy’,\(^{815}\) and to discuss the IFI’s choice of zakat and income purification fund expenditure.

Nowadays, corporate philanthropy is regarded as an essential part of companies’ corporate social responsibility (CSR), where it could be seen as unacceptable not to engage in charitable activities as asserted by Gautier and Pache.\(^{816}\) However, it is claimed that companies in civil law countries applying a stakeholder model have more freedom to engage in CSR activities than those in common law countries following a shareholder model, due to the higher risk of shareholder litigation against managers in the latter countries.\(^{817}\) Brown, Helland and Smith explain that the agency problem inherited in the common law countries might encourage managers to use their power to expropriate the company’s philanthropy for their benefit at the expense of shareholders.\(^{818}\) Nevertheless, it has been shown that the existence of major shareholders might help in reducing this problem. Liang and Renneboog confirm that, with the power they have, major shareholders can affect the company’s charitable orientation as they may favour different charitable policies and can use their voting powers to implement them.\(^{819}\) They can also discourage an excessive levels of philanthropy, as stated by Bartkus, Morris and Seifert.\(^{820}\)

This is not to imply that corporate philanthropy is inconsistent with maximising shareholder value or that major shareholders may reduce the company’s charitable donations. On the contrary, corporate philanthropy is actually associated


\(^{820}\) Barbara Bartkus, Sara Morris, and Bruce Seifert, ‘Governance and Corporate Philanthropy: Restraining Robin Hood?’ (2002) 41 Business and Society 319, 323
with higher shareholder value. Also, concentrated ownership or the existence of large shareholders do not necessarily have a significant influence on corporate charitable giving. This is to say, however, that shareholders’ interests should be taken into consideration when setting the company’s charitable policy and that large shareholders can control and steer the company’s philanthropy in the way that they see fit.

As explained in Chapter One, SCG is distinct from the shareholder or stakeholder models of corporate governance as it is a faith-based model. Under this distinct model, the main objective is to achieve Shariah compliance, whether in the process of maximising shareholder value or in terms of taking into consideration the interests of other stakeholders. Therefore, shareholders in IFIs are not expected to reject the charitable activities of their institutions, especially in the light of the fact that the charitable activity has a religious ground. However, they should be given the right to be informed of the IFI’s charitable policy and to discuss its choice of goodwill donations, the expenditures made for zakat and the income purification fund. This is to help to avoid the governance issue of managers’ expropriation, mentioned above, and the issue of accidental money abuse through money laundering and the financing of terrorism and proliferation, highlighted in Chapter Two. Unfortunately, companies rarely allow shareholders to express their opinions before

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823 See C. Distinct model: a faith-based model in 1.8.2.2 The theory behind Shariah corporate governance in Chapter One.
824 Giving charity is highly encouraged and rewarded by Shariah, and there is a lot of evidence from the Quran and Sunnah about the benefits of charity, which encourages Muslims to give. For example, Allah Almighty says in the Holy Quran, Surah Al-Baqarah, Chapter 2, Verse 245, ‘Who is it that would loan Allah a goodly loan so He may multiply it for him many times over? And it is Allah who withholds and grants abundance, and to Him, you will be returned.’ Saheeh International (tr), The Qur’an (3rd edn, Al-Muntada Al-Islamy Trust 2010) 52. Also, Prophet Muhammad (PBUH) said, ‘Seven people will be shaded by Allah under His shade on the day when there will be no shade except His .... and a man who gives charity so secretly that his left hand does not know what his right hand has given.’ Muhammad Bukhari, Sahih Al- Bukhari, vol 8 (Muhammad Khan tr, Darussalam 1997), Hadith 6479
825 See 2.3.6 Governance problem related to the IFI’s Shariah financial obligations in Chapter Two.
giving decisions are made. 826 However, shareholders are encouraged to engage actively with their companies using all the possible means.

4.4.6 The right to discuss the work of the SSB and its Shariah rulings:

The right of inquisition or right of inspection is one fundamental right of shareholders that entitles them to examine and inspect the books and records of the company at all reasonable times. 827 Even if it is not expressly acknowledged to shareholders, this right is considered as a common law privilege based on the ownership of shares. 828 In this regard, shareholders are entitled to ask questions to the board and place items on the agenda of the AGM. 829 In an IFI, as stated by the AAOIFI, shareholders have the right to initiate dialogue with the institution. 830 More specifically, the IFSB confirms the shareholders’ right to ask questions about work of the SSB and to direct their enquiries straight to its members. 831 It is also considered good governance practice that SSB members provide clarification on how they reached their opinion in the annual report. 832 However, can shareholders object to the adoption of a particular fatwa issued by the SSB or to discuss this adoption?

As explained in Chapter Two, fatwas, in principle, are not mandatorily binding, however, for IFIs, they usually become compulsory. 833 Even if the national law does not oblige IFIs to follow the opinions of their SSB, the IFIs usually do so as part of their SCG. Therefore, shareholders, in principle, have no right to object to a particular fatwa followed by the institution, unless they have evidence that it is incorrect. As stated by Canizares, ‘Shareholders may always contest at law the decisions of the company taken in the general meeting whenever the decision

827 Ernest Raba and Charles Clark, ‘Shareholders Rights’ (1953) 5 Baylor Law Review 146, 147
828 Ernest Raba and Charles Clark, ‘Shareholders Rights’ (1953) 5 Baylor Law Review 146, 147
829 OECD, G20/OECD Principles of Corporate Governance (OECD 2015) 22
830 AAOIFI, Accounting, Auditing and Governance Standards (AAOIFI 1997), Chapter Governance Standard for Islamic Financial Institutions No. 6 Statement on Governance Principles for Islamic Financial Institutions, 56
833 See 2.3.1 Enforceability force of Shariah rulings in Chapter Two.
involves a breach of the law or the company's statutes’. Therefore, if the decision taken by an IFI is based on an incorrect fatwa, shareholders have the right to object to that decision following the legal procedures.

As for the right to discuss the SSB’s opinions, Islamic Shariah has set etiquette for asking scholars for their opinion or talking to them. The person should be polite when speaking with or asking a scholar, should start with the oldest and most knowledgeable, should respect their revered position, should not question them about their knowledge and background, and should choose the right time to ask, for example, not asking them when they are angry, anxious or standing. Regarding asking the scholar to provide evidence for their fatwa, there are two perspectives in Islamic jurisprudence. The first one bans common people from asking the scholar to provide evidence; if they still need to check, they might ask another scholar about it. The other opinion states that there is no prohibition on asking about the evidence and the scholar is obliged to provide it if it is direct, but if it is indirect then there is no obligation on them to provide it because, in this case, the opinion was reached by diligence, which is difficult for common people to understand. Ibn Hamdan supports the second opinion - that the person can ask for evidence as a caution, i.e. to guard themselves against falling into the category described by God as, ‘They have taken their scholars and monks as lords besides Allah’. Therefore, although shareholders have the right to ask Shariah scholars some questions regarding their work, it is preferable to observe the code of conduct and etiquette set by Islamic jurisprudence.

4.4.7 The right to take legal proceeding against the SSB members:

All duties and responsibilities of the institution should be adhered to and all rights of shareholders should be facilitated. Any violation of these rights might form a ground for civil or even criminal prosecution. According to the OECD, the confidence

834 Sola Canizares, ‘The Rights of Shareholders’ (1953) 2 International and Comparative Law Quarterly 564, 571
836 Al-Nawawi believes this is the right opinion. Yahya Addin Al-Nawawi, Adab Al-Fatwa wa Al-Mufti wa Al-Mustafti (Dar Al-Fikr Publishing 1988) 85
837 This is the opinion of Al-Sam’ianny stated in Yahya Addin Al-Nawawi, Adab Al-Fatwa wa Al-Mufti wa Al-Mustafti (Dar Al-Fikr Publishing 1988) 85
838 Ahmad Al-Hanbaly, Sifat Al-fatwa wa Al-Mufti wa Al-Mustafti (Al-Maktab Al-Islami 1960) 84
in the institution is enhanced if the ‘legal system provides mechanisms for shareholders to bring lawsuits when they have reasonable grounds to believe that their rights have been violated’. In addition, the OECD emphasises the right of shareholders to initiate legal and administrative proceedings against the BoD and the management as a means to enforce their rights. The directors and managers in a corporation are fiduciaries who must behave in specific upright ways towards the shareholders as the beneficiaries of fiduciary duties. Hence, in the case of any breach of these duties, shareholders have the right to take legal action on behalf of the corporation to seek their enforcement.

An essential part of the directors’ fiduciary duty in an IFI is to ensure the institution’s Shariah compliance in adherence to the institution’s AoA, and they may be held accountable for any failure in performing this duty. In this context, it is acknowledged that shareholders of an IFI have the right to challenge the directors in the courts for any failure in the performance of their duties that negatively affects the extent of the institution’s Shariah compliance. This accountability is stressed by the AAOIFI, which emphasises the ultimate responsibility of the BoD with regard to the institution’s Shariah governance and the duty of the management to facilitate the work of the SSB.

However, a question arises as to the ability of shareholders to initiate legal procedures against the SSB members for any misconduct. Addressing this matter requires an exploration of the personal liability of SSB members towards the shareholders. This liability will be discussed from three different angles: in the international Islamic frameworks, in law and in Shariah.

4.4.7.1 The liability of SSB members in the international Islamic frameworks:

The AAOIFI has emphasised only the accountability of the BoD and

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839 OECD, G20/OECD Principles of Corporate Governance (OECD 2015) 20
840 OECD, G20/OECD Principles of Corporate Governance (OECD 2015) 20
843 Osama Shibani and Christina De Fuentes, ‘Differences and Similarities Between Corporate Governance Principles in Islamic Banks and Conventional Banks’ (2017) 42 Research in International Business and Finance 1005, 1006
844 AAOIFI, Accounting, Auditing and Governance Standards (AAOIFI 1997), Chapters Governance Standard for Islamic Financial Institutions No. 1 Shari’a Supervisory Board: Appointment, Composition and Report, 5 - Governance Standard for Islamic Financial Institutions No. 2 Shari’a Review, 14
management to shareholders and their responsibility to build a productive relationship with them, without mentioning the accountability of the SSB.\textsuperscript{845} The IFSB states that the appointment letter is the tool that defines ‘the form of relationship, level of fiduciary duties, and chain of accountability’ of SSB members within the institution and towards the shareholders.\textsuperscript{846} It also affirms the sole responsibility of Shariah members for their professional acts and their work, in addition to their responsibility for the work done by the personnel working under their supervision.\textsuperscript{847} Nevertheless, the IFSB has set some conditions for Shariah members to be accountable towards the institution's stakeholders, mainly they may be held accountable if they breach their clear mandate and duties.\textsuperscript{848}

4.4.7.2 Potential personal liability of SSB members in law:

In law, liability exists once all its essential elements are present. Breach or failure to satisfy any of the contractual or statutory duties could form a basis of administrative, civil or criminal liability. A SSB member is personally responsible for their acts and, like any other person, may be called to account based on civil or even criminal liability in some cases. As discussed in Chapter Two, a SSB member is seen as a fiduciary.\textsuperscript{849} The fiduciary relationship is initially governed by the agreement letter between its two parties as it is a contractual relationship.\textsuperscript{850} In this context, the

\begin{itemize}
\item AAOIFI, \textit{Accounting, Auditing and Governance Standards} (AAOIFI 1997), Chapter Governance Standard for Islamic Financial Institutions No. 6 Statement on Governance Principles for Islamic Financial Institutions, 57
\item It asserts that they need to be equipped with,
\begin{enumerate}
\item ‘a mandate that grants it appropriate powers to carry out its role and functions;
\item well-organised operating procedures with regard to meetings, the recording of meetings, decision-making processes and to whom its decisions will be passed for effective implementation, including processes to review those decisions whenever necessary; and
\item a sound code of ethics and conduct that would enhance the integrity, professionalism, and credibility of the members of the Shariah board.’ IFSB, ‘Guiding Principles on Shariah Governance Systems for Institutions Offering Islamic Financial Services’ (2009) IFSB Paper no IFSB-10, 9 <https://www.ifsb.org/published.php> accessed 27 December 2019
\end{enumerate}
\end{itemize}
agreement between a SSB member and an IFI is the document that determines the nature and extent of the authority of SSB members in principle.\textsuperscript{851}

This rule is also enforced by Shariah, where a fiduciary is bound by the agreement and to act within its limits, especially when they are paid for their services.\textsuperscript{852} Nevertheless, it is acknowledged that the fiduciary relationship goes beyond the contract, as it enforces a set of statutory fiduciary duties, whether or not they have been included in the agreement.\textsuperscript{853} Most significantly: (a) the duty of loyalty, which requires delivering faithful services; (b) the duty to avoid all conflict of interests with the beneficiaries; (c) the duty of care and due diligence in performance; (d) the duty of confidence that governs the dealing with and the use of confidential information.\textsuperscript{854} Islamic Shariah also enforces an additional duty on a fiduciary, which is the duty to report on their mandate.\textsuperscript{855} Fiduciary duties are all related and are designed to protect beneficiaries from abuse by the fiduciary.\textsuperscript{856}

Hence, a SSB member, as a fiduciary, is first bound by the contract between them and the IFI and required to act within its limits and controls. Then, in conducting their duties, they should be loyal and faithful to all IFIs they are serving by not putting themself in a position where their duty to one IFI conflicts with their duty to another. Also, they need to avoid any situation of conflict of interest between them and any IFI they are serving and to refrain from making any improper use of the information acquired in the course of exercising their membership. Moreover, they need to act with due diligence and care in fulfilling their mandate in general. This emphasises that the SSB member is bound by both contractual and non-contractual liabilities.\textsuperscript{857}

\textsuperscript{851} According to the IFSB, ‘The appointment letter, which becomes the contract for service for the members appointed to serve on the Shariah board of the IIFS, is the primary document that determines the form of relationship, level of fiduciary duties, and chain of accountability between the Shariah board, the IIFS and its stakeholders.’ IFSB, ‘Guiding Principles on Shariah Governance Systems for Institutions Offering Islamic Financial Services’ (2009) IFSB Paper no IFSB-10, 9 <https://www.ifsb.org/published.php> accessed 27 December 2019
\textsuperscript{852} JalaluEddin Bin Shash, \textit{Aqd Al-Jawahir Al-Thaminah fi Madh’hab Aa’lim Al-Madinah}, vol 2 (Dar Al-Gharb Al-Islami 2003) 832
\textsuperscript{853} Larry Ribstein, ‘Fencing Fiduciary Duties’ (2011) 91 Boston University Law Review 899, 906
\textsuperscript{855} Ministry of Trust and Islamic Affairs, \textit{Al-Mawso’ah Al-Fiqhiyyah}, vol 45 (Al-Muqahwy 2006) 89
\textsuperscript{856} Julian Velasco, ‘Fiduciary Duties and Fiduciary Outs’ (2013) 21 George Mason Law Review 157, 163
\textsuperscript{857} The fiduciary duty is usually enforced by law and failure to include it in the agreement does not affect this fact. According to Ribstien, ‘The fact that fiduciary duties are imposed by default rule rather than by explicit agreement should not take them out of the contractual realm.’ Larry Ribstein, ‘Fencing Fiduciary Duties’ (2011) 91 Boston University Law Review 899, 906
Consequently, SSB members are responsible towards the institution and shareholders for their decisions, reports and rulings and any violation of the contractual agreement or breach of their fiduciary duties might incur their personal liability: for example, if a SSB member violates their professional ethics (e.g. knowingly discloses confidential information) or if they commit a professional wrong that causes harm to the institution or its shareholders, such as providing misleading information or fatwa, shareholders are entitled to call them to account and start legal proceedings against them. Aldohni confirms that when SSB members are seen as fiduciaries, ‘they will be subjected to the same legal standards applied to directors while executing their duties. Therefore, should they fail to implement Islamic governance agenda then they can be held accountable’. 858

4.4.7.3 Accountability of Shariah members in Shariah:
A. General accountability:

Muslims believe that they are accountable to God and that they will be held accountable for their deeds on the Day of Judgment. 859 This accountability lies in their responsibility to adhere to the rules of Shariah, including performing their duties with integrity and honesty. 860 It is considered the highest accountability to Muslims and the basis of every other worldly accountability. Therefore, for Muslims, this should be the most powerful impulse that urges them to follow Shariah strictly and to do what pleases God and avoid what angers Him. Accordingly, following the rules of Shariah, a SSB member should exercise their duties with honesty and integrity and

858 Abdul Karim Aldohni, ‘Islamic Financial Institutions and Corporate Sustainability: A Study of Oman, Dubai and Malaysia’ in Beate Sjåfjell and Christopher Bruner (eds), The Cambridge Handbook of Corporate Law, Corporate Governance and Sustainability (Cambridge University Press 2019) 501
859 Allah Almighty says in the Holy Quran, Surah Al-Imran, Chapter 3, Verse 30, ‘The Day every soul will find what it has done of good present [before it] and what it has done of evil, it will wish that between itself and that [evil] was a great distance. And Allah warns you of Himself, and Allah is Kind to [His] servants.’ Saheeh International (tr), The Qur’an (3rd edn, Al-Muntada Al-Islamy Trust 2010) 70. Prophet Muhammad (PBUH) said, ‘All of you are guardians and are responsible for your subjects. The ruler is a guardian of his subjects, the man is a guardian of his family, the woman is a guardian and is responsible for her husband’s house and his offspring; and so all of you are guardians and are responsible for your subjects.’ Muhammad Bukhari, Sahih Al- Bukhari, vol 7 (Muhammad Khan (tr) Darussalam 1997), Hadith 5188
860 Allah Almighty describes the believers as, ‘They who are to their trusts and their promises attentive.’ The Holy Quran, Surah Al-Muminun, Chapter 23, Verse 8. Saheeh International (tr), The Qur’an (3rd edn, Al-Muntada Al-Islamy Trust 2010) 484. He also warns the believers from betrayal, ‘O you who have believed, do not betray Allah and the Messenger or betray your trusts while you know [the consequence].’ The Holy Quran, Surah Al-Anfal, Chapter 8, Verse 27. Saheeh International (tr), The Qur’an (3rd edn, Al-Muntada Al-Islamy Trust 2010) 244
provide sufficient effort and take due diligence in reaching their Shariah rulings.\footnote{Ahmad Al-Hanbaly, \textit{Sifat Al-Fatwa wa Al-Mufti wa Al-Mustafti} (4\textsuperscript{th} edn, Al-Maktab Al-Islami 1984); Yahya Addin Al-Nawawi, \textit{Adab Al-Fatwa wa Al-Mufti wa Al-Mustafti} (Dar Al-Fikr Publishing 1988)} However, due to the intangible nature of this accountability, it requires a strong belief in God and the consequences of disobeying Him to be effective. This is why the competent criteria for appointing a Shariah member should not only depend on the member’s knowledge of Shariah and \textit{Fiqh Al-Muamalat} but also their reputation and character.\footnote{Knowledge alone is not enough to allow a person to be involved in issuing a \textit{fatwa}; there are other requirements related to the personality, as shown earlier in the context of addressing the SSB members’ qualification. See C. Qualifications and competency in 2.2.1.2 Governance of SSB in Chapter Two.}

\textbf{B. The accountability of Shariah scholars with regard to providing Shariah rulings:}

First, it is important to highlight the fact that providing \textit{fatwa} without knowledge is prohibited in Shariah and the scholar who does not have sufficient knowledge in a specific matter should say ‘I don’t know,’ as stated by Ibn Al-Qayyim.\footnote{Ibn Al-Qayyim Al-Jouziyyah 1, \textit{I’laam Al-Muwaqqi’een an Rab Al-Alameen}, vol 1 (Dar Ibn Al-Jouzy Publishing 2002) 35. See also Mansour Al-Bahoti M, \textit{Sharh Muntaha Al-Iradat}, vol 6 (Al-Risala 2000) 458} However, even with knowledge, mistakes may happen. Therefore, Islamic jurisprudence addresses the case of providing an incorrect \textit{fatwa} and its remedy as follows.

\textbf{a. Providing an incorrect \textit{fatwa}:}

If this mistake is due to the \textit{mufti}'s lack of competency, or they are competent but did not contribute with sufficient care in reaching the \textit{fatwa}, then they have committed wrongdoing under the rules of Shariah.\footnote{Prophet Muhammad PBUH said: ‘… Then the people will take ignorant ones as their leaders, who, when asked to deliver religious verdicts, will issue them without knowledge, the result being that they will go astray and will lead others astray.’ Muhammad Al-Qazwini, \textit{Sunan Ibn Majah}, vol 1 (Nasiudin Al-Kattab tr, Darussalam 2007), Hadith 52. See also, Yahya Addin Al-Nawawi, \textit{Al-Majmou}, vol 1 (Maktabat Al-Irshad 1980) 79} However, if the \textit{mufti} is competent and contributed with the needed care and still reached a wrong \textit{fatwa} then they are not seen as a wrongdoer. On the contrary, they will be rewarded hereafter for their diligence.\footnote{Prophet Muhammad (PBUH) said, ‘If a judge gives a verdict according to the best of his knowledge and his verdict is correct (i.e. agrees with Allah and His Apostle's verdict) he will receive a double reward, and if he gives a verdict according to the best of his knowledge and his verdict is wrong, (i.e. against that of Allah and His Apostle) even then he will get a reward.’ Muhammad Bukhari, \textit{Sahih Al-}}
b. Actions to be taken by mufti and mustafii in relation to an incorrect fatwa:

If a mufti acknowledges that they have reached an incorrect opinion, they are then obliged to go back on it and not to provide it again in a similar situation in the future. They should also inform the mustafii of its inaccuracy before they apply it. According to Al-Nawawy, the mustafii should be informed even if they applied the wrong fatwa because the mufti now believes that it is incorrect. According to Judge Abu Ya’ly, if a mufti reached their opinion by diligence and then after consideration changed their opinion, they are not obliged to inform the mustafii if the latter has already applied the first opinion.

c. The effects of an incorrect fatwa:

1. If a mufti in their fatwa contradicted an explicit verse in the Quran or Sunnah, a consensus, or evident reasoning, then the impact of this incorrect fatwa should be undone. For example, if the subject of the fatwa is sale, then the transaction should be revoked; if marriage, then the couple should be separated; and if money was received, then it should be returned.

2. If the incorrect fatwa was reached by diligence and the mufti changed their opinion, then the person who followed and applied their first fatwa is not obliged to undo its impact. This is based on the rule that ‘diligence is not repealed by diligence’ in Shariah. The evidence for this rule is drawn from an incident that happened with Caliph Umar Ibn Al-Khattab when he changed his opinion in two similar cases. Nevertheless, some of Al-Shafi’ei and Al-Hanbali scholars exclude marriage from this rule.

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Bukhari, vol 9 (Muhammad Khan (tr) Darussalam 1997), Hadith 7352. A Shariah scholar is in a similar position as when providing a Shariah ruling.

666 Caliph Umar Ibn Al-Khattab said, ‘Let nothing prevent you from changing your previous decision if after consideration you feel that the previous was incorrect.’ Ibn Al-Qayyim, Al-Jouziyyah I, I’laam Al-Muwajjifeen an Rab Al-Aameen, vol 2 (Dar Ibn Al-jouzy Publishing 2002) 185-159. See also Ministry of Trust and Islamic Affairs, Al-Mawso’ah Al-Fiqhiyyah, vol 32 (Dar Al-Safwa 1995) 44

667 This is what was scholars of the first Islamic generation used to do. Abdulrahman Ibn Al-Jouzi, Ta’heem Al-Futia (Al-Dar Al-Athariyah 2006) 91

668 Yahya Addin Al-Nawawi, Al-Majmou, vol 1 (Maktabat Al-Irshad 1980) 79

669 Abdulrahman Ibn Al-Jouzi, Ta’heem Al-Futia (Al-Dar Al-Athariyah 2006) 91

670 This rule is explained in detail by Imam Al-Sayouty. Please see Jalaluddin Al-Syouti, Al-Ashbah wa Al-Naza’er (Dar Al-Kotob Al-Ilimiyah 1983) 101. See also Yahya Addin Al-Nawawi, Al-Majmou, vol 1 (Maktabat Al-Irshad 1980) 79

671 For more details, see Ministry of Trust and Islamic Affairs, Al-Mawso’ah Al-Fiqhiyyah, vol 32 (Dar Al-Safwa 1995) 44

672 Ministry of Trust and Islamic Affairs, Al-Mawso’ah Al-Fiqhiyyah, vol 32 (Dar Al-Safwa 1995) 44
d. Remedy for an incorrect fatwa:

There is an apparent disagreement among leading Muslim schools of thought on the mustafti’s right to compensation if they damage something in the application of an incorrect fatwa.

First: Al-Maliki’s opinion. 874 (a) If a mufti reaches their fatwa by diligence, then they do not need to reimburse the damage. (b) If they copy the opinion of another scholar and they follow it themselves, then they should reimburse the damage. (c) If the mufti is unknowledgeable and yet they provide fatwa, then they need to be disciplined.

Second: Al-Shafiei’s opinion. 875 A mufti should reimburse the damage if they are a qualified scholar to provide fatwa and vice versa because the mustafti should bear the responsibility of asking an unqualified scholar. 876

Third: Al-Hanbali’s opinion. A Mufti is obliged to reimburse the damage if they are an unqualified scholar and vice versa. 877 This is because the mufti, in this case, has shammed the mustafti with their ability to provide fatwa. 878

Given the previous illustration of the SSB members’ accountability, it can be seen that a Shariah scholar is responsible for their acts and wrongdoings in both law and Shariah; more specifically, they can be held personally responsible if they breache their fiduciary duties. The only unusual opinion in Shariah is that of Al-Shafi’ei school where an unqualified mufti is not affected by providing an incorrect fatwa and the responsibility is borne by the mustafti. Therefore, it can be said that shareholders of an IFI can challenge the SSB members in courts and hold them accountable for their acts if they breach any of their contractual, statutory or fiduciary duties. It is then expected that if a SSB member did not take due diligence in providing Shariah rulings that caused harm to the institution, shareholders have the right to hold them accountable for breaching their duty of care. Similarly, if a SSB member misused any confidential information acquired in the course of their

874 Muhammad Al-Desouqi, Hashiyat Al-Desouqi ala Al-Sharh Al-Kabeer, vol 1 (Dar Ihya’ Al-Kotob Al-Arabiyah) 20
875 Ministry of Trust and Islamic Affairs, Al-Mawsu’ah Al-Fiqhiyyah, vol 32 (Dar Al-Safwa 1995) 45
876 Al-Nawawi said this is the opinion of the Shafi’i scholar Aby Is’haq Al-Isfaryeeny. Yahya Addin Al-Nawawi, Al-Majmou, vol 1 (Maktabat Al-Irshad 1980) 79
877 This is based on the analogy of the unqualified doctor ruling. Prophet Muhammad (PBUH) said, ‘Whoever gives medical treatment, with no prior knowledge of medicine, is responsible for any harm done.’ Mohammed Al-Qazwini M, Sunan Ibn Majah, vol 4 (Nasiudin Al-Kattab tr, Darussalam 2007) Hadith 3466
878 Ministry of Trust and Islamic Affairs, Al-Mawsu’ah Al-Fiqhiyyah, vol 32 (Dar Al-Safwa 1995) 45
appointment, they will be held accountable for misappropriation. However, if a SSB member did take the due diligence in reaching their opinion and still provided an incorrect fatwa that caused harm to the institution, they should not be asked to reimburse the damage in application of Shariah rules. This is an example of fatwa risks that should be managed and taken into account by the institution. The right to sue SSB members is an essential right of shareholders in SCG that empowers their stewardship. It would also change the current trend that makes Shariah scholars immune from legal proceedings.  

All the previous rights are classified under the ‘voice’ rights of shareholders, which can help them to express their dissatisfaction with the company or approach the competent authority or the courts to seek more protection of their interests. However, in some situations, these voice rights become useless in protecting the interests of shareholders, for example, in the case of minority shareholders who do not have the power to impact the management’s decisions, or when the management is not cooperating with the concerned shareholders to rectify the raised problems. In such situations, dissatisfied shareholders will most likely choose to use their ‘exit’ right. The right to exit an IFI for non-Shariah-compliance issues is the final right of shareholders that is addressed in this section.

4.4.8 The right to exit an IFI due to non-Shariah compliance issues:

Significant changes could occur to the institution that might affect the interests of shareholders. Therefore, unhappy shareholders should have the right to dissent and exit with fair conditions. As a matter of protecting shareholders in the event of a merger, consolidation, or takeover or when bringing about a change in the nature of the company’s business, some jurisdictions establish the right to dissent in favour of a minority of shareholders, which gives them the right to receive the cash value of their shares.

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Aishath Muneeza and Rusni Hassan, ‘Shari'ah Corporate Governance: The Need for a Special Governance Code’ (2014) 14 Corporate Governance 120, 127–128
Hirschman observes that managements find out about its failings via two routes: (a) shareholders leave the firm (the exit option); or (b) shareholders express their dissatisfaction through different means (the voice option). Albert Hirschman, Exit, Voice and Loyalty: Responses to Decline in Firms, Organisations, and States (Harvard University Press 1970) 4
Benjamin Robinson, ‘Dissenting Shareholders: Their Right to Dividends and the Valuation of Their Shares’ (1932) 32 Columbia Law Review 60
shares or the right for an appraisal under court supervision in the case of disagreement.883

In the context of Islamic finance, shareholders of an IFI should be informed and given the opportunity to approve or reject decisions concerning fundamental corporate changes, which might affect their interest in the institution, and especially its Shariah compliance. These changes include, but are not limited to, the amendment of the AoA, extraordinary transactions (such as the sale of all or substantial amount of the corporate assets), mergers, consolidation, takeover or dissolution. This is based on the company’s obligation to respect the legal arrangement accepted by those who deal with it. Shariah also sets the same rule. In Shariah, this is seen as a matter of contract termination, which is permissible in certain circumstances. The original rule is that Muslims should fulfil their contracts884, however, termination of contract is also permissible if both parties agree to it or if one party breaches the contract where the other party raises the matter to the court and asks for contract termination.885 Therefore, in Shariah, termination can be done by mutual agreement or by one party exercising one of their remedies due to the fault of the other party.

It is envisaged that merger or takeover might affect the IFIs’ Shariah compliance positively or negatively. Positively, if the IFI merges with or is acquired by another IFI that has a higher level of Shariah compliance; in this case, shareholders should face no problem. However, the change could affect an IFI negatively if it merges with or is acquired by another IFI that has a lower level of Shariah compliance, or even terminates its Shariah compliance entirely if it merges with, or is acquired by, a conventional institution (the same thing applies for consolidation). In the latter case, shareholders who are interested in Shariah compliance should not be forced to continue in an institution that has become significantly different from the one they originally joined, even if the shares’ value has not been reduced. According to MacIntosh, the protection sought by shareholders in the face of fundamental changes does not always have to be due to impairment of the shares’ value: for


884 Allah Almighty says in the Holy Quran, Surah Al-Ma’idah, Chapter 5, Verse 1, ‘O you who have believed, fulfil [all] contracts.’ Saheeh International (tr), The Qur’an (3rd edn, Al-Muntaada Al-Islamy Trust 2010) 141

885 Ministry of Trust and Islamic Affairs, Al-Mawso’ah Al-Fiqhiyyah, vol 32 (Dar Al-Safwa 1995) 133
example, they may desire protection against changes in the risk of the business without affecting the value of securities.\textsuperscript{886} 

Therefore, in the case of a merger or consolidation or a takeover that negatively affects an IFI’s level of Shariah compliance, shareholders of that IFI should be given the right to dissent, which allows them to withdraw their investment and receive the value of their shares or to raise the matter to the court for an appraisal if no agreement can be reached. Moreover, even without a merger, consolidation or a takeover, it would seem more appropriate to award a dissenting right to shareholders if an IFI has not fulfilled a certain level of Shariah compliance according to the institution’s annual Shariah compliance report.

The previous section of the chapter illustrated the power of shareholders in IFIs, their interest in Shariah compliance and their rights in SCG, which provides the theoretical justification for choosing them as a supporting solution to help with enhancing SCG. The following section is dedicated to a practical exploration of shareholders in IFIs and their rights in the three jurisdictions covered by the study - Malaysia, Kuwait and the UK - to get a better understanding of their powers and rights in practice.

4.5 Shareholders of IFIs in Malaysia, Kuwait and the UK:

Addressing the ownership structure of IFIs in Malaysia, Kuwait and the UK requires examining the type of their ownership, whether it is concentrated or dispersed, and the identity of the controlling shareholder, whether it is a foreigner, family, institution or state. According to Sheehan, it is important to know the identity of the controlling shareholders, as it is possible that the motivation for concentrated ownership differs from one shareholder to another.\textsuperscript{887} The ownership structure of IFIs in Malaysia, Kuwait and the UK has been found from the information available in the annual reports and websites of IFIs, and the stock exchange in these countries about their top shareholders, as shown in Table Two in Appendix Two.

In Malaysia, the ownership structure of public companies is highly concentrated in general. As for IFIs specifically, according to Abbas Abdul Rahman and Mahenthrian, they are ultimately owned by the government, followed by foreign, family and institutional ownership. The ownership of IFIs is highly concentrated with more than 80% equity being held by the top ten shareholders. This is seen clearly, for example, in the ownership of Hong Leong Bank Berhad, where the top six shareholders hold 80% of the bank’s shares with an ultimate controller that owns more than 55% of the shares. Ownership of Bank Muamalat Malaysia Berhad is more concentrated as all shares are held by two shareholders only, with 70% of shares owned by the top shareholder. Bank Islam Malaysia Berhad provides the highest rate of ownership concentration as 100% of its shares is held by a single shareholder, which is the bank’s parent company. Shareholders of Islamic banks in Malaysia are mostly local, state-owned institutions and large companies; however, foreign investment is also seen in these banks. In general, most Islamic banks in Malaysia are local but there are also a good number of foreign banks (slightly more than 1:2).

The ownership structure of Islamic banks in Kuwait is similar to Malaysia, as they have concentrated ownership with an ultimate owner, either a government-owned institution or a large company. For example, the major shareholders of KFH are four government-owned institutions that hold almost 50% of the bank’s equity,

and the ultimate owner owns more than 24% of the shares.\textsuperscript{895} Similarly, 50% of the equity in Warba Bank in Kuwait is held by the top four shareholders (two state-owned institutions, one large company and an individual) and the ultimate controller owns more than 25% of shares.\textsuperscript{896} Ownership is further concentrated in Boubyan Bank in Kuwait as 70% of its shares is owned by only two large companies and the ultimate controller owns over 59% of the bank’s shares.\textsuperscript{897} Foreign investment in Islamic banking is also allowed in Kuwait\textsuperscript{898}, but the ratio of foreign Islamic banks is less than Malaysia as Kuwait has only one foreign Islamic bank alongside five local Islamic banks.\textsuperscript{899}

Similar to Malaysia and Kuwait, the ownership of Islamic banks in the UK is also highly concentrated with a single controller and key shareholders that are institutions and large companies. For example, Al-Rayan Bank has only one key shareholder that holds 98% of the bank’s shares, which is the bank’s parent company.\textsuperscript{900} As for the BLME, five shareholders own almost 50% of the shares with a controller that holds over 20% of the shares.\textsuperscript{901} However, it is noticed that although Islamic banks in the UK are all incorporated in the UK\textsuperscript{902}, they have a high foreign

\textsuperscript{898} In the past, Kuwait’s laws used to set a restriction on foreign investment, as a foreign investor was not allowed to own more than 49% of a company’s shares. However, in 2013, after issuing Law No. 116 of 2013 Regarding the Promotion of Direct Investment in the State of Kuwait, this restriction was removed. Accordingly, a foreign investor in Kuwait can own up to 100% of any company in any industry, with a few exceptions related to national security. See Law No. 116 of 2013 Regarding the Promotion of Direct Investment in the State of Kuwait, Article 12. As for the exceptions, see Council of Ministers, ‘Council of Ministers Decision No. (75) of 2015 Regarding the List of Excluded Direct Investments from the Provisions of Law No. (116) of 2013 regarding the Promotion of Direct Investment in the State of Kuwait’ (January 2015) <https://www.kdipa.gov.kw/en/laws-2/> accessed 31 December 2019
\textsuperscript{899} Central Bank of Kuwait, Islamic Finance in Kuwait: Broadening Horizons (Thomson Reuters, 2018) 4
\textsuperscript{901} Please see BLME, ‘Key Shareholders’ <https://www.blme.com/about-blme/investor-relations/corporate-governance/key-shareholders/> accessed 30 December 2019
\textsuperscript{902} See Bank of England, ‘List of Banks as Compiled by the Bank of England as at 31st August 2019’ <https://www.bankofengland.co.uk/-/media/boe/files/prudential-
investment rate, mostly from Islamic countries. For example, all key shareholders of BLME are state-owned institutions and large companies from Kuwait. This is in contrast to the local Islamic banks in Kuwait and Malaysia, where their key shareholders are mostly locals.

It is also noted that the investment of IFIs in each other is prevalent. For example, four of the five key shareholders of BLME are IFIs and Islamic investment companies. Nevertheless, shareholding by conventional financial institutions is also detected in IFIs. A striking example is the substantial shareholding of two conventional banks in Boubyan Bank in Kuwait. The national bank of Kuwait holds a controlling stake of 59.9% and the Commercial Bank of Kuwait comes next with a 9.7% holding. From Malaysia, Great Eastern Life Assurance Co (a conventional insurance company) owns 1% of the Islamic bank Hong Leong Bank Berhad. However the most obvious example is the full ownership of Affin Islamic Bank Berhad by its parent conventional bank.

Accordingly, the final outcome reached from this point is that IFIs in Malaysia, Kuwait and the UK have concentrated ownership with a single controller. As for the identity of the shareholders, they are usually state-owned institutions and large companies that can be local or foreign. This confirms the outcome of the two studies referenced at the start of this chapter in the context of addressing the ownership structure of IFIs in literature. Therefore, IFIs in the examined jurisdictions have large shareholders who own a controlling stake that enables them to influence the IFI’s direction and its corporate governance policy. These large shareholders are expected to be interested in the Shariah compliance of IFIs for the same reasons that were explained earlier in this chapter. However, the question arises here, do they have the shareholders’ rights determined above? The following point provides an answer to this question.

907 See Affin Islamic Bank Berhad Annual Report (2018) 80
4.6 Rights of shareholders in Malaysia, Kuwait and the UK:

This section addresses the rights of shareholders in Malaysia, Kuwait and the UK in the light of the ideal system of rights of shareholders in SCG proposed earlier in this chapter.

4.6.1 Malaysia:

As seen in Chapter Three, Malaysia applies a centralised model of SCG where SCG in IFIs is strictly regulated and supervised. Due to this strict regulation and supervision, Shariah compliance is legally protected and ensured according to the country’s definition of Shariah compliance and hence shareholders do not need to engage intensively with their IFIs to protect their interest in Shariah compliance. However, there is always scope for improvement in order to reach complete Shariah compliance that meets both the legal requirements and the spirit of Shariah. This strict regulation has its effect on the rights attributed to shareholders in SCG and, therefore, as will be seen below, shareholders in IFIs in Malaysia are entitled to some rights but not others.

First, with regard to the shareholders’ control right related to the appointment of SSB members, shareholders in Malaysia have the right to vote in the general meetings in general\(^\text{908}\), but they are not given the right to vote on the appointment of SSB members. According to the Guidelines on the Governance of Shariah Committee, SSB members are appointed and reappointed by the BoD upon the recommendation of the nominee committee after obtaining approval from the Central Bank.\(^\text{909}\) They are then officially appointed by the Central Bank.\(^\text{910}\) The qualification requirements for SSB members are stated in the Guidelines, but there is no obligation of the IFI to disclose them to shareholders.\(^\text{911}\) Not giving shareholders the right to vote on the SSB members’ appointment in IFIs could be because their appointment is certified by the Central Bank as the national financial supervisor. This prior approval

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\(^{908}\) Companies Act 2016, Section 71(1) (Malaysia)

\(^{909}\) Guidelines on the Governance of Shariah Committee for the Islamic Financial Institutions (BNM/RH/GL/012-1), Section 8 (Malaysia).


\(^{911}\) Guidelines on the Governance of Shariah Committee for the Islamic Financial Institutions (BNM/RH/GL/012-1), Section 11, 12 and 13 (Malaysia). See also Shariah Governance 2019 (BNM/RH/PD 028-100), Section, Section 12 (Malaysia)
is expected to provide assurance that every nominated scholar meets the qualification requirements, and therefore, all the nominated scholars are equally qualified. However, it should be noted that there might be some aspects other than those stated in the Guidelines that affect the decision of appointing a SSB member, such as those related to the character and reputation of the scholar. Hence, it is believed that shareholders still need to be given the opportunity to discuss and choose the members of the SSB in the AGM. Another gap in the rights of shareholders in Malaysia is related to their right to discuss and approve the remuneration of SSB members. It is not apparent from the Malaysian Shariah governance guidelines and regulations that shareholders of IFIs are entitled to this right. The Guidelines only confirm the SSB members’ right to receive remuneration determined by the BoD without mentioning any right of shareholders to have a say about it.912

The requirements for information disclosure stated in the Guidelines on Financial Reporting for Licensed Islamic Banks say more about the shareholders’ rights in IFIs as they determine the essential information that needs to be disclosed by IFIs. In the statement of corporate governance, an IFI should disclose information about its risk management framework for managing and controlling a wide range of banking risks, including the Shariah non-compliance risk.913 The directors’ report should include information about the roles and authority of the SSB and the institution’s responsibility towards payment of zakat.914 As for the SSB report, it should include the opinion of the SSB on the institution’s compliance with Shariah principles.915 Finally, in the financial statement, the institution should disclose the remuneration of the SSB members.916 These disclosure requirements provide the majority of information in which the shareholders are interested. However, they are still lacking. There is no legal obligation on an IFI to disclose the following information: (a) the qualifications of SSB members; (b) whether or not the IFI will pay the shareholders’ zakat; (c) the IFI’s philanthropy and choice of money

912 Guidelines on the Governance of Shariah Committee for the Islamic Financial Institutions (BNM/RH/GL/012-1), Section 21(g) (Malaysia)
915 Guidelines on Financial Reporting for Licensed Islamic Bank (BNM/RH/GL/002-2), Part 2, Shariah Committee’s Report, Section 9. See also Shariah Governance 2019 (BNM/RH/PD 028-100), Section 22.1
distribution. Concealing this information will reduce the ability of shareholders to practise their right of inquisition and engage with the IFIs.\textsuperscript{917}

With regard to the shareholders’ right to take legal proceedings against SSB members, the Malaysian SCG regulations set some rules that govern the SSB members’ accountability that confirms their personal accountability for their acts and opinions. First, the 2019 Shariah Governance Framework emphasises the accountability of the SSB for the quality, accuracy and soundness of its decisions and views and this accountability remains, even in case of delegation.\textsuperscript{918} The accountability of SSB is strengthened in the IFSA Act of 2013 with the enforcement of criminal sanctions for committing any act that contravenes Shariah compliance in the IFI.\textsuperscript{919} Yossuf refers to this provision to give evidence that SSB members in an IFI can be sued for providing a wrong decision on Shariah compliance.\textsuperscript{920} In addition, shareholders can always resort to the general rules in the Malaysian Companies Act to protect their interest in Shariah compliance. Accordingly, shareholders can bring legal actions for themselves or on behalf of the IFI for any Shariah-non-compliant act committed by the IFI. They can sue the SSB members directly on behalf of the IFI if they are responsible for this issue and the IFI did not take legal actions against them under the ‘derivative proceedings' section.\textsuperscript{921} It is worth mentioning that the rules of a derivative claim in Malaysia do not provide clear guidance to shareholders about the grounds for pursuing a claim. However, it was accepted in the courts that a breach of directors’ fiduciary duties could form the ground for a derivative action.\textsuperscript{922} In addition to filing a derivative claim, shareholders can also sue the IFI itself if the wrongdoing is seen to be a result of running the institution’s affairs in a manner oppressive to the

\textsuperscript{917}Shareholders in Malaysia have the right to attend, practice and speak at the AGM. Companies Act 2016, Section 71(1) (Malaysia). They also have the right to be given ‘a reasonable opportunity at the meeting to question, discuss, comment or make recommendation on the management of the company’. Companies Act 2016, Section 195 (Malaysia)

\textsuperscript{918}See Shariah Governance 2019 (BNM/RH/PD 028-100), Sections 10.3 and 10.8 (Malaysia)

\textsuperscript{919}According to Section 29 (1), (3) and (6) of the IFSA Act, a SSB member may be held liable and imprisoned for no longer than eight years or given a large fine or both for contravening the Shariah compliance of an IFI. Note that Shariah compliance here refers to the compliance with the Shariah standards issued by the Central Bank in accordance with the advice or rulings of the national Shariah council. See Islamic Financial Services Act, Section 29 (1) (Malaysia)


\textsuperscript{921}See Companies Act 2016, Section 347 (Malaysia)

shareholders’ interests under the Companies Act (Section 346) which provides an ‘oppression remedy’. In this regard, Lord Wilberforce in *Re Kong Thai Sawmill (Miri) Sdn. Bhd. and others v Ling Beng Sung* clarifies the law, stating that ‘there must be a visible departure from the standards of fair dealing and a violation of the conditions of fair play which a shareholder is entitled to expect before a case of oppression can be made’.

Finally, with regard to the shareholders’ right to exit an IFI due to a substantial change that affected its level of Shariah compliance, there is no direct rule that regulates this issue in the guidelines and regulations of SCG in Malaysia. However, Ying confirms that shareholders in Malaysia have the traditional right to sell their shares to express their dissatisfaction at the company’s performance. In general, shareholders under the Capital Markets And Services Act 2007 have this right in the case of a takeover offer. Therefore, where a takeover offer has been made to an IFI that might reduce or diminish its Shariah compliance, shareholders interested in Shariah compliance might be able to exit the IFI and surrender their shares on the terms of the takeover offer or such other terms as may be agreed. However, according to Hishammuddin and Gledhill, in Malaysia, ‘there are no appraisal rights afforded to shareholders under law. Such rights may be provided for under the constitution of private companies’. Also, it is noticed that the Capital Markets and Services Act 2007 only confers the right to exit the company in the event of a takeover, and so it is not clear whether shareholders have this right in the event of a merger or any other substantial change to the IFI’s objectives or nature of work.

4.6.2 Kuwait:

SCG is also regulated in Kuwait but less intensively than in Malaysia as it follows a decentralised model. Accordingly, it was seen that the rules of SCG are not as detailed and properly regulated as the rules in Malaysia. Nevertheless, the rights conferred on shareholders in relation to SSB members are greater than those of

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923 See Companies Act 2016, Section 346 (Malaysia)
924 See *Re Kong Thai Sawmill (Miri) Sdn Bhd and others v Ling Beng Sung* [1978] 2 MLJ 227, 4
926 Capital Markets and Services Act 2007, Sections 222–224 (Malaysia)
928 See 3.6.2 Kuwait in Chapter Three.
conferred on shareholders in Malaysia. For example, in Kuwait, shareholders have the right to appoint and remove SSB members and to have a say in their remuneration. They also have the right to approve any case of conflict of interests related to the SSB members’ appointment. This could be attributed to the fact that IFIs under the decentralised model depend heavily on SSBs to ensure their Shariah compliance with a lenient national supervision. Therefore, it is essential that shareholders are able to engage with their appointment and pay in order to ensure their independence.

With regard to the shareholders’ right of information related to the Islamic banks’ SCG, Islamic banks are obliged to issue an annual Shariah compliance report that should include the extent of the bank’s Shariah compliance, the work conducted by the SSB throughout the financial year, any Shariah non-compliant incident, and the number of the SSB’s meetings and each member’s attendance. Moreover, each Islamic bank is obliged to publish the Shariah rulings of its SSB. These disclosure requirements are fundamental, especially the work of SSB members, their meetings, attendance and their Shariah rulings, which will help shareholders to practise their right of inquisition in order to discuss the work of the SSB and its Shariah rulings. However, the requirements fail to include the SSB members’ remuneration, the number of their memberships, especially given that a Shariah member can serve three local Islamic banks simultaneously, the bank’s policy for Shariah non-compliance risk management, the payment of shareholders’ zakat, the banks’ philanthropy, and the choice of money distribution. This means that there is no legal obligation on Islamic banks in Kuwait to inform shareholders about the aforementioned aspects of

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929 Instructions on Shariah Supervisory Governance for Kuwaiti Islamic Banks 2016, Chapter 3, Principle 1, Section 1(5) and Section 3(First) and (Ninth)
930 Instructions regarding Shariah Supervision Governance in Kuwait Islamic Banks 2016, Chapter 3, Principle 2
932 Instructions on Shariah Supervisory Governance for Kuwaiti Islamic Banks 2016, Chapter 3, Principle 1, Section 3(3), (Fifth) and (Tenth)
933 Instructions regarding Shariah Supervision Governance in Kuwait Islamic Banks 2016, Chapter 2, Section 3
934 It is acknowledged that shareholders in Kuwait are entitled to determine the SSB members’ pay and, therefore, one might say that this information is known to them. However, according to the Shariah governance rules, shareholders can also delegate this issue to be determined by the BoD. Therefore, this disclosure remains important for shareholders, especially to enable them to provide an informed decision about the SSB members’ reappointment.
935 Instructions on Shariah Supervisory Governance for Kuwaiti Islamic Banks 2016, Chapter 3, Principle 1, Section 3(Second)
SCG.

As for the right to bring a claim, SCG rules in Kuwait, in the same way as those in Malaysia, also confirm the SSB members’ responsibility for their Shariah opinions. They also emphasise their duty of confidentiality. However, SCG rules in Kuwait do not include a direct criminal or civil penalty that could be applied to SSB members or directors in the event of contravening Shariah non-compliance by an Islamic bank, as in Malaysia. However, they can be subject to the penalties prescribed in the general rules regulating the fiduciary relationship in the Civil Law. According to these rules, shareholders are able to sue SSB members and directors for any breach of their fiduciary duties. The liability, however, is only civil - it requires the payment of compensation to reimburse any damage. Therefore, providing an incorrect Shariah ruling can only give rise to the SSB member’s civil liability, even if their act reduces Shariah compliance in an Islamic bank, in contrast to the case in Malaysia as seen above. The difference in the SSB member’s duty between the two countries might justify this contrast in the penalties as the SSB members in Malaysia have to comply with the Shariah rulings of the centralised board so there should be no room for providing a wrong fatwa, while the SSB members in Kuwait issue their own Shariah rulings. However, in this context, Kuwait comes the closest to applying the rules of Shariah, as a Shariah scholar can only be held civilly liable for providing a wrong fatwa, as seen earlier in this chapter. Moreover, as in Malaysia, shareholders in Kuwait have the right to sue the board on behalf of the company for any shortcomings in running the business. In addition, each shareholder has the right to ask for a personal remedy if they were personally affected by the wrongdoing.

Finally, it is not very clear from Kuwaiti laws whether shareholders have the right to exit an IFI in the case of a significant change that affected its level of Shariah compliance. However, in general, according to the Capital Markets Authority Act, in the case of a merger or acquisition, unhappy shareholders have the right to submit an objection to the Authority explaining their reasons and the Authority shall decide on

936 Instructions on Shariah Supervisory Governance for Kuwaiti Islamic Banks 2016, Chapter 3, Principle 1, Section 3(1)
937 Instructions on Shariah Supervisory Governance for Kuwaiti Islamic Banks 2016, Chapter 3, Principle 4
938 Law no 67 of 1980 Regarding the Civil Law, Articles 704 to 710 (Kuwait)
939 Law no 1 of 2016 on the Promulgation of the Companies Law, Article 204 (Kuwait)
940 See 4.4.7.3 Accountability of Shariah members in Shariah in this chapter.
941 Law no 1 of 2016 on the Promulgation of the Companies Law, Article 203 (Kuwait)
942 Law no 1 of 2016 on the Promulgation of the Companies Law, Article 204 (Kuwait)
the grievance.\(^{943}\) If shareholders are still not happy with the Authority’s decision, they can challenge this decision in court.\(^{944}\) Therefore, right of shareholders to dissent is available in Kuwait, but is it not clear whether it can be granted for Shariah non-compliance issues in IFIs. If the change is seen as significant to an IFI’s objective and nature of business, shareholders might have a good chance for their grievance to be accepted.

4.6.3 The UK:

As seen in Chapter Three, SCG is not regulated in the UK.\(^{945}\) Therefore, the above-mentioned rights of shareholders in SCG are all absent in their literal sense. Thus, in this context, shareholders depend mainly on the rights granted to them voluntarily by the IFIs. However, shareholders can always benefit from the general rights of shareholders stated in the country’s national laws.

Generally speaking, according to the UK Companies Act, all shareholders have the right to vote in the AGM (section 284) and the right of information and inspection with regard to several aspects of the company, such as the register of members (section 116), the directors’ service contracts (section 229), the minutes of the AGM (section 358), and the annual accounts (section 423). Extra particular rights are granted to shareholders with a specific percentage of holdings. For example, shareholders holding 5% of shares have the right to call a general meeting (section 303), shareholders holding 10% have the right to obtain an audit of the company’s accounts (section 476), shareholders holding 50% have the right to pass an ordinary resolution (section 282), and shareholders holding 75% have the right to pass a special resolution (section 283). As articulated by MacNeil, shareholders in the UK have decision-making rights, including approval of changes to the company’s constitution, approval of certain transactions and approval of an issue of shares; rights as to the appointment and removal of directors, even without having to show good cause for their removal; shareholding rights related to the equitable treatment of shareholders; and intervention rights including the rights stated above for shareholders with specific percentages of holdings.\(^{946}\) Moreover, as mentioned in

\(^{943}\) Kuwait Capital Markets Authority Executive Bylaws: Module 9, Article 3(12)

\(^{944}\) Kuwait Capital Markets Authority Executive Bylaws: Module 9, Article 3(12)

\(^{945}\) See 3.6.3 The UK in Chapter Three.

Chapter One and elaborated further in Chapter Three, the UK follows a shareholder approach, which puts the interests of shareholders first by placing a clear duty on directors to promote the success of the company for the benefit of its members but taking into account the concept of ‘enlightened shareholders value’.947

To some extent, these general rights, especially the right of information, right of inspection and the intervention rights, along with the duty of directors to promote the success of the company for its members, will provide shareholders of IFIs in the UK with the basic means for their activism. However, in order for their activism to be more productive and enhance the practices of SCG in their IFIs, they need to be equipped with the special SCG rights identified earlier in this chapter. Hence, the rights of shareholders related to SCG should be self-regulated and granted to shareholders by IFIs through enclosing them in the AoA, memorandum and shareholder agreement if necessary, as long as they do not violate the applicable national laws. More specifically, IFIs need to emphasise the rights related to the IFI’s Shariah compliance and SSB members; the right to appoint and remove SSB members; the right to discuss and approve their remuneration; the right to be provided with information about their background, work and multiple memberships, and Shariah rulings; and the right to be provided with information related to the IFI’s SCG policy, extent of Shariah-compliance and Shariah non-compliance risk management. Moreover, they need to be provided with information about their own zakat and the institution’s zakat and charitable activities.

Islamic banks in the UK tend to implement an SCG policy, however, it is not clear whether they grant their shareholders these rights. For example, the AoA of Al-Rayan Bank only include the general rights of shareholders, such as the right to call a general meeting and the right to speak and vote in the general meeting.948 However, none of the rights related to SCG are found. It is seen from the corporate structure of Islamic banks in the UK that they are committed to appointing a SSB949, however, it

947 See A. The shareholder theory: the product of the agency problem in 1.8.1.2 Theories of corporate governance in Chapter One, and 3.6.3.3 The UK Corporate Governance Code in Chapter Three.
is not clear in all cases whether shareholders are entitled to appoint the members. Al-Rayan Bank curtly mentions on its website that Shariah scholars are appointed by shareholders of an Islamic bank (without specification) in the context of answering frequently asked questions.\textsuperscript{950} It is worth mentioning that Article 2.2 of the 2010 AoA of Al-Rayan Bank has clarified that the SSB members shall be appointed by the directors only and can only be removed by them.\textsuperscript{951} However, this Article has been removed by the 2011 amendment of Al-Rayan Bank’s AoA.\textsuperscript{952} This is in contrast to the case of Gatehouse Bank, which clearly states that the SSB members are appointed ‘by the BoD, pursuant to the delegated authority of, and reporting directly to, the Bank’s shareholders’.\textsuperscript{953} Therefore, for the previous two banks, it appears that shareholders do not appoint the SSB members. The BLME, on the other hand, applies a different system. Its AoA provide that the shareholders shall engage and hire scholars for the SSB according to the qualifications determined by the BoD and approved by the shareholders.\textsuperscript{954} This confirms that shareholders in the BLME have the right to appoint SSB members and approve the criteria for their appointment.

As for the right of information related to Shariah compliance, it is seen that Islamic banks in the UK issue a Shariah-compliance report as part of their annual report, including a statement from the SSB on the bank’s extent of Shariah compliance. As for the information related to the payment of zakat, it is seen that the banks are committed to informing their shareholders whether or not they are going to


\textsuperscript{954} Article 115 of the BLME Articles of Association states that, ‘The company shall engage and hire eminent scholars who possess the requisite qualifications, as determined as the discretion of the board and approved by the company, to be appointed to the SSB.’ BLME, ‘Articles of Association of Bank of London and The Middle East’ (2016), Article 115<https://beta.companieshouse.gov.uk/company/05897786/filing-history?page=2> accessed 30 December 2019

With regard to the shareholders’ right to lodge a dispute against the SSB members or directors for issues related to the quality of the IFI’s Shariah compliance, shareholders can make use of the general rules of derivative claims and unfair prejudice remedies in the UK Companies Act 2006 that are similar to the rules in Malaysia and Kuwait, addressed above. However, more details can be given about these rules in the UK. When harm is inflicted on a company, it is long established in the common law, based on the rule in \textit{Foss v. Harbottle}, that: (a) the proper plaintiff for a wrong done to a company is the company itself in respect to the company’s separate personality from its shareholders and directors; and (b) in respect to the rule of majority and internal management principles, if the wrongdoing against the company can be ratified by the majority of shareholders then there is no ground for litigation about it by any individual shareholder.\footnote{Jenkins LJ states in \textit{Edwards v Halliwell}, ‘If, on the other hand, a simple majority of members of the company or association is against what has been done, then there is no valid reason why the company or association itself should not sue.’ Edwards v Halliwell [1950] 2 All ER 1064, 94 Sol Jo 803.} Also, there is a judicial reluctance to interfere in the companies’ business policies.\footnote{Alhassan Bawah, ‘A Comparison of the Statutory Provisions of the United Kingdom (UK) Companies Act 2006 and Ghana's Companies Act 1963 (Act 179), to the Rule in Foss v Harbottle’ (2019) 10 Beijing Law Review 153, 156} Accordingly, based on the rule in \textit{Foss v. Harbottle}, the right to bring a claim is only granted to the company itself and shareholders with a simple majority.\footnote{Alhassan Bawah, ‘A Comparison of the Statutory Provisions of the United Kingdom (UK) Companies Act 2006 and Ghana's Companies Act 1963 (Act 179), to the Rule in Foss v Harbottle’ (2019) 10 Beijing Law Review 153, 154} This means that individual shareholders are restricted from taking legal action against the wrongdoers, even if the wrong is a matter of irregularity or breach of the company’s regulations, as long it is approved by the majority.\footnote{Jenkins LJ states in \textit{Edwards v Halliwell}, ‘If, on the other hand, a simple majority of members of the company or association is against what has been done, then there is no valid reason why the company or association itself should not sue.’ Edwards v Halliwell [1950] 2 All ER 1064, 94 Sol Jo 803.} Nevertheless, this ban can be circumvented in some exceptional cases where an individual shareholder can take a derivative action in their own name
against the wrongdoer and obtain a corporate remedy. The exceptional circumstances are set out in Edwards v Halliwell as: (a) if the act complained of is ultra vires or illegal; (b) if it invades the personal and individual rights of a shareholder; (c) if it can be done or sanctioned by a special majority; or (d) if it amounts to a fraud on the minority. 961 These cases might not be seen as exceptions to the rule in Foss v. Harbottle, but as cases where there is no chance of confirmation by the majority. 962

Allowing shareholders to bring a derivative action is an essential defensive mechanism, especially when the wrongdoers are the directors, since they have the power to prevent any legal actions against them by the company. 963 At present, Part 11 of the UK Companies Act 2006, has given any individual shareholder the right to take derivative action in their own name but on behalf of the company to redress any wrong done to it. It has broadened the grounds on which a shareholder can bring a derivative claim to include actions ‘in respect of an actual or proposed act or omission involving negligence, default, breach of duty or breach of trust by a director of the company’. 964 Therefore, it is clear that a shareholder can pursue a derivative claim in respect to a breach of directors’ general duties set in the Companies Act (Chapter 2 Part 10). 965 In this regard, the UK has more explicit guidance for the courts and shareholders than the case in Malaysia and Kuwait. 966 Hence, when directors of an IFI do not take an action to rectify a non-Shariah-compliant issue or an act that leads to reducing the extent of the IFI’s Shariah compliance as part of their duty to achieve Shariah compliance, such as following an incorrect fatwa, shareholders (whether majority or individuals) might have ground for a derivative action. 967 This can also be

961 Edwards v Halliwell [1950] 2 All ER 1064, 94 Sol Jo 803
964 Companies Act 2006, Section 260(3) (UK)
967 It should be noted that, according to Article 261 of the UK Companies Act 2006, a shareholder must apply to the court for permission before proceeding with his derivative claim. The court then will decide whether or not to grant permission based on the disclosure of a prima facie case. In this regard, in 2008, two cases brought a derivative claim based on breach of directors’ fiduciary duties; however, in both cases, the court refused to grant permission to continue with the claim. See Mission Capital plc
applicable in the case where a SSB member breaches their fiduciary duties and the directors decide not to take any legal action against them.

Part 30 of the UK Companies Act 2006, relating to the protection of members against unfair prejudice, provides another ground for claims that might help shareholders in an IFI to dispute and enforce their personal rights of being part of a proper Shariah-compliant business. According to Sections 994 and 996 of this Part, a shareholder can protect their interests in a company through filing a petition to the court on the ground of being treated in an unfairly prejudicial way, where the court, if satisfied, has the authority to order the company to take action in a way that provides relief to the complaining shareholder, including the purchase of their shares. The main difference between the derivative claim and unfair prejudice is that a derivative claim is used for pursuing a corporate remedy, while filing an unfair prejudice petition is for seeking a personal remedy. However, a shareholder can commence both claims against the defendant if the claim has mixed grounds comprising of unfairly prejudicial conduct and corporate misconduct that is appropriate to a derivative claim, as happened in Clark v Cutland. In a number of cases, courts have accepted that a breach of directors’ fiduciary duties is unfairly prejudicial conduct as well.

Moreover, poor Shariah compliance could be seen as making a false statement about the Islamic products and services of an IFI, which might expose it to sanctions under the Consumer Protection from Unfair Trading Regulations 2008 for making false statements about the provisions of services. Similarly, making misleading or untrue representations of products or services in order to make money is an offence

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v Sinclair and another [2008] EWHC 1339 (Ch); Franbar Holdings Ltd v Patel and others [2008] EWHC 1534 (Ch)
968 Companies Act 2006, Sections 994 and 996 (UK)
970 Lady Justice Arden stated, ‘When the misappropriation came to light, Mr Clark commenced a derivative action on behalf of the company against the trustees to recover the monies which had been misapplied. Later he commenced unfair prejudice proceedings under section 459 of the Companies Act 1985. The derivative action was in due course consolidated with the unfair prejudice proceedings but it was in the latter proceedings that relief was ultimately granted.’ Clark v Cutland [2003] EWCA Civ 810, [2004] 1 WLR 783 [2]
971 For example, in ‘Re a Company (No. 008699 of 1985), the directors of the company provided advice as to the acceptance of competing bids. It was held that this was potentially a breach of the directors’ fiduciary duties and could constitute unfairly prejudicial conduct’. Julia Tang, ‘Shareholder Remedies: Demise of the Derivative Claim’ (2012) 1 UCL Journal of Law and Jurisprudence 178, 207
972 See the Consumer Protection from Unfair Trading Regulations 2008 (S.I. 2008/1277), regulations 5, 9 and 13 (UK)
under the Fraud Act of 2006.\textsuperscript{973} These are the options available to shareholders in the UK that might help in their attempt to resolve a dispute related to Shariah compliance in their IFI, however, it is always recommended that shareholders establish a shareholder agreement including provisions for dispute resolution, especially that there is a chance that the shareholders’ right to bring a claim using the previous mechanisms is limited or removed by contractual agreement.\textsuperscript{974} This is also important due to the problems that shareholders might face with their dispute in the English courts because of the interpretation of the term ‘Shariah’ and the lack of acceptance of its rules as the applicable law in English courts, as will be seen in the next chapter.

Finally, with regard to the shareholders’ right to exit an IFI due to a substantial change that affects its level of Shariah compliance, it is seen that the UK Companies Act, as is the case in Malaysia, confers the right to exit in general on shareholders in relation to a takeover offer (section 979 or 983). Any shareholder who is not happy with the offer is able to submit an application to the court and the court may order that: (a) the offeror is not entitled and bound to acquire the shares; or (b) that the terms on which the offeror is entitled and bound to acquire the shares shall be such as the court thinks fit (section 986 (1) or (3)). In this regard, the court may require consideration for a higher value than the value specified by the offer if it was unfair (section 986(4)). Therefore, where a notice is given to shareholders of an IFI about a takeover, the shareholder who thinks that the takeover is unfair and will affect their interest in Shariah compliance, can submit an application to the court explaining their reasons to exit the company.

The previous explanation indicates that none of the jurisdictions examined fully acknowledge the rights of shareholders in SCG. Therefore, shareholders’ rights and protection with regard to their interest in Shariah compliance in IFIs need to be strengthened in all of the three jurisdictions. It was noted that shareholders in Kuwait have more rights than those in Malaysia, but in both jurisdictions, shareholders are better equipped for their activism than shareholders in the UK. Nevertheless, as mentioned earlier, Shariah compliance in Malaysia is strongly protected and, therefore, the scope for the shareholders’ activism in this jurisdiction is narrow.

\textsuperscript{973} See Fraud Act 2006, Section 2 (UK)
\textsuperscript{974} See for example, with regard to the right of shareholders to file an unfair prejudice petition, Fulham Football Club (1987) Ltd v Richards [2011] EWCA Civ 855; Flanagan v Liontrust Investment Partners LLP [2015] EWHC 2171(Ch).
Having said that, it is still important that shareholders of IFIs in Malaysia, as in any other country, are equipped with all the rights determined in this chapter in order to be able to supervise the implementation of SCG in their institutions, even with the existence of strong national supervision. National supervision and shareholder supervision do not contradict each other, on the contrary, they are complementary. There is no doubt that national supervision is essential, however, this should not deny shareholders the opportunity to perform their own supervisory role. Moreover, shareholder supervision could be more effective than national supervision as shareholders are closer and more connected to their institutions and can apply more focused supervision. In addition, the investors’ decision to join an IFI could be affected by the number and quality of rights given to them.

Finally, with regard to shareholders in the UK, where the protection of their interest in Shariah compliance is inadequate and the scope for activism at its widest, the ownership structure of IFIs in the UK indicates that they are powerful, and therefore, can utilise their controlling power to protect their interest in Shariah compliance through self-regulation. The issue, on the other hand, will be challenging for minority shareholders in the UK when the controlling shareholders are not very keen to protect Shariah compliance in the IFI as will be seen in the next chapter.

4.7 Conclusion:

It was seen in this chapter that IFIs have powerful and controlling shareholders that are able to effect changes to the IFIs’ corporate governance system and business in general. It was also seen that Shariah compliance is one of the most important factors behind buying shares in IFIs. It is of significance to shareholders for different purposes. To some, it is important for religious reasons, to others, it is required for financial reasons, yet to others, it is demanded for legal reasons. In the end, all of them need to be assured of its effectiveness in IFIs. However, in order for shareholders to utilise their power and engage with their IFIs, they need to be equipped with several rights related to SCG that are different from the general rights of shareholders. As seen in this chapter, there are several rights that need to be recognised to shareholders in any SCG model, most importantly, the right of information related to the IFI’s Shariah compliance, the right to appoint and remove SSB members, the right to discuss and approve the SSB members’ remuneration, the right to discuss the work of the SSB and its Shariah rulings, and the right to bring
legal proceeding against the SSB members. Acknowledging these rights to shareholders in IFIs would result in a better SCG and better shareholder engagement.

Corporate governance policies of IFIs should highlight the difference in shareholders’ rights between the conventional and Islamic systems and therefore address them in a clear and more specific way. It is unfortunate to see that there are no specific rules in the legislation of the leading Islamic countries that provide clear and detailed provisions for the rights of shareholders in SCG, in the same way that there is for their basic and general rights. This gap might reflect negatively on the protection of shareholders’ interests and their active engagement in the IFIs. In Malaysia, although SCG is effectively regulated and strictly supervised, shareholders still need to be equipped with the rights mentioned in this chapter to ensure that compliance to Shariah rules and SCG regulations is factual and credible. These rights are even more important for shareholders in Kuwait, as the national supervision is not strong and the supervisory system has a number of defects. The need for these rights is at its highest for shareholders in the UK due to the absence of national supervision of SCG. Therefore, IFIs in the UK are strongly encouraged to self-regulate these rights by including them in the AoA, memorandum and shareholder agreement if necessary, as long as they do not violate the applicable national laws.

Having examined the character of shareholders in IFIs, their interest in Shariah compliance and their rights in SCG in theory and practice, the next chapter explains the active role they can play in the promotion of SCG and Shariah compliance in IFIs and the obstacles for their activims.
Chapter Five: Shareholder Activism in Shariah Corporate Governance

5.1 Introduction:

It was seen in the previous chapter that the ownership of IFIs is concentrated in the hand of few strong shareholders. Their interest in Shariah compliance was also confirmed. Therefore, it is believed that they can influence SCG in their investee IFIs if they play their role as real owners, especially given they have several rights that can help them with their activism. A number of previous studies have addressed the role that can be played by large shareholders to influence BoD decisions, management control, agency problems and corporate performance, however, they have mainly focused on the role of shareholders in avoiding financial distress and reducing corporate failure.975 On the other hand, scant attention has been paid to the role shareholders can play in influencing non-financial aspects of corporate governance. Specifically, none has investigated the role shareholders can play in influencing the IFIs’ SCG and their Shariah compliance in general. Therefore, this chapter explores the role of shareholders in achieving the goal of effective SCG in IFIs. It attempts to answer the research question, ‘to what extent can shareholders be active and improve SCG in Islamic finance in practice?’

The chapter starts by providing a general overview of shareholder activism. It then moves on to explain the religious obligations of Muslim shareholders under Shariah. Consequently, the chapter explains the role of shareholders in enhancing SCG, which is divided into two main sections. The first section addresses the legal framework of shareholder activism available in the countries covered by the study, which usually comes in the form of a stewardship code. Among the three jurisdictions, only the UK and Malaysia have such a framework. Kuwait, on the other

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hand, lacks any rules, whether mandatory or recommended, that support shareholder activism. Therefore, only the UK and Malaysian stewardship codes and their suitability to regulate and encourage shareholder activism in IFIs will be examined in this section. The second section then explores in detail the methods that can be used by shareholders in IFIs in general, and in the three jurisdictions in particular, to defend their right of complete Shariah compliance. The chapter ends with an examination of the main obstacles to shareholders’ activism in SCG and the means to overcome such difficulties.

5.2 General overview of shareholder activism:

Traditionally, shareholders have two options regarding their ownership in companies: either to be loyal to the investee company and hold their shares or to sell the shares and exit. Nevertheless, deciding to hold shares is insufficient to be described as a responsible shareholder. Shareholders also need to monitor the company’s performance, voice their concerns to the management and try to enhance the company through their effective stewardship. Moreover, being a responsible shareholder in a company should not only be prompted by the fear of losing the funds invested but also by a growing sense of loyalty to that company.

Shareholder activism is seen as any mechanism used by shareholders to effect change in a company. It is a general term that refers to the method employed by a shareholder or a group of shareholders in dealing with the BoD, or even sometimes with other shareholders, in an attempt to influence the governance of a company and the way it is managed. Raja and Kostyuk define it as, ‘The way in which shareholders can assert their power as owners of the company to influence its behaviour’. Activism usually aims to influence the institution’s corporate governance and corporate performance in a positive way. But this engagement does not

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977 Gavin Davies and Stephen Wilkinson, ‘Shareholder Activism in the UK’ in Beatriz Arroyo and Gemma Bridge (eds), The International Comparative Legal Guide to: Mergers & Acquisitions 2014 (8th edn, Global Legal Group 2014) 7
not just involve attending general meetings and voting: it also aims to benefit the company and adds value to it in the long term.979

Utilising their rights and powers, shareholders are able not just to monitor managers but also to bring about a change in the company’s approach to management.980 Companies with responsible shareholders tend to be more successful and better functioning than ones without such vigilant owners.981 This engagement enables the shareholders to raise any concerns to the company and also allows the company to interact and respond.982 Nili illustrates the two main factors that affect the extent of shareholder activism and its impact on the corporate governance of a corporation. The first is the incentive for shareholders to be active, which is the result of balancing the return they get from their activism against its cost. The second is the external influences that have a direct or indirect effect on the shareholders’ desire to be active, such as the legal and economic obstacles.983 Sharma looks into these factors from a wider angle and adds other aspects, such as the national culture and religion.984

Usually, the main objective of shareholder corporate activism is to pinpoint weakly-performing corporations and force them to enhance their management and governance strategy.985 The four most sought after objectives of shareholder activism are: (1) to change the board’s composition or its policy; (2) to change the executive’s remuneration; (3) to change the audit and risk management policy; or (4) to change the company’s social behaviour.986 Therefore, shareholder activism is not always ignited by financial considerations, but can also be driven by the non-financial aspects of the company. In this context, it is believed that some shareholders can be motivated

979 Demetra Arsalidou, Rethinking Corporate Governance in Financial Institutions (Routledge 2016) 141
by their religious beliefs that stem from adherence to divine rules. In their activism, they aim at creating an investment that complies with religious rules and principles and at the same time achieves profits. This is the type of activism that is expected from shareholders of IFIs, and which is required to enhance the institutions’ SCG and overall Shariah compliance. As such, we can call them ‘Shariah shareholders’.

Shariah compliance is a unique feature of IFIs. If this compliance is weakened, Shariah shareholders will be affected. Therefore, they should not stand passively by, but should play their role as owners. With the rights and powers they have, they should not depend entirely on the BoD but strive to safeguard and promote the institution’s Shariah objectives. Shariah shareholders need to take their role as owners seriously and make greater use of their rights, especially those highlighted in the previous chapter. They need to take a long-term trading approach to their investment, replacing short-term attitudes so that their share certificate in an IFI is not treated merely as paper to be traded for money. IFIs are very important entities, especially to Muslims, and shareholders should have far more important goals and ambitions with respect to them.

5.3 Shareholders’ religious obligations under Shariah:

Religion is one of the factors that affect some shareholders’ investment decisions and engagement in companies. Shariah shareholders are motivated by their religious beliefs to invest in IFIs and enhance their SCG, and this is one of the non-financial reasons why IFIs are growing. There are a number of rules in Shariah that place an obligation on Shariah shareholders to engage actively in IFIs to enhance Shariah compliance in such institutions. Shareholder activism is crystallised in three obligations in Shariah: (1) the obligation to enjoy the right and forbid the wrong; (2) the obligation to cooperate in righteousness; and (3) the obligation to protect property.

5.3.1 The obligation to enjoy the right and forbid the wrong:

Allah Almighty says in the Holy Quran, ‘The believing men and believing women are allies of one another. They enjoy what is right and forbid what is wrong’.\textsuperscript{987} Prophet Muhammad (PBUH) also said, ‘Whosoever of you sees an evil, let him change it with his hand; and if he is not able to do so, then [let him change it]
with his tongue; and if he is not able to do so, then with his heart – and that is the weakest of faith’.  

And, ‘Enjoy what is good and forbid what is evil, before you call and you are not answered’.  

According to these commands, Muslims are obliged to draw the attention of other Muslims if they are doing something forbidden in Shariah and to guide them through righteousness. However, it is worth mentioning that this obligation is not placed on all Muslims as it is regarded as fard kifayah. Nevertheless, knowledgeable Muslims are still required to adhere to it. Under this obligation, Shariah shareholders need to interfere and raise their voices if they see that their IFI is not properly adhering to the rules of Shariah.

5.3.2 The obligation to cooperate in righteousness and not in sin and aggression:

Allah Almighty says, ‘And cooperate in righteousness and piety, but do not cooperate in sin and aggression’. Muslims under this obligation are required to cooperate with each other in all aspects of life in order to help each other reach piety and leave sins and aggression. In particular, this means that, in Shariah, if a Muslim calls others to do the right thing, they will be rewarded as much as those who follow their call. The same accumulative system applies if they call others to do errors, but this time in reverse as they will earn sins. As per this obligation, Shariah shareholders, as partners in business, should cooperate with each other to work toward the success of their IFI and not stand passively by or, even worse, support any

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988 Yahya Addin Al-Nawawi, The Forty Hadiths of Imam Al-Nawawi (Mahmoud Makkok tr, Garnet Publishing 2017) Hadith 34  
989 Muhammad Al-Qazwini, Sunan Ibn Majah, vol 5 (Nasiudin Al-Kattab tr, Darussalam 2007), Hadith 4094  
990 Yahya Addin Al-Nawawi, Sahih Muslim Bisharh Al-Nawawi, vol 2 (Al-Maktabah Al-Masriyyah 1929) 22–23. Fard kifayah is ‘A legal obligation that must be discharged by the Muslim community as a whole, such as military struggle; if enough members in the Muslim community discharge the obligation, the remaining Muslims are freed from the responsibility before God. However, if a communal obligation is not sufficiently discharged, then every individual Muslim must act to address the deficiency. In recent Islamic literature, this terminology is used to discuss social responsibility, such as feeding the hungry, commanding good, and forbidding evil’. See John Esposito, The Oxford Dictionary of Islam (Oxford University Press 2003), ch Fard al-Kifayah  
991 Yahya Addin Al-Nawawi, Sahih Muslim Bisharh Al-Nawawi, vol 2 (Al-Maktabah Al-Masriyyah 1929) 22–23  
992 The Holy Qur’an, Surah Al-Ma‘idah, Chapter 5, Verse 2. Saheeh International (tr), The Qur’an (3rd edn, Al-Muntada Al-Islamy Trust 2010) 141  
993 Ibn Al-Qayyim Al-Jouziyyah, Zad Al-Muhajer (Dar Al-Hadith 1990) 4  
994 Prophet Muhammad (PBUH) said, ‘If anyone summons other to follow right guidance, his reward will be equivalent to that of the people who follow him, without their rewards being diminished in any respect on that account; and if anyone summons others to follow error the sin of which sins being diminished in any respect on that account.’ Sulaiman Al-Sijistani, Sunan Abu Dawud, vol 5 (Nasiruddin Al-Khattab tr, Darussalam 2008), Hadith 4609
Shariah non-compliant practices. In this regard, they are required to contribute time, effort and knowledge to enhance the company’s Shariah compliance and SCG.

5.3.3 The obligation to protect property as one of the five objectives of Islamic Shariah (Maqasid Al-Shariah):

As mentioned in Chapter One, in the context of explaining SCG and the shareholder model, protecting property is one of the five objectives of Shariah, and Muslims are required to observe this obligation. Maximising property is one way of protecting it. This can be done through investment or doing business with others. However, this maximisation is only allowed if it complies with Islamic Shariah rules and principles. Therefore, Shariah shareholders, when maximising their property in an IFI, should be vigilant in monitoring their own money and not accept any non-Shariah-compliant practice from the management’s side.

5.4 The role of the IFIs’ shareholders in achieving the objectives of Shariah corporate governance: shareholder activism

Investors with special interests usually start their investment journey with an investigation process to find an investment opportunity that suits their financial goals and at the same time aligns with their beliefs. This process continues by making a decision based on an awareness of reality and ends in the aim to support and develop the company. Given these considerations, investors who are interested in Shariah compliance before they decide to finance any IFI can be expected to undertake an investigation process to include or exclude IFIs from their selections. Generally, Shariah investors seek to buy shares in IFIs that are fully Shariah compliant. This investigation results in choosing IFIs that implement a strong and robust SCG policy, including an efficient SSB and an excellent rate of Shariah compliance in their Shariah review reports. IFIs that do not fulfil these basic requirements will usually be excluded from their investment plan.

Nevertheless, Shariah investors should understand that there is no perfectly Shariah-compliant company. Taking that into consideration, they can be expected to try to create an investment that, at least, meets their minimum Shariah standards and

995 The five objectives of Islamic Shariah are protecting: (1) religion, (2) life, (3) lineage, (4) intellect, and (5) property. Yousef Al-Badawi, Maqasid Al-Shariah ind Ibn Taymiyah (Dar Al-Nafa’es 2000) 63 – 65. See A. Shariah corporate governance and shareholder model in Chapter One.
996 Ministry of Trust and Islamic Affairs, Al-Mawso‘ah Al-Fiqhiyyah, vol 7 (That Al-Salasil 1986) 68
also achieves their financial goals. They are likely to invest in IFIs that, even if not entirely Shariah compliant, do not contravene the basic rules of Shariah and have the potential for improvement. Here, Shariah shareholders can be expected to work to enhance Shariah compliance in such institutions.

As seen from the previous chapter, the ownership structure of IFIs is concentrated; shareholders are mostly institutions or other large companies and they are likely to be interested in Shariah compliance, which provides the rationale for their activism. Institutional shareholders as activists are expected to engage with the company and improve its corporate governance, unlike hedge funds that usually aim to impose their own strategies on the company in order to enforce financial changes to increase shareholder return only. 997 However, despite all the rights and powers they have, institutional shareholders are still criticised for being passive and maintaining an observer status with respect to the company’s business development and for reacting only to fundamental changes. 998 Noguera states that it is unrealistic to expect investors to be active without placing an obligation on them to engage because they need a motive to increase their engagement. 999 Supporters of shareholder engagement believe that, for institutional shareholders to be active and act as supervisors, their rights need to be accompanied by some duties and responsibilities. 1000 The above-mentioned religious obligations established in Shariah might drive some shareholders in IFIs to be active, but legal rules to encourage and regulate their activism are still needed. Shariah shareholders need principles and rules to encourage and guide them in the exercise of their activism in their investee IFIs. These guidelines could come in the form of a stewardship code or self-regulation by the institutional investors themselves. Therefore, the following point explores the available stewardship

1000 Demetra Arsalidou, Rethinking Corporate Governance in Financial Institutions (Routledge 2016)
guidelines in the jurisdictions covered by this study and their suitability in managing Shariah shareholders’ activism in IFIs.

5.4.1 Stewardship guidelines for shareholder activism in IFIs:

There are stewardship guidelines for institutional shareholders in the UK and Malaysia but not in Kuwait. The UK was the first country that issued guiding principles in 2010 in the form of a stewardship code to regulate shareholders’ engagement. At the time, Sullivan described this code as ‘the first of its kind in the world’. She said, ‘Countries considering stewardship codes – to encourage best practice for shareholders to engage with the companies in which they invest – are eyeing the UK’s recently published guidelines’. And indeed, in 2014, Malaysia issued the Malaysian Code for Institutional investors using the UK Stewardship Code as a model.

5.4.1.1 The UK Stewardship Code:

After the global financial crisis and failure of several financial institutions in the UK, Sir David Walker, the former chairman of Barclays, was asked to review the corporate governance system in UK banks. In his review, he examined the role of institutional shareholders and their engagement with the banks in which they were investors. In this investigation he observed the passivity of institutional investors who did not address (neither individually or collaboratively) concerns identified in banks and therefore had little impact in restraining managers. Lord Paul Myners, who was the Financial Services Secretary to the Treasury at the time, also attacked shareholders for their failure to act like real owners. He reminded them of their duties and prompted them to engage with their companies actively, as this would influence

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1001 Ruth Sullivan, ‘UK Seen as Model for Stewardship Guidelines’ (Financial Times, 2010) <https://www.ft.com/content/0e0bb5c5-9c02-11df-a7a4-00144feab49a> accessed 24 December 2019
1002 Ruth Sullivan, ‘UK Seen as Model for Stewardship Guidelines’ (Financial Times, 2010) <https://www.ft.com/content/0e0bb5c5-9c02-11df-a7a4-00144feab49a> accessed 24 December 2019
corporate behaviour.\textsuperscript{1005}

In 2009, the Institutional Shareholders’ Committee (ISC) published the Code on the Responsibilities of Institutional Investors, including principles of best practice for institutional investors that wish to engage with the companies in which they invest.\textsuperscript{1006} The primary objective of this code was to ‘enhance the quality of the dialogue of institutional investors with companies to help improve long-term returns to shareholders, … and help with the efficient exercise of governance responsibilities’.\textsuperscript{1007} Walker acknowledged the significance of the ISC principles and recommended developing them into a Stewardship Code under the sponsorship and oversight of the Financial Reporting Council (FRC).\textsuperscript{1008} In 2010, the FRC published the first version of the UK Stewardship Code (UKSC) embracing the ISC’s principles, which it revised in 2012.\textsuperscript{1009} The UKSC is regularly updated; the most recent revised version was published in 2020.\textsuperscript{1010}

The UKSC 2012 was directed to institutional investors in UK listed companies. Its primary focus was to encourage institutional shareholders to monitor their investee companies, try to effect corporate changes and, generally, be active stewards.\textsuperscript{1011} Like the UK Corporate Governance Code, the UKSC 2012 was applied on a ‘comply-or-explain’ basis.\textsuperscript{1012} It contained seven principles giving guidelines for institutional investors. Principle 1 required institutional shareholders to disclose publicly their policy on how they will discharge their stewardship responsibilities. The stewardship activities include having dialogue and engaging with companies on matters such as

\textsuperscript{1005} Kate Burgess, ‘Myners Lashes Out at Landlord Shareholders’ (Financial Times, 2009) <https://www.ft.com/content/c0217c20-2eaf-11de-b7d3-00144feabde0> accessed 24 December 2019


\textsuperscript{1009} The UK Stewardship Code 2012, 2. For more about the origins of the UK Stewardship Code, please see Demetra Arsalidou, ‘Shareholders and Corporate Scrutiny: The Role of the UK Stewardship Code’ (2012) 9 European Company and Financial Law Review 342, 348


\textsuperscript{1011} Demetra Arsalidou, ‘Shareholders and Corporate Scrutiny: The Role of the UK Stewardship Code’ (2012) 9 European Company and Financial Law Review 342, 353

\textsuperscript{1012} The UK Stewardship Code 2012, 2–4
strategy, performance, risk, capital structure and corporate governance, including culture and remuneration. Principle 2 required institutional shareholders to have in place a policy on identifying and managing conflicts of interest about their stewardship that should be publicly disclosed. Principle 3 provided important guidelines for institutional shareholders on how to achieve effective monitoring. It highlighted several matters that investors should take into consideration in their monitoring process, including looking into the companies’ performance, development, effective leadership, adherence to the UKSC and reporting quality, as well as attending the general meetings. Principle 4 regulated the cases where investors need to elevate their stewardship activities to a higher and more formal level when soft intervention has been unsuccessful. This included, among other things, submitting a resolution and requisitioning a general meeting. Principle 5 encouraged the collective engagement of institutional investors with other investors through groups whenever necessary, such as at times of significant corporate or wider economic stress, or when the risks posed threaten to destroy significant value. Principle 6 drew the attention of investors to the importance of using their right to vote in a responsible manner. In this regard, they needed to have a clear voting policy and disclosure of voting activity. Finally, Principle 7 required institutional shareholders to report periodically on their stewardship and voting activities to show how they have discharged their responsibilities.

The UKSC 2020 imposes several key changes to the UKSC 2012. First: it notes the different roles of players within the investment community. It encompasses 12 Principles for asset managers and asset owners and 6 Principles for service providers. All the Principles are supported by reporting expectations, which determine the information that should be included in the stewardship report in order to become a signatory. Second, it emphasises the stewardship purpose, as signatories will be expected to develop their organisational purpose and demonstrate how it allows them to fulfil their stewardship objectives. Third, it extends the stewardship activities beyond the listed companies to include listed and private equity holdings, bonds, infrastructure and alternatives. Fourth, the environmental, social and governance (ESG) factors have been added to the code and signatories will be expected to take

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1014 See the UK Stewardship Code 2020, Principle 1 for asset managers and asset owners, and Principle 1 for service providers
them into account when fulfilling their stewardship responsibilities.\textsuperscript{1015} Fifth, under this new code, signatories are expected to report on their stewardship activities upon signing the code and every subsequent year.\textsuperscript{1016} Finally, the 2020 version has changed the UKSC’s method of application to ‘apply-and-explain’ instead of ‘comply-or-explain’, which means that the signatories are now required to apply the principles and provide clear explanations on their application.\textsuperscript{1017}

5.4.1.2 The Malaysian Code for Institutional Investors:

The initial step for the Malaysian Code for Institutional Investors (MCII) was the issuance of a ‘Guide of Best Practice for Institutional Investors’ by the Institutional Investor Committee and the Minority Shareholder Watchdog Group (MSWG).\textsuperscript{1018} Later in 2011, the Security Commission, in its Corporate Governance Blueprint, addressed the issue of institutional investors and their role and active participation in the exercise of shareholder rights that raise the level of corporate governance.\textsuperscript{1019} The Blueprint referenced the International Corporate Governance Network and the UKSC as examples of existing codes for institutional investors’ active role in companies.\textsuperscript{1020}

In 2014, the MCII was issued by the Security Commission and the MSWG as one of the deliverables of the Blueprint.\textsuperscript{1021} The MCII is intended to provide institutional investors with guidance on the exercise of their stewardship

\textsuperscript{1015} See the UK Stewardship Code 2020, Principle 7 for asset managers and asset owners
\textsuperscript{1019} Securities Commission Malaysia, ‘Corporate Governance Blueprint’ (2011), 13 <https://www.sc.com.my/api/documentnms/download.ashx?id=0a494b24-2910-4b14-98e0-ac6b99916d87> accessed 30 December 2019
\textsuperscript{1020} Securities Commission Malaysia, ‘Corporate Governance Blueprint’ (2011), 15 <https://www.sc.com.my/api/documentnms/download.ashx?id=0a494b24-2910-4b14-98e0-ac6b99916d87> accessed 30 December 2019
\textsuperscript{1021} Malaysian Code for Institutional Investors 2014, Background Para 1
responsibilities. Like the UKSC, the MCII has a soft law nature; it sets out best practice recommendations and encourages institutional investors to adopt them. However, the main difference is that the MCII does not place an obligation on investors to explain the reasons for their non-adherence to its principles.

The MCII outlines six key principles with guidelines for institutional investors. It is clear that the MCII, in its principles 1, 2, 3, 4, and 6, has closely mimicked principles 1, 2, 3, 4, and 6 of the UKSC 2012 relating to institutional investors’ responsibility to disclose their stewardship policies, monitor their investee companies, manage conflicts of interest, engage appropriately with their companies, and the need to publish their voting policy. Two principles of the UKSC 2012 have not been incorporated into the MCII: Principle 5, which addresses the collective engagement of institutional investors, and Principle 7, which obliges institutional investors’ to report periodically on their activism. As will be seen later in this chapter, collective engagement is an important method that is used by institutional investors to engage with their companies and that can be strong and effective in achieving their activism objectives. It is therefore essential to include it in the stewardship code with some guidance, such as the need to notify the investee companies of the intention to collaborate with other investors and the circumstances leading to this collaboration, as highlighted by the UKSC 2012. According to Yi, this principle has not been included in the MCII for reasons including: (a) the possibility that collective engagement might be used to manipulate the market; (b) the difficulty in establishing a clear policy for this type of engagement; and (c) competition law considerations.

A new principle (Principle 5) has been introduced by the MCII that has no parallel in the UKSC 2012, which is seen as an added advantage to the MCII. This principle requires institutional investors to integrate corporate governance and consider sustainability, including ESG factors, in their investment decision-making.

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1022 Malaysian Code for Institutional Investors 2014, Background Para 4
1023 See Malaysian Code for Institutional Investors 2014, Principles 1,2,3,4 and 6
1024 See 5.4.2.4 Shariah shareholders’ collective engagement in this chapter. See also the UK Stewardship Code 2012, Principle 5.
process. In this regard, they should evaluate the quality of the companies’ disclosures on the application of the corporate governance code, the quality of their sustainability report and their adherence to responsible investment. Also, institutional investors should have a policy on how they are going to include sustainability consideration in their activities. It is worth mentioning that public feedback on the MCII has reinforced the importance of applying these factors to all stewardship activities and not only in the investment process. This principle is a positive addition to the MCII as it highlights the importance of aligning corporate governance and sustainability considerations with the investment decision. This will reflect positively on the way public companies design and market their corporate governance and sustainability policies. In addition, this principle brings the MCII in line with the UN Principles for Responsible Investment. Nevertheless, as seen above, the FRC has acknowledged the importance of the ESG factors and is taking them into account in the 2020 revision of the UKSC.

5.4.1.3 Criticism of the UK Stewardship Code and the Malaysian Code for Institutional Investors:

The stewardship codes of both countries are excellent initiatives to encourage active engagement by institutional shareholders to achieve better corporate governance and long-term success in public companies. However, there are still doubts about their effectiveness and implementation in real life for the reasons explained below.

First, in terms of clarity and definition of keywords, the UKSC 2012 has failed to provide a clear definition of the term ‘stewardship’ and explanation of the role and responsibilities of the asset owners and managers. This is in contrast to the MCII, which provides a detailed definition of the term ‘stewardship’, including the steward’s key responsibilities, as well as a definition of all the parties included in the investment

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1028 See the UK Stewardship Code, 2020, Principle 7
chain.\textsuperscript{1030} It should be noted, however, that the 2020 revision of the UKSC has rectified this issue.\textsuperscript{1031}

With regard to managing conflicts of interest, it is clear that both codes have accepted the fact that conflict of interest situations will inevitably arise in relation to the institutional investors’ stewardship activities, for example when an investor needs to vote on matters related to a parent or client company. In this regard, both codes mandate the institutional investors to put in place and publicly disclose a policy to manage conflicts of interest but without an obligation to disclose potential conflicts of interest from the start.\textsuperscript{1032} The new 2020 version of the UKSC has paid attention to this issue and requires signatories to identify and manage any instance of actual or potential conflicts of interest.\textsuperscript{1033}

The main issue for both codes, however, lies in their method of application. The UKSC 2012 applied a comply-or-explain method similar to that applied to the UK Corporate Governance Code. Therefore, the criticism raised about this method, highlighted in Chapter Three, arises here as well: principally, the issue of not providing an informative and meaningful explanation.\textsuperscript{1034} With regard to the UKSC 2012 specifically, O’Dwyer believes that the comply-or-explain method will not have a significant impact on encouraging investors to engage with the investee companies, since compliance to the UKSC’s principles is voluntary provided they give an explanation for any deviation from its principles.\textsuperscript{1035} This non-binding nature puts the burden on investors to weigh up the reasons behind non-compliance and is impractical, especially with respect to international investors who can be unfamiliar with this method and may not understand what the UKSC requires from them.\textsuperscript{1036} In addition, because of this soft law nature, it is possible that institutional investors will be able to evade their monitoring responsibility if they choose not to comply because

\begin{itemize}
  \item \textsuperscript{1030} Malaysian Code for Institutional Investors 2014, Definitions – Stewardship.
  \item \textsuperscript{1031} A definition of the term ‘stewardship’ is seen in the 2020 UKSC as, ‘The responsible allocation, management and oversight of capital to create long-term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society.’ The UK Stewardship Code 2020, 4.
  \item \textsuperscript{1032} See the UK Stewardship Code 2012, Principle 2 and the Malaysian Code for Institutional Investors, Principle 4.
  \item \textsuperscript{1033} See the UK Stewardship Code 2020, Principle 3 for asset owners and asset managers and Principle 3 for service providers.
  \item \textsuperscript{1034} See 3.6.3.3 The UK Corporate Governance Code in Chapter Three.
  \item \textsuperscript{1035} Aidan O’Dwyer, ‘Corporate Governance After the Financial Crisis: The Role of Shareholders in Monitoring the Activities of the Board’ (2014) 5 Aberdeen Student Law Review 112, 122.
  \item \textsuperscript{1036} Demetra Arsalidou, \textit{Rethinking Corporate Governance in Financial Institutions} (2016 Routledge) 174.
\end{itemize}
there are no penalties for non-compliance.\textsuperscript{1037} This is in contrast to the UK Corporate Governance Code, which applies the same method but has backing for non-compliance in the Financial Services and Markets Act Section 91, which sets out penalties for a breach of listing rules.\textsuperscript{1038} MacNeil states that the limited nature of the UKSC’s legal obligation undermines its status as an industry-wide standard.\textsuperscript{1039}

Moreover, Principle 4 of the UKSC 2012 required investors to establish guidelines for their stewardship activism. As observed by Roach, the use of the word ‘guidelines’ exacerbates the problem of the principles’ soft law nature as it does not require institutional investors to set binding rules, rather it merely implies having a set of recommendations.\textsuperscript{1040} Similarly, although it is regarded as good practice to require investors, based on Principle 1, to publicise the manner in which they are going to discharge their stewardship responsibilities and all the relevant information, the soft law nature of the UKSC 2012 minimised the effectiveness of this requirement, as no sanctions will be imposed on investors that do not disclose or do not provide a proper level of disclosure.\textsuperscript{1041} Even if there was a statutory obligation on investors to have a stewardship policy, a weakness would still appear in the lack of a legal obligation on the part of the FRC, as the body responsible for evaluating the implementation and effectiveness of the UKSC,\textsuperscript{1042} to evaluate their implementation of the policy once they chose not to comply with the UKSC. Having said that, following Section COBS 2.2.3 of the FCA Handbook - Business Standards: Conduct of Business Sourcebook, non-adherence to comply-or-explain in the application of the UKSC exposes some firms\textsuperscript{1043} to public censure and/or financial penalties under Sections 205 and 206 of the UK Financial Services and Markets Act 2000, which adds strength and some

\textsuperscript{1037} Lee Roach, ‘The UK Stewardship Code’ (2011) 11 Journal of Corporate Law Studies 463, 474
\textsuperscript{1038} Roach explains that companies that do not comply with the UK Corporate Governance Code or explain their non-compliance might be subject to a penalty according to Article 91 of the Financial Services and Markets Act 2000. Lee Roach, ‘The UK Stewardship Code’ (2011) 11 Journal of Corporate Law Studies 463, 474. Note that Section 91(6) of the Financial Services and Markets Act 2000 was amended by Section 20 of the Financial Services Act 2012 (UK).
\textsuperscript{1040} Lee Roach, ‘The UK Stewardship Code’ (2011) 11 Journal of Corporate Law Studies 463, 484
\textsuperscript{1042} The UK Stewardship Code, 2012, 3. For more about the Financial Reporting Council (FRC), please visit its website at <https://www.frc.org.uk/about-the-frc> accessed 30 December 2019
\textsuperscript{1043} Firms that are authorised to carry on regulated activities that manage investments for a professional client that is not a natural person, excluding a venture capital firm. See the FCA Handbook – Business Standards: Conduct of Business Sourcebook, Section COBS 2.2.3
compulsory effect to the UKSC’s method of application.\textsuperscript{1044} Finally, it is worth mentioning that the UKSC 2012 does not extend to foreign investors, but the FRC hopes that they will willingly commit to it.\textsuperscript{1045}

Despite all previous criticisms, the 2016 FRC report proved that the UKSC has contributed to improving the quality and quantity of institutional shareholders’ stewardship since its issuance.\textsuperscript{1046} Many signatories have reported well on their stewardship approach with few deficiencies.\textsuperscript{1047} Moreover, as a matter of transparency in performing its mandate of listing the investors who comply with the UKSC, the FRC has decided to remove signatories that report poorly from the list, which can be seen as a public censure for non-compliance.\textsuperscript{1048}

Nevertheless, as mentioned above, the 2020 revision of the UKSC has adopted a slightly different method of application for its principles, i.e. ‘apply-and-explain’. Under this method, ‘signatories are required to apply the Principles and make a clear statement to explain how they have done so’.\textsuperscript{1049} This method then assumes that institutional investors apply the codes’ principles and requires them to explain how they achieve this, as opposed to the ‘comply-or-explain’ method, which only expects the investors to comply with the principles, but if they do not comply, they should explain why and disclose what alternative approach they have taken. Moreover, the 2020 UKSC has given the FRC the power to evaluate the institutional investors’ application to sign the code and assess their reporting against it.\textsuperscript{1050}

With regard to the MCII, it also has a soft law nature, where its principles are

\textsuperscript{1050} See the UK Stewardship Code 2020, 6
set out in the form of best practice recommendations but without imposing a comply-or-explain obligation on the institutional investors if they decide not to comply with the principles. It is suggested that the omission to require explanations for any departure from the MCII principles weakens the quality of the investors’ disclosures, which was seen clearly in comparison to the explanations provided by UK institutional investors.1051 Nevertheless, in 2016, the Institutional Investors Council Malaysia (IICM) – the body responsible for monitoring the investors’ adherence to the MCII1052 – revealed a good level of adherence to the MCII among its member organisations.1053 In its report, the IICM evaluated the stewardship, engagement and resources for stewardship activities of institutional investors, as well as the challenges faced and areas of improvement.1054

Finally, as highlighted by Yi, a stewardship code should not forget the role that can be played by beneficiaries and clients to drive demand for better stewardship.1055 Indeed, a stewardship code should include a section on stewardship activities of other stakeholders in the investee companies, not just shareholders, and establish principles for whistleblowing.

5.4.1.4 The suitability of the UK and Malaysian stewardship codes to govern Shariah shareholders’ activism:

From studying the UK and Malaysian stewardship codes, it can be said that they are a good step along the path of shareholder activism that should be instructive for other jurisdictions, including Kuwait, which does not have any rules (soft nor obligatory), to regulate institutional investors’ stewardship. A stewardship code is an essential legal framework to guide shareholders’ involvement and encourage them to play an active role in corporate governance. Nevertheless, the main question that needs to be addressed here is whether the UK and Malaysian stewardship codes are

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1052 For more about the Institutional Investors Council Malaysia (IICM) please visit <http://www.iicm.org.my/> accessed 30 December 2019
1053 For more, please see Institutional Investors Council Malaysia, Investor Stewardship and Future Key Priorities 2016 (Institutional Investors Council Malaysia 2016)
1054 Institutional Investors Council Malaysia, Investor Stewardship and Future Key Priorities 2016 (Institutional Investors Council Malaysia 2016) 18–33
suitable for providing guidance for Shariah shareholders and encouraging their engagement in IFIs?

Both codes are generic and do not provide any specificity for investee companies with a special nature, such as Shariah-compliant companies. This might not be surprising for the UK due to the lack of SCG regulation in the first place. However, it is quite odd for Malaysia with the existence of a well-established regulatory system for IFIs and SCG. For example, it can be seen that the MCII in Principle 2 encourages institutional investors to monitor the adherence of their investee companies to the Corporate Governance Code 2012 alone, without any reference to the SCG framework for Islamic investee companies. There is not a single reference to Shariah compliance or SCG in the MCII, not even in the sustainability aspects that should be taken into consideration by institutional investors in their investment decision-making process. Principle 5 has only included the environmental, social and governance aspects.

Nevertheless, it is still acknowledged that both the UKSC and MCII fit all types of institutional investors’ activism in relation to monitoring the corporate governance of any investee company, due to their generic nature. Hence, they can be used to guide Shariah shareholders’ activism in IFIs but will not fully satisfy their stewardship activities in relation to SCG and Shariah compliance. A few modifications need to be observed.

A stewardship code that caters for the institutional investors’ stewardship activities in IFIs should first highlight the specificity of companies with a special nature of business, including companies that comply with Shariah. Second, the code should emphasise the institutional investors’ responsibility towards monitoring the non-financial aspects of their investee companies, including Shariah compliance. Third, the code should mandate institutional shareholders to observe and monitor the implementation of any corporate governance rules adhered to by their investee companies. In this regard, the stewardship code needs to refer to the specific corporate governance code, if one exists, such as the Shariah Governance Framework 2019 in Malaysia and the Instructions Regarding Shariah Supervision Governance in Kuwait Islamic Banks 2016 in Kuwait and any other related regulations. If there is no national SCG code, institutional investors should monitor compliance with any rules willingly followed by their investee companies, such as those of the AAOIFI or IFSB.

As for the method of application, it should be acknowledged that the comply-
or-explain method, although lacking binding force, has some evident advantages. First, it is compatible with the flexible and fast-moving nature of the business environment because it allows investors to set their own rules, ones that correspond to the nature of their business and their specific needs. Second, it opens the stewardship code up for scrutiny and criticism from institutional investors because they have to give an explanation if they choose not to comply. Third, it allows for other ideas and methods of investor stewardship, which might be used to develop the principles of the stewardship code in the future. To avoid the problems raised around this method, the monitoring body needs to monitor and evaluate the quality of the stewardship policy disclosed by non-complying institutional investors and not just to evaluate the reasons for their deviation from the code. If an institutional investor fails to adhere to the stewardship code’s guidelines or have its own policy, the monitoring body should impose some disciplinary actions, such as not authorising it to carry on business or to be listed in the market. In addition, the monitoring body needs to issue a list of investors that comply with the stewardship code and carry out an annual evaluation process for the code. Having said that, it is believed that the ‘apply-and-explain’ method provides a better compliance rate by the institutional shareholders once they become signatories, for they will be required to apply the principles and explain the measures used for their application as well as their results. Finally, it is acknowledged that drafting, issuing, implementing and regularly evaluating a stewardship code involves high costs, time and resources. However, because of its importance and benefits in encouraging shareholder activism, some of the costs can be placed on the institutional investors, for example by requiring them to pay listing fees.

5.4.2 Shariah shareholders’ methods of engagement:

This section addresses the main approaches that are recommended for Shariah shareholders to effect changes in their investee IFIs: (a) a quiet approach, where shareholders monitor the IFI’s performance and communicate the outcomes; (b) a formal intervention, where a shareholder proposes a resolution and accesses the proxy system; (c) shareholder litigation; and (d) shareholder collective engagement. There are other means and tactics used by activist shareholders, such as derivatives dealing
and stock lending\textsuperscript{1056} and other more aggressive means, including the investment-limiting and adversarial interventions,\textsuperscript{1057} but these methods are mainly related to financial activism. The chosen methods, instead, are the methods most used by shareholders to influence the governance of companies\textsuperscript{1058} and are seen to be the most effective for enhancing the non-financial aspects of the company, including SCG in IFIs.

5.4.2.1 Shariah shareholders’ quiet approach: to monitor the IFI’s performance and communicate the outcomes:

As highlighted in the previous chapter, there are several rights in SCG that should be granted to shareholders in IFIs. They are closely related to the shareholders’ general right of information, the right to initiate dialogue with the institution, and the right to discuss and approve certain matters with the institution. Activist shareholders normally start their activism with purposive dialogue and private communication with the investee companies.\textsuperscript{1059} Dialogue areas include corporate strategies, key business opportunities, corporate governance and executive remuneration, among others.\textsuperscript{1060}

Therefore, as an initial step, Shariah shareholders need to monitor the performance of their investee IFIs on a regular basis and communicate the issues of concern directly and clearly to the board. This monitoring process should mainly focus on the extent and efficiency of the IFI’s SCG and Shariah compliance. In this regard, they should satisfy themselves that the investee IFI is running a proper Shariah-compliant business. Therefore, an essential part of their stewardship should aim at holding the managers accountable for any unjustified deviation from proper and full Shariah compliance.

\textsuperscript{1056} Khurram Raja and Alex Kostyuk, ‘Perspectives and Obstacles of the Shareholder Activism Implementation: A Comparative Analysis of Civil and Common Law System’ (2015) 13 Corporate Ownership and Control 520, 520


\textsuperscript{1058} Davis and Thompson state, ‘Shareholders influence the governance of individual firms both formally, through the proxy system where they can initiate and vote on proposals, and informally, through negotiations with corporate management.’ Gerald Davis and Tracy Thompson, ‘A Social Movement Perspective on Corporate Control’ (1994) 39 Administrative Science Quarterly 141, 156


\textsuperscript{1060} Kuek Ying, ‘Shareholder Activism Through Exit and Voice Mechanisms in Malaysia: A Comparison with the Australian Experience’ (2014) 26 Bond Law Review 1, 17
Shareholders’ engagement should be directed towards corporate governance reforms in their investee companies. Shareholders should urge the BoD in their IFIs to implement a robust SCG policy that caters for the institution’s needs and special characteristics. They should ensure that the IFI committees are structured effectively and this should mainly include the appointment of a SSB and a number of affiliated units or supporting officers in the institution’s internal structure, depending on the IFI’s size and business complexity. In this regard, they need to oversee the institution’s adherence to the national laws and recommended guidelines for SCG in the jurisdiction, if they exist. If no such rules exist, or if the existing rules are not compulsory, they should always aim at implementing the rules that best serve the IFI’s Shariah compliance.

Shareholders need to make sure that the SSB is effective and works properly in order to provide an adequate Shariah audit. In this regard, they need to determine that the SSB has a suitable number of Shariah scholars commensurate with the IFI’s size and complexity of business. When they are given the right to appoint the SSB, as is the case in Kuwait and in the UK in some IFIs, shareholders should conduct an investigation before approving the names recommended by the BoD. This investigation is required to ensure the fulfilment of the competence criteria set by the national guidelines or the IFI for Shariah scholars. In this regard, shareholders are encouraged to view the qualifications and previous experience of the nominated Shariah scholars and their memberships of other SSBs. They should approve those whom they consider satisfy the competence criteria and reject those who do not. In this regard, shareholders in Kuwait in particular have a big responsibility to strengthen the independence of SSB members. It was seen in relation to the Kuwaiti system of SCG, the law illustrates some cases of conflict of interest for SSB members but allows the Islamic bank to ignore them. However, the law also obliges the Islamic bank to disclose and clarify this issue to the shareholders, which indicates that they have a say.

Shareholders should ask questions and demand more clarification whenever it is needed. When shareholders do not have the right to appoint SSB members, as is the case in Malaysia, they need to verify that the BoD has followed the necessary rules.

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See a. The SSB in C. Instructions regarding Shariah supervision governance in Kuwait Islamic banks 2016 in 3.6.2.2 Kuwait regulatory and supervisory framework for Islamic banks in Chapter Three.
for their appointment. As such, shareholders in Malaysia need to make sure that the IFI has been granted the approval from the central bank before appointing a particular scholar, as instructed by Bank Negara Malaysia.  

Shareholders should also take into consideration and rules on SSB members’ multiple memberships when approving their appointment. In Kuwait, following the instructions of the Central Bank, shareholders should check that Shariah scholars in their IFIs are not members of more than three local Islamic banks. However, for better governance, if possible, shareholders should aim at appointing a scholar who does not serve on more than one local IFI of the same industry and a limited number of international boards, as recommended in Chapter Two. This also applies to shareholders in the UK whenever they have the right to appoint SSB members, as is the case in the BLME. In addition, shareholders should monitor the SSB members’ commitment to attending meetings, the frequency of this attendance collectively and on an individual basis, the efficiency of their audit and reporting process and in general their adherence to the Shariah audit system implemented by the IFI; they should use these factors as key performance indicators. This is not to say that shareholders have to monitor the IFI on a day-to-day basis – rather, they need to make sure that they get all the information needed.

Shareholders need to engage in the governance of the remuneration of members of the SSB as well. As seen in Chapter Four, Kuwait is the only country among the three jurisdictions that grants shareholders a legal right to have a say in the SSB members’ remuneration. Therefore, shareholders in Kuwait, before approving this payment, need to view and discuss the remuneration policy and the methods used for determining Shariah scholars’ remuneration set by the IFI. Most importantly, they should not approve an exaggerated amount of remuneration or a variable remuneration based on performance, or approve any deduction from their pay based on risk that is only speculated to be posed by them, as highlighted in Chapter Two.

Shareholders are encouraged to ask questions about the SSB’s work and to direct their enquiries straight to its members. They need to discuss Shariah rulings

1062 Guidelines on the Governance of Shariah Committee for the Islamic Financial Institutions (BNM/RH/GL/012-1), Section 8
1063 See Instructions on Shariah Supervisory Governance for Kuwaiti Islamic Banks 2016, Chapter 3, Principle 1, Section 3(Second)
1064 See 2.3.5 Multiple memberships of Shariah scholars in SSBs in Chapter Two.
1065 See 4.6.2 Kuwait in Chapter Four.
1066 See 2.3.4.3 Standards for SSB remuneration (Fourth) in Chapter Two.
issued by the SSB and ask for more clarification whenever they feel it is necessary. This can happen, for example, when a Shariah ruling is not clear, contains an odd opinion or an opinion that opposes or contradicts an agreed opinion issued by other Shariah scholars in the field of Islamic finance. This is fairly important in jurisdictions where Shariah national supervision is lenient or absent as is the case in Kuwait and the UK, as in both countries the quality and efficiency of Shariah compliance are determined by Shariah scholars sitting on the SSBs. Nevertheless, as highlighted in Chapter Four, shareholders should not object to the adoption of a certain fatwa unless they have solid evidence that it is incorrect. Moreover, they need to make sure that their IFIs are abiding by the Shariah opinions of their SSB, especially if this obligation is not imposed by the law, as is the case in the UK. In such a situation, shareholders need to make certain that their investee IFIs commit themselves to follow the fatwas of their SSBs by having an article in this regard in their AoA.

As per the above explanation, shareholders are encouraged to engage with their investee IFIs and monitor their SCG and Shariah compliance and raise any concerns to the institution for discussion and clarification, even if they do not have all the rights in SCG discussed in Chapter Four. However, the previous practices are all characterised as soft activism or quiet approaching, which is not always effective in achieving the investors’ goals for their activism, especially when there is no legal obligation on management to engage with shareholders and listen to their recommendations and ideas. They instead would need to approach investee IFIs in a stronger and more formal manner, as will be explained in the following point.

5.4.2.2 Shariah shareholders’ formal intervention: shareholder proposal

When management or the board is unresponsive to the concerns raised behind the scenes, activist shareholders will usually enforce their demands in a stronger and more formal manner. It is acknowledged that a shareholder proposal is the main

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1067 See 4.4.6 The right to discuss the work of SSB and its Shariah rulings in Chapter Four.
1068 In general, see Doron Levit, ‘Soft Shareholder Activism’ (2019) 32 The Review of Financial Studies 2775, 2794
tool for shareholders to be heard by management and other shareholders, and the way to have their interests considered in an official setting. Therefore, when an IFI is not responding to the concerns raised by a shareholder with regard to, for example, an instance of the IFI’s failure to comply with Shariah or the effectiveness of its SCG, they may submit a shareholder proposal and access the proxy system in the AGM.

Submitting a shareholder proposal for inclusion in the company’s annual meeting proxy materials is granted to shareholders in Malaysia, Kuwait and the UK. However, local laws usually set several criteria that should be met before submitting a shareholder proposal. For example, there is a certain number of shares that should be held by the shareholder or shareholders submitting the proposal. In the UK, the ownership should be at least 5% of the voting rights for eligibility to include a resolution to be voted on at the AGM. In Kuwait and Malaysia, the proposing shareholders should own at least 10% of the voting rights. In terms of the proposal content, there are some rules that should be adhered to, or otherwise the board can disregard the proposal and exclude it from the proxy. In the UK, it is long established that shareholders should not be prevented from holding a meeting and accessing the proxy system, however, the UK Companies Act 2006 grants the board the power to refuse the proposal in certain situations: if it is ineffective, defamatory, frivolous or vexatious. Malaysia applies the same rule but adds another ground for refusal: if the proposal would not be in the best interests of the company. Giving the board the right to decide whether to accept or ignore a shareholder proposal for the aforementioned reasons might limit proposals that are not in proper order and repel any attempt to abuse the requisition process. However, it also gives the board a large discretion to refuse the proposal, which could undermine its effectiveness as a tool for

1072 Companies Act 2006, Part 13 (UK)
1073 Law no 1 of 2016 on the Promulgation of the Companies Law, Section 206 (Kuwait). Companies Act 2016, Section 311 (3)(a) (Malaysia)
1074 Back in 1883, it was observed by Cotton LJ in Isle of White Railway Company v. Tahourdin: ‘It is a very strong thing indeed to prevent shareholders from holding a meeting of the company, when such a meeting is the only way in which they can interfere, if the majority of them think that the course taken by the directors, in a matter which is intrà vires of the directors, is not for the benefit of the company’. Isle of White Railway Company v. Tahourdin (1883) 25 Ch D 320, 330
1075 Companies Act 2006, Section 338 (2) (UK)
1076 Companies Act 2016, Section 311 (5) (Malaysia)
shareholder activism. This is in contrast to Kuwait, where the law has obliged the board to accept the proposal once it is ‘reasoned’ without any further conditions or specification.\textsuperscript{1077} However, the fact that the UK requires the holding of fewer shares for submitting a proposal should not be ignored. Moreover, a shareholder whose proposal has been rejected by the board can always raise the matter before a court.\textsuperscript{1078}

It is worth noting that the success of shareholders’ activism depends on the voting outcome on the proposal, the identity of the proposal’s sponsors (whether institutions, coordinated groups or individual investors) and the corporate governance performance of the targeted firm.\textsuperscript{1079} According to Gillan and Starks, proposals sponsored by institutions and coordinated groups have great superiority over those sponsored by individual investors.\textsuperscript{1080} Gordon and Pound also confirm that ‘Proposals receive more votes when ownership is highly concentrated among institutional investors’.\textsuperscript{1081} One of the main reasons behind the success of the institutional and coordinated groups’ proposals is their ability to support their negotiations with the company.\textsuperscript{1082}

Here a question arises as to whether the result of the vote on the shareholder proposal is binding on the company or just advisory. In the UK and Kuwait, the answer is that the result of the vote is binding on the company.\textsuperscript{1083} However, whether

\textsuperscript{1077} Law no 1 of 2016 on the Promulgation of the Companies Law, Section 206 (Kuwait)
\textsuperscript{1078} From the UK, for example, in \textit{Kaye v Oxford House (Wimbledon) Management Company Limited}, a number of directors in their capacity as shareholders called a general meeting and proposed resolutions. In the meeting, another director declared that the resolutions were vexatious and asked to close the meeting and left. The requisitioners disregarded his decision and passed all the resolutions. He raised the matter before the court. The Judge decided that the resolutions passed were not vexatious as ‘they were not troublesome, burdensome or were proposed for no proper purpose connected to the company’. See Kaye v Oxford House (Wimbledon) Management Company Limited (2019) EWHC 2181 (Ch) [134]
\textsuperscript{1080} ‘Proposals sponsored by institutional or coordinated investors receive over 175% as many votes as those sponsored by individuals.’ Stuart Gillan and Laura Starks, ‘Corporate Governance Proposals and Shareholder Activism: The Role of Institutional Investors’ (2000) 57 Journal of Financial Economics 275, 285 and 295
it is better for the result of the shareholder proposal to be binding or advisory is debatable. Stuart and Starks have questioned the success of shareholder proposals and their ability to effect changes in corporations if they are non-binding, while Buchanan and others found that shareholder proposals can achieve their goal even if they are not adopted by the company. Loss and Seligman observe that, 

[I]t is not too important that these proposals are not carried … the very opportunity to submit proposals, even of advisory nature, affords a safety valve for stockholder expression at a price that to the registrant would seem to be relatively slight.

Glac also supports the idea that shareholder proposals are effective even if they do not received approval from the majority of shareholders, as they still draw the managements and public’s attention to the proposal’s subject.

From the above explanation, it can be understood that shareholders in IFIs in Malaysia, Kuwait and the UK, if they have the required number of shares, can always call for a meeting and propose resolutions anytime they have concerns about the IFI’s SCG or Shariah compliance. This is definitely an easy option for institutional shareholders as they usually have the required number of shares, the capacity to cover the proposal expenses and the voting power. They can also use this tool to discipline SSB members, especially if the members are not re-elected every year. In this regard, shareholders may requisition a meeting to put forward resolutions to remove or replace a SSB member. This might be used on an occasion where shareholders feel that a SSB member has proved to be unqualified to sit in the institution’s SSB. However, shareholders should make sure that the proposal is solemn, genuine and evidence-based to minimise the chances of its exclusion. Even if the proposal does not succeed, the threat of this proposal itself is an efficient check on the SSB

Activism, and their Impact on a Target’s Performance’ (2015) 19 Journal of Management and Governance 5, 11. For Kuwait, see Kuwait Companies Act 2016, Section 206
Bebchuk, Brav and Jiang explain that, with regard to the BoD in companies, the board is staggered when the directors are elected for three years, and two-thirds of directors do not come for re-election in any year, while it is considered to be not staggered if the directors are re-elected each year. Lucian Bebchuk, Alon Brav and Wei Jiang, ‘The Long-Term Effect of Hedge Fund Activism’ (2015) 115 Columbia Law Review 1085, 1149
members’ accountability to shareholders. Shareholders can also use a shareholder proposal to appoint a new or an extra SSB member. In this situation, the IFI should include in the proxy materials the shareholders’ nominee for the election of SSB members if the nominee meets the appointment requirements and criteria outlined by law or by the IFI. However, this option is only available to shareholders in Kuwait and the UK, as shareholders in Malaysia do not have the right to appoint SSB members. Nevertheless, shareholders in Malaysia might be able to use the proposal to push the BoD to appoint a particular SSB member after getting an approval from the Central Bank.

Finally, in order for a shareholder proposal to have a good chance of succeeding and achieving its goal, the proposing shareholder needs to seek support from other shareholders for votes, either by getting them to vote for the proposal or by borrowing their voting rights to vote. After the vote is cast, the borrowed voting rights revert to the original owners (if this system is applied in the country). In this situation, the activist shareholder should provide good reasons and justification for their proposal in order to win the support of other shareholders. Specifically, they need to prove their good intentions and commitment to the enhancement of the IFI’s SCG and Shariah compliance and not to pursuing their own interests.

5.4.2.3 Shariah shareholders’ litigation:

When soft and formal intervention methods have not been successful in achieving the objectives of a shareholder’s activism in an IFI, the shareholder concerned can always resort to their right to litigation to defend their interest in being part of a Shariah-compliant business. As highlighted in the previous chapter, shareholders have the right to hold directors accountable for any breach of their fiduciary duties in achieving Shariah compliance. Accordingly, shareholders should not hesitate to sue the directors for any act that has affected the IFI’s Shariah compliance as they are ultimately responsible for ensuring its Shariah compliance. Moreover, they can hold SSB members personally responsible for any breach of their

1090 AAOIFI, Accounting, Auditing and Governance Standards (AAOIFI 1997), Chapter Governance Standard for Islamic Financial Institutions No. 2 Shari’a Review, 14; Osama Shibani and Christina De Fuentes, ‘Differences and Similarities Between Corporate Governance Principles in Islamic Banks and Conventional Banks’ (2017) 42 Research in International Business and Finance 1005, 1006
fiduciary duties or shortcomings in performing their supervisory role that resulted in reducing the IFI’s level of Shariah compliance.

As explained in the previous chapter, it is believed that the laws in the UK, Malaysia and Kuwait, allow shareholders to sue directors and the SSB on behalf of the IFI for any deficiency in running the business in compliance with Shariah, based on the rules of derivative claims. They can also ask for a personal remedy if the wrongdoing has directly affected them, based on the rules of ‘oppression remedy’ in Malaysia, the rules of ‘unfair prejudice’ in the UK, and Article 204 of the Kuwaiti Companies Law in Kuwait. However, in this context, shareholders in the UK in particular will face a major obstacle in the English courts pertaining to the interpretation of the term ‘Shariah’ and acceptance of its rules as the applicable law, as will be explained later in this chapter.

5.4.2.4 Shariah shareholders’ collective engagement:

For a better chance of achieving the goal of their activism, Shariah shareholders need to work together. The study of Opler and Sokobin provides evidence that coordinated monitoring by institutional investors is effective in enhancing the monitored institutions with regard to their corporate governance, operation and market performance. A later study by Gillan and Stuart also confirms that the activism of a coordinated group of investors is more successful than non-coordinated activism. Moreover, Islamic Shariah encourages collaboration and collective work between Muslims as this boosts their power in the face of obstacles and helps them to complete their tasks. In addition, people who work

1091 See 4.6 Rights of shareholders in Malaysia, Kuwait and the UK in Chapter Four.
1092 See 4.6 Rights of shareholders in Malaysia, Kuwait and the UK in Chapter Four.
1095 Allah Almighty says in the Holy Quran, Surah Ali-Imran, Chapter 3, Verse 103, ‘And hold firmly to the rope of Allah all together and do not become divided.’ Saheeh International (tr), The Qur’an (3rd edn, Al-Mundada Al-Islamy Trust 2010) 83. Moreover, Prophet Muhammad (PBUH) analogises the relationship between the believers as the bricks of a building that strengthen each other. He said, ‘A believer to another believer is like a building whose different parts enforce each other.’ The Prophet then clasped his hands with the fingers interlaced (while saying that)’. Muhammad Bukhari, Sahih Al-Bukhari, vol 3 (Muhammad Khan tr, Darussalam 1997), Hadith 2446
together will be blessed and will receive help from God in completing their tasks.\textsuperscript{1096} Therefore, shareholders who share an interest in a proper Islamic business need to unite and cooperate with each other to boost their chance to enhance SCG and Shariah compliance in their investee IFIs.

Collaboration between Shariah shareholders could be done through different mechanisms:

A. establishing a ‘shareholder group’, which provides a number of advantages. First, it helps in decreasing the activism cost as shareholders in the group can share the expenses. Second, it helps in supporting a shareholder proposal by collecting prior approvals from the shareholders in the group. Third, being in a group makes it easier for shareholders to communicate. Finally, collaborative working might attract other investors, especially individual shareholders, to join the group.

B. establishing a ‘forum of investors’ is another way of collaborative working between investors who share similar interests. This forum can be used to encourage Shariah investors around the world to monitor and engage more in the governance of IFIs. The UK has a striking example in this regard. Following the Kay report, an investors’ forum of institutional investors was established to facilitate their collective engagement in UK companies.\textsuperscript{1097} The ‘Investor Forum’ is an attempt to inspire responsible ownership by institutional investors through establishing a group of activist investors from all over the world to facilitate collective engagement.\textsuperscript{1098} It is based on two key objectives: to encourage a long-term approach and to create a model for collective engagement.\textsuperscript{1099} Another example is the Council of Institutional Investors (CII), which

\textsuperscript{1096} Prophet Muhammad (PBUH) said, ‘The Hand of Allah is with the Jama’ah (the group).’ Hafiz An-Nasai, \textit{Sunan An-Nasai} vol 5 (Nasiruddin Al-Kattab tr, Darussalam 2008), Hadith 4025
\textsuperscript{1098} David Oakley, ‘Investors Invited to Join Forces to Rein in Wayward Governance’ (Financial Times, 2013) <https://www.ft.com/content/3a3de368-5b42-11e3-a2ba-00144feabcde> accessed 30 December 2019
\textsuperscript{1099} For more about the Investor Forum, please visit its website at <https://www.investorforum.org.uk/purpose> accessed 30 December 2019.
combines a number of institutional investors in the US. Like the UK forum, this council provides a platform for investors to collaborate, share information, and jointly monitor corporate governance practices in corporations. The CII issues and circulates an annual list of firms that are considered to perform poorly. Remarkably, the Opler and Sokobin study, which investigated the performance of the corporations that appeared on the CII’s list before and after listing, found that corporations experienced improvement in performance after listing. They believe that this positive result is partially attributed to the pressure placed on corporations due to appearing in the focus list.

The similarity of the shared goals across different investors serves as a strong factor that brings investors together to protect their interests. This similarity makes investors strong, focused and organised, which gives them an advantage over managers due to the fact that managers usually have diverse and fragmented interests. In this context, there are groups of activists that realise that the benefits of activism go beyond shareholder value. For example, labour unions work to defend and protect the interests of workers, and to pursue those interests, the unions play a significant role in shareholder activism. Their activism mainly focuses on aligning the interests of workers, shareholders and managers in companies. Schwab and Thomas emphasise the activism of labour unions and the methods they use to push through changes in corporate governance in companies where they invest and to get them to listen to shareholders’ complaints.

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1100 The Council of Institutional Investors (CII) is a group of US institutional investors that aim to be a leading voice for effective corporate governance practices in companies and strong shareholders rights and protection. For more please visit the CII website at <http://www.cii.org/index.asp> accessed 30 December 2019.


1103 Gerald Davis and Tracy Thompson, ‘A Social Movement Perspective on Corporate Control’ (1994) 39 Administrative Science Quarterly 141, 160


pushing bylaw amendments are all examples of such methods. Another example of activist groups that are driven by non-financial motivation is the social movement organisations that work to improve corporate social responsibility in public companies. Davis and Thomas state that what distinguishes a collective action is that members are able to continue their activism even if some of them opt out.

These forums/investor groups and other similar bodies are significant initiatives in the field of corporate governance as they recognise the importance of collective engagement in monitoring the investee companies and allow investors with similar interests to combine their effort and pool their resources. Despite their different objectives, they all meet at the point that they convert shared interests into collective action. In a similar context, Shariah compliance activists need to get together, form a body and start a screening movement that has the mandate of monitoring SCG practices in IFIs. In their supervision, they need to focus on the efficiency of the SSBs as well as the whole SCG system applied by the IFIs. They need to target IFIs that have a poor Shariah compliance. For example, IFIs that are known to have an inefficient SSB, offer Shariah non-compliant products or services either directly or indirectly, or do not adhere to good standards of SCG. To achieve their objective, Shariah investors need to share information with other shareholders and publicise their findings.

Given the previous explanation, it can be said that Shariah shareholders can play an important role in enhancing SCG in IFIs. They can use their ownership power to push corporate governance reforms in IFIs. However, they need to develop a more strategic model of their role in SCG. A strategic model would require Shariah investors to concentrate on areas where their interests coincide with other shareholders and where they can demonstrate that their actions will enhance the IFI’s Shariah compliance. According to Goranova and Ryan, ‘In order for the efforts of influential activists to be beneficial to the firm’s remaining shareholders, the activist’s

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1107 Gerald Davis and Tracy Thompson, ‘A Social Movement Perspective on Corporate Control’ (1994) 39 Administrative Science Quarterly 141, 152
1108 Gerald Davis and Tracy Thompson, ‘A Social Movement Perspective on Corporate Control’ (1994) 39 Administrative Science Quarterly 141, 165
interests must be aligned with theirs’. Shariah shareholders have to convince other shareholders that they are acting in areas where they have an informational advantage of the institution’s SCG. If they can demonstrate to other shareholders that they are using their monitoring power to take actions to enhance Shariah compliance in the institution and in return this would contribute to enhancing the institution’s overall firm value in the Islamic finance sector, then other shareholders will be more willing to join their group or support their activism in future voting initiatives.

After demonstrating the means and methods that can be used by Shariah shareholders to engage with their investee IFIs, the following point demonstrates some obstacles that might hinder their activism with some suggested solutions.

5.5 Obstacles facing Shariah shareholders activism in IFIs:

Generally speaking, obstacles that might hinder shareholder activism and monitoring duty revolve around the lack of information, some regulatory restrictions or barriers, the free-riding problem by other investors and the conflict of interest between the activist investors and management of the investee companies. Shariah shareholders might face these general problems in their activism, however, this section attempts to shed light on problems specifically affecting Shariah shareholders’ activism to defend Shariah compliance in IFIs, mainly: (a) problems related to the ownership structure of IFIs, and (b) problems related to accepting Shariah as the applicable law in the courts.

5.5.1 Problems related to the ownership structure of IFIs:

Ownership concentration is claimed to cause expropriation of minority shareholders’ rights. As seen in the previous chapter, the ownership of IFIs is

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1111 Paul Laux and James Markham, ‘Shareholders in Corporate Governance’, in Alexander Kostyuk, Udo Braendle and Rodolfo Apreda (eds) Corporate Governance (Virtus Interpress 2007) 96
highly concentrated with the existence of a controlling shareholder. This ownership concentration, however, should not be an issue to Shariah shareholders in an IFI when the controlling shareholder complies with Shariah in its business, and at the same time, is interested in Shariah compliance in the investee IFI. On the other hand, the existence of a controlling shareholder in an IFI might cause a problem to other shareholders and their right to Shariah compliance when it is evident that the controller’s business contradicts Shariah rules or when it is not interested in Shariah compliance in the investee IFI. Therefore, this point highlights two situations affecting Shariah compliance in IFIs related to their ownership structure where Shariah shareholders stand helpless against them: (a) when investors with a non-Shariah-compliant business invest in an IFI, and (b) when the controlling shareholder in an IFI is not interested in Shariah compliance.

5.5.1.1 Non-Shariah-compliant investors:

As highlighted in Chapter One, for IFIs to preserve their Shariah compliance they should not deal in any way with prohibited money. Prohibited money in Shariah is divided into two categories: (1) prohibited in itself, as would be the case with alcoholic beverages or swine used as barter goods, and (2) prohibited for a reason where the money itself is not prohibited but the prohibition happens because an external matter contaminates the money. In the second category, if the money is gained in a prohibited way or via a corrupted agreement, and it is therefore prohibited: for example, the money gained from usury, gambling, prostitution or theft.

When money is considered as prohibited in Shariah, Muslims accordingly are not allowed to benefit from it and should get rid of it in some way, such as giving it back to its owner or giving it to the poor if the owner is unknown. Prohibited money does not enter into the Muslim’s ownership from the beginning and consequently they cannot use or benefit from it. It is worth noting that getting rid of prohibited money is a legal duty.

1113 See 4.5 Shareholders of IFIs in Malaysia, Kuwait and the UK in Chapter Four.
1114 See 1.1 An overview of Islamic finance in Appendix One.
1116 Muhammad Al-Ghazaly, Eh’ya’ Ulum Al-Din, vol 2 (Dar Ibn Hazm 2005) 129. Muhammad Al-Qutroby, Tafseer Al-Qurtoby (Dar Al-Kotob Al-Masriyah 1936) 366
1117 There is a disagreement between the main four Shariah schools of thought regarding the ownership of the money earned from a corrupted contract, such as usury or gambling. Abo Hanifa allowed the
of prohibited money is not considered as sadaqah (charity) but redemption. This is very similar to what has been mentioned in Chapter Two about the IFI’s duty to purify its earnings from any unavoidable non-Shariah-compliant income that is regarded as prohibited money.

There is no doubt that it is forbidden for Muslims to earn prohibited money (either as itself or for a reason) and the person who knowingly earns it is sinful under Shariah. It is not just earning and benefiting from the prohibited money that is banned but also taking this money with its owner’s permission. This rule, however, is applied if the person taking the money certainly knows that it is prohibited. In this case, the one who earns the money and the one who deals with them are both sinners under Shariah. In addition, Muslims should not agree to take and invest prohibited money in compliance to God’s command not to cooperate in sin and aggression. This provision is not invalidated by saying that the money will be used in permissible ways.

The other matter related to money is the case of intermingled prohibited and permissible money in a way that makes it difficult to separate them and whether this contaminates the whole amount of money or not. Islamic jurisprudence addresses this matter under the subject of ‘the admixture of prohibited and permissible money’. In this situation it is important to look at the amount of the prohibited money in this admixture. According to Ibn Taimiyah, if the prohibited money is the majority in the whole amount of money then the whole money is contaminated and therefore it is regarded as prohibited money. Imam Al-Ghazaly shares the same opinion, however, he believes the right thing to do is not to take the money, even if the

ownership, Al-Shafie and Ahmad did not allow the ownership and Malik allowed it only if it is not possible to return it to its owner. Taqi Addin Ibn Taymiya, Majmou’ Al-Fatwai, vol 29 (Majma’a Al-Malik Fahad 2004) 327–328
1118 Muhammad Al-Ghazaly, E`h’ya’s ‘Olum Al-Din, vol 2 (Dar Ibn Hazm 2005) 131
1119 Prophet Muhammad (PBUH) said, ‘There is no flesh raised that sprouts from the unlawful except that the fire is more appropriate for it.’ Muhammad Al-Tirmidhi, Jami Al-Tirmidhi, vol 2 (Abu Kallyl tr, Darussalam 2007), Hadith 614
1122 Abbas Al-Baz, Ahkam Al-Mal Al-Haram (Dar Al-Nafa’es 1998) 62
1123 The Holy Quran, Surah Al-Ma’idah, Chapter 5, Verse 2, ‘And cooperate in righteousness and piety, but do not cooperate in sin and aggression. And fear Allah; indeed, Allah is severe in penalty.’ Saheeh International (tr), The Qur’an (3rd edn, Al-Muntada Al-Islamy Trust 2010) 141
1124 Muhammad Al-Ghazaly, E`h’ya’s ‘Olum Al-Din, vol 2 (Dar Ibn Hazm 2005) 94
1125 Imam Ibn Taimiyah says, ‘If the permissible is the majority it is not prohibited then.’ Taqi Addin Ibn Taymiya, Majmou’ Al-Fatwai, vol 29 (Majma’a Al-Malik Fahad 2004) 151
prohibited money is not the largest proportion. If it is impossible to know the percentage of the prohibited share in the whole amount of money, Imam Abdullah Al-Hanbali believes it is makruh (disliked/hateful) to deal with this money. This is based on the Islamic rule of dealing with suspicions, set by Prophet Muhammad (PBUH).

Therefore, based on the above explanation, an IFI should certainly not deal with well-defined prohibited money. When the prohibited money is mixed with permissible money in one pool, it is allowed to be used by IFIs in a permissible business unless the amount of prohibited money is greater than the amount of permissible money. However, Muslim scholars still believe it is preferable not to take it. In application of this rule, an IFI should refrain from investing in Shariah non-compliant companies, such as those dealing with alcohol, gambling and tobacco, as well as conventional banks and insurance companies, as their activities are all prohibited in Shariah and their money is seen as prohibited. However, as clarified in Chapter One in the context of distinguishing Shariah compliance from corporate social responsibility, avoiding dealing with Shariah non-compliant businesses should go both ways: not to invest in them and not to open the way for them to invest in IFIs. When investors in Shariah non-compliant business finance an IFI through buying shares, especially in large numbers, the IFI will be using prohibited money in its business and should no longer be seen as Shariah compliant. Shariah shareholders, who are a minority in this situation, are unable to defend their interest in Shariah.

1126 Muhammad Al-Ghazaly, Eh‘yaa‘ Olum Al-Din, vol 2 (Dar Ibn Hazm 2005) 106
1127 Abdullah Al-Hanbaly, Al-Mughni, vol 6 (Dar Alam Al-Kotob 1997) 372. It is worth noting that Makruh in Shariah means ‘reprehensible, detested, hateful, odious. Usually refers to one of the five legal values in Islamic law (the other four are fard or wajib, obligatory; mustahabb or mandub, preferred; halal, permissible; and haram, prohibited). Makruh acts are not legally forbidden but discouraged. Muslims are advised to avoid makruh acts because the continued and insistent commission of such acts will lead to sin’. John Esposito, The Oxford Dictionary of Islam (Oxford University Press 2003), ch Makruh. See also Abdullah Al-Baidhawy, Minhaj Al-Wosol Ila Ilm Al-Usool (Al-Risalah 2006) 18
1128 He says, ‘Leave what makes you in doubt for what does not make you in doubt. The truth brings tranquillity while falsehood sows doubt’. Muhammad Al-Tirmidhi, Jami Al-Tirmidhi, vol 4 (Abu Kallyl tr, Darussalam 2007), Hadith 2518. He also said, ‘The lawful is clear and the unlawful is clear, and between that are matters that are doubtful (not clear); many of the people do not know whether it is lawful or unlawful. So whoever leaves it to protect his religion and his honor, then he will be safe, and whoever falls into something from them, then he soon will have fallen into the unlawful.’ Muhammad Al-Tirmidhi, Jami Al-Tirmidhi, vol 3 (Abu Kallyl tr, Darussalam 2007), Hadith 1205
1130 See a. Difference in the source of responsibility in C. Distinct model: a faith-based model in 1.8.2.2 The theory behind Shariah corporate governance in Chapter One.
compliance and have no choice but to accept this dent in the IFI’s Shariah compliance or to exit.

The suggested solution to protect the interest of minority shareholders in Shariah compliance is to restrict Shariah non-compliant investors’ ownership in IFIs. They should not be allowed to finance an IFI, whether in the initial subscription or in terms of the capital increase, unless they provide evidence that the money comes from a permissible source. This restriction can be achieved by imposing special shareholder suitability requirements for IFIs or by self-regulation. Shareholder suitability requirements exist in Malaysia but apply to financial institutions in general. Bank Negara Malaysia (BNM) has set these requirements to ensure that shareholders of financial institutions ‘that are able to exercise influence directly or indirectly are persons of integrity and good reputation’.\textsuperscript{1131} According to the Malaysian shareholder suitability policy, three main requirements should be observed by each shareholder who holds 5% or more in a financial institution. The first is related to the shareholder’s honesty and integrity: they should refrain from doing any act that might tarnish their or the institution’s reputation.\textsuperscript{1132} The second is related to the shareholder’s exercise of their control right: a shareholder should not exert influence over the institution unless it is to its best corporate governance interest.\textsuperscript{1133} The final requirement is related to the shareholder’s financial soundness: he should maintain a sound financial position on a continuous basis.\textsuperscript{1134}

It is worth mentioning that these requirements and their subsection standards are not on the same level of enforceability. Some are compulsory and failure to comply with them exposes the defaulting shareholder to enforcement action, while others are advisory and shareholders are encouraged to adopt them.\textsuperscript{1135} For the purpose of monitoring the shareholders’ suitability, BNM does an ongoing assessment and thus has the power to ask shareholders of financial institutions to provide any relevant documents or information and obliges them to respond.\textsuperscript{1136} Note that

\textsuperscript{1131} Shareholders Suitability 2014, Sections 1 and 5 (Malaysia)
\textsuperscript{1132} For more details please see Shareholders Suitability 2014, Section 7 (Malaysia)
\textsuperscript{1133} For more details please see Shareholders Suitability 2014, Section 8 (Malaysia)
\textsuperscript{1134} For more details please see Shareholders Suitability 2014, Section 9 (Malaysia)
\textsuperscript{1135} Shareholders Suitability 2014, Section 2 (Malaysia)
\textsuperscript{1136} Shareholders Suitability 2014, Section 6 (Malaysia)
enforcement action could extend to prohibiting the defaulting shareholders from exercising their voting rights and even direct them to surrender their shares.\textsuperscript{1137}

It is acknowledged that the main purpose behind setting the Malaysian shareholders’ suitability requirements is to safeguard financial institutions and maintain their safety and stability, as the policy focuses on the financial soundness and integrity of shareholders and their professional conduct. However, they are also seen as measures set by the central bank to determine whether an investor is suitable to be a major shareholder in a financial institution. Moreover, the law requires the shareholders to observe these requirements on an ongoing basis and enforces sanctions for failing to meet them. Therefore, for the purpose of protecting Shariah compliance in IFIs and Shariah shareholders’ interests, it is recommended to set shareholder fit and proper criteria or suitability requirements specifically for IFIs that require the shareholder, as well as being financially fit, to provide proof that the money contributed to finance an IFI is Shariah compliant. From studying the legal systems of Malaysia, Kuwait and the UK, it is clear that there is no such rule, and therefore the Shariah compliance of IFIs can be compromised as well as the interests of Shariah shareholders. Having said that, it is be possible that the first requirement of the current Malaysian shareholder suitability requirements mentioned above might be activated against any shareholder who introduces prohibited money to an IFI based on the fact that this might tarnish the IFI’s reputation.

It is already seen that conventional banks are interested in Islamic finance. For example, in Malaysia, Affin Islamic Bank is a wholly owned subsidiary of Affin Bank, the parent company – a conventional bank.\textsuperscript{1138} Also, the establishment of what is known as ‘Islamic windows’\textsuperscript{1139} by conventional banks is another practical example. It is worth mentioning here that there is controversy about the permissibility in Shariah of dealing with Islamic windows, especially in countries where Islamic banks exist for reasons related to their Shariah compliance.\textsuperscript{1140} Currently, there is no

\textsuperscript{1137} Financial Services Act 2013, Section 94 (Malaysia). Islamic Financial Services Act 2013, Section 106 (Malaysia)
\textsuperscript{1138} Affin Islamic Bank Berhad Annual Report 2018 p80
assurance that prohibited money has not been used in the establishment of these Islamic entities. Finally, it should be noted that this is not a call for the prevention of dealing with Shariah non-compliant businesses in total, as this is not the purpose of this study. The purpose, however, is to set measures to ban prohibited money from entering IFIs. Moreover, permissibility is the general rule in Shariah and prohibition is an exception; therefore, every business is considered as permissible unless there is an explicit rule in Shariah that clearly prohibits it. This restriction should not be expanded or applied in an extreme sense. Prohibition should not be applied to anything unless it is definitely known to be prohibited in Shariah. For example, the ownership of Shariah non-compliant investors in Islamic IFIs should not be prohibited when the Shariah non-compliant investor pays the money to shareholders for exchange of shares, as the prohibited money in this case does not enter the property of the IFI but that of the exiting shareholders. This is similar to what happened to Boubyan Bank in Kuwait. Boubyan Bank was established in 2004 by investors with Shariah-compliant businesses. In 2009, the National Bank of Kuwait (a conventional bank) bought 13% of Boubyan Islamic Bank and has been increasing its share ever since. As of 2019, National Bank of Kuwait owns almost 60% of Bank Boubyan.

5.5.1.2 Controlling shareholders:

The interest of shareholders in Shariah compliance was confirmed in Chapter Four. It is believed that such shareholders would not agree to join an IFI that has apparent Shariah compliance problems. However, due to the fact that Shariah compliance in the decentralised model (Kuwait) and absent model (UK) is determined by SSB members without proper external supervision, there is always a possibility that their opinion about the IFI’s Shariah compliance does not reflect the true picture, especially when controlling shareholders are not interested in the proper application of Shariah rules, as will be explained below.

It is acknowledged that shareholders with the majority or a substantial proportion of shares are able to influence the institution’s decisions. Because they hold a controlling share, they have enough voting power to dictate to the institution.

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Flannigan explains that control in corporations is initially divided between the shareholders and the BoD. Shareholders have structural control that gives them the ability to establish, maintain or change the structure of a corporation, which is manifested in their ability to elect and remove directors and amend the AoA.\textsuperscript{1143} The BoD, on the other hand, has asset control and so can take decisions on how the business is run, which includes, for example, the right to purchase or dispose of assets, expand the business (either by internal growth or takeovers) and issue securities.\textsuperscript{1144} Flannigan then asserts that the concentration of structural control in the hand of one person or group of people, due to the ownership of a substantial proportion of shares, can be utilised indirectly to exercise asset control.\textsuperscript{1145} In addition, controlling shareholders may use ‘terrorem’ to force the BoD to comply with their wishes lest they replace the directors, which may lead to a significant change in asset control and management.\textsuperscript{1146} Finally, he confirms that there is a judicial consensus that, ‘Circumstances of unauthorized asset control may lead to a finding that it is the controller carrying on the business’.\textsuperscript{1147}

Similarly, in SCG, although it is acknowledged that a SSB is appointed in the IFI’s governance structure to guide them on their Shariah-related matters and ensure their Shariah compliance, shareholders still have structural control, which confers on them the right to appoint and replace its members, as seen in Kuwait and some of the IFIs in the UK.\textsuperscript{1148} Their selection or replacement may lead to a significant change in the institution’s level of Shariah compliance, especially when prior approval from the financial supervisor in the country is not required.\textsuperscript{1149} In this context, when controlling shareholders are not interested in Shariah compliance, they will focus on

\begin{itemize}
\item \textsuperscript{1143} Robert Flannigan, ‘Corporations Controlled by Shareholders: Principals, Agents or Servants?’ (1987) 51 Saskatchewan Law Review 23, 26
\item \textsuperscript{1144} Robert Flannigan, ‘Corporations Controlled by Shareholders: Principals, Agents or Servants?’ (1987) 51 Saskatchewan Law Review 23, 27
\item \textsuperscript{1145} Robert Flannigan, ‘Corporations Controlled by Shareholders: Principals, Agents or Servants?’ (1987) 51 Saskatchewan Law Review 23, 28
\item \textsuperscript{1146} Robert Flannigan, ‘Corporations Controlled by Shareholders: Principals, Agents or Servants?’ (1987) 51 Saskatchewan Law Review 23, 29
\item \textsuperscript{1147} Robert Flannigan, ‘Corporations Controlled by Shareholders: Principals, Agents or Servants?’ (1987) 51 Saskatchewan Law Review 23, 77
\item \textsuperscript{1148} See 4.6.2 Kuwait and 4.6.3 The UK in Chapter Four.
\item \textsuperscript{1149} Ullah, Harwood and Jamali state that, ‘The controlling strategies start from the time of hiring of Shari’a scholars where management prefers to hire lenient scholars, by limiting their authority to product approval only.’ Shakir Ullah, Ian Harwood and Dima Jamali, ‘Fatwa Repositioning: The Hidden Struggle for Shari’a Compliance Within Islamic Financial Institutions’ (2018) 149 Journal of Business Ethics 895, 908
\end{itemize}
finding Shariah scholars that certify their activities, rather than making these activities Shariah-compliant, which is described as ‘fatwa shopping’.\textsuperscript{1150}

Controlling shareholders can also negatively influence Shariah compliance by putting pressure on the BoD to make use of an investment opportunity or approve a merger or takeover that is questionable in terms of Shariah compliance and put pressure on SSB members to authorise it at the expense of the interests of Shariah shareholders. Ullah, Harwood and Jamali observe that ‘Managers may try to use covert means such as misrepresentation and overt pressure, such as to influence Shari’a scholars and seek concessions from them in some cases’.\textsuperscript{1151} When SSB members are appointed and remunerated by the shareholders or the BoD in an IFI, there is always an issue about their independence and objectivity in issuing Shariah rulings. To keep their position and remuneration they might become lenient and permissive in interpreting the rules of Shariah at the expense of their correct application.\textsuperscript{1152} A current example is seen in Kuwait as KFH is in the process of acquiring the conventional bank Ahli United (AUB) in Bahrain. According to the agreement between the two banks, the acquisition will go through the issuance of shares equivalent to about 53.96% of KFH’s current shares for AUB (the exchange ratio of 2.3 AUB shares for 1 KFH share).\textsuperscript{1153} It is acknowledged that the AUB will change its nature to become an Islamic bank, however, this will happen over the period of at least four to five years. During this transition period, it is estimated that the profits of the AUB will be worth more than USD 400 million.\textsuperscript{1154} This amount of


\textsuperscript{1152} There are some known incidents in this regard where Shariah scholars have not paid a proper attention to Shariah rules in Islamic finance when providing Shariah opinions. See Ibrahim Warde, \textit{Islamic Finance in the Global Economy} (Edinburgh University Press 2000) 227-228; Volker Nienhaus, ‘Governance of Islamic Banks’ in Kabir Hassan and Mervyn Lewis (eds) \textit{Handbook of Islamic Banking} (Edward Elgar 2007) 137; Raphi Hayat and Kabir Hassan, ‘Does an Islamic Label Indicate Good Corporate Governance?’ (2017) 43 Journal of Corporate Finance 159, 160


money will be the outcome of non-Shariah-compliant activities and hence is regarded as prohibited money, which should be discarded.\textsuperscript{1155}

That being so, Shariah compliance in IFIs should be safeguarded in a better way. The law has to ensure that controlling shareholders do not abuse their powers. Each IFI needs to implement some rules to prevent practices by controlling shareholders that might negatively affect its SCG and Shariah compliance. In this regard, when the protection is not provided by the law, each IFI needs to protect its Shariah compliance through the shareholders’ agreement by including specific provisions on shareholders’ responsibilities.\textsuperscript{1156} It should be noted that any rule included in the agreement should not go so far as to deprive shareholders of the ability to exercise their legal rights, or increase their liability above the nominal amount of their shares.\textsuperscript{1157}

From the standpoint of freedom of contract, a shareholders’ agreement can be utilised to protect the IFI’s Shariah compliance from the influence of controlling shareholders. This involves the inclusion of certain provisions in the agreement that limits such shareholders’ ability to affect the IFI’s Shariah compliance. The significance of the shareholders’ agreement lies in the individual responsibility it imposes on shareholders, which cannot be achieved by the AoA alone.\textsuperscript{1158} However, IFIs are public companies and it is impractical to set up shareholders’ agreements between all its members. Rather, a shareholder agreement is recommended to be set up with shareholders with influential holdings.

In this regard, the shareholders’ agreement could include two clauses in particular. The first clause addresses the general obligation that the shareholder should not push through any changes to the IFI that negatively affect its Shariah compliance, directly or indirectly. The second clause addresses the remedy once the first clause has been breached. A breach of the shareholder contract might lead to the application of some penalties to the violating shareholder, such as voiding their

\textsuperscript{1155} Naif Al-Ajmi, ‘The position of KFH and AUB deal’ (YouTube, 2018) <https://www.youtube.com/watch?v=FvaWK8OvZzQ> accessed 25 December 2019

\textsuperscript{1156} As means to strengthen the protection of shareholders and strike balance between their rights, it is seen that companies utilise their AoA or the shareholders’ agreement or both through the inclusion of some special provisions in them. Graham Stedman and Janet Jones, Shareholders’ Agreement (Sweet & Maxwell 1998) 1

\textsuperscript{1157} Bisgood v. Henderson’s Transvaal Estates Ltd [1908] 1 Ch 743, 759

\textsuperscript{1158} As Lord Buckley stated, ‘The purpose of the memorandum and articles is to define the position of the shareholder as shareholder, not to bind him in his capacity as an individual.’ Bisgood v. Henderson’s Transvaal Estates Ltd [1908] 1 Ch 743, 759
contractual agreement or even forfeiting their shares. However, the deterrents should be ascertained and drafted clearly in the contract so that the shareholder is clearly informed of the consequences of their agreement.

This solution is recommended to be followed by IFIs where SCG regulation and national supervision is absent or lenient, such as in the UK and Kuwait. However, it must be acknowledged that, although shareholders have the right to enter into a private agreement, this agreement cannot violate the primacy of mandatory rules set by law. Freedom of contract between shareholders only creates an obligation on the shareholders themselves and does not in any way become a regulation of the company.\textsuperscript{1159}

That being so, a private agreement between shareholders or between them and the company cannot undermine the primacy of mandatory rules of law, especially the statutory rights of shareholders or the company. Any agreement that does not create such a conflict should be valid.\textsuperscript{1160} The inclusion in a shareholder agreement of a clause that prevents shareholders from weakening an IFI’s Shariah governance and Shariah compliance does not appear to conflict with statutory rules or public policy, either in Kuwait or the UK, rather it is an application of the IFI’s AoA.

5.5.2 Problems related to accepting Shariah as the applicable law in courts:

Muslims believe that Islamic Shariah is not just a religion but a system that regulates all aspects of life, including legal affairs.\textsuperscript{1161} Therefore, defining a person as a ‘Muslim’ has two meanings: religious and juristic. Accordingly, to say of anyone that they are a ‘Muslim’ implies from the religious point of view that they follow Islamic devotions, beliefs and teachings. However, it should also imply from the juristic perspective that their legal capacities and affairs are governed by the practical legal rules of Shariah. In other words, Shariah should - ideally - be regarded as their

\textsuperscript{1159} According to Lord Davey, ‘Of course, individual shareholders may deal with their own interests by contract in such way as they may think fit. But such contracts, whether made by all or some only of the shareholders, would create personal obligations, or an exception personalise against themselves only, and would not become a regulation of the company, or be binding on the transferees of the parties to it, or upon new or non-assenting shareholders. There is no suggestion here of any such private agreement outside the machinery of the Companies Acts.’ Welton v. Saffery [1897] A.C. 299, 331
\textsuperscript{1160} See Russell v Northern Bank Development Corp Ltd [1992] 1 W.L.R. 588 HL, 593. In this case the court held that the agreement between shareholders is valid on the basis that it does not place a restriction on the company’s statutory right to increase its capital, rather it is only an agreement as to how shareholders cast their votes, which binds the existing shareholders only and not the future ones.
\textsuperscript{1161} Muhammad Kamali, ‘Law and Society’ in John Esposito (ed), The Oxford History of Islam (Oxford University Press 1999) 108
personal law. That being so, Islamic Shariah reflects a concept of identity similar to nationality where its rules have to be applied whenever a Muslim party is involved. IFIs as entities that do business in compliance to Shariah rules are also considered as Islamic persons whose legal matters should be governed by the practical legal rules in Shariah, or otherwise their Shariah compliance will be compromised.

However, Shariah shareholders might face a problem in having Shariah considered as the applicable law for their disputes due to the variety of the legal systems applied in countries where IFIs operate. There are countries where Shariah is the base of their legislation, such as Saudi Arabia and Sudan. Other counties apply a mixed system (Shariah and other secular laws), including Kuwait and Malaysia. Yet other countries only apply secular laws, as is the case in the UK or any other non-Muslim jurisdiction. In Islamic countries, where Shariah is the base for legislation, Shariah shareholders should not face the aforementioned problem, as the court should automatically apply Shariah rules. However, the problem might rise in Islamic countries with mixed legal systems (eg Malaysia and Kuwait) and becomes more complicated in totally secular jurisdictions (eg the UK), as explained below.

5.5.2.1 The application of Shariah rules to IFIs’ disputes in Malaysia:

Malaysia applies a dual judicial system that constitutes of civil courts and Shariah courts. The Shariah court is responsible for the administration of Islamic laws in the country, such as family laws and succession laws in its civil jurisdiction, and to try only specific criminal offences in its criminal jurisdiction. However, it must be highlighted here that IFIs in Malaysia are subject to the Islamic banking laws, as well as the civil laws, and that the IFIs’ cases are resolved by the civil court and not the Shariah court, and this could cause some problems. According to Aldohni, ‘The

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1162 Sudan Constitution 2005, Section 5 (Sudan). Basic Law of Governance 1992, Section 1 (Saudi Arabia). Supreme Court of Saudi Arabia has also confirmed that the judicial system in Saudi Arabia rules according to the rules and principles of the Holy Quran and Sunnah. Ministry of Justice of Saudi Arabia, Principles and Decisions of Saudi Supreme Court for the years 1971 to 2016 (Markaz Al-Boooth 2017) 10. Saudi Arabia also rejects to recognise non-Shariah-compliant practices, for example decision no 291 of 1981 of the Ministry of Justice decisions provides that the loans of conventional banks cannot be registered or certified in Saudi courts and official authorities. Ministry of Justice of Saudi Arabia, Principles and Decisions of Saudi Supreme Court for the years 1971 to 2016 (Markaz Al-Boooth 2017) 63. Also, according to Decision number 637 of 1999, judgments are certified only if they comply with the rules of Quran, Sunnah or proper consensus. Ministry of Justice of Saudi Arabia, Principles and Decisions of Saudi Supreme Court for the years 1971 to 2016 (Markaz Al-Boooth 2017) 484
1164 See Section 46(2) of Administration of Islamic Law (federal Territories) Act 1993 as at 2013
ability of the civil court to resolve an Islamic banking dispute varies from case to case depending on the judge's knowledge, court attitude and the other circumstances. In this context, the civil court might apply the civil law rules instead of the rules of Shariah, which could undermine the Shariah compliance of IFIs. Nevertheless, the most distinctive feature of the Malaysian legal system, with respect to IFIs, is the Shariah Advisory Council (SAC) – the authority for the ascertainment of Islamic law for the purposes of Islamic financial business and the power of its Shariah rulings. According to the Central Bank of Malaysia Act, the opinions and Shariah rulings of the SAC are binding on the court or arbitrator in any proceedings related to the Islamic finance business. Therefore, the court is bound by the rulings of the SAC in any Shariah matter related to IFIs. Due to this supremacy, Shariah rulings of the SAC will be the applicable set of rules for IFIs in Malaysia in any litigation related to their Shariah compliance. Having said that, the SAC has no power over the court in relation to the application of Shariah rules, as it only determines those rules and then leaves their application to the court.

Moreover, Malaysia has been more cautious in avoiding any conflict between secular laws and Shariah in relation to IFIs. In this regard, Section 279 of the Islamic Financial Services Act 2013 confirms the supremacy of the provisions of this Act (Islamic legislation) over the Companies Act (a secular piece of legislation) in the case of any conflict. However, the weakness of this Section appears in the fact that the Companies Act is not the only secular legislation in Malaysia to which IFIs might be

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1167 Central Bank of Malaysia Act 2009, Chapter 1
1168 Central Bank of Malaysia Act 2009, Sections 56 and 57
(1) Where in any proceedings relating to Islamic financial business before any court or arbitrator any question arises concerning a Shariah matter, the court or the arbitrator, as the case may be, shall—
   . (a) take into consideration any published rulings of the Shariah Advisory Council; or
   . (b) refer such question to the Shariah Advisory Council for its ruling.
(2) Any request for advice or a ruling of the Shariah Advisory Council under this Act or any other law shall be submitted to the secretariat.
‘Any ruling made by the Shariah Advisory Council pursuant to a reference made under this Part shall be binding on the Islamic financial institutions under section 55 and the court or arbitrator making a reference under section 56.’
subject, meaning conflict between secular laws and Shariah is still possible. Therefore, it would be better if the law generally states that any legislation on IFIs should be applicable only to the extent that does not conflict with the rules of Islamic finance legislation and Shariah.

5.5.2.2 The application of Shariah rules to IFIs’ disputes in Kuwait:

As explained in Chapter Three, Kuwait, by its constitution, is an Islamic country and Shariah is a main source and not the main source of legislation.\textsuperscript{1170} This resulted in having a mixed legal system that is based on Shariah but still allows the application of some secular rules. Normally, for any dispute related to the banking system, including conventional and Islamic banks, the court searches for an applicable rule in a number of laws following a specific order. The court starts with the Central Bank Law for Islamic banks or the Capital Markets Authority Law for the other IFIs, and both have rules regulating an Islamic business.\textsuperscript{1171} If there is no applicable rule, it goes to the Companies Law, which has one article regulating Islamic companies in general; if there is no applicable rule, it goes to the Commercial Law; if there is no applicable rule, it goes to the rules of the Commercial Custom; if there is no applicable rule, it goes to the Civil Law; and if there is no applicable rule, it applies the rules of Islamic Shariah.\textsuperscript{1172}

In the case of a dispute related to IFIs and their Shariah compliance, there is no explicit mandatory rule in Kuwait law that requires the court to apply the rules of Shariah. However, the court still needs to consider whether Shariah rules apply on the facts of the case for two reasons. First, IFIs have obliged themselves to operate in compliance with Shariah rules, which means it is their code of practice. Second, Shariah compliance is a legal requirement for licensing and recognition of these institutions as Islamic in the law. This can be seen clearly in the definition of an Islamic bank as a ‘Bank that works in compliance with Shariah rules and conducts all

\textsuperscript{1170} According to Article 2 of Kuwait Constitution, ‘The religion of the State is Islam, and the Islamic Shariah shall be a main source of law.’ It is worth mentioning that the interpreting memorandum of Kuwait constitution has interpreted ‘Shariah’ as the rules of Islamic jurisprudence.

\textsuperscript{1171} See Law no 32 of 1968 Concerning Currency, the Central Bank of Kuwait and the Organisation of Banking Business, Chapter 10. See also Kuwait Capital Markets Authority Executive Bylaws: Module Five, Chapter 2

\textsuperscript{1172} See Law no 1 of 2016 on the Promulgation of the Companies Law, Article 15 (Kuwait)

\textsuperscript{1173} Article 2 of Kuwait Commercial Law no 68 of 1980, ‘If there is no applicable rule in this law, commercial custom should be applied, if there is no commercial custom, the civil law should be applied.’ Article 1 of the Law no 67 of 1980 Regarding the Civil Law (Kuwait) ‘If this code lacks an applicable rule, the court shall apply the rules of Islamic jurisprudence ….’
its business in a manner that does not conflict with the provisions of Shariah’. In addition, Article 15 of the Kuwait Companies Law obliges Islamic companies to follow the rules of Islamic Shariah as their code of practice. Therefore, the court would still follow the previous order in search for an applicable rule but taking into consideration Shariah rules. In other words, the court may apply the rules regulating the IFIs along with the general rules regulating the banking system to IFIs’ disputes, as long as they do not contradict the rules of Shariah based on the rule of maslaha (public interest), which means that anything that is not directly regulated in Shariah but does not contradict its rules is also considered to be part of Shariah.

Nevertheless, it is important to note that the rules regulating IFIs in Kuwaiti law are mostly administrative or procedural and do not tackle the subject matter of the Islamic banks’ practice and what is allowed or not allowed to be conducted by them in terms of Shariah compliance. They merely emphasis that the practice of IFIs should comply with Shariah rules or should not conflict with the provisions of Shariah. Therefore, in a dispute that requires an examination of an IFI’s Shariah compliance, for example if a shareholder claims that a specific practice, product or service of its investee IFI does not comply with the rules of Shariah, the court would go straightaway to the rules of Islamic Shariah as the applicable set of rules. In this regard, the court has full authority to study the case and rule on the disputed issue according to the rules of Shariah. In this regard, the court’s ruling prevails over any ruling given by the IFI’s SSB and will be binding on the disputing parties. This is because, according to the Kuwait constitution, courts are independent and not subject to any authority. Of course, the court has the discretion to seek the opinion of an expert Shariah scholar in Shariah matters whenever this opinion is needed, but it is merely advisory for the court.

1174 Law no 32 of 1968 Concerning Currency, the Central Bank of Kuwait and the Organisation of Banking Business, Article 86
1175 Maslaha is defined as ‘public interest; a basis of law. According to necessity and particular circumstances, it consists of prohibiting or permitting something on the basis of whether or not it serves the public’s benefit or welfare. The concept of public interest can be very helpful in cases not regulated by the Quran, Sunnah, or Qiyas (analogy)’. John Esposito, The Oxford Dictionary of Islam (Oxford University Press 2003), Chapter Maslaha. It is part of ijtihad (human intellect effort) as a secondary source of Shariah where Shariah scholars issue a ruling in a new matter that has not been directly regulated in Shariah. It is usually used to deal with modern matters which adds flexibility to Shariah and makes it applicable to all times, places and circumstances. Mohamad Kamali, Principles of Islamic Jurisprudence (3rd edn, The Islamic Texts Society 2003) 235; Felicitas Opwis, ‘Maslaḥa in Contemporary Islamic Legal Theory’ (2005) 12 Islamic Law and Society 182, 183; Ibrahim Shatibi, Al-Mu’wafaqat fi Usul Al-Shariah (Dar Al-Kotob Al-Ilmiyah 2004) 25. Muhammad Masud, Shatibi’s Philosophy of Islamic Law (2nd edn, Kitab Bhavan 2009).
1176 Kuwait Constitution 1962, Article 163
In the light of the above explanation, although there is no explicit provision in Kuwaiti laws acknowledging Shariah as the applicable set of rules in the case of disputes related to IFIs’ Shariah compliance, it is clear that courts would still apply Shariah rules. This illustrates that the problem of conflict between Shariah and secular laws should not be an issue in Kuwait, even though it is a mixed legal system. Nevertheless, it is recommended that an explicit article be added to the chapters regulating IFIs in Kuwaiti laws to confirm the primacy of Shariah rules over the other laws in any dispute related to their business. A better alternative for addressing the matter is to issue a comprehensive law to regulate Islamic finance in Kuwait that spells out the rules of Shariah regulating the business of IFIs, which will make it easier for the court to find the applicable rule and will reduce its authority to examine the case from the Shariah perspective and provide judgment without consulting specialised Shariah scholars.

5.5.2.3 The application of Shariah rules to IFIs’ disputes in the UK:

In secular jurisdictions the problem of accepting Shariah as the law applicable to IFIs’ disputes is more complicated due to the fact that Shariah is not in any way part of their legal system. Moreover, secular jurisdictions usually do not accept Shariah as a foreign law that can be enforced, mainly because it is not the law of a particular country and also because Shariah rules may be subject to multiple interpretations. Therefore, in principle, in any dispute related to financial institutions, a court in the UK would not distinguish between an Islamic or a conventional institution in the application of national law.

1177 The rules for the choice of law applicable to contractual obligations are set by the Rome Convention. Article 1 of the Convention clarified that the chosen law is ‘a choice between the laws of different countries,’ excluding a non-national system of law. See Rome Convention on the Law Applicable to Contractual Obligations [1980] OJ L266. This Convention is now replaced by the Rome I Regulation. See Article 24 of Regulation (EC) No 593/2008 of the European Parliament and of the Council of 17 June 2008 on the law applicable to contractual obligations (Rome I). With regard to the freedom of choice, Article 3 of the Regulation states that ‘The choice shall be made expressly or clearly demonstrated by the terms of the contract or the circumstances of the case.’ Nevertheless, it must be noted that according to Article 18 of the Regulation, the chosen law ‘shall be applied to the extent that it contains rules which raise presumptions of law.’ It is worth mentioning that the Rome Convention was enacted in the UK under Section 2(1) of Contracts (Applicable Law) Act 1990, and the Rome I Regulation came into force in 2009 by the Law Applicable to Contractual Obligations (England and Wales and Northern Ireland) Regulations 2009. However, these Regulations were amended post Brexit by the Law Applicable to Contractual Obligations and Non-Contractual Obligations (Amendment etc.) (EU Exit) Regulations 2019 and came into force on exit day. The purpose for this amendment was to ensure the relevant application of the Regulations in the UK after the UK left the EU.
Applying the rules of the conventional laws on IFIs without taking into consideration their specificity might impair their Shariah compliance, as the court might not accept a claim based on the ground of a violation of the rules of Shariah and might not be able to provide a judgment on the Shariah or non-Shariah compliance of a certain matter. For example, when a shareholder files a case claiming that the BoD in the investee IFI has passed a non-Shariah-compliant transaction, the court would not be able to provide a ruling as to whether or not the transaction contradicts the rules of Shariah. Accordingly, IFIs should find a way to enforce Shariah as the rules applicable to their disputes in secular jurisdictions.

Some IFIs tend to include a choice of law provision in their contracts and agreements, stating that any dispute related to their business should be governed by the rules of Shariah or merely state that the agreement is conducted under the provisions of Shariah. However, this might not succeed in getting Shariah accepted as the applicable law in courts. Clear examples are seen in the UK in the case of Beximco Pharmaceuticals Ltd and Others v Shamil Bank of Bahrain Ec and the case of Islamic Investment Company of the Gulf (Bahamas) Ltd. v. Symphony Gems N. V & Others. In both cases the court declined to give legal effect to Shariah rules and applied the English law solely. In this regard, as Aldohni notes, if the court had taken into account the rules of Shariah, the result would have been completely different.

In Shamil Bank of Bahrain v. Beximco Pharmaceuticals and others, the clause was: ‘Subject to the principles of the Glorious Shari‘a, this Agreement shall be governed by and construed in accordance with the laws of England’. The court, in the first instance, rejected the application of Shariah rules on two grounds: first, it held that Shariah is not a law of a particular country, as set by the Rome Convention and its principles are not principles of law. Second, there cannot be two governing laws to the contract. The Judge also referred to the uncertainty of Shariah rules

that are applicable to the Agreement and the court’s inability to determine them.\textsuperscript{1182} The court refused his argument and indicated that the correct way to achieve this incorporation was by ‘sufficiently identifying specific ‘black letter’ provisions of a foreign law or an international code or set of rules apt to be incorporated as terms of the relevant contract’.\textsuperscript{1184} The court then confirmed that ‘The general reference to principles of Sharia in this case affords no reference to, or identification of, those aspects of Sharia law which are intended to be incorporated into the contract’.\textsuperscript{1185}

The \textit{Islamic Investment Company of the Gulf (Bahamas) Ltd. v. Symphony Gems N. V \& others} case involved an Islamic \textit{Murabaha}h agreement (passive partnership). The clause was: ‘The purchaser wishes to deal with the seller for the purpose of purchasing supplies under this Agreement in accordance with the Islamic Shariah’.\textsuperscript{1186} The agreement also has a clause stating that it ‘shall be governed by, and shall be construed in accordance with, English law’.\textsuperscript{1187} Accordingly, the Judge held that: ‘It is absolutely critical to note that the contract with which I am concerned is governed not by Shariah law but by English law’.\textsuperscript{1188} It should be noted that the court in this case was aware that the agreement was non-Shariah compliant based on advice obtained from an expert from Saudi Arabia, who gave evidence that the concerned agreement concerned did not have the essential characteristics of a \textit{Murabaha}h

\textsuperscript{1182} In this regard, Morison J stated that ‘There is clearly great controversy as to the strictness with which principles of Sharia'a law will be interpreted or applied. The English court, as a secular court, is not suited to ascertain and determine highly controversial principles of a religious based law.’ Shamal Bank of Bahrain v. Beximco Pharmaceuticals Limited and Others [2003] EWHC 2118 (Comm) [36]
\textsuperscript{1183} Beximco Pharmaceuticals Ltd and Others v Shamal Bank of Bahrain Ec [2004] EWCA Civ 19 [49]
\textsuperscript{1184} Beximco Pharmaceuticals Ltd and Others v Shamal Bank of Bahrain Ec [2004] EWCA Civ 19 [51]
\textsuperscript{1187} Islamic Investment Company of the Gulf (Bahamas) Ltd. v. Symphony Gems N. V \& others [2002] Queen’s Bench Division (Commercial Court) 1, 6
\textsuperscript{1188} Islamic Investment Company of the Gulf (Bahamas) Ltd. v. Symphony Gems N. V \& others [2002] Queen’s Bench Division (Commercial Court) 1, 8.
contract. Nevertheless, it concluded that the agreement ‘is a contract governed by English law. I must simply construe it according to its terms as an English law contract’.1189

First, it is important to highlight that, in terms of considering Shariah rules as principles of law, the fact that some jurisdictions do not accept Shariah rules as principles of law does not alter the fact that Shariah has a complete set of rules that regulate legal aspects of different fields including business. In this regard, in 1937 at the International Conference on Comparative Law held in The Hague, Shariah was recognised as a self-sufficient and independent law after a group of scholars from Al-Azhar University succeeded in expounding the civil and criminal rules in Shariah to the members of the conference.1190 Yet, it is still understandable that, for the purpose of litigation and legal proceedings, the parties need to be more specific.

As seen from the above cases, merely including a clause in the IFIs’ agreements specifying Shariah as the chosen law in the case of disputes is insufficient for solving the problem of the conflict of laws. It puts the court in a difficult situation in determining specific rules to apply to disputes, which would expose the implementation of Shariah rules to failure if the court is not satisfied with the clarity of the rules. Therefore, in order to have a better chance of enforcing Shariah rules and giving effect to its rules in the UK, IFIs need to choose the law of the particular Islamic jurisdiction that they consider best regulates Islamic finance.1191 For example, to choose the law of Malaysia. The possibility of this recommendation being successful is supported by the English court’s understanding of the parties’ freedom to choose the law that is to govern their contract. Foster states that the English law ‘has a very broad interpretation of the principle of freedom of contract, enabling transactions to be structured in accordance with the Sharia’.1192 In this context, in Dana Gas PJSC v Dana Gas Sukuk Ltd case, the parties (an Islamic institution and

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1190 Subhi Mahmassani, Falsafat Al-Tashri fi Al-Islam: The Philosophy of Jurisprudence in Islam (Farhat Ziadeh tr, Leiden Brill 1961) 52
1191 According to Aldohni, in the UK: ‘For the choice of law to be valid, the chosen law must be a system of law of a country rather than a non-national system of law.’ Abdul Karim Aldohni, ‘A Compatibility Analysis of Islamic Financial Disputes: English Private International Law and Islamic Law’ (2019) 14 Journal of Comparative Law 218, 227.
other non-Islamic parties) agreed to choose the law of an Islamic country that
endorses Shariah rules to govern their *Mudarabah* agreement (passive partnership
agreement). With regard to the applicable law the court stated that,

> [I]n general, questions about whether a contract is valid and enforceable is decided in the
> English courts by applying the law which governs the contract. Furthermore, the parties are
generally free to choose the law which is to govern their contract. ….. Thus if the contract is
governed by the law of a foreign country, the court will apply the country’s law to determine
its validity.

Nevertheless, it is important to emphasise that a determination of the
applicable law needs to be included expressly in all and every agreement to which an
IFI is party, even if it is a subcontract or related agreement, in order to avoid the
reversal that happened in the same case where the court, in the end, applied English
law and enforced a non-Shariah-compliant obligation. Here, the court established that
the process between the parties, by which the purchase was to take place, had been
split into two separate stages: the first stage (*Mudarabah* Agreement) was governed
by UAE law, and the second stage (Purchase Undertaking in the case of failure to
perform the first stage, which includes an obligation to pay interest) was governed by
English law. In this context the court stated,

> [W]here the contract is governed by English law, it is English law which determines whether
> the contract is valid and enforceable. The fact that the contract or its performance would be
> regarded as invalid or unlawful under the law of some other country … is generally speaking
> irrelevant.

Therefore, due to the fact that it is legal under English law to receive
compensation for the use of money (interest), the court decided on the validity of the
Purchase Undertaking, even if it was unlawful under UAE law in the application of
Shariah rules. Thus, in the end an Islamic institution was required to perform a non-
Shariah-compliant agreement. It is worth noting, however, that according to the
English law, this general rule has an exception where the performance of the contract
is illegal by the law of the place of performance in application of the *Ralli Brothers*
principle that was first established in *Ralli Brothers v Cia Naviera Sota y Aznar* in
1920. Based on this principle, an English court will not enforce an obligation in a
foreign country where this obligation is considered illegal, even if the obligation is

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1193 See Dana Gas PJSC v Dana Gas Sukuk Ltd [2017] EWHC 2928 (Comm)
1194 Dana Gas PJSC v Dana Gas Sukuk Ltd [2017] EWHC 2928 (Comm), [36], [37]
1195 Dana Gas PJSC v Dana Gas Sukuk Ltd [2017] EWHC 2928 (Comm), [38]
1196 ‘Under this principle English court will not force an obligation which requires a party to do
something which is unlawful by the law of the country in which the act has to be done.’ Dana Gas
PJSC v Dana Gas Sukuk Ltd [2017] EWHC 2928 (Comm), [59]
lawful under the English law.

Therefore, the first possible solution to the problem of ensuring the application of Islamic finance rules in the UK is through the inclusion of a clear clause in each and every agreement of the IFI specifying the law of an Islamic country regulating Islamic finance as the applicable law in case of any dispute.\(^{1197}\) It should be noted here that this solution will help to apply the rules of Islamic finance derived from Shariah set by a particular jurisdiction and not, in any way, means that the English court will apply Shariah rules as a non-system which is still seen as ‘an abstract concept that lacks certainty’.\(^{1198}\) Moreover, this solution would invoke other issues. For example, (a) the choice of law still needs to be proven to the court satisfaction; and (b) a secular court is expected to interpret the Shariah provisions incorporated in an English contract without a legal obligation to seek a Shariah expert opinion; and (c) the court is expected to evaluate and validate the different opinions of Shariah experts witnesses if employed by the parties.\(^{1199}\)

An alternative solution is to avoid judicial trials entirely and subject the agreement to international arbitration by including a clause on this regard in all agreements, as well as determining a clear set of rules to be applied on the dispute.\(^{1200}\) The arbitration agreement can state that any dispute arising out of or in connection to the agreement is to be finally settled by arbitration in accordance with the rules of Shariah and determine a set of rules, such as the rules of an Islamic country or the rules of international organisation regulating Islamic finance, such the Shariah standards of the AAOIFI. What distinguishes arbitration from litigation is the parties’ ability to choose the procedural rules applicable to their dispute, and arbitral tribunals often take a much more flexible approach to the rules of law to be applied.\(^{1201}\)


\(^{1199}\) For more see Abdul Karim Aldohni, ‘A Compatibility Analysis of Islamic Financial Disputes: English Private International Law and Islamic Law’ (2019) 14 Journal of Comparative Law 218, 234


\(^{1201}\) Oliver Cain and Nicholas Dawson, ‘Litigation and enforcement in the UK (England and Wales): overview’ (Thomson Reuters Practical Law, 2019) <https://uk-practicallaw-thomsonreuters-
regard, IFIs need to refer to an international arbitral institution as their choice of arbitrator in case the of disputes, such as the International Court of Arbitration of the International Chamber of Commerce (ICC), the International Centre for Settlement of Investment Disputes (ICSID), or the International Centre for Dispute Resolution (ICDR). Nevertheless, the same issues raised above for the first solution might arise here if the parties are not clear as to the rules of Shariah that they wish to apply to their dispute, and the lack of expertise in Shariah and Islamic finance when the dispute is heard by a secular arbitrator. Therefore, the International Islamic Centre for Reconciliation and Commercial Arbitration (IICRA) in Dubai, might be the best option for IFIs as it specialises in settling financial disputes in the light of Shariah rules. Nevertheless, it must be noted here that the English arbitration law, unlike the English private international law, is more flexible about the choice of law as it allows the arbitral tribunal to settle disputes with ‘other considerations’, if agreed upon by the parties. This allows the parties to enforce the rules of Shariah in the UK even though it is a non-national system, as evidenced by the approach in *Sanghi Polyesters Ltd (India) v. The International Investor KCFC.*

5.6 Conclusion:

This chapter examined shareholder activism in SCG as the role shareholders should play to defend their interest in proper Shariah compliance. Shariah shareholders should adapt to the legal system in which they do business. In countries

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1202 For more about the International Court of Arbitration please visit <https://iccwbo.org/dispute-resolution-services/icc-international-court-arbitration/>, for ICSID please visit <https://icsid.worldbank.org/en/>, and for ICDR please visit <https://www.icdr.org/> all accessed 30 December 2019

1203 In this regard, Aldohni cited two cases: *Petroleum Development Ltd. v. Sheikh Abu Dhabi* and *Ruler of Qatar v. International Marine Oil Company Ltd,* where the choice of Shariah has been rejected due to its non-system nature. See Abdul Karim Aldohni, ‘A Compatibility Analysis of Islamic Financial Disputes: English Private International Law and Islamic Law’ (2019) 14 Journal of Comparative Law 218, 236

1204 ‘The center settles in all financial and commercial disputes that arise between financial or business institutions that choose to apply the provisions of Islamic law, Sharia principles, in resolving disputes arise between these institutions and their clients or between them and third parties through reconciliation or arbitration.’ For more please visit the IICRA website <https://www.iicra.com/> accessed 30 December 2019

1205 See Arbitration Act 1996, Section 46(1) (UK)

1206 For more about this case see Abdul Karim Aldohni, ‘A Compatibility Analysis of Islamic Financial Disputes: English Private International Law and Islamic Law’ (2019) 14 Journal of Comparative Law 218, 237-238
applying a centralised system, such as Malaysia, Shariah shareholders are not vulnerable in the event that they ever lose control over the IFI as Shariah compliance is well protected and therefore the role they can play is narrow. In contrast, in decentralised or self-regulated systems, as in Kuwait and the UK, the role of shareholders is wider and more essential, hence it is important that their ownership stays concentrated.

Major shareholders, including institutional shareholders, state-owned institutions and other block holders, in IFIs have a responsibility to monitor the institutions’ SCG and Shariah compliance. They have the power to get the management to listen to them and the ability to effect changes in these institutions. Shariah investors should use their power to assist in the creation of efficient Shariah-compliant institutions and a more sustainable Islamic finance industry. A stewardship code can play a major role in encouraging their activism, but the available codes, whether in the UK or Malaysia, are generic and might not be very effective in providing guidance related to Shariah compliance activism.

Shariah shareholders need to make use of their rights and start engaging more with IFIs using different methods, starting from soft engagement - including having dialogue with the IFI - and progressing through to more formal means, such as filing a shareholder proposal. Shareholders might also use their right of litigation whenever they think it is necessary. In addition, Shariah shareholders of different IFIs are encouraged to get together and form a shareholder forum to monitor and evaluate the SCG of different IFIs. There is no doubt that Shariah shareholders will face some obstacles through their activism, however, this should not stop them from practising their stewardship role.
Chapter Six: Conclusion and Final Recommendations

6.1 Summary and review of main findings:

It was clarified in Chapter One that SCG is a faith-based model that is distinct from the existing known models of corporate governance.\(^{1207}\) It is the policy implemented by IFIs to ensure their Shariah compliance. The key features of this policy are the appointment of a SSB in the internal structure of the IFI and the management of Shariah non-compliance risk. However, it was shown in Chapter Two that the governance policy implemented by IFIs and their approach to fulfilling Shariah compliance have a number of problems that might challenge its effectiveness.\(^{1208}\)

The first problem is related to the binding force of the SSB’s rulings for the IFI.\(^{1209}\) Not every IFI considers the Shariah rulings of their SSB as binding. Recognising the binding force of the SSB’s opinions is important in order to ensure the IFIs’ adherence to the decisions of their SSB, which contributes to their Shariah compliance in return. Although it is acknowledged that fatwas are not compulsory in principle, fatwas of SSBs are seen to be binding on IFIs due to the fact that they are not issued unless agreed upon by all or a majority of Shariah members of the SSB which constitutes one of the cases where a fatwa becomes compulsory in Shariah. In addition, IFIs usually oblige themselves by their AoA to follow these rulings in order to show the credibility of their Shariah compliance and this is another case where a fatwa becomes compulsory in Shariah.

The second problem is related to the conflict of interests and independence of the SSB members in IFIs.\(^{1210}\) Despite the fact that Shariah scholars are respected religious figures, they are still not infallible and are subject to conflicts of interest and Shariah confirms this fact. The system of their appointment and remuneration where the BoD is deeply involved coupled with the fact that their Shariah opinions might affect the BoD’s financial decisions raises questions of the actual or perceived independence of the SSB’s Shariah decision making. SSB members also depend heavily on the results presented to them by the internal Shariah unit or officers in

\(^{1207}\) See C. Distinct model: a faith-based model in 1.8.2.2 The theory behind Shariah corporate governance in Chapter One.
\(^{1208}\) See 2.3 Problems of Shariah corporate governance in Chapter Two.
\(^{1209}\) See 2.3.1 The binding force of Shariah rulings in Chapter Two.
\(^{1210}\) See 2.3.2 Conflict of interest in Chapter Two.
performing their supervisory duty. This is all likely to affect their independence and the quality of their Shariah supervision and, in return, might weaken Shariah compliance in IFIs. Therefore, the independence of SSB members needs to be ensured and properly managed so as to avoid any case of conflict of interests.

The third issue that is claimed to affect SCG is the divergence in Shariah rulings between different SSBs.\textsuperscript{1211} It is agreed that standardisation in Shariah rulings is a positive matter and if achieved, it would add an advantage to Islamic finance in general. However, genuine disagreement between Shariah scholars on some matters related to Islamic finance should not form an obstacle to IFIs’ development; divergence is permissible in Shariah and at times is even necessary. Flexibility in Shariah allows scholars to use \textit{ijtihad} to set down rules that suit the circumstances of each country and circumstances without contradicting the basic rules and principles of Shariah.

The fourth issue that requires more attention in SCG is the remuneration of SSB members, especially since it might affect the members’ independence and objectivity.\textsuperscript{1212} In addition, there is an observation in Shariah regarding the right of Shariah scholars to receive payment for providing \textit{fatwas}. Furthermore, the risk posed by SSB members should not affect their pay if this risk is speculated only. Unfortunately, not all IFIs have a clear remuneration policy for SSB members that is transparent to shareholders. Moreover, the amount of remuneration received by each member is not always publicly disclosed.

The fifth problem in SCG of IFIs is the multiple memberships of Shariah scholars in several SSBs.\textsuperscript{1213} Shariah scholars serve a number of SSBs in different IFIs simultaneously. Also, SSBs around the world are dominated by a small group of well-known Shariah scholars. This practice can have a harmful effect on the IFIs for several reasons. Most importantly, it overloads Shariah scholars with increased responsibilities to supervise Shariah compliance in several institutions, which leads to their inability to give sufficient time to each board and hence failure to perform their duties efficiently. Also, it concentrates and increases the authority, influence and wealth of a few selected scholars, which might increase the chance of power abuse.

\textsuperscript{1211} See 2.3.3 Divergence of Shariah rulings in Chapter Two.
\textsuperscript{1212} See 2.3.4 SSB remuneration in Chapter Two.
\textsuperscript{1213} See 2.3.5 Multiple memberships of Shariah scholars in SSBs in Chapter Two.
Moreover, being a member of more than one board in the same industry increases the chance of conflicts of interest and breaches of confidentiality.

The sixth problem is related to the IFI’s financial obligations under Shariah. Many IFIs are not transparent with their zakat payment and income purification processes, which raises a governance issue. It is essential that IFIs be vigilant and provide sufficient information about distributing charity, zakat and purification funds to avoid being vulnerable to any financing abuse.

Chapter Three explained that SCG in IFIs is regulated and supervised in some jurisdictions to ensure its propriety and credibility. It was apparent that the national supervision of SCG is different from financial prudential supervision as it focuses on the IFIs’ adherence to Shariah rules and the rules of SCG. National Shariah supervision revolves around supervising the IFIs’ adherence to the rules of SCG set out in the national laws. In addition, the country may establish a CSB at the central bank level to issue standardised Shariah rulings for Islamic finance and supervise their implementation by SSBs in IFIs, which ensures a level of harmonisation between them. Both the IFSB and the AAOIFI confirm the authority’s duty to supervise SCG in IFIs. The IFSB issued principles for banking supervision in 2015 and the AAOIFI issued a governance standard for the central Shariah board in 2017. From studying the supervisory systems applied in Malaysia, Kuwait and the UK as leading countries in Islamic finance, it is apparent that national Shariah supervision comes in three levels: strict, lenient and absent, which then form the three main models of SCG: centralised, decentralised and self-regulated.

Countries with a centralised system, represented by Malaysia, apply the strongest regulation and supervision. This includes the availability of a comprehensive SCG framework with mandatory and recommended provisions for IFIs. There is also a CSB whose Shariah rulings are compulsory for all SSBs in the country. Moreover, failing to adhere to the compulsory rules of SCG might subject the IFI to civil and criminal sanctions. Thus, SCG in Malaysia is highly regulated and

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1214 See 2.3.6 Governance problem related to the IFI’s Shariah financial obligations in Chapter Two.
1215 See 3.2 Shariah supervision as distinct from prudential supervision in Chapter Three.
1216 See 3.4 International standards of national Shariah supervision and the governance of the centralised Shariah board in Chapter Three.
1217 See 3.5 Overview of the different supervisory systems in Islamic finance in Chapter Three.
Shariah compliance in IFIs is strictly supervised, which helps IFIs to achieve a high level of Shariah compliance as defined by the country.\footnote{1218 See 3.6.1 Malaysia in Chapter Three.}

Next comes the decentralised system, represented by Kuwait, where SCG is also regulated using mandatory and recommended rules, however, in terms of supervising the Islamic banks’ compliance to Shariah rules, the system relies mainly on the SSBs. In this system, SSBs are free to issue Shariah rulings the way they see fit without any ex-ante or ex-post national supervision. The effectiveness of the decentralised system might not be less than the centralised system in helping Islamic banks to reach a proper level of Shariah compliance, if proper supervision is applied in relation to the quality of Shariah scholars appointed to the individual SSBs. However, the system in Kuwait, in particular, has some defects that weaken its effectiveness.\footnote{1219 See 3.6.2 Kuwait in Chapter Three.} Mainly: (a) the system for solving disagreements between SSB members is questionable as the scholars expected to resolve the issue are not necessarily experts in \textit{Fiqh Al-Muamalat} or Islamic finance; (b) there are no clear Shariah standards for Islamic finance in Kuwait; (c) the system allows Shariah scholars to serve three local Islamic banks and an unlimited number of IFIs. It also allows Islamic banks to disregard SSB members’ conflicts of interest as they deem appropriate; and (d) the inclusion of external Shariah firms to supervise Shariah compliance in Islamic banks is ineffective, as it requires the external firms to oversee the Islamic banks’ adherence to the opinions of their SSBs without ensuring the opinions’ validity.

Finally, the absent model is found in the UK where there is no national Shariah supervision due to the fact that SCG is not regulated and IFIs are subject to the same rules as conventional financial institutions.\footnote{1220 See 3.6.3 The UK in Chapter Three.} Therefore, the SCG of IFIs in the UK is self-regulated and their Shariah compliance is exclusively supervised by their internal SSB. The UK legal system does not place any obligation on the IFIs to appoint a SSB, or to set minimum qualification requirements for Shariah scholars sitting on that board, or to set a strategy for resolving any case of disagreement among them or any other matter related to the governance of the SSB, as this body is alien to UK laws. Nevertheless, IFIs in the UK still implement a SCG policy and oblige themselves to achieve Shariah compliance in business according to their AoA. They usually make use of the international SCG standards. However, the implementation of
these standards, or any self-regulated standards, as well as the quality of Shariah rulings are still not subject to any external supervision.

After SCG and its problems were discussed in Chapter Two and the different national regulatory and supervisory systems and their effectiveness in ensuring Shariah compliance in IFIs were examined in Chapter Three, it was clear that SCG is not strong or adequate in every jurisdiction where IFIs exist and additional efforts need to be applied. Hence, this study suggests that shareholders as the third pillar of corporate governance alongside the company and the jurisdiction need to play an active role in SCG to protect Shariah compliance in their investee IFIs. The scope for their engagement was determined based on the effectiveness of the SCG regulatory and supervisory system. Therefore, due to the adequate regulation of SCG and high supervision in Malaysia, the scope for shareholders’ engagement is narrow. Shareholders in Kuwait have a wider scope for their activism due to the existence of defective regulation and lenient supervision. As for shareholders in the UK, they have the widest scope for their activism, and the greatest need for activism, due to the absence of SCG regulation and supervision.

Shareholders in IFIs were introduced then in Chapter Four.\textsuperscript{1221} IFIs are usually institutionally owned, with the existence of powerful large shareholders. The interest of those shareholders in Shariah compliance was also confirmed in Chapter Four, with several reasons being given.\textsuperscript{1222} Some shareholders prefer to invest their money in alignment with their religious beliefs, others are obliged by their AoA to invest in Shariah-compliant companies, yet others see Shariah compliance as an important aspect of the IFIs’ financial development. All of these shareholders, although for different reasons, meet at the point that Shariah compliance is an essential motive for their investment in IFIs and this is why we call them ‘Shariah shareholders’.

In order for Shariah shareholders to be active and protect their interest in Shariah compliance, they need to be equipped with several rights.\textsuperscript{1223} What mainly distinguishes these rights from the general rights of shareholders is that they are

\textsuperscript{1221} See 4.2.2 Shareholders of IFIs and their ownership structure in Chapter Four.
\textsuperscript{1222} See 4.3 Shareholders’ interest in Shariah compliance in IFIs in Chapter Four.
\textsuperscript{1223} See 4.4 The fundamental rights of shareholders in Shariah corporate governance in Chapter Four.
related to the IFI’s SSB and Shariah compliance as distinctive characteristics of these institutions.

**First,** the shareholders’ right of information in IFIs should entitle them to obtain timely and regular information related to the institution’s SCG, including but not limited to information related to: the work of the SSB as a body and each of its individual members; the extent of the institution’s Shariah compliance; Shariah opinions issued by the SSB; the institution’s policy of managing Shariah non-compliance risks; and on any incidents that happened during the financial year and how they have been handled. Moreover, shareholders should be given information about the IFI’s Shariah financial obligations, including information about the IFI’s *zakat*, charity and income purification, and how they have been calculated and given away. ¹²²⁴

**Second,** shareholders of IFIs should have the right to be informed annually as to whether the IFI will pay the *zakat* of their shares, in order to avoid any misunderstanding or possible dispute between the IFI and its shareholders in this regard.¹²²⁵

**Third,** shareholders in IFIs should be given the right to appoint and remove SSB members as part of their control rights, especially in countries that lack national Shariah supervision so that the appointment and dismissal of Shariah members are not under the full authority of the BoD, in order to ensure their competence.¹²²⁶

**Fourth,** shareholders in IFIs should be given the right to have a say in the remuneration of the SSB members and not leave it under the full discretion of the BoD.¹²²⁷ This is important to enable them to approve the remuneration strategy and be reassured of its Shariah compliance.

**Fifth,** shareholders should be allowed to discuss and authorise the IFI’s philanthropy and charitable activities. This is to help avoid any chance of money expropriation by the managers and any accidental money abuse in unwanted or non-Shariah-compliant outgoings.¹²²⁸

**Sixth,** the shareholders’ right of inquisition or inspection of an IFI should entitle them to ask questions about the SSB’s work and about each individual

¹²²⁴ See 4.4.1 The right of information related to the IFI’s Shariah compliance in Chapter Four.
¹²²⁵ See 4.4.2 The right toward *zakat* of shareholders in Chapter Four.
¹²²⁶ See 4.4.3 The right to appoint and remove SSB members in Chapter Four.
¹²²⁷ See 4.4.4 The right to discuss and approve the SSB members’ remuneration in Chapter Four.
¹²²⁸ See 4.4.5 The right to authorise an IFI’s philanthropy in Chapter Four.
They should be allowed to ask about the SSB’s Shariah opinions and to direct their enquiries straight to its members, bearing in mind the etiquette set by Shariah for asking scholars for their opinion.

**Seventh,** directors in an IFI are liable to shareholders in respect of achieving Shariah compliance in the institution. Therefore, any failure in performing this duty might raise their accountability. SSB members, as fiduciaries, are also liable to shareholders for their decisions, reports and rulings, and any violation of the agreement clauses in their agreements or breach of their fiduciary duty or other statutory duties might raise their personal liability. Therefore, shareholders of IFIs should have the right to challenge the directors and SSB members in courts and hold them accountable for their acts if they breach any of their contractual or statutory duties.  

**Finally,** shareholders invest with a company on the ground of some basics, interests and promises. If the basics have been changed or the interests are not met by the company, shareholders will be unhappy and will want to exit. In this regard, shareholders of IFIs should be given the right to dissent and exit the institution if their interest in a proper Shariah compliance is not met.  

There are, however, no specific rules in the legislation of the leading countries in Islamic finance that provide clear and detailed provisions for the rights of shareholders in SCG, there is merely protection for their basic and general rights.  

This gap might reflect negatively on the protection of shareholders’ interests and their active engagement in IFIs. In Malaysia, the high level of regulation has its effect on the rights acknowledged to shareholders in SCG and, therefore, shareholders of IFIs in Malaysia are entitled to some rights but not others. Shareholders in Malaysia still need to be equipped with all the rights motioned above, to ensure that compliance with Shariah rules and Shariah governance regulations is not just a matter of box ticking but is genuine. In Kuwait, shareholders are given more rights in respect of SSB members more than those conferred on shareholders in Malaysia, yet still not all rights are acknowledged to shareholders. These rights are even more important for shareholders in Kuwait as national supervision is not strong and the supervisory

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1229 See 4.4.6 The right to discuss the work of SSB and its Shariah rulings in Chapter Four.
1230 See 4.4.7 The right of legal proceeding against the SSB members in Chapter Four.
1231 See 4.4.8 The right to exit an IFI due to non-Shariah compliance issues in Chapter Four.
1232 See 4.6 Rights of shareholders in Malaysia, Kuwait and the UK in Chapter Four.
1233 See 4.6.1 Malaysia in Chapter Four.
1234 See 4.6.2 Kuwait in Chapter Four.
system has a number of defects. In the UK, shareholders in IFIs are not entitled to any of these rights in their literal sense due to the absence of national supervision of SCG.\textsuperscript{1235} It is then up to the IFIs to recognise the shareholders’ rights related to their Shariah practice and SSB and to include them in their AoA and shareholder agreement as long as they do not violate the national laws. If these rights are not embraced by IFIs in the UK, shareholders can only benefit from the general rights of shareholders addressed in the national laws.

Finally, as explained in Chapter Five, shareholder activism is the mechanism used by shareholders to enhance and develop corporate governance in their investee companies.\textsuperscript{1236} Shariah shareholders should use this mechanism to achieve the objectives of SCG in IFIs and to protect their interest in proper Shariah compliance. An essential part of their stewardship should be to hold the managers accountable for any unjustified deviation from proper and full Shariah compliance. This activism by shareholders is not just financially driven but also for religious purposes, as Shariah obliges Muslims to enjoy the right and forbid the wrong, to cooperate in righteousness and to protect property.\textsuperscript{1237} However, even with their rights and powers, Shariah shareholders still need principles and guidelines to encourage and lead them in the exercise of their role as owners. This can be done through a national legal framework by issuing a stewardship code, or through self-regulation by the respective IFI.\textsuperscript{1238}

Among the three countries, only the UK and Malaysia, which has drawn inspiration from the UK, have a stewardship code.\textsuperscript{1239} However, both codes are generic and might not be very effective in providing guidance related to activism in SCG.\textsuperscript{1240}

Despite the lack of guidelines, Shariah shareholders can still be active and engage with their investee IFI and attempt to enhance their SCG using soft or more formal methods, or even to raise the matter to the courts.\textsuperscript{1241} Shariah shareholders of different IFIs can also get together to achieve a stronger impact.\textsuperscript{1242} There is no doubt

\textsuperscript{1235} See 4.6.3 The UK in Chapter Four.
\textsuperscript{1236} See 5.2 General overview of shareholder activism in Chapter Five.
\textsuperscript{1237} See 5.3 Shareholders’ religious obligations under Shariah in Chapter Five.
\textsuperscript{1238} See 5.4.1 Stewardship guidelines for shareholder activism in IFIs in Chapter Five.
\textsuperscript{1239} See 5.4.1.1 The UK Stewardship Code and 5.4.1.2 The Malaysian Code for Institutional Investors in Chapter Five.
\textsuperscript{1240} See 5.4.1.4 The suitability of the UK and Malaysian stewardship codes to govern Shariah shareholders’ activism in Chapter Five.
\textsuperscript{1241} See 5.4.2 Shariah shareholders’ methods of engagement in Chapter Five.
\textsuperscript{1242} See 5.4.2.4 Shariah shareholders’ collective engagement in Chapter Five.
that Shariah shareholders might face some obstacles in relation to their activism, such as lack of information, legal barriers and free riding.  

However, two specific obstacles have been highlighted in this regard for the fact that, if they exist, they will jeopardise Shariah compliance in IFIs and Shariah shareholders will be powerless to prevent this. The first obstacle is associated with the IFI’s ownership structure, mainly: (a) when investors with non-Shariah-compliant business are allowed to buy a large number of shares in IFIs without any assurance that the money contributed comes from a Shariah-compliant source; and (b) when controlling shareholders in an IFI are not interested in the proper application of Shariah rules and hence favour financial gain over the proper application of Shariah rules. Shariah shareholders can face this problem in all three jurisdictions – Malaysia, Kuwait and the UK – as there are no direct rules in their legal systems that regulate the ownership of non-Shariah-compliant investors in IFIs or repel the negative influence of controlling shareholders on Shariah compliance in IFIs.

The second problem that might face Shariah shareholders is the difficulty in accepting Shariah as the applicable law in courts in any dispute related to SCG or the Shariah compliance of their investee IFIs. This problem, however, is not a major one for shareholders in Kuwait or Malaysia as, although Shariah is not the base for all their legislation, courts still give regard to Shariah rules in relation to IFIs’ disputes. However, this problem is significant for Shariah shareholders in the UK, as the courts will apply the country’s secular laws in any dispute related to the IFIs in the UK without taking into consideration their Islamic nature, which might impair their Shariah compliance.

6.2 Recommendations for practice:

In the light of the above findings, this section summarises the thesis’s suggested recommendations. It starts by providing recommendations for legislators in Malaysia and Kuwait as countries interested in regulating SCG, and then for Islamic banks in the UK. Finally, the section ends with recommendations for Shariah shareholders in the three jurisdictions, to ensure proper Shariah compliance in Islamic
banks.

6.2.1 Recommendations for legislators in Malaysia:

It is acknowledged that SCG in Malaysia is adequately regulated and Shariah compliance in IFIs is highly ensured and therefore the Shariah shareholders’ interest in Shariah compliance is protected to a high standard based on the country’s definition of Shariah compliance. Nevertheless, this high standard of regulation should not prevent shareholders from practising their role as stewards in IFIs. On the contrary, this stewardship should be legally encouraged. In addition, their right to Shariah compliance needs to be protected if they become minority shareholders. Therefore, some recommendations are directed to legislators in Malaysia as follows:

6.2.1.1 To acknowledge all the rights of shareholders in Shariah corporate governance:

It is recommended that the SCG framework in Malaysia include all the rights of shareholders in SCG mentioned in Chapter Four. Most importantly, it should entitle shareholders to: (a) the right to have a say in the appointment and remuneration of SSB members; (b) the right to receive information about the payment of their zakat; (c) the right to discuss and authorise the IFI’s philanthropy and choice of money distribution; (d) the right to exit the IFI due to any substantial change that has affected its level of Shariah compliance or due to failure in achieving an appropriate level of Shariah compliance.

6.2.1.2 To amend the Malaysian Code for Institutional Investors to cater for Shariah compliance activism in IFIs:

A few amendments are recommended to ensure that the Malaysian Code for Institutional Investors (MCII) is compatible with the institutional investors’ stewardship activities in IFIs. First the MCII should highlight the specificity of companies with a special nature of business, including companies that comply with Shariah. Second, the MCII should emphasise the institutional investors’ responsibility towards monitoring the non-financial aspects of their investee companies, including Shariah compliance. Third, the MCII should require institutional shareholders to observe and monitor the implementation of any corporate governance rules adhered to by their investee companies. In this regard, the MCII should include the Shariah

6.2.1.3 To amend the Shareholder suitability requirements policy to cater for shareholders in IFIs:

To avoid the entry of forbidden money to the IFIs, it is recommended that an additional requirement be added to the shareholder suitability policy in Malaysia – specifically for IFIs – that requires the shareholder, as well as being financially fit, to provide proof that the money contributed to finance an IFI is Shariah compliant.

6.2.1.4 To ensure the supremacy of the Islamic finance legislations over the secular legislations:

To avoid any case of conflict or inconsistency between Malaysian secular laws and its Islamic finance laws, the priority of the Islamic finance legislations should be ensured. Most importantly, Section 279 of the Islamic Financial Services Act 2013, which confirms the priority of this Act provisions over the Companies Act provisions, should be amended to give priority to the Islamic Financial Services Act over any other legislation in the case of conflict or inconsistency.

6.2.2 Recommendations for legislators in Kuwait:

SCG is also regulated in Kuwait and the system relies mainly on Shariah scholars sitting on SSBs to ensure Shariah compliance in Islamic banks. This decentralised system can be as effective as the centralised system in Malaysia if it is regulated and supervised in a proper way. The decentralised system in Kuwait has a number of defects that weaken its effectiveness. The following points present some recommendations to overcome these problems.

6.2.2.1 To rectify the current supervisory system of Shariah corporate governance:

If the current decentralised system is preferred to be kept in Kuwait, it is recommended that some amendments are implemented:

First: to amend the system for solving disagreements between the SSB members in Islamic banks. Hence, it is recommended to appoint at least one scholar who is expert in Islamic finance and *Fiqh Al-Muamalat* on the *fatwa* board in the
Ministry of Awqaf and Islamic Affairs to deal with the matters referred to the fatwa board from different SSBs.

Second: to draft clear Shariah standards for Islamic finance derived from Islamic Shariah rules and include them in the laws regulating Islamic banks in Kuwait, mainly in the Companies Act 2016 and the Central Bank Act 1968. In this regard, legislators can benefit from the Shariah standards issued by the Islamic organisations such as the AAOIFI Shariah Standards.

Third: to regulate the multiple memberships of Shariah scholars by allowing a Shariah scholar to serve only a single SSB of the same industry.

Fourth: to regulate the external Shariah firms effectively. It is helpful to have independent Shariah advisory firms that are composed of SCG advisors, who can be Shariah scholars with profound knowledge in both Shariah and Islamic finance. They can be for example, former SSB members who do not serve Islamic banks anymore due to retirement or some legal restrictions. However, it is important to emphasise that these scholars need to be certified by the central bank and by the Ministry of Awqaf and Islamic Affairs as the authority responsible for ascertaining and supervising Shariah-related matters in the country. This certification should cover their competence and efficiency to practise such business. Contrary to the current system that requires each Islamic bank to appoint an external Shariah firm to perform an annual review to examine the bank’s compliance with the rulings of its SSB, these external Shariah firms should instead be required to review the Shariah rulings of SSBs and the proper implementation of Shariah rules in the Islamic banking sector in total and to provide a report to shareholders in the AGM.

6.2.2.2 To establish a centralised Shariah board:

Establishing a CSB at the central bank’s level is an alternative solution for rectifying the current supervisory system in Kuwait. The system in Kuwait needs to impose a balanced national Shariah supervision where the national supervision is not very strict or completely absent. The supervisory authority needs to obtain both supervisory and advisory functions. This both allows the monitoring of Shariah scholars in SSBs and their work quality and also ensures that they are provided with the required facilities to perform their duties and to develop themselves professionally.
Therefore, it is recommended that a CSB be vested with supervising the SSBs in Kuwait and monitoring the proper implementation of Shariah rules. However, it is not recommended that this supervision be centralised in a manner that strips away the SSBs’ ability to issue their own Shariah rulings. In this regard, the system should encourage discussion and the exchange of opinions between Shariah scholars of the CSB and different SSBs while the final decision will be for the CSB in case of disagreement. This is to eliminate the possibility of politicising SSBs, to avoid the bureaucracy of the centralised system and to open the door for Shariah scholars from different schools of thoughts to share their opinions and issue Shariah rulings. Therefore, the following points provide the basic ground for establishing a CSB in Kuwait:

**First**, Shariah scholars sitting in the CSB should be experts in Shariah especially *Fiqh Al-Muamalat* and in Islamic finance. In terms of their job status, it is believed that being a member in this board should be through permanent employment rather than just a matter of hiring consulting services. They should also be restricted from serving as Shariah scholars in different SSBs inside Islamic banks, which they are required to oversee, in order to protect their independence, objectivity and stewardship duty. In addition, the CSB’s members should not be allowed to provide any verbal or written Shariah consultancy whether for money or for free to any IFI unless through the required channel of seeking the CSB’s Shariah opinion.

**Second**, the CSB’s main duty is to provide advice and guidance to SSBs any time it is needed as well as to resolve any disagreements between the members of SSBs. It should also observe the proper implementation of Shariah rules in Islamic banks without imposing standardised Shariah rulings for all SSBs. This board will then replace the national *fatwa* board in the Ministry of Awqaf and Islamic Affairs and its mandates towards SSBs in Kuwait. The referral to the CSB by SSBs is optional but if it happens then the decision is binding and final. However, the CSB should also be vested with a supervisory role that allows it to interfere whenever an Islamic bank has undertaken a clearly non-Shariah-compliant activity. This board is specialised and its mandate should not be extended to other regulatory and supervisory functions in the country or otherwise it will be distracted and overloaded in a manner that negatively affects its duty to monitor the Islamic finance sector.
Third, Islamic banks should obtain prior approval from the CSB before appointing any Shariah scholar in their SSBs. This will help to ensure the Shariah scholar’s competency to serve SSBs and strengthen their independence.

Fourth, adopting international standards for the CSB, such as the AAOIFI governance standard for the CSB, should not be to the point of imposing the Shariah rulings of the international Shariah board on the SSBs in Kuwait as this might open the door to the control of the local SSBs by the international organisation.1248

Finally, it should be noted that the establishment of this board does not mean that Kuwait has to give up its decentralised supervisory system; it only helps to support Shariah scholars sitting in different SSBs by ensuring that they are fit and proper to serve SSBs and by giving them guidance and advice. It also has a supervisory role to ensure the correct implementing of Shariah rules by SSBs and to stop any clear deviation from achieving this objective. It should be mentioned here that recently, in December 2019, the Kuwait National Assembly announced that the Central Bank of Kuwait Law 1968 will be amended soon, and this amendment will include the establishment of a CSB that consists of highly qualified Shariah scholars from different Islamic schools of thought. The responsibilities of this board are not clear yet, however, the Governor of the Central Bank stated that it will be responsible – among other duties – for resolving any disagreement between SSB members instead of the *fatwa* board (as suggested above by this thesis).1249

6.2.2.3 To acknowledge all the rights of shareholders in Shariah corporate governance:

The SCG framework in Kuwait should also acknowledge the rights of shareholders mentioned in Chapter Four. In this context, in order to include all the recommended rights, shareholders should be entitled to all information related to SCG in their Islamic banks. The current framework does not require Islamic banks to disclose the SSB members’ remuneration, the number of their memberships, the bank’s policy for Shariah non-compliance risk management, the payment of

1248 See 3.4.2 The AAOIFI governance standard for the central Shariah board (CSB) in Chapter Three.
1249 Salem Abdul Ghaifour, ‘The Establishment of a Higher Shariah Supervisory Board’ (Al-Qabas Newspaper, December 2019) <https://alqabas.com/article/5737385-%D8%A5%D9%86%D8%B4%D8%A7%D8%A1-%D9%87%D9%8A%D8%A6%D8%A9-%D8%B9%D9%84%D9%8A%D8%A7-%D9%84%D9%8B1%D9%82%D8%A7%D8%A8%D8%A9-%D8%A7%D9%84%D8%B4%D8%B1%D9%89%D9%8A%D8%A9> accessed 20 January 2020
shareholders’ zakat, the banks’ philanthropy, and the choice of money distribution. In addition, the accountability of SSB members for ensuring Shariah compliance in Islamic banks should be strengthened in the legal framework by setting specific sanctions for knowing contravention of Shariah rules in the course of their duty to supervise Shariah compliance in Islamic banks. Finally, it is recommended that shareholders be given the right to exit the Islamic bank with fair conditions in the case of a change in the Islamic bank’s level of Shariah compliance or Islamic nature.

6.2.2.4 To issue a stewardship code:

Kuwait is also recommended to issue a stewardship code to encourage and guide the engagement of institutional investors in public companies in general, taking into consideration the specific nature of Islamic banks. The code needs to encourage institutional investors to monitor the SCG implemented in their investee Islamic banks and their adherence to the Instructions Regarding Shariah Supervision Governance in Kuwait Islamic Banks of 2016 as well as the internationally accepted SCG standards.

It is recommended that the code be enforced in an apply-and-explain method to strengthen the level of institutional investors’ compliance and reporting. All institutional investors should be encouraged to become signatories. The supervisory body, whether Kuwait Central Bank or the Capital Markets Authority needs to evaluate the quality of institutional investors’ implementation of the code’s principles and publicly disclose the results. If an institutional investor fails to apply the stewardship code’s guidelines and clearly explain their implementation, the supervisory body should impose some disciplinary actions, such as not authorising it to carry on business or to be listed in the market. In addition, the supervisory body needs to issue a list of investors that apply the stewardship code and carry out an annual evaluation process for the code. Finally, it is acknowledged that drafting, issuing, implementing and regularly evaluating a stewardship code require high costs, time and resources. However, because of its importance and benefits in encouraging shareholder activism, some of the costs can be placed on institutional investors by, for example, requiring them to pay listing fees.
6.2.2.5 To issue a shareholders’ suitability policy for financial institutions:

Kuwait also lacks a policy for shareholders’ suitability in Islamic banks. This is an important policy to safeguard the stability of the financial sector. Kuwait can benefit from the Malaysian shareholder suitability policy, however, the specific nature of Islamic banks should be taken into consideration. Therefore, similar to the recommendation for Malaysia to avoid the entry of forbidden money into Islamic banks, this policy should require shareholders with a non-Shariah-compliant business that wish to buy shares in an Islamic bank to provide evidence that the contributed money comes from a Shariah-compliant source.

6.2.2.6 To limit the controllers’ ability to negatively impact the Islamic banks’ Shariah corporate governance and Shariah compliance:

The law, mainly the Central Bank Law, needs to ensure that controlling shareholders do not abuse their powers in a way that might affect Shariah compliance in Islamic banks. In other words, the law needs to ensure that the controller’s ability to effect a change in the Islamic bank will not weaken or jeopardise its proper Shariah compliance. This is to protect the interest of Shariah shareholders in Islamic banks who will be a minority when the controller is not interested in the proper application of Shariah rules. Therefore, the law should enforce a general obligation that the shareholder or group of shareholders should not make direct or indirect changes to the Islamic bank’s SCG unless it is in the best interests of its Shariah compliance. Moreover, for better enforcement, a sanction should be imposed for the breach of this obligation.

6.2.3 Recommendations for IFIs in the UK:

SCG is self-regulated and supervised in the UK by the individual IFIs. Therefore, the following recommendations are directed to the IFIs and not to the legislators in the country.

6.2.3.1 To establish a Shariah corporate governance policy:

It is recommended that each IFI to issue a detailed SCG policy following the internationally accepted standards and including a section for the SSB that clarifies its definition, appointment, composition, qualifications, roles and duties, ethical criteria and legal status as illustrated in Chapter Two. The IFI should also establish a policy
for managing Shariah non-compliance risk and a remuneration policy that includes the criteria for the SSB members’ remuneration. Moreover, the IFI should establish a system for resolving disagreements between the SSB members. The issued policies should be made available to shareholders and the public by publishing a copy on the institution’s website. In addition, each IFI needs to commit itself to following the opinions of its SSB by including a clause in its AoA and SCG policy and emphasising that SSB members do not interfere in the management and financial decisions of the IFI, to avoid the application of the FCA Handbook ‘fit and proper’ standards and restrictions for persons with executive functions.1250

6.2.3.2 To regulate the remuneration of SSB members:

In setting their remuneration policy, IFIs are encouraged to benefit from the international standards, and the remuneration of the SSB members needs to be an essential part of that policy. The policy needs to explain the nature of the Shariah members’ duties, their appointment contract and the criteria for the determination of their remuneration. All information should be clear, well documented and transparent. In setting the remuneration of the SSB members, IFIs should take into consideration the rules of Shariah. In this regard, it is best to exclude providing fatwa as a remuneration measurement factor when determining Shariah members’ remuneration, as it is merely a religious act. Moreover, in setting the remuneration of the SSB members, the IFIs should not take into consideration the risk imposed by them unless it is an actual risk in order to avoid the prohibited speculation.1251 In addition, the nature of the SSB members’ responsibilities requires that their remuneration is fixed because they are not expected to promote the institution’s business or raise its profitability. From the standpoint of transparency and information disclosure, each IFI should disclose clear, comprehensive and timely information related to the SSB members’ remuneration. The annual report should include all information related to the remuneration of SSB members and their performance.

6.2.3.3 To regulate the SSB members’ multiple memberships:

Initially, IFIs should not appoint a Shariah scholar who serves many SSBs in order to protect their confidentiality, ensure the productivity of their SSB and reduce

1250 See 2.3.1 The binding force of Shariah rulings in Chapter Two.
1251 See 2.3.4.2 Risk Associated with SSB Members in Chapter Two.
conflict of interest issues. The IFI should disclose all information related to their Shariah scholars’ membership, including the number of boards served internationally and the number of meetings attended and missed by each Shariah member. To overcome the shortage in Shariah scholars, it is recommended that IFIs open the doors for female Shariah scholars to serve their SSBs and encourage them to do so even if they are not highly experienced. They can start by appointing a female Shariah scholar on top of the required number of Shariah scholars on the SSB to provide them with an opportunity to obtain experience; with time, women will gain the needed experience and the IFIs can go back to appointing the usual number including women. The same system can be used for junior Shariah scholars.

6.2.3.4 To regulate the rights of shareholders in Shariah corporate governance:

With regard to the rights of shareholders in SCG, IFIs should voluntarily confer these rights on shareholders as a matter of corporate governance good practice by including them in the IFI’s AoA as well as the shareholder agreement. In this regard, IFIs need to cover the rights that are not generally addressed in national laws, as explained below:

(1) Shareholders should be entitled to receive regular information related to the IFI’s SCG, including but not limited to information related to the work of the SSB as a body and each of its individual members, on the extent of the institution’s Shariah compliance, on Shariah opinions issued by the SSB, the certified and rejected transactions and on the institution’s Shariah non-compliance risks and how they have been managed. Moreover, each IFI needs to disclose complete details on its Shariah financial obligations. This should include stating the amount paid each year for zakat, charity and income purification, how they have been calculated and their expenditures.

(2) Shareholders of an IFI should be entitled to elect and remove members of the SSB in the AGM. Each Shariah scholar should be subjected to a separate vote on an individual basis. The shareholders can either vote for, against or abstain, and the same system applies for their removal or replacement. In addition, they should be given the opportunity to discuss and approve the SSB members’ pay at the outset and every few years.

(3) It is fairly important that the IFI clearly notifies its shareholders on whether it is going to pay their individual zakat or not every financial year. This is in
order to avoid double payment of zakat if they do pay it on dividends or to let shareholders know that they should pay zakat of their shares if they do not.

(4) To emphasise the shareholders’ right of dispute against the SSB members, the IFI needs to strengthen the accountability of SSB members for the quality, accuracy and soundness of their decisions and views and this accountability remains even in the case of delegation. This accountability should be confirmed in the IFI’s AoA as well as the SSB member’s appointment letter.

(5) The IFI should also acknowledge the shareholders’ right to exit the institution due to a substantial change that affected its level of Shariah compliance or for not achieving a proper level of Shariah compliance.

6.2.3.5 To prevent the entry of prohibited money to the IFIs through shareholding:

To prevent the entry of prohibited money into IFIs, the ownership of investors with a non-Shariah-compliant business in an IFI should be restricted. Therefore, such investors should not be allowed to finance an IFI whether in the initial subscription or in terms of a capital increase unless they provide evidence that the money comes from a permissible source. However, it is important to emphasise that, as a matter of transparency, any ownership restriction or means of capital structure should be clearly disclosed by the IFI if it decides to apply them. Also, this restriction should not be expanded or applied in an extreme sense for commercial awareness purposes. Prohibition should not be applied to anything unless it is definitely known to be prohibited in Shariah. For example, the ownership of non-Shariah-compliant investors’ in Islamic IFIs should not be prohibited when the non-Shariah-compliant investor pays the money to shareholders for an exchange of shares, as the prohibited money in this case does not enter the property of the IFI but that of the exiting shareholders.

6.2.3.6 To limit the controllers’ ability to impact the Islamic banks’ Shariah corporate governance and Shariah compliance negatively:

IFI need to protect their Shariah compliance from the negative influence of the controlling shareholders. A shareholder agreement can be utilised to achieve this objective. This involves the inclusion of two specific provisions in the shareholder agreement that limit the controlling shareholders’ ability to affect the IFI’s Shariah
compliance bearing in mind that this agreement should not violate the primacy of mandatory rules set by law. The first clause addresses the general obligation that a shareholder or a group of shareholders, who collectively own a controlling percentage of shares, should not do any direct or indirect action to effect changes in the IFI unless it is in the best interest of its SCG and Shariah compliance. The second clause addresses the remedy once the first clause has been breached. The deterrents should be ascertained and drafted clearly in the contract so that the shareholder is clearly informed of the consequences of their agreement.

6.2.3.7 To ensure the application of Shariah rules to the IFI’s disputes:

It is important to consider Shariah as the law applicable to IFIs, whether Shariah is the basis of the country’s legal system or not. Therefore, in order to have a better chance of enforcing Shariah rules and to give effect to its rules in courts in the UK, IFIs need to choose the law of a particular Islamic jurisdiction that regulates Islamic finance well: for example, to choose the law of Malaysia as their choice of law. Nevertheless, it is important to emphasise that this determination of the applicable law needs to be included expressly in each and every agreement to which an IFI is party of even if it is a subcontract or related agreement.

Another alternative solution to applying Shariah rules in IFIs disputes is to entirely avoid judicial trials and subject the agreement to international arbitration by including a clause in this regard in all agreements, determining a clear set of rules to be applied to the dispute. Parties can state in the agreement that any dispute arising out of or in connection to the agreement is to be finally settled by arbitration in accordance with the rules of Shariah, but it is always better to be more specific and determine a set of rules, such as the rules of an Islamic country or the rules of an international organisation regulating Islamic finance, such the Shariah standards of the AAOIFI. In this regard, IFIs need also to refer the matter to an international arbitral institution in the case of disputes, such as the International Court of Arbitration (ICC), the International Centre for Settlement of Investment Disputes (ICSID), or the International Centre for Dispute Resolution (ICDR). However, the best option for IFIs could be the International Islamic Centre for Reconciliation and Commercial Arbitration (IICRA) in Dubai as it is specialised in settling financial disputes in the light of Shariah rules.

In both solutions, especially when the court/arbitrator is not specialised in the
rules of Shariah, it is always advisable for the parties to appoint an expert in Shariah and Islamic finance and to rely on their evidence whenever an interpretation or Shariah opinion is required. It should be noted, however, that the parties need to obtain permission from the court for this appointment.

6.2.4 Recommendations for shareholders activism in the three jurisdictions:

This thesis suggests that shareholders’ engagement with their investee IFIs will result in a better SCG and Shariah compliance. Shariah shareholders in Malaysia have a narrow scope for their activism due to its high regulation and supervision, while in Kuwait the scope is wider as the national supervision is lenient and the system is defective. In the UK, Shariah shareholders have the widest scope for their activism due to the absence of national regulation and supervision. Therefore, the following recommendations are directed to all Shariah shareholders in the three countries, each in so far as they are compatible with the scope of their activism.

First, it is worth mentioning that when evaluating the institution’s SCG, shareholders should observe the national SCG rules, if they exist, or the internationally accepted principles. They should effectively practise their role as monitors and steer away from using a box-ticking method in their evaluation. However, they should take into consideration several factors, such as the size of the institution, its nature of business and level of business complexity bearing in mind that following the rules of Shariah is the raison d’être for such institutions. In this context, Shariah shareholders are recommended to use four methods in performing their stewardship: soft, formal, judicial and collective.

6.2.4.1 Soft engagement:

Shariah investors should monitor the performance of their investee IFI on a regular basis and communicate the issues of concern directly and clearly to the institution. This monitoring process should include the extent and efficiency of the IFI’s Shariah compliance. In this regard, Shariah investors should satisfy themselves that the investee IFI is undertaking a properly Shariah-compliant business as detailed below:

First, an essential part of the shareholders’ engagement should be directed towards the corporate governance reforms in their investee IFIs. Shariah investors should urge the BoD in an IFI to implement a robust SCG policy that caters for the
institution’s needs and special characteristics. They should ensure that the investee IFI committees are structured effectively and this should include the appointment of a SSB in the institution’s internal structure that is commensurate with its size and the complexity of business.

Second, Shariah shareholders need to make sure that the SSB is effective and works properly in order to provide an adequate Shariah audit. In the case where Shariah scholars are approved or certified by the national authority, as is the case in Malaysia, shareholders are not required to do an intense investigation to choose the best scholar. However, if there is no such prior approval, as is the case in Kuwait and the UK, shareholders are required to do an investigation before approving the names recommended by the BoD. This investigation is necessary to ensure the fulfilment of the competence criteria set by the IFI for Shariah scholars. In this regard, investors are encouraged to view the qualifications and previous experience of the recommended Shariah scholars. They should approve those whom they see as fit and satisfying the competence criteria and reject those who do not. Investors should ask questions and demand more clarifications whenever they are needed.

Third, Shariah shareholders should be keen on receiving all information related to the IFI’s SCG and Shariah compliance. As part of their monitoring duty, they can demand more information about the extent of the IFI’s Shariah compliance. They can ask for more frequent Shariah compliance reports; the main annual report and other periodic reports during the financial year. Shareholders have to view and scrutinise the IFI’s Shariah reports and discuss any incident of non-Shariah compliance and ask for clarification on how it has been dealt with.

Fourth, Shariah shareholders need to be engaged in the governance of the pay of members of the SSB as well. They are encouraged to view and discuss the remuneration policy and the determination measures set by the IFI, taking into consideration the recommendations presented in Chapter Two for the SSB members’ remuneration. Most importantly, Shariah investors should not approve an exaggerated amount of remuneration or a variable remuneration based on performance.

Fifth, Shariah shareholders should also take into consideration the SSB members’ multiple membership requirements presented earlier in Chapter Two when approving their appointment. In this regard, they should take a responsible attitude and not approve the appointment of any Shariah member who is a member in more than one local IFI of the same industry or more than a reasonable number of IFIs
internationally no matter how well-known the scholar is. In addition, Shariah shareholders need to monitor the SSB members’ commitment to attend meetings and the frequency of this attendance collectively and on an individual basis. In addition, they should monitor the efficiency of their audit and reporting process and, in general, their adherence to the Shariah audit system implemented by the IFI.

**Sixth:** Shariah shareholders in IFIs are encouraged to ask questions about the SSB’s work and to direct their inquiries straight to its members. They need to discuss Shariah rulings issued by the SSB and ask for more clarification whenever they feel it is necessary. This can happen, for example, when a Shariah ruling is not clear, contains an odd opinion or an opinion that opposes or contradicts an agreed opinion issued by other Shariah scholars in the field of Islamic finance.

6.2.4.2 Formal engagement:

When soft engagement has not achieved its goal, Shariah shareholders in such cases need to approach the company in a firmer and more formal way to enforce their demands. The most popular practice is to submit a shareholder proposal and access the proxy system in the AGM. In this context, Shariah shareholders in the three countries can submit a proposal including their concerns, observations and recommendations for a reform to be voted on by the other shareholders in the AGM.

The proposal can be used to enforce reforms in the IFI’s SCG system and its organs or to amend any practice that threatens the extent of the IFI’s extent of Shariah compliance. For example, if any incident of non-Shariah compliance is registered or detected and the IFI does not take the required measures and procedures to rectify it and prevents its reoccurrence in the future, shareholders should use their power to force this amendment. Moreover, a shareholder proposal can be used as a tool to remove or replace SSB members, especially if they are not reelected every year. This might be used on the occasions where Shariah shareholders feel that a Shariah member is no longer qualified to be in the IFI’s SSB.

Shariah shareholders can also use a shareholder proposal to appoint a new or an extra SSB member. In this situation, the IFI should include in the proxy materials the shareholders’ nominee for the election of SSB members if the nominee meets the appointment requirements and criteria outlined by the law or by the IFI.

In order for a shareholder proposal to have a good chance of succeeding and achieving its goal, two matters should be taken into consideration by Shariah
shareholders: (a) the issue raised should be serious, genuine and evidence based to minimize the chances of its exclusion by the BoD; and (b) the proposing shareholder needs to seek support from other shareholders for votes. In this situation the activist shareholder should provide good reasons and justification for their proposal to win the support of other shareholders. Specifically, they need to prove their good intention and commitment to the enhancement of the institution’s SCG and Shariah compliance rather than the pursuit of their own interests. Nevertheless, even if the proposal does not succeed, the threat of this requisition itself is an efficient means of monitoring the IFI’s performance and Shariah compliance.

6.2.4.3 Shareholders’ litigation:

When soft and formal intervention methods have not been successful in achieving the objectives of a shareholder's activism in an IFI, the shareholders concerned can always raise the matter to the court. They can hold directors accountable for any breach of their fiduciary duties in achieving Shariah compliance in an IFI. Moreover, they can hold SSB members personally responsible for any breach of their fiduciary duties or shortcomings in performing their supervisory role that resulted in reducing the level of the IFI’s level of Shariah compliance. This option is believed to be available to shareholders in the three countries based on the rules of derivative claims, oppression remedy and unfair prejudice.

6.2.4.4 Collective engagement:

For a better chance to achieve the goal of their activism, Shariah shareholders need to work together. Collaboration between Shariah shareholders can be done through establishing a ‘shareholder group’. This would provide a number of advantages. First, it would help in decreasing the activism costs as shareholders in the group can share the expenses. Second, it can help in supporting a shareholder proposal by collecting prior approvals from the shareholders in the group. Third, being in a group will make it easier for shareholders to communicate with each other.

Establishing a ‘forum of investors’ is another way of collaborative working between investors who share similar interest. This forum can be used to encourage Shariah investors around the world to monitor and engage more in the governance of IFIs. In this context, Shariah advocates of different IFIs are recommended to get together, form a body and start a Shariah movement to monitor Shariah compliance
and SCG practices in IFIs. In their supervision they need to focus on the efficiency of the SSB as well as the whole SCG system applied by the institution. They need to target IFIs that have a poor Shariah compliance rate, for example, IFIs that are known to have an inefficient SSB, offer Shariah non-compliant products or services either directly or indirectly, or do not adhere to the internationally accepted standards of SCG. To achieve their objective, Shariah investors need to share information with other shareholders and publicise their findings.

6.3 Scope for further research:

This study has not dealt with some issues in the field of SCG that might fruitfully be pursued in future research. Research on SCG could be continued, to study:

- The role of other stakeholders and market forces in achieving the objectives of SCG. In general, to investigate how to ensure Shariah compliance in IFIs through the activism of other stakeholders.
- The impact of shareholders’ engagement on the IFIs’ SCG and Shariah compliance before and after engagement.
- The possible development of guidelines for a Shariah shareholders’ stewardship code in IFIs.
Appendix One: Islamic finance in Malaysia, Kuwait and the UK:

1.1 An overview of Islamic finance:

Islamic Shariah governs all aspects of Muslims’ life, including commerce and business. It is then very important for a devoted Muslim to follow the rules of Shariah in financial transactions. Kettell explains that Shariah sees money as a medium of exchange, a way to give value to a thing only and cannot be used on its own to generate more money. Schoon confirms that the ethical framework of Shariah considers making money with money is immoral and wealth should be grown through trade and investment. With regard to financial transactions, Islamic Shariah enforces three main restrictions: the prohibition of maysir (gambling), the prohibition of gharar (uncertainty), and most importantly, the prohibition of dealing with interest, which is considered as riba (usury) in Shariah.

The idea of Islamic finance is primarily based on the principle of profit and loss sharing (PLS) as a method of resource allocation. Due to the prohibition of riba in Shariah, an IFI provides interest-free services. Accordingly, an IFI deals with its depositors and investors on a partnership basis. This restriction has its effects on the Islamic banking system as a whole, making it very different from the conventional

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1252 Brian Kettell, Case Studies in Islamic Banking and Finance: Case Questions and Answers (John Wiley & Sons Ltd 2011) xix
1253 Natalie Schoon, Modern Islamic Banking: Products and Processes in Practice (John Wiley & Sons Ltd 2016) 43
1254 Interest is defined as ‘any excess of money paid by the borrower to the lender over and above the principal amount for the use of the lender’s liquid money over a certain period of time’. Imtiaz Pervez, ‘Islamic Finance’ (1990) 5 Arab Law Quarterly 259, 263
1255 The prohibition of riba is found in Shariah primary sources, Quran and Sunnah. The Quran explicitly prohibited riba where He says, ‘But God has permitted trade and has forbidden interests.’ The Holy Quran, Surah Al-Baqarah, Chapter 2, Verse 275. Saheeh International (tr), The Qur’an (3rd edn, Al-Muntada Al-Islami 2010) 61. From Sunnah, Prophet Muhammad (PBUH) says, ‘Avoid the seven destroyers. It was said: “What are they, O Messenger of Allah?” He said, “….., consuming riba, …”’. Muslim Ibn AlHajaj, Sahih Muslim, vol 1 (Nasiruddin Alkhattab (tr), Darussalam 2007) Hadith 262; Muhammad Bukhari, Sahih Al- Bukhari, vol 3 (Muhammad Khan (tr), Darussalam 1997) Hadith 6857. Fiqh, on the other hand, elucidates that interest is considered as a prohibited riba. The International Islamic Fiqh Academy confirms that any interest above the debt is a type of riba that is prohibited in Shariah. Organisation of Islamic Co-operation, ‘Decisions and Recommendations of International Islamic Fiqh Academy 1988-2009’ (Decision no 10/2) 22. See also The General Presidency for the Departments of Scientific Research and Ifta, Fatawa Al-Lajnah Al-Da’emah lil Bohoth Al-Elmiyyah wa Al-Ifta, vol 13 (General Presidency for the Departments of Scientific Research and Ifta 2005) Fatwa 7301. In addition, The International Islamic Fiqh Academy prohibits buying shares in any company that deals with riba. See Organisation of Islamic Co-operation, ‘Decisions and Recommendations of International Islamic Fiqh Academy 1988-2009’ (Decision no 1/7) 118
1256 Mohamed Ariff, ‘Ethics Based Financial Transactions: An Assessment of Islamic Banking’ in Mohamed Ariff and Munawar Iqbal (eds), The foundations of Islamic Banking (Edward Elger 2011)
banking system, which deals freely with interest. Alternative banking contracts, transactions and products have been put in place to conform to Shariah rules. The products and transactions include mudarabah (passive partnership), musharakah (active partnership), murabahah (sales contract at a profit mark-up), ijarah (leasing), tawwaruq (subtitle asset backing a loan) and Sukuk (asset-backed bonds).

Moreover, following the rules of Shariah requires an IFI to earn and deal with halal (permissible) money only, i.e. all its assets and money should be to the extent permitted by Shariah.

The techniques employed in Islamic finance are traced back to the Prophetic Era. As articulated by Lewis and Algaoud, the Prophet Muhammad (PBUH) applied the PLS principle through the mudrabah technique when he acted as agent for his wife Khadija while managing her business. Similar practices were applied by his followers after his death. More recent employment of Islamic banking methods can be detected in the mid 1940s and late 1950s in Malaya and Pakistan, followed more clearly and more successfully in the 1960s and 1970s through the establishment of the Mit Ghamr project, which was incorporated into the Nasser Social Bank in Egypt, and the Tabung haji in Malaysia. As for the Gulf region, oil-driven wealth along with the religiously conservative nature of society have called for founding a Shariah compliant finance.

Hence, the Islamic Development Bank was established in Saudi Arabia in 1975. In the same year, Dubai Islamic Bank was established in the UAE as the first private Islamic bank in the region, followed by Kuwait Finance House (KFH) in 1977.

From these simple primitive beginnings, the Islamic finance industry has grown greatly in recent decades and it is expected to continue to grow in the future,
where Islamic banking remains indisputably the largest sector of this industry.\footnote{See the IFSB stability reports in 2019, 2018 and 2017 where the Islamic finance industry has recorded a continuance improvement for three years in a row in terms of its total worth. IFSB, \textit{Islamic Financial Services Industry Stability Report 2017} (IFSBI 2017) 3 and 7; IFSB, \textit{Islamic Financial Services Industry Stability Report 2018} (IFSBI 2018) 3; IFSB, \textit{Islamic Financial Services Industry Stability Report 2019} (IFSBI 2019) 3.} Nowadays, the Islamic financial industry represents a global value of USD 2.19 trillion.\footnote{Fayaz Lone, \textit{Islamic Banks and Financial Institutions: A Study of their Objectives and Achievements} (Palgrave Macmillan 2016) 17. Barclays and Lloyd’s Banking Group are examples of large conventional banks offering Islamic financial services. For more please see \url{https://www.barclays.co.ke/islamic/} and \url{https://www.lloydsbank.com/legal/current-accounts/islamic-account.asp} both accessed 16 December 2019} The number of Islamic banks is increasing and large conventional banks are now offering Islamic services through establishing Islamic windows or by offering Islamic financial services in the bank.\footnote{Greg Rung, Travis Hollingsworth and Rico Brandenburg, ‘Islamic Finance: Building 150 Financial Institutions by 2020’ (Oliver Wyman 2011) 3} Multiple financial reports from different global bodies confirm the significance of the Islamic finance sector in the international financial system and the tremendous growth it has shown over the past few years. For example, Oliver Wyman states that although the Islamic finance sector is relatively small, the market is growing on an annual basis by more than 30% and is likely to grow more in the future.\footnote{Ernst and Young reported that the industry grew by 16% between 2008 and 2012, where Shariah compliant assets reached USD 1.54 trillion with 38 million customers around the world; they anticipated that, by 2020, the participation banking profit pool would reach USD 30.3 billion.\footnote{Ernst and Young, ‘World Islamic Banking Competitiveness Report 2016’ (Ernst & Young Global Limited 2015) 5 and 20 <https://ceif.iba.edu.pk/pdf/EY-WorldIslamicBankingCompetitivenessReport2016.pdf> accessed 16 December 2019} The Islamic banking industry, including fully-fledged banks, subsidiaries and windows, make up the largest sector in the Islamic finance industry, representing 71.7% of the whole industry assets.\footnote{According to Pew Research Centre, Muslim populations around the world are expected to increase by 35% during the coming years, rising from 1.6 billion in 2010 to reach 2.2 billion in 2030 where they will make up 26.4% of the world’s total population. Pew Research Center, ‘The Future of the Global Muslim Population’ (Pew Research center, 27 January 2011) <https://www.pewforum.org/2011/01/27/the-future-of-the-global-muslim-population/> accessed 16 December 2019. In Europe, Muslim population is expected to increase to reach 8% of overall population by 2030. Deloitte, ‘Islamic Finance at Deloitte: No Interest… but Plenty of Attention’ (Deloitte General Services 2014) 3 <https://documents.pub/document/2010-27-5-islamic-financeappendix-online.html> accessed 16 December 2019} Deloitte credits various factors for the growth of Islamic banking but mainly the growing Muslim population,\footnote{IFSBI, \textit{Islamic Financial Services Industry Stability Report 2019} (IFSBI 2019) 7} the need for
products to invest oil surplus in, and the demand for ethical investments by Muslim and non-Muslim investors.\textsuperscript{1271}

In short, the main principles of Islamic finance are: (a) the IFI should not charge any payment over the amount of the principle (interest); (b) profit and loss should be shared between the IFI and the person who deals with it (a matter of partnership); (c) uncertainty or speculation activities are also prohibited; and finally, (d) the IFI’s investments, business relationships and money in general should be Shariah compliant, which requires avoiding dealing with non-Shariah complaint business entities.\textsuperscript{1272} This industry is an important element of global finance. It has shown significant growth, resilience and increasing market penetration over the past few years. It is still expanding and the upcoming development prospects are promising as several global markets are keen to welcome and embrace Islamic funds.\textsuperscript{1273}

\textbf{1.2 Islamic finance in Malaysia:}

Malaysia is an Islamic country located in the Southeast Asia.\textsuperscript{1274} It is one of the leading countries in the Islamic finance industry and has the most developed and comprehensive Islamic financial system in the world.\textsuperscript{1275} According to the International Monetary Fund and World Bank report in 2013, the supervisory and regulatory system in Malaysia has a high level of compliance with international standards in general.\textsuperscript{1276} In terms of Islamic finance, the report states that authorities in Malaysia aim for the country to become a global Islamic financial hub and to

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\textsuperscript{1271} Deloitte, ‘Islamic Finance at Deloitte: No Interest... but Plenty of Attention’ (Deloitte General Services 2014) 5 <https://documents.pub/document/2010-27-5-islamic-financeappendix-online.html> accessed 16 December 2019

\textsuperscript{1272} Abdussalam Abu-Tapanjeh, ‘Corporate governance from the Islamic perspective: A comparative analysis with OECD principles’ (2009) 20 Critical Perspectives on Accounting 556, 557

\textsuperscript{1273} The Islamic Research and Training Institute and IFSB ‘Islamic Financial Services Industry Development: Ten-Year Framework and Strategies A Mid-Term Review’ (The Islamic Research and Training Institute and IFSB 2014) i <https://www.ifsb.org/sec03.php> accessed 16 December 2019

\textsuperscript{1274} Federal Constitution 2010, Section 3 (Malaysia)


\textsuperscript{1276} International Monetary Fund, \textit{Malaysia: Financial Sector Stability Assessment} (International Monetary Fund 2013) 5

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develop the sector in collaboration with other jurisdictions. The Islamic financial system in Malaysia is not confined to Islamic banks. It consists of other entities, such as Islamic funds, companies, cooperatives, agencies, national bodies and the financial market.

Islamic banking in Malaysia has been successfully conducted for more than 30 years. The first Islamic bank in Malaysia was established under the name of ‘Bank Islam Malaysia Berhard’ in 1983. Currently, Malaysia has eleven fully-fledged local Islamic banks and six foreign Islamic banks. In 2018, the IFSB reported that Asia embraced 24.4% of the total Islamic financial assets, mainly contributed by Malaysia. The value of the Malaysian Islamic financing assets exceeded USD 100 billion, which is equivalent to 25% of the global total assets in the Islamic finance market as of September 2017.

It is believed that Malaysia has achieved this position in Islamic finance due to the significant steps taken to develop its infrastructure and reputation. Writers acknowledge that Malaysia has a well-structured regulatory and supervisory system that supports the development of a SCG framework in Islamic finance and provides assurance of proper Shariah compliance in IFIs. Moreover, Malaysia has also paid attention to education in the field of Islamic finance in order to develop human resources that meet the industry requirements nationally and internationally. One of the main initiatives in this context is the establishment of the International Centre for

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1277 International Monetary Fund, *Malaysia: Financial Sector Stability Assessment* (International Monetary Fund 2013) 35


1279 Nurul Mahdzan, Rozaimah Zainudin and Sook Au, ‘The Adoption of Islamic Banking Services in Malaysia’ (2017) 8 Journal of Islamic Marketing 496, 498


Education in Islamic Finance (INCEIF) in 2005 with a strong financial support from the Central Bank of Malaysia.\textsuperscript{1286}

1.3 Islamic finance in Kuwait:

Kuwait is also an Islamic country but located in the Middle East and one of the Gulf countries (GCC).\textsuperscript{1287} Despite its small geographical size, it is seen as a pioneer country in Islamic finance. Like Malaysia, the Islamic finance sector in Kuwait consists of a variety of Islamic banks, funds and companies. Although Islamic companies outnumber Islamic banks (54 companies to five banks in 2013), financial activity of banks dominate, being 96.5% of total financing.\textsuperscript{1288} Islamic banking in Kuwait started shortly before it did in Malaysia. KFH was the first Islamic bank in Kuwait, and was established in 1977. It is now one of the leading Islamic banks in the Islamic finance sector as a whole.\textsuperscript{1289} This was followed by the establishment of a number of other Shariah-compliant banks in the country.

Currently, there are five fully-fledged domestic Islamic banks in Kuwait - two of which were converted from conventional to Islamic banks - and one foreign Islamic bank branch, between them holding over USD 76.9 billion assets as in 2018.\textsuperscript{1290} This makes up around 39% of the whole banking system in Kuwait. It also means that Kuwait has the second highest percentage of Islamic banks in any country that hosts both Islamic and conventional banks.\textsuperscript{1291} In addition, Kuwait can be characterised as a leading country in Shariah scholarship, ranking first in the number of Islamic institutions (68) appointing a minimum of three Shariah scholars.\textsuperscript{1292} Kuwait has 86 Shariah scholars that are experts in Islamic finance and they hold

\textsuperscript{1286} For more about the INCEIF please visit its website at <https://www.inceif.org/> accessed 30 December 2019. Also see Mohamad Zaid Mohd Zin and others, ‘Products of Islamic Finance: A Shariah Compliance Advancement’ (2011) 5 Australian Journal of Basic and Applied Sciences 479, 482
\textsuperscript{1287} Kuwait Constitution 1962, Article 2
\textsuperscript{1290} Central Bank of Kuwait, Islamic Finance in Kuwait: Broadening Horizons (Thomson Reuters, 2018) 4
\textsuperscript{1292} Central Bank of Kuwait, Islamic Finance in Kuwait: Broadening Horizons (Thomson Reuters, 2018) 6
positions in a number of SSBs nationally and internationally. This is mostly due to the high academic level of Shariah studies in Kuwait.

1.4 Islamic finance in the UK:

Islamic finance is not confined to Islamic countries or Muslims. A number of non-Muslim countries also compete to thrive in the industry. Islamic banking has been developed in non-Muslim countries in two forms: fully-fledged Shariah-compliant banks and Islamic banking windows of conventional banks. In addition, some conventional banks offer Islamic services as part of their activities, to cater for customers interested in Shariah-compliant banking. The UK has been chosen as a representative of non-Muslim jurisdictions hosting Islamic finance, as it has been, for more than 30 years, a leading voice in the development of this sector and has a distinct history with Islamic banking in comparison to other non-Muslim countries.

According to Malik, Malik and Shah, the UK was the first non-Muslim country that declared its intention to host and support Islamic finance. It has now become the Western hub for Islamic finance, especially after being the first Western country to issue sovereign Sukuk in 2014. It is home to more than 20 Islamic banks, including five standalone Shariah-compliant banks with USD 728 million net...

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1294 The School of Shariah and Islamic studies is part of Kuwait University that offers undergraduate and postgraduate degrees in all fields of Islamic jurisprudence including *fiqh al-muamalat* (the main qualification for Shariah scholars serving in SSBs). Information about the School of Shariah and Islamic studies at Kuwait University can be found at [http://kuweb.ku.edu.kw/ku/AboutUniversity/Colleges/KuwaitUniversityColleges/index.htm](http://kuweb.ku.edu.kw/ku/AboutUniversity/Colleges/KuwaitUniversityColleges/index.htm) accessed 30 December 2019. Having said that, Thomson Reuters reports that Islamic finance still needs ‘more undergraduate degrees to be introduced to equip young and aspiring professionals with a firm foundation in Islamic finance, which could be complemented with a postgraduate degree, diploma or professional certificate in the future’. Shereen Mohamed, Abdulaziz Goni and Shaima Hasan, Islamic Finance Development Report 2018: Building Momentum (Thomson Reuters, 2018) 34 [https://ceif.iba.edu.pk/pdf/Reuters-Islamic-finance-development-report2018.pdf](https://ceif.iba.edu.pk/pdf/Reuters-Islamic-finance-development-report2018.pdf) accessed 22 December 2019


assets, which makes it the top non-Islamic country hosting Islamic institutions in the West.\textsuperscript{1298} With regard to the growth of Shariah assets, Riaz asserts that, ‘The UK has the eighth fastest growing Islamic banking sector in the world with only Islamic nations ahead of it’.\textsuperscript{1299}

According to Aldohni, the development of Islamic finance in the UK is attributed to a number of factors: mainly, the unique financial position of London (the world’s financial centre\textsuperscript{1300}), its ability to attract investment from oil countries that needed to manage their overflowing cash in a more developed financial market but through Islamic channels, and its need to provide a vehicle for saving the growing wealth of Muslim people in the UK (over three million as of 2018 \textsuperscript{1301}) who prefer to deal and invest in Islamic finance.\textsuperscript{1302} Another contributing factor is the presence of several major international financial institutions – such as Citi, Deutsche and HSBC – in the Muslim regions, which added to their knowledge of the Islamic finance market and encouraged them to establish Islamic windows in their home countries, including the UK.\textsuperscript{1303}

The first Islamic banking experience in the UK was in the 1980s when Al-Baraka International Bank was established as a fully-fledged Islamic bank under the Banking Act 1987.\textsuperscript{1304} It stayed the only Islamic bank during the 1980s and early

\textsuperscript{1299} Umair Riaz, ‘Perceptions and Experiences of British Based Muslims on Islamic Banking and Finance in the UK’ (PhD thesis, University of Dundee 2014) 24
\textsuperscript{1302} Abdul Karim Aldohni, The Legal and Regulatory Aspects of Islamic Banking: A Comparative Look at the United Kingdom and Malaysia (Routledge 2011) 20-26
\textsuperscript{1303} Michael Ainley and others, ‘Islamic Finance in the UK: Regulation and Challenges’ (Financial Services Authority, November 2007), 7 <https://www.isfin.net/sites/isfin.com/files/islamicFinance_in_the_uk.pdf> accessed 22 December 2019
\textsuperscript{1304} Rodney Wilson, ‘Challenges and Opportunities for Islamic Banking and Finance in the West: The United Kingdom Experience’ (2000) 7 Islamic Economic Studies 35, 40
1990. However, due to some regulatory problems, it gave up its banking licence in 1993.¹³⁰⁵ Later in 2004, the Islamic Bank of Britain (currently Al-Rayan Bank) was established as the first wholly Shariah-compliant retail bank in the UK.¹³⁰⁶ This was followed by a number of wholesale investment banks, such as BLME and Gatehouse Bank in 2007.¹³⁰⁷ Islamic finance in the UK has also caught the attention of conventional retail banks, with Barclays and Lloyds Banking Group now offering Islamic finance services including Islamic current accounts and mortgages.¹³⁰⁸

The UK government has demonstrated flexibility and significantly supported the Islamic finance industry to facilitate its development in the UK, resulting in the establishment of a number of IFIs, as seen above. The authority took it upon itself to follow a ‘no obstacles, but no special favours’ approach with Islamic banks.¹³⁰⁹ In this regard, in the early 2000s, the UK took a number of actions to deal with the tax treatment for Shariah-compliant financial transactions by introducing specific provisions called ‘alternative finance arrangements’. The rules cover several types of financing arrangements: the removal of double tax on Islamic mortgages that arise where a financial institution buys a property and then re-sells it to the individual (Murabahah) in 2003¹³¹⁰; the extension of tax relief on Islamic mortgages to equity

¹³⁰⁵ In 1991, after the collapse of the Bank of Credit and Commerce International in the UK, international banks became questionable. Hence, the Bank of England started scrutinising the system of Al-Baraka bank and found that it did not have a banking licence in its home country, which raised a suspicion on its ability to operate in the UK without support from its home country. The bank was unable to refute these doubts and eventually surrendered its licence. Yusuf Karbhari, Kamal Naser and Zerrin Shahin, ‘Problems and Challenges Facing the Islamic Banking System in the West: The Case of the UK’ (2004) 46 Thunderbird International Business Review 521, 522-531. See also, Abdul Karim Aldohni, ‘Soft Law, Self-Regulation and Cultural Sensitivity: The Case of Regulating Islamic Banking in the UK’ (2014) 15 Journal of Banking Regulation 164, 169-170
¹³⁰⁷ For more about Gatehouse Bank and BLME please visit their websites at <https://gatehousebank.com/about-us> and <https://www.blme.com/about-blme/history/> both accessed 30 December 2019
¹³⁰⁸ It should be mentioned, however, that Barclays offer Islamic finance services in Kenya only. For more please visit Barclays Bank’s website at <https://www.barclays.co.ke/islamic/> accessed 30 December 2019. As for Lloyds Bank, please visit its website at <https://www.lloydsbank.com/legal/current-accounts/islamic-account.asp> both accessed 30 December 2019.
¹³¹⁰ This is in regard to Stamp Duty or Tax and Land Transfer Tax. See Finance Act 2003, Sections 71 to 73 (UK). For more see HM Land Registry, ‘Practice Guide 69: Islamic Financing’ (September 2019)
sharing arrangements (\textit{Musharakah}) in 2005\textsuperscript{1311} and to corporate entities in 2006\textsuperscript{1312}, and the tax treatment for \textit{Sukuk} as alternative finance investment bonds\textsuperscript{1313}. Moreover, the UK issued the rules of ‘Home Purchase Plans’ to accommodate Islamic home financing arrangements (mortgage), mainly \textit{Ijarah} (leasing) and diminishing \textit{Musharakah} (diminishing partnership).\textsuperscript{1314} This is in addition to the steps taken by the Bank of England in 2017–2018 to establish central bank liquidity facilities on a Shariah compliant basis to level the playing field for Islamic finance in the UK.\textsuperscript{1315} There are also advisory bodies to help in the promotion and development of Islamic finance in the UK, such as the Islamic Finance Sectoral Advisory Group (SAG) that is a part of TheCityUK.\textsuperscript{1316}

The UK not only aims to establish itself as a financial hub for Islamic finance in the West but as an academic centre as well. According to the Thomson Reuters Islamic Finance Development Report 2017, the UK has positioned itself as a pre-eminent Islamic finance educator by offering 76 Islamic finance courses, which is more than the courses offered by some leading Islamic countries, such as Malaysia and Indonesia.\textsuperscript{1317} Moreover, the UK also strives to be a leading centre for financial technology (FinTech).\textsuperscript{1318} In this context, Islamic FinTech has demonstrated

\textsuperscript{1311} See Finance Act 2005, Chapter Alternative Finance Arrangements, Section 53 (UK)
\textsuperscript{1312} See Finance Act 2006, Section 95 (UK)
\textsuperscript{1313} See Finance Act 2009, Schedule 61 (UK)
\textsuperscript{1316} For more about the SAG please visit <https://www.thecityuk.com/about-us/our-committees-and-groups-2/islamic-finance/> accessed 16 February 2020
\textsuperscript{1317} Having said that, the report also stated that, following Brexit, there is a fear that students from Europe might be reluctant to pursue their education in the UK universities to avoid any residence restriction which might lead other countries in Europe to take this opportunity to offer Islamic finance courses to attract European students, which is already happening in Germany and Turkey. Shereen Mohamed and Abdulaziz Goni, ‘Islamic Finance Development Report 2017: Towards Sustainability’ (Thomson Reuters, 2017) 70 <https://islamicbankers.files.wordpress.com/2017/12/icd-thomson-reuters-islamic-finance-development-report-2017.pdf> accessed 22 December 2019
\textsuperscript{1318} FinTech is defined as ‘the new breed of companies that specialize in providing financial services primarily through technologically enabled mobile and online platforms’. William Magnuson, ‘Regulating FinTech’ (2018) 71 Vanderbilt Law Review 1167, 1174. According to Thomson Reuters’s report, ‘The UK has made efforts to position itself as a global fintech and Islamic finance hub, and was ranked the number one fintech hub in the world’. Shereen Mohamed and Abdulaziz Goni, ‘Islamic
noticeable progress in the UK, where new innovative financial tools have been developed to complement the traditional mortgages used to fund properties.\textsuperscript{1319} A number of UK-based Islamic FinTech companies are now offering Islamic digital services. For example, MercyCrowd and Yielders offer Islamic property crowdfunding\textsuperscript{1320}, and Ummah Finance is expected to be the first fully digital Islamic bank in the UK\textsuperscript{1321}. Moreover, in 2018, a cross-sectoral UK Islamic FinTech Panel was established to further advance the UK’s position in Islamic FinTech.\textsuperscript{1322}


\textsuperscript{1320} Crowdlending is ‘a non-intermediary way of debt financing, through which individuals can borrow and lend money between themselves’. The crowdlending elements that have been utilised by Islamic finance include peer-to-peer crowdfunding, remittance and mobile wallet. Maria Todorof, ‘Shariah-compliant FinTech in the Banking Industry’ (2018) 19 ERA Forum 11, 12-13. For more about the mentioned companies please visit the their websites at <https://www.mercycrowd.com/> and <https://www.yielders.co.uk/> both accessed 30 December 2019.


Appendix Two: Tables:

Table 1: Remuneration received by SSB members in Islamic banks in different countries:

<table>
<thead>
<tr>
<th>Name Islamic bank</th>
<th>Country</th>
<th>Annual report</th>
<th>Number of SSB members</th>
<th>Annual collective remuneration in the bank’s currency</th>
<th>Equivalent amount in GBP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Qatar International Islamic Bank</td>
<td>Qatar</td>
<td>2018</td>
<td>Three</td>
<td>944,000 QR</td>
<td>202,000.00</td>
</tr>
<tr>
<td>Hong Leong Islamic Bank Berhad</td>
<td>Malaysia</td>
<td>2018</td>
<td>Five</td>
<td>246,000 RM</td>
<td>46,000.00</td>
</tr>
<tr>
<td>Boubyan Bank</td>
<td>Kuwait</td>
<td>2018</td>
<td>Four</td>
<td>90,000 KD</td>
<td>225,215.00</td>
</tr>
<tr>
<td>Bahrain Islamic Bank</td>
<td>Bahrain</td>
<td>2018</td>
<td>Three</td>
<td>65,000 BD</td>
<td>131,000.00</td>
</tr>
<tr>
<td>Meezan Bank</td>
<td>Pakistan</td>
<td>2018</td>
<td>Three</td>
<td>14,200 million Rs (Resident only)</td>
<td>71,125.00</td>
</tr>
<tr>
<td>Institution</td>
<td>Country</td>
<td>Year</td>
<td>Type of ownership</td>
<td>Controller’s shares and identity</td>
<td>Identity of major shareholders</td>
</tr>
<tr>
<td>-------------------------------------------------</td>
<td>---------------</td>
<td>------</td>
<td>-------------------</td>
<td>----------------------------------</td>
<td>------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Hong Leong Islamic Bank Berhad</td>
<td>Malaysia</td>
<td>2018</td>
<td>Concentrated</td>
<td>Over 55% A state-owned institution</td>
<td>Local state-owned institutions and large companies</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>80% is held by 10 shareholders</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bank Muamalat Malaysia Berhad</td>
<td>Malaysia</td>
<td>2018</td>
<td>Concentrated</td>
<td>Over 70% A large company</td>
<td>Local state-owned institutions and large companies</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>100% is held by 2 shareholders</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bank Islam Malaysia Berhad</td>
<td>Malaysia</td>
<td>2018</td>
<td>Concentrated</td>
<td>100% The parent company</td>
<td>A local large company</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>100% is held by 1 shareholder</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Affin Islamic Bank Berhad</td>
<td>Malaysia</td>
<td>2018</td>
<td>Concentrated</td>
<td>100% The parent company</td>
<td>A local large bank</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>100% is held by 1 shareholder</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Kuwait Finance House (KFH)</td>
<td>Kuwait</td>
<td>2019</td>
<td>Concentrated</td>
<td>Over 24% A local state-owned institution</td>
<td>Local government-owned institutions</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>48% is held by 4 shareholders</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Boubyan Bank</td>
<td>Kuwait</td>
<td>2019</td>
<td>Concentrated</td>
<td>Almost 60% A conventional bank</td>
<td>Local large companies</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>70% is held by 2 shareholders</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Warba Bank</td>
<td>Kuwait</td>
<td>2019</td>
<td>Concentrated</td>
<td>Over 25% A local state-owned institution</td>
<td>Local state-owned institutions, large companies</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>50% is held by 4 shareholders</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bank Name</td>
<td>Location</td>
<td>Year</td>
<td>Ownership Structure</td>
<td></td>
<td></td>
</tr>
<tr>
<td>---------------------------------</td>
<td>----------</td>
<td>------</td>
<td>----------------------------------------------------------</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ahli United Bank</td>
<td>Kuwait</td>
<td>2019</td>
<td>Over 18% Local state-owned institution and an individual</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Kuwait International Bank</td>
<td>Kuwait</td>
<td>2019</td>
<td>Over 35% A local large company and a state-owned institution</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Al-Rayan Bank</td>
<td>UK</td>
<td>2018</td>
<td>98% A foreign large company and a state-owned institution</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bank of London and Middle East Bank (BLME)</td>
<td>UK</td>
<td>2018</td>
<td>Over 20% An Islamic bank and foreign large companies</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
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