

**An Empirical Investigation into the Problems and Challenges Facing
Islamic Banking in Malaysia**

**A thesis submitted in fulfilment of the requirements for the degree of Doctor of
Philosophy at Cardiff University, Cardiff**

By,

Nor Aiza Mohd Zamil

Master of Science in Accounting (International *Islamic* University Malaysia, Kuala Lumpur)

Bachelor in Accounting (International *Islamic* University Malaysia, Kuala Lumpur)

Diploma in Social Science Research Methods (Cardiff University, Cardiff)

**Accounting & Finance Section
Cardiff Business School
September 2014**



DECLARATION

This work has not previously been accepted in substance for any degree and is not concurrently submitted in candidature for any degree.

Signed (Nor Aiza Mohd Zamil)

Date

STATEMENT 1

This thesis is being submitted in partial fulfilment of the requirements for the degree of (insert MCh, Md, MPhil, **PhD** etc., as appropriate)

Signed (Nor Aiza Mohd Zamil)

Date

STATEMENT 2

This thesis is the result of my own independent work/investigation, except where otherwise stated.

Other sources are acknowledged by footnotes giving explicit references.

Signed (Nor Aiza Mohd Zamil)

Date

STATEMENT 3

I hereby give consent for my thesis, if accepted, to be available for photocopying and for inter-library loan, and for the title and summary to be made available to outside organisations.

Signed (Nor Aiza Mohd Zamil)

Date

ACKNOWLEDGEMENTS

First and foremost, I am very grateful to Allah, the Almighty, for giving me the strength, and energy to undergo all the challenges in life. Also, I am grateful to Allah for allowing me to always remain true to myself.

Secondly, I would like to thank all my teachers and lecturers throughout my life. They have taught me to go through life with my own capacity and capability. They made me realize that success is not an easy task but not an impossible one. They have broadened my perspective on life. They have assisted me to be a better person and to face life with courage and the application of ability.

It has taken the sincere efforts of many people together for me to complete this thesis successfully. I would like to thank my supervisor, Dr. Yusuf Karbhari for his guidance, patience and valuable comments in supervising me to make this piece of work possible. It was a great pleasure for me to conduct this thesis under his supervision.

Next, I would like to acknowledge and give special thanks to the Ministry of Higher Education of Malaysia and Universiti Sains Malaysia for the funding of my PhD studies. In addition, I would like to forward my appreciation to my truest friends. They are always there for me...through thick and thin.

Finally, I would like to express my deepest appreciation to my father and my mother. Thank you for your unconditional love and support. It is because of their spirit that I have been encouraged to overcome every challenge that came along my way. They taught me that in every situation I should not withdraw, hold back, or be afraid. They polished me to excel in life. And to my siblings, Hayati, Asmaa and Syaimaa, I always aim for the best in order to inspire them to achieve success in their own interest.

ABSTRACT

The establishment and operation of Islamic banking and finance is governed by *Shari'ah* principles. These specific underlying principles give a new dimension to its governance structure, which is known as *Shari'ah* Governance. The aim of this research is to examine the theoretical and practical aspects of problems and challenges facing Islamic banking and finance in Malaysia. The study focuses on four main issues: legal and regulatory framework, *Shari'ah* compliance, management, and accounting. In order to achieve the objectives, this study surveys different groups of respondents who are involved in the operation of Islamic banking and finance, using semi-structured interviews. The key respondents are members of the *Shari'ah* Committee, *Shari'ah* Officers and Chief Executive Officers (CEO). The major problems and challenges which emerged from the interview findings are the influence of the dual-banking environment, lack of support from the regulatory framework related to products and services, *Shari'ah* non-compliance, operation and management, lack of expertise in human capital, lack of accountability, and lack of influence of accounting practices and auditing. The majority of key respondents explicitly highlighted these findings. According to agency theory, accountability is the primary corresponding function for decision making in the banking system; however, this does not appear to be transparent in the *Islamic* banking sector. As in most contexts of *Islamic* banking, inadequate accounting practices are also considered to be the major challenge that *Islamic* banking face. Regarding this challenge, the *Islamic* banking system has not achieved the ultimate objective in implementing *Shari'ah* in the banking system. However, with constraint and uncertainty, several efforts have been made to achieve a homogeneous structure. Radical innovation of accounting practices that support *Shari'ah* could be the alternatives to assist the *Islamic* banking system to become more efficient and effective. Theories such as agency theory, stakeholder theory and institutional theory could serve as pillars to support the implementation in order to enhance *Shari'ah* activities. In addition, the explanation of agent morality of the stakeholder model is also important, as Islamic banking personnel need to uphold *Shari'ah* principles and commercial viability. Furthermore, institutional theories are employed in the explanation of the organisational behaviour of IBs.

TABLE OF CONTENTS

Contents

DECLARATION.....	ii
ACKNOWLEDGEMENTS.....	iii
ABSTRACT.....	iv
TABLE OF CONTENTS.....	v
LIST OF TABLES.....	x
LIST OF FIGURES.....	xi
LIST OF ABBREVIATIONS.....	xii
GLOSSARY OF TERMS.....	xiii
CHAPTER ONE.....	1
1.1 Introduction: Background of the Study.....	1
1.2 Motivation and Rationale of the Study.....	6
1.3 Aims and Objectives of the Study.....	9
1.4 Scope of the Study.....	11
1.5 Methodology.....	13
1.6 Contribution of the Study.....	15
1.7 The Structure of the Thesis.....	18
CHAPTER TWO.....	23
2.1 Introduction.....	23
2.2 Establishment of Islamic Banking and Finance.....	23
2.2.1 Historical Background of <i>Islamic</i> Banking and Finance Industry (IBFI).....	23
2.2.2 Development of Malaysian <i>Islamic</i> Banking and Finance Industry (MIBFI).....	28
2.2.2.1 Development of MIBFI within the Global Sector.....	39
2.3 Islam and <i>Islamic</i> Banking System.....	41
2.3.1 The Objectives of <i>Shari'ah</i>	44
2.4 Philosophy of <i>Islamic</i> Banking and Finance.....	49
2.4.1 Prohibition of Interest in All Forms of Transactions.....	50
2.4.2 Trade-Based Activities.....	53
2.4.2.1 Underlying Principles of Trade-Based Contracts.....	54
2.4.3 Profit and Loss Sharing Framework (Profit Sharing and Loss Bearing).....	55
2.4.4 Prohibition of <i>Gharar</i>	58
2.4.5 Payment of Zakah.....	60
2.5 Theoretical Framework of <i>Islamic</i> Banking and Finance.....	61
2.6 Summary.....	65

CHAPTER THREE	68
3.1 Introduction.....	68
3.2 Credibility of the Islamic Banking System.....	69
3.2.1 <i>Shari'ah</i> Compliance in Islamic Banks	70
3.2.2 Islam Morality and Accountability	75
3.2.3 Trust in Islamic Banking.....	78
3.3 Theories underlying Islamic Banking and Finance	81
3.3.1 Agency Theory.....	81
3.3.1.1 Agency Problems in Islamic Banking and Finance	83
3.3.2 Transaction Cost Theory.....	87
3.3.2.1 Transaction Cost Theory in Islamic Banks.....	89
3.3.3 Stakeholder Theory.....	91
3.3.3.1 Agent Morality.....	92
3.3.3.2 Agent Morality with Ethical Religious Consideration.....	94
3.3.4 Institutional Theory.....	98
3.3.4.1 Institutional Isomorphism	101
3.3.4.2 NIS and Decoupling.....	105
3.3.4.3 Banking in NIS Perspective	106
3.4 Summary	106
CHAPTER FOUR	109
4.1 Introduction.....	109
4.2 Islamic Banking and Finance Structures.....	109
4.3 Managing Risk in Islamic Banks	111
4.4 Islamic Banking and its Legal and Regulatory Framework.....	116
4.5 Impact of Islamic Banking and Finance Practices	118
4.5.1 Performance of Islamic Banking and Finance	118
4.5.2 Customer Perspectives on Patronising Islamic Banking	130
4.6 Problems and Challenges facing <i>Islamic</i> Banking and Finance	134
4.6.1 Problems on Islamic Banking and Finance.....	136
4.7 Islamic Banking and Finance and Their Impact on Accounting.....	149
4.7.1 Accounting in Religious Organisations	149
4.7.2 Accounting in the <i>Islamic</i> Perspective.....	150
4.7.3 Accounting and Accountability	153
4.7.4 Accounting in <i>Islamic</i> Banking	154
4.8 Islamic Banking and Finance and Their Impact on Auditing	174
4.9 Summary	182
CHAPTER FIVE.....	184

5.1	Introduction.....	184
5.2	Purpose of the Study	185
5.3	Study Population.....	191
5.4	Research Design.....	195
5.5	Research Strategy.....	197
5.6	Research Method	199
5.6.1	Semi-structured Interviews	199
5.6.1.1	The rationale for using Semi-structured Interviews.....	202
5.6.2	Administering Semi-structured Interviews	205
5.6.3	Analysis of the Interview Data	213
5.7	Summary	220
CHAPTER SIX		221
6.1	Introduction.....	221
6.2	Malaysia: Dual-banking System	222
6.2.1	Competition.....	223
6.2.1.1	Influence of Conventional Banking Products in Customers' Demand.....	224
6.2.1.2	Lack of Customer Awareness and Knowledge.....	226
6.2.1.3	Negative Public Perception.....	227
6.2.2	Monetary Policy Issues	232
6.3	Review of Legal and Institutional Structure of <i>Shari'ah</i> Compliance and Accounting and Auditing in Malaysian Islamic Banks	235
6.3.1	Interpretation of <i>Shari'ah</i> Law	236
6.3.2	The Guidelines Governing the <i>Shari'ah</i> Governance System.....	238
6.3.2.1	<i>Shari'ah</i> Manual as a Guideline for the Implementation.....	243
6.3.2.2	<i>Shari'ah</i> Committee Report.....	245
6.3.3	Current Legal and Regulatory Framework related to Operation and Products and Services	248
6.3.3.1	The Need to have More Legal and Regulatory Framework that will Support the <i>Shari'ah</i> -based Operation	248
6.3.3.2	Inexistence of Regulations for Each and Specific IB's Product.....	251
6.3.4	Financial Regulatory Procedures	253
6.3.4.1	Malaysian Accounting Standards Board (MASB).....	253
6.3.4.2	Interview Findings: Financial Regulatory Procedures.....	256
6.4	Summary	261
CHAPTER SEVEN		264
7.1	Introduction.....	264
7.2	Consideration of <i>Shari'ah</i> Compliance and Commercially Viable in Islamic Banking and Finance in Malaysia	265

7.2.1	Perception of the <i>Shari'ah</i> Compliance and Commercially Viable and its Implementation	265
7.2.2	Dichotomy between the Theoretical Framework of Islamic Banking and its Implementation	273
7.2.3	Unresolved <i>Shari'ah</i> Matters	275
7.2.4	Solution for <i>Shari'ah</i> Non-Compliance Cases	277
7.3	Management.....	282
7.3.1	Human capital	282
7.3.1.1	Roles of Players in Ensuring the Direction of IB	282
7.3.1.2	Lack of Awareness among Top Management and Lower Management in Theoretical and Practical Aspects of Islamic Banking Practices.....	284
7.3.1.3	Lack of Expertise in Islamic banks.....	288
7.3.2	Implementation of <i>Shari'ah</i> Approved Procedures	293
7.3.2.1	Approval of Product Development and Innovation	293
7.3.2.2	The Knowledge Gap between <i>Shari'ah</i> Scholars and Technical Expertise portrayed during Product Conceptualisation and Approval.....	296
7.3.2.3	Implementation of Approved Products (Post-compliance).....	303
7.3.3	Accounting System	309
7.4	Lack of Influence of Accounting Practices and Reporting in Communicating Reliable and Credible Information.....	311
7.4.1	The Role of Accounting and Finance	311
7.4.2	Financial Accounting and Reporting	313
7.4.3	Product Conceptualization: Lack of Accounting and Finance Expertise among <i>Shari'ah</i> Scholars.....	315
7.5	<i>Shari'ah</i> Auditing	317
7.5.1	Lack of <i>Shari'ah</i> Audit's Expertise	321
7.5.2	No External <i>Shari'ah</i> Auditor that Oversees the Practices.....	322
7.6	Summary.....	323
CHAPTER EIGHT		327
8.1	Introduction.....	327
8.2.....		329
8.2	Institutional Isomorphism Pressure in the Islamic Banks.....	329
8.2.1	Coercive Isomorphism	329
8.2.1.1.....		330
8.2.1.1	<i>Shari'ah</i> Law Pressure.....	330
8.2.1.2	Regulative Pressure.....	331
8.2.1.3	BNM's Guidelines and Standards.....	332
8.2.1.4	Control (BOD's Pressure).....	332

8.2.2	Mimetic Pressure	333
8.2.3	Normative Pressure	334
8.2.3.1	Norms and Values of Society	334
8.2.3.2	Lack of Cooperation among <i>Muslim</i> Countries	335
8.2.3.3	Lack of Customer's Education and Awareness	336
8.2.3.4	Professional Training and Exposures.....	337
8.2.3.5	Lack of Professional Bodies and Code of Ethics to Regulate <i>Shari'ah</i> Scholars	338
8.2.4	Institutional Isomorphism in Accounting Practices in Islamic Banking	340
8.2.4.1	Coercive Isomorphism: Accounting Standards	341
8.2.4.2	Mimetic Pressure	342
8.2.4.3	Normative Pressure	343
8.3	Associates Activities and Resources.....	344
8.3.1	Financial Transactions (<i>Shari'ah</i> Compliant vs. <i>Shari'ah</i> -Based).....	344
8.3.2	Competency of Human Capital.....	346
8.4	Theoretical Perspective drawn from the Corporate Governance Theories	348
8.4.1	Secular and Sacred Activity in Islamic Banks	348
8.4.2	Linkage between <i>Akhlaq</i> and <i>Muamalat</i>	350
8.4.3	Accounting and Accountability in Islamic Banks	353
8.4.3.1	Accountability in Ensuring <i>Shari'ah</i> Compliance.....	354
8.4.3.2	Accounting, Auditing and <i>Shari'ah</i> Compliance.....	359
8.5	Lack of Clear Direction to Achieve the <i>Maqasid</i> of <i>Shari'ah</i>	361
8.5.1	The Need on Awareness of Other Stakeholders	363
8.6	Summary	365
CHAPTER NINE		366
9.1	Recapitulation of the Interview Findings.....	366
9.2	Reflections: Review of the Findings vs. Recent Development in the Industry	370
9.3	Theoretical Contributions	374
9.4	Practical Contributions and Recommendations	376
9.5	Limitations and Suggestions for Future Research	382
REFERENCES		384
APPENDICES		408

LIST OF TABLES

Table 2.2.1 Size of the Global Islamic Financial Services Industry (AUM USD Bn)	40
Table 3.3.1 Unique Agency Relationship in IFIs and its Specific Mechanisms (generated from Safieddine 2009)	84
Table 3.3.2 Comparison of Organisation Economic Theories (Kim and Mahoney 2005)	90
Table 3.3.3 Information extracted from (Scott 1995)	104
Table 4.7.1 Main Differences between FAS developed for Islamic banks and conventional banks (extracted from Venardos 2005)	163
Table 5.3.1 List of the ICBs and CCBs in Malaysia Selected for this Study	194
Table 5.6.1 Analysis of Respondents of the Semi-Structured Interviews amongst Commercial Banks	206
Table 5.6.2 Analysis of Respondents of the Semi-Structured Interviews amongst Regulatory Authority	207
Table 5.6.3 Analysis of Respondents of the Semi-Structured Interviews amongst Islamic Accounting Scholars	207
Table 5.6.4 Percentage of Interviewees according to Group	208
Table 5.6.5: Interviewees according to Profile	209
Table 5.6.6 Analysis Showing the Total Asset of Banks Participating in Semi-structured Interview	211
Table 5.6.7 Analysis Showing the Total Asset of Banks Participating in Semi-structured Interview	211
Table 6.3.1 Pronouncements by MASB for <i>Islamic</i> Banking and Finance Industry (generated by author)	254
Table 7.4.1 Transactions – From Concept to Reporting – <i>Shari’ah</i> Compliant Financial Transactions	312
Table 9.2.1 MFRS Standards relating to Financial Transactions	371
Table 9.2.2 Additional Financial Reporting Regulation for Islamic Banks in Malaysia from 2010 to 2012	371
Table 9.2.3 Pronouncements by MASB for <i>Islamic</i> Banking and Finance Industry after 2010 (generated by author)	372
Table 9.2.4 MASB’s Discussion Papers	372

LIST OF FIGURES

Figure 1.7.1 Research Framework for Problems and Challenges Facing <i>Islamic</i> Banking and Finance in Malaysia (generated by author).....	22
Figure 2.3.1 The relationship between <i>Islam</i> and the <i>Islamic</i> Banking System (Source: Ismail 1992, 250; cited by Haron 1997, 31)	42
Figure 2.3.2 (Hofstede 2000, 11)	43
Figure 2.3.3 The linkage of Akhlaq with <i>Shari'ah</i> (practices and activities) (Source: Ismail 1992, 250; cited by Haron 1997, 31 and Hofstede 2000)	44
Figure 2.3.4 Objective of <i>Shari'ah</i>	46
Figure 2.4.1 <i>Islamic</i> Theory of Profit (Source: Rosly 2005a)	56
Figure 2.4.2 The Relationship between Banks and Entrepreneurs under Profit and Loss Sharing (Source: Karsten 1983).....	58
Figure 2.4.3 <i>Gharar</i> (Uncertainties in Contractual Agreements) (Source: Rosly 2005a).....	59
Figure 3.3.1 Association rule system and cultural schema with associates' activities and resources (Scott 2001).....	105
Figure 5.5.1 The Interpretive Research Process (Russel 1996; extracted from Abdul-Rahman and Goddard 1998)	198
Figure 5.6.1 The Qualitative Research Strategy used by the Researcher	200
Figure 5.6.2 Data Analysis in Qualitative Research (Creswell 2009)	216
Figure 7.3.1 Processes Flow from Conceptualization of Products to Approved Products on the Shelf (Source: Findings from this study)	294
Figure 7.3.2 Interaction between <i>Shari'ah</i> and Technical Personnel in Islamic Banks (generated by author)	300
Figure 8.1.1 Association rule system and cultural schema with associates activities and resources in providing stability and meaning of life (generated from the findings of this study).....	328
Figure 8.3.1 Current responses by IBs towards BNM's stimuli to move towards risk sharing products (from the findings of this study).....	346
Figure 8.4.1: Linkage between Akhlaq and Aqidah with <i>Mua'malat</i> (the idea of onion diagram was adapted from Hofstede (2000)).....	352
Figure 8.4.2 The Relationship between various Processes in ensuring the Accounting and Accountability of Islamic banks in Meeting the Objectives of <i>Shari'ah</i>	353

LIST OF ABBREVIATIONS

AAOIFI	Accounting and Auditing Organisation for <i>Islamic</i> Financial Institutions
ASIFI	Accounting Standards for <i>Islamic</i> Financial Institutions
BAFIA	Banking and Financial Institution Act
BIMB	Bank Islam Malaysia Berhad
BNM	Bank Negara Malaysia
CCBs	Conventional Commercial Banks
CEO	Chief Executive Officer
GPS 1	Guidelines on Governance of <i>Shari'ah</i> Committee
GSIFI	Governance Standards <i>Islamic</i> Financial Institutions
i.e.	that is
IAIB	International Association of <i>Islamic</i> Banks
IASB	International Accounting Standards Board
IB	<i>Islamic</i> bank
IBA	<i>Islamic</i> Banking Act
IBFI	<i>Islamic</i> Banking and Finance Industry
IBS	<i>Islamic</i> Banking Subsidiary
IBs	<i>Islamic</i> Banks
IBSc	<i>Islamic</i> Banking Scheme
ICBs	<i>Islamic</i> Commercial Banks
IFI	<i>Islamic</i> Financial Institutions
IFRS	International Financial Reporting Standards
IiBFI	International <i>Islamic</i> Banking and Finance Industry
KFH	Kuwait Finance House
MiBFI	Malaysian <i>Islamic</i> Banking and Finance Industry
NSAC	National <i>Shari'ah</i> Advisory Council ¹
PLS	Profit and loss sharing
SA	<i>Shari'ah</i> Audit
SC	<i>Shari'ah</i> Committee ² Members
SSB	<i>Shari'ah</i> Supervisory Board

¹“*Shari'ah* Advisory Council” means the *Shari'ah* Advisory Council on Islamic finance established under section 51 of the Central Bank of Malaysia Act 2009 (IFSA 2013)

²“*Shari'ah* Committee” means the *Shari'ah* committee of an institution established pursuant to section 30 of the Central Bank of Malaysia Act 2009 (IFSA 2013)

GLOSSARY OF TERMS

<i>Adalah</i>	Justice
<i>Al-ijarah</i>	A contract of lease which is subsequently followed by a sale contract
<i>thumma al-bay'</i>	contract
<i>Amanah</i>	Trust
<i>Bay' al-dayn</i>	A contract of sale of debt
<i>Bay' al-inah</i>	A back-to-back sale contract or a sale repurchase, usually the sale is at higher price while the buying back is at a lower price
<i>Bay' al-salam</i>	A sales contract where the price is paid in advance and the goods are delivered in the future
<i>Bay' bithaman ajil</i>	A sales contract on a deferred payment basis
<i>Daruriyyat</i>	Essentials
<i>Falah</i>	Success in both this world and the Hereafter
<i>Fiqh-mu'amalah</i>	<i>Islamic</i> law and commercial practices
<i>Gharar</i>	Ambiguity and uncertainty present in any contractual relationship
<i>Hadith</i>	Traditions of the holy Prophet of Islam describing his utterances, actions, instructions, and actions of others (Companions) tacitly approved by him
<i>Hajiyyat</i>	Complementary requirements
<i>Halal</i>	Permissible according to the <i>Islamic</i> Law
<i>Haram</i>	Prohibited according to the <i>Islamic</i> Law
<i>Harus</i>	Permissible practice according to the <i>Islamic</i> Law
<i>Hibah</i>	Reward
<i>Ibahah</i>	Permissibility
<i>Ihtikar</i>	Hoarding
<i>Ijarah</i>	A lease contract
<i>Ijarah mawsufah fi al-zimmah</i>	A lease contract of a specified future asset which is not in existence at the time of contract
<i>Ijtihad</i>	Legal opinion
<i>Israf</i>	Extravagance, exaggeration in spending wealth and wasting
<i>Khiyannah</i>	Embezzlement
<i>Ma'aruf</i>	Propagation of Good
<i>Maqasid-Ash-Shari'ah</i>	Objectives of the <i>Islamic</i> Law
<i>Maslahah</i>	Benefits or interest
<i>Maslahah</i>	Benefits on different changed circumstances
<i>Mu'amalah</i>	All kinds of economic activities related to exchange of goods and services
<i>Mudharabah</i>	It is a form of silent partnership between two parties where one provides the capital for a project and the other, <i>mudharib</i> , manages the project. Profits are distributed according to a predetermined ratio while losses are borne by the provider of the capital
<i>Mudharib</i>	Entrepreneur within the <i>mudharabah</i> contract
<i>Murabahah</i>	A sales contract where the goods are sold at a price which includes a profit margin agreeable to both parties

<i>Musharakah</i>	A partnership contract where partners contribute the capital for financing the project. All parties share profits on a pre-agreed ratio but losses are shared on the basis of equity participation
<i>Musharakah mutanaqisah</i>	A diminishing partnership contract where the partners usually enter into two types of contracts: a joint ownership contract and an <i>ijarah</i> (lease) contract in which the bank will gradually sell its shares to the client. In terms of distribution of profit and loss in <i>musharakah</i> type of financing, all profits generated will be shared among the partners in a proportion which is mutually agreed on in the contract, while the losses will be shared in proportion to the partners' capital.
<i>Qard al-hasan</i>	Charitable loan with no interest
<i>Qiyas</i>	Analogical reasoning
<i>Quran</i>	The book of Allah revealed to the Prophet Muhammad (pbuh)
<i>Riba'</i>	An increase over the principal in a loan transaction; usury or interest. In a commodity exchange <i>riba'</i> denotes the disparity in the quantity or time of delivery. Technically, <i>riba'</i> denotes any increase that must be paid by the borrower to the lender along with the principal sum as a condition for the loan or loan extension
<i>Shari'ah</i>	The divine guidance as given by the Holy Qur'an and the Sunnah, it embodies all aspects of the <i>Islamic</i> faith, including belief and practice
<i>Sunnah</i>	Actions, sayings and utterances of the holy Prophet Muhammad (pbuh)
<i>Tahsiniyyat</i>	Desirable
<i>Takaful</i>	A system of insurance in Islam that is based on the principle of mutual assistance (tawun)
<i>Taqlif</i>	Accountability
<i>Tatfif</i>	Causing damage
<i>Tawarruq</i>	A sale contract where the financial institution will buy an asset and immediately sell it to a customer on a deferred payment basis. The customer then sells the same asset to a third party for immediate delivery and payment, the end result being that the customer receives a cash amount and has a deferred payment obligation for the marked-up price to the financial institution
<i>Tawheed</i>	A principle in Islam, i.e. oneness of God
<i>Ummah</i>	<i>Muslim</i> nation
<i>Uqud</i>	Contracts
<i>Usul al-fiqh</i>	The study of evidences and indications of rules within <i>Islamic</i> law
<i>Usury</i>	An equivalent to <i>riba'</i>
<i>Wadi'ah</i>	Safekeeping of deposits by customers in a financial institution
<i>Wadi'ah yad dhamanah</i>	Safekeeping of deposits by customers in a financial institution where the deposit is guaranteed by the financial institution
<i>Waqf</i>	Retention of a property for the benefit of a charitable or a humanitarian objective
<i>Zakat</i>	Fund supposed to be collected from the rich to be distributed to the poor to ensure socioeconomic justice through equitable distribution of wealth

CHAPTER ONE

INTRODUCTION

1.1 Introduction: Background of the Study

The establishment and operation of Islamic banking and finance is governed by *Shari'ah* principles. It is expected that its operations will comply with *Shari'ah* Law and will contribute towards achieving the objectives of *Shari'ah* Law (*maqasid As-Shari'ah*). After fifty years and thirty years of its development and growth internationally and in Malaysia, respectively; the industry has achieved various milestones in terms of legal and regulatory framework, *Shari'ah* governance, standards and resolutions, and infrastructure for a level playing field. In Malaysia, the regulators and government give full support to providing institutional infrastructure and architecture for Islamic banks to operate to their fullest extent. In addition, the development and growth of IBF in Malaysia has been considerable and it has liberalised its market to foreign players. As an established industry in Malaysia, it also aspires to become the international hub of Islamic finance³. Despite the positive development of the IBF industry, more effort and attention are still required in order to ensure that the development and growth of the industry can guarantee that the objectives of the *Shari'ah* Law are achieved. The aim of this research is to examine the theoretical and practical aspects of problems and challenges facing Islamic banking and finance in Malaysia. The focus of the study is on aspects of four issues: legal and regulatory framework, *Shari'ah* compliance, management, and accounting. In the course of achieving the objectives, this study surveys different groups of respondents who are involved with the operation of Islamic banking and finance in the IBs, using semi-structured interviews.

³ Islamic finance is defined as a financial service or product principally implemented to comply with the main tenets of *Shari'ah* (Islamic Law) (Gait and Worthington 2008).

The underlying principles of *Islamic* banking and finance are governed by *Shari'ah* Law, which is based on four sources: the *Qur'an* (the revelation of Allah), the *Hadith* (the sayings and actions of the Prophet Muhammad (*pbuh*) during his lifetime), *Ijma'* (consensus of Muslim scholars) and *qiyas* (analogical deductions from other three sources for contemporary issues). In addition, the underlying principles of *Islamic* banks are the prohibition of *riba'* (i.e. interest), the promotion of trade and commercial activities as the underlying principles of products and services in *Islamic* banks, the profit and loss sharing framework, the prohibition of *gharar*, and payment of *zakah*. Thus, the *Islamic* bank provides the solution for Muslims in terms of principles, instruments, and issues involved in banking business activities; since the operations of the activities are based on the principles of the *Shari'ah* (Nawawi 1999; Rosly 2005b; Kettell 2002).

Initially, the establishment of *Islamic* banking and finance arose due to the growing interest and demand of Muslims to engage with banking activities according to *Islamic* teachings. In the early stage, the establishment of IB aimed to fulfil the needs of Muslims to deposit their money and be assured that the money deposited would be managed Islamically. Islamically managed deposits and financing activities would guarantee that the money was free from interest, would assist Muslims to use it for religious causes such as pilgrimage and would allow Muslims to enjoy a '*barakah*' (blessed) income. Therefore, the development and growth of *Islamic* banks increased over time to meet the increasing demand of customers. In addition, besides attracting its establishment in various countries, it also managed to attract the interest of both Muslims and non-Muslims to deposit their money and allow the bank to invest their money in accordance with *Shari'ah* Law.

According to the history and development of the IBFI, the industry has evolved from fifty years ago and has undergone extensive development. It has progressed and developed both in *Islamic* and non-Muslim majority countries. However, there is still a lack of appropriate legal and regulatory framework in their establishment. Some *Islamic* countries still have an inadequate infrastructure in operating IBs, while some IBs have had difficulties in their operation and management due to unclear explanations in their legal and regulatory frameworks. Furthermore, the IBs started to internationalise in Europe, North America, South Korea, Japan, China, Singapore and elsewhere. These countries operate under the conventional economic system or under the dual banking system. Each IB is dynamic and unique based on the economic and financial system of the individual country.

The structure and scope of the operations and activities of the *Islamic* banking and finance industry in Malaysia and internationally has undergone significant development and seen a number of initiatives launched. The development and initiatives in the industry in Malaysia can be categorised as the most comprehensive among the countries offering IB. Specifically, among others, the development of and initiatives in *Islamic* banking and finance can be categorised into two levels: one being the Malaysian level and the other, the international level. At the Malaysian level, there are: (1) the legal and regulatory framework supporting the industry, (2) the Malaysian Financial Sector Master Plan, (3) the Accounting Standards by the Malaysian Accounting Standards Board, (4) the BNM's guidelines, and (5) the SC's guidelines. Under the Malaysia Financial Sector Master Plan, the development of the industry is categorised into four phases. They are: (1) the establishment of *Islamic* financial institutions, (2) conventional banks with appropriate firewalls in place, permitted to offer *Islamic* financial products and services, (3) the option to transform SPTF (IBSc) into *Islamic* Subsidiaries and (4) liberalisation and international integration. On the other hand, there have

also been various developments and initiatives internationally, such as the establishment of AAOIFI and IFSB to support the industry in terms of ensuring the soundness and stability of the *Islamic* banking industry. In addition, a 10-Year Master Plan has been initiated by the IRTI, IFSB and IRTI, IDB. Other discussions related to the development in the industry are the *Islamic* Financial Sector Development Forum, the *Islamic* Financial Sector Working Group and the Policy Framework of Microfinance. The IB is also bound to comply with international banking regulations, such as IBSc and BASEL.

The establishment of *Islamic* banks is expected to fulfil the objectives of *Shari'ah* by (1) carrying out banking operations based on *Islamic* law, (2) managing wealth and operations in accordance with *Shari'ah*, and (3) ensuring that the innovation and implementation of products and services are *Shari'ah* compliant. The objectives of *Shari'ah* consist of promotion of welfare and prevention of corruption and vices towards attainment of total welfare of the nation. The compliance of *Islamic* banks with *Shari'ah* principles is examined in its various components such as product, concept, process, skill set, technology and risk management. The adherence to the *Shari'ah* principles in its operations is expected to drive towards the fulfillment of the *Shari'ah* objectives. Also, it will increase the trust and confidence of the public in the soundness, stability and competitiveness of *Islamic* banks. In addition, besides the *Shari'ah* compliance of *Islamic* banks, the business performance of *Islamic* banks is equally important. However, in the *Islamic* banking system, business performance (i.e. profitability) is not the main elements in measuring the performance as *Islamic* banks ought to balance the material objectives and social objectives. The material objectives and social objectives are explained through business performance and attainment of total welfare of the nation, respectively. Thus, the efforts to maximise profit should be aimed within the framework of social and moral conduct.

The *Islamic* banking system that operates on a dual-banking system faces difficulties in operating in accordance with *Shari'ah* due to its underlying regulatory and financial infrastructure being based on conventional banking. Since the underlying regulatory and financial infrastructures are based on the conventional economic system, they cannot fully support the overall operations of IB in full *Shari'ah* compliance. Moreover, this may hinder the development and innovation of more products and services based on *Shari'ah*. These results are a departure from the principles of *Islamic* banking operations that were being explained earlier and therefore may raise problems and challenges which may delay the achievement of the objectives of *Shari'ah*.

The impact of these developments and initiatives has affected all of the aspects of banking activities, at least to some extent, and has been particularly evident in the way the products and services (i.e. business transactions) provided by the *Islamic* commercial banks, *Islamic* banking subsidiary that was previously known as *Islamic* banking system, conventional *Islamic* Banks (i.e. the *Islamic* banking system) *Islamic* subsidiaries and foreign *Islamic* financial institutions are managed and controlled. The unique structure of *Islamic* banks coupled with the development and initiatives to support their establishment and operations has led to further challenges and requirements of the *Islamic* banking and finance industry; in its activities and in introducing new products and services that uphold *Islamic* principles. This support is important due to the fact that most *Islamic* banks operate in a conventional economy which functions according to different principles from those of *Islamic* banks. However, the commendable achievements during the operations of IBs should not lead us to ignore the problems and challenges that IBs are facing. These problems and challenges are

mainly due to the different environment, philosophy, and practices of IBs that surround their operations.

1.2 Motivation and Rationale of the Study

The credibility of Islamic banking and finance is important to ensure the sustainability of the Islamic banking system. The credibility of IBF can be explained by the legitimacy of its practices and the accountability of its market players. The legitimacy of IBF is explained by its compliance to *Shari'ah* and to the legal and regulatory framework. Furthermore, market players in the industry ought to exercise adequate accountability (Abdul-Rahman 1998) in ensuring that the management, operations, products and services are *Shari'ah*-compliant.

The literature on the performance of Islamic commercial banks in Malaysia begins with the performance of the BIMB. Although the BIMB experienced growth in terms of assets and deposits, its improved profitability remained lagging behind the conventional banks (Hassan 1999; Samad and Hassan 1999; Samad 1999; Naughton and Shanmugan 1990). Furthermore, studies on the technical efficiency of Islamic banks have shown that fully-fledged Islamic banks in general and the BIMB, in particular, performed below optimum level; which implies the inefficient use of resources (Amir and Azmi 2004; Rosly and Afandi 2003; Hamid and Ahmad 2001). Further, Samad (1999) discovered that his findings reflected weaker productivity and managerial efficiency during the period of year 1992 to 1996. Furthermore, studies on efficiency were carried out by Yahaya (2005), Mokhtar et al. (2008), Sufian (2007) and Mohd-Zamil and Abdul-Rahman (2007) for the periods between 1990 to 1997, 1997 to 2003, 2001 to 2004 and 2001 to 2004, respectively. Mohd-Zamil and Abdul-Rahman (2007) found that fully-fledged Islamic banks were less efficient as compared to conventional commercial banks. They also found that managerial efficiency in Conventional Commercial

Banks (CCBs) is higher than in Islamic Commercial Banks (ICBs). Several factors supporting the lower level of managerial efficiency of ICB are the management structures of ICBs (Saaid et al. 2003), the capital structures of ICBs (Sarker 1999a), less expertise and unskilled labour in ICBs (Saaid et al. 2003) to improve the management in the process of mobilisation of inputs into outputs (i.e. inefficient use of resources) (Saaid et al. 2003; Amir and Azmi 2004; Yahya et al. 2001; Hamid and Ahmad 2001), less capability to develop attractive and innovative products and to market the products to customers (Sarker 1999a), the volume of operations of CCBs (Samad 2004), the technological advancement of CCBs (El-Gamal and Inannoglu 2002; Okuda and Hashimoto 2004), networking created by CCBs, changes in economic conditions and policies (Amir and Azmi 2004), and government interference. Measuring the performance of Islamic banks is important in ensuring better performance in the future. Furthermore, the advancement of technology and the impact of globalisation and liberalisation in the financial services industry will result in a more competitive environment. Thus, the performance level will serve as an early warning system to various parties such as the bank's management, the depositors and investment account holders, and the government. Further action needs to be taken accordingly in order to ensure that the financial institution is ready to face the challenges ahead.

In addition, the performance of Islamic banks requiring attention in order to provide better opportunities for Islamic banking business activities in the future, the Islamic banks face challenges from their customers. Studies on the reasons behind patronising the Islamic banking business show that, although the establishment of Islamic banks is due to a religious impetus, customers' patronage the banking business were not solely motivated by religious reasons. Customers' choice of bank is based on other reasons such as fast and efficient service (Erol and El-Bdour 1989; Haron et al. 1994; Metawa and Almosawi 1998; Gerrard

and Cunningham 1997; Erol et al. 1990; Hegazy 1995; Al-Sultan 1999), the bank's reputation and image (Erol and El-Bdour 1989; Erol et al. 1990; Naser et al. 1999), confidentiality (Erol and El-Bdour 1989; Haron et al. 1994; Gerrard and Cunningham 1997; Erol et al. 1990), social responsibility (Hegazy 1995), profitability (Metawa and Almassawi 1998), cost (Metawa and Almassawi 1998), socioeconomics (Metwally 2002), and demographic characteristics (Metwally 2002).

The Islamic banks face problems and challenges in various aspects of the bank's operations, both externally and internally. Externally, the Islamic banks are involved with local government and legislative authorities, Islamic banking industry regulators and supervisory and international regulatory bodies. The local government and legislative authorities are involved with the national legal infrastructure, and the power of industry regulators and supervisors. The Islamic banking industry regulators are concerned with the requirements of the supervision of *Shari'ah* compliance. International regulatory bodies refer to international organisations such as the Islamic Financial Services Board (IFSB), the Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI), the Basel Committee on Banking Supervision (BASEL) and others. Differences in governance structure, existence SSB, accounting regulations and standards, legal and regulatory authorities and supervisory authorities led to differences in the implications of accounting principles and practices in Islamic banks. Furthermore, Islamic banks are bound to comply with local and international legal and regulatory frameworks.

In studying the problems and challenges facing Islamic banks in Malaysia, this research focused on four issues: *Shari'ah* compliance, legal and regulatory frameworks, auditing and accounting practices and management. While the first three matters were straightforward, the

fourth referred to the operational and administrative aspects of the institution comprising of matters pertaining to human capital, the system and internal processes. This study addressed the problems and challenges regarding various aspects within the establishment, operations and products and services of IBs. Corporate governance and institutional theories had framed the research through economical, functional and institutional factors that influenced or propelled IBs. Thus, the related theories were explored and associated to IBs in order to provide a more meaningful result and understanding regarding the relationship between these issues.

1.3 Aims and Objectives of the Study

The aim of this research is to examine the theoretical and practical aspects of problems and challenges facing Islamic banking and finance in Malaysia. The focus of the study is on aspects of four issues, which are: legal and regulatory framework, *Shari'ah* compliance, management, and accounting. Based on the issues at hand, the main questions of this study is to investigate whether accountability for *Shari'ah* compliance is considered and embraced in the governance structure of the company and consideration of accounting and auditing systems as mechanisms of accountability in Islamic banks.

1. To identify the problems and challenges facing *Islamic* banking and finance industry related to the legal and regulatory framework, *Shari'ah* compliance and management and accounting.
2. To evaluate whether the process and current practices of ensuring *Shari'ah* compliance in the *Islamic* banking and finance industry is implemented efficiently in Malaysia.
3. To delineate and discuss the problems and challenges facing SSB, *Shari'ah* auditing, financial auditing and financial accounting, and reporting in providing reliable information in terms of efficient resource allocation and ensuring *Shari'ah* compliance in *Islamic* banks.
4. To identify the current practices of *Shari'ah* advisory boards, *Shari'ah* auditing and financial accounting, and reporting in ensuring the reliability of financial reporting, compliance with relevant laws and regulation

together with the efficiency and effectiveness of *Shari'ah* compliance in *Islamic* banking in Malaysia

In order to achieve these aims, this study surveys different groups of respondents who are involved with the operation of *Islamic* banking and finance, using semi-structured interviews to examine the above-mentioned questions. The key respondents are *Shari'ah* Committee members, *Shari'ah* Officers and Chief Executive Officers (CEOs). The study also attempts to answer a number of specific research questions, as follows:

Shari'ah compliance:

1. What are the problems and challenges facing *Islamic* banking and finance in ensuring the *Shari'ah* compliance of its operation in terms of the operations of *Islamic* banks, business ethics governing their behaviour, transactions that are driven by *Shari'ah*-approved contracts (i.e. the validity and permissibility of the contract) and *Shari'ah* as the governing law of all affairs of the corporation?
2. What are the efforts made and actions taken in the *Islamic* banking system and finance to ensure *Shari'ah* compliance in the IB?
3. How can the process be enhanced in order to improve the level of compliance in *Islamic* banks?

Legal and regulatory framework:

1. What are the problems and challenges related to the legal and regulatory framework of *Islamic* banks?
2. What are the problems and challenges in complying with national and international legal and regulatory frameworks?

Accounting and auditing practices:

1. What are the problems and challenges facing the *Islamic* banking and finance industry in terms of accounting practices, accounting standards and auditing?
2. What are the problems and challenges facing SSBs in *Islamic* banks in relation to accounting and auditing?

3. Is there a need for standardisation and harmonisation of accounting practices and accounting standards in *Islamic* banks? What efforts are being made to standardise and harmonise these practices?
4. Are the personnel in *Islamic* banks capable and competent in performing their duties and responsibilities?

Management:

1. What are the problems and challenges related to management (i.e. human capital, system, and internal process)?
2. How can the IBs ensure that the management aspects are in place and it is well carried out towards achieving the objectives of its establishment?
3. How can IBs improved the elements in management aspects to ensure that it is well carried out?

The following section provides a brief discussion of the theoretical framework that has been chosen to inform the findings emerging from the semi-structured interviews.

1.4 Scope of the Study

This study is informed mainly by the institutional theory (i.e. New Institutional Sociology (NIS)) as the primary theoretical framework and corporate governance theories such as agency theory, transaction cost economics theory, and stakeholder theory which are also used to support the *Shari'ah* governance and implementation of *Shari'ah* activities.

Firstly, both agency theory and transaction cost theory focus on the agent-principal relationship and the governance of transactions, respectively. Furthermore, both theories highlight the conflict of interest that may arise from information asymmetry. In addition, the contractual focus of agency theory is *ex-ante* incentive alignment and monitoring mechanism, while transaction cost theory focuses on the *ex-post* governance mechanism. In IB, the additional agency relationships involved are the need to comply with *Shari'ah* and the separation of cash flow and control rights. Since IAHs are not granted the monitoring and

control right that enjoy by shareholder, the IAH ought to depend on vicarious monitoring carried out by shareholders. Thus, it raises the need for mechanism to safeguard the IAH's interest. However, in gaining legitimacy, organisations should not focus solely on economic aspects (i.e. efficiency and profitability) in order to meet the shareholders' interests.

Stakeholder theory addresses morals and values in managing an organisation. It is argued that the scope of corporate governance and accountability in stakeholder theory is wider than that which the agency theory offers. In stakeholder theory, the institution not only aims to meet the shareholders' interests, but also the interest of the stakeholders. In line with the objectives of the establishment of Islamic banking and finance to fulfil the objectives of *Shari'ah*, (Iqbal and Mirakhor 2004) asserted that the corporate governance model in the Islamic economic system is a stakeholder-centred model. Furthermore, the inclusion of agent morality in the stakeholders' model is important since it highlights the importance of managers taking certain moral duties into consideration before referring to shareholders' wealth in approaching business policies (Quinn and Jones 1995). Agent morality is viewed as non-instrumental ethics in business policy, producing policy recommendations that are morally binding on managers. In the context of IBs, the *Islamic* agent morality concept is beyond the normal agent morality. *Islamic* agent morality involves accountability towards shareholder, stakeholder and ultimately to God. The Islamic agent morality is grounded by the underlying *Shari'ah* principles and akhlaq and aqidah as the core of the behaviours and conducts.

NIS is also considered to be a relevant framework in this study as it demonstrates that Islamic banking and finance practices are driven not only by economic and functional factors but also by institutional factors (Dambrin et al. 2007). Furthermore, the NIS emphasises that organisations compete to obtain both economic resources and institutional legitimacy

(DiMaggio and Powell 1991). There are three institutional mechanisms, as explained by (DiMaggio and Powell 1983). According to DiMaggio and Powell (1983), the first mechanism is coercive isomorphism, which occurs as a result of formal and informal pressures exerted on organisations by other organisations upon which they are dependent, and by cultural expectations in the society within which the organisations operate. The second mechanism is mimetic isomorphism. DiMaggio and Powell (1983) suggest that uncertainty is the main motivation for organizations to imitate others. This pressure arises from the drive to reduce uncertainty. Organizations tend to imitate when technologies are poorly understood, when goals are ambiguous, or when symbolic uncertainty is created by the environment (DiMaggio and Powell 1983). The third mechanism is normative isomorphism. This is a pressure arising from professionalization, which socialises personnel within the organisation to view certain types of structures and processes as legitimate.

It is important to understand the diverse perspective of its operation such as economic and functional factors and economic resources and institutional. It is more crucial to understand it in the context of IB as IB in Malaysia it operates under dual-banking system and expose to various problems and challenges. The IB is also being criticized and questioned on its roles to ensure *Shari'ah* compliance and achievement of the objectives of *Shari'ah*. Thus, it is important to understand the conflicting institutional pressures faced by IBs.

1.5 Methodology

In order to accomplish the research objectives mentioned above, firstly, a review of the history and development of the Islamic banking and finance industry internationally and in Malaysia was produced, followed by an explanation of *Shari'ah* principles and the theoretical framework underlying the operations of Islamic banking and finance. In addition, this study

also reviews the theoretical frameworks presented in studies on governance framework such as agency theory, economic cost theory, stakeholder theory and institutional theory. Moreover, the literature on the problems and challenges facing Islamic banking and finance was reviewed. In discussing the problems and challenges facing Islamic banks, the credibility of Islamic banking system was further examined in terms of *Shari'ah* compliance in Islamic banks, the concept of accountability in Islam, and trust in IB. Furthermore, literature on accounting and auditing as a system of accountability in Islamic banks was reviewed.

With regards to research design, this study employed a qualitative method and primary data was gathered through semi-structured interviews. The qualitative research is broadly grounded in a philosophical position which is interpretive (Mason 1996). It is an inductive approach to the relationship between theory and practice (Bryman 2001). The semi-structured interviews assisted in fulfilling the aim of the thesis. The researcher conducted interviews between September 2010 and December 2010. Semi-structured interviews allowed the interviewer to inquire about the problems and challenges facing Islamic banks in Malaysia from the perspectives of the interviewees. The interviewees were selected on the premise that their knowledge, experience and involvement in the industry would add more value to understanding the problems and challenges facing the IBs. The interviewees include *Shari'ah* Board members, NSACs, the Head of *Shari'ah* Departments or *Shari'ah* officers and CEO/COOs.

Qualitative methods may have the power to take the researcher into the minds and lives of the social actors and to capture how the social world is interpreted, understood, experienced and produced (McCracken 1988; Mason 1996; Bryman 2001). Furthermore, the use of the semi-structured interview in this study to explain the problems and challenges facing Islamic banks

in terms of legal and regulatory framework, *Shari'ah* compliance, management and accounting and auditing assisted the researcher in understanding the theoretical and practical problems and challenges facing this industry. In addition, the use of semi-structured interview in this study may encourage other researchers to adopt such a research method to explore, in depth, other contexts in the Islamic banking industry.

1.6 Contribution of the Study

Malaysia has long been recognised as an example and model for the majority of Muslim countries that successfully manage to offer IB products and services. Furthermore, the development and growth of IBs in Malaysia has been dramatic and has involved various other branches of Islamic finance. However, the industry faces a number of problems in its current performance. In addition, differences in jurisdiction have led to inconsistencies in its operations, products and services offered. This could be due to differences in the opinion of scholars when determining the permissible level of certain rulings. Thus, in Malaysia specifically, there is a competition between conventional banks and Islamic banks in the same jurisdictions and in different jurisdictions. Studying the problems and challenges facing Islamic banks that involve the legal and regulatory framework, *Shari'ah* compliance, management and accounting and finance is important in building a better IBF industry that will be a point of reference to other interested countries with dual banking system. This will further support the aspiration of IB in Malaysia to be at the forefront of the international IBF industry.

This study makes a number of contributions to the literature. First, it is hoped that it will provide an understanding and explanation of the problems and challenges facing Islamic banking and finance in relation to its legal and regulatory framework, *Shari'ah* compliance,

management and accounting and finance in order to ensure that the objectives of the establishment are met. In this respect, the focus of Islamic banking is not only on maximising its profits, but also on meeting the objectives of *Shari'ah*; which are mainly concerned with achieving the complete welfare of the Muslim nation through the promotion of well being and the prevention of corruption and vice. Thus, it portrays the importance of upholding the accountability and legitimacy of the institutions in preserving their credibility.

Secondly, this study investigates the perceptions of *Shari'ah* experts of accounting and auditing in Islamic banks. This will assist in understanding and explaining accounting and auditing practices in Islamic financial institutions. Accounting practices portray the way religious organisations employ their resources in order to meet social needs. Furthermore, the importance of understanding accounting as a situated practice in churches (Booth 1993) is possibly a fruitful way of adding to our more general explanation of the prominence of accounting in *Islamic* banks. Thirdly, by adopting a qualitative methodology, this study will respond to calls for a more field-based research in Islamic banks by exploring *Shari'ah* governance in general, and accounting and auditing practices in particular.

Fourthly, theories such as the agency theory, stakeholder theory and NIS were used to explain the implementation of activities and resources in IBs through underlying *Shari'ah* principles. While examining the agency theory, a unique agency relationship in IB was identified and discussed. In addition to the usual agency relationship, IBs face the separation of cash flow rights from the rights to control investments and the need to comply with *Shari'ah*. This left the IAH to depend on the role of vicarious monitoring carried out by shareholders in order to prevent the management from exposing funds to an intolerable risk level. However, the current problem in the IB industry, where it is faced with various

Shari'ah non-compliance cases, raised the matter of trust in the accountability of players. Thus, this study viewed the importance of morality and ethics, or *akhlaq*, which should be instilled in accordance with *Shari'ah*, and must further be demonstrated in players' behaviours and conducts. In addition, the perspective of *akhlaq* was explained in an onion diagram displayed in Figure 8.4.2; adapted from Hofstede (2000). *Akhlaq* was categorised as an internal and deep culture; while *Shari'ah* practices was categorised as a surface culture. Furthermore, the incorporation of an agent morality in normative stakeholder theory was still less apparent in the decision-making of Islamic banks. Therefore, this study suggested that the agent morality in IB practices should be grounded in *Shari'ah* principles, and the onion diagram of *akhlaq* and *aqidah* should be assimilated so as to uphold the concept of agent morality. Agent morality in IBs was accountability to the shareholders, stakeholders and, ultimately, to God; which differentiated normal agent morality from Islamic agent morality. In addition, the NIS offered an explanation as to how various types of institutional isomorphism may influence the problems and challenges faced by IBs in Malaysia. The result of this study portrayed conflicting institutional isomorphism which was contributed by the loose coupling of actual IBs' practices from the formal IB's underlying theoretical structures. In addition, the accounting practices in IBs were further depicted by conflicting institutional isomorphism.

In practical and methodological terms, it is hoped that by gaining a better understanding of the problems and challenges facing IB, the existing legal and regulatory framework and its enforcement, the operation and implementation of products and services and accounting system and auditing will lead to a better approach considered by the regulators and management of banks; in terms of configuring an enhanced system to ensure *Shari'ah*

compliance, accounting and auditing systems are present in order to ascertain that a system of accountability is in place.

1.7 The Structure of the Thesis

The thesis consists of nine chapters, which are organised as follows: Chapter One is the introduction, which concentrates on the background and the objectives of the study. In addition, this chapter provides a brief explanation of the research problems, research questions, and theoretical and methodological approaches used in this study, as well as the importance of conducting such research and the contribution of the research.

Chapter Two provides a review of the philosophy and theoretical framework of Islamic banking and finance. The chapter starts with a brief review of the establishment of Islamic banking and finance, followed by its key developments in Malaysia. This is then followed by an overview of the philosophical and theoretical frameworks underpinning its operations.

Chapter Three explains and discusses the theoretical framework underpinning the study. Although institutional theory is the main theory used to inform the findings of this study, other theories related to corporate governance such as agency theory, transaction cost theory and stakeholder theory were also used. The first part of the chapter is devoted to briefly outline corporate governance theories such as agency theory, transaction cost theory and stakeholder theory (focusing on agent morality). When possible, these approaches will be associated with the governance of Islamic banking and finance. In addition, the relationship between these theories and institutional theories are outlined. Afterwards, the chapter explains the main ideas and concepts of the NIS; such as social legitimacy, institutional isomorphism, decoupling or loose coupling and to what extent these issues exist in the

Islamic banking industry. In order to explain the problems and challenges related to its legal and regulatory framework, *Shari'ah* compliance, management and accounting and auditing were considered. The chapter also reviews the utilisation of institutional theories in the research on banking institutions.

Chapter Four provides a review of the literature on the problems and challenges facing Islamic banking and finance in relation to the legal and regulatory framework, *Shari'ah* compliance, management and accounting and auditing. The chapter starts with a review of the literature on the credibility of the Islamic banking system, which stems from legitimacy of its practices and accountability of its market. The credibility of the Islamic banking system is further discussed in terms of *Shari'ah* compliance in Islamic banks, the concept of accountability in Islam and trust in IB. Next, the chapter reviews the literature on the impact of Islamic banking and finance practices in terms of its performance and customers' perspectives in patronising Islamic banking and finance institutions. Furthermore, it reviews literature on the problems, challenges and risks in Islamic banking and finance. In addition, there is a review of literature on accounting and auditing as a system of accountability in Islamic banks.

Chapter Five is concerned with the research methodology, describing the research objectives and the processes used in this study. It presents in detail the rationale for the adoption of a semi-structured interview and the issues related to data collection. Regarding the in-depth interviews, negotiating access and interview strategies were discussed. In addition, the relevant analysis to be employed was also highlighted.

Chapters Six and Seven present the findings from the semi-structured interviews. Chapter Six reports the findings in terms of the legal and institutional framework. This chapter begins with brief background information about the Malaysian dual-banking system and further discusses the effects of operating within this system. The chapter also provides a discussion of legal and institutional structures related to *Shari'ah* governance, accounting and auditing in Malaysian Islamic banking and finance. The discussions contained the interpretation of *Shari'ah*, guidelines governing the *Shari'ah* governance system, issues on legal and regulatory framework related to operation, products and services and financial regulatory framework. Chapter Seven of this study reports the findings in terms of *Shari'ah* compliance and accounting and auditing practices in Islamic banks. It focuses on how *Shari'ah* compliance is commercially viable, and how *Shari'ah*-approved procedures are being implemented and considered in the governance system. Next, the chapter discusses the influence of accounting practices and reporting and *Shari'ah* auditing. Chapter Seven concludes by explaining how approved *Shari'ah* compliance procedures are being implemented, and also the consideration of accounting and auditing systems and the system of accountability.

Chapter Eight examines the theoretical analysis of the interview's findings. It starts with the explanation on how accountability towards *Shari'ah* compliance is portrayed by different levels of personnel. Where appropriate, the researcher relates the findings with the agency theory, agent morality and normative stakeholder's theory. Next, the chapter discusses the different mechanisms of institutions isomorphism that are experienced by the Islamic banking industry in Malaysia and how they influence and shape the problems and challenges faced by Islamic banking and finance. Finally, the chapter explains how the mechanisms of institution's isomorphism influence and shape the accounting practices in Islamic banks.

Lastly, Chapter Nine discusses the contribution and limitations of the study. The chapter begins with a summary and review of the case findings. Then, the theoretical and practical contributions of the study are presented. Next, the chapter offers some limitations and suggestions for future research. The thesis ends by highlighting the limitations of the study and providing some suggestions for future research. The framework for the thesis has been constructed to assist in navigating the various parts and chapters. This is displayed in Figure 1.7.1 below.

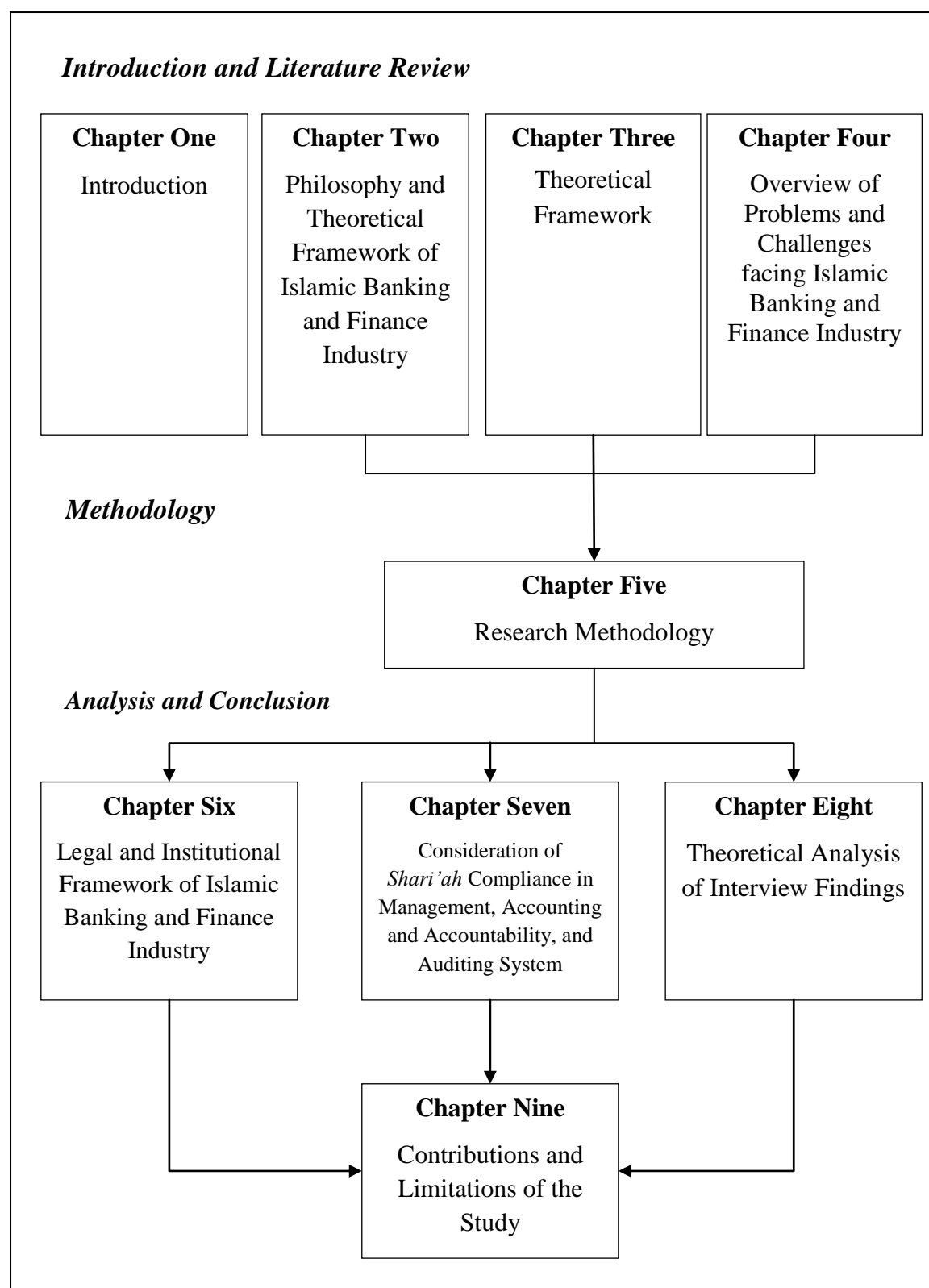


Figure 1.7.1 Research Framework for Problems and Challenges Facing *Islamic Banking and Finance* in Malaysia (generated by author)

CHAPTER TWO

PHILOSOPHY AND THEORETICAL FRAMEWORK OF ISLAMIC BANKING AND FINANCE (IBF) INDUSTRY

2.1 Introduction

The aim of this chapter is to provide background information on the history, development and growth of international Islamic Banking and Finance industry (IBFI), in general, and Malaysian Islamic Banking and Finance industry, in particular. It begins with a brief discussion of the historical background of the Islamic banking and finance industry, followed by an explanation of the development of Malaysian Islamic banking and finance industry. Next, it explains the objectives and philosophy of the establishment of Islamic banking and finance. Finally, the chapter then discusses the theoretical framework of Islamic banking and finance.

2.2 Establishment of Islamic Banking and Finance

2.2.1 Historical Background of Islamic Banking and Finance Industry (IBFI)

The existence of IBs started from the early 1960's to date. In 1963, the first modern experiment with *Islamic* banking was undertaken in Egypt. As the government in power did not welcome a manifestation of *Islamic* activism, the establishment of the Mit Ghamr Saving Bank was made under cover. It took the form of a savings bank based on profit-sharing in the town of Mit Ghamr and lasted until 1967, by which time there were nine other banks in the country operating in the same way as the Mit Ghamr Saving Bank (Ariff 1988). These banks did not charge or pay interest, but shared the profits with depositors, and investments were made mostly in trade and industry; directly or in partnership with others (Ariff 1988). Rural savings were collected by a series of small savings banks in northern Egypt (Kahf

2005b). Later, in 1971, the Mit Ghamr Saving Bank was incorporated into a new government controlled institution, the Nasser Social Bank, which had the responsibility of collecting *zakat* (i.e. the *Islamic* wealth tax). It was the first recognised interest-free commercial bank and was established in Cairo with the objective of developing a social security system in Egypt.

During late 1962, a pilgrimage fund known as the Pilgrims' Savings Corporation (PSC) was established in Malaysia. It became the first non-bank *Islamic* financial institution. Its aim was to assist *Muslim* society in Malaysia to manage their money ethically. Its objective was to mobilise savings of *Muslims* intending to perform the pilgrimage and to channel the funds to permissible investments according to *Shari'ah* principles (Aziz 2005). This institution also managed and administered funds in order to enable *Muslims* to go to Makkah for pilgrimage. In addition, the existence of the PSC helped attract *Muslims* to deposit their money confidently; knowing and believing that the money would be managed *Islamically*. In 1969, the Government merged the PSC with the Pilgrims' Affairs Office (PAO) to form the Pilgrims' Management and Fund Board (PMFB), better known as Tabung Haji.

A major expansion in *Islamic* banking activities started to take place in the 1970s, partly due to the oil revenue boom in the Gulf and the growing economic influence of the more conservative *Muslim* states of the Gulf (Wilson 2000). In December 1973, the Organisation of *Islamic* Countries (OIC) established the *Islamic* Development Bank (IDB). The IDB is an international government-funded *Islamic* bank that was established by 22 *Muslim* countries in 1973. The membership of the *Islamic* Development Bank currently consists of 56 countries. The main function of the IDB was to provide assistance in the form of equity capital and

loans for *Shari'ah*-compliant projects, for the economic development and social progress of member countries and to promote *Islamic* banking worldwide.

In 1975, the Dubai *Islamic* Bank, the first commercial *Islamic* bank in the UAE, was established. Then, in 1977, the Faisal *Islamic* Bank of Egypt, the Faisal *Islamic* Bank of Sudan and Kuwait Finance House were established. Following that, the Jordan *Islamic* Bank was established in 1978. In the same year, the *Islamic* Banking System with international holding was established in Luxembourg. This was the first *Islamic* financial institution in a Western country. The existence of *Islamic* Banking System with international holding shows that the expansion of *Islamic* banking was not only confined to the Middle East but also attracted the attention of its international counterparts. In 1979, an *Islamic* bank was established in Bahrain, namely, the Bahrain *Islamic* Bank.

Due to the massive expansion in *Islamic* banking activities, some commercial banks started offering *Islamic* banking facilities (e.g. state-owned banks in Egypt, and the National Commercial Bank in Saudi Arabia) (Wilson 2000). The cooperation between IBs and conventional banks started in early 1980s, when Kleinwort Benson, Citibank and Saudi International Bank were the pioneers in this process (Smith 2000; Wilson 2000). Such developments showed that the *Islamic* financial instruments were increasingly being accepted internationally, even in non-*Islamic* countries, and the basic principles were understood (Wilson 2000). As asserted by (Smith 2000, p. 98), this cooperation was based on the following reasons:

- *IBs increasingly worked with conventional banks to find profitable, low-risk investment vehicles through which to deploy funds*

- *There was a continuing focus on the use of Islamic funds to finance raw commodities and international cross-border trade*
- *Had its base not only in religion (which it did) but also had the overriding need for efficiency and competitiveness*
- *To enable the commercial IBs to compete with conventional banks in their own markets and to build a retail market share*
- *For the large multi-national Islamic groups, the cooperation was useful not only in terms of efficiency but also because it was through conventional banks that routine banking transactions needed to be executed*

Other international players were Citibank, Merrill Lynch, Kleinwort Dredner, ANZ, ABN Amro, Goldman Sachs, HSBC etc.; the large, regional-based entities, ABC, GIB, as well as many of the Saudi Arabian and Malaysian commercial banks and specialist entities, such as the *Islamic* Investment Banking Unit of the United Bank of Kuwait (Smith 2000). The establishment of Citibank's first *Islamic* banking subsidiary in Bahrain was expected to lead to significant cooperation, accompanied by an eventual realisation of substantial benefits by both Western and *Islamic* banks (Pomeranz 1997).

The expansion of IBs continued in the 1980s. In 1981, Dar al-Mal al-Islami was established in Switzerland followed by the commencement of the *Islamic* Bank International of Denmark in 1983. In the same year, due to the rapid development of PMFB in Malaysia, Bank Islam Malaysia Berhad was established. The Malaysian Government felt the need to establish IBs in Malaysia to attract *Muslim* savers. In addition, in early 1983, three *Muslim* countries, namely Iran, Pakistan and Sudan, decided to transform their economies and financial sectors. The following year, in 1984, an *Islamic* bank was established in Qatar, known as the Qatar *Islamic* Bank.

In addition, in 1987, the Dallah Al Baraka Group established Al-Tawfeek Co. This Group made its first offerings in the certificated form of medium-term investment assets with market-making or buyback guarantees. Next, in 1990, IDB launched its Unit Investment Fund, where again the sponsor provided liquidity for an offering invested in essentially illiquid assets. This fund now has its shares listed on the Bahrain Stock Exchange. Then, in 1993, the International Investor, quickly followed by the International Investment Group, set the pace (Smith 2000). Also, in 1993, Dallah Al Baraka Bank gave up its banking licence and moved to investment banking due to a number of challenges faced by the bank (Karbhari et al. 2004). The development of Islamic banks also continued in the South-East Asia region. The Indonesian government took the initiative of establishing Bank Mu'amalah Indonesia, an *Islamic* bank that started operations in 1992. The development of Islamic banks also took place in other countries, such as Brunei, Singapore and Thailand⁴ in 1993, 2002 and 2007, respectively.

Currently, the world is witnessing rapid and massive progress being made in further developing the *Islamic* banking and finance industry. The development of IB is not concentrated in the Middle East (i.e. Bahrain, Iran, Jordan, Kuwait, Lebanon, Qatar, Saudi Arabia, Syria and UAE), South Asia (Bangladesh and Pakistan) and Southeast Asia (i.e. Indonesia, Malaysia, Brunei, Thailand and Singapore), but also reaches the Africa (i.e. Sudan, Algeria) and the Europe (Bosnia, Denmark, France, Germany, Holland, Luxembourg, Russia, and Switzerland)⁵ along with other Western markets (i.e. Australia⁶, UK⁷, US and

⁴ Namely, Islamic Bank of Brunei, Islamic Bank of Thailand and The Islamic Bank of Asia, respectively.

⁵ Bosnia Bank International (Bosnia), Islamic Bank International of Denmark Copenhagen (Denmark), BNP Paribas (France), Commerzbank and Deutsche Bank (Germany), ABN Amro (Holland), Samba Capital Management International (Luxembourg), Badr Bank (Russia), Dar Al Maal Al Islami Trust and Union Bank of Switzerland (Switzerland)

⁶ MCCA-Islamic Finance & Investments (Australia), Arab Bank Australia, and Islamic Co-operative Finance Australia Limited

⁷ Islamic Bank of Britain

Canada⁸). Among financial institutions in the US involved in Islamic finance are: Al Baraka Corp., Al Manzil Islamic Financial Services, Lariba Bank, Goldman Sach's Islamic banking subsidiary and the Muslim Credit Union. Although the financial activities offered by each country may differ, the interest in participating in the *Islamic* Finance market is very encouraging. Moreover, throughout the years, the existence of *Islamic* banks has attracted the attention of Western central banks such as the Federal Reserve Board and the Bank of England, international financial institutions like the International Monetary Fund (IMF) and the World Bank.

2.2.2 Development of Malaysian *Islamic* Banking and Finance Industry (MIBFI)

The development of Islamic banking and finance worldwide resulted in different economic structures within which Islamic banks operate. Islamic banks could operate in countries that adopt *Shari'ah* law by removing interest from the operations of banking systems, while those that function in *Muslim* countries along with conventional banks (Arab and *Muslim* countries) or co-exist with conventional financial institutions and conventional banks, are allowed to offer financial services that comply with *Shari'ah* principles and to trade *Islamic* financial products through a dedicated *Islamic* unit (i.e. *Islamic* window or *Islamic* subsidiary) (Karbhari et al. 2004; Chapra and Khan 2000). Furthermore, Islamic financial activities consist of *Islamic* banking, Takaful and *Islamic* capital markets which different countries use to varying extents.

Malaysia is well known for its dual or parallel banking system, with IBs running their business along with their conventional counterparts; while in Pakistan, Iran, and Sudan, the banking systems operate solely on a single *Islamic* banking system (Rosly 2005b). Under the

⁸ UM Group, Islamic Co-operative Housing Corporation Ltd., Qurtuba Housing Coop & Al-Itihad Investment Inc., The Bank of Tokyo-Mitsubishi UFJ, Ltd.,

dual banking system, the conventional commercial banks are allowed to (1) offer financial services that comply with *Shari'ah* principles and (2) to trade *Islamic* financial products through a dedicated *Islamic* Unit (i.e. *Islamic* window or *Islamic* subsidiary). In addition, in the dual banking system, both types of banks utilise the same banking infrastructure (Yakcop 2003). Furthermore, according to Yakcop (2003, 6), the two basic advantages of operating in the dual banking system are as follows:

1. *The range of Islamic banking products in a dual system tends to be wider when compared to the products in a single Islamic system. In a dual system, therefore IBs cannot afford to be complacent, since they operate in a competitive and dynamic environment. In the single Islamic system model, on the other hand, the financial institutions would not have similar incentive to expand the range of the Islamic banking products as the possibility of domestic customers shifting away to a conventional system does not rise.*
2. *In addition to a wider range of services, the Islamic banking products in the dual banking system can also be expected to have a higher level of sophistications compared to the Islamic product in the single Islamic system.*

Furthermore, in Malaysia, there are two legislations for banking operations, i.e. the *Islamic* Banking Act 1983 (IBA) and the Banking and Financial Institutions Act 1989 (BAFIA). The IBA (1983) defines *Islamic* banking business as a banking business whose aims and operations do not involve any element which is not approved by the religion of Islam. BAFIA (1989) defines banking business as:

- *The business of:*
 - *Receiving deposits on current account, deposits account, savings account or other similar account;*
 - *Paying and collecting cheques drawn by or paid in by customers; and,*
 - *Provision of finance;*
- *Such other business at the bank (BNM), with the approval of the Minister may prescribe*

Based on the definitions of the banking business and IBs, it can be concluded that the bank plays its role in mobilising the deposits from the depositors (i.e. finance providers) to the investors (i.e. finance users). Basically, the functions and definitions of the banking sector do not vary between conventional and IBs, but the philosophy, objectives, and operations differ between them (Al-Saud 2000; Ahmad 1991).

The development of *Islamic* banking has passed through four distinct phases. In addition, each phase witnessed various other developments to ensure that *Islamic* banking operations support the development of the industry. Thus, this shows that the developments were achieved through collective efforts from various parties. These include government, regulators, supervisory board, SSB, practitioners, academics and researchers in the industry. Furthermore, Aziz (2004a, 1) stated, regarding the development of the *Islamic* banking activities in Malaysia:

The Islamic financial system in Malaysia has evolved as a viable and competitive component of the overall financial system, complementing the conventional system as a driver of economic growth and development. The rapid progress of the domestic Islamic financial system, reinforced by significant developments in the Islamic financial infrastructure, including the legal and Shari'ah infrastructure and the regulatory and supervisory framework, has strengthened the position of the Islamic financial system as an increasing important component in meeting the changing requirements of the new economy.

Aziz (2004a) asserted that to achieve a viable and competitive component of the overall financial system, progress and significant development play an important role. Further, the industry aims to create a sustainable, sound and stable system. This would involve *Shari'ah* compliance and credibility of the services offered and confidence of the public in financial institutions.

Furthermore, the development of the Islamic financial system in Malaysia can be categorised into four phases. The first phase refers to the development in the 1980s, when it began with the establishment of the first Islamic bank, Bank Islam Malaysia Berhad (BIMB) in 1983. The setting up of the bank was governed by the *Islamic Banking Act 1983*. The establishment of *Islamic* banks provided *Muslims* and non-*Muslims* with the opportunity and alternative to do their banking business activities in accordance to governing principles based on *Shari'ah*. In addition, the Government Investment Act was enacted to allow for government investment certificates to be issued facilitating the Bank's liquidity operations (Aziz 2005). Within a year of its establishment, the *Takaful* or *Islamic* investment insurance company was established. These developments were aimed towards establishing a comprehensive *Islamic* financial system that would place Malaysia as an international *Islamic* finance hub.

The second phase involved the development in the 1990s. During this phase, the industry allowed conventional banks to offer Islamic financial products and services provided that they had appropriate 'firewalls' to segregate the conventional and Islamic operations. The scheme was called the interest-free banking scheme and was launched on 4th March 1993. It later became known as the Islamic Banking Scheme (IBSc). This development aimed to improve the development of the IB and to attract mainstream acceptance and pervasiveness (Bank Negara Malaysia 1993; Nor 2002). Licensed financial institutions were allowed to offer IBS if they met the requirements stated in specific guidelines on *Islamic* Banking issued by BNM on 5th July 1993. In addition, various initiatives were introduced and carried out throughout the year in an effort to raise the profile of Malaysia as an international *Islamic* financial centre.

Furthermore, in 1994, there came the implementation of the Islamic Interbank Money Market (IIMM) and the introduction of BIMB securities as the first step to promote the Islamic Capital Market. In October 1996, the BNM issued the requirements for banking institutions involved in IBS to disclose the balance sheet and profit and loss account for Islamic banking operations as an additional item under the Notes to the Accounts. Moreover, BNM established a National *Shari'ah* Advisory Council (NSAC) as the highest authority to decide on *Shari'ah* issues pertaining to the Islamic financial system in an effort to harmonise the differences in opinions in 1997.

An important event in *Islamic* banking during 1999 was the establishment of the second *Islamic* bank in Malaysia, namely Bank Mu'amalah Malaysia Berhad (BMMB). The bank commenced operations on 1st October 1999. The founding of the second *Islamic* bank was expected to play a key role in fostering an active and progressive *Islamic* banking system (Bank Negara Malaysia 1999). Furthermore, in April 1999, the KLSE *Shari'ah* Index was launched to facilitate public investment in instruments that was in line with *Shari'ah* Law.

Then, year 2000 marked the third phase of its development; continuous efforts were made in the industry to encourage the expansion of the IBS. In March 2001, the BNM formulated and launched the Financial Sector Master Plan (FSMP), which incorporated the ten-year master plan for *Islamic* banking and *Takaful*. FSMP addressed *Islamic* banking and *Takaful* as the major potential growth sectors. The FSMP aimed to promote Malaysia as a regional financial centre for *Islamic* banking and finance. In achieving its aim, the FSMP created efficient, progressive and a comprehensive *Islamic* financial system, and provided an avenue for the industry to evolve a competitive, dynamic and resilient financial system that withstands the challenges brought about by globalisation and the liberalisation of the financial markets. The

BNM also aimed for the IBs and IBSc to capture at least 20% of the banking market share by 2010 (Bank Negara Malaysia 2000).

In 2001, the Malaysian Accounting Standard Board (MASB) issued FRS *i-1*₂₀₀₄ (Presentation of Financial Statements of *Islamic* Financial Institutions). The objective of the standard was to provide a basis for the presentation and disclosure of financial statements of *Islamic* financial institutions (Bank Negara Malaysia 2001). In addition, the *Islamic* Financial Services Board (IFSB) was created on 3rd November 2002, based in Kuala Lumpur, Malaysia. The establishment sought to promote integrated supervision and regulation of the unique risks associated with *Islamic* financial products, and the development of relevant standards to calculate risks associated with said products. The IFSB serves as an association of central banks, monetary authorities and other institutions that are responsible for the regulation and supervision of the *Islamic* financial services industry. The IFSB is intended to liaise and co-operate with other standard-setting bodies in the areas of monetary and financial stability, and will promote good practices in risk management within the industry through research, training and technical assistance (Anonymous 2004)⁹. To date, the IFSB has issued 10 standards, guiding principles and technical notes for the *Islamic* financial services industry, focusing on Risk Management, Capital Adequacy, Corporate Governance, Supervisory Review Process, Transparency and Market Discipline, Recognition of Ratings on *Shari'ah* Compliant Financial Instruments, Development of *Islamic* Money Markets, *Shari'ah* Governance, Governance for Takaful and conduct of business by institutes offering *Islamic* financial services. The work of the IFSB complements that of the Basel Committee on Banking Supervision, the International Organisation of Securities and the International Association of Insurance Supervisors.

⁹ Report of the Islamic Capital Market Task Force of the International Organization of Securities Commissions

Furthermore, in 2002, the Guidance Notes on the Sell and Buy Back Agreement were introduced by BNM to enhance the liquidity in *Islamic* money market participants to source their funding requirements (Bank Negara Malaysia 2002). In the same year, the International *Islamic* Financial Market (IIFM) was established to strengthen the efficacy of the *Islamic* financial system in achieving balanced growth and development (Bank Negara Malaysia 2003). The IIFM encourages active participation by both *Islamic* and non-*Islamic* financial institutions in the secondary market for *Islamic* financial instruments. The IIFM's primary focus lies in the advancement and standardisation of *Islamic* financial instrument structures, contracts, product development and infrastructure; and the issuance of guidelines and recommendations for the enhancement of *Islamic* Capital and Money Market globally. It provides independent *Shari'ah* advice and guidelines for the issuance of new financial products (Anonymous 2004). IIFM published IIFM Standard Agreements Adaptation Procedures and Policies for Institutions, IIFM Standard on Interbank Unrestricted Master Investment Wakalah Agreement, ISDA/IIFM Mubadalatul Arbaah (MA) (Profit Rate Swap), ISDA/IIFM Tahawwut (Hedging) Master Agreement (TMA) and Master Agreement for Treasury Placement (MATP). In addition, there are various Sukuk reports and market research. Moreover, the board of directors of the IIFM established the Global *Shari'ah* Supervisory Committee (GSSC). This aims to enhance cross-border acceptance of *Islamic* financial products. At the same time, IIFM endorsement facilitates cross-border listings on various international stock exchanges, thereby encouraging the trading of *Islamic* products and instruments in the secondary market (Anonymous 2004). Furthermore, in enhancing the regulatory framework, the BNM conducted a review of the Framework of Rate of Return and issued the Guidelines on the Specimen Reports and Financial Statements for Licensed

Islamic Banks (GP8-i). The issuance of GP8-i aimed to promote consistency and standardise the presentation and disclosure of financial statements.

The fourth phase in the development was liberalisation and international integration. In accordance with the financial sector master plan in 2004, the BNM approved the issuance of new *Islamic* banking licences under the IBA 1983 to three leading foreign *Islamic* financial institutions from the Middle East, namely: the Kuwait Finance House, Al-Rajhi Banking & Investment Corporation and a consortium of *Islamic* financial institutions represented by the Qatar *Islamic* Bank, the RUSD Investment Bank Inc. and the Global Investment House. The issuance of the licences was part of the liberalisation of the *Islamic* financial system in Malaysia. The liberalisation aimed to promote a competitive environment that would ensure cost-effective pricing to benefit Malaysian consumers and businesses, and strengthen trade and investment linkages with the rest of the world (Bank Negara Malaysia 2006).

Besides the liberalisation in the issuance of new *Islamic* banking licenses under the IBA 1983 to the foreign *Islamic* institutions, there was the liberalisation of foreign exchange administration rules in 2004. The establishment of the IBs would increase competition among *Islamic* Banks (IBs) and *Islamic* Banking Subsidiary (IBS) in Malaysia. Furthermore, an important measure was taken in 2004 in which several conventional banking groups participating in the IBS transformed their current *Islamic* window institutional structure into an *Islamic* subsidiary within the mainstream banks. In addition, a significant development in the domestic *Islamic* financial market was the recent issuance of Ringgit-denominated *Islamic* debt securities by two multilateral financial institutions. These improvements allowed domestic and foreign institutions to tap on regional and international business opportunities (Bank Negara Malaysia 2006). These significant developments aimed to promote future

growth in positioning Malaysia as a leading *Islamic* financial hub for the international financial community (Bank Negara Malaysia 2006). Liberalisation of foreign ownership in *Islamic* finance has yielded positive results, as manifested in the increased foreign interest and investment in both *Islamic* banking and *takaful* during the same year. It also encouraged international integration among the *Islamic* banks and resulted in increased competition.

In 2004, the BNM continued to strengthen the overall infrastructure development of the *Islamic* banking system. Numerous initiatives were made to streamline the policy direction such as developing and strengthening institutional financial infrastructure, risk management, enhancing the regulatory, prudential and operational frameworks, strengthening *Shari'ah* and legal infrastructure¹⁰ and enhancing human capital development and consumer education. There has also been a continuous effort to enhance the supervision of the *Islamic* banking system.

In 2005, the *Islamic* financial system in Malaysia showed significant progress in an increasingly liberalised and competitive environment, in line with the increased integration of the Malaysian *Islamic* financial system into the global *Islamic* financial landscape (Bank Negara Malaysia 2005). There were also continuous efforts to strengthen the financial infrastructure, *Shari'ah* framework and legal framework of *Islamic* Financial Institution in Malaysia. In particular, in new areas of growth including investment banking and *Islamic* banking and *Takaful*, foreign equity limits were raised. Consequently, the entrance of new players in *Islamic* finance was one of the factors that contributed to a more diversified and competitive financial services sector in Malaysia. In 2006, *Islamic* banking and *Takaful* activities gathered momentum as eight new players commenced operations. It was expected

¹⁰ An effective *Shari'ah* framework combined with a sound legal system in an essential element of a comprehensive *Islamic* banking system

that the entrance of new players in *Islamic* finance and the newly formed investment banks would generate increased activity with the launching of innovative products and services to attract a wider range of customers, including foreign clients. In addition, the International Centre for Education in Islamic Finance (INCEIF) was brought into operation in the second quarter of 2006 to offer professional certification and postgraduate programmes as part of the effort to build the necessary talents and skills in Islamic finance (Bank Negara Malaysia 2005).

The Malaysia International *Islamic* Financial Centre (MIFC) initiative was launched to promote *Islamic* financial products and services in international currencies in the global market. Under this initiative, the financial centre gathered momentum with approval given to *Islamic* banks to establish the International Currency Business Units (ICBU). In addition, a major development in the *Islamic* money market operations was the issuance of the Bank Negara Malaysia Sukuk Ijarah on 16, February 2006 with an issue size of RM400 million. The *Islamic* International Rating Agency (IIRA) started operations in July 2005 to facilitate development of the regional and national financial markets by outlining relative investment or credit risk, providing an assessment of the risk profile of entities and instruments. The basis of establishing IIRA lies in the need to have absolute independence of rating judgment, objective and impartial rating committees, highly-trained professional analytical staff and business objectives determined by the market by incorporating the unique features of IF. The IIRA is structured with a Board of Directors and a completely independent Rating Committee in order to maintain its independence. The IIRA's shareholding encompasses various agencies that can be classified into multilateral financial institutions, rating agencies, and banks and insurance companies. Its shareholders operate from eleven countries, which constitute the agency's primary marketing focus. In addition, professional analytical research

for its multiple constituencies established by IIRA is expected to set a high standard for the market, enhancing the level of understanding of the value of fundamental analysis in assessing default or investment risk. It is also expected that IIRA will enhance transparency in the investment decision process by educating investors on the use of ratings criteria and the methodology utilised elsewhere.

The industry continues to develop and grow. It continues to introduce various initiatives and measures in numerous areas such as tax incentives, liquidity management in the Islamic money market, *sukuk*, unit trust and fund management, marketing and advertisement, operational efficiency, international technical cooperation, learning and knowledge management in central banking and financial services, business and training, regional collaboration with other central banks, supervisory agencies in emerging economies, foreign deposit investment and various areas in legal and regulatory framework. Initiatives and measures are being undertaken to develop the Islamic finance and encourage the entry of new Islamic banks. There are expected strong activities in the Islamic Capital Markets and growth will be further enhanced in the Malaysian Islamic banking industry. These efforts are additionally designed to develop a comprehensive domestic Islamic financial system and further nurture it for Malaysia to become an Islamic finance hub.

Since the establishment of the IBS was due to religious impetus and an alternative to the established conventional banks, the principles stipulated by the religion of Islam (i.e. *Shari'ah* law) are the governing principles of its operations and it governs the products and services offered by the IB. In highlighting the importance of IBS to fulfil the need of the Islamic banking business activities, the following section explains the linkage between Islam and IBS.

2.2.2.1 Development of MIBFI within the Global Sector

The existence of Islamic banks provides Muslims and non-Muslims with opportunity and alternative to do their business and financial transactions. The development of Islamic financial structure in Malaysia is aimed towards a comprehensive Islamic financial system that will place Malaysia as an Islamic finance hub. Its operation that is based on dual banking system where the Islamic banking system operates side-by-side with the conventional system may attract the attention of other country that is based on conventional banking system to develop their Islamic financial system. Various initiatives are being introduced and carried out throughout the year as an effort to heighten Malaysia as an international Islamic financial centre.

The substantial growth in IB may be explained by its demand, acceptance and development of its operation since it was introduced. In addition, it is crucial that the operations of its IBs manage to increase the confidence of the clients to ensure that IB is continued to develop and grow. The confidence is not only by ensuring that the Islamic banking industry's performance are able to allow its confine operation and growth, it is also to employ special measure to ensure that the operation and management are comply to the *Shari'ah* Law.

The following, Table 2.2.1, presented the breakdown of Islamic financial assets in a selected number of countries from 2007 to 2012. The data portrayed Islamic financial assets in the Malaysian Islamic Banking industry in connection with global Islamic finance. Compared to selected countries, internationally, the Malaysian Islamic bank had ranked number three throughout the specified period.

Table 2.2.1 Size of the Global Islamic Financial Services Industry (AUM¹¹ USD Bn)¹²

Country	2007	2008	2009	2010	2011	2012
Iran	235	293	369	406	413	416
Saudi Arabia	92	128	161	177	205	215
Malaysia	67	87	109	120	131	155
United Arab Emirates	49	84	106	116	118	120
Kuwait	63	68	85	94	95	103
Bahrain	37	46	58	64	65	71
Qatar	21	28	35	38	47	68
UK	18	19	24	27	33	37
Turkey	16	18	22	25	35	41
Bangladesh	6	8	9	10	13	17
Sudan	5	7	9	10	11	14
Egypt	6	6	8	9	12	19
Pakistan	6	5	6	7	12	13
Jordan	3	5	6	6	11	13
Syria	1	4	5	5	5	4
Iraq	--	4	5	5	9	12
Indonesia	3	3	4	5	9	22
Brunei	3	3	4	4	8	10
Other Countries	7	7	9	10	125	281
Total	639	822	1036	1139	1357	1631

Referring to the historical and growth and development of *Islamic* banking and finance in Malaysia, this study intend to explore four issues (i.e. *Shari'ah* compliance, legal and regulatory framework and accounting and finance). The issues are covered in one overarching piece of research to provide an overview of the problems and challenges facing Islamic banks in Malaysia. In exploring the issues, this study conducts the semi-structured interviews with senior officials, *Shari'ah* committee, NSAC, and scholars. The interviews findings are narrated and interpreted. Further, the governance theories such as agency theory, transaction cost theory, stakeholder theory (i.e. agent morality) and institutional theories will

¹¹ The acronym is stands for Asset under Management

¹² Global Islamic Finance Report 2013 extracted from <http://gifr.net>

be employed to support the findings of this study. Also, it assists in understanding the conflicting institutional issues face by IBs.

2.3 Islam and Islamic Banking System

The relationship between *Islam* and the *Islamic Banking System* is explained in Figure 2.3.1 *Islam*, which means peace and submission, comprises three fundamental elements: *Aqidah*, *Shari'ah*, and *Akhlaq*. *Aqidah* deals with the faith and belief of the believers and *Muslims'* belief in *Allah* through the understanding of the revelation of the *Qur'an*¹³, *Sunnah*¹⁴, *Ijma'*¹⁵ and *Qiyas*¹⁶. All the sources of the *Shari'ah* will help the individual *Muslim* to understand the rules and principles underlying the *Shari'ah*. Besides understanding the rules and principles, it will also increase the individual's faith in *Allah*. *Akhlaq* deals with matters related to moralities and ethics. It is defined as virtue, morality and good manners in accordance with *Shari'ah* principles and it is demonstrated through man's behaviour or conduct.

¹³ The *Qur'an* is a book revealed to the Prophet Muhammad as a guidance to all *Muslim* (Zaid 1995).

¹⁴ The *Sunnah* is the words and practices of the Prophet Muhammad based on the guidance of God. It is the second primary source of *Islamic* (Zaid 1995).

¹⁵ *Ijma'* is the consensus of the *Muslim Nation* on certain issues (Zaid 1995).

¹⁶ *Qiyas* consist of the analogical deductions from the *Qur'an*, *Sunnah* and *Ijma'* for issues that are not directly mentioned in the *Qur'an* and *Sunnah* (Zaid 1995).

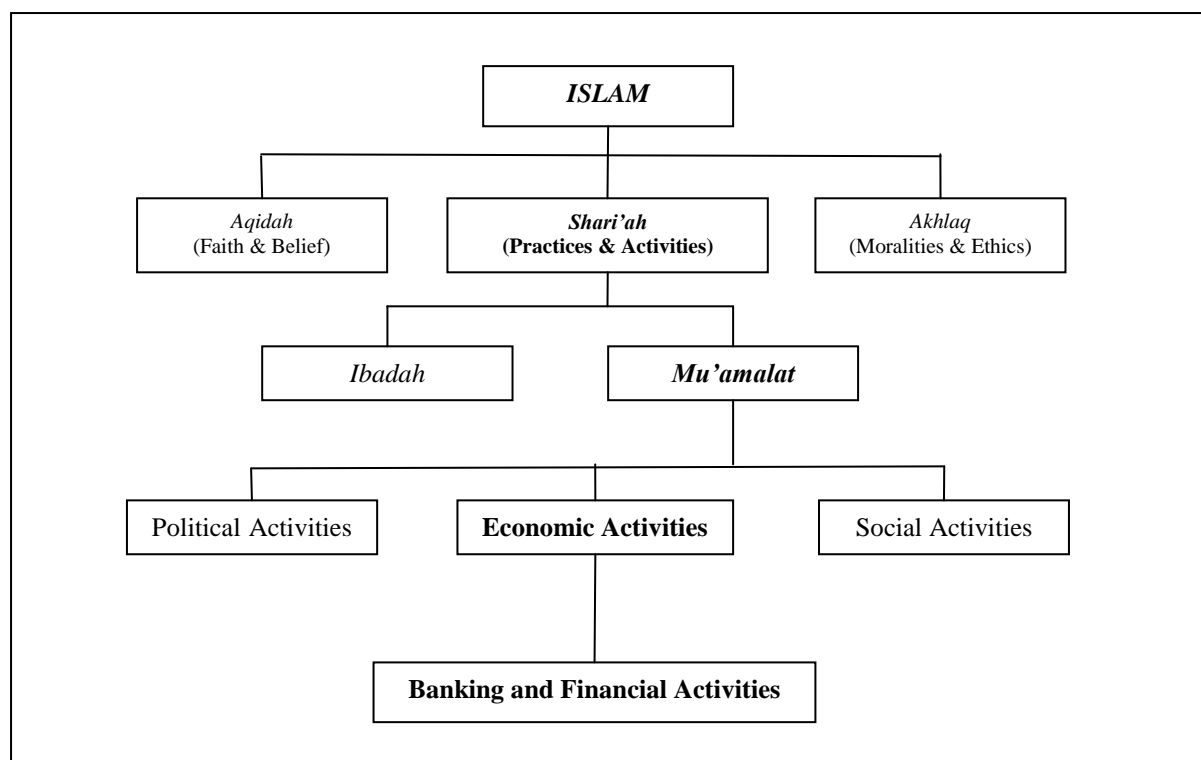


Figure 2.3.1 The relationship between *Islam* and the *Islamic Banking System* (Source: Ismail 1992, 250; cited by Haron 1997, 31)

The *Shari'ah*, which deals with practices and activities, is further divided into *Ibadah* (i.e. ritual deeds or worshipping Allah), *Mu'amalat* (i.e. business transactions, marriage and crime). The *Shari'ah* is the overall law that governs *Muslims*. It helps to build the relationship of a *Muslim* with *Allah* (God), relationships with other human beings and the relationship with the environment. *Mu'amalah* is practised for political, economic and social activities. The establishment of banking and financial activities led to the fulfilment of the need of *Muslims* to ensure that the economic activities of the *Ummah* are managed smoothly.

Thus, it is explained that Islam does not recognise the separation between spiritual and temporal affairs, considering commerce as a matter of morality and subject to the precepts of the *Shari'ah* (Karim 2001). The principles that have been revealed in the *Qur'an* and the guiding principles in business affairs should not be treated separately. As the guiding principles are inferred from the *Qur'an* and *Hadith*, both elements should be practised

together. Hence, *Islamic* banks, like other *Islamic* business organisations, are established with the mandate to carry out their transactions in strict compliance with *Islamic Shari'ah* rules and principles (Karim 2001).

Furthermore, in reference to Figure 2.3.2, Hofstede (2000) categorised values (i.e. moralities and ethics), as deep culture where it is core, internal, tangible and not prone to change. On the other hand, rituals, heroes and symbols are categorised as surface culture, where it is related to external practices.

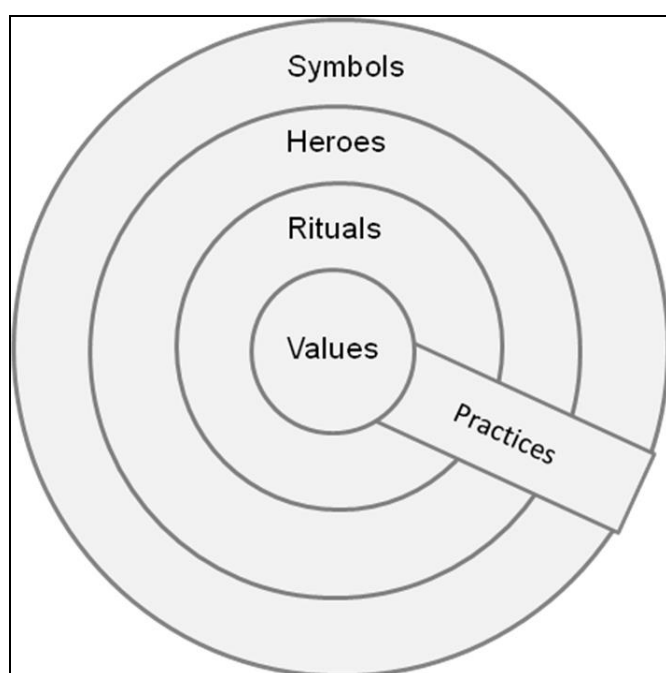


Figure 2.3.2 (Hofstede 2000, 11)

In relation to Hofstede (2000), *akhlaq* should have linkage with practices and activities. However, in the context of Islam, the influence of *akhlaq* carries a greater impact as it is in accordance with *Shari'ah* principles which is originated from divine sources as explained in the earlier paragraph. In integrating Hofstede (2000) on values and the initial Figure 2.3.1, this study draws linkage from *akhlaq* to *Shari'ah* as being portrayed in Figure 2.3.3.

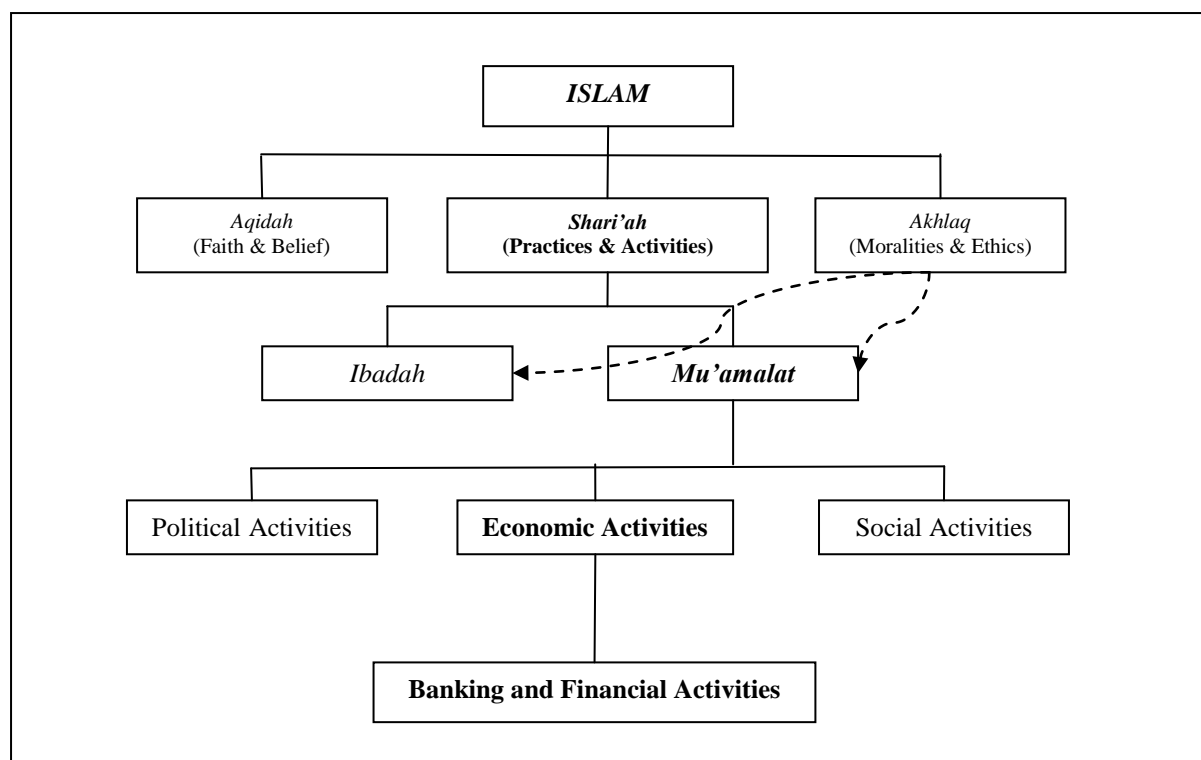


Figure 2.3.3 The linkage of Akhlāq with *Shari'ah* (practices and activities) (Source: Ismail 1992, 250; cited by Haron 1997, 31 and Hofstede 2000)

2.3.1 The Objectives of *Shari'ah*

Since the operations of *Islamic* banking and finance are based on *Shari'ah* principles, it is intended to fulfil the *maqasid as-Shari'ah* (i.e. the objectives of *the Shari'ah*) that aim to attain the total welfare (*maslahah*) of the *Muslim* nation. Welfare is defined in the Oxford Advanced Learner's Dictionary (2001; p. 1355) as "the general health, happiness and safety of a person". In the perspective of Islam, well-being and happiness is to be achieved in this world and in the hereafter, also known as *al-falah*, which refers to ultimate success. In addition, the *maslahah* is meant to preserve the goals of *Shari'ah* where the welfare of the *Ummah* is achieved through the attainment of these goals (Nyazee 2000). Furthermore, Kamali (1989, as cited in Abdul-Rahman 2003) identified three areas which constitute the primary objectives of *Shari'ah*; namely, to educate the individual, to establish justice, and to realise welfare (i.e. *maslahah*) of the people.

Furthermore, to elaborate the philosophy of *Islamic* banking, Ali (1988, quoted by Haron 1997, 11) was of the view that

“The Islamic economic order is based upon a set of principles found in the Qur’an. No matter what aspect of the Islamic Economics order is introduced, for practical operations it has to base itself on the Qur’anic concept of social justice. The Islamic Financial system, therefore, cannot be introduced merely by eliminating riba’ but only by adopting the Islamic principles of social justice and introducing laws, practices, procedures and instruments which help in the maintenance, dispensation of justice, equity and fairness.

Ali (1988, quoted by Haron 1997) emphasised the need of the practical operation of the *Islamic* banking operation to be based on *Qur’anic* concepts of social justice. The philosophy revealed in the *Qur’an* and the guiding principles in business affairs should not be treated separately. All revelations that require *Muslims* to uphold justice and virtue serve as principles which guide IBs in managing their business dealings (Haron 1997, 2000; Rosly 2005a; Nawawi 1999; Siddiqui 2001; O’Sullivan 1996a, cited in Pomeranz 1997). Justice can be achieved by prohibiting all sources of unjustified transactions (Nawawi 1999). Unjustified transactions will result in an unjustified means of profit and wealth creation. Thus, in managing the assets of the banks, the management of IBs should spend their accumulated wealth on the needy and for providing well-being for the whole of society (Haron 1997).

In order to reach a state where the complete welfare of the *Ummah* is achieved, the operation should uphold the objectives of *Shari’ah*; which are the promotion of welfare (i.e. *masalih*, pl. *maslahah*) and prevention of corruption and vice (i.e. *mafasid*) (Abozaid and Dusuki 2007; Abdul-Rahman 2003; Nyazee 2000). On the other hand, a *Muslim* jurist defines objectives of *Shari’ah* as seeking benefits and the rejection of harm, as directed by the lawgiver or *Shari’ah* (Nyazee 2000; Abozaid and Dusuki 2007). The promotion of welfare can be further divided into obligations, recommendations and permitted; while the prevention

of corruption and vice is divided into prohibited and detested. Thus, if the *Ummah* observed all the elements involved in the operations, the *Muslim* nation is expected to achieve complete welfare. Figure 2.3.2 below explains the components of the objectives of *Shari'ah* to achieve complete welfare:

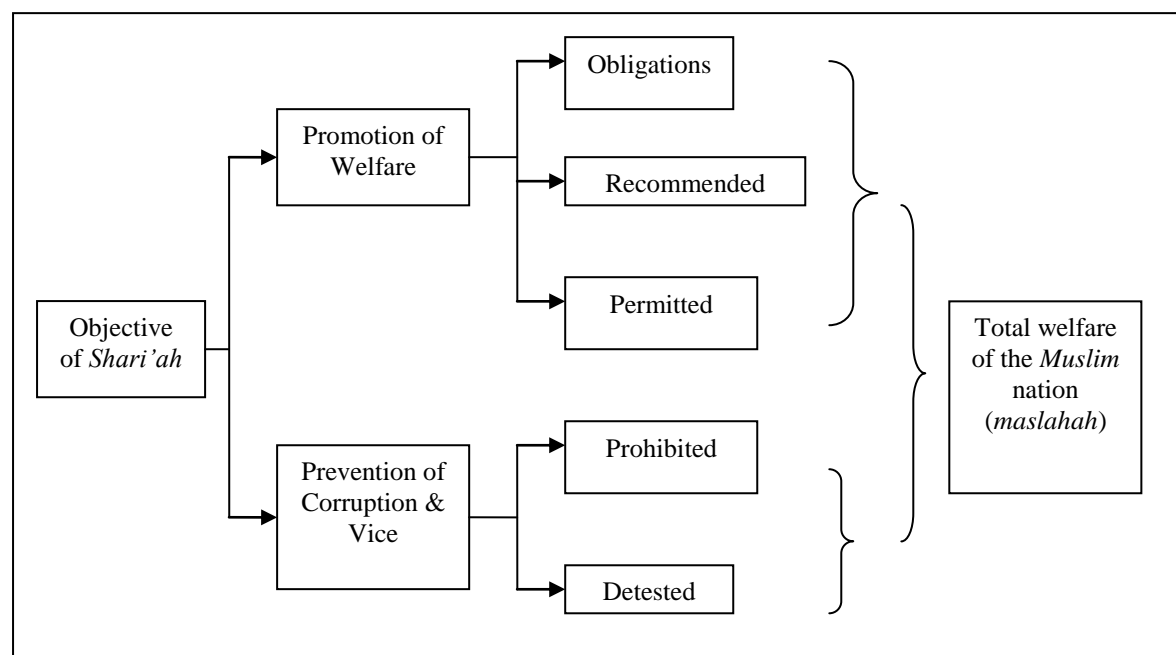


Figure 2.3.4 Objective of *Shari'ah*

In order to guarantee that the interest of the *Ummah* is protected, Shatibi (Abdul-Rahman 2003) classified the protection of interest (i.e. protection of *masalih*) into three interrelated types, namely, the essentials (i.e. *daruriyat*), the complements (i.e. *hajiyyat*) and the so-called embellishments (i.e. *tahsiniyat*). Essentials are the basic needs of people which they depend on to live. The basic needs are classified into five elements that have been discussed by Imam Al-Ghazali (Abozaid and Dusuki 2007; Dusuki and Abozaid 2007; Kamali 2003; Abdul-Rahman 2003). These are protection of faith (*din*), protection of life (i.e. *nafs*), protection of posterity (i.e. *nasl*), protection of reason (i.e. *aql*) and protection of property (i.e. *mal*). The fulfilment of the essential elements will assist in the establishment of welfare in this world and in the hereafter (Nyazee 2000; Kamali 2003). Complementary interest refers to interests

which, if we neglect them, will lead to minor hardship; for example, smoking. It will not bring total disruption if you do it in your daily life, but it could make you prone to illnesses and affect others as well. Anything that complements the basic needs of an individual can also be categorised under complementary. It has the aim of facilitating life or removing hardships and is compatible with the *Shari'ah* (Kamali 2003). Embellishments refer to attitudes that nourish the current values that an individual has. Therefore, it is a matter of desirability at this level of interest, since they seek to attain refinement and perfection in customs and conducts of people (Kamali 2003). An example is to control excessive desire by practising moderation in life, giving out *sadaqah* besides paying *zakah* or performing more prayers in addition to the five obligatory prayers.

These classifications can be used as a benchmark in making decisions, while at the same time, ensuring that the interest of the *ummah* is protected. Abdul-Rahman (2003) takes the three classifications in protecting the interest, as an ethical filtering mechanism that can be used as a means to resolve ethical conflicts. They can also be utilised as the basis of setting appropriate priorities for the work to be undertaken (Abdul-Rahman 2003). In addition, Dusuki and Abozaid (2007) proposed that the classifications are a framework that can be used by the manager when faced with potential conflicts arising from the diverse expectations and interests of a corporation's stakeholders. Thus, these classifications will serve as a checklist in order to direct the decisions made in accordance with the objectives of its establishment.

In addition, IBs should operate based on *Islamic* teachings by engaging in legitimate and lawful business in order to fulfil all obligations and responsibilities, properly execute transactions to help and assist the needy, managing the wealth in a proper and orderly manner

and avoiding any overspending and wastefulness (Haron 1997). Other principles that need to be observed by the players are to manage the business dealings of *Islamic* banking with honesty and equity, to carry out trading activities in a faithful and beneficial manner and to perform work with honest efforts (i.e. earnest endeavour and striving to earn one's rightful livelihood) (Haron 1997, 2000). In addition, it is important for the players to observe *Islamic* ethical and moral standards (O'Sullivan 1996a, cited in Pomeranz 1997). Furthermore, the business activities of *Islamic* banking should also be based on the ethical values of *Islam* and any investments in unlawful businesses, such as dealings which involve interest, manufacturing and trading of alcohol, trading of pork, drugs, gambling, pornography, etc., are prohibited (Rosly 2005a; Gait and Worthington 2008; Iqbal et al. 1998; Ali 2000; O'Sullivan 1996a, cited in Pomeranz 1997). Also, any business activities that aim at earning a profit through hoarding, black-marketeering, profiteering, short weighting and hiding the defects of merchandise are prohibited. The IBs had a good monitoring mechanism in screening prospective investment portfolio involve in unlawful business (Ullah et al. 2014).

The International Association of *Islamic* Banks (IAIB p.27; Al-Omar and Abdel-Haq 1996) in its statement in 1990 elaborates on the purposes of *Islamic* banks as thus:

"The Islamic banking system involves a social implication, which is necessarily connected with the Islamic order itself, and represents a special characteristic that distinguishes Islamic banks from other banks based on other philosophies. In exercising all its banking or developmental activities, the Islamic bank takes into prime consideration the social implications that may be brought about by any decision or action taken by the bank. Profitability--despite its importance and priority is not therefore the sole criterion or the prime element in evaluating the performance of Islamic banks, since they have to match both between the material and the social objectives that would serve the interests of the community as a whole and help achieve their role in the sphere of social mutual guarantee. Social goals are understood to form an inseparable element of the Islamic banking system that cannot be dispensed with or neglected."

In explaining the purpose of IBs, the IAIB pointed out that the main involvement of *Islamic* banks is related to the *Islamic* order and is connected to its specific characteristics of social implication. By implementing the *Islamic* business principles that have been indirectly expressed in the *Qur'an*, IBs are expected to be financial institutions that could play an efficient role as an intermediary between finance providers and finance users. Moreover, besides upholding the *Islamic* business principles, it should aim to maximise profits within the framework of social and moral conduct. Thus, the operation of IBs should be operated without breaking the law prescribed in the *Shari'ah* and should be directed to the achievement of the socioeconomic objectives of an *Islamic* society (Ahmad 1991).

Furthermore, the social implication is the main consideration in making any decision or action taken by the banks. Although profitability is important for commercial entities, it is not the main criterion in evaluating performance in *Islamic* banks. As a result, profitability and social objectives are considered to be elements that will serve the interest of the community as a whole and to achieve the role of *Islamic* banks in the sphere of social mutual agreement guarantee. Social goals are also understood to form and inseparable element of the IBS that cannot be dispensed with or neglected.

2.4 Philosophy of Islamic Banking and Finance

This section seeks to explain the philosophy of *Islamic* banking by looking at the basic principles and concepts of IBs. It is of vital concern to understand the philosophy of IBs, as the management and the regulators of IBs are applying it when directing its objectives and policies. The philosophy is also used as the benchmark/indicator in guaranteeing that the IBs are upholding the true *Islamic* principles in their operations (Haron 1997, 2000).

Furthermore, according to (Haron 1997, 2000), the foundations of the philosophy of *Islamic* banking are principles that have been revealed in the *Qur'an* and *Hadith*. The philosophy of *Islamic* banking acts as the backbone of its establishment. The operations of IBs, as one of the mechanisms for the development of the *Islamic* economic system, are based on the said philosophy.

The following subsections are intended to discuss the philosophy of *Islamic* banking further. A discussion of the prohibition of *riba'*, trade-based commercial activities, profit and loss sharing in the operation of *Islamic* banking, prohibition of *gharar* and payment of *zakah* is presented in the next five subsections.

2.4.1 Prohibition of Interest in All Forms of Transactions

Islamic banking is a growing phenomenon that was established to satisfy the financial needs of devout *Muslims* who observe the prohibition of interest-based transactions (El-Gamal 1997). The prohibition of *riba'* is a basic difference between the *Islamic* and conventional banking systems (Al-Saud 2000). The operations of *Islamic* banks are bound by the prohibition of *riba'* that was revealed in the *Qur'an*¹⁷. *Riba'* is prohibited in all forms and intentions; thus, all transactions based on the giving or taking of *riba'* should be avoided (Ahmad 1991).

The concept of *riba'* originated from the definition of *zada* or *ziyadah*, which means addition, excess or increase (Nawawi 1999; Muslehuddin 1974). Similarly, Imam Fakhruddin Razi explained that *riba'* means and indicates increase or addition (Qureshi 1991). *Riba'* can be

¹⁷The revelation on the prohibition of *riba'* in the *Qur'an* can be classified into 4 stages: the first stage is the moral denunciation of *riba'* in *Ar-Rum* verse 39, the second stage is *riba'* and the Jews in *An-Nisa* verse 61, the third stage is legal prohibition of *Riba'* in *Ali-Imran* verse 130-132 and finally, the fourth stage is *Al-Bay'* as the alternative to *riba'* in *Al-Baqarah* verse 275-281.

either in kind or in money, as an excess or surplus over and above the loan capital and transaction. This increase originates either in the thing itself or in an exchange of one dollar to two dollars (Nawawi 1999). According to Aggarwal and Yousef (2000) *riba'* could also represent any predetermined or fixed return in a financial transaction.

In the pre-Islamic era, *riba'* referred to the then-prevalent practice of lending. The debtor had to pay a fixed amount above the principal to the creditor for the use of money loaned for a certain period. This additional amount, which could be more than double the principal sum that was due, was called *al-riba'* (Karsten 1983). *Riba'* can be classified into two types, namely *Riba' al-Nasi'ah* and *Riba' al-Fadl*. Muslim jurists define *Riba' al-Nasi'ah* as referring to loans bringing to the lender a fixed increment after an interval of time, or an extension of time over the fixed period and increase of credit over the principal (Nawawi 1999; Rosly 2005a).

Riba' al-Nasih is also sometimes called *Riba' Al-Qur'an*, the *riba'* of the Al-Quran. The etymology of the term *Nasih* refers to the verb *Nasi*, which means to defer (also to forget). Therefore, this type of *riba'* refers to a deferred payment in excess of the lent principal; i.e., it recognises a time value for money. This type of *riba'* is strictly prohibited in the Qur'an, and it is considered as one of the major sins (El-Gamal 1997). On the other hand, *Riba' al-Fadl* is described as *riba'* by way of excess over and above the quantity of the commodity advanced by the lender to the borrower (Nawawi 1999). *Riba'* exists if there is either inequality or delay in delivery of the goods offered (Nawawi 1999). Thus, the barter or the sale becomes usurious (*riba'wi*) if there is an exchange with an increase of surplus in exchanging one commodity against the other (Nawawi 1999).

As explained by Qureshi (1991), Imam Fakhruddin Razi in his book, *al-Tafsir al-Kabir*, emphasizes that there are basically 3 reasons for the unlawfulness of *riba'*. The first reason is that if the creditor can guarantee its income from the interest paid by the debtor, this will lead to exploitation and living in reduced circumstances, which is a great inequity. Charging excess or surplus in exchange of one commodity against the other will lead to the exploitation of the borrowers. The borrowers would have to pay back the interest on top of the principal. This will make the lenders more fortunate at the expense of the borrowers. In addition, the strong condemnation of interest-based transactions is intended to uphold equity and the protection of the poor (i.e. the borrower) (Khan 2000). In other words, interest or *riba'*, supports the possibility for wealth to accumulate in the hands of a few, and thereby it shows that man's concern for his fellow men has decreased (Nawawi 1999; Rosly 2005a; Karsten 1983).

Secondly, since interest or *riba'* is predetermined and the creditor is certain to receive the interest imposed, it may prevent the creditor from being involved in any occupation because it is easy to receive income from the interest on a loan (Imam Fakhruddin Razi, as explained by Qureshi 1991). In this situation, the creditor will not make any effort or undergo any hardship in acquiring income and this will hinder the progression of worldly affairs (Imam Fakhruddin Razi, as explained by Qureshi 1991). Finally, the unlawfulness of *riba'* is due to an aim of mutual sympathy, human goodness and obligations because the practice of *riba'* may lead to borrowing and squandering (Imam Fakhruddin Razi, as explained by Qureshi 1991).

2.4.2 Trade-Based Activities

Most of the discussions on the operations of IBs focused on the prohibition of *riba'*. In fact, the operations of IB are not only based on the prohibition of *riba'*, but also deal with the application of trade-based activities. Due to the lack of attention to the application of trade-based activities in financing activities, the public tends to perceive that *Islamic* banking consists of banking institutions that operate without *riba'*; and they fail to see the other principles underlying them (Rosly 2005a). Trade in IBs is not limited to commercial activities, it also involves exchange. Trade is a means of doing business transactions to avoid *riba'*. Trade-based financing activities are allowed in the *Qur'an* in the following verse:

Those who eat riba' will not stand (on the Day of Resurrection) except like a person beaten by Shaytan (Satan) leading him to insanity. That is because they say: "Trading is only like riba'," whereas Allah has permitted trading and forbidden riba' (Qur'an, al-Baqarah: 2:275).

Basically, *al-bay'* is allowed in *Islam* because it assumes acquiring profits through equivalent counter-value (*'iwad*) which consists of risk, work, effort and liability; while acquiring profits from a loan (i.e., *Riba'*) rejects the idea of risk-sharing and risk-taking (Rosly 2005a). *Islam* does not allow gain from financial activities unless the beneficiary is also subject to the risk of potential loss; the legal guarantee of least nominal interest would be viewed as a guaranteed gain (Rosly 2005a; Karsten 1983). While discussing the permissibility, or otherwise, of various types of financial transactions, *fuqaha'* made it quite clear that while a predetermined return on an amount of money advanced as a loan (i.e., interest) is not permissible, a variable return on capital provided to any party for business purposes is perfectly compatible with the *Shari'ah*; provided that the proportions in which the profits will be shared among the parties of the contract are agreed in advance and losses, if any, are shared in strict proportion to the capital contributed by each party (Ahmad 2000).

This illustrates that in accordance to the framework of *Shari'ah*, the economic behaviour and *Islamic* commercial ethics have important impacts on financial transactions (Ayub 2007). Through the operations of *Islamic* banks that emphasise the prohibition of *riba'*, trade-based activities are used to replace interest-based activities. Trade-based activities are managed through various underlying principles. The next subsection discussed the principles of trade-based activities that govern products and services offered by *Islamic* banks.

2.4.2.1 Underlying Principles of Trade-Based Contracts

The trade and commercial activities offered by *Islamic* banks can be classified into two types of contracts. They are: contract of exchange and contract of profit sharing. When it comes to mobilisation and utilisation of funds, *Islamic* banks are using these basic contracts. A contract of exchange can be further divided into two types of sale contracts: exchange of goods for money and exchange of services for money. Contracts of exchange of goods for money are comprised of spot sale (i.e. *bay' al-musawaammah*¹⁸), deferred sale or credit (i.e. *al-murabahah*¹⁹ and *al-bai'-bithamin ajil*²⁰) and deferred sale or sale by order (i.e. *Istisna*²¹ and

¹⁸ This is a normal sale where the parties bargain on price, a sale is executed and goods are delivered while payment is deferred (Ayub 2007).

¹⁹ *Murabahah* means cost-plus-profit contract (i.e. mark-up price). *Islamic* banks use the *murabahah* contract for imports of goods or raw materials (Nawawi 1999). It is where the banks will buy the goods or raw materials and sell it to the buyer at cost-plus profit. Under this contract, parties bargain on the margin of profit over the known cost-price (Ayub 2007). The seller has to reveal the cost-incurred by him for acquisition of the goods and provide all cost-related information to the buyer (Ayub 2007). The purchaser should be informed of his cost of purchase and the profit amount. There are two types of *murabaha*. The first type is *murabaha*, which involves two parties that are seller and buyer. Under this contract, the sale of goods is at cost plus mark-up. The second type is *murabaha* to the purchase orderer (MPO). MPO involves three parties, namely, the purchase orderer, the purchaser and the seller.

²⁰ This means deferred payment. It can also be known as *murabahah* to purchase orderer (MPO) with obligation to purchase. It is a term used in *Islamic* banks in Malaysia (Nawawi 1999). It is where the *Islamic* banks buy goods/equipments or raw materials and sell it to the buyer at a mark-up price and it becomes payable immediately on the expiry of the delayed payment terms (Nawawi 1999). *Bai' Muajjal*, also called *bai' bithamin ajil*, is sale against deferred payment. The sale price typically exceeds the spot price of the good by some fixed mark-up which is negotiated prior to the transaction (El-Gamal 1997).

²¹ *Istisna'a* is a sale where a specific commodity is transacted before it comes into existence. In this type of sale, the price is fixed with the consent of the buyer and seller and the necessary specification of the commodity intended to be manufactured is fully settled (Usmani n.d.). Under this contract, the purchaser orders from a

*salam*²²). Contracts of exchange of services for money are: *ijarah* and *al-ijarah wa-iqtina*, *kafalah*²³ and *wakalah*²⁴.

In contrast, a contract of profit sharing can be classified into *mudarabah* (i.e. Trustee partnership) and *musharakah* (i.e. general partnership). *Mudharabah*²⁵ contracts are divided into *al-mudharabah al-mutlakah* (i.e. restricted *mudharabah*) and *al-mudharabah al-muqayyadah* (i.e. restricted *mudharabah*); and *musharakah*²⁶ can be categorised as *shirkat 'inan*, *shirkat mufawada*, *shirkat wujuh* and *shirkat amal*.

2.4.3 Profit and Loss Sharing Framework (Profit Sharing and Loss Bearing)

As mentioned in the previous subsection, the *Islamic* banking business runs on the basis of trade. In trade, the *Islamic* theory of profit is built on the principle of *'iwad*, explained in

manufacturer to manufacture a specific commodity for the purchaser, using material from the manufacturer. The time of delivery is not necessarily fixed (Usmani n.d.).

²² *Salam* is a contract agreed upon between two parties where the seller undertakes to supply specific goods to the buyer at a future date in exchange of an advanced price fully paid at the spot (Usmani n.d.; Siddiqi 1986). The price is cash, but the supply of the purchased goods is deferred (Usmani n.d.).

²³ *Kafalah* means guarantee. It refers to the guarantee provided by a person to the owner of the goods, who has placed or deposited his goods with a third party; whereby any subsequent claim by the owner with regards to his goods must be met by the guarantor, and not by the third party (Sudin, 1997).

²⁴ This refers to a situation where a person nominates another person to act on his behalf (i.e. agency) (Sudin, 1997).

²⁵ Under this contract, the capital provider (i.e. the investor or Rabb al-Maal) provides the capital, and the entrepreneur (i.e. Mudarib) provides his time and effort. The entrepreneur is the investor's partner in the profit and in the capital used on the journey and in its dispositions (Al-Sarakhi²⁵; cited in Ayub 2007; Usmani, 2008). However, if the loss is due to the violation of the contract, the mudarib will bear the loss (Usmani, n.d., Razali, 1999). The capital provider may specify a particular business for the entrepreneur; he may either (1) authorize the entrepreneur to invest the money in a specific business only, which is called *al-mudharabah al-muqayyadah* (i.e. restricted *mudarabah*) or (2) allow the entrepreneur to invest the money in any business he deems fit, which is called *al-mudharabah al-mutlaqah* (i.e. unrestricted *mudarabah*) (Usmani n.d.; Ayub 2007). In addition, in this contract, there are no work interferences by capital providers. The entrepreneur should comply with *Shari'ah* rules and capital provider's instructions. Moreover, there is no guarantee of recovery of fund except for betrayal guarantee (performance bond). There are three main forms of Mudarabah contract: bilateral Mudarabah, multilateral mudarabah and re-mudarabah (i.e. two-tier *mudarabah*).

²⁶ *Musharakah*, or partnership, is a standard corporation-like arrangement, where all losses and profits are shared according to pre-negotiated rules. Partners in *musharakah* have the right to co-manage all projects, unlike *mudharabah*, where the entrepreneur has sole control of the enterprise's management (El-Gamal 1997). There are 2 types of *musharakah* as being applied in *Islamic* banks. The first type is constant *musharakah* where the partner's share in *musharakah* capital remains constant throughout the year and it can be short term. The second type is *musharakah* diminishing to ownership, where one party has the right to purchase a part of the other party's share which declines until one becomes the sole proprietor of all capital where it ends in transferring ownership to one party (*musharaka mutanaqisah*).

Figure 3.4.1 (Rosly 2005a). ‘*Iwad*, which can also be defined as equivalent counter value, is the profit margin when a trader sells at a price higher than the cost price. Profit is not predetermined and fixed but is uncertain and variable, and may even be negative (Qureshi 1991). Profits are residuals that reward entrepreneurs for undertaking risky investments (Rosly 2005a; Karsten 1983). Furthermore, ‘*iwad* should consist of risk and, work, effort and liability (Rosly 2005a). In reference to the concept of ‘*iwad*, it is expected that the owner of capital who participates in a venture by providing credit to the entrepreneur on a profit-and-loss-sharing basis will be more concerned with the use of his funds than if he lends them at fixed interest rates (Karsten 1983).

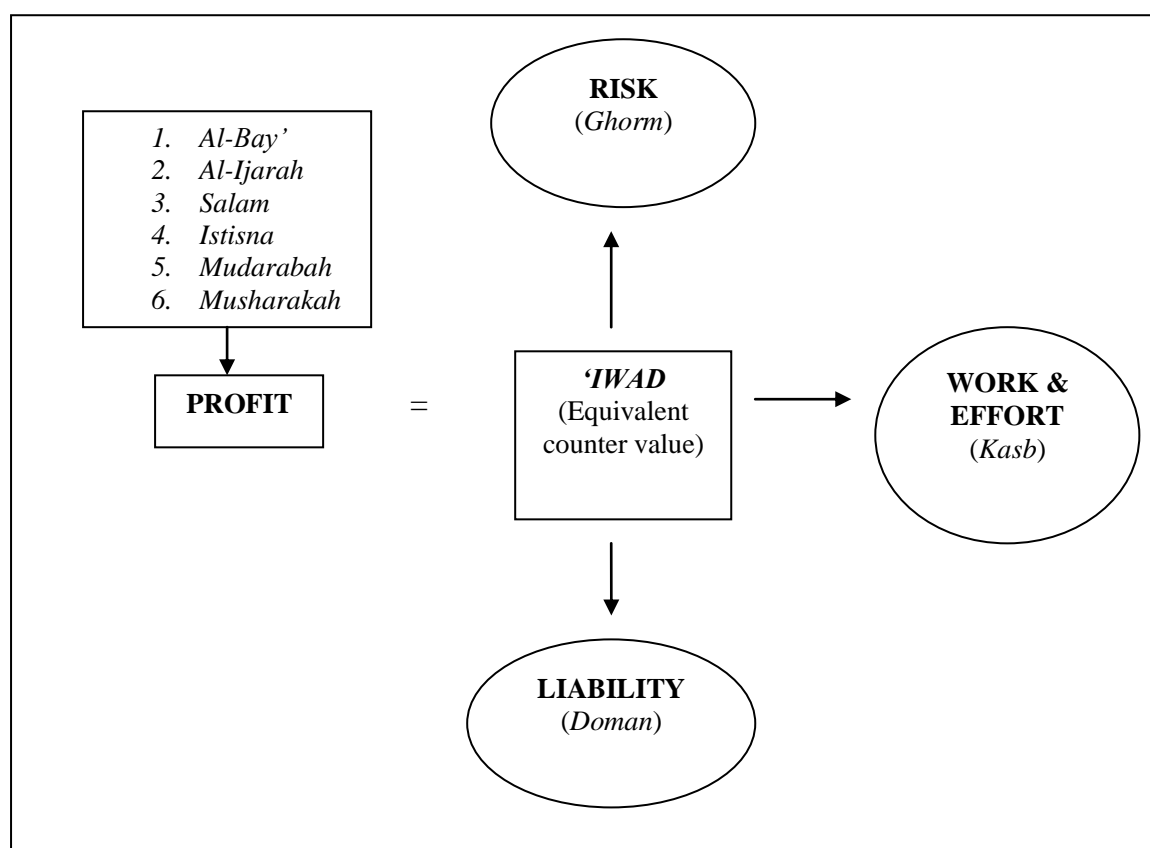


Figure 2.4.1 Islamic Theory of Profit (Source: Rosly 2005a)

The underlying principles of *Shari'ah* that govern IB promote a profit and loss sharing framework as an ideal mode of financing to achieve justice and socioeconomic objectives.

Under the financing model, both capital provider (i.e. lender) and entrepreneur (i.e. borrower) should be at par and jointly share the risks of the business through profit and loss (Pramanik 1993). As an intermediary between depositors or investors and entrepreneurs, the funds can be used for the financing of working capital, for industry, agriculture or any other lawful investments and services, without imposing interest, but with the sharing of profits (Nawawi 1999). Furthermore, the profit and loss sharing may lead to a more efficient and optimal allocation of resources than does the interest-based system (Siddiqui 2001). In addition, this framework is expected to reduce significantly the inequitable distribution of income and wealth and is likely to control inflation to some extent (Pramanik 1993). The relationship between banks and entrepreneurs under Profit and Loss Sharing is shown in Figure 2.4.2.

This relationship is expected to comprise direct involvement. The banks require more information about the business activities they financed and are more likely to seek to influence the business decisions of entrepreneurs (Karsten 1983). In addition, the banks provide information and expertise in terms of technical and managerial decisions. The direct involvement of the banks discourages entrepreneurs to manoeuvre the business shrewdly and to improve their skills. Thus, the positive effects in providing comprehensive support services by the banks will be counterbalanced with the negative effects on entrepreneurs' willingness to accept risks (Karsten 1983). Furthermore, by sharing profit and loss, the banks can function as the absorber of shocks stemming from the real sector. Thus, it will ensure justice between the parties involved as returns to the bank on finance are dependent on the operational results of the entrepreneur (Siddiqui 2001).

The IBs should treat their customers equally. This should be observed by the management of IBs, particularly when imposing charges on customers and also when fixing the profit sharing

ratio, either with an investor or with their business partners (Haron 1997). Furthermore, the accumulated profit should be utilised for the betterment of the community.

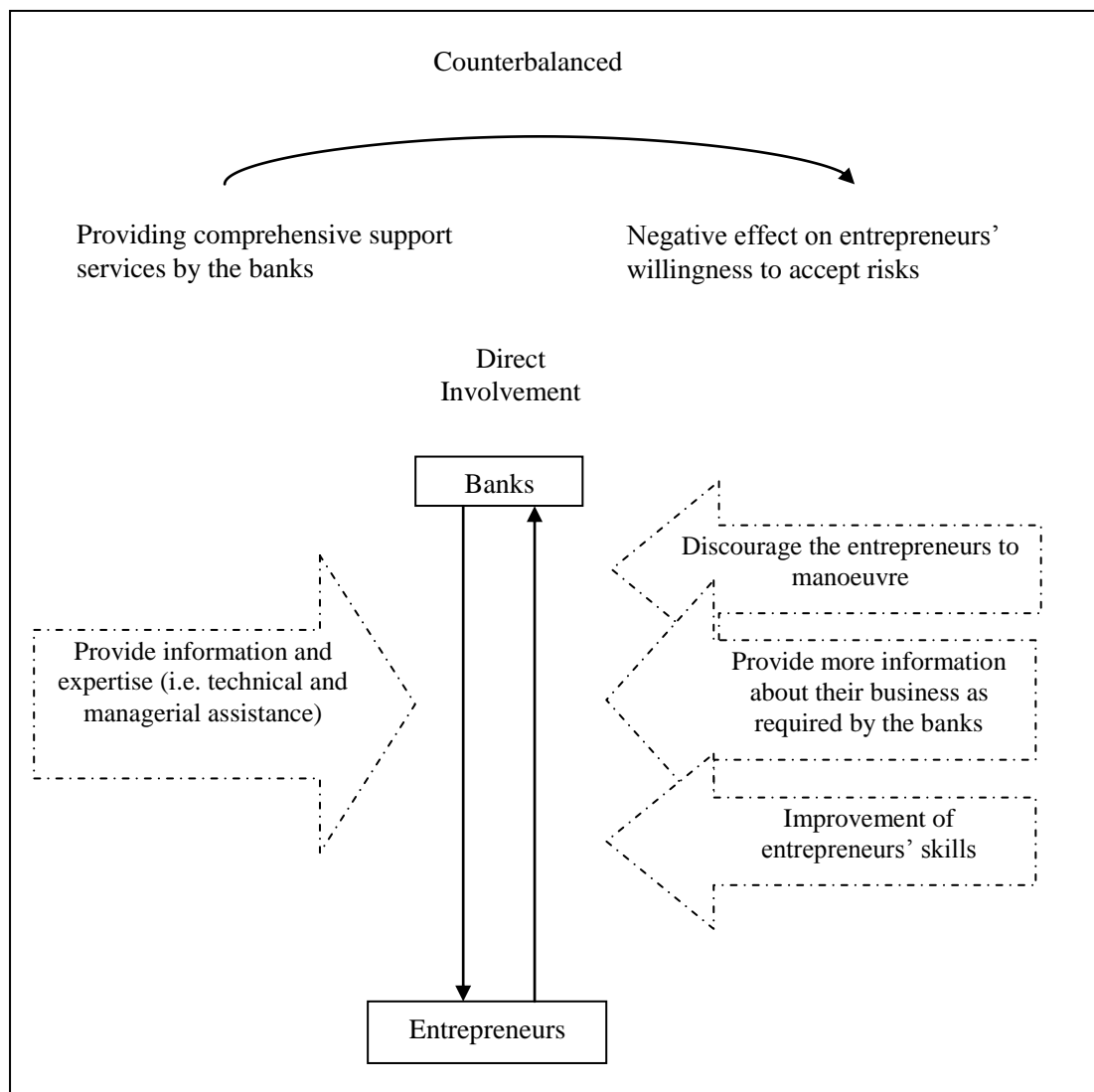


Figure 2.4.2 The Relationship between Banks and Entrepreneurs under Profit and Loss Sharing (Source: Karsten 1983)

2.4.4 Prohibition of Gharar

Gharar refers to the uncertainty, hazard, chance or risk that is caused by lack of clarity regarding the subject matter or the price in a contract or exchange (Rosly 2005a; Khir et al. 2008; Ayub 2007). Professor Mustafa Al-Zarqa (cited in Khir et al. 2008) interprets *gharar* as the “sale of probable items whose existence or characteristics are not certain, due to the risky

nature which makes the trade similar to gambling”. *Gharar* relates to uncertainty or contingency in the basic elements of any agreements such as buyer and seller, price, object of sale, delivery and quality (Rosly 2005a; Khir et al. 2008).

Figure 2.5 below explains uncertainties that may occur in the contractual agreement. The figure above explains that uncertainty in the contractual agreement. If any elements of the uncertainty occur in the *'aqd*, it will result in *zulm*. *Zulm* may take the form of unjustified gains, injury to contracting parties and disputes.

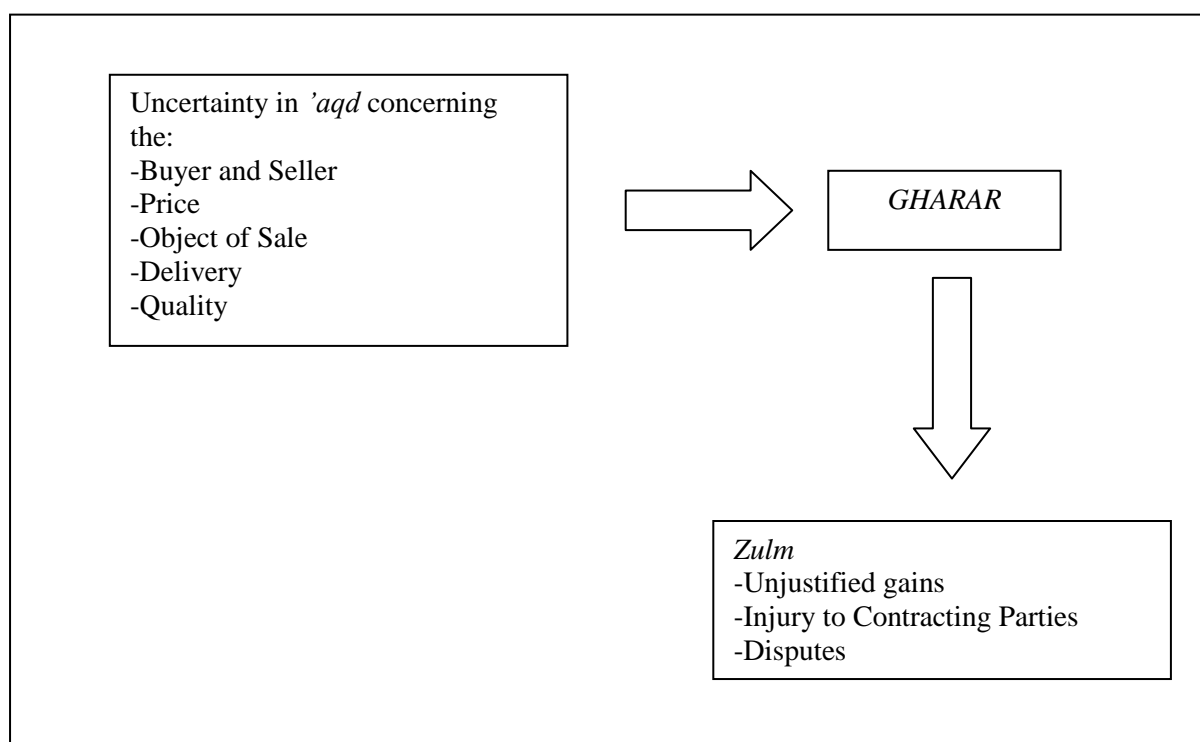


Figure 2.4.3 *Gharar* (Uncertainties in Contractual Agreements) (Source: Rosly 2005a)

Furthermore, the uncertainty in the *mu'amalah* is “where there is a matter that is concealed by one party, where it (this concealment) can raise a sense of inequality as well as tyranny” (Khir et al. 2008). In the legal terminology of jurists, *gharar* is the sale of a thing which is not present at hand, the sale of a thing whose consequence is not known or a sale involving hazards in which one does not know whether it will come to be or not, e.g. the sale of fish in

water, or a bird in the air (Iqbal and Mirakhor 1999; Ayub 2007). Furthermore, examples of *gharar* are when the delivery of one of the exchanged items is not in the control of any party, or the payment from one side is uncertain or the sale of one home going through after the buyer's house is sold. *Islamic* jurists (*fuqaha*) have made it clear that any contract is deemed null and void when *gharar* is evident (Rosly 2005a) When *gharar* occurs in contractual obligations, contracts can no longer be operative. The contract will become invalid and neither party shall receive protection from the legal system.

In order to ensure that the transaction is free of all *gharar* elements, every step involved in concluding the transaction needs to be closely observed. Each transaction needs to be free from uncertainty regarding the subject matter and its counter value in exchanges. Ayub (2007) explains in detail that in each transaction, the commodity must be defined, determined, deliverable and clearly known to the contracting parties. In addition, the availability, existence, deliverability and the actual state of the goods must be clearly known.

2.4.5 Payment of Zakah

The word '*zakah*' means growth, increase, cleanness, and purity in Arabic (Ibn Faris 1998, cited by Ahmed 2004). Giving *zakah* means 'giving a specified percentage on certain properties to certain classes of needy people' (Khir et al. 2008). In addition, giving out *zakah* is considered as a means to seek the pleasure of Allah, as stated in the following verse from the Qur'an;

“And whatever you invest by way of *riba*' so that may increase upon peoples wealth, increases not with God; but what you give by way of *zakah* seeking the pleasure of god, those – they receive recompense manifold” (*Al-Rum: 39*).

In *Islamic* banks, *zakah* is paid on behalf of their shareholders (Karim 1990a). Giving *zakah* and charitable activities are among the actions that will contribute to the well-being of the *ummah* (Maali et al. 2006). When money is given out for *zakah*, the aim is to narrow down the gap between the rich and the poor. In other words, it is a percentage of surplus money being distributed directly to the poor or through other religious organisations.

The following section explains the underlying principles of *Shari'ah* that govern the operations of Islamic banking and finance.

2.5 Theoretical Framework of Islamic Banking and Finance

In the *Islamic* banking system, the surplus spending units are pooled in the form of deposits and channelled to the deficit spending unit. The flow of funds is guided by the standards derived from *Shari'ah* principles (Rosly 2005a; Rosly and Sanusi 1999). Thus, this will uphold the role of IBs as true fiduciary agents that gather the surplus capital of the *ummah* and allocate it to projects and activities in line with the goals, values, and philosophy of the *ummah* (Aziz 2003). The banks will have a range of products and services provided to the customers to fulfil the needs of their needs in the banking business. The unique relationship exists in the IBs' operation result from its specific underlying principles that govern the underlying contracts of its products and services. The main basic underlying concepts are *al-murabahah*, *istisna*, *salam*, *kafalah*, *wakalah*, *mudarabah*, and *musyarakah*.

IB involves various types of investments on the asset side of IB. These investments can be classified as PLS- and non-PLS-based investments. PLS-based instruments are *mudarabah* and *musyarakah*, while non-PLS-based instruments are *murabahah*, *ijarah* and *salam*. There are also hybrid types of investments that combine the PLS-based and non-PLS-based

instruments which claim to consist of fixed and variable elements. Furthermore, given that the operations of *Islamic* banks that are theoretically based on the “two-tier *mudharabah*” model and “two-windows” model, it involves different parties in operations and transactions (El-Hawary et al. 2004; Venardos 2005; Ahmad 1994; Kahf 2005a; Iqbal et al. 1998; Iqbal and Mirakhor 2011).

The relationships within *Islamic* banks involve *Islamic* banking depositors on the liability side and investment on the asset side. The liability side shows *Islamic* bank deposits, which are divided into non-investment deposits (i.e. demand and savings), restricted investment account holders (IAH^R) and unrestricted investment account holders (IAH^U). The liabilities and equity side of the bank’s balance sheet includes deposits accepted on a *mudharaba* basis. “Two-tier *mudharaba*” involves fund mobilisation and fund utilisation based on profit sharing. The fund mobilisation (i.e. first tier) involves the investors and the banks; with the investors acting as a supplier of funds and the banks acting on behalf of the investors as a ‘*mudarib*’ to invest the money in profitable projects (Haron 1997; Nawawi 1999; Rosly 2005a; Haron 2000; Sadeq 1990; Batchelor 2006). Furthermore, the fund utilisation (i.e. second tier) features a *mudharaba* contract between the bank as supplier of funds and entrepreneurs seeking funding and sharing profits with the bank according to a ratio stipulated in the contract (El-Hawary et al. 2007).

Sharp distinctions have to be drawn between non-investment deposits and investment deposits. On one hand, the non-investment deposits operate under the contract of *Wadiyah Yad Dhamanah* (i.e. guaranteed custody). As the depositors deposit their money in the banks, the non-investment account holder will be guaranteed the principal amount of the deposits and will receive *hibah* according to bank’s discretion, which depends on the bank’s overall profitability (Safieddine 2009; Lewis and Algaoud 2001). Demand deposits will not yield any

return and are repayable on demand at par value. They are also treated as liabilities and may be subject to a service charge. In addition, depositors are aware that Islamic banks will use their deposits for financial risk-bearing projects (Venardos 2005). In this model, both types of deposits can be used for their financing and investment activities and the bank's assets and liabilities are fully integrated, which is far riskier (Venardos 2005). In addition, it should minimise the need for active asset/liability management (El-Hawary et al. 2007).

The IAH^R and IAH^U are governed by the *mudharabah* contract. The investment accounts are operated under profit and loss sharing (PLS) which has limited-term, non-voting equity in which capital is not guaranteed and there is no predetermined return (Napier 2007; Maurer 2005; Lewis and Algaoud 2001; Sundararajan and Errico 2002; Sarker 1999b). This is not a liability as their value is not guaranteed and they may incur losses. The IAH^R restricts the nature of investment for deposits that they put forward and will actively involve in the decision-making of the investment, while IAH^U will leave finding a suitable investment to the discretion of the bank (Siddiqi 1983). In addition, the IAH^U's funds could be commingled with the shareholders' funds. The relationship between IAH and shareholders is unique, drawn from the theoretical framework underlying the operations. Shareholders are those who invest in the Islamic bank itself and have voting privileges on its boards, while depositors are those who deposit their money into investment accounts (Maurer 2005; Grais and Pellegrini 2006b). In the event of profit, the IB and IAH will share an agreed percentage of profit (Archer et al. 1998; Napier 2007; Safieddine 2009). However, in the event of a loss, the bank does not risks or loses as *mudharaba*-depositors and bank shareholders share the loss (Safieddine 2009; Lewis and Algaoud 2001). The relationship between the parties are unequal, as a loss to one is a gain to the other (Maurer 2005). In addition, the IAH is closer to shareholder risks. Furthermore, although IAH^R and IAH^U involve exposure to different

degree of risks, their relationship with the management of the bank is subject to the same monitoring arrangement (Archer et al. 1998).

On the other hand, the second-tier involves financing entrepreneurs on the condition that profits accruing from their business shall be shared between the bank and the entrepreneurs in a mutually agreed proportion. However, the loss shall be borne only by the financier. According to (Chapra 1992), since the *Islamic* equity of IBs is based on the profit and loss reward sharing system, in such a system, investment and financing allocations are based on the evaluation of the strength of the proposal and the value judgment, and could reflect greater efficiency in allocating resources to both the demand and supply side. This model does not mandate a specific reserve required for either type of deposits (Venardos 2005; El-Hawary et al. 2007). However, Mirakhor (1989) and Khan (1986) opine that, contrary to investment deposits, demand deposits are liabilities that are not supposed to absorb any loss and therefore, a reserve requirement should be imposed.

In addition, the liabilities in the “*two-window*” model are divided into two windows, as the name suggests. Contrary to “*two-tier mudharabah*”, “*two-window*” is in line with the opinion of Mirakhor (1989) and Khan (1986) that 100% reserves should be held in demand deposits. In addition, demand deposits may be chosen where they are assumed as *amanah* (safekeeping). Demand deposits are considered to belong to depositors at all times. Thus, the bank cannot use the deposits as the basis to create money through fractional reserves (Venardos 2005). On the other hand, investment deposits may be chosen to finance risk-bearing investment projects with depositor’s full awareness. The bank does not guarantee the return from the investment and a reserved requirement is not applied to them. The bank may

charge a service fee for safekeeping services, and interest-free loans may only be granted from funds specifically deposited for that purpose (Venardos 2005).

2.6 Summary

The first part of the chapter reviewed the history of international and Malaysian Islamic banking and finance industry. It continued by explaining the development of Islamic banking in Malaysia. The industry that was emerging internationally 50 years ago has developed significantly and its market shares are growing year by year. However, due to the different underlying principles, greater effort needs to be made by the regulators in order to provide infrastructure and architecture that are suitable for IB's operations. In Malaysia itself, various initiatives and measures are being introduced to IB in order to ensure that IB is being offered a level playing field with the conventional banks in order to secure its competitiveness and sustainability. In addition, the importance of the regulators shown through various initiatives and measures is further linked with the underlying principles of the IB.

Furthermore, in an Islamic financial institution, religious values are central to Islamic banking core values and missions (Rammal and Parker 2012). The literature reviewed in this chapter shows that the Islamic banking system is different from the conventional system in terms of the specific philosophy guided by the revelation and the ethical values that lie underneath it. Among others, the religious values being preached in the operations of Islamic banking and finance are based on *Shari'ah* principles. They are the prohibition of *riba*, promotion of trade-based activities and an underlying contract of the products and services; profit is to be earned through work and effort and liability, prohibition of uncertainty and payment of *zakah* to be distributed to a specified group of people. Humans are responsible for

managing the resources entrusted to them through applying *Shari'ah* principles. The correct application of *Shari'ah* principles is expected to promote welfare and prevent corruption and vices in achieving the welfare of the *ummah*. From the individual perspective, managing the resources in accordance with *Shari'ah* principles will ensure achievement of justice and *al-falah* (i.e. success in the world and hereafter).

In addition, as *Islamic* banking is guided by *Shari'ah* principles, adherence would fulfil the objective of its existence. However, besides upholding the *Islamic* economic order, it is important to uphold social justice and support the legal and regulatory framework, practices, procedures and instruments that will promote justice, equity and fairness. Thus, through implementing the *Islamic* business principles that have been indirectly expressed in the Qur'an, IBs are expected to be financial institutions able to play an efficient role as an intermediary between finance providers and finance users. In order to achieve its objectives, *Islamic* banks are required to adhere to the *Shari'ah* principles in their dealings and transactions, and therefore adherence to the *Shari'ah* principles in its operations of *Islamic* banks is crucial. In addition, adherence to these principles will lend credibility in the eyes of the public and will increase their trust and confidence in the soundness, stability and competitiveness of *Islamic* banks. The chapter also discusses the theoretical framework of *Islamic* banking and finance and the agency problems arising from the relationships in IB, which comprise a double agency problem; i.e. the separation of ownership and control of shareholders, and the separation of cash flow rights from the rights to control the investment.

In the operation of *Islamic* banking, various products are applied to comply with and fulfil the underlying principles. Different principles of *Islamic* banking lead to different sources of funds and uses of funds. Furthermore, different principles lead to different types of contracts

being used. As explained in the previous chapter, the main sources of funds are shareholders' equity, current accounts, investment accounts and savings accounts. The financial instruments are *musharakah*, *mudharabah*, *murabahah*, *ijarah*, *salam*, *istisna* and *qard-hassan*; which are the alternative underlying concepts provided by *Islamic* principles. The establishment of *Islamic* banks with specific principles has led to various challenges in guaranteeing that the practices are based on the theory laid out. Furthermore, the ability of *Islamic* banks to play their role as defined by *Islamic* law should be assessed by a local statutory body (act) or local regulatory framework that governs the institutions. The different economic, social and environmental conditions of the IBs' operations should be considered.

The next chapter will discuss the theories underlying *Islamic* banking and finance practices.

CHAPTER THREE

THEORETICAL FRAMEWORK

3.1 Introduction

The aim of this chapter is to present an overview of Islamic theories literature and the integration of traditional theories from the conventional banking literature into the Islamic banking context. In the first section, the chapter presents on the credibility of the Islamic banking system, *Shari'ah* compliance and its implementation in Islamic banks, Islam and accountability, and trust in Islamic banking. Furthermore, this chapter draws on agency theory, stakeholder theory, legitimacy theory and institutional theory to address the problems and challenges facing Islamic banking and finance in terms of regulations, management, *Shari'ah* compliance and accounting. These theories are discussed as they are often used in the field of finance and financial institutions. The chapter also clarifies the relationship between these theories and institutional theory.

Firstly, the chapter discusses the themes that constitute the credibility in Islamic banks. It also discusses the *Shari'ah* compliance and its implementations. Furthermore, it explains the relationship between Islam and accountability. Accountability in Islam is where *tawhid* is explained as it provides the framework for institution and the nature of Islamic banking activities that are also governed by the ethical and moral behaviour of the agent. In addition, the concept of accountability is further associates with trust. Secondly, the chapter presents the agency theory, which is associated with the agency problem in Islamic banking and finance. Next, it presents the transaction cost theory. Then, after discussing theories based on the organisational economic theory, it continues by focusing on the wider scope of the organisation proposed by stakeholder theory. In the same section, the concept of agent

morality is explained through integrating into the stakeholder model. Finally, the chapter discusses institutional theory and focuses on new institutional sociology before the conclusion.

3.2 Credibility of the Islamic Banking System

It is important for the regulators and market players to ensure the credibility of the banking system in order to secure the sustainability of Islamic banking operations. The credibility of the banking system is an assurance of the safety and soundness of the financial system that depends on the injection of greater market disciplines in banking business through reinforcement by prudential regulation and effective supervision. It will inculcate trust and confidence of the stakeholders in the soundness, stability and competitiveness of IBs (Ayub 2007) and will attract the interest of the customers and investors to subscribe to Islamic banking business activities.

The credibility of the Islamic financial system stems from the legitimacy of its practices and the accountability of the market players. Legitimacy involves the belief that the business organisation is mandated to do, and is actually doing, what it claims and appears to be doing, and also that it may be expected to continue to act in that way in the future (Gambling et al. 1993). The legitimacy of Islamic banks is explained by the *Shari'ah* compliance of its banking operation, management and products and services (DeLorenzo 2007; Karim 1990a). In addition, Islamic banks are also bound to comply with other national and international regulations related to banking institutions.

Following the discussion regarding credibility of Islamic banking and finance, the subsequent next three subsections will discuss *Shari'ah* compliance in Islamic banks, the concept of Islam and accountability and trust in Islamic banks.

3.2.1 *Shari'ah* Compliance in Islamic Banks

The establishment of Islamic banks is rooted in religion (i.e. *Shari'ah* Law) and it is demanded by strict believers who wanted to perform their banking activities in compliance with the principles of *Shari'ah*, as discussed in Chapter Two. Furthermore, the operations of Islamic banks that are based on *Shari'ah* are not limited to Muslims, as IB welcome non-Muslim customers and potential customers to engage in Islamic banking activities and enjoy the benefits that Islamic banks offer.

An obligation to ensure and certify the *Islamicity* of all their products, services and operations are in conformity with *Shari'ah* (implementations, compliance) (Khan and Ahmed 2001) relates to effective performance, bank management and the difficulties of monitoring for *Shari'ah* boards. In addition, safeguarding *Shari'ah* compliance would allow Islamic finance to play a greater role as it is the major asset distinguishing this industry (Muslim and Zaidi 2008). The compliance with *Shari'ah* principles in every aspect of its operations is important and will fulfil the initial objective of establishing *Islamic* financial institutions that are based on the *Shari'ah* principles. Strict compliance with *Shari'ah* reflects a holistic view of Islam (as *Shari'ah* is a complete and integrated code of life encompassing the individual and society, in this world and Hereafter), and it demonstrates the commitment of every individual and organisation to realise justice, brotherhood and social welfare (Dusuki and Abdullah 2007b). It will also reflect complete well-being and happiness (i.e. welfare) in this world and in the Hereafter (i.e. *akhirah*) of the Muslim nation (i.e. *ummah*). In order to achieve

complete welfare, it should uphold the promotion of well-being and the prevention of corruptions and vices. Furthermore, according to Shatibi (cited in Abdul-Rahman 2003), the interest of the *ummah* should be protected through three categories, which can be visualised as a pyramid. At the bottom of the pyramid is the essential, next is complementary and at the peak of the pyramid is embellishment. In order to ensure the total welfare of the *ummah*, these three categories can be used as a guideline to provide products and services, to exercise corporate social responsibilities and to make decisions in every aspect of its operation.

In contrast, non-compliance will result in unfulfilled objectives of *Shari'ah* (i.e. *maqasid as-Shari'ah*) and the goal of the operations to protect the welfare of the society would not be achieved. This will also result in an unsustainable banking system and lead to a failure to achieve fairness for the stakeholders. The customers and investors will lose their confidence in the *Islamic* bank and it will draw them away from the involvement in *Islamic* banking, which will lead to the unpopularity of the system. This may not be a problem to the customers and investors, as they will turn to the conventional system. However, the *Islamic* banking system would not be able to survive and this would result in the malfunction of the system as a whole. *Shari'ah* non-compliance will lead to a number of consequences such as higher cost, financial losses, liquidity problems, bank runs, bank failure, industry smearing and financial instability (Ginena 2014). Currently, it is difficult to measure the *Shari'ah* compliance risk as financing and investing activities are not standardised across IBs (Ariss and Sarriddine 2007).

Shari'ah compliance of *Islamic* banks is classified into *ex-ante* compliance and *ex-post* compliance (Abdul-Rahman 2008). Dusuki and Abdullah (2007b) further elaborated on the *ex-ante* compliance as being the *Shari'ah* compliance of product and validity and

permissibility of contracts from *Shari'ah* perspectives. Since *ex-ante* relates to the validity and permissibility of the products and services, Abdul-Rahman (2008) asserts that *ex-ante* compliance relates to the SSBs' supervision, monitoring and control tasks that take place before and during implementation of the bank's dealings. This would involve *Shari'ah* compliance at different stages that are (1) the designing of the contract; the process of the transactions, (3) the conclusion and execution of the contract and (4) the implementation of the terms of the contract and (5) the liquidation (Abdul-Rahman 2008). Furthermore, during the *ex-ante* compliance, the auditor certifies permissible financial instruments through *fatwas* (Grais and Pellegrini 2006c). This involves the role of the religious auditor advising the BOD and the managing director (MD) of the bank's operations, contracts and procedures to ensure its *Shari'ah* compliance (Abdul-Rahman 2008).

Dusuki and Abdullah (2007b) further elaborate the *ex-ante* compliance as *Shari'ah* compliant of product and validity and permissibility of contracts from *Shari'ah* perspectives. They conclude that the product is considered valid when it complies with *Shari'ah* conditions and requirements pertaining to a contract in its form and structure (Dusuki and Abdullah 2007b). When a product is valid, the contract meets all contractual conditions and requirements. The product is considered permissible if the substance of the contract is *Shari'ah* compliant and the purpose of the contract must be in line with the *Shari'ah*. The contract is considered permissible if it serves the legal purpose and intention. The approach to determine the validity of the contract is agreed upon by Hanafi and Shafie. On the other hand, Maliki and Hanbali hold that the validity of the contract should represent, or is based on, the real intention or the substance of the contract. Based on the example of al-Shafie²⁷, Dusuki and Abdullah (2007b) concluded that the emphasis on the form or expressed intention to validate

²⁷ Examples of instances when real intention does invalidate a contract include selling of grapes to a winery, or selling arms to the enemy (whose intention must be to attack the Muslims).

a contract is more applicable when the real intention is difficult to determine. However, the *fuqaha*' are in agreement in determining the permissibility of the contract. Thus, the validity is based on the form of the contract and permissibility is based on the substance of the contract and the intention of the contractors; a valid contract is not necessarily permissible (Dusuki and Abdullah 2007b; Dusuki 2005).

On the other hand, the *ex-post* compliance will involve verifying whether the transactions comply with issuing fatwas (Grais and Pellegrini 2006c). It checks the executive management's compliance with *Islamic* principles and with the advice given by SSB (Abdul-Rahman 1998). In addition, the compliance process will be useful for *zakah* as it ensures that the net assets are correctly calculated and that the funds are properly administered. Furthermore, the *ex-post* compliance involves a thorough and comprehensive *Shari'ah* audit review and vouches for the transactions that took place after the execution of the contracts (Abdul-Rahman 2008). During this stage, a random sample of the completed transactions will be taken to establish that these transactions conform to *Shari'ah* rules and guidelines. The compliance practices need to be reported to the management, which may require the assistance of internal or external auditors (Abdul-Rahman 2008).

In order to ensure the *Shari'ah* compliance of Islamic banking operations, the industry is equipped with arrangements, both internal and external to the institution. The internal arrangement involves in-house religious advisors (*ex-ante* monitoring) and an internal *Shari'ah* review structure (*ex-post* monitoring). The external arrangement involves the procedures and the internal systems of producing *fatwas* and central *Shari'ah* advisory councils (Grais and Pellegrini 2006c). The external arrangement will relate to the issuance of *fatwas* by the SSBs (Grais and Pellegrini 2006c). Grais and Pellegrini (2006c) believe that the

issuance of *fatwas* should be guided by standardising contracts and practices that can be harmonised by self-regulatory professionals and associations. The process of monitoring and evaluating *Shari'ah* compliance in IBs relies on the internal arrangement of the banks (Grais and Pellegrini 2006a). Thus, the difficulties in monitoring its *Shari'ah* compliance raises the need for the central bank to undertake the *Shari'ah* audit during the process of its banking inspection so that the conformity of *Shari'ah* is examined along with that of national banking laws and standards, accounting practices or the establishment of the independent *Shari'ah* audit firm in the private sector; undertaking a *Shari'ah* audit along with their account audit (Chapra and Khan 2000; Iqbal and Mirakhor 1999).

Besides achieving the objectives of *Shari'ah* through its compliance with *Shari'ah* principles in every aspect of its operation, the IB is expected to gain the economic benefits of its operations. The success of the Islamic banking operation is not confined to the compliance with *Shari'ah* principles. Besides safeguarding the interest of stakeholders through *Shari'ah* compliance (Mohd Ariffin 2005; Grais and Pellegrini 2006c, 2006b), the financial interest of the stakeholders will be protected through the business performance of IB (Grais and Pellegrini 2006c, 2006b). Thus, *Islamic* banks are not only focused on maximising profit, but should be highly regarded as institutions that uphold social objectives and promotes *Islamic* values to its stakeholders in accordance with *Shari'ah* (Dusuki 2008). Furthermore, both elements will ensure that the IB industry can be developed on a sustainable basis and secure fairness for stakeholders such as investors, the business community and institutions (Ayub 2007).

The next section discusses the relationship between Islam and accountability and the nature of Islamic banking activities that are also governed by the ethical and moral behaviour of the agent.

3.2.2 Islam Morality and Accountability

The concept central to Muslim belief is *tawhid*, which means unity of God. There is no partner and no equal to God. Other concepts that are related to this central idea are *khalifah* (vicegerency) and *adalah* (justice). God created man as a vicegerent (*khalifah*) and man is responsible for resources entrusted to him. Mankind is a trustee that should act according to the principles and rules of ethics derived primarily from Islamic Law and Islamic moral values. Thus, mankind holds property as a trust from God and should show commitment to moral values, particularly through the values of *halal* and *haram*, brotherhood, social and economic justice, equitable distribution of income and wealth and fostering the common good (Ahmad 1994; Khan 1991; Siddiqi 2006a).

Another concept that arises from the responsibilities entrusted to man is *taklif* (accountability). It is a concept ingrained in the basic creation of mankind. Humans are accountable for the utilisation of the resources in the best possible manner, i.e. in an honest and ethical way, for themselves and for others. Humans' accountability before Allah will make them answerable to all their deeds in this world (Haniffa and Hudaib 2007; Abdul-Rahman 1998; Dusuki 2005). Furthermore, Allah-fearing conduct in everything that humans do is based on the belief that Allah is observing the acts of all His servants, which would make humans desist from doing something which is not pleasing to Allah. Thus, humans would take precautions to avoid wrongdoing, which might incur Allah's punishment. Accountability to God for the resources entrusted to them represents a different dimension of

accountability (i.e. beyond private and societal accountability) than in the Western economic system (Maali and Napier 2007; Haniffa et al. 2004). It implies a greater scope of accountability as it extends towards society (Maali and Napier 2007; Lewis 2001, 2006). Accountability in Islam is not limited to immediate stakeholders but is extended towards the society, and ultimately to God. As people are individually accountable for their actions regarding that with which they are entrusted on the Day of Judgement (i.e. the hereafter), it adds a new dimension to the evaluation of actions and objects compared to those embodied in Western financial statements (Baydoun and Willett 1997; Siddiqi 1981).

In order to safeguard that the responsibilities are being fulfilled, man need to ensure that the relationship between man and God, fellow human beings, and the environment should be protected. Thus, in managing the resources entrusted to them, they are expected to be just towards themselves and the *ummah*. Mankind is responsible for the universe, environment, wealth and other creatures and this responsibility should be based on trust and justice (AbuSulayman 1993). There are three basic criteria for the attainment of social justice: absolute freedom of conscience, complete equality of all human beings and the permanent mutual responsibility of society and individuals (Sardar 1987, as cited in Sulaiman and Willett (2003). Being just involves a direct and indirect relationship between them and the *ummah*. A direct relationship will involve guaranteeing that each customer is dealt with justly, by providing customers with adequate information pertaining to particular products and services. On the other hand, an indirect relationship will involve consideration of the impact of the environment towards the *ummah* as a whole when it comes to making decisions.

Accountability is viewed by Roberts and Scapens (1985) as a relationship relating to “the giving and demanding of reasons for conduct”. Abdul-Rahman (1998) views corporate accountability as the rights of stakeholders which “may be affected over activities and policies, to make demand as well as to seek reasons for actions taken by the corporations”. In the context of banking institutions, commercial and investment banks continuously face the changing demands of the marketplace. The industry may face various forces; for example, increasing competition, liberalisation, product innovation and legal and regulatory framework. According to Perro and Ruoff (1997) in the commercial and investment banking institutions, the accountability of the players is meant to ensure that despite the changing demands and myriad strategic and tactical choices, players at all levels will ascertain that the activities in the banks will result in value creation.

Furthermore, the creation of value requires the interaction of different groups of players who generate revenues, incur expenses and manage risks and capital in optimising financial outcomes by balancing capital allocation with risks and returns (Perro and Ruoff 1997). In addition, Islamic banks are affected by further changes and creations of values related to integrating *Shari'ah law* principles in their banking activities. On one hand, accountability in banks need to be carefully managed in order to improve business performance and create sustained shareholder trust (Perro and Ruoff 1997). On the other hand, accountability in Islamic banks needs to be carefully managed in order to improve business performance and create sustained trust of shareholders, stakeholders, society and God (Triuwono 2004). In assuring business performance, Islam places certain moral restraints on fostering self-interest within the social context and does not violate the Islamic objectives of social and economic justice and overlooks equitable distribution of income and wealth (Dusuki 2008; Kahf 2006; Dusuki and Abozaid 2007; Dusuki and Abdullah 2007a; Mohammad and Shahwan 2013).

3.2.3 Trust in Islamic Banking

Islamic banking is an alternative to the existing conventional banking system which is based on interest and *riba*'. An Islamic bank is not only a firm but also a moral trustee of the depositors whose trust is given to banking firms. In the context of Islamic banking activities, the stakeholders trust IB to employ the resources in accordance with the *Shari'ah*. IB needs to guarantee that all aspects of the operation, management and products and services are in compliance with *Shari'ah*. To ensure that the products and services are in accordance with *Shari'ah* involves certain procedures approved by qualified scholars (Errico and Farahbaksh 1998). Furthermore, it is explained that the Islamic banking business is not regarded as a worldly affair, but rather, it is a form of worship that includes economic dealings, preserving the relationship with society and environment and fulfilling obligations to God (Triuwono 2004). Thus, humans are expected to show their awareness of the difference between the sacred and profane aspects when carrying out their economic activities and also be conscious that they are accountable for all their worldly affairs in the hereafter (Triuwono 2004).

In addition, according to Islamic ethics, IB's management are accountable to the depositors in this world and in the Hereafter if they fail to keep the trust invested in them (Samad and Hassan 1999). The agent-principal relationships within Islamic banks arise from the partial control of the resources entrusted to the managers by the shareholders and investment account holders. Management is regarded as the agent to whom the supplier (principals) of investment and equity capital entrust a portion of their resources in a *Shari'ah* approved manner. The expectation of the bank's stakeholders towards the management is seen as a form of trust. In addition, in IB, the relationship resulting from trust is not only defined by the agent-principal relationship as such, but rather it is inclined to be part of a broader

relationship for which the agent is responsible to God, implying the involvement of ethical and moral attitudes (Triyuwono 2004). Thus in Islam, the ethical problem is halted at its root rather than being addressed when it occurs. In addition, effective and consistent enforcement of a single code of ethics should be applied at all levels of staff without regard to their positions. This is to ensure *adalah* (justice) and to strengthen employee morale by creating a level ground for everyone to follow the same rules.

A governance is a mechanism to increase trust where the significance and rewards attached to cooperative outcomes might induce the agent to act honestly and with principles (Sarker 1999b). Arrow (1974, 23) highlighted that “trust is an important lubricant of a social system. It is extremely efficient; it saves a lot of trouble to have a fair degree of reliance on other people’s word”. Similarly, “invisible institutions” of ethics and morality are important in reducing agency costs and transaction costs more generally (Sarker 1999b). It has not been possible to develop a system of PLS contracts between the lender (i.e. the bank) and the entrepreneur that can keep monitoring costs at a reasonable level and eliminate the moral hazard issues which arise when the parties have asymmetric information on the prospects and outcomes of an investment venture (Sarker 1999b).

Furthermore, Triyuwono (2004) interprets trust as a divine symbol in the context of Islamic banking business and accounting practices. The interpretation utilises a symbolic interactionism that has been combined with a triangular concept of Islamic faith, knowledge and action. Trust is explained as the principles of *Islamic* banking and finance and the body appointed to ensure that the compliance is in place, and that the accounting practices in the financial institutions produce additional financial reports in implying its accountability towards its shareholders, stakeholders, society and God. It is reflected in the appointment of

SSB, prohibition of *riba*', application of PLS instruments and payment of zakah (Triyuwono 2004; Karim 2001; Rosly 2005b).

It is important for the IBs to formalise and define the responsibility and accountability of BOD and management, internal accountability standards to specify responsibility for managing customer information asymmetry by the central bank, accountability of SSB, BOD and management to ensure that accountability and line of authority are clearly delineated, accountability at various levels in order to facilitate effective management, accountability for negligence and operating within prudent limits and the accountability of the line management. On the other hand, in accounting practices, trust is interpreted as accountability in the sense that the agent should be responsible to God, shareholders, stakeholders and society (Triyuwono 2004). Thus, although there is complete trust, the *Islamic* banking system needs reliable accounting and a full exchange of information between the bank and the business (Lewis and Algaoud 2001). This implies additional reports in the *Islamic* banking financial statement. Furthermore, Triyuwono (2004) holds that following the acceptance of the trust, human beings should adhere to the guidance of God. The association with the shareholders and the society at large is related to the principal-agent relationship, and the association between the agent and God is related to ethical and moral attitudes. The *Shari'ah* foundations of accountant ethics as prescribed by the AAOIFI standards extend the accountability towards Allah. This is because humans are accountable to Allah for their deeds in this world and they will be rewarded or punished based on their good or evil deeds, respectively (Chapra 2000).

The next section will discuss the theories underlying Islamic banking and finance.

3.3 Theories underlying Islamic Banking and Finance

In recent years, theoretical perspectives drawn from the corporate governance theories such as agency theory, transaction cost theory, and stakeholder theory have been used by a number of researchers in the area of Islamic banking and finance (see for example, Hassan and Lewis 2007; Safieddine 2009; Hasan 2010; Dar and Presley 2000; Muda and Ismail 2011; Iqbal and Mirakhor 2004; Dusuki 2005, 2006, 2008; Al-Shamali et al. 2013; Archer et al. 1998). In addition, institutional theory is also discussed to portray the institutional pressures that may influence the operations of IB. The institutional theory highlights the relationship between organisational structure and wider social environment in which organisations are situated (Hussain and Gunasekaran 2002).

It may be useful to briefly outline the theories that frequently underpin studies on Islamic banking and finance to show their importance and why a certain number of them have been chosen in this study.

3.3.1 Agency Theory

The agency theory explains the contractual relationship between the principal and the agent. It is concerned with resolving problems that can arise from an agency relationship. Jensen and Meckling (1976) defined an agency relationship as

“... a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent.”

The agency problems may stem from the separation of ownership and control between shareholders and management of the company (Solomon 2007). Furthermore, although stewardship theory views management as a steward who can be motivated to act in the best

interests of the principals in a spirit of partnership and for the benefits of the firm (Lewis and Algaoud 2001; Davis et al. 1997), agency theory sees managers and employees as agents whose interests may diverge from those of their principal (Jensen and Meckling 1976). The agency theory assumes that the goals of the principal and agent are conflicting and the agent does not necessarily make decisions in the best interest of the principal (Maurer 2005; Solomon 2007)²⁸. For example, as shareholders' primary objective is maximising their wealth, company managers may pursue their own personal objective, that is, an aim to gain the highest bonuses possible (Solomon 2007). Agency problems may also result from the fact that the agents or managers do not bear the risks or the "*wealth effects of their decisions*" (Fama and Jensen 1983).

Furthermore, the principal cannot accurately predict the agents' actions and exert control over them (Lewis and Algaoud 2001). Among the agency problems that may occur are non-pecuniary benefits or perquisites, and information asymmetry (Archer et al. 1998; Khalil et al. 2002). Information asymmetry further leads to moral hazards and the adverse selection problem (Lewis and Algaoud 2001; Khalil et al. 2002; Solomon 2007). Information asymmetry assumes that full and complete information is not uniformly available to all interested parties. In the process of acquiring information to make investment decisions, the information acquired is not the same for everyone; the transactors may have less than perfect information while some may have 'inside' information (Khalil et al. 2002). Information asymmetry leaves the way open for the possibility of managers' acting out of self-interest (Maurer 2005). Furthermore, upholding their self-interest will lead in perquisites and non-pecuniary benefits. The incentive problem often arises from asymmetric information (Errico

²⁸ Suggested by self-interested maximization (Maurer, 2005)

and Farahbaksh 1998; Khalil et al. 2002). It arises when a contract or financial arrangement creates incentives for parties to behave against the interest of others (Khalil et al. 2002).

Accordingly, there are particular characteristics in the banking industry in terms of the governance of banks. This is where greater opaqueness and greater government regulations exist; these may have complex implications for corporate governance (Levine 2003, 2004). Furthermore, normal agency problems exist between principal and agent in publicly-listed companies, and an additional agency relationship involving regulators is introduced in banks that operate under highly regulated or administered markets (Ciancanelli and Gonzalez 2000), leading to a more complex agency problem. In addition to information asymmetry between owners and managers, there are further levels of asymmetric information between (1) depositors, bank and regulator, (2) owners, manager and regulator and (3) borrower, manager and regulator (Ciancanelli and Gonzalez 2000). Moreover, in banking institutions, the private interest of the owners and the public interest in the overall stability of the system may diverge (Ciancanelli and Gonzalez 2000).

3.3.1.1 Agency Problems in Islamic Banking and Finance

In addition to a normal agency relationship that involves the separation and ownership and control of the shareholder and normal agency problems face by the bank, the additional agency relationship in IFIs is the need to comply with *Shari'ah* and separation of cash flow rights from the rights to control the investments by the IAH in Islamic banks (Safieddine 2009). Safieddine (2009) discussed the specific agency relationship in IB and its specific mechanism as the following Table 3.3.1:

Table 3.3.1 Unique Agency Relationship in IFIs and its Specific Mechanisms (generated from Safieddine 2009)

UNIQUE AGENCY RELATIONSHIP IN IFIs	MECHANISM
The need to comply with <i>Shari'ah</i>	Importance of the establishment of <i>Shari'ah</i> Supervisory Board
	Disclosure of the following information: -Set <i>Shari'ah</i> -related rules and principles -Provide a clearance of <i>Shari'ah</i> compatibility of all products -Oversee compliance and its verdict as to create confidence with respect to compatibility with <i>Shari'ah</i>
The rights of depositors and IAHs – separation of cash flow and control rights	Vicarious monitoring (Archer et al. 1998)
	A governance framework consisting of a group of <i>shura</i> (consultants), including representatives of the shareholders, creditors, the public, the board of directors, and the SSB (Asri and Fahmi 2004)
	The rights of shareholders be extended to unrestricted IAHs by granting them representation on the board (Grais and Pellegrini 2006b, 2006a)
	IAH be represented in the audit committee or in the annual general assembly, while keeping their rights limited (Archer et al. 1998)
	Access to reliable and accurate information, and Islamic banks must strictly control the financial reporting system and the regular disclosure of pertinent information (i.e. the returns on IAH and shareholder funds, the bases and percentages for the allocation of assets, and profits and expenses in a way to enhance transparency and enable investors to monitor the performance of their investments)

Besides maximising shareholders' wealth, any *Shari'ah* non-compliance arrangement in IB is an additional source of double agency problem (Safieddine 2009). Furthermore, IBs are normally incorporated with limited liability and the contractual relations from the standpoint of secular law are between the IAH and the bank (as a legal person) and not between IAH and shareholders (Archer et al. 1998). Thus, the IAH does not have the right to interfere with the management of funds and monitoring bank's management; the violation of the right can nullify the contract (Archer et al. 1998; Napier 2007; Safieddine 2009). In addition, as a result of separation between control rights and cash flow rights, IAH is not granted the

monitoring and control rights that shareholders enjoy. The IAH depends on the role of vicarious monitoring carried out by shareholders in order to prevent the management from exposing the funds to intolerable risk levels (Safieddine 2009; Archer et al. 1998). The implications of the relationships existing in IBs raise the issue of how IAH may influence the behaviour of the bank's management in order to safeguard their interests within the terms of the *mudharaba* contract (Archer et al. 1998; Napier 2007; Safieddine 2009).

In Islamic banks, more depositors are left unprotected and more public disclosure of information about bank's policies, objectives and operational strategies are necessary to enable creditors and depositors to monitor bank performance (Errico and Farahbaksh 1998). Information asymmetry suggests that there are genuine grounds for IAH to be concerned about the non-pecuniary and perquisite benefits with which they may be charged as compared to shareholders (Napier 2007; Archer et al. 1998). Further, during fund utilisation, information asymmetry may lead to adverse selections and moral hazards. Agency problems that relate to adverse selections and moral hazards are associated with hidden characteristics, hidden actions and hidden information, respectively. In addition, on one hand, adverse selection emerges as a result of the existence of *ex ante* asymmetry with regard to the agent's characteristics (talent, skill, experience, ingenuity, leadership and so on) and the validity of the project. On the other hand, moral hazards relates to the existence of the *ex-post* information asymmetries, the discretionary power of the agent, the unobserved nature of an agent's action and the existence of a linear relationship between reward and performance (Khalil et al. 2002).

Furthermore, since the capital value and return on investment (ROI) of deposits are not fixed and not guaranteed, these depend on the bank's performance in investing depositors' funds.

Thus, the bank's management would have an incentive for overconsumption of perquisites at the expense of IAH, as well as shareholders (Napier 2007). In addition, the depositors would have a greater incentive to monitor the bank's performance in order to protect the capital value of their funds and to ensure that the rates of return paid to them reflect a fair application of the PLS principles on the bank's net profit.

The divergence from the principals' interest can be controlled by establishing incentives for the agent and by incurring monitoring costs for the agent's activities (Jensen and Meckling 1976). There are three main incentive issues related to financing activities in IBs. First, the absence of collateral may aggravate the adverse selection problem (Lewis and Algaoud 2001; Sarker 1999b). Entrepreneurs expecting high non-monitoring benefits but low realised profits will choose PLS financing because they will expect high total returns at an artificially low cost of capital (Lewis and Algaoud 2001). However, since the intentions cannot be observed and there may be incentives that lie or mislead a counterpart, as the profit is shared between the firm and the bank at an agreed-upon ratio, there may be an incentive on the part of an immoral entrepreneur to report a lower profit to keep a larger share of it for him/herself (Iqbal et al. 1998; Khalil et al. 2002).

Secondly, in PLS, the entrepreneurs have every incentive to under-report or artificially reduce declared profits. Reduced declared profits may be done through taking excessive perquisites, extra leisure or resorting to accounting subterfuges (Sarker 1999b). Thirdly, a *mudharaba* contract accentuates the moral hazard problem because the bank cannot enforce upon the enterprise the action and effort needed to maximise its outcome (Lewis and Algaoud 2001). Problems of moral hazards arise when a contract or financial arrangement creates incentives for parties to behave against the interest of others (Khalil et al. 2002). Moral

hazard refers to the incentives the entrepreneur or borrower (i.e. the user of the funds) may have in concealing the true level of profits or absorbing some of the profits through unauthorised perquisites (Khalil et al. 2002).

In addition to the tendency of managers to divert their attention from their duty to maximize shareholders' wealth, the conflict of interest between IAH and bank's management may result in a tendency of managers to divert attention from managing the funds in a *Shari'ah* compliant manner (Safieddine 2009). Although the appointment of a SSB aims to ensure that the management of banks applies the *Islamic* mechanism according to *Shari'ah* Law, the banks and its management's actions towards depositors need to be controlled (Napier 2007). Appropriate incentives need to be designed in order to motivate the bank and its management to behave in accordance with the interest of the parties involved (Napier 2007; Khalil et al. 2002). Further, the incentives raise issues about how a principal is able to rely on the agent acting in the interests of the principal employing him rather than in his own self-interest and against that of the principal (Khalil et al. 2002).

3.3.2 Transaction Cost Theory

Three types of institutional theory have often been adopted: new institutional economics (NIE), old institutional economics (OIE) and new institutional sociology (NIS). The NIE considers the transaction as its primary unit of analysis (DiMaggio and Powell 1991). It consists of two parts, i.e. the institutional environment and the institutions of governance (Williamson 1998). The agency theory and the transaction cost theory are related to the institutions of governance and originated in Coase's papers on 'The Problem of Social Cost' in 1960 and on 'The Nature of the Firm' in 1937, respectively (Williamson 1998).

The agency theory relates to the nexus of the contract (Jensen and Meckling 1976). Furthermore, the theory focuses on agent and principal relationship due to the separation of ownership and control between them. Among others, the agency problems are non-pecuniary and perquisite and asymmetry information. Asymmetry information further resulted to moral hazard and adverse selections. The agency theory involves the marginal structure (i.e. price and output) and deals with an efficient incentive alignment between the principal and the agent with the anticipation of different risk aversion and/or multi-task factor or multi-principal concerns (Williamson 1998). On the other hand, transaction cost theory is related to the governance structure and addresses all types of contracting relations. It manifests as an organisational construction in which efficient boundaries could be set by aligning different transactions with governance structure in a discriminating way (Williamson 1998, 1987).

In the light of TCE, Williamson (1998) suggested three generic structures, namely, the market, hierarchy (i.e. vertical integration) and hybrid (i.e. a combination of market and hierarchy). Central to TCE is the attenuation of the *ex-post* hazards of opportunism through the *ex-ante* choice of governance (Williamson 1998). Key attributes in human actors are bounded by rationality and opportunism. Both of these attributes are derived from cognitive ability and self-interestedness of human actors (Simon 1985). Cognitive abilities relate to bounded rationality. Bounded rationalities in TCE assume that all complex contracts are unavoidably incomplete and it's a behaviour that is intended to be rational but is only limitedly so (Williamson 1998). On the other hand, self-interestedness relates to frailty motives (i.e. weakness in a person's character or moral standards) (Williamson 1998). Furthermore, in TCE, it is described as opportunism (i.e. nothing but a thorough examination of the hazards will enable the mitigation of this hazard). In making investment decisions,

bounded rationality holds that an agent's rationality is limited by the information they have and the cognitive ability of their mind (Simon 1985; Williamson 1998)

3.3.2.1 Transaction Cost Theory in Islamic Banks

In the IB, a ratio of shareholders' funds of the IAH funds perceived as adequate by the market would both encourage potential IAHs to invest (screening), reassuring existing IAHs that they do not need to withdraw their funds (bonding) as they can rely on 'vicarious' monitoring (Archer et al. 1998). This shows that the ex-ante contractual relation established by the *mudharaba* contract requires the IAH to place trust in the monitoring of management exercised by the shareholders.

The possibility that the bank could incur a loss (i.e. borne by shareholders) relating to investment accounts, may be due to the negligence or misconduct of the bank's management and that will affect the level of shareholders' equity; whether it is determined by regulatory agencies or by the market (Archer et al. 1998). Similar to an all-equity-firm, the IAH funds would lead the management of IBs to accept any value-enhancing investment irrespective of asset specificity. Furthermore, shareholders of IBs would be unlikely to have incentives to engage in overly high-risk ventures, since the 'up-side' as well as the 'down-side' risk is shared with the IAH as residual claimants.

The previous two sections discuss the agency theory and transaction cost theory, which are classified as the organisational economics theories. The following table 3.2.2 offers a comparison of these two theories:

Table 3.3.2 Comparison of Organisation Economic Theories (Kim and Mahoney 2005)

	AGENCY THEORY	TRANSACTION COST THEORY
UNIT OF ANALYSIS	Principal-agent contract	Transaction
FOCAL DIMENSION	Incentives	Various types of asset specificity
FOCAL COST CONCERN	Residual loss	Maladaptation
CONTRACTUAL FOCUS	Ex-ante incentive alignment Monitoring mechanism	Choice of (ex post) Governance mechanism
THEORETICAL ORIENTATION	Constrained optimisation	Comparative assessment
STRATEGIC INTENT	Shareholder view	Shareholder view
SOURCES OF MARKET FRICTIONS	Information asymmetry, unobservability, risk aversion (by agent)	Bounded rationality, uncertainty, informational asymmetry, opportunism and asset-specificity

As agency theory focuses on the relationship between owners and managers of the organisation, the manager is seen as the economic agent of the shareholders, with the right of implicit ownership of private property (Shankman 1999). Thus, this implies the moral obligation of the managers towards the interest of the owners. While transaction cost theory shares many of the assumptions of agency theory, it focuses on the boundaries between contracting parties (Quinn and Jones 1995). Transaction costs stem from the need to negotiate, monitor and enforce the implicit and explicit contracts required to bring resources together and utilise them efficiently.

Consequently, the stakeholder theory addresses matters beyond maximising the profit, but recognises stakeholders' interest as they serve to increase the wealth of the firm (Shankman 1999). The focus on the implications to the agency relationship in stakeholder theory is when stakeholders' interest does not lead to greater profit. Thus, the relationship of traditional managers-shareholders is only limited to economic responsibilities between them.

Furthermore, in addressing such issues, Quinn and Jones (1995) propose implicit moral responsibilities in the functioning of efficient markets in stakeholder theory.

3.3.3 Stakeholder Theory

The stakeholder theory is intended to both explain and to guide the structure and operation of an established corporation (Donaldson and Preston 1995). The corporation is viewed as an organisational entity through which numerous and diverse participants accomplish multiple, and not always entirely congruent, purposes (Freeman 1994; Donaldson and Preston 1995). Freeman (1994, 46) defines a stakeholder as “*any individual or group who can affect or is affected by the achievement of the organisation’s objectives*”.

Donaldson and Preston (1995) categorised stakeholder theory into three approaches: descriptive, instrumental and normative. With descriptive data, the theory is used to describe or explain specific characteristics and behaviours with respect to its stakeholder relationship. Concurrently, with instrumental data, the theory is used to identify the connections, or lack of connections, between stakeholder management and the achievement of traditional corporate objectives. The normative view proposes narrative acts of moral behaviour and philosophical guidelines for the operation and management of operations in stakeholder context (Dusuki 2006). For example, in Islamic banks, the consumers have a right to products that are governed by the *Shari’ah* principles and take into consideration the values preached by the *Shari’ah*; thus, the institution is obligated to take this group into account when making decisions about product design. In addition, with normative data, the theory is used to interpret the function of the corporation.

Deegan (2002) classified stakeholder theory into two branches: ethical (or normative) and managerial (or positive). The ethical branch refers to the responsibilities of an organisation that influence how they should treat their stakeholders. On the other hand, the managerial branch refers to the need to manage a particular stakeholder group. In accordance with the managerial branch, an organisation is drawn to managing a specific stakeholder group that is deemed to be “powerful” due to their ability to control resources (Deegan 2002).

3.3.3.1 Agent Morality

As the agency theory views the manager as an agent for shareholders, the manager’s motivation is to maximise the shareholder’s value (i.e. firm’s value), normative stakeholder theory holds that the manager’s decisions ‘ought to be’ motivated by the principled moral reasoning (Quinn and Jones 1995). The former is called instrumental ethics and the latter is called non-instrumental ethics. Instrumental ethics advocates that manager act morally in the effort to increase shareholder’s wealth. On the other hand, non-instrumental ethics advocates that although wealth is a consideration, it cannot undermine the moral principles when wealth and principle come into conflict (Quinn and Jones 1995).

The philosophical perspective of the moral obligations of manager is called agent morality (Quinn and Jones 1995). Agent morality refers to the moral obligation of the manager before referring to shareholders’ wealth in formulating business policies. Furthermore, Shankman (1999) suggested that the nature of responsibility in the stakeholder model should include certain moral imperatives. They suggested that business policies should be referred to certain moral duties. The priority of moral duties is created when stakeholders’ interests do not lead to greater profits (Shankman 1999). Quinn and Jones (1995) identified four principles: honouring agreements, avoiding lying, respecting the autonomy of others and avoiding doing

harm to others, as a precondition of the efficient working of the market or for the principal-agent model.

Two theories that are stakeholder approach to management and Tom Donaldson's social contract embed deontological ideas in a business framework. These effort have translated moral ideas into business setting to make the language of discourse more accessible to senior managers of corporation (Quinn and Jones 1995). The strengths of both approaches led them in recognizing the importance of non-instrumental morality to a 'business system' and grounding their arguments in the practices of firms. Despite of the strength possess by both approaches they are not without problems. Amongst others, Quinn and Jones (1995) highlighted pertaining to (1) criticism aimed at social contract theory, (2) relevancy of firm as a moral unit and (3) the 'real contracts' objection that applies equally to both theories. Some criticisms pertaining to social contract theory are what constitute implicit social contracts, parties involved in the contracts and the necessities and enforceability of the contract. Furthermore, the stakeholders' theory and social contract theory are claimed to outcast the contract of principal and agent by implicit stakeholders claims on the firm and implicit social contract between firm and society. However, the superiority of implicit social contracts is being questioned in terms of its legality in portraying agency obligations to shareholders. In addition, although Quinn and Jones (1995) highlighted that as Fama (1980) suggested that each firm has its founding contract and goals, the ability of its implicit social contract and its relation to stakeholders as the foundation of its moral obligations is arguable.

Quinn and Jones (1995) agree that, it is accurate and apparent to put forth that human have moral obligations despite of their position in the corporation. Thus, Quinn and Jones (1995) concluded that behind the works of Donaldson and Freeman, morality need to be grounded in

a well-understood business and cultural context before it is refer by the managers as guidance for business policy.

3.3.3.2 Agent Morality with Ethical Religious Consideration

Over the last decade, the principles of good governance and codes of best practice are not only manifested in attaining maximum profitability, economic efficiency or fair dealing but it is about endeavoring in ensuring that institutions are directed and controlled in accordance to moral standards acceptable to the general community (Gooden 2001). The agent morality perceived manager to make reference to certain moral duties before making reference to shareholders wealth in fashioning business policies (Quinn and Jones 1995). However, despite acceptable moral standards underlying the concept of best practice in governance, Haniffa and Hudaib (2002) in view that there are three difficulties from Islamic point of views. Firstly, the difference exists in ethical foundation between conventional business morality and religious moral authority. The former is based on socially derived ‘secular humanist’ value and the later is stems from religious moral authority. Secondly, primary beliefs and values of Western corporate culture is rooted in self-interest and, even if modified to some extent, there is no comprehensive requirement to take account of wider interest of society. Thirdly, the major theoretical model of corporate governance is based on agency theory rather than stewardship theory (Davis et al. 1997), which motivated to act as self-interested opportunistic agents who have to be watched over and controlled, which is not the one that ought to be appropriate for Muslims.

The establishment of Islamic banks is based on religious impetus which is underlies by *Shari’ah* law. The detail discussion on the principles of *Shari’ah* and Islamic morality has been discussed in Chapter 2 and in the earlier section of this chapter, respectively. Chapter 2

Section 2.3 discussed the relationship between Islam and Islamic banking system. The section outlined the objectives of *Shari'ah* law (i.e. law/principles underlying the operation of IB). Next, Section 2.4 explained thoroughly the philosophy of IB that was based on the *Shari'ah* principles. Furthermore, Chapter 3 Section 3.2 received the credibility of the IB system. It highlighted that credibility of the system will increase the trust and confidence of the stakeholders. Also, the section emphasized sustainability as a result of credibility. In addition, the section also delineated the factors that contribute to credibility (i.e. legitimacy of practices and accountability of player. The section further discusses on the *Shari'ah* compliance, Islamic morality and accountability and trust in IB.

Ideally, in the case of Islamic banks, *Shari'ah* principles as its underlying principles should be grounded in its business practice. Furthermore, the Islamic banks needs to balance financial performance with ethical behaviours. The latter provides an incentive to make decision on certain matters, which may not necessarily attribute to financial outcomes but more for attaining fairness and equity to a wider group of stakeholders (Sulaiman et al. 2011). In the case of Islamic banks, the management needs to ensure the compliance with *Shari'ah* regarding its products and services, its operations and the maximisation of its wealth. In addition to maximization of wealth within the ambit of *Shari'ah*, the establishment is also aimed to ensure that the social objective in ensuring that the welfare of the *ummah* is protected.

According to Islamic perspective, the principles of property rights and contract are being used to identify the classification of stakeholders and their rights and responsibilities (Dusuki 2006). Furthermore, the design of governance system in Islam can be best understood in light of principles governing the rights of individual, society, and state, the laws governing

property ownership, and the framework of contracts (Dusuki 2006; Iqbal and Molyneux 2005). Recognition and protection of rights in Islam is not limited to human beings only but encompasses all forms of life as well as environment. Any violation of these rules is considered a transgression and leads to disruption in social order. In addition, the concept of stakeholders is managed in Islam through the Islamic norms and values that delineate each organization (Dusuki 2006). Thus, there is normative core grounded to the Islamic moral and ethical principles for the use of the stakeholder concept.

Furthermore, the obligation arising from both explicit and implicit contracts are equally important in the Islamic framework. On one hand, the explicit contracts relates to the provisions to protect both parties involved in the contracts. On the other hand, principles of the property rights and contracts underlie their action towards various stakeholders that might be affected by the firms (Dusuki 2006; Iqbal and Molyneux 2005). The implicit contracts are more eternal as it is governed by the moral and ethical principles enshrined in the *Shari'ah*. Also, it is more divine as it requires man to manifest the covenant (al-mithaq) through his submission in absolute true willingness as prescribed by the Divine Law of *Shari'ah* (Al-Attas 2005). Man as creation of God called vicegerent (i.e. Khalifah) and their accountability towards himself, other human beings, environment and finally to God is being discussed in subsection 3.2.2 in this chapter. Failure to fulfil these obligations means he or she has breach the Divine contract, thus resulted to betrayal and facing consequences in this world as well as in the hereafter (Dusuki 2006).

In addition, a subsection in Chapter 2 did discuss pertaining to the objectives *Shari'ah* and the objective of the establishment of Islamic banks. It was highlighted that the establishment was not the sole criterion in evaluating the performance of Islamic banks. The performance of

Islamic banks should possess prime consideration that is social implication of its establishment. Therefore, consideration for aggregate welfare of stakeholders is a moral and religious initiative based on the belief that a company should be ethical regardless of its financial performances (Dusuki 2006). However, this implies that the IB is not driven by the principle of profit maximisation solely. Besides profit maximisation, the IB should acknowledge its social and moral responsibility for the welfare of its stakeholders. In addition, maximisation of the shareholder's wealth is allowed as IB did not engage with socially disruptive or violation of the norms of Islamic justice. This in fact contradicts the doctrine of self-interest idealised in neoclassical economics (Dusuki 2006).

The perspective of agent morality is suitable for the practices of Islamic banks as they should uphold the *Shari'ah* principles and maintain high returns to meet the stakeholders' interests. Furthermore, non-instrumental ethics are supported by the religion of Islam, as it creates a harmony between the material and moral by urging Muslims to provide a spiritual orientation to material effort (Chapra 1979). Moreover, the spiritual orientation is aimed to establish human brotherhood, social justice, economic justice, and equitable distribution of income and individual freedom within the context of social welfare. Since the non-instrumental ethics is coherent, but unpersuasive (Quinn and Jones 1995), the managers in IB should ensure and control the implementation of Islamic morality in business policy and working environment are in accordance to the ethical religious consideration. In addition, the awareness of individual on the importance of assimilating the Islamic teaching in day-to-day activities should be inculcated to the managers.

Furthermore, Key (1999) addressed four criticisms of stakeholder theory. They are: that it is an inadequate explanation of the firm's behaviour within its environment, does not

adequately address additional linkages between external and internal stakeholder groups that impact and affect the firm, does not adequately address the system of the environment in which the firm exists and inaccurately assesses the environment as static. The following discussion focuses on institutional theory, highlighting the need to understand the nature of the pressure, both economic and institutional, which can have an impact on the way organisations are structured (Scapens 2006).

3.3.4 Institutional Theory

Institutions posit different base in order to comply with varying mechanisms and logics, diverse empirical indicators and alternative rationales for establishing legitimacy claims. As previously mentioned, institutional theory can be divided into three types that are often adopted in literature. They are: new institutional economics (NIE), the old institutional economics (OIE) and the new institutional sociology (NIS).

According to Klein (2000), new institutional economics (NIE) is an interdisciplinary enterprise. It combines various fields such as economics, law, organisational theory, political science, sociology and anthropology to understand the institutions of social, political and commercial life. These fields are taken from various social sciences disciplines, but its primary language is economics. The goal of NIE is to explain what institutions are, how they arise, what purpose they serve, how they change and how they should be reformed, if at all (Klein 2000). NIE views accounting practices as one of the larger set of features that can legitimize organisations through the construction of an appearance of rationality and efficiency (Carruthers 1995).

A conception has emerged about the role of institutional arrangements in constructing rationality, not just in the absence of effective instrumentalities, but as a framework for defining and supporting the full range of means-ends chains. A concern with effectiveness, efficiency and other types of performance measures does not exist in a vacuum but requires the creation of distinctions, criteria, common definitions and understandings. The broader cultural-cognitive, normative and regulatory aspects of institutions shape the nature of competition and markets, as well as the meanings of effective performance and efficient operations (Scott 2005). In sum, institutional frameworks define rational arguments and approaches.

Within these broader frameworks, other types of institutional provisions may support the creation of structures that are more attuned to ensuring accountability, gaining legitimacy and securing social fitness, rather than directly improving the quality or quantity of products and services. Such requirements, while not directly related to the core technologies, can nevertheless make important contributions to organisations by adopting them, increasing recognisability, acceptability and reputation. Institutions are varied in their effects as well as in the levels at which they operate (Scott 2005). Increasing isomorphism is taken to be the central indicator that institutional processes were at work (Scott 2005).

Carruthers (1995) argues that the ceremonial adherence to legitimate norms may have little material impact because the formal organisation structure is decoupled from the actual organisational process. The key issues which remain unsettled in new institutional factors are (1) whether substantial decoupling undermines organisational legitimacy, (2) who the key audiences for organisational appearance are and (3) the relation between technical and institution factors (Carruthers 1995). On the other hand, Scott and Meyer (1983, cited in Scott

2005) introduced the intermediate argument noted above, that rational (or technical) performance pressures are not necessarily opposed, but somewhat orthogonal to institutional forces - each a source of expanding rationalised structural arrangement. Banks confront strong pressures of both types; effects that produce quite complex structures (Scott 2005). Under the NIE, banks face rational/technical performance pressure and institutional forces. The institutional forces are categorised as having three aspects; they are regulatory aspects, normative aspects and cultural-cognitive aspects.

A central tenet of institutional theory (DiMaggio and Powell 1983; Meyer and Rowan 1977; Scott 1995) suggests that institutional pressures lead organisations to adopt similar structures, strategies and processes. That is, external forces work to make companies more alike – that is what institutional literature calls “organisational isomorphism” (DiMaggio and Powell 1983). Government, industrial associations and other social actors define actions deemed acceptable and exert pressures on companies for conformity. In order to reduce environmental uncertainty and conform to social expectations, companies imitate practices used by other organisations (DiMaggio and Powell 1983; Haveman 1993). The rational/technical performance related to the institutions of governance originated from Coase’s papers on ‘The Problem of Social Cost’ in 1960 and on ‘The Nature of the Firm’ in 1937, respectively (Williamson 1998). The institutions of governance in NIE mainly concentrate on agency theory and the transaction cost theory (Williamson 1998). The agency theory involves making an appropriate institutional environment right, and transaction cost economics relates to establishing a correct governance structure. As NIE assists in focusing on the economic factors that shape the organisational structures and practices, it is necessary to look beyond economics in order to obtain a full understanding on the organisational practices that can be addressed by NIS (Scapens 2006). In contrast to NIE, NIS adopts a broader,

multidimensional approach for focusing on issues related to external and internal organisational context (DiMaggio and Powell 1991; Scott 1995). Furthermore, NIS has contributed significantly to the understanding of the relationship between organisational structures and the wider social environment in which organisations are situated (Hussain and Gunasekaran 2002).

3.3.4.1 Institutional Isomorphism

Isomorphic mechanisms consist of coercive, mimetic and normative. Various researchers have explained the antecedents to isomorphic mechanisms. The following three subsections discuss these isomorphic mechanisms.

a. Coercive Isomorphism

According to DiMaggio and Powell (1983), coercive isomorphism occurs as a result of formal and informal pressures exerted on organisations by other organisations upon which they are dependent, and by cultural expectations in the society within which organisations operate. Pressures may be felt as force, persuasion, or as invitations to join in collusion. It also results in change due to direct response to government mandate (DiMaggio and Powell 1983). Furthermore, it can also be represented in rules enshrined in a regulatory system, and pressures from the global networks of multinational corporation (Guler, Guillen and Mcpherson 2002, 212-213; cited in Irvine 2008). For example, organisations may change some of their structural systems to conform to a change in legal and regulatory framework and to meet societal preferences and expectations. In addition, Weber, (cited in DiMaggio and Powell 1983) explains that common legal environmental affects many aspects of an organisational behaviour and structure. He explained that (1) legal and technical requirement of the state, (2) vicissitudes of the budget cycle, and (3) ubiquity of certain fiscal years,

annual reports and financial reporting requirements which shape an organisation in similar ways.

b. Mimetic Isomorphism

The second mechanism is mimetic isomorphism. DiMaggio and Powell (1983) opined that uncertainty is the prevailing reason that motivates organisations to imitate. This pressure arises from the drive to reduce uncertainty. Organisations tend to imitate when technologies are poorly understood, goals are ambiguous or when symbolic uncertainty is created by the environment (DiMaggio and Powell 1983). In this situation, the organisation is usually unsure of how to react and therefore will copy successful organisational behaviour (Carruthers 1995; DiMaggio and Powell 1983, 1991). The successful organisation is the model for the less successful organisation. For example, a newly established organisation may model itself upon a well-established organisation.

c. Normative Isomorphism

The third mechanism is normative isomorphism. This is a pressure arising from professionalization which socialises personnel within the organisation to view certain types of structures and processes as legitimate. Normative isomorphism refers to a normative, less explicit, system of norms and values (Scott 1995) and organisational behaviour which is taken for granted (Haunschild 1993). The latter manifests itself in the workings of professions (Haunschild 1993; DiMaggio and Powell 1983) and interorganisational networks (Haunschild 1993). DiMaggio and Powell (1983) interpreted professionalization as the collective struggle of members of an occupation, the conditions and methods of their work to control "the production of producers", and to establish a cognitive base and legitimation for their occupational autonomy.

Furthermore, professions are subject to the same coercive and mimetic pressures as are organisations. Although professionals within an organisation may differ from one another, they exhibit much similarity to their professional counterparts in other organisations. Two aspects of professionalization are formal education and legitimation in a cognitive base produced by university specialists, and the growth and elaboration of professional networks that span the organisations across, which new models diffuse rapidly (DiMaggio and Powell 1983). An important mechanism in the working of professions is filtering personnel through the hiring of individuals from firms within the same industry; the recruitment of fast-track staff from a narrow range of training institutions, with skill-level requirements for particular jobs, and common promotion practices such as always hiring top executives from financial or legal departments (DiMaggio and Powell 1983). On the other hand, interorganisational networks function as a mechanism for the diffusion of innovative practices (Haunschild 1993).

In a similar vein, the following table allows us to further associate the institutional forces discussed by Scott (1995) as regulative, normative and cultural-cognitive to the antecedents of coercive, normative and mimetic isomorphism, respectively, as discussed by (DiMaggio and Powell 1983). Thus, they explain that the institutional forces are the factors influencing the institutional isomorphism (i.e. institutional isomorphism and institutional forces are the same). Furthermore, Table 3.2.3 displays Scott (1995) explanation on the basis of compliance, the basis of under, mechanisms, logic, indicators and the basis of legitimacy.

Table 3.3.3 Information extracted from (Scott 1995)

	REGULATIVE	NORMATIVE	CULTURAL-COGNITIVE
BASIS OF COMPLIANCE	Expedience	Social Obligation	Taken-for-granted Shared Understanding
BASIS OF UNDER MECHANISMS	Regulative Rules	Binding Expectations	Constitutive Schema
LOGIC	Coercive	Normative	Mimetic
INDICATORS	Instrumentality	Appropriateness	Orthodoxy
BASIS OF LEGITIMACY	Rules Laws Sanctions	Certification Accreditation	Common Beliefs Shared Logics of Action
	Legally Sanctioned	Morally Governed	Comprehensible Recognizable Culturally Supported

Furthermore, Scott (2004) argues that institutions are comprised of three elements that are “cultural-cognitive, normative and regulative elements that, together with associated activities and resources, provide stability and meaning to social life” (Scott 2001, 48). Figure 3.2.1 below shows the association between the rule system and cultural schema with associated activities and resources perceived to provide stability and meaning to social life.

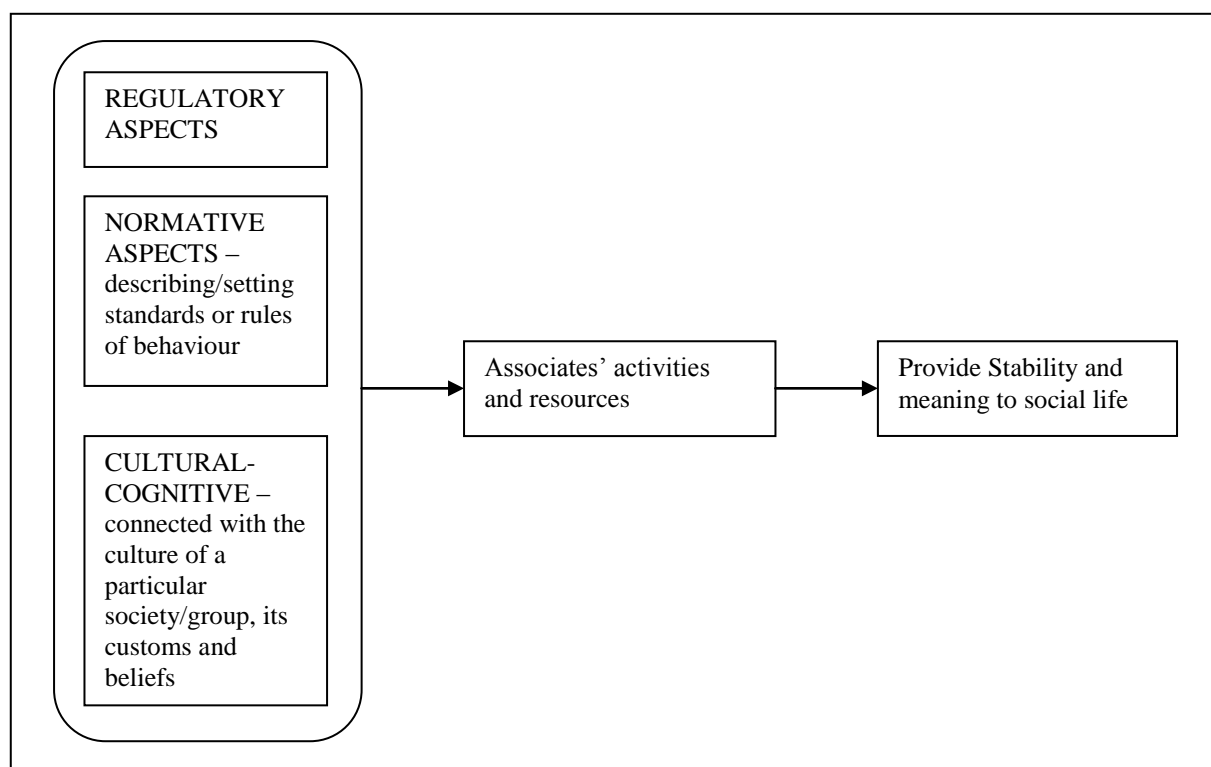


Figure 3.3.1 Association rule system and cultural schema with associates' activities and resources (Scott 2001)

3.3.4.2 NIS and Decoupling

Another important element in NIS is the issue of decoupling or loose coupling. Decoupling signifies a situation where the organisation separates its formal organisational structure from the actual organisational practice (Meyer and Rowan 1977; Carruthers 1995). It relates to presentation of organisation itself rather than to how it actually transpires within the organisation. Organisational formal structures consist of rational procedures, processes and rules which will lead to efficient organisational decisions and better outcomes (Meyer and Rowan 1991). Furthermore, a rationalised system is explained by a cultural system of organisation that is constructed to signify appropriate methods for pursuing purposes or goals. Thus, the adoption of the organisational structure gathers social legitimacy (Carruthers 1995).

3.3.4.3 Banking in NIS Perspective

Various researchers have highlighted the utilisation of institutional theory in banking institutions (Cheung and Liao 2005; Hussain and Gunasekaran 2002; Yamak and Süer 2005; Shi et al. 2007; Riaz 2009). The perspective of institutional theory implies that financial institutions are subject to technical and institutional pressures. They are also more opaque and highly regulated compared to their non-financial counterparts. Furthermore, since the information asymmetry in banking institutions involves additional parties such as depositors, regulators and the government, the application of the agency-based assumption to the financial sector is inadequate in explaining corporate governance and related social responsibility practices (Yamak and Süer 2005). In addition, the institutional theory is employed to explain how the institutional perspectives affect practices in financial institutions. For example, Hussain and Gunasekaran (2002) employ the theory to reveal how it affects non-financial performance measures in financial institutions. In addition, Yamak and Süer (2005) employ the institutional theory in investigating the conflicting nature of being a stakeholder in shaping corporate social responsibility practices in financial institutions.

3.4 Summary

The main purpose of this study is to understand and examine the theoretical and practical aspects of problems and challenges facing Islamic banking and finance in Malaysia. It focuses on four aspects of issues, which are the legal and regulatory framework, *Shari'ah* compliance and management and accounting. The credibility of the Islamic banking system lies in the legitimacy of its practices and accountability of the market players. Meanwhile, in Islam, the accountability and trust are the entrusted elements embodied in an *Islamic* morality that motivates them to perform their duties as a vicegerent. However, due to the agency

relationship and the problems of information asymmetry, the depositors, shareholders and regulators would rely on the reporting and monitoring system to establish that the manager is protecting the stakeholders' interests.

The agency theory, transaction cost theory, stakeholder theory and institutional theory are considered appropriate to support the implementation in IBF to enhance the *Shari'ah* activities. Banking institutions operate in a highly regulated industry and possess unique characteristics with additional parties within financial institutions that are depositors, regulators and government. Firstly, both agency theory and transaction cost theory focus on the agent-principal relationship and the governance of transactions, respectively. At the same time, as the normal agency relationship leads to separation between ownership and control, the underlying principles of Islamic banking and finance create an additional agency relationship that is the separation of cash flow rights from the right to control the investments by the IAH. Both theories highlight the conflict of interest that may arise from information asymmetry. In addition, the contractual focus of agency theory is *ex-ante* incentive alignment and monitoring mechanism. On the other hand, transaction cost theory focuses on the *ex-post* governance mechanism. However, in gaining legitimacy, an organisation should not focus solely on economic terms (i.e. efficiency and profitability) in order to fulfil the shareholders' interests.

In line with the objectives of the establishment of Islamic banking and finance to meet the objectives of *Shari'ah*, Iqbal and Mirakhor (2004) assert that the corporate governance model in the Islamic economic system is a stakeholder centered model. Next, the stakeholder theory addresses morals and values in managing organisations. It argues that the scope of corporate governance and accountability is wider than that which the agency theory had offered. In

stakeholder theory, the institution is not only aiming to fulfil the shareholders' interests, but also the interests of the stakeholders. Furthermore, the inclusion of agent morality in the stakeholders' model is important in the context of the Islamic banking and finance industry. However, the morality in the context of the IBF industry needs to be grounded in the underlying principles governing the operation of IBF.

Finally, the NIS is employed since it will assist in explaining aspects of the problems and challenges facing Islamic banking and finance in Malaysia, driven not only by economic or functional factors, but also by institutional factors. Furthermore, institutional theory is employed to explain how the institutional perspectives affect practices in financial institutions.

Furthermore, in conclusion, theories such as agency theory, transaction cost theory, stakeholder theory and institutional theory are adopted, with the additional consideration of underlying *Shari'ah* principles. The next chapter presents and discusses the review of the literature related to problems and challenges facing the Islamic banking and finance industry.

CHAPTER FOUR

OVERVIEW OF PROBLEMS AND CHALLENGES FACING

ISLAMIC BANKING AND FINANCE INDUSTRY

4.1 Introduction

The previous chapter reviewed and discussed the credibility of *Islamic* banking, the essence of the Islamic morality and trust. Also, the review continues with discussion on theories underpinning *Islamic* banking and finance operations. The theories are taken from previous studies that relate to conventional and *Islamic* banking. Theories that were discussed in the previous chapter are agency theory, transaction cost theory, stakeholder theory and the agent morality concept in the stakeholder model and institutional theory.

This chapter reviews the problems and challenges facing Islamic banking and finance in terms of *Shari'ah* compliance, legal and regulatory framework, management, accounting and auditing. This chapter can be further classified into several main parts, which are: Islam and accountability, *Shari'ah* compliance and its implementation in Islamic banks, the impact of its operation in terms of operational performance and customer preference and the problems and challenges facing Islamic banking and finance. Furthermore, the chapter focuses on legal and regulatory framework, risk in Islamic banks, and accounting systems as embodied in the organisational system of accountability. In addition, the chapter continues with the review of accounting practices, the key development in research in accounting and auditing practices.

4.2 Islamic Banking and Finance Structures

The operations of IBs emphasize on the prohibition of *riba*, the trade and commercial activities are used to replace the interest-based activities. The trade and commercial activities

would be managed through different types of contract. Consequently, profit-sharing and equity participation are the principles on which Islamic banks are not allowed to engage in lending operations on the basis of interest-bearing deposits or other forms of interest (Nawawi 1999). Besides different principles underlying its products and services, the administration of the Islamic banking system is the same as conventional banking systems, with different ethical values and moral behaviours. Thus, distinguish features of Islamic banking are based on (1) risk-sharing, (2) emphasis on productivity as compared to credit worthiness, and (3) moral dimension (Iqbal et al. 1998). Further, the functions of Islamic banks can be classified into four that are (1) investment through Mudaraba or agency contract, (2) investment using Islamic financial contracts, (3) financial services (e.g. letter of guarantee, money traders) and (4) social services (Mohamed Ibrahim 2007).

The fundamental differences between Islamic and conventional banking, is not only in the way they practice their business, but also their values which guide Islamic banking's whole operations and outlooks (Dusuki 2008). The means to generate sources of funds and manage the uses of the funds are different from conventional banks. Each mode of financing in the Islamic bank is governed by a set of rules and accrues different rights and obligations of the parties, bank and clients involved (Ismail and Latif 2001). This is explained by the different nature of each contract underlying its operation. Furthermore, Mirza and Baydoun (1999) argue that the firm's contracts with its claimants, including the society at large, drive its accounting and reporting policies.

The operation of Islamic banks is explained by the instruments used by Islamic banks in mobilising the fund received from the surplus unit (i.e. depositors) to deficit unit. The sources of funds are current accounts (i.e. demand deposits accounts), saving accounts and

investment accounts (i.e. Restricted Investment Accounts and Unrestricted Investments Accounts). These accounts are structured under various *Shari'ah* principles such as al-mudhrabah, and wadiah yad dhamanah (i.e. trust account). The funds are then mobilised to the deficit unit through various instruments such as equity financing, term financing, trade financing and investments. On the other hand, the balance sheet of the conventional bank consists of assets and liabilities. Assets are classified into loans and advances to customers, cash and cash balances with other banks, cash and cash balances with central bank, investment in associates, subsidiaries and joint ventures, and financial assets held for trading. Liabilities consist of deposits, reserve funds, customers' deposit, borrowings and other liabilities.

4.3 Managing Risk in Islamic Banks

The operation of IBs involved with risks requires banks to operate in a different way than a conventional bank would (Ismail and Latif 2001). Due to the unique principles underlying each Islamic transaction or contracts, IB is associated with different risks as compared to their conventional counterparts. The nature of risks faced by capital owner in an Islamic bank varies in accordance to the types of financial instruments it uses, the people it hires to manage the bank and its degree of transparency (Rosly and Zaini 2008). Furthermore, various Islamic modes of financing have their own risk characteristics that are unique to the extent that the nature and magnitude of some of the risks are different for Islamic banks due to the need for compliance with *Shari'ah* (Sundararajan and Errico 2002; Rosly and Zaini 2008; Dusuki 2005; Venardos 2005).

Specifically, Sundararajan and Errico (2002) opine that there are a few special risks surrounding PLS modes. The use of PLS and non-PLS modes entail complex issues such as

risk measurement, income recognition, adequacy of collateral and disclosure index. The special nature of investment deposit in Islamic banks leads to other risks. Other risks are few risk-hedging instruments and techniques, underdeveloped or non-existent interbank and money markets and government securities, limited availability and access to lender of last resort facilities by central banks and regulatory and supervisory practices concerning Islamic banking as highly diverse (i.e. access to any systemic liquidity arrangement operated by central banks, risk weights for capital adequacy calculations and legal recognition granted to Islamic banking). Islamic banks are excluded from the lender of last resort function in many traditional banking systems in Muslim countries²⁹ (Dudley 1998 and Naughton 2000; as quoted by Zaher and Hassan 2001). Also, there is lack of liquidity and safety in the application of Islamic finance (Maniam et al. 2000). These may due to limited set of short-term traditional instruments, shortage of products for medium-to-long-term maturities and lack of alternative option for public debt financing. Lack of security product being designed in line with Shari'ah and nature of the products offered that are more motivated by the CB's products (Mat-Rahim and Zakaria 2013). Another reason for these shortcomings is the lack of markets in which to sell, trade, and negotiate financial assets of the bank. Also, the nature In addition, the security market is lack depth and breadth where there are no venues for securitizing inactive assets and taking them off the balance sheet (Iqbal 2007). Thus, Islamic liquidity solutions should be emphasized. Lender of last resort should be provided on a non-interest basis for Islamic banks. Products such as *sukuk* should be promoted to enable Islamic banks to hold marketable securities that can be liquidated with ease and speed and without much loss when needed (Hassan and Dicle 2005).

²⁹ except Malaysia – it has an active interbank money market and Islamic clearing system that is run by the central bank – in the process to setting up a liquidity management house to internationalize their system, which ultimately develop into a leader of last resort

Poor support of institutional infrastructure exposes Islamic banks to systemic risks comprised of business environment risk, institutional risk and regulatory risk (El-Hawary et al. 2004). Business environment risk is due to the lack of standardised contracts for Islamic financial instruments and the absence of effective litigation and dispute resolution systems. Institutional risk is due to the lack of consensus among Fiqh scholars on contractual rules governing financial transactions. Various interpretations of the fundamental *Shari'ah* rules resulting in differences in financial reporting, auditing and accounting treatments by Islamic banks, will create confusion among the customers. Also, this risk will raise the IBs' exposure to counter-party risks arising from the unsettled nature of contracts, and may lead to potential litigation problems. Regulatory risk is resulted from negligence or mistakes in complying with regulations that would lead to penalties. This could result from a high degree of discretion on the part of the supervisor or from limited transparency in the regulation (Khan and Ahmed 2001). In the effort to achieve compliance in regulation, IBs that are subject to the dual banking regulation, may face confusion due to uncertainty in choosing the rules to be followed, as there are differences between SSB of individual IFI within each country and differences between the regulatory bodies in various countries.

Mohd Ariffin (2005) discusses the banking risks. She classified banking risks into 4 categories, they are: credit risk, market risk, operational risk and liquidity risk. According to her, credit risk is expected to be high under *Mudaraba* and *Musharaka* because of the asymmetric information problem (Mohd Ariffin 2005). It is where the entrepreneur does not provide sufficient information to the financier on the actual profit of the bank. This form of credit risk is referred to as 'capital impairment risk', as the obligor has no contractual obligation to return the financier's capital intact (Mohd Ariffin et al. 2009). Other unique risks are fiduciary risk and displaced commercial risk. Fiduciary risk is a category under

operational risk, namely the risk of breach of the *Mudaraba* contract, or misconduct or negligence on the part of the bank as *Mudarib*, with the result that the *Mudaraba* fund becomes a liability of the bank. Operational risk, which arises due to the failure of systems, processes and procedures, is another area of concern. Weak internal control processes may present operational risks and expose an Islamic bank to potential losses. In addition, governance issues are equally important for Islamic banks, investors, regulators, and other stakeholders. The roles of *Shari'ah* boards bring unique challenges to the governance of Islamic financial institutions. Similarly, human resource issues, such as the quality of management, technical expertise and professionalism, are also subject to debate (Iqbal 2007).

It is important to establish an understanding and awareness of the risks inherent in Islamic banking activities. Emphasis should be given on achieving the operational efficiency, strengthen risk management infrastructure and institution of sound and dynamic risk management. Furthermore, it has increased the need for strengthened risk management capabilities by the industry, and for greater attention to this aspect of regulators and supervisors in promoting the stability and integrity of the financial system. The Islamic financial market is experiencing underdeveloped risk management and diversification with weak management and lack of proper risk-monitoring systems that exposed the market with high risks (Iqbal 2007).

According to Sundararajan and Errico (2002), innovative solutions and appropriate adaptations of availability risk management frameworks are needed to reflect the special characteristics of Islamic financial products. The risk management in Islamic banking involves addressing the special risks of IBs by strengthening the regulatory and disclosure framework, while addressing other general risk factors in an Islamic environment and

institutional development approach. In assessing the special risk of IBs, CAMEL is involved along with main elements of suitable information disclosure requirements.

The Basel Capital Accord, Basle II covers three pillars that are the calculation of capital adequacy ratios, supervisory processes and market discipline, respectively. A key issue relates to the implementation of Pillar 1 of the Basel II Accord (i.e. capital adequacy requirements) that were established to measure different types of risks faced by conventional banks. Thus the provisions do not include specific risks related to Islamic banks (Ariss and Sarieedine 2007). Furthermore, Basle II is a welcomed development for Islamic Banking as it's an on-going effort to strengthen the international financial architecture, with the guidelines by IFSB and AAOIFI to provide better CAR framework to account for risk profile of IBs (Sundararajan and Errico 2002; Ariss and Sarieedine 2007). Although the Basel II is fairly suits the IBs, modification need to be done towards risk measurement and risk management in line with its specific characteristics (Abdullah et al. 2011). In addition, AAOIFI issued statement on 'The Purpose and Calculation of the Capital Adequacy Ratio for Islamic Banks' which is similar to suggestion by BASLE II except difference related to liabilities side of IBs. Further, IFSB considering the used of fund and assessing appropriate risk weights to each asset item. Also, BNM issued various guidelines related to CAR that can be referred to Appendix 4.

Also, Ariss and Sarieedine (2007) highlight issues associated to nature of risks arising from the uses of funds and its implication on the banking books of IFIs and lack of international regulatory bodies that provides to types of risk that are unique to IFIs. Islamic finance faces issues in developing risk mitigating or hedging financial instruments that comply with *Shari'ah* requirements. However, a study by Tafri et al. (2011) imply inadequate risk

management tools and systems where they found significant differences in the level of extensiveness of the usage of most standard risk tools such as market value at risk (VaR), usage of stress testing results, the usage of credit risk mitigation methods and usage of operational risk management tools between Islamic and conventional banks. Furthermore, formulating a strategy for risk management in Islamic financial markets will require holding comprehensive and detailed discussions of the scope and role of derivatives within the framework of the *Shari'ah*; expanding the role of financial intermediaries with special emphasis on facilitating risk sharing; applying *takaful* (*Shari'ah*-compliant mutual insurance) to insure financial risk; and applying financial engineering to develop synthetic derivatives and off-balance-sheet instruments (Iqbal 2007).

4.4 Islamic Banking and its Legal and Regulatory Framework

The effort to build the legal and regulatory framework and prudential supervision of *Islamic* banks is crucial, as there are unique characteristics of *Islamic* banks as compared to their conventional counterparts. The theoretical nature that upholds various types of contracts that are free of interest, highlights the PLS mode of financing as a type of financing that will guarantee the justice distribution of wealth and avoid the accumulation of wealth in one hand. In addition, there are other types of contracts being introduced, such as *Murabahah*, *BBA*, *Ijarah*, *Salam*, etc. The development of regulatory and supervisory framework that would address the issues specific to *Islamic* institutions would further enhance the integration of *Islamic* markets and international financial markets (Iqbal 1997).

The regulation and the supervision framework of the banking industry is important to increase the information available to investors (transparency), to ensure the soundness and stability of the financial system, and to improve monetary and for *Shari'ah* supervision of IBs

(Gambling et al. 1993). Through the history and development of the Islamic banking system, it can be concluded that the development of the Islamic banking system, related to the introduction and establishment of regulation and supervision framework, is increasing in number. The efforts are not only experience by Islamic banking systems in Malaysia, but also Islamic banking systems nationally. However, Dudley (1998) and Naughton (2000), as quoted by Zaher and Hassan (2001) and Iqbal (1997), address the fact that uniformity, regulatory and supervisory framework that is supportive of an Islamic financial system has not yet been developed. Different regulatory and supervisory frameworks will lead Islamic banks to adhere to their national regulatory and supervisory framework, which is obviously different to each other. This will lead to difficulties in comparing the financial statements and practices of the IBs.

Consequently, it would have different approaches in supporting the establishment of the *Islamic* banking and finance according to the country where it is operated. Currently, the *Islamic* banks that operate in the dual banking system face some provisions of conventional laws that may limit the scope of products and services offered by *Islamic* banking (Iqbal et al. 1998). Furthermore, the IBs face difficulties operating in non-*Islamic* countries or non-*Islamic* legal and regulatory systems owing to the absence of a regulatory body that operates in accordance with *Islamic* principles (Iqbal 1997). Wilson (1999) highlights the regulatory issues in Western countries (i.e. United Kingdom) where little account has been taken to the needs and preferences of *Muslim* clients, especially with regards to those who wish to respect the *Shari'ah Islamic* law which prohibits interest-based transactions.

Meanwhile, although the IB can structure their *Islamic* contract, they may face difficulties in terms of enforcement of the agreement in court, which may require extra effort and cost

(Iqbal et al. 1998). Also, Iqbal et al. (1998) proposed that in order for the industry to allow *Islamic* institutions to operate according to *Islamic* rules and to encourage financial market for *Islamic* financial transactions, the industry needs law in terms of the *Islamic* banking law and laws concerned with financial intermediation. Furthermore, a uniform regulatory and legal framework supportive of an *Islamic* financial system is required and has not yet been developed (Iqbal 1997).

4.5 Impact of Islamic Banking and Finance Practices

As the contracts of products and services used in managing the sources and uses of funds are governed by *Shari'ah* principles, it is expected that the bank will forge a closer link between financial activities and real economic activities that creates value. Although its underlying principles is based on the religion of Islam (i.e. *Shari'ah* Law), the Islamic finance is an open system which possesses no regional, ethnic, or class affiliation and the IB is not allowed to create new risks to gain profit (Siddiqui 2001). Due to the differences in the nature of Islamic banks, the following subsections will discuss the effect of Islamic banking business on the performance of IBF and customers' preferences.

4.5.1 Performance of Islamic Banking and Finance

Although IBs can survive even within a conventional banking framework, they need to gain support from appropriate banking laws and regulations (Sarker 1999a). Furthermore, in order for IBs to become truly liquid and efficient, they must develop more standardised and universally (or at least widely) tradable financial instruments (Sarker 1999a). It is crucial for ICBs in Malaysia to operate at an efficient pace to ensure their competitiveness with the CCBs. If the factors that impede their efficiency level are not considered and improved by the management of the ICBs, it is probable that the ICBs will not be able to improve their

business and make full use of any opportunity that will come their way. ICBs should keep abreast of current technological developments that may affect their ability to move forward. In addition, ICBs should always prepare themselves to face challenges and to be more receptive to the changes in the economy with the lower level of efficiency that they possess. The most recent challenge that ICBs should be aware of is the issuance of new conditional licences under the IBA and Takaful Act to allow qualified local and foreign lenders, and even Takaful operators, to conduct the full range of Islamic banking and Takaful business in foreign currencies by the BNM.

The strategy to further liberalise the Islamic banking sector in Malaysia is to create more competition, to tap new growth opportunities, and to raise the efficiency of the Islamic banking industry as a whole (Majid et al. 2007). Islamic banks in Malaysia are now facing ever-increasing competition, particularly with the issuance of three new licences to three foreign-owned fully-fledged Islamic banks. The competition from conventional banks is also expected to further increase in the near future due to globalisation. Ahmad Mokhtar et al. (2008) found that the technical and cost efficiencies of Malaysian Islamic banks could be additionally improved. In this regard, a concerted effort is required from the management and policy makers to try to optimise the utilisation of scarce resources owned by the banking industries in Malaysia. The findings would also assist them to set directions for the improvement of Islamic banking operations in Malaysia. Finally, this study could open up a fruitful avenue for future research in the area of Islamic banking efficiency and competition in other Muslim countries. Action should be taken by the ICBs to enable them to operate at full efficiency levels to meet the challenges and tackle opportunities, and also to face the threats that hinder the ICB in performing efficiently and ensuring better performance in terms of efficiency.

Operational Performance (i.e. Efficiency) of Islamic Banking and Finance

The financial performance and operational performance of banking institutions are measured using a ratio analysis and economic measurement of the efficiency (i.e. the efficiency frontier), respectively. Generally, the efficiency measures using the efficiency frontier in the banking sector would imply increased profitability, greater amounts of funds intermediated, better prices and service quality for consumers and greater safety and soundness if some of the efficiency savings are applied towards improving a capital buffer that absorbs the risks (Berger et al. 1993, 221; as cited by Iqbal and Molyneux 2005).

Measuring the performance of Islamic banks would assist the banks to know what their achievements are relative to other banks. This will not only help individual banks (i.e. bank management) to improve their performance, but also serve as a signal to the depositors-investors, and regulators in making further related decisions or actions. The evaluation of bank performance is important for various parties such as depositors, bank managers and regulators. The interest in knowing about the performance of the banks will depend on individual needs. In a competitive financial market, bank performance provides a signal to depositors-investors whether to invest or withdraw funds from the bank (Samad and Hassan 1999; Iqbal and Molyneux 2005). In addition, improvements in cost (overall) efficiency will mean achieving higher profits and increasing the chances of survival in deregulated and competitive markets. Similarly, it signals a direction to bank managers whether to improve their deposit service or loan service or both in order to improve finances (Samad and Hassan 1999). The regulator is also interested in knowing the performance for regulatory purposes (Samad and Hassan 1999; Iqbal and Molyneux 2005).

In addition, there is a need for a continuous effort to develop and redefine its boundaries by providing better services and products, which is crucial (Qayum 1998). This is mainly due to the competition faced by the ICBs, as the Conventional Commercial Banks (CCBs) is so well established in terms of conventional banking practices and techniques, while an Islamic bank may be able to find only a small number of customers who want to abide by all the principles of the *Shari'ah* in their dealings with IBs (Meenai 1998). Thus, since its inception, various studies have been done to assess the efficiency of Islamic banks (Naughton and Shanmugan 1990; Samad and Hassan 1999; Samad 1999; Hassan 1999; Wilson 1995; Wong 1995; Amir and Azmi 2004; Rosly and Afandi 2003; Yahaya 2005; Mokhtar et al. 2008; Mohd-Zamil and Abdul-Rahman 2007; Sufian 2007; Saaid et al. 2003; El-Gamal and Inannoglu 2002; Okuda and Hashimoto 2004; Sarker 1999a; Yudistira 2003; Hamid and Ahmad 2001; Yahya et al. 2001)

Naughton and Shanmugan (1990) found that BIMB's share of total banking had risen at the end of its 4th year of operation, the six years of its operations overall witnessed a dramatic growth record achieved in terms of assets and deposits. In terms of profits and losses of the operations, while BIMB suffered a loss in the first year of operation, a profit was recorded every subsequent year (Naughton and Shanmugan 1990). In addition, Samad and Hassan (1999) found that BIMB made significant progress in profitability during the period of 1984-1997. They evaluated the profitability, liquidity, risk and solvency of the institutions for the period. They found that BIMB progressed significantly on ROA and ROE. Despite the liquidity performance being stagnant over the period, its risks increased from year to year. However, the improved profitability (PER) performance when compared with a conventional bank(s) showed that BIMB was lagging behind the conventional bank. These results are consistent with those of Samad (1999) and Hassan (1999).

The operations of the IB in Malaysia are similar in many ways to those of conventional banks and it can be considered to be a fully-fledged commercial bank with financing arranged in accordance with *Shari'ah* and a wide range of corporate and private customers (Naughton and Shanmugan 1990). According to Naughton and Shanmugan (1990), the loss suffered was due to the bad debts and financing which led to tighter internal controls. First, BIMB did not have a wide scope for investment in any stock or security because of religious constraints. It can only invest in *Shari'ah* approved projects. As the *Shari'ah* Board supervises bank investment, it cannot invest beyond the *Shari'ah* Board's approved investments even if it can earn a higher rate of returns. Secondly, investment in government bonds is a major source of earnings. The rate of return on government bonds is lower than on other types of investments. Thirdly, in order to provide the guarantee of depositors' deposits and trust (*amanah*), BIMB maintains more liquidity than the conventional banks. This is evident from the inter-bank comparison of liquidity ratio. Furthermore, Samad and Hassan (1999) found that the bank's maintenance of liquidity position remains unchanged between 1984-1989 and 1990-1997. However, inter-bank comparison of liquidity measures of performance among the group of eight banks and two individual banks provides no evidence either way. When the ratios of BIMB are compared to other conventional counterparts, it seems that there is no difference in performance in terms of ROA, ROE and economic participation. In addition, IBs are found to be statistically more liquid and less risky and solvent. In terms of the most liquid assets, i.e. cash, cash-deposit ratio, BIMB showed a better performance than Perwira Affin and is significantly at the 5% level. Despite a better performance, BIMB lags behind the group of eight banks (Samad and Hassan 1999).

Both Wilson (1995) and Wong (1995) studied the first 10 years of operations in Bank Islam Malaysia Berhad (BIMB). They found that BIMB had greater flexibility with respect to its liquid asset holdings than conventional banks. Although there was a close association between what was happening to the macro-economy and aggregate commercial bank deposits, Wilson (1995) and Wong (1995) found no correlation between macro-economic performance and that of BIMB. Furthermore, Wong (1995) found that liberalisation of the Base Lending Rate had partly contributed to the decrease in the growth of deposits. While the growth trend of the banking industry had moderated in the late 1980s, BIMB's trend is still showing a decline. In addition, BIMB had higher than average capital adequacy. Nevertheless, the achievement of BIMB is commendable.

Amir and Azmi (2004) examined the technical efficiency of BIMB from 1984 to 1995 using Stochastic Frontier Analysis (SFA). They found that BIMB performed below optimum level where the input element was not fully utilised as compared to deposits and capital. The operations of BIMB were greatly influenced by internal and external factors, such as improper allocation of input, changes in the economy and changes in monetary policy. In addition, in comparing the performance of Bank Islam Malaysia Berhad (BIMB) and IBS in Malaysia from 1996 to 1999, Hamid and Ahmad (2001) studied 9 commercial banks including Bank Islam Malaysia Berhad, using a cross-sectional regression analysis and ratio analysis. Hamid and Ahmad (2001) found that BIMB was not utilising the financing of its resources to generate more income towards strengthening shareholders' funds. It was also giving out small amounts of financing and investment in proportion to the total Islamic banking funds, total assets and total deposits (Hamid and Ahmad 2001). Furthermore, BIMB showed a dramatic *decline in profitability*, as measured by ROA and ROE, while on average, the Islamic banking counters of other banks were showing considerable growth (Hamid and

Ahmad 2001). Overall, the majority of BIMB's financing was in the form of long-term loans and it appears that the fully-fledged ICBs is not as strong and profitable as the conventional IBS (Hamid and Ahmad 2001).

Further attempts were made by Rosly and Afandi (2003) to measure the performance of IBS in Malaysia as compared to the mainstream banks. They used ratio analysis to measure performance and found that the high ROA for IBS does not reflect the efficient use of resources. This finding is further supported by lower asset utilisation and higher investment margin as compared to interest margin. Moreover, they explained that the higher profit margin ratio for Islamic Banking Systems (IBS) can be explained by overhead factors being funded by the mainstream banks.

Samad (1999) sought to determine the relative efficiency position, in terms of productivity and managerial efficiency of BIMB and 7 conventional banks of Malaysia from 1992 to 1996. Samad (1999) applied the weighted ratio approach to measure efficiency and ANOVA. Samad (1999) determined managerial efficiency by ROA and return on equity. He found that the managerial efficiency of conventional banks is higher than that of the IBs. In terms of the productivity efficiency test, the study showed mixed results. The average fund utilisation rate of Islamic banks was lower than the conventional banks. Furthermore, the profits earned by the Islamic banks, either through the use of deposit or loanable funds or used funds, were lower than the conventional banks. This reflects the weaker efficiency position of the Islamic banks compared to that of the conventional banks.

However, Samad (1999) used the profit maximisation test, loan recovery test and investment utilisation test to determine productive efficiency. In addition, the productivity test through

loan recovery signified that the efficiency position of the Islamic banks seemed to be higher than that of the conventional banks (Samad 1999). Furthermore, BIMB's bad debt as a percentage of equity, loans and deposits showed a clear superiority, although the view was not supported by ANOVA (Samad 1999).

Further research on the technical efficiency of banks that are listed in the Kuala Lumpur Stock Exchange (KLSE) 1st board from 1990-1997 was carried out by Yahaya (2005), who measured technical efficiency to examine the cost efficiency and to justify how productive banks are run in order to survive in a highly competitive environment. She used the stochastic econometric cost frontier. In association with the Malaysian banking environment, the technical efficiency tends to decline with total loans to assets, provision of loan loss to total loans and loan growth. The technical efficiency tends to increase with bank size and deposit to total assets. Her study revealed that the trend of banking technology improvements in Malaysia could be explained by falling technical efficiency closer to the cost frontier than before.

Mokhtar et al. (2008) measured the TE and CE of the fully-fledged Islamic banks as well as Islamic windows in Malaysia using the non-parametric frontier method, DEA. The samples in this study that were used are 2 fully-fledged Islamic banks, 20 Islamic windows and 20 conventional banks. They found that, on average, the efficiency of the overall Islamic banking industry has increased during the period from 1997 to 2003. The study also revealed that, although the fully-fledged Islamic banks were more efficient than the Islamic windows, they were still less efficient than the conventional banks. Finally, Islamic windows of the foreign banks were found to be more efficient than Islamic windows of the domestic banks (Mokhtar et al. 2008).

Sufian (2007) suggests that scale efficiency dominates the pure technical efficiency effects in determining Malaysian Islamic banks overall or technical efficiency. Sufian (2007) found that from 2001 to 2004, bank operating in Malaysia experienced diseconomies of scale. The results from both the Spearman and the Pearson correlation coefficients confirmed the dominant effect of scale efficiency over pure technical efficiency in determining Malaysian banks overall efficiency during the period of study. In addition, various accounting measures of bank performances were correlated with the efficiency scores derived from the DEA (Sufian 2007). He found that the overall efficiency was positively and significantly associated with all the accounting measures of performance. Furthermore, Sufian (2007) found that larger Malaysian Islamic banks tend to disburse more loans and were more efficient compared to its smaller counterparts. Market share had a positive and significant effect on Malaysian Islamic bank's efficiency, and more efficient banks tend to be more profitable.

Mohd-Zamil (2007) in his study made over the same period as Sufian (2007) found that both of the Islamic Commercial Banks (ICBs) in Malaysia were less efficient than the Conventional Commercial Banks (CCBs). This finding suggests that the managerial efficiency of the CCBs is higher than that of the ICBs. Among several factors contributing to the low managerial efficiency of ICBs in Malaysia as compared to the CCBs may be: the management structures of ICBs (Saaid et al. 2003), the capital structures of ICBs (Sarker 1999a), less expertise or unskilled labour in ICBs (Saaid et al. 2003) to improve the management in the process of mobilisation of inputs into outputs (i.e. inefficient use of resources) (Saaid et al. 2003; Amir and Azmi 2004; Hamid and Ahmad 2001; Yahya et al. 2001), less capability to develop attractive and innovative products and to market the products to the customers (Sarker 1999a), volume of operations of CCBs (Samad 2004), the

technological advancement of CCBs (El-Gamal and Inannoglu 2002; Okuda and Hashimoto 2004), networking created by CCBs, changes in economic conditions and policy (Amir and Azmi 2004) and government interference.

Evidence to date suggests that the sources of the inefficiency of BIMB and BMMB are technical inefficiency and scale inefficiency, respectively (Mohd-Zamil and Abdul-Rahman 2007). The technical inefficiency in BIMB is supported by Yudistira (2003), who found that the inefficiency of IBs, inside and outside the Middle East, was related to purely technical inefficiency rather than scale inefficiency. Furthermore, Mohd-Zamil and Abdul-Rahman (2007) suggests that the source of inefficiency in BIMB was mainly technical inefficiency (i.e. inefficient operations or management). Efficient operations and management refers to the ability of a particular financial institution (e.g. a bank) to manage its inputs (i.e. labour, capital and total deposits and loanable funds) and turn them into outputs (i.e. loans and advances). In other words, this would reflect on the managerial ability and expertise, and technological advancement of the banks.

As explained by previous studies, BIMB performs below its optimum level where the input element is not fully utilised (Amir and Azmi 2004). The operations of BIMB are highly influenced by internal and external factors, such as inappropriate allocation of input, changes in the economy and changes in monetary policy (Amir and Azmi 2004). This is further supported by Samad (1999) who found that the managerial efficiency of the conventional banks was higher than that of the IBs. In addition, in terms of the productivity efficiency test, Samad (1999) discovered that the average fund utilisation rate of Islamic banks was lower than that of the conventional banks. Moreover, profits earned by the Islamic banks, either through the use of deposits, loan funds, or used funds, are lower than those of the

conventional banks (Samad 1999). This reflects the weaker efficiency position of Islamic banks compared to that of conventional banks (Samad 1999).

Furthermore, Mohd-Zamil and Abdul-Rahman (2007) found that the technical efficiency of the BMMB under the assumption of constant return to scale is mainly attributed to the disadvantageous conditions of scale efficiency. This shows that the BMMB may have the potential to improve its efficiency by scaling-up its activities. Scaling-up its activities can refer to injecting more capital or increasing the amount of deposits by encouraging more depositors to deposit their money in the bank to increase investments made by the bank in profitable financing activities.

The evaluation of the performance of IBS should be measured by examining current banking activities. Treating the performance level as an early warning to improve its operations in order to ensure a better performance in the future. A number of studies have explored the efficiency of Islamic banks when operating their banking business activities, with various findings. Although, generally, it was found that IB experienced increased profitability year by year, in most countries it is still in the lower rank in terms of its relative efficiency. It is crucial for ICBs to operate at an efficiency level. If they are not considered and improved by the management of the ICBs, it is probable that they will not be able to improve their business and make full use of any opportunity that will come their way. ICBs should keep abreast of current technological developments that may affect their ability to move forward. In addition, they should always prepare themselves to face challenges and to be more receptive to changes in the economy with the lower level of efficiency that they possess. Internationally, the WTO agreement that allows member countries to open up their economies would result in direct competition between IB and the internationally well-established CB (Karbhari et al.

2004). Furthermore, there has been an increase in the number of international CBs that offer Islamic banking services or an Islamic window (Karbhari et al. 2004; Iqbal et al. 1998).

Therefore, the IBs should also equip themselves in view of the globalisation and financial liberalisation of the industry. In Malaysia, the most recent challenge that ICBs should be aware of is the issuance of new conditional licenses under the IBA and Takaful Act to allow qualified local and foreign lenders, and even Takaful operators, to conduct the full range of *Islamic* banking and Takaful business in foreign currencies by the BNM. This means that *Islamic* banks in Malaysia are now facing ever-increasing competition, particularly with the issuance of three new licences to three foreign fully-fledged *Islamic* banks. The competition from conventional banks is also expected to increase further in the near future due to globalisation (Mokhtar et al. 2008; Iqbal et al. 1998).

Inadequate technological progress, structure, capital and networking of the ICBs are likely to give the benefit of *Islamic* banking in foreign currencies to the CCBs. Financial liberalisation and technological advancement has brought about increased competition and greater innovation in the development of products and services, operational processes and delivery channels (Aziz 2006). Action should be taken by the ICBs to enable them to operate at full efficiency levels to meet the challenges and to take advantage of opportunities. They must face the threat that will hinder their ability to perform efficiently in order to ensure better performance in terms of efficiency. Mohd Ariffin (2005) asserts that IBs face challenges that are likely to affect the growth of IB within a more competitive environment. IBs are competing with their conventional counterparts to attract current and investment account holders, and more instruments are needed to attract more customers (Mohd Ariffin 2005; Iqbal et al. 1998). Furthermore, besides facing the competition and globalisation of the

industry, it should not be purely commercial, as the players should guarantee that the socioeconomic objectives of its establishment are also upheld. In addition, it is crucial for the operations of IBs to win the confidence of the clients to ensure that IB continues to develop and grow. The following section discusses and examines the factors influencing customers' preferences in the Islamic banking business.

4.5.2 Customer Perspectives on Patronising Islamic Banking

The existence of the Islamic banking system that upholds social and economic justice, and aims for equitable wealth and income distribution is expected by the public (i.e. *Muslims*) to prosper. Thus, it is crucial to measure the performance of the IBs in order to ensure that their operations are based on the Islamic principles and that they are operating at their competitive advantage.

Islamic banks are recognised as becoming an increasingly viable route for accessing finance in many countries around the globe. Despite the growth and development of IB that has been the priority of regulators and bankers, and research on performance that has drawn interest from various researchers, various factors may contribute to the customers' preferences when it comes to their choice of financing methods. Studies on customer's attitudes towards Islamic finance can be divided into the attitudes of individual customers, the attitudes of business firms and the attitudes of financial institutions. Although Islamic banks were established mainly due to a religious impetus, the factors involved in its patronage are not entirely due to religion. While some authors have found that religion may be an important motivation behind the selection of Islamic banks (Metwally 1997; Metawa and Almosawi 1998; Al-Sultan 1999; Hegazy 1995; Zainuddin et al. 2004; Naser et al. 1999), others found it to be an unimportant factor (Erol and El-Bdour 1989; Haron et al. 1994; Dar 2004; Erol et al.

1990). Also, there are studies that found that the motivation in selecting Islamic banks is due to both religious and economics reason (Ahmad and Haron 2002; Dusuki and Abdullah 2007b).

Various authors have found that the factors that will be taken into consideration in determining the attitudes, behaviour and patronage of bank customers are fast and efficient service (Erol and El-Bdour 1989; Haron et al. 1994; Metawa and Almosawi 1998; Gerrard and Cunningham 1997; Erol et al. 1990; Hegazy 1995; Al-Sultan 1999), the bank's reputation and image (Erol and El-Bdour 1989; Erol et al. 1990; Naser et al. 1999), confidentiality (Erol and El-Bdour 1989; Haron et al. 1994; Gerrard and Cunningham 1997; Erol et al. 1990), social responsibility (Hegazy 1995), profitability (Metawa and Almosawi 1998), cost (Metawa and Almosawi 1998), socioeconomics (Metwally 2002), and demographic characteristics (Metwally 2002).

In terms of the awareness of customers of Islamic banking products and services, Erol and El-Bdour (1989) found that the customers of Islamic banks in Jordan are aware of the Islamic banks and the methods used, based on information from relatives and friends. In addition, Zainuddin et al. (2004) found that spouses, friends and relatives affected the decision-making process of Islamic bank users. Haron et al. (1994) discovered that although Malaysian customers are aware of the existence of Islamic banks, they were uninformed about specific Islamic financing methods.

Despite the unique and distinctive bank-customer relationship offered by IBs, which is similar to a partnership in which the depositors are regarded as shareholders of the bank and shareholders of the investment project that are undertaken (Qayum 1998; Grais and Pellegrini

2006c), the financial intermediation processes in the CBs and IBs are basically the same . Metwally (1996) found that in patronising banking services, customers find that Islamic banks do not significantly differ from conventional banks in terms of benefits and costs of bank products and services. However, IBs are equal with CBs in terms of self-competency and speed of services (Metwally 1996).

Ahmad and Haron (2002) explore the perceptions of the people responsible for the financial affairs of public listed companies in Malaysia. Among the issues covered in this study were the usage of conventional and Islamic banking facilities, respondents' understanding of the Islamic banking system and their personal opinion of various aspects of Islamic banking products. Ahmad and Haron (2002) found that Islamic banking products were not popular among Malaysian corporate customers, as only 11 out of 45 respondents maintained a banking relationship under the Islamic banking system. In addition, although the respondents claimed that they had knowledge of Islamic banks, they showed a limited knowledge regarding Islamic banks. Furthermore, the true aspiration of establishing Islamic banks was not understood by the respondents as they were still of the view that the adoption of profit maximisation principles was crucial in ensuring the competitiveness of the Islamic banking business. Ahmad and Haron (2002) also asserted that religion and economics were the reasons why customers choose Islamic banks. Although the respondents perceived that IB products and services had the potential to be accepted by customers, the industry is still lacking in marketing activities when it comes to promoting their products and services (Ahmad and Haron 2002). The factors perceived as most important in the selection of the bank were the cost and benefit to the company, followed by service delivery (fast and efficient), size and reputation of the bank, convenience (location and ample parking), and friendliness of bank personnel.

Although the establishment of Islamic banks is based on religious impetus, research found mixed results regarding the religious factor as the main motivation behind the selection of Islamic banks. Other factors that are prevailing in the selection of IB are: fast and efficient services, the bank reputation and image, confidentiality, social responsibility, profitability, cost, socioeconomics, and demographic characteristics. Although there are awareness about IB's products and services, the customers are uninformed about the specific products. In addition, customers found that the services offered by IB were not significantly different from conventional banks' products and services. Thus, although the development of IB industry consist of various initiatives to encourage its competitiveness and stability, the existence and operation did not manage to draw the confidence of the public in subscribing to its Islamic banking business.

The clients' confidence is not only by ensuring that the *Islamic* banking industry's performance is able to allow its operation and growth, it is also to employ additional measures to guarantee that the operation and management are complying with the *Shari'ah* Law. By establishing that the IBs has *Shari'ah* compliance in all aspects of its operation and is commercially viable, would protect its stakeholders' interest and portray good reputation of IB, which in turn, will then create confidence among the customers and would attract more people to subscribe to IBs' products and services. IB should be able to communicate better with the public through its formal reporting channel. In addition, the following subsection will discuss the problems and challenges facing IBs

4.6 Problems and Challenges facing Islamic Banking and Finance

The problems of Islamic banking and finance are attributed to any issues that are difficult to deal with or to understand. The problems could be big, major or serious problems and it could be related to financial, practical, or technical problems. Financial problems are problems related to money and finance (i.e. financial services). Practical problems are related to real situations rather than ideas or theories. It could be related to practicality (i.e. usefulness) of implementing the Islamic banking products and services in the Islamic banks or practicality of operating the Islamic banking industry. Where practicality is concerned, it is related to the current state of the art of Islamic banks in achieving *maqasid al-Shari'ah* (i.e. objectives of Islamic/*Shari'ah* Law). According to Siddiqi (2006b), the issue of *maqasid al-Shari'ah* have not received due attention. The lack of attention could be due to an overriding concern in inventing or adapting new financial requirements legalistically (Siddiqi 2006b). Furthermore, the legal issues of Islamic finance did not go without any critiques. Technical problems are related to problems in: the practical use of accounting, finance and technology in the operations of Islamic banking and finance, skills needed in the operation of Islamic banking and finance, the understanding and application of *Shari'ah* law (i.e. the extent of understanding of the *Shari'ah* matters and the implementation of *Shari'ah* in Islamic banking products and services) and the details of a law or set of rules. The need of Islamic banks is rooted from the critiques of conventional banking systems that are based on interest. Also, there is a perception that the conventional system is not geared towards achieving the goals of *Shari'ah* (i.e. justice and fairness and general welfare of the people) (Siddiqi 2006). The challenges faced by Islamic banks are new and difficult tasks that test their ability to operate and uphold the Islamic *Shari'ah* principles and achieve the objectives of *Shari'ah*.

Furthermore, the expectations of stakeholders in the governance of IB as a financial institution that was established based on religious impetus, are to ensure its *Shari'ah* compliance and business performance. The fulfilment of these elements will lead to fulfilment of the objectives of *Shari'ah*. However, in the current IB's practices, researchers are highlighting various problems. In the financial market that is becoming more liberal and global, the banking institutions face higher competitions that result in various challenges confronting the IBF industry. Such research begins at the late 1990's.

The development of research on IBF comprises of various aspects of its establishment and practices. The growing stakeholder's interest towards its unique underlying features led to more researches in the area. In the field of *Islamic* banking that is still at its infancy, various fields of research are being explored. Most early researches explored the underlying theoretical principles of Islamic banking and finance and its socioeconomic objectives (Kahf 2006; Siddiqi 2006b; Chapra 1979; Chapra 1984, 1991). The validity and permissibility of the contracts and the different nature of products and services underlying Islamic banking operations are also being explored (Dusuki 2005). Also, researchers have delved into various scopes in the operations and corporate governance of *Islamic* banks.

Consequently, researchers started to show their interest in various areas of research and so the research of Islamic banking and finance began to emerge. Besides continuous studies on the development and growth of the Islamic banking institutions and Islamic finance, researches in this area started to explore the theoretical and practical aspects of *Shari'ah* compliance of its products and services (Aggarwal and Yousef 2000; Archer et al. 1998; Archer and Karim 2006; Bashir 1983; Chapra and Khan 2000; Chowdhury 1999; Karim and Ali 1989; Samad et al. 2005; Kahf and Khan 1992).

4.6.1 Problems on Islamic Banking and Finance

This subsection will review literature regarding the problems faced by Islamic banking and finance. The issues that will be discussed in this chapter are: inconsistency of *Shari'ah* interpretation, reliance of debt-based products, product innovation and development, human capital management, lack of training and research and development.

a. Inconsistency of *Shari'ah* Interpretation

The *Shari'ah* interpretations are the legal rulings applied in today's Islamic banking and finance, arrived at by using one or the other of four different techniques, namely: interpretations of the revealed sources (*ijtihad*), choice (*ikhtiyar*), necessity (*darura*), and artifice (*hila*) (Venardos 2005). The selections of one technique over another are used to obtain more *Fiqh* rulings (Venardos 2005). Different schools of thoughts would have different methods of interpreting the *Shari'ah* laws. Besides numerous techniques to derive the *Fiqh* rulings, the different interpretations may occur to accommodate *Shari'ah* principles to the existing legal system and custom of a particular country (Venardos 2005).

The inconsistency of *Shari'ah* interpretation given by the SSB related to principles governing products and services is due to the diversity of opinion as to whether particular practices or products are *Shari'ah* compliant (Ainley et al. 2007; Wilson 2007; Maniam et al. 2000). Variant *Shari'ah* advisory boards may differ over details such as the legal status of the rulings and internal supervision. The differences in the *Shari'ah* interpretation may involve numerous rulings on similar practices between SSB of different banks or SSB of different jurisdictions (Ainley et al. 2007; Mohd Ariffin 2005). This results in some products and services to be approved as being *Shari'ah* compliant by some *Shari'ah* scholars but not by

others (Ainley et al. 2007; Errico and Farahbaksh 1998). Furthermore, the issue of different interpretation of *Shari'ah* advisory board is also highlighted by (Dudley (1998) and Naughton (2000), cited in Gambling et al. 1993; Karim 2001; Iqbal 1997; Karbhari et al. 2004; Khan 2007; Iqbal et al. 1998; Chapra and Khan 2000; Kahf 1999; Maniam et al. 2000; Zaher and Hassan 2001).

The interpretation may differ over details such as the legal status of the rulings and internal supervision. In different jurisdictions, there are a lack of mutual recognition on the validity of respective rules, practices and underlying *Shari'ah* interpretation (Errico and Farahbaksh 1998). The current scenario of IB practice shows that IBs in Malaysia have different interpretations of *Shari'ah* rulings and product permissibility from the gulf countries. It was found that the Middle East is stricter with the interpretations of *Shari'ah* as compared to Malaysia (Mohd Ariffin 2005). Grais and Pellegrini (2006a) quoted from the proceedings of the Fourth Harvard University Forum on Islamic Finance that CIBAFI sampled about 6,000 fatwas and found that 90% were consistent across banks. Although the discrepancies in interpretations only occur to a certain concept, there are many issues which arise and result in contradictory practices because of differences in the interpretations of the application of *Shari'ah* principles (Banaga et al. 1994).

Also, inconsistency of *Shari'ah* interpretation is resulted from different fiqh rulings, regulatory systems and customs at a certain jurisdiction and problems and challenges in the application and implementation of products and services at a national and international level. According to Karbhari et al. (2004) the disadvantages of the difference in *Shari'ah* interpretation are time-consuming and costly and it construes what IB really is, and that hinders widespread acceptance. However, consolidating what occurs in different jurisdictions

always presents problems (Wilson 2007). Furthermore, it hinders rigorous product development and innovation and results in slow development of globally accepted financial products (Anonymous 2004), which leads to variations in the Islamic financial products offered. These differences prevent smooth progress and innovation in the creation of the Islamic financial product, hinders marketability of the Islamic banking products and services internationally towards the globalization of the industry and further affect the growth of the industry.

Besides facing difficulties in understanding the unique underlying principles of IB products, the differences in *Shari'ah* interpretation may raise doubts and confusion in the minds of clients at the national level (Iqbal et al. 1998). It is becoming more crucial due to the development of IB in one jurisdiction, in other jurisdictions and the wake of Western banks in Islamic banking (Iqbal et al. 1998; Karbhari et al. 2004). Consequently, it will lead to problems in integrating national markets with international markets of Islamic banks. Although the global growth of IBF's industry is taking advantage of the diversity and flexibility in *Shari'ah* opinions, it may soon become a constraining factor in the global growth of the industry if the challenges arising out of the use of diversity and flexibility in fiqh are not properly recognised and regulated (Khan 2007).

The differences in the interpretation of *Shari'ah* advisory board further challenged the standardization of products and services offered by the IBs (Wilson 2007). Though the infrastructure for standardizing the supervision and monitoring of the global expansion of the IFI is rapidly growing, institutional arrangements for a regulated use of diversity and flexibility in *Shari'ah* rules are still a missing link (Khan 2007). Institutional arrangements are needed to further prepare the industry to play a bigger role in the development of the

global economy and also to ensure the adherence to the very specific element that makes the industry an Islamic industry (Khan 2007). According to Grais and Pellegrini (2006c), in the effort to establish adequate consistency of interpretation and enhance the enforceability of contract before civil law, the *Islamic* banks will depend on internal and external arrangements that will emphasize the market discipline. Internal and external arrangements are put in place by IIFS to protect stakeholders' financial interests (Grais and Pellegrini 2006c). The standardisation of interpretations are expected to clarify the functions of Islamic banking and may assist in clearing the way for more coherent regulation, and better understanding and acceptance of Islamic banking as a serious competitor to conventional banking systems (Karbhari et al. 2004; Ainley et al. 2007).

On the other hand, Muslim and Zaidi (2008) reported that in regards to full and total harmonisation of *Shari'ah* standards, the *Shari'ah* scholars are in the view that the harmonisation would prevent the dynamism of *Shari'ah* law to ensure its suitability in applying the *ijtihad* procedures. Furthermore, since each religious board may have its preferences or adhere to a different school of thought (Iqbal and Mirakhor 1999), the harmonisation of *Shari'ah* rulings may mean the precedence of one school of thought over the other; which cannot be universally acceptable.

b. Reliance of debt-based products

Earlier chapters discussed various types of trade in Islamic banks. It can be classified into a contract of profit sharing (*Musyarakah* and *Mudharabah*) and contract of exchange. Contract of exchange involves exchanging goods for money (*Bay' al-Musawwamah*, *Murabahah*, *BBA*, *Istisna*, and *Salam*) and exchanging services for money (*Ijarah*, *Kafalah* and *Wakalah*). The ideal model of IB proposed that both sides of the balance sheet apply PLS model to

ensure that the industry would fully utilise the benefits that the IB system has to offer (Rosly 2005a; Qureshi 1991; Karsten 1983; Nawawi 1999; Haron 1997; El-Hawary et al. 2004; Iqbal et al. 1998; Haron 2000; Kahf 2005b; Ahmad 1994; Pramanik 1993; Sadeq 1990; Siddiqui 2001; Venardos 2005; Iqbal and Mirakhor 2011). Meanwhile, the macroeconomic implications of Islamic banking were still being worked out on the assumption that it would be largely based on profit sharing (Siddiqui 2006b). It was argued that financial intermediation based on profit sharing rather than lending will contribute to more efficiency and greater stability in the economic system in general, and the financial market in particular (Siddiqui 2006b).

Despite the establishment of Islamic banks promoting contracts based on profit and loss sharing, most Islamic banks, investment companies and investment funds across the globe resort to the second line fixed return techniques (i.e. Contract of exchange) including *murabahah* (cost-plus sale), *bai' bithaman 'ajil* (deferred payment sale), *bai' al-salam* (purchase with deferred delivery), *bai' al-istisna* (commissioned manufacturing), and *ijarah* (leasing) (Errico and Farahbaksh 1998; Aggarwal and Yousef 2000; Dar and Presley 2000; El-Hawary et al. 2004; Dusuki 2005; Samad et al. 2005; Rosly and Zaini 2008; Zaman and Movassaghi 2001; Satkunasingam and Shanmugam 2004). While many Islamic banks have made an early attempt to offer products based on PLS, they eventually converge to use products utilising debt and lease as the main models of operation (El-Gamal 1997). Proponents of Islamic banking argue that the profit-sharing contracts are superior financial instruments of debt for a variety of reasons, including the risk-sharing properties of equity (Ebrahim and Safadi 1995). In addition, advocates of Islamic banking such as Chapra (1992) and Siddiqui (1983) have argued that Islamic banks will promote growth in Islamic countries by providing long-term financing for a growth-oriented economy (Aggarwal and Yousef

2000). The shift away from profit and loss sharing (PLS) activities reflects the divergence of practice from theoretical principles (Errico and Farahbaksh 1998; El-Hawary et al. 2004). The degree of divergence varies from country to country, which results in different focus of banking supervision (Errico and Farahbaksh 1998).

The preference and popularity of mark-up instruments over PLS is contributed by various reasons. Islamic banks have a lack of comprehensive institutional infrastructure and support needed to direct it to behave in accordance with the theoretical framework (Errico and Farahbaksh 1998). The industry experiences a lack of legal and institutional framework to facilitate appropriate contracts, as well as mechanisms to enforce them; it also experiences a lack of appropriate products containing a broad range and a variety of maturity structures of financial intermediation (Iqbal and Mirakhor 1999). More regulations are required to support the innovation and development of products based on PLS. In addition, the need for well-defined property rights for efficient PLS function and fairer treatment in taxation, are considered to be a major obstacle in the use of PLS and secondary markets for trading in Islamic financial instruments; *Mudaraba* and *Musharaka* are particularly non-existent (Dar and Presley 2000).

Preference may also result from risk aversion in conducting asset allocations as well as vulnerability due to liquidity on the liability side. Consequently, this resulted in the dominance of asset portfolios of short-terms, low profit and safe trade related transactions limiting the funds that can be invested in longer-terms and more profitable but riskier assets. Severe competition from conventional banks and other financial institutions led the IBs to offer less risky modes of financing (Dar and Presley 2000; El-Hawary et al. 2004; Dusuki 2005; Iqbal and Molyneux 2005; Satkunasingam and Shanmugam 2004; Rosly and Zaini

2008; Sundararajan and Errico 2002; Venardos 2005; Lewis and Algaoud 2001) and priority of short-term project over long-term project (Lewis 2001; Iqbal and Mirakhor 1999; Dar and Presley 2000; Siddiqi 2006b; Chapra 1992; Hassan 1999; Siddiqi 1983; Aggarwal and Yousef 2000; El-Hawary et al. 2004; Kuran 1986).

Furthermore, the existence of the economies that are characterised by agency problems will be biased toward debt financing (Aggarwal and Yousef 2000; Iqbal and Mirakhor 1999; Mirakhor 1987; Kuran 1983; Satkunasingam and Shanmugam 2004; Lewis and Algaoud 2001; Samad and Hassan 1999; Hassan 1999; Samad et al. 2005; Dar and Presley 2000; El-Gamal 1997). As agency problems become more severe, debt becomes the dominant instrument of finance (Aggarwal and Yousef 2000). Although traditional finance literature shows that debt contracts are superior to equity contracts, equity contracts can be superior to debt contracts in an economy where informational asymmetries resulting from adverse selections and moral hazards are smaller (Hassan 1999). The abundance of short-term funds compared to long-term funds available for lending is a rational response on behalf of banks to solve informational asymmetries prevalent in the credit market (Hassan 1999). In addition, Iqbal and Mirakhor (1987) found that adverse selection can result in the use of debt-like instruments by *Islamic* banks. Informational asymmetry is due to inefficient markets resulting in costly delegated monitoring (Iqbal and Mirakhor 1999). Also, in the banking operation, the IB experience imbalance between management and control rights where restrictive roles of shareholders (investors) in management and the dichotomous financial structure of PLS contracts make them non-participatory in nature (Dar and Presley 2000).

Also, lack of PLS could be due to immense unresolved problems relating to Islamic banking services, especially *mudaraba* accounts (Satkunasingam and Shanmugam 2004). It is evident

that the equity principles (i.e. Profit-sharing basis) has yet to be operationalized and reflected on the return of *mudarabah* deposits and shareholder's funds (ROMD) and returned on bank capital (ROE) (Rosly and Zaini 2008). This is explained by the large discrepancy between ROMD and ROE which imply that *mudarabah* deposits have been treated in a similar fashion as fixed deposits, where banking risks are entirely borne by the bank's capital (Rosly and Zaini 2008). Rosly and Zaini (2008) opine that Islamic banking may not be able to find its competitive edge in profit sharing or commercial ventures as stipulated by the Qur'an under the pretext of *al-bay'*. The debt-based products and services that are being offered by the Islamic banks have gone through thorough discussions and deliberations in ensuring that the substance and form of the contracts are in compliance with the *Shari'ah*. Although debt-based instruments are widely in use, its acceptability under Islamic law is disputed because it can imply a fixed return on investment for the bank (Aggarwal and Yousef 2000; Rosly 2005a; Dusuki 2005). However, the debt-based instrument does not go without critics.

In a true BBA sale, the bank should purchase the house from the developer. Sale and Purchase Agreement (S&P) should take place between the bank and the developer. In this manner, the bank will hold the risk of ownership (*ghorm*) and hold their rights to earn profits from the sale (Rosly 2005a). However, a bank whether Islamic or otherwise, can only provide financing facilities and is not allowed purchasing and selling assets to earn money. The same applies to Islamic banking. Civil transactions require the customer to purchase the property from the developer. The Islamic Banking Act (IBA) of 1983 is a civil law and stays under the jurisdiction of civil courts. It embraces some *Shari'ah* values but not enough to overrun existing banking laws to reflect a genuine Islamic conception of sales (*al-bay'*)(Rosly 2005a).

The non-conformance of mark-up instruments is experienced through the fictitious dealings of banks that do not actually buy, possess, sell or deliver the goods as stipulated by the *Shari'ah* (Dusuki 2005). The contract is concluded through signing a number of legal documents of purchase, sale and transfer without actually dealing in goods or sharing any real risks (Dusuki 2005). In addition, the operationalization of the mark-up instruments have not fully conformed to the spirit of the *Shari'ah* (Rosly 2005a; Dusuki 2005) due to limitations in terms of legal and regulation in the process of concluding the contract. In most jurisdictions, IFI is still required to comply with the regulations governing conventional financing and to use accounting standards that may not fully adapt to the substance of their business activities (El-Hawary et al. 2004).

Also, this type of instrument gives rise to delinquency problems where late payment cannot be penalized, costly repossessions may occur and essentially fixed rate financing when finance companies apply high charges and fixed selling price are practised (Lewis and Algaoud 2001). Furthermore, due to the over dependency of the Islamic banks on fixed rate asset financing namely BBA, Islamic banks are exposed to potential interest rate risks (Rosly 1999; Yap and Kader 2008; Lewis and Algaoud 2001; Rosly 2005b). In addition, through the implementation of this instrument, the bank will be exposed to declining profit when market interest rates increase (since the return are fixed) and it will face pre-payment risks when market rates decline (Lewis and Algaoud 2001).

c. Products Innovation and Development

The above discussions highlighted the main issues raised from Islamic finance product development such as heavy reliance on the fixed mode of Islamic concepts, underutilisation of Islamic partnership concepts and the practice of legal advice and harmonisation of

Shari'ah opinions (Muda and Jalil 2007). As the IBF adopts the conventional bank's products and services by still maintaining the *Shari'ah* characteristics, the products and services are limited and confined to the development of conventional bank's products and services. The IBF's industry face financial engineering innovations in driving the global financial system toward greater economic efficiency by expanding the opportunities for sharing risks, lowering transaction costs and reducing asymmetric information and agency costs. Financial engineering involves the design, development and implementation of innovative financial instruments and processes as well as the formulation of creative solutions. Financial engineering may lead to a new consumer-type financial instrument, or a new security, or a new process or creative solution to corporate financial problems; such as the need to lower funding costs, manage risks better or increase the return on investments (Iqbal 2007; Iqbal et al. 1998).

d. Human capital management

Human capital is one of the most important resources which companies rely on to improve their efficacy and efficiency, and hence gain a competitive advantage (de Pablos 2003, as cited in El-Bannany 2008). In the *Islamic* banking and finance industry, there is a severe shortage of scholars with dual specialization; having simultaneous working knowledge of modern finance and *Shari'ah* (Iqbal et al. 1998; Maniam et al. 2000). Furthermore, in terms of safeguarding invested funds and realized profits, sufficient supply of trained banking staffs that are skilled in investment and *Islamic* banking practices are needed (Venardos 2005). Skilled human capitals are needed as *Islamic* banks are more dependent than conventional banks on the existence of an adequate and appropriate set of policies and infrastructure for portfolio diversification, monitoring and control (Venardos 2005). The skills and knowledge gap would cause delay or problems on certain functions of *Islamic* banks.

The problem is revealed in the application of Islamic finance in the Islamic banking industry. It lacks the technical staffs that are familiar with the system and have adequate knowledge to enhance the implementation of the moral and social values of the system (Maniam et al. 2000). Also, the human capital is inadequate in regards to knowledge and experience on the part of both management and personnel regarding *Islamic* banking, due to their experience in conventional banks which resulted in lack of creativity (Kahf 1999). Furthermore, since Islamic banks are forced to derive their employees from conventional banks, this causes problems in the performance, understanding of *Shari'ah* ruling and advising bank's customers on the characteristics of different types of new Islamic techniques of banking relationships and services, etc. (Kahf 1999). Although IB experience growth annually, the extent of innovation is still very little (Kahf 1999; Mohd Ariffin 2005).

e. Lack in Training and Research and Development

Since the human capital in IB is still lacking in its expertise in various aspects of its operationalization, further investment should be made in the respected area through education, training, research and development and sharing and exchange of information. In this regard, there is a need for *Islamic* financial players to intensify efforts in the training and development of expertise in the various specialised areas of *Islamic* finance. The existence of training in the human capital in *Islamic* finance is extremely important in order to have the people with the right kind of skills and commitment (Iqbal et al. 1998). According to Iqbal et al. (1998) training programs designed to overcome the scarcity of human capital is still lacking.

Kahf (1999) believes that the insufficient training for the personnel is further caused by the fact that (1) the process of establishing *Islamic* banks and their growth happens to be a lot faster than allowing them to adequately train their personnel and fully acquaint them with their new techniques, (2) IBs is forced to derive their employees from conventional banks, thus causing problems in the performance, understanding *Shari'ah* rulings and advising bank's customers on the characteristics of different types of new *Islamic* techniques of banking relationships and services etc., and (3) IBs are still new so they did not accumulate sufficient historical experience (Kahf 1999). In the case of Malaysia, there is a possibility that the IB's personnel are derived from conventional banks and the problem is becoming more serious for the personnel in the *Islamic* subsidiaries of the conventional banks. Although the personnel in the *Islamic* subsidiaries may work in *Islamic* banking schemes (i.e. *Islamic* window) before, there is a possibility of insufficient skills that may exist due to the extension of the business.

Furthermore, based on an interview by Safieddine (2009) in his study about *Islamic* financial institutions and corporate governance, he found that the *Islamic* financial institutions are aware of the need to institute good corporate governance in their institutions and most of them have proceeded to implement the good corporate governance. However, the interviewee pointed out that "the lack of training aimed at enlightening directors and executives on their roles in promoting corporate governance would prevent them from performing their responsibilities effectively." (Safieddine 2009). This shows that the lack of training in *Islamic* financial institutions is not only regarding the *Shari'ah* principles that relates to product innovation and development, ethics and behaviour and operations; training is also lacking in terms of CG as different characteristics and values are needed to really understand the corporate governance practices. In other words, an understanding on *Shari'ah* is needed to

gauge all scopes of the corporate governance in *Islamic* financial institutions, both general expertise and *Shari'ah* knowledge. According to Safieddine (2009), the lack of training is reflected on the lack of clarity, or at least, the lack of consistency in relation to the main roles of the BOD.

In Malaysia, various institutions and programs were established, such as: the *Islamic Banking and Finance Institute Malaysia (IBFIM)*, *International Centre for Education in Islamic Finance (INCEIF)*, *International Centre for Leadership in Finance (ICLIF)*, and *Financial Sector Talent Enrichment Programme (FSTEP)*, launched in January 2008. IBFIM, which is an industry-owned training institute, will now focus on providing technical programmes in *Islamic* finance. In the area of Abdul-Rahman (2008) highlights that the industry is still lacking in research and development in critical review of the current SSC practices; and to evaluate the sufficiency and the limitations of the present governance framework, research and development could also unfold other potentials to ensure that the development of the *Islamic* banks is at par with their conventional counterparts. However, the *Islamic* banks, neither individual nor as a group, spend enough amount on research and development (Iqbal et al. 1998; Mirakhor 1997). This resulted in a lack of opportunities to intermediate the funds from *Islamic* communities in *Islamic* permissible portfolios, which could open up opportunities for Western financial institutions to discover or offer this market niche. It also resulted in a lack of availability of authentic information (i.e. Consistent data series on the activities of *Islamic* banks for a reasonable number of years) accessible anywhere (Iqbal et al. 1998).f teaching, some universities in some *Muslim* countries, particularly Egypt, Saudi Arabia, Pakistan and Malaysia have initiated a few teaching programs to produce graduates with dual specialisation (Iqbal et al. 1998). In meeting the increasing manpower

requirements, institutions of higher learning and the *Islamic* banking and finance institutes have also initiated new programmes on *Islamic* finance.

4.7 Islamic Banking and Finance and Their Impact on Accounting

4.7.1 Accounting in Religious Organisations

Studying accounting in its organisational and social context demonstrate that accounting systems in a particular organisation are not a context-free technical phenomena (Abdul-Rahman and Goddard 1998; Laughlin 1988). Accounting in a particular organisation portray that its technical and more visible elements of accounting systems find their meaning and nature, in a dynamic interrelated way, with the social and historical context implicitly (Laughlin 1988).

Research on accounting and religion, or religious organisations that focus on church, are associated with the development of non-profit accounting research. It emphasizes on the lack of adequate financial and management accounting practices, the development of appropriate accounting principles and the standardization of practices to improve accountability to stakeholders (Booth 1993). It contributes to the development of research in the areas of accounting principles, accountability process and control in non-profit organisations. However, although there is considerable development of research in accounting and non-profit organisations, research related to accounting in religious organisations is still at an embryonic stage (Carmona and Ezzamel 2006).

Such researches emphasize on the organisations' activities between sacred and secular divide (Booth 1993; Laughlin 1988, 1990). Booth (1993) defines sacred as a main activity of the organisation where it supports the pursuit of spiritual activities over all others, while secular

or profane are secondary activities of the organisation; where support activities are needed. The division between sacred and secular is based on the influence of the religious belief system. In religious organisations, studies related to church highlight sacred activities as core activities, and supporting activities such as accounting are considered as secular (i.e. Profane) activities (Laughlin 1990, 1988). Furthermore, studies on religious organisations found that they are dynamic processes of resistance involving the sacred and secular. The dynamic processes relate to the interference of secular activities into the sacred domain (Booth 1993). Besides the sacred and secular divide in its organisational activities, Laughlin (1988) concludes two other factors to demonstrate the way the social context influences the technical practices of accounting in the Church of England (i.e. Religious organisation); that is, aligning accounting systems to achieve important tasks (i.e. Resourcing system) of the church (i.e. Religious organisation) and accountability. It aims towards maintaining the sacred and profane state of the Church through its accounting system and securing its own sustainability.

However, the separation between sacred and secular is not recognised in Islam (Karim 2001; Abdul-Rahman and Goddard 1998). The influence of religion in Islam is not only confined to spiritual acts but it encompasses all integrated aspects of life. In addition, the study by Abdul-Rahman and Goddard (1998) on two state religious councils in Malaysia, found that accounting systems are not perceived as separate from religious activities but are considered as one of the required support tools.

4.7.2 Accounting in the Islamic Perspective

The importance of accounting in Islam is being highlighted in the Quran in chapter Al-Baqarah, verse 282. The overall context of this verse provides explanation regarding *mu'amalah* (i.e. Business transactions). It provides a reminder to the believers that what they

do in this world will be accounted for in the hereafter. Overall, this particular verse can be categorised into three parts. The first part explains Allah's injunction towards debtors to write or record the amount of their debt. The second part explains the obligation to bring witnesses to ensure that what was recorded will be validated. In addition, the third part reminds the believers not to be wearied in writing and witnessing debt. The translation of the first part of the verse is as follows:

O you who believe! When you contract a debt for a fixed period, write it down. Let a scribe write it down in justice between you. Let not the scribe refuses to write as Allah has taught him, so let him write. Let him (the debtor) who incurs the liability dictate, and he must fear Allah, his Lord, and diminish not anything of what he owes. But if the debtor is of poor understanding, or weak, or is unable himself to dictate, then let his guardian dictate in justice.... (Al-Baqarah: 282)

On one hand, the need to bring forward witnesses as required in accordance with the verse portrays the importance of having a third party to validate the information and data recorded or written down. Also, there is a need to bring witnesses forward so as to avoid any injustice and to create justice, fairness and a prosperous life. In line with what has been revealed in the Qur'an, the existence of professional bodies is to ensure that in performing their duties and responsibilities, the accountant (i.e. Professional) upholds a certain standard of professional values, ethics and governance; guaranteeing that quality exists in the profession and is upheld by the professional.

On the other hand, the need to record a transaction is an important matter in accounting for the transaction. The debt is written as a proof of a certain transaction, which the debtors or the creditors are accountable or liable for the amount stipulated. Besides writing or recording the debt by the creditors or debtors themselves, they may call for a representative which we

can consider as accountants. The representative or accountant need to be a just, reliable and credible person who would justly manage those who do not know how to record or fall under the category of children, old people, etc. They should inform all the details of the debt, and the amount of debt written must be precise and exact. All the processes are written and informed on the reason of accountability to another man and the ultimate accountability to Allah.

This verse is an example that Islam is a religion that does not separate the sacred and secular. In the revelation (i.e. Qur'an), the focus was not solely on sacred issues such as *ibadah*, fasting and payment of *zakat* which relate to maintaining relationship with Allah, it went further to focus on how to maintain our relationship with human beings and the environment. This verse deals with the injunction to record any debt, the need to have witnesses when writing the debt and the reminder to the believers to not feel weary in writing down or recording the debt. These details are an example of the connection between our practices in this world (i.e. *Dunya*) to prepare ourselves for the Hereafter (i.e. *Akhirat*). Since the believers are accountable with support activities in the Hereafter, ensuring that profane activities are being performed correctly will result in a good life in the Hereafter.

In IB, it is different in nature than the religious organisations being classified. IB is financial institutions that are highly regulated by national and international regulations. It is a commercial organisation that is profit orientated. The core businesses are providing financing and investment opportunities to the public (i.e. Deficit unit and surplus unit). Religious elements or principles are anchoring the operations. Despite its underlying principles, commercial or business activities in IB are influenced by conventional systems. The ultimate objective is to achieve the *maqasid as-Shari'ah* (i.e. The objective of *Shari'ah*). Since the

operation of banking is well known and structured by the conventional system, the assimilation of products and services that are based on *Shari'ah* principles are found to be difficult as the products and services still carry the influence of conventional banking practices.

4.7.3 Accounting and Accountability

Functionalism, System Theory, Structuralism and Interpretive treat the relationship between subject and object and between individual and society as a “dualism” (Roberts and Scapens 1985). In place of this dualism, Giddens proposes a theory of “the duality of structure” in which the relationship between subject and object is described in dialectic form (Roberts and Scapens 1985). Giddens explained regarding “the duality of structure” as follows:

By the duality of structure I mean that the structural properties of social systems are both the medium and outcome of the practices that constitutes these systems (Giddens 1979, 69; cited in Roberts and Scapens 1985).

According to Roberts and Scapens (1985) Giddens’ framework is attractive in understanding the significance of accounting in the production and reproduction of organisational life through the centrality of the notion of practice and practices; and in particular, the analysis of the interdependent character of practices with the concepts of “system”³⁰ and “structure”³¹. System is categorised into social integration and system integration. Social integration is systemness at the level of face-to-face interactions and system integration is systemness at the level of relationship between groups’ collectivities. On the other hand, structure is categorised into speech and language. Speech is the element of action and interaction and it involves space and time, activity of subject and generated communication with others.

³⁰ Refer to the visible pattern or forms of interdependence in society.

³¹ Explain the continuity and spread (reproduction) of these particular forms of interdependence between individuals through time .

Language is structure or structural property that is a “virtual order” outside space and time and subjectless. Language, as a structure, only reproduces through being drawn upon in speech by subjects and is neither an intended product of any one subject nor oriented towards another.

Studies were conducted on the way in which accounting systems become embodied, through use, in organisational systems of accountability (Roberts and Scapens 1985). For example, one of the main objectives of accounting is to enhance accountability through providing a fair information flow between the accountant and the accountee (Lewis 2006). Furthermore, accounting in its organisational and social context demonstrate that an accounting system in a particular organisation is not a context-free technical phenomena, the technical and more visible elements of accounting systems find their meaning and nature in a dynamic interrelated way, with the social and historical context implicit in any particular organisation (Laughlin 1988). In addition, it is important to understand how accountability is actually exercised in practice concerning different situations (Laughlin 1990). Also, practices of accounting institutionalise the notion of accountability through the rights of some people to hold others into account for their actions; the reciprocal rights and obligations will be open to negotiation and to the differential of interpretation, and will involve the operation of relation of power (Roberts and Scapens 1985).

4.7.4 Accounting in Islamic Banking

Furthermore, according to Lewis and Algaoud (2001), although theoretically, there is a complete trust, the *Islamic* banking system needs a reliable accounting and a full exchange of information between the bank and the business. Various literatures emphasize on the existence of agency problems and the problems and challenges related to accounting, auditing

and financial reporting. Also, since shareholders have no access to the same information as the agent, they take on faith that the information that managers disclose to them is an accurate reflection of an underlying reality (Maurer 2005). Thus, there is a question of how far the element of trust can be relied upon, as various problems and challenges exist in accounting and auditing practices and financial reporting regulation. Unfortunately, it is difficult and costly to estimate the contribution of particular short term financing on the returns of a given business.

Accordingly, due to different underlying principles that govern the *Islamic* banking operation and products and services, *Islamic* banks experience different development or initiatives made by government, regulators, supervisors and efforts made by the standard setters. Among others, the differences that occur would relate to the regulatory framework (i.e. Including financial reporting regulations), bank governance and supervisory board. Furthermore, the *Islamic* banking operation would experience different implication towards accounting in *Islamic* banks as compared to its conventional banks (Napier 2007). The different implications in accounting practices in *Islamic* banks may consist of compliance with *Shari'ah* and international and national accounting standards, accounting measurement and valuation, accounting treatment, accounting information system and disclosure and transparency (El-Hawary et al. 2004).

As being explained earlier, Islamic banks possess different financial techniques as compared to conventional banks. Basically, there are six financing techniques that are *murabaha*, *mudaraba*, *musharaka*, *ijarah*, *istisna* and *salam*. In relation to the financing techniques, accounting treatment is being used to represent or portray substance and form of the transactions. It will then ensure the validity and permissibility of the contract. Askary and

Clark (1997) discuss the characteristics of *Islamic* accounting information as conformity with *Shari'ah*, relevance, understandability, materiality, faithful presentation and reliability. Each and every characteristic will include emphasis on upholding the *Shari'ah* compliance of the transactions (Haniffa and Hudaib 2007). Also, as it is fundamental to understand accounting in this context, the accounting operate explains the need for *Shari'ah*-compliant activities to demonstrate their compliance with *Shari'ah* requirements; this justifies a need for differential financial reporting (Nasir and Zainol 2005).

Thus, to meet the objective more disclosures are needed (Ismail and Latif 2001; Karim 2001) to enable the users to be informed on this matter. Every transaction in IBs has particular characteristics that assist in illustrating the application of accounting concepts (Napier 2007). The implication of accounting and financial reporting in the IB's practices is portrayed in terms of: reporting of investment accounts, allocation of administrative expense and revenue from other banking operations, distribution of profit between banks and IAHs, expense and revenue recognition of *murabaha* financing, agency problems of investment depositors and valuation of assets and liabilities related to PLS financing that relates to accounting measurement and valuation (Napier 2007; Ismail and Latif 2001). Besides portraying the *Shari'ah* principles underlying its contracts and transactions, accounting and reporting in the IB system should reflect their rights and obligations in order for users to properly assess the positions of the banks (Ismail and Latif 2001). Furthermore, the implication would comprise of information for the IB to report in order for users to assess the bank's risk exposure (Ismail and Latif 2001). Aligned with the development of *Islamic* banking and finance industry worldwide and its growing interest among banking industry in developed countries, accounting researcher starts to discuss the need of *Islamic* accounting to report the business activities of *Islamic* banks that are involved with underlying *Shari'ah* principles.

The functions of financial accounting will ensure the users of the accounts that business transactions are carried with proper authority and according to management's policy and directions (Benedict and Elliott 2008). In the operations of any institution including *Islamic* banks, accounting is an important element to communicate financial information about their financial activities to the users of the accounts. Due to its religious influence, *Islamic* banks are expected to communicate financial information in terms of financial performance and *Shari'ah* compliance of the financial transactions. The ability of *Islamic* banks to provide a sound understanding for the customers and the public in the workability and validity of the *Islamic* banking system as an interest-free financial intermediation is important (Chapra and Khan 2000). Furthermore, accounting treatment and reporting practices can be used to develop a system for (1) control, (2) performance and (3) accountability of the *Islamic* banks towards its stakeholders (Karim 2001).

Accounting for Islamic banking should not create any separation between sacred and secular (Abdul-Rahman 1998; Triyuwono 2004; Kamla 2009). The assimilation of Islamic knowledge in the accounting practices should reflect on an accounting system that creates and provides information that reflects on deeper social and ethical dimensions (Kamla et al. 2006). The role of financial reporting and accounting in IBs is intended to communicate the financial and non-financial information, social statistical systems and systems of monitoring and accountability towards internal and external stakeholders (Kamla et al. 2006). Although financial growth and efficiency are the main elements to evaluate the performance of banking institutions, it is important for the stakeholder to evaluate whether IBs are practicing in accordance with values that they advocate and met their religious and financial commitments. On one hand, in upholding the financial commitment it should contribute positively to social

justice and ensure that the sources of the deposits and profits come from fair and honest practices (Kamla 2009). On the other hand, the religious commitment is not only measured through the *Shari'ah* compliance of the overall operations, products and services, but it should be extended to the macroeconomics' impact from the banking business activities.

Accounting should enable the regulator, the auditor and the society to establish whether the organisation has contributed positively to social justice and whether its money and profits come from fair and honest practices. Also, it should be established and portrayed whether the bank has contributed to elevating its customers from poverty conditions or not. Internal accounts going beyond financial growth and efficiency could also provide the institution or the Islamic bank's management with information on whether they have met their religious, as well as, their financial commitments. External and internal accounting should be related to wider social accountability concepts, including details of the types of projects the banks are financing and their social and environmental impacts and assessments. Accounting that enhances organisations as well as society's appreciation of the organisational impact on the overall socioeconomic systems is more in-line with the knowledge and principle of Islam. The role of accounting regulatory bodies and of accountants can also be changed to embrace a more holistic approach.

a. Studies on accounting practices of Islamic banks

Since the governing principles of *Islamic* banks are closely related to religion, IB is considered as having an ethical identity (Haniffa and Hudaib 2007). As an ethical-funded institution, the stakeholders of *Islamic* banks need an assurance that a properly-constituted body of people are truly and visibly in command of their day-to-day operations and are reporting upon them fairly (Gambling et al. 1993). Due to different underlying principles

governing Islamic banks, the stakeholders would expect that the players will ensure that the operations of Islamic banks will adhere to the principles of *Shari'ah*. Besides adhering to its principles, ultimately, the operation of Islamic banks is expected to achieve the socioeconomic objectives (Abdul-Rahman 2003; Kasim et al. 2009).

Furthermore, Gambling et al. (1993) believes that the adequacy of those reports is entirely dependent upon the adequacy of their internal procedures, and the personal integrity of those who operate them. The information in the financial statement is important for (1) legitimacy and credibility, (2) control mechanism for shareholders, investors or depositors on how the management of the banks manages its fund, (3) monitoring mechanism for bank's management towards its entrepreneur and (4) for users of the information to access the performance and state-of-the-art of *Islamic* banks. Haniffa and Hudaib (2007) found that the disparity between communicating and ideal ethical identities of IBs is below average. The finding did not reflect upon the accountability and justice of the bank managers towards its society and, ultimately, to God (Haniffa and Hudaib 2007). Therefore, sufficient consideration should be given towards communication management, image and reputation for ethical and religious perspectives.

Thus, the accounting process supports the banking activities in providing appropriate information (i.e. financial and non-financial data) to stakeholders and giving assurance that the entity is continuously operating within the ambit of *Shari'ah* and is able to deliver its socioeconomic objectives (Kasim et al. 2009). Also, it is a means in communicating IB players' accountabilities to their stakeholders and, ultimately, to God (in respect of inter-human/environmental transactions) (Abdul-Rahman 2003; Kasim et al. 2009). Furthermore,

the adequacy of the report would be highly dependent upon its internal procedures and the integrity of the players (Gambling et al. 1993).

There are five distinctive features that differentiate *Islamic Banks* (IBs) from their competitors (conventional banks), they are (a) underlying philosophy and values; (b) provision of interest-free products and services; (c) restriction to *Islamically* acceptable deals; (d) focus on developmental and social goals; and (e) subjection to additional reviews by the *Shari'ah* Supervisory Board (SSB) (Haniffa and Hudaib 2007). Consequently, the general philosophy prevailing in society and the growth of business enterprise may be associated with the development of accounting (Taylor and Turley 1986). As institutions develop, it creates new classes of users of financial information, new categories of transactions and new accounting problems (Taylor and Turley 1986). The different underlying features of the IB's operations give different implications in accounting for Islamic banks, such as compliance towards *Shari'ah* law and regulatory framework, disclosure and transparency, accounting information system, accounting treatment and accounting measurement and valuation.

Moreover, Sundararajan and Errico (2002) proposed interrelated areas of disclosure requirements, such as investment objectives and policies including: concentration, types of securities, disclosure and monitoring of risk factors, good governance and internal controls, performance data and professional qualification and experience of management and senior staff. Haniffa and Hudaib (2007) expect IBs to communicate clearly in their annual reports the following:

- i. *commitments to operate within Shari'ah principles/ideals*
- ii. *commitments to provide returns within Shari'ah principles/ideals*
- iii. *commitments to engage in investment activities that comply with Shari'ah principles*

- iv. *commitments to engage in financing activities that comply with Shari'ah principles*
- v. *commitments to fulfil contractual relationships with various stakeholders via contract (uqud) statements*
- vi. *current and future directions in serving the needs of Muslim communities*
- vii. *statements of appreciation to stakeholders*

Also, the development of adequate instruments, markets and market infrastructure to support their operations is important as this will facilitate the risk management in IBs and enable the IBs to successfully compete with conventional banks in the global financial system (Sundararajan and Errico 2002). A study by Ariffin et al. (2007) found that the type of risks, the risk management, the asset quality and the compliance with *Shari'ah* requirements are the most important risk information required by Islamic bank supervisors to monitor the risk profile of Islamic banks. Furthermore, information that is not required by current financial reporting standards (IAS and AAOIF) which are required by the IB's supervisors, includes rating of the bank by a rating agency and the implementation of good governance (Ariffin et al. 2007).

Haniffa and Hudaib (2007) explored whether any discrepancy exists between the communicated (i.e. Information disclosed in the annual report) and ideal (i.e. Information deemed vital based on the *Islamic* ethical business framework) ethical identities. They measured it using the Ethical Identity Index (EII). The study using the longitudinal survey over a three year period (i.e. 2002—2004) on 7 IBs in the Arabian Gulf resulted in only one IB that was above average. The remaining 6 IBs were found to suffer from the disparity between the communicated and the ideal ethical identities. Furthermore, Haniffa and Hudaib (2007) found the largest incongruence to be related to four dimensions: commitments to society, disclosure of corporate vision and mission, contribution to and management of *Zakah*, charity and benevolent loans and information regarding top management. They

suggested that the results will have an important implication for communication management if IBs are to enhance their image and reputation in society, as well as to remain competitive. They argued that *Islamic* banks must not only remain truly *Islamic* but also to communicate this distinction more effectively, as a contrast to conventional bank products. Also, the findings may give implications on reflecting accountability and justice towards the society, and, ultimately, to God. Moreover, Iqbal et al. (1998) found that their attempt to collect statistical data relating to the main activities of Islamic banks and analyse it using various statistical techniques, cannot be done due to constraint by the quantity and quality of available data. In addition, Brown and Skully (2007) found that there is a lack of consistency and quality of the industry's financial statement where specific Islamic reporting data was not available from Turkish banks.

There are reasonably well articulated thoughts on how the principles of Islam would be applied in order to generate a practical system of financial reporting (Napier 2009). It results in considerable growth of contemporary literature of accounting in Islamic financial institutions. Although the literature offers extensive prescription for financial and management accounting, consistent with *Shari'ah* principles, it gives less impact on the principles in practice due to the domination of western accounting norms (Napier 2009).

b. Accounting Standards

Differences in the underlying principles of Islamic banks had resulted in differences between balance sheet structures of Islamic and conventional banks (El-Hawary et al. 2004) and the unique features of Islamic financial contracts have important implications for accounting and financial reporting. Ibrahim and Yaya (2005) further highlight the consideration of *Islamic* ethical principles in developing accounting in for IB and ensuring that the socio economics

objective is included. Thus, by producing accounts based on the accounting standards that are being established and by considering the unique characteristics of IBs, the information will correspond as more or less true to the economic reality of the organisation (i.e. in this case IBs) upon which the accounts were based (Laughlin and Puxty 1983). It creates growing concerns for the need to have a set of financial reporting standards to facilitate Islamic banks in the preparation of financial statements (Ismail and Latif 2001; El-Din 2004). Three main differences between Financial Accounting Standards (FAS) developed for Islamic banks and conventional accounting framework are the treatment of Investment accounts, concept of substance over form and the time value of money that are further explain as in the table below;

Table 4.7.1 Main Differences between FAS developed for Islamic banks and conventional banks (extracted from Venardos 2005)

	Islamic Accounting Framework	Conventional Accounting Framework
The Treatment of Investment Accounts	<p>Restricted Investment Accounts (RIA)-do not qualify for inclusion in Balance Sheet</p> <p>-Investment restrictions on the Islamic Banks</p> <p>Unrestricted Investment Accounts (URIA)-permits the IBs to commingle its own assets with that of URIA unconditionally and without restrictions-assets to be reflected on the Balance Sheet of an Islamic banks</p>	<p>Assets of URIA would not qualify for recognition as asset of the bank because the economic benefits embodied in those assets flow to holder of URIA and not the bank</p>
Concept of substance over form	<p>One of the of the fundamental qualitative characteristics of accounting information under conventional accounting but the distinction is not recognised by FAS</p>	<p>Accounting for items according to their substance and economic reality and merely their legal form is one of the key determinants of reliable information</p> <p>-In some instances these two diverge and choosing how to present these transactions can lead to different result</p>

	Islamic Accounting Framework	Conventional Accounting Framework
		-Different arise when an asset and liability is not recognised in the accounts, through benefits or obligations may result from the transaction
The time value of money	In <i>Shari'ah</i> money is not commodity. Therefore, does not have a time value Net Present Value (NPV) not admissible as an acceptable basis of measurement under FAS-which recognises only the historical cost basis and the cash equivalent basis for impaired asset	NPV is a way of comparing the value of money now with the value of money in the future NPV as an acceptable basis of measurement-FASB and IAS are increasingly moving towards a fair value basis of measurement and encourage the use of NPV as a unit of measurement when market value is not readily available

Furthermore, various researches highlighted that an appropriate regulatory framework governing Islamic banks need to place greater emphasis on the management of operational risk information (Errico and Farahbaksh 1998), disclosure issues and information disclosure (Archer et al. 1998; Errico and Farahbaksh 1998) which is normally the case in conventional banking. In marking themselves in the global financial markets, IBs are required to prepare financial statement in accordance to international accounting and financial standardisation (Ratna 2011).

Accounting standards prepared especially for *Islamic* banks will provide better accounting practices that are in-line with *Islamic* financial products (Hassan and Dicle 2005). Well-defined principles and standards are crucial for ensuring efficient resource allocation, information disclosure, building investor's confidence, monitoring and surveillance (Zaher and Hassan 2001; Ismail and Latif 2001; Iqbal 1997). Besides enhancing user's confidence in the information of the Islamic bank's financial statement and thus ensuring efficient resource allocation, it should also reflect on the precepts of the *Shari'ah* (Ismail and Latif 2001; El-

Din 2004; Ariffin et al. 2007). The accounting standards are aimed at narrowing but not eliminating the area of difference in accounting practices (Perks 1993). It provides a uniform application of rules and produce results, which would not be biased by the objective of only one group of users (Iqbal and Molyneux 2005). Thus, it will improve comparability and contribute to harmonisation of accounting standards between institutions and countries (Perks 1993; Solé 2007; Iqbal et al. 1998; Iqbal 1997; Hassan and Dicle 2005; Errico and Farahbaksh 1998). Furthermore, proper standards will help the integration of Islamic financial markets with international markets (Iqbal 2007; Dudley 1998; Naughton 2000; extracted by Zaher and Hassan 2001).

IB has to seek the most appropriate means through which accounting standards could be developed and implemented in order to present adequate, reliable, and relevant information to financial statement users (Ariffin et al. 2007; Iqbal et al. 1998). Iqbal et al. (1998) proposed that the IB should disclose most essential information, such as the exact way of calculating the share of profit of different types of deposit holders that is to be made public, details of the use of funds by the banks that are not declared and other various aspects of activities. Lack of transparency in financial reporting resulted in competition with CB to attract funds, a slow pace of innovation, exposing investors to many risks and hazards that lead to financial panics and withdrawal from the IAH and problems of moral hazard and adverse selection in financial markets (Ariffin et al. 2007).

Thus, the disclosure and transparency of accounting and auditing play a crucial role (El-Hawary et al. 2004; Ariffin et al. 2007; Mohd Ariffin 2005; Al-Omar and Abdel-Haq 1996; El-Din 2004; Iqbal et al. 1998; Solomon 2007). This is due to the fact that it is essential that all parties should have full access and information to their transactions, covered by

agreements (Ariffin et al. 2007). In addition, it provides an assessment of the degree of risks associated with participation. Regulation should be underlied by measurement and comparison of risk exposure (El-Hawary et al. 2007). The increasing need of transparency in financial investments and statements of the bank called for the regulators to regulate and standardize regulation. However, disclosure of accounting results may not be an adequate instrument for risk assessment because, as a structure, accounting is directed toward value, not risk allocation (Merton 1995, cited in El-Hawary et al. 2004). This situation gives additional importance to other services, such as the allocation and dissemination of financially relevant information and credit rating (El-Hawary et al. 2004). In addition, it also raises the need for committee (i.e. IIRA, IFSP and LMC) to regulate and standardize regulations in order to make investing more attractive to creditors.

Errico and Farahbaksh (1998) discussed legal foundations, management of operational risk, information disclosure and licensing procedures; they highlighted that an appropriate regulatory framework governing IBs need to place greater emphasis on the management of operational risks and information disclosure issues that is normally the case in conventional banking. Furthermore, Karim (2001), Archer et al. (1998) and Errico and Farahbaksh (1998) examined the issues related to regulation and supervision of IFI. They are in view that appropriate regulatory framework need to place greater emphasis on accounting standards and information disclosure. Also, there is a growing concern for the need to have a set of financial reporting standards to facilitate IB's in the preparation of financial statements (Ismail and Latif 2001). Also, the increasing need of transparency in financial investments and statements of the banks is a challenge facing IBs. The present environment of the IBs operation leads to erroneous corporate governance affecting market psychology where IBs must adopt accountability, transparency and efficiency. In referring to transparency, the

present situation of IBs leaves a lot to be desired (Iqbal et al. 1998) such as knowing most essential information, as in the exact way of calculating the share of profit of different types of deposit holders to be made public; details of the use of funds by the banks are not declared and various aspects of the activities of the IBs will increase the confidence of clients and will help avoid panics.

1. Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)

Financial Accounting Organisation for Islamic Banks and Financial Institutions (FAOIBFI) was registered in March 1991 in Bahrain as an international autonomous non-profit making corporate body. The *Islamic Development Bank (IDB)* established FAOIBFI as a private standard-setting body to address the issues related to accounting in Islamic finance (Karim 2001, 1995; Al-Omar and Abdel-Haq 1996). Later, FAOIBFI was known as Accounting and Auditing Organisation for *Islamic* Financial Institutions (AAOIFI) when auditing standards are added. The organisation is composed of a Financial Accounting Standard Board and a supervisory committee. The Financial Accounting Standard Board is responsible for setting accounting standards and consists of unpaid part-time members representing Islamic banks, users of financial statement of these banks, practicing accountants, academics, *Shari'ah* scholars and regulatory bodies. Supervisory committee responsible for fund raising are represented by same categories as the Financial Accounting Standards Board.

The objective of the organisation is to prepare and develop accounting, auditing, governance and ethical standards relating to the activities of *Islamic* financial institutions, taking into consideration international standards and practices, and the need to comply with *Shari'ah* rules (Karim 2001). Also, AAOIFI was established to introduce standardization in the accounting practices of *Islamic* financial institutions (Iqbal et al. 1998; Solé 2007; Al-Omar

and Abdel-Haq 1996). In addition, appropriate accounting standards have also been put in place to reflect the true and fair value of banking operations that would lead to greater accountability and responsibility on the part of financial institutions (Aziz 2004b).

The need arises due to the nature of *Islamic* financial transactions as an important foundation to enhance the reliability, consistency and clarity of financial reporting by *Islamic* financial institutions, which would also enhance investor confidence in *Islamic* finance³² (Al-Omar and Abdel-Haq 1996). Karim (2001) and Gambling et al. (1993) see two main reasons that motivate the *Islamic* banks to mandate their accounting policies. The first reason is due to the fear that the national regulatory agencies, in which *Islamic* banks operate, may interfere to regulate the financial reporting of these institutions. The second reason is to allow an appropriate degree of comparability between these banks. Also, AAOIFI takes steps to cast light on the need to develop and implement actions that specifically cater to the unique characteristics of the contracts that govern the operations of these banks.

The AAOIFI has made an important regulatory debut. It seeks to support the faith of Islam by developing accounting standards for *Islamic* investment vehicles and by conducting related training and publicity. Also, it expects to strengthen the effectiveness of *Shari'ah* committees by facilitating evaluation of emerging financing instruments and by aiding in the implementation of *Islamic* ethics (Pomeranz 1997). By the end of 2012, AAOIFI has issued 26 financial accounting standards, five auditing standards, seven governance standards and two codes of ethics. It has also issued a Statement on the Purpose and Calculation of the Capital Adequacy Ratio for *Islamic* Banks. AAOIFI also takes part in efforts to achieve harmonization with the concepts and applications among the different *Shari'ah* supervisory

³² Report of the *Islamic* Capital Market Task Force of the International Organisation of Securities Commissions (July 2004).

boards of *Islamic* financial institutions in different jurisdictions through the preparation, issuance and interpretation of *Shari'ah* standards for *Islamic* financial institutions. In this respect, AAOIFI has successfully issued 45 *Shari'ah* standards by the end of 2012, including standards for *istisna'* and parallel *istisna'*, *musharakah*, *mudharabah*, *salam*, *ijarah* and *murabahah*. The list of the standards issued by AAOIFI can be referred to in the Appendix.

Since AAOIFI is based on the *Shari'ah*, the code of ethics that was stipulated in the standard is not just limited to performing jobs to meet with users' requirements, but also in performing the accountant's responsibility and accountability to God as a vicegerent on earth. The ethical accounting is important in the process of performing a profession as an accountant. Referring to that, the standards of accounting that exist today, without fail, did include the code of ethics in this profession. Besides the conventional accounting standard, AAOIFI mentioned ethics in its standard on Code of Ethics for Accountants and Auditors of *Islamic* Financial Institution. The code of ethics in AAOIFI was divided into three sections. The first section describes the *Shari'ah* foundations into seven basic foundations: integrity, vicegerency, sincerity, piety, righteousness, Allah fearing conduct and accountability. From these basic foundations, the standard further developed six ethical principles: trustworthiness, legitimacy, objectivity, professional competence and diligence, faith driven conduct and professional conduct and technical standard. AAOIFI then further elaborated on the rules of ethical conduct based on the six basic principles. The ethical accounting is important in the process of performing a profession as an accountant. Referring to that, the standards of accounting that exist today without failed did include the code of ethics in this profession. Besides the conventional accounting standard, AAOIFI mentioned about ethics in its standard on Code of Ethics for Accountants and Auditors of *Islamic* Financial Institution.

AAOIFI also works towards persuading regulatory authorities to adopt its standards. AAOIFI's standards are currently mandatory in Bahrain, Sudan, Jordan and Qatar. They are also being implemented as guidelines by the Monetary Agency of Saudi Arabia and are being used as the basis on which the Malaysia Accounting Standards Board (MASB) develops its domestic Islamic accounting standards. The implementation of the standards is aimed to (1) render the financial statements of Islamic banks comparable and transparent (Karim 2001; Solé 2007) and (2) provide relevant and reliable information to user of financial statements of Islamic banks (Karim 2001). In addition, there is growing need for a body of accounting standards purposely designed to cater the specificities of Islamic products (Solé 2007) that are being introduced through financial innovation.

Mohamed Ibrahim (2007) believes that there are two reasons for the need of a different set of standards for Islamic financial institutions. The first reason is due to the fact that the IFIs are not based on the conventional worldview, which underlies the current International Financial Reporting Standards (IFRS) (Mohamed Ibrahim 2007). In contrary to the conventional banks that are based on a decision usefulness framework, Islamic accounting is based on accountability and a *Shari'ah* compliance framework, which seeks to:

“Determine the rights and obligations of all interested parties, including those rights and obligations resulting from incomplete transactions and other events, in accordance with the principles of the Islamic Shari'a and its concepts of fairness, charity and compliance with Islamic business values.”
(AAOIFI, SFA 1)

Mohamed Ibrahim (2007) suggests that Islamic accounting did not abandon the objective of financial accounting in providing useful information to the users of its report. However, in Islamic accounting, useful information is provided to enable the users to make legitimate

decisions in banking business, such as having a contract to buy, sell or hold decisions to increase their wealth (Mohamed Ibrahim 2007). Secondly, different standards are needed due to different underlying principles that lead to different functions of the contracts used by the Islamic financial institutions (Mohamed Ibrahim 2007; Zaher and Hassan 2001; Solé 2007; El-Din 2004). Furthermore, IBs motivated to mandate their accounting policies because of the fear that the national regulatory agencies, in which IBs operate, may interfere in regulating the financial reporting of these institutions and to allow an appropriate degree of comparability between these banks (Karim 1990b, 2001; Iqbal et al. 1998). The decision to regulate IB's financial reporting is further due to arguments that are in support of the disclosure of regulations because of market failure and the development of accounting standards, which would be perceived by potential investors as a sign of an industry in the process of becoming mature (Karim 1990b).

AAOIFI is making much-needed progress in both developing and promoting financial reporting and auditing standards that specifically aim to enhance standardization across *Islamic* financial institutions worldwide (Karbhari et al. 2004). However, although it is expected that this set of standards will regulate the financial reporting of *Islamic* banks and financial institutions (Karim 2001), it would seem that the AAOIFI has, at present, insufficient legal backing and compliance to enforce its standards; since they are entirely voluntary (Ismail and Latif 2001; Karbhari et al. 2004; Iqbal et al. 1998). Thus, the establishment of such standards cannot guarantee that all the *Islamic* banks and financial institutions will adhere to it and hardly any perceptible change in the accounting practices of *Islamic* bank was observed (Iqbal et al. 1998). The compliance to the self-regulatory standards depends on the acceptance of the rules proposed by the self-regulatory body and by the regulators. Thus, the effectiveness of self-regulation would depend on consensus between

the self-regulatory body and the regulators (Archer et al. 1998; Karim 2001). In the real practice, the latter seems to withhold if the former is too demanding (Archer et al. 1998). It prevails over the regulation by government or public sector bodies which enforcement powers may play an important role (Archer et al. 1998). In order to ensure that the establishment of AAOIFI would gain support, the standard-setters need to convince the regulatory agencies on the need of IB to have accounting standards different from those implemented in their country, and accordingly, to allow the existence of dual accounting standards (Karim 2001).

Furthermore, IB is expected to work very closely with the national banking regulators where the *Islamic* bank operates, in order to gain their support in encouraging the management of the banks to implement the standards (Gambling et al. 1993; Karim 2001). The central bank can ensure that the *Islamic* banks follow the guidelines set by them and recommend some measures to improve their performance (Mohd Ariffin 2005). Karim (2001) categorized the approaches into three groups, they are: countries that enacted Islamic banking in their laws, countries that have not enacted laws to regulate IBs and the IBs operate within the law that govern all the banks in these countries and countries that have not enacted an Islamic banking law, but subjected IBs to their fiduciary law. The supervision of IBs is done by the central banks, except for some countries (e.g. Kuwait) where the Ministry of Commerce supervises the Islamic bank in the country. AAOIFI's standards are currently mandatory in Bahrain, Sudan, Jordan and Qatar. They are also being implemented as guidelines by the Monetary Agency of Saudi Arabia and are being used as the basis on which the Malaysia Accounting Standards Board (MASB) develops its domestic *Islamic* accounting standards. Furthermore, lack of understanding of the unique characteristics of IBs seems to be reflected on the approaches taken by supervisory authorities to regulate IBs (Karim 2001).

The implementation of accounting standards of Islamic banks will depend on the statutory act and regulators. Currently, countries offering Islamic banking and finance prefer custom-made products and services that conform to the approval of its SSB. SSB's approval will take into consideration *Shari'ah* compliance, compliance with national and international legal and regulatory frameworks relevant to banking institutions and customs. Specific standards for the Islamic finance industry that play a crucial role in the development and growth of the industry would provide the common basis for *Shari'ah* compliance, facilitate Islamic financial institutions in ensuring that their products and services are fully *Shari'ah* compliant, institutionalize necessary components of the *Shari'ah* compliance and supervision processes, promote harmonization of Islamic finance practices across the world, provide tools for comparing financial performance of Islamic financial institutions across the world and assisting users of IB's financial statement in making informed decisions regarding their dealings with Islamic financial institutions.

Low implementation of AAOIFI's standards portrays lack of appreciation by the relevant agencies that are responsible for enforcing accounting standards for the benefits that can be gained by implementing AAOIFI standards; rendering the financial statement of IBs comparable and transparent and providing relevant and reliable information to users of financial statements of IBs (Karim 2001). Furthermore, the industry face a lack of consistency in the accounting treatment of various *Islamic* banking operations and require more effort and support from regulators, standard-setting bodies and central banks (Mohd Ariffin 2005; Karim 2001; Karbhari et al. 2004; Brown and Skully 2007). The *Islamic* banks faced dissimilarities of accounting practices among other *Islamic* banks, resulting in difficulties in making meaningful comparisons between their balance sheets or profit and loss

(Iqbal et al. 1998). Also, the concepts used in balance sheets or profit and loss statements are not rigorously defined (Iqbal et al. 1998). Thus, a further challenge faced by the industry is to develop a uniform regulatory environment and legal framework; which are still yet to be developed (Mohd Ariffin 2005; Karim 2001; Sundararajan and Errico 2002). Such development will support the global financial stability, conducive to effective prudential supervision of IFI in their home countries and also facilitate and sustain international expansion of *Islamic* banking (Sundararajan and Errico 2002). Furthermore, the development will assist the integration of *Islamic* markets with international markets

Present situation of IBs leaves a lot to be desired, as the industry faces major challenges to achieve financial transparency and enhance quality of financial services to the society (El-Din 2004). Information provided for the depositors and investors are important in lending confidence towards related services and financial returns, and to maintain capital at a level sufficient for solvency purposes that would allow them to make a better and accurate decision (Ariffin et al. 2007).

4.8 Islamic Banking and Finance and Their Impact on Auditing

The *Shari'ah* auditing practices stem from the increasing demand of stakeholders that require assurance of *Shari'ah* compliance and accountability (Abdul-Rahman 2008). Compliance with the operation of Islamic banks consists of product compliance, transactions, implementations, contracts, and documentation executions and determination of income (Besar et al. 2009). While accounting system is controlled by the management, the independence audit is an act on behalf of its shareholders, depositors investors and other stakeholders (Archer et al. 1998). It is a mechanism that allows regulators to monitor, control and take action on any IFI if they do not meet the *Shari'ah* (Abdul-Rahman 2008). In

addition to the mechanism, every regulatory structure needs to have adequate enforcement power to ensure that necessary actions can be taken in the event of violation of *Shari'ah* (Abdul-Rahman 2008). Currently, it relies on the internal corporate structure to ensure *Shari'ah* compliance (Abdul-Rahman 2008).

Furthermore, the internal review unit may be entrusted to review transactions (Grais and Pellegrini 2006c). SSBs form one of the internal control processes by which Islamic banks assure users of their financial reporting that the transactions conducted by the bank and the accounting practices do not breach the *Shari'ah* injunctions (Karim 2001, 1990a; Aziz 2006). During the ex-ante auditing, the auditor certifies permissible financial instruments through fatwas, while the ex-post auditing will involve verifying that transactions comply with issued fatwas (Grais and Pellegrini 2006c). It involves the role of the religious auditor advising the BOD and the MD of the enterprise's operations, contracts, and procedures to guarantee its *Shari'ah* compliance (Abdul-Rahman 1998). As previously mentioned, the ex-post auditing will involve verifying that transactions comply with issued fatwas (Grais and Pellegrini 2006c). It also checks that the executive management's compliance with Islamic principles conform with the advice which it has been given (Abdul-Rahman 1998).

The internal review unit will collaborate with external auditors to issue opinions on whether the institutions' activities meet *Shari'ah* requirements (Karim 1995; Archer et al. 1998; Grais and Pellegrini 2006c). The religious report is classified into two, (Briston and El-Ashker 1986, cited in Abdul-Rahman 1998) they are the direct form and the indirect form. The direct form is a religious auditor's report indicating their access towards all financial records and documents which deemed necessary in examining his auditing duties (Abdul-Rahman 1998). The indirect form involves forwarding the religious auditor's report to the financial auditor

who will accordingly testify on the *Shari'ah* compliance of the company (Abdul-Rahman 1998).

The opinion will be presented in a report to inform users of the financial statements and whether or not the banks have adhered to the Islamic principles (Karim 1995; Archer et al. 1998). In addition, SSB has more powers and rights; their authority is equal to that of the external auditors. They specify the precepts which must be followed by the banks in all its financial transactions involved in accounting policy pursued by the bank, and issue a special report which is published with the external auditor's annual report (Karim 1990b). However, the role of SSB is not as clearly defined as that of the external auditors (Banaga et al. 1994). Moreover, these processes will be supported by rating agencies, stock markets, financial media and researchers (Grais and Pellegrini 2006c). Thus, these bodies will send signals to market players.

In addition to the external arrangement, the internal review unit may be entrusted to review the transactions (Grais and Pellegrini 2006c). The duties of the SSB lie in three main areas, namely: *ex-ante* auditing, *ex-post* auditing and the checking of calculation of Zakah (Karim 1990b; Abdul-Rahman 1998; Grais and Pellegrini 2006b). The auditing process will be useful for *zakah* as it can establish that the net assets are calculated correctly and the funds are properly administered. In addition, the SSB disposes of non-*Shari'ah* compliant earnings, and advises on the distribution of income and expenses among shareholders and investment account holders (Karim 1990a; Grais and Pellegrini 2006b). In addition to these duties, the SSB also advises the financial auditor (and the management) of the bank on the accounting treatment of issues which require a departure from generally accepted accounting principles in order to comply with the *Shari'ah* (Karim 1990b).

The *Shari'ah* Governance Framework states that

The IFI shall establish formal reporting channel(s) among the key functions to ensure that the reporting on Shari'ah matters is carried out effectively and on timely manner. In this regard, the Shari'ah Committee shall functionally report to the board of directors. The Shari'ah review function shall report concurrently to the Shari'ah Committee and management, and the Shari'ah audit findings shall be reported to the Board Audit Committee and Shari'ah Committee. All Shari'ah non-compliance events are to be reported to the board of the IFI and the Bank.

Moreover, the AAOIFI requires both the SSB and the financial auditors of Islamic banks to report on the compliance of these banks with *Shari'ah* doctrines. According to Besar et al. (2009), more development and disclosure are needed to provide a greater assurance to stakeholders on *Shari'ah* compliance. To ensure compliance, the procedures for decision-making by the *Shari'ah* committee of Islamic banking institutions need to be clear and transparent, and the role and responsibility of the committee needs to reflect on their responsibility and accountability to the management and to the public (Khir et al. 2008). In accordance with the general purpose of disclosure and transparency, specific disclosure on *Shari'ah* related matters aim to lend credibility to the Islamic banks and increase the trust and confidence of the stakeholders in the soundness, stability and competitiveness of IBs.

Besar et al. (2009) emphasise the importance of the *Shari'ah* committee report and execution of the *Shari'ah* review in exercising governance, particularly in ensuring bank compliance with the *Shari'ah*. Its opinion is presented in a report to inform users of financial statements whether or not the banks have adhered to *Islamic* principles (Karim 1995; Archer et al. 1998). As mentioned, the SSB has greater powers and rights; their authority is equal to that of the external auditors. It specifies the precepts which must be followed by banks in all its financial

transactions and is involved in accounting policies pursued by the bank. Furthermore, it issues a special report which is published with the external auditor's annual report (Karim 1990b). However, the role of the SSB is not as clearly defined as that of the external auditors (Banaga et al. 1994). In addition, a *Shari'ah* committee report on Islamic banks show that it lacks the depth of providing such assurance. Besar et al. (2009) opine that the assurance by the *Shari'ah* committee is merely an endorsement of the bank's *Shari'ah* compliance in general, without any emphasis on the actual operation or conduct of the respective banks.

According to Grais and Pellegrini (2006a) SSBs possess 5 main CG categories. The first category is independence. This independence is due to the appointment of members of an SSB by the shareholders of the institutions presented by the BOD to which they report. The institution employs SSBs, and their remuneration is proposed by the management and approved by the board. Both characteristics explained the SSB member's dual relationship with the financial institution where they act as a provider of remunerated services and as assessors of the nature of operations; which could create conflicts of interest. In addition, Kasim et al. (2009) found that a few of SSB works as a team, consisting of internal auditors and management of the *Shari'ah* to perform *Shari'ah* auditing. According to (Kasim et al. 2009), working in a team is seen as threatening the principle of independence. Also, none carried out the *Shari'ah* auditing by either internal auditors alone or external auditors by themselves. Kasim et al. (2009) is in the view that the full potential of an audit cannot be realised if they are not wholly and truly independent, as the social purpose will be frustrated. (Kasim et al. 2009) found that heavy dependence on the internal people, such as the management of the *Shari'ah* unit, is placed to carry out *Shari'ah* audit in IFIs. Self-review threats may occur, as no separation of duties is clearly determined.

The second category is confidentiality where it relates to the practices of *Shari'ah* scholars often sitting on the SSBs of several IIFS, thereby gaining access to proprietary information of possible competing institutions. However, this is not always true for all jurisdictions. In the case of Malaysia, the SSB is restricted to be in one institution under the same category (i.e. Islamic Banks, Takaful or financial market). Also, in Malaysia, there are two layers of *Shari'ah* governance appointed at the BNM's level and the level of individual institutions. The third category is competence where SSB are expected to be familiar with Islamic law and to have financial expertise. In practice, very few scholars are well-versed in both disciplines (Kasim et al. 2009; Grais and Pellegrini 2006c). The fourth category is the consistency of judgement across IIFS, over time or across jurisdictions, within the same institution. Currently, the industry is still lacking the consistency in the opinions between various SSBs. The consistency in opinion would assist to promote the customer's confidence in the industry and the enforceability of contracts. On the other hand, conflicting opinions on the admissibility of specific financial instruments or transactions would hurt business confidence and market efficiency. Finally, the fifth category is disclosure of information relating to *Shari'ah* advisory functions, which would strengthen the credibility that the offered services are essentially distinct from the conventional ones and that they promote market discipline.

Abdul-Rahman (2008) discussed an apparent gap in *Shari'ah* supervisory practices in Malaysia. Although SSCs of IBs expressed opinion on *Shari'ah* compliance, regardless of how thorough the audit process of *Shari'ah*'s legal contract, documentation and operation are rarely conducted. In addition, report produced by the *Shari'ah* committee on compliance of the operation with *Shari'ah* as observed, lacks the depth of providing such assurance (Besar et al. 2009). The report is merely an endorsement of the bank's *Shari'ah* compliance, in general, without any emphasis on the actual operational or conduct of the respective banks.

Although SSC advise the IFI in matters related to *Shari'ah*, the main responsibility lies with the management of the IB. Thus, it remains to be seen to what extent the SSC is legally liable in the case of *Shari'ah* non-compliance and irregularities (Abdul-Rahman 2008).

Abdul-Rahman (2008) suggests that *Shari'ah* advisers rarely carry out a thorough internal review or audit on the operations of Islamic banks due to their restricted scope of work. There are insufficient execution of *Shari'ah* is reviewed by the respective banks to support the report issued by the *Shari'ah* committee (Besar, 2009). In Malaysia, no comprehensive *Shari'ah* audit program has been developed (Abdul-Rahman 2008). Another gap found is the absence of guidelines from regulators and lack of experience in the area; this is a major challenge encountered by respective sections and units (Abdul-Rahman 2008; Besar et al. 2009). Kasim et al. (2009) proposed that MIA, or the regulatory body in charge of IFIs, should be assigned to take the responsibility of identifying and implementing a comprehensive and integrated *Shari'ah* auditing framework in order to cater to the ever increasing number of IFIs in Malaysia (Kasim et al. 2009). Also, SSC need protection, not only by the law, but also morally in the eyes of the public (Abdul-Rahman 2008).

There is and existence of functional gaps found in the SSCs. SSCs is qualified *Shari'ah* scholars, but they have not been subjected to rigorous training or exposed to specific training programmes. Inadequate professional qualifications of *Shari'ah* scholars prevent them to effectively function and express their independent opinion (Abdul-Rahman 2008). Expertise and knowledge in conducting *Shari'ah* review are currently scarce, as the importance of such a review is not emphasized (Abdul-Rahman 2008; Kasim et al. 2009; Besar et al. 2009). Also, the *Shari'ah* auditing practice lacks people in *Shari'ah* and accounting qualifications, since indirectly, they are important in determining the vision and mission of Islam and

confirm that it is preserved within the IFI (Kasim et al. 2009; Shafii et al. 2013). In addition, Kasim et al. (2009) found that *Shari'ah* auditors with accounting qualifications often tend to not have *Shari'ah* qualifications at the same time (the higher the qualification in accounting, the lower the qualification in *Shari'ah*).

The *Shari'ah* auditing practices report of the SSC indicates a statement of opinion that reflects a complete assurance that the operations of the Islamic banks were conducted in conformity with *Shari'ah* compliance (Abdul-Rahman 2008). By providing assurance, it will protect the stakeholders' confidence on the operations of Islamic banks. Furthermore, the interest of the stakeholders will be safeguarded. It is explained that the SSB is not only advising the BOD on the *Shari'ah* compliance, it also serves as a check and balance to guarantee that the management and operations of the Islamic banking institutions do not deviate from the Islamic principles in the formulation of the policies. However, IFI service industry has not fully or systematically undertaken *Shari'ah* audit (Abdul-Rahman 2008) and there is no systematic review that is being comprehensively undertaken to ensure proper *Shari'ah* compliance (Kasim et al. 2009). Currently, these are the various challenges faced by the industry when conducting *Shari'ah* auditing.

The industry needs to establish audit evidence, *Shari'ah* audit programme and procedures, planning, examination and reporting (Abdul-Rahman 2008). The collaboration between IFI, BNM, accounting firms, auditing firms and SSCs is crucial in developing *Shari'ah* audit programs and to ensure proper conduct of *Shari'ah* compliance. Kasim et al. (2009) found that the *Shari'ah* audit process is still a highly unstructured task. Apparently, the *Shari'ah* audit practitioners themselves are somehow unable to respond to the *maqasid as-Shari'ah* agenda, despite their apparent willingness to do so. Kasim et al. (2009) found that a gap

exists between the 'desired' and the 'actual' scope of audit. By demonstrating the desire to extend the scope of *Shari'ah* auditing, the lack of expertise, specification and definition on the scope of *Shari'ah* auditing practices concerns the respondent of the questionnaire survey in her study. Most of the IFI are using the conventional framework of auditing because of the non-availability of *Shari'ah* auditing framework, even though the majority of the respondents' framework perceived that there is a need for *Shari'ah* auditing to be different from the conventional (Kasim et al. 2009).

Some of the reasons for not favouring to extend the scope are due to the capitalistic mentality by certain quarters and the lack of awareness on widening the scope into social and environmental aspects, as well as performance audit by others (Kasim et al. 2009). Thus, it is relevant to develop a framework for *Shari'ah* auditing in IFI in Malaysia. Rigorous developments need to be enhanced in terms of *Shari'ah* audit education and research and development (Abdul-Rahman 2008). This is to enable critical review of the current SSC practices, to evaluate the sufficiency and the limitations of the present governance framework. Also, the auditing practice needs requirements for a framework that will detail out policy guidance to properly conduct internal and external *Shari'ah* audit (Abdul-Rahman 2008). Due to the absence of recognised guidelines and *Shari'ah* auditing standards, there is a major problem facing the current *Shari'ah* auditing framework (Kasim et al. 2009). In addition, AAOIFI standards that address the auditing issues are not mandatory to Malaysian IFI (Kasim et al. 2009).

4.9 Summary

Although IB earned profits year by year, they still rank lower than their conventional counterparts in terms of profitability and efficiency. Given that their customer preference in

patronising IB are not solely due to religious impetus, their preferences are more geared towards other qualities such as profitability, pricing, quality of services, reputation, image and socioeconomics. Thus, due to the current performance of IB and customer preference, more effort needs to be done to attract the confidence of the customers towards IBs products and services.

Furthermore, the general problems and challenges facing Islamic banking and finance discussed in this chapter are: inconsistency in *Shari'ah* interpretation, reliance on debt-based products, product innovation and development, human capital management and lack of training and research and development. The discussions continue with legal and regulatory framework and risk management of IB industry. Also presented are: the accounting in religious organisations, accounting and Islamic perspectives, the application of the accounting system to enhance the system of accountability in the institutions and auditing practices.

The next chapter discusses the research methodology of this study, which outlines and explains the research design that has been adopted in this study.

CHAPTER FIVE

RESEARCH METHODOLOGY

5.1 Introduction

This chapter aims to discuss the purpose of this study, describing the selection of Islamic banks in Malaysia (which are the research subject) as well as detailing the methodology, which was designed within the researcher's ontological and epistemological framework. The design of this study involves the use of data, which was collected prevalently from primary sources through semi-structured interviews.

In this study, semi-structured interviews were undertaken in an attempt to obtain a more precise understanding of the problems and challenges facing *Islamic* banking and finance (i.e. *Islamic Accounting*, *Islamic Banking* and *Islamic Finance*). This chapter on methodology will examine (1) semi-structured interviews that will be undertaken in the research in greater depth, (2) providing information on the research instruments used, (3) procedures followed and (4) techniques adapted to enhance the quality of semi-structured interviews.

In addition, the researcher also used annual reports to find descriptive information about the institutional investigation and the participants involved. Consequently, this chapter will also describe secondary data sources used in this study. Detail of the research methods used in this study will be explained later in this chapter. Finally, this chapter included the discussion on the limitations of following the research method, which is employed in this study.

5.2 Purpose of the Study

Alternatively, there are problems and challenges existing in the operation of *Islamic* banks in Malaysia and other parts of the world. The study of problems and challenges facing *Islamic* banking and finance in Malaysia is important because it has not been examined in certain areas of the state. Such studies are important as Malaysia has aspired to promote the country as a hub for international Islamic finance. Also, various countries seek advice and refer to the Malaysian model to establish Islamic banks in their countries. There is a growing interest in the literature on the problems and challenges facing Islamic banking and finance. However, the empirical literature, which focuses on theoretical and practical aspects of problems and challenges facing Islamic banking and finance, tends to be very limited. Several empirical studies relevant to the present scope of research are included. The knowledge of problems and challenges would give impact on the enhancement of legal and regulatory framework in order to ensure that the Islamic banks continue to develop and grow. Also, it will contribute to a better infrastructure and architecture of Islamic banking operations in order to ensure that the benefits of establishing Islamic banks are fully achieved.

In addition, this study explores the heightening awareness of the problems and challenges that had been discussed in talks and conferences, speeches from the bankers, governors, academician and scholarly literature; the discussions have been discussed repeatedly without being assured of the importance they gave to the industry. In correspondence to the heightening awareness and creating dialogue—it is hoped that research in this area can lead to a better understanding of the way things

appear objectively, and through that insight, improvements in practice will be led (Creswell 1998).

Research objective and research questions

The *Islamic* banks were established to fulfil the demand of society for banking activities that are based on the *Shari'ah*. The different underlying principles that govern the operations of *Islamic* banks differentiate them from their conventional counterparts. Furthermore, the *Islamic* banks in Malaysia operate under the dual-banking system. Since 1983, the establishment of *Islamic* banking and finance in Malaysia has seen a massive development in various aspects, such as system-wide implementation, proper institutional framework, appropriate legal framework and supportive policies, supervisory framework, development of accounting standards, accounting and finance and other initiatives and guidelines. In addition, the establishment and development of *Islamic* banks involve collaboration of various parties. Thus, the different underlying principle of ICBs that operates side-by-side with CCB involves a new paradigm of banking business. As the ICB evolves, it may face strengths and weaknesses that may call for support in terms of its infrastructure and may further contribute to various problems and challenges faced by *Islamic* banks.

Since IB operates side by side with conventional banks under the conventional economic system, the *Islamic* banking establishment called for reform (changes) in various aspects of the banking business. Although some aspects of the conventional banking business can be applied to IBS, others need to be changed in order to allow the IB to operate at its optimum capacity. Generally, in upholding its underlying

principles and ensuring that it has achieved the objectives of its establishment, IBs (in Malaysia and internationally) face various problems and challenges that hinder their capabilities fully to utilize their creativity in providing products and services that will be subscribed by its customers and to guarantee that its operation and operationalization is in accordance with *Shari'ah*. Furthermore, as a financial institution whose operations are based on religious impetus, its roles are to uphold the commercial viability and compliance to legal and regulatory framework along with *Shari'ah* principles.

This study intends to explore and unveil the problems and challenges in the regulation, *Shari'ah* compliance and management of IBS in Malaysia, by understanding the institutional forces and rational/technical performance pressures (i.e. Related to the governance of the transactions). This study examines the problems and challenges facing *Islamic* banks with respect to management, *Shari'ah* compliance, legal and regulatory framework and accounting and auditing framework by analysing the implementation (i.e. Practice of *Islamic* Banking, *Islamic* Finance and *Islamic* Accounting) of *Islamic* banks in Malaysia. This is crucial for facing the more liberalised and globalised industries in the future. The important question arises from the (1) developments/initiatives of the infrastructures and architectures of the industry that support the operations of *Islamic* banking and finance, and (2) the current operations of *Islamic* banking and finance (particularly on the *Shari'ah* as a governing principle of its operation) that is different from conventional banks and (3) empirical literature on problems and challenges faced by the industry, raising the need to study the problems and challenges facing IBF in Malaysia.

Besides operating with different governing principles, as compared to their conventional counterparts, the mission and vision of IBs are also different. The objectives of the establishment of Islamic banks are not limited to providing banking business activities that are based on *Shari'ah*, but it also aims to ensure that the objectives of the *Shari'ah* are also achieved. *Islamic* banking and finance provides opportunity for the *Muslims* to subscribe to the banking business in accordance with the *Shari'ah* Law. Furthermore, the ultimate objective of establishing the banking business that is based on *Shari'ah* is to achieve the *Maqasid as-Shari'ah* (objectives of the *Shari'ah*). In addition, by providing a banking business that is in accordance with *Shari'ah*, it is expected that the public, as a whole, will be enjoying the benefits of achieving the objective of *Shari'ah* and lead to an improved economic and social life. Consequently, the IBs are expected to uphold the stakeholders' interest by guaranteeing *Shari'ah* compliance and business performance of the *Islamic* banking and finance industry. Thus, the ultimate measure of the success of the IBF is evaluated in terms of improved effectiveness in ensuring *Shari'ah* compliance and business performance. The effectiveness in ensuring the *Shari'ah* compliance, and in particular, differences in effectiveness as compared to conventional banks are difficult to control and monitor. Due to the religious elements in the establishment of IB, IBs appoint a *Shari'ah* Supervisory Board (SSB) to give assurance to the stakeholders of IFIs on *Shari'ah* compliance of its operations and products and services. There are guidelines and standards formulated on the duties and responsibilities of the SSB to ensure that the SSBs are able to deliver their responsibility and accountability. However, various problems and challenges occur in providing support in terms of infrastructure and guaranteeing the compliance in operations, products and services. The basic themes that relate to the *Shari'ah* compliance are the *Shari'ah*

interpretations fatwas and guidelines, ex-ante *Shari'ah* Compliance (proposal, deliberate, approve) and ex-post *Shari'ah* Compliance (implementation).

1. What are the problems and challenges facing *Islamic* banking and finance in ensuring *Shari'ah* compliance of its operations in terms of operations of *Islamic* banks, business ethics governing the behaviour, transactions that are driven by *Shari'ah* approved contracts (i.e. Validity and permissibility of the contract) and *Shari'a* as the governing laws of all affairs of the corporation?
2. What is the effort or interaction in the *Islamic* banking system and finance in establishing the *Shari'ah* compliance in the IB?
3. How can the process be addressed in order to improve the level of compliance in *Islamic* banks?

Besides complying with *Shari'ah* principles, *Islamic* banks should also comply with the legal and regulatory framework, guidelines and standards. However, *Islamic* banks' compliance with the accounting standards would depend on the jurisdiction. Currently, different jurisdictions apply different standards.

1. What are the problems and challenges related to the legal and regulatory framework of *Islamic* banks?
2. What are the problems and challenges in complying with the national and international legal regulatory framework?

It is important for *Islamic* banks to uphold the interest of stakeholders in terms of (1) *Shari'ah* compliance and (2) business performance. Failing to do so will have a negative impact on *Islamic* banks. One of the possible impacts would be displaced commercial risk. This is where the IAH withdraws the funds due to the non-compliance risk. The financial statement is important, as it is a report that communicates financial performance and *Shari'ah* compliance in operations. The annual report is a means of assessing all the information about the operations of *Islamic* banks and to communicate the assurances of the auditor on the operations of

Islamic banks. The disclosures in the annual report will assist the users of the annual report to make informed decisions. In addition, the operations of *Islamic* banks are also bound by the *Shari'ah* audit. In addition, the implementation of the IB on the products and services offered is also an important element of IBs. In monitoring and controlling the implementation, the role of accounting and audit is important. Although, being important elements, the practices are still in the infancy level. The problems are state of the art in implementing accounting and auditing in IB as a watchdog on matters that may jeopardise its credibility.

1. What are the problems and challenges facing *Islamic* banking and finance industry in terms of accounting practices, accounting standards and auditing?
2. What are the problems and challenges facing SSB in *Islamic* banks?
3. Is there a need for standardisation and harmonisation of accounting practices and accounting standards among *Islamic* banks? What efforts have been made to standardise and harmonise the practices?
4. Are the personnel in *Islamic* banks capable and competent in performing their duties and responsibilities?

In addition, this study will also include the management issues. Management refers to the operational and administrative aspects of the organization comprising of issues pertaining to human resource, system, and internal process.

1. What are the problems and challenges related to management (i.e. human capital, system, and internal process)?
2. How can the IBs ensure that the management aspects are in place and it is well carried out towards achieving the objectives of its establishment?
3. How can IBs improved the elements in management aspects to ensure that it is well carried out?

Thus, the general objective of this study is to obtain perceptions of a sample of senior officials of the Malaysian *Islamic* bank's management, *Shari'ah* supervisory board, academician on the problems and challenges facing *Islamic* banking and finance in Malaysia and the impact of the operations of *Islamic* banking and finance in Malaysia on them/their organisation in terms of the (1) legal and regulatory framework, (2) *Shari'ah* Compliance, (3) management, and (4) accounting. Thus, in line with the general objective, this study seeks:

1. To identify the problems and challenges facing *Islamic* banking and finance industry related to legal and regulatory framework, *Shari'ah* compliance, management and accounting.
2. To evaluate whether the processes and current practices of ensuring the *Shari'ah* Compliance in the *Islamic* Banking and Finance industry are being implemented efficiently in Malaysia.
3. To discuss and delineate the problems and challenges facing SSB, *Shari'ah* audit, financial audit and financial accounting and reporting in providing reliable information in terms of efficient resource allocation and ensured *Shari'ah* compliance in *Islamic* banks. The factors and elements will play its role as the monitoring and control mechanism of *Islamic* banks' operations.
4. To identify the current practices of *Shari'ah* advisory, *Shari'ah* audit and financial accounting and reporting in guaranteeing the reliability of financial reporting, compliance with relevant law and regulation, along with the efficiency and effectiveness of *Shari'ah* Compliance in *Islamic* banking in Malaysia.

5.3 Study Population

Non-banking financial institutions in Malaysia have been operating in Malaysia since 1963. Initially, such establishments fulfilled the need of Muslims to deposit their money for the purpose of pilgrimage. Since then, demands for the *Islamic* banking activities have increased as more Muslims have become aware of the requirements of *Shari'ah* in banking and financial activities. To meet the demands of *Islamic* banking

business activities, the Islamic banking industry was developed in 1983. The emergence of the industry went through various phases of growth to ensure its long-term sustainability. This resulted in an increased number of banks offering Islamic banking products and services. It began with conventional banks offering Islamic banking windows and, consequently, was given an option to transform themselves into Islamic banking subsidiaries. Furthermore, liberalisation of the economic policy has provided an opportunity for foreign international Islamic banks to operate in the country. The increased number of banking institutions and the liberalisation of the economic policy will further promote the country to become a hub for international Islamic finance.

To date, there are 65 licensed banking institutions that have been established in Malaysia. The licensed banking institutions consist of 22 foreign and Malaysian-owned commercial banks, 17 ICBs (i.e. 6 foreign and 11 Malaysian-owned), 2 international *Islamic* banks, 7 money brokers, 2 other financial institutions and 15 investment banks. In this study, the sample consists of 17 ICBs that are considered relevant to the present research, ranging from fully-fledged Islamic banks to international Islamic banks and Islamic banking subsidiaries. Since the study intends to explore the problems and challenges related to regulation, management and *Shari'ah* compliance of the *Islamic* IB system, the selection of the banks to be used as research subjects should be representative of the senior officials' respective banking institutions. This is useful to obtain the perceptions of the practitioners (i.e. CEOs and *Shari'ah* Officers) since they are involved and experienced in banks. This study will also look at the views of the supervisors and academicians of the IBF industry on the problems and challenges faced by IBs in Malaysia. The interviewees represent fully-

fledged, *Islamic* banking subsidiary and foreign *Islamic* banks. Table 5.3.1 below displays the shortlisted banks, which represents the research subject of this study. An interview with a sample of personnel in each of the *Islamic* Banks included in the study is in accordance to the availabilities of some characteristics such as experience, academic status, and seniority, so that they are considered representatives of their banks.

Table 5.3.1 List of the ICBs and CCBs in Malaysia Selected for this Study

NO.	BANK NAME	FULL-FLEDGED ISLAMIC BANKS		TOTAL ASSET BY CATEGORY (2010)	
		Domestic Banks	International Banks	Medium (Between RM1, 000 million to RM10, 000 million assets)	Large (More than RM10, 000 million assets)
1	Affin <i>Islamic</i> Bank Berhad	✓		✓	
2	Al Rajhi Banking and Investment Corporation (Malaysia) Berhad		✓	✓	
3	Alliance <i>Islamic</i> Bank Berhad	✓		✓	
4	Am <i>Islamic</i> Bank Berhad	✓			✓
5	Asian Finance Bank Berhad		✓	✓	
6	Bank Islam Malaysia Berhad	✓			✓
7	Bank Mu'amalat Malaysia Berhad	✓			✓
8	CIMB <i>Islamic</i> Bank Berhad	✓			✓
9	EONCAP <i>Islamic</i> Bank Berhad	✓		✓	
10	Hong Leong <i>Islamic</i> Bank Berhad	✓		✓	
11	HSBC Amanah Malaysia Berhad		✓	✓	
12	Kuwait Finance House (Malaysia) Berhad		✓		✓
13	Maybank <i>Islamic</i> Berhad	✓			✓
14	OCBC Al-Amin Bank Berhad		✓	✓	
15	Public <i>Islamic</i> Bank Berhad	✓			✓
16	RHB <i>Islamic</i> Bank Berhad	✓			✓
17	Standard Chartered Saadiq Berhad		✓	✓	

5.4 Research Design

Research design can be classified into exploratory, descriptive or explanatory approach. These approaches will identify how the research problems are being identified (Saunders et al. 2000; Ghauri and Gronhaug 2002). This research will employ the exploratory approach. Exploratory studies are valuable means of finding out 'what is happening; to seek new insights; to ask questions and to assess phenomena in a new light' (Robson 1993, 42). It is a particularly useful approach if you wish to clarify your understanding of a problem. There three principal ways of conducting exploratory research (1) a search of literature, (2) talking to experts in the subject and (3) conducting focus group interviews. Its great advantage is that it is flexible and adaptable to change. (Adams and Schvaneveldt 2001) reinforce this point by arguing that the flexibility inherent in exploratory research does not mean absence of direction to the enquiry. What it does mean is that the focus is initially broad and becomes progressively narrow as the research progress (Saunders et al. 2000).

The exploratory approach is relevant to this study as the research problem is more or less understood (Ghauri and Gronhaug 2002). It may portray that the issue was new or researchers had written little on it (Neuman 2000). Besides exploring a new issue, it may comprise a new way of looking a certain topic such as theoretical perspectives or new way measuring it. Thus, it promotes flexibility where it can be conducted in best possible way (Ghauri and Gronhaug 2002).

In undergoing this type of research, the researcher is expected to possess the ability to observe, get information, and construct information i.e. theorizing (Ghauri and Gronhaug 2002). Also, the researchers are also expected to be someone that are

creative, open minded, and flexible; adopt an investigative stance; and explore all sources of information (Neuman 2000). According to (Neuman 2000) the goals of exploratory research are (1) become more familiar with the basic facts, setting, and concerns, (2) create a general mental picture of the conditions, (3) formulate and focus questions for future research, (4) generate new ideas, conjectures, or hypotheses, (5) determine the feasibility of conducting research, and (6) develop techniques for measuring and locating future data.

This study employs the qualitative method and it is undertaken in the form of semi-structured interviews. Semi-structured interviews allow the interviewer to inquire about the problems and challenges facing Islamic banks in Malaysia from the perspective of the interviewer through their experience and involvement in the industry. In addition, it aims to gather insight into the problems and challenges facing IB in Malaysia.

The qualitative research is grounded in philosophical positions which are broadly interpretive (Mason 1996). It is an inductive approach to the relationship between theory and practice (Bryman 2001). Qualitative methods may have the power to take the researcher into the minds and lives of the social actors and to capture how the social world is interpreted, understood, experienced and produced (McCracken 1998, Mason 1996, Bryman 2001). In addition, it captures the social reality as a constantly shifting emergent property of individuals' creating (McCracken 1998, Bryman 2001). Furthermore, the method of data generating is flexible and sensitive to the social context in which data is produced and on methods of analysis and explanation

building which involve understanding of the complexity, detail and context (Mason 1996).

Besides emphasis and focus on understanding the participants' point of view, observations and measurements in natural settings, it gives researcher subjective 'insider view' and closeness and richness of data. Qualitative research is exploratory and is useful when the researcher does not know the important variables to examine (Creswell 2003). This type of approach may be needed because the topic is new and has never been addressed with a certain sample or a certain group of people; or existing theories do not apply with the particular sample or group under study (Morse 1991; cited in Creswell 2003). Meanwhile, the qualitative research is not mended to be generalised to the population, but it is for the researcher to find out whether the theory can be generalised (Bryman and Bell 2007). Access is also an issue that should be taken into consideration. There is a possibility that few respondents are willing to sit for all the hours it takes to complete the portraits (McCracken 1988). This could be avoided by explaining the estimating the duration of the interview to the participants ahead of time.

5.5 Research Strategy

On the basis of exploratory research design, this study adopted the interpretive research process as suggested by Russell (1996) as illustrated in the following Figure 5.5.1.

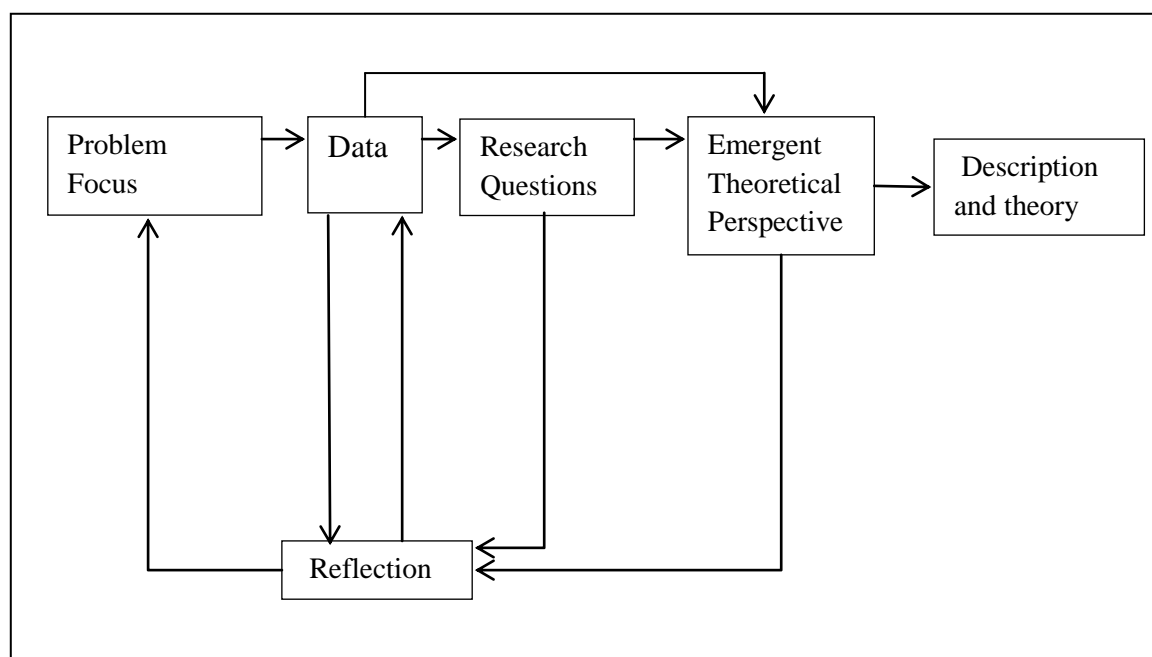


Figure 5.5.1 The Interpretive Research Process (Russel 1996; extracted from Abdul-Rahman and Goddard 1998)

Russell (1996; as cited in Abdul-Rahman and Goddard 1998) depicts the interpretive research process that is iterative which continuous analysis and reflection through stages of exploration of an initial problem focus. The researcher progressively discovers the issues and questions of centrality to the interviewee and develops an emergent theoretical perspective. Through further reflection and data analysis the researcher eventually develops a theoretical understanding of the problem being studied.

Meanwhile, Bryman and Bell (2007) generally associated inductive strategy of linking data and theory with a qualitative research approach. The inductive assumes theory as the outcome of research. It involves the process of drawing generalizable inferences out of observation. In addition, inductive approach is likely to entail a modicum of deductive approach. Thus, the involvement of inductive and deductive

approach is known as iterative strategy where it involves weaving back and forth between data and theory.

In this study, during the continuous analysis and reflection through stages of exploration of an initial problem focus, the researcher did support the initial problem focus to the existing corporate governance theories and institutional theory. During this stage, the process partly involves with deductive approached. On the other hand, the inductive approach came into picture during further reflection and data analysis the researcher eventually develops a theoretical understanding of the problem being studied. The theoretical understanding draws generalizable inferences out of observation.

5.6 Research Method

5.6.1 Semi-structured Interviews

Qualitative methodology, or qualitative researching, can be implemented through qualitative interviewing, participant observation and document analysis. Qualitative interviewing is the most commonly used qualitative methods. It consists of a semi-structured, unstructured or loosely-structured types of interviews (Mason 2002). Mason (2002) is of the view that qualitative interviews relates to instructional exchange of dialogue, a relatively informal style, thematic, topic-centred, biographical or narrative approach; and it ensures the right context is brought into the interview to produce situated knowledge. As illustrated in Figure 5.4.1 above, the research design was conducted through the use of a series of qualitative semi-structured interviews.



Figure 5.6.1 The Qualitative Research Strategy used by the Researcher

The semi-structured interview was selected since it was deemed more flexible than standardised methods, such as structured interviews. The emphasis was explicitly on how interviewees framed and understood issues and events that were being raised. The frames were what the interviewees saw as important in explaining and understanding events, patterns and forms of behaviour (Bryman 2001). By using the list of themes, it allowed for the exploration of emerging themes and ideas; rather than just relying on the questions formulated before the interview. Also, in a semi-structured interview, interviewers may use probing questions in order to obtain in-depth responses on certain issues.

This study intended to contribute towards the need to inform about the problems and challenges facing Islamic banking and finance in Malaysia; and to also include a theory which was both informed and developed through observations. The aim of the research was fulfilled by employing semi-structured interviews. The researcher conducted interviews between September 2010 and December 2010. The semi-structured interview allowed the interviewer to inquire about problems and challenges

facing Islamic banks in Malaysia from the perspective of the interviewees through their knowledge, experience and involvement in the industry. This added more value in understanding the problems and challenges facing IBs. The interviewees included *Shari'ah* Board members, NSAC, heads of *Shari'ah* Department (or *Shari'ah* officers) and CEOs/COOs.

Other qualitative methods are personal observation and document analysis. Personal observation involves with a better grasp on social reality and is immersed in a natural setting; this may provide implicit features in a natural setting due to the continued presence (Bryman and Bell 2007). This allows a better understanding of the object being researched. It also allows the researcher to explore unexpected topics or issues. However, due to the continued engagement with human behaviour, this may lead to reactive effects between the researcher and the respondents and it may be disturbing as the researcher will be at the organisation for a long period of time. On the other hand, dealing with document analysis does not involve reactive effects as it does not involve human respondents; it may deal with external criticism and internal criticism. External criticism is defined as assessing the authenticity of the data, while internal criticism is defined as an examination of the document's contents to establish credibility (Neuman 2000).

In addition, it may be argued that unnatural characters may be encountered in an interview, which may lead to the emergence of reactive effects (Bryman and Bell 2007). On one hand, the qualitative interviews attendant's roles and expectations may well outrage potential respondents for many reasons, such as: the resentment towards the intrusion by a complete stranger, the refusal to be accurate or attentive in their

response, the desire to share in the control of the interview and ask questions of the interviewer and the fear of the potential use to which their responses might be put (Oppenheim 1992; Creswell 2003). On the other hand, they may feel enormously flattered at being interviewed at all, engage in elaborate displays of friendship and hospitality, involve the interviewer in personal or family matters and also seek to strike up a lasting relationship (Oppenheim 1992). However, the intense reactive effect of potential respondent outrage is not as much as participant observation. Also, as compared to personal observation, the impact of people's time will probably be less in an interview session (Bryman and Bell 2007).

In addition, to avoid criticism that the research may have too much reliance on the researcher's point of view, the qualitative research need to consider a thorough planning of critical self-scrutiny by the researcher, or active reflexivity (Bryman and Bell 2007; Mason 1996). Also, the researcher should have thorough considerations of the design in order to avoid any misleading outcomes (Mason 1996). Furthermore, the researcher needs to be flexible and sensitive to the specific dynamics of each interview and aware of the need to tailor-make it on the spot. Also, the researcher needs to engage with the data to ensure that the data generated from the interview will allow appropriate comparisons to be made (Mason 1996).

5.6.1.1 The rationale for using Semi-structured Interviews

Conducting research in highly regulated industries would portray a different accessibility and involve with various highly sensitive matters. Thus, it may be difficult to inquire access to observe them or to view other various unpublished reports due to the nature of the banking business activities. The semi-structured

interview is more relevant in sharing the experiences with the elite groups involved with the IBF industry. Also, it has the advantage of eliciting the opinion of busy people who are used to making appointments and schedules (Fowler 2002). More focus data can be obtained through semi-structured interviews and can capture issues resistant to personal observation (Bryman and Bell 2007). Also, it leads to the wide coverage of people and situations where it brings breadth of coverage. For example, when exploring the accounting implications of *Islamic* banking practices, although the observation on the financial statements can be done, we failed to understand the conflicts behind it, and the difficulties of the preparer of the accounts due to different implications of IBs operations towards accounting practices in IBs. Therefore, various issues can be understood from the respondents. In addition, semi-structured interviews could entail the reconstruction of events (Bryman and Bell 2007). It could be done by asking the respondents to reflect on how a certain issue arises and this would give an understanding of the underlying reason on how current issues emerge. However, before engaging with the interview session, thorough evaluation of literature, related government documents, statutory act and published documents are vital to gain a better understanding on the subject matter.

As this study seeks to acquire the problems and challenges facing IBF in Malaysia that operates under a dual banking system, the qualitative method is deemed suitable to further enhance the perceptions of the sample through the survey method. A study that involves the interaction between researcher and respondent will lead to the understanding of the problems and challenges that are currently being experienced by them. It will basically focus on the accounting and finance practices in IBs, banks' shareholders or board of directors, the bank's management, Investment Accounts

Holders (IAH) and other related technical problems. Other related issues will be highlighted, such as human talent, marketing, customer awareness and education, etc.

The semi-structured interview employed in this study will be used in the process of gathering data in understanding the conflict and tension of the elite groups in IBs. Semi-structured interview covers a wide range of instances (Bryman and Bell 2007). It typically refers to a context in which the interviewer has a series of questions that are in the general form of an interview schedule but are able to vary the sequence of questions (Bryman and Bell 2007). Also, the researcher will have a list of themes and questions to be covered, although these may vary from interview to interview (Saunders et al. 2000). Moreover, necessary additional questions may be required to explore the research questions and objectives given to the nature of events within particular organisations (Saunders et al. 2000).

A study by Karbhari et al. (2004) on the problems, challenges and opportunities of IBF in the United Kingdom (UK) used a series of interviews. Also, a study by Susela (1999) was done using an in-depth interview with 65 actors to understand the conflicts and tensions within the Malaysian accounting profession and the power struggle therein to dominate the accounting standard setting process in Malaysia (i.e. Developing country). Furthermore, a study by Abdul-Rahman and Goddard (1998) used interpretive accounting research to inspect the accounting practices in a cultural setting. It makes a contribution towards the need for accounting research to become more explanatory on accounting as a social practice; wherein theory is both informed and developed by observation. They used semi-structured interviews, unstructured interviews and document analysis.

5.6.2 Administering Semi-structured Interviews

The interviews used for data collection were started on September 2010 until December 2010. They were conducted after the Ethics Committees of Cardiff Business School approved the interview guidelines. After obtaining the approval, the expected interviewees were contacted through e-mail. E-mail addresses were acquired from websites. The e-mail included an attachment of a covering letter explaining the objective of the study and a support letter from the researcher's supervisors. After sending the email, a gap of 48 hours was given for receiving any feedbacks or making any subsequent follow-ups. There are different types of feedbacks. The first type of feedback is when the researcher receives the feedback on the same day where the potential interviewee will identify or set-up the appointment for the interview. This group of interviewees reply to the email immediately and communicate their willingness to be interviewed. Then, appointments are set-up. The second type of feedback is when the researcher was required to contact interviewees at a later date to set-up an interview. The follow-up process was being done in two ways, either by subsequent emails or by telephone calls. However, there are interviewees who refused to be interviewed, whereby they did not reply to the researcher's email. Subsequently, emails and telephone calls were made to those interviewees who did not reply to the initial email. The potential interviewees' unwillingness was identified when the researcher made personal calls after sending a second follow-up email. Some interviewees were being approached during the Islamic finance conference; however, their willingness was communicated and the researcher called them at a later date for an appointment.

Besides sending emails and having face-to-face approaches, the researcher also used gatekeepers to gain access to the interviewees. It is important for the researcher to know and communicate to the gatekeeper in order to gain access to the right people. Attempts were also made to call CEO's secretary to obtain assistance in making follow-ups or feedbacks for the interview sessions with CEOs. Moreover, the opportunity to attend conferences, international forums, workshops and courses was used to meet and approach potential interviewees accordingly. Usually further phone calls were made for the follow-up process.

The interviews were conducted with Chief Executive Officers (CEO), *Shari'ah* Committee, National *Shari'ah* Advisory Councils of Bank Negara Malaysia (NSAC), *Shari'ah* Officers and a few academicians. The interviews consisted of 5 CEO, 1 COO, 11 *Shari'ah* committees, 2 NSAC, 1 ex-NSAC, 9 *Shari'ah* Officers and 2 academicians (i.e. who did not hold any advisory duties). The list of the interviewees through Table 5.5.1 and Table 5.5.3 are as follows:

Table 5.6.1 Analysis of Respondents of the Semi-Structured Interviews amongst Commercial Banks

Banking Institutions	<i>Shari'ah</i> Board Members Interviewed	Head of <i>Shari'ah</i> Department Interviewed	CEO/ COO Interviewed
IB1	✓ ✓	✓	
IB2			
IB3	✓		✓
IB4			
IB5			
IB6	✓		
IB7	✓ ✓	✓ ✓	✓
IB8		✓ ✓	✓
IB9	✓		

Banking Institutions	Shari'ah Board Members Interviewed	Head of Shari'ah Department Interviewed	CEO/ COO Interviewed
IB10	✓		
IB11	✓		
IB12			
IB13			✓
IB14	✓	✓	✓
IB15			
IB16			
IB17		✓	✓
Development Bank	✓		

Table 5.6.2 Analysis of Respondents of the Semi-Structured Interviews amongst Regulatory Authority

Regulatory Authority	Interview Participants
National <i>Shari'ah</i> Advisory Council (NSAC) of Bank Negara Malaysia	NSAC 1 NSAC 2 Ex-NSAC

Table 5.6.3 Analysis of Respondents of the Semi-Structured Interviews amongst Islamic Accounting Scholars

Respondents	Interview Participants
Islamic Accounting Scholars	IAS 1 IAS 2

In addition, the interviewees are further classified according to profiles in Table 5.5.4 on the next page. The interviewees were identified by codes to preserve the confidentiality agreement made between the researcher and the interviewee.

Overall, the data collection process involved 31 interviewees. The interviewees were representative of full-fledged *Islamic* banking subsidiaries and foreign *Islamic* banks.

The largest group of interviewees consisted of the *Shari'ah* Committee who represented 35.5% of the overall interviewees, followed by *Shari'ah* Management and CEO and COO who represented 29% and 19.3%, respectively. In addition, there was a small number of NSAC, Academician and ex-NSAC. NSAC and Academician represented 6.5% each and ex-NSAC was 3.2% (Please refer to Table 5.5.4).

Table 5.6.4 Percentage of Interviewees according to Group

Percentage	Amount	Interviewees' Group
35.5%	11	<i>Shari'ah</i> Committee
6.5%	2	NSAC
19.3%	6	CEO and COO
29.0%	9	<i>Shari'ah</i> Management
6.5%	2	Academician
3.2%	1	Ex-NSAC

The following table 5.5.5 presents details of interviewees according to profile.

Table 5.6.5: Interviewees according to Profile

Interviewees' Code	CEO	NSAC	SC	Shari'ah Mgmt	Academician	Full-fledged IB	Local Islamic Subsidiary	International Islamic Subsidiary	Development Bank
SC01			✓		✓	✓			
SC02			✓		✓	✓			
SC03			✓		✓	✓			
SC04			✓		✓		✓		
SC05			✓		✓		✓		
SC06			✓		✓		✓		
SC07			✓		✓		✓		
SC08			✓		✓			✓	
SC09			✓		✓			✓	
SC10			✓		✓		✓		
SC11			✓		✓				✓
NSAC01		✓			✓				
NSAC02		✓			✓				
Ex-NSAC					✓				
CEO01	✓						✓		
CEO02	✓							✓	
CEO03	✓						✓		
CEO04	✓						✓		
CEO05	✓						✓		
COO06	✓							✓	
SO01				✓			✓		

Interviewees' Code	CEO	NSAC	SC	<i>Shari'ah</i> Mgmt	Academician	Full-fledged IB	Local <i>Islamic</i> Subsidiary	International <i>Islamic</i> Subsidiary	Development Bank
SO02				✓				✓	
IB03								✓	
SO04				✓			✓		
SO05				✓			✓		
SO06				✓				✓	
SO07				✓		✓			
SO08				✓		✓			
SO09				✓			✓		
A01					✓				
A02					✓				
A03					✓				

Furthermore, table 5.5.6 and 5.5.7 below; provide details on the response from the semi-structured interview by the types of banks and ownership and by the total asset categorisation, respectively.

Table 5.6.6 Analysis Showing the Total Asset of Banks Participating in Semi-structured Interview

Type of Full-fledged Islamic Banks	Ownership					
	Domestic		Foreign		Total	
	No	%	No	%	No	%
Full-fledge Islamic Banks	2	100.00	0	.0	2	100.00
Islamic Subsidiary	6	66.67	3	33.33	9	100.00
Total	8	72.73	3	27.27	11	100.00

Table 5.6.7 Analysis Showing the Total Asset of Banks Participating in Semi-structured Interview

Type of Full-fledged Islamic Banks	Total Asset by Category							
	Small (Less than RM1, 000 million assets)		Medium (Between RM1, 000 million to RM10, 000 million assets)		Large (More than RM10, 000 million assets)		Total	
	No	%	No	%	No	%	No	%
Full-fledge Islamic Banks	0	.0	0	42.85	2	57.15	2	100.00
Islamic Subsidiary	0	.0	7	100	2	.0	9	100.00
Total	0	.0	7	63.64	4	36.36	11	100.00

Also, the researcher analysed the qualification background of different groups of interview participants, namely *Shari'ah* board members, NSAC, top management, and *Shari'ah* officers. The researcher's information regarding the qualification backgrounds of the interviewees were identified through the annual report and website of the Islamic banks, websites of BNM, other association's websites where the interviewee were attached and from the interviews held with the researcher. *Shari'ah* board members and NSAC are mainly academics in Malaysian universities. Although the most suitable area of *Shari'ah* related to

Islam is *Fiqh Muammalat*, the *Shari'ah* board members and NSAC possessed other various areas of *Shari'ah* branches such as, *Usuluddin*, *Fiqh* and *Usul-Fiqh*, and *Quran* and *Sunnah*. In addition, the *Shari'ah* officer possessed various branches of *Shari'ah* knowledge in their first degree or Master's Degree. On the other hand, the top management possessed technical qualifications for their first degree and/or Master's degree. If we refer to the top management background, most of them are without the formal knowledge/background of *Shari'ah* (refer to annual report). Basically, they have already acquired the knowledge and experience of managing the conventional banks and managing the operations of the banks. Presumably, they acquire the knowledge of *Shari'ah* through conferences, training, meetings, working, and discussions or from institutions established by various other institutions. Where appropriate, the qualification of interviewees was used to describe the qualification and expertise of the interviewee when reporting analysis of the interview in later chapters.

In obtaining the information to explore the problems and challenges facing Islamic banking and finance (IBF) in Malaysia, the researcher was involved with the interview participants that are experienced in working with the Islamic banks (IBs), also involved with the formulation or the establishment of new regulations, standards or guidelines, the development of products and services in the IBF and researchers and academics in this area. In studying the IBF in Malaysia, the researcher employed semi-structured interviews where the information provided by the interviewee may supply 'indirect' information filtered through the views of the interviewee. The presence of the researcher may lead to biased responses and there is a possibility that certain individuals are not articulate or perceptive (Creswell 2003). The researcher needed to assure interviewees of the confidentiality of the interview data and the anonymity of participants in the interview. According to Saunders et al. (2000) ethical consideration will emerge as researchers plan their research, seek access to individuals and

organisations, data collection, data analysis and reporting. Thus in this study, at every stage of research, the ethical consideration will be assessed accordingly. Specifically, in using the interview method, the researcher was aware of the matters of confidentiality, privacy, avoidance of harm and informed consent.

It is worth noting that each of the interviews conducted by the researcher will be commenced with brief explanations regarding the objectives of the research; and the interviewees will be assured of the confidentiality of the data that they shared in the interview session. Furthermore, the researcher forwarded the consent form to the interviewees. Besides obtaining the informed consent of the interviewees, the researcher was obligated to explain clearly and correctly her research to the interviewees; the researcher also disclosed the dictation machine that will be used during the interview. This is to explicitly exercise the researcher's responsibility to guide, protect and oversee the interest of the people being studied (Neuman 2000). Furthermore, the researcher kept close contact with relevant personnel to ensure that all the ethical issues are dealt with. The data sources for this study consisted of interview notes. All the interviews were conducted with CEOs, National *Shari'ah* Advisors, and *Shari'ah* officers from various commercial *Islamic* Banks. The interview sessions were carried out at the interviewees' office or the offices where the SC were being appointed (responsible or contracted for). The interviews were tape recorded and transcribed. There are only two interview sessions that were not tape-recorded. Interview notes and tapes were transcribed and coded, providing textual material for analysis.

5.6.3 Analysis of the Interview Data

On the basis of a social constructivism, this study comprehensively explores the problems and challenges in Malaysia, as it is a country that has a robust regulatory framework and

infrastructure to facilitate development in Malaysia. Problems and challenges will be incorporated in this study. It explores the general and broad overview of problems and challenges facing *Islamic* banking and finance industry, then, it will investigate the problems and challenges in ensuring the *Shari'ah* compliance in its operation and accounting and auditing practices and the problems and challenges related to regulation and management (i.e. Monitoring and control that exists).

It is important to examine such areas due to the emerging development of *Islamic* banks and the core objectives of the banking businesses to provide a banking system that is based on *Shari'ah*. The problems and challenges will be analysed through the view, perspectives, perception, and experience of the senior officials of NSAC, SAC, the bank's management, *Shari'ah* officer, finance officers and academician. The meaning (i.e. subjective meaning)³³ from the interviewee are diverse and numerous, which will entail the researcher to observe complexity of views rather than constricting meanings into a few categories or ideas (Creswell 2009).

The interviews that were conducted with the officials of several key financial institutions have had many years of experience in Islamic banks. These interviews would lend a good piece of work where it would bring together the perspectives of the academics (i.e. Literature review) and practitioners (semi-structured interview with NSAC, SAC, the Head of *Shari'ah* Department or *Shari'ah* officer and CEO). The subjective meaning are not merely reproduced on individuals but are constructed through interaction with others (hence social constructivism) and through historical and cultural norms that operate in individuals live

³³ Social constructivist hold assumptions that individuals developed subjective meaning of their experiences – meanings directed towards certain objects or things (Creswell 2009). In this study, it is referred to the meaning provides by the interviewees through their involvement and experience in Islamic banking and finance industry in Malaysia.

(Creswell 2009). This requires the researcher to make critical and in-depth assessment of the interviewees' perspectives through their knowledge and experience in the industry in relation to the general understanding gathered from the literature survey in relation to inform the problems and challenges facing Islamic banking and Finance in Malaysia, and to also include theory which is both informed and developed through observation. The researcher's intent is to make sense of (or interpret) the meaning the interviewees have had about the problems and challenges facing Islamic banking and finance in Malaysia. Thus, in contrary to start with a theory, interviewer generate or inductively develop a theory or pattern of meaning (Creswell 2009). Moreover, the interpretation is shaped by researcher's own experience and background.

The problems and challenges facing IBF are explored through the experience of the respondents that are involved with the operation and development of IBs. It allows an understanding of the problems and challenges faced by IBF in Malaysia. It is perceived that through this method, it is possible to generate knowledge about and evidence for the research (Mason 1996). In addition, people are seen as data sources in the sense that they are the source of knowledge, evidence, experience and whatever else is relevant to the research. Further, in answering the research questions, the researcher expects depth, nuance, complexity and roundness in the data acquisition (Mason 2002).

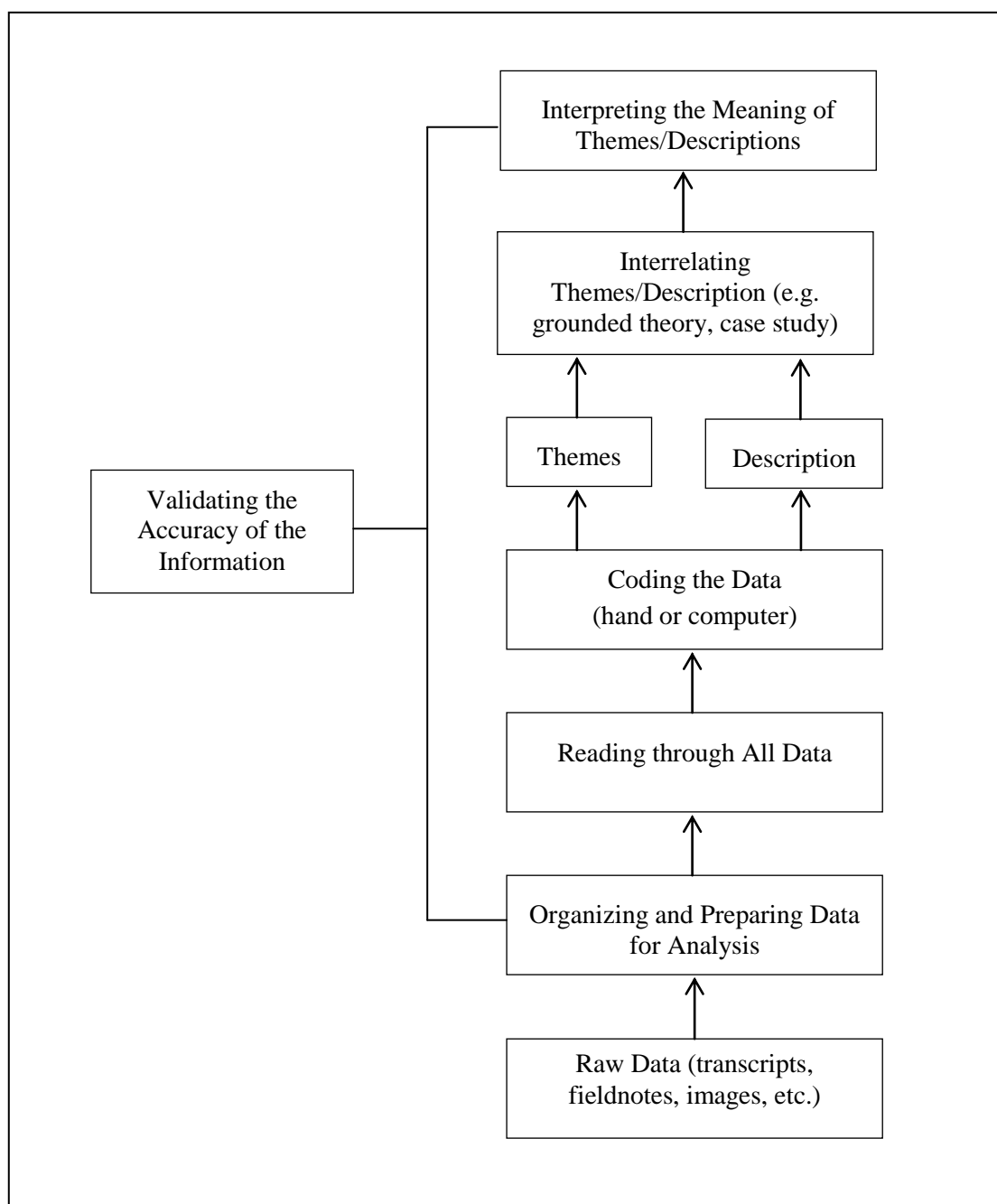


Figure 5.6.2 Data Analysis in Qualitative Research (Creswell 2009)

Figure 5.6.2 above presents an overview of the steps involved in data analysis in qualitative research as outlined by (Creswell 2009). The first step of analysing the data from the qualitative interviews was to organize and prepare for data interview by transcribing interviews, optically scanning material, tying up field notes and sorting and arranging the data according to source of information (Creswell 2009). Next, the researcher read through all the transcribed interviews to obtain an overview of the information from the organized data

and reflect upon its overall meaning before coding the textual data. Then, detailed analysis with coding process is being done (Creswell 2003, 2009). The researcher started to collect text data by segmenting important sentences or paragraphs into categories, which were then labelled using specific terms to a description of the setting of people, as well as, categories or themes for analysis. The themes were inductively generated from the raw material (Boyatzis 1998). Finally, the researcher advanced the description and themes in the form of narrative passage and interpret and give a meaning to the data (Creswell 2003, 2009).

In reference to Figure 5.6.2, the first three steps involved in the data analysis were being done manually. However, the fourth step is being done manually and using software. While reading through all the data, the researcher highlighted segments that are deemed important into categories and labelled using specific terms. Concurrently, the researcher scribbled the appropriate terms for the highlighted segments. Also, the researcher scribbled thoughts and made comments in expanding and supporting the highlighted segments. Then, the terms were abbreviated as code.

The data analysis process is continued using software that is Atlas.ti version 6.2 in assisting the researcher to analyse the interview data. Atlas.ti is a computer software and one of the Computer Assisted Qualitative Data Analysis Software (CAQDAS) available for analysing qualitative data. Analysis of qualitative data through the use of CAQDAS was the intellectual task of the researcher because the software itself could not function on its own unless instructed by the researcher (Hwang 2008; Konopásek 2008). In order to obtain necessary skills, the researcher attended a few training courses that were offered by the university.

Basically, the transcribed interviews and the memos on thoughts developed throughout the first three of the analysis process served as the Primary Documents (PD). This PD had to be assigned in a single platform known as the 'hermeneutic unit'. After the PD has been assigned, the next step is to extract segments of the PD into pieces of information, known as 'quotation', which were deemed important and relevant to the topic under investigation. Atlas.ti makes the quotation a 'self-contained object for ease of analysis by researchers'.

Once the related processes being done using Atlas.ti, the researcher managed to extract all the codes (i.e. categories or themes) with all segments assigned to each code. Also, the segments are linked to assigned memos and comments. Next, the researcher continued the data analysis process such as advanced the description and themes in the form of narrative passage and interprets and gives meaning to the data manually.

Furthermore, bias in reporting the results from qualitative interview³⁴, can be eliminated and controlled by standardising the stimulus, where any variations seen in the responses will be a true measure, rather than an object of personal methods (Mason 2002). The interview session needs to be done with an understanding of the complexities of social interactions and not merely just performing the interview (Mason 1996).

The data analysis process was continued by using the Atlas.ti version 6.2 software in assisting the researcher to analyse the interview data. Atlas.ti is one of the Computer Assisted Qualitative Data Analysis Software (CAQDAS) available for analysing qualitative data. The analysis of qualitative data through the use of CAQDAS was the intellectual task of the researcher since the software itself could not function on its own unless instructed by the

³⁴ where the data reflects the view of the researcher instead of the respondents

researcher (Hwang 2008; Konopásek 2008). In order to obtain the necessary skills, the researcher attended a few training courses offered by the university.

Basically, the transcribed interviews and memos on the thoughts developed throughout the first three segments of the analysis process served as Primary Documents (PD). The PD had to be assigned in a single platform known as the 'hermeneutic unit'. After the PD was assigned, the next step was to extract segments of the PD into pieces of information, known as 'quotations', which were deemed important and relevant to the topic under investigation. Atlas.ti made the quotation a 'self-contained object for ease of analysis by researchers'.

Once the related processes were completed using Atlas.ti, the researcher managed to extract all the codes (i.e., categories or themes) with all the segments assigned to each code. Furthermore, the segments were linked to assigned memos and comments. Next, the researcher continued the data analysis process; whereby, advancing the descriptions and themes in the form of narrative passages and interpreting and providing meaning to the data manually.

Moreover, bias in reporting the results from a qualitative interview³⁵ was eliminated and controlled by standardising the stimulus; where any variations seen in the responses became a true measure, rather than an object of personal methods (Mason 2002). The interview sessions had to be accomplished with a comprehension of the complexities of social interactions, and not just mere performance of interviews (Mason 1996).

³⁵ where the data reflected the view of the researcher instead of the respondents

The findings from the in-depth interviews were presented in Chapter Six, Seven and Eight in the form of narrative passages, which included interpretations and quotes. Where necessary, the qualification of the interviewees, the size of the banking institutions and the ownership of the bank were also mentioned in order to emphasise the facts given by participants on the topics under discussion.

5.7 Summary

This chapter explained the research methodology of the study. The objective of this study is to explore and understand the problems and challenges facing Islamic banking and finance in Malaysia. It focuses on four aspects of issues, they are: legal and regulatory framework, *Shari'ah* compliance, management and accounting. In order to achieve the objectives, a semi-structured interview was considered to be appropriate in this study. The semi-structured interviews were conducted with various interviewees who are currently involved in the operations of the Islamic banks in Malaysia. This chapter also explained the methods of data collection and data analysis to answer the questions posed in this study.

CHAPTER SIX

LEGAL AND INSTITUTIONAL FRAMEWORK OF ISLAMIC BANKING AND FINANCE INDUSTRY

6.1 Introduction

In an attempt to explore the problems and challenges facing *Islamic* banking and finance industry in Malaysia, a series of semi-structured interviews were undertaken by practitioners and academicians (i.e. *Shari'ah* scholars). The interviews intended to make a contribution towards the need to inform the problems and challenges facing *Islamic* banking and finance industry in the context of Malaysia, from the perspective of the interviewees. Semi-structured interviews allow the interviewer to inquire about the problems and challenges facing *Islamic* banks in Malaysia from the perspective of the interviewee, through their experience and involvement in the industry. The research looks at the regulatory framework, practices (i.e. Management), accounting practices and *Shari'ah* compliance within the *Islamic* banking setting (i.e. *Islamic* Financial Institutions). In addition, it aims to gather insight into the problems and challenges facing IB in Malaysia with the hope to complement the literature review from the previous chapter.

This chapter starts with a brief perception of the interviewee on the impact of IB's operation under the Malaysian dual banking system. Next, the effect of such a system on the operationalization of *Islamic* banking system was presented. The chapter also presents a review of the legal and institutional structures of *Islamic* banks and findings on the problems and challenges related to legal and regulatory frameworks.

6.2 Malaysia: Dual-banking System

Malaysia has made effort in providing a platform for the establishment and operation of *Islamic* banking and finance by introducing it through the dual-banking system. The operation of *Islamic* Bank (IB) under the dual-banking system provides the opportunity for IBs and Conventional Banks (CB) to operate in parallel. Under this environment, the conventional economic system is the primary system, and the initial idealism and infrastructure are based on the conventional system. Doing *Islamic* banking business under the dual-banking system would expedite the establishment and development and would also assist in the operation of IB.

Although IB possesses different underlying principles as compared to conventional, it can benefit from the existing conventional infrastructure. Also, further development of the infrastructure can be extended from the conventional banking system to equip and support the industry in operating *Islamic* banking business in the current system. In addition, the regulator needs to either revise existing legal framework or propose necessary framework to support the system. Currently, the differences in underlying principles are supported and equipped with the introduction of various standards, acts, guidelines, parameters, pronouncements, etc. Furthermore, the IB took a pragmatic approach in introducing a different way of doing banking business activities. The decision to establish the *Islamic* banks in this environment provides an opportunity for the *Muslim* to have an alternative banking system that is based on *Shari'ah* and an avenue to the non-*Muslim* and western countries to participate in this development in order to keep abreast with the current growth and expansion of IB.

6.2.1 Competition

However, due to its dual-banking system, the Malaysian IB industry faced higher levels of competition. A *Shari'ah* Committee (SC) of medium-sized local IBS is of the view that the *Islamic* banks operating in a dual-banking system face competitive environments.

“Since we are practicing in the dual-banking system, the competitive nature of a dual-banking environment exposes Islamic banks to various types of risks and the challenges.”

In addition, despite the benefits of operating under the dual-banking system, SC of medium-sized foreign IBS and SC of large-sized full-fledged IB are highlighting the reality of IB operating under the dual-banking system.

“Under the dual-banking system, the banks face challenges in islamising the financial institutions.”

“Another challenge facing Islamic banks is to operate in the system that is still offering conventional banks.”

Both SC highlighted that the industry is facing challenges in Islamising the banking business activities. Due to its underlying system, the *Islamic* bank operates in the environment that is influenced by the conventional banks. Furthermore, although, the IB system is established as an alternative system, it is seen as a secondary banking business system to the overall financial system. The CEO of medium-sized local IBS highlighted that IB is seen as a second figure to the conventional system.

“Since IB is operating under the conventional banking environment and mindset, the IB plays as a second figure instead of an alternative to conventional banks.”

Also, IBs operating in the dual-banking system shows that it faces various problems and challenges to develop the operations of *Islamic* banks in the long run and in ensuring that the IBs are meeting the objectives of *Shari'ah*. The effect of operating under the dual-banking system can be categorized into influence of CB's products and services, customer's awareness, and negative public perception towards IB. The following subsections further discuss the effects.

6.2.1.1 Influence of Conventional Banking Products in Customers' Demand

The familiarity of the IB system among the customers and the public is still not well established. The highly competitive environment and familiarity of the customer with conventional banking products resulted in a demand towards products that are similar to conventional banking products. Furthermore, the CEO of large-sized local IBS highlighted that the customers demand towards its the products and services drive the product development in IBs.

“This is normal for the Islamic bank in their process to make a new product, if the customer needs such product, the bank will produce, in the name of meeting the customer's demands or needs....”

In order to meet the demand of the customers, the *Islamic* banks replicate the conventional product and make it *Shari'ah* compliant by changing the name and changing any terms that are not in compliance with *Shari'ah*. The replication of the CB's product is applied to sell viable products and to meet the demand of the customer. This is being highlighted by CEOs of large and medium-sized IBS. Both CEOs emphasize on the earlier existence and establishment of CB to operate based on *Shari'ah* Law, which are based on a conventional economic system, and the competition of the IB to being able to offer products that are comparable within IB's with CB's products.

“Since conventional banking is established when banking systems started in the country, it is a challenge for IB to innovate or develop products that are effective in comparison to conventional banks’ products and services and other Islamic bank’s products and services and be able to compete with those products...”

“It is a challenge for us to operate within the maxim and requirements of Islamic banking using conventional resources....”

New types of products and services in the *Islamic* banking portfolio will render various perceptions among the public. SC of medium-sized local IBS is highlighting this matter in the following:

“As Islamic banks in Malaysia operate in a dual-banking system it positions conventional banks as a benchmark to make any decisions to innovate and to develop products. For example, the Islamic banks will refer to conventional banks in order to develop a product. This may hinder the development of the Islamic banks as it competes with conventional.”

Since these types of products are being *Islamised* from conventional products, it carries conventional product influences within it. Most of the products offered in Malaysia are *Shari’ah* compliant products. The industry faced various hindrances that made it difficult to develop *Islamic* based products that are unique to Islamic banks. The SC of medium-sized local IBS and CEO of large-sized local IBS are highlighting this matter as follows:

“The root of the problem that causes Islamic banks to be underdeveloped and unable to offer a product that are based on an Islamic spirit is our development of products that are based on a conventional spirit.”

“... We have the conventional counterpart that has been there since banking started in the country and one challenge is to be able to make your product to be effective in comparison, not only within the Islamic banking industry itself, but to compete with the conventional products.”

Also, the COO of medium-sized foreign IBS, highlighted the challenge in innovating *Shari'ah* based products in *Islamic* banks under the dual-banking system.

“Basically, in Malaysia the key challenge facing operating in the dual-banking environment is that, it will be difficult for us to develop products that are unique to Islam. Furthermore, the market is actually demanding products that have similar characteristics as conventional because they are familiar with the conventional product. So that is the from all facets of the players that are involved, not to say players, from everybody who have a stake in the industry; be it the regulators, be it the customers, be it those people we have been dealing with, we have this challenge of trying to come out with something young and familiar to everybody.”

Lack of awareness and education pertaining to Islamic banking products and services influenced the preference and demand towards IB's products and services. It resulted in customers patronising IB's products that are driven by other elements such as pricing and returns, and possess similar characteristics with conventional banks. The demand and preference of the customers influence the characteristics of products and services offered by IB having similar characteristics as CB.

6.2.1.2 Lack of Customer Awareness and Knowledge

Meanwhile, the preference and demand of products and services in IB is influenced by the customer awareness and knowledge regarding their *Shari'ah* principles in patronising *Islamic* banking products and services. Due to lack of customers' awareness and education, the accounting academician and SC of medium-sized local IBS (possess an accounting qualification) opine that the reason customers patronise *Islamic* banks are not motivated by religious impetus.

Nowadays, “the customers and public patronise IB by looking at other qualities such as qualities of services and returns that they will receive.”

“... They patronise Islamic banks hardly because of religious conviction but purely due to the same reason as normal conventional customers. They just look for a product which is cheaper, services which are more convenient, efficient, and processes that are not complex and complicated.”

Furthermore, on the same note, a SC of medium-sized local IBS highlighted the reality of customers who are not driven by religious factors in engaging with banking business which increase the competition faced by IB.

“If you look at the development in Malaysia under the dual-banking system you will find that the customers are unIslamic.”

Furthermore, since the customers are very familiar with the conventional banking business and risk aversion, the customers' decision to subscribe to *Islamic* banking products are still being influenced by the returns that they may receive if they invest the money in conventional banks.

6.2.1.3 Negative Public Perception

Due to lack of understanding and awareness regarding Islamic banking, the human capital may face difficulties in explaining to the customers and the public regarding its products and services. Lack of proper and comprehensive information may result in misunderstandings and misconceptions among customers and the public on the products and services offered by *Islamic* banks. Thus, this will become another problem faced by the industry, which is negative public perception. This problem might start from a lack of education, understanding and awareness about the *Islamic* banking and finance among the bankers, which lead to miscommunication with the customer and the public. In the *Islamic* banks, there is a lack of pool of expertise that is able to explain and educate the customers pertaining to IB's products and services. It begins with the front line staff in the bank that fails to explain properly to the

customer regarding the *Islamic* banking products and fails to attend to the query and complaint by the customer, accordingly. The NSAC of BNM further explains that issues pertaining to lack of knowledge in staff may result in lack of understanding of customers in appreciating the *Islamic* banking business and transactions.

“When the bankers and the customers concluded the aqad (i.e. the contract executed between the bankers and the customers), for example, the uncertainty of the selling price are the things that may lead to why the bankers may forget to actually highlight and specify to their customers when they conclude the purchase. And the way they explain the product to the end user may not reflect an Islamic product, they may just explain the product to their customer as a loan and say that there is no difference from conventional in terms of the rate that you have paid. Of course in terms of the rate, the pricing may be similar but the contract, the whole underlying principles, are different. So, these are the things that perhaps they do not have full knowledge of and therefore they cannot really educate their customers or the end user on those aspects.”

In addition, negative perception may arise from the attitude of the customers and the public that keep comparing the IB and CB without really understanding the underlying principles of IB. The customers are very familiar with the conventional banks and tend to compare between both services. Consequently, due to the lack of explanation from the front line, customers will misunderstand and confuse the overall operations and products of the *Islamic* banking operations. The CEO of medium-sized foreign IBS highlighted as follow:

“The Islamic banking customers are very used to conventional products that lead to the tendency to choose product that eliminate the uncertainty and tendency of customers choosing debt-based product.”

Since the staff cannot appreciate the difference between *Islamic* banks and conventional banks' products, they may provide wrong information that will entail false understanding of the customers, potential customers and the public. The customers and the public may interpret the information that they received differently or wrongly which will result in claims

that there are no differences between *Islamic* and conventional products. Various interviewees such as a *Shari'ah* officer of medium-sized local IBS, and a *Shari'ah* officer of large-sized full-fledged IB highlighted as follows:

“When we are not clear on our map we tend to follow conventional bank’s practices. So, in the end, the public will claim that there are no differences between Islamic and conventional. For them, it is either with ‘i’ or without ‘i’. Then, we change it to Arabic names, I feel that these will create uneasiness and there is no difference. The public will feel that it is neither Islamic nor conventional.”

“Public would claim (i.e. accuse) Islamic banks as an opportunist because Muslims who are aware of the prohibition of Riba’ went to IB to have an alternative banking system. However, when they come to us, our profit rate is high (i.e. in the case of BBA). If we said that conventional is cheaper, let us look at the pricing, the conventional banks had BLR and spread and we don’t have such elements. In addition, in Islamic banks, if you make early settlement IB will give you discount known as ibra’. This is where the human capital of IB is important – the human capital needs to explain to them the differences between conventional and Islamic banks. We need human capital that is able to explain comprehensively to customers, so that; any accusation or confusion of the customer can be cleared up. This is for those that had negative perceptions.”

Also, different steps involved in the process to seal the deal, which is not familiar to the customer, may lead to a negative perception by the customer. SC of medium-sized local IBS explains an example of the lack of explanation by the staff to make the customer aware is the explanation of documentation processes in IB that involved various documents exceeding that of CB:

“... Involve with a lot of documentation to ensure that aqad of contract is met – lead to negative public perception - in order to meet the Shari’ah requirement, the transactions involve various documents (with certain sequence) to ensure the Shari’ah compliance (sales aqad).”

Besides various contracts and documentations involved, the cost in contract stamping is also increased. Various procedures are further involved in concluding a contract to ensure that the *aqad* is fulfilled and to ensure it is *Shari'ah* compliant. However, there is always a reason why it involves various documentations and why the sequence should be preserved. Regardless, when the public is not well informed, it will lead to negative perceptions of the overall operation.

As previously mentioned, negative perception may arise from the attitude of the customers and the public that keep comparing the IB and CB without really understanding the underlying principles of IB. The customers are very familiar with the conventional banks and tend to compare between both services. Consequently, due to the lack of explanation from the front line and the lack of knowledge and understanding of customers, customers will become confused and muddled in regards to the overall operations and products of the *Islamic* banking operation. As a result, customer will choose a product that is similar to CB as they are more aware of CB's product. This will produce a more debt-based product, which holds less risk and less uncertainties being sold to the consumer.

The negative perception of IB by the public relates to lack of education, understanding and awareness of the customers and players. When the customers are lacking in the knowledge pertaining to *Islamic* banks, it is expected that the players would play their role to assist or explain properly to the customers or potential customers. However, since the HC in the industry is also lacking in education, understanding and awareness of the knowledge and spirit regarding IB, it results in confusion, misunderstandings and misconceptions of the customers and potential customers. These are coupled with the familiarity of the public towards CB which leads them to compare IB and CB in every aspect, and will result in

negative perceptions which will drive customers or potential customers to shy away from subscribing to IB businesses.

When discussing the competition in the Islamic banking industry, the *Shari'ah* scholars were very concerned about the difficulties faced in Islamising the dual-banking system. In contrast, the CEOs were concerned of the fact that IBs were seen as secondary to CBs, in which the operations of IBs were shadowed by CBs.

CEOs drew attention to how demands of the customers were created. In this case, the demands of IBs' customers were influenced by the familiarity with CB products. As the top management, it is their concern in knowing what is being demanded by customers since it will assist them in providing products and services that are viable in the market. As a result, various products bore the same characteristics as conventional products. It may seem viable, however, the *Shari'ah* scholars highlighted that in the long-term, this provided the same macroeconomic impact as conventional products. Measuring the religious commitment through the *Shari'ah* compliance of the overall operations, products and services should be extended to the macroeconomic impact of business banking activities. The lack of a macroeconomic impact would hinder the fulfilment of the objectives of *Shari'ah*. However, the macroeconomic implications of Islamic banking are still being formulated on the assumption that it should largely be based on profit sharing (Siddiqi 2006b). It was argued that Islamic financial intermediation would generally contribute to increased efficiency and greater stability in the economic system, and particularly in the financial market (Siddiqi 2006b). Furthermore, among others, the application of an Islamic financial intermediation is expected to create risk-bearing capital and new entrepreneurs to generate innovative sources of growth in the economy; meeting the capital needs of entrepreneur expertise, enabling the

circulation of wealth, reducing income inequality and ensuring economic stability (Khan 1994). However, having various products that possess similar characteristics with conventional products will result in an Islamic banking institution that bears the same exposure as a conventional banking institution; whereby, any shock on the asset side would create an immediate crisis for the bank, which may derail it from its equilibrium.

Shari'ah scholars further emphasised the lack of education, knowledge and awareness of customers who influence the preference of choosing IBs' products and services. Moreover, CEOs and *Shari'ah* scholars shared concerns over the lack of education, knowledge and awareness among human capital when communicating with customers; which may influence the perception of customers, or potential customers, in choosing IBs' products and services. In general, CEOs were more concerned with the capability of IBs to market their products; therefore, focus was given to factors that may increase the demand towards IBs' products and services. On the other hand, *Shari'ah* scholars were more concerned about the factors that influenced the decisions made by customers in choosing IBs' products and services.

6.2.2 Monetary Policy Issues

In Malaysia, the Islamic Inter bank Money Market (IIMM) was introduced in 1994 as a short-term intermediary to provide a ready source of short-term investment outlets based on *Shari'ah* principles. The establishment of IIMM provides avenue for the Islamic financial institutions with the facility for funding and adjusting portfolios over the short-term, and serving as a channel for the transmission of monetary policy. Financial instruments and interbank investment would allow surplus banks to channel funds to deficit banks, thereby maintaining the funding and liquidity mechanism necessary to promote stability in the system. IIMM served as a platform for IBs and banks participating in the Islamic Banking

Scheme (IBS) to match the funding requirements effectively and efficiently. Although IIMM operates in an interest-free environment and trades *Shari'ah*-compliant instruments, it is exposed to risks associated with conventional money markets (Bacha 2008). In addition, he found that based on Malaysian data, Islamic money market profit rates/yields were highly correlated and move in tandem with conventional money market rates. Despite the existence of IIMM, the accounting academician did highlight pertaining to the problems of liquidity that still exist in the industry due to innovation of financial instruments based on more liberal interpretations that lead to *Shari'ah* controversy.

In operating in parallel with CB, IB is being compared and benchmarked to CB in its performance, pricing and returns. Some measures are being used to calculate performance that may not be suitable to be used in IB, in terms of product development and innovation. It is a competition to market and sell IB's products, as it will be compared to CB's products in every aspect without taking into consideration its underlying principles. Furthermore, the CEO of a medium-sized foreign IBS and SC of large-sized full-fledged IB highlighted that the challenge faced by them is having an *Islamic* equivalent product for all conventional banks. Although, it is quite straightforward to have an equivalent product for products offered by conventional banks in the retail market, it is a big issue when it comes to treasury products since it involves issues in terms of *Islamic* concepts, *Shari'ah* issues, market expectations and tension between *Shari'ah* scholars and practitioners.

“... Take a conventional product and Islamize the product and sell it as an Islamic product”

There are Shari'ah issues of Islamic concepts for treasury products, derivatives, futures and options. There is still a lot of void area. We face Shari'ah issues such as, whether it is possible to have an equivalent Islamic product for all conventional products that the market demands and tensing

Shari'ah scholars on the practitioners to have this.

In addition, IB is being compared and benchmarked to CB in its performance, pricing, and returns. Some measures are being used to calculate performance that may not be suitable to be used by IB, in terms of product development and innovation; it is a competition to market and sell IB's products since it will be compared to CB's products in every aspect without understanding the principles underlying it. Measures used for IB is based on CB which lead to the unsuitability of measures, as IB's products hold different elements compared to CB's products. Examples of the measures are: measures for profit percentage, product pricing, risk measures, rating agency's measures, accounting and reporting and auditing that are still being referred to CB. Consequently, in the dual-banking system, the profit percentages offered by Islamic banks are tied to the percentage offered by conventional banks. NASC from BNM and SC medium-sized local IBS has highlighted the following:

"... The profit rates of the Islamic banks are influenced by the profit rate of the conventional banks. Thus, we can see that the profit percentage of Islamic banks is being controlled by profit rate in conventional banks...."

"In the dual-banking system, Islamic banks position conventional banks as a benchmark to make any decisions related to innovation and development of products and services. This may hinder the development of the Islamic banks as it competes with the conventional."

Furthermore, it is not relevant for *Islamic* banking to benchmark their activities to their conventional counterparts due to the different underlying principles and the different nature of products and services. However, since *Islamic* banks are operating in the conventional economic system, it ends up benchmarking it to conventional banks. Also, IB may have the limitation to innovate new products, as there is no legal and regulatory support, and high risk and high capital are needed. Also, IB is still dependent on CB's rules and regulations such as

rules for accounting and reporting and auditing, moreover, there are still various decisions that are being benchmarked to CB. The accounting academician ex-SC of large-sized local IBS (currently SC of Corporation Bank and Director of Islamic Banking Institute) highlighted that the *Islamic* banks are still faced with a lack of legal backup to produce products that are *Shari'ah* based:

“... Islamic banks are dependent on conventional bank’s rules and regulations....”

“Although BNM encourages the IB to develop and innovate banking products that are Shari’ah based, there is a lack of facilitation from BNM of regulation to support the PLS product.”

“Regulation is broad, not only talking about the central bank, but also capital market regulations, security commission, then the tax authority and the government; so, you have the full range of regulatory issues. And then the market structure, whether the market structure supports this like the Bursa, the trading platform and so on, whether they can accommodate such new things. So obviously, what you need to do is to move incrementally, on an incremental basis.”

Also, *Islamic* banking subsidiaries are aimed at moving forward and being at par with conventional subsidiaries. This creates the tension among the practitioners where everything that they do needs to be compared with conventional banks which hinder the development of *Islamic* banks in achieving the objectives of its establishment.

6.3 Review of Legal and Institutional Structure of *Shari'ah* Compliance and Accounting and Auditing in Malaysian Islamic Banks

This section is intended to draw understanding of the legal and institutional structures that might drive the IB to be *Shari'ah* compliant; and reliability in accounting and auditing practices. This section will also review and examine the existing legal and institutional

framework in Malaysia in the area of *Shari'ah* compliance and accounting and auditing practices.

6.3.1 Interpretation of *Shari'ah* Law

Since there are no comprehensive lists regarding what is permissible in *Islamic* business transactions, the *Ulama'* or scholars will carry out discussions to determine the permissibility of certain rulings for the business transaction. The agreed opinions on the permissibility of certain rulings that are derived from the discussions are called *Ijma*. In the context of *Islamic* banks, the opinions of the scholars will be binding upon *Muslims* when operating *Islamic* banks. In reaching the agreed opinions, the scholars will take into consideration various aspects. Among others, the scholars will take into consideration schools of thought (i.e. *Mazhab*), jurisdiction, public perception, culture, custom, market convention, law of the land, etc. Since these factors differ from one jurisdiction to another jurisdiction, it results in different opinions or interpretations of *Shari'ah* made by the scholars. Furthermore, the way in which we want to implement the *Shari'ah* principle in banking product or transaction may be hindered by the land code (i.e. Law of the land), familiarity of the customer with *Islamic* banking products and custom and culture.

In the *Islamic* banking industry, we will find that local *Shari'ah* scholars will make different interpretations based on their locality, which resulted in different products being offered in certain countries. The different interpretations result in difficulties in offering local *Islamic* banking products to global market. In accounting, different interpretations resulted in different ways of recording and classifying the banking transactions, which raise difficulties in comparing the annual report for *Islamic* banks operating in different countries.

The different interpretations of *Shari'ah* affect Malaysian *Islamic* banks if the banks decide to offer their products in the international market. At this point of time, affected *Islamic* banks will restructure the underlying concepts of the products to suit the international market. Thus, difficulties faced by *Islamic* banks due to different interpretations call for harmonization of the *Shari'ah* interpretations. When asked regarding different *Shari'ah* Interpretation of *Islamic* banks, the CEO of large-sized full-fledged IB and the CEO of medium-sized foreign IBS highlighted that consolidation of *Shari'ah* interpretation is important in order to gauge the international market:

“As far as we are concerned, to date, the different Shari'ah interpretation doesn't impact us so much. We don't do many international transactions. Thus, I don't think the differences in Shari'ah opinion will affect us so much.”

“Due to differences in interpretation, Middle Eastern countries are rejecting certain products that are approved in Malaysia. This raises the need to harmonize Shari'ah interpretation.”

Currently, the CEOs acknowledge the differences of *Shari'ah* interpretation and realised that in order for IBs to market their products internationally, it is important for the harmonisation of interpretations to allow marketability of Malaysian IBs products and services in international market. However, currently, most IBs in Malaysia who intended to market their products and services in international market will develop products that are suitable with the intended market. Since there is such flexibility, the differences of interpretation did not affect the overall operation.

On the other hand, among the *Shari'ah* scholars, they acknowledged the uniqueness of having differences in interpretations due to certain permissible factors. Since the *Shari'ah* interpretation in Malaysia is being harmonised and controlled with the existence of SC and

NSAC, it did not raise any problems at the national level. However, lack of harmonisation between jurisdictions would further affect development and globalisation of the industry.

The debate among the accounting academician pertaining to the harmonisation of the *Shari'ah* interpretation did not receive any attention from the top management of IBs or *Shari'ah* scholars. This may be strongly due to the flexibility in developing new products based on the location of the IB's industry. Thus, at the moment, the debate to harmonise the *Shari'ah* interpretation was left unattended.

6.3.2 The Guidelines Governing the *Shari'ah* Governance System

As the establishment of IB is based on the *Shari'ah* law, it is crucial to ensure that the operations of *Islamic* banks are complying with *Shari'ah* with all aspects of its operations. Besides guaranteeing the compliance on the operation aspects, IB should also ensure that it fulfils the demand of the stakeholders in terms of commercial viability and returns. Thus, *Shari'ah* compliance and commercial viability are two main important governances in the objectives of IB. In addition, IB's management need to uphold the *Shari'ah* principles in banking business and at the same time, facing influenced from their conventional the CB. Also, in its effort to comply with *Shari'ah*, IB is needed to abide with legal structures that are based on the conventional banking system.

It is important for *Islamic* banks to ensure that the overall operations are in accordance to the principles of *Shari'ah*, which is unique as compared to conventional banks. Besides complying with the *Shari'ah* principles, *Islamic* banks are also bound to abide with current legal and regulatory frameworks that are relevant to them. This could consist of legal and regulatory frameworks for banking institutions and *Islamic* banking institutions, at the

national and international level. In the operations of Islamic banks, the IBs consist of corporate governance that governs its operations. The purpose of having the corporate governance system in place is to ensure that the institutions are governed towards maintaining the interest of the stakeholders. Among the stakeholders are the shareholders, IAH, institutional investors, borrowers, entrepreneurs, governments, and customers.

The component of corporate governance will ensure that the interest of the stakeholders will be taken into consideration. In order for the management to report on the operations, management and various internal experts to the BOD, the management will prepare the annual reports that will communicate the financial position and performance of the IBs. In addition, auditing is needed in the banking system to evaluate the institutions' personnel, system, process, enterprise, project or product. The audit will be carried out to ascertain the validity and reliability of information. It will also provide an assessment of a system's internal control.

Furthermore, according to the speech by the Governors of BNM on 29th May 2002, the regulation of banking institutions needs to be complemented and reinforced with good corporate governance. She further emphasizes that:

“In the context of the banking industry, corporate governance involves the manner in which the business and the affairs of the individual banking institutions are being governed by their board of directors and senior management, how the economic returns are generated to the owners, the day-to-day running of the operations of the business and the consideration of the interests of recognised stakeholders, including depositors; and how they behave in a safe and sound manner, in compliance with applicable laws and regulations.” (Aziz 2002)

In this assertion, the Governor highlights the transparency in the conduct of banking institutions, facilitated by the proper accounting standards that reflect the true and fair values of banking operations which would lead to greater accountability and responsibility of the part of the bank's management (Aziz 2002).

Meanwhile, in realizing the importance of corporate governance in Malaysia, BNM introduces specific guidelines on the directorship and the prohibition of loans to directors, staff and their interested corporations. The IBs is expected to observe these guidelines, as it is universal in nature. The main objectives of these guidelines are:

- 1) *to engender public confidence in banking institutions and to ensure that the management and the board of directors exhibit integrity and professionalism in the running of the banking institutions, including its directors and staff as well as family members and interested corporations*
- 2) *to prevent conflict of interests and accord responsibility on the banking institutions to provide complete and accurate information*

Furthermore, the BNM introduces guidelines specific to the *Islamic* banks that are Guidelines on Corporate Governance for Licensed *Islamic* (GP1-i) and Guidelines on the Governance of *Shari'ah* Committee for the *Islamic* Financial Institutions. Also, there are various standards for supervisory and statutory bodies on corporate governance such as (1) BNM GPS 1 – Guidelines on the Governance of *Shari'ah* Committee of IFIs, and *Shari'ah* parameter, (2) IFSB Guiding Principles on *Shari'ah* Governance System, Corporate Governance, Disclosure to Promote Transparency and Market Discipline for IFIs and (3) AAOIFI Standards on *Shari'ah* governance, fatwa and compliance. Despite the existing guidelines, there is still a need for Guidelines on *Ijtihad*, *Ifta'* and *Khilaf* (Laldin 2009)

In addition, good corporate governance emphasizes on ensuring fairness, transparency and accountability IFSB 3 (2006). Differences could be that the *Islamic* approach has religious values and requirements of the *Shari'ah* ingrained in it (Khan and Ahmed 2001). Generally, IFSB 10 refer to corporate governance of IFSI as structures and processes adopted by stakeholders in the IFSI (from financial regulators to market players) to guarantee compliance with *Shari'ah* rules and principles. Also, IFSB 3 emphasizes on the (1) general governance approach of IIFS, (2) rights of Investment Account Holders (IAH), (3) compliance with *Shari'ah* rules and principles and (4) transparency of financial reporting in respect to investment accounts. The general approaches of IIFS are (a) IIFS shall establish a comprehensive governance policy framework which sets out the strategic roles and functions of each organ of governance and mechanisms for balancing the IIFS's accountabilities to various stakeholders and (b) IIFS shall ensure that the reporting of their financial and non-financial information meets the requirements of internationally recognized accounting standards, which are in compliance with *Shari'ah* rules and principles and are applicable to the *Islamic* financial services industry, as recognized by the supervisory authorities of the country. The rights of IAH are (a) IIFS shall acknowledge IAHs' right to monitor the performance of their investments and the associated risks, and put into place adequate means to ensure that these rights are observed and exercised and (b) IIFS shall adopt a sound investment strategy which is appropriately aligned to the risk and return expectations of IAH (bearing in mind the distinction between restricted and unrestricted).

Also, the IFSB 10 (2009) defines the *Shari'ah Governance System* as:

The set of institutional and organisational arrangements through which an IIFS ensures that there is effective independent oversight of Shari'ah compliance over each of the following structures and processes: (1) issuance of relevant Shari'ah pronouncements or resolutions, (2) dissemination of

information on such Shari`ah pronouncements/resolutions to the operative personnel of the IIFS who monitor the day-to-day compliance with the Shari`ah pronouncements/resolutions vis-à-vis every level of operations and each transaction, (3) an internal Shari`ah compliance review/audit for verifying that Shari`ah compliance has been satisfied, during which any incident of non-compliance will be recorded and reported, and as far as possible, addressed and rectified and (4) an annual Shari`ah compliance review/audit for verifying that the internal Shari`ah compliance review/audit has been appropriately carried out and its findings have been duly noted by the Shari`ah board.

In IFSB 10 (2009), the standards emphasize the (1) general approach to the *Shari`ah* Governance System, (2) competence, (3) independence, (4) confidentiality and (5) consistency. Also, the *Islamic* banks should protect the interest of the Investment Accounts Holder (IAH), and be transparent in smoothing any returns. The compliance with *Shari`ah* rules and principles are (a) IIFS shall have in place an appropriate mechanism for obtaining rulings from *Shari`ah* scholars, applying *fatāwā* and monitoring *Shari`ah* compliance in all aspects of their products, operations and activities and (b) IIFS shall comply with the *Shari`ah* rules and principles as expressed in the rulings of the IIFS's *Shari`ah* scholars. The IIFS shall make these rulings available to the public. The transparency of financial reporting in respect to investment accounts is (a) IIFS shall make adequate and timely disclosure to IAH and the public of material and relevant information on the investment accounts that they manage.

In line with the emphasis on stakeholders' interests, the IFSB 3 (2006) explains the role of the Audit Committee and Governance Committee. The former, monitors the operations of *Islamic* banks primarily from the standpoint of IAH's interest, while the later, monitor the operations primarily from the standpoint of shareholders. If any differences arise between the committees, the BOD will have ultimate responsibility for reconciling those differences. Furthermore, IFSB 3 (2006) highlights the reporting of financial and non-financial

information. The reporting will express the compliance of the IIFS towards the recognised international accounting standards that are also recognised by the supervisory body of the country and comply with *Shari'ah* rules and principles by the IIFS. Furthermore, the Islamic Financial Service Act 2013 (IFSA 2013) highlighted *Shari'ah* compliance and *Shari'ah* governance in Division 1 and Division 2 of act IV of the Act.

6.3.2.1 *Shari'ah* Manual as a Guideline for the Implementation

Since the IB's products and services are based on *Shari'ah* Law and IB are lacking of HC that are well-versed in both technical and *Shari'ah*, coupled with unique characteristics underlying its product and services, it is crucial to ensure that the implementation of the contract is fully observed in order to guarantee that the product is *Shari'ah* compliant in substance and form. In order to ensure that the requirement is fulfilled, and *Shari'ah* compliance is upheld in every aspect of banking activities, the IB initiates a *Shari'ah* compliance manual in every product and every aspect. The *Shari'ah* compliance manual is expected to minimise any non-*Shari'ah* compliance risk in the implementation of the approved products. The *Shari'ah* officer of medium-sized foreign IBS highlighted that all banks are required to have manuals to assist the HC to deliver their responsibilities.

“Islamic banks are required to have Shari'ah compliance manuals for every product and support services, especially for Islamic banking subsidiary that is operating on leveraged model. We leverage on our HR, compliance, legal and vendor. We have the Shari'ah compliance manual that guides from end to end of products.”

In this stage, the relationship between accountants, accounting experts or accounting executive and *Shari'ah* committee seems lost. In order to complement the lack of expertise, the bank produced the *Shari'ah* manual; a certain checklist in hiring staff for *Islamic* banking subsidiary or electing a representative from *the Shari'ah department* for advising the

accounting and auditing team. However, in the *Islamic* banks in Malaysia, there are *Islamic* banks that already have the *Shari'ah* manual in place, and *Islamic* banks that do not have the *Shari'ah* manual in place but are in the process of developing it. Besides manuals, banks do provide or organize internal and external training to their staff. The *Shari'ah* officer of medium-sized foreign IBS stated the following:

“... We have our own compliance manual to complement our existing conventional bank’s manual that we had.. The Shari’ah compliance manual addresses all that, from end-to-end, and also for the support services, so, that our initiative to ensure Shari’ah compliance, in every aspect, of the bank....”

However, the manual is not fully available in all IB or IBS. It is still under construction for some banks. In the effort to implement the SA, SC of medium-sized local IBS and NSAC of BNM highlighted that the industry and institution are still lacking in the *SA Framework*.

“We don’t have the framework for SA. That’s why ISRA will take the initiative to come out with the framework. We are now working in a research team to come out with the framework of SA. When it comes to implementation, will it have enough expertise? Currently, the bank has their auditors. We are not talking about the external auditor; we are talking about internal auditor, because the processes need to be audited. At least now we have to ensure that the bank actually does their internal auditing or internal Shari’ah auditing.”

“We are moving towards SA except that, of course, we need to have an adequate infrastructure because the issue now is that who is going to conduct the review? So those are the kind of things that we need to address. In ISRA we are doing that, we are coming out with the SA framework... What are the areas that need to be audited, and what are the scope and all related issues?”
(P3)

In addition, the NSAC of BNM emphasized that the *Shari'ah* manual is needed to develop the *Shari'ah* framework which could be a challenge to the industry as banks vary in the extent of having *Shari'ah* manual. There are mixed findings in terms of the availability of

Shari'ah manual, whereby the IB may have it, is developing it or may not have it at all:

“Actually Islamic finance has grown in the past 35 years. Islamic finance was in the market, of course, there are many challenges that Islamic finance has gone through. First of all, in developing proper Shari'ah framework for the banks, you see, each and every bank must have their own Shari'ah manual.”

One of the duties and responsibilities of the *Shari'ah* committee is to endorse the *Shari'ah* manual. It was highlighted in the Guidelines of the Governance of *Shari'ah* Committee for Islamic financial institutions as follows:

To endorse Shari'ah Compliance Manuals

The Islamic financial institution shall have a Shari'ah Compliance Manual. The Manual must specify the manner in which a submission or request for advice be made to the Shari'ah Committee, the conduct of the Shari'ah Committee's meeting and the manner of compliance with any Shari'ah decision. The Manual shall be endorsed by the Shari'ah Committee. (Part E, No.20 (b))

The current situation calls for the need for harmonisation of all levels of operation such as internal supervision, techniques, terminology, contract, form used, etc. Furthermore, harmonisation in reports, balance sheets, and other financial statements is also important. In addition, harmonisation of manual and definitions of different transactions as well as methods of accounting would assist in comparing and enhancing current performance and development and growth (Kahf 2005a).

6.3.2.2 Shari'ah Committee Report

A *Shari'ah* Committee Report of large-sized local *Islamic* banking subsidiary in Malaysia for the year 2008, 2009, and 2010 was taken as an example. In the 2008 annual report, the SC highlighted three points regarding the *Shari'ah* advisory services performed by them. In the

report, the SC gave confirmation that they have reviewed the principles and the contracts relating to the transactions and applications introduced by the Bank and they have provided the *Shari'ah* advisory services on various aspects to the Bank in order to ensure compliance with applicable *Shari'ah* principles, as well as, the relevant resolutions and rulings made by the *Shari'ah* Advisory Councils of the regulatory bodies. On the other hand, in the report they highlight that responsibility to ensure the Bank's management holds that the Bank conducts its business in accordance with *Shari'ah* rules and principles. Also, the *Shari'ah* Committee reports their responsibility to form an independent opinion, based on their review of the operations of the Bank on (a) the contracts, transactions and dealings entered into by the Bank during the period that they have reviewed are in compliance with the *Shari'ah* rules and principles and (b) the main sources and investments of the Bank disclosed to them conform to the basis that had been approved by them in accordance with the *Shari'ah* rules and principles.

In 2009 and 2010, the report had a minor change where in the reports; the SC extended their opinion on the following details:

- a. New products, business initiatives and enhanced processes introduced by the Bank during the year that they were reviewed are in compliance with the *Shari'ah* rules and principles,
- b. The main funding sources and investment activities of the Bank disclosed to them conform to the basis that had been approved by them as well as in accordance with *Shari'ah* rules and principles and
- c. Financial statements of the Bank for the year together with the calculation of Zakat disclosed to them are in compliance with the *Shari'ah* rules and principles.

However, despite what is being reported in the *Shari'ah* committee's report, the SC of medium-sized local IBS and accounting academician did express their concern on the reliability of the report:

“Every year the Shari’ah advisor will sign the report saying that the operation of Islamic bank is in compliance but how sure are they that it is truly in compliance with Shari’ah when it comes into implementation?”

“If you look at the SAB’s report, you will find that they certified everything. So, when I asked the Shari’ah Compliance Review Team, he said, it is too good to be true. It is impossible not to have any mistakes but actually when we go and audit, he mentioned that there are a lot of Shari’ah non-compliance in the branches.”

It shows that, although the SC expressed their opinion on the *Shari’ah* compliance of the products and operations of IB in the report, the reliability of the report can still be questioned.

Besar et al. (2009) emphasized the importance of the *Shari’ah* committee report and execution of *Shari’ah* review in exercising governance, especially in ensuring bank compliance with *Shari’ah*. However, the *Shari’ah* committee report in IBs show that it lacks the depth of providing such an assurance. Furthermore, the assurance by the *Shari’ah* committee is merely an endorsement of the bank’s *Shari’ah* compliance in general, without any emphasis on the actual operational or conduct of the respective banks. This scenario created an expectation gap in the practices to report the *Shari’ah* compliance in banking activities.

The *Shari’ah* committee report, published in IB’s annual report, had shown significant changes in terms of its contents regarding communication to stakeholders; in comparison to the *Shari’ah* committee’s report during the earlier years of its establishment. Surprisingly, the *Shari’ah* scholars (i.e., the committee) voiced their concerns on the reliability of opinions and endorsements. This portrayed low confidence levels of the *Shari’ah* committee on the reliability of the report. In addition, the degree of compliance in IBs is still doubtful, although

Shari'ah committees did extend their endorsements towards such a report. This is a serious issue that must be addressed, as it will influence IBs' credibility and reputation in the eyes of stakeholders as a whole.

6.3.3 Current Legal and Regulatory Framework related to Operation and Products and Services

6.3.3.1 The Need to have More Legal and Regulatory Framework that will Support the *Shari'ah*-based Operation

Consequently, the existing environment where *Islamic* banking and finance operates is considered as not having a suitable environment to implement the *Islamic* principles fully. As an example, the most marketable and popular product in the industry is BBA that is based on *Murabahah* underlying principles. It is a debt-based product. The nature of this product is similar to loans in conventional banks; however, there are differences in documentation to ensure the *Shari'ah* compliance of the product. On the other hand, *musyarakah* and *mudharabah* are products that are based on PLS where it has certain principles underlying it. These products involve sharing of profit and loss. Also, these products involve sharing effort and risk. However, for IB to implement the PLS products, the CEO of large-sized local IBS opine that there are no legal backup from national and international laws.

"... We are moving towards offering Islamic products that are not found in the conventional market. For example, products that are based on Musyarakah principles or contracts are not available in conventional because conventional products under BAFIA do not allow banks to offer products where the bank itself can be the owner of the equity. Also, in terms of mudharabah products, contracts which apply mudharabah contract where we can offer, for example, profit sharing investment account, PSIA, whether it is general PSIA or dedicated PSIA, under the same principle that we can be a matchmaker between investor (mudharib) and the project provider or the business itself, so these are, in our case, products that we are currently developing, to offer to the market place."

Another challenge for *Islamic* banks is having a controversial *Shari'ah* contract. Although the regulators come out with guidelines for alternative contracts to replace BBA, *bay al-'inah* and *tawarruq*, it is difficult to come out with an alternative contract. *Shari'ah* officers of large-sized full-fledged *Islamic* banks state, regarding the alternative contracts, as follows:

"It is really a big challenge for us to come out with new contracts for new products to face out BBA, 'inah and tawarruq. The fact that our highest portfolio is from BBA and 'inah. (...). So, when BNM came out with an instruction to find other solutions besides BBA and 'inah, that will give a big impact to the business movement of the banks. Banks have to come out with new contracts where the reliability and controversy level is tolerable. As an example, when we come out with tawarruq and we received a lot of criticism...."

An accounting academician and CEO of large-sized full-fledged IB also highlighted the same issue. According to him, the reason why the bank did not respond to the new rulings by the BNM is due to its short-termism:

"Due to the short-termism nature of the industry and the fact that it is only looking at the market in profit maximizing aspects, they lose the idealism. Therefore, they don't even respond to some stimuli by the BNM that they should move away from the sort of liberal interpretation towards a more accepted interpretation of Shari'ah and be faithful to the Shari'ah views. This will take some times for industrialist to learn and appreciate."

"When we moved towards conformance, there is a higher authority that can make things into conformance, which is good, and it will eradicate a lot of the Shari'ah problems that we have about having different interpretations, we moved towards a more improved framework of better Shari'ah conformance."

Currently, despite of the unfamiliarity of customers in these products, the infrastructure of the industry still did not support the operationalizing of the products that are based on PLS. *Islamic* banks in Malaysia are bound to comply with national and international regulatory

frameworks. Besides, *Islamic* banking statutory acts, BNM's guideline, *Shari'ah* resolutions and *Shari'ah* parameters, *Islamic* banks are also bound to comply with related general regulations. In addition, it needs to compromise with existing legal systems and regulations that are based on the conventional economic system which does not fully support the application of *Islamic* contracts. A *Shari'ah* Officer in medium-sized foreign IBs and large-sized full-fledged IB stated that there are international regulations that hinder the development of the products.

“International regulations (i.e. BASEL) requires higher capital reserve that slows down the development of products that are based on PLS”

“Hindrance from international legal framework...”

Although, Malaysia is considered as having a comprehensive infrastructure to support the operation of *Islamic* banks, it still face problems in terms of legal and regulatory framework that may hinder or slow down the development of the product and services. Furthermore, it creates hindrance for IB to operationalize some products that are different from conventional banks and that are unique to *Islamic* banks. The *Shari'ah* officer of large-sized full-fledged IB highlighted as follows:

“The legal issues hinder the Islamic bank's operation and application to be in line with Shari'ah and civil law, lead Islamic banks to face various hindrances to operate in a Shari'ah compliance manner and, at the same time, bind to the law and regulation”

Also, the act, standards and guidelines introduce by BNM are still inadequate; it raised the need to revise the legal and regulatory standards in conventional banking systems to ensure its suitability for *Islamic* banking operations. The IBF industry in Malaysia still demands more standards and guidelines. Also, SC in medium-sized foreign IBS is in view that various standards need to be established to support the current operation, and various provisions need

to be revised in order to support evolution and emergence of the industry. These are to allow *Islamic* banks to introduce more products that are based on *Shari'ah*.

“... Due to the high regulatory nature of the industry, the Islamic banks have to follow and implement BNM's rules and regulations. Some of the BNM's rules and regulations are not Islamic, although they try to make it Islamic through amendments and new guidelines. In practice, it is still not really Islamic to support IBs' operations Islamically.”

CEOs, *Shari'ah* officers and scholars expressed their concerns in regards to the lack of legal and regulatory frameworks in supporting the development and innovations of *Shari'ah*-based products.

6.3.3.2 Inexistence of Regulations for Each and Specific IB's Product

Ideally, the *Shari'ah* committee believes that the legal and regulatory frameworks should fully support the underlying principles of *Islamic* banking systems. For example, there should be an act for each of the *Islamic* banking concept to assist in the development of products. Meanwhile, there are still various provisions that need to be revised in order to make them applicable to the practices of IB. In addition, relevant provisions also need to be improvised so that it fits the current development of the industry. It will also assist in the development of a wider range of products and services that can be offered to the bank's customers. The CEO of IBS is in view that:

“BNM had made a positive move by putting forward a temporary measure to refer any rising dispute to NSAC. NSAC is given an authority to pass a rule to the civil court and their decision pertaining to Shari'ah matter is binding. Although despite the positive move being introduced by BNM, the industry needs to have further enhancement of legislation. We are still using the framework of civil court where we still apply knowledge and procedure of civil court. We face a gap in dealing with Shari'ah interpretation in civil court.”

Also, CEO of IBS and SC of IBS focus on certain issues related to the operation such as taxes and land code:

“We are experiencing an evolution from conventional to Islamic that is still governed by conventional banking laws that may not be suitable to be adapted by the Islamic bank. In terms of the legal system in Malaysia, we need a more suitable approach to solve the issues that are related to the operations such as taxes and land code. Also, there are some of the banking acts that need to be revised and improvised. Islamic banks may need a different approach to that.”

In addition, *Shari’ah* officers of medium-sized local IBS agreed that the legal and regulation needs an on-going (i.e. continuous) improvement.

“In discussing about legal, I would consider it as ongoing and developing. BNM issued Islamic Banking Act 1983, and enhanced the Shari’ah Governance Framework for IFIs. These are the best effort to ensure that the governance of Shari’ah in IB is in a proper way. Perhaps, small issues regarding cases that are being heard in the court can be handled based on a case-to-case basis. In addition, as long as BNM, national laws or national judges and the industry can understand the process flow, and their roles and responsibilities, which will be great.”

Supports to guarantee the development of IB comes from different agencies, bodies and other groups of stakeholders. First level support comes from government and regulators. In Malaysia, government and regulators, such as BNM, Bursa Malaysia and SC, give support in terms of legal, regulations and infrastructure. Also, their effort includes marketing and promoting the IB to the global world. The regulator’s will and effort to develop IB is supported by the government’s will. It also obtains support from various stakeholders’ groups, that are (1) banks or financial institutions – employees, (2) shareholders to invest in the *Islamic* financial institutions, and (3) customers who demand the products and services and (4) public. Despite the support from various parties, there are problems faced by the industry in having the act approved. The interviewee did highlight on the BNM’s initiatives

to require judges to refer to NSAC in any event of dispute. However, at the same time, the industry is still in need of specific contracts to support specific *Islamic* products. The COO of medium-sized foreign IBS is in the view that some of the regulations are beyond BNM's control:

“... I think there are things that are beyond BNM's control, for example things like when it comes to laws, we have seen some laws which have taken a very long time to actually get through. Even with the support from BNM, it still didn't get through parliament, and what not, because we have the government officers not really appreciating what the proposal is all about and related things to it. That is why it is difficult to change, amend or review the law although with the support of...”

Current situations called for the need to have specific statutory acts for each *Shari'ah* based product to support the development and innovation of products and services in this industry.

6.3.4 Financial Regulatory Procedures

This section is divided into a brief explanation pertaining to Malaysian Accounting Standards Board (MASB) and the finding from the interviews pertaining to financial regulatory procedures.

6.3.4.1 Malaysian Accounting Standards Board (MASB)

The Malaysian Accounting Standards Board issued a tailor-made set of accounting standards for *Islamic* financial business. The board of MASB is comprised of members of the Malaysian Institutes of Accountants (MIA). The selection of the members is through election and usually involves accountants in the Big 4 audits company. In addition, it is not owned by government and governed by the Parliament Act (i.e. Financial Reporting Act). Parties involved in standards issuance are (1) MASB – main board, (2) working group – (a) working

team (those who are familiar with subject area) – academician and (b) have to be approved by the main board and (3) representative of auditors (Big 4), bankers, and regulators.

In 2001, Malaysian Accounting Standard Board (MASB)³⁶ has issued FRS *I* -1₂₀₀₄ (Presentation of Financial Statements of *Islamic* Financial Institutions). Related to the adoption of AAOIFI, the BNM had no objection as long as there was no contradiction to the national requirements (Ismail and Latif 2001). FRS *I* -1₂₀₀₄ considered existing International Accounting standards (IASs) issued by the IASC, MASB standards and Financial Accounting Standards issued by AAOIFI³⁷. The following table explains the current pronouncement by MASB.

Table 6.3.1 Pronouncements by MASB for *Islamic* Banking and Finance Industry (generated by author)

Types of Pronouncement	Pronouncements	Comments	Effective Date
FRS <i>i</i> -1 ₂₀₀₄	Presentation of Financial Statements of <i>Islamic</i> Financial Institutions	Dec 2000 - Issued as MASB <i>i</i> -1 in Dec 2000 (shall be withdrawn for application for financial statements with annual periods beginning on or after 1 January 2010)	
Statement of Principle (SOP)	SOP <i>i</i> -1 Financial Reporting from an <i>Islamic</i> Perspective (DSOP <i>i</i> -1)	Comments received on 16 February 2009 Issuance date 15 September 2009	-
Technical Releases (TR)	TR <i>i</i> -1 Accounting for <i>Zakat</i> on Business	-	1 July 2006
Technical Releases (TR)	TR <i>i</i> -2 <i>Ijarah</i>	Jul 2004 - Issued as TR <i>i</i> -2 in April 2006	1 July 2006
Technical Releases (TR)	TR <i>i</i> -3 Presentation of Financial Statements of <i>Islamic</i> Financial Institutions	Comments received on 3 April 2009	1 Jan 2010

³⁶ The standard-setting body in Malaysia.

³⁷ <http://www.Islamic-banking.com/news/Malaysia/archieve/first-0401> Retrieved 13 May 2007.

After the issuance of the FRS *I-1*₂₀₀₄, MASB also issued 2 technical documents from the *Islamic* Perspective. The Technical Release (TR) and Statement of Principle (SOP) issued are TR *i-3 Presentation of Financial Statements of Islamic Financial Institutions* and SOP *i-1 Financial Reporting from an Islamic Perspective*, respectively. TR and SOP are developed within the framework of the law and MASB approved accounting standards to provide additional guidance on the application of MASB's pronouncements. With the issuance of TR *i-3*, the Board gives notice for the withdrawal of FRS *i-1*₂₀₀₄ *Presentation of Financial Statements of Islamic Financial Institutions*. The issuance of TR *i-3* is in line with the Board's policy that MASB approved accounting standards will apply to *Islamic* transactions and any additional guidance will be in the form of Technical Releases.

TR *i-3* retains the additional guidance in FRS *I-1*₂₀₀₄ on presenting the financial statements of *Islamic* financial institutions that are not provided in FRS 101. Among others, the additional guidance relates to the disclosure of unusual supervisory restrictions imposed on an *Islamic* financial institution, the disclosure of the distribution of investment accounts and their equivalent, and the disclosure of the method of allocating income from various categories of deposits if the *Islamic* financial institutions co-mingle with various types of deposits into a single pool of funds. This TR is to be read in conjunction with FRS 101.

SOP *i-1* sets out the principles that MASB believes should underlie its future pronouncements on financial reporting from an *Islamic* perspective. It is concerned with the display and presentation of information that, from an *Islamic* perspective, should form part of the financial reporting. The deliberations will form the basis upon which future pronouncements on financial reporting from an *Islamic* perspective will be developed. This

Statement complements, and is to be read in conjunction with, the *Framework for the Preparation and Presentation of Financial Statements*. The main principle in SOP i-1 is that *Shari'ah* compliant transactions and events shall be accounted for in accordance with MASB approved accounting standards, unless there is a *Shari'ah* prohibition³⁸.

Furthermore, on the 1st of August 2008, the Financial Reporting Foundation (FRF) and MASB announced their plan to bring Malaysia to full convergence with International Financial Reporting Standards (IFRSs) by the 1st of January 2012. As capital markets have become increasingly global, the conversion from Financial Reporting Standards (FRSs) to Malaysian Financial Reporting Standards (MFRSs), equivalent to IFRSs will help place Malaysian businesses activities on a level playing field with its international counterparts. Thus, Malaysian Islamic Banking and Finance will employ the MFRSs in preparing its financial reports.

6.3.4.2 Interview Findings: Financial Regulatory Procedures

Accordingly, accounting is an established field in the conventional banks and conventional business entities, however, in terms of accounting to account for *Islamic* banking activities and *Islamic* business organisations, the branch of knowledge is not well developed; although the AAOIFI had started establishing its standards in order to account for *Islamic* products and corporate governance. However, the AAOIFI's standards are voluntary in nature and in Malaysia, the *Islamic* banks are not bound to comply with AAOIFI's standards.

³⁸ MASB issues 4 amendments to FRSs, 1 technical release, 1 statement of principle and withdraws 1 FRS (15 September 2009) from http://www.masb.org.my/index.php?option=com_content&view=article&id=1435:masb-issues-4-amendments-to-frss-1-technical-release-1-statement-of-principle-and-withdraws-1-frs-15-september-2009&catid=54:press-release-2009&Itemid=37 retrieved on 17 December 2009

In reality, the *Islamic* banking in Malaysia is bound to comply with IFRS in preparing their financial statements. Since, most of the products offered are debt-based products (i.e. That can be considered in substance as a loan) the industry did not face much problems in accounting for such transactions. However, once the IB will venture into risk sharing products, it needs support from the policy-makers. This is where the IFRS need to harmonise the standards to fit with the IB's business transactions. This matter is addressed by accounting academician and SC in large-sized full-fledged IB in the following:

“In accounting practices they said that they follow IFRS, well because they have to follow MASB by statute. At this stage, I don't think it is a problem; because most of the products in Malaysia are murabahah or BBA that is basically, in substance, is the loan. So I suppose they could use IFRS for loan accounting. This will prevent them from going over to more risk sharing products, and BNM is encouraging this, but if they introduce risk sharing products then we have a problem; we can't treat it as a loan. So in terms of accounting standards, we have to look for it. IFRS has to solve this issue.”

“At the same time, we have to remember, we have a committee known as AAOIFI. Some of AAOIFI's decisions sometimes can be implemented according to local economy suitability. However, sometimes the AAOIFI's decisions cannot be implemented in Malaysia, while in another locality, it may be possible.”

This is being supported by SC in medium-sized local IBS that the accounting practices in Malaysia are bound to comply with IFRS. Currently, any contradictions between *Shari'ah* principles and the related provisions of IFRS are being discussed by ISRA and MASB.

“..., for example, we can recognize it as income because from the Shari'ah point of view there is no issue, as long as if anything happens you still need to repay or return the money. From the accounting point of view if the IAS does not actually restrict that, it is ok, so this is the thing that also has been discussed by the Shari'ah committee before we approve the product. And when the product is being approved at our level, it will then be passed to the BNM. BNM will then look into the product again from all aspects, from the Shari'ah aspect, from the risk aspect, the technicality, even from the technical aspect as

well – all are something which is common.”

In addition, the NSAC of BNM stated that future efforts will focus on any contradictions between *Shari'ah* principle and MASB in ensuring suitability of currently used accounting standards.

“... of course in accounting, the approach taken by many institutions are bounded by IFRS, so we are also working with MASB to look into this matter if there is any contradiction between Shari'ah principle and what is in IFRS. In fact, we are going to conduct a study on that. Currently, most of the bank is using IFRS.”

IFRS does not fully support the *Islamic* financial transactions. Thus, it will not encourage the objectives of a particular transaction and it will not communicate the true economic values of the transactions. Furthermore, the accounting academician is in the view that the adoption of IFRS may raise problems if they insist on convergence in terms of disclosure and presentation:

“ACCA has suggested some alternatives and I think there is something that is needed to be considered. At least they should come out with separate disclosure, and the standard presentation. Otherwise it will be a disaster if they insist on total convergence. Especially for risk based sharing contracts because this is a different set of obligation and it is not the same as the loan contract. So the accounting would have to be different. I am not sure how it is going to be but I hope, we will have to sit and wait and see what will IASB do about it.”

In order for the industry to move forward, the accounting academician believes that the path to embrace the accounting standards, based on AAOIFI, is still unclear. The use of *Islamic* accounting standards is in demand to streamline the operation of the *Islamic* banks in achieving its objectives:

“The forces, the political economy power, the big 4, the standards, the people

and the industry itself, are very strong. The fact that Islamic accounting will show up for what they are, maybe a wolf in sheep's clothing, they scare; they just want to pretend that they are just like any other banking. However, if you follow Islamic accounting perhaps, there is some sort of incentive where it shows the real performance and then people will take steps to do the right thing correctly in behaviors so that we reach the objectives. Otherwise, I fear that adopting IFRS, as it is now, would have problems.”

The accounting and financial reporting of IB is bound by the IFRS and MFRS. At the time being, it was still suitable to be applied by IB due to the nature of products offered which were debt-based products. In addition, in order for the industry to apply IFRS, harmonisation between conventional accounting standards and *Islamic* banking products were needed to accommodate the nature of IB financial transactions. In addition, in terms of financial reporting, the reporting for IB still lacks uniformity when providing information to the users of financial reports and stakeholders. In the IB, there are still differences of treatment that would breach the concept of fairness of the reporting.

An accounting academician states that the decision to highlight the specialization of *Islamic* accounting where it is derived from different worldviews and is in need of different accounting standards would be alienated in the environment where people are discussing harmonization and convergence. Furthermore, the accounting academician voiced out that there is no support from the chairman of MASB for having a specialized accounting for *Islamic* banks:

“... We have to think in a rational way because we are also making business transactions with another organization nationally and internationally. If we are very rigid to uphold that we are from different worldview and require different accounting standards, maybe it will be a bit difficult. The difficulties may happen due to the fact that, in the profession, other people are talking about harmonization, convergence, and yet, we are talking a different tune where we are talking about specialization and the uniqueness of our industry. (...), I do not know what the Chairman of MASB’s views on this. But the way

he was talking, in the discussion I attended, I think he is not really keen on saying that Islamic banking has unique features as compared to other business organizations and does need to be allocated or need to have a separate accounting standards. At this moment, this is the thinking that he is having.”

The action to harmonise the IFRS standard is being supported by another accounting academician:

“Islamic banks should apply Islamic accounting, which might be different from IFRS. It is a challenge now. I don’t think IFRS will be the solution. If Islamic finance and the Muslims want to achieve the social economic objective of Islamic banking and finance, then you can’t adopt IFRS, unless IFRS has a parallel set of standards just for Islamic finance, which they don’t want to have; they want to converge. In my opinion, I don’t think convergence is possible. However, harmonization is possible. But they (i.e. IFRS) are enforcing the issue. But we will see how it develops, it’s better, but then again, AAOIFI has done a lot of work. However, the standards are a bit obsolete, they are under-funded, so I think we need a white line to save the AAOIFI and bring it up to speed and rigour, to the level of at least decent standards setting bodies, that’s are capable of rising to the challenge, while keeping it owns values system and fighting off convergence. Also, we can harmonize the standards where the Shari’ah says otherwise, so it is not in harmony with IFRS.”

Furthermore, COO in medium-sized foreign IBS state that the drawback is that current standards being used by the industry are not really accommodating to the products specific to *Islamic banks*;

“Some of the factors that did not accommodate the establishment of more IB products are unfamiliar with customers, laws that are not accommodating, risk framework, BASEL and accounting standards. These factors are more accommodating for existing conventional products.”

In addition, although the industry is recommending standards of AAOIFI and technical pronouncement by MASB, the industry is highly regulated, and the bank is bound to follow the instructions from Central Banks. Various efforts need to be pulled to look into the

suitability of the current standards and practices. Also, they need to look into the need to harmonize the practices, classification of debt and equity and measurement and valuation. Accounting standards, as a guideline for the bank to produce a reporting medium, enables the users to evaluate and monitor whether IB is able to manage or materialise the social economic objectives and to measure performance in accordance with the *Shari'ah* as underlying principles.

6.4 Summary

The *Islamic* banks in Malaysia are operating under a dual-banking system and currently the operation of *Islamic* banks is highly influenced by the operation of the conventional banks. It is portrayed in the education, awareness and demand of the public and customers, and how IB behaves in its operation. Despite the development of *Islamic* banking in Malaysia and comprehensive infrastructure offered by the regulators and government, *Islamic* banking is facing problems and challenges in its operation. Furthermore, the competitive environment under the dual-banking system, and the familiarity of the customers and the public, resulted in the operation and products and services of *Islamic* banks being very dependent on their conventional counterparts.

Due to the demand of the customers on products and services that are having the same characteristics with conventional banks, it resulted in the influence of CB's products and services in Islamic banks. In addition, IB faces challenge in terms of customers. Customers lack of awareness and knowledge pertaining to IB's products and services, influence their demand towards IB's product and services. Thus, knowledge and understanding of *Shari'ah* among the customers and the public will lead to an appreciation of the underlying nature of the IB's products and services.

Furthermore, the chapter examined the regulatory framework of the banking industry in Malaysia, in general, and those adopted and implemented by the Islamic banking industry in Malaysia, in particular. The main findings of this chapter related to problems and challenges in the legal and institutional framework and can be summarised as follows. Firstly, the inconsistency in interpretation of *Shari'ah* in the Malaysian industry is not seen as a problem and it is harmonised and controlled by the existence of NSAC and SC. Currently, Malaysian IB only market their product in the local market. In the event that they decide to market their product globally, they will do modification towards the products and services in accordance to the selected jurisdiction. The competition exists between local full-fledged *Islamic* banks, local *Islamic* banking subsidiary, foreign *Islamic* banking subsidiary and full-fledged *Islamic* banks. Also, nowadays various *Islamic* banks are being introduced in foreign countries such as Europe, Unites States of America, Hong Kong, China, etc., that increase the competition in the industry. Thus, in the future, lack of harmonisation will further affect development and globalisation of the industry. Also, calls for the harmonization will assist in terms of financial reporting and users of financial statement to make a comparison of performance between IB in different jurisdictions. Secondly, the interviewees highlighted on the reliability of the *Shari'ah* committee report issued yearly. Also, it was found that, not every IB has the *Shari'ah* manual as a guideline for the staff in carrying out their duties and responsibilities. Thirdly, in terms of legal and regulatory framework for the operation and products and services of IB, it is found that more regulatory framework is needed to support the *Shari'ah*-based operation and inexistence of statutory acts for each IB's products and services to encourage more product development and innovation. Finally, in terms of financial reporting, IBs in Malaysia comply with MFRSs, based on IFRS. Various researchers are opposed to the idea of complying with the IFRS, as it is not fully fit to account for Islamic banking business

activities. However, since the current products and services in IB resemble the CB's products and services, the compliance with IFRS is acceptable. However, the industry needs to have an accounting standard that fully support their products and services, especially products based on PLS.

Thus, this chapter provided the context of the institutional and regulatory framework of Islamic banking and finance industry in Malaysia. The next chapter is devoted to the detailed findings concerning how *Shari'ah* compliance issues have been considered and embraced in the accounting and auditing system of Islamic banks. Also, next chapter will look into the findings related to the management (i.e. human resource, internal process and system).

CHAPTER SEVEN

INTERVIEW SURVEY RESULTS: SHARI'AH COMPLIANCE, ACCOUNTING SYSTEM, AND AUDITING PRACTICES

7.1 Introduction

The previous chapter provided a review of the institutional framework of the Malaysian Islamic banking and finance industry. It examined the regulatory framework of the banking industry in Malaysia, in general, and those adopted and implemented by the Islamic banking industry in Malaysia, in particular.

This chapter focuses on how *Shari'ah* compliance are considered and embraced in the accounting and accountability, and auditing system of the Islamic bank. This chapter starts by outlining the consideration of *Shari'ah* compliance and commercially viable IBF Malaysia. Next, it discusses on the management aspect where the discussion is further classified into three issues that are human capital, internal processes and system (i.e. accounting system). The internal processes discuss accountability in ensuring *Shari'ah* compliance in ex-ante and ex-post compliance. Then, the role of accounting practices and reporting in communicating reliable and credible information are presented. Finally, the chapter outlines the *Shari'ah* Auditing matters.

7.2 Consideration of *Shari'ah* Compliance and Commercially Viable in Islamic Banking and Finance in Malaysia

7.2.1 Perception of the *Shari'ah* Compliance and Commercially Viable and its Implementation

It has been discussed in earlier chapters that the establishment of *Islamic* banks is governed by the *Shari'ah* principles. The *Shari'ah* requirements laid the unique principles of *Islamic* banks that differentiate it from its conventional counterpart. It is important to ensure the *Shari'ah* compliance in its operation, management and products and services. Furthermore, as *Shari'ah* is the root of the establishment, it is important to uphold its requirements, as it will able to maintain its competitiveness and viability. Also, *Shari'ah* will help the banks to maintain its image and reputation. *Shari'ah* is being discussed by SC of a medium-sized foreign *Islamic* banking subsidiary (IBS) as a symbol of the image and reputation of IBs, as follows:

*“IBs carried huge responsibility and accountability to ensure compliance with the *Shari'ah* requirement. In addition, it is the main focus of the stakeholders when discussing about image and reputation of the bank.”*

In addition, in the interviews undertaken, the interviewees indicated the importance of *Shari'ah* in IB. The *Shari'ah* is portrayed as an integral and essential part of its establishment. According to the SC in the medium-sized foreign IBS, *Shari'ah* is very vital in portraying the legality of *Islamic* banks.

*“*Shari'ah* is the essential requirement. The contracts in IB are based on *Shari'ah* and it must be SC or else the contract is void. If the contract is not *Shari'ah* compliant, it is not legal.”*

Also, it is vital for the institutions to establish proper *Shari'ah* Governance Framework to ensure the adherence to *Shari'ah* that would portray the credibility of IBs. In addition, the SC

of medium-sized local IBS highlighted that: the failure to uphold compliance of *Shari'ah* will defeat the purpose of establishing *Islamic* banks.

“In Islamic banks, Shari'ah is a very fundamental element. Furthermore, ensuring Shari'ah compliance is very important. If Shari'ah is not being upheld and did not receive full attention, it will defeat the purpose. If the bank contravene with Shari'ah principles, it will be considered as non-Shari'ah compliance cases. Without Shari'ah compliance, the Islamic banks are only known as an Islamic bank without the proper implementation and spirit.”

Some top management mentioned the importance of corporate culture and management commitment towards upholding *Shari'ah* compliance. The CEO of the large-sized fully-fledged *Islamic* banks expresses his concerns on understanding the roles and responsibilities of his SC and senior management in ensuring the operations of the Banks is *Shari'ah* compliant. He symbolised *Islamic* banking as ‘faith’ banking. He mentioned that:

“... As far as our bank is concerned, we pride ourselves in being a Shari'ah compliant bank. When we mention about Shari'ah compliant bank, we are referring it to faith banking. Islamic banking is about faith and Shari'ah and dictates faith in terms of how we are doing things (...) that's one thing that you have to be clear under Islamic banking; you cannot find a way around anything that is non-Shari'ah compliant. (...), as far as we are concerned, we are very clear that the most important marketing theme is Shari'ah and we are bound by Shari'ah . We pride ourself that in whatever we do, we check and uphold Shari'ah as our priority. In terms of moving forward, Shari'ah plays a key role in this organisation.”

According to the above, in the full-fledged *Islamic* bank, the CEO is very clear with the mission, vision and initial objectives of its establishment. Such aspiration is important because this will guide overall operations. Also, the SCs of the same large-sized full-fledged IB support the statement of the CEO.

“Besides good relationship and good communication with the CEO and management, I have the understanding that, in most of the banks, the SC does

not have any problem with the Board. The top management will support the implementation of what is being dictated by SC...

“... I am glad that in this organisation, the CEO gives the SC full freedom and full authority for us to review, supervise and examine to what extent a certain activity is Shari’ah compliant. In addition, we will provide comments accordingly.”

The statements from the SC show that, although they may face difficulties with deliberation and discussion in the process of ensuring *Shari’ah* compliance of the products and services offered by IB, they have full support from the CEO where they have good communication, and full authority and freedom in making decision and fulfilling their responsibility and accountability. This may assist the SC to decide regarding the decision on *Shari’ah* compliance of products.

Furthermore, the CEO of medium-sized IBS is very enthusiastic in explaining the involvement by the CEO of the parent bank where he actually pushes everybody to involve in the development of *Islamic* banks. According to him, it is important to have support from the CEO and top management. And they received such support from the parent bank to develop and expand IBS of the parent bank.

“Why our bank has been successful in Islamic banking is partly because we include it as KPI (i.e. Key performance index) in our balanced scorecard. So, the development and growth of Islamic banking business activities are owned directly from our president. Then the group has owned the shares of KPI and then it can be streamlined to the lower level. It is total ownership at the highest level of the bank in order for Islamic banking to grow; in order for us to actually get the buy-in from the staff to assist in developing the Islamic banking business activities.”

In addition, the CEO of large-sized IBS expresses his awareness of *Shari’ah* compliance, where he is concerned, on the importance of their team to explain properly to the SC so that

they wouldn't influence the decision making process of the SC. This is to guarantee that the decision of the SC is solely based on *Shari'ah* rather than in favour of the top management.

“Since the SC in this bank are those who have been in the market for a long time, they are quite experienced in this area. In terms of communicating with the SC, we explain to them and as they understand what is being communicated, they will apply the appropriate underlying Shari'ah requirement to the subject matter. However, it is challenging if the SC is new to the market, as it will be difficult to explain and make them understand certain matters.”

Also, besides establishing *Shari'ah* compliance, it is also important to ensure its commercial viability. Commercially viable institutions would entail high returns and would manage to give good returns to its shareholders and customers. In addition, high returns would result in high amounts of *zakat* paid and can be beneficial to the society. Meanwhile, SC of large-sized full-fledged IB highlighted that despite the need to guarantee that the IB fulfils the *Shari'ah* principles underlying it, the need to ensure that the IB is viable and manage to have good return is equally important in establishing its credibility.

“In doing banking business, banks need to portray a healthy image to its shareholders and stakeholders. Although, generally, customers or the public will refer to the profit and other numbers that portray its performance. However, we are not looking at a profit, in the worldly context, but we are looking at profit in getting barakah (i.e. Beneficent force from Allah)....”

Furthermore, it results in more focus on commercialisation activities rather than meeting the objectives of its establishment. This is supported by Mirakhor (1997) where he opines that IB is playing safe in ensuring the viability of banking business by not taking too many risks. Also, he stated that by playing safe, IB did not portray that they achieved market depth that will ensure long term profitability and survival (Mirakhor 1997). It creates another challenge in the IB industry to ensure that the IB is *Shari'ah* compliant and commercially viable. Being

Shari'ah compliant is part of the initial objective of the establishment and being commercially viable is part of the nature of commercial institutions. *Shari'ah* compliant is ensuring that all aspects of its operation, management, products and services are in line with everything stipulated in *Shari'ah* principles. On the other hand, commercially viable institutions would entail high returns and would manage to give good returns to its shareholders and customers. In addition, high returns would result in high amounts of zakat paid and can be beneficial to the society.

However, the *Islamic* financial institutions may face a situation when the approved *Shari'ah* compliant product is not commercially viable in the market. Under this situation, the institutions have to find other alternative products, and the introduction of the new approved product need to be held. As a result, the institutions need to ensure that the products offered are products that are *Shari'ah* compliant and viable to be marketed. In order to fulfil such requirements, the institutions left with products similar to conventional banking products, as they are more familiar to the public at large. NSAC of BNM stated that the challenge facing IB is to be commercially viable and *Shari'ah* compliant. Also, other SC in various IBS supports this opinion.

“It is challenging to meet the demand of both being conventionally viable and competitive, and at the same time, achieve the ideals under the Shari'ah and the Shari'ah objectives.”

In addition, the CEO of large-sized IBS expressed that based on his experience; there is an instance where although the product is *Shari'ah* compliant, commercially, it is not in the interest of the top management. This emphasizes that; the CEO is very clear on the objective of the establishment and committed to ensuring that *Shari'ah* compliance is upheld in IB. According to the CEO:

I am very clear when I explained to the SC; I don't want to influence them to make any decision in our favour and compromise with the Shari'ah matters. Although conventionally, I want SC to decide in our favour but sometimes, because of Shari'ah principles, we cannot decide anything which is commercially in our favour..."

The scenarios above are discussed by Muslim and Zaidi (2008) as the complexity in synchronizing business ideas and *Shari'ah* compliance. It is compounded by the existence of multiple interrelationships between the *Shari'ah* Supervisory Board of an Islamic institution and the management, external auditor and the Audit and Review Committee. Meanwhile, the SC from medium-sized local IBS further agrees that there are increased awareness and concerns of the IBS's top management regarding the importance of *Shari'ah* compliance. However, he highlights on the need to make sure that the decision made should be in line with the interest of the parent bank that is concerned on the progress and profit element of the IB.

"If you are in Islamic subsidiary, you are equally concerned with Shari'ah aspect. However, if Shari'ah actually impede the progress or the profit element, the parent bank may not be receptive to the idea or will not be interested to pursue the Islamic agenda."

In general, the BOD of the parent bank would influence the CEO and top management's decision in IBS. In addition, the SC of medium-sized local IBS and CEO of large-sized full-fledged IB express their concerns on the influence of the decision made by the top management of the parent bank (i.e. CB) on the decision that should be made by the top management of IBS. The top management of parent bank who are driven by profit and key performance indicators (KPI) influence the top management of IBS in making decisions to meet the expectations of the parent bank.

“Conventional bank – driven by bosses who are– driven by profits & KPI”

“Currently, the problems with SC, in the conventional banks, are that their bosses who are conventional people are driving their decisions. When their bosses are conventional people and drive them to take profit, they cannot compromise and they have to deliver the profit to the boss. Otherwise, they don't have a job....”

The SC in medium-sized local IBS further highlights that the SC may approve a product as a *Shari'ah* compliant product but it may not be in the market, as due to its viability and commercial value, the conventional parent bank may not approve it. Most of the time banks would focus on commercial viability of the product and not focusing on the real economic benefits that can be reaped from the *Islamic* financial system. Furthermore, IBS has to follow everything being dictated by the parent banks.

“However, there are many instances where if there is a conflict between the Shari'ah and business concerns dictated by the parent bank, the Shari'ah will prevail, but at the end of the day, the products or the services may not go through because it was not approved by the parent banks. (...).”

The *Islamic* banks are following the direction of its top management (as an example in the case of *Islamic* banking subsidiary), it will be following the direction made by the parent bank. Furthermore, the CEO of a medium-sized local IBS mentions that he is just an employee:

“I am just an employee... the stakeholders and the country has to have the will to bring IB to the next level in order to allow IB to move to the right direct. It has to be a concerted effort and we will face a lot of challenges... In addition, along the way, we need perseverance. Although it may not be perfect, it may be improvised and changed. Everything is evolutionary not revolutionary.”

As an employee, CEO of IBS is bound to fulfil the interest of the owners and shareholders. He is an agent for them and the employee needs to deliver in accordance with the owner's

interest. In addition, IB should also be streamlined to ensure the achievement of the socioeconomic objectives of an *Islamic* society (Ahmad 1991; Siddiqui 2001). According to the CEO of the large-sized full-fledged *Islamic* bank, besides targeting profits, *Islamic* banks should not deviate from its original objectives (i.e. *Maqasid as-Shari'ah*). Thus, it is important to guarantee that the expectations of shareholders and customers are met and that the objective of *Shari'ah* is fulfilled. A *Shari'ah* officer in medium-sized local IBS also supports this view.

“... We do not do Islamic banking just to make pure profits. We do it to adhere to the ruling that Allah has given in terms of trade. We have to organise trade in such a way that He concurs with, that's our duty. We have to be very clear on that. If we are not very clear, it will lead us to deviate from the original objectives.”

“... The Islamic banks are beyond gaining profit. It is also expected that with the profit gained, society's problems are solved.”

In light of the above, it is evident that the players understand the objectives of *Shari'ah* governance in upholding the *Shari'ah* requirements and ensuring that IBs are commercially viable. The awareness of the market player on both objectives is very clear. However, the players may face challenges and difficulties in ensuring that both objectives are being upheld, as there is possibility that the commercially viable products are given priority, as compared to *Shari'ah* compliant and *Shari'ah* based products. In addition, the operation of IB should also give emphasis to achieve the objective of *Shari'ah* (i.e. *Maqasid as-Shari'ah*).

Thus, in the industry, the top management in different governance structure of *Islamic* banks have slightly different styles in leading the organisations. It seems that there is no problem with local full-fledged *Islamic* banks and foreign full-fledged *Islamic* banks. However, top management in local and foreign *Islamic* banking subsidiary will choose between *Shari'ah*

compliance and commercially viable in making decisions on which product they will launch. They may withdraw their decision to market approved *Shari'ah* compliant products due to its commercial viability.

7.2.2 Dichotomy between the Theoretical Framework of Islamic Banking and its Implementation

In regards to the implementation, various interviewees stated that there are differences in implementation as compared to the approval made by *the Shari'ah Board*. Various interviewees highlighted on the influence of educational background and experience towards the way the human capital implements the *Shari'ah* approved procedures. The NSAC of BNM is in view that:

“... We are lacking HR who works in the Islamic Bank and understands the whole philosophy of Islamic financial services. Normally the personnel of Islamic banks have been working in the conventional bank. So, they are conventional bankers and they shift to work into Islamic bank.”

Furthermore, various highlights portray that the difference in implementation is everywhere and CEO, *Shari'ah* officer and *Shari'ah* board are aware of the risks that they may face. The lack of appreciation of the theoretical aspects of the underlying concepts that leads to different practical implementations can be gathered from the interviewees. The following are quotations from NSAC at BNM and CEO of large-sized IBS and various interviewees on their concern and awareness regarding the implementation in *Islamic* banks:

“We learn about Mudharabah, we learn about Musyarakah, we learn about the different type of ijarah and others. But when it comes to implementation, it is implemented differently, so you need to combine between the two; Between the theoretical aspects and how they are being implemented.”

“Of course there will always be issues in implementing anything because you

are trying to operationalize something that is new and people will always be reluctant to change the way they do things because they feel it is more cumbersome (...). Of course it will take some time for everyone to be fully trained on how to go about appreciating compliance with Shari'ah in a daily basis. So, it is the normal issue of trying to operationalize something new."

The dichotomy between the theoretical underlying principles and practical matters was being emphasized in various interview sessions. This issue is being highlighted repetitively and it has been the concerns of the SC regarding the failure of human capital to understand and appreciate the theoretical and practical aspects that would lead to mistakes in implementation, which will violate the *Shari'ah* compliance. Although the players may not deliberately make mistakes in the implementation stage, any wrong implementation of the processes and procedures will contribute to the non-*Shari'ah* compliance risk. It will contribute to the rising of *Shari'ah* issues and would give impact to the fulfilment of *Shari'ah* compliance. In addition, it will tarnish the credibility and reliability of *Islamic* banks.

The repetitive concerns from the SC resemble the importance of this matter. Continuous emphasis on the difficulties of personnel to appreciate the difference between theory and practice of *Islamic* banks raises the importance of having personnel that really understand technical and *Shari'ah* matters. By understanding the theory and application of *Islamic* banks, it would guarantee that the mind setting, ethics and the value of the personnel are to direct and ensure that the implementation is done rightly towards achieving the objectives and mission and vision that are in line with the objectives of *Shari'ah*. Thus, human capital awareness is needed in order to prove that their practices are in-line with the *Shari'ah*.

Both CEOs and *Shari'ah* scholars emphasised the importance of ensuring *Shari'ah* compliance in every aspect of operations, products and services of *Islamic* banks. However,

different groups of interviewees portrayed numerous views and perspectives regarding compliance. In reference to *Shari'ah* scholars, they were more concerned with the differences between theory and practice, since the theory was based on religion and it is crucial to uphold *Shari'ah* principles. The *Shari'ah* principles must be maintained as they are the root of the system. Moreover, upholding *Shari'ah* principles will consequently lead to the achievement of *Shari'ah* objectives, which will then guarantee the welfare of society.

CEOs had shown their awareness on the need and importance of *Shari'ah* compliance in all aspects of operations. However, in terms of products and services, *Shari'ah* compliance was not the sole criteria in the offered products. Another important element was the viability of products and services. If a product that was well-developed and approved in terms of *Shari'ah* compliance was not viable in the market, the offered product would then be held. CEOs are responsible to shareholders and other stakeholders; thus, it is crucial for them to ensure *Shari'ah* compliance and business performance. On the other hand, *Shari'ah* scholars possessed a different aspiration. They were more focused on guaranteeing that the objectives of *Shari'ah* are achieved, and that the public would enjoy the benefits.

7.2.3 Unresolved *Shari'ah* Matters

In Malaysia, any unresolved matters regarding a new product developed or innovated at the bank level need to be resolved or approved by the NSAC. In this case, the product's proposal needs to be sent to the NSAC for approval before it is displayed or made available on the shelf. In the process to ensure the *Shari'ah* compliance of the product, the *Shari'ah* committee of the bank may bring any dispute raised between the SC at the bank level to the NSAC. NSAC will discuss the matters, and any decision decided by the NSAC will prevail. In addition, any decision agreed by the SC will also need to be brought forward if the

decision is perceived to give impact to the industry as a whole, for example, the SC proposed a decision that will involve national issues such as abandoning a housing project.

In abandoning a housing project, the decision to return the customer's money may seem as the best decision for the bank because they are capable and ready to do so, and the SC approves it. However, it may result in disputes by customers from different *Islamic* banks. Although, the different *Islamic* banks may have a reason for its decision, it may result in misunderstandings and confusion among the customers. Consequently, this will become a national issue. On this note, it is better for the *Islamic* bank to refer to their SC's decision to the NSAC to have a better view and decision. A decision made by NSAC will establish harmonization in the overall operation of *Islamic* banks by looking at the macro level of certain situations. This will assist the industry to avoid any difference in operation that will raise misunderstanding and confusion.

Shari'ah compliance is the heart of all the activities of *Islamic* banks. *Shari'ah* governance framework in the *Islamic* banks is designed towards achieving the *Shari'ah* compliance. Two levels of *Shari'ah* governance that are designed at the bank and industry level would at least be able to assist in achieving harmonisation in *Shari'ah* pronouncement and rulings. The existing SC appointed by the bank and BNM comprise of expertise from comprehensive areas of expertise. The blend of knowledge is expected to open wider avenues for *Shari'ah* pronouncement and rulings. Although they have a blend of knowledge, they may still lack dual knowledge of expertise. Thus, they are still dependent on technical expertise to understand technical matters in order to operationalize the products approved.

However, the establishment and appointment of NSAC are not aimed for improving the performance of *Islamic* banks. Due to comprehensive background of the NSAC, their establishment is considered as a reference point in the industry if the industry faces any issue or if the industry fails to reach an agreement in confirming a certain ruling regarding products and services, and any other related matters of the operation. Also, they are appointed to ensure that all *Islamic* banks fully comply with the principles of *Shari'ah*. It is a council to safeguard the *Shari'ah* and give confidence and assurance to the stakeholders that the products are *Shari'ah* compliant. The SC of medium-sized local IBS highlighted that:

“... The roles of SC are not intended to ensure that the performance of Islamic bank is better in the dollar and cents perspective. Their roles are more on Shari'ah governance to ensure that the principles have been complied by all IB. This is very important because Islamic banks are governed by Shari'ah. In the Shari'ah governance framework in Malaysia, we have the centralised Shari'ah governance, meaning that we have NSAC. So, their role is to ensure that all Islamic banks fully comply with the principles of Shari'ah. Some may argue that their roles can impede the performance because sometimes IB cannot apply everything that they plan to do, as it contravenes Shari'ah principles. In addition, when there is a conflict between Shari'ah and dollars and cents, Shari'ah will prevail. It serves as an authority to ensure and safeguard the Shari'ah principles in line with the interest of stakeholders who demand confidence and assurance that the entire products are Shari'ah compliant. Shari'ah compliance is assured at two levels of governance, at the respective individual bank, and at the central bank.”

The existence of NSAC in the Islamic banking and finance industry would assist in the harmonisation of *Shari'ah* interpretations at a national level. In future, it is perceived that such a council will support the development and innovation in the industry.

7.2.4 Solution for *Shari'ah* Non-Compliance Cases

Furthermore, various interviewees highlighted the non-*Shari'ah* compliance cases in the IBs. *Shari'ah* officers of foreign medium-sized IBS and SC of large-sized full-fledged IB

highlighted that the banks experienced the non-*Shari'ah* compliance cases. Also they highlighted the process involved in identifying and clarifying the non-*Shari'ah* compliance cases and deciding the solution to resolve the issues.

*“The audit committee, our board, risk management team or myself will highlight any non-*Shari'ah* compliance case. Then, we will discuss and try to find a solution to rectify the non-*Shari'ah* compliance, which is mostly related to income. In addition, when we are talking about banks, we have some other misconduct. We will decide, whether the income has to go to charity or disposed, that is what we normally do.”*

*“Any major or minor problems related to the overall operation of the IB will be reported and tabled at a special meeting. So, we will review and analyses the report, especially those related to *Shari'ah* (i.e. non- *Shari'ah* compliance cases). For example, no signature on the contract will relate to the ownership of the asset. In addition, in the case of buying and sales of asset in bay' al-*inah*, we should be clear on the ownership of the asset during the first and the second contract. Thus, the contracts need to be analyzed to avoid any *Shari'ah* issues.”*

*“We will explain and clarify those issues that related to *Shari'ah*. Also, we will call related personnel to give an explanation on how they implement the transaction of the products and services. Previous cases that we deal with involve explanation and discussion with CEO, and other main or branch officers involved. In addition, we remind them that we cannot compromise with the same non- *Shari'ah* compliance cases to repeat in the future.”*

In general, non-*Shari'ah* compliance cases are resolved according to their nature of *Shari'ah* issues. Three different ways of resolving the issues are mostly discussed in the interview. In regards to non-*Shari'ah* compliance issues that relates to income, the income will be channelled to a charity or public fund. On the other hand, the non-*Shari'ah* compliance that relates to documentation will be amended. The NSAC of BNM and SC of medium-sized local IBS discussed the issues pertaining to channelling the non-*Shari'ah* compliance income to public fund and charity.

“I know at other banks, not necessarily in Malaysia but even globally, they encounter those instances where they do the annual report and they look at some of that transaction, they found out that there is some non-compliance which they normally do not recognise the transaction that resulted from the non-compliant transactions, so they have to donate those incomes to charity. So, those are some of the instances of non-compliance cases that we have encountered.”

“Usually, any amount of money related to non- Shari’ah compliance cases will be channelled to a public fund.”

“So far, they rectify the non- Shari’ah compliance internally. The worst-case scenario would be that part of the income reported is actually unearned income of the bank. For example, when there is a contract that is invalid, whatever you earned from the contract is not proper. So, in the case of invalid contract, if you have the customer, you can actually return the unearned income back to the customer and there were instances where we ask the party to donate to the charity. The bank cannot take it as an addition to the profit.”

Furthermore, the NSAC of BNM, COO of medium-sized foreign IBS, and SC of large-sized full-fledged IB emphasized issues regarding non-Shari’ah cases on documentation.

“And we have seen also from case law, cases that have been brought to the court that were non-Shari’ah compliant with the documentation. In that situation, we have to look at how the bank handles it because sometimes the cases can happen upon recovery and not necessarily within. Thus, it seems that there is nothing wrong when you do the transaction, but when you recover, you claim things that you should not claim in your claim of the customer in default.”

“... When the contract was done and they found that there is a change in selling price due to the gap in time, and the change in the rate, that caused problems because when a customer was met to understand that issue, the customer was not illuminated on the buying and selling transaction, so, then we have to remedy and we have to actually repeat the transaction”

“I think it depends to related Shari’ah issues. There is some solution that is

not going to be easy where the customer may need to go back to the lawyer's office, sign everything all over again. However, although the processes to rectify are troublesome, we have no choice, if we have to do it then we have to do it. We try to minimize the entire process by focusing on the training, to make sure that they are all equipped with the relevant knowledge.”

“In order to rectify the cases that involve minor non-Shari’ah compliance cases, such as no signature on the contract, wrongly dated and timed, or no date written, we will call the manager and seek for clarification. In some cases, we can rectify by informing the real situation and make a modification and correction on the contract.”

Also, various court cases being reported in Malaysia involve disputes from products and services offered by *Islamic* banks. In addition, according to the various reported news and interviews, there are a lot of reported court cases that relate to non-*Shari’ah* issues in the implementation of the products and services.

The problems highlighted earlier were directly related to the implementation factor; whereby, the implementer had wrongly operationalised the contracts of the products and services which resulted in the problems regarding non-*halal* earnings. On the other hand, Malaysia and the global industry had witnessed cases beyond ‘non-*halal* earnings’. IBs had faced court cases concerning *Bai’ Bithamin Ajil* (BBA) between Bank Islam Malaysia Berhad (BIMB) v. Lim Kok Hoe & Anor, along with other appeals (i.e., involving 12 separate cases). The cases were brought to the Court of Appeal and the learned judge declared that the BBA was contrary to the religion of Islam. In such cases, the validity and enforceability of the BBA contract was questioned on two main grounds: they are (1) “far more onerous than the conventional loan with *riba* (interest)”, and (2) the BBA practiced in Malaysia was not acceptable by the four *Mazhabs* in *Islam*. The Court of Appeal had set aside the judgment of the High Court and allowed an appeal for two reasons, they were: (1) the comparison between a BBA contract and a conventional loan was inappropriate as the instruments were

not alike and possessed different characteristics. Moreover, the court had a duty to defend, protect and uphold the sanctity of the contract entered into between the parties, unless it was vitiated by any vitiating factor recognised by law. (2) In order to recognise the BBA as a financial instrument, it was not necessary for it to be approved by all the *mazhabs* since the agreement may have been derived from other primary sources, such as *Al-Qur'an* and *Hadith*. Thus, judges in civil courts should not take it upon themselves to declare any matters pertaining to this issue.

Aside from an example from court cases in Malaysia, a court case from the international industry had involved the 2011 Goldman Sachs *sukuk* matter which was consequently flawed by controversy since it was arguably based on a reverse *tawarruq*; a concept that had not received general acceptance from *Shari'ah* scholars. Reverse *tawarruq* was rated as unacceptable by some scholars in an effort to hide the use of interest. *Shari'ah* structural problems portrayed the failure of the bank/*Shari'ah* experts in devising the underlying principles governing such contracts. Furthermore, it illustrated the complexities in designing contracts as it demanded a comprehensive understanding of *Shari'ah* principles, along with technical knowledge. This raised the issue pertaining to the nature of *Shari'ah* compliance's approval process in Islamic finance; the regulation and registration of this process; the inexistence of a professional body to certify the professionalism of *Shari'ah* advisors; and the miscommunications and misunderstandings between *Shari'ah* scholars and technical expertise regarding the operationalisation of the instruments.

The implication of non-*Shari'ah* compliance can be categorised into two groups: non-financial impact and financial impact (Chik 2011). The non-financial impacts are against the commands of Allah, devoid from Allah's blessing or *barakah* and are contravention of the

provision of the *Islamic Banking Act 1983* (Section 3 (5) (a) & Section 4). In the case of *Islamic banking*, non-financial impacts can jeopardize their reputation as an IFI (Chik 2011). On the other hand, the financial impacts are invalidation of contracts (*'aqad*), non-halal income and capital adequacy ratio (CAR) as per IFSB, subject to regulatory decision (Chik 2011).

7.3 Management

7.3.1 Human capital

7.3.1.1 Roles of Players in Ensuring the Direction of IB

Currently, the development of *Islamic banks* is expected to achieve its *Maqasid as-Shari'ah*. The interviewees voiced their concern about the route that will be taken by *Islamic banks* in order to enable them to fulfil the initial objective of having *Islamic financial institutions*. They are also concerned with government support for the direction that will be taken by the *Islamic banks* in order to achieve its objectives. Although the interviewees realised that *Islamic banks* are being constrained by the infrastructures that are based on the conventional economic system, the initial objectives need to be upheld to achieve the benefits of establishing the *Islamic financial institutions* for stakeholders and the public as a whole.

Thus, besides focusing on the returns, the *Islamic bank* should also focus on achieving the *maqasid as-Shari'ah*, which is the pillar of its establishment. Furthermore, a *Shari'ah Officer* in medium-sized local IBS explained the role of players and institutions as:

I believe that the Islamic banking players need to make more effort to ensure that the IB will stand as an institution that is truly complying with Shari'ah in terms of governance, legal and Islamic risk management. However, if the player is not ready and they do not possess clear values and a clear worldview, it would be the same as conventional banking. The players have to understand the differences between Islamic and conventional banking."

Early establishment of the direction will guarantee that the players do not deviate from the right direction in achieving the *maqasid as-Shari'ah* (i.e. objective of *Shari'ah*). Players should play their role in ensuring that IB is moving towards achieving *maqasid as-Shari'ah*. A *Shari'ah* Officer in a medium-sized local IBS stated that it seems that the industry commercialised IB, whereas at the same time, it should be very clear on the foundation and principles of IB in determining its direction to achieve its *Shari'ah* objectives.

“...At the macro level, I would say that we are lacking a map of Islamic finance.... Islamic banks are a subset of Islamic economics. However, it seems that we have commercialised Islamic banking. By rights, we should emphasize the foundation to make ourselves clear with the Islamic banking map.”

A CEO of a large-sized local IBF highlighted his concerns on this matter. He stated that we should be very clear on the foundation and principles of IB in determining its direction to achieve its *Shari'ah* objectives. Since Malaysia is taking a pragmatic approach in its early establishment, IB seems to mirror the CB by Islamising banking products and services; that approach seemed to be suitable during the early years of its establishment. However, after three decades, IB players need to identify where it is heading. The way forward for IB is either becoming true *Islamic* banking or just mirroring CB.

“... The bigger issue is where Islamic banking is heading: (1) true Islamic banking way or (2) as a mirror of a conventional bank. If we do not change the way we do Islamic banking in Malaysia and in the world, we will forever be operating in a conventional environment or mindset. Where is Islamic banking heading? – Are we going to mirror conventional banks but have Islamic products or are we going to follow the Shari'ah way, that is, truly Islamic banking. It will take a lot of reengineering, a mindset change, a paradigm shift and a review at things. It is going to be a long evolution, the revolutionary kind of thing. Being a truly Islamic bank in a dual environment...”

In addition, a *Shari'ah* officer from a medium-sized local IBS voiced the same concern.

“... At the macro level, I would say that we are lacking a map of Islamic finance... In terms of competition, Malaysia manages to compete. However, we are still unclear in terms of direction to create our own identity in our journey (i.e. destiny). In the future, the Islamic banks will need to create their own destiny. This explains that the Islamic banks go beyond gaining profit. It is also expected that with the profit gained, society's problems are solved.”

Furthermore, an accounting academician also declared that the establishment of *Islamic* banks was intended to achieve the *maqasid as-Shari'ah* (i.e. objective of *Shari'ah*):

“... The whole purpose of Islamic banking and finance is to realise the objective of Islamic economics, which is a socioeconomic objective that Chapra has defined. The objectives include need fulfillment and equitable earnings ...”

The CEOs and *Shari'ah* officers in Islamic banks are currently highlighting the roles of players in order to influence future progress. The awareness of CEOs is crucial, as it will drive the actions of subordinates in IBs. The important role of the top management was further elaborated in the first segment of the following subsection. However, Islamic banks are also bound by various authorities in the decision-making process.

7.3.1.2 Lack of Awareness among Top Management and Lower Management in Theoretical and Practical Aspects of Islamic Banking Practices

In order for the industry to move towards true *Islamic* banks, various interviewees highlighted the readiness of the industry to implement the conceptual or theoretical model of the *Islamic* banking business. The interviewees expressed their heightened awareness of the need to streamline the operation of *Islamic* banks to achieve the objectives of *Shari'ah* (i.e. *maqasid as-Shari'ah*). As banks were established from a religious impetus (i.e. *Shari'ah*

Law), they are expected to achieve its objectives of *Shari'ah* (i.e. *maqasid as-Shari'ah*). The interviewees voiced their concerns on the route that will be taken by *Islamic* banks in order to enable them to fulfil the initial objective of having *Islamic* financial institutions.

They are also concerned with government support in facilitating the direction that will be taken by the *Islamic* banks in order to achieve their objectives. Although the interviewees realised that *Islamic* banks are being constrained by the infrastructures based on the conventional economic system, the initial objectives need to be upheld to achieve the benefits of establishing the *Islamic* financial institutions to stakeholders and the public as a whole.

The industry is in need of having a CEO, or top management of *Islamic* banks, who appreciate and understand the theory and practice of the operation of *Islamic* banking and finance, and the differences between what is being preached in theory and what is being practised in the *Islamic* banks. *Shari'ah* background and technical background possessed by the top management would result in the CEO understanding and having the ability to appreciate the practical and theoretical aspect of the product, services and operation in *Islamic* banks.

It will also assist top management to make decisions with the right mindset. It is important for a leader to understand the objectives of establishing the *Islamic* banks and to be able to streamline the mission, vision and objectives of the IB that uphold both commercial viability and socioeconomic benefits. Lack of appreciation of the aspiration of the establishment could hinder the development and would stop the lower level staff from carrying out their responsibilities in accordance to the principles of *Islamic* banks. *Shari'ah* exposure will also influence the top management to make decisions with the right mindset.

Due to different authorities in the decision-making process and the knowledge and skills possessed by the top management, the NSAC of BNM expressed his concern at the lack of leadership of top management, leading the bank with the wrong mindset. He foresees that the future leaders of the *Islamic* banks would have more *Shari'ah* exposure to establish more understanding on the concepts and applications of *Islamic* banks.

“... in 5 to 10 years to come I want to see people who have good Shari'ah experience leading the Islamic banks. That way, it will be easier for them to understand the concept as well as the application.”

The interviewee, who is an NSAC of BNM, highlights the importance of people who lead the financial institution knowing the objectives, mission, vision, concept, application and adequacy of human capital to innovate. In addition, he emphasises the importance of having full support from top management. Furthermore, an NSAC of BNM, a *Shari'ah* Officer of a large-sized local IBS and a SC of a medium-sized local IBS emphasise on the need for top management to direct the IB towards achieving its socioeconomic objectives. They also highlight that some banks lack the top management's will altogether, which is crucial to the ability to disseminate the true spirit of the establishment and operation of *Islamic* banks.

“All it needs is the political will of the top management. In some Islamic subsidiary banks, the spirit is not supported by parent banks. This results in the difficulty of some banks to have support from their top management.”

“It is difficult and crucial to have support from top management....”

“... Interest and influence of upper level management will make the process of influencing the lower level management easier. This shows the commitment of upper level management (i.e. top management) towards lower level management.”

The industry is in need of having CEOs or top management of *Islamic* banks who appreciate and understand the theoretical and practical issues of the operation of *Islamic* banking and finance, and the differences between the theoretical and practical aspects in *Islamic* banks. Furthermore, the SC of large-sized fully-fledged IB highlights the same concern towards the middle management and the front line. They are also expected to understand and appreciate the theoretical and practical aspects of the operation of *Islamic* banks.

“... Sometimes, the staff cannot apply their knowledge of the conventional bank to the Islamic bank. They cannot fulfil what we want and expect.”

At the same time, a *Shari'ah* officer in a medium-sized local IBS mentioned the same issue that it is a challenge directly to apply knowledge from conventional banks in an *Islamic* bank:

“... To be well-versed with banking operations, as an Islamic banking operation is not the same as a conventional operation....”

Meanwhile, a COO of a medium-sized foreign IBS explains that in the IBS, the human capital for developing and innovating products resides in IB, while other experts are leveraged based on the parent banks. Furthermore, A CEO of large-sized fully-fledged IBS confirmed that in the IBS they only have a support team to support the *Islamic* banking activities of the bank.

“So the parents have got all the expertise, but the expertise in Islamic banking products, Shari'ah and Islamic banking risk, is all with the Islamic banking subsidiary. Other than these elements, we are leveraging on the parent bank.”

“Our model is basically based on the leverage model, which means that we don't recreate another stand-alone bank. Within the banking group we basically leverage on the parent bank's infrastructure, (...). First and foremost, Maybank Islamic is a centre of excellence in product innovation. The centre is the manufacturer of Islamic products for the group's commercial banking business. These units are leveraged in terms of policy but we monitor

the risk profiles for our various lending portfolios. In addition, we have our own Islamic global market, Islamic treasury, Islamic business, Human capital, and business development. Furthermore, we provide support to the various businesses because the business sector in parent bank sells our products. (...). They (i.e. the personnel from conventional counterparts) sell the products but we have our own team here that supports the sales of these products.”

Although SC highlighted the need of obtaining a top management that possessed the right mind-set in developing IBs, a CEO in large IBS, a NSAC at BNM and a SC at the bank level highlighted the issue of the lack of expertise in human capital. The industry is lacking in experts that are qualified in both technical and *Shari'ah* knowledge that will expedite certain processes and would appreciate the different requirements in IB. The balance in requirements is important to all type of work. On the other hand, in the case of fresh graduates, they are very new in the industry and it is where they start their career. However, being in the bank with senior staff that has previous experience in *Islamic* banks gives the fresh graduates supervision. Thus, the SC finds that the values that are in accordance with the *Shari'ah* teaching are not transpired. Further discussions related to the lack of expertise in the industry were presented in the next subsection.

7.3.1.3 Lack of Expertise in Islamic banks

It is important for the staff to acquire dual knowledge in order for them to understand the theoretical and practical aspects of *Islamic* banking and finance. The understanding is needed, as this will create *Islamic* banking staffs that are able to apply their knowledge to reach an intersection between theory and practice. This is important as the implementation of products and services are bound by the *Islamic* financial infrastructure in the country. As in Malaysia, the application of *Shari'ah* in products and services are still bound to the law of the country and various international regulations. Furthermore, interviewees also emphasized the importance of having dual knowledge and multi-skills (i.e. The right combination of

knowledge and skills).

Also, by having dual knowledge, it increases their understanding of the overall operations of *Islamic* banks. In addition, according to NSAC at BNM, SC in IBS and an accounting scholar, it would be an advantage for the banks if the staff had value added skills such as understanding skills and dual language (i.e. English and Arabic):

“As personnel in IB, you really have to understand and know about the details underlying it. In the Islamic banking industry, we lack personnel with effective interpersonal skills in understanding and acquiring more knowledge regarding IB.”

“... Besides technical and practical knowledge and skill of the personnel working with IB, those who possess proficiency in English and Arabic would be highly sought after....”

The level expertise in IB influences the way they show appreciation of *Shari’ah* in the operation, products and services and implementation. Also, the existence of *Muslim* and non-*Muslim* staff influence their appreciation of *Shari’ah* matters. In referring to Malaysia’s structure and underlying *Shari’ah* principles, it suggests that dual knowledge would result in understanding and appreciating the unique operation and environment of IB’s industry and would allow diversification of HC that would enable us to find the intersection point between theoretical and practical, this in turn, would allow better products to be developed and innovated. In addition, the lacking of *Shari’ah* knowledge among practitioners and the lacking of technical knowledge among *Shari’ah* scholars, calls for in-depth knowledge to allow everybody to appreciate the *maqasid Shari’ah* and the spirit of *Islamic* banking. Adequate knowledge and understanding allows better understanding of the subject matters and processes taken place, and to avoid *Shari’ah* issues after the product is approved (i.e. structure, process, documentation, verification of contracts).

Furthermore, technical expertise in the bank is needed to acquire basic knowledge of *Shari'ah*. As an example, the HC in product development and innovation would be able to design a product that is viable and *Shari'ah* compliant. Also, the new product may face fewer problems when it is reviewed by the *Shari'ah* Advisors, which will expedite its launching. On the other hand, the SA that possesses the technicalities of IB operations on product and system would need less time to approve a certain product. Also, they will produce more reliable and credible decisions, as they understand the technical part of the operation. This is supported by SC in medium-sized local IBS.

*“Actually the most important aspect that the BNM is trying to encourage is to have a mix of backgrounds by the SC. In my experience, if a person who have *Shari'ah* knowledge, per say, without having any technical knowledge, they may not have the idea of what is being presented to them. Also, they may easily approve the product without real understanding on the operationalization of the product. Bankers, being a banker, they just want the product to be approved. Sometimes, they want a certain thing and they will invoke controversy... *Shari'ah* advisors don't actually know what has been presented, they may not ask further and they just approve, while there is a lot of *Shari'ah* issues in terms of the processes, and documentation. It is not just looking at the structure, but it involves verifying the contract and all related issues. Due to the involvement, I think there is a need to enhance the capability of a *Shari'ah* advisor, in terms of having dual-knowledge.”*

Also, the familiarity with technical knowledge for those who have acquired *Shari'ah* knowledge is very basic. The area of *Shari'ah* that they are acquiring is also a main concern as it is the measure of the depth of knowledge that the human capital has in terms of supporting the *fiqh mu'alamat*. Also, they may possess other areas of *Shari'ah* knowledge which may indirectly help them understand *fiqh mu'amalah* or will help them to deliberate on the *Islamic* transaction and *mu'amalah*. However, as highlighted by NSAC of BNM, those

with Fiqh *mu'amalah* knowledge and those with other area of *Shari'ah* would have different ways of deliberating the *Shari'ah* principles.

“... If you are talking about Shari'ah, we do have people that are qualified, have good knowledge in Shari'ah, Fiqh, Fiqh mu'amalah, or usul fiqh but we do not have many people who know the expect of mu'amalah in detail, and people that understand the complicated banking products.”

Furthermore, the accounting academician and NSAC of BNM emphasized the importance of having double majoring or multi-knowledge, and multi-skills (i.e. the right combination of skills).

“... I think you have to specify the diversification of human capital in IBF or Islamic financial services, as it is very unique. In that sense, you need to have a blend of knowledge....”

“... The graduates who have double majoring would be highly demanded, for example, somebody who has Shari'ah and, at the same time, has a legal training that will be highly sort after....”

Furthermore, the competition is also applied to the *Islamic* subsidiaries of conventional banks. This is due to the nature of the subsidiaries that operate on a leveraged model where certain departments reside in the subsidiary and other departments are leveraged on parent banks. In the subsidiary, there will be a department that will train the parent's bank staff that are involved in sales of the product. In addition, the staffs are originally from conventional banks or they are actually conventional bank's (i.e. Parent bank) staffs that are being leveraged to the *Islamic* banking subsidiaries. They lack proper knowledge, requirements and understanding on the *Islamic* banking products and services. Also, they lack skills and abilities to explain *Islamic* banking products to customers.

The CEO of large-sized local IBS and NSAC BNM further highlighted the efforts of the IBS level to ensure that the human capital is ready to develop IBS in tandem with their conventional counterparts in every aspect of the operation. Furthermore, the interviews focused on training, campaign and advertising to ensure that the end-to-end process of developing products and support to the sales person at parent banks and *Islamic* financial service pricing are affected or influenced by conventional markets.

“Business development unit will ensure end-to-end process of developing Islamic products. Furthermore, the unit will provide support in terms of training, campaigning and advertising to the sales person at the parent bank. In addition, we will make sure that we will move in tandem with our conventional counterpart.”

“Since Islamic banking and finance operates in the same environment and market forces with conventional banks, we experienced that Islamic financial service pricing is affected or influenced by the conventional market due to its competition....”

In summary, the discussion regarding human capital in IB concludes that the human capital is still lacking in education and knowledge in respect to *Shari’ah* knowledge, or technical knowledge and skills. Also, there is a lack of experience among the HC in IB. In terms of experience, the staff may either gain their experience from conventional banks or fresh graduates enter into the IB without any experience. On one hand, the HC that possessed experience from CB may be influenced by their experience in doing work in IB. On the other hand, fresh graduates entering the IB will be influenced and taught by their colleagues that had previous experience in IB. In addition, the HC are *Muslim* and non-*Muslim*. The IBS even shared the same human capital with parent banks. Thus, their education, expertise, knowledge, experience, background, way of thinking, paradigm and different worldview influence the way the HC make decisions, perform their accountability and responsibility, form opinions and appreciation to the real spirit of its establishment, execute operations and

objectives and the missions and visions of IB. Thus, the lacking in the qualities or requirements needed from the staff is an evidence for the need for education and training to create awareness and to increase the awareness level of staff.

7.3.2 Implementation of *Shari'ah* Approved Procedures

7.3.2.1 Approval of Product Development and Innovation

The *Shari'ah* compliance processes are classified into two categories: pre-compliance and post-compliance. The pre-compliance processes are also known as pre-launch processes or ex-ante compliance. The processes are done before the product is being introduced to the market to affirm its *Shari'ah* compliance. At this stage, the product is conceptualised. The conceptualization of products involves various parties in *Islamic* banks.

In an interview with *Shari'ah* officers, they highlight that in order for them to table product proposals to the *Shari'ah* board, it usually includes the product development department, legal department, and any other related department to forward its product proposal to the *Shari'ah* department. It involves the product development team to propose a proposal for new products by obtaining the structure of the products and establishing the *Shari'ah* compatibility of the product. The proposal will be sent to the legal department for them to review the legality of the product. Then, the proposal will be sent to the *Shari'ah* department for them to review in terms of *Shari'ah* compliance and it will be presented to the *Shari'ah* Committee (SC) of the bank.

The following figures explain the flow from product approval to offering the product to the bank's customers. The product approval stages consist of the first three steps. Furthermore, the implementation of approved products takes place at the front-line level.

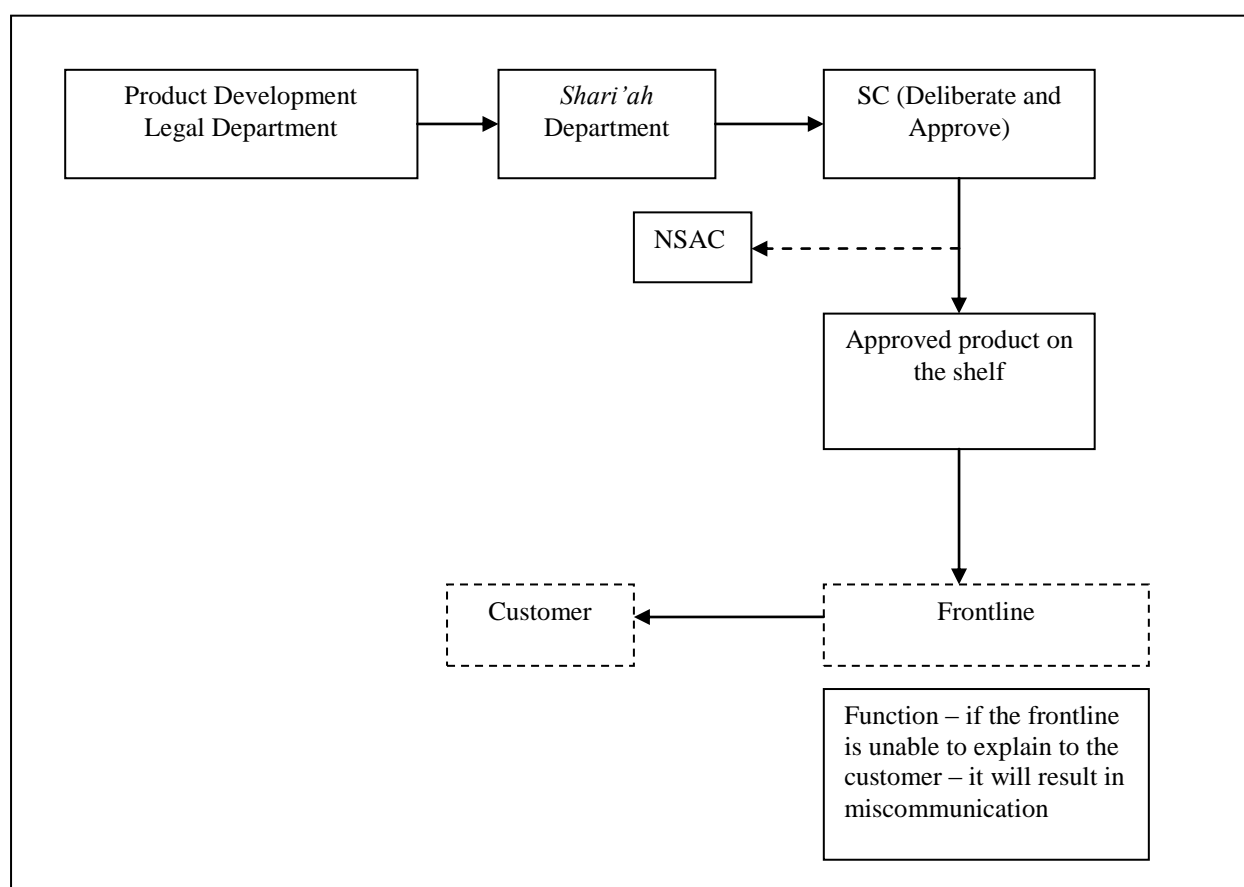


Figure 7.3.1 Processes Flow from Conceptualization of Products to Approved Products on the Shelf (Source: Findings from this study)

During the approval of product development and innovation stage, the committees involved will confirm the initial proposal for the development of products through Islamisation of *Islamic* banking products (i.e. Making the product *Shari'ah* compliant or innovation of *Shari'ah* based products). The *Shari'ah* board will discuss and deliberate the underlying concepts and *modus operandi* before they endorse and validate the contract in order to ensure that the contracts are *Shari'ah* compliant. Also, they will deliberate on *Shari'ah* related matters, and any *Shari'ah* issues that may arise will be discussed and resolved. The deliberation will be done thoroughly until the SC is satisfied with the *Shari'ah* compliance of the product. The discussion and deliberation on certain products may take more than one meeting. Once the product is approved, the concept used is approved, the contract associated

is identified, the documents involved are confirmed and the processes involved in a transaction are being laid down; the product is now ready to be placed on-the-shelf. However, if the product is not approved, it will be revised and then tabled to the SC again. Furthermore, the problem will become more crucial as most of the individuals do not possess dual knowledge. However, in this situation those who have dual knowledge would be the middleman between the *Shari'ah* people and the technical people.

Thus, in this situation the SC requires the cooperation of the bank's management and *Shari'ah* officers in the *Shari'ah* department to enable them to understand the practice of *Islamic* banks. In order for SC to approve on certain products proposed by the banks, they will go through a series of meetings that consists of thorough deliberations and discussions with practitioners. The practitioners need to be transparent in explaining the way they do business and in the way they explain things. This will help the SC to understand the underlying nature of the product and how it is being implemented in the banks. Nonetheless, they will still face problems if there are any issues arising from any misunderstanding that raised the need to narrow down the gap between the two parties. The bank's management is expected to show their cooperation, attitude, and understanding of the management that are based on *Shari'ah* as the basis of operation, ability to execute orders or decisions. On the other hand, *Shari'ah* department should play its role to avoid miscommunication between bank's management and the *Shari'ah* committee in order to have a better product innovation, development and implementation.

The cooperation between the parties involved and SC is highly needed in ensuring that the SC is enabled to perform their duties. The cooperation with different parties will help the SC to deliver their accountability to approve the product and signing the report and to give

assurance to the public that the practices of *Islamic* banks are in accordance with *the Shari'ah*. Also, it helps the *Islamic* banks to perform their duties. Besides, in order to guarantee that the SC is able to perform their duties and accountability, they need to equip themselves with various types of knowledge.

The involvement of the *Shari'ah committee* with technical matters varies according to their expertise. For example, the SC with accounting and finance backgrounds would have direct involvement with accounting and financial matters. However, those SC without any background in accounting and finance admitted their knowledge gap and their reliance on technical staff. Also, the SCs awareness on the importance of accounting to account for communicating the true economic value of *Islamic* banks to the stakeholders as a whole were increased.

7.3.2.2 The Knowledge Gap between *Shari'ah* Scholars and Technical Expertise portrayed during Product Conceptualisation and Approval

The *Shari'ah* committees/scholars without the technical background will depend on the explanation from the technical people to clarify the proposal of the product in order for the *Shari'ah* committee/scholars to understand the technicalities and implementation of the product. SC in large-sized full-fledged IB (who possess an economics background) and SC in medium-size foreign IBS refer to the dependant on the explanation made by the technical HC.

“SC depends on the explanation of the bankers regarding the proposal of the product in order for them to understand the technicalities and the implementation of the product...”

“I wouldn't know if they tell us wrongly. When this happens, I would consider

that they are not sincere enough in explaining to us. In my capacity, I wouldn't be able to know and I am really dependent on them. As for myself, I should have good communication with the management. Consequently, management must stress this point to all departments and stakeholders in the institution to ensure that everything is Shari'ah compliant. We are not masters of everything, we do have some constraints...."

Furthermore, both interviewees stress on the importance of transparency during the explanation to *Shari'ah* committees/scholars. The transparency in giving out explanation and information will ensure the level of accuracy of the decisions made by the SC. SC in large-sized full-fledged IB highlighted pertaining to transparency.

"I used to tell my colleague that, in our effort to deliver our accountability as Shari'ah committee, we need transparency. Without transparency, we are afraid that it will affect the decision that we make as we are very much dependent on explanation being made by the technical people." (P22)

According to SC in large-sized full-fledged IB (who possess an economics background), besides ensuring that the information that they receive is correct, the *Shari'ah* people may face difficulties in understanding the explanation given by the technical people due to a lack of background in technical matters:

"In addition, the language of technical people and Shari'ah people is different. In the meeting, what we explain to the technical people may be understood differently by them. However, we try to understand what they mean and we will try to interpret what they told us. Sometimes, there is also a situation where there is human capital that both knowledge will need a middle man to reduce the gap between Shari'ah and technical people. This is really important or else the SC will end up approving something that is different in implementation as to what we understand."

The fact that SCs depend on the explanation of technical people to understand the technical perspectives of a certain transaction/contract would entail that the reliability of the explanation depends on the trustworthiness of the staff. In this instance, the SC of large-sized

full-fledged IB note that it is important to have staffs that possess the right values, such as honesty.

“... If they rely totally on the explanation by the bankers and they did not seek clarification, they will never know the honesty of the bankers in the bank. Maybe if they are Muslim, they may understand, but you will never know.”

In addition, the SC of full-fledged IB also emphasizes the possibility that the *Shari'ah*, or technical HC, misinterpret what is being discussed and delivered. Thus, this raises the importance of good communication. Currently, most of discussion, explanation and deliberation would involve the head of department (HOD), SC and *Shari'ah* department officers. Although the middle management may represent the HOD on a number of meetings, the SC shared their concern about the lack of capability and involvement between all levels of HC. They found that the middle management faced problems to explain and to understand how *Shari'ah* is applied in the *Islamic* banks. Lack of explanation will result in unclear information for the SC on the underlying nature of the product, and the dissatisfaction of the HOD on the decision made by the SC. Consequently, the HOD will call another meeting to clarify the decision made. This could be due to the lack of opportunity given to the staff to meet and communicate with SC or the inability of the staff to understand the discussion.

In addition, there are also instances where problems arise when the explanation given by the assistant officer is not clear. The head officer, then, needs to clarify. This shows that the head office is more capable of doing the explanations. Consequently, the HC and SC need to have more exposure and understanding to enable them to be able to explain the subject matter. The SC in large-sized fully-fledged IB (who possesses an economics background) in the following quote highlighted the problems faced by the industry pertaining to the inability of the staff to understand or explain:

“The way the lower level managers explain certain subjects may result in dissatisfaction of higher level managers with the explanation or justification made by the Shari’ah advisors. This is due to the inability of lower level managers to explain properly to the Shari’ah advisors.”

The above discussion explains on the dynamic issues among *Shari’ah* scholars and the innovator and implementer due to the different expertise and background in carrying out the responsibility and accountability. Firstly, this section highlights the dynamics issues in terms of understanding the *Shari’ah* matters and technical matters by the technical people and *Shari’ah* scholars, respectively. These issues will results in misunderstanding and miscommunication of both parties in ensuring that the operationalisation of a certain contracts is in accordance with *Shari’ah*.

General expectations on the reliance of *Shari’ah* people regarding the explanation of the technical people are being highlighted. In the following Figure 7.3.1, the flow of information during the conceptualization phase is being drafted.

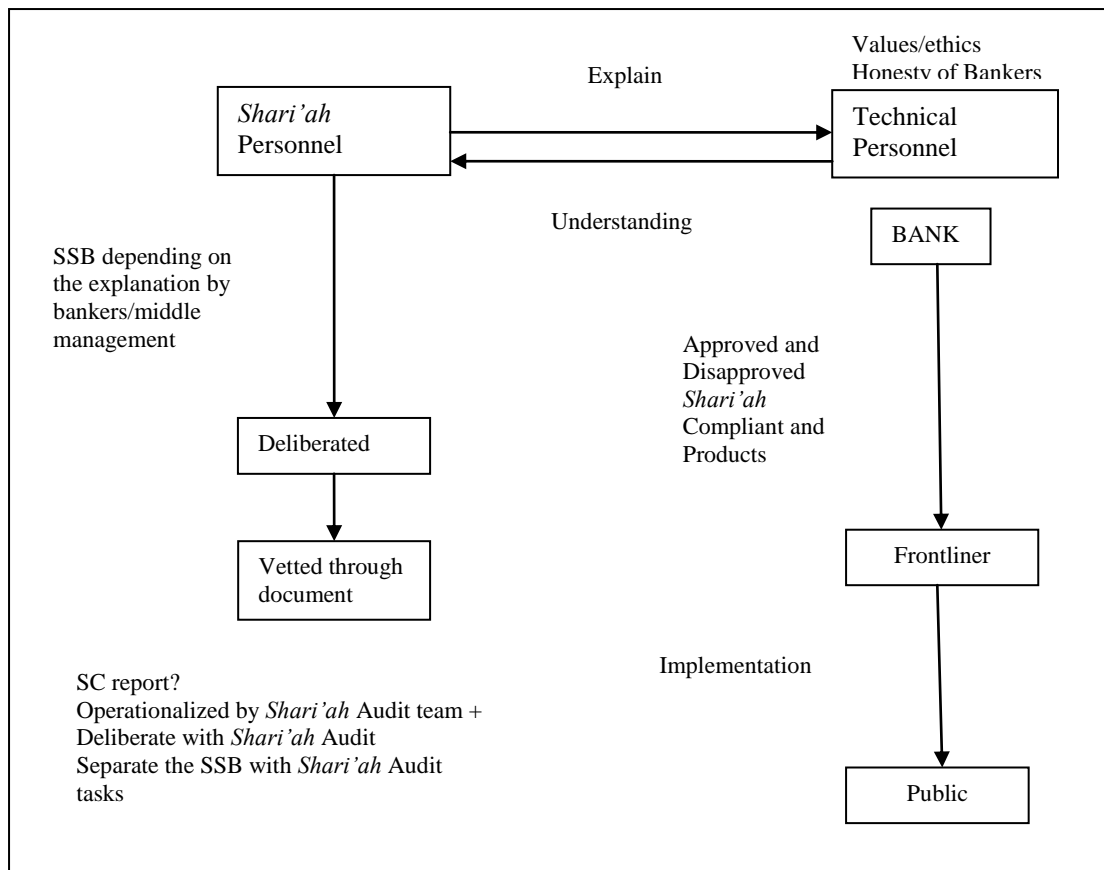


Figure 7.3.2 Interaction between *Shari'ah* and Technical Personnel in Islamic Banks (generated by author)

The above diagram explained that the *Shari'ah* people are lacking in technical knowledge and technical people are lacking in *Shari'ah* knowledge. Thus, they are depending on each other to provide information explained to them in the area that they are deficient in. *Shari'ah* people will explain *Shari'ah* matters and will try to understand technical matters of the technical expertise, and technical people will explain technical matters and will try to understand *Shari'ah* matters. This shows that *Shari'ah* people and technical people are highly dependent on each other.

The industry needs expertise in *Shari'ah* committees/scholars and it needs to strengthen the *Shari'ah* department to reduce turnaround time to obtain approval, to expedite the approval process, to assist the audit process, to resolve internal *Shari'ah* issues, oversee the products

and services, documents involved, advertisement, marketing and ethics and to reduce full dependence of SC. In addition, to expedite the decision-making process, the IBs need to have a pool of staff that can synergise their expertise.

Furthermore, an SC of medium-sized local IBS having a *Shari'ah* Department or *Shari'ah* Secretariat in the *Islamic* banking is important, as the staff would have direct access to *Shari'ah* experts:

“ ... We need to have more Shari'ah scholars in the bank holding important positions, it is good for day to day decision making, as they have direct access with front liner ... ”

However, through the SC from medium-sized local IBS and *Shari'ah* officer of medium-sized foreign IBS, it was found that the *Shari'ah* department in banks still lack strength. According to them, strong *Shari'ah* department will reduce waiting time for certain approval processes. By strengthening the *Shari'ah* department, it is perceived that the approval process will be expedited because the staffs are full-time with the bank. In addition, the audit processes will follow suit.

“So, I would suggest that Islamic banks should have Shari'ah department as a fundamental department which will look into Shari'ah elements in the products and other elements that should comply with the Shari'ah . Shari'ah officers in Shari'ah department will be responsible for the products, product's name, documents, advertisement, marketing and staff's ethics.”

“... We have to have a very strong Shari'ah secretariat that can advise, I mean, in-house Shari'ah, as well as external committee...”

In addition, a CEO from the large-sized local IBS discusses the issue of lack of expertise of *Shari'ah* management.

“... Issues in terms of people, skill level that is available in the industry in regards to Islamic banking, especially in terms of *Shari'ah* management ...”

The knowledge gap that exists between the *Shari'ah* scholars and technical expertise in the industry will result in the demand of *Shari'ah* committees/scholars expertise in understanding the roles, functions and operations of Islamic banks. It will further reduce turnaround time to obtain approval, to expedite the approval process, to assist the audit process, to resolve internal *Shari'ah* issues, oversee the products and services, documents involved, advertisement, marketing and ethics and to reduce full dependence of SC. In addition, to expedite the decision-making process, the IBs need to have a pool of staff that can synergise their expertise. Thus, it is important to have *Shari'ah* committee/scholars that are able to understand the technical perspective of IB's products and services, to understand transactions in accordance to *Shari'ah* and to understand the *Shari'ah* rules relating to the product offered.

The move to an established *Shari'ah* department in IB or IBS will strengthen the *Shari'ah* governance in IBs. The interviewees explained that the *Shari'ah* department would assist communication between IBs and SC. It is also perceived that the department can assist and expedite various processes in IB, for example, when proposing new product development or innovation. Also, the department may be the middleman between technical and *Shari'ah* personnel. However, the department is still lacks expertise on *Shari'ah* management. The department needs to be strengthened to improve the current *Shari'ah* management in IBs.

The Internal *Shari'ah* Control department is the most essential element of *Shari'ah* compliance outside of the *Shari'ah* supervisory board and is the mirror through which the *Shari'ah* supervisory board images the financial institution or product. This department needs to have an authoritative relationship within the institution and must fulfill the conditions of

knowledge and independence among many other conditions, like integrity and availability of resources. It must also possess appropriate relationships with the *Shari'ah* supervisory board and management, and must have access to any information it requires in order to ensure proper *Shari'ah* compliance (Muslim and Zaidi 2008).

7.3.2.3 Implementation of Approved Products (Post-compliance)

Post-compliance is also known as post-launch or ex-post compliance. The post-compliance processes come after the product is being approved and are ready to be introduced to the market. Once the products are approved and on the shelf, it is the responsibility of the front-line staff to carry out their responsibilities in order to ensure that the implementation (i.e. the process to conclude the contract) is *Shari'ah* compliant.

Although the pre-compliance process is critical in ensuring that the *Shari'ah* compliance of the product is in place, the responsibility of the line management is also important to guarantee that the implementation of the product is in accordance with *Shari'ah* (i.e. in accordance with what has been approved by the SC). Furthermore, the implementation of the front-line staff is crucial, as it will operationalize all the procedures that have been approved by the *Shari'ah* board. During ex-post compliance, the accountability lies in the hand of the implementer such as the front-line staff. In addition, the implementation of the approved and endorsed products and services by the *Shari'ah* committee is a concern. It is crucial for the bank to ensure that all the procedures and obligations are established and performed. Thus, the line management will carry out the implementation and execution of the approved product and the execution of the sales and purchase agreement.

In the process of selling or providing the product and services to the customer, they need to ensure that the contract is carried out according to the proper sequence laid out by the *Shari'ah* committee to guarantee that it is *Shari'ah* compliant. The line management is also the liaison between the bank management and clients. They are responsible for giving information to current clients and potential clients on *Islamic* banking products. It is expected that they are able to give to the client the correct information regarding the products and services. Besides a correct explanation, the line management is expected to explain the differences that occur between products in the conventional banks and products in the *Islamic* banks. Relevant information must be disclosed to customers for them to gain a better understanding of the products.

The correct implementation will ensure that the products and services are *Shari'ah* compliant. On the other hand, the failure to establish that the implementation is in accordance with *Shari'ah* will result in a risk of the *Shari'ah* non-compliance risk. During the implementation, various *Shari'ah* non-compliance cases were identified. The SCs of a medium-sized local IBS highlighted that he encountered *Shari'ah* non-compliance cases during his experience of carrying out the review.

“When I go to the bank and perform the review process myself, there are many instances where many things are not in accordance with what have been agreed and decided at the Shari'ah committee level. These are the things that need to be strengthened and improvised from time to time.”

“When the product is tabled to us and we approve, the bank staff will exercise the implementation of the product. Sometimes, we find that there are matters that did not comply with Shari'ah.”

Similarly, the SC of a fully-fledged IB highlighted the *Shari'ah* non-compliance at the implementation stage. In addition, the NSAC of BNM emphasised ex-post compliance

problems faces by IB. During the ex-post compliance she associated the problems with lack of training and knowledge of front-line staff.

“During the implementation stage, we found out that there were a few cases of Shari’ah non-compliance.”

“There have been cases of non- Shari’ah compliance such as the incorrect execution of some of the transactions and the bank has rectified this internally because such cases are discovered along the way. For example, let us say it is a financing product, and by rights, the bank would have to actually enter into the S&P transaction with the customer. However, due to lack of training of their frontline staff or at the branches, the staff actually disburse the financing amount prior to the signing and the contract being concluded between the parties.”

In addition, an SC of a medium-sized local IBS states that lack of expertise in both *Shari’ah* and technical knowledge risk *Shari’ah* non-compliance cases in *Islamic* banks. *Shari’ah* non-compliance cases will have an impact on *Islamic* banking’s reputation and image.

“If we did not give sufficient attention to expertise in Shari’ah and technical knowledge, it will lead to a Shari’ah non-compliance risk. It is a risk where the bank will violate compliance with Shari’ah principles and cause Shari’ah non-compliance, which will tarnish the Islamic bank's image and the image of Islam, as Islamic banking cannot represent Islam itself.”

Furthermore, the existence of a manual as a guideline for the personnel in *Islamic* banking operations still exposes the bank to *Shari’ah* non-compliance. The COO of a medium-sized foreign IBS expressed the difficulties of ensuring the implementation of *Islamic* banking’s products and services by the front-line staff, despite training being given and the manual provided.

“... I think it’s going to be impossible for us to ensure everybody does what is being instructed, and that the training is all encompassing from the sales people to the people who do the processing. There is a checklist. If they sell

something, when the facilities are approved, they will be checked, before the facility is disbursed. The checklists are intended to ensure that all the processes are in place. However, sometimes, there are cases where we discover Shari'ah non-compliance issues during the fourth level. During this level, we had offered the facilities, the customer had accepted the facilities and all documents were drawn up, but before the facilities were disbursed we found out that something had gone wrong as the sales people had not done certain things."

Ex-post *Shari'ah* compliance is sometimes not implemented in accordance with what has been deliberated and approved by the *Shari'ah* committee. Furthermore, various interviewees highlighted examples of *Shari'ah non-compliance*. In addition, the COO of a medium-sized foreign IBS and the CEO of a medium-sized local IBF spoke of *Islamic* banks offering fixed deposit accounts at its *Islamic* branches when they cannot offer such products.

"I would like to highlight an issue regarding the opening of conventional fixed deposit in Islamic branches. We had stipulated rulings for Islamic branches that they cannot open up a conventional fixed deposit account. However, we found out that they opened the FD account. We raised this issue with them. They need to refer to us to justify what is the cause and what is the action to be taken. Once we receive the report, we compiled and tabled it to the Shari'ah committee for their rectification and action."

"One example is the opening of conventional fixed deposit in Islamic branches. Actually our rulings for Islamic branches are that they cannot open them, but we discovered that they opened an FD account."

In various interviews, interviewees highlighted *Shari'ah* non-compliance cases that arose in *Islamic* banks. The causes can be categorised into major cases and minor cases. It was revealed by the NSAC of BNM that *Shari'ah* non-compliance in implementation may be due to the lack of understanding among HCs, which may result in mistakes that are not deliberately made.

"... Although the product may initially be approved by the Shari'ah advisor as

Shari'ah compliant in terms of implementation, they may make mistakes due to lack of understanding on the part of the personnel in charge. They may not deliberately want to make those mistakes but sometimes they do not really understand what would be an issue in terms of Shari'ah compliance. They may think that they applied it correctly, whereas in the end, it turns out that it has an impact in terms of Shari'ah compliance."

The above statements show the lack of knowledge of support staff. Furthermore, throughout the interviews, various SCs found that the front-line staff would take an easy way out by informing the customer that there was nothing very different between conventional and *Islamic* banking products. Examples of explanations being used by the front-line staff when dealing with customers are (1) more documents or contracts involved in the *Islamic* banking product that may lead to higher cost of stamping, (2) the *Islamic* banks replaced the term 'interest' with 'profit' and in general, the *Islamic* banks use the same type of product and change its underlying concept with the same economic benefits, and (3) in the case of debt-based products, the payback value may be higher in IB which will result in IB's customers needing to pay more than conventional banking customers. Furthermore, in the case of a housing loan or a car loan that is based on BBA, the customers sometimes complain that the *Islamic* banking consumer tends to pay as much as, or the same as, a conventional customer. The front-line staffs do not attend to the complaint or accusations appropriately. Moreover, when there is a delay in concluding a car loan contract, the front-line staffs do not explain to the customer that in order for them to conclude the contract, the asset should exist. Hence, the delay of the contract signing is due to the delay of the car distributor in ensuring that the car is in existence. In addition, the front-line staff should explain to the customer the underlying concept of the products and should supply an explanation on the calculation or additional information. There are also claims that mention the greater number of contracts that need to be signed when the customer is involved with *Islamic* banking products. This explains flaws in the implementation or execution of contracts for *Islamic* banking products and services.

These matters have been highlighted by a NSAC of BNM and the CEO of a medium-sized IBS as follows:

“... There are still a lot of areas to be improved because in explaining the IB’s products and services to the customers and potential customers, they do not really understand the product in terms of Shari’ah compliance and why the product is different from conventional banking products....”

“Shari’ah is about the legality of the contract (i.e. the aqad). The document must be drawn up properly and in proper order, especially ‘inah. All the stipulated processes must be gone through in a particular manner. We are particular with how the sales person implements it. We have to educate them in training. However, we don’t know whether they are doing it correctly. In order to know, the Shari’ah department personnel will go and check the transactions. If there is any breach of contract, we have to report it....”

Implementation of line management (i.e., lower management) ensured that the operationalisation of products and services were in accordance with approved procedures. However, various *Shari’ah* non-compliance cases were identified by SCs during their review exercises. The reasons, among others, for *Shari’ah* non-compliance were lack of knowledge pertaining to *Shari’ah* matters, and the inexistence of a manual regarding the operationalisation of products and services to guide practices.

Thus, this depicted that the lower management did not deliberately exercise non-compliant practices. It revealed a lack of appreciation of *the Shari’ah matter* at the front-line side. Moreover, it portrayed a lack of accountability in ensuring that the compliance was in place. The *Shari’ah* non-compliance, at the implementation stage, must be dealt with at product issuance to guarantee that SC had decided the whole process. The lack of accountability led to various *Shari’ah* non-compliance cases,

which will prevent *Islamic* banking from fulfilling its initial objectives. In this situation, the IB was considered not fully *Shari'ah* compliant.

7.3.3 Accounting System

Since IB is established due to its underlying principles that are based on *Shari'ah* law, the accounting system and standards used to account for its products and services should be suitable, and can manage to communicate the financial results and its true economic values. The right standards and systems will assist the IB to communicate its performance in terms of financial performance and *Shari'ah* compliance. Furthermore, it is also ideal if the financial reporting could communicate the success of the IB in meeting the objectives of *Shari'ah*.

According to COO medium-sized foreign IBS, the *Islamic* banks are trying to understand AAOIFI requirements and they try to implement whenever possible. However, in order to implement the relevant provisions, they need a system that can support its application. However, further enhancement of the current system in the bank will be withheld until BNM issues guidelines to support it. The main compliance measure of the IB is to comply with BNM's rulings.

“... This industry is a very tightly regulated industry, unless BNM says that everybody has got to follow AAOIFI, until then, we basically can't spend. Moving into AAOIFI standards cost a lot of money, simply because when you adopt new things, the first thing that is going to be affected is your computer system because all accounting entries are basically supported by a system, and you know system changes cost a huge amount of money.”

It was noted by a *Shari'ah* officer of medium-sized local IBS regarding the chart of accounts, that the *Islamic* banks still share the same chart of accounts as the conventional banks. Since IB is based on the conventional chart of accounts, it still uses the conventional terms.

Furthermore, although they are in the process of featuring a dedicated *Shari'ah* chart of accounts, the changes will take effect gradually. However, during the reporting of terms, revision will be made to ensure that the terms used portray *Islamic* transaction terms.

“Just to share with you about our accounting charts. Since we have shared services between conventional and Islamic, we used the same chart for both services, (i.e. conventional charting). That’s why we still use the terms loan and interest. So, in the future, we would like to have our own dedicated Shari’ah charting, for example, how we record ijarah, investment and financing. We should gradually have our own Islamic charting”

However, using the same charting may result in less appreciation on the difference between recording the *Islamic* banking products and conventional accounting products. This may mislead the understanding of the IB’s products. Furthermore, SC of medium-sized local IBS (who possess an accounting background) discussed the issues, pertaining to accounting that was brought up during a meeting with *Shari'ah* Boards:

“... You can collect rental in advance, for example, in the case of property that is being abandoned or property that cannot be completed due to whatever reason, the whole amount of money is needed to be returned to the customer... Normally it is not being treated as asset, so it will be treated as liability but the issue from the accounting sometimes bank whether they want to recognize an income or not now. The main reason why banks want to recognize it as income is because it can project its profit better. Although the house is not yet ready but you have charged the rental and the rental will be immediately treat as an income so your profit will be higher; that will reflect better for the bank. Unless you choose another approach, because this is rental in advance, meaning that whatever happens to the property, you have to return. So assuming that there will be no problem, you just treat that as your income, so you can recognize your income now. This is the dilemma or the issue; whether you can recognize as income or as a liability or rental in advance.”

The *Shari'ah* committee focus on treatments of income for *Islamic* banking transactions to accommodate the reporting of profit. Also, proper attention should be given to the classification, valuation and measurement of debt and equity. As IB is operated using

different underlying principles, it also requires different performance measurement and incentive plans to the staff. Furthermore, SC of medium-sized local IBS (who possess an accounting background) is of the view that:

“... We cannot follow IFRS. We have to keep in line with our own thing, like we have to set in place different performance, that is not only financial; we have to set in place different Islamicity performance measurement.”

Currently, the bank will withhold any changes related to the system until it receives further instructions from BNM.

7.4 Lack of Influence of Accounting Practices and Reporting in Communicating

Reliable and Credible Information

The analysis of the accounting practices in IBs can be classified as the role of accounting and finance, approval of product development and innovation, implementation of approved products, financial accounting and reporting, accounting system, financial regulatory procedures and *Shari'ah* auditing.

7.4.1 The Role of Accounting and Finance

Despite the religious requirements in the establishment, operation and products and services of IB, the accounting and auditing practices in the *Islamic* banking and finance industry serve as an important mechanism for monitoring and control. In addition, it oversees the implementation of the financial transactions as approved by the SC. This would give assurance to the stakeholders on the extent of *Shari'ah* compliance in the operations of *Islamic* banks and it would lend credibility and legitimacy of the *Islamic* banks to the stakeholders at large.

The following table explains the process in ensuring *Shari'ah* compliance of financial transactions that involves approval of product development and innovation, implementation of approved, financial accounting and reporting and auditing.

Table 7.4.1 Transactions – From Concept to Reporting – *Shari'ah* Compliant Financial Transactions

<i>Shari'ah</i> Compliance	Financial Institutions	Accounting Standards	Auditing Standards
Approval of Product Development and Innovation	Implementation of Approved Product	Financial Accounting and Reporting	Auditing
Prudential Requirement			
<i>Shari'ah</i> -Based Prudential Requirement			

The approval of product development and innovation involves the *Shari'ah* committee's deliberation on the concepts underlying the contracts. Also, it involves discussions between *Shari'ah* committee and the bank's personnel or bank's management (i.e. Product development department, legal department, *Shari'ah* department) regarding the approval on product and service proposals, its operationalization and other related issues. During this stage, the SC would ensure that the underlying concepts of products and services are *Shari'ah* compliant. Next, it involves the implementation of approved product by the financial institutions. The contract should reflect underlying concepts approved by the *Shari'ah* councils. Also, it should portray contractual obligations established and performed. The next stage involves the financial accounting process to establish whether the methods in which the contracts are accounted negate the validity of *Shari'ah* compliance. The final stage is auditing. The implementation of auditing is raised due to the risks of the parties of the contracts that are reflected in the contracts. In this regard, the conventional-based and Islamic-based prudential regulation would guide how the risks and rewards would be reflected in the financial system.

7.4.2 Financial Accounting and Reporting

The accounting involves recording, classifying, and summarizing the financial transactions. A proper recording, classifying, and summarizing of financial transactions will represent the underlying nature (i.e. A true economic substance) of the product, and will define the way the contract is accounted. In addition, proper recording of the transaction will also determine the validity of *Shari'ah* compliance of the transaction. Thus, it is important for the IB to account for the transactions in accordance to its underlying nature to enable the user of the accounting report to have a better picture of the IB's activities.

In addition, the questions about the financial treatment and financial reporting on *Islamic* financial transactions are still based on the local application of accounting and auditing standards of the products. Some of the standards may not be suitable for application to *Islamic* banking and finance products due to the different underlying concepts; the bank would refer to the MASB's technical paper or any other related guidelines. The NSAC of BNM and accounting academician are in the view that proper accounting of financial transactions will help the preparer of financial reports and users to understand the IB activities.

“It is important to record the Islamic financial transaction correctly as it will help the preparer of accounting record or treatment of Islamic transaction to think Islamically.”

“The whole process of balancing is in the effort to have proper relevant classification, so if we need a new classification, so be it, you can't divide the world into equity and debt. It is difficult to operationalize if the debt features and equity features are being separated. It faces problems such as the problem of two different entities, one is the shareholders and another is the IAHs.”

Although, in the beginning, the IB gives up the ideal sort of *Shari'ah* due to *darurah* or *maslahah* approach, this cannot be a continuous practice. Despite focusing on its growth and development, attention should be given to the ideal aspirations behind its establishment. Focus is needed on the role of accounting and auditing as a watchdog, or monitoring the *Islamic* bank, in order to guarantee that it meets its goals and social economic objectives. The accounting academician highlighted that:

“... In the earlier establishment of IB, we have to give up our ideal way of Shari'ah. In this case, we can use darurah approach, or maslahah approach for the moment, but again you have to be cautious; and I believed that, accounting and auditing, is very important key tools in monitoring, being a watchdog, to ensure that in 50 or a hundred years times, Islamic banking and finance will meet its goals and social economic cause.”

Thus, in this context, the role of accounting treatment and financial reporting is crucial in order to communicate with the users of the financial statements on the banking activities of *Islamic* banks. In the case of *Islamic* banks, besides providing information that will assist the users to make arm-length transactions, it is also a medium to communicate whether the establishment of *Islamic* banks is in accordance with *Shari'ah* and towards achieving the objectives of *Shari'ah*.

As *Islamic* banking in Malaysia is being established under the dual-banking system, some of the legal and regulatory frameworks are still based on the conventional system. As for accounting practices, the *Islamic* banks are bound to comply with IFRS and MFRS. Interviewees had their opinions on the need to have more suitable standards to support underlying operations of *Islamic* banks. However, before looking at the accounting standards, we will discuss the accounting treatment in *Islamic* banks.

7.4.3 Product Conceptualization: Lack of Accounting and Finance Expertise among Shari'ah Scholars

This is regarding the involvement of SC on accounting and finance elements in IB. There are two groups of SC, (1) SC with accounting and finance background, which is very limited and (2) SC without accounting and finance background. Views of *Shari'ah* committee will vary in accordance to their qualification.

Through the interviews, various feedbacks are received from the interviewees regarding accounting and finance. According to SC in medium-sized local IBS with an accounting background and SC from medium-sized foreign IBS, the accounting entry is decided after the *Shari'ah* Advisor reviews the contract. Before the approval is made, the accounting entry involved is identified and the contract will be tabled to SC for another review.

“After the contract has been prepared, the committee will then review the contract. Then, the IT infrastructure will be developed and the accounting treatment will be decided. When the whole package is ready, it will be tabled again to the Shari'ah committee for them to look into the whole aspect of the product offered from a to z. The product structure, legal document, accounting entry and marketing aspect of it needs to be verified, endorsed and approved by the Shari'ah advisor.”

“Before we approve the product, we really need to deliberate by looking into all aspects – legal, accounting, internal policy of the institution, and everything. The approved product will be the product that we have duly considered on all aspects.”

The *Shari'ah* committee, with an accounting background, discussed his involvement in deciding the accounting treatment. However, the involvement of SC in deciding the accounting treatment does not happen in all banks. They are aware of SC without accounting and finance knowledge. However, although the SC is without an accounting background,

emphasis was made on taking into consideration accounting matters in ensuring the *Shari'ah* compliance. SC from medium-sized foreign IBS also noted the gap in accounting knowledge faced by SC.

“There is expertise gap in the area of accounting and finance.”

Most of the *Shari'ah* committee and *Shari'ah* officer emphasized that during the discussion and deliberation of the *Shari'ah* contracts, they did not highlight or mention accounting or auditing issues. However, if one of the *Shari'ah* committee possessed an accounting, finance or economics background, there may be some discussions about the accounting and auditing issues. The discussion is very rare as a *Shari'ah committee* with accounting or finance background is very limited. During this stage, it was found that the *Islamic* banks lack *Shari'ah* expertise that are well versed in technical knowledge, and lack of technical expertise who are well versed in *Shari'ah* knowledge. This is explained by the lack of technical staff that has *Shari'ah* knowledge, and the *Shari'ah* committee will depend on explanations of the technical department to understand technical matters in *Islamic* banks.

Also, there are SC in large-sized full-fledged IB and SC from medium-sized foreign IBS who admits their lack of knowledge regarding accounting and finance.

“... I need to learn about accounting, we do have constraints because of that, so at the moment..”

“In my observation, Shari'ah scholars don't understand accounting. Even though they know a little bit of it, it is not that much. Finance is friendlier as compared to accounting, but again, it is not the whole perspective of finance and accounting in particular. For example, they come out with formula, scholars struggle to understand. So, how we work normally is we depend on accountants, we depend on their information, what they explain to us and then how this can be incorporated.” (P32)

“I had never encountered those who are experts in accounting and at the same time, know about Islam usul Fiqh, Fiqh method, business contract, etc. What we have in the industry is two different individuals that possess different expertise and they try to give the best out of their expertise.” (P22)

“... The best practice is that we rely on the accountant (accounting people) to explain to us; how its working and how the accounting element is being treated for certain products or transactions. Then of course, we always emphasize on disclosure and transparency. Other than that, it will be difficult for us to gauge.” (P32)

In addition, accounting academician and SC in full-fledged IB did highlight that due to the lack of knowledge regarding technical matters (i.e. accounting) between the SC, they relied on the explanation from the accounting expertise to understand the underlying substance of the transactions. Also, there is a lack of awareness of people involved in this process (i.e. who sits on the *Shari'ah* board) regarding how to account for the products and services. Specifically, in terms of accounting and finance, we found that there is a lack of accounting experts who sits on the board and can understand the *Shari'ah* principles underlying the products and can explain how to account for the products and services. Unfortunately, there is a lack of accounting and auditing experts who possess knowledge in *Shari'ah*. In addition, there is also a lack of specific laws, or accounting standards, supporting unique underlying concepts of IB. These further support the dynamic issues of *Shari'ah* scholars understanding of the roles, functions, and operation of IB.

7.5 *Shari'ah* Auditing

The *Shari'ah* board may face difficulties in ensuring the compliance of the products (Ahmad & Khan, 2001). An obligation to obtain approval about the *Islamicity* of its products and also a certificate about all its operations being in conformity with *Shari'ah*, relates to the effective

performance that involves the bank management, which is found to be difficult for *the Shari'ah board* to monitor. Thus, the difficulties raise the need (1) for the central bank to undertake the *Shari'ah* audit (SA) during the process of its banking inspection so that the conformity of *Shari'ah* is examined along with that of the national banking laws and accounting practices or (2) establishment of the independent SA firm in the private sector to undertake SA along with their account audits (Chapra & Khan, 2000).

Although there is a new requirement in the latest updated *Shari'ah* Governance Framework for the bank to provide more SC at bank level that consist of SC from various backgrounds, *Islamic* banks currently faces difficulties in searching for SC that can meet such requirement. Thus, to find suitable personnel, in terms of SC that are suitable to be appointed as SC, is challenging. Challenges in developing or implementing the *Shari'ah* governance framework are expertise to do SA and *Shari'ah* Review. As emphasized earlier, *mu'amalah* involves complicated banking products, where sometimes there are dichotomy between what is being approved and how it is implemented. The industry still has an inadequate number of expertises that is able to appreciate the theoretical and practical aspects of the products and services. Currently, *Shari'ah* department personnel and audit personnel are responsible for carrying out both tasks.

Findings regarding problems among the HC to appreciate and understand the dichotomy between theoretical and practical aspects of innovating and implementing products and services, resulted in the misunderstanding of *Shari'ah* related matters. In addition, the existence of non-*Shari'ah* compliance cases heightened the need to have the *Shari'ah* compliance audit in the context of product implementation. Auditing will assist the institution to guarantee what is being deliberated by the *Shari'ah* Advisors, is being implemented

correctly and accordingly. Thus, IB requires SA practices, in addition to financial audit practices.

Various evidences from the *Shari'ah* review process reported by *the Shari'ah committee* and the *Shari'ah* officers show that there is evidence of *Shari'ah* non-compliance where the mistakes were not deliberately done. Various reasons have been discussed earlier such as educational background, experience and lack of knowledge about the operation of *Islamic* banks. The problems of non-compliance with implementation of products and services need to be curbed to ensure that IB is able to maintain their credibility as an *Islamic* financial institution.

Meanwhile, CEO of large-sized full-fledged IB and SC of Corporation Bank and Director of *Islamic* banking institute highlighted on the need for *Shari'ah* audit to reduce the risk of non-*Shari'ah* compliance cases from occurring.

"I think it is a healthy move that the industry is moving towards Shari'ah audit, and they rightfully should and it will assist us in identifying all the level of Shari'ah non-compliances in the operationalization of Islamic banks. Sometimes, we claim that we operate in compliance with Shari'ah but sometimes the products that we sell are not Shari'ah compliant in certain aspects. Also, we heard some nightmare stories from some other banks pertaining to non- Shari'ah compliance cases."

"Normally, we will rectify for the future and not for the past. Shari'ah audit is not well implemented. This is the problem, and banks do not reveal to the Shari'ah committee. So, they need to strengthen the Shari'ah audit, and Shari'ah department. Then, the Shari'ah department need to work together with the audit, either Shari'ah audit can be done internally or externally. As a simple example, you can even have an accounting firm that has the Shari'ah audit department or the consultancy where they have Shari'ah people that are trained in auditing and performing the Shari'ah audit."

Furthermore, SC of BNM and SC of medium-sized local IBS noted the importance of *Shari'ah* audit seen by the management of the banks.

“... In terms of performing Shari'ah audit, banks which are subsidiaries of conventional will depends on their management, because I think the sense of being an Islamic bank is perhaps not as strong as full-fledged Islamic banks. So, it may take some time for those banks to appreciate the need to do Shari'ah audit, because at the end of the day, it will help in terms of avoiding the potential risk in case there is a non-Shari'ah compliance.”

“There is no audit in the context of Shari'ah in the implementation of products whether Islamic banking comply with the Shari'ah guidelines or principles. The Shari'ah audit needs to be implemented to avoid any dichotomy between theory and practice and application of Islamic banking. We don't want a situation where theory is left on the paper and the implementation is equivalent to conventional banks.”

In order to empower the implementation of post-approval, BNM introduced *Shari'ah* Governance Framework (SGF) as guidelines of governing *Shari'ah* in *Islamic* banks. This is the most comprehensive guideline as compared to those offered in *Islamic* banks in their countries. At the point of the interview, the *Shari'ah* auditing was still not well established and among all *Islamic* banks operating in Malaysia, 2011 was the first year that they implemented *Shari'ah* auditing in the bank. NSAC of BNM perceived that it will take some times for the player in the industry to appreciate changes in operationalization of *Shari'ah* auditing.

“So, it may take sometimes for those banks to appreciate the need to do an SA. At the end of the day, it will help in terms of avoiding the potential risk in case there is a non-Shari'ah compliance.”

Since, the implementation of the SA is just launched and implemented; it is still not discussed or tabled. The inadequacy on how the implementation is being practiced at the implementation level highlights the need of SA and external SA. This was discussed with

CEO of medium-size local IBS.

“SA is in its infancy; we have started Shari’ah, but Shari’ah compliance audit are not SA per say. I think it is a healthy thing that the industry is moving towards SA and they rightfully should be...”

Also, SC of Corporation Bank highlights that SA is not well implemented. Thus, IB really needs to strengthen the *Shari’ah* Auditor and the *Shari’ah* department. In addition, the *Shari’ah* department needs to work with the internal or external *Shari’ah* Auditor.

“In addition, SA is not well implemented. In IB, this is the problem, and banks do not reveal it to the Shari’ah committee. Thus, they need to strengthen the SA, and Shari’ah department. Then, the Shari’ah department need to work together with the audit; SA can be done either internally or externally.”

The establishment of SA in the industry is currently at its infancy, and various efforts and skills must be pooled in order to ensure that its implementation will provide an improved degree of Shari’ah compliance and serve as an effective internal control system.

7.5.1 Lack of Shari’ah Audit’s Expertise

Also, there is a lack of SA expertise in the industry that is able to be performed or exercises by the SA, which will hinder the implementation of the SA. The industry is absent of experts in *Shari’ah*, *Islamic* banking and audit skills in terms of knowledge and experience. This issue is being highlighted by SC of medium-sized local IBS, ex-NSAC of BNM and *Shari’ah* officer in large-sized full-fledged IB as follows:

“The challenge to do the SA is lack of expertise in the context of Shari’ah expertise in managing the SA. Due to that, we feel the need for us to develop more Shari’ah expertise that are majoring in mu’amalah in SA team. On the other hand, the industry should ensure the readiness and understanding of expertise to apply or implement SA to ensure that they understand both banking and Shari’ah.”

“... There are no expertises to perform SA.”

“The industry is lacking with personnel that acquire audit and operational background to be a Shari’ah auditor.”

Thus, the industry lacks the expertise to implement *Shari’ah* auditing in SA with functional and technical expertise, establishment of a plan for the Audit framework, lack of manual for SA; and ability of the staff to be critical to enable them to make judgements regarding *Shari’ah* matters, *Shari’ah* compliance reviews and *Shari’ah* compliance auditing.

7.5.2 No External *Shari’ah* Auditor that Oversees the Practices

Various interviewees touched on the existence of external *Shari’ah* auditor. According to a SC at medium-sized local IBS and SC at large-sized full-fledged IB (both acquired accounting and economics background, respectively), an independent external *Shari’ah* Auditor is needed to verify the IB activities.

“In my opinion, regarding the implementation process, eventually there must be an independent external auditor to verify it. This is to fulfil the interest of shareholders and stakeholders. Their concerns are financial transparency in the operation of the bank and Shari’ah aspect.”

“... The SA should have the same effect with financial audit in terms of action taken against staff.”

Also, the existence of external *Shari’ah* auditor will assist the industry and institution to view the extent that IB meets the objective of its operation. In addition, according to SC of another medium-sized local IBS, the IB institutions need external *Shari’ah* Auditor to verify on their financial transparency and *Shari’ah* aspect.

“A challenge for auditing is to have an external Shari’ah auditor that oversees the practices of Islamic banking or financial institution. The existence of the external auditor would assist the industry to monitor what has been delivered by the Islamic banks and is in line with the guidelines and resolutions by BNM or Shari’ah committee by looking into the parameters for auditing.”

However, according to NSAC at BNM, the regulator is still considering whether or not to require the external *Shari’ah* auditor:

“Another thing, which is perhaps still missing, is external audit and I think the external SA. In addition to their internal Shari’ah secretariat and audit committee, the regulator has been considering whether the external SA should be made compulsory for the Islamic banks. If they have been given an exposure draft of the Shari’ah governance framework to see the input from the industry on this matter.”

Although the need to have the external *Shari’ah* Auditor in IB exists, the regulator is still verifying whether to have it as compulsory.

7.6 Summary

The establishment of Islamic banking and finance is due to the demand of practicing *Muslims* to enable them to engage in banking business activities that are based on *Shari’ah*. The concerted effort in establishing the Islamic banks is a noble effort in order to fulfil the demand of the respective customers. Also, the *Shari’ah* Law promotes the offering a range of products and services that are free from *riba*, the prohibitions of uncertainty, trade-based by encouraging PLS concepts, and payment of *zakah*. In addition, the *Shari’ah* Law is intended to fulfil the objective of *Shari’ah*, where its focus on the socioeconomic objectives of the Islamic financial institutions.

Islamic banks operate in established conventional economic systems. Operating under such systems, some countries still do not fully implement the *Islamic* banking system. Furthermore, the infrastructure and architecture do not fully support the overall products and services that can be offered by IB. Thus, in operating and complying with the rules and regulation that do not fully comprehend to *Islamic* banks lead to problems and challenges facing *Islamic* banks. Also the banks face problems and challenges in the development of *Islamic* banks in reaching a wider market share where liberalization and globalization is introduced. Due to the reasons of its establishment, the IB is expected to operate in a *Shari'ah* compliant manner in every aspect of its operation and products and services. The IB is expected to operate within the ethical manner proposed by the religion of Islam. In addition, the products and services are expected to be *Shari'ah* compliant, where the contract is permissible and valid in its substance and form.

Also, it is a challenge for IB to have its HC possessing the conventional banking background and experience, education, and the way they perform their duties and responsibilities that are being influenced by CB. Knowledge and understanding on *Shari'ah* and *Mu'amalah* will lead the staff to appreciate the need and importance of operating and implementing in accordance to *Shari'ah*. It affects the level of *Shari'ah* compliance in transactions concluded in *Islamic* banks. Consequently, lower level of education and understanding of the staff will lead to higher risk of non-*Shari'ah* Compliance. Furthermore, understanding of *Shari'ah* would assist frontline to offer explanations to customers and potential customers, and will avoid any negative perception towards IB's practices. Also, the awareness of stakeholders or potential stakeholders is needed in order to allow the *Islamic* finance being implemented in the industry. Efforts to educate the HC and the public should be on going to ensure optimum results.

It is important to have a CEO or top management that possesses the appropriate expertise and exposure to the appropriate combination of technical knowledge and *Shari'ah* knowledge as it will influence their decisions and the way they assume their responsibility and accountability. Furthermore, the top management's will and support are needed in the operations of *Islamic* banks. The IB needs the influence of top management in development and direction. The CEO or top management also need to be able to balance the demands of the stakeholders, the objective, mission and vision of the IB's establishment, the underlying principles of *Islamic* banks and the objectives of *Shari'ah* (*Maqasid as-Shari'ah*). Furthermore, the top management's ethos in developing IB in the right direction should be communicated to the middle and front-line management. In addition, the interviewees highlighted achieving healthy development through upholding the initial idealism and meeting good and social economic objectives. Also, the *Islamic* economic system is bound by the spiritual goal to establish human brotherhood, social justice and economic justice, equitable distribution of income and wealth and individual freedom within the context of social welfare (Chapra 1979).

Despite the awareness and concern of the top level management regarding the need for IB to ensure *Shari'ah* compliance in all its activities, there is a mixed response pertaining to the decision of top management when there are issues between *Shari'ah* compliance and commercially viable. Furthermore, the study found that there is dichotomy between the theoretical framework of IB and its implementation. Also, the researcher highlights the implementation of *Shari'ah* approved products where explanation regarding approval of products and services, unresolved *Shari'ah* matters, various non-*Shari'ah* compliance cases during its implementation and the need to strengthen the role of *Shari'ah* department.

Besides inadequate accounting standards that will assist the IB to account for Islamic banking activities, the industry is lacking in accounting systems that assist the preparer of the account to communicate the accounting data. Currently the bank is still using the conventional accounting system in the bank and any modification to suit the Islamic banking terms will be made during the reporting period.

Furthermore, the problems related to accounting and auditing was discussed. Also, there is no external *Shari'ah* auditor that oversees the practice. In addition, the *Shari'ah* auditing is also lacking in terms of its implementation procedures. Both accounting and finance faced a lack of expertise.

CHAPTER EIGHT

REVIEW AND THEORETICAL ANALYSIS OF INTERVIEW

FINDINGS

8.1 Introduction

This chapter provides a review and theoretical analysis of the interview findings. The agency theory, stakeholder theory and institutional theory are used to inform the findings, as the aim of the study is to understand and explain how *Shari'ah* compliance and accounting and accountability are practiced in IBF.

In reviewing the finding from this study, the following figure explains the association between rule system and cultural schema with social behaviour and associates activities and resources, in providing stability and meaning to social life. The rule system and cultural schema are comprises of institutional forces that influence the institutional isomorphism. Figure 8.1.1 portrayed and inference of the association into the Islamic banking and finance industry.

The first part of this chapter will reflect the interview findings on institutional isomorphism pressure in the IBs and accounting practices. Next, it reflects the interviews finding on the associates activities and resources and, corporate governance theories discussed in Chapter Three. Finally, the reflection pertaining to the rule system and cultural schema and social behaviours and associates activities is further discussed in relations to lacking of clear direction towards the achievement of *maqasid as-Shari'ah* (i.e. providing stability and meaning to social life) are being presented, discussed and reflected towards the interviews findings.

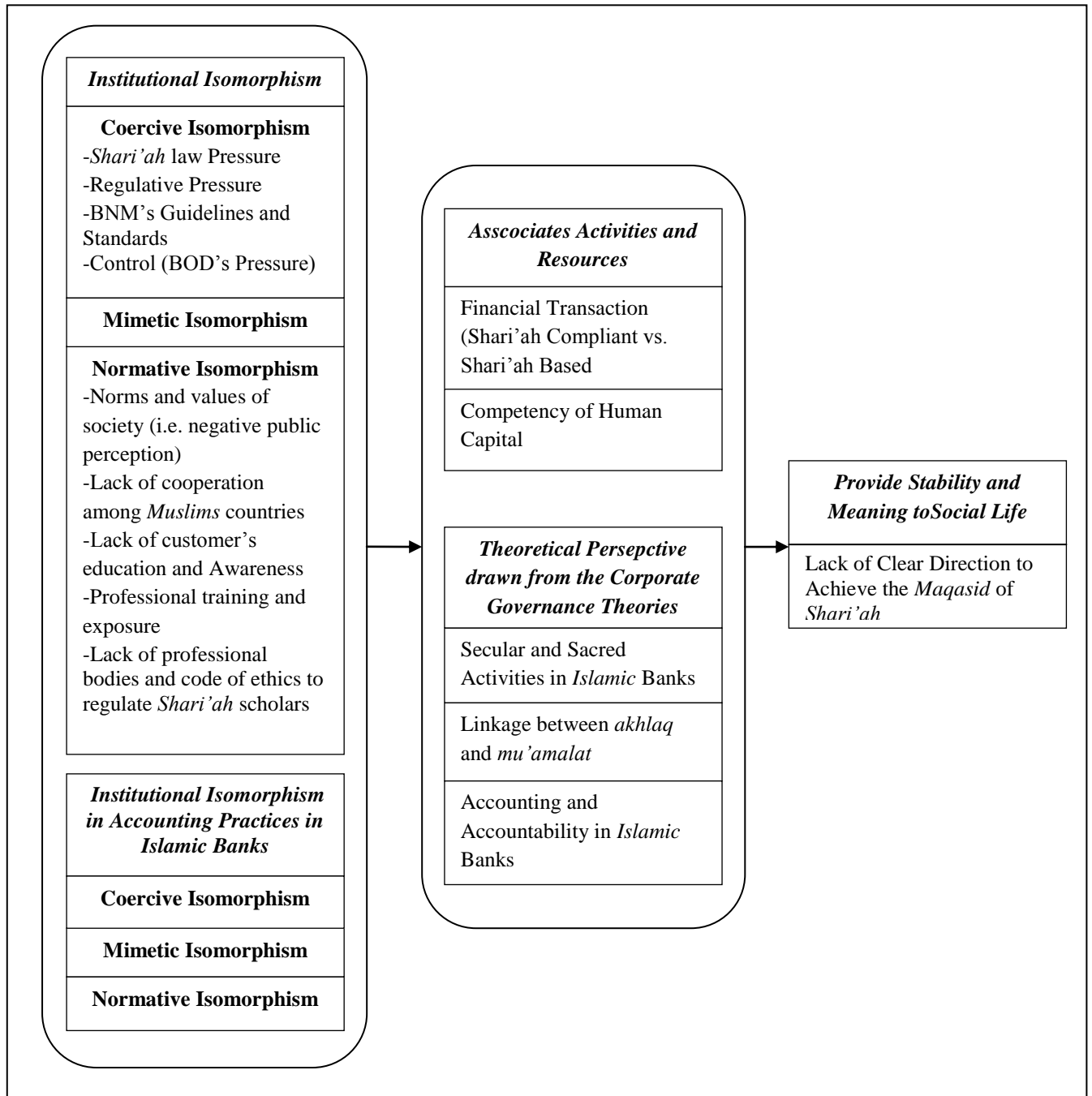


Figure 8.1.1 Association rule system and cultural schema with associates activities and resources in providing stability and meaning of life (generated from the findings of this study)

8.2 Institutional Isomorphism Pressure in the Islamic Banks

As explained by DiMaggio and Powell (1983) the institutional isomorphism occurs through three mechanisms that are: coercive isomorphism, mimetic isomorphism and normative isomorphism.

8.2.1 Coercive Isomorphism

The IB's industry faces high competition operating under the dual-banking system. The IB operates in an economy that is dominated by conventional systems. The establishment of IB marks a challenge due to the dominations or influences of CB. Since IB is established under the dual-banking system, it is sharing various infrastructures with CB. Although the IB shares some infrastructures that are suitable for its operation, it needs additional architecture and infrastructure in order to allow IB to evolve and develop. Besides the influencing of CB in its operation, CB influences the mindset and the way IB offers banking business.

Competition exists between local and foreign full-fledged *Islamic* banks, and local and foreign *Islamic* banking subsidiary. The opportunity and challenges faced by different governance structure are numerous as different governance structure operates with different levels of resources and capacity. Also, competition exists when IB goes global and international (Mokhtar et al. 2008; Iqbal et al. 1998; Aziz 2006). Nowadays various *Islamic* banks are being introduced in foreign countries such as Europe, Unites States of America, Hong Kong, China, etc. This adds to increased competition in the industry. Also, there are local IBS that have established IB branches in international markets.

8.2.1.1 Shari'ah Law Pressure

Shari'ah principles are the essence of the establishment of *Islamic* banks (Haron 1997, 2000). Initially, the establishment is motivated by the need of practicing *Muslims* who demanded an *Islamic* financial system that enables them to do their banking business based on the principles outlined in the religion of Islam. Due to that, all of the products, management and operations are based on the *Shari'ah* principles. Upholding *Shari'ah* principles and providing good returns will lead to meeting the stakeholders' expectations on the existence of *Islamic* banks (Karim 2001; IAIB 1990; as explained in Al-Omar and Abdel-Haq 1996; Ali 1998; as quoted Haron 1997).

The *Islamic* banks appoint a *Shari'ah* board as an element in its governance. The top management appoints the *Shari'ah* board to ensure and endorse that the products and services offered are in compliance with *Shari'ah*. This process is known as ex-ante compliance and occurs during the conceptual stage of the products and services. During this stage the product's proposal proposed by the product development team is forwarded to SB for discussion and deliberation. Besides approving and endorsing the contract, the SB looks into its compliance with current legal and regulatory frameworks, the legal documents involved in procedures and operationalization.

Shari'ah interpretation is the interpretation of *Shari'ah* Laws. The interpretation is based on culture, customs and law of the land. Furthermore, it's based on the existence of different school of thoughts. In addition, different *Shari'ah* interpretation is due to different culture, customs and law of the land. As a result, numerous practices and application of contracts exists across continents and countries. Although differences occur between the Middle East

and Malaysia, the main differences lie in *Bay' Bithamin Ajil*, *Bay' al-'inah*, and *Tawarruq* (Mohd Ariffin 2005).

In Malaysia's case, any differences that occur in the application of contracts will be monitored and harmonised by the NSAC at BNM level. Differences across continents and countries will be harmonised by developing a product that is suitable for the respective continents.

8.2.1.2 Regulative Pressure

The legal and regulatory frameworks of IB are still insufficient of specific laws that cater the specific contracts or underlying principles of *Islamic* banking products. For example, currently the industry complies with the Hire Purchase Act to operationalize the products based on *Ijarah*. The HPA consist of terms that are contradicting with the practice of IB. the industry has inadequate statutory acts to address specific concerns in IB products and services. Existing law may not address specific issues/concerns of *Islamic* transactions.

Since *Islamic* banking institutions are highly regulated institutions, it is bound to comply with national and international regulative standards such as rules, controls, rewards, and sanctions (Scott 2005). Internationally, banking institutions are being governed by BASEL and various other standards such as accounting standards. Locally, it receives a direct response to government mandate (DiMaggio and Powell 1983) such as guidelines, parameters, resolutions from BNM, rulings from Bursa Malaysia and Securities Commission, statutory regulations and tax rulings. Furthermore, according to Sundararajan and Errico (2002) the key challenges ahead for IBs are challenges related to IFSB and New Basel Capital Accord, which are a welcome development for Islamic Banking. The development of the New Basel

Capital Accord is an ongoing effort to strengthen the international financial architecture. However, the implementation of both developments towards the IBs is still under question. As in Malaysia, there are other developments towards the performance and growth of the Islamic banking and finance. Other developments that affect the Malaysia's IBs are Malaysia Financial Master Plan, 10 Years Strategy and Plan for the Development of Islamic Financial Services Industry (joint effort by the Islamic Development Bank and the Islamic Financial Services Board), Guidelines by Bank Negara Malaysia (i.e. the Central Bank of Malaysia) and FRS_i-1. In addition, in order to ensure the suitability in adopting the international standards, the risk weighting will require the evolution of a methodology suitable for determining the relative risk of different modes of Islamic finance (Chapra and Khan 2000). Currently, the adoption of international standards may tend to create a natural bias towards a greater utilisation of the less risky debt-creating sales based on modes of finance and it tends to hinder the development of the PLS mode of financing (Chapra and Khan 2000).

8.2.1.3 BNM's Guidelines and Standards

The *Islamic* banking industry in Malaysia applies the market-based regulation where there are interference of regulators in identifying the relevant statutory law, guidelines and resolution. The banks will implement what is being instructed by BNM. It is less likely that the bank will respond to voluntary based regulation or voluntary changes to current organisational practices, as these will incur higher costs.

8.2.1.4 Control (BOD's Pressure)

Decision making in the *Islamic* banks usually rests in the hand of the CEO. Although in terms of ensuring *Shari'ah* compliance will be discussed and deliberated by the *Shari'ah* Advisors,

the CEO will have the final say on whether to market the product (i.e. Between commercially viable and *Shari'ah* compliance). The decision making style in IB is as follows:

The CEO in the local and foreign full-fledged *Islamic* banks will have the final say. The CEO has the considerable understanding of the direction of the *Islamic* banks. However, the decision made in local full-fledged *Islamic* banks do not involve high capital investment, or projects that need high amount of capital or long term investments. Foreign full-fledged *Islamic* banks have a wider opportunity to involve with higher capital and long-term projects or investments. Moreover, the CEO in the local and foreign *Islamic* Banking Subsidiary will also have the final say with the influence from the CEO of the parent bank. Furthermore, some of the operations are leveraged from the parent company which is operating on conventional banking services. Consideration between commercially viable and *Shari'ah* compliance/based products, may opt out the *Shari'ah* compliant products as it may not be commercially viable.

8.2.2 Mimetic Pressure

Besides pressures from the legal and regulatory framework, pressure on guidelines and pronouncement from institutions such as BNM, Bursa Malaysia and Securities Commission, IBs' standard response is uncertainty (DiMaggio and Powell 1983). With an established existence of the conventional banks, it may expose Islamic banks to unequal competition as the conventional bank is established and superior to Islamic banks (Iqbal et al. 1998). It will also bring their efficiency, market research and innovative capabilities, sophisticated banking and result in oriented approach to Islamic banking, which may lead to the development of new products and provision of better services to consumers (Iqbal et al. 1998). Thus, in order for the Islamic Banks to keep a reasonable share of the market, it needs to increase its

efficiency substantially (Iqbal et al. 1998). Furthermore, since IBs is new in the banking industry, it tend to mimic its established its conventional counterparts (DiMaggio and Powell 1983; Haveman 1993); particularly in situations of uncertainty when organisations replace "technical rules" with the "institutional rule and 'imitate similar/large/successful organisations'" (Haveman 1993, 623).

Since the CB is more established than IB, IB may face uncertainty in their operations, in developing and innovating products and services and in marketing their products and services. Among others, the IB faces uncertainty on the acceptability of the public if IB offers a product that is totally unique and is *Shari'ah* based. Since most of the customers are more familiar with CB's products and services and demanded for such products, IB tends to mirror CB's products by developing it to be a *Shari'ah* compliant product. Also, there is the uncertainty of the viability of the *Shari'ah* based product (i.e. Profit and loss sharing product such as *musharakah*). The uncertainty faced by the *Islamic* banks leads the bank to mimic CB. The more the current *Islamic* banking practices diverge from the paradigm version, the more IB loses their distinctive features and tends to resemble conventional banks (Zaher and Hassan 2001).

8.2.3 Normative Pressure

8.2.3.1 Norms and Values of Society

In consequence to HC, that are still lacking in knowledge and understanding regarding *Shari'ah* and technical matters and lack the ability to appreciate the theoretical and practical of IB's products and services, it resulted in the negative public perception and lack of awareness among the public. The lack of the ability to explain and communicate to the customers pertaining to the IB's products and services, leave the customers and the public

with inadequate information and knowledge regarding the application of *Shari'ah* to the products and services. Furthermore, the negative public perception may also arise from the attitude of the public and customers that keep on comparing the IB and CB without further understanding the different principles underlying each banking system. Insufficient awareness and knowledge pertaining to *Islamic* banking resulted in the wrong interpretation on information received from the IB personnel. Also, customers ought to receive proper and thorough explanation from the bankers regarding various steps and costs involved in concluding the contract in IB.

8.2.3.2 Lack of Cooperation among *Muslim* Countries

Another effort need to be nurtured is cooperation among *Muslim* countries to do business transactions and further enhance, develop and support the *Islamic* banking and finance industry. At the moment, the industry is still bereft of cooperation between other *Muslim* countries. SC of large-sized full-fledged IB, CEO of medium-sized local IBS and accounting academician have highlighted this matter.

“These are important – public wants, institutions want, regulators wants and that’s automatically related to political power, if we can’t achieve these, we won’t be able to get this facility (IB operates in Malaysia).”

“Cooperation and unity among Muslims countries to actually have the urge to do Islamic transaction (Islamic product) – perform the business between two parties.”

“We need co-operation and not competition in Muslim countries.”

In order to guarantee the *Islamic* banks move towards achieving the true *Islamic* objectives, the industry needs the religion, economics, political and social will. In addition, the industry needs collective readiness of all groups of stakeholders. This involves proactive support from

the bank's top management, values of the players and will of the bank to move forward. Also, it may expect more relevant products to ensure that the economic system achieves the objective of *Shari'ah*.

Furthermore, according to the interviewees, in directing the IB to achieve its objective, the industry also needs the readiness of the players and the customers, or potential customers, who want to subscribe to the implementation of the IB's operation in accordance with its theoretical framework. Due to the IB's banking business that is valued based on the value of its underlying asset that represents the true economic value of the asset, it is important for the readiness of the customer to live in moderation and in accordance to one's financial capability as IB is not based on leverage, but it depends on the true value of the asset.

8.2.3.3 Lack of Customer's Education and Awareness

Lack of awareness and knowledge among the customers and public regarding products and services in *Islamic* banks and their familiarity with products and services in CB influences their preference and choice of IB's products and services. Inadequate understanding and knowledge of customers and the public influence their demand on *Islamic* banking products. The customers prefer products that are very similar to CB's products. This results in more debt-based products as compared to profit and loss sharing products. This situation adds to the challenge in operating and offering products in IB that operates under the dual-banking system. Also, it is challenging for IB to develop more treasury products that are similar or equivalent to CB's products. Besides, customers' preferences are based on the CB, the benchmarking of banking profit rates and rules and regulations, which are also based on CB.

In Malaysia, the factors of why customers patronise IB is portrayed in the combination of *Islamic* and financial reputation and quality services offered by the bank (Dusuki and Abdullah 2007b). Also, the customers' choice would consider good social responsibility practices, convenience and product price (Dusuki and Abdullah 2007b). In addition, *Muslim* customers and the public show a lack of seriousness in considering their banking activities. As Islamic banking activities possess the specific underlying principles, the principles underlying it are outlined in *Shari'ah* law. It is the way of doing banking business that is preached by the religion of Islam. Although, there is *khiyar* (freedom of choice) in choosing where to deposit or invest their money, the *Muslim* public have no choice in deciding whether they should deposit or invest in conventional or *Islamic* banks. However, the freedom of choice exists when they are choosing between the existing *Islamic* banks in the industry.

8.2.3.4 Professional Training and Exposures

Although there are training and education to increase the knowledge and expertise of the HC on matters related to the IB's operation, the personnel do not portray the effectiveness of such training and education opportunities in delivering their duties. There is evidence of internalisation and assimilation of knowledge among the HC. The *Shari'ah* officer in fully-fledged *Islamic* banks highlighted the remarks she received from their staff regarding knowledge that they gained during the training, as the staff forgot certain *Shari'ah*-related knowledge.

In realising the problems of HC in IB, various training courses have been established by IB for their staff. The training consists of internal and external training. It involves formal education and courses, forums, workshops, conferences and seminars. The staffs need to be educated with suitable knowledge, that is, *Shari'ah* and technical knowledge in theoretical

and practical application in the industry. Besides training, these types of knowledge can be acquired through research based on current practice or research based on *maqasid as-Shari'ah* and spirit of *Islamic* finance. In addition, various universities and banking institutions could offer various courses to enhance their knowledge formally. However, the industry is still lacking a professional body to govern professionalism and provide certification of IB. In addition, IB needs to have a formal filtering system in hiring HC in IB.

Various training courses are organised by the *Islamic* banks, central banks and industry. Among others, there is internal training, where training is organised inside the bank. The training is organised by the *Shari'ah* committee or *Shari'ah* officers or independent parties. Usually a *Shari'ah* committee and a *Shari'ah* officer carry out the training in the main office. There is also external training where the bank sends out the staff to seek training or knowledge from universities or *Islamic* banking institutions. In addition, there are various conferences, forums, and talks organised at the international or national level. Although there are various training courses organised, the effectiveness and efficiency of the training is to be questioned.

8.2.3.5 Lack of Professional Bodies and Code of Ethics to Regulate *Shari'ah* Scholars

In *Islamic* banks, *Shari'ah* scholars have been appointed to *Shari'ah* committees on a part-time basis by the bank. The *Shari'ah* Governance Framework defines their responsibilities thus:

“The Shari'ah Committee shall be responsible and accountable for all its decisions, views and opinions related to Shari'ah matters. While the board bears the ultimate responsibility and accountability in the overall governance of the IFI, the board is expected to rely on the Shari'ah Committee on all Shari'ah decisions, views and opinions relating to the business of the IFI. As the Shari'ah decisions, views and opinions bind the operations of the IFI, the

Shari'ah Committee are expected to rigorously deliberate the issues at hand before arriving at any decisions."

"The Shari'ah Committee is expected to perform a supervisory role on Shari'ah matters related to the institution's business operations and activities. This shall be achieved through the Shari'ah review and the SA functions. Regular Shari'ah review reports and the SA observations should enable the Shari'ah Committee to identify issues that require its attention and where appropriate, to propose corrective measures."

"In discharging its duties, the Shari'ah Committee is expected to disclose sufficient information in the IFI's annual financial report on the state of compliance of the IFI, as per the requirements under the Guidelines on Financial Reporting for Licensed Islamic Banks (GP8-i) and Guidelines on Financial Statements for Takaful Operators (GPT) the underlying theoretical concepts are Shari'ah compliant."

Despite the accountability and responsibility expected from an SC, the industry is still lacking a professional body that regulates *Shari'ah* Scholars or SC. In this context, the professional body is designed to facilitate the profession of the SC where the interest of professionals and the public is protected. Furthermore, the body would ensure a certain level of professionalism is established and outline necessary standards of training, code of conduct and code of ethics.

Thus, with the existence of a professional body, it is expected that the body would ensure training, and professional education programmes. It would also be expected to extend the professional certification for professionals. In Malaysia, currently, the ISRA is an institution established by the regulator to look into *Shari'ah* research, training, and education. However, the call to have a professional body is important as the industry is evolving and developing.

8.2.4 Institutional Isomorphism in Accounting Practices in Islamic Banking

The role of accounting and finance in IB ranges from the conceptualisation of the product until reporting. It involves various steps or levels in the accounting and accountability systems in *Islamic* banks. The overall processes involve ensuring *Shari'ah* compliance is upheld in all aspects related to products and services, which encompasses its underlying principles, its legal documentation and so forth. It is also expected to show an account of human capital that involves guaranteeing that *Shari'ah* compliancy is upheld. Furthermore, the accounting and accountability system is expected to disclose contractual obligations established and performed.

The conceptualisation of products involves processes to ensure the *Shari'ah* compliance of the underlying contract. The initial stage of proposing a product involves discussion of different departments separately, and it is then forwarded from one related department to another (product development, legal, accounting, etc.). There is no synergy between the departments where representatives from each department sit together to discuss developing and innovating new products. Synergy may help to reduce the time taken to produce a product proposal with a better understanding of various related matters. In addition, any unresolved matters related to new developments or products innovation and its implication in a wider scope can be forwarded to NSAC for further discussion and deliberation. This will ensure better harmonisation in IB practices in Malaysia (i.e., two layers of *Shari'ah* supervision).

The accounting system and treatment should explain the substance and the form of the products and services offered by IB. In addition, the reporting of IB is expected to portray disclosure and transparency of relevant information. The reporting is expected to

communicate true economic benefits of products and services, reliable information, credibility and legitimacy and social and religion-related information. Monitoring and control on related matters regarding *Islamic* banking and finance require *Shari'ah* compliance and compliance to national and international legal requirements in implementation, to lend assurance to the shareholders and stakeholders that the IB assumes their accountability as expected.

8.2.4.1 Coercive Isomorphism: Accounting Standards

The IB is bound to accounting regulations. It is a concern of Malaysian IB to comply with local requirements and IB's guidelines pertaining to accounting standards. As products and services are different from CB, it is expected that there are specific accounting standards laid down to account for the products and services. However, currently in IB, it is still bound to comply with local and international standards (i.e. MASB and IFRS respectively).

Financial treatment and financial reporting are still based on the local and international application of accounting and auditing. In Malaysia, IB is bound by MASB standards and IFRS. Currently, the existing standards can still support the products and services offered by IB due to the current nature of IB's products and services, which are similar to conventional products and services. More accounting standards to support the innovation of more *Shari'ah* - based products are needed in order to assist the recording and reporting of such products.

Furthermore, the industry facing lack of accounting principles and standards (Maniam et al. 2000). There is still a lack of disclosures and transparencies of relevant information pertaining to the *Islamic* banking business. In terms of accounting standards, self-regulated *Islamic* accounting standards (i.e. AAOIFI) have been established, and the management will

try to follow them as much as possible. In addition, since it is not mandatory and there are no instructions from BNM (i.e. regulators) to comply with the AAOIFI, the bank will give priority to BNM's ruling to implement new systems and comply with the new standards at a cost to the bank.

Although, there are AAOIFI standards to support the *Islamic* accounting treatment, it is self-regulated and the compliance is voluntary in nature. Although there are voluntary accounting standards (i.e. AAOIFI) that support the *Islamic* banking products and services, by law, the IB is bound to comply with the MASB and IFRS. In addition, there is lack of legal back-up in offering more *Shari'ah* based products. Currently, the existing accounting standards are not really accommodating to the products specific to IB. As, current IB's products and services are very much similar to CB, the problems related to the application of accounting standards will arise as IB innovates more *Shari'ah* based products. IB will try to comply with AAOIFI whenever possible. However, changes will incur costs and the bank will need to wait for instructions from BNM to comply with any changes. In Malaysia, the Islamic banking will comply with MFRSs. In addition, in terms of disclosures, IB is bound to comply with GP8i, which is a guideline published by BNM.

8.2.4.2 Mimetic Pressure

There is no proper accounting system to account for *Islamic* transactions. The accounting chart is based on conventional banks' accounting chart. Furthermore, the accounting system and accounting standards are still based on the conventional accounting system. The accounting information system uses the conventional system – the chart of accounts uses the chart of accounts designed for conventional banks. Modification and changes to the conventional terms is made when reporting is done. Ideally, having an *Islamic* banking chart

of accounts would result in a more accurate way to account for IB's products and services. It would also give an accurate way to explain the substance and form of the products and services and its underlying principles. In addition, it would be expected to communicate performance and *Shari'ah* compliance and also be able to communicate the financial results and true economic values. Thus, it would assist in monitoring and control in achieving the objectives of *Shari'ah*.

8.2.4.3 Normative Pressure

Accounting practices in *Islamic* banks are little in difference from those in conventional banks. Overall, a conversation with an interviewee gives the impression that the accounting is only the support department (i.e. support activity) of the *Islamic* banking. The *Shari'ah* committee have begun to express their awareness of the importance of accounting and financial reporting. Most of them admit that there is insufficient knowledge regarding accounting and finance.

SCs lack accounting and financial knowledge and expertise. Only a few SCs and *Shari'ah* officers possess accounting and finance knowledge. Usually, SCs with knowledge and expertise of accounting and finance will act as middleman to reduce the gap between SCs and technical experts. Furthermore, SCs with accounting and finance backgrounds will have direct involvement in accounting and financial matters. SCs with accounting and finance backgrounds explain their involvement in discussing accounting treatment and classification of transactions with accounting experts. However, those SCs without any background in accounting and finance highlighted their knowledge gap and their reliance on technical staff. In order for SCs to approve certain products proposed by the banks, they go through a series of meetings that consist of thorough deliberations and discussions with practitioners. The

practitioners need to be transparent in explaining the way they do business and in the way they explain matters. This will help the SC to understand the underlying nature of the product and how it is being implemented in the banks. On the other hand, the accounting expertise or personnel in IBs lack *Shari'ah* knowledge. In the process, they still face problems if there are any issues resulting from any misunderstandings that give rise to the need to close the gap between the two parties. In the whole process, a high degree of trust is expected from the technical experts when explaining to the SCs. Reliable information is highly sought after, as it will assist SCs to make reliable and credible *Shari'ah* decisions.

8.3 Associates Activities and Resources

8.3.1 Financial Transactions (*Shari'ah* Compliant vs. *Shari'ah* -Based)

The products and services offered in IB are commercially driven. Currently, in IB, the products and services are *Shari'ah* compliant where the development of the products and service are benchmarked to the existing CB's products and services. In offering products and services in Islamic banking and finance industry in Malaysia, Malaysia's market is still focus in offering products and services that are based on debt or deferred payment. Usually, these types of products are being replicated from CB's products and services and had gone through conceptualisation processes in order to ensure its *Shari'ah* compliant.

The IB's products and services are offered with innovations in terms of underlying principles, contracts used, procedures involved, etc. The underlying principles of the products and services will be deliberated, discussed and approved by SC before being offered to the customers. However, the decision to decide whether a product will be offered to the customer will be made by the top management and will be based on the viability of such products and the demand for it by the customers. Furthermore, although profit and loss sharing products

are based on *Shari'ah*, they will contribute to greater stability in the economic system in general, and the financial markets, in particular (Siddiqi 2006a). There are still factors that hinder the IB to offer such products, such as insufficient regulations, or products not favoured by the customers due to its high risk and involvement in long-term financing.

However, it is being argued by academician in Islamic economics that, although such products may appear to be *Shari'ah* compliant, it is lacking of macroeconomic impact that lead to fulfilment of the objective of *Shari'ah*. The following Figure 8.4.1, explains that, although the BNM stimuli IBs to offer risk sharing products, IB's still maintain with deferred payment or debt based due to lack expertise in PLS's products, no support from legal and regulatory framework, knowledge of customer on PLS's product, ensuring compliance in all aspects, meeting customer needs, performance tools, monitoring tools, and lack of financial reporting, transparency and auditing supporting PLS's products.

Since, more debt-based product than equity based product, more efforts are needed in order to gradually introduce *Shari'ah* based products and services in order to open up possibilities and opportunities for the public to engage with banking and financial activities. In addition, the *Shari'ah* scholars further voiced out that on the need to have IB's products that are more *Shari'ah* compliant. The *Shari'ah* committee term it as greener product. Thus, it is a call to have products that are based on the *Shari'ah* principles (i.e. value based system). Furthermore, it is not a problem to have *Shari'ah* compliant product, however, it should be greener in the sense that the products are not just simply mirrors of conventional banking products, but it must be based on a value based system. The economic values of the products and services should aim to eradicate poverty and promote welfare of the public.

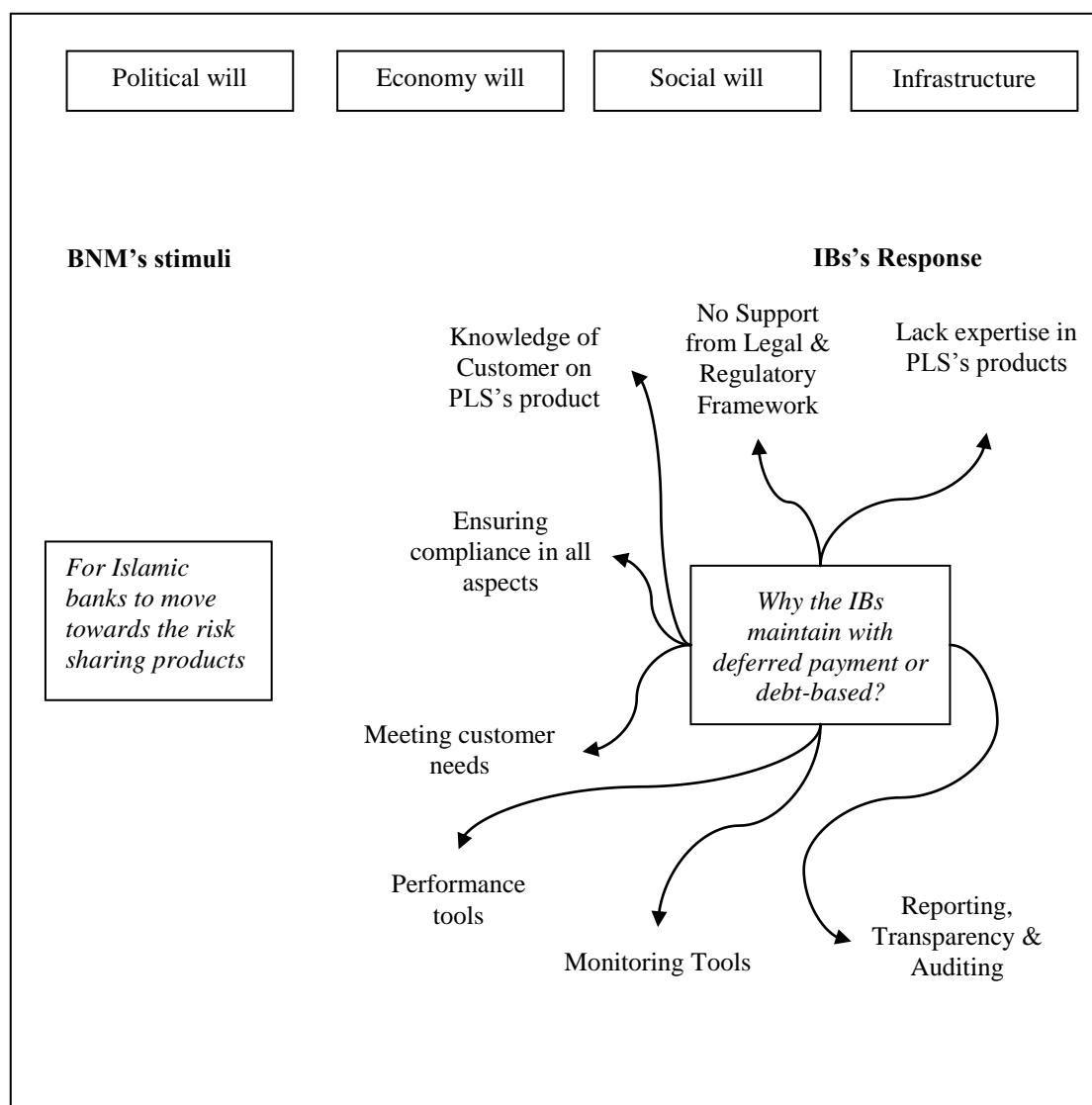


Figure 8.3.1 Current responses by IBs towards BNM's stimuli to move towards risk sharing products (from the findings of this study).

8.3.2 Competency of Human Capital

The findings from this study shown that problems faced by IBs in terms of their HC are (1) lacking of personnel who leading the Islamic bank (i.e. head of Islamic bank) with *Shari'ah* background, (2) lacking of middle management that able to appreciate the theoretical and practical aspect of the product, (3) lacking of frontliner that being able to act as the liaison between the bank management and the customer, being able to explain to the customers, (4) lacking of staff with double majoring, (5) lacking of staff that know various language (i.e. at least English and Arabic), (6) lacking of staff with specific skills such as, accounting, risk

management, process, (7) lacking of staff that understand the Islamic spirit, (8) lacking of adequacy of HC to innovate, and (9) lacking of mechanism to produce more capable HC. Furthermore, knowledge and understanding on *Shari'ah Muamalat* will lead the staff to appreciate the need and importance of operating and implementing in accordance to *Shari'ah*.

Also, it affects the level of *Shari'ah* compliance transaction practices in Islamic banks. The lower the education and understanding level of the staff, the higher the risk of *Shari'ah* non-compliance. In improving the quality of HC in IBs, training is introduced to serve as mechanism to enrich and enhance the knowledge of the staffs. However, if there don't possess the spiritual awareness it is difficult for them to understand the reason behind it which resulted with difficulty in retaining the knowledge and understanding the true Islamic banking and underlying on the importance to ensure everything is *Shari'ah* compliance.

These lead to lack of appreciation of *Shari'ah* and lack of ability to appreciation of theoretical and practical implementation of Islamic banks which results in *Shari'ah* non-compliance cases. Although they may not deliberately make mistake in the implementation stage, any wrong implementation of the processes and procedures will contribute to the *Shari'ah* non-compliance risk. It will contribute to the arisen of *Shari'ah* issue and would give impact to the achievement *Shari'ah* compliance. Usually, the communication between staff and *Shari'ah* committees occur between head of department and *Shari'ah* committee, renders more understanding to the HOD as compare to middle and lower level management. Furthermore, it results in (1) no proper explanation is given by the staff, (2) no full disclosure of information before the customer engage with the contract without full knowledge or understanding on the contract, and (3) lack of understanding of the staff on the contract leads to lack of understanding of the customer. Thus, it portrayed lacking in portraying their

appreciation towards ensuring *Shari'ah* compliance in all the transaction among lower level management.

8.4 Theoretical Perspective drawn from the Corporate Governance Theories

As discussed in the earlier chapter, the principles underlying the establishment and operation of *Islamic* banks are called *Shari'ah* Law. *Shari'ah* Law is derived from *Al-Qur'an*, *as-Sunnah*, *Ijma'* and *Qiyas*. The establishment of *Islamic* banks is rooted from an element of *Shari'ah* laws that is called *mu'amalat* (i.e. business transaction). It is an alternative to the conventional economic system that is based on *riba'*. As the establishment of IB is based on the *Shari'ah* law, it is crucial to ensure that the operations of *Islamic* banks are complying with *Shari'ah* in all aspects of its operations. Besides ensuring the compliance on the operations' aspects, IB should also ensure that it fulfilled the demand of the stakeholders in terms of commercial viability and returns. Thus, *Shari'ah* compliance and commercial viability are two main important governance's objectives in IB.

8.4.1 Secular and Sacred Activity in Islamic Banks

In associating secular and sacred activity, Booth (1993) and Laughlin (1990) explained accounting as a secular activity which supports the sacred activities of the churches. Abdul-Rahman and Goddard (1998) found that there is no difference between sacred and secular in religious councils and the accounting system is perceived as part of the organisation's activities. In this study, IB is perceived as a commercial institution (i.e. an *Islamic* financial institution). Although there are often debates between religious experts and management to approve products and services as *Shari'ah* compliant, there is also a struggle for accounting experts to ensure that the accounting records and reporting that accounts for the banking and financial activities are in place.

The management is part of its central phenomena as financial institutions are embedded with religious elements. Their conventional counterpart influences IB's management, while at the same time; they need to uphold the *Shari'ah* principles in their banking business. In its effort to comply with *Shari'ah*, A unique agency relationship has been identified and discussed. In addition to the usual agency relationship, IBs face the need to comply with *Shari'ah* and separation of cash flow rights from the rights to control the investment. This leaves the IAH to depend on the role of vicarious monitoring carried out by shareholders in order to prevent the management from exposing the funds to an intolerable risk level. In addition, there are dynamics interests among the principals.

In the Islamic banking industry where it applies market-based regulation, the banks experienced interference of regulators in identifying and choosing relevant statutory law, guidelines, and resolution. The banks will implement what is being instructed by BNM. There is less likely that the bank will respond to voluntary based regulation or voluntary changes to current organizational practices, as these will incur cost.

Decision making in the Islamic banks usually rest in the hand of the CEOs. Although in terms of ensuring *Shari'ah* compliance will be discussed and deliberated by the *Shari'ah* Advisors, the CEOs will have the final say on whether to market the product (i.e. between commercially viable and *Shari'ah* compliance). Furthermore, most of the CEOs did not possess formal *Shari'ah* education. This might affect the understanding and appreciation of lower level management. Thus, further dynamic in the interest between shareholders and stakeholders exist. The management is not only bound to fulfil the interest of the IAHs and depositors but they also bound to fulfil the interest of the shareholers. The IAHs and

depositors may aim at Shari'ah compliance and financial performance of IBs, while shareholders may give more priority towards financial performance. This may delay towards the achievement of socioeconomic objectives. Concurrently, it will delay the benefits of the establishment of IBs that may be enjoyed by the public such as poverty eradication, promotions of welfare and prohibition of vices towards the achievement of total welfare of the public.

8.4.2 Linkage between Akhlaq and Muamalat

The NIS offers an explanation as to how different types of institutional isomorphism could influence the problems and challenges faced by IB in Malaysia. Thus, the institutional isomorphism could influence how the agent response in making decision. In addition, agent morality is viewed as non-instrumental ethics in business policy, producing policy recommendations that are morally binding on managers.

The incorporation of an agency morality in normative stakeholder theory is still less apparent in the decision making process of Islamic banks. The inclusion of agent morality in the stakeholders' model is important in the context of the Islamic banking and finance industry. However, the morality in the context of the IBF industry needs to be grounded in the underlying principles governing the operation of IBF. Also, the Islamic agents and non-Muslim agents in Islamic banks should ensure that they integrate *akhlaq* and *aqidah*, and ethics and morality respectively with daily practices and activities as explained in Figure 8.4.2. The perspective of agent morality is suitable for the practices of Islamic banks as they should uphold the *Shari'ah* principles and maintain high returns to meet the stakeholder's' interest. Furthermore, non-instrumental ethics are supported by the religion of Islam as it creates a harmony between the material and moral by urging *Muslims* to provide a spiritual

orientation to material effort. The spiritual orientation is aimed to establish human brotherhood, social justice, economic justice, equitable distribution of income, and individual freedom within the context of social welfare (Chapra 1979).

The linkage between *Akhlaq* and *Muamalat* is one of the sources of divergence between Islamic finance's aspirations and realities. The following Figure 8.3.1 represents how the religion of Islam is being inherent in the believers. *Aqidah* and *Akhlaq* is at the core and thus internal. On the other hand, *Ibadah* and *Mu'amalat* reflect the *Shari'ah* practices and activities. Furthermore, economic activities are a branch classified under *Mu'amalat* which involves banking and financial activities in fulfillment of the need of Muslims to enable them to manage their surplus and deficit of deposits smoothly. The Figure 8.3.1 is different than Figure 2.3.1 in pp. 41 of Chapter Two as the following figure is more robust in explaining the importance of *Akhlaq* and *Aqidah* in all aspect of practices and activities. This is supported by the importance of *Akhlaq* (i.e. ethics) in making decision highlighted by (Rosly 2005a; Gait and Worthington 2008; Iqbal et al. 1998; Ali 2000; O'Sullivan 1996a, cited in Pomeranz 1997; Abdul-Rahman 2003; Karim 2001; Sulaiman et al. 2011; Samad and Hassan 1999; Haniffa and Hudaib 2007; Dusuki 2005, 2006; Abdul-Rahman 1998; Triyuwono 2004; Chapra 1979; Ayub 2007; Ahmad 1994; Khan 1991; Siddiqi 2006a). The assimilation of *Akhlaq* in daily practices and activities is not confining to religious matters but it covers all matters comprehensively. In addition, *Akhlaq* and *Aqidah* are the main and integral sources in decision making of an agent morality in Islamic point of view.

In addition, the institution is the outcome of the actions of individual players of the firm (Burns and Scapens 2000). The players shape how the institution behaves. The existence of *Shari'ah* law underlies the operations and management demands of the players to behave by

incorporating relevant values in order to be able to drive the institutions to achieve its mission, vision and objectives. At the same time, the institutions are expected to meet the objective of its establishment, that is, to realise the objectives of *Shari'ah*.

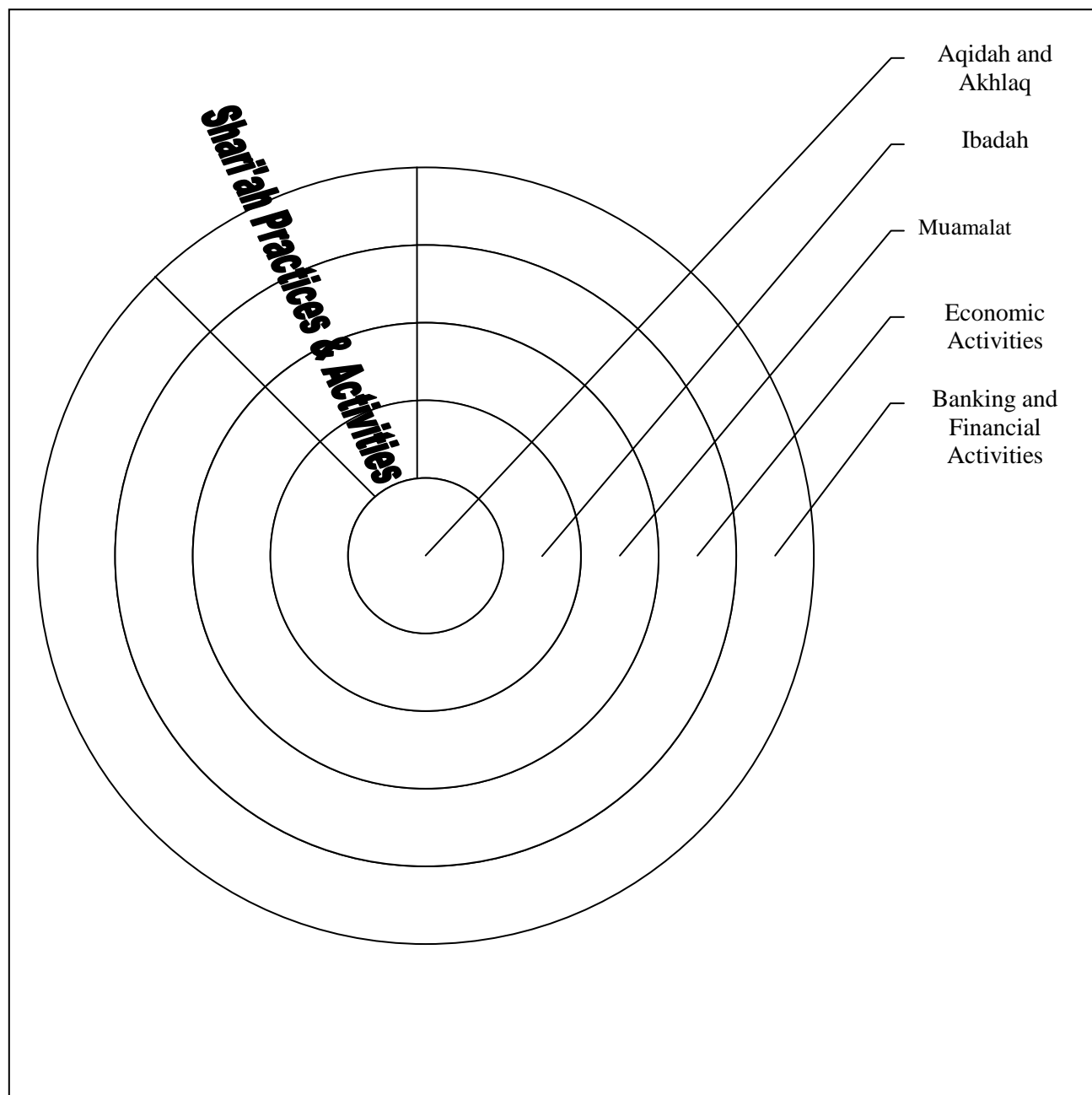


Figure 8.4.1: Linkage between Akhlaq and Aqidah with Muamalat (the idea of onion diagram was adapted from Hofstede (2000)³⁹)

³⁹ The idea of onion diagram in explaining the linkage between Akhlaq and Aqidah with Muamalat is being adapted from Hofstede, G. (2000), *Cultures Consequences, Comparing Values, Behaviours, Institutions, and Organizations Across Nations*, 2nd ed., Sage Publications, Thousand Oaks, CA, p. 11

The findings from the interviews shows that, although in theory, *akhlaq* and *aqidah* is the heart of the action, it was not integrate in the day to day practices which lead to lack of appreciation of *Shari'ah* portrayed by the staffs.

8.4.3 Accounting and Accountability in Islamic Banks

The following figure explains the processes involves in Islamic banking and finance operation. The processes are *Shari'ah* compliance process, financial reporting, and monitoring and control that involve with financial audit and *Shari'ah* audit. These processes are interactional and expected to ensure the accounting and accountability processes that eventually will assist the IBs in meeting the objectives of *Shari'ah* in the long run.

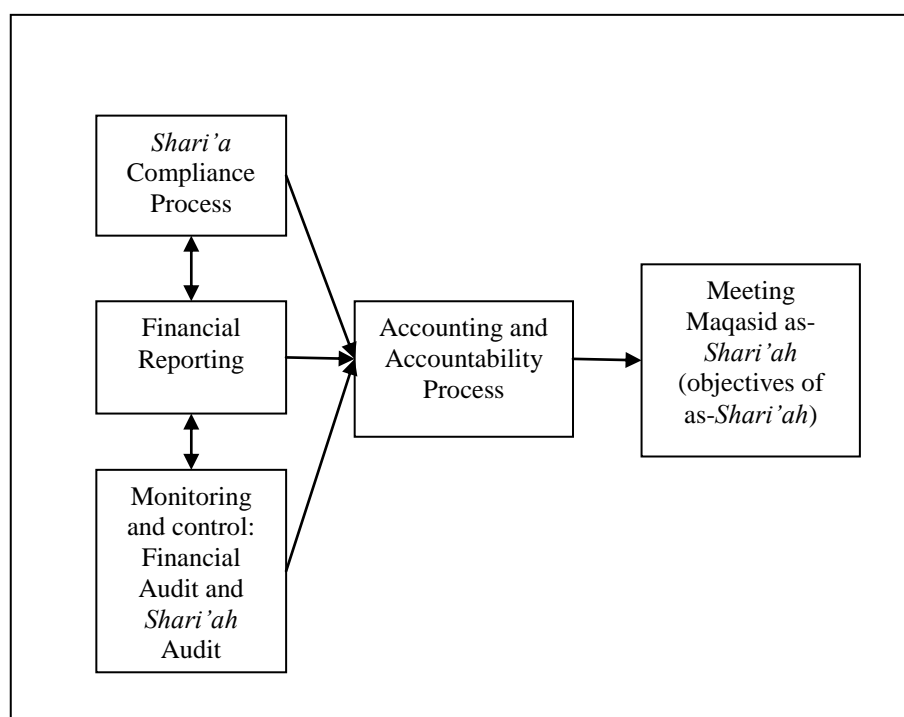


Figure 8.4.2 The Relationship between various Processes in ensuring the Accounting and Accountability of Islamic banks in Meeting the Objectives of *Shari'ah*

In consideration of the Figure 8.4.3 above the following subsections discusses the accountability in ensuring that the processes are in place.

8.4.3.1 Accountability in Ensuring Shari'ah Compliance

The contracts on the *Islamic* banking businesses are being developed and innovated by taking into consideration the principles and the objective of *Shari'ah*. These approaches are based on several concepts that have been practiced by *Muslim* traders. However, in modern days, some modification and differences take place to meet the demand of the customers, national land code, and customs of the people. The behaviour of the player in the *Islamic* banks is also governed by the ethics in the *Islamic* business organisation.

Shari'ah compliance accountability lies in every staff or individuals of Islamic banks. In ensuring the *Shari'ah* compliance in IB it involves two time period that are ex-ante compliance and ex-post compliance. In ex-ante compliance, the accountability lies in the *Shari'ah* experts to approve the transactions. However, at this point of time the *Shari'ah* committee require explanation of product development, legal, marketing and other support department. During ex-post compliance the accountability lies in the hand of the implementer such as the frontline staff.

Between these two stages, the SA portrays greater accountability as compared to the frontline. This can be explained by the knowledge and education of the SA that enable them to extent approval to the products and services offered by the banks. On the other hand, during implementation, we found that there are various *Shari'ah* non-compliance cases. It is where when the frontline staffs deliver their duty, they fail to deliver it properly. This portrayed that the staff portray that they just deliver their job but the sensitivity to ensure that the compliance should be in place is not portrayed.

This stage involves the implementation phase where products and services are being marketed to the customer. It is expected that contractual obligation is established and performed as per the approved design by the SC. Various perceptions are being highlighted by interviewees on *Shari'ah* compliance such as integral and essential, rationale of its establishment, legality, ensures competitiveness and viability and image and reputations. Non-*Shari'ah* compliance is seen as defeating the purposes of its establishment. Furthermore, there is also a growing concern from top management regarding the importance of *Shari'ah* compliance. However, during the implementation of approved products and services, various non-*Shari'ah* compliance cases were being reported to the *Shari'ah* officer and SC. These cases involve financial and non-financial. During this phase, the line management portrays insufficient accountability in ensuring that the implementation process is being carried out in accordance to what has been approved by the SC.

Lack of knowledge and expertise resulted in ignorance on how *Shari'ah* works, and how finance works within *Shari'ah*. This entails inadequate appreciation of *Shari'ah* and inadequate appreciation of theoretical and practical implementation of *Islamic* banks which results in non-*Shari'ah* compliant cases. The non-*Shari'ah* compliance cases could be due to lack of knowledge and experience, the education background and previous experiences possessed by the line management contributed to mistakes, not deliberately done, by the line management. Although the SC assumed that middle and lower level management might not deliberately make mistakes in the implementation stage, any wrong implementation of the processes and procedures will contribute to the non-*Shari'ah* compliance risk. It will contribute to the occurrence of *Shari'ah* issues and would give impact to the achievement of *Shari'ah* compliance. It is not a healthy scenario and it portrays scarce appreciation towards *Shari'ah* matters and a lack of understanding and skills.

The CEO of a full-fledged bank symbolised IB, as faith banking and expressed his concerns on understanding the roles and responsibilities of his SC and SMgmt in ensuring the operations of the Banks is *Shari'ah* compliant. Furthermore, the CEO in full-fledged *Islamic* banks shows their clear understanding of the mission and vision of the establishment of *Islamic* banks. This is explained through their support and full-authority given to the SC and management in fulfilling their accountability and responsibility. Meanwhile, some of the CEO in IBS are very involved with the IB development as it is included in their key performance indicator (KPI), and the involvement include the CEO of the parent bank. Also, the CEO of IBS highlighted on the importance of the team to explain properly to SC without influencing SC to make any decisions at the bank management's favours. However, there is also the CEO of the parent bank that will dictate what products and services should be offered by the IBS. Thus, some products that are approved *Shari'ah* compliant may not be offered to customers, as it is deemed not viable by the parent bank's top management.

a. Personal vs. Managerial Accountability

The accountability in Islam has been discussed in the earlier chapter. In Islam, the accountability is seen as a means in which a man, as a *khalifah* (i.e. Vicegerent), is being accountable for the resources entrusted to him. He will be accountable in what he is doing in this world, and in the Hereafter. Thus, while performing his activities, man should observe the Allah-fearing conduct to create awareness on performing the act of accountability. Due to centuries of decline, disintegration and lack of proper education, Islamic values are not reflected either in individual or social behavior or in the prevailing legal, social, political, and economic institutions of Muslim countries (Chapra 2000).

Accountability in *Shari'ah* compliance lies in every staff or individuals of *Islamic* banks. In ensuring the *Shari'ah* compliance in IB, it involves two time periods that are ex-ante compliance and ex-post compliance. In ex-ante compliance, the accountability lies in the *Shari'ah* experts to approve the transactions. However, at this point of time, the *Shari'ah* committee require an explanation of the product development, legal, marketing and other support department. During ex-post compliance, the accountability lies in the hand of the implementer, such as the front-line staff.

Between these two stages, the SC portrays greater accountability as compared to the front-line. This can be explained by the knowledge and education of the SA that enable them to extend approval for the products and services offered by the banks. During implementation, it has been discovered that there are various *Shari'ah* non-compliance cases. At the implementation stage, when the front-line staffs deliver their duty, they fail to deliver it properly – the staff portrays that they just deliver their job but their awareness to ensure that the compliance should be in place is not portrayed.

In referring to an earlier discussion on IB's staff, it was reported that the staff is lacking in knowledge and understanding regarding *Shari'ah* law and how *Shari'ah* and *Islamic* finance are implemented in *Islamic* banks; they also lack experience working in IB, lack appreciation of *Shari'ah*, lack awareness on *Shari'ah* Law which lead to non-*Shari'ah* compliance. In general, the *Shari'ah* compliance accountability is highly influenced by occupational grouping in the IB. It is shown that, the religious background expertise and top management show and portray higher *Shari'ah* compliance accountability. Technical expertise and middle and line management show and portray a lower level of accountability in ensuring *Shari'ah* compliance.

The different level of awareness pertaining to personal accountability in IB can be seen at the different occupational level in Islamic banks. The SC is accountable to ensure that they give approval that the products and services offered by IB is in accordance with *Shari'ah* and thus, it is *Shari'ah* compliant. In giving approval, the SC will have a meeting to deliberate and discuss the *Shari'ah* matters and issues related to the products and services. In addition, the discussion is extended to ensure that the legal documents, operating procedures and accounting treatment are permissible. SC portrays their personal accountability in accordance to what they understand and what is being explained to them. At this level, the middle management is accountable to provide reliable and valid information to assist the SC to deliberate and discuss certain matters before extending approval to products or services. Furthermore, the communication between the head of department and *Shari'ah* committee renders more understanding to the HOD, as compared to middle and lower level management.

In addition, the middle management is more towards ensuring that what has been approved will be implemented by the front line accordingly. It is the concern of higher management that the products and services offered by IB will be viable in the market and there is a demand for it. This is to ensure that the interest of the shareholders and stakeholders, in terms of business performance of IB, will be protected. If it is perceived that the products that have been approved are not viable, the decision to market the products will be delayed or put on hold.

Furthermore, the awareness of front-line (i.e. Line management) in ensuring that what is being implemented is in accordance with *Shari'ah* seems insufficient as various non-*Shari'ah*

compliance cases are being reported to the CEO and SC. Also, it seems that the front-line do not portray their appreciation towards ensuring *Shari'ah* compliance in the transactions. Furthermore, lack of understanding of the staff on the contract leads to the lack of understanding of the customer due to improper explanation and disclosure of information, which should be given by the staff before the customer engage with the contract. This will result in inadequate knowledge or understanding of the contract. Furthermore, the staffs also portray a lack of awareness to the importance of upholding the *Shari'ah* compliance.

b. Accountability on Non-*Shari'ah* Compliances

Despite various non-*Shari'ah* compliance cases in *Islamic* banks, various interviewees highlighted how the IB rectifies problems pertaining to non-*Shari'ah* compliance. The rectifications on the non-*Shari'ah* compliance cases in *Islamic* banks can be categorised into two groups: financial and non-financial cases. When the *Shari'ah* officers come across non-*Shari'ah* compliance by the *Shari'ah* officer through *Shari'ah* review, they will demand an explanation from the management regarding the non-*Shari'ah* compliance. Explanations received by the *Shari'ah* officers will be tabled to the *Shari'ah* committee. In some cases where some procedures are not fulfilled, it will be rectified by amending or tolerating until they find better solutions. Also, there are rectifications that involve information or accounting figures that have been entered into the system, which they call the purification process. In addition, there are also cases being brought to the court that related to the structure of the financial instruments.

8.4.3.2 Accounting, Auditing and *Shari'ah* Compliance

The financial accounting practices in the IB are seen as complying with the statutory requirement reporting and auditing processes, as practiced by conventional banks. It is

complied to meet the demand of the management, shareholders, stakeholders and the auditing functions performed by the external auditor. In addition, being a highly regulated institution, banking institutions need to comply with local legal framework and international standards. Also, in this industry, the accounting and auditing regulation is well established in accordance to conventional banking operations, products and services. Accounting practices in Islamic banks is still not much different from conventional. Overall, based on the conversation with interviewee, it gives impression that the accounting is only the support department (i.e. support activities) of the Islamic banking.

It is an important tool to communicate the financial performance and *Shari'ah* compliance of IB. The financial performance is presented in accordance with the statutory requirement and BNM's guidelines and *Shari'ah* compliance is being assured through SC's report. This will assist the stakeholders and shareholders in making decisions. Although the statutory requirements for financial reporting are initially designed for conventional banks, BNM's and MFRS guidelines were created to support the need of reporting in IB. Currently, the problems present are pertaining to accounting treatments, which are still tolerable due to the similar nature of products and services with conventional banks, however, more standards and guidelines are needed to support *Shari'ah* based products such as *Musyarakah* and *Murabahah*.

The *Shari'ah* committees start to express their awareness on the importance of accounting and financial reporting. Most of them admit that they are lack of knowledge and regarding accounting and finance. They emphasized the gap between *Shari'ah* expertise and technical expertise. Also, SC found that they lack technical knowledge such as accounting and finance. Furthermore, they are aware that more knowledge needs to be acquired by them in order to

have a better understanding on the operationalisation of the products and services in terms of accounting and finance. SC and *Shari'ah* officers showed an increased awareness on how they perceived accounting and accountability practices in IB. The process of ensuring the *Shari'ah* compliance of *Islamic* transactions will influence how people understand the nature and underlying concepts of the products. Also, they portray the importance of such practices in communicating reliable information to the public.

8.5 Lack of Clear Direction to Achieve the *Maqasid* of *Shari'ah*

In the context of Islamic banking and finance, in achieving the stability and meaning to social life as being promoted by the objective of *Shari'ah* law, it is influenced by the rule system and cultural schema and social behaviour and associates activities of the conventional banks. The findings of this study witnessed the problems and challenges of Islamic banking and finance industry in ensuring that it is operating in its full capacity to meet the demand of both being conventionally viable and competitive and at the same time achieving the ideals under the *Shari'ah* and the *Shari'ah* objectives.

In achieving the *maqasid as Shari'ah*, the industry is still lacking of clear future direction to achieve the objectives. This is further challenged by the dual-banking system of IB industry and the influence of CB in its operation. Thus, it will increase the competition faced by IB. Furthermore, as the regulators liberalised its banking system and participated in the globalisation, the competition level will further increase. Also, the monetary policies are very much influenced by conventional market.

Despite of growth and development of Islamic banking and finance in Malaysia (i.e. the most comprehensive infrastructure and legal and regulatory framework introduced), the dual

banking system is still a threat to the industry. Under the dual banking system, Islamic banks are overshadowed by the existence of the conventional banks. Since the base system is conventional banking system, most of the operations of Islamic banks is being referred and compare to its counterpart. The stakeholders are being unreasonable to compare both systems as it is not the same and it would render misunderstanding among the stakeholders. Thus, this leads to the high competition between Islamic banks in Malaysia. The increased liberalization further increases the competition.

The dual banking system further influence, (1) legal and regulatory framework where there are lack of specific laws that cater the specific contracts or underlying principles of Islamic banking product, lack of specific law that support Islamic banks to operate in accordance to *Shari'ah* principles in achieving *Shari'ah* objectives, (2) knowledge, education, values and experience of players are influenced by the conventional banks, and (3) products offered to customers are depends of customers' familiarity and awareness.

Furthermore, the Islamic banking and finance industry in Malaysia is lacking of map to direct way forward for Islamic banks. It seems that the Islamic banks give high focus on the development and growth in term of its commercial viability. On the other hand, the *Shari'ah* objectives of the establishment seem to receive lack of highlight or attention. Also, the achievement of *Islamic* banks in terms of growth profit and total asset is highlighted. The fulfilment of the *Shari'ah* objectives is another benchmark to ascertain the success of the bank. Commercially viable and *Shari'ah* compliance are equally importance. In addition, those elements need to be streamlined to achieve the objectives of *Shari'ah*. Thus, it will fulfil the real needs of having Islamic financial system.

8.5.1 The Need on Awareness of Other Stakeholders

In addition, in achieving the true IB, the question raised is: are different groups of people, organizations and governance structure in the industry and regulators (BNM) have the same aspiration, perspective, understanding, awareness and tuning to achieve the true *Islamic* banks that uphold the objective to achieve the *Maqasid as-Shari'ah*? There is a need to synchronize the aspiration, understanding, awareness and tuning among them through communication and discussion (*muzakarah*).

The socioeconomic objectives of *Islamic* economics need to be upheld (Kahf 2006; Siddiqi 2006b; Chapra 1979; Chapra 1984, 1991; Nyazee 2000; Kamali 1980; cited by Abdul-Rahman 2003; Haron 1997; Abozaid and Dusuki 2007; Dusuki and Abozaid 2007; Kamali 2003; Ahmad 1991; Metwally 2002; Kasim et al. 2009; Siddiqui 2001). IB needs to achieve healthy development through upholding the initial idealism in meeting these socioeconomic objectives. In addition, Chapra (1979) supported the above statement where he opined that profit is recognised in Islam. However, since profit can be categorised as just and unjust, certain moral restraints should be put in place to foster individual self-interest within a social context in order to not violate the *Islamic* goals of social and economic justice and equitable distribution of income and wealth (Chapra 1979).

Also, the information and ideas need to be shaped to increase awareness among the stakeholders. There is a need to be clear on the objectives of the establishment of *Islamic* banks to assist in defining where *Islamic* banking is heading. It would also help the bank to streamline their operations and decisions. Thus, besides focusing on the returns, the *Islamic* bank should also focus to achieve the *Maqasid as-Shari'ah*, which are the pillars of its establishment. A *Shari'ah* Officer in IBS explains the roles of players in ensuring the

maqasid as-Shari'ah is achieved.

According to the interviewees, an institution that provides platforms and players itself should be creative enough, in terms of *Shari'ah*, and well versed with banking operations whereby it is not following the conventional banks operations. Among others, factors that may hinder the *Islamic* banks to move towards true *Islamic* banking are the overall readiness of the public and player, cooperation among *Muslim* countries, cooperation and collaboration of all parts of stakeholders, economics, political, religious and social will, and lack of map. Thus, players need to play their roles in ensuring that the real objectives of its establishment are achieved.

Generally, in order for the industry to move towards true *Islamic* banks, various interviewees highlight on the readiness of the industry to implement the conceptual or theoretical mode of the *Islamic* banking business. The interviewees express their heightened awareness on the need to streamline the operation of *Islamic* banks to achieve the objectives of *Shari'ah* (i.e. *Maqasid as-Shari'ah*). Also, they highlight the readiness of the players and the customers, or potential customers, who want to subscribe to the IB that implement the *Islamic* banking operation in accordance to its theoretical framework. It is importance for the customer to possess readiness to live in moderation and in accordance to one's financial capability, as IB is not based on leverage, but it depends on true value of asset.

Another effort need to be nurtured is co-operation among *Muslim* countries to do business transactions and further enhance and develop the *Islamic* banking and finance industry. At the moment, the industry is still inadequate in the cooperation between other *Muslim* countries. In order to ensure the *Islamic* banks move towards achieving the true *Islamic*

objectives, the industry needs the religious, economic, political and social will. In addition, the industry needs collective readiness from all groups of stakeholders. This involves proactive support from the bank's top management, values of the players and will of the bank to move forward. Also, it may expect more relevant products to ensure that the economic system achieves the objective of *Shari'ah*.

8.6 Summary

The chapter begins with an explanation on how the operation of Islamic banking and finance is influenced by institutional factors. The NIS is considered to be a relevant theoretical framework to inform the interview's findings. By using institutional theory, the findings of this study offer explanation on how the operation of Islamic banking and finance are influenced by institutional factors. Based on this perspective, coercive isomorphism, mimetic isomorphism and normative isomorphism existed to explain how the problems and challenges are considered in the operation of Islamic banks. Furthermore, the NIS is also used to explain the institutional influence of accounting in Islamic banks. In the final part of the chapter, linkage between *akhlaq* and *muamalat*, financial transactions activities in terms of *Shari'ah* compliant and *Shari'ah* based, accounting and accountability and auditing, competency of HC and the need on awareness of other stakeholders are reflected from the interview findings.

CHAPTER NINE

CONTRIBUTIONS AND LIMITATIONS OF THE STUDY

9.1 Recapitulation of the Interview Findings

The theoretical perspectives underlying Islamic banking and finance were discussed in Chapter Two. The underlying *Shari'ah* principles explained had consisted of the prohibition of interest; trade and commerce and its underlying principles; the profit and loss-sharing framework; prohibition of *gharar*; and payment of *zakah*. These principles were derived from the *Islamic* law. Furthermore, when engaging in financing or investment in *Islam*, both parties are allowed to conduct permissible types of trade-based activities that are approved in *Islam*. For example, impermissible trade-based activities in *Islam* are those involving alcohol, gambling, pork production and pornography production. Moreover, the principles of *Shari'ah* prohibit the uncertainty that leads to the forbiddance of any speculative practices and excessive leveraging. Uncertainty may be caused by a lack of clarity existing in the contractual agreement or transactions concerning the buyer and seller, price, object of sale, delivery and quality. Furthermore, the occurrence of uncertainty will lead to *zulm*, which encompasses unjustified gains, injury to contracting parties and disputes. Thus, contractual obligations and the disclosure of information are highly regarded. A believer's behaviour is governed by *Islamic* moral values and ethics. In *Islam*, there are concepts central to *Muslim* beliefs such as the unity of God, vicegerency, justice and the accountability of resources entrusted by God. The accountability in *Islam* is beyond private and societal accountability, as it extends to the accountability to God. The underlying principles governing its operations are employed to ensure that the business activities engaged by the public are in accordance to the teachings of *Islam*, with the aim of obtaining the benefits of the objectives of *Shari'ah* (*maqasid as-Shari'ah*).

Chapter Three began by discussing the credibility of the Islamic banking system. The credibility of Islamic financial institutions was explained by the legitimacy of their practices and the accountability of their players. In regards to credibility, the section further reviewed *Shari'ah* compliance in *Islamic* banks, Islamic morality and accountability and trust in *Islamic* banking. Islamic morality included *tawhid* as part of the discussion since it provided the necessary framework for institutions. The chapter continued with the theories of corporate governance underlying the Islamic banking and finance operations, their products and services. The theories included agency theory, transactions economic theory and stakeholder theory; with emphasis on agent morality in formulating business policies. Each of the discussed theories had reflected upon Islamic banking, their finance operations and their products and services. Since agency theory and transactions cost theory were classified as organisation economic theories, the former focused on the principles-agents contract, while the later focused on the governance of those contracts. The underlying principles governing Islamic banking and finance had rendered various implications toward principals-agent relationships and the governance of contracts. Next, the chapter continued the discussion with stakeholder theory and emphasised on agent morality. Agent morality was classified as non-instrumental ethics. It advocated that in the event where wealth and principles came into conflict, it cannot undermine the moral principles. Thus, an agent morality prioritised moral obligations before shareholders' wealth in formulating business policies. In the context of this study, morality was grounded with ethical religious considerations. The stakeholders theory did not include the connection between internal and external stakeholders or the consideration of the environment in which the institutions operate. In order to understand the nature of the institutional pressures which carry an impact on the way institutions are structured, this study discussed the influence of the institutional theory. The institutional

framework supports a certain structure that leads toward guaranteeing accountability, gaining legitimacy and securing social fitness. In addition, an institution face institutional pressures that influence them to adopt similar structures, strategies and processes. The institutional pressures were categorised into coercive isomorphism, mimetic isomorphism and normative isomorphism. The inclusion of such theories directed the research towards scrutinising the agent-principals relationship, governance structures of transactions, moral behaviours and philosophical guidelines for the operation and management of IBs in the stakeholders' context and understanding of internal and external pressures faced by IBs in Malaysia.

Chapter Four presented the literature review of the problems and challenges facing IBs. This chapter was categorised into four themes: *Shari'ah* compliance, legal and regulatory frameworks, accounting and auditing practices and management.

Chapter Five presented and discussed the research methodology of this study. This study was conducted using a semi-structured interview aimed at *Shari'ah* board members, the Heads of the *Shari'ah* department, the CEO's of Islamic banks and NSAC of the Central Bank of Malaysia. This study undertook a qualitative methodology and chose the semi-structured interview method. The semi-structured interview was conducted to inquire from interviewees the problems and challenges facing IBs through their experiences and involvement in the industry. The study employed the interpretive research process and linked the data and theory through an iterative strategy which involved both inductive and deductive approaches. The analysis of the data was prepared using Atlas.ti version 6.2.

Chapter Six and Chapter Seven presented the findings from the interviews conducted in this study. Chapter Six focused on the discussion regarding the legal and institutional frameworks

of IBs. It presented the IB's industry in Malaysia as it operated under the dual-banking system. The dual-banking system resulted in IBs facing competition and monetary policy issues since the industry is heavily influenced by the conventional banking system. Next, the chapter discussed the legal and institutional structures where the subsection was further classified into interpretations of *Shari'ah* law, framework-related operations, products and services and financial regulatory procedures. Chapter Seven presented the consideration of *Shari'ah* compliance in management, accounting and accountability and the auditing system. It began the chapter with an explanation on the perceptions of the interviewees relating to *Shari'ah* compliance and commercial viability, and how *Shari'ah* compliance was implemented in IBs. The discussion continued with the dichotomy between the theoretical framework of IBs and its implementation, unresolved *Shari'ah* matters and the solutions for *Shari'ah* non-compliance cases. Next, the chapter reviewed the management (i.e., human capital, implementation of *Shari'ah* approved products and accounting systems), accounting and accountability and auditing.

Chapter Eight presented the review and theoretical analysis of the interview findings. A diagram correlating the rule system and cultural schema with associated activities and resources in providing stability and the meaning of life was further displayed. In the context of this study, the association reflected the institutional pressures and theoretical perspectives drawn from governance theories that were assessed and concluded towards achieving the objectives of *Shari'ah*.

9.2 Reflections: Review of the Findings vs. Recent Development in the Industry

BNM Administered Legislation

The establishment of the *Islamic Financial Services Act 2013* (IFSA, 2013) portrayed the importance of ensuring *Shari'ah* compliance through the inclusion of provisions related to rectifying non-*Shari'ah* compliance in Part IV, Division 1, Number 28, Point 3, 4 and 5 of the IFSA 2013. The inclusion of provisions will assist in the handling of the problems faced by Islamic banks pertaining to *Shari'ah* non-compliance cases. However, it is important to educate and create awareness to market players on the importance of *Shari'ah* compliance. Moreover, Part IV (Division 1) and Part VI (Division 4) included the audit, *Shari'ah* compliance and auditors, respectively.

Additional and Updated Guidelines and Circular

Additional and updated Guidelines and Circular by BNM was referred to in Appendix 4. The latest list of guidelines and circular showed that more guidelines were focused on capital adequacy, prudential limits and standards in *Shari'ah* for creating a more stable and healthy Islamic financial industry. In relation to financial reporting regulations, the BNM issued the updated GP8-i and the standards setter (i.e., MASB) developed for other additional regulations.

Financial Reporting Regulation for Islamic Banks in Malaysia from 2010 to 2013

The financial reporting of Islamic banks had faced gradual development in terms of its regulatory framework to assist the MASB's plan to converge with IFRS in 2012. The MFRS standards related to financial transactions were listed in the following Table 9.1.1.

Table 9.2.1 MFRS Standards relating to Financial Transactions

MFRS
MFRS 139 Financial Instruments
MFRS 7 Disclosure of Financial Instruments

In guaranteeing the development of initiatives regarding the financial reporting regulations for Islamic banks, MASB developed various initiatives to ensure that the available standards are able to support the financial reporting in IBs. The initiatives were mainly aimed to establish whether the financial treatment and reporting were *Shari'ah* compliant. The standards and initiatives were introduced by MASB in order to safeguard the convergence with the IFRS in 2012. In addition, BNM had issued an updated GP8-*i*. The issuance that provided guidelines on financial reporting suggested a greater disclosure for IBs. The following Table 9.1.2 summarised the additional financial reporting regulations for IB from 2010 to 2012.

Table 9.2.2 Additional Financial Reporting Regulation for Islamic Banks in Malaysia from 2010 to 2012

Year	Details on Financial Reporting Regulation	Effective Date
2010	MASB proactively sought advice from the BNM's <i>Shari'ah</i> Advisory Council for the <i>Shari'ah</i> point-of-view on basic accounting principles; such as time, value of money and substance of contracts over legal forms.	1 January 2010
2010	Circular on the Application of FRS and Revised Financial Reporting Requirements for <i>Islamic</i> Banks.	1 January 2010
19 November 2011	MASB issued a newly approved accounting framework; the Malaysian Financial Reporting Standards (MFRS) framework.	
June 2011	MASB Exposure Draft 75 IFRS-compliant Financial Reporting Standards.	Issued as Malaysian Financial Reporting Standards in November 2011
2012	BNM issued an updated GP8- <i>I</i> ; the objective of the Guidelines on Financial Reporting for Licensed <i>Islamic</i> Banks (GP8- <i>i</i>).	2013

In reference to seeking advice from NSAC pertaining to the accounting principles, MASB was further involved in working groups such as MASB *Islamic* Technical Unit and Standing Committee on *Islamic* Financial Reporting and The Asian-Oceania Standard Setters Group (AOSSG) *Islamic* Finance Working Group. Both working groups undertake research and accounting matters that are related to *Islamic* financial reporting. The former was formed in Malaysia and intended to assist the national standards setter pertaining to *Islamic* financial reporting; the latter was formed to cater the accounting issues in the region and take into consideration the various interpretations that exist.

Furthermore, in 2011, MASB introduced another pronouncement called the Technical Release *Shari'ah* Compliant Sales Contract which applied to the accounting of a *Shari'ah*-compliant sales contract; excluding contracts for sale. Table 9.1.3 explained the technical pronouncement after 2010.

Table 9.2.3 Pronouncements by MASB for *Islamic* Banking and Finance Industry after 2010 (generated by author)

Types of Pronouncement	Pronouncements	Comments	Effective Date
Technical Releases (TR)	TR <i>i-4 Shari'ah</i> Compliant Sale Contracts	-	1 Jan 2011

In addition, MASB disclosed three discussion papers regarding *takaful*, *sukuk* and *Shari'ah*-compliant profit-sharing contracts, as in the following:

Table 9.2.4 MASB's Discussion Papers

Title	Issue Date	Comments Due to MASB
Discussion Paper <i>i-1</i> (DP <i>i-1</i>) <i>Takaful</i>	16 December 2011	16 March 2012
Discussion Paper <i>i-2</i> (DP <i>i-2</i>) <i>Sukuk</i>	16 December 2011	16 March 2012
Discussion Paper <i>i-3</i> (DP <i>i-3</i>) <i>Shari'ah</i> Compliant Profit-sharing Contracts	16 December 2011	16 March 2012

It seems that there are various developments to strengthen the financial reporting practices in Islamic banks in Malaysia. Malaysian IBF industry confirmed that its financial transactions are harmonised and comparable; however, not necessarily similar to its conventional counterparts. The effort to jointly discuss with *Shari'ah* scholars and the establishment of working groups pertaining to accounting issues was a good move for the involvement of *Shari'ah* with technical expertise. In addition to the efforts made by MASB and BNM, the clause regarding transparency requirements was included in IFSA 2013. Thus, this depicted an effort from regulators and standard setters in Malaysia of guaranteeing that the financial reporting regulation of IBs appraised to the uniqueness of the system. The development in regulations displayed a greater focus on transparency in IBs, and the progress in encouraging the banks to offer PLS products.

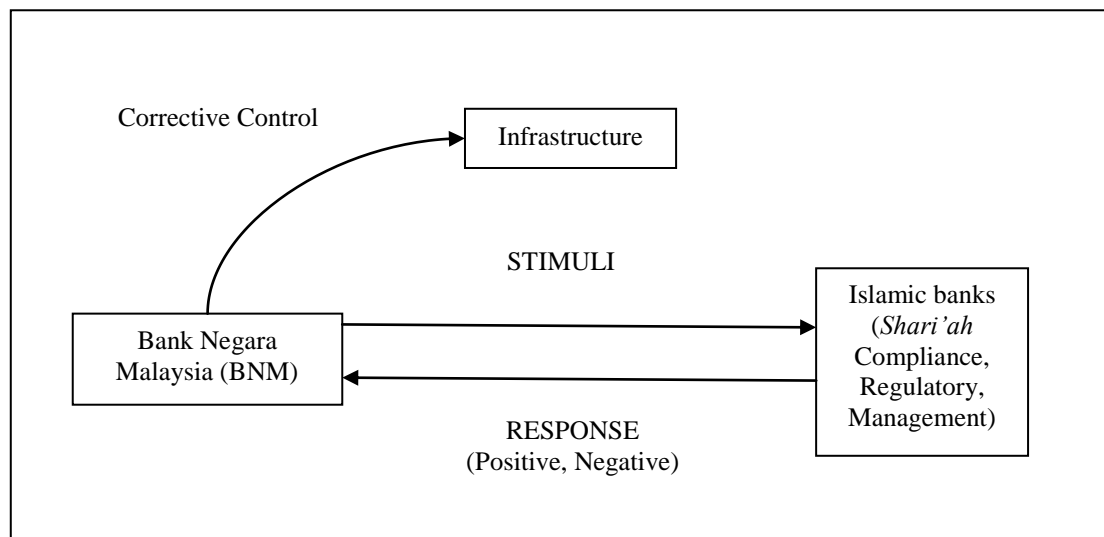


Fig. 9.2.1 Corrective control by BNM in the Infrastructure of IBs

Figure 9.2.1, above, explained the relationship between the interview findings and current developments in the industry. In the previous Figure 8.4.1, the findings had illustrated that although there were stimuli from BNM to encourage IBs to offer products based on PLS,

various aspects were lacking when it came to supporting the stimuli. Current development demonstrated that there are new financial reporting regulations pertaining to PLS, guidelines regarding sale-based contracts and the inclusion of statutory laws relevant to *Shari'ah* non-compliance. It would be interesting to further explore the responses from IBs and customers in relations to current developments.

9.3 Theoretical Contributions

According to the discussions presented in the previous chapters, this study provided a number of theoretical contributions. First, the findings of this study explained how the institutional isomorphism faced by IBs operating in the dual banking system was responsible for the loose coupling of actual IBs' practices from formal IBs' underlying theoretical structures. As previously discussed in Chapter Eight, the findings revealed that IBs in Malaysia faced conflicting institutional pressures from outside. Even though the establishment of IBs was aimed to uphold business and financial transactions that comply with *Shari'ah*, the existence of laws and regulations that promote the development of *Shari'ah*-based products and services are still lacking, and customers are demanding products similar to CBs. Thus, the findings of this study revealed that IBs faced conflicting demands, which led to loose coupling practices.

Second, IBs face institutional pressures regarding accounting practices. The national and international accounting standards did not support the disclosures of all aspects of promoted principles by the proposed dealings of *Shari'ah*-based products, which impeded the innovation of products and services in IBs and left the industry with products similar to CB.

Third, the findings from this study introduced a new perspective in viewing *akhlaq* and *aqidah* in daily practices. While *ibadah* and *mu'amalat* reflected *Shari'ah* practices, *akhlaq* and *ibadah* are at the core, intangible and cannot be measured by other individuals. However, the importance of *akhlaq* is demonstrated in the conducts of individuals, portrayed in their daily practices.

Fourth, in relation to the onion diagram of *akhlaq* and *aqidah*, agent morality ensured that the moral obligation was preferred before shareholders' wealth in formulating business policies; this entailed a greater implication in Islamic institutions. In Islamic institutions, *akhlaq* should be grounded in individuals to guarantee that *Shari'ah* principles are well-established in business practices. Thus, the accountability of players in Islamic banks goes beyond the normal accountability practices in CB as it extends toward the accountability to God.

Fifth, although the establishment of IBs aimed at providing customers with alternative choices in the banking business, the industry is faced with other demands influenced by CBs. *Shari'ah* scholars were focused on *Shari'ah* matters in products and services of Islamic banks. Their views were fixated upon guaranteeing that *Shari'ah* principles are upheld and that the overall practices of Islamic banks would result in the fulfilment of *Shari'ah* objectives. Furthermore, regulators support the overall ideal establishment, operations and the products and services of Islamic banks, however, lack of regulations is still present; and IBs must also comply with international regulations which rendered IBs to offer products that were similar to CBs. In addition, the CEOs in IBs governed by various governance structures (i.e., local and international full-fledged IB and local and international IBS) influenced the decision-making of IBs. Although CEOs support IBs, the products and services offered were largely based on the demands of customers. In this situation, any *Shari'ah*-approved products

and services that were not viable were held, and other products in demand were placed on the shelf; without taking into consideration the economic values of such products. Thus, due to the dynamic actors and relations within the industry, this explained the support received from the government in securing the sustainable existence of IBs.

Sixth, *Shari'ah* non-compliance cases occur unintentionally due to lack of knowledge, awareness and education of personnel. However, *Shari'ah* non-compliance issues in IBs, and the trust forwarded by IAHs towards shareholders to ensure that operations, products and services are carried out in accordance to *Shari'ah* was still at stake. Moreover, the possibility that shareholders will emphasise the financial performance in comparison to *Shari'ah* compliance would also affect the trust between IAHs and IBs. The reliability of IBs to produce financial reports to communicate or imply their accountability towards shareholders and stakeholders was also important. However, the lack of accounting regulations in supporting *Shari'ah* compliance and *Shari'ah*-based products and services may not communicate the true economic conditions of IBs. The assimilation of *akhlaq* and *aqidah* in shareholders' daily practices would lead to more reliable and vigorous monitoring. Thus, with increased *akhlaq* (i.e., morality and ethics), more trust can be forwarded to shareholders by the IAH. The relationship between shareholders and agents, and the public and agents, was based on the principal-agent relationship; and the relationship between agents and God was based on an ethical moral attitude.

9.4 Practical Contributions and Recommendations

Besides theoretical contributions, this study offered some practical contributions. Firstly, although *Islamic* banking and finance was equipped with additional legal and institutional frameworks to support its unique underlying principles, it was not sufficient for *Islamic*

banks to operate in their optimum capacity when employing the resources entrusted to them. In IB, it was expected that those with religious backgrounds would portray a good example by exercising *Shari'ah* compliance. On the other hand, IBs' staff who had no religious background, would have less appreciation of the importance of *Shari'ah* compliance in IB. This contributed to the difference of actions between people with a *Shari'ah* background and people with a technical background. The educational background, the expertise and the experience of the staff influenced the level of *Shari'ah* appreciation. Most of the staff failed to appreciate the unique features of *Shari'ah* and the various environments, along with the legal and regulatory frameworks that lead to differences of implementation in the current banking environment. It is highly crucial for these institutions to obtain staff that had worked in conventional banks or markets so that they may understand the entire principle of *Islamic* financial services. Since they had worked in the conventional market, in a certain way, they are influenced by the conventional way of thinking, attitudes and understanding. A lack of appreciation in *Shari'ah* compliant processes was shown in numerous *Shari'ah* non-compliance cases; explained by CEOs, *Shari'ah* officers and the *Shari'ah* committee. Although there was a claim by NSAC that any mistake done by the staff was not deliberate, it still provided an impact to *Shari'ah* non-compliance risks and *Shari'ah* issues at the macro level. Furthermore, *Shari'ah* non-compliance will affect the credibility and reliability of *Islamic* banks.

The introduction of *Shari'ah* Governance Framework (SGF) and other *Shari'ah* guidelines and circular of BNM for *Islamic* banks operating in Malaysia still exposed *Islamic* banks to *Shari'ah* non-compliance. Majority of the time, *Shari'ah* non-compliance occurred during the implementation stages. The study stressed that this was due to the lack of accountability at the middle management and line management levels. It was also associated with inadequate

levels of awareness and education on the importance of *Shari'ah* in *Islamic* banks' operations, and their products and services. A lack of accountability of players gave impact to the credibility of the financial system and affected the image and reputation of *Islamic* banks. In addition, this lack of accountability will increase the exposure of *Shari'ah* non-compliance risks. In order to control *Shari'ah* non-compliance risks, the management should monitor the implementation stage. The establishment of a *Shari'ah* manual may reduce the exposure of *Shari'ah* non-compliance risks. Moreover, the establishment of *Islamic* Financial Services Act 2013 (IFSA, 2013) had portrayed the importance of ensuring *Shari'ah* compliance through the inclusion of provisions related to rectifying non-*Shari'ah* compliance in Part IV, Division 1, Number 3, 4 and 5 of the IFSA 2013. However, attention should be given to guarantee the enforcement of the statutory act.

This study provided an insight regarding the top management's understanding and support towards upholding *Shari'ah* compliance in its operations, products and services. Their understanding and support was crucial in securing the nature of products and services offered by IBs. Furthermore, the decisions of the top management was important, as it influenced the internal resolutions involving the marketability and viability of products and services offered to customers. In *Islamic* banks in Malaysia, the top management considered a certain criteria in offering products and services, such as the demand of the customers, the viability of the products and services and *Shari'ah* compliance of the underlying contracts. In the current competition with conventional counterparts, the viability of products and services was the main criteria that was taken into consideration. In the event where a product was approved as *Shari'ah* compliant but was not viable in the market, it would be put on hold. The study suggested that awareness should be created to assess the macroeconomic impact in guaranteeing that the products and services offered by *Islamic* banks would benefit the

society at large. Thus, rigorous research in product development and innovation should be encouraged to ensure that products and services of IB are viable, *Shari'ah* compliant and aim at achieving the objectives of *Shari'ah* in the long run. Furthermore, regulators should give attention to the economic value of products and services in the future in order to guarantee that the objectives of *Shari'ah* are upheld so as to achieve benefits for the society at large.

The values that stakeholders embrace will determine whether the market will move forward or remain stagnant. It will allow stakeholders to understand the underlying aspirations of the establishment of *Islamic* banking and finance. Their understanding will lead to the comprehension of the underlying reasons behind any decisions made by the banks. This awareness will encompass all areas in *Islamic* banking and finance operations. It will further aid in the growth of the industry. The embraced values will then determine whether the overall operations are different than conventional banking. Values will prompt an individual to deliver their responsibilities and accountabilities in accordance to *Shari'ah*; whereby, they uphold *Shari'ah* as the guideline. Thus, values instilled in human capital will drive the *Islamic* bank to move in-line with its underlying requirements and to achieve the objectives of *Shari'ah* (*Maqasid as-Shari'ah*).

Values are intangible, therefore, the extent of values in oneself cannot be measured. However, values can be observed through individual behaviours, shown by the way they handle things. Evidently, lack of values in practitioners can be inferred through their performed methods in establishing *Shari'ah* compliance. The way they appreciate the importance of *Shari'ah* is manifested when they do not take things lightly. Ideally, if they possess the values that are expected in the teachings of Islam and they understand the requirements of the *Islamic mu'amalah*, then they would fully appreciate their role in the

industry. The *Islamic* value integration of personnel will ensure their understanding regarding the *Islamic* banking system. Their mission and vision will be different, both will be based on *Shari'ah* principles and they will support the development towards achieving the objectives of *Shari'ah*; taking into consideration the limitations present such as the legal and regulatory frameworks, and supporting the concept that we would like to introduce in *Islamic* banks. Furthermore, findings from this study illustrated that the internalisation of values was not apparent at a certain level of personnel, and the role of regulative pressures was important. Thus, the role of norms or values in influencing the social order needs cannot be propelled without the help of coercive institutions (Kuran 1995).

Establishing the beginning to end process of product development (i.e., from drafting the proposal of a new product until the product is approved and sold to the customer) and ensuring the product was *Shari'ah* compliant, the staffs are also accountable to subscribe to *Islamic* teachings in their day-to-day activities and actions. Moreover, players are expected to embrace *Islamic* Finance as part of their own personality, whereby it portrays themselves and, at the same time, benefit the society. The players should acquire relevant knowledge of *Islamic* principles in order to guarantee that they understand the information worldwide and are ready to implement IB products and services in accordance with *Shari'ah*. However, due to the lack of *Shari'ah* compliance observed by the staff, a lack of values and appreciation of values was rendered. Problems regarding the internalisation of values (ethics) among individuals involved in the industry are further present.

The banking industry is a highly regulated industry. IBs are governed by their underlying principles. Thus, in the dual-banking system, IBs are also bound to comply with national and international banking regulations; which is very much influenced by the conventional system.

The legal and regulatory framework of *Islamic* banks is still facing problems and challenges in terms of laws; which resulted in contradicting practices of IB (e.g. HPA), laws specific to addressing *Islamic* financial contracts and laws that address certain issues or concerns of *Islamic* transactions. However, any disputes are resolved in the civil law court where judges are not trained in *Shari'ah* Law; this may raise controversy between the decisions made by judges and the contracts of products and services agreed and endorsed by respective *Shari'ah* advisors. Based on the Central Bank of Malaysia Act 2009, if any disputes arise, the judge is required to refer to NSAC in order to minimise uncertainty.

Accounting practices in *Islamic* banks are still not much different from conventional ones. Overall, based on the conversations with interviewees, an impression was given that the accounting was only from the support department (i.e., support activities) of *Islamic* banking. Furthermore, the *Shari'ah* committee expressed their awareness on the importance of accounting and financial reporting. Most had admitted that they possessed inadequate knowledge regarding accounting and finance. Accounting in *Islamic* banks lack accounting standards that support *Islamic* bank products and services. Currently, employing conventional accounting standards does not raise any issues since the nature of products and services offered by *Islamic* banks share similar characteristics with products offered by CB. However, in order to encourage products that are unique to *Islamic* banks, such as products based on profit and loss sharing concepts, a call for standards unique to IB is required.

Harmonisation refers to the harmonisation of local and international practices. At the national level, the industry requires harmonisation in terms of its practices; for example, in the way certain measurements are calculated and the way things are implemented. The harmonisation of local practices will ensure that the bank is more transparent to customers, and avoid any

misunderstandings regarding certain charges made by the banks. In addition, at the international level, an inadequacy is present in terms of the harmonisation of *Shari'ah* standards and other related standards; such as accounting treatment and corporate governance. This must be resolved to assist regulators and practitioners worldwide. Despite the time frame needed to achieve harmonisation in those areas, various efforts must be done towards realising the urgency of harmonising the relevant areas.

The need for *Shari'ah* auditing in IB resulted from various non-compliance cases during the implementation phase. Interviewees questioned the veracity of SC reports, which are needed to lend credibility and reliability to SC reports. However, some factors are currently insufficient in order for the industry to implement *Shari'ah* auditing; such as functional and technical expertise in SC, the establishment of a plan for the auditing framework, a manual for SC, the ability of staff to be critical enough to make judgements regarding *Shari'ah* matters, *Shari'ah* compliance reviews and *Shari'ah* compliance auditing.

9.5 Limitations and Suggestions for Future Research

This study possessed a qualitative research design in which it employed a semi-structured interview to explore the problems and challenges facing *Islamic* banking and finance in Malaysia. It focused on the problems and challenges related to the legal and regulatory frameworks, *Shari'ah* compliance, management, accounting and finance. In addition, semi-structured interviews with the *Shari'ah* Board members, NSACs, the Head of *Shari'ah* Departments (or *Shari'ah* officers) and CEO/COOs were conducted based on convenient sampling, and limited to several *Islamic* commercial banks.

The first limitation of this study was that the qualitative research intended to achieve theoretical generalisation rather than statistical generalisation. The NIS theory, and other supported theories (such as the agency theory and agent morality in normative stakeholder theory) were utilised to demonstrate the interview findings. Furthermore, *Shari'ah* law governs the underlying principles of *Islamic* banking operations, thus, the theoretical generalisation made with the conventional theory were supported by *Shari'ah* law. In order to avoid such limitations in future, researchers should examine different settings such as *Islamic* financial institutions in different countries or various types of *Islamic* financial institutions. Future research in *Islamic* financial institutions may provide further theoretical extensions to related theories in this area of research.

The limitation of this study was that the findings were acquired through semi-structured interviews with *Shari'ah* Board members, NSACs, the Head of *Shari'ah* Departments (or *Shari'ah* officers) and CEO/COOs. Future studies should explore the same context of research by interviewing the technical expertise personnel in *Islamic* banks in order to obtain their views in accordance to their experiences.

The semi-structured interviews in this study were used to explain the problems and challenges facing *Islamic* banks in terms of the legal and regulatory frameworks, *Shari'ah* compliance, management, accounting and auditing; this assisted the researcher in the understanding of theoretical and practical problems and challenges facing this industry. In addition, the use of semi-structured interviews in this study may encourage other researchers to adopt such a method to extensively explore similar, or other, contexts in the *Islamic* banking industry.

REFERENCES

- Abdul-Rahman, A. R. 1998. Issues in corporate accountability and governance: An Islamic perspective. *The American Journal of Islamic Social Sciences* 15 (1):55-69.
- . 2003. Ethics in accounting education: Contribution of the Islamic principles of Masalih. *IIUM Journal of Economics and Management* 11 (1):1-18.
- . 2008. Shari'ah audit for Islamic financial services: The needs and challenges. In *International Shari'ah Research Academy (ISRA) Islamic Finance Seminar (IIFS)*. Kuala Lumpur: ISRA Islamic Finance Seminar, 1-14.
- Abdul-Rahman, A. R., and A. Goddard. 1998. An interpretive inquiry of accounting practices in religious organisations. *Financial Accountability & Management* 14 (3):183.
- Abdullah, M., S. Shahimi, and A. G. Ismail. 2011. Operational risk in Islamic banks: examination of issues. *Qualitative Research in Financial Markets* 3 (2):131-151.
- Abozaid, A., and A. W. Dusuki. 2007. The challenges of realizing Maqasid al-Shari'ah in Islamic banking finance, 1-19.
- AbuSulayman, A. A. 1993. *Towards an Islamic theory of international relations: New directions for methodology and thought*. edited by I. o. K. S. (1). Herndon, VA: International Institute of Islamic Thought.
- Adams, G. R., and J. D. Schvaneveldt. 2001. *Understanding research methods*. edited by J. D. Schvaneveldt. 2 ed. Longman Group: New York.
- Aggarwal, R. K., and T. Yousef. 2000. Islamic banks and investment financing. *Journal of Money, Credit and Banking* 32 (1):93-120.
- Ahmad, N., and S. Haron. 2002. Perceptions of Malaysian corporate customers towards Islamic banking products and services. *International Journal of Islamic Financial Services* 3 (4).
- Ahmad, Z. 1991. Islamic banking at the crossroads. In *Development & finance in Islam*, edited by A. H. M. Sadeq, A. H. Pramanik and N. M. N. Hassan. Kuala Lumpur: International Islamic University Press, 155-171.

- . 1994. Islamic banking: State of the art.
- . 2000. Conversion of interest-based to Islamic banking. In *Anthology of Islamic Banking*, edited by A. Siddiqi. London: Institute of Islamic Banking & Insurance, 83-96.
- Ahmed, H. 2004. *Role of zakat and awqaf in poverty alleviation*. Jeddah: Islamic Research and Training Institute, Islamic Development Bank Group.
- Ainley, M., A. Mashayekhi, R. Hicks, A. Rahman, and A. Ravalia. 2007. Islamic finance in the UK: Regulation and challenges: Financial Services Authority.
- Al-Attas, S. M. N. 2005. Islamic philosophy. *Journal of Islamic Philosophy* 1 (1):11-43.
- Al-Omar, F., and M. Abdel-Haq. 1996. *Islamic banking: theory, practice, and challenges*. London & New Jersey: Zed Books.
- Al-Saud, M. A.-F. 2000. A state of trusteeship. In *Anthology of Islamic banking*, edited by A. Siddiqi. London: Institute of Islamic Banking & Insurance, 3-5.
- Al-Shamali, F. A., A. Sharif, and Z. Irani. 2013. Islamic banking reinterpretation of the stakeholder theory. *Middle East Journal of Business* 4 (1):8-12.
- Al-Sultan, W. 1999. Financial characteristics of interest-free banks and conventional banks, University of Wollongong.
- Ali, M. 2000. Equity and morality in Islamic banking. In *Anthology of Islamic Banking*, edited by A. Siddiqi. London: Institute of Islamic Banking & Insurance, 62-68.
- Amir, A., and W. N. W. Azmi. 2004. X-efficiency of Bank Islam Malaysia Berhad (BIMB): A preliminary study. In *The National Seminar in Islamic Banking and Finance (iBAF) 2004: The Global Challenges and Competitiveness of Malaysian Financial Institutions* Malaysia.
- Anonymous. 2004. Report of the Islamic Capital Market Task Force of the International Organization of Securities Commissions. In *Islamic Capital Market Fact Finding Report*: OICU-IOSCO.
- Archer, S., and R. A. A. Karim. 2006. On capital structure, risk sharing and capital adequacy guidelines to Islamic banks. *Journal of Banking Regulation* 9 (3):269-280.

- Archer, S., R. A. A. Karim, and T. Al-Deehani. 1998. Financial contracting, governance structures and the accounting regulation of Islamic banks: An analysis in terms of agency theory and transaction cost economics. *Journal of Management and Governance* 2:149-170.
- Ariff, M. 1988. Islamic banking. *Asian-Pacific Economic Literature* 2 (2):48-64.
- Ariffin, N. M., S. Archer, and R. A. A. Karim. 2007. Transparency and market discipline in Islamic banks. Paper read at 6th International Conference on Islamic Economics and Finance, at Jakarta.
- Ariss, R. T., and Y. Sarieedine. 2007. Challenges in implementing capital adequacy guidelines to Islamic banks. *Journal of Banking Regulation* 9 (1):46-59.
- Arrow, K. J. 1974. *The limits of organization*. New York: W. W. Norton and Company.
- Askary, S., and F. Clark. 1997. Accounting in the Quranic verses. Paper read at International Conference, 'The Vehicle for Exploring and Implementing Shariah Islamiah in Accounting, Commerce and Finance', at University of Western Sydney: Macarthur.
- Asri, M., and M. Fahmi. 2013. *Contribution of the Islamic worldview towards corporate governance* 2004 [cited 14 July 2013].
- Ayub, M. 2007. *Understanding Islamic Finance*. West Sussex, UK: John Wiley & Sons.
- Aziz, Z. A. 2002. Accounting standards for Islamic financial institutions. *Special Address at the Second Seminar for Central Banks and Monetary Agencies*, 29 May 2002.
- . 2003. Building a comprehensive Islamic financial system: New opportunities. *Address at the Institute of Islamic Banking and Insurance International Conference (OIC) Business Forum*, 26 September 2003.
- . 2004a. New opportunities, new market and new frontier in islamic banking and finance. *ASLI's Conference on Developing Islamic Banking and Capital Market*, 25 August 2004.
- . 2004b. Towards creating and Islamic financial system as an integral part of the international financial system - strategies and challenges. *Address at the Asian Islamic Banking and Finance Summit*, 21 September 2004.

- . 2005. Designing a blueprint for a progressive *Islamic* banking sector. *Seminar on Ten-Year Masterplan for Islamic Financial Services Industry- 'Building a Progressive Islamic Banking Sector: Charting the Way Forward'*, 22 June 2005.
- . 2006. Towards building a robust Islamic financial system. *Address at the Second International Conference on Islamic Banking: Risk Management, Regulation and Supervision*, 7 February 2006.
- Bacha, O. I. 2008. The Islamic inter bank money market and a dual banking system: The Malaysian experience. *International Journal of Islamic and Middle Eastern Finance and Management* 1 (3):210-226.
- BAFIA. 1989. Banking and Financial Institutions Act 1989, edited by B. N. Malaysia. Kuala Lumpur.
- Banaga, A., G. Ray, and C. Tomkins. 1994. *External audit and corporate governance in Islamic banks: A joint practitioner-academic research study*. Vermont: Ashgate Publishing Company.
- Bank Negara Malaysia. 1993. Annual report 1993. Kuala Lumpur: Bank Negara Malaysia.
- . 1999. Annual report 1999. Kuala Lumpur: Bank Negara Malaysia.
- . 2000. Annual report 2000. Kuala Lumpur: Bank Negara Malaysia.
- . 2001. Annual report 2001. Kuala Lumpur: Bank Negara Malaysia.
- . 2002. Annual report 2002. Kuala Lumpur: Bank Negara Malaysia.
- . 2003. Annual report 2003. Kuala Lumpur: Bank Negara Malaysia.
- . 2005. Annual report 2005. Kuala Lumpur: Bank Negara Malaysia.
- . 2006. Annual report 2006. Kuala Lumpur Bank Negara Malaysia.
- Bashir, B. A. 1983. Portfolio management of Islamic banks : 'Certainty model'. *Journal of Banking & Finance* 7 (3):339-354.
- Batchelor, V. B. 2006. Comparable Measurement of Bank Productivity within a Dual Islamic and Conventional Banking System. In *2nd International Research Conference on*

Islamic Banking and Risk Management, Regulation and Supervision. Kuala Lumpur, Malaysia.

- Baydoun, N., and R. Willett. 1997. Islam and accounting: Ethical issues in the presentation of financial information. *Accounting, Commerce & Finance: The Islamic Perspective Journal* 1 (1):1-25.
- Benedict, A., and B. Elliott. 2008. *Financial Accounting: An Introduction*: Prentice Hall/Financial Times.
- Besar, M. H. A. H., M. E. A. Sukor, N. A. Muthalib, and A. Y. Gunawa. 2009. The practice of Shariah review as undertaken by Islamic banking sector in Malaysia. *International Review of Business Research Papers* 5 (1):294-306.
- Booth, P. 1993. Accounting in churches: A research framework and agenda. *Accounting, Auditing & Accountability Journal* 6 (4):37-67.
- Boyatzis, R. E. 1998. *Transforming qualitative information: Thematic analysis and code development*. London: Sage Publications.
- Brown, K., and M. Skully. 2007. Islamic banks from a global perspective. *Journal of Islamic Economics, Banking and Finance* 3 (2):1-29.
- Bryman, A. 2001. *Social research methods*. Oxford: Oxford University Press.
- Bryman, A., and E. Bell. 2007. *Business research methods*. 2nd ed. New York: Oxford University Press.
- Burns, J., and R. W. Scapens. 2000. Conceptualizing management accounting change: an institutional framework. *Management Accounting Research* 11 (1):3-25.
- Carmona, S., and M. Ezzamel. 2006. Accounting and religion: A historical perspective. *Accounting History* 11 (2):117-127.
- Carruthers, B. G. 1995. Accounting, ambiguity, and the new institutionalism. *Accounting, Organizations and Society* 20 (4):313-328.
- Chapra, M. U. 1979. *Objectives of the Islamic economic order*. Leicester, UK: The Islamic Foundation.

- Chapra, M. U. 1984. The nature of riba in Islam. *Hamdard Islamicus* 7 (1):3-24.
- . 1991. The need for a new economic system. *Review of Islamic Economics* 1 (1):9-47.
- Chapra, M. U. 1992. *Islam and the economic challenges*. 17 vols. Kano, Nigeria: The Islamic Foundation.
- . 2000. Is it necessary to have Islamic economics? *Journal of Socio-Economics* 29:21-37.
- Chapra, M. U., and T. Khan. 2000. Regulation and supervision of Islamic banks. Jeddah, Saudi Arabia: Islamic Research and Training Institute, Islamic Development Bank.
- Cheung, M. T., and Z. Liao. 2005. Recapitalization of Thailand's bank after the 1997 crisis: Interpretation and critique from a neo-institutional perspective. *Asia Pacific Business Review* 11 (3):411-427.
- Chik, M. N. 2011. Shariah audit: Shariah Perspective. In *International Shariah Audit Conference*. Crown Plaza Mutiara, Kuala Lumpur.
- Chowdhury, M. A. M. 1999. Resource allocation, investment decision and economic welfare: Capitalism, socialism and Islam. *Managerial Finance* 25 (5):34.
- Ciancanelli, P., and J. A. R. Gonzalez. 2000. Corporate governance in banking: A conceptual framework.
- Creswell, J. W. 1998. *Qualitative inquiry and research design choosing among five traditions*. Thousand Oaks: SAGE Publications, Inc.
- . 2003. *Research design qualitative, quantitative, and mixed methods approaches*. 2nd ed. Thousand Oaks: Sage Publications.
- . 2009. *Research design qualitative, quantitative, and mixed methods approaches*. 3rd ed. Thousand Oaks: Sage Publications.
- Dambrin, C., C. Lambert, and S. Sponem. 2007. Control and change - Analysing the process of institutionalisation. *Management Accounting Research* 18 (2):172-208.

- Dar, H. A. 2004. Demand for Islamic financial services in the UK: Chasing a mirage? In *Economic Research Paper*.
- Dar, H. A., and J. R. Presley. 2000. Lack of profit and loss sharing in Islamic banking: Management and control imbalances. Loughborough, United Kingdom: Centre for International, Financial and Economics Research, Department of Economics, Loughborough University.
- Davis, J. H., F. D. Schoorman, and L. Donaldson. 1997. Toward a Stewardship Theory of Management. *The Academy of Management Review* 22 (1):20-47.
- Deegan, C. 2002. Introducton: The legitimizing effect of social and environmental disclosures - a theoretical foundation. *Accountability, Auditing & Accountability Journal* 15 (3):282-311.
- DeLorenzo, Y. T. 2007. Shari'ah compliance risk. *Chicago Journal of International Law* 7 (397-408).
- DiMaggio, P. J., and W. W. Powell. 1983. The iron cage revisited: Institutional isomorphism and collective rationality in organizational fields. *American sociological review*:147-160.
- . 1991. *The new institutionalism in organizational analysis*. London: University of Chicago Press.
- Donaldson, T., and L. E. Preston. 1995. The stakeholder theory of the corporation: concepts, evidence, and implications. *The Academy of Management Review* 20 (1):65-91.
- Dusuki, A. W. 2005. Corporate social responsibility of Islamic banks in Malaysia: A synthesis of Islamic stakeholders' perspective, Loughborough University.
- . 2006. Corporate governance and stakeholder management of Islamic financial institutions. In *National Seminar in Islamic Banking and Finance 2006*. KUIM, Nilai.
- . 2008. Understanding the objectives of Islamic banking: A survey of stakeholders' perspectives. *International Journal of Islamic and Middle Eastern Finance and Management* 1 (2):132.
- Dusuki, A. W., and N. I. Abdullah. 2007a. Maqasid al-Shari'a, Maslahah and corporate social responsibility. *The American Journal of Islamic Social Sciences* 24 (1):25-45.

- Dusuki, A. W., and N. I. Abdullah. 2007b. Why do Malaysian customers patronise Islamic banks? *The International Journal of Bank Marketing* 25 (3):142.
- Dusuki, A. W., and A. Abozaid. 2007. A critical appraisal on the challenges of realizing Maqasid Al-Shari'ah in Islamic banking and finance. *IIUM Journal of Economics and Management* 15 (2):143-165.
- Ebrahim, M.-S., and A. Safadi. 1995. Behavioral norms in the Islamic doctrine of economics: A comment. *Journal of Economic Behavior and Organization* 27:151-157.
- El-Bannany, M. 2008. A study of determinants of intellectual capital performance in banks: The UK case. *Journal of Intellectual Capital* 9 (3):487-498.
- El-Din, S. I. T. *Issues in accounting standards for Islamic financial institutions* 2004 [cited 17 January 2008. Available from www.sbp.org.pk/departments/ibd/ISSUES_IN_ACCOUNTING_STANDARDS.pdf.
- El-Gamal, M. A. 1997. Can Islamic banking survive? A micro-evolutionary perspective. Madison: Department of Economics, University of Wisconsin, 1-16.
- El-Gamal, M. A., and H. Inannoglu. 2002. Efficiency vs. heterogeneous technologies in the Turkish banking: 1990-2000. In *Economic Working Paper*: Rice University.
- El-Hawary, D., W. Grais, and Z. Iqbal. 2004. Regulating Islamic financial institutions: The nature of the regulated. Washington: World Bank, 1-46.
- El-Hawary, D., W. Grais, and Z. Iqbal. 2007. Diversity in the regulation of Islamic financial institutions. *The Quarterly Review of Economics and Finance* 46:778-800.
- Erol, C., and R. El-Bdour. 1989. Attitudes, behaviour, and patronage factors of bank customers towards Islamic banks. *International Journal of Bank Marketing* 7 (6):31-37.
- Erol, C., E. Kaynak, and R. El-Bdour. 1990. Conventional and Islamic banks: Patronage behaviour of Jordanian customers. *International Journal of Bank Marketing* 8 (4):25-35.
- Errico, L., and M. Farahbaksh. 1998. Islamic banking: Issues in prudential regulations and supervision: International Monetary Fund, Monetary and Exchange Affairs Department, International Monetary Fund (IMF), 1-32.

- Fama, E. F. 1980. Agency problems and the theory of the firm. *The Journal of Political Science* 88 (2):288-307.
- Fama, E. F., and M. C. Jensen. 1983. Separation of ownership and control. *Journal of Law and Economics* 26:327-349.
- Fowler, F. J. 2002. *Survey research method*. Thousand Oaks, California: Sage Publications.
- Freeman, R. E. 1994. *Strategic management: a stakeholder approach*. Englewood Cliffs, NJ: Prentice Hall.
- Gait, A. H., and A. C. Worthington. 2008. An empirical survey of individual consumer, business firm and financial institution attitudes towards Islamic methods of finance. *International Journal of Social Economics* 35 (11):783-808.
- Gambling, T., R. Jones, and R. A. A. Karim. 1993. Credible organizations: Self-regulation v. external standard-setting in Islamic banks and British charities. *Financial Accountability & Management* 9 (3):195.
- Gerrard, P., and J. B. Cunningham. 1997. Islamic banking: A study in Singapore. *The International Journal of Bank Marketing* 15 (6):204.
- Ghauri, P., and K. Gronhaug. 2002. *Research methods in business studies: A practical guide*. 2nd ed. Essex: Pearson Education Limited.
- Ginena, K. 2014. Shari'ah risk and corporate governance of Islamic banks. *Corporate Governance* 14 (1):86-103.
- Gooden, S. 2001. Participation of stakeholders in the corporate governance of Islamic financial institutions. *New Horizon*, November, 12-15.
- Grais, W., and M. Pellegrini. 2006a. Corporate governance and Shariah compliance in institutions offering Islamic financial services: World Bank Policy Research.
- . 2006b. Corporate governance and stakeholders' financial interests in institutions offering Islamic financial services: World Bank Policy Research.
- . 2006c. Corporate governance in institutions offering Islamic financial services: Issues and options In *Journal of Islamic Economics, Banking and Finance*, 1-43.

- Hamid, S. A., and F. Ahmad. 2001. Rating of Malaysian commercial banks: A DEA approach. *Banker's Journal Malaysia* 118:5-8.
- Haniffa, R., and M. Hudaib. 2002. A theoretical framework for the development of the Islamic perspective of accounting. *Accounting, Commerce & Finance: The Islamic Perspective Journal* 6 (1&2):1-71.
- Haniffa, R., and M. Hudaib. 2007. Exploring the ethical identity of Islamic banks via communication in annual reports. *Journal of Business Ethics* 76 (1):97-116.
- Haniffa, R., M. Hudaib, and A. M. Mirza. 2004. Accounting policy choice within the Shariah Islamiah framework. Saudi Arabia: Department of Accounting & MIS, King Fahd University of Petroleum & Mineral, 1-27.
- Haron, S. 1997. *Islamic banking: Rules & regulations*. Kuala Lumpur: Pelanduk Publications.
- . 2000. The philosophy of Islamic banking. In *Anthology of Islamic banking*, edited by A. Siddiqi. London: Institute of Islamic Banking & Insurance, 55-58.
- Haron, S., N. Ahmad, and S. L. Planisek. 1994. Bank patronage factors of Muslim and non-Muslim customers. *The International Journal of Bank Marketing* 12 (1):32.
- Hasan, Z. 2010. New insights for agency theory in Islamic financial institutions: A reappraisal. In *Finance, Business and Economic Discussion Group of School of Government and International Affairs, Durham University*. Durham University.
- Hassan, M. K. 1999. Islamic banking in theory and practice: The experience of Bangladesh. *Managerial Finance* 25 (5):60-113.
- Hassan, M. K., and M. F. Dicle. 2005. Basel II and regulatory framework for Islamic banks. *Journal of Islamic Economics, Banking and Finance* 1 (1):1-16.
- Hassan, M. K., and M. K. Lewis. 2007. Product development and Shariah issues in Islamic finance. *Thunderbird International Business Review* 49 (3):281-284.
- Haunschild, P. R. 1993. Interorganizational imitation: The impact of interlocks on corporate acquisition activity. *Administrative Science Quarterly* 38 (4):564-592.
- Haveman, H. A. 1993. Mimetic Isomorphism and entry into new markets. *Administrative Science Quarterly* 38 (4):593-627.

- Hegazy, I. 1995. An empirical comparative study between Islamic and commercial banks' selection criteria in Egypt. *International Journal of Commerce and Management* 5 (3):46-61.
- Hofstede, G. 2000. *Cultures consequences, comparing values, behaviors, institutions, and organizations across nations*. 2 ed. Thousand Oaks, CA: Sage Publication.
- Hussain, M. M., and A. Gunasekaran. 2002. An institutional perspective of non-financial management accounting measures: A review of the financial services industry. *Managerial Auditing Journal* 17 (9):518.
- Hwang, S. 2008. Utilizing qualitative data analysis software: A review of Atlas.ti. *Social Science Computer Review* 26 (4):519-527.
- Ibrahim, S. H. M., and R. Yaya. 2005. Emerging issues on the objectives and characteristics of Islamic accounting for Islamic business organizations. *Malaysian Accounting Review*.
- IFSA. 2013. Islamic Financial Services Act 2013: Bank Negara Malaysia.
- IFSB 3. 2006. Guiding principles on corporate governance for institutions offering only Islamic financial services: Islamic Financial Services Board.
- IFSB 10. 2009. Guiding principles on Shari'ah governance systems for institutions offering Islamic financial services: Islamic Financial Services Board.
- Iqbal, M., A. Ahmad, and T. Khan. 1998. Challenges facing Islamic banking: Islamic Research and Training Institute, Islamic Development Bank.
- Iqbal, M., and P. Molyneux. 2005. *Thirty years of Islamic banking: History, performance and prospect*. London: Palgrave Macmillan.
- Iqbal, Z. 1997. Islamic financial system. *Finance & Development*, 42-45.
- . 2007. Challenges facing Islamic financial industry. *Journal of Islamic Economics, Banking and Finance* 3 (1):1-14.
- Iqbal, Z., and A. Mirakhor. 1987. Islamic banking: International Monetary Fund, 1-8.

- Iqbal, Z., and A. Mirakhor. 1999. Progress and challenges of Islamic banking. *Thunderbird International Business Review* 41 (4,5):381.
- . 2004. Stakeholders model of governance in Islamic economic system. *Islamic Economic Studies* 11 (2):44.
- Iqbal, Z., and A. Mirakhor. 2011. *An Introduction to Islamic Finance: Theory and Practice*: Wiley.
- Irvine, H. 2008. The global institutionalization of financial reporting: The case of the United Arab Emirates. *Accounting Forum (Elsevier)* 32 (2):125-142.
- Ismail, H., and R. A. Latif. 2001. *Survey & analysis of financial reporting of Islamic banks worldwide*. Selangor: HIZI Print Sdn. Bhd.
- Jensen, M. C., and W. H. Meckling. 1976. Theory of the firm: Managerial behavior, agency costs and ownership structure. *Journal of financial economics* 3 (4):305-360.
- Kahf, M. 1999. Islamic banks at the threshold of the third millennium. *Thunderbird International Business Review* 41 (4,5):445.
- . 2005a. Basel II: Implications for Islamic banking. In *6th International Conference on Islamic Economics and Banking*. Jakarta.
- . 2005b. Islamic banks: The rise of a new power alliance of wealth and Shari'a scholarship. *The Politics of Islamic Finance*. Edinburgh University Press: Edinburgh.
- . 2006. Maqasid al-Shariah in the prohibition of riba and their implications for modern Islamic finance. In *IIUM International Conference on Maqasid al Shari'ah*. Kuala Lumpur.
- Kahf, M., and M. F. Khan. 1992. Short-term financing of commodity production in Islamic banking. In *Seventh Annual Meeting of Experts on Islamic Banking*. Kuala Lumpur.: Kuala Lumpur.
- Kamali, M. H. 2003. *Principles of Islamic Jurisprudence*. 3 ed. Cambridge: Islamic Texts Society.
- Kamla, R. 2009. Critical insight into contemporary Islamic accounting. *Critical Perspectives on Accounting*.

- Kamla, R., S. Gallhofer, and J. Haslam. 2006. Islam, nature and accounting: Islamic principles and the notion of accounting for the environment. *Accounting Forum (Elsevier)* 30 (3):245-265.
- Karbhari, Y., K. Naser, and Z. Shahin. 2004. Problems and challenges facing the Islamic banking system in the west: The case of the UK. *Thunderbird International Business Review* 46 (5):521.
- Karim, R. A. A. 1990a. The independence of religious and external auditors: The case of Islamic banks. *Accounting, Auditing & Accountability Journal* 3 (3):34-44.
- . 1990b. Standard setting for the financial reporting of religious business organisations: The case of Islamic banks. *Accounting and Business Research* 20 (80):299-305.
- . 1995. The nature and rationale of a conceptual framework for financial reporting by Islamic banks. *Accounting and Business Research* 25 (100):285-300.
- . 2001. International accounting harmonization, banking regulation, and Islamic banks. *The International Journal of Accounting* 36 (2):169-193.
- Karim, R. A. A., and A. E.-T. Ali. 1989. Determinants of the financial strategy of Islamic banks. *Journal of Business Finance & Accounting* 16 (2):193-212.
- Karsten, I. 1983. Islam and financial intermediation. *Banker's Journal Malaysia* 46:32-50.
- Kasim, N., S. H. M. Ibrahim, and M. Sulaiman. 2009. Shariah auditing in Islamic financial institutions: Exploring the gap between the "Desired" and the "Actual". *Global Economy & Finance Journal* 2 (2):127-137.
- Kettell, B. 2002. *Islamic banking and finance in the Kingdom of Bahrain*. Manama: Bahrain Monetary Agency.
- Key, S. 1999. Toward a new theory of the firm: A critique of stakeholder "theory". *Management Decision* 37 (4):317-328.
- Khalil, A., C. Rickwood, and V. Murinde. 2002. *Agency contractual problems in profit-sharing financing practices by Islamic banks*. edited by M. Iqbal and D. Llewellyn. Cheltenham: Edward Elgar.

- Khan, M. A. 1991. Islamic economics: The state of the art. *Toward Islamization of Disciplines*:301ñ338.
- Khan, M. A. 2000. Globalization of financial markets and Islamic financial institutions. *Islamic Economic Studies* 8 (1):59-60.
- Khan, M. F. 1994. Comparative economics of some Islamic financing. *Islamic Economic Studies* 2 (1).
- Khan, M. F. 2007. Setting standards for Shariah application in the Islamic financial industry. *Thunderbird International Business Review* 49 (3):285.
- Khan, T., and H. Ahmed. 2001. Risk management: an analysis of issues in Islamic financial industry. *occasional paper* 5.
- Khair, K., L. Gupta, and B. Shanmugan. 2008. *Islamic banking: A practical perspective*. Selangor: Pearson Malaysia Sdn. Bhd.
- Kim, J., and J. T. Mahoney. 2005. Property rights theory, transaction costs theory, and agency theory: An organizational economics approach to strategic management. *Managerial and Decision Economics* 26:223-242.
- Klein, P. G. 2000. New institutional economics. *Encyclopedia of law and economics* 1:456-489.
- Konopásek, Z. 2008. Making thinking visible with Atlas.ti: Computer assisted qualitative analysis as textual practices. *Forum: Qualitative Social Research* 9 (2).
- Kuran, T. 1983. Behavioral norms in the Islamic doctrine of economics: A critique. *Journal of Economic Behavior & Organization* 4:353-379.
- . 1986. The economic system in contemporary Islamic thought: Interpretation and assessment. *International Journal of Middle East Studies* 18 (2):135-164.
- . 1995. Further reflections on the behavioral norms of Islamic economics. *Journal of Economic Behavior & Organization* 27 (1):159-163.
- Laldin, M. A. 2009. Shari'ah governance from scholars' perspective. In *Managing Shariah Risk through Shariah Governance*. London, UK: International Shari'ah Research Academy for Islamic Finance (ISRA), Institute for Islamic Banking and Insurance (IIBI), and Thomson Reuters.

- Laughlin, R. C. 1988. Accounting in its social context: An analysis of the accounting systems of the Church of England. *Accounting, Auditing & Accountability Journal* 1 (2):19-42.
- . 1990. A model of financial accountability and the Church of England. *Financial Accountability & Management* 6 (2):93.
- Laughlin, R. C., and A. G. Puxty. 1983. Accounting regulation: An alternative perspective. *Journal of Business Finance & Accounting* 10 (3):451-479.
- Levine, R. 2003. The corporate governance of banks.
- . 2004. The corporate governance of banks: A concise discussion of concepts and evidence: World Bank.
- Lewis, M. K. 2001. Islam and accounting. *Accounting Forum* 25 (2):103.
- . 2006. Accountability and Islam. In *Fourth International Conference on Accounting and Finance in Transition*. Adelaide, Australia.
- Lewis, M. K., and L. M. Algaoud. 2001. *Islamic banking*. UK: Edward Elgar Publishing Limited.
- Maali, B., P. Casson, and C. Napier. 2006. Social reporting by islamic banks. *Abacus* 42 (2):266-289.
- Maali, B., and C. Napier. 2007. Twenty-five years of Islamic accounting research: A silver jubilee review. In *Fifth Asia Pacific Interdisciplinary Research in Accounting Conference (APIRA2007)*. Auckland, New Zealand, 1-31.
- Majid, A., M. Zulkhibri, and F. Sufian. 2007. Market structure and competition in emerging market: evidence from Malaysian Islamic banking industry. *Journal of Economic Cooperation* 28 (2):99-121.
- Maniam, B., J. B. Bexley, and J. F. James. 2000. Perception of Islamic financial system: Its obstacles in application, and its market. *Academy of Accounting and Financial Studies Journal* 4 (2):22-36.
- Mason, J. 1996. *Qualitative researching*. London: Sage Publication Limited.

- . 2002. *Qualitative researching*. London: Sage Publications.
- Mat-Rahim, S. R., and R. H. Zakaria. 2013. Comparison on stability between Islamic and conventional banks in Malaysia. *Journal of Islamic Economics, Banking and Finance* 9 (3):131-149.
- Maurer, B. 2005. Implementing empirical knowledge in anthropology and Islamic accounting. In *Global Assemblages: Technology, Politics, and Ethics as Anthropological Problems*, edited by A. Ong and S. J. Collier. USA: Blackwell Publishing, 214-231.
- McCracken, G. 1988. *The long interview* Newbury Park: Sage Publications, Inc.
- Meenai, A. A. 1998. What is the objective behind the establishment of Islamic banks? *New Horizon*, 2.
- Metawa, S. A., and M. Almosawi. 1998. Banking behavior of Islamic bank customers: Perspectives and implications. *International Journal of Bank Marketing* 16 (7):299-313.
- Metwally, M. 1996. Attitudes of Muslims towards Islamic banks in a dual-banking system. *American Journal of Islamic Finance* 6 (1):11-17.
- Metwally, M. 2002. The impact of demographic factors on consumers' selection of a particular bank within a dual banking system: a case study. *Journal of International Marketing and Marketing Research* 27 (1):35-44.
- Metwally, M. M. 1997. Differences between the financial characteristics of interest-free banks and conventional banks. *European Business Review* 97 (2):92.
- Meyer, J. W., and B. Rowan. 1977. Institutionalized organizations: Formal structure as myth and ceremony. *The American Journal of Sociology* 83 (2):340-363.
- . 1991. Institutionalization organizations: Formal structure as myth and ceremony. *The New Institutionalism in Organizational Analysis*:41-62.
- Mirakhor, A. 1987. Analysis of short-term asset concentration in Islamic banking: International Monetary Fund, Research Department, 1-21.
- Mirakhor, A. 1997. Progress and challenges of Islamic banking. *Review of Islamic Economics* 4 (2):1-11.

- Mirza, M., and N. Baydoun. 1999. Do Islamic societies need their own accounting and reporting standards? *Journal of Academy of Business Administration* 4 (2):39-45.
- Mohamed Ibrahim, S. H. 2007. IFRS vs AAOIFI: The clash of standards: Munich Personal RePEc Archive (MPRA).
- Mohammad, M. O., and S. Shahwan. 2013. The objective of Islamic economic and Islamic banking in light of Maqasid Al-Shariah: A critical review. *Middle-East Journal of Scientific Research (Research in Contemporary Islamic Finance and Wealth Management)* 13:75-84.
- Mohd Ariffin, N. 2005. Enhancing transparency and risk reporting in Islamic banks, School of Management, University of Surrey, Surrey, United Kingdom.
- Mohd Ariffin, N., S. Archer, and R. A. A. Karim. 2009. Risks in Islamic banks: Evidence from empirical research. *Journal of Banking Regulation* 10 (2):153-163.
- Mohd-Zamil, N. A., and A. R. Abdul-Rahman. 2007. Efficiency of Islamic and conventional commercial banks in Malaysia: A Data Envelopment Analysis (DEA) study. In *IUM International Conference on Islamic Banking and Finance (IICiBF 2007)*. Kuala Lumpur, Malaysia.
- Mokhtar, H. S. A., N. Abdullah, and S. M. Alhabshi. 2008. Efficiency and competition of Islamic banking in Malaysia. *Humanomics* 24 (1):28-48.
- Muda, M., and A. Jalil. 2007. Islamic financial product development: Shariah analysis, 1-15.
- Muda, R., and A. G. Ismail. 2011. Profit-loss sharing and economic value added in Islamic banking model: Research Center for Islamic Economics and Finance, 1-22.
- Muslehuddin, M. 1974. *Economics and Islam*. Lahore: Islamic Publications.
- Muslim, A., and I. Zaidi. 2008. An examination of the relationship between service quality perception and customer satisfaction. *International Journal of Islamic and Middle Eastern Finance and Management* 1 (3):191.
- Napier, C. 2007. Other cultures, other accountings? Islamic accounting from past to present. In *5th Accounting History International Conference*. Banaff, Canada.
- Napier, C. 2009. Defining Islamic accounting: Current issues, past roots. *Accounting History* 14 (1 & 2):121-144.

- Naser, K., A. Jamal, and K. Al-Khatib. 1999. Islamic banking: A study of customer satisfaction and preference in Jordan. *International Journal of Bank Marketing* 17 (3):135-150.
- Nasir, M. N., and A. Zainol. 2005. Globalization of financial reporting: An islamic focus. In *Globalization of Accounting Standards Conference*. Prato, Italy.
- Naughton, S., and B. Shanmugan. 1990. Interest-free banking: A case of Malaysia *Journal of Islamic Banking and Finance*:40-57.
- Nawawi, R. 1999. *Islamic law or commercial transaction*. Kuala Lumpur: CT Publication Sdn. Bhd.
- Neuman, W. L. 2000. *Social research methods qualitative and quantitative approaches*. Needham Heights: Allyn and Bacon.
- Nor, M. Y. 2002. Islamic financial market development: The Malaysian strategy. *The Kuala Lumpur International Islamic Capital Market*, 26 - 27 March 2002.
- Nyazee, I. A. K. 2000. *Islamic jurisprudence: Usul Al-Fiqh*. Vol. 3: International Institute of Islamic Thought.
- Okuda, H., and H. Hashimoto. 2004. Estimating cost functions of Malaysian commercial banks: The differential effects of size, location, and ownership. *Asian Economic Journal* 18 (3):233-259.
- Oppenheim, A. N. 1992. *Questionnaire design, interviewing and attitude measurement*. New York: Continuum.
- Perks, R. W. 1993. *Accounting and society*. 1st ed. London: Chapman.
- Perro, V. C., and S. C. Ruoff. 1997. Improving accountability in banking. *Commercial Lending Review* 12 (3):44-50.
- Pomeranz, F. 1997. The accounting and auditing organization for Islamic Financial Institutions: An important. *Journal of International Accounting, Auditing & Taxation* 6 (1):123.
- Pramanik, A. H. 1993. *Development and distribution in Islam*. Kuala Lumpur: Pelanduk Publications.

- Qayum, K. 1998. The scope and challenges of Islamic banking. *New Horizon*, August, 13-18.
- Quinn, D. P., and T. M. Jones. 1995. An agent morality view of business policy. *Academy of Management Review* 20 (1):22-42.
- Qureshi, A. I. 1991. *Islam & theory of interest*. Lahore: Sh Muhammad Ashraf.
- Rammal, H. G., and L. D. Parker. 2012. Islamic banking in Pakistan: A history of emergent accountability and regulation. *Accounting History* 18 (1):5-29.
- Ratna, M. 2011. The Islamic financial industry in the wave of IFRS convergence: Survey of issues and development. In *5th IIUM International Accounting Conference*. Kuala Lumpur, Malaysia.
- Riaz, S. 2009. The global financial crisis: An institutional theory analysis *Critical Perspectives on International Business* 5 (1/2):26-35.
- Roberts, J., and R. Scapens. 1985. Accounting systems and systems of accountability -- understanding accounting practices in their organisational contexts. *Accounting, Organizations and Society* 10 (4):443-456.
- Robson, C. 1993. *Real world research: A resource for social scientists and practitioner-researchers*. Oxford, UK: Blackwell Publishing.
- Rosly, S. A. 1999. Al-Bay' Bithaman Ajil financing: Impacts on Islamic banking performance. *Thunderbird International Business Review* 41 (4,5):461.
- . 2005a. *Critical issues on Islamic banking and financial markets*. Kuala Lumpur: Dinamas.
- . 2005b. Islamic banking: Doing things right and doing right things. *Malaysian Journal of Economics Studies* 42 (1,2):31-40.
- Rosly, S. A., and A. B. M. Afandi. 2003. Performance of Islamic and mainstream banks in Malaysia. *International Journal of Social Economics* 30 (12):1249-1265.
- Rosly, S. A., and M. Sanusi. 1999. The application of Bay' Al-Inah and Bay' Al-Dayn in Malaysian Islamic bonds: An Islamic analysis. *International Journal of Islamic Financial Services* 1 (2).

- Rosly, S. A., and M. A. M. Zaini. 2008. Risk-return analysis of Islamic banks' investment deposits and shareholders' fund. *Managerial Finance* 34 (10):695.
- Saaïd, A. e. E., S. A. Rosly, M. H. Ibrahim, and N. Abdullah. 2003. The X-Efficiency of the Sudanese Islamic banks. *IJUM Journal of Economics and Management* 11 (2):123-141.
- Sadeq, A. H. M. 1990. *Economic development in Islam*. Kuala Lumpur: Pelanduk Publications.
- Safieddine, A. 2009. Islamic financial institutions and corporate governance: New insights for agency theory. *Corporate Governance: An International Review* 17 (2):142-158.
- Samad, A. 1999. Comparative efficiency of the Islamic bank vis-a-vis conventional banks in Malaysia. *IJUM Journal of Economics and Management* 7 (1):1-27.
- . 2004. Performance of interest free Islamic banks vis-à-vis interest based conventional banks of Bahrain. *IJUM Journal of Economics and Management* 12 (2):115-129.
- Samad, A., N. D. Gardner, and B. J. Cook. 2005. Islamic banking and finance in theory and practice: The experience of Malaysia and Bahrain. *The American Journal of Islamic Social Sciences* 22 (2):69-86.
- Samad, A., and M. K. Hassan. 1999. The performance of Malaysian Islamic bank during 1984-1997: An exploratory study. *International Journal of Islamic Financial Services* 1 (3):1-14.
- Sarker, M. A. A. 1999a. Islamic banking in Bangladesh: Performance, problems & prospect. *International Journal of Islamic Finance Services* 1 (3).
- . 1999b. Islamic business contracts, agency problem and the theory of the Islamic firm. *International Journal of Islamic Financial Services* 1 (2):12-28.
- Satkunasingam, E., and B. Shanmugam. 2004. Disclosure and governance of Islamic banks: A case study of Malaysia. *Journal of International Banking Regulation* 6 (1):69-81.
- Saunders, M., P. Lewis, and A. Thornhill. 2000. *Research method for business students*. 2nd ed. England: Pearson Education Limited.

- Scapens, R. W. 2006. Understanding management accounting practices: A personal journey. *The British Accounting Review* 38:1-30.
- Scott, W. R. 1995. *Institutions and organizations*. Thousand Oaks, CA: Sage.
- . 2001. *Institutions and organizations*. Thousand Oaks, CA: Sage.
- . 2005. *Institutional theory: Contributing to a theoretical research program*.
- Shafii, Z., S. Salleh, H. M. M. Hanefah, and K. Jusoff. 2013. Human capital development in Shari'ah Audit. *Middle-East Journal of Scientific Research (Research in Contemporary Islamic Finance and Wealth Management)* 13:28-34.
- Shankman, N. A. 1999. Reframing the debate between agency and stakeholder theories of the firm. *Journal of Business Ethics* 19:319-334.
- Shi, W., N. Shambare, and J. Wang. 2007. The adoption of internet banking: An institutional theory perspective. *Journal of Financial Services Marketing* 12 (4):272-286.
- Siddiqi, M. N. 1981. *Muslim Economic Thinking*. Leicester: The Islamic Foundation.
- . 1983. *Banking without interest*. Leicester: The Islamic Foundation.
- Siddiqi, M. N. 1986. *Model of an Islamic bank*. Chicago: Kazi Publication.
- Siddiqi, M. N. 2006a. Islamic banking and finance in theory and practice: A survey of state of the art. *Islamic Economic Studies* 13 (2):1-48.
- . 2006b. Shariah economics and the progress of Islamic finance: The role of Shariah experts. In *Pre-Forum Workshop on Select Ethical and Methodological Issues in Shariah-Compliant Finance, 7th Harvard Forum on Islamic Finance*. Cambridge, Massachusetts, USA.
- Siddiqi, S. H. 2001. Islamic banking: True modes of financing. *New Horizon*, May-June.
- Simon, H. 1985. Human nature in politics: The dialogue of psychology with political science. *Journal of Law, Economics, and Organization* 11:293-304.
- Smith, D. 2000. Islamic finance - Past, present and future. In *Anthology of Islamic Banking*, edited by A. Siddiqi. London: Institute of Islamic Banking and Insurance, 97-101.

- Solé, J. 2007. Introducing Islamic banks into conventional banking systems. Washington: International Monetary Fund, 1-26.
- Solomon, J. 2007. *Corporate Governance and Accountability*: John Wiley & Sons.
- Sufian, F. 2007. The efficiency of Islamic banking industry in Malaysia foreign vs domestic banks. *Humanomics* 23 (3):174-192.
- Sulaiman, M., N. A. Majid, and N. M. Ariffin. 2011. Corporate governance of Islamic Financial Institutions in Malaysia. In *8th International Conference on Islamic Economics and Finance*. Doha, Qatar.
- Sulaiman, M., and R. Willett. 2003. Using Hofstede-Gray framework to argue normatively for an extension of Islamic Corporate Reports. *Malaysian Accounting Review* 2 (1):1-35.
- Sundararajan, V., and L. Errico. 2002. Islamic financial institutions and products in the global financial system: Key issues in risk management and challenges ahead. In *Risk Management in an Islamic Financial System*. Central Bank of the Islamic Republic of Iran, Tehran: International Monetary Fund.
- Susela, S. D. 1999. "Interests" and accounting standard setting in Malaysia. *Accounting, Auditing & Accountability Journal* 12 (3):358.
- Tafri, F. H., R. Abdul-Rahman, and N. Omar. 2011. Empirical evidence on the risk management tools practised in Islamic and conventional banks. *Qualitative Research in Financial Markets* 3 (2):86-104.
- Taylor, P., and S. Turley. 1986. *The regulation of accounting*. Oxford: Basil Blackwell Ltd.
- Triuwono, I. 2004. Trust (Amanah), the divine symbol: Interpretations in the context of Islamic banking and accounting practices. In *Fourth Asia Pacific Interdisciplinary Research in Accounting Conference*. Singapore.
- Ullah, S., D. Jamali, and I. A. Harwood. 2014. Socially responsible investment: insights from Shari'a departments in Islamic financial institutions. *Business Ethics: A European Review* 23 (2):218-233.
- Usmani, T. 2006. *Musharakah and Mudharabah* n.d. [cited 16 June 2006].

- Venardos, A. M. 2005. *Islamic banking & finance in South-East Asia: Its development & future*. Singapore: World Scientific Publishing Co. Pte. Ltd.
- Williamson, O. E. 1987. Transaction cost economics: The comparative contracting perspective. *Journal of Economic Behavior & Organization* 8 (4):617-625.
- . 1998. Transaction cost economics: How it works; where it is headed? *De Economist* 146 (1):23-58.
- Wilson, R. 1995. Islamic development in Malaysia. In *Leading issues in Islamic banking and finance*, edited by S. Al-Harran. Kuala Lumpur: Pelanduk Publications, 59-81.
- . 1999. Challenges and opportunities for Islamic banking and finance in the West: The United Kingdom experience. *Thunderbird International Business Review* 41 (4,5):421.
- . 2000. Islamic banking and its impact. In *Anthology of Islamic Banking*, edited by A. Siddiqi. London: Institute of Islamic Banking & Insurance., 69-73.
- . 2007. Islamic finance in Europe. *Journal of Islamic Economics, Banking and Finance* 3 (2):1-32.
- Wong, S. S. 1995. Bank Islam Malaysia: Performance evaluation, 1983-1993. In *Leading issues in Islamic banking and finance*, edited by S. Harran. Kuala Lumpur: Pelanduk Publications, 83-101.
- Yahaya, N. Y. 2005. X-efficiency and technological innovation in Malaysian banks. In *Malaysian Finance Association 7th Annual Conference Consolidation and Prudent Financial Management: Road to Malaysian Economic Prosperity*. Terengganu Malaysia.
- Yahya, S., C. W. Hooy, and W. K. Goh. 2001. Rating of Malaysian commercial banks: A DEA approach. *Banker's Journal Malaysia* 118 (5-18).
- Yakcop, N. M. 2003. From moneylenders to bankers: Evolution of Islamic banking in relation to Judeo - Christian and oriental banking traditions. In *International Islamic Banking Conference*. Prato, Italy.
- Yamak, S., and Ö. Süer. 2005. State as a stakeholder. *Corporate Governance* 5 (2):111-120.

- Yap, K. L., and R. A. Kader. 2008. Impact of interest rate changes on performance of Islamic and conventional banks. *Malaysian Journal of Economic Studies* 45 (2):113-134.
- Yudistira, D. 2003. Efficiency in Islamic banking: An empirical analysis of 18 banks. *Journal of Economic Literature*.
- Zaher, T. S., and M. K. Hassan. 2001. A comparative literature survey of Islamic finance and banking. *Financial Markets, Institutions & Instruments* 10 (4):155-199.
- Zaid, O. A. 1995. Accounting books and reports in the Islamic states. In *Accounting, Commerce and Finance: The Islamic Perspective International Conference 1*.
- Zainuddin, Y., N. Jahyd, and T. Ramayah. 2004. Perception of Islamic banking: Does it differ among users and non users. *Jurnal Manajemen dan Bisnis* 6 (3):221-232.
- Zaman, M. R., and H. Movassaghi. 2001. Islamic banking a performance analysis. *The Journal of Global Business* 12 (22):31-38.

APPENDICES

Appendix 1 Milestones of Malaysia's Legislation and Guidelines

YEAR	LEGISLATION AND GUIDELINES
1965	Companies Act 1965
1983	The <i>Islamic</i> Banking Act 1983
1983	Government Investment Act 1983
1984	The <i>Takaful</i> Act 1984
1989	Amendment of BAFIA 1989 (Section 124)
1993	SPTF Guideline 1993 (Interest-free Banking Scheme's Guidelines)
2001	
2002	Guidance Notes on the Sell and Buy Back Agreement by Bank Negara Malaysia
2002	<i>Islamic</i> Financial Standards Board (IFSB) was established
2002	International <i>Islamic</i> Financial Market (IIFM) was established
2002	<i>Islamic</i> Financial Board Act 2002
2003	Introduction of <i>Islamic</i> Variable Rate Mechanism
2003	Framework of the Rate of Return.
2003	Guidelines on the Specimen Reports and Financial Statements for Licensed <i>Islamic</i> Banks (GP8-i) to promote consistency and standardize the presentation and disclosure of financial statements.
2004	Guidelines on Directorship in the <i>Islamic</i> Banks GP1-i
2004	Guidelines on Financial Reporting for Licensed Institutions or BNM/GP8
2004	Revised Framework of the Rate of Return
2004	A similar Market Risk Capital Adequacy Framework
2004	Bank Negara Malaysia issued a two-phase implementation approach for the <i>Islamic</i> banks following the issuance of the two-phase implementation approach of Basel II
2004	Policy on <i>Takaful</i> Coverage for financing-I (<i>Islamic</i> Financing)
2004	On-line system known as Product Approval & Repository System (PARS)
2004	Guidelines on the Governance of <i>Shari'ah</i> Committee for the <i>Islamic</i> Financial Institutions
2004	Government of Malaysia announced the tax neutrality policy for <i>Islamic</i> banking and finance in the 2005 Budget to create an equitable tax treatment of <i>Islamic</i> banking and financial transactions vis-à-vis similar conventional banking transactions
2009	Central Bank of Malaysia Act 2009
2013	<i>Islamic</i> Financial Service Act 2013
2013	Financial Service Act 2013

Appendix 2 Guidelines and Circular introduced by BNM for *Islamic* banks operate in Malaysia

No	Guidelines
Capital Adequacy	
1	Capital Adequacy Framework for <i>Islamic</i> Banks**updated 2011/01/10 Attachment 1 Attachment 2
2	Guidelines on Recognition and Measurement of Profit Sharing Investment Account as Risk Absorbent
3	Guideline on Minimum Capital Funds Unimpaired by Losses for <i>Islamic</i> Banks **updated 2008/09/23
4	Risk-Weighted Capital Adequacy Framework and Capital Adequacy Framework for <i>Islamic</i> Banks (General Requirements and Capital Components) **updated 2011/01/07
5	Capital Adequacy Framework for <i>Islamic</i> Banks (CAFIB) - Disclosure Requirements (Pillar 3) **updated 2010/12/17
6	Capital Adequacy Framework for <i>Islamic</i> Banks (CAFIB) - Internal Capital Adequacy Assessment Process (Pillar 2) **NEW 2010/12/08
Financial Reporting	
7	Guidelines on Financial Reporting for Licensed <i>Islamic</i> Banks
8	Circular on the Application of FRS and Revised Financial Reporting Requirements for <i>Islamic</i> Banks **NEW 2010/02/09
Prudential Limits & Standards	
9	Statutory Reserve Requirement
10	Liquidity Framework-i (for <i>Islamic</i> Banking Institutions)
11	Guidelines on Accepted Bill-i (AB-i)
12	Guidance Notes on Sell and Buy Back Agreement Transactions
13	<i>Shari'ah</i> Resolutions in <i>Islamic</i> Finance
14	Guideline of Introduction of New Products
15	Guidelines on Investment in Shares, Interest-in- Shares and Collective Investment Schemes for <i>Islamic</i> Banks. **updated 2008/10/09
16	Guidelines on Musharakah and Mudharabah Contracts for <i>Islamic</i> Banking Institutions
17	Guidelines on Corporate Governance for Licensed <i>Islamic</i> Banks (Revised BNM/GP1-i) ** updated 2011/02/28 Attachment 1 ** NEW 2011/02/28
18	Guidance Notes on Sell and Buy Back Agreement Transactions
19	<i>Shari'ah</i> Resolutions in <i>Islamic</i> Finance
20	Guidelines on Investment in Shares, Interest-in- Shares and Collective Investment Schemes for <i>Islamic</i> Banks. **updated 2008/10/09
21	Guidelines on Musharakah and Mudharabah Contracts for <i>Islamic</i> Banking Institutions

No	Guidelines
22	Guidelines on Corporate Governance for Licensed <i>Islamic</i> Banks (Revised BNM/GP1-i) ** updated 2011/02/28 Attachment 1 (ZIP,43KB) ** NEW 2011/02/28
23	Guidelines on Credit Transactions and Exposures with Connected Parties for <i>Islamic</i> Banks **updated 2008/04/23
24	Guidelines on the Governance of <i>Shari'ah</i> Committee for the <i>Islamic</i> Financial Institutions
25	Guidelines on International <i>Islamic</i> Bank **updated 2010/01/13
26	Appointment of External Auditors by <i>Islamic</i> Banks **updated 2008/04/24
27	Guidelines on Permitted Capital Market Activities by <i>Islamic</i> Banks
28	Guidelines on <i>Skim Perbankan Islam</i> (consolidated)
29	Prohibition on Specific/ Restricted and Loss-Bearing Fund Placement from <i>Islamic</i> Banks to Parent Banking Institutions **updated 2010/01/13
30	Activities by <i>Islamic</i> Banks **updated 2010/04/01
<i>Shari'ah</i>	
31	<i>Shari'ah</i> Parameter Reference 1 - Murabahah **updated 2009/09/03 Related attachment: <i>Shari'ah</i> Parameter Reference 1: Murabahah Contract (Frequently Asked Questions) **updated 2009/09/01
32	<i>Shari'ah</i> Governance Framework for <i>Islamic</i> Financial Institutions ** updated 2010/10/26
33	Concept Paper on <i>Shari'ah</i> Parameter Reference 4: Musharakah Contract ** NEW 2010/06/15 Attachment 1: Draft of <i>Shari'ah</i> Parameter Reference 4: Musharakah Contract Attachment 2: Feedback Form on Draft of <i>Shari'ah</i> Parameter Reference 4: Musharakah Contract (SPR4)
34	Schedule of <i>Shari'ah</i> Advisory Council Meetings for 2011 ** NEW 2010/12/28
35	Concept Paper on <i>Shari'ah</i> Parameter Reference 5: Istisna' Contract ** NEW 2010/12/28 Attachment 1: Draft of <i>Shari'ah</i> Parameter Reference 5: Istisna' Contract Attachment 2: Feedback Form on Draft of <i>Shari'ah</i> Parameter Reference 5: Istisna' Contract (SPR5)

Appendix 3 List of Standards issue by AAOIFI

Standards	Contents
Accounting standards:	<ol style="list-style-type: none"> 1. Objective of financial accounting for <i>Islamic</i> banks and financial institution (IFIs). 2. Concept of financial accounting for IFIs. 3. General presentation and disclosure in the financial statements of IFIs. 4. Murabaha and Murabaha to the purchase orderer. 5. Mudaraba financing. 6. Musharaka financing. 7. Disclosure of bases for profit allocation between owners' equity and investment account holders. 8. Equity of investment account holders and their equivalent. 9. Salam and Parallel Salam. 10. Ijarah and Ijarah Muntahia Bittamleek. 11. Zakah. 12. Istisna'a and Parallel Istisna'a. 13. Provisions and Reserves. 14. General Presentation and Disclosure in the Financial Statements of <i>Islamic</i> Insurance Companies. 15. Disclosure of Bases for Determining and Allocating Surplus or Deficit in <i>Islamic</i> Insurance Companies. 16. Investment Funds. 17. Provisions and Reserves in <i>Islamic</i> Insurance Companies. 18. Foreign Currency Transactions and Foreign Operation. 19. Investments. 20. <i>Islamic</i> Financial Services Offered by Conventional Financial Institutions. 21. Contributions in <i>Islamic</i> Insurance Companies. 22. Deferred Payment Sale. 23. Disclosure on Transfer of Assets. 24. Segment Reporting.

Standards	Contents
	25. Consolidation. 26. Investment in Associates.
Auditing standards:	1. Objective and principles of auditing. 2. The Auditor's Report. 3. Terms of Audit Engagement. 4. Testing for Compliance with <i>Shari'ah</i> Rules and Principles by an External Auditor. 5. The Auditor's Responsibility to Consider Fraud and Error in an Audit of Financial Statements.
Governance standards:	1. <i>Shari'ah</i> Supervisory Board: Appointment, Composition and Report. 2. <i>Shari'ah</i> Review. 3. Internal <i>Shari'ah</i> Review. 4. Audit and Governance Committee for IFIs. 5. Independence of <i>Shari'ah</i> Supervisory Board. 6. Statement on Governance Principles for IFIs. 7. Corporate Social Responsibility.
Ethics standards:	1. Code of ethics for accountants and auditors of IFIs. 2. Code of ethics for employees of IFIs.
<i>Shari'ah</i> Standards:	1. Trading in currencies. 2. Debit Card, Charge Card and Credit Card. 3. Default in Payment by a Debtor. 4. Settlement of Debt by Set-Off. 5. Guarantees. 6. Conversion of a Conventional Bank to an <i>Islamic</i> Bank. 7. Hawala. 8. Murabaha to the Purchase Orderer. 9. Ijarah and Ijarah Muntahia Bittamleek. 10. Salam and Parallel Salam. 11. Istisna'a and Parallel Istisna'a. 12. Sharika (Musharaka) and Modern Corporations. 13. Mudaraba. 14. Documentary Credit.

Standards	Contents
	15. Jua'la. 16. Commercial Papers. 17. Investment Sukuk. 18. Possession (Qabd). 19. Loan (Qard). 20. Commodities in Organised Markets. 21. Financial Papers (Shares and Bonds). 22. Concession Contracts. 23. Agency. 24. Syndicated Financing. 25. Combination of Contracts. 26. <i>Islamic</i> Insurance. 27. Indices. 28. Banking Services. 29. Ethics and stipulations for Fatwa. 30. Monetization (Tawarruq) 31. Gharar Stipulations in Financial Transactions 32. Arbitration 33. Waqf 34. Ijarah on Labour (Individuals) 35. Zakah 36. Impact of Contingent Incidents on Commitments 37. Credit Agreement 38. Online Financial Dealings 39. Mortgage and its Contemporary Applications 40. Distribution of Profit in Mudarabah-based Investments Accounts 41. Islamic Reinsurance 42. Financial Rights and Its Disposal Management 43. Liquidity and Its Instruments 44. Bankruptcy 45. Capital and Investment Protection

Appendix 4 Additional and Updated Guidelines and Circular introduced by BNM for Islamic Banks operate in Malaysia

No	Guidelines
Capital Adequacy	
1	Capital Adequacy Framework for Islamic Banks (Risk-Weighted Assets) **effective 1 st January 2013 Attachment 1 – Reporting Manual Attachment 2 – Reporting Templates
2	Guidelines on Recognition and Measurement of Profit Sharing Investment Account as Risk Absorbent **updated 2011/07/26
3	Capital Adequacy Framework for Islamic Banks (Capital Components) ** <i>effective 1st January 2013</i> i. Attachment 1 - Response to Feedback Received ii. Attachment 2 - Capital Components Reporting Forms and Manual Attachment 3 - Capital Instruments Eligible for Gradual Phase-Out Treatment
4	Capital Adequacy Framework for Islamic Banks (CAFIB) - Disclosure Requirements (Pillar 3) ** <i>updated 2010/12/17</i>
5	Capital Adequacy Framework for Islamic Banks (CAFIB) - Internal Capital Adequacy Assessment Process (Pillar 2) ** <i>updated</i>
Financial Reporting	
6	Financial Reporting for Islamic Banking Institutions** <i>2013/06/28</i>
Prudential Limits & Standards	
7	Guidance Notes on Sell and Buy Back Agreement * <i>updated 2013/06/28</i>
8	Guidelines on Corporate Governance for Licensed Islamic Banks (Revised BNM/GP1-i) ** <i>updated 2013/06/19</i> Attachment 1 (ZIP,43KB)
9	Guidelines on Credit Transactions and Exposures with Connected Parties for Islamic Banks ** <i>updated 2014/07/21</i>
10	Guidelines on the Governance of Shariah Committee for the Islamic Financial Institutions * Same guideline applies to Banking
11	Guidelines on International Islamic Bank ** <i>updated 2010/01/13</i>
12	Guidelines on Permitted Capital Market Activities by Islamic Banks
13	Guidelines on <i>Skim Perbankan Islam</i>
14	Prohibition on Specific/ Restricted and Loss-Bearing Fund Placement from Islamic Banks to Parent Banking Institutions ** <i>updated 2010/01/13</i>
15	Guidelines on Property Development and Property Investment Activities by Islamic Banks ** <i>updated 2010/04/01</i>
16	Guidelines on Ibra' (Rebate) for Sale-Based Financing * Same guideline applies to Banking, Insurance & Takaful and Development Financial Institutions** <i>NEW 2013/02/04</i>
17	Prudential Standards on Securitisation Transactions for Islamic Banks ** <i>NEW 2013/06/28</i>
18	Application to be Approved as Financial Holding Company Pursuant to Sections 280(2) and 280(3) of the Financial Services Act 2013 and Section 290(1) of the Islamic Financial Services Act 2013 ** <i>NEW 2013/06/28</i>
19	Capital Funds for Islamic Banks
20	Regulatory treatment for IILM Sukuk

No	Guidelines
21	Single Counterparty Exposure Limit for Islamic Banking Institutions Attachment 1
22	Islamic Corporation for the Development of the Private Sector (ICD) as an Interbank Player
23	Application to be Approved as Financial Holding Company Pursuant to Sections 280(2) and 280(3) of the Financial Services Act 2013 and Section 290(1) of the Islamic Financial Services Act 2013 <i>NEW 2013/06/28</i>
24	Fit and Proper Criteria <i>** NEW 2013/06/28</i>
25	External Auditor <i>**effective until 31 December 2014</i>
26	External Auditor <i>** effective 1 January 2015</i>
27	Appointed Actuary : Appointment and Duties <i>** Updated 2014/04/28</i> Attachment 1 - Response to Feedback Received
28	Operational Risk Management
Shari'ah	
29	iii. Shariah Governance Framework for Islamic Financial Institutions <i>** updated 2010/10/26</i> This supersedes previous guideline below: Guidelines on the Governance of Shariah Committee for the Islamic Financial Institutions
30	Concept Paper on Shariah Parameter Reference 4: Musharakah Contract <i>** NEW 2010/06/15</i> Attachment 1: Draft of Shariah Parameter Reference 4: Musharakah Contract Attachment 2: Feedback Form on Draft of Shariah Parameter Reference 4: Musharakah Contract (SPR4)
31	Schedule of Shariah Advisory Council Meetings for 2013 <i>** updated 2012/12/03</i>
32	Concept Paper on Shariah Parameter Reference 5: Istisna' Contract <i>** NEW 2010/12/28</i> Attachment 1: Draft of Shariah Parameter Reference 5: Istisna' Contract Attachment 2: Feedback Form on Draft of Shariah Parameter Reference 5: Istisna' Contract (SPR5)
33	Resolutions of Shariah Advisory Council of Bank Negara Malaysia 2010 - 2011 <i>** NEW 2012/07/11</i>
34	Concept paper on Shariah Requirements, Optional Practices and Operational Requirements of Musharakah <i>** NEW 2013/12/20</i>
35	Concept paper on Shariah Requirements, Optional Practices and Operational Requirements of Mudarabah <i>** NEW 2013/12/20</i>
36	Concept paper on <i>Ijarah</i> <i>** NEW 2014/06/24</i>
37	Concept paper on <i>Istisna'</i> <i>** NEW 204/06/24</i>

Appendix 5 Corresponding Letters

Cardiff Business School
 Director Professor Roger Mansfield MA PhD (Cantab)
 Asian Accounting Finance and Business Research Unit
 Director Dr Yusuf Karbhari BA (Hons) MBA PhD (LTM)



Cardiff University
 Aberconway Building
 Colum Drive
 Cardiff CF10 3EU
 Wales UK
 Tel: +44(0)29 2087 4000
 Fax: +44(0)29 2087 4419
 www.cardiff.ac.uk

28 September, 201N

Dear Sir/Madam,

Request for Participation in Interview: Research on Problems and Challenges facing Islamic Banking and Finance Industry in Malaysia

I draw your kind attention to the above. Nor Aiza Mohd Zamil is a PhD candidate at Cardiff Business School, Cardiff University, undertaking research on the Problems and Challenges facing Islamic banking in Malaysia.

The purpose of this study is to gather in depth information on the existing practices and to ascertain the major issues facing the Islamic banking and finance industry. In order to obtain this information, we need your kind approval to interview senior management (i.e. Chief Executive Officer (CEO) or Chief Operation Officer (COO), senior finance officials of the Islamic bank, (preferably the finance director/ assistance finance director or equivalent) as well as senior Shariah officials of the Islamic bank (preferably the Shariah director/ assistance Shariah director or equivalent). The interview will take approximately one hour to one and half hours each.

We understand that your time is valuable, but your kind assistance, on the successful completion of this study is both priceless and fundamental. I am sure you agree that the research is both topical and interesting and will provide a very useful insight into current issues facing the Industry. We would like to emphasize that anonymity is guaranteed. All information provided will be treated with no disclosure of any individuals or organizations.

Thank you in advance for your assistance. We would appreciate a reply from you as soon as possible.

Sincerely,

Dr Yusuf Karbhari
 PhD Supervisor
 Accounting and Finance Section
 Cardiff Business School
 Cardiff University
 Tel: +44 (0) 29 2087 6057
 Fax: +44 (0) 29 2087 4419
 Email: Karbhari@cardiff.ac.uk

Sincerely,

Nor Aiza Mohd Zamil
 PhD Candidate
 Accounting and Finance Section
 Cardiff Business School
 Cardiff University
 Tel: 019-9800780
 Email: mohdzamilNA@cf.ac.uk
aizamz78@yahoo.com

Cardiff Business School
Director Professor Roger Mansfield MA PhD (Cantab)
Asian Accounting Finance and Business Research Unit
Director Dr Yusuf Karbhari BA (Hons) MBA PhD IJTM



Cardiff University
Aberconway Building
Colum Drive
Cardiff CF10 3EU
Wales UK
Tel: +44(0)29 2087 4000
Fax: +44(0)29 2087 4419
www.cardiff.ac.uk

28 September, 2010.

Dear Sir/Madam,

Request for Participation in Interview: Research on Problems and Challenges facing Islamic Banking and Finance Industry in Malaysia

The abovementioned subject is referred. Nor Aiza Mohd Zamil is a PhD candidate conducting a research on problems and challenges facing Islamic banking in Malaysia.

The purpose of this study is to gather more in depth information on the existing practices and ascertain and discuss problems and challenges facing Islamic banking and finance industry. In order to obtain this information, we need your kind permission to interview yourself as a Shariah Advisor in the respective Islamic Bank. The interview will take approximately one hour to one and half hours.

We understand that your time is valuable, but your kind assistance, on the successful completion of this study is both priceless and fundamental. I am sure you agree that the research is both topical and interesting and will provide some useful insights currently facing the Industry. Additionally, we would like to emphasize that the anonymity is guaranteed. All information provided will be treated with no disclosure of any individuals or organizations.

Thank you in advance for your assistance. We would appreciate a reply from you soon.

Sincerely,

Dr Yusuf Karbhari
Supervisor
Accounting and Finance Section
Cardiff Business School
Cardiff University
Tel: +44 (0) 29 2087 6057
Fax: +44 (0) 29 2087 4419
Email: Karbhari@cardiff.ac.uk

Sincerely,

Nor Aiza Mohd Zamil
PhD Candidate
Accounting and Finance Section
Cardiff Business School
Cardiff University
Tel: 019-9800780
Email: mohdzamilNA@cf.ac.uk
aizamz78@yahoo.com

Appendix 6 Ethical Approval Form

**CARDIFF BUSINESS SCHOOL ETHICAL APPROVAL FORM:
PHD THESIS RESEARCH**

(For guidance on how to complete this form, please see <http://www.cf.ac.uk/carbs/research/ethics.html>)

For Office Use:	Ref	Meeting
<p>Does your research involve human participants? Yes <input checked="" type="checkbox"/> No <input type="checkbox"/></p> <p>If you have answered 'No' to this question you do not need to complete the rest of this form, otherwise please proceed to the next question</p>		
<p>Does your research have any involvement with the NHS? Yes <input type="checkbox"/> No <input checked="" type="checkbox"/></p> <p>If you have answered Yes to this question, then your project should firstly be submitted to the NHS National Research Ethics Service. Online applications are available on http://www.nres.npsa.nhs.uk/applicants/. It could be that you may have to deal directly with the NHS Ethics Service and bypass the Business School's Research Ethics Committee.</p>		
Name of Student:	NOR AIZA MOHD ZAMIL	
Student Number:	0809170	
Section:	ACCOUNTING AND FINANCE	
Email:	MohdZamilNA@Cardiff.ac.uk	
Names of Supervisors:	Dr. Yusuf Karbhari	
Supervisors' Email Addresses:	karbhari@Cardiff.ac.uk	
Title of Thesis:	The Problems and Challenges facing Islamic Banking and Finance in Malaysia	
Start and Estimated End Date of Research:	Jan 2008 - June 2010	
Please indicate any sources of funding for this research:	Minister of Higher Education Malaysia & Universiti Sains Malaysia	

**APPLICATION APPROVED
RESEARCH ETHICS COMMITTEE
CARDIFF BUSINESS SCHOOL
CARDIFF UNIVERSITY**

1. Describe the Methodology to be applied in the research

The research design for this study of problems and challenges facing Islamic banks utilizes a qualitative method approach which will employ the semi-structured interview. Due to the exploratory nature of the study, a series of face-to-face unstructured interviews will be conducted in order to generate more information about problems and challenges facing Islamic banking and the finance industry in Malaysia. This information will then bring together the perspectives of the academics, researchers and practitioners in the industry.

The interviews will be undertaken in an attempt to obtain a more precise understanding of the problems and challenges facing the Islamic banking and finance industry in Malaysia. The semi-structured interviews will be used as a mechanism to gather data and to understand the problems and challenges facing Islamic banking and finance in Malaysia. Semi-structured interviews cover a wide range of instances (Bryman and Bell 2007). This typically refers to a context in which the interviewer has a series of questions that are in the general form of an interview schedule but is able to vary the sequence of questions (Bryman and Bell 2007). Also, the researcher will have a list of questions and themes to be covered, although these may vary from interview to interview (Saunders et al. 2000). On the other hand, necessary additional questions may be required to explore the research questions and objectives, given the nature of events within particular organizations (Saunders et al., 2000).

The semi-structured interview is selected because it is more flexible than standardized methods, such as the structured interview. By using the list of themes, it will allow for exploration of emergent themes and ideas rather than just relying on the questions being formulated before the interview. Also, in the semi-structured interview, I intend to use probing questions in order to gain in-depth responses on certain key issues.

The interview questions include questions on specific areas covering issues facing the Islamic banking and finance industry in Malaysia. The questions are divided into various sections depending on the sample group. The aim is to explore the broad and general overview of the problems and challenges of Islamic banks. It intends to study the breadth of the topics. The overview will be explored through views, perspectives, perception, and experience of the senior officials of

regulators, supervisors, practitioners, individual and institutional investors, academics, and researchers.

In addition to that, the study would like to explore the problems and challenges facing practices (i.e. operation) and implementation of Islamic Banking and Finance in respect of (1) procedural and legal Shariah problems, (2) suitability of the establishment of Islamic Banking and Finance under current support by the legal and regulatory framework and supervision framework and corporate governance and (3) implication of accounting and auditing practices.

A copy of the interview guide for Senior Officials/Finance Officers at Islamic Banks is included in **Appendix 1**.

The interview formats are;

SECTION 1: GENERAL OVERVIEW

SECTION 2: SHARIAH COMPLIANCE

SECTION 3: SHARIAH AUDIT

SECTION 4: ACCOUNTING PRACTICES

SECTION 5: QUALITY OF INFORMATION

SECTION 6: USES OF INFORMATION

SECTION 7: HUMAN CAPITAL EXPERTISE

SECTION 8: CHALLENGES

SECTION 9: VIEWS ON FUTURE OF ISLAMIC BANKING AND FINANCE

A copy of the interview guide for (1) Chief Executive Officers (CEO) at Islamic Banks, (2) Senior Officials/Shariah Officers and Shariah Supervisor Board (SSB) at Islamic Banks, (3) Senior Officials/Islamic Banking Officers at Bank Negara Malaysia is included in **Appendix 2**. The interview formats are;

SECTION 1: GENERAL OVERVIEW

SECTION 2: SHARIAH COMPLIANCE

SECTION 3: SHARIAH AUDIT

SECTION 4: ACCOUNTING PRACTICES

SECTION 5: HUMAN CAPITAL EXPERTISE

SECTION 6: CHALLENGES

SECTION 7: VIEWS ON FUTURE OF ISLAMIC BANKING AND FINANCE

A copy of the interview guide for Individual and Institutional Investors is included in **Appendix 3**. The interview formats are;

SECTION 1: GENERAL OVERVIEW

SECTION 2: QUALITY OF INFORMATION

SECTION 3: USES OF INFORMATION

SECTION 4: HUMAN CAPITAL EXPERTISE

SECTION 5: CHALLENGES

SECTION 6: VIEWS ON FUTURE OF ISLAMIC BANKING AND FINANCE

2. Describe the participant sample who will be contacted for this Research Project. You need to consider the number of participants, their age, gender, recruitment methods and exclusion/inclusion criteria

Approximately 45 to 60 senior officials in the Islamic banking and finance industry in Malaysia will be selected. The senior officials will consist of regulators, Shariah Supervisory Board (SSB), bank management, individual and institutional investors, accountants, academics and researchers. As at 2009, in Malaysia there were 21 licensed Islamic banking institutions established. The licensed banking institutions consist of foreign-owned and Malaysian-owned Islamic commercial banks, 17 Islamic Commercial banks (i.e. 6 foreign and 11 Malaysian-owned) and 4 international Islamic banks.

The sample will be in accordance with the availability of certain characteristics, such as experience, academic status, and seniority, so that they are considered representative of their banks in particular and Islamic banking and finance in general. Essentially, the sample would possess one or more of the following criteria;

- (1) experience in working with the Islamic banks or Islamic banking industry;
- (2) involvement with formulation or establishment of new regulations, standards or guidelines;
- (3) involvement with development of products and services in IBF;
- (4) investment in the Islamic banking institutions;
- (5) experience as researchers and academics in this area.

Face to face semi-structured interview will be undertaken in the participant's office or any convenient place that is suitable for the formal situation of the interview.

3. Describe the consent and participant information arrangements you will make, as well as the

methods of debriefing. If you are conducting interviews, you must attach a copy of the consent form you will be using.

Informed consent is the act of informing participants about all aspects of the process when they are being asked to participate in a research. Prior to interviewing, the participant will be informed of the purpose and anticipated benefits of the study, and given assurance of confidentiality and anonymity. This is to ensure that there is no dispute on the main concern of conducting the research.

Participants will be given a detailed consent form and they will give their consent by completing the consent form. A detailed consent form will contain information about who is conducting research, the purpose of the research, the type of research intervention, time commitment, the benefits, opportunities to ask questions, voluntary participation, the right to withdraw, an assurance of confidentiality and anonymity. Participants will read and sign the consent form and will be informed that they may withdraw at any time or may even refuse to answer any question if they so wish.

Also, participants have the option to obtain a summary of the findings at the end of the study if they wish to.

4. Please make a clear and concise statement of the ethical considerations raised by the research and how you intend to deal with them throughout the duration of the project

Generally, the information obtained in this study is pertaining to problems and challenges facing Islamic banking and finance in Malaysia based on the participants' experience and involvement in the industry. There is a need to obtain consent from the participants in assuring them of the confidentiality of the interview data and anonymity of participants in the interview. In this study, participants will be asked to give their consent directly by signing a consent form. In the consent form, participants are not required to provide their contact details to ensure anonymity.

PLEASE NOTE that you should include a copy of your questionnaire

NB: Copies of your signed and approved Research Ethics Application Form together with accompanying documentation must be bound into your Dissertation or Thesis.

SUPERVISOR'S DECLARATION

I hereby declare that I believe that all research ethical issues have been dealt with in accordance with the University's policies and the research ethics guidelines of the relevant professional organisation.

Signature: _____ Date: _____

STATEMENT OF ETHICAL APPROVAL

This project has been given ethical approval by the Research Ethics Committee of the University of Malaya.

Signature: _____ Date: _____

Signature: _____ Date: _____

Signature: _____ Date: _____

5. Please complete the following in relation to your research:

		Yes	No	n/a
(a)	Will you describe the main details of the research process to participants in advance, so that they are informed about what to expect?	<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
(b)	Will you tell participants that their participation is voluntary?	<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
(c)	Will you obtain written consent for participation?	<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
(d)	Will you tell participants that they may withdraw from the research at any time and for any reason?	<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
(e)	If you are using a questionnaire, will you give participants the option of omitting questions they do not want to answer?	<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
(f)	Will you tell participants that their data will be treated with full confidentiality and that, if published, it will not be identifiable as theirs?	<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
(g)	Will you offer to send participants findings from the research (e.g. copies of publications arising from the research)?	<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

PLEASE NOTE:

If you have ticked No to any of 5(a) to 5(g), please give an explanation on a separate sheet.

(Note: N/A = not applicable)

There is an obligation on the lead researcher to bring to the attention of Cardiff Business School Ethics Committee any issues with ethical implications not clearly covered by the above checklist.

Two copies of this form (and attachments) should be submitted to Ms Lainey Clayton, Room F09, Cardiff Business School.

Signed



Print Name

NOR AIZA MOHD ZAMIL

Date

6th JUNE 2010

SUPERVISOR'S DECLARATION

As the supervisor for this research I confirm that I believe that all research ethical issues have been dealt with in accordance with University policy and the research ethics guidelines of the relevant professional organisation.

Signed



(Primary supervisor)

Print Name

DR YUSUF KARBHARI

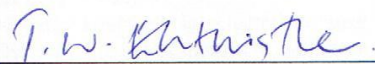
Date

6th JUNE 2010

STATEMENT OF ETHICAL APPROVAL

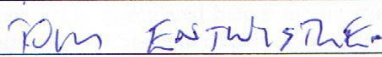
This project has been considered using agreed School procedures and is now approved.

Signed



(Chair, School Research Ethics Committee)

Print Name



Date

10 September 2010.

APPLICATION APPROVED
RESEARCH ETHICS COMMITTEE
CARDIFF BUSINESS SCHOOL
CARDIFF UNIVERSITY

Appendix 7 Interview Survey Questions for Senior Officials/Finance Officers at Islamic Banks

INTERVIEW CHECKLIST

Interview Survey Questions for Senior Officials/ Finance Officers at Islamic Banks

Introduction

Thank participants for their time.

Express appreciation of willingness to be interviewed. Give assurance that the details provided would be treated in the STRICTEST OF CONFIDENCE (*present the consent form for Anonymous data and Confidential data*). Any results disclosed will be done so in aggregate form and individual banks/organizations will not be identified.

Mention nature and relevance of research

Background Information

Name of Islamic Bank:

Date Established:

Name of Participant:

Position:

No. of Years in Islamic Banks;

No. of Years in Banking Institution:

No. of employees in this Bank:

No. of SSB in this Bank:

No. of Islamic *Shari'ah* Review Unit (ISRU) (if any):

No. of Islamic *Shari'ah* Review Unit (ISCU) (if any):

Approximate No. of staff with *Shari'ah* qualification:

Approximate No. of staff with *Shari'ah* and technical qualification:

SECTION 1: GENERAL OVERVIEW

1. Could you describe current problems and challenges facing Islamic banks or Islamic banking and finance industry?
2. Could you describe the main problems encountered by the accounting and finance department, SSB, *Shari'ah* compliance in an Islamic bank?
3. Is there any pertinent problem(s) arising from the current practice of Islamic banking and finance? If yes, could you please explain such problem(s)?
4. Could you indicate to me the problem(s) that are of concern to you?
5. Is there any additional information or issues pertaining to the operation of Islamic banking and finance Malaysia?

Development and Opportunities

6. Could you share your experience and observations on the development and opportunities of Islamic banks and the Islamic banking and finance industry?

Regulation

7. Various development and initiatives has been developed to enhance the establishment and operation of Islamic banks. The industry witnessed various initiatives and development such as IFSB, AAOIFI and various initiatives such as Central Bank of Malaysia's (BNM) guidelines, accounting standards by Malaysia Accounting Standards Board (MASB) and other statutory act are initiated to support the establishment in Malaysia. Could you tell which of the initiatives is being implemented or referred by your institution?
8. In your opinion, do Islamic banks and the Islamic banking and finance industry need a separate set (i.e. additional set) of regulatory frameworks? Why?
9. Is there any need for the IBF industry to standardize or harmonize accounting or any other relevant standards (international Islamic standards or conventional standards) to achieve better transparency, disclosure and accountability?
10. Is there any support from regulators, central banks and national ruling to achieve standardization or harmonization?

Products and Services

Current development in Islamic finance has witnessed the development of more Islamic products.

11. Could you comment on the level of development and innovation in the industry and its future?

Shari'ah Issues

12. Could you describe *Shari'ah* issues of your concern?
13. Could you comment of unresolved *Shari'ah* issues of your concern?

Centralization of Shari'ah Supervisors

14. Does the establishment of the *Shari'ah* Advisory Council of Bank Negara Malaysia (SAC) show any difference or improvement to the structure of *Shari'ah* Supervisory Board (SSB) in the country?
15. Could you comment on the expertise of your SSB?

16. Do you think that the existence of SAC and SSB in your institution has improved management, operation, and *Shari'ah* compliance of products and services offered? Could you describe the improvement that occurs?
17. Could you explain the relationship between SSB and the accounting and finance department (including *Shari'ah* Audit) in the Islamic bank?

Shari'ah Interpretations

18. Could you comment on the *Shari'ah* interpretations and rulings made by SSB?
19. How do you perceive the effect that interpretations of *Shari'ah* have on accounting practices and accounting information?
20. In your opinion, how do different *Shari'ah* interpretations influence the *Shari'ah* audit practices?
21. In your opinion, is there any need to have standardization or harmonization in the interpretations of *Shari'ah*?
22. How useful is standardization/harmonization of *Shari'ah* interpretations towards the development of Islamic banking and finance industry?
23. What is the factor that impedes the consolidation or convergence of the *Shari'ah* interpretations that are different according to jurisdictions?
24. What is your comment on Malaysia's effort to bridge the gaps in the interpretations of *Shari'ah* in relation to the conduct of IB business among the *Shari'ah* scholars in different parts of the world through IIFM – GSSC (Global *Shari'ah* Supervisory Committee)?

SECTION 2: SHARI'AH COMPLIANCE

25. What is the importance of *Shari'ah* compliance in your institution?
26. What factors influence *Shari'ah* compliance?
27. Could you explain the 'primary basis' of the *Shari'ah* compliance process by IB?
Why is this particular basis adopted?
What does the process involve?
How does it work?
28. How do you measure *Shari'ah* compliance risk? Is there any measurement of *Shari'ah* compliance risk? If there is no measurement of *Shari'ah* compliance risk, is there any main characteristic that is being considered?
29. How do your institutions manage ex-ante compliance and ex post compliance?
30. How often do SSB/ ISCU/ ISRU discuss *Shari'ah* compliance plan and other financial related issues with the accounting and finance department?
31. What are the problems and challenges in undergoing *Shari'ah* compliance procedure (i.e. ex ante and ex post)?

SECTION 3: SHARI'AH AUDIT

32. Could you describe the *Shari'ah* audit committee and *Shari'ah* audit procedures? (i.e. How is it established? Who are the members? What are the criteria and qualification of the members of the *Shari'ah* audit committee?)
33. What is the primary intention of framing the audit?
34. Do you have explicit targets in undergoing *Shari'ah* audit?
35. Do *Shari'ah* audit responsibilities follow responsibilities and accountability to the management and public?
36. In addition, is there any internal evaluation of *Shari'ah* compliance systems and support in your institution take place?
37. Have major or minor problems ever been encountered with SSB/ISCU/ISRU on *Shari'ah* compliance (i.e. personnel not implementing the products and services as per approved)? What is the plan of action for *Shari'ah* non-compliance?

SECTION 4: ACCOUNTING PRACTICES

38. Could you explain the current accounting practices of your institutions?
39. What is the implication of accounting practices on the operations of IBs?
40. Are the current practices of accounting and finance 'different' from the conventional commercial banking system in existence? Do we need different type of accounting? If yes, is it worth to do so?
41. How do you perceive the effect that accounting practices and accounting information have on the operation?
42. What is the impact of current accounting practices on the operations of IFI if the IFI were to operate within a global financial market dominated by western accounting norms?
43. Have the chosen accounting policies of IB been formally discussed and agreed by the board of management?
44. Who is responsible for monitoring the accounting procedures?
45. If any matter arises in selecting or implementing the accounting policies, is there any reference made to the SSB?

SECTION 5: QUALITY OF INFORMATION

46. How would you evaluate the quality of the information by the Islamic banks' financial reports? (In terms of their relevance, reliability, understandability, comparability, timeliness, and materiality)

47. Do you think that the financial information produced by Islamic banks can be improved? If so, please explain.

SECTION 6: USES OF INFORMATION

48. Could you explain the usefulness of accounting report and accounting information in the operation of Islamic Banks?
49. Please explain the extent to which your organization applies commercial accounting standards?
50. Who are the main users of your organization's annual reports?
51. In your opinion, how useful the Islamic bank's financial statements are in determining the accountability process?
52. Could you explain the information and other elements that are required by the individual and institutional investor with regard to investment in Islamic banking?
53. What measure can be enhanced to provide better reporting to the stakeholders?

SECTION 7: HUMAN CAPITAL EXPERTISE

54. Could you comment on the lack of human capital expertise in Islamic Banks?
55. Based on your experience, what are the:
- a. expectations of practitioners?
 - b. expectations of the scholars and expectation towards education system?
 - c. limitations of the education system and scholars?
 - d. communication of expectations between practitioners and academics?
56. To what extent do we need various efforts such as research and development, training, teaching, to enhance the human capital expertise in Malaysia?

SECTION 8: CHALLENGES

57. Could you describe the challenges facing Islamic banking and finance industry in Malaysia? What is your view on the challenges? (i.e. globalization--developmental role of IBs within globalization, internationalization, competition, upholding the equity financing and risk).

SECTION 9: VIEWS ON FUTURE OF ISLAMIC BANKING AND FINANCE

58. Could you comment on the effect of current initiatives and development on progress and growth of Islamic banks?

59. How do you foresee the future of Islamic banking and finance industry in Malaysia and the future of its operation?

Appendix 8 Interview Survey Questions for (1) Chief Executive Officers (CEO) at Islamic Banks (2) Senior Officials/ *Shari'ah* Officers and *Shari'ah* Supervisor Board (SSB) at Islamic Banks and (3) for Senior Officials/ Islamic Banking Officers at Bank Negara Malaysia (Central Bank of Malaysia)

INTERVIEW CHECKLIST

Interview Survey Questions for (1) Chief Executive Officers (CEO) at Islamic Banks (2) Senior Officials/ *Shari'ah* Officers and *Shari'ah* Supervisor Board (SSB) at Islamic Banks and (3) for Senior Officials/ Islamic Banking Officers at Bank Negara Malaysia (Central Bank of Malaysia)

Introduction

Thank participants for their time.

Express appreciation of willingness to be interviewed. Give assurance that the details provided would be treated in the STRICTEST OF CONFIDENCE (*present the consent form for Anonymous data and Confidential data*). Any results disclosed will be done so in aggregate form and individual banks/organizations will not be identified.

Mention nature and relevance of research

Background Information (CEO)

Name of Islamic Bank:

Date Established:

Name of Participant:

Position:

No. of Years in Islamic Banks;

No. of Years in Banking Institution:

No. of employees in this Bank:

No. of SSB in this Bank:

No. of Islamic *Shari'ah* Review Unit (ISRU) (if any):

No. of Islamic *Shari'ah* Review Unit (ISCU) (if any):

Approximate No. of staff with *Shari'ah* qualification:

Approximate No. of staff with *Shari'ah* and technical qualification:

Background Information (SSB or *Shari'ah* Department)

Name of Islamic Bank:

Date Established:

Name of Participant:

Position:

No. of Years in Islamic Banks;

No. of Years in Banking Institution:

No. of employees in this Bank:

No. of SSB in this Bank:

No. of Islamic *Shari'ah* Review Unit (ISRU) (if any):

No. of Islamic *Shari'ah* Review Unit (ISCU) (if any):

Approximate No. of staff with *Shari'ah* qualification:

Approximate No. of staff with *Shari'ah* and technical qualification:

Background Information (Scholars)

Name of Scholar: _____ Date Established: _____
 Qualifications: _____ Position: _____
 Designation: _____
 SSB of: _____
 No. of Islamic Banks before this: _____ No. of Years in Banking Institution: _____
 No. of employees in this Bank: _____ No. of Years in Islamic Banks: _____
 No. of SSB in this Bank: _____ Average year in a particular bank: _____
 No. of Islamic *Shari'ah* Review Unit (ISRU) (if any): _____
 No. of Islamic *Shari'ah* Review Unit (ISCU) (if any): _____
 Approximate No. of staff with *Shari'ah* qualification: _____
 Approximate No. of staff with *Shari'ah* and technical qualification: _____

Background Information

Name of Participant: _____ Position: _____
 No. of Years in Islamic Banking Industry: _____

SECTION 1: GENERAL OVERVIEW

1. Could you describe current problems and challenges facing Islamic banks or Islamic banking and finance industry?
2. Could you describe the main problems encountered by the accounting and finance department, SSB, *Shari'ah* compliance in an Islamic bank?
3. Is there any pertinent problem(s) arising from the current practice of Islamic banking and finance? If yes, could you please explain such problem(s)?
4. Could you indicate to me the problem(s) that are of concern to you?
5. Is there any additional information or issues pertaining to the operation of Islamic banking and finance Malaysia?

Development and Opportunities

6. Could you share your experience and observations on the development and opportunities of Islamic banks and the Islamic banking and finance industry?

Regulation

(For regulators only)

7. In your opinion, what are the roles play by the BASEL, Islamic Financial Services Board (IFSB) and Accounting and Auditing Organization of Islamic Finance (AAOIFI) in providing or supporting the infrastructure of the Islamic banks? Have the international standards created a difference in the way Islamic finance is practiced in Malaysia? How?

8. What are the challenges in terms of the implementation and enforcement of the regulation?
9. What is your comment on self-regulation and government-based regulation in the Islamic Banking and Finance Industry?

(For other groups of respondent)

10. Various development and initiatives has been developed to enhance the establishment and operation of Islamic banks. The industry witnessed various initiatives and development such as IFSB, AAOIFI and various initiatives such as Central Bank of Malaysia's (BNM) guidelines, accounting standards by Malaysia Accounting Standards Board (MASB) and other statutory act are initiated to support the establishment in Malaysia. Could you tell, which of the initiatives is being implemented or referred by your institution?
11. In your opinion, do Islamic banks and the Islamic banking and finance industry need a separate set (i.e. additional set) of regulatory frameworks? Why?
12. Is there any need for the IBF industry to standardize or harmonize accounting or any other relevant standards (international Islamic standards or conventional standards) to achieve better transparency, disclosure and accountability?
13. Is there any support from regulators, central banks and national ruling to achieve standardization or harmonization?

Products and Services

Current development in Islamic finance has witnessed the development of more Islamic products.

14. Could you comment on the level of development and innovation in the industry and its future?

Shari'ah Issues

15. Could you describe *Shari'ah* issues of your concern?
16. Could you comment of unresolved *Shari'ah* issues of your concern?

Centralization of Shari'ah Supervisors

17. Does the establishment of the *Shari'ah* Advisory Council of Bank Negara Malaysia (SAC) show any difference or improvement to the structure of *Shari'ah* Supervisory
18. Could you comment on the expertise of your SSB?
19. Do you think that the existence of SAC and SSB in your institution has improved management, operation, and *Shari'ah* compliance of products and services offered? Could you describe the improvement that occurs?

20. Could you explain the relationship between SSB and the accounting and finance department (including *Shari'ah* Audit) in the Islamic bank?

Shari'ah Interpretations

21. Could you comment on the *Shari'ah* interpretations and rulings made by SSB?
22. How do you perceive the effect that interpretations of *Shari'ah* have on accounting practices and accounting information?
23. In your opinion, how do different *Shari'ah* interpretations influence the *Shari'ah* audit practices?
24. In your opinion, is there any need to have standardization or harmonization in the interpretations of *Shari'ah*?
25. How useful is standardization/harmonization of *Shari'ah* interpretations towards the development of Islamic banking and finance industry?
26. What is the factor that impedes the consolidation or convergence of the *Shari'ah* interpretations that are different according to jurisdictions?
27. What is your comment on Malaysia's effort to bridge the gaps in the interpretations of *Shari'ah* in relation to the conduct of IB business among the *Shari'ah* scholars in different parts of the world through IIFM – GSSC (Global *Shari'ah* Supervisory Committee)?

SECTION 2: SHARI'AH COMPLIANCE

28. What is the importance of *Shari'ah* compliance in your institution?
29. What factors influence *Shari'ah* compliance?
30. Could you explain the 'primary basis' of the *Shari'ah* compliance process by IB?
Why is this particular basis adopted?
What does the process involve?
How does it work?
31. How do you measure *Shari'ah* compliance risk? Is there any measurement of *Shari'ah* compliance risk? If there is no measurement of *Shari'ah* compliance risk, is there any main characteristic that is being considered?
32. How do your institutions manage ex-ante compliance and ex post compliance?
33. How often does SSB/ ISCU/ ISRU discuss *Shari'ah* compliance plan and other financial related issues with the accounting and finance department?
34. What are the problems and challenges in undergoing *Shari'ah* compliance procedure (i.e. ex ante and ex post)?

SECTION3: SHARI'AH AUDIT

35. Could you describe the *Shari'ah* audit committee and *Shari'ah* audit procedures? (i.e. How is it established? Who are the members? What are the criteria and qualification of the members of the *Shari'ah* audit committee?)
36. What is the primary intention of framing the audit?
37. Do you have explicit targets in undergoing *Shari'ah* audit?
38. Do *Shari'ah* audit responsibilities follow responsibilities and accountability to the management and public?
39. In addition, is there any internal evaluation of *Shari'ah* compliance systems and support in your institution take place?
40. Have major or minor problems ever been encountered with SSB/ISCU/ISRU on *Shari'ah* compliance (i.e. personnel not implementing the products and services as per approved)? What is the plan of action for *Shari'ah* non-compliance?

SECTION 4: HUMAN CAPITAL EXPERTISE

41. Could you comment on the lack of human capital expertise in Islamic Banks?
42. Based on your experience, what are the:
 - a. expectations of practitioners?
 - b. expectations of the scholars and expectation towards education system?
 - c. limitations of the education system and scholars?
 - d. communication of expectations between practitioners and academics?
43. To what extent do we need various efforts such as research and development, training, teaching, to enhance the human capital expertise in Malaysia?

SECTION 5: CHALLENGES

44. Could you describe the challenges facing Islamic banking and finance industry in Malaysia? What is your view on the challenges? (i.e. globalization--developmental role of IBs within globalization, internationalization, competition, upholding the equity financing and risk).

SECTION 6: VIEWS ON FUTURE OF ISLAMIC BANKING AND FINANCE

45. Could you comment on the effect of current initiatives and development on progress and growth of Islamic banks?
46. How do you foresee the future of Islamic banking and finance industry in Malaysia and the future of its operation?

Appendix 9 Interview Survey Questions for Individual and Institutional Investors of Islamic Banks

INTERVIEW CHECKLIST

Interview Survey Questions for Individual and Institutional Investors of Islamic Banks

Introduction

Thank participants for their time.

Express appreciation of willingness to be interviewed. Give assurance that the details provided would be treated in the STRICTEST OF CONFIDENCE (*present the consent form for Anonymous data and Confidential data*). Any results disclosed will be done so in aggregate form and individual banks/organizations will not be identified.

Mention nature and relevance of research

Background Information

Name of Participant:

Position:

No. of Years in Islamic Banking Industry:

SECTION 1: GENERAL OVERVIEW

1. Could you describe current problems and challenges facing Islamic banks or Islamic banking and finance industry?
2. Could you describe the main problems encountered by the accounting and finance department, SSB, *Shari'ah* compliance in an Islamic bank?
3. Is there any pertinent problem(s) arising from the current practice of Islamic banking and finance? If yes, could you please explain such problem(s)?
4. Could you indicate to me the problem(s) that are of concern to you?
5. Is there any additional information or issues pertaining to the operation of Islamic banking and finance Malaysia?

Development and Opportunities

6. Could you share your experience and observations on the development and opportunities of Islamic banks and the Islamic banking and finance industry?

Products and Services

Current development in Islamic finance has witnessed the development of more Islamic products.

7. Could you comment on the level of development and innovation in the industry and its future?

Shari'ah Issues

8. Could you describe *Shari'ah* issues of your concern?
9. Could you comment of unresolved *Shari'ah* issues of your concern?

SECTION 2: QUALITY OF INFORMATION

10. How would you evaluate the quality of the information by the Islamic banks' financial reports? (In terms of their relevance, reliability, understandability, comparability, timeliness, and materiality)
11. Do you think that the financial information produced by Islamic banks can be improved? If so, please explain.

SECTION 3: USES OF INFORMATION

12. What are the main uses of Islamic bank's annual reports?
13. Could you explain the usefulness of accounting report and accounting information to user's need?
14. In your opinion, how useful the Islamic bank's financial statements are in determining the accountability process?
15. Do annual reports of Islamic bank give users an annual overview of the operations of the organization and an annual opportunity to review aspects of those activities? If No, why not?
16. Could you explain the information and other elements that are required by the individual and institutional investor with regard to investment in Islamic banking? What measure can be enhanced to provide better reporting to the stakeholders?
17. As an institutional investor, how are you being informed about the PLS and how it can best serve this institution?
18. What are the factors that influence the decision of the investor (i.e. ethical and religious)?
19. How would you rate the disclosure quality of information in an Islamic bank's annual report?
20. Does the rating of items disclosed by financial analysts influence institutional investor's decisions?
21. Could you comment on the credibility and quality of the information provided in the annual report?

SECTION 4: HUMAN CAPITAL EXPERTISE

22. Could you comment on the lack of human capital expertise in Islamic Banks?
23. Based on your experience, what are the:
 - a. expectations of practitioners?
 - b. expectations of the scholars and expectation towards education system?
 - c. limitations of the education system and scholars?
 - d. communication of expectations between practitioners and academics?
24. To what extent do we need various efforts such as research and development, training, teaching, to enhance the human capital expertise in Malaysia?

SECTION 5: CHALLENGES

25. Could you describe the challenges facing Islamic banking and finance industry in Malaysia? What is your view on the challenges? (i.e. globalization--developmental role of IBs within globalization, internationalization, competition, upholding the equity financing and risk).

SECTION 6: VIEWS ON FUTURE OF ISLAMIC BANKING AND FINANCE

26. Could you comment on the effect of current initiatives and development on progress and growth of Islamic banks?
27. How do you foresee the future of Islamic banking and finance industry in Malaysia and the future of its operation?

Appendix 10 Summary of Problems and Challenges facing *Islamic* Banks in Malaysia

The three groups agree that the problems and challenges facing *Islamic* banking in Malaysia are product development and innovation, human capital, different interpretation, customer awareness, legal and regulatory, directions of *Islamic* banks, negative public perceptions, problems resulted from the dual banking system, ensuring *Shari’ah* compliance, accounting and transparency, *Shari’ah* review and audit, controversial *Shari’ah* contract, and *Shari’ah* Management. The CEO and *Shari’ah* committee find that technical and implementation, competition, small scale, system, moral hazard, ethics, and business issues. In addition, the *Shari’ah* Officer also finds that involvement of *Shari’ah* committee that is resources of *Shari’ah* committee. On the other hand, there are also problems and challenges that are being highlighted by a certain group of interviewees. The *Shari’ah* committees highlight their concern about the lack of involvement of *Shari’ah* Scholars, the *Shari’ah* Officers highlight on *Shari’ah* research, *Shari’ah* issues, and promotion or marketing and the National *Shari’ah* Advisors highlight on infrastructure and support, *Islamic* subsidiaries, and establishment professional body.

The following table lists the summary of findings from the interview;

Table 1: Summary of Findings

Problems and Challenges		
CEO	<i>Shari’ah</i> Officers	<i>Shari’ah</i> Committees
<u>Product</u> Turnaround time Mimic conventional product <i>Shari’ah</i> compliance – innovation Innovation – equity based Effective in comparative Legal support Viability	<u>Product</u> Roll-out product Commercially viable, <i>Shari’ah</i> compliance Innovation – mirror, <i>Shari’ah</i> based, <i>Shari’ah</i> compliance Derivatives	<u>Product</u> <u>Development/Innovation</u> Product roll-out <i>Shari’ah</i> mimic conventional <i>Shari’ah</i> based and <i>Shari’ah</i> compliance

Problems and Challenges		
CEO	Shari'ah Officers	Shari'ah Committees
<u>Human capital</u> Fees Capabilities Expertise (<i>Shari'ah</i> , risk management, product innovation/development) Knowledge (Dual) Training	<u>Human capital</u> Dual knowledge Shortage Ethics	<u>Human capital</u> Expertise (Education) (Amanah, Knowledge, Limitation of SA – dual knowledge) Understanding Skills <u>Shari'ah</u> Committees/Officers (communication, accountability-chairman, middleman's expert in dual field, Independence) Top Management (Aspiration, Influence, Political Will) Middle Management Frontliner Training Acquiring Knowledge Providing Training Brain Drain
<u>Different Shari'ah Interpretation</u>	<u>Different Shari'ah Interpretation</u>	<u>Harmonization</u> (Local, <i>Shari'ah</i> Interpretation for cross border, International)
<u>Customer</u> Knowledge Awareness/understanding Familiarity Education and Training Readiness	<u>Customer</u> Understand Aware Familiarity with conventional bank's product	<u>Awareness and Seriousness</u> (<i>Shari'ah</i> Committee, Human capital, public-society, attitude-customer, academicians/scholars, regulators)
<u>Lack of knowledge and awareness</u> lead to negative perceptions by the public (P34)	<u>Negative Public Perception</u>	<u>Public Perception</u> (Confuse, misperception, misunderstood)

Problems and Challenges		
CEO	Shari'ah Officers	Shari'ah Committees
<u>Legal</u> Dispute Resolution Court	<u>Legal</u> BNM (support and requirement) International – BASEL Court Local Skeleton Non-Shari'ah	<u>Legal and Regulation</u> Act and standards to support the controversial Shari'ah Contract Amend and Review Current Law No Specific Contract Court Islamic Contract
<u>Dual Banking System</u>	<u>Dual Banking System</u>	<u>Dual Banking System</u>
<u>Heading (Map, Direction)</u> Pure Islamic banking – political will, economic will, religious will)	<u>Direction, and Objective</u> Socio-economic Objectives	<u>Direction</u> (future, maqasid)
<u>Ensure Shari'ah Compliance</u> <u>Proper Shari'ah Banking Transactions</u>		
<u>Support from top management</u>	<u>Support from top management</u>	<u>Support from top management</u> (P3, P22, P17)
<u>Proper Shari'ah Banking Transactions</u>		<u>Technical and Practical Theory and Implementation</u>
	<u>Research</u> Shari'ah governance Concept paper Parameter research Shari'ah Department	
<u>Competition</u>		<u>Competition</u>
<u>Small Scale/Market Size</u> Convergence between Muslims Countries		<u>Scale</u>
<u>Accounting Standards</u>	<u>Accounting Standards</u> Liquidity Accounting and auditing	<u>Transparency (accounting)</u>

Problems and Challenges		
CEO	Shari'ah Officers	Shari'ah Committees
<u>Shari'ah Audit</u> Implementation Shari'ah Auditor (cost, mindset, experience, operation, education and awareness) Readiness Knowledge Ensure Shari'ah Compliance Proactive <u>Compliance Review Functions</u> People	<u>Audit</u> Need HC Importance No Shari'ah assessment on accounting <u>Evaluate and Analysis</u> Post-Compliance	<u>Shari'ah Review and Audit Practices</u> (Implementation of framework – Shari'ah Governance Framework) <u>Monitoring and Execution</u>
<u>Controversial Shari'ah Contract</u> Difficult contract without legal backing <u>Cooperation and Unity between Muslim Countries</u>	<u>Controversial Shari'ah Contract</u>	<u>Controversial Shari'ah Contract</u> Act and standards to support the controversial Shari'ah Contract (Same as legal)
<u>System</u>		<u>System</u>
	<u>Shari'ah Committee</u> Resources	<u>Involvement of Shari'ah Scholars</u>
<u>Shari'ah Management</u>	<u>Strong Shari'ah Department and Shari'ah Officer</u>	<u>Strengthen Shari'ah Department</u>
	<u>Shari'ah Issues</u> Islamic Finance	
		<u>Infrastructure and Support</u>
		<u>Islamic Subsidiary</u>
<u>Moral hazard</u>		<u>Ethics and Values</u>
		<u>Professional Bodies</u>
	<u>Promotion and Marketing</u>	
<u>Business Issues</u> Asset liability management		<u>Business Issues</u>