



**EXAMINING THE PRACTICE OF SHARIAH
GOVERNANCE IN ISLAMIC FINANCIAL
INSTITUTIONS IN SRI LANKA**

BY

HAYATHU MOHAMED AHAMED HILMY

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International Islamic University Malaysia**

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ABSTRACT

Shariah governance is the salient feature of Islamic finance that validates the entire operation of Islamic Financial Institutions (IFIs) as compliant with Islamic law and differentiate them from conventional financial institutions. The scarcity has been found in the literature that elaborates Shariah governance practices of IFIs in Sri Lanka though the outfit of Islamic finance reached two decades of services in the country. Considering the shortage of literature, this study intends to examine the legal aspects and the actual practices of Shariah governance in Sri Lanka's IFIs. This study examines the law and regulations on Shariah governance as well as identifies the macro and micro level application of Shariah governance in Sri Lanka. The literature observation and document analysis were applied to explore the relevant domestic and international regulation on Shariah governance in the country. The practice of Shariah governance has been examined through interview and document analysis to find out the compliancy of IFIs with the regulations and international Shariah standards they follow by highlighting three main areas of Shariah governance that are the process structure, Shariah supervisory board and accountability. As a qualitative study, the data were gathered through the primary sources such as the information derived from the interview with experts, legislations, international Shariah standards, annual reports and other institutional documents from the IFIs; and supported by the secondary data available in the literatures such as articles in journals, books, newspaper reports, the IFIs websites and the like. The findings of this study indicate that there is no legislation in Sri Lanka that legally enforces on Shariah governance framework at macro level. But, each IFIs has setup Shariah governance institutionally at micro level. However, the findings further explore the gaps and shortcomings in the practice of Shariah governance at IFIs in the abovementioned three main areas of Shariah governance practices. Based on the findings extracted from the analysis, the recommendations were put forward to enhance the Shariah governance practices in Sri Lankan IFIs which is the significant contribution of this study. To ensure the relevancy of the recommendations, the experts' views and the country's political, judicial and ethnic behaviors were also taken into consideration while formulating the policy recommendation.

خلاصة البحث

الحكم بالشرعية الإسلامية هي السمة البارزة للتمويل الإسلامي والتي تصادق على توافق كافة عمليات المؤسسات المالية الإسلامية مع الشرعية الإسلامية، بالإضافة إلى تمييزها عن المؤسسات المالية التقليدية. كان هناك نقص في المؤلفات المتعلقة بممارسات الحكم بالشرعية الإسلامية للمؤسسات المالية الإسلامية في سريلانكا على الرغم من أن خدمات التمويل الإسلامي قد وصل إليها من قبل عقدين. نظرا إلى النقص في المؤلفات، فقد هدف هذا البحث إلى دراسة الجوانب القانونية، والممارسات الفعلية للحكم بالشرعية الإسلامية في المؤسسات المالية الإسلامية في سريلانكا. يدرس هذا البحث القوانين واللوائح المتعلقة بالحكم بالشرعية الإسلامية، بالإضافة إلى تحديد التطبيق الكلي والجزئي للحكم بالشرعية الإسلامية في سريلانكا. تمت مراجعة المؤلفات وتحليل الوثائق لاستكشاف اللوائح المحلية والدولية المتعلقة بالحكم بالشرعية الإسلامية في البلاد. تم أيضا التحقق من ممارسات الحكم بالشرعية الإسلامية من خلال إجراء المقابلات وتحليل الوثائق لمعرفة مدى التزام المؤسسات المالية الإسلامية باللوائح والمعايير الشرعية الدولية التي تتبعها من خلال تسليط الضوء على ثلاثة مجالات رئيسية للحكم بالشرعية الإسلامية، وهي بنية العمليات، وهيئة الرقابة الشرعية، والمساءلة. وكدراسة نوعية، تم جمع البيانات من المصادر الأولية مثل المعلومات المستمدة من المقابلات مع الخبراء، ومن التشريعات، والمعايير الشرعية الدولية، والتقارير السنوية، والوثائق المؤسسية الأخرى التابعة للمؤسسات المالية الإسلامية؛ بالإضافة إلى دعم البيانات الثانوية المتاحة في المؤلفات مثل مقالات المجالات، والكتب، وتقارير الصحف، والمواقع الإلكترونية للمؤسسات المالية الإسلامية، وما شابه ذلك. تشير نتائج هذه الدراسة إلى أنه ليس هناك تشريعات في سريلانكا تطبق قانونيا إطار الحكم بالشرعية الإسلامية على المستوى الكلي، ومع ذلك فقد هيأت كل المؤسسات المالية الإسلامية الحكم بالشرعية الإسلامية على المستوى الجزئي. ومع ذلك فإن النتائج تستكشف الثغرات وأوجه القصور في ممارسة الحكم بالشرعية الإسلامية في المؤسسات المالية الإسلامية في ثلاثة مجالات رئيسية لممارسات الحكم بالشرعية الإسلامية. واستنادا إلى النتائج المستخلصة من التحليل تم تقديم توصيات لتعزيز ممارسات الحكم بالشرعية الإسلامية في المؤسسات المالية الدولية الإسلامية السريلانكية، وهي المساهمة الهامة لهذه الدراسة. ولضمان ملاءمة التوصيات المعطاة، أخذ في الاعتبار آراء الخبراء، وأيضا السلوكيات السياسية والقضائية والعرقية في البلد عند صياغة التوصيات.

APPROVAL PAGE

I certify that I have supervised and read this study and that in my opinion, it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a dissertation for the degree of Master of Science (Islamic Banking and Finance).

.....
Rusni Hassan
Supervisor

.....
Zariah Abu Samah
Co-Supervisor

I certify that I have read this study and that in my opinion it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a dissertation for the degree of Master of Science (Islamic Banking and Finance).

.....
Ahmad Azam Bin Othman Dean,
Internal Examiner

This dissertation was submitted to the IIUM Institute of Islamic Banking and Finance and is accepted as a fulfilment of the requirement for the degree of Master of Science (Islamic Banking and Finance).

.....
Syed Musa Alhabshi
Dean, IIUM Institute of Islamic
Banking and Finance

DECLARATION

I hereby declare that this dissertation 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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In the name of Allah, The Most Gracious, The Most Merciful.

Praise and Gratitude be to Allah, The Lord of All Worlds. Prayers and peace be upon the most noble of the prophets and messengers Muhammad (*Sallahualaihiwasallam*), His family, His companions and all his sincere followers after them.

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CHAPTER ONE

1.1 INTRODUCTION

Islamic finance is a system that strictly complies with Islamic law without involvement of interest, which is the key element in conventional banking. Islamic finance is a way to accommodate the values of Islam in finance. It is based on Islamic law, or Shariah, which is designed to promote social and economic justice (Mizushima, 2013). Therefore, the main distinguishing feature of Islamic finance from its conventional counterpart is Shariah. The mechanism used to ensure Shariah compliance of Islamic Financial Institutions (IFIs) is through the Shariah governance framework. The Shariah governance system helps IFIs to mitigate Shariah non-compliance risk that may damage the credibility and reputation of the IFIs (Ahmed & Khatun, 2013). The role of Shariah governance is to ensure Shariah compliance either in Shariah legitimacy of products or Shariah compliancy of services offered by IFIs (SGF, 2010). Thus, Shariah governance is an integral part of the IFIs by which the institutions validate their conformity with Islamic teachings in all aspects of the IFIs' activities including management, administration, operation, products, and services. When Islamic finance spreads in various countries, the implementation of Shariah governance in IFIs gives different experiences and challenges depending on the countries' existing legal and regulatory environment.

1.2 BACKGROUND OF THE STUDY

Sri Lanka is one of the non-Muslim countries that has established Islamic finance in the banking and financial sector. Researchers have different views regarding pioneering efforts in Islamic finance in Sri Lanka. Some of them said that Islamic

finance emerged in Sri Lanka in 1980 with the establishment of the Islamic Service Society in Akurana, Sri Lanka. Due to the lack of services and legal relevance of the company, it had not been taken into consideration by academicians and researchers (Nafees & Habeebullah, 2016). Further, it is a well-known fact in Sri Lankan Islamic financial industry that Amana Investment Limited (AIL), established in 1997, is the pioneer IFI in the country. It was a collective effort carried out by a group of people comprising bankers such as Ismail Deen Marikar and Uthman Qasim, and other qualified people with the guidance of a prominent Islamic finance scholar, As Sheikh Taqi Usmani. As a result, the first Islamic financial institution known as AIL started operation in 1997 as an Islamic investment company. In 2010, it became a full-fledged Islamic bank and renamed as Amana Bank (Nafees & Habeebullah, 2016). Meanwhile, Amana Takaful Limited (ATL) was established in 1999 to provide Islamic insurance products and services. These initiatives paved the way to the establishment of new IFIs afterwards.

Year 2005 marked a milestone in the history of Islamic finance in Sri Lanka in which important amendments took place to legalise Islamic banking business in commercial banks. The Sri Lankan Banking Act No. 30 of 1988 was amended with some new paragraphs to enable commercial banks to deal with sale-based and equity-based products (Shah, 2014). These amendments accelerated the development of Islamic finance in the country where leading conventional commercial banks gradually started Islamic windows and offered Islamic banking products. Islamic finance spread all over the island and attracted the interest of people regardless of religions and cities (Farook, 2007).

Currently, Islamic finance services in Sri Lanka are offered by many conventional players such as commercial banks, investment companies, insurance

providers, and leasing companies. These institutions can be categorised into six main categories, namely full-fledged Islamic banks, Islamic windows in conventional banks, full-fledged *takaful* companies, Islamic windows in insurance companies, Islamic leasing companies, and Islamic investment companies. The categorisation is based on the types of Islamic finance providers that offer Islamic banking products and services. The companies that provide Islamic finance education or consultation or Islamic capital market products are not included in this categorisation because this research intends to examine Shariah governance practices of IFIs where Islamic financial transactions take place.

However, Islamic Finance News (8 March 2016) cited Richard Pieris Arpico Finance and categorised the industry into seven and announced there are 44 participants in the local Islamic financial space including all seven categories such as banking and finance, *takaful*, consultancy and advisory, education, software and IT and Islamic microfinance. Out of 44 institutions sixteen are in the banking and finance sector and four are in Islamic insurance sectors which are the categories taken to this survey. The banking and finance segment and Islamic banking window operations dominate in terms of numbers; there is only one full-fledged Islamic bank, the Amana Bank (IFN News, 2016). *Takaful* had been led by ATL for around 16 years from its inception. Recently, two big players, Hatton National Bank Group (HNB) and Lanka Orix Leasing Company (LOLC) which have subsidiaries for insurance have started *takaful* windows. Moreover, Islamic equity market in Sri Lanka is still in infancy stage with limited products and Islamic funds (Redmoney, 2014).

It is worthy to note at this juncture that Islamic finance has been established in Sri Lanka despite the Muslims being a minority group in the country (Sabri, Rauf, & Zaheed, 2016). Because, Sri Lanka's demographics profile shows it is a small island

with a total population of 22.235 million. A majority of the people are Buddhists, making up 74.9% of the total population. Muslims are a second minority group in the country after the Hindus, comprising 9.2% of the population' (IndexMundi, 2017). The growing number of IFIs in Sri Lanka despite the small Muslim population in the country is highly appreciated by many researchers and professionals and they have forecasted positive growth in the future (Redmoney, 2014). There is obviously an emerging market of Islamic finance in Sri Lanka. Further, a survey report published by Kuwait Finance House on the topic of "Islamic Finance in Asia: Development, Growth and Opportunities" declared Sri Lanka as one of the growing countries in Islamic finance (KFH Research Ltd, 2013).

Despite the growth of Islamic finance industry, some incidences may interrupt its advancement. KPMG country report on Islamic finance stated that Islamic finance experienced a slowdown in 2009 because some players ceased their operations (KPMG, 2011). Some researchers highlighted that mismanagement in Shariah governance is one of the main reasons for the collapse of those institutions (Mazahir & Hilmy, 2013).

There are four main legal regulatory authorities relevant to the banking and financial sector in Sri Lanka: the Central Bank of Sri Lanka (CBSL), the Registrar of Companies (ROC), the Insurance Board of Sri Lanka (IBSL), and the Security Exchange Commission (SEC). The CBSL is the apex body for the entire monetary, financial, and payment systems of Sri Lanka that regulates and supervises the entire banking and financial industry. Further, the CBSL is the responsible body for granting and cancelling banking licenses. The ROC of Sri Lanka is the authority that governs trade policies and other business registration (inland, overseas, and offshore) under the relevant Acts. It authorises and supports effective functioning of companies and

commercial activities. On the other hand, insurance companies and insurance brokers are regulated by the IBSL, which is the responsible body for insurance business in the country. It has been established for the purpose of development, supervision, and regulation of the insurance industry. The capital market operations such as stock broking, stock exchange, and unit trust are regulated by the SEC. Further, the SEC monitors the Colombo Stock Exchange to ensure proper conduct of business.

1.3 PROBLEM STATEMENT

The strategic element that distinguishes Islamic finance from its counterpart is Shariah. If any action of the IFIs deviated from the principles of Shariah, then the IFIs become similar with conventional institutions because the main element that makes the IFIs different from their conventional counterpart is the Shariah-based contracts. Therefore, Shariah governance is crucial for the consistency of IFIs. Shariah compliance is the backbone and the foundation for the existence of Islamic banking (Mizushima, 2013). The tool for ensuring and measuring competency and efficiency of Shariah compliance of Islamic financial operations is an efficient Shariah governance framework. Renowned standard setting bodies such as the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), the Islamic Financial Services Board (IFSB), and domestic central banks such as the Bank Negara Malaysia (BNM) have issued guidelines on Shariah governance. IFIs need to have a systematic or standardised Shariah governance model adopted from recognised guidelines in order to retain their reputation and public and stakeholders' confidence. However, the implementations of Shariah governance in IFIs of various countries show the different shapes of framework and diverse banking and financing models

(Hasan, 2011). The degree of involvement of regulatory authorities in Shariah governance of IFIs also varies depending on the legislation of the respective countries.

Sri Lanka's history in Islamic finance has reached almost two decades. Most of the big players in conventional finance in the country have started Islamic windows. However, the area of Shariah governance is still a subject of criticism whereby the IFIs do not have a proper arrangement for Shariah governance (Maseehudin, 2011). In the history of Sri Lanka, the collapse of two IFIs which were subsidiaries conventional players had brought negative impact on the industry. Ceylinco Profit Sharing Limited, which was established under the Ceylinco group has stopped operation while another subsidiary named as Ceylinco Takaful had been suspended by the IBSL from the operation with effect from 5 August 2009 (Sri Lanka Islamic Finance, 2010). This news was a shock for the Islamic financial industry as well as for the public. These failures were criticised in various aspects. However, the major criticism by the public in the media and newspapers was negligence of Shariah rules and misguidance of Shariah people (Sri Lanka Muslims, 2015).

Further, the same criticism was published in a Tamil Newspaper, '*Meelpaarvai*' on 05 August 2011, stating that the reason behind these failures was non-qualified Shariah people sitting on the Shariah Supervisory board (SSB) (Anam, 2011). This scenario had led to the investigation of the roles of regulators in Sri Lanka regarding Shariah governance, as well as the legal relevance of Islamic finance and Shariah governance in the country, which is a non-Muslim state and legislated with conventional regulatory and governance standards.

On the other hand, Islamic finance in Sri Lanka has shown positive growth and the country has been listed among the countries where Islamic finance is emerging (KFH Research Ltd, 2013). Since Shariah governance is the key element for the

viability of IFIs, the growth of Islamic finance cannot be achieved without proper arrangement of Shariah governance. Therefore, it further attracts the interest to examine how IFIs in Sri Lanka set up their Shariah governance.

1.4 RESEARCH OBJECTIVES

The study aims to investigate the influence of Shariah governance in IFIs in Sri Lanka and to explain the current legislative and regulatory framework in order to explore the obstacles and challenges of effective implementation of Shariah governance. Further, this study intends to identify the gap between the regulatory framework of Shariah governance and current practices in order to propose an appropriate best suited Shariah governance model for Sri Lankan IFIs. Thus, the study pursues the following research objectives to achieve the aim of the research:

- 1- To examine the regulatory framework of Shariah governance of IFIs in Sri Lanka.
- 2- To explore the current practices of Shariah governance in IFIs and the extent of compliance with the standards they follow.
- 3- To recommend the measures to enhance the practices of Shariah governance in IFIs in Sri Lanka.

1.5 RESEARCH QUESTIONS

To achieve the above mentioned objectives, the following research questions have been projected:

- 1- What are the regulations governing Shariah governance practices of IFIs in Sri Lanka?
- 2- How do IFIs in Sri Lanka practice Shariah governance?

- 3- What are the ways and means to improve Shariah governance practices of IFIs in Sri Lanka?

1.6 SIGNIFICANCE OF THE STUDY

Sustainability of the industry is more important than its growth and development. Without prearrangement for consistency of growth, the industry may collapse in the future. Since Shariah governance is fundamental for Islamic finance, it should have proper installation with enforcement and power. To attain positive development of certain level, Islamic financial industry needs to bring the industry under the authentic and proper Shariah governance framework which complies with the true principles of Islam (Haqqi, 2014). In an industry where Shariah governance is not legislated or regulated, there is a possibility that the players will go against Shariah compliance of their products and services. However, regarding Shariah governance around the globe, some regulatory authorities have shown greater involvement to arrange Shariah governance in Islamic financial industry while some countries on the other hand favour otherwise (Hasan, 2010).

It should be verified in the legislations of Sri Lanka whether the regulations occupy greater or lesser influence or no influence at all for Shariah governance of IFIs in Sri Lanka. The growing number of Islamic windows in conventional banks and conventional leasing companies shows an emerging market of IFIs in Sri Lanka. Therefore, it necessitates well-planned guidelines to safeguard the Islamic financial industry and its consistent growth, as otherwise it may lead to loss of reputation and public confidence. Further, it is extremely worthwhile for the growing industry to follow relevant guidelines issued by the international standard setters such as AAOIFI and IFSB.

This study will also contribute to the literature in Shariah governance. It is hoped that this study will support in enriching literature in the area of regulation and implementation of Shariah governance guidelines in a dual banking system where conventional principles are dominating. Although considerable research had been conducted in the area of Shariah governance, only a few of the research deliberated on Shariah governance practices in Sri Lanka. Hence, the researcher, undertakes this study in the hope that its findings may provide certain inventions and plans to improve Shariah governance practices in the country. Further, this study will illustrate the existing regulations and Shariah governance practices in Sri Lanka and the barriers to proper application. Besides, the findings of this study might be helpful for the practitioners, legislators, and academicians in identifying the gap between regulations and real practices and in shaping up the industry's Shariah governance practices.

1.7 SCOPE OF THE STUDY

The scope of this study is limited to the institutions offering Islamic financial products and services in Sri Lanka, namely Islamic banks, Islamic banking windows, *takaful* companies, *takaful* windows, Islamic leasing companies, and Islamic investment companies. One institution will represent each category in this study. This research focuses on Shariah governance and its regulatory settings only. Further, this study is intended to examine the regulatory framework on Shariah governance and the actual practices of IFIs in order to identify the gap. Arising from the identified gap, the recommendations will be put forward. In this regard, some best practices of Shariah governance from across the border will be prescribed as examples of successful applications. This study attempts to provide the best ways to ensure healthy Shariah

governance framework by systematically analysing the existing practices of Shariah governance and its obstructions.

1.8 REVIEW OF RELEVANT RESEARCHES ON SHARIAH GOVERNANCE

Shariah governance has attracted the attention of many academicians and researchers in the field of Islamic finance. Many journal articles have discussed the models and structures of Shariah governance frameworks in various jurisdictions. In addition, books, presentations, and other publications that elaborate on Shariah governance and its importance are widely available. The literature encompass most aspects of Shariah governance including theories, practices, models, legal frameworks, processes, structures, and characteristics.

The article written by Siti Normala and Nyasary in 2014 addressed the theoretical framework of Shariah governance. This study discussed the concept of Shariah governance and named five primary functions of Shariah governance, which are accountability, disclosure and transparency, competency, confidentiality, and independence (Obid & Naysary, 2014). However, it is a theoretical study and they did not test their work against any legislation or regulation except for the AAOIFI Standards, which were used to explain the theory. Another paper written by Nawal Kasim, Sheila and Syed comparatively discussed Shariah governance standards and guidelines issued by international standard setting bodies such as the AAOIFI, the IFSB, and the BNM (Nawal Kasim, NuHtay, & Salman, 2013). This study elaborated on the concept and application of Shariah governance in different perspectives.

Most of the literature on Shariah governance published in Malaysia or otherwise discussed Malaysian Shariah governance framework or pointed out examples from Malaysia. Therefore, it is hard to find a paper on Shariah governance

that did not state anything about the Malaysian context. Publications addressing other countries are fewer compared to those on Malaysia. Laws and regulations of Shariah governance along with practical structures and processes have been emphasised in various literature. In this regard, a recently published article Hazizi and Kassim (2016) in Malaysia discussed the extent of Shariah governance disclosure, which is one of the main characters of Shariah governance. They found that if any SSB consist of majority of Shariah experts along with other professionals in the board, there will be a significant improvement in Shariah governance disclosure.

Another study Miskam and Nasrul (2013) reported on the effects of the Islamic Financial Services Act (IFSA 2013) on Shariah governance in Malaysia. They argued that IFSA 2013 has strengthened Shariah governance practices more than the previous legislations. Likewise, another research (Mizushima, 2013) also deliberated on Malaysian Shariah governance practices and the effects of the Malaysian Shariah Governance Framework (SGF 2010) comparatively with conventional corporate governance.

Moreover, it was argued R. Hassan and Hussain (2013) that Malaysia has enough regulatory frameworks in order to supervise Shariah advisors. They pointed out the impact of all relevant regulations regarding Islamic finance onshore and offshore to support their argument. However, some legal issues on Shariah governance practices were identified by (Kunhibava, 2015). She found some issues on the role of the central SSB which Shariah Advisory Council (SAC) and the institutional SSB known as Shariah Committee (SC) and proposed amendments to the existing Acts such as the IFSA 2013, the Central Bank of Malaysia Act 2009 (CBMA), and the SGF 2010.

Another article was published in 2015 by a group of researchers on the regulatory system of Islamic banks in Pakistan, Malaysia, Bahrain, and the United Kingdom (UK). This paper analysed the development of Islamic banks in the respective countries based on several elements such as regulation, especially regulators of Islamic banks, supervision, governance authorities, and others (Tanveer, Shah, & Jamil, 2015). Likewise, the issues and challenges of Shariah governance and Shariah supervisory system in Southeast Asia's and the Gulf Coast Countries' (GCC) models were discussed comparatively (Grassa, 2013). Arising from the analysis, he pointed out the importance to have Shariah governance with enforceability and legal power and he gave his view against voluntary enactments of Shariah governance in some jurisdictions.

Ayedh and Echchabi (2015) explored Shariah governance practices adopted by Yemeni Islamic banks. He found that although the IFIs in Yemen adopted the AAOIFI Standards in offering Islamic finance products and services including Shariah governance, the Central Bank of Yemen does not provide any endorsement to enforce the Shariah governance framework. Further Ahmed and Khatun (2013) discussed on Shariah governance in Bangladeshi Islamic finance industry to measure the extent of the industry's compliance with Shariah Governance Standards of the AAOIFI. He found that the only full-fledged Islamic bank in Bangladesh has higher compliance with the standards compared to other IFIs. Thus he put forward his recommendation to ensure compliance with Shariah governance.

There is another research found that examined Shariah governance in Malaysia, the GCC countries (Kuwait, Bahrain, Qatar, Saudi Arabia, and the UAE), and the UK. The models and processes of Shariah governance and Shariah compliance in those countries were discussed and divided by the researcher into five approaches