

SHARIAH COMPLIANCE PROCESS AND CORPORATE GOVERNANCE IN ISLAMIC BANKING INSTITUTIONS (IBIs): A PROPOSED MODEL

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Abstract

Banking, by its very nature, entails taking a wide array of risks. One such risk is reputational risk, which arises from operational failures, i.e. failures to comply with the relevant laws and regulations, or other sources. Reputational risk is particularly damaging for banks since the nature of their business requires them to maintain the confidence of the depositors, creditors, and the general marketplace. Thus, the compliance issue is one of the most crucial factors in determining smooth and successful banking operations. *Shariah* compliance is a distinct feature of the Islamic banking industry. The need to have comprehensive and rigorous mechanisms in place to ensure *shariah* compliance as well as an effective and reliable *shariah* review process are the two key contributing factors for the industry to further progress. Indeed, the *shariah* compliance process is one of the areas upon which Islamic Banking Institutions (IBIs) must focus as part of the overall corporate governance. The purpose of this paper is to propose a *shariah* compliance framework for IBIs drawing from the present requirements on corporate governance (CG) in Malaysia. The framework proposes that the compliance process for IBIs is done through the internal auditing framework by establishing an internal *shariah* audit team. The framework proposes the Internal *Shariah* Audit Team (ISAT) to be a special cell of the Internal Audit Committee (IAC), which will review operations and transactions relating to *shariah* matters on a regular basis. The team should have bilateral functional interactions with both the IAC and the *Shariah* Supervisory Board (SSB).

Keywords: *Shariah* Compliance Process, Corporate Governance, Internal *Shariah* Audit Team (ISAT), *Shariah* Compliance Report.

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1. Introduction

The Islamic banking and finance industry has become a global phenomenon and is increasingly generating renewed interest among the players in the financial world amid the recent sub-prime and financial crisis. More importantly, the Islamic banking industry has established itself as an emerging alternative to conventional interest-based banking and has been expanding rapidly over the last two decades in both Muslim and non-Muslim countries. The growing importance of the operations of the Islamic banking industry in the global market is undeniable with a growth rate of between 10% and 20% over the last decade (Anon, 2004; Dudley, 2004; Zaher and Hassan, 2001). The current global Islamic banking assets, and assets under management have reached USD750 billion and are expected to hit USD1 trillion by 2010. There are over 300 Islamic financial institutions worldwide across 75 countries. According to the Asian Banker Research Group, the World's 100 largest Islamic banks have set an annual asset growth rate of 26.7%, and the global Islamic Finance industry is experiencing an average growth of 15-20% annually (Mckinsey, 2008).

In Malaysia, the Islamic banking industry has been in existence for over 30 years. Like their conventional counterparts, Islamic banks also play a very important role in resource mobilization, resource allocation and resource utilization, and employ funds in line with *shariah* law towards ensuring development in the societies in which they operate. The enactment of the Islamic Banking Act 1983 enabled the country's first Islamic Bank to be established, and, thereafter, with the liberalisation of the Islamic financial system, more IBIs have been established. Malaysia's track record of building a successful domestic Islamic financial industry over 30 years gives the country a solid foundation – the financial bedrock of stability that adds to the richness, diversity and maturity of the financial system. Presently, Malaysia's Islamic banking assets total some USD65.6 billion with an average growth rate of 18 to 20% annually (Bank Negara Malaysia, 2008).

The compliance issue is one of the most crucial factors in determining smooth and successful banking operations, as emphasized by the Basel Committee on Banking and Supervision, Compliance and the Compliance Functions in Banks (2005):

“Compliance should be part of the culture of the organization; it is not thus the responsibility of the specialist compliance staff.”

In the banking industry, any act of non-compliance by a bank would cause serious damage to the bank as it would deliberately expose itself to compliance risk. The compliance risk for banks is defined as:

“the risk of legal or regulatory sanctions, financial loss or loss to reputation a bank may suffer as a result of its failure to comply with all

applicable laws, regulations, codes of conduct and standards of good practice (together 'laws, rules and standards')" (Basel Committee on Banking and Supervision, Compliance and the Compliance Functions in Banks, 2005).

The concept of compliance from the *shariah* perspective is very much wider in scope since its conformity applies to all aspects of the conduct of Muslims including their banking transactions. From the perspective of IBIs, a bank should avoid participating knowingly in transactions that transgress or bypass any *shariah* regulatory requirement, to avoid being exposed to compliance risk. Vicary (2005) accentuates that *shariah* compliance is one of the areas in which Islamic banks must focus as part of the overall CG. Similarly, Shanmugam (2005) stresses that CG within the Islamic banking environment is covered by *shariah*, which has a crucial role in governing bank transactions and operations. Alvi (2005) further adds that one of the distinctive features of Islamic financial products is the criterion of being *shariah* compliant. He also highlights that there is a need for proper regulation and supervision of Islamic banks to ensure continued investor confidence in the system.

The aim of this paper is to propose a *shariah* compliance framework for IBIs drawing from the present requirements for CG in Malaysia. We organize this article as follows: first, we provide a brief description of the Islamic banking industry. Second, we briefly discuss the risk management and compliance in the banking system. Third, we describe the concept of *shariah* compliance. Fourth, we describe our proposed framework. We conclude with suggestions for further research.

2. The Theory and Practices of Islamic Banking

Haron (1995) defines Islamic banking as a banking system in which the operations are governed by *shariah* law. Al-Omar and Abdel-Haq (1996) elaborate on the term by contrasting between the more general term of Islamic banking and the narrower concept of interest-free banking. According to them, Islamic banking is a banking system that is in consonance with the ethos and value system of Islam. Interest-free banking, on the other hand, denotes a number of banking instruments or operations that avoid interest. Al-Omar and Abdel-Haq (1996) further add that in the case of Islamic banking, the bank is not only obligated to avoid interest-based transactions, but, more importantly, it is expected that the bank will participate actively in achieving the goals and objectives of Islamic economics (which is to achieve socio-economic justice). It is claimed that Islamic banking is the fastest growing segment of the credit market in Muslim countries (Zaher and Hassan, 2001). Islamic banking, as claimed by Zaher and Hassan (2001), is becoming a stronger industry and is considered to be a niche

market. Kuran (1995) contends that Islamic banking has indeed made a positive contribution to many economies by stimulating national and international trade as well as in mobilizing some dormant deposits into economic circulation.

There are similarities between Islamic and conventional banks in the sense that both offer the same services and play an important role in the economic development of their societies (Naser and Pendlebury, 1997). However, the *shariah* compliant feature is unique to Islamic banking operations. Since interest is prohibited in all forms and for all purposes, Islamic banks have adopted various *shariah* principles in their operations, as suggested by Muslim jurists and scholars. According to Haron (1995) the most widely used *shariah* principles can be broadly classified into four categories: principles that are based on profit-loss sharing (*mudaraba* and *musyaraka*), principles that are based on fixed charges (*murabaha*, *bai-mu'azzal*, *ijara*, and *ijara wa-iktina*), principles that are based on free charges (*qard hassan*), and, finally, principles that are applicable directly or indirectly to the operation of Islamic banks (*wadiah* and *rahn*).

Malaysia has been at the forefront of Islamic banking globally, and, accordingly, Bank Negara Malaysia (BNM) set a target for Islamic banking to achieve 20% of the market share in the banking industry by the year 2010. As highlighted earlier, the Islamic banking industry is unique due to its emphasis on Islamic principles. It is therefore pertinent that Islamic banking products are in compliance with *shariah* requirements in every respect to ensure investor confidence concerning their '*Islamicity*'. Once *shariah* compliance is assured, exposure to adverse publicity, reputation damage, or, worse, financial loss and/or sanctions of various types, is avoided.

Nik Norzul Thani (2007) emphasised that for the industry to further progress, comprehensive and rigorous mechanisms needed to be in place to ensure *shariah* compliance. It is further suggested that an effective and reliable *shariah* review process is extremely important in ensuring good *shariah* governance (Syed Musa and Mohd Daud, 2007). According to Alwin *et al.* (2006), further research is vital for developing an efficient *shariah* review process in Malaysia.

Syed Alwi (2007) asserts that, in general, *shariah* review has been used by Islamic financial institutions to ensure *shariah* compliance. However, he feels that a *shariah* review process is not sufficient since its scope is rather limited. He suggested a *shariah* audit as a more appropriate tool to ensure *shariah* compliance since it covers a wider scope of examination, which includes the technology supporting the operations, operational processes as well as the people involved in key areas of risk.

The findings from a study carried out by Kamarul and Roslina (2006) found that there is a lack of confidence among Muslim customers regarding the extent of adherence to *shariah* principles of the Islamic banking products. In addition, the general perception is that Islamic banking, as it is practiced now, has no substantial difference to conventional banking (Anwar, 1999).

3. Risk Management and Compliance

Risk as an uncertainty of outcome is a defining characteristic of business ventures. In other words, risk is inherent in business operations. A business organization has to undergo risk as part of the continuity of its activities and manage risk as efficiently as possible for its survival and growth. Compliance with standard business practices – voluntarily delineated or officially required – can be seen as a prudent approach towards the minimization, if not elimination, of the harmful exposure to risks. In the banking business, the risk management and compliance function is considered to be more important because of a bank's fiduciary duty. The present research views the *shariah* compliance of the Islamic banking industry in the broader spectrum of the risk management of a bank.

Risk management in the banking business has special significance due to the fiduciary nature of a bank's duty. Conventionally, a bank's obligation to its depositors is mostly independent of the returns that the bank earns. Hellwig (1995) argues that the low realization of returns does not reduce the bank's obligation towards its depositors. Being simultaneously a receiver and a provider/user of funds, the banking business is exposed to a number of risks; traditionally, these include credit risks, market risks, liquidity risks and operational risks (Chapra and Khan, 2000).

Credit risks arise from the volatility of a bank's net cash flow as a result of an unexpected decline in its total cash flow due to the potential defaults by counter-parties. This can give rise not only to a liquidity crunch but also adversely affect the quality of the bank's assets. Market risks consist of interest rate risks, exchange rate risks, and commodity as well as equity price risks. Liquidity risks arise when there is an unexpected decline in a bank's net cash flow and the bank is unable to raise resources at a reasonable cost by either selling its assets or borrowing through the issuance of new financial instruments. This situation may render the bank unable to meet its obligations as they become due, or fail to fund new opportunities for profitable business. Operational risks arise from the breakdown of internal controls and CG. These risks can lead to shortfalls in a bank's net income or cash flow as compared to that expected or targeted; thus, creating problems for management.

Among a host of risks that the banking industry faces, ***non-compliance risk*** or ***reputation risk*** deserves special mention in the context of this research. Competition has been intensified in the global banking and financial industry resulting in an increase in the outright incentive of risk taking by banks (Hellwig, 1995). Excessive risk taking, which is a form of moral hazard in banking, has the potential to create a tendency to subvert applicable laws, rules and standards of conduct. When this action in potency is realized, non-compliance risks arise. This risk for banks is defined as:

“the risk of legal or regulatory sanctions, financial loss or loss to reputation a bank may suffer as a result of its failure to comply with all

applicable laws, regulations, codes of conducts and standards of good practice (together 'laws, rules and standards')" (Basel Committee on Banking and Supervision, Compliance and the Compliance Functions in Banks, 2005).

Non-compliance results in erosion in the confidence of depositors and investors and deteriorates a bank's reputation. Once a bank loses its reputation, large-scale withdrawal by its depositors and investors may put its very existence at stake. This is because the development and maintenance of a sound and efficient banking system presupposes an "atmosphere of mutual trust between the providers and the users of funds" (Chapra and Khan, 2000). For an Islamic bank, non-compliance risks pose a greater danger. In conventional banking, if non-compliance is followed by, or associated with, expected returns for depositors, the bank in question may not face any problem that could arise from a large-scale withdrawal by depositors. However, non-compliance with *shariah* regulations by an Islamic bank makes the bank susceptible to irreversible loss of religiously sensitive depositors and investors – the major source of its funds. It is worth noting that the risk of non-compliance with *shariah* principles and regulations is not confined to this material temporal world for the (top) officials of an Islamic bank. If an infringement of *shariah* principles occurs in their cognizance and with their consent, this will endanger their interests in the eternal life.

In general, banks have been equipped with various techniques for the identification, control and management of the risks to which they are being exposed; hence, the most challenging task for the regulators and supervisors is to develop a sound risk management culture in the bank. In the absence of such a culture, the application of risk management techniques is liable to be too mechanical and too routine to build a robust buffer against the unhealthy exposure to risks.

4. Shariah Compliance: The Concept

The concept of compliance from the *shariah* perspective is very much wider in scope since its conformity applies to all aspects of the conduct of Muslims including their economic dealings. For an economic act or economic transaction to be *shariah* compliant, it must meet the criterion of economic justice. El-Sheikh (2008) stresses that the doctrine of economic justice (fairness in economic dealings),

"...rests on two fundamental maxims: (1) The avoidance of gharar (unjustified jahl or absence of necessary knowledge); (2) The avoidance of "unjustified enrichment" (fadl mal bil 'iwad)" (pg. 120).

From the perspective of IBIs, a bank should avoid participating knowingly in transactions that transgress or bypass any *shariah* regulatory requirement,

in order not to be exposed to compliance risk. For Grais and Pellegrini (2006), *shariah* compliance practically means four things: (1) not to engage in interest-based transactions; (2) not to conduct a purely financial transaction disconnected from real economic activity; (3) not to participate in a transaction where there is exploitation of any party; and (4) not to participate in activities regarded as harmful to society. Vicary (2005) suggests that *shariah* compliance is one of the areas that Islamic banks must emphasize as part of the overall corporate governance. This is critical as good corporate governance provides a framework for the resolution of issues and conflicts that arise from time to time among the stakeholders of a financial institution. A good CG framework embodies the principles of fairness, transparency, accountability and responsibility. These principles are as important to the Islamic banking institutions as they are to conventional banking. Hence, there is a need to put in place a mechanism for *shariah* compliance over and above the local regulatory requirements.

The compliance process for Islamic banking products comprises two different stages. In the first stage, the product is subjected to rigorous discussion and review in terms of its “*Islamicity*”. Abdallah (1994) categorizes this process as an “*ex-ante*” *shariah* audit (see also IFSB Exposure Draft 10, 2008). He describes the “*ex-ante*” *shariah* audit as all activities performed by IFIs to ensure that they comply with *shariah* rules and guidelines in drawing up the contracts and agreements, during the process of transactions, during the execution and conclusion of the contract including the implementation of the terms of the contract. In Malaysia, the “*ex-ante*” *shariah* audit is normally conducted by the bank’s *Shariah* Committee as well as the BNM’s *Shariah* Advisory Council (SAC). The second stage of the compliancy process would be to ensure compliance in terms of the operations and management of the products, which is better known as “*ex-post*” *shariah* audit (Abdallah, 1994; IFSB Exposure Draft 10, 2008). Abdallah (1994) explains that the “*ex-post*” *shariah* audit is basically to check random samples of completed transactions to ensure that these transactions conform to *shariah* rules and guidelines. For many, the first phase of the compliancy process in the Islamic banking industry is deemed to be sufficient as the members of the responsible bodies comprise of Islamic scholars who are the proponents of Islamic banking. However, the main concern would be in the operations and management stage of these products as it is handled by practitioners with diverse backgrounds and motives.

Muhamad *et al.* (2011), in discussing the market segmentation for Islamic banking customers, have suggested three different factors – religious values, ethical values and economic desires – that guide consumers/investors in their decision of whether to use/invest in the Islamic financial products. Bringing this perspective into the market reality, Ghoul and Karam (2007) discuss and compare the objective and components of faith-based funds (Islamic and Christian funds) and ethical funds in making investment decisions. Their study shows that the screening criteria used by these funds are quite similar. They argue that

what distinguishes Islamic funds the most is their objection to interest income/expense, the requirement for certain financial ratio standards, and the objection to pork and music companies, which may be implied as being *shariah* compliant. Thus, investor confidence can only be boosted through the conformity of *shariah* compliance procedures. The absence of rigid procedures and processes for *shariah* compliance may erode investor confidence, which may cause the failure of an Islamic bank, and, ultimately, lead to a wide-ranging crunch in the financial system and a possible crisis.

5. The Proposed Framework

The purpose of this section is to propose a framework for *shariah* compliance drawing from the present requirements of CG in Malaysia. Hashim (2009) defines governance as “a combination of processes and structures conducted by the board of directors to authorize, direct and oversee management towards the achievement of the organization’s objectives”. Rezaee (2009) describes CG as “an ongoing process of managing, controlling, and assessing business affairs to create shareholder value and protect the interests of other stakeholders”. He further adds that there are seven essential functions of CG; namely, oversight, managerial, compliance, internal audit, advisory, external audit, and monitoring.

Hashim (2009) proposes the involvement of four different parties in the governance process as depicted in Figure 1. The first party would be the oversight

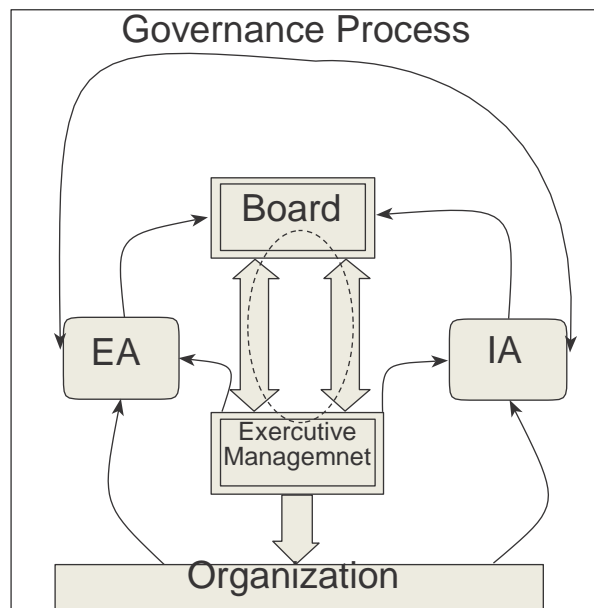


Figure 1: The Governance Process (Hashim, 2009)

group, which particularly includes the board and committees of the board in the organization; the second group suggested is the stewardship group, which mainly comprises the executive management of an organization; thirdly, he proposed the involvement of the performance group, which basically consists of the operating and supporting management staff within an organization; and, finally, he includes the assurance group, which encompasses the internal and external auditing function. The increasing emphasis on the internal audit function is reflected in the mandatory requirement made by Bursa Malaysia for all public listed companies to have an internal audit function in place starting from 2006 (Kadir, 2009).

Rezaee (2009) provides the changing definition of internal audit as summarized in Table 1. The latest definition views internal auditing as a function rather than a service activity. As a service activity, internal auditors would have limited authority, resources, independence, and would be viewed as assistants to management (eyes and ears of management). However, as a separate internal audit function, internal auditors would have more authority, resources, and be viewed as the eyes and ears of the audit committee. There is a shift from “*serving management*” to “*serving the organization*” to finally “*an integral component of corporate governance as a separate value-added function*”.

The focus of internal auditing has shifted away from appraisal and compliance activities towards objective assurance and consulting activities. The role of internal auditors has changed from providing management with input and objective feedback to directly participating in decision-making. It is envisaged that the close working relationship of internal auditors with the audit committee enables them to gain a better recognition and greater cooperation from management, safeguard their independence; and receive adequate authority and resources to fulfil their assigned responsibilities (Razaee, 2009).

Table 1: The Changing Definition of Internal Audit (Rezaee, 2009)

1947	1981	1999
Independent appraisal activity within an organization for the review of accounting, financial and other operations as a basis for protective and constructive service to management [<i>emphasis added</i>].	An independent appraisal function established within an organization to examine and evaluate its activities as a service to the organization [<i>emphasis added</i>].	Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization’s operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes [<i>emphasis added</i>].

Based on this premise, it is proposed that the compliance process for Islamic banking products is implemented through the internal auditing framework by establishing an internal *shariah* audit team as presented in Figure 2. As mentioned earlier, all public listed companies in Malaysia are required to have their own internal audit function in place irrespective of whether the operationalization of this function is done in-house or outsourced. In our proposed framework, we assume that the function is under the responsibility of a distinct unit referred to as the Internal Audit Committee (IAC). The above *shariah* compliance framework proposes the establishment of an Internal *Shariah* Audit Team (ISAT) that constitutes a special cell of the IAC, the remit of which will include reviewing the operations and transactions relating to *shariah* matters on a regular basis. To discharge its responsibilities, the team will have bilateral functional interactions with both the IAC and the *Shariah* Supervisory Board (SSB). It will hold discussions with the SSB and seek the opinion of the SSB on *shariah* non-compliance issues and their possible resolution. The team will prepare a specific report on *shariah* compliance issues and communicate it to the IAC. This report will then become an integral part of the internal audit report, which will be communicated to the Audit Committee (AC) by the IAC. Thus, through the AC, the report on *shariah* compliance will eventually reach the Board of Directors (BOD). It is the responsibility of the BOD to communicate the findings/resolutions on the processes of *shariah* compliance to the management and advise the latter to take corrective action as and when needed.

It is important to note that for the sake of transparency at all levels, there will be information and communication flows between the IAC, the SSB and the AC. Moreover, at the final stage, the BOD, upon receiving the report on the

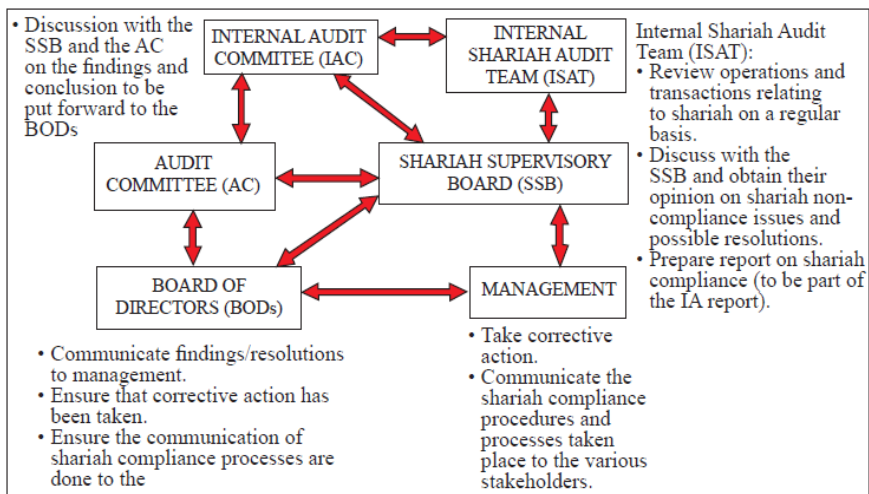


Figure 2: Proposed *Shariah* Compliance Framework

processes of *shariah* compliance, may seek explanations from the AC and the SSB. As a final note, it is very important for IBIs to communicate the details of the *shariah* compliance procedures conducted within the said institution to the various stakeholders so as to maintain their trust and confidence in the Islamicity of the products of IBIs, particularly for the conservative Muslim stakeholders.

6. Summary and Conclusion

Reputational risk that arises from operational failures, i.e. failure to comply with relevant laws and regulations, or other sources, is damaging for banks since the nature of their business requires them to maintain the confidence of depositors, creditors and the general marketplace. Thus, compliance issues need to be given serious consideration to ensure smooth and successful banking operations. The *Shariah* compliance requirement is unique to the Islamic banking operations, and, hence, it is pertinent that a comprehensive and rigorous mechanism is implemented to ensure *shariah* compliance, and an effective and reliable *shariah* review process is in place as part of the overall CG for IBIs. The paper proposes a *shariah* compliance framework for IBIs based on the present requirements concerning corporate governance in Malaysia. It is proposed that the compliance process for IBIs be undertaken through the internal auditing framework as one of the main components of CG. It is suggested that a special unit, known as the Internal *Shariah* Audit Team, be established as part of the internal auditing process to ensure that the operations of IBIs are *shariah* compliant.

Future research may be conducted to explore the perception of the key players in the Islamic banking industry on the proposed framework as well as to investigate the actual practices in IBIs relating to the compliance process.

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