



THE PERCEPTION OF THE ACADEMICIANS ON
CHARACTERISTICS OF *SHARI'AH* COMMITTEE
(SC) FOR ISLAMIC BANKS IN MALAYSIA

BY

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A dissertation submitted in fulfilment of the requirement
for the degree of Master of Science (Accounting)

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FEBRUARY 2013

ABSTRACT

Islamic banks (IBs) should comply with *Shari'ah* to gain the confidence of the Muslim society in particular and the world at large. Islamic banks necessitate credible and independent bodies which ensure that all of their actions and transactions are compliant with *Shari'ah* principles. This raises the question of the characteristics of *Shari'ah* committee (SC) members in Islamic banks. This is because there are many factors that influence for the SC members in Islamic banks. The researcher applied this research in Malaysia because it is one of the advanced countries in the field of Islamic banks, and the prospects for Malaysia becoming a leader in this field. Therefore, this study is designed to examine the perception of SC related academicians in three faculties (Economic, Law, and *Shari'ah*) in Malaysia on the characteristics of SC in IBs. The study selected five variables that influence SC works in Islamic banks, which are attributes of SC members, duties and responsibilities, independence, professional advice, and performance. The study utilises questionnaires to obtain the perception of SC related academicians. There are 96 academicians who are actively involved as the respondents of the study. The study renders the importance of SC's characteristics in order to verify the Islamic activities and transactions. Additionally, it prompts the SC to establish a special *Shari'ah* review report for the directors, regulators, and management. Furthermore, the respondents perceived that SC should have responsibility to shareholder at first level than depositors, and customers. The respondents also support that SC should also legally responsible to customers.

خلاصة البحث

من الواجب على المصارف الإسلامية أن تتماشى مع الشريعة الإسلامية لتتمكن من خلق ثقة في المجتمع الإسلامي بوجه خاص وفي العالم بوجه عام، لذا ينبغي للمصارف الإسلامية مراعاة أن تكون جميع معاملتها مطابقة للشريعة الإسلامية، وانطلاقاً من هذه الطروحات رأى الأكاديميون ومطورو المصارف الإسلامية أن تكون هناك هيئة مستقلة تقوم بعمل تقارير عن أنشطة المصارف الإسلامية ومطابقتها للشريعة الإسلامية. ويؤمن الباحث بأهمية أن تكون تلك الهيئة ذات مقدار كاف من المسؤولية والكفاءة والجودة في عملها لإصدار تقاريرها لمعرفة أنشطة المصارف الإسلامية ومطابقتها للشريعة الإسلامية. وقد حدّد الباحث على وجه الخصوص الدور الأكاديمي في تقييم خصائص هذه اللجنة، لأن الشريحة الأكاديمية شريحة مستقلة في آرائها، وهي متنوعة في توجهاتها حسب حقلها الأكاديمي، لذا حدد الباحث ثلاث كليات لتقييم الهيئة الشرعية في عملها وهي الاقتصاد، والقانون، والشريعة، وقد اعتمد الباحث في عمله على الدراسة الميدانية، وتم أخذ عينة في خمس جامعات في ماليزيا وعاصمتها كوالالمبور، واستخدمت الاستبانة في ذلك الجانب، وكان عدد المجيبين عن الاستبانة ٩٦ أكاديمياً. وقد قام الباحث بتحديد خمسة عوامل تحدد تقييم جودة كفاءة الهيئة الشرعية وهي الوظيفة والاستقلالية والمسؤولية والأداء والمهارة. وقد خلصت النتائج إلى أن جميع الذين أجابوا عن الاستبانة قد أكدوا على أهمية هذه الخصائص للجنة الشرعية في عملها لتكون أكثر وضوحاً في تقاريرها ولتعطي صورة أوضح عن أنشطة المصرف، وقد اكتشف الباحث عبر هذه الدراسة أن اختلاف الخلفية الأكاديمية لم يؤثر في رأي الأكاديميين في طروحاتهم حول الهيئة الشرعية، حيث كانت جميع الأجوبة متطابقة على الرغم من اختلاف الكليات الثلاث، ولم تكن هناك اختلافات كثيرة في إجاباتهم بشكل عام، وهنا يطيب للباحث أن يوصي الكاتب في الدراسات المستقبلية بضرورة وجود مقارنة بين الأكاديميين والمهنيين لمعرفة آراء كل منهما حول أهمية هذه الخصائص للهيئة الشرعية.

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 (Accounting).

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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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OF *SHARI'AH* COMMITTEE (SC) FOR ISLAMIC BANKS IN
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ACKNOWLEDGEMENTS

In the first place, it is Allah Most High, whom I feel I am greatly indebted to for it is He Who paved the path before me and made the insurmountable surmountable.

Next, I would firstly to record my sincere appreciation to my memorable supervisor and also lecturer Associate Prof. Dr Siti Normala Sheikh Obid, Dr. Noraini Mohd. Ariffin, and Associate Prof. Muslim Har Sani Bin Mohamad to whom I indeed am indebted. Indeed, it is Dr. Fatima Abdul Hamid who requested, motivated, and encouraged me unflinchingly to strive for the best.

I am also grateful to my valuable lecturers namely: Prof.Dr. Abdul Rahim Abdul Rahman, Associate Prof. Dr. Muhammad Akhyar Adnan, Associate Prof. Dr. Shahul Hameed Mohamed, Associate Prof. Dr. Nazli Anum Mohd. Ghazali, Associate Prof. Dr. Hafiz-Majdi Ab. Rashid, and Dr. Hairul Azlan Annuar whose assistance, however, did not stop there but rather their genuine encouragement, yeoman service and sincere commitment carried on all through up to the successful completion of the thesis. I am greatly indebted to Dr. Alaa Assaiqeli, Dr. Ousama Abdulrahman and Br. Fikri Ali who help me in my study and my research, in completing this challenging task.

Further, my ineffable gratitude goes to my existence, my father Prof. Dr. Mahdi Saleh Hejris and my mother Kaledh Abed, for without their unremitting love and constant prayer, this work would have never seen light.

Last but not least, I thank my brothers and sisters who encouraged me to complete my study, whose prayer and moral support I appreciate.

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LIST OF ABBREVIATIONS

| | |
|-----------|---|
| AAOIFI | Accounting and Auditing Organization for Islamic Financial Institutions |
| BNM | Bank Negara Malaysia |
| BoD | Boards of Directors |
| CB | Central Bank |
| CIBAFI | Council for Islamic Banks and Financial Institutions |
| CIBAFI | Council for Islamic Bank and Financial Institution |
| GCC | Gulf Countries Council |
| IB(s) | Islamic Bank(s) |
| IFI(s) | Islamic Financial Institution(s) |
| IIRA | Islamic International Rating Agency |
| IIUM | International Islamic University Malaysia |
| ISFI | Islamic Finance Rule Book |
| Kulliyyah | Faculty |
| QCB | Qatar Central Bank |
| QFC | Qatar Financial Center |
| QFMA | Qatar Financial Market Authority |
| SA | Saudi Arabia |
| SAC | <i>Shari'ah</i> Advisory Council |
| SB | <i>Shari'ah</i> Board |
| SC | Shari'ah Committee |
| SCFs | <i>Shari'ah</i> Consulting Firms |
| SFC | <i>Shari'ah</i> Federal Court |

| | |
|------|--------------------------------------|
| SGF | <i>Shari'ah</i> Governance Framework |
| SSB | <i>Shari'ah</i> Supervisory Board |
| SSCs | <i>Shari'ah</i> Supreme Councils |
| UKM | University Kebangsaan Malaysia |
| UM | University of Malaya |
| UPM | University Putra Malaysia |

CHAPTER ONE

INTRODUCTION

1.0 INTRODUCTION

The number of Islamic banks has increased rapidly all over the world and the success of Islamic banks (IBs) has increased significantly in recent years. Chapra and Ahmed (2002) illustrated that the number of IBs has doubled around the world over the last 25 years. A similar case is also seen in Malaysia where the Islamic banking industry is growing at a rapid scale (Sufian, 2007). In fact, there is a potential for the growth of Islamic banks in Malaysia where the *Shari'ah* committee (SC) contributes to the success and development of Islamic banks and helps the external auditors in performing their work in IBs. The SC is also expected to support and offer assistance to them so that compliance with *Shari'ah* can be assured completely. In other words, the presence of the SC in the Islamic banks leads to the development of these banks through the "rule of religious, social, economic, legal, and governance" (Garas and Pierce, 2010).

This chapter is organised as follows: Section 1.1 is the background of the study while Section 1.2 presents the problem statement in this study. The objectives of the study are discussed in Section 1.3. Following this, Section 1.4 presents the research questions. The significance of the study is discussed in Section 1.5. Section 1.6 presents the motivation of the study, followed by Section 1.7 which ends the chapter by summarising the organisation of the thesis.

1.1 BACKGROUND

Shari'ah supervision through the *Shari'ah* Committee (SC) plays an essential role in the governance of Islamic financial institutions (IFIs). The important roles that SC plays have been documented in various sources (Rammal, 2006; Shaukat, 2009; Besar, Sukor, Muthalib and Gunawa, 2009). SC is the most important body in guiding the operation of Islamic banks (IBs) and in ensuring their compliance with the spirit of *Shari'ah* (Besar, et al., 2009).

Garas and Pierce (2010) stated that SC is important in the development of IFI based on the following reasons. The first reason is due to the lack of understanding of *Shari'ah* principles among the management and staff of IFIs, and, therefore, the existence of *Shari'ah* supervision is vital to assist the IFIs in conducting *Shari'ah* compliant business. Secondly, SC also provides suggestions regarding activities to ensure compliance with Islamic principles. Thirdly, the SC has an “economic power” in IFIs. In other words, El-Khelaifi (2002), as quoted by Garas and Pierce (2010:388), stated that the SC has the power to approve and create *Shari'ah* compliant products to enhance the profitability of IBs. Finally, the SC sets its internal policy with tasks, responsibilities, and relations with other governance structures in the IFIs in order to take the lead in the activities of IFIs.

In Malaysia, Bank Negara Malaysia (BNM) is the supreme authority that governs the SCs of all IFIs. In its effort to regulate and guide IFIs on the matter of supervision, BNM issued a *Shari'ah* Governance Framework (SGF) to regulate SCs in IFIs. As clearly stated in the framework in section two, the SC for the Islamic Financial Institutions is defined as:

The board is ultimately accountable and responsible on the overall Shariah governance framework and Shariah compliance of the IFI, by putting in place the appropriate mechanism to discharge the

aforementioned responsibilities. The board is also expected to perform diligent oversight over the effective functioning of the IFI's Shariah governance framework and ensure that the framework commensurate with the size, complexity and nature of its business (SGF: 10).

As such, in Malaysia the most authoritative body is the *Shari'ah* Advisory Council (SAC) of Bank Negara Malaysia. It was established in May 1997 as the highest authority for *Shari'ah* supervision in Islamic finance in Malaysia. It acts as the authoritative body to advise Bank Negara Malaysia (BNM) on Islamic banking and Takaful operations. The SAC has authority and power to issue fatwas and resolutions concerning the complaints made by all financial institutions in the country. In 1993, BNM established the Islamic Banking Act section 5 (b) which further specified the need for the establishment of the SAC to ensure that all Islamic banks and financial institutions carry out transactions in compliance with the *Shari'ah* rules and guidelines, and "that there is, in the articles of association of the bank concerned, provision for the establishment of a *Shari'ah* advisory body to advise the bank on the operation of its banking business".

Reemphasising the importance of SC, the *Shari'ah* Governance Framework of BNM (2010), in section two requires that the SC of IFIs should have at least five members in which the "majority of whom must possess strong knowledge in *Shari'ah* and backed by the appropriate qualifications in that area". In addition, it should also comprise experts in law and finance to further enhance the quality of the SC.

The main responsibility of the SC is to provide advice and guidance to the Board of Directors of the IFIs on *Shari'ah* matters, particularly concerning the new products to be introduced by the IFIs (Besar et al., 2009). Practically, the role of the SCs in Malaysia consists of two main responsibilities in ensuring *Shari'ah* compliance. These are "ex-ante" and "ex-post" compliances (Abdul Rahman, 2008).

The “ex-ante” means that these actions of the SC include the certainty that the banks and financial institutions conform to the *Shari’ah* rules and guidelines concerning the design of the contracts and agreements, the procedure of transactions during the conclusion and execution of the contracts, and even the implementation of the terms of the contract and liquidation. The “ex-post” compliance, however, denotes taking “random samples” of completed transactions to ensure that these transactions follow *Shari’ah* rules and guidelines (Abdul Rahman, 2008).

Based on the above explanation, it is clear that the responsibility of the SC is important in Islamic banks, for IBs to be efficient. Various characteristics of the SC have been proposed by many authors (e.g. Abdul Rahman, 2008; Karim, 1990; Banaga, Ray, and Tomkins, 1994; and AAOIFI Governance Standard, 2002; BNM Governance Standard, 2010). Based on prior research, the current research has identified five characteristics or criteria pertaining to the governance framework for the Islamic banks, which, if put in-to practice would ensure or lead to the effectiveness of the SC. These characteristics or criteria are divided into two categories. The first category is “ex-ante”, which includes the attributes of SC members, duties and responsibilities, and independence. The second category is the “ex-post”, which includes professional advice, and performance. However, the “ex-post” characteristics have not been examined previously and they are considered as new variables in the current study.

The characteristics from previous studies were selected in order to get a comprehensive idea on the perceptions of academicians regarding the characteristics of the SC in Islamic banks. The discussion over the results will include both the characteristics identified by the current study and previous researches related to the activities and responsibilities of the SC.

DeLorenzo (2000) said that the SC is regarded as a "religious audit", which is considered as part of the SC, but its scope is far more extensive. In fact, the SC is a body that promises that a financial "product "or" service" complies with *Shari'ah*, either by conforming (to one degree or another) or preserving a recognised Islamic legal norm. *Shari'ah* supervision may take the form of existing monitoring through periodic audits. Such audits may be undertaken by the mean of site visits, document reviews, or consultation with the management at regular intervals.

According to Mirakhor (1997), it is not a coincidence that at present, Islamic banking is making its most promising progress in Malaysia. This country has one of the latest repressive financial systems, low inflation, low interest rates, and a dynamic and vibrant equity market as well as a strong private sector.

From this point, it can be said that the main responsibility of SC is monitoring *Shari'ah* compliance of products and services in IBs. However, there has been criticism of the characteristics of the SC due to various issues. The main issue that appears is that the independency and other criteria of the SC have been questioned in the literature. Indeed, the credibility of the financial information issued by Islamic banks depends on the perceived independence of the SC (Karim, 1990). Due to the vital role in IBs, it is crucial that SCs are effective in fulfilling their functions.

1.2 PROBLEM STATEMENT

The Muslim consumers or investors may not have the necessary knowledge to appraise the Islamic banking products in light of *Shari'ah* instruction or understand the purpose of the existence of *Shari'ah* supervision. The importance of *Shari'ah* supervision is to ensure that the Muslim consumers and clients' awareness of financial products and services are lawful (*halal*) to Muslims (DeLorenzo, 2006). Furthermore,

it provides a form of guarantee and advocacy that the money being invested in the IFIs is duly used in compliance with *Shari'ah* rulings and that unlawful (*haram*) elements are eliminated (Malik, 2010). Such certification, according to DeLorenzo, is generally documented in a formal fatwa, which may be thought of as a form of due diligence.

Despite the fact that the SC monitors *Shari'ah* compliance of products and services in IBs, which have been set up since the establishment of these banks, there are still questions arising concerning the characteristics of the SC in IBs, which include the independence, and duty and responsibility of the SC in IBs. However, the rapid growth of modern products and services and their development has caused the SC in IBs to face certain challenges in keeping pace with these developments. Therefore, tracking such a development in Islamic banking products and services could add a further burden on the SC members, specially in terms of the characteristics that they should possess in order to tackle such challenges.

The characteristics to be met by members of SCs are crucial to ensure the smoothness of the operation of IBs. Therefore, the SC should have powerful features to achieve its function in Islamic banks and achieve objectivity and fairness in its outputs through its annual reports. The current study attempts to describe how the academicians perceive these characteristics for IBs in Malaysia.

1.3 OBJECTIVES OF THE STUDY

As stated, the main objective of this study is to investigate the characteristics of the SC in Islamic banks in Malaysia. The detailed research objectives are to examine:

1. The perception of SC related academicians concerning the importance of the characteristics of SCs with regards to attributes, duties and

responsibilities, independence, performance, and professional advice of SCs in Islamic banks in Malaysia;

2. The perception of the SC related academicians concerning the responsibilities of the SCs in Islamic banks in Malaysia to stakeholders; and
3. The perception of academicians concerning the need to make a special *Shari'ah* review report to all stakeholders of Islamic banks in Malaysia.

1.4 RESEARCH QUESTIONS

The research questions are formulated as follows:

- 1- What is the perception of SC related academicians concerning the importance of the characteristics, namely, attributes of members, duties and responsibilities, independence, performance, and professional advice of SCs in Islamic banks in Malaysia?
- 2- What is the perception of SC related academicians concerning the responsibilities of SCs to different stakeholders for Islamic banks in Malaysia?
- 3- What is the perception of SC related academicians concerning the need to make a special *Shari'ah* review report by the SCs to all stakeholders of the Islamic banks in Malaysia?

1.5 SIGNIFICANCE OF THE STUDY

The gathered information from the perception of the SC related academicians could provide the knowledge of the importance of the SC characteristics. One distinct feature of the modern Islamic banking industry is the role of the *Shari'ah* supervision,

which forms an integral part of an Islamic financial institution. In addition, the SC in IBs emphasises the importance of moral and material aspects in the Muslim society to ensure the operation of Islamic banks. The SC also ensures that the operations of IBs are in compliance with the *Shari'ah* principles. This study supports the SC in achieving the objectives of the development of Islamic banks in Malaysia.

Furthermore, regulators can utilise the results of the current study to develop more comprehensive regulations concerning the discussed aspects. In addition, this current study can be considered as preliminary empirical evidence as the perception of academicians is used to examine the characteristics of SCs in Islamic banks.

1.6 MOTIVATION FOR THE STUDY

Realising the importance of the achievement of *Shari'ah* compliance in all IB products, services and transactions, there must be an adequate standard and regulation that focuses on the characteristics of the SC and *Shari'ah* review process conducted by the SAC. Thus, these regulatory bodies can develop and improve the characteristics of the SCs in IBs in Malaysia and other countries. To date, there is no study in Malaysia that has examined the characteristics of SCs from the perspective of an academician. Accordingly, the sample selection was carried out following the view that academicians are more related to the SC. This is because of three factors that give academicians preference over the professionals who are currently working in the banks. Firstly, academicians are recognised as being reliable in the scope of academia, being a credible source to rely upon in research. Secondly, some of these academicians are already members of a SC. Thirdly, in terms of the operation of Islamic banks, academicians are the most well versed to consult in that their research pertains to this field, providing them with a sharper ability in judging these matters

with more objectivity and, more importantly, with full independence when compared to consulting those currently working inside banks. This is in accordance with what was presupposed by Khan (1985), who stated that academicians have the ability to develop IBs, and, on this basis, the researcher applied the sample procedure that fits the purpose of the study. Therefore, the study attempts to be the first in Malaysia. Abdallah (1994), as quoted by Garas and Pierce (2010:388), and Karim (1995), stated that SCs should consist of scholars from the fields of economics, law, and *Shari'ah*. As such, this study has identified three faculties from these areas in order to investigate the opinions of academicians concerning the characteristics of the SCs in IBs in Malaysia.

The academicians were given questionnaires to see how they perceive the characteristics of SC members, specifically, the attribute, duty and responsibility, independency, professional advice and performance. Finally, the findings obtained from this study are expected to contribute towards a better understanding of SC characteristics in Malaysia as well as to extend the literature on SC studies.

Obtaining the perceptions of academicians may be useful to improve the quality of SCs as well as the accountability of the SCs in the IBs. The current study will inevitably contribute to the existing literature on the characteristics of SCs in Islamic banks.

Unfortunately, there are no such comprehensive standards and regulations implanted in Islamic countries that focus on the important characteristics for SCs in IBs (e.g. attributes, performance, professional advice). Therefore, the current study tries to investigate the vital criteria of SC, which may be useful for some of the regulatory bodies in Muslim countries. Furthermore, these characteristics become increasingly important, as they have to improve the quality of SCs to assess the

financial instruments, products, and services of IBs and the extent of their compliance with Islamic principles.

In addition, Hasan (2005) mentioned that it is a legal requirement for each IB to establish an SC, which includes three backgrounds (i.e. religious scholars, practitioners and academicians). Academicians are considered independent in their opinions and are not biased. Furthermore, academicians are more knowledgeable and experienced in terms of providing critical evaluation on the existing characteristics of SCs.

1.7 ORGANISATION OF CHAPTERS

The dissertation is organised into seven chapters that run as follows:

Chapter One: This is the introductory chapter, which presents a brief discussion of the background of the study, problem statement, research questions, research objectives, significance, and motivation for the study.

Chapter Two: The literature review provides an extensive review in the sphere of SCs. The researcher specifically focuses on past studies undertaken in the context of emerging economies, as the current study is being done in such a country, i.e. Malaysia. Moreover, since *Shari'ah* Supervision provides the regulations for *Shari'ah* supervision in IFIs and their implementation in different countries, this chapter discusses the guidelines in Malaysia, Bahrain, Saudi Arabia, Qatar, and Pakistan. The chapter also provides a summary of the differences and similarities of SC that exist in Islamic banks.

Chapter Three: This chapter develops the theoretical foundation of the study. As there are very limited studies that have directly used a theoretical framework in

the SC study field, the study works on the development of a conceptual framework for SC. The chapter also discusses the testing of propositions.

Chapter Four: The chapter describes the methodological framework of the study, sample selection procedures, sample size, and data analysis.

Chapters Five: The research findings present descriptive statistics and summarise the data presented. The results are shown in table form for the readers ease of understanding.

Chapter Six: The conclusion provides a summary of the study, analysis of the results, contributions, implications, limitations and future research of the study. The chapter ends with recommendations for future research.