

An exploratory study to investigate the role of Shariah Governance in Islamic financial institutions:  
A case of Emerging Economy

Turkish Online Journal of Qualitative Inquiry (TOJQI)  
Volume 12, Issue 10, October 2021: 1366-1380

## **An exploratory study to investigate the role of Shariah Governance in Islamic financial institutions: A case of Emerging Economy**

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### **Abstract**

In recent years, Shariah Governance for both Islamic financial institutions (IFI) and practitioners have been increasingly popular. A robust Shariah governance structure is essential for IFI's due to their fast growth across the world, as it guarantees that all stakeholders are treated fairly, while also improving transparency and responsibility. This study explores the question “what are the major indicators/components of Shariah Governance in Islamic financial institutions?”. The face-to-face interviews are employed to achieve the research objectives. The central bank and Islamic banks of Pakistan were contacted for this study. According to the findings of the study, Shariah refers to laws, regulations, guidelines, objectives, and instructions that are exclusively based on Shariah principles. Shariah Governance, according to this study, is a technique for validating Shariah compliance throughout the entire operation of Islamic banks. SG is essential for Islamic banks to follow Shariah principles, certify Shariah compliance, and regulate the functioning of IFI's. Following the data analysis, Nvivo concluded that there are six distinct roles that SGs play in the IFI's. These roles include, efficacy of Shariah governance, knowledge and competence of BOD/SSB, BOD/SSB role, Shariah advisory committee role and Shariah audit function. This study will be of significant value to national and international regulatory agencies, as it explains why Islamic banks and financial institutions require a good supervisory governance (SG). Diverse stakeholders need a strong SGF that can attract their attention and interest in order to safeguard and meet their interests, expectations, and demands.

**Keywords:** Shariah Governance, Islamic financial Institutions, Shariah Board, Shariah Audit, Shariah Advisory Committee

## 1. Introduction

A global reputation for excellence has emerged for Islamic Financial Institutions (IFIs) after serving in more than 100 countries for the last 50 years. The capitalism and globalized counterparts, on the other hand, pose a stumbling block to Islamic finance and accounting (Kamla, 2009). Zafar and Sulaiman (2019) noted that Islamic finance's supremacy is also reflected in its contributions to mankind. Islamic financial institutions are at the core of the Islamic economy (Mushafiq & Sehar, 2021). Islamic finance regulations must create a Shariah Governance Framework (SGF) that can be used nationally and serve the global financial system as a result of IFIs' rapid growth (Archer et al., 2012). Mohiuddin and Islam (2016) also asserts that the Islamic financial system cannot be fully and comprehensively governed if it lacks true moral aspects.

Despite being a crucial component of the entire Shariah governance framework, Shariah governance has gotten little attention in the preceding literature till now, according to the previous research (Morrison, 2014; Yoshikawa, Tsui-Auch, & McGuire, 2007). Islamic financial institutions are unable to provide the religious and ethical legitimacy that most stakeholders seek without adequate governance systems in place. IFI's performance will be affected by Shariah governance, as a result of which they will be unable to carry out their normal operations. Due to its high level of openness and accountability, Shariah governance promotes justice among all stakeholders (Chapra & Ahmed, 2002). Those who trust the institution to manage their assets or investments in line with Shariah principles would lose confidence and trust as a result of the presence of non-Shariah compliant components; (Alam, Rahman, Runy, Adedeji, & Hassan, 2021; Karbhari, Naser, & Shahin, 2004)

In recent years, Shariah Governance frameworks for both IFIs and practitioners have been increasingly popular (Alwi, Parmitasari, & Syariati, 2021). A robust Shariah governance structure is essential for IFI's due to their fast growth across the world, as it guarantees that all stakeholders are treated fairly, while also improving transparency and responsibility (Alam, Rahman, et al., 2021). Many key issues exist in Pakistan's Shariah governance practice, including the lack of an adequate legal framework to support SBP's regulations, the absence of a legal framework for Islamic banking transactions, inconsistencies in regulations, as well as less diversified central SACs without any legal protection for their rulings (Wasim, 2020). This study seeks to analyse the role of Shariah Governance for Islamic banks by conducting semi-structured interviews with 17 respondents from Islamic financial institutions. The respondents come from diverse categories of designations, such as regulatory officials and members of Shariah Supervisory Boards (SSBs) etc. This study explores the question “what are the major indicators/components of Shariah Governance framework in Islamic financial institutions?”

According to the researcher's knowledge, no prior study has empirically determined the key indicators/components of Shariah Governance Index in Islamic finance organizations. This is the primary contribution of this research. As a result, the literature will take on a new dimension in a number of ways. SGF's involvement in supervising Islamic financial institutions in Pakistan and throughout the world is the subject of the first part of the research. It will also be utilized to describe SGF's practical effect on attracting consumers and other stakeholders, which will result in a high degree of financial success as well. The Board of Directors (BOD) also has the responsibility of designing an effective and efficient SG strategy for Islamic banks in order to increase their

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performance and Shariah compliance quality. Fourth, this study contributes to the body of knowledge on Islamic banking and finance by emphasizing the importance of SGF, which would increase customer and general public trust in their policy and operational activity while also ensuring openness and transparency in their overall responsibilities. Fifth, the study emphasises the need of a solid SG guideline for Islamic banks to function successfully, protect stakeholders' interests, promote sustainable growth, and acquire legitimacy from authorities and society that support stakeholder, resource dependence, and institutional theory. The development of an SGF will increase openness and transparency, as well as the professionalism and prestige of Islamic financial institutions.

### **Literature Review**

In previous studies, several concepts (such as agency, stewardship, stakeholder, and legitimacy theory) were utilized to show CG and SG (Alam, Rahman, et al., 2021; Wasim, 2020). In this case, management is granted more discretion as a result of the stakeholder theory. It reinforces CG's management philosophy while safeguarding the interests of all stakeholders (Freeman, 1994). In this regard, SG explains the duties, powers, and responsibilities of all relevant entities in relation to Islamic banking. A corporate social responsibility programme is also being implemented to reinforce ethical behaviour and specific standards (Suchman, 1995). If a company fails to perform commercial duties and maintain legitimacy in social conduct, its dependability will be questioned (Dowling & Pfeffer, 1975). As well as legitimacy and reputation, institutions are evaluated within a social framework (Deephouse & Carter, 2005). To achieve this legitimacy, a well-developed theoretical instrument dealing with pressures (regulatory, normative, and cognitive) might be utilized (Deephouse & Carter, 2005).

In financial institutions, corporate governance is of particular importance, as they deal with huge sums of money that are managed by various banks and belong to a variety of account holders and investors (Shamsi, Bashir, & Panhwar, 2013). Governance in IFIs is not only important for fund administration, but also for shareholder rights and the responsibility of Muslims to fulfil religious requirements, among other things. Muamalat and devotion to Allah (SWT) became the mainstream of Shariah governance in Islamic financial institutions (IFIs) as a result of Shariah governance (Setyowati, Abubakar, & Rodliah, 2017).

In IFIs, global SG standards differ by country because to the diverse legal and regulatory restrictions that apply to the unique government procedures for Islamic banking and finance activities (Z. Hasan, 2012). Worldwide, SG practices may be divided into three distinct categories: centralized, laissez-faire and hybrid approaches (Noordin & Kassim, 2019). It is the central bank's responsibility to issue fatwas on Islamic banking issues, provide SG guidelines for IFIs, designate institutional SSB, and direct the central bank on Shariah concerns under the central bank's centrally structured organization (Noordin & Kassim, 2019).

Malaysia, Sudan, Brunei, Indonesia, and Iran use this type of SG model, which is believed to have more extensive and rigorous Shariah rules than other systems. Decentralized SG models, often known as laissez-faire or self-regulatory approaches, are established by a specific SSB of IFIs and are less influenced by regulators and market actors. In this structure, IFIs and institutional SSBs maintain Shariah compliance in their entire business activities, goods, and services, as well as in their

ways of doing business and their processes and methods. In the absence of a central regulating authority, this self-developed method may raise issues regarding Shariah compliance quality, services, and fatwa decisions among IFIs due to the varying interpretations and judgments of Shariah principles among IFIs (Goud, Konde, Mohod, & Kharche, 2014).

This practice is followed by Saudi Arabia, Kuwait, and Qatar, as well as non-Islamic nations such as the United Kingdom, Germany, France, South Korea, Hong Kong, and Japan. Last but not least, the IFIs in the hybrid-structured nations must check Shariah compliance on their own and must submit their actions to the central regulating authority. According to the United Arab Emirates, IFIs must disclose any Shariah compliance problems to the "UAE's National Council of Shariah Supervisory Committees of IFIs" (Noordin & Kassim, 2019). According to Pakistani Shariah law, the institutional SSB must adhere to certain "fit and appropriate" standards and submit a Shariah compliance report to Pakistan's federal Shariah authority.

As a result of several research, it has been determined that the Shariah Committee (SC) plays an important role in establishing Shariah governance. Shariah governance has grown increasingly important in IFIs as a result of the establishment of SC, according to Grassa (2013) Governorship of Shariah Committee, Shariah Committee, and Profit. By guiding, evaluating and overseeing Islamic bank operations, the SC's role is to supervise bank transactions that are in accordance with Islamic law. In order to guarantee that bank activities, comply with Shariah requirements, the SC consults the Quran, Hadith, Ijma Ulama, and Qias, which are Islam's primary sources. A fatwa is also consulted when approving the financial activities of Islamic banks, which the SC reviews to verify they are in compliance with Shariah (Khan & Zahid, 2020). As a result, Shariah supervision under SC provides a solution for obstacles and conflicts, as well as advances in the organization (Garas & Pierce, 2010).

The Shariah audit role at IFIs is significantly necessary due to the possible negative impact on financial and non-financial performance that might occur (Shafii, Ali, & Kasim, 2014). Since the present Shariah audit handbook is deemed inadequate, it was also necessary to provide guidance to practitioners in conducting the Shariah compliance auditing process (Kasim, Mohd-Sanusi, Mutamimah, & Handoyo, 2013). Moreover, auditing always has a good influence on financial operations and evaluates accounting records and the financial state of a company. Using systematic risk management, the internal audit might assist the firm in monitoring its operations and adding value to the company. According to A. Hasan and Sabirzyanov (2015) study, the internal audit role is critical to the financial performance of a company.

## **2. Methodology**

As part of the research aim, a qualitative research approach is used to understand the major role and indicators of Shariah Governance (Moflih, 2016). Researchers used a variety of interpretative approaches to characterize, decode, and understand the meaning of certain more or less naturally occurring events that occur in the social environment, rather than the frequency of their occurrence (Cooper & Schindler, 2011). "Qualitative research and case studies might provide answers to "what" inquiries, as well as "why" and "how" ones, in a more detailed and comprehensive manner" (Alam, Islam, & Runy, 2021).

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It was decided to use semi-structured interviews to collect data and gain a better grasp of the study problem. Semi-structured interviews are those in which the interviewer asks a few questions that have been prepared, but has some latitude in the questions (Dane, 1990). Due to its versatility, the researchers were able to investigate in depth the respondents' points of view, which resulted in a wider range of information in the replies (Dane, 1990). Respondents can express their thoughts based on their experiences and expertise through this approach (Saunders, Lewis, Thornhill, & Bristow, 2019). Due to its differences from the other interview methods, this one allows interviewees to express their perceptions on the supplied information or phenomena (Berg, 2004). It is also important for explaining and comprehending events, as well as for providing a greater grasp of respondents' situations (Bryman & Bell, 2007).

During the study process, the researchers conduct a face-to-face interview in order to clarify and better grasp the research questions. Face-to-face interviews allow participants to give more detailed replies. In qualitative research, this approach helps participants comprehend the questions and ensures their freedom while expressing their ideas (Gillham, 2000). SG tasks in Islamic banks have been explicitly addressed in interviews with regulators, SSB members, Shariah department executives, and Bangladeshi field specialists. As a result of the research study, 17 respondents were interviewed (Alam, Rahman, et al., 2021), and they are symbolically coded. The respondents' backgrounds are shown in Table 2.

Research strategy is also a judgement that links research objectives and research questions to processes for data collecting, data processing, and the results of the data obtained (Yin, 2009). The Nvivo has been picked to evaluate transcriptions and other documents, as well as to improve data analysis (Gibbs & Su, 2002). The Nvivo programme is used for initial coding, categorization, and theme creation from the collected data (Strauss, 1987; Alam, 2020). Additionally, it allows for a more environmentally friendly data administration approach than the traditional paper and pencil method (Alam, Rahman, et al., 2021).

## 4.0 Results

### 4.1 Respondents' Profile

Table 4.1 lists the respondents' characteristics. R1 through R17 have been allocated to the respondents as pseudonyms to protect confidentiality. The average age of the interviewees was 38, with 12 of them holding administrative roles and 5 being Islamic scholars. Ten respondents were from full-fledged Islamic banks, six came through Islamic windows of conventional banks, and one was from the State Bank of Pakistan. All managers are mature enough to comprehend the concepts of Shariah Governance, Financial Technology, Risk Perception, and Islamic Bank Performance.

**Table 4.1: Respondents' Profile**

Row ID	Respondent ID	Experience	Age	Nature of Bank	Bank Name	Designation
1	R01	16	44	Islamic	Al-Baraka	Manager
2	R02	15	45	Islamic	Meezan	Vice. President

3	R03	06	28	Islamic	Bank Islami	IT-Manager
4	R04	11	44	Islamic	Dubai Islamic	Manager
5	R05	08	37	C-Islamic	SBP	Director
6	R06	07	33	C-Islamic	MCB	Team Leader
7	R07	08	36	Islamic	Faysal bank	Manager
8	R08	15	35	C-Islamic	HBL	Manager
9	R09	09	38	C-Islamic	Al-Falah	Manager
10	R10	06	42	C-Islamic	Allied Bank	Manager
11	R11	16	45	C-Islamic	UBL	Manager
12	R12	17	37	C-Islamic	Askari Bank Ltd	Manager
13	R13	12	34	Islamic	Al-Baraka	Islamic Scholar
14	R14	15	39	Islamic	Meezan	Islamic Scholar
15	R15	13	35	Islamic	Bank Islami	Islamic Scholar
16	R16	10	33	Islamic	Dubai Islamic	Islamic Scholar
17	R17	09	31	Islamic	Faysal bank	Islamic Scholar

#### 4.2: Thematic Analysis

As shown in Table 4.2, themes or nodes that were coded for the purpose of presenting the text in an instructive way were identified. In data analysis, themes are noteworthy patterns across data sets that are related to a particular study issue (Fereday & Muir-Cochrane, 2006). According to the table, we have the majority of the themes from effectiveness of Shariah Governance (N=69) from all the respondents. Then there are 51 and 49 references regarding role of Shariah advisory committee and Shariah supervisory board respectively. Knowledge and competence and role of Shariah audit are on the fourth and fifth with 30 and 41 references respectively. The primary themes are bold, and there are several sub-themes within them. Each node includes a description of the theme's sources and references. There are some variations in language because these themes were evaluated by two different researchers to minimise bias, but the content and context are the same.

**Table 4.2: Themes, Sources, and References**

<b>Name</b>	<b>Source s</b>	<b>Referenc es</b>
<b>Effectiveness of Shariah Governance</b>	<b>17</b>	<b>69</b>
Assessment	9	17
Evaluation	2	15
Financial Statement	4	12

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Product Development	7	11
Product Manual	4	16
Religious Assurance	4	15
Religious issues	3	17
SGF guidelines	2	13
Supervisory Role	2	14
External Auditor	3	11
Operations	7	11
Practices	4	16
Financial Instruments	4	15
Management of IFI	3	17
Objectives	2	13
Shariah Principle	2	14
Shariah Compliance	3	11
<b>Knowledge and Competence of BOD/ SSB</b>	<b>17</b>	<b>30</b>
Education	1	14
Experience	2	6
Fiqh Knowledge	4	8
Knowledge in Islam	1	6
Legal Expert	2	5
Training	2	4
Finance	1	6
Financial Budget	2	5
Accounting Knowledge	2	5
Islamic Scholars	1	3
Financial Management	2	4
<b>Role of BOD/SSB</b>	<b>17</b>	<b>49</b>
Appointment of Shariah Board Members	4	8
Assessment of Shariah Board Members	1	4
Board Size	2	5
Communicate Information	2	4
Board Composition	1	6
Managerial Role	2	5
Monitoring Role	2	2
Product Innovation	1	3
Performance Enhancement	5	2
Strategic Role	1	1
Board Size	3	3
Assistance to SBP	2	5
<b>Role of Shariah Advisory Committee</b>	<b>17</b>	<b>51</b>
Advise the SBP	2	3
Advising and guiding	2	5
Criteria for Appointment	2	4

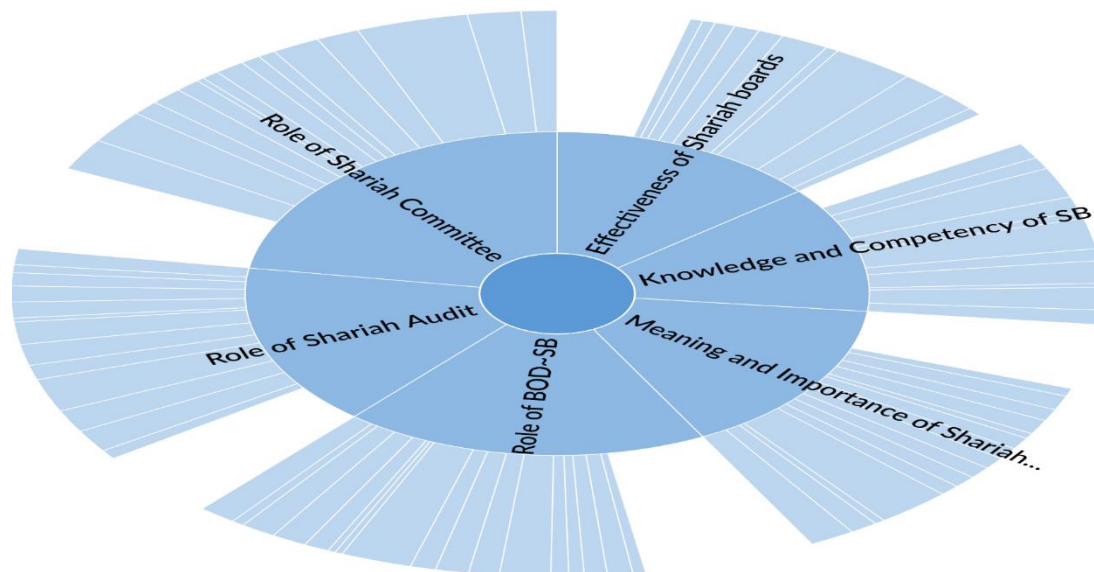
4.3  
and

Knowledge	1	6
Monitory Management	2	5
Products and Instruments	2	2
Prudential regulations	1	3
Reviewing and Managing	5	2
Shariah Issues	1	1
Shariah Ruling	3	3
Sound Advice	2	5
Full time Job	5	3
<b>Role of Shariah Audit</b>	<b>17</b>	<b>41</b>
Accounting Qualification	1	3
Conventional Framework	5	2
Expert Auditors	1	1
Shariah Principle	3	3
Legal Expertise	2	5
Examination of books of Accounts	5	3
Shariah Audit	2	3
Religious Assurance	3	3
Shariah Audit Regulations	2	5
Competence Level	5	3
Shariah Rules	2	3

Themes

categories

There are six different roles that the SG plays, as determined by Nvivo's data analysis of the interviews. These roles include following efficacy of Shariah governance, knowledge and competence of BOD/SSB, BOD/SSB role, Shariah advisory committee role, Shariah audit function, and others. As seen in Figure 1, Nvivo detected a theme and categories.



### 4.3 Cluster Analysis







## 5. Discussion

### 5.1 Shariah Governance and Its role in Islamic Financial Institution

The perspectives of respondents on Shariah governance and its function in Islamic financial organizations are presented in this framework. According to the literature, Islamic finance SG principles place a high value on strong CG norms and structures, openness, information sharing, and rigorous adherence to those values (Hashim, Mahadi, & Amran, 2015). In the following lines, many responders address the notion of Shariah governance:

“To ensure Shariah compliance, it's critical that Islamic financial institutions adopt Shariah principles and improve Shariah regulations.” (R1)

“The importance of a strong and comprehensive SG structure for the overall growth of Islamic financial institutions cannot be overstated. It has the ability to safeguard the interests of all interested parties”(R5)

“The SG system is essential in guaranteeing proper Islamic rules and regulations, as well as Shariah compliance in IFI instruments, commodities, operations, practices, and management, and it is impossible to achieve Shariah compliance without it” (R9)

“For Islamic banks and financial organizations, SG is critical in implementing Shariah principles and improving Shariah compliance quality” (R11)

“Moreover, SG is required to safeguard and satisfy the interests and expectations of shareholders, as well as the firm's performance.” (R16)

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IFI governance is discussed by several scholars, including the role of board of directors and Shariah boards. A variety of governance structures are provided by Islamic banks' SG, according to literature, which is distinct from commercial corporate governance (Choudhury & Hoque, 2006; Quttainah, Song, & Wu, 2013).

“The Board has an active role in approving and overseeing the implementation of the SG structure, as well as evaluating senior management's effectiveness in executing SAC resolutions and SC recommendations and judgments.” (R11)

“In fulfilling its managerial function, the BOD is obliged to be fully aware of Shariah non-compliance risk, as well as other risks associated with IBIs, in order to protect the IB's image and financial standing.” (R13)

SGF rules state that SB has two major responsibilities: Zakat management and offering guidance on religious activities. External Auditors will offer a quality judgement on whether the financial statements are accurate and fair.” (R16)

“As an SB, we are responsible for overseeing the entire operations of the Islamic bank. We are provided access to the whole process of the product handbook at the product development stage. In fact, since we desire to be genuinely Islamic, our SB was quite rigorous....” (R17).

"Before the bank sells a product to its clients, the SB will discuss and provide advice on product creation in accordance with Islamic principles. Then, we (SB) will determine if the product is highly recommended and authorized by religion or not." (R8).

According to several studies, Shariah advisory committees play an important role when it comes to ensuring the proper application of Shariah governance in Islamic financial institutions. Shariah advisory committees are essential for implementing Shariah governance principles, according to (Hakimi, Rachdi, ben selma mokni, & Hssini, 2018).

“In addition to overseeing operations that might result in Shariah non-compliance incidents, we also affirm them and approve correction measures”. (R7)

“The Shariah advisory Committee's main role is to examine and approve Shariah compliance on products/instruments produced by the SBP to execute its central banking and monetary management duties for the Islamic banking industry.” (R14)

“It is the responsibility of the SAC of SBP to give advice on Shariah-compliant processes for Islamic banking operations, and guidelines, instructions, and policies established by SBP in relation to the Islamic banking industry, which have been authorized by its SAC”. (R15)

“When SBs from Islamic financial institutions give contradictory Shariah views, the SAC's primary role is to help the SBP with Shariah decisions.” (R17).

Another key indication that ensures successful Shariah compliance in Islamic financial organizations is Shariah Audit. Shariah Auditing is a systematic method of gathering adequate and suitable audit evidence to offer an opinion on whether the subject matter (i.e. financial statements) complies with Shariah rules and regulations (Kasim, Mohamed Ibrahim, Ibrahim, & Sulaiman, 2009) . The Maqasid

Ash-Shariah and Shariah Auditing play an important role in making Islamic Financial Law more effective (Arwani, 2018). Some interviewees express their views on the role of Shariah.

“The primary objective of Internal Shariah Audit is to ensure that activities of the Islamic Banking Branches (IBBs) are Shariah compliant and Shariah rules, principles and guidelines prescribed by the SBP in IBD Circulars, Shariah Board (SB) and Islamic Banking Division (IBD) of the bank from time to time are fully complied” (R7)

“Shariah Audit provides higher level of assurance that makes Islamic finance more acceptable and trustworthy to the mass people and the stakeholders” (R9)

“The key objective of Shariah Audit is to provide periodical assessment and to add value and improve the degree of the audit assurance and make people believe that the Islamic institutions are following all the Shariah financing standards” (R11)

Based on the above discussion it is concluded that effective Shariah governance mechanism is very important for ensuring Shariah compliance in an institutions and the role of Shariah boards members, Shariah advisory committee and Shariah Audit is very crucial in this regard. Previous literature supports all the findings of current study (Al-Nasser Mohammed and Muhammed, 2017; Alam et al., 2020; Alam and Miah, 2021).

## 5.2 Conclusion

This study explores the question “what are the major indicators/components of Shariah Governance in Islamic financial institutions?”. The face-to-face interviews are employed to achieve the research objectives. The central bank and Islamic banks of Pakistan were contacted for data for this study. Nvivo concluded that there are six distinct roles that SGs play in the IFI's. These roles include, efficacy of Shariah governance, knowledge and competence of BOD/SSB, BOD/SSB role, Shariah advisory committee role and Shariah audit function. As the first research to highlight the importance of SG in Islamic financial institution, this study adds to the existing literature. For an Islamic financial institution to be complete, as well as to secure its distinct identity from the general banking system and corporate governance system, an SG manual, according to this study, is essential.

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