

SHARĪ'AH GOVERNANCE FRAMEWORK OF ISLAMIC
BANKING IN OMAN

BY

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ABSTRACT

Sharī'ah compliance is the backbone for the activities and governance of Islamic banking and finance. IFIs are required to ensure sound *Sharī'ah* governance to achieve their target in ensuring a solid *Sharī'ah* compliance mechanism. Oman adopted a Shariah governance framework that is very similar with other countries such as Malaysia, Pakistan, and Bahrain. Therefore, there is a very high potential that the same issues of Shariah governance apply to in Oman too. This study aims to examine the current practice of *Sharī'ah* governance in Oman from the perspectives of *Sharī'ah* advisors, bankers and regulators. The study focuses on the present practice of *Sharī'ah* governance framework and related issues such as independence, competency and disclosure. The study used descriptive research method in terms of collecting secondary data and information for the literature review. Since the availability of data and information on *Sharī'ah* governance practices in Oman is very limited, a semi-structured interview was conducted with *Sharī'ah* advisors, officers and regulators to explore their perceptions on *Sharī'ah* governance and related issues. The findings of the study reveal that the regulators have put in place an excellent *Sharī'ah* governance framework and it is considered one of the best frameworks in Islamic banking industry. However, there are shortcomings and weaknesses in the current practice of *Sharī'ah* governance framework such as lack of experience, lack of research in the field of Islamic banking and finance and low position of internal *Sharī'ah* review. The study suggests that Intensive training should be organized by the CBO for the Omani members of SSB in the field of Islamic banking and finance.

خلاصة البحث

التوافق الشرعي هو العمود الفقري لأنشطة وحوكمة المصارف الإسلامية والمالية، ولذلك هذه المؤسسات المالية الإسلامية لديها واجب أساسي في تحقيق حوكمة شرعية متينة لتحقيق هدفها في ضمان التوافق الشرعي المنشود، تبنت عمان إطارا للحوكمة الشرعية يتشابه مع بعض الدول مثل ماليزيا وباكستان والبحرين، وعليه فهناك احتمال كبير أن تقع قضايا تتعلق بتطبيق إطار الحوكمة الشرعية في عمان كما حدثت في هذه الدول التي طبقت هذا الإطار. هدفت الدراسة إلى بحث وتقصي إطار الحوكمة الشرعية الحالي في عمان من منظور المنظمين وأعضاء اللجان الشرعية وبعض موظفي المصارف الإسلامية. كما ركزت الدراسة أيضا على الممارسة الحالية للحوكمة الشرعية في عمان وبعض قضاياها الأساسية مثل الاستقلالية والكفاءة والشفافية، استخدمت الدراسة أسلوب البحث الوصفي من حيث جمع البيانات والمعلومات الثانوية في الدراسات السابقة، ونظرا لقلّة الدراسات في هذا الموضوع تم استخدام أسلوب المقابلة شبه المنظمة مع أعضاء اللجان الشرعية والمنظمين وبعض موظفي المصارف لدراسة نظرتهم حول نظام الحوكمة الشرعية في عمان. أظهرت نتيجة الدراسة أن إطار الحوكمة الشرعية للمصارف الإسلامية في عمان يعتبر واحدا من أفضل الأطر والأنظمة في صناعة المالية الإسلامية الحالية، إلا أن هناك بعض نقاط الضعف والنقص بحاجة إلى معالجة مثل نقص الخبرة ونقص الدراسات في مجال المصارف الإسلامية والمالية في عمان بالإضافة إلى ضعف مكانة المراجع الشرعي، أوصت الدراسة القائمين والممارسين لنظام الحوكمة الشرعية في عمان إلى ضرورة تدريب أعضاء اللجان الشرعية من العمانيين في مجال الصيرفة الإسلامية والمالية.

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DECLARATION

I hereby declare that this thesis is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

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This research is dedicated to my parents, my wife, and children

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LIST OF ABBREVIATIONS

AAOIFI	Accounting and Auditing Organisation for Islamic Financial Institutions
AGM	Annual General Assembly
BCBS	Basel Committee for Banking Supervision
BNM	Bank Negara Malaysia (Central Bank of Malaysia)
BOD	Board of Directors
CBB	Central Bank of Bahrain
CBO	Central Bank of Oman
CEO	Chief Executive Officer
CIS	Commonwealth of Independent States
CSB	Central <i>Sharī'ah</i> Board
GCC	Gulf Co-operation Council
GS	Governance Standards
HAS	Higher <i>Sharī'ah</i> Authority
HSSA	Higher <i>Sharī'ah</i> Supervisory Authority
IAASB	International Auditing and Assurance Standards Board
IBRF	Islamic Banking Regulatory Framework
IFIs	Islamic Financial Institutions
IFSA	Islamic Financial Services Act
IFSB	International Financial Services Board
IFSB	Islamic Financial Services Board
IIFS	Institutions Offering Islamic Financial Services
ISRA	International <i>Sharī'ah</i> Research Academy
MIS	Management Information System
OECD	Organization for Economic Co-operation and Development
SBP	State Bank of Pakistan
SKM	Suruhanjaya Koperasi Malaysia
SSB	<i>Sharī'ah</i> Supervisory Board

CHAPTER ONE

INTRODUCTION

1.1 INTRODUCTION

Islamic banking and finance are considered as one of the most important aspects of the global financial system. The industry of Islamic banking and finance grew rapidly in the last decades to become a significant force on the global scale. Moreover, the Islamic banking industry has succeeded in developing ways to ease its movement and integration into the global financial industry (Hassan, 2014).

The Sultanate of Oman is the most recent country among the six-nation Gulf Cooperation Council (GCC) to introduce Islamic finance. The Islamic banking experience in Oman is recent compared to other Gulf countries. The operation of finance and banking remain limited to commercial banks in the Sultanate. The legislations and laws do not allow Islamic banks to operate in the Sultanate until late 2012 when the Sultan issued significant amendments to the Banking Law promulgated by Royal Decree 114/2000. This opened the way for Islamic banks and the Islamic “windows” of conventional banks to operate in Oman (Vizcano, 2014).

Corporate and *Shari'ah* governance play a crucial role in Islamic finance industry. Sound corporate governance will assist to enhance honesty, transparency, accountability, integrity and responsibility in the institution in general. In addition, *Shari'ah* governance has a significant role in Islamic finance industry in enhancing the confidence of the shareholders and other stakeholders, it is important to assure that all activities and business of any Islamic Financial Institutions (IFIs) are in line with *Shari'ah* rules and principles (ISRA, 2016).

In this respect, the Omani Central Bank introduced a new *Sharī'ah* governance framework for Islamic banking in the Sultanate to bring the country's Islamic finance industry forward. The Central Bank of Oman (CBO) launched the *Sharī'ah* governance framework in 2012 and required all Islamic banking institutions to fully comply with the *Sharī'ah* governance framework in 2013. The primary target is to provide a sound regulatory framework for the Islamic banks to operate within the required *Sharī'ah* framework. This will enhance and strengthen the investors' confidence in the rapidly growing Islamic finance industry in Oman (Vizcano, 2014).

The literature shows that there are some crucial issues in *Sharī'ah* governance that should be solved to have an effective *Sharī'ah* governance implementation. The issues include matters such as independence, competency and disclosure.

1.2 THE MAIN ISSUES

1.2.1 Independence

Accounting and Auditing Organization for Islamic Financial Institution (AAOIFI) Governance Standards (GS) No.5 para.2 (2015) defines independence as "An attitude of mind which does not allow the viewpoints and conclusions of its possessor to become reliant on or subordinate to the influences and pressures of conflicting interests. It is achieved through organizational status and in an objective way".

The issue of independence arises from the fact that *Sharī'ah* supervisory board members receive remuneration from the IFIs, which may lead to a potential conflict of interest (ISRA, 2016; Farook & Farooq 2011; Garas & Pierce, 2010). The problem comes from the perception that the members of the *Sharī'ah* supervisory board may legitimize illegal or dubious operations to keep their positions active as a member of *Sharī'ah* Supervisory Board (SSB) in the Islamic financial institution (Rammal, 2006;

Abdul Aziz, 2012; Lahsasna & Saba, 2014). Another issue of independence of *Sharī'ah* board is the appointment of SSB members is made during Annual General Meeting (AGM), the board of director (BOD) may influence the shareholders in nominating the members of SSB (ISRA, 2016). According to Rammal (2006) the members of SSB should not be employees in the bank and must not be affected by command of the BOD. The AAOIFI GS No.1 laid out that members of SSB must be appointed by the shareholders during AGM of the bank upon recommendation of the BOD.

There is still a need for an effective *Sharī'ah* governance framework in the form of law or regulation to reinforce the credibility of the IFIs that relies heavily on the perceived independence of the SSB.

1.2.2 Competency

One of the main issues faced by the Islamic finance industry is the need for scholars who have an experience in Islamic finance. Recently, many IFIs seek out to senior and well-versed *Sharī'ah* scholars to be on the member of their SSB. This is to enhance the confidence of clients who deal with the IFIs that well-versed *Sharī'ah* scholars of repute are observing the *Sharī'ah* compliance process (Belder et al., 2008; Abdul Aziz, 2012; Wilson, 2009; Gruening & Iqbal, 2008; Hamza, 2013). The issue of competency may influence the efficiency of the SSB, particularly in issuing appropriate *Sharī'ah* rulings as they should possess the required professional education and training with expertise in *Sharī'ah* (ISRA, 2016). A survey has been conducted on the qualification of members of the SSB, and the survey has found that 76.6% of SSB members have training and qualifications, while 8.6% were erudite in commercial and *Sharī'ah* law. However, only 11.4% have expertise in *Sharī'ah*, economic and law (Bakar, 2002).

These practices may influence the competence of the *Sharī'ah* supervisory board's roles. Especially when SSB members provide robust and concrete *Sharī'ah* decision as they should possess sufficient knowledge and training with experience in *Sharī'ah* (ISRA, 2016).

1.2.3 Disclosure and Transparency

The current practice of *Sharī'ah* governance shows that the level of disclosure of necessary information is weak, even the information about *Sharī'ah* rulings are very hard to be viewed by the public (ISRA, 2016).

A survey has shown that there are shortcomings and weaknesses of disclosure of information practice, especially in the *Sharī'ah* report (Grais & Pellegrini, 2006). Significant issues of *Sharī'ah* governance such as disclosure may affect the credibility and image of Islamic banks in the eye of the public and shareholders. Hasan (2011) conducted a survey on disclosure of *Sharī'ah* governance practice in GCC, UK, and Malaysia. He found that there are significant differences in the extent of disclosure practice. For example, in GCC countries the extent of disclosure practice was very low, where 55% of the IFIs are ranked in the (Emerging Practice) group and no one of them in the (Good Practice) or (Best Practice) groups. In the UK the level of disclosure practice was fair and better than GCC countries, where 20% of the IFIs were ranked in the (Improved practice) and (Good practice) groups. It is interesting to note that the level of disclosure practice in Malaysia was slightly higher than the UK and GCC countries, as more than 80% of IFIs were in groups of the (Improved Practice) and (Best Practice).

The literature describes the main issues and challenges of *Sharī'ah* governance framework and how these issues affect efficiency of *Sharī'ah* governance framework

worldwide. In this regard, Oman has adopted *Sharī'ah* governance framework which is very similar to other countries that faced these issues of *Sharī'ah* governance. Therefore, this study will examine these main issues in *Sharī'ah* governance framework of Oman.

1.3 PROBLEM STATEMENT OF THE STUDY

The literature argues that there are some significant issues and challenges pertaining to the current practice of *Sharī'ah* governance across the world, namely, with regards to independence, competency, and disclosure. These unresolved issues need to be examined properly. The literature shows that without solving these important issues of *Sharī'ah* governance, the system of *Sharī'ah* governance would not be efficient.

Oman adopted a *Sharī'ah* governance framework that is very similar with other countries such as Malaysia, Pakistan, and Bahrain. Therefore, there is a very high potential that the same issues of *Sharī'ah* governance framework apply to Oman too. This similarity can be seen in the *Sharī'ah* governance framework issued by the Central Bank of Oman in 2012. Oman started to operate the Islamic banks in the last few years due to the increasing demand from the people. Prior to that there was no political will to have Islamic banks in Oman. Apparently, as far as the researcher is concerned, very few literature or data is available on the *Sharī'ah* governance framework and issues in Oman. Hence this study attempts to examine the *Sharī'ah* governance framework of Oman to verify the real issues faced. Once the issues are identified and verified, this study will provide some recommendations that may assist in dealing with these issues.

1.4 RESEARCH OBJECTIVES

This study is designed to achieve the following objectives:

1. To investigate the practice of *Sharī'ah* governance framework of Islamic banking in Oman
2. To examine the real features and strengths of the *Sharī'ah* governance framework for Islamic banking in Oman.
3. To identify problems and weaknesses faced by *Sharī'ah* advisors and internal *Sharī'ah* reviewer under *Sharī'ah* governance framework of Oman.
4. To verify the extent of independence, competency and disclosure practiced by *Sharī'ah* board members in Omani Islamic banks.

1.5 RESEARCH QUESTIONS

The study will answer the following formulated research questions, which are derived from the objectives of the study.

1. How is the *Sharī'ah* governance framework for Islamic banking practiced in Oman?
2. What are the features and strengths of the *Sharī'ah* governance framework for Islamic banking in Oman?
3. What are the problems and weaknesses faced by *Sharī'ah* advisors and internal *Sharī'ah* reviewer under *Sharī'ah* governance framework of Oman?
4. How does the regulatory mechanisms ensure independence, competence, and transparency in the Omani *Sharī'ah* governance framework for Islamic banking?

1.6 SIGNIFICANCE OF THE STUDY

The study will provide in-depth information about *Sharī'ah* governance for Islamic banks in Oman, its importance, and models. The emphasis is on the nature of the implementation of the *Sharī'ah* governance framework in practice and some issues related to *Sharī'ah* governance such as independence, competence and disclosure. There is a lack of specific and in-depth research on *Sharī'ah* governance in Oman. Hence, this study will assist those in charge of Islamic banks in Oman to recognize the current condition of *Sharī'ah* governance in Oman and gives them a deeper understanding of its strengths and weaknesses. Furthermore, the study expects that the findings would assist the regulator in strengthening the supervision and operation process of the *Sharī'ah* governance framework. The study will suggest some possible improvements for the *Sharī'ah* governance model and its implementation in Oman.

1.7 SCOPE AND LIMITATIONS OF THE STUDY

The scope of this study is limited to the *Sharī'ah* governance of Islamic banks in Oman. The research will explore the model of *Sharī'ah* governance, which has been practiced by the Islamic banks in Oman, and the issues of concern in the practice. Therefore, the research finding may not be applicable to other *Sharī'ah* governance framework of other countries.

Secondly, there is limitation of literature pertaining to Islamic banking and finance in Oman, especially on *Sharī'ah* governance framework. This creates difficulties in terms of designing the conceptual framework, attributes and dimensions of *Sharī'ah* governance framework of Oman.

Thirdly, the semi-structured interview was conducted on a relatively small size of sample, due to the difficulties in finding the targeted respondents. Moreover, due to

the nature of SSB's work in Islamic banks, the researcher met only a small number of SSB members for the semi-structured interview.

Fourthly, though interview is the best tool to address this type of research to guarantee reliability and accuracy, the method has proven to be time consuming, costly and tiring. The interviewees sometimes asked for postponements and there was also a few cancellations. Therefore, the researcher was required to prepared back up list of other interviewees to get a total of 25 respondents. Some interviewees also faced difficulties in understanding the questions given, hence, the researcher was required to spent time to explain the questions carefully to prevent any misunderstanding.

Fifth, the research is limited to the SSB members, HSSA members and *Sharī'ah* officers in eight Islamic banks and windows in Oman as well as CBO. The study did not cover other IFIs such as takaful companies. Therefore, the findings of this research cannot be generalized to other institutions that are part of Islamic finance industry such as takaful companies. Future studies on other IFIs in Oman, in term of *Sharī'ah* governance may need to be conducted. The future studies should examine these institutions and their experience on *Sharī'ah* governance issues and compare the findings with the experience of Islamic banks in Oman.

1.8 CONCEPTUAL FRAMEWORK OF THE STUDY

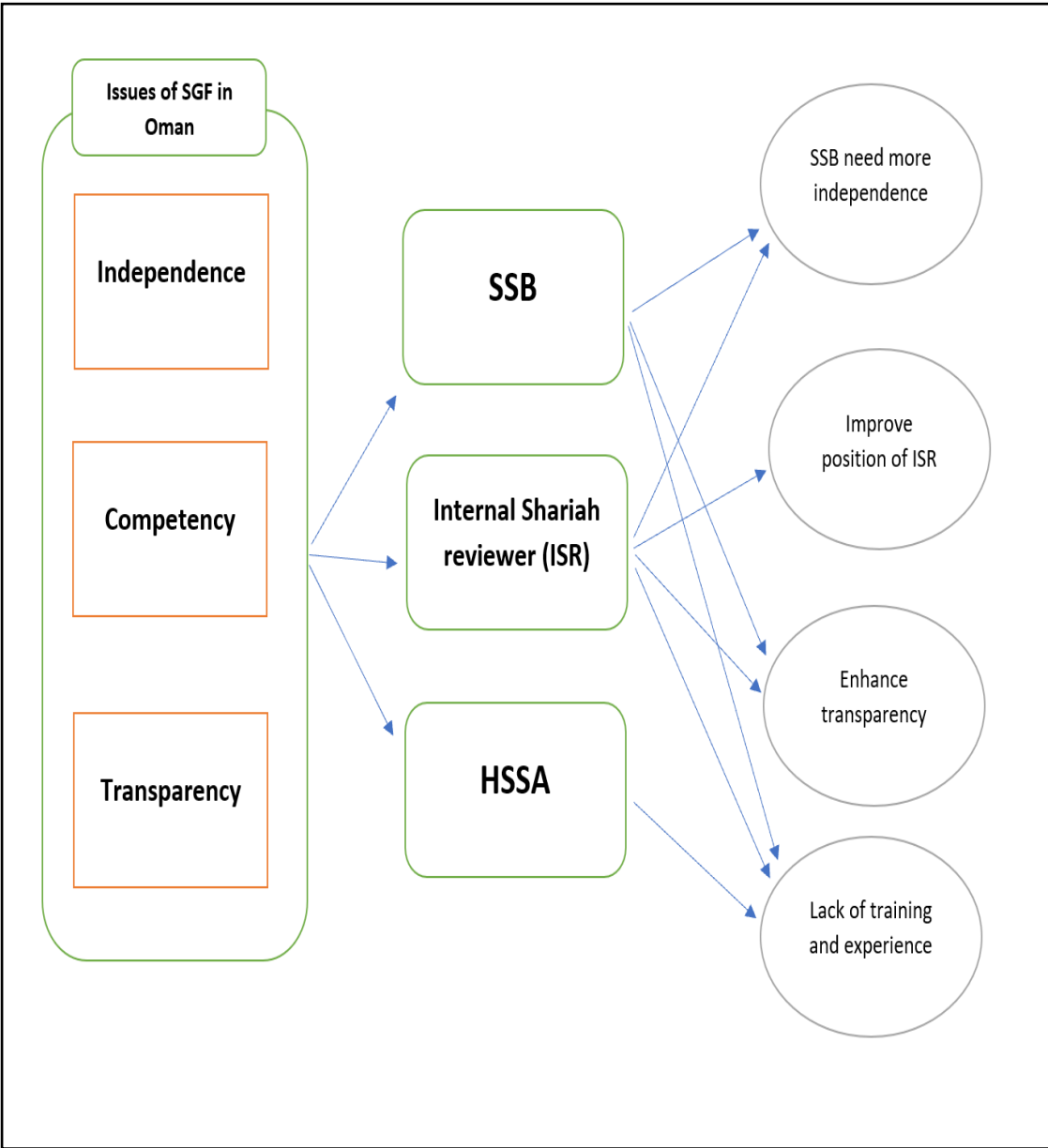


Figure 1.1 Conceptual Framework

1.9 LITERATURE REVIEW

The literature review in this study is classified into three sections: corporate governance in the IFIs, *Shari’ah* governance in selected countries and Issues in *Shari’ah* governance.