# *SHARĪʿAH* GOVERNANCE IN ISLAMIC FINANCIAL INSTITUTIONS IN MALAYSIA, GCC COUNTRIES AND THE UK

**BY**

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Executive Summary

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# EXECUTIVE SUMMARY

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## ABSTRACT

*Shari'ah* governance is peculiarly exclusive and unique to Islamic systems of financial management. While affirming the need for sound and efficient *Shari'ah* governance as a crucial part of corporate governance in Islamic financial institutions (IFIs), it has nevertheless been found that little has been written on the subject. In view of the scarcity of literature and specific studies in this area, this study aims to explore the state of *Shari'ah* governance practices in IFIs, particularly in Malaysia, GCC countries (Kuwait, Bahrain, United Arab Emirates, Qatar and Saudi Arabia) and the UK, as these jurisdictions present distinctive models and approaches towards *Shari'ah* governance in diverse legal environments. This study explores and analyses the extent of *Shari'ah* governance practices by highlighting seven main areas of *Shari'ah* governance: (i) *Shari'ah* governance approaches; (ii) regulatory frameworks and by-laws; (iii) roles of *Shari'ah* boards; (iv) attributes of *Shari'ah* boards in terms of independence, competency, transparency and confidentiality; (v) operational procedures; (vi) *Shari'ah* board assessment; and (vii) disclosure practice.

Since the availability of data and information on *Shari'ah* governance practices is very limited, a detailed questionnaire was generated for the sourcing of primary data from IFIs. As part of the qualitative research strategy, semi-structured interviews were conducted with *Shari'ah* scholars, specifically to explore their perceptions on selected *Shari'ah* governance issues. In addition, the content analysis approach was used in extracting and analysing the data and factual input derived from information and resources on IFIs' websites, exchange websites, annual reports and financial statements. The findings in this study interestingly reveal that there are shortcomings and weaknesses in the present practice of *Shari'ah* governance in all seven core areas mentioned above. Based on the empirical analysis extracted from the research findings, the study finally offers and formulates some policy recommendations for the purpose of enhancing and improving the present *Shari'ah* governance system.

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## INTRODUCTION

**Aim:** To analytically explore the extent of *Shari'ah* governance practices in IFIs by analysing the practices and implementation of *Shari'ah* governance in Malaysia, GCC countries and the UK through the perceptions and opinions of participants and available documents.

**Objectives:**

(i) To investigate the different approaches of IFIs to *Shari'ah* governance;
(ii) To study the regulatory framework and internal policies of *Shari'ah* governance in IFIs;
(iii) To examine the roles and functions of the *Shari'ah* board in IFIs;
(iv) To examine the attributes of *Shari'ah* board members on independence, competency and transparency, and confidentiality;
(v) To examine the operational procedures of *Shari'ah* governance in IFIs;
(vi) To investigate the perception of IFIs of their *Shari'ah* board's performance;
(vii) To ascertain the extent of disclosure of *Shari'ah* governance practices in IFIs;
(viii) To provide, in light of the empirical results of the research, certain essential guidelines and policy recommendations that can be considered to enhance and improve the *Shari'ah* governance system.

**Hypotheses:**

(i) There are significant differences in the approaches of various IFIs to *Shari'ah* governance;
(ii) There are significant differences in the regulatory and internal frameworks of *Shari'ah* governance in IFIs;
(iii) There are significant differences in the roles and functions of *Shari'ah* boards;
(iv) There are significant differences in the attributes of *Shari'ah* board members in terms of competency, independence, transparency and confidentiality;
(v) There are significant differences in the operational procedures of *Shari'ah* governance practices;
(vi) The IFIs are satisfied with the performance and contribution of the *Shari'ah* boards;
(vii) There are significant differences in the extent of disclosure of *Shari'ah* governance practices.

**Observation:** IFIs in Malaysia, GCC countries and the UK have a varying set of frameworks for the *Shari'ah* governance system. The existing *Shari'ah* governance frameworks and practices need further enhancement and improvement, in order to bring into focus the measures and efforts that need to be taken in order to strengthen the IFIs.

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## CORPORATE GOVERNANCE: A CONVENTIONAL PERSPECTIVE

**Objective:** To explore the conceptual dimension and theoretical framework of corporate governance from conventional perspectives by referring to the two main dominant corporate governance systems of the Anglo-Saxon and the European models.

**Corporate Governance Model:** The Anglo-Saxon model, which is formulated on the basis of agency theory, represents the shareholder value system, while the European model, which is constructed on the basis of stakeholder theory, seems to offer remedies for the defects of the shareholder model by promoting the stakeholder value orientation system.

In the context of financial services, the OECD Principles of Corporate Governance and the BCBS on Enhancing Corporate Governance for Banking Organizations seem to bridge the gap between these two models by acknowledging the essence of the shareholders' value and at the same time recognizing the large stakeholders' interest. In this regard, the BOD, the supervisory board, the managers, the shareholders, the depositors and the regulatory authorities are the key participants in corporate governance in the conventional financial services sector.

**Issue on Corporate Governance from Islamic Perspective:** The understanding of the conceptual and theoretical framework of corporate governance is imperative in this study since it will enlighten further discussion of corporate governance from an Islamic perspective. The model of corporate governance system from a conventional perspective raises an issue of the design of an efficient corporate governance structure of IFIs within an Islamic paradigm. It is very important to identify characteristics, values, norms and behaviour of corporate governance from an Islamic perspective. As an observation, the initial study finds that the corporate governance model in Islam is inclined towards the stakeholder value orientation, where its governance style aims at protecting the wider group of stakeholders.

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## CORPORATE GOVERNANCE: IN SEARCH OF AN ISLAMIC PERSPECTIVE

**Objectives:** To provide an overview of the foundational dimension of corporate governance from an Islamic perspective, with special emphasis on the governance framework of IFIs as well as to generate basic understanding of corporate governance in Islam and to clarify any issues involved so as to differentiate its value and features from its Western counterpart.

**Roles of Corporate Governance:** To promote corporate fairness, transparency and accountability and to protect the rights and interests of all stakeholders. Its framework goes beyond the relationship between the shareholders, BOD, management and stakeholders, since it also includes how maintain the relationship with God. In this aspect, IFIs require the additional framework of *Shari'ah* to safeguard and maintain not only the relationship with God but to include other human beings and the environment.

**Theoretical Framework of Corporate Governance in Islam:** The foundational dimension of Islamic corporate governance is rooted in the fundamental principles of *Tawhid*, the *shuratic* process, property rights and contractual obligation. The corporate governance model in the Islamic economic system is a stakeholder-centred model in which the governance style and structures protect the interests and rights of all stakeholders rather than the shareholders per se. Based on this aspirational foundation, key participants in corporate governance in Islamic corporation, particularly IFIs, such as the BOD, the shareholders, the depositors, the managers and particularly the *Shari'ah* board, play significant roles in ensuring all transactions, activities and businesses are in line with *Shari'ah*, Islamic values and ethics.

***Shari'ah* Governance as part of Corporate Governance:** IFIs require a specific organizational arrangement in the form of '***Shari'ah* governance'** to ensure that *Shari'ah* objectives and the IFIs' goal are both realized within the parameters of *Shari'ah*, Islamic values and ethics.

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## THE *SHARI'AH* GOVERNANCE SYSTEM IN IFIs

**Objective:** To provide an overview of the *Shari'ah* governance system and its related issues namely its conceptual framework, historical development, objective of *Shari'ah* governance system, roles of *Shari'ah* board, models of *Shari'ah* board, international standard-setting agency, *Shari'ah* governance process and issues and challenges.

**Conceptual Framework:** "A set of institutional and organizational arrangements through which IFIs ensure that there is effective independent oversight of *Shari'ah* compliance over the issuance of relevant *Shari'ah* pronouncements, dissemination of information and an internal *Shari'ah* compliance review". *Shari'ah* governance system adds an additional layer of governance to the existing corporate governance structure. It covers *ex ante* and *ex post* aspects of *Shari'ah* compliance.

**Roles of *Shari'ah* Governance**: Legitimacy of the product, promotion of moderation and justice in financial transactions, confidence and trust of stakeholders, and as part of the risk management tools exclusive to IFIs.

**Roles of *Shari'ah* Board**: To ensuring and enhance the credibility of IFIs as well as having the authority to issue *fatwas* via collective *ijtihad*. (i) ***Shari'ah* Board at the International Level**: harmonization and convergence in the concepts and application amongst the *Shari'ah* supervisory boards of IFIs. (ii) ***Shari'ah* Board at Macro Level**: harmonization and standardization of *fatwas*, and acts as the highest authority for IFIs. (iii) ***Shari'ah* board at the Micro Level:** participation in product development and structuring activities, reviewing and approving matters related with *Shari'ah*, issuance of *fatwas*, *Shari'ah* auditing, issuance of an annual certification of *Shari'ah* compliance, to ensure the *Shari'ah* compliance of IFIs' investment in shares, equities, *sukuk* and other business avenues and computation of *zakat.*

***Shari'ah* Board Model:** (a) Internal SB: (i) *Shari'ah* Boards at Individual IFI Level (ii) Central *Shari'ah* Board for the Whole Group (b) External SB: (i) National *Shari'ah* Boards (ii) *Shari'ah* Boards at International Level (iii) *Shari'ah* Advisory Firms (iv) Individuals Undertaking *Shari'ah* Advisory Roles (v) Standard Setting Agency: AAOIFI

***Shari'ah* Governance Standard and Guiding Principles:** AAOIFI: governance standards Nos. 1–5. IFSB: The IFSB-10, which specifically addresses the issue of the *Shari'ah* governance system in IFIs.

***Shari'ah* Governance Process:** The appointment, composition and qualification of the *Shari'ah* board, the *Shari'ah* compliance process, *Shari'ah* coordination, the *Shari'ah* compliance review and the *Shari'ah* report.

**Issues and Challenges**: Independence of *Shari'ah* Board, Competency, Conflict of Interest and Confidentiality, Disclosure and Transparency, *Shari'ah*-Compliant versus *Shari'ah*-Based, Consistency and Remit of Various Institutions of *Shari'ah* Boards.

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## REGULATORY FRAMEWORK OF *SHARI'AH* GOVERNANCE SYSTEM IN MALAYSIA, GCC COUNTRIES AND THE UK

**Objective:** To examine the regulatory framework of *Shari'ah* governance system.

**Regulatory Approach:** Reactive Approach: UK and Turkey, Passive Approach: Saudi Arabia, Minimalist Approach: UAE, Bahrain, Qatar, Kuwait. Pro-Active Approach: Malaysia. Interventionist Approach: Pakistan.

**Regulatory Issues:**

**Legal Status of *Shari'ah* Pronouncements**: there are loopholes and shortcomings in the *Shari'ah* governance framework, particularly in positioning *Shari'ah* board decisions as binding and mandatory.

**Conflict of Laws:** The question of how *Shari'ah* principles apply in the event of a conflict of laws, either with the laws of the jurisdiction or other statutory legislation and how it will be adjudicated in a court

**Court Jurisdiction:** Judges' ability to decide Islamic finance cases and to what extent the judges' attitude is to refer Islamic finance disputes to a *Shari'ah* board for deliberation

**Differences of *Shari'ah* Resolution**: The differences of various *fatwa* rulings amongst the *Shari'ah* boards may affect Islamic finance, especially when it involves international entities and cross-border transactions.

**Executive, Advisory and Supervisory Roles of the *Shari'ah* Board**: If Executive Authority, it is possible that many *Shari'ah* scholars may not meet the fit and proper criteria required by the FSA and the existing practice of multiple membership of *Shari'ah* boards in various IFIs may be considered as contrary to the rule of conflict of interest. If merely advisory, it raises another significant issue as to the actual function of the *Shari'ah* board and to what extent its deliberations bind the IFIs.

**Observation:** *Shari'ah* governance system in Malaysia, GCC Countries and the UK can be classified into two types, namely regulated via legal and supervisory requirements, as in the cases of Malaysia, Bahrain, Kuwait, the UAE and Qatar, or through self-regulation, as in the cases of Saudi Arabia and the UK. Malaysia is identified as strong proponent of a 'regulatory-based approach', Bahrain, Kuwait, the UAE and Qatar as a 'minimalist approach', Saudi Arabia as a 'passive approach' and the UK as a 'reactive approach'. In view of numerous legal issues involved in the existing *Shari'ah* governance framework, the need to have a comprehensive legal framework and an effective *Shari'ah* governance system is really crucial.

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## RESEARCH METHODOLOGY

**Objectives:** To provide elaboration and embellishment on the research methodology used in this study. It explains specific methods of data collection and data analysis including research design, reliability and validity, data collection, sampling and data analysis methodology. It also provides detailed information about the research instruments, the process of data collection and data analysis approaches.

**Methodology and Method:** This study employed qualitative research methodology. The research adopted a mixed-method approach that would be able to verify the findings from one method to another.

**Data Collection Method:**

| Questionnaire (35 IFIs) and Interview (13 Respondents) | Unobtrusive Research Method |
|---|---|
| i. To investigate the different approaches of IFIs to *Shari'ah* governance | i. To ascertain the extent of disclosure practice of *Shari'ah* governance practices in IFIs |
| ii. To study the regulatory framework and internal policies of *Shari'ah* governance in IFIs | |
| iii. To examine the roles and functions of the *Shari'ah* board in IFIs | |
| iv. To examine the attributes of *Shari'ah* board members on independence, competency and transparency, and confidentiality | |
| v. To examine the operational procedures of *Shari'ah* governance in IFIs | |
| vi. To investigate the perception of IFIs of the *Shari'ah* board's performance | |

**Data Analysis**:

**(a) Questionnaires**: The study utilized descriptive analysis and an interpretative method. The study also constructed a specific *Shari'ah* governance index to measure and to quantify the extent of *Shari'ah* governance practices. This index enables the study to rank and rate IFIs according to the level of practices, which either fall into 'Underdeveloped Practice', 'Emerging Practice', 'Improved Practice', 'Good Practice' and 'Best Practice'.

**(b) Semi-Structured Interview**: The study employed systematic procedures of coding and categorizing.

**(c) Unobtrusive Data**: Utilized the content analysis approach and disclosure indices in extracting and analysing the data and factual input derived from websites, annual reports and financial statements. In order to quantify the extent of *Shari'ah* governance disclosure practices, the study used a quantitative measure to rank IFIs into five categories: 1–5 disclosures is ranked as 'Underdeveloped Practice', 6–10 as 'Emerging Practice', 11–15 as 'Improved Practice', 16–23 as 'Good Practice' and 24–30 as 'Best Practice'

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## LOCATING THE ASPECTS OF *SHARI'AH* GOVERNANCE SYSTEM IN ISLAMIC BANKING: ANALYSIS OF THE QUESTIONNAIRE SURVEY

**Objective:** The survey aims at understanding the extent of current *Shari'ah* governance practices by examining its general approach, regulatory and internal framework, roles of the *Shari'ah* board, attributes of the *Shari'ah* board in terms of independence, competency, transparency and confidentiality, operational procedures, and assessment of the *Shari'ah* board.

**Findings:**

**(a) Country Specific Behaviour:**

**(i) Malaysia**: (31.4%) fall into the 'Good Practice' and only 17.1% 'Improved Practice' category, Average of 37.1 best indicators 'Good Practice'.
**Observation:** Well-conceived regulation and the proactive approach of the regulatory and supervisory authorities, positive initiative at the individual IFI level have contributed to better development of the *Shari'ah* governance system.

**(ii) GCC countries**: 20% 'Improved Practice', 8.6% 'Emerging Practice' and 17.1% 'Underdeveloped Practice', Average of 22.2 best indicators 'Emerging Practice'.
**Observation:** Weak supervision and monitoring by the supervisory authorities as well as less initiative at individual IFI level are amongst the contributory factors that have led to these negative findings.

**(iii) UK:** 2.8% fall into each of the 'Improved Practice' and 'Good Practice' categories with an average of 34.5 best indicators.
**Observation:** Strong regulation and supervision is not the sole factor that may positively influence *Shari'ah* governance practice

**(b) Year of Incorporation:**

**(i) Cluster 1:** Most of them falling into the 'Improved Practice', 'Emerging Practice' and 'Underdeveloped Practice'. **(ii) Cluster 2**: A total of 14.2% of IFIs fall into the 'Good Practice' category, **(iii) Cluster 3**: Majority of IFIs (14.2%) fall into the 'Improved Practice' category. **(iv) Cluster 4**: 11.4% are ranked as being in the 'Improved Practice' category.
**Observation:** The early establishment of IFIs is not the determining factor for the extent and quality of *Shari'ah* governance practices.

**Conclusion:** More than 65% of IFIs require significant enhancement and improvement of *Shari'ah* governance where a small percentage of 35% of IFIs falling into the 'Good Practice' category with an average of 30.2 best indicators. The overall *Shari'ah* governance practices are still in the stage of development and need immediate attention by policymakers and regulatory authorities as well as the internal organs of governance in the IFIs, such as shareholders, the BOD and senior management.

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## SEARCHING FOR THE PERCEPTIONS OF THE *SHARI'AH* SCHOLAR ON *SHARI'AH* GOVERNANCE SYSTEM IN ISLAMIC BANKING: ANALYSIS OF THE SEMI-STRUCTURED INTERVIEWS

**Objective:** To examine *Shari'ah* board members' views and opinions pertaining to *Shari'ah* governance issues.

**Findings:**

(i) **General Issues:** 4 main issues pertaining to *Shari'ah* governance, namely roles of regulators, regulation, IFIs' management and *Shari'ah* rulings.

(ii) **Internal Policies:** There are some weaknesses in the existing internal framework of *Shari'ah* governance. Majority of IFIs have not issued by-laws or policies to detail with the processes, authorities, scopes and framework of the *Shari'ah* review.

(iii) **Functions:** Advisory and supervisory. Only 2 *Shari'ah* scholars mentioned that *Shari'ah* board have a duty to promote and instil Islamic ethics and values. The study classifies *Shari'ah* scholars into two types, namely 'Conservative' (legalistic approach) and 'Pragmatic' (*Maqasid Shari'ah*).

(iv) **Competency:** *Shari'ah* scholars need training on the technical aspects of banking and finance. Only some IFIs conduct training or allocate funds for such a purpose. Majority of IFIs did not assess or evaluate the *Shari'ah* board's performance.

(v) **Independence:** Lack of understanding on the actual meaning of independence. The independence of the *Shari'ah* board refers to professional independence, whereby it is very important to avoid any appearance which may negate the perception of independence.

(vi) **Transparency and Confidentiality**: *Shari'ah* scholars theoretically have access to all documents, information and records but they rarely exercised this privilege and rely heavily on the documentation presented to them. In term of confidentiality, IFIs have adequate mechanisms to ensure confidentiality.

(vii) **Operational Procedures:** IFIs have good practice in terms of providing specific guidelines or operational procedures. The study found that the *ex post* processes of *Shari'ah* compliance are greatly determined by the internal audit function of IFIs and not the *Shari'ah* board itself.

(viii) **Assessment:** *Shari'ah* scholars claimed that they took into consideration the aspects of *maslahah* and *maqasid Shari'ah* but they face problems reconciling the conflict between profit and social motives as.

**Conclusion:** The existing practice of *Shari'ah* governance needs further enhancement and improvement, at least in the above six areas. Regulation plays very important role together with serious implementation, supervision and enforcement. In addition, any gaps or communication barriers amongst the stakeholders in IFIs must be eliminated.

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## INVESTIGATING *SHARI'AH* GOVERNANCE THROUGH UNOBSTRUSIVE RESEARCH: ANALYSIS OF THE ANNUAL REPORTS, FINANCIAL STATEMENTS AND WEBSITE FINDINGS

**Objective:** To examine the level of disclosure and transparency of *Shari'ah* governance in IFIs.

### *Shari'ah* Governance Disclosure Indices: Country Specific Behaviour

**Overall:** Malaysia have better *Shari'ah* governance disclosure scores with an average of 16.2 ('Good Practice'). IFIs in GCC countries fall into the 'Emerging Practice' category with an average score of 7.9. IFIs in the UK that fall into the 'Improved Practice' category with an average score of 10.8.

**Malaysia:** 50% of IFIs are ranked in the 'Good Practice', 30% in 'Improved Practice', 15% in 'Emerging Practice' and 5% in 'Best Practice'.
**Observation:** The proactive approach of Malaysian regulatory authorities leads to better disclosure and transparency. IFIs in Malaysia also demonstrate serious commitment on the aspect of *Shari'ah* governance, where the majority of the *Shari'ah* governance disclosures that have been made were classified as voluntary disclosures and are not mandatory by law or regulation.

**GCC Countries:** (46.2%) are ranked in the 'Emerging Practice' category, followed by 22.2% in 'Underdeveloped Practice' and 29.6% in 'Improved Practice'. Only 1.9% of IFIs achieved the level of 'Good Practice'.
**Observation:** Less interference from regulatory authorities and lack of regulatory frameworks on *Shari'ah* governance contribute to the minimal transparency.

**UK:** 33.3% of IFIs are ranked in the 'Emerging Practice' and 'Improved Practice' categories and 16.7% of IFIs in the 'Good Practice' category.
**Observation:** IFIs independently develop their *Shari'ah* governance framework through self initiative. The regulatory-based approach is not the sole factor.

### *Shari'ah* Governance Disclosure Indices: Year of Incorporation

**(i) Cluster 1:** The average scores (11), 'Improved Practice'. (ii) **Cluster 2:** The average scores (9.9), 'Emerging Practice' **(iii) Cluster 3:** The average scores (11.5), 'Improved Practice'. **(iv) Cluster 4**: The average scores (9.5), 'Emerging Practice'.
**Observation:** There is a negative correlation between the age of the IFI based on year of incorporation and the extent of *Shari'ah* governance disclosure practice.

**Conclusion:** The current state of disclosure and transparency of *Shari'ah* governance practices deserves immediate attention, further reform and improvement, at least in the aspects of commitment to *Shari'ah* governance, *Shari'ah* board information, *Shari'ah* report, *Shari'ah* compliance review, *Shari'ah* pronouncements and information on products and services.

Executive Summary

## CONTEXTUALISING THE FINDINGS AND CONCLUSION

**Objectives:** To provide a brief discussion of the research findings and offer some recommendations for further enhancement of the *Shari'ah* governance system.

### Overall Research Findings:

***State of Shari'ah Governance Practices for Hypotheses 1–6***

| *Shari'ah* Governance | 'Underdeveloped Practice' | 'Emerging Practice' | 'Improved Practice' | 'Good Practice' | 'Best Practice' | Average Practice |
|---|---|---|---|---|---|---|
| Malaysia (17 IFIs) | | | 35.2% | 64.7% | | 'Good Practice' |
| GCC Countries (16 IFIs) | 35.2% | 18.8% | 43.8% | | | 'Emerging Practice' |
| UK (2 IFIs) | | | 50% | 50% | | 'Improved Practice' |
| Overall (35 IFIs) | 17.1% | 8.6% | 40% | 32% | | 'Improved Practice' |

***State of Shari'ah Governance Practices for Hypothesis 7***

| *Shari'ah* Governance | 'Underdeveloped Practice' | 'Emerging Practice' | 'Improved Practice' | 'Good Practice' | 'Best Practice' | Average Practice |
|---|---|---|---|---|---|---|
| Malaysia (20 IFIs) | | 15% | 30% | 50% | 5% | 'Improved Practice' |
| GCC Countries (54 IFIs) | 22.2% | 46.2% | 29.6% | 1.9% | | 'Emerging Practice' |
| UK (6 IFIs) | 16.7% | 33.3% | 33.3% | 16.7% | | 'Emerging Practice' |
| Overall (80 IFIs) | 16.3% | 37.5% | 30% | 15% | 1.3% | 'Improved Practice' |

**Recommendations:** The recommendations put forward are consistent with the existing guidelines on corporate and *Shari'ah* governance of the AAOIFI, the IFSB, the Islamic Financial Services Industry Development; Ten Year Framework and Strategies and Islamic Finance and Global Financial Stability.

**Epilogue:** The study has yielded substantial findings revealing that there are shortcomings and weaknesses in numerous aspects of the *Shari'ah* governance. There are significant differences in the general approach to *Shari'ah* governance, the regulatory framework and internal policies, the roles and functions of the *Shari'ah* board, the attributes of *Shari'ah* board in terms of competency, independence, transparency and confidentiality, operational procedures, and performance measures of the *Shari'ah* board. The extent of *Shari'ah* governance disclosure is at a minimal level. The study strongly advocates a continuous and systematic approach in enhancing and improving the existing *Shari'ah* governance practices.

Executive Summary