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## Shariah Governance Framework for Islamic Banking Institutions (IBIs): A Critical Analysis

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# ***Shariah* Governance Framework for Islamic Banking Institutions (IBIs): A Critical Analysis**

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## **Abstract**

The purpose of the current study is to critically analyse the *Shariah* Governance Framework (SGF 2018) of the State Bank of Pakistan (SBP). SGF 2018 provides the foundation for the operations of the Islamic Banking Institutions (IBIs) in Pakistan. The requirement of *Shariah* compliance along with the compliance of the contemporary banking standards makes it more challenging for the staff of the IBIs to ensure the satisfaction of all stakeholders. Besides profitability, the clientele of the IBIs needs complete satisfaction regarding the fact that their funds are administered according to the *Shariah* laws and returns are generated only from the business operations permissible in the *Shariah*. SGF 2018 was critically analysed by systematically and objectively identifying its special characteristics relevant for the IBIs. Moreover, utilising the interpretive and naturalistic approaches including both observational and narrative based discourses associated with ground realities, the current study outlines pragmatic modifications in the existing framework to bridge the gap between the *Shariah* Board (SB) and the Board of Directors (BOD). Over the years, *Shariah* governance mechanisms have evolved significantly in Pakistan. However, there is always the need and room for improvement and further development. SGF enables the smooth functioning of the IBIs with a predetermined set of instructions and objectives. Nevertheless, the IBIs need continuous monitoring and handholding to implement the SGF in its true letter and spirit. The current study critically analysed the SBP's updated SGF 2018 through content analysis and identified some important gaps in it. These gaps include the absence of the Board's Committee of *Shariah* Governance (BCSG) and the lack of attention towards *Shariah* compliance. Furthermore, the ratings of the IBIs were investigated and discussed with reasonable clarity. It was observed that the lack of performance evaluation of the BODs and the SBs is an important impediment in the development and expansion of the IBIs. The current study identified that the existing SGF is devoid of determining the key performance indicators (KPIs) for the IBIs in terms of their *Shariah* compliance as well as the performance of their respective BODs and SBs. Therefore, the study proposed a new SGF for the IBIs to ensure a close

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liaison between their respective BODs and SBs through the existing BCSG, along with the provision of the KPIs required for gauging their *Shariah* compliance rating.

**Keywords:** Islamic Banking Institutions (IBIs), Key Performance Indicators (KPIs), *Shariah* Governance Framework (SGF), *Shariah* Board (SB), *shariah* compliance ratings

**Note:** The article was presented during Islamic Finance Conference on Emerging Trends in Islamic Finance on December 09, 2019 at IBA – CEIF Karachi, Pakistan.

## Introduction

*Shariah* governance through *Shariah* Boards (SBs) is essential to monitor and govern the operations of the Islamic Banking Institutions (IBIs) in order to ensure their integrity, credibility, transparency and reputation. *Shariah* governance ensures the *Shariah* compliance of the Islamic banking operations, procedures and practices (Masruki et al., [2018](#)).

IBIs are required to establish SBs with the aim to supervise their operations in order to ensure that they abide by the *Shariah* principles. According to the *Shariah* Governance Framework (SGF 2018) issued by the State Bank of Pakistan (SBP), SBs have the power to ban any of the operations and activities of the IBIs which is non-compliant with the *Shariah* principles. The decisions of the SB related to *Shariah* compliance are binding even for the Board of Directors (BOD), which actually appoints the SB members including the chairman after the approval from the SBP. This indicates that having an effective and efficient SB is a matter of prime concern for the IBIs; otherwise, weak and inefficient SBs may adversely affect the reputation, integrity and perception of Islamic banks and the Islamic finance industry. Moreover, the Investment Account Holders (IAH) and depositors may lose their trust on Islamic banks and this may affect the financing and investment decisions among the existing and future customers of the IBIs.

At the moment, the fundamental role of an SB is to ensure the compliance of an IBI's operations, affairs and activities with the *Shariah* principles. The SB must advise the BOD about the *Shariah* matters related to the banking operations, coordinate with the Executive Management (EM) to ensure that the procedures conform to the SGF, and maintain the record of discrepancies for remedial measures. However, some argue that SBs hamper the performance of Islamic banks, although these notions exist only because of the narrow view of their role in the operations of the IBIs. If SBs do not perform their duties in the real spirit, the meagre differences existing today between the conventional and Islamic banks will vanish. We need to enhance the competency level of the SBs to ensure that the IBIs

stand clearly apart from their conventional counterparts with much better returns on investments and equity.

### **Objectives of the Study**

The objective of the current research is to critically analyse the SBP's updated *Shariah* Governance Framework 2018 for the IBIs. The aim is to determine if the said framework provides a robust and an all-encompassing structure for the effective and efficient *Shariah* supervision of the IBIs and how it can be further improved to secure even better outcomes for them.

### **Critical Analysis**

The aim of critical analysis is to evaluate a phenomenon or framework with respect to the intended objectives. If there is a gap between the intended goals and the existing framework, then critical analysis helps to identify areas for improvement in order to achieve better outcomes. Critical analysis is the evaluation of the transcript while breaking down the manuscript in different parts for comprehensive investigation (CA, [2020](#)). The current study involves the critical analysis of the SGF 2018 to suggest pragmatic modifications in its existing version. The aims is to bridge the gap between the SBs and the BODs for better coordination and troubleshooting besides taking additional initiatives, such as determining the Key Performance Indicators (KPIs) for both the bodies and *Shariah* compliance ratings of the IBIs.

### ***Shariah* Governance of the IBIs**

The term '*Shariah* governance' refers to a unique mechanism of the IBIs aimed to ensure that their operations adhere to the Islamic principles. The IBIs have to comply with a two-tier governance system. Firstly, they need to ensure compliance to the conventional financial regulations conforming to the Islamic guidelines. Secondly, they have to remain within the framework of the *Shariah* (the Islamic law). *Shariah* governance of an IBI is controlled by an effective SB consisting of qualified religious scholars certified by the SBP on the basis of their qualification and experience in the relevant field (Grassa, [2015](#)).

According to the IFSB ([2009](#)) Standard 10, "*Shariah* governance system refers to the set of institutional and organizational arrangements through which an IIFS (institution offering Islamic financial services) ensures that there is effective independent oversight of *Shariah* compliance."

According to Eldersevi ([2019](#)), "*Shariah* governance is integral to Islamic financial system's stability. The institutionalisation of a sound *Shariah* governance

framework strengthens public confidence in the integrity, management and business operations of the Islamic financial institutions. The *Shariah* governance framework for Islamic financial institutions has played a critical role in supporting robust and orderly developments of the Islamic finance industry. In particular, the framework has led to the institutionalisation of governance structures, policies and processes to promote end-to-end *Shariah* compliance in Islamic finance operations.”

Bahari and Baharudin (2016) argued, “*Shariah* governance is a system that ensures all activities and business transactions of IBIs are free from non-allowable elements such as *riba*, *gharar*, *maisir* and other similar attributes.” SGF is a structural process by which Islamic banks monitor, control and conduct their activities. Therefore, it is important to critically analyse the SGF and to eliminate its weaknesses in order to ensure productive and reputable financial operations of the IBIs (Alam et al., 2019).

### Critical Analysis of the SGF 2018

The existing SGF provides a *Shariah* governance structure to the IBIs stating the varied roles and responsibilities of the SB and other relevant bodies including the Board of Directors (BOD), Executive Management (EM), *Shariah* Compliance Department (SCD), and *Shariah* audit (see Exhibit 1 to know the flow of activities and control in SGF 2018).

Critical analysis of the SGF 2018 leads to the following important aspects for consideration:

1. IBIs have to ensure an “effective mechanism for the BOD’s oversight of IBI’s *Shariah* compliance environment.” However, the SGF 2018 provides no formal mechanism for direct communication between the BOD and the SB.
2. IBIs shall ensure the “accountability of management and staff of the IBI in implementation of the Framework.” Nevertheless, there is no such mechanism delineated in the SGF 2018 which allows for the accountability of the EM to ensure its true implementation. SCD is assigned the role of a bridge between the SB and the EM with an apparent role as a facilitator. However, it gives too much space to the EM by encouraging it to nurture business motives and allows it to put aside the spirit of the IBIs. The current framework keeps the SB vulnerable and subject to EM interventions through the BOD’s authority.

3. SGF 2018 further suggests, “The BOD shall be ultimately responsible and accountable for ensuring full conformity of the IBI’s operations with *Shariah* principles. The BOD needs to be fully cognizant of the risk of *Shariah* non-compliance and its potential implications on the reputation and business of the IBI. The BOD shall introduce an effective mechanism including diligent oversight on the functioning of the Framework and compliance with the *fatawa*, instructions, and guidelines of the SB.”

Without communicating directly with the SB, how the BOD will discharge the duty of conformity with the *Shariah* principles, remains unclear. What are the risks for window operations associated with *Shariah* non-compliance, as they are known already as part of the conventional banking system? How SGF 2018 will ensure that window operations are not subject to cynicism? What is the threshold for reputation damage and what is the mechanism for rating reputation? Diligent oversight without a regular and direct interaction between the BOD and the SB seems little difficult. Only two meetings in a year may not be enough to understand the circumstances, business pressures, public sentiment, and regulatory difficulties for the SB to maintain *Shariah* compliance.

4. According to SGF 2018, “the BOD should also be fully aware of its fiduciary responsibility. The IAHs expect IBIs to not only exercise prudence in deployment of their funds in different avenues but also to ensure *Shariah* conformity of the returns to be earned and distributed to them.”

If we are confident about the delivery of fiduciary responsibilities by the BOD, then why the decisions of the SB are binding for the BOD and if not, then either the composition of the BOD itself should be diversified or its interaction with the SB should be enhanced. Post hoc diligence to ensure the *Shariah* conformity of returns through Board Audit Committee and Internal *Shariah* Audit Unit is not sufficient. *Shariah* conformity starts from the conception and development of products and stretches all the way to their deliverance. There are several obstacles and bottlenecks in the conception, development and deliverance of products which a BOD can only resolve through frequent and direct communication with the SB. There are sometimes subtle but important conflicts of interest between the EM and SB which need the BOD’s attention. SGF has to provide guidelines to eliminate this gap.

5. SGF 2018 proposes, “The BOD shall appoint a SB to perform such functions as stipulated under Para 3(B) of this Framework and shall cause to take appropriate measures for introducing and implementing an effective *Shariah* compliance framework.”



If the BOD is responsible for the appointment of the SB of an IBI, then the BOD should have a mechanism in place for the performance appraisal of the SB as a body and also that of every member of the SB individually, according to the international best practices. BOD should prescribe the KPIs for the SB members for their annual performance appraisal. SGF 2018 does not provide any KPIs for SBs, nor does it provide the rubric for the performance appraisal of SBs and their members. Currently, contract extension of an SB and its members remains the discretion of line managers including the heads of Islamic banks and/or their CEOs. This situation depicts an obvious conflict of interest since those who have to ensure the bottom line of IBIs play a key role in the contract extension of the SB members who are actually responsible for *Shariah* compliance, irrespective of profits. We cannot ignore the potential lucrateness of the SB positions; therefore, being soft at times to each other by SB and EM is quite probable. The purpose is to enjoy the favourable attitude of EM by the SB members during their contract renewal.

The BOD itself has to ensure an attractive bottom line for equity holders and IAHs. SGF 2018 fails to determine if *Shariah* compliance remains a top agenda for the BOD, at least in Islamic banks. SGF needs to incorporate a mechanism to monitor and resolve this matter. It is only possible through a strong governance mechanism which involves the regular annual appraisal of all the governing bodies including the BOD.

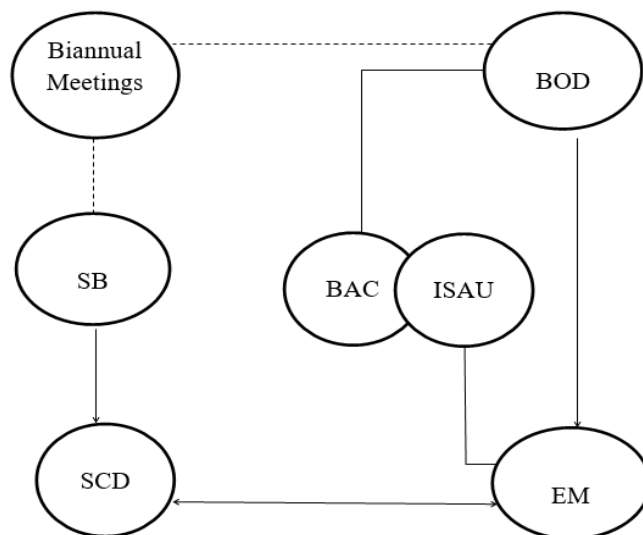
A considerable effort is currently being made by the IBIs to “provide exposure to the SB members with regard to domestic and international developments in Islamic banking and finance.” However, there is significant negligence when it comes to “trainings and/or orientation programs on Islamic banking and finance for the members of the BOD and appropriate training programs for senior executives to improve their understanding and general acumen in Islamic finance.” Similarly, there is less attention paid towards “programs on a regular basis for orienting and sensitizing the BOD and senior executives about the business utility and importance of an enabling *Shariah* compliance environment and the key distinguishing features of Islamic finance products vis-à-vis conventional banking products.”

6. SGF 2018 suggests that “the SB members shall be appointed for a term of three (3) years” subject to the SBP’s clearance. However, it does not describe the Standard Operating Procedures (SOPs) for their contract renewal. Indeed, term-based contract renewal provides significant space to the EM to silently remain an important factor in the continuity of the services of the SB members.

Further, this contractual status is a continuous threat for the SB members which prohibits them from working independently. The interventions of EM and their access to the BOD as well as the reliance of the BOD on EM to determine if the contracts of the SB members should be extended or the respective IBI needs their replacement is probably the most important vulnerability in the existing SGF. It may be the root of several minor compromises by the SB members regarding *Shariah* compliance, which may cause a real damage to the reputation of IBIs as *riba* free banks. The implicit dependence of contract renewal on the EM and/or the BOD can potentially fade the distinction between conventional and Islamic banks. For ensuring the real independence of the SB members, the current framework needs to outline their service structure with standardized compensatory brackets according to their qualification, experience and above all, their performance as contributors towards the development of the Islamic Banking and Finance.

**Figure 1**

*Existing Shariah Governance Framework*



Reliance on the SBP's clearance can be misleading because if an IBI is determined to disengage with any SB member, it is not difficult to submit a proposal for an equally competent *Shariah* scholar. While such a proposal may praise the services of the existing SB member, yet at the same time, it may aspire to have a fresh mind for the betterment of the respective IBI, which will obviously be difficult for the SBP to decline. Therefore, it is much needed to have a well thought of,



transparent, performance-based contract renewal mechanism for the SB members, which is not possible without well-defined KPIs.

7. On the one hand, SGF 2018 proposes that “all decisions, rulings, and *fatawa* of the SB shall be binding on the IBI.” On the other hand, it provides the SB team with a fragile contractual platform of services. SGF suggests that “SB shall be responsible and accountable for all its *Shariah* related decisions.” However, it fails to give a framework intended to ensure the accountability of the SB.
8. Beside other functions, SCD “shall ensure that all organs of *Shariah* governance including the BOD oversight mechanism, internal *Shariah* audit, and enforcement of the SB’s directives by EM are operative and are effectively discharging their respective functions and responsibilities as defined in the Framework.” The question is how a Resident *Shariah* Board Member (RSBM) or an equivalent officer will evaluate or ensure the BOD’s oversight activities and the EM’s enforcement of the SB’s directives? IBIs will require an exclusive apparatus to ensure that the BOD is fulfilling its responsibilities. The task of monitoring the enforcement of the SB’s decisions by the EM also requires a relatively higher office than the contractual office of RSBM.
9. SGF 2018 also suggests a bit more than the practical scope of the SCD mentioning that “the Head SCD shall periodically submit a report to the SB on the overall *Shariah* compliance environment of the IBI, the ownership and commitment of the BOD and EM in building the necessary infrastructure for *Shariah* compliance together with identifying key areas of improvement.” How the Head SCD will measure the ownership and commitment of the BOD without being able to participate in all its meetings remains an open question. Alternatively, to avoid confusion, SGF 2018 should outline those key areas which the SCD has to focus to determine the BOD’s commitment to *Shariah* compliance.
10. SGF 2018 is devoid of the motivational aspect for the IBIs, such as there is a lack of any *Shariah* compliance rating system designed to give a prominent place to those IBIs who are as good in *Shariah* compliance as in their financial performance indicators.
11. SGF 2018 also neglected to explicitly identify the KPIs of IBIs in order to give them a fast track for expansion. IBIs are unique institutions with special requirements of *Shariah* compliance. Therefore, all of their managing and

regulatory bodies, from BOD to ISAU, have to be completely abreast of the KPIs for greater organizational success.

### **Performance of SBs**

There are a limited number of studies available which investigated the influence of the SB's performance on the overall performance of an IBI. It will be easier to discuss the performance of SB if we equate it with the BOD of a bank. As New York Stock Exchange suggests, it is important for boards to "conduct a self-evaluation at least annually to determine whether it and its committees are functioning effectively." It is a generally accepted best practice for a board to conduct self-evaluation. However, "delineating the findings of Board evaluation is not enough. To be a meaningful exercise, the outcomes must result in an actionable plan. The process of implementing the outcomes then naturally becomes a crucial step in the entire evaluation process and should deserve the full attention of the Board and in turn of the management" (Deloitte, [2014](#)).

The alternative engagement of an external independent expert or a consultant or advisor to facilitate the evaluation process of an SB may work better. Those who favour an independent external evaluation argue that with the independent external interventions, the evaluation process becomes more reliable and acceptable for the relevant stakeholders. Overtime, internal evaluation tends to become a very much mechanical process, while an external facilitator / advisor / evaluator can bring in fresh perspectives and approaches. According to Deloitte ([2014](#)), "In large international corporations, Board evaluations are usually conducted by the Governance and Nomination Committees with the help of outside experts. However, there are many companies, especially those in Europe and particularly in the UK, who advocate that the exercise should be conducted only by an independent external expert who would be in a better position to make an independent assessment."

Good evaluations have both quantitative and qualitative aspects. The latter usually informs the evaluations with rich data, which brings greater objectivity to them. The evaluation process involves the identification of the areas for evaluation, formulating a questionnaire regarding the areas for evaluation, and obtaining the responses of the individual SB members to the questionnaire on a rating scale. Thereof, it consists of conducting interviews with the individual SB members and analysing the responses to the questionnaire, as well as the responses obtained during interviews (Deloitte, [2014](#)). The findings may be reported to the BOD and SB; both for their deliberations and for the corrective measures required for future developments intended to improve the efficiency and effectiveness of the IBI

operations. The SB can develop an action plan and may periodically review the progress of its implementation (Deloitte, [2014](#)).

### **Individual Evaluation of the SB Members**

Although there may be hardly any differences regarding the evaluation of SB members. However, we need to develop an opinion regarding the performance evaluation of the individual SB members; whether it is a valuable exercise or it can inhibit the SB's dynamics and group performance. The evaluation of the individual SB members most probably will differ from the SB's evaluation in several respects, though the evaluation methodology and the processes may largely remain the same. Both processes can have qualitative and quantitative parts – questionnaire responded on a rating scale followed by interviews – but the parameters of the evaluation may differ (Deloitte, [2014](#)). The parameters designed for the evaluation of the individual SB members may incorporate their contribution to the SB's strategic thinking, their research and publications in the area of Islamic banking and finance, their leadership and commitment, their participation in the SB's meetings, their communication and interpersonal skills, ethical issues and dilemmas faced by them, and their relationship with the EM.

### **Learning from the International Best Practices for Board Evaluation**

The following table elaborates the practices related to Board evaluation adopted in some developed and developing countries (Deloitte, [2014](#)).

**Table 1**

*Learning from the International Best Practices for Board Evaluation*

Institution/Source	Frequency	Recommendations
The U.K. Corporate Governance Code	Annual	(i) The Board should undertake a formal and rigorous annual evaluation of its own performance and that of its Committees and individual directors. (ii) Evaluation of the Board of FTSE 350 companies should be externally facilitated at least every three years (on a comply-or-explain basis).
U.S. National Association of Corporate Directors (NACD)	Regularly	The Governance Committee is responsible for ensuring that a process exists for the Board to routinely assess its own performance and the performance of its

Institution/Source	Frequency	Recommendations
IBGC Code of Best Practices (Brazilian Institute of Corporate Governance)	Annual	Committees, as well as for each director to perform a self-assessment. (i) A formal evaluation process of the performance of the Board, of individual directors and of the CEO. (ii) The process shall be conducted by the Chair. (iii) The participation of an outside expert may contribute to the effectiveness of the process. (iv) Evaluation system shall be adapted to each organization. (v) Disclosure of the process and of the evaluation results to the shareholders.
CNV (Argentina's securities regulator)	Annual	A formal Board Evaluation.
Mexican Code	Not defined	Performance evaluation of the Board and its members' fiduciary duties. Board of listed companies should undergo annual internal evaluations
OECD	Annual	covering both the competencies and performance of their members as well as the Board's functioning.

Source: Adopted from Deloitte (2014), *Performance Evaluation of Boards and Directors*

If the performance evaluation of the BOD is mandatory and carries significant usefulness for banks, then it is hard to ignore the importance of determining the KPIs of the SB and the performance appraisal of the individual SB members against the identified KPIs.

### Shariah Compliance Ratings

Shariah compliance is probably the most important reason that people do engage with the IBIs, especially in Muslim communities. "Literature, on the basis of surveys of customers of the IBIs, clearly suggests that one of the primary reasons to transact business with IBIs is *Shariah* compliance. Therefore, the *Shariah* compliance character of each institution needs to be documented for the broader benefit of all relevant stakeholders. *Shariah* compliance rankings of IBIs –

especially banks due to their leadership role based on asset volume – are justified for the following important reasons” (Hanif, [2018](#)).

- A rating system will help in boosting the customers’ trust and confidence in the IBIs as *Shariah* compliant financial institutions.
- A ranking system will exert positive pressure on the EM of the IBIs to increase the application of *Shariah* based financial contracts, provided the higher score reserved for them. It will also motivate them to adopt a mechanism to reduce the violations of the *Shariah* principles.
- The rating system will lead to reward in the form of more business from the customers for those who score high in *Shariah* compliance. According to Hanif ([2018](#)), in a survey the participants showed a stronger preference (by expected customers and investors) for transacting business with a financial institution graded higher for Islamic ethics and values.
- The ranking system will identify the leading institutions by recognizing their hard work aimed to ensure *Shariah* compliance in their banking operations. It will also identify opportunities for those who score relatively low in the ranking to develop their future strategies.
- The rating system will certainly give reliable cues to the customers to choose an IBI according to their needs and requirements. Rating systems usually identify explicitly the strengths of the participating organizations. Besides overall ranking, they also provide much better understanding about different organizations operating in a sector.
- Islamic investors have a dual concern in terms of financial stability and *Shariah* compliance of the IBIs. A *Shariah* compliance ranking coupled with a financial rating will address their concerns.
- *Shariah* compliance ratings of the financial industry will help different professionals to identify and extend their roles to strengthen the IBIs.

### **KPIs for the IBIs**

The fundamental motivation behind the implementation of the SGF remains the better performance of the IBIs within the *Shariah* guidelines. According to Hanif ([2018](#)), “Islam promotes justice; as such, a just financial system is required to satisfy at least two conditions – sharing of risk and rewards, and equitable access to finance – in addition to stability. Access to finance means it is also available for the less privileged. This would provide employment opportunities and help to

alleviate poverty and reduce inequalities of income and wealth. A well-documented principle of the Islamic financial system is *al-kharaj bi al-daman* (benefit goes with liability). Cash lending for return (risk-free return) is prohibited because it is *riba*. The lender is not liable for the cash while it is on loan; hence, he has no right to benefit from it while the borrower is liable for it. Cash lending without return is a charitable loan, which is praiseworthy. Debts are not totally eliminated within the Islamic financial system. Focus on equity financing does not mean elimination of debt financing. However, certain restrictions are imposed. No direct lending-and-borrowing on interest is allowed; rather, there is a focus on asset-based financing. A moderate amount of risk is involved in asset-based financing (used for debt financing). Hence, debt financing is not risk-free.”

Moreover, transactions are based on real assets, not fictitious assets. “The supplier of assets possesses the ownership of the underlying assets and bears ownership risk. As a result of restrictions on debt-financing, speculation is eliminated and credit expansion corresponds to a rise in the real economy, leading to financial stability. Finally, *Shariah* compliance, in letter and spirit, in the governance of IFIs is expected” (Hanif, [2018](#)).

The objectives of Islamic finance include the equitable distribution of wealth, stability in the financial system and adherence to the *Shariah* norms. “Equitable distribution of wealth is achieved through risk-reward sharing and availability of finance with the less privileged. Financial stability is linked to matching credit with the rise in real economy” (Hanif, [2018](#)).

“*Shariah* compliance covers broader areas including discouraging *riba*, *gharar* and *maysir*, promoting socially responsible investments, and ensuring *Shariah* compliance in operations. These important objectives of Islamic finance need to be considered to determine KPIs of IBIs” (Hanif, [2018](#)). These KPIs may include the following five categories for the *Shariah* compliance ranking:

- (1) Portfolio construction: Deposits, financing and investments (participatory modes and asset-based financing).

According to Hanif ([2018](#)), “Deposits under the Islamic banking system are collected either as current accounts or investment accounts on the basis of *mudarabah*. A current account is a contract of loan between the depositor (lender) and the Islamic bank (borrower). Accepting current deposits under *amanah* (trust) is not recommended because the bank cannot use the funds collected for commercial benefits. Islamic banks get a huge amount of money in current accounts and use that money to generate revenue but do not share it with the depositors. It is

suggested that a portion of that amount should be reserved for *qard e hasana* (charity loans) for the needy and poor. Small amounts of loans should be provided to the less privileged small entrepreneurs engaged in cottage industries, students and employees of the government or private sector with low salaries – to buy household items. Additionally, such loans should be made available for certain emergencies including accidents, deaths or marriage ceremonies of the poor masses.”

- (2) Access to finance: The share in the financing of the underprivileged segments of the society including the low-income groups and the rural economy after the screening of the customers in the light of the *Shariah* and the established CSR principles.
- (3) Market share: The bigger the slice of the pie the more profitable the IBI will be. Hence, it is important to focus on the market share of the IBIs in both segments, that is, Islamic banking and finance and the conventional banking industry to ensure their in-depth penetration in the society.
- (4) *Shariah* compliance: It includes *Shariah* board, internal control and *Shariah* audit, charitable operations, human resources, product development and organization.
- (5) Reputation: *Shariah* compliance, innovative products, disclosures and the opinions of stakeholders determine the reputation of the IBIs. Therefore, reputation remains an important KPI for the IBIs due to the active vigilance of the customers.

Every individual, company and organization develops a reputation over time based on people’s perceptions. Developing a good reputation takes years of service; however, it can be ruined in an instant. The key question for the IBIs is whether they will passively let others form opinions about them or will actively manage and maximize their most valuable asset, that is, their reputation. A good reputation of *Shariah* compliance and profitability will attract customers, investors and talented employees leading to an increased market share. Over time, IBIs that consciously nurture their dual reputation of *Shariah* compliance and profitability may enjoy a halo effect that will make people trust them and give them the benefit of doubt during rocky periods (Alsop, [2004](#)).

## Conclusion and Recommendations

The development of a comprehensive *Shariah* Governance Framework (SGF 2018) is a commendable initiative taken by the State Bank of Pakistan. It provides

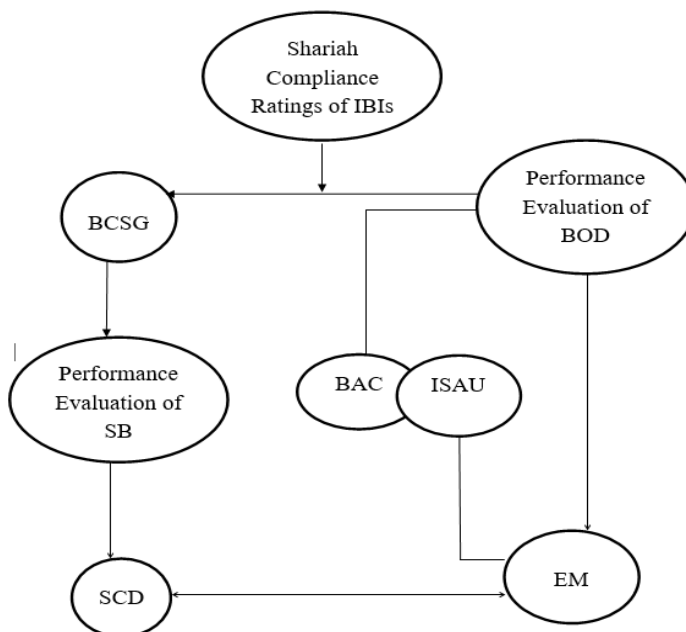


guidelines for the IBIs in Pakistan to ensure *Shariah* compliance in their operations, business development and disbursement of permissible earnings. The roles and responsibilities of the BOD, EM, SB and other key departments have been delineated in it. However, its critical analysis suggests the following important limitations:

- SGF 2018 is unable to outline a mechanism that ensures close coordination between the BOD and the SB. Therefore, it is recommended here to incorporate Board’s Committee of *Shariah* Governance (BCSG) for developing a close liaison between the two key components of the IBIs.
- SGF 2018 lacks in determining the KPIs for the BOD, the SB and for the IBIs as a whole. Therefore, this study recommends establishing the KPIs for these organs of Islamic banking and finance (IBF) industry. Five KPIs for the IBIs have been identified including portfolio construction, access to finance, market share, reputation, and *Shariah* compliance.

**Figure 2**

*Proposed Shariah Governance Framework for the IBIs*



- There is no provision for rating the good performance of the IBIs in terms of their *Shariah* compliance. The current study recommends incorporating a *Shariah*

compliance rating system in the IBF industry to promote healthy competition and to enhance confidence in the IBIs among their target customers.

The current study proposes a few modifications in the existing SGF 2018 as depicted in the following Figure 2. It is expected that the proposed SGF will bring more success for the IBIs in terms of more business opportunities and a better reputation.

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