



**AN INVESTIGATION ON SHARĪ'AH GOVERNANCE
PRACTICES OF ISLAMIC FINANCIAL INSTITUTIONS
(IFI) OPERATING IN SRI LANKA**

BY

FATHIMA NAZEEFA NAMIZ FAWZER

**A thesis submitted in fulfilment of requirement for the
degree of Doctor of Philosophy in
Islamic Banking and Finance**

**IIUM Institute of Islamic Banking and Finance
International Islamic University Malaysia**

FEBRUARY 2018

ABSTRACT

Islamic Banking and Finance as an alternative banking and finance method is one of the fastest growing industries in the world. With double-digit growth rate, the operations of Islamic Financial Institutions had been accepted and adopted in more than 75 countries. The crux of any Islamic Financial Institution is to adhere and comply with the Sharī'ah rules and precepts. The mechanism to ensure Sharī'ah compliance in all its operation is carried out by Sharī'ah Governance. Sharī'ah Governance practices vary according to the legal and regulatory requirement in their respective countries. Having a strong Sharī'ah Governance framework, structure and process will ensure development and growth of Islamic Banking and Finance industry nationally and internationally. Various studies show that the lack of rigour is shown in Sharī'ah Governance practices in non-Muslim countries. Thus, the purpose of this study is to examine the Sharī'ah Governance practices and its effectiveness in Islamic Financial Institutions operating in Sri Lanka. A comparative study of Sharī'ah Governance practices in different types of Institutions, namely Islamic Banks, Islamic Banking windows, Takaful operators and Islamic Finance companies are explored. The research design employed to achieve the objectives and questions established in this study uses the sequential exploratory mixed method. A combination of both qualitative and quantitative investigation where the first phase of investigation is conducted through qualitative method followed by quantitative method. The qualitative investigation is supported by content analysis and semi-structured interviews, which are analysed manually using a thematic approach, followed by a quantitative study using survey questionnaires from operators analysed through Partial Least Squares (PLS) path. Findings show that full-fledged Islamic Finance operators have written documents representing the Sharī'ah Governance process, while other Institutions follow AAOIFI Sharī'ah Governance standards in general. The interview with the Sharī'ah Board members revealed that currently Sharī'ah Governance practices are effective, but requires improvement and state support in the future. Out of six hypothesis developed in relations to the constituents of Sharī'ah Governance, three were accepted, namely Sharī'ah Board, Board of Management and Sharī'ah Audit have an effect on the effective Sharī'ah Governance practices and three are rejected namely, Transparency, regulation and standards does not affect the effectiveness of Sharī'ah Governance practices in Sri Lanka. Based on the findings appropriate recommendations are put forth that will strengthen the Sharī'ah Governance practices in Sri Lanka.

ملخص البحث

تعد الخدمات المصرفية الإسلامية، والتمويل المصرفي وسيلة بديلة للتمويل المصرفي بوصفها إحدى أسرع الصناعات المالية نمواً في العالم. وبفضل معدل نمو مزدوج الرقم، تم قبول واعتماد عمليات المؤسسات المالية الإسلامية في أكثر من ٧٥ بلداً. إن جوهر أي مؤسسة مالية إسلامية هو التقيد والامتثال للشريعة الإسلامية وقواعدها. إن آلية ضمان الالتزام بالشريعة في جميع عملياتها تتم من قبل إدارة الشريعة الإسلامية حيث تختلف ممارسات الحوكمة الشرعية وفقاً للمتطلبات القانونية والتنظيمية في بلدانها. إن وجود إطار قوي للحوكمة الشرعية، والهيكلي، والعملية سيضمن تطوير ونمو صناعة الخدمات المصرفية الإسلامية والمالية على الصعيدين الوطني والدولي. وتظهر دراسات مختلفة أن عدم الدقة في ممارسات الحوكمة الشرعية في البلدان غير الإسلامية. وبناءً عليه، فإن الغرض من هذه الدراسة هو دراسة ممارسات الحوكمة الشرعية وفعاليتها في المؤسسات المالية الإسلامية العاملة في سريلانكا. يتم دراسة مقارنة ممارسات الحوكمة الشرعية في مختلف أنواع المؤسسات، وهي المصارف الإسلامية والنوافذ المصرفية الإسلامية ومشغلي التكافل وشركات التمويل الإسلامي. يستخدم تصميم البحث لتحقيق الأهداف والأسئلة التي أثيرت في هذه الدراسة الأسلوب المختلط الاستكشافي المتسلسل. ومزيجاً من كل من التحقيق النوعي والكمي حيث تتم المرحلة الأولى من التحقيق من خلال الطريقة النوعية تليها الطريقة الكمية. ويدعم التحليل النوعي تحليل المحتوى والمقابلات شبه المنظمة، التي يتم تحليلها يدوياً باستخدام نهج مواضيعي، تليها دراسة كمية باستخدام استبيانات المسح من مشغلي تحليلها من خلال مسار المربعات الجزئية (بلس). وتظهر النتائج أن مشغلي التمويل الإسلامي الكاملين قد كتبوا وثائق تمثل عملية حوكمة الشريعة الإسلامية، في حين تتبع المؤسسات الأخرى معايير حوكمة الشريعة الإسلامية بشكل عام. وكشفت المقابلة مع أعضاء مجلس الشريعة أن ممارسات حوكمة الشريعة حالياً فعالة، ولكنها تتطلب تحسناً ودعمًا من الدولة مستقبلاً. ومن بين الفرضيات الست التي تم تطويرها فيما يتعلق بمكونات حوكمة الشريعة، تم قبول ثلاثة منها، وهي مجلس الشريعة، ومجلس الإدارة والتدقيق الشرعي ذات تأثير في ممارسات الحوكمة الشرعية الفعالة، وتم رفض ثلاثة منها، تؤثر الشفافية واللوائح والمعايير في فعالية ممارسات الحوكمة الشرعية في سريلانكا. واستناداً إلى النتائج التي تم التوصل إليها توضع توصيات مناسبة تعزز ممارسات الحوكمة في سريلانكا.

APPROVAL PAGE

The thesis of Fathima Nazeefa Namiz Fawzer has been approved by the following:

Rusni Hassan
Supervisor

Abideen Adewale
Co-Supervisor

Muslim Har Sani
Internal Examiner

Abdul Ghafar Ismail
External Examiner

Zurina Shafii
External Examiner

Mohammed Naqib
Chairperson

DECLARATION

I hereby declare that this thesis is the result of my own investigation, 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.

Fathima Nazeefa Namiz Fawzer

Signature.....

Date

INTERNATIONAL ISLAMIC UNIVERSITY MALAYSIA

**DECLARATION OF COPYRIGHT AND AFFIRMATION OF
FAIR USE OF UNPUBLISHED RESEARCH**

**AN INVESTIGATION ON SHARĪ‘AH GOVERNANCE
PRACTICES IN ISLAMIC FINANCIAL INSTITUTIONS (IFI)
IN SRI LANKA**

I declare that the copyright holder of this thesis are jointly owned by the student and IIUM.

Copyright © 2018 Fathima Nazeefa Namiz Fawzer and International Islamic University Malaysia. All rights reserved.

No part of this unpublished research may be reproduced, stored in a retrieval system, or transmitted, in any form or by any means, electronic, mechanical, photocopying, recording or otherwise without prior written permission of the copyright holder except as provided below

1. Any material contained in or derived from this unpublished research may be used by others in their writing with due acknowledgement.
2. IIUM or its library will have the right to make and transmit copies (print or electronic) for institutional and academic purposes.
3. The IIUM library will have the right to make, store in a retrieved system and supply copies of this unpublished research if requested by other universities and research libraries.

By signing this form, I acknowledged that I have read and understand the IIUM Intellectual Property Right and Commercialization policy.

Affirmed by Fathima Nazeefa Namiz Fawzer

.....
Signature

.....
Date

This thesis is dedicated to my beloved husband

Mohamed Fawzer Farook

And

My loving parents

Marhoom S.M.M.M.Namiz and Marhooma Shibly Nawazia Namiz

ACKNOWLEDGEMENTS

All praise is due to Almighty Allah, the Beneficent, and the Most Merciful who taught the use of pen and taught man that which he knew not. I am particularly grateful to Allah for his blessing and mercy from the day I was born up until this moment, without it the successful completion of my PhD journey would not have been possible.

I would like to express my deepest gratitude to my supervisor, Prof. Dr. Rusni Hassan, whose encouragement and support, made me come to this level. I treasure and hold fast to my heart the experiences and moments spent together to complete this thesis. My deepest gratitude goes to Assoc.Prof. Dr Abideen Adwale for his guidance and patience in the progress of my PhD research project. Special thanks goes to kak.Fadilah for always accommodating my requests in short notice.

My special appreciation goes to Mr. S.C. Kaluarachchi, Head of Business School, and Dr. Athula Pitigala Arachchi, CEO of Asia Pacific Institute of Information Technology for the support given to complete my studies.

I take this opportunity to express my humble gratitude to all Sharī'ah Board Members, who willing helped me in conducting the interviews, as well as the Head of Islamic unit and HR managers of IFIs in Sri Lanka.

My special appreciation goes to my family members, my brothers, sister-in-laws, darling nieces and nephews, and all my cousins, who had contributed in many ways during my long journey. Especially to my father-in-law, Dr. B.M Farook and Mother-in-law Fauzul Inaya who had always been there for me. I also would like to extend my thanks to all my colleagues in APIIT for their moral support and encouragement rendered to me. Sincere thanks to my dear friend Sundus Kakoosa whoes presence has always been a blessing.

I owe deeply to my dearest husband Fawzer Farook, whose trust, encouragement, support, love, motivation, patience and sincere duas made me achieve the greatest accomplishment in my life. He had been my pillar of strength through all my obstacles. He has always been my inspiration and aspiration in life. The best thing that has happened in my life is being your wife. Jazakallah ma.

My special remembrance and thoughts always go to my late parents, Mr. S.M.M.M Namiz and Shibly Nawazia for planting the seed of seeking knowledge in me. It is that seed that have grown to be a tree today. I miss both of you very much. I take this moment to remember my dear brother Mifraz Namiz, sister, my aunties and uncles who passed away. Ya Allah I beg you to forgive them all for their mistakes and grant all of them the best place in Jannah.

Lastly my heartfelt appreciation goes to IIUM, the garden of knowledge and Virtue. I sincerely thank all my lectures who taught me during my Bachelors, MBA and my PhD. It is your guidance that had transformed me to the person I am today. Jazakallah.

TABLE OF CONTENTS

Abstract	ii
Abstract in Arabic	iii
Approval Page.....	iv
Declaration	v
Copyright	vi
Dedication	vii
Acknowledgements	viii
List of Tables	xiii
List of Figures	xiv
List of Acronyms	xv
CHAPTER ONE: INTRODUCTION	1
1.1 Background of the Study	1
1.2 Problem Statement.....	10
1.3 Research Objectives.....	13
1.4 Research Questions.....	14
1.5 Significance of the Study.....	14
1.6 Scope and Research Method.....	16
1.7 Structure of the Thesis	17
CHAPTER TWO: LITERATURE REVIEW.....	18
2.1 Introduction.....	18
2.2 Islamic Banking and Finance in Sri Lanka.....	18
2.2.1 Regulation in Sri Lanka	21
2.3 Corporate Governance in Financial Institutions	23
2.3.1 Corporate Governance Models	26
2.3 The Concept of Corporate Governance in Islamic Financial Institutions (IFI).....	28
2.4 Sharī'ah Governance Practices in the World.....	33
2.5 Sharī'ah Governance	35
2.5.1 Sharī'ah Governance Framework	41
2.5.2 Sharī'ah Governance Structure	42
2.5.2.1 Classification of Sharī'ah Governance Structure	42
2.5.3 Sharī'ah Governance Process.....	45
2.5.4 Sharī'ah Governance Function.....	46
2.6 Key Organ of Sharī'ah Governance Mechanism.....	47
2.6.1 Sharī'ah Board	47
2.6.1.1 Classification of Sharī'ah Board.....	50
2.7 Theoretical Underpinning of this Study	50
2.9 Conceptual Framework for Sharī'ah Governance	54
2.10 Constituents of Sharī'ah Governance: The 3P Model	56
2.10.1 People.....	57
2.10.1.1 Sharī'ah Board.....	58
2.10.1.2 Board of Directors and Senior Management	60
2.10.2 Process	61

2.10.2.1 Process & Procedure of Shari'ah Governance	61
2.10.2.2 Shari'ah Audit and Review.....	62
2.10.3 Policy	64
2.10.3.1 Regulation and Standards	64
2.10.3.2 Transparency and Disclosure.....	64
2.11 Hypothesis	65
2.12 Literature Gap.....	67
2.13 Conclusion	68
CHAPTER THREE: RESEARCH METHODOLOGY	70
3.1 Introduction.....	70
3.2 Philosophical Worldview.....	70
3.3 Research Design	72
3.3.1 Research Method.....	72
3.4 Study Area: Sri Lanka	75
3.5 Population of the Study	76
3.6 Sampling Method	78
3.6.1 Qualitative study	78
3.6.2 Quantitative study	80
3.7 Sources of Data.....	81
3.7.1 Primary Data	81
3.7.1.1 Interview	81
3.7.1.2 Survey Questionnaire	82
3.7.2 Secondary Data	83
3.8 Research Instruments.....	83
3.8.1 Interviews.....	83
3.8.2 Survey Questionnaire.....	84
3.9 Data Analysis.....	85
3.9.1 Qualitative.....	85
3.9.2 Quantitative.....	87
3.10 Response Rate.....	89
3.11 Ethical Consideration.....	90
3.12 Conclusion	91
CHAPTER FOUR: FINDINGS AND DISCUSSIONS	93
4.1 Introduction.....	93
4.2 Qualitative Research Findings	93
4.2.1 Content Analysis	93
4.2.2 Interview Analysis	97
4.2.2.1 State a Brief Background of Yourself.	99
4.2.2.2 The Role and Functions as an SBM	99
4.2.2.3 Opinion about the Qualification of Shari'ah Board Members.....	100
4.2.2.4 Basis of Appointment	101
4.2.2.5 Basis of Remuneration.....	101
4.2.2.6 Composition of Shari'ah Board.....	102
4.2.2.7 How Many Meeting SBM Sit in a Year	102
4.2.2.8 Support of the Board of Management (BOD) and Senior Management.....	103

4.2.2.9 Who has Higher Authority When it Comes to Sharī`ah Compliances Issues.....	103
4.2.2.10 Do the BOD or Senior Management Restrict Your Independence?	104
4.2.2.11 Do IFIS Conduct Sharī`ah Audit?	104
4.2.2.12 The Process of Sharī`ah Audit.....	104
4.2.2.13 Do IFI Conduct Sharī`ah Review	105
4.2.2.14 Availability of Standard Operating Procedure (SOP) Relevant To Sharī`ah Governance.	105
4.2.2.15 How Do the IFIS Communicate to the Stakeholders Regarding Matters Related to Sharī`ah Governance?	106
4.2.2.16 Process of Documenting the Minutes	106
4.2.2.17 What Standards IFI Follow?.....	107
4.2.2.18 The Role of Sri Lankan Government Particularly Central Bank of Sri Lanka Stand on Sharī`ah Governance.....	107
4.2.2.19 Is the Sharī`ah Governance effective in Sri Lanka?	108
4.2.2.20 What are the Areas to Improve in Sharī`ah Governance?.....	108
4.3 Discussion of Qualitative Findings.....	109
4.4 QuantitaTive Research Findings.....	110
4.4.1 Preliminary Analysis.....	110
4.4.2 Descriptive Analysis	111
4.5 Measurement Model Assessment	114
4.5.1 Internal Consistency Reliability.....	114
4.5.2 Indicator Reliability	115
4.5.3 Convergent Validity	116
4.4.4 Discriminant Validity.....	117
4.6 Structural Model	118
4.6.1 Path Coefficient.....	119
4.7 Predictive Relevance	120
4.8 Hypotheses Testing.....	121
4.9 Discussion of Quantitative Findings.....	123
4.10 Conclusion	124

CHAPTER FIVE: CONCLUSION, IMPLICATION AND FUTURE

RESEARCH	125
5.1 Introduction.....	125
5.2 Summary of the Qualitative Findings.....	125
5.2.1 Content Analysis	126
5.2.2 Interview Findings	127
5.3 Quantitative Findings.....	130
5.4 Contribution of the Research	131
5.4.1 Theoretical Contribution.....	131
5.4.2 Practical Contribution	132
5.5 Recommendation	133
5.5.1 Policy Recommendation	133
5.5.2 General Recommendation.....	135

5.6	Limitation and Future Research.....	136
5.6.1	Limitation of the Study	136
5.6.2	Future Research Opportunities.....	136
5.7	Conclusion	137
REFERENCES.....		139
APPENDIX A	TYPE OF INSTITUTES.....	147
APPENDIX B	INVITATION LETTER.....	150
APPENDIX C	INTERVIEW PROTOCOL	153
APPENDIX D	INTERVIEW TRANSCRIPTION OF INFORMANT	156
APPENDIX E	NOTATIONAL CONVENTIONS.....	172
APPENDIX F	STANDARD OPERATING PROCEDURE FOR SHARĪ AH GOVERNANCE OF SAMPLED IFI	173
APPENDIX G	QUESTIONNAIRE SURVEY	178
APPENDIX H	CONTENT ANALYSIS.....	184
APPENDIX I	INTERVIEW ANALYSIS.....	185

LIST OF TABLES

Table 2.1	Classification of Sharī'ah Governance Structure	45
Table 2.2	List of Proposed Hypothesis	65
Table 3.1	Research Question, Objectives and corresponding methodology and data collection method	74
Table 3.2	Population of the IFIs (as at 31.12.16)	77
Table 3.3	Sample IFIs in Sri Lanka	78
Table 3.4	Sharī'ah Board Members in Sri Lanka	79
Table 3.5	Population, Sample method and Sample profile	80
Table 3.6	Validity Guidelines for Measurement and Structural model	89
Table 3.7	Response Rate	90
Table 3.8	Ethical Considerations undertaken by the researcher	91
Table 4.1	Themes and Sub-themes according to the research questions and Objectives	98
Table 4.2	Summary of Descriptive Statistics	113
Table 4.3	Internal Consistency Reliability	115
Table 4.4	Factor Loadings	116
Table 4.5	AVE Value	116
Table 4.6	Discriminant Validity Heterotr	117
Table 4.7	Fornell-Larcker Criterion	118
Table 4.8	Coefficient of Determination (R^2)	119
Table 4.9	Path Coefficient	120
Table 4.10	Predictive Relevance	120
Table 4.11	Results for Predictive Relevance	121
Table 4.12	Bootstrap Results	122
Table 4.13	Hypotheses results	122

LIST OF FIGURES

Figure 2.1	Proposed Conceptual Framework	56
Figure 2.2	3P Model	57
Figure 2.3	Factors Affecting Shari'ah Governance	66
Figure 4.1	Path Model Diagram	123

LIST OF ACRONYMS

AAOIFI	Accounting and Auditing Organization for Islamic Financial Institutions
BOD	Board of Directors
CBSL	Central Bank of Sri Lanka
GCC	Gulf Cooperation Council
IFI	Islamic Financial Institution
IBF	Islamic Banking and Finance
IFSB	Islamic Financial Services Board
IFSA	Islamic Financial Services Act
MENA	Middle East and North African region
OIC	Organization of Islamic Cooperation
OCED	Organization for Economic Co-operation and Development
SB	Sharī'ah Board
SSB	Sharī'ah Supervisory Board
SBM	Sharī'ah Board Member
LCB	Licensed Commercial Bank
LSB	Licensed Specialized Bank
LFC	Licensed Finance Companies
SLC	Special Leasing Companies
PD	Primary Dealers
IBSL	Insurance Board of Sri Lanka
PLS	Partial Least Square

CHAPTER ONE

INTRODUCTION

1.1 BACKGROUND OF THE STUDY

Islamic Banking and Finance (IBF) industry globally had come a long way since its humble inception in the 1960s. It is evident that IBF industry is performing better in terms of growth compared with the conventional banking growth rate. Currently, the IBF industry's average growth rate is around 17 percent annually in the world, compared to 4.3% of the conventional financial industry (*Islamic Financial Services Industry Stability Report, 2015*). Despite IBF industry outperforming the conventional finance industries in terms of growth rate (*Islamic Financial Services Industry Stability Report, 2015*), it is still insignificant with regard to its scale of operations and asset value. Nevertheless, its development and growth had attracted many countries to incorporate Islamic Banking and Finance (IBF) as an alternative finance to compensate to the demerits of the current monetary and financial sector.

In the early stage of IBF industry, it was predominately catering for and practised in Muslim majority countries. However, the exponential growth and merits of this system have undoubtedly unleashed many opportunities, outside the Muslim world. The stability of the Islamic financial system with respect to the resilience towards Global Financial Crisis in 2007 (Saqlain, 2015) had instrumented the need for alternative finance and a microscopic focus on Islamic Finance in the world. The horizon of Islamic finance has expanded and is continuing to spread in many jurisdictions. At present more than 85 countries, with over 700 Islamic Financial Institutions (IFI) practices Islamic Finance, with an estimated asset value of USD 1.2

trillion (Siddiqui, no date). The horizon of Islamic Finance has expanded its scope of operations in the Middle East, Far East, US, Europe, Africa, as well as South and Central Asian countries.

Islamic Finance (IF) industry was considered a niche market catering only to the specialist segment. This context has changed as IBF industry has catapulted into the mainstream banking industry (Saqlain, 2015). The growth and development of IBF industry had led to explore many prospects as well as to address the challenges and issues pertinent to this industry. Though the industry has grown substantially, still the market share of IBF industry compared with conventional finance industry is approximately around 1% (“World Islamic Banking Competitiveness Report 2016”). The IBF industry must delve in the possibilities of tapping a larger market share with products and services that can cater to the varied needs of its customers for its survival and sustainability.

The concept of Islamic Finance promotes fair and equitable treatment to all its stakeholders and avoid operations that will deter or harm the society. According to Ayub (2007) justice and fair play is the *raison d’etre* of any economic system that is to be sustainable in the long run. Thus Islamic Finance is built upon the foundation of justice and fair play. Any factors that harms or deters the useful function of justice and fair play is prohibited in Islam, such as interest, gambling and speculation.

In recent years, there is a surge of Muslim minority countries trying to adopt Islamic Finance. Countries like the UK, USA, Australia, Japan, South Africa, Belgium, Hong Kong and Singapore are few countries that have initiated changes in the legal and regulatory framework to accommodate Islamic Finance as an alternative finance in their jurisdictions (*Islamic Financial Services Industry Stability Report*, 2015). Sri Lanka been among the few Muslim minority countries that amended its legislation to practice

Islamic Banking and Finance, when the world was skeptical of the existence of Islamic Finance.

The success path of IBF is not a bed of roses, rather a path with many obstacles and hindrances. Past ten to twenty years had been progressive years' in terms of the industry growth and product innovations. Withstanding many financial crises had become a unique feature that had widened the scope of the industry. However, there are tenacious concerns that need to be addressed by the industry. One of the key issues that need deliberation is the aspect of corporate governance in Islamic Financial Institutions (IFIs), in other word, the Sharī'ah Governance in IFIs.

The majority of public use IFIs for religious reasons, therefore it is the responsibility of the regulators to ensure that IFIs perform their fiduciary duty of complying with the principles of Sharī'ah. Greater transparency and vigilant Sharī'ah governance are two ways to make sure that IFIs are acting by the reason for its existence (Ahmed, 2011; Chapra & Ahmed, 2002).

The area of Sharī'ah Governance in Islamic Financial Institutions had gained significant critics and emphasis around the globe to be adoptable and adaptable to suit the varying requirements. Best governance practices are paramount important to the development and sustainability of the IBF industry nationally and internationally. According to Islamic Financial Services Board (IFSB), a standard-setting institution specifically addressing IBF industry in their '*Guiding Principles on Corporate Governance for Institutions offering only Islamic Financial Services*', generally known as IFSB-3 (2006) emphasis that corporate governance of institutions offering Islamic Banking and Finance products and services must comply with Islamic Sharī'ah rules and principles (IFSB, 2006).

Corporate Governance in Islamic Financial Institution is different in terms of its objectives and scope, compared to its conventional counterparts. The fundamental difference in corporate governance of IFI is the compliance of Sharī'ah rules and regulations in all aspect of its operations, as this is the crux of operation in any IFIs. In fact, both IFIs, as well as conventional financial institutions, exists to make a profit and increase shareholders wealth like all business entities. However the operations of IFIs are not limited to making profits only, rather it has a wider responsibility to God and society (Hasan, 2012). This higher accountability to God makes Islamic business entities different and unique. The concept of Tawhid (Oneness of Allah and complete submission to Allah) determines the actions and results of any Islamic business entity's operations (Choudhury and Hoque, 2006).

In this context the corporate governance of IFIs requires special governance system. To address this requirement IFSB-10, '*Guiding Principles on Sharī'ah Governance Systems for Institutions offerings Islamic Finance Services*' was developed (IFSB, 2009). Followed by six governance standards issued by Accounting and Auditing for Organisations of Islamic Financial Institutions (AAOIFI), a standard-setting institution which specialises in accounting and auditing for Islamic Finance Institutions in 2010 (AAOIFI, 2010).

These standards established the platform for a strong corporate governance, which encompasses Sharī'ah governance as the base especially for institutions offering Islamic Financial products and services (Hassan, Abdullah et al., 2013). The character of corporate governance is more comprehensive and wide-ranging which has numerous feature of authority. Sharī'ah authority is mainly to preserve the extreme association and responsibility to Almighty Allah comparing to the general purpose of corporate equality, transparency and responsibility. Secondly to have a fair and equitable

responsibility toward its different stakeholders. As asserts by Hasan (2012, p.25), “Islamic Financial Institutions require an additional framework of Sharī‘ah to safeguard and maintain not only the relationship with God but to include all other human beings and the environment.”

IFIs in any way cannot compromise on the compliance on Sharī‘ah rules and principles; all IFIs must have Sharī‘ah governance system or framework that will ensure effective Sharī‘ah compliance. Therefore Sharī‘ah governance system is the means of achieving effective and efficient Sharī‘ah compliance that will avoid any causes and consequences’ of Sharī‘ah non-compliances. Sharī‘ah non-compliance risk will result in tarnishing the confidence of IFIs stakeholders that will in return lead to the disruption of sound and stable IBF industry (Chapra and Habib, 2002).

Some countries have crafted comprehensive Sharī‘ah governance framework to strengthen and sustain the momentum of unparallel growth and stability of the IBF industry, Malaysia leads the way by having its own Sharī‘ah Governance Framework (Hasan, 2012; Hassan, Abdullah et al., 2013). Few countries in Gulf Corporation Countries (GCC) follow the standards issued by AAOIFI, while other countries follow the standards of IFSB, while few countries use a combination of AAOIFI and IFSB governance standards. However, in few countries there is no specific governance framework or guidelines about Sharī‘ah governance in IFIs. These countries, does not differentiate the Islamic financial system and the conventional financial system, the practices of Sharī‘ah governance is purely based on the discretion of the individual IFIs.

The practices of Sharī‘ah governance in jurisdictions like Malaysia, Pakistan and Sudan, have Sharī‘ah governance standards issued at the central or national level. While some countries guidelines are issued at the individual IFIs. This corresponds to the role and participation of regulators. Countries where regulatory body takes an active

role are usually jurisdictions where Sharī'ah governance standards are issued at the central or national level. Whereas, countries where Sharī'ah governance standards are left to the discretion of the individual IFIs, the role and participation of regulators are minimal. The major concern in this regard is countries that do not have specific guidelines about Sharī'ah governance or the regulatory body, the regulatory authority does not recognise or distinguish between conventional or Islamic financial institutions.

This is the prevailing situation in Sri Lanka, where the Central Bank of Sri Lanka (CBSL) does not distinguish the nature of operations between an Islamic financial institution and a conventional financial institution. All rules and regulations apply to both sectors are the same. According to Joseph (2015), it is the responsibility of the individual IFI to have the Sharī'ah governance process and it does come under the preview of the central bank responsibility to oversee the Sharī'ah aspect of operations. This puts IBF industry in Sri Lanka in a vulnerable position which will damage further development of the IBF industry in Sri Lanka.

There is a unanimous consensus among the scholars in Islamic Finance and Economics that composition and institution of Sharī'ah Board (SB) (Sharī'ah Supervisory Board (SSB) or Sharī'ah Committee (SC)) is the most fundamental organ of the Sharī'ah governance framework. SB enables Sharī'ah compliances of all activities, one of the basic tenets of Islamic Finance. The focal reason for the existence of Sharī'ah board is to ensure that all operations and actives conform to the precepts of Sharī'ah law in general and in specific Sharī'ah transactional law. In other words compliance regarding the substance and form of Sharī'ah rules and principles is an essential part of Sharī'ah board (Grassa, 2015). Sharī'ah non-compliance will have a

perilous effect on the industry`s stability and growth (Garas and Pierce, 2010; Ginena, 2014; Grassa, 2015)

This study will be focusing on the Shari`ah governance practices in different types of Islamic Financial Institutions operating under Islamic Banking and Finance industry in Sri Lanka. Sri Lanka, commonly known as Ceylon in an island situated in the Indian Ocean. It is located in South Asia, close to south-east India. Sri Lanka is a diverse multicultural country with a population of approximately 21 billion. It consists of 75% Sinhalese following Buddhism as their religion, 11.2% Sri Lankan Hindus, following Hinduism, 9.2% Muslims following Islam and 7% Christians following Christianity. The literacy rate is one of the highest in South Asia with 95.6%. The country is growing steadily with a real GDP growth rate for 2014 at 7.3% annually. Per capita income is USD 3280 in the year 2014 with a target of achieving USD 7000 by the year 2020 (CBSL, 2014). The country is progressing in all aspect after ending the civil war of 30 years. The economic and political environment looks favourable with great potential growth.

Islamic Banking and Finance was first introduced to Sri Lanka in 1999 by Amana Investments (Amana Bank, no date; KPMG, 2011). Before this, there exist the application of Islamic Finance at an individual or family arrangement level (Salieh, 2006). Amana Investment through this initiation created the market awareness and offered limited Shari`ah compliant products and services to Sri Lankan financial sector. These services were primarily catered for the needs of Muslim customers in Sri Lanka. However, the acceptance of Islamic Finance was received in a skeptical way by the government and regulators. According to Salieh (2006) the regulatory approval for Amana Takaful was obtained faster compared to the the approval of Islamic investment

bank. This testifies that it took almost seven years to get the regulatory approval for the establishment of Islamic Banking in Sri Lanka.

Much-needed vigour to the IBF industry in Sri Lanka that has been long waited for was made in 2005. Firstly through the amendment to the Banking Act, No 30 of 1998, this facilitates commercial banks and specialised banks to offer Sharī'ah compliant products and services. Secondly, by the revision in the Tax system to accommodate Islamic finance (KPMG, 2011). With the new legislation in place, many commercial banks and finance companies operating in Sri Lanka have opened Islamic windows operations.

The industry and various stakeholders of the IBF were very much optimistic about the development and progress of the industry's progress locally (Salieh, 2006). As one of the few countries that amended the legislation in the South Asia, Sri Lanka IBF industry desired to be the Islamic Finance hub in the South Asia region (Kamil, 2015). The market pressure by the IBF players to push towards better regulations and facilities to boost the industry was much talked and argued in various platforms such as seminars and conferences (utoeduconsult, n.d)

However, the need for more amendments in the legislative and regulatory framework to make the level playing ground same for conventional and Islamic financial players is an important stepping stone for the progress and development of the IBF industry in Sri Lanka (Salieh, 2006; KPMG, 2011). One such focused area where regulators and government lack support is the corporate governance or Sharī'ah governance for IFIs (Razak, 2013; Hilmy and Mazahir, 2014). There is no regulation from Central Bank of Sri Lanka (CBSL) or any guidelines issued by Sri Lankan government to control and monitor the governance process especially regarding the Sharī'ah governance. (Joseph, 2015).

Overall for the past 15 years, this industry is growing slowly but steadily (Senewiratne, 2013; Kamil, 2015) compared to other Muslim minority countries like Singapore and the UK where the progress and development are robust. The conventional financial sector in Sri Lanka is comparatively performing and developing better than IBF industry. Nevertheless, the efforts in strategically marketing and promoting this industry and its products had been still at the infancy stage (Farook, 2007). In an interview with daily news Mr Leonard Perera, Head of Credit, Merchant Credit of Sri Lanka (MCSL) said the “Growth Potential of Islamic Finance is inevitable if the industry plans the growth more steadily by distinguishing its services by capitalising on the benefits of interest-free, and asset and service backed contractual certainty” (Senewiratne, 2013). Krishan Thilakratne, a prominent personality in financial sector in Sri Lanka posed a valid concern by making a remark like “What we see now is most of the conventional players opening windows, but we should question if they are really committed to taking Islamic finance into grass root level – the bottom of the pyramid,” (*DailyMirror*, 2014a)

Another crucial reason for Sri Lanka to take cautious and slow steps is due to the increasing pressure from the cultural and ethnical group against Sharī‘ah law and the introduction of Islamic banking and finance in Sri Lanka (*DailyMirror*, 2014b). The opposition is mainly of the fear that Islamic Banking is purely connected with religion and faith and finance cannot be co-existing. This situation intensified as more political parties also joined in the protest of Sharī‘ah Law practised in Banking and Financial institutions. Due to this, the initiatives taken by the government and CBSL in giving the necessary infrastructure about legal and regulatory support to IBF industry were slowed.