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Shariah Governance in Islamic Banks: Challenges and Opportunities

1. Introduction

Islamic banking presents an ethical framework for banking and finance shaped by the ontological and epistemological covenants – derived from the Islamic Shariah law – of *riba* (interest), *gharar* (speculation) and *maysir* (gambling) (see Ahmed, 2011; Beck et al., 2013; Haniffa and Hudaib, 2007; Kahf, 2004; Nawaz, 2019, Virk, Nawaz and Molyneux, 2022, among others). These covenants bring significant differences in the financial intermediation, product designing, development and commercialisation processes of conventional and Islamic banks (IBs). The application of these Shariah restrictions entrusts IBs to engage in services and transactions that are clear of interest features, speculative trading or investments, and be involved in risk sharing of the proceeds and revenues with the borrower (Nawaz and Virk, 2019).

All commercial entities offering Shariah-compliant financial services are mandated to keep their operations within the ambit of the Islamic jurisprudence. The modus operandi for religious compliance includes having Shariah Supervisory Boards (SSB), centralised supervisory and regulatory systems or a mixture of both with an emphasis on internalising Shariah compliance in the Islamic financial institutions.[1] Nonetheless, at large, Islamic corporations typically incorporate Shariah governance through SSBs at the corporate board level, which is one of the most distinct features of Islamic banking business model (Mollah and Zaman, 2015; Nawaz, 2019; Nawaz, Haniffa and Hudaib, 2021). This system usually draws

[1] The Islamic Financial Services Board (IFSB, 2019: 1) define SSB as "a board comprised of a panel of Shariah scholars who provide Shariah expertise and act as special advisers to the institutions." Similarly, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI, 2005, p. 4) Governance Standard No. 1 defines a Shariah board as "an independent body entrusted with the duty of directing, reviewing and supervising the activities of Islamic financial institutions for the purpose of Shariah compliance and issuing legal rulings pertaining to Islamic banking and Finance."

parallel to the two-tier governance system that separates management and governance (Hopt and Leyens, 2021). This similarity is rather superficial as SSB functions in a co-governance capacity where their role may further be divided into supervisory and advisory capacities (Virk, Nawaz and Molyneux, 2022). In addition, management, and company directors, through company boards as in unitary governance systems, maintain the eventual company decision making, planning and principal capacity system. This is in contrast to the management and governance dichotomy witnessed in dual governance systems e.g., Germany, Finland and China, among others.

The religious governance system in the IBs places committees/boards, among other provisions, which comprise Shariah scholars, overseeing if the approved projects by managers or conventional unitary system boards are in adherence to Islamic rules. Hypothetically, this internal control system i.e., SSBs operates in a limiting role without any fiduciary responsibility that is typically assigned to company boards and incumbent directors. In line with the larger aims of equity and justice within Islamic teachings and law, Shariah governance committee is envisaged with the duty of directing, reviewing and supervising the activities of IBs to ensure Shariah compliance (Malkawi, 2013). However, AAOIFI standards do not specifically hold Shariah scholars liable on the pursuance of wider aims of Islamic law for IFIs and IBs. Overall, Shariah governance in IBs is thus monitoring of pay-offs and transparency of products and services in a manner that none of the transacting parties are exploited in the corporate contractual and undertakings – more broadly known as *Fiqh al-Muamalat* (jurisprudence of transactions).

It is of paramount importance to divulge more on the role, importance and scrutiny of Shariah governance is Islamic banking sectors. Despite the significance of Shariah governance in Islamic banking business model and religiosity of Muslim clients, only scant attention has been paid to the link between governance and IB outcomes in general and Shariah governance in

particular.[2] Mollah and Zaman (2015), for instance, show that IBs' performance is positively linked with increasing size of SSB and when SSB are assigned a supervisory role whereas Nawaz (2019) finds contrary evidence using alternate performance measure. Nawaz's work also shows that Shariah compliance is not homogenous across IBs, and Shariah governance mechanisms are lax especially in large IBs. Safiullah and Shamsuddin (2019) document that the composition of SSB, with supervisory credentials, is conducive to improving Islamic banks' profit efficiency. The limited empirical evidence shows is mixed and is largely silent on various aspects of Shariah governance, thus calls for further empirical research.

In this special issue of the Journal of Islamic Accounting and Business Research (JIABR) on '*Corporate Governance in Islamic Banks: Challenges and Opportunities*', the research papers provide an assessment on the status quo of governance of the Islamic banking and finance industry, analysing various facets of the Islamic banking and finance business model as well as identifying avenues for future research. The next section provides a summary of the papers accepted for publication in this special issue. Section 3 concludes this editorial.

2. Summary of Papers

This special issue is an earnest effort for the readership of Journal of Islamic Accounting and Business Research (JIABR) on issues pertaining to Shariah governance. An invitation for call for papers was initiated through an international conference call: Decision making in a disruptive – seminars on *Critical Issues in Islamic Finance, Law, and Governance*. The authors also conducted a workshop on "*Corporate Governance in Islamic Institutions: Theory, Practice and Challenges*". The workshop was held on 22nd June 2022 and was hosted by the

[2] A great deal of research have been conducted analysing various features of Islamic banking business model: efficiency (Beck et al., 2013; Johnes, Izzeldin and Pappas, 2014), stability (Čihák and Hesse, 2010), securitization (Jobst, 2007), investment financing (Aggarwal and Yousef, 2000), risk (Safiullah and Shamsuddin, 2019), failure risk (Alandejani, Kutan and Samargandi, 2017), and loan default rates (Baele, Farooq and Ongena, 2014), among others.

School of Business Studies, Institute of Business Administration, Karachi, Pakistan. Selected papers from the conference were invited for submission to the special issue. With the support of JIABR and collaborating institutions a topical and timely debate on Shariah governance was encouraged to further the discourse on how religious governance would deal with challenges of future in supporting businesses, customers, due-diligence and wider Islamic goals of equity while engaging in critical discourse. There were also several papers that were directly submitted for the special issue. In total, 23 papers were submitted to the special issue. After a thorough review process, following JIABR's guidelines, eight papers have been accepted for publication in this special issue.

The summary of the special issues with key findings is provided below around classifications of opportunities, challenges.

Acceptance and impact of Islamic finance in creating business, economic and governance opportunities

Ullah, Haroon, Hussain and Rehman (2023) in their work ***"Islamic Labelling and Corporate Governance: A Perspective of Shariah Compliance Firms"*** argue that Islamic label of an organization attracts faith-based investing. There is a rising concern that labelling could be used to attract religiously inclined clientele base and if there are consistency issues pertaining to Islamic rules (principles), it would create issues of legal and ethical liabilities and undermine investor confidence. In this context, this study attempts to examine the effect of Islamic labelling on corporate governance in the Pakistani setting. The study employed a panel dataset comprising 120 Shariah-compliant and non-Shariah-compliant non-financial firms listed on the Pakistan Stock Exchange over the period 2013 to 2020. For analysis, the study employed static panel data estimation techniques. The findings deduced from empirical estimations reveal that Islamic labelling is positively associated with robust corporate governance dimensions such as

board size, board independence, CEO duality among others. Findings are consistent using alternate estimation approach of system GMM.

Shah, Bhatti, Anwar, and Soomro (2023) in their titled work "***Intention to adopt Islamic finance through the mediation of attitudes towards Islamic finance"*** explore the intention to adopt Islamic finance through the mediation of attitudes toward Islamic finance among micro-business owners of Pakistan. The study employs correlational analysis to quantify responses of micro-business owners through survey data that results in a cross-sectional design. The data filtration utilises 236 valid cases to carry out relational analysis. The results through structural equation modelling (SEM) reveal a significant positive effect on the perception of Shariah compliance (PoSC), knowledge of the Islamic financial system (KoIF), religious preferences (RP) and loyalty on intention to adopt Islamic finance (ItIF). Furthermore, attitudes towards Islamic finance (AtIF) are a potent factor in developing the relationship between PoSC, KoIF, RP, loyalty and ItIF. In the wake of known operational inconsistencies and controversies in Shariah compliance, this study's findings would be helpful for planners and policymakers in developing policies that favourably enhance the attitudes and intentions among individuals towards Islamic financing. The results would inspire investors and retailers to go to Islamic finance with the assurance that they will receive a consistent product and service from an interest-free financial system that is compliant with Shariah law or Islamic obligations. The study would provide implications for the financial institutions in Pakistan and the rest of the Muslim world. The study offers insights from micro-business owners of Pakistan.

Haridan, Hassan, Shah, and Mustafa (2023) in their titled work ***"Financial innovation in Islamic banks: evidence on the interaction between Shariah board and FinTech"*** investigate the role of the Shariah Board (SB) in the innovation of digital finance products through SBs' interaction with financial technology (FinTech). By using semi-structured interviews, the paper examines 34 views and experiences of scholars and other practitioners from the FinTech and

Islamic banking industries to gain an in-depth understanding of SBs' Shariah compliance roles in FinTech inclusion in Malaysian Islamic banks (IBs). Taking advantage of Malaysia's comprehensive Shariah Governance Framework for IBs, the study highlights the importance of SBs to better address the opportunities and challenges of financial innovation for the development of IBs with the inclusion of FinTech. The study further finds that digital solutions and tools, such as Robo Advisory system and blockchain, enhance SBs' roles by providing more effective and timely Shariah assurance regardless of the volume of data information and storage. Given SBs significant role in conforming to the Shariah, the study contributes significantly to assisting the regulatory and policy promulgation that enhance SBs' integrity and credibility in response to the growth of IB infrastructures and financial innovation.

Performance of Islamic institutions in response to COVID-19 pandemic

Yudaruddin (2023) in the titled work ***"Government Policy Response to COVID-19 and Bank Performance: A Comparison Between Islamic and Conventional Banks"*** aims to examine the joint impact of the COVID-19 pandemic and the government response on the performance of Islamic and conventional banks. Data were collected from a sample of 94 conventional and 14 Islamic banks in Indonesia from March 2020 to September 2021. The system GMM estimation is used to analyse the data. This study finds robust results regarding the negative impact of the COVID-19 pandemic and the positive effects of government responses to COVID-19 pandemic on bank performance in Indonesian banking. Moreover, in line with the rise in confirmed COVID-19 cases, a higher government policy response index improves bank performance, both in conventional and Islamic banks. This paper highlights the importance of the government policy response index to absorb the negative impact of the COVID-19 outbreak on banking performance. This paper provides novel insights into the joint impact of the COVID-19 pandemic and government response to COVID-19 pandemic on bank performance between conventional and Islamic banks.

Mkalaf and Hilo (2023) in their titled work ***"Using the Tobin's Q model to evaluate the Impact of Credit Risks on the Bank's Market Value during the Corona pandemic"*** aim to assess the impact of credit risk on the market values of the private banks during Corona pandemic. This study identify critical issues on credit risk at six large private banks. A conceptual framework is designed based on the Tobin's Q model for investigating study hypothesizes. A quantitative financial analysis methods have been used for processing data such as financial ratios, arithmetic mean, and multiple linear regression. The most important results of this study are the lack of influence of credit risk on the market value of selected banks. Although the dimensions of credit risk have a critical importance in increasing or decreasing the market value. So, these banks must continue to adopt quantitative financial analysis to measure credit risks to avoid their risk. The need for financial indicators to help assess the market value of banks during the economic crises caused by the closure of commercial institutions during the Corona pandemic. With the continued increase in bank credit to support these institutions, borrowers, and cash withdrawals, which may affect their market reputation.

Challenges stymieing Islamic finance – economic growth, innovation culture and data aggregation

Naz and Gulzar (2023) in the titled work ***"Islamic financial development & economic growth: The emergence of Islamic financial market in Pakistan"*** argue that in the wake of wider goal of equity in Islamic societies, it is paramount to evaluate if Islamic financial services are resulting in economic growth. This study seeks to empirically evaluate how the development of Islamic finance affects the long-run and short run economic growth in Pakistan. The impact is evaluated at institutional level through Islamic banking development (IBD), Islamic bond market development (IBM) and Islamic stock market development (ISM) as measures of Islamic financial development, whereas real GDP is taken as measurement proxy of economic growth. Using quarterly data from Q1:2006 to Q4:2021 several estimation approaches are

employed. Findings indicate that in the long run there is a significant and positive correlation between IBD and ISM with the real GDP but ISM is negatively cointegrated with real GDP in the short run. In contrast, IBM and real GDP are not cointegrated in the long run, although the relationship is significant but negative in the short run. Results highlight that Islamic financial development in Pakistan can contribute to the country's economic development, but its impact is mixed at this stage. This can be improved through developing better infrastructure, increasing skilled professionals, creating a favourable legal environment, and ensuring financial sector stability. Investors can diversify their investments and mitigate risk by adding Islamic financial instruments to their portfolios. This pioneering study simultaneously measures the cause & effect relationship between Islamic financial development indicators (Islamic banking, Islamic bond, Islamic stock) and economic growth in Pakistan. The effect of robust religious monitoring in one of the largest Muslim economies shows financial development is linked to economic output.

Usman, Li, Chaudhry, and Akhter (2023) in the titled work ***"Does Religion Impact Corporate Innovation in Developing Countries?"*** examine how religion affects corporate innovation in developing countries. Firm and country-level indicators are used to evaluate the relationship. The study's final sample consists of manufacturing firms from 41 developing countries across different world regions from 2014 to 2018. This paper finds that firms operating in more religiously diverse countries with lower religious restrictions are likely to be more innovative. Furthermore, secularization stimulates corporate innovation in contrast to traditional religious societies. Interestingly, results also indicate that religion hinders corporate innovation by restraining its followers' involvement in innovative activities under riskiness, which downgrades corporate innovation culture. This study employed data from non-financial firms from developing countries; therefore, the study's findings could be generalized to other developing economies with caution, as economies operating at different stages of development

can have different outcomes of the proposed relationship. The study findings are important for innovative firms as they can take advantage by segmenting the population based on religious and atheist groups. Results also have some implications for developing countries to foster firm-level innovation through constructing effective policies and ensuring the development of diverse and free religious societies because such societal traits increase corporate innovation and are fruitful for national competitiveness and growth. This study contributes to institutional economics and corporate innovation by exploring the link between religion and economic development through the innovation channel by analysing the latest cross-countries evidence. It is a pioneering work in empirical comparison of influence on innovations of different religions.

Butt, Sadaqat, and Shear (2023) in ***"Does Islamic financial development foster economic growth? International evidence"*** observe that contemporary evidence links Islamic Financial Development (IFDI) to economic growth. There are at least two major flaws in these investigations. First, the proxy employed to measure IFDI may not represent the whole impact of IFDI on economic growth because it only considers a subset of variables like Islamic Banks' deposits or sukuk issuance, etc. Second, it is difficult to extrapolate findings to other markets because most studies were conducted in just one nation or a small group of countries. Overcome these data identification and sample limitation issues drive organization of research aims in this work. In doing so, this work uses the aggregate financial development of IFDI as a proxy for Islamic finance. The index measures the quantitative growth, knowledge, Corporate Social Responsibility (CSR), governance, and awareness of the Islamic financial sector. Moreover, this work uses a broad set of countries to better understand the relationship between IFDI and economic growth by segregating the countries as Muslim and non-Muslim, as well as developing and developed nations. Using Panel data set of 67 countries starting from 2012 to 2020, this study investigates the relationship between Islamic Finance and economic growth.

In sum, this work highlights Islamic finance contribution to economic expansion. This connection is more robust in Muslim and developing nations than it is in non-Muslim and developed nations. Results are robust to the inclusion of control variables in related literature as well as to the alternate proxy for Islamic Finance Development. To promote a country's economic growth, this work initiates a discourse on how regulators should focus on Islamic finance. To increase the reach of Islamic products, the government should take initiatives to raise public awareness of Islamic finance shaping investor confidence in financial sector and its intermediary role in achieving systematic goals. Among others, this is one of first studies that use cross-country analysis linking IFDI to economic growth, covering both Muslim and non-Muslim nations, as well as both developing and developed nations. In addition, this study, unlike its predecessors, employed a more robust and comprehensive index of Islamic Finance developed by Thomson Reuters.

3. Conclusion

Islamic finance has grown into a large international sector on the back of double-digit growth spawning over the last three decades. However, more recently growth has slowed down. There could be several factors including anaemic global growth. Nonetheless, there are several endogenizing considerations that Islamic finance research and practice should consider in achieving the wider objectives of Islamic finance. Firstly, fundamental questions relating to the essence of Islamic finance and its underpinned principles and to what extent it has succeeded in changing social and financial inequalities in developing countries require attention. Secondly, how ethicality of religious governance and agency issues of religious agents are addressed in promoting consistent regulatory systems and the oversight of religious governance and scholars need further consideration. Third, product and service development are improving financial intermediation that spurs entrepreneurship and innovation, however, religiosity that hampers innovation is detrimental achieving economic growth. In this vein, Usman et al.

(2023) findings are especially pertinent. That is, policy making, regulations and businesses should consider development of Shariah-complaint products and services does not lead to excluding and regressive marketing narratives – business strategies that check pro-innovation investing and client orientation towards innovation. That is, evidence in their work points that pro-innovation investing is available in markets that are less religiously inclined. However, Ullah et al. (2023) and Shah et al. (2023) show that there are gains in creating labels and perceptions that are coherent and do not leave religiously inclined investors in a mix.

That is, the exponential growth in Islamic finance that is already slowing down will have a knock-on effect on the ability of financial intermediaries to raise funds for the firms – net-demanders of capital – that pursue a pro-innovation agenda under uncertainty. Nonetheless, the net effect of investment in innovation is known to contribute to economic development internationally and with a caveat in the Muslim world (Butt et al., 2023; Naz and Gulzar, 2023; Usman et al., 2023).

Another important research agenda for future is stipulation of legal and regulatory frameworks that should ensure consistency and coherence of application of Islamic laws and civil/criminal laws in enhancing the reliability, stability, and trust in the Islamic finance sector. In sum, lack of wider understanding, opaqueness and inconsistent application of company by-laws contributes to financial instability and absence of trust in the Islamic financial markets and intermediation. Regulatory frameworks have to move ahead from creating awareness on investor perceptions on suitability of Islamic products to trust-enhancing market environment that promotes transparency, investor confidence and financial services that create jobs in real economy on the back of investments in the future of knowledge economies and sustainable solutions. In sum, this should be available through qualified and aggregated datasets (Butt et al. (2023) and through efficient provision of financial services in periods when markets squeeze (Mkalaf and Hilo, 2023; Yudaruddin 2023). In turn, this is also linked to standardisation of

governance mechanisms at macro-level (e.g., accreditation and regulatory bodies) and micro-level (internally at company levels) and require further scrutiny while exploiting different dimensions of data and applicable religious governance standards across Muslim countries. Importantly, the core issues confronting the future growth and stability of Islamic finance sector should speed up and expand the base of financial innovation that has remained overall slow and controversial in some instances. This raises several operational, legal and developmental issues when financial innovations yield efficient organizational forms allowing firms to deliver quality and utilitarian products demanded by their customers at the lowest price by mitigating transaction costs. The gains of embedding technology can result in financial services efficiency as well streamlining the work of SBs as shown in Haridan et al. (2023). Therefore, future research should build over the findings presented in research works through this special issue to provide theoretical and empirical frameworks to alleviate social and economic inequalities while supporting future of innovation through transparent and evolving religious compliance systems. A transformative agenda for future of Islamic finance and religious governance structures on the noted research problems bring evidence base that will lead Islamic finance as truly an ethical model that mitigates the adverse implications of conventional financial intermediation by making a change for societies by reducing social and economic inequalities.

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