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*ESSAYS ON THE SHARI'AH GOVERNANCE  
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HISTORICAL EVOLUTION OF THE ROLES OF  
SHARI'AH SCHOLARS*

HARUN SENCAL

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**ESSAYS ON THE *SHARI'AH* GOVERNANCE SYSTEM IN  
ISLAMIC BANKS: DISCLOSURE PERFORMANCE OF  
*SHARI'AH* BOARDS AND HISTORICAL EVOLUTION OF THE  
ROLES OF *SHARI'AH* SCHOLARS**

by

**Harun Sencal**

**A Doctoral Thesis**

**Submitted in fulfilment of the requirement for the award of  
The Degree of Doctor of Philosophy at  
Durham University Business School  
Durham University**

**2017**

# Essays on the *Shari'ah* Governance System in Islamic Banks: Disclosure Performance of *Shari'ah* Boards and Historical Evolution of the Roles of *Shari'ah* Scholars

by

Harun Sencal

## Abstract:

During the last decades, we witness the convergence of Islamic banking sector towards conventional banking sector, which was more evident after the 1990s with the entrance of Islamic Banks (IBs) into competition with conventional banks in the global market. Because of such convergence, initial aspirations of Islamic banking sector during the emergence period in the 1960s as part of Islamic Moral Economy (IME) have mostly failed resulting in high utilisation of debt-financing instruments accompanied with lack of consideration for social consequences of everyday practices of IBs. Although it is expected that supervisory role of *Shari'ah* Boards (SBs) should prevent or at least moderate the observed convergence beyond merely relying on the legal-rational interpretation of Islamic law or *Shari'ah*; they are rather considered as facilitators of the divergence of IBs from IME norms.

In order to investigate the role and status of *Shari'ah* scholars in IBs and the reasons behind the lack of ability of *Shari'ah* scholars to prevent the observed social failures of IBs, it is important to identify three main problems; (i) examination of supervisory role of SBs through *Shari'ah* Annual Reports (SARs) within IME framework; (ii) investigation of the process of divergence of IBs from initial aspirations of IME within postcolonial framework; and (iii) exploration of paradigm shifts in *ifta* (issuing legal opinion) institution's *raison d'être* with the objective of tracing the roots of modern SB as an *ifta* institution to explore the main reasons behind the inability of *Shari'ah* scholars in SBs to prevent the divergence from the IME objectives.

This research, therefore, aims at constructing and constituting an Islamic Corporate Governance (ICG) system and its constituents through the foundational principles of Islamic ontology by framing it on the Islamic Political Economy (IPE) structure and IME substance. In addition, research aims to empirically examine SBs disclosure performance through their most effective communication channel with stakeholders, namely SARs to determine the performance of *Shari'ah* scholar in *Shari'ah* compliancy related communication. Furthermore, this study aims at examining the theoretical aspects of SBs to identify the process that makes this division as a source of legitimacy in terms of *Shari'ah* compliancy through analysis of the evolution of *ifta* institution in history and its transformation into SB division.

Referring to the ontological and epistemological sources of Islam, a theoretical ICG system is developed in this study in Essay 1. Based on this theoretical foundation and available standards on SBs, Essay 2 presents an empirical analysis on the extent of disclosure in SARs as well as the factors affecting the level of disclosure in these reports with a sample size of 305 SAR from 41 IBs of 15 countries for the period of 2007-2014 through statistical and econometrics methods. The results of disclosure analysis indicate that SARs do not contain adequate details to convince stakeholders in *Shari'ah* compliancy of IBs. However, *Shari'ah* scholars' explicit approval of *Shari'ah* compliancy of the institution in SARs without disclosing details of their analysis seems a sufficient condition for the stakeholders considering the high growth rate of the Islamic banking sector during last decades.

This study further examines the SB as modern *ifta* institution in its historical trajectory to explore how such trust has been gained and whether similar conditions are valid for *Shari'ah* scholars employed in modern Islamic banking sector today. However, before investigating historical trajectory of *ifta* institution, this study analyses the relationship between IBs and conventional banks which especially became a matter of concern as with the entrance of IBs to the global financial market, they have to compete with conventional banking sector in terms of performance, efficiency, minimisation of cost and increased shareholder value.

The aim of Essay 3 is to analyse the sources of observed convergence in IBs towards conventional banks through the phases that IBs have evolved, for which the development of

modern Islamic banking sector is analysed in three stages and explored separately: (i) Establishment of first Islamic bank as a hybrid institution until the entrance of Islamic banking sector into competition at global scale; (ii) Convergence of Islamic banking institutions to conventional banking due to competition at the global scale; (iii) Co-optation and adoption of Islamic banking structure and instruments by conventional banks. As the current trajectory in Islamic banking sector demonstrates, IBs and conventional banks with Islamic windows follow a pragmatist approach to achieve growth and lacks the adherence to the initial goals of Islamic economics movement, which aimed at establishing an alternative sector based on Islamic ontological and epistemological sources. Considering the convergence of IBs towards their conventional counterparts during the last decades and insufficient disclosure in SARs by SB members, we claim that the source of an 'Islamic' identity in IBs is not due the practical success of SBs alone, but also the role and status of *Shari'ah* scholars (and indirectly SBs) in the sight of stakeholders. This requires the investigation of SB division from a theoretical perspective to understand its emergence and evolution, for which the *ifta* institution and its evaluation is examined through its historical trajectory.

Essay 4, therefore, critically explores and explains the evolution of *ifta* institution and the role and status of *Shari'ah* scholars in pre-modern period so that their 'legitimacy source role' in IBs can critically be explored and understood. Essay 5, by building on the fourth essay, aims at critically exploring the transformation of *ifta* institution and the role and status of *Shari'ah* scholars in the modern period through the conceptual framework of institutional logics. Our research revealed that there are three important transformations between pre-modern and modern period in terms of the role and status of *Shari'ah* scholars. These are embeddedness of *Shari'ah* scholars into the financial sector in modern period rather than the society as in the pre-modern period; transformation of the source of legitimacy of *Shari'ah* scholars from society to 'being assigned to a SB by the management of IB'; and lastly, complexity of products and services in the modern period compared to the pre-modern period.

In order to overcome the social failure of Islamic finance sector and prevent the convergence towards conventional sector as a result of these transformations, this study offers a civil society based control mechanism that goes beyond '*halal*' and *Shari'ah* compliant product and services, and investigate the products and services with IME based dimensions through a fuzzy logic approach. In the conclusion, we discuss the reasons behind the lack of ability of *Shari'ah* scholars in preventing the social failures of IBs during the last decades based on five essays.

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## **DECLARATION**

*I hereby declare that the materials contained in this thesis have not been previously submitted in application for another degree to this or to any other learning institution.*

*I further declare that except for those quotes, citations or references that have been duly acknowledged, this thesis is the result of my original investigation.*

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*Durham*  
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# CHAPTER 1

## INTRODUCTION

### 1.1. INTRODUCTION AND BACKGROUND

While the textual sources and practice of Islamic economics and finance is as old as Islam as a religion, Islamic economics movement in modern times emerged in the postcolonial period in organising the economic life in Muslim societies in line with the social formation of Islam with an Islamically authenticated meaning of life. While it is termed as Islamic ‘economics’, its reference through Islamic normativeness refers to moral economy in Polanyian (1957) sense, and therefore, as a disruptive and counterhegemonic movement, it has aimed at rescuing land, labour, capital and human among other stakeholders from the hegemony of self-regulated market economy or capitalism as expressed by neo-classical form of economics. In its alternative paradigm, therefore, Islamic moral economy (IME) is expressed through embeddedness, sharing economy, cooperative and collaborative economy, non-fictitiousness, de-commodification and fair and just economy with re-distributive objectives.

Since capitalist hegemony has not given an opportunity space for the development and expansion of IME as a paradigmatic system within Islamic ontology, emerging petrodollars in the post oil-shocks in the 1970s paved the way for the partial realisation of Islamic economics with the emergence of Islamic commercial banking in the form of Dubai Islamic Bank in 1975, despite the fact that the very first Islamic bank was a social bank, Mith Ghamr Bank, in lower Egypt established in 1963 but was closed down by the regime due to its positive impact in capacity building.

The commercial banking model has been prevailing in the Islamic banking sector since the first Islamic bank, which has been constructed with the Qur’anic verse (2:275) that ‘*riba* (interest) is prohibited, while trade is made *halal* or lawful’. In ensuring *Shari’ah* compliancy, in addition to the prohibition of interest or *riba*, *gharar* or excessive uncertainty, *maysir* or gambling and speculation is prohibited along with the prohibition

of dealing with certain sectors such as those are considered harmful for human well-being. Alongside such *fiqh* or Islamic law injunctions relating to negative screening process, IME principles expects financing activities should be conducted in line with profit-and-loss sharing and risk sharing forms so that sharing, participatory, collaborative and co-operative nature of economy should be achieved, and that Islamic banking and finance should be conducted in an embedded social formation. As part of IME paradigm, Islamic banking and finance is also expected to work within real economy by avoiding fictitious commodities, prevent commodification and also discourage debt culture through profit-and-loss sharing schemes. A number of historical Islamic financing instruments are available for Islamic banks and financial institutions in the form of asset-backed, asset-based and debt-based instruments, while asset-backed instruments are essentialised by IME. The IME paradigm also suggests an extended stakeholding governance system in line with the ontological nature of Islam.

Despite such aspirational world, Islamic banking and finance paradigm is relegated to *Shari'ah* compliancy in the form of prohibition of *riba*, *gharar* and *maysir* by giving up the transformational expectations identified by IME. In making sure that Islamic banks and financial institutions work within these negative screening conditions, *Shari'ah* compliancy is essentialised, which, as a role, is fulfilled by *Shari'ah* Board (SB) as a modern institution.

SB is one of the most important and distinguishing characteristics of Islamic banks (IBs) as part of *Shari'ah* governance. The role of SB is to assure that operations of IBs comply with *Shari'ah* rules and principles through directing, reviewing and supervising activities of IBs. It can, therefore, be claimed that the 'Islamic' nature of IBs is derived from the effectiveness of this division to achieve its role as a *Shari'ah* compliancy related supervisory unit in practice and by providing and substantiating the 'Islamic identity'. Majority of the stakeholders of IBs, however, trust in *Shari'ah* compliancy of IBs without analysing the existential necessity of this unit or investigating the details of the supervisory process; as for them the presence of such a unit is satisfactory condition for *Shari'ah* compliancy. This observation suggests that there is something more in the SB division beyond merely practical success of conducting the supervisory and auditory task; something exclusively due to the nature of this unit – being composed of *Shari'ah* scholars who represent the religious authority in IBs. Hence, SBs constitute

an essential part of Islamic banking and finance activity; however, considering the unprecedented increase in the size and nature of such activities over the last two decades in particular, the study of SBs have become an important focal point with serious issues being raised on the Islamicity of IBs.

This study, hence, aims to explore both empirical aspects of SB in IBs through their most effective communication channel with stakeholders, namely *Shari'ah* annual reports (SAR), to explore whether this important division fulfils its task properly; and theoretical aspects of SBs to identify the process that makes this division as a source of legitimacy in terms of *Shari'ah* compliancy through analysis of the evolution of *ifta* (issuing a legal opinion) institution in history and its transformation into SB division in IBs. It should be noted that *ifta* institution can, originally, be described as a civil society based non-enforcing legal opinion institution, while in the evolution of history it moved between civil society and state incorporating the commercial sector interest in current times. Thus, the significance of this study lies in its empirical as well as theoretical contribution.

The SBs are expected to issue an annual report, *Shari'ah* Annual Report (SAR) to disclose the necessary information to ensure stakeholders that the operations of IBs are conducted per *Shari'ah* rules and principles. Although such annual reports are the most important intermediary between SBs and stakeholders, the extent of disclosure of SBs vary among the IBs considerably despite the fact that AAOIFI (The Accounting and Auditing Organisation for Islamic Financial Institutions), being the essential independent standard setting body, has provided sets of standards for the contents and disclosure of SAR in Islamic banks.

The empirical analysis of SB division in this study, hence, aims to explore the extent of disclosure in SBs' annual reports with the objective of identifying the factors affecting the level of disclosure in these reports. This analysis aims to explore the extent of disclosure in SARs of 41 IBs from 15 different countries for the period of 2007-2014. In addition, it examines the factors determining such disclosure through bank level and country level factors.

Most of the studies regarding the extent of disclosure of IBs neglect to analyse SAR issued by SBs and focus on social responsibility or other aspects of corporate

governance of IBs. Literature focusing on the components of SARs of IBs, therefore, is very limited. However, review of the available literature highlights the lack of uniformity in SARs. We argue that, therefore, a detailed analysis of SARs across countries to reveal the level of disclosure and factors affecting it will fill an important gap in the literature.

Although SARs provide an insight for the level of success of supervision of SB and tangible evidence for 'Islamic' identity of IBs, we claim that the source of such identity in IBs is not due the practical success of SBs alone, but also the role and status of *Shari'ah* scholars (and indirectly SBs) in the sight of stakeholders. This requires the investigation of SB division from a theoretical perspective to understand its emergence and evolution, for which we need to explore the *ifta* institution and its evolution after the death of the Prophet Muhammad.

As a civil movement, *mujtahids* (Islamic scholars), the original institutional form of presenting *Shari'ah* scholarship, were ordinary 'people' without any elite power or official status in the legal system. However, due to their deep understanding of Islam and knowledge in *Shari'ah* (everyday articulation of Islam including legal aspects), they attracted people to their circles. Their source of legitimacy was their knowledge regarding the *Shari'ah* and their students and followers who made them centre of attraction, which is the historically registered process. Thus, individually they emerged with the 'acceptance' of public around them.

After the period of rightly guided caliphates, dynasties, who rose to the power from the end of 7<sup>th</sup> century, needed legitimacy in the sight of the populace. The lack of legitimacy of the ruling elite led the powerful elite, who usurped the power, to approach *mujtahids* in the pursuit of legitimacy to overcome the religious legitimacy under the 'Sultanate Rule'.<sup>1</sup> Through co-opting prominent *Shari'ah* scholars within their rule or negotiating with them, they could attain the legitimacy in the eyes of the people as a ruling authority.

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<sup>1</sup> After the death of Prophet Muhammad, Rightly Guided Caliphate system had emerged. They were nominated among the public to be given consent (*bay'a*) for the leadership/caliphate of the society; and they were the companions of the Prophet and, therefore, they had Islamic legitimacy. However, this governance mechanism had been changed from the end of 7<sup>th</sup> century with the Sultanate system, in which the leadership was transferred from father-to-son leading to the creation of dynasties.

With the fall of *Shari'ah*-based dynasties and establishment of nation-states in the 20<sup>th</sup> century, *Shari'ah*-based law systems were replaced by Western-based law systems either through colonisation or revolutionary process aiming to Westernise the Muslim societies. After the establishment of nation-states, states and governments have no longer needed *Shari'ah* legitimacy which moved most of the *mujtahids* to 'state-independent' status. Nevertheless, the re-emergence of Islam as part of identity search in nation states since the 1950s, brought Islam to the centre in everydayness in majority of the Muslim societies. In particular, with the emergence of Islamic finance during 1960s, the need for *Shari'ah* legitimacy has taken a new turn with the need for institutional legitimacy. In other words, instead of dynasties or political authorities, commercial companies have come to pursue *Shari'ah* legitimacy to prove that their business is legitimate per *Shari'ah*. Hence, they accommodated *Shari'ah* scholars in their corporate identity, as a member of SB, as *Shari'ah* compliancy is a dynamic process and cannot be completed, for example, with having a certificate at one point in identifying it. Therefore, although *ifta* institution started as a civil movement at the initial period of Islam, it has now become part of corporate governance in modern Islamic banking sector.

This study, hence, locates the results of the empirical attempt in this study within the larger context of *ifta* institution or *Shari'ah* scholarship with the objective reflecting on SBs performance in relation to SAR within the evolutionary nature of this institution. This is important; as *Shari'ah* scholars have been heavily criticised for their role in the observed social failure of IBs; and this study, therefore, examines the historical root of the issue in an evolutionary manner to identify the inability of *Shari'ah* scholars to make the necessary turn in IBs towards Islamic Moral Economy (IME) expectations, which is considered as the foundational claims of Islamic normative world.

## **1.2. PROBLEM STATEMENT**

During the last decades, one of the main debates in Islamic finance circle is the observed convergence of Islamic finance and banking sector towards conventional finance and banking sector, which was more evident after the 1990s with the entrance of IBs into competition with conventional banks in the global market. Because of such convergence, initial aspirations of Islamic banking sector during the emergence period in the 1960s as part of IME have mostly failed resulting in high utilisation of debt-

financing instruments accompanied with lack of consideration for social consequences of everyday practices of IBs. Although it is expected that supervisory role of SBs should prevent, or at least moderate the observed social failure of IBs in not being able to meet IME expectations, *Shari'ah* scholars' strategy of relegating Islamic morality to mere legal-rational objectives of *Shari'ah* has facilitated the increased pace of convergence. This debate is summarised as 'form-over-substance' approach in everyday practice of IBs. Thus, by focusing intentionalist approach through form-based legalism, *Shari'ah* scholars are blamed for not essentialising the substantial morality through consequentialism.

In order to investigate the role and status of *Shari'ah* scholars in IBs and the reasons behind the lack of ability of *Shari'ah* scholars to prevent the divergence of IBs from IME, it is important to identify three main problems; (i) examination of supervisory role of SBs through SARs within IME framework; (ii) investigation of the process of divergence of IBs from initial aspirations of IME within postcolonial framework; and (iii) exploration of paradigm shifts in *ifta* institution's *raison d'être* after the rightly guided caliphate period with the objective of tracing the roots of SB as a modern *ifta* institution to reveal the main reasons behind the inability of *Shari'ah* scholars in SBs to prevent the divergence.

### **1.3. AIMS, OBJECTIVES, RESEARCH QUESTIONS AND BRIEF THEORETICAL FRAMEWORKS**

Based on the identified problems above, this research is structured to develop five main essays with several objectives; and therefore, an attempt is made to identify their respective aims, objectives, research questions, and theoretical frameworks as follows:

#### **1.3.1. Essay 1: Constructing an Islamic Corporate Governance System: A Theoretical Attempt**

***Aim:***

This chapter aims at constructing and constituting a theoretical frame of Islamic Corporate Governance (ICG) System and its constituents through the foundational principles of Islamic ontology by basing it on the Islamic Political Economy (IPE) structure and IME substance.

***Objectives:***

This essay, therefore, has the following objective:

- (i) developing a critical and advanced understanding of Islamic substantive morality based Islamic corporate governance system for Islamic banks and financial institutions;

***Research questions:***

The articulated aim and objective are explored through the following research question:

- (i) What is the nature, constituents and articulations of Islamic Corporate Governance Model?

***Theoretical framework:***

In developing ICG system for Islamic banks and financial institutions, a theoretical framework of IPE structure with the underlying norm and moral requirements of IME is employed. This essay argues that the nature of Islamic banking sector and its substance requires a particular theoretical framework to capture the underlying ontological realities of knowledge (or Islamic ontology) that offers Islamic banking sector as an alternative sector to the conventional banking rather than mere mimicry of it. To achieve this goal, we employ, therefore, Islamic Political Economy (IPE) as the theoretical framework, through which, we attempt to construct ICG as a system of governance of corporates within an Islamic order through the substance derived from IME, which integrates substantive morality into the equation in addition to the *fiqh* or Islamic law construct.

***Research Method:***

In this chapter discursive method is utilised through interpretivism to construct and constitute an ICG within IPE and IME.

### **1.3.2 Essay 2: The State and the Determinants of Islamic Governance Disclosure in Islamic Banks: Analysis of *Shari'ah* Annual Reports**

#### ***Aim:***

This essay aims at analysing the disclosure practices of SBs shared with stakeholders of IBs through SARs to ensure 'Islamic' identity of IBs intact, which is expected to locate the articulation level of *Shari'ah* compliancy in the form of *Shari'ah* scholars' performance.

#### ***Objectives:***

This essay, therefore, has three main objectives:

- (i) exploring the extent of disclosure in SARs through a *Shari'ah* disclosure index developed based on AAOIFI guidelines for SAR, namely SDI<sub>AAOIFI</sub>;
- (ii) exploring the extent of disclosure in SARs through a *Shari'ah* disclosure index developed based on IME framework which extends SDI<sub>AAOIFI</sub>;
- (iii) identifying the determinants affecting the level of disclosures in SARs.

#### ***Research questions:***

The articulated aims and objectives are explored through the following research questions:

- (i) To what extent *Shari'ah* scholars fulfil disclosure expectations of AAOIFI guidelines in SARs?
- (ii) To what extent *Shari'ah* scholars fulfil disclosure expectations of IME framework in SARs?
- (iii) Which factors have an impact in disclosure level of SARs?

#### ***Theoretical framework:***

This essay is constructed as a disclosure analysis to identify the nature and level of communicated information in SARs. It, therefore, employs two indices to measure the

extent of disclosure in SARs which are constructed through AAOIFI guidelines for a SAR and IME framework. The IME frame, as discussed in Chapter 2, is a larger concept than AAOIFI standards in essentialising the substantive morality of Islam; as AAOIFI guidelines have been constructed based on Islamisation of knowledge framework and also through legal maxims.

Since the requirements and expectations of IME based theoretical framework essentialise ‘morality’ as a ‘consequence’ not only as an ‘intention’, second index was developed for this essay to assess the disclosure performance exhibited in SARs, which goes beyond the available guidelines of AAOIFI, as it expects the disclosure of further details of *Shari’ah* compliancy, particularly in relation to substance of practices.

### ***Research Method:***

In responding to the aims and objectives of his study, this study explores the extent of disclosure in the *Shari’ah* Boards’ annual reports of 41 IBs from 15 countries for the period of 2007-2014, making in total a collection of 305 SARs. It should be noted that due to the unavailability of 23 *Shari’ah* annual reports within the sample period, this study has a sample of 305 instead of 328 SARs.

As for the sampled Islamic banks, the sampling is based on criteria that they were established in 2007 or before and have published SARs, which are available online and should be in English or Arabic language for the period of 2007-2014.

As for the estimation method, in determining the factors affecting disclosure level of SBs, one-step system generalized method of moments (GMM) approach is utilised. One-step GMM is selected over two-step GMM due to the small sample size which leads to problem of over-fitting in two-step GMM and makes asymptotic standards errors not suitable for hypothesis testing (Beck and Levine, 2004). System GMM approach also resolves the endogeneity of regressors while avoiding dynamic panel bias (Uddin *et al.*, 2017).

### **1.3.3 Essay 3: Exploring Institutional and Product Emergence in Islamic Banking Sector: A Postcolonial Perspective**

#### ***Aim:***

The aim of this essay is to analyse the sources of observed convergence in IBs towards conventional banks through the phases that IBs have evolved. In order to fulfil this aim, development of modern Islamic banking sector is divided into three stages and explored separately:

- (i) Establishment of the first Islamic bank as a hybrid institution until the entrance of Islamic banking sector into competition at the global scale;
- (ii) Convergence of Islamic banking institutions to conventional banking due to competition at the global scale;
- (iii) Co-optation adoption of Islamic banking instruments and structures into conventional banking framework.

#### ***Objectives:***

In line with the identified aim, the following objectives are developed:

- (i) Exploring the emergence of Islamic banking sector;
- (ii) Exploring the process and means of convergence of Islamic banking sector towards conventional banking sector;
- (iii) Exploring the process of convergence of conventional banking sector towards Islamic banking sector;

#### ***Research questions:***

In fulfilling the above aim and objectives, the following research questions are developed:

- (i) What has been the motivation that led to the emergence of Islamic banking sector?;

- (ii) Through which means Islamic banking sector managed to mimic conventional banking sector resulting in convergence towards conventional banking sector?;
- (iii) What is the motivation that leads to the convergence of conventional banking sector towards Islamic banking sector through reverse mimicry?

***Theoretical framework:***

This study aims to locate the emergence and the development of Islamic banking sector within the theoretical framework of multiple modernities with the help of postcolonial concepts of ‘hybridity’, ‘mimicry’, ‘menace’ and ‘reverse mimicry’. The existing debate in the literature demonstrates that multiple modernities framework is proposed as a result of observed failure of the imposed modernity as one and the only universal truth. Although the claim of universal truth has failed, due to the hegemonic domination of Eurocentricity, the experience has proven that modern is still produced by reference of various (non-European) cognitive rationalities leading to multiple modernities (Eisenstadt, 2000). Consequently, instead of accepting the project of the Western modernity as it is, every society, which has been imposed with the principles and institutions of modernity, adopted them in many cases according to local characteristics of the society leading to multiple modernities through a particular ‘blending process’ (Eisenstadt, 2000).

While locating Islamic banking sector within the multiple modernities framework, we also utilise four postcolonial concepts to define the relationship between Islamic banking and conventional banking within convergence process. We argue that the first Islamic bank emerged as a ‘hybrid’ institution, while the following relationship between Islamic banking and conventional banking continued as the ‘mimicry’ of conventional banking which has facilitated the convergence. The response of conventional banking to hybridity and mimicry of Islamic banking is captured as menace and reverse mimicry. Thus, the convergence and resemblance of Islamic banking led conventional banking to ‘menace’, which resulted in a ‘reverse mimicry’, while Islamic banking had to compromise with its own value proposition to fit into neoclassical operational framework.

***Research Method:***

In responding to the research questions, critical discourse analysis will be utilised to reveal the power relationship between IBs and conventional banking. In doing so, historical discourses and texts are utilised.

**1.3.4 Essay 4: An Inquiry into Public Policy and *Shari'ah* Scholarship in the Making: Historical Perspectives**

***Aim:***

The aim of this paper is to critically explore and explain the evolution of *ifta* institution and the role and status of *Shari'ah* scholars in the pre-modern period so that their 'legitimacy source in IBs can critically be explored and understood.

***Objectives:***

In responding to the aim of this essay, the following objectives are developed:

- (i) to trace the evolution of *ifta* institution from the emergence until the modern period;
- (ii) to critically examine the role and status of *Shari'ah* scholars in the society over the centuries to locate the transformation has taken place.

***Research questions:***

The following research questions are developed in articulation of the defined aim and objectives:

- (i) What was the impact of embeddedness of *Shari'ah* scholars into the society on *ifta* institution during pre-modern period?
- (ii) What is the role and status of *Shari'ah* scholars in the society as a result of their embeddedness?
- (iii) What is the relationship between *Shari'ah* scholars and ruling authority as a result of their embeddedness?

### ***Conceptual framework:***

This essay aims to answer how everyday practice of Muslims affected the evolution of the *ifta* institution through the concept of embeddedness. In other words, we explore the role and status of jurist-consults through the nature of their embeddedness into the society. In this essay, to encompass both economic and non-economic relationships between *Shari'ah* scholars and their surroundings, namely society, we prefer to use the definition of embeddedness as Beckert (2003: 769) defined: “indissoluble connection of the actor with his or her social surrounding”, which relates to social formation. Every society has its own unique social formation, which leads to different degrees and ways to articulate the connection of social actors with their surroundings. In this regard, this essay explores relationship of *Shari'ah* scholars with their surroundings shaped by (various degrees) of Islamic social formation during the early periods of Islam.

### ***Research Method:***

In responding to the research questions, discursive analysis constitutes the method of analysis of the existing textual material. In doing so, historical discourses and texts are utilised.

## **1.3.5 Essay 5: Reflecting on the Role of *Shari'ah* Scholars in Islamic Finance Industry: Transformation of *Ifta* Institution in Modern Period**

### ***Aim:***

In building on the previous essay, this essay aims at critically exploring the transformation of *ifta* institution and the role and status of *Shari'ah* scholars in modern period as experienced in Islamic banking sector.

### ***Objectives:***

To fulfil the defined aim, the following objectives are developed:

- (i) to trace the transformation of *ifta* institution from pre-modern period to modern period to understand the nature of evolution;

- (ii) to explore and critically examine the role and status of *Shari'ah* scholars in modern Islamic banking sector.

***Research questions:***

The following research questions are developed in responding to the defined aim and objectives:

- (i) What are the social and legal impacts of replacement of Islamic law with the Western based secular law *vis-à-vis ifta* institution resulting in modern SBs?
- (ii) To what extent do SBs have power to influence operations and everyday actions of IBs?
- (iii) What are the reasons behind the lack of ability of *Shari'ah* scholars to promote objectives of *Shari'ah* in IBs?

***Conceptual framework:***

Since historical contingency suggests a shift towards market capitalism in Muslim societies, the role and status of *Shari'ah* scholars in IBs in modern period can be explored through the use of the concept of 'institutional logics', particularly its assumption of embedded agency, since contemporary IBs are established with a Western-style modern corporate model with an additional claim of *Shari'ah* compliancy legitimised by SBs under capitalist market system. It is important to note that the corresponding institutional form of *Shari'ah* compliancy in market system is SBs, which is the organisational form of individual *Shari'ah* scholars fitting into the corporate nature of market system.

Institutional logics is defined as "the socially constructed, historical patterns of material practices, assumptions, values, beliefs, and rules by which individuals produce and reproduce their material subsistence, organize time and space, and provide meaning to their social reality" (Thornton and Ocasio, 1999: 804). As the definition suggests, institutional logics, in this study, explains the evolutionary working mechanism of *ifta* institution.

As a result of the emergence of the capitalist market order with its own institutional logics such as its unique organisation of time, creation of fictitious commodities and prioritisation of instrumental reasoning in shaping everyday life of the individuals as well as organisations, we can observe the transformation of *ifta* institutions under the influence of this prevalent institutional logics. This is due to embeddedness of *Shari'ah* scholars as individuals and IBs as organisations into the capitalist market.

Embedded agency assumption claims that “the interests, identities, values, and assumptions of individuals and organizations are embedded within prevailing institutional logics” (Thornton and Ocasio, 2008: 103). In this, by ‘prevailing institutional logics’ in the case of IBs, we refer to the institutional logics of the capitalist market order.

We do not argue that institutional logics of capitalist market system is the only logic in IBs since embedded agency assumption acknowledges that actions of individuals are shaped by different societal sectors (Thornton and Ocasio, 2008). Society as the inter-institutional system allows logics of different societal sectors to be influential in a context (Thornton and Ocasio, 2008). In the context of IBs, therefore, Islam as a religion and its institutional logic is also influential. Existence of *Shari'ah* scholars by itself is an indication of impact of Islam on IBs. Nevertheless, the dominant nature of the capitalist markets causes religion to have only partial impact on the everyday practice of IBs. In other words, rather than having IBs as articulation of Islamic morality and fulfilment of ‘the objectives of *Shari'ah*’ in society, we observe, in majority of the cases, replication of conventional banks in everyday operations with the same institutional logics with an excess of fulfilment of ‘the form of *Shari'ah*’ to keep the ‘Islamic’ identity intact in the eyes of the stakeholders. Although we do not claim that every *Shari'ah* scholar in SBs has such embeddedness, it is a useful concept to explain part of social failure in Islamic banks (Asutay, 2007; 2012) along with other two explanations, namely transformation of source of legitimacy of *Shari'ah* scholars and complexity of the modern period. We, therefore, claim that under the high impact of the capitalist markets, some *Shari'ah* scholars have been influenced by the values and norms of the capitalist markets in their *fatwa* (legal ruling) process in IBs, since these IBs themselves have also been shaped by the very same norms and values beyond any other factors.

### ***Research Method:***

In responding to the research questions, discursive analysis constitutes the method of analysis by utilising legal opinions of and the interviews conducted with *Shari'ah* scholars. However, it is important to state that this study utilises interviews conducted with *Shari'ah* scholars by other studies as available in various sources. As an analysis method, the interpretative method enables to give further meaning to data and material through meaning-making exercise.

## **1.4. RESEARCH METHODOLOGY**

In this research, both qualitative and quantitative research methodologies are used. Critical discourse analysis (CDA), as part of qualitative research methodology within explanatory research design, however, constitutes the main research method since the nature of the research in all chapters except for Chapter 3 is theoretical and discursive.

In Chapter 3, as part of quantitative methodology, content analysis and econometric methods are used to explore and analyse the level of disclosure in *Shari'ah* annual reports and the factors determining the level the disclosure scores. Further details of these research methods are presented in Chapter 3.

Since critical discourse analysis (CDA) constitutes the main base of the remaining chapters, it is useful to discuss here, which mainly relates to revealing the meaning from the textual documents (Morris, 1994). A discourse reflects a way of understanding and communicating the world under the influence of an ideology. Textual analysis, thus, is utilised to identify the content and structure of a textual material and, then, interpret the available material (Denzin and Lincoln, 1994). However, it is important to note that CDA explores “all levels and dimensions of discourse” such as grammar, rhetoric and speech acts among others (Van Dijk, 1995:18). The focus of CDA is to reveal the power structures and relations of dominance among various groups and how these are articulated in everyday practice and resisted by the members of these groups through discourse, in which ideology plays a central role in establishing the relations of power and dominance as well as resisting against it (Van Dijk, 1995).

In developing a system of Islamic corporate governance, we conduct an exploratory analysis in the epistemological sources of Islam, namely the Qur'an and *Sunnah*, which

reflects a worldview shaped by the ontology of Islam. Existing corporate governance systems, on the other hand, are also explored through CDA to reveal how it is also shaped by the dominant ideology, namely positivist ontology, and through power relations, dominate the existing IBs resulting into a social and moral failure in these institutions. It is important to note that *Tawhidi* ontology is *a priori* in shaping the everyday behaviours of Muslim individuals, which, therefore, constitutes the underlying structure of this research. *Tawhidi* ontology, as explored further in Chapter 3, constitutes the essentialist part of an Islamic order in which the principles and values of an order extracted from the epistemological sources through discourse analysis to shape the moral substance of relationships and reflects the objectives of the *Shari'ah*. Socially constructed part of Islamic order, on the other hand, represents the everyday practice of individuals and institutions through the way they socially construct the Islamic norms derived from its ontology. Thus, they are socially constructed as subjects and institutions as a result of the relations of power and dominance within the society. Thus, while Chapter 2 aims to reveal the principles and values through discourse analysis from the epistemological sources to establish *tawhidi* ontology, Chapters 4-6 utilises CDA to explore IBs and discourses around it to reveal the power structures in the everyday practice.

In constructing and constituting the ICG in Chapter 2, therefore, discursive method is utilised. This method is used to explore the axiomatic framework that constitutes the substance of ICG derived from ontology and epistemology of Islam, to offer an alternative paradigm in a holistic manner. With the use of multi-disciplinary research approach, therefore, this study brings together the 'context of discovery' through identifying the ontological base by subjecting it to interpretivist analysis through hermeneutics. As part of social constructivist process, the 'context of justification' is developed to explore the epistemology in line with the ideas suggested by the 'context of discovery'. In this, heuristics side helps to develop the constituents of the aimed ICG by, for example, defining the axioms of IME through subjecting the 'text' to interpretation through deduction from the revealed knowledge. Thus, it provides with the fundamental propositions through which a construction process can be initiated in a later stage. This is, naturally, followed by utilising inductive method which is utilised bringing together the deconstructed and interpreted material to formulate and structure an ICG. In other words, 'context of discovery' or heuristics approach takes place within

exploratory research method, while ‘context of justification’ is conducted through formulative approach by constituting a new model and a new way of looking at the social reality, which, here is an ICG system.

In Chapter 4, critical discourse analysis is applied to explore the emergence and development of IB institutions with the objective of revealing the power relations between IBs and conventional banks. In this power relationship, as part of the critical discourse analysis, IBs are located as colonised subjects, while capitalist system and conventional banking sector as an articulation of this system are considered as colonisers. A post-structural discourse analysis is instrumental in conducting a macro level analysis (Diaz-Bone *et al.*, 2007). This method is particularly considered suitable for the analysis of the postcolonial relationship between IBs and conventional banks, since post-structural theory explores “the relation of the enlightenment, its grand projects and universal truth-claims, to the history of European colonialism” (Young, 2004: 41).

In examining the discourse of IBs and conventional banks as an articulation of colonised-coloniser relationship at a macro level, this research focuses on the power relations and transformations of both institutional structures, particularly in terms of corporate structure and available products and services. The development of efficient and low-cost product and services as well as adoption of *Shari’ah* governance structure by conventional banking sector are essential in conducting discourse analysis on the power relationship between these two sectors.

In Chapter 5 and Chapter 6 benefits also from critical discourse analysis as the research method. In addition to analysis of power relations between various parties, a text-based discourse analysis is utilised to develop a micro level analysis of the discourse developed and maintained by *Shari’ah* scholars obtained from written and spoken text to reveal their role and status in this power struggle (MacLure, 2003).

We can argue that this study can be considered as a post-Washington Consensus approach in developing new structure for knowledge development and practice and rendering a novel reading for societal transformation through the ethical and spiritual principles of Islam. Hence, it fits into disruptive nature of knowledge development, and therefore, as a research frame, it should be located within ‘reconstructive post-

colonialism'. It is also important to note that this research benefits from the literature on the construction of an axiomatic framework based on ontology and epistemology of Islam extensively.

## **1.5. RESEARCH RATIONALE AND MOTIVATION**

Experience of IBs during the last decades have demonstrated that their growth is achieved through convergence of IBs towards conventional finance system at the expense of articulation of IME that should be inherent in these institutions. Capitalistic view of development justified such a trade-off by prioritising the growth over IME. However, despite the social failure of IBs in relation to IME, they are still considered by the majority of customers as 'Islamic', which, as this research claim, is due to the existence of SBs. This leads us to critically explore the functionality and accomplishment of SBs in substantiating 'Islamic' identity of IBs. To achieve that, firstly, we examine the most important communication channel of SBs with stakeholders, namely *Shari'ah* annual reports.

SARs are used to convey the practical success of SB to the stakeholders. The information provided in these reports and the level of disclosure show the practical success or failure in terms of supervisory and auditing of SB members and how much SB members willing to share the success or failure with stakeholders. In either case, whether they disclose the information or not, as the most important channel between SB members and customers, the annual reports are the most efficient way to claim 'Islamic' identity of a financial institution. However, considering the literature, which proves the inadequacy of these annual reports, there should be something else beyond the current and even the historical reality to establish and sustain 'Islamic' identity of these institutions.

By tracing the roots of SB as a modern *ifta* institution to the early periods, a comparison between the two will be beneficial to reveal 'the thing' inside the SB beyond the practical accomplishment, which keeps 'Islamic' identity of IBs intact despite the social and IME failure of many IBs. Thus, this research is motivated through the observed convergence of IBs towards conventional banks and the role played by *Shari'ah* scholars in not preventing but rather facilitating this process.

The experience that IBs are operating with the capitalist logic rather than Islamic moral norms demonstrate that capitalist hegemony rather than Islamic legitimacy determines the operations of IBs and *Shari'ah* scholars essentialise the capitalist legitimacy in their role as SB members in IBs in providing *Shari'ah* compliancy. Thus, such observations in the everyday practice of IBs constitutes the rationale for this research.

## **1.6. SIGNIFICANCE OF THE STUDY**

Convergence of Islamic banking sector towards conventional banking under the market conditions and pressures in recent years led SBs mainly involving in the task of inventing 'Islamic' alternatives of the conventional products. This, in return, occupied the literature with legal disputes and literal discussions of *fiqhi* rulings about transformation of conventional instruments into *Shari'ah*-compliant counterparts without taking IME perspective and impacts of such instruments in the society into account. It is important to note that despite the minimisation of embeddedness of IBs and opposing legal rulings declared by reliable scholars and institutions such as International Council of *Fiqh* Academy (ICFA), 'Islamic' identity of IBs through *Shari'ah* compliancy is kept intact which is evidenced by the growth of share of Islamic banking sector in the financial system implying the increased demand for Islamic banking as part of Islamic identity.

To investigate the success of IBs in establishing and sustaining an 'Islamic' identity, this study approaches the SB division of corporate governance of IBs from different perspectives. Firstly, by analysing the level of disclosure in *Shari'ah* annual reports as a means of providing trust in *Shari'ah* compliancy instead of merely an accounting point of view, we measure the impact of efficiency of SB division (at least efficiency of SB as it is presented to the stakeholder through these annual reports) on providing trust in *Shari'ah* compliancy of IBs. In addition, a broad analysis of disclosure of *Shari'ah* annual reports reveals key features to compose a comprehensive *Shari'ah* annual report. To achieve this, we extend AAOIFI guidelines with an IME based index to contribute to the critical accounting research. Especially, examination of the characteristics of SB members will fill a gap in the literature by exploring the impact of *Shari'ah* scholars on compilation of these reports.

However, inadequacy of *Shari'ah* annual reports for convincing stakeholders in *Shari'ah* compliancy of IBs leads us searching beyond the empirical success of SBs to find the source of legitimacy and 'Islamic' identity and further analyse the concept of SB as an *ifta* institution at a theoretical level. By exploring the evolution of *ifta* institution, we trace the roots of SB in Islamic law tradition to reveal how SB as an *ifta* institution provide legitimacy and trust in *Shari'ah* compliancy at an abstract level. This exploration will guide us to provide a discourse for how SBs should be located in Islamic banking sector and which strategies SB should follow to play a key role in establishing IME and re-embedding the IBs into the society.

In overall, this research makes an important contribution in each of these problematised areas by providing an extensive empirical as well as discourse and narrative method related research, which makes this research an original piece as it critically explores and examines topical issues which have not been undertaken in the literature before.

## **1.7. CONTRIBUTION OF THE THESIS**

Contribution of the research presented in this thesis to the literature can be explained through three particular areas.

Firstly, in terms of theoretical contribution, this study attempts to theoretically construct an IME-based Islamic corporate governance system for the existing IBs and other Islamic financial institutions. Such a governance system is aimed to sustain IBs as an alternative structure due to their peculiar ontological and epistemological sources.

Secondly, in terms of empirical contribution, this study conducts a content analysis study to explore the level of disclosure in SARs with a large sample covering from 2007 to 2014 by sampling 41 IBs. By constructing two disclosure indices, namely AAOIFI-based and IME-based disclosure index, this study examines to what degree SBs communicate with the stakeholders through SARs and fulfil the expectation of AAOIFI standards and IME expectations. Considering the large sample size and construction of IME-based disclosure index, this chapter contributes to elaborate the level of disclosure in SAR further. It should, therefore, be noted that developing an IME aspiration index is a contribution in terms of expanding the material and attempt in the literature. In addition, having 41 IBs for the 2007-2014 to generate empirically based analysis for two indices should be considered as a contribution.

Thirdly, in terms of policy making, this study explores the emergence and development of Islamic banking as an institution and investigate the historical transformation of *ifta* institution as the underlying institution of *Shari'ah* supervisory structure of IBs. Revealing the significant transformation points in the historical development of *ifta* institution through critical discourse analysis, this investigation helps to shed light on how to develop appropriate policies to prevent the convergence of IBs towards conventional banking system and instrumentalisation of *Shari'ah* scholars in the process. Particularly, in the conclusion chapter, this study aimed at developing such a policy suggestion to overcome the existing problems in the industry.

## **1.8. AN OVERVIEW OF THE RESEARCH**

After this introductory chapter, the rest of the research is organised as follows:

Chapter 2 – ‘*Constructing an Islamic Corporate Governance System: A Theoretical Attempt*’ attempts to develop an IME based ICG system within the theoretical framework of IPE. Although there are various corporate governance approaches developed from a conventional perspective, due to difference in approaches towards the human nature, source of legitimacy and stakeholders, they do not necessarily fit into Islamic CG frame which emerges from a different ontology, namely ontology of Islam. Therefore, a distinctive ICG system is required so that the CG of IBs should articulate the Islamic ethics and morality in their everyday practice which is attempted in this chapter.

Chapter 3 – ‘*The State and The Determinants of Islamic Governance Disclosure in Islamic Banks: Analysis of Shari'ah Annual Reports*’ presents an empirical analysis by examining the extent of disclosure in the SBs’ annual reports in the case of 41 Islamic banks from 15 different countries for the period of 2007-2014. It also examines the factors affecting the disclosure level through bank level and country level variables. Furthermore, this study constructs two different indices; an index based on AAOIFI guidelines and its extended version based on IME framework. By critically approaching AAOIFI guidelines and extending it with a more substantive framework, namely IME, this study aims at contributing critical accounting research with a focus on Islamic banking sector.

Chapter 4 – *‘Exploring Institutional and Product Emergence in Islamic Banking Sector: A Postcolonial Perspective’* explores the emergence of Islamic banking sector as a result of colonial process by locating prototype of Islamic banking sector as a hybrid institution through the combination of the Western saving bank and Islamic principles within the multiple modernities framework. This essay argues that colonial process has not ceased by the formation of Islamic banking as a hybrid institution but ongoing relationship between colonised and coloniser led to alterations in both. Mimicry of Islamic banks to conventional banks as a result of globalisation and competition under the pressure of market mechanism led to a convergence towards former colonial power, namely conventional banking sector. This mimicry of Islamic banking, in return, caused a ‘menace’ for conventional banking, due to the fear of customer loss. As a response, conventional banks have started to mimic Islamic banks. This mimicking resulted in another hybrid structure: a banking institution which is established in a modern framework and shaped by positivist ontology, and at the same time, through a window, acting in compliance with Islamic law and is bound by *Shari’ah* scholars’ rulings instead of ‘enlightenment’s rationalism’ to fulfil the requirements of operationalising Islamic finance. This essay, hence, argues that the emergence and development trajectory of modern Islamic banking sector can be understood within the context of its relationship with ‘hegemony’ or conventional finance in the form of convergence, hybridity and mimicry in product, instrument and institutional offerings under different historical settings.

Chapter 5 – *‘An Inquiry into Public Policy and Shari’ah Scholarship in the Making: Historical Perspectives’* explores the role and status of *Shari’ah* scholars within the pre-modern context, particularly first five centuries after the emergence of Islam. Thus, this essay explores the embeddedness of jurist-consults into the society during pre-modern period and outcome of such embeddedness in terms of their role and status in the society and influence of this embeddedness on legal rulings. In order to substantiate embeddedness of these scholars and how it influenced their legal and non-legal affairs, we first explain the concept of embeddedness and explore the nature of jurist-consults’ embeddedness. Then, we show how such embeddedness influenced their evaluation of judicial cases. In order to substantiate this point, books of legal opinion of jurists-consults are examined with the intention of revealing how these scholars; (i) incorporated the realities of society into the decision process of law making; (ii) used

legal tools to find a solution/cure for the emerging problems; (iii) and considered the outcomes of their rulings for the society before issuing any legal decision. After investigating the embeddedness of these prominent scholars in the early period of Islam and its impact on legal process, we explore the relationship between ruling authority and scholars and ruling class' strive for legitimacy through these scholars.

Chapter 6 - '*Reflecting on the Role of Shari'ah Scholars in Islamic Finance Industry: Transformation of Ifta Institution in Modern Period*' critically explores the transformation of *ifta* institution and the role and status of *Shari'ah* scholars in the Muslim societies during the modern period.

The emergence of Islamic banks (IBs) in a secular governance structure, however, posed the question of Islamic legitimacy of these institutions. These IBs, by definition, claim that they comply with *Shari'ah* principles, which requires evidencing this claim. As a result of such pursuit of legitimacy (in such post-modern times), IBs aimed to employ *Shari'ah* scholars, especially those specialised in economics and finance (*fiqh al-muamalat*) to attain legitimacy in the eyes of the stakeholders, particularly, the customers (El-Gamal, 2006). However, three major transformations have taken place in terms of role and status of *Shari'ah* scholars between pre-modern period and modern period, as follows:

Firstly, in the pre-modern period, *ulama* were submerged into the society whereas *Shari'ah* scholars in SBs submerged into the IB sector more due to the nature of their profession compared to their submergence into the society.

Secondly, in pre-modern period, *ulama* attained their 'civil leader' status through their deep knowledge in *Shari'ah*, sustaining an exemplary way of life and having an embedded relationship with the society, which bestowed upon them individually rather than as a class of 'learned people', the power to negotiate on behalf of people with the elite-ruling class. Therefore, replacing these local leaders was not a viable option with the intention of increasing negotiation power of ruling authority. However, negotiation power of the *Shari'ah* scholars in SBs, compared to the pre-modern period, has lessened, since *Shari'ah* scholars in SBs attain their source of legitimacy by being appointed to a specific SB rather than deriving their negotiation power directly from the society.

Thirdly, complexity of the society and everyday practices of people changed drastically compared to the pre-modern era in the Muslim world. Therefore, while foreseeing the consequences of legal rulings were easier during the pre-modern period and could be undertaken by individual scholars, interdependent and complex nature of the modern world obliges *Shari'ah* scholars to work in collaboration with other disciplines such as sociology, economics, politics, *etc.*

Through investigating three transformations between pre-modern and modern period in terms of the role and status of *Shari'ah* scholars in detail, this essay aims to explore the sources of the observed current tension in the operation of IBs in relation to *Shari'ah* compliancy and the role of *Shari'ah* scholar, as the latter has become a constant debate in Islamic banking related discussions.

Chapter 7 - '*An Interpretative Discussion and Conclusion*' presents an integrated and interpretative discussion by bringing together all the findings from each essay whereby it presents the role of SBs as a part of ICG in IBs and its importance on assuring *Shari'ah* compliancy in IBs. In doing so, a grand narrative is developed to locate the findings established in the earlier chapters within a meaning-making exercise. Our research revealed that there are three important transformations between pre-modern and modern period in terms of the role and status of *Shari'ah* scholars. Rather than being embedded into the society, *Shari'ah* scholars are embedded into the financial sector in modern period; the source of legitimacy of *Shari'ah* scholars has changed from society to 'being assigned to a SB by the management of IB'; and lastly, products and services in particular, and everyday life in general became more complex in the modern period compared to the pre-modern period. In order to overcome the social failure of Islamic finance sector and prevent the convergence towards conventional sector as a result of these transformations, this study offers a civil society-based control mechanism that goes beyond '*halal*' and *Shari'ah* compliant product and services and investigate the products and services with IME based dimensions through a fuzzy logic approach.

## CHAPTER 2

# CONSTRUCTING AN ISLAMIC CORPORATE GOVERNANCE SYSTEM: A THEORETICAL ATTEMPT

### 2.1. INTRODUCTION

Corporate governance (CG) has been an emerging topic in accounting and finance related research with an increased interest during the last decade mainly due to its essential role in the financial system and the globalisation of the economy. Since CG has a crucial role in the working mechanism of economy, explorations and analyses of CG from different perspectives have emerged, such as types of corporate governance systems – outsider and insider systems - (Dignam and Galanis, 2016), information disclosure (Hermalin and Weisbach, 2012) and the role of CG in bank failures (Berger *et al.*, 2016).

With the emergence of the Islamic banks (IBs) after the 1970s, CG models in conventional system has been studied from an Islamic perspective to explore its conformity with Islamic principles and viability in IBs with the objective of locating and/or developing a distinctive GC structure for these institutions in line with Islamic operational principles (*see*: Abu-Tapanjeh, 2009; Choudhury and Hoque, 2004). Although IBs' CG is similar to the conventional CG in terms of its structural and functional nature, essentialisation of Islamic norms, values and forms, as part of its construct, makes Islamic Corporate Governance (ICG) distinct, particularly in terms of *Shari'ah* governance and accounting practices with a particular emphasis on the holistic as well as moral paradigm of Islam articulated through transparency, environmental concerns, the rights of the stakeholders and social justice (*see*: Choudhury and Hoque, 2004; Kamla *et al.*, 2006; Kamla, 2009; Haniffa and Hudaib, 2011; El-Halaby and Hussainey, 2015).

Implementation of Islamic norms and values in the IBs essentialises and fulfils the ‘Islamic identity’ of these institutions, which distinguishes them as a separate sector, namely the Islamic banking sector, within the existing capitalist financial system. However, convincing the customers of *Shari’ah* compliancy of a company is more important than providing *Shari’ah* compliant products and services. In order to assure *Shari’ah* compliancy of an IB as well as its products, services and operations, and ensure trust in the customers for *Shari’ah* compliancy, ICG incorporates *Shari’ah* Board (SB) in various forms and titles, as a distinct division compared to conventional CG (Malkawi, 2013). Being one of the most distinguishing feature of ICG in IBs, *Shari’ah* scholars in the SBs aim at ensuring the *Shari’ah* compliance of financial transactions, which provides the confidence to the customers of the Islamicity of their transactions. In operationalising SBs, as piecemeal solution, AAOIFI (the Accounting and Auditing Organisation for Islamic Financial Institutions) developed standards for *Shari’ah* governance identifying the working mechanism of SBs along with developing standards for various operational aspects of Islamic banking and finance. However, their efforts have not extended to develop the operational base of a holistic ICG System, which is theoretically attempted in this research.

Although conventional CG theories have been instrumental in explaining the practice in the conventional sector, they do not necessarily fit into Islamic CG frame due to difference in approaches towards human nature, source of legitimacy and stakeholders emerging from the ontological differences. Therefore, a distinctive ICG developed within substantive morality articulation of Islamic Moral Economy (IME) within Islamic Political Economy (IPE) theoretical framework is required so that the CG of IBs should articulate the Islamic ethics and morality in their everyday practice which is attempted in this section.

As in the current practice, the focus has only been on the financial transactions related compliancy, while Islamic impact on the rest of running the organisations, namely IBs, are not considered nor is conceptualised. The existing *Shari’ah* compliancy in IBs hence relates only to ‘form’ in the *muamalat* or financial transactions, while Islamic ethics or substance by definition is expected to prevail in the transactions and also in the running of organisations in the form of corporate governance. This can overcome the inconsistency observed in the IB industry in the sense that if the financial operations

of an IB is made *Shari'ah* compliant, by definition and nature of its structure, its governance and operations should also comply with Islamic norms. In other words, 'Islamic' in IB should also have governance implications beyond financial transactions in articulating Islam's comprehensive normative world encompassing every aspect of life. Such a critical perspective, hence, rationalises the necessity and emergence of ICG as a sub-theme.

In order to achieve this goal, there is a need for a theoretical frame which can deliver an integrated and interactive system understanding within Islamic normative world. Thus, Islamic Political Economy (IPE) provides the comprehensive theoretical framework (Asutay, 2007a), which produces ICG as a system of governance of organisations and corporates within an Islamic order through the substance derived from IME, which integrates substantive morality into the equation in addition to the *fiqh* or Islamic law construct. This is due to the fact that the current *Shari'ah* compliancy-oriented paradigm reflects the partial reality of Islamic norm by merely essentialising *fiqh*, while issues such as CG goes beyond the form and requires the incorporation of morality and public interest.

As explained in detail in Chapter 1, this study aims at constructing and constituting a theoretical frame of ICG System and its constituents through the foundational principles of Islamic ontology in relation to economy, finance and political economy related behaviour and articulated knowledge by basing it on the IPE structure and IME substance. In contrast to the available material in CG in IBs, which treats IBs within the existing market system and neo-classical terms, the requirements and expectations of IME based theoretical frame is more substantial and more demanding than the available models due to essentialising 'morality' as a 'consequence' not only as 'intention', as the latter is attempted by '*fiqh* (Islamic law) only' dominant approach. In other words, for an IME based theoretical frame, morality of the process is necessary but not sufficient condition, and, therefore, consequences of a process are expected to be moral as well. Such a model is attempted to bring up a critical perspective in developing a particular and peculiar theoretical frame, namely ICG, for the evaluation of CG issues in IBs.

The rest of the chapter is organised as follows: Section 2.2 discusses CG through a conceptual articulation and critically reflects upon the existing conventional CG

theories. In section 2.3, it is attempted to construct a theoretical framework of ICG. In section 2.4, moral foundations of constructed theoretical framework is further elaborated. In the last section, the concluding remarks are presented.

## **2.2. CORPORATE GOVERNANCE: A CONCEPTUAL SURVEY**

Since the mid-eighties, CG has drawn attention from many disciplines which resulted in development of the codes of good corporate governance such as Treadway Commission (1987) in the U.S and the Cadbury Code (1992) in the U.K which led to similar developments in other countries as well (Berghe, 2002). The need for such a governance system, in theory, was emerged because of the separation of the ownership of a company and its management leading to the emergence of corporation as another class of entity. Based on the premise that the executive managers are self-interested individuals, they might exploit such separation to take opportunistic actions for their self-interest at the expense of shareholders and stakeholders (Larcker and Tayan, 2011).

Although there is no agreed upon definition for ‘corporate governance’, it is useful to provide some working definitions to develop an idea about the concept. On its widely quoted definition, Cadbury (1992, at para 2.5) defines the corporate governance as “the system by which companies are directed and controlled”. In a more comprehensive definition, which details Cadbury’s (1992) reference to system, Blair (1995: 19) defines CG as “the whole set of legal, cultural, and institutional arrangements that determine what publicly traded corporations can do, who controls them, how that control is exercised, and how the risks and returns from the activities they undertake are allocated”. Thus, Blair (1995) elaborates ‘the system’ of Cadbury (1992) by replacing it with ‘the whole set of legal, cultural, and institutional arrangements’ and adding ‘who’ and ‘how’ questions in the definition.

With the emergence of ‘institutional approach’, some contenders define CG from an institutionalist perspective. Considering the institution as “the humanly devised constraints that shape human interaction” (North, 1990: 3–4), CG, in this context, could be represented as “the set of organizational and institutional mechanisms that define the powers and influence the managers’ decisions” (Charreaux, 2008: 19). In a recent definition, accepting the separation of ownership and management of self-interested managers as the main point of the concept, Larcker and Tayan (2011:8) defines CG as

“the collection of control mechanisms that an organization adopts to prevent or dissuade potentially self-interested managers from engaging in activities detrimental to the welfare of shareholders and stakeholders”.

As indicated by the diversity of the definitions, CG is a subjective concept and the background, and the field of the author influence the approach. Lack of universality on the definition of CG reveals itself as different approaches to the CG. There are currently two dominant approaches in the CG, namely ‘shareholder-oriented approach’, of Anglo-Saxon origin, and ‘stakeholder or socially oriented European approach’. First approach prioritises the property right, in other words, maximisation of shareholders’ wealth. The defenders of this approach provide several reasons in rationalising this approach: (i) there exists other mechanism of protection for the other stakeholders such as trade unions for employees and specific contractual provisions for long-term creditors, unlike shareholders who are unprotected against the misuse of power by managers; (ii) the objectives of each stakeholders are different, and it is impossible to satisfy them all. On the other hand, stakeholder approach defends that organization should play a social role in community and be accountable for its social responsibilities by responding to various stakeholders. Thus, for this approach, the corporate, hence, should combine the interest of different stakeholders and try to satisfy them, beyond solely maximising shareholders’ interest (Charreaux, 2008).

Different assumptions and approaches towards human nature and CG led to the emergence of different theories of CG. Following section explores some major theories of CG within the conventional realm of knowledge.

### **2.2.1. Agency Theory**

Agency theory in corporate governance is utilised to explore the relationship between managers and shareholders, which emerge as a result of separation of ownership and management. Agency relationship originates from a contract signed between principal (owner) and agent (manager) in order to delegate some authority to the manager to operate the businesses of principal on behalf of them. The problem arises, however, if there is a conflict of interest between the agent and principal if both are self-interested and utility maximiser individuals (Jensen and Meckling, 1976; Fama and Jensen, 1983). In such a case, agents often exploit their authority for decision making by taking actions

considering their own interest instead of the interest of principles (Barnea *et al.*, 1985). In order to minimise the negative effect of conflict of interest between principal and agent, Jensen (1983) acknowledges two steps:

(i) the first step, also named as formal agency literature, explores the risk-return balance of each party, namely principal and agent. Accordingly, the risk-bearing mechanism between principal and agent, hence, must be monitored through the relationship between organisation and contracts;

(ii) the second step, also named as positive agency theory, explores the structure established in the first step and aim to produce solutions to the agency problems (Agarwal *et al.*, 2014).

Although it is a useful theory for explaining important dynamics relating to the nature of corporations, contenders in this area suggested some limitations for the agency theory, which are as follows (Agarwal *et al.*, 2014):

(i) assumption of complete contracts despite to bounded rationality, information asymmetries, transaction costs, *etc.*;

(ii) assumption of elimination of agency costs through contracting, while it is invalid due to imperfections in the market;

(iii) lack of recognition of parties who are not part of the contract, namely third party, which may lead to undesirable social welfare problems;

(iv) assumption of interest of shareholders in financial performance alone;

(v) assumption of opportunistic and self-interested managers although there can be managers loyal to their company as well.

### **2.2.2. Stewardship Theory**

An alternative theory for self-interested agents suggested by agency theory is 'stewardship theory', which considers managers as trustworthy individuals and good stewards. Instead of being motivated by only self-interest, these managers are assumed to be motivated to work for the good of the firm (Davis *et al.*, 1997), in other words, their aim is to serve their organisations in a way to maximise the performance (Fox and

Hamilton, 1994). Although these two theories are mutually exclusive, they can both be valid in different circumstances. In cases where there is a persisted coalition between managers and owners, stewardship theory can be correct whereas such coalition does not exist, such as by a takeover threat, agency theory can be valid, where each party pursue their self-interests (Donaldson, 1990).

### **2.2.3. Stakeholder Theory**

Through expanding the scope of the firm more than shareholders, ‘stakeholder theory’ increase the number of the parties involved in the entire operations of organisations and corporations by “taking into account all of those groups and individuals that can affect, or are affected by, the accomplishment of organizational purpose” (Freeman, 1984: 25). By expanding the role of the firm and its responsibilities, stakeholder theory does not oppose to shareholder theories, but provide a more efficient way to increase the shareholder wealth. In other words, by taking all stakeholders into account as defined above, they contend, the firm has a competitive advantage which leads to higher shareholder value of the firm (Pfarrer, 2010: 88).

A topic of debate in this theory is whether the firm can accomplish to satisfy the interests of all stakeholders, since the stakeholders usually have different interests which may conflict with each other (Jensen, 2002). Jones *et al.* (2002), for instance, suggest that not all stakeholder should be considered as equal, and, therefore, only the relevant stakeholders should be prioritised. Nevertheless, “the impact of the firm on the rights and legitimate interests of its stakeholders” (de Ven and Jeurissen, 2005: 299) is crucial from the business ethic perspective and should be considered.

### **2.2.4. Transaction Cost Economics**

Long before transaction cost as a concept became an area of research in the economic science, it is discussed in the literature by scholars such as Hicks (1935) and Coase (1937) as a study of the effects and outcomes of exchange which involves cost (Hardt, 2009) and as a study of investigating the reasons of the existence of firms. However, it emerged as a concept in economics in the 1970s to explore the impact of governance of institutions on economic value (Tadelis and Williamson, 2012).

As a corporate governance related theory, similar to the ‘agency theory’, ‘transaction cost economics’ (TCE) is a shareholder theory that prioritises the maximisation of shareholders’ wealth and shares common premises regarding the nature of the managers such as being opportunistic, self-interested individuals who consider their interest before the interest of the firm (Pfarrer, 2010: 88). Thus, TCE utilises a contractual approach to explore the firms (Williamson, 1996). By expanding the theory of firm suggested by pioneering contenders such as Coase (1937) who claims that firms exist to avoid transaction cost, Williamson (1996) explores the firm in the context of potential opportunistic behaviour in the market. In other words, Williamson (1996) suggests, it could be possible to carry out the same productive activity both in a firm and through autonomous contracts in the market as long as there is no problem of opportunistic behaviour of the actors (Conner, 1991). The central concepts of his theory, hence, are the existence of opportunistic behaviour and bounded rationality in the framework of bilateral monopoly and uncertainty (Hardt, 2009).

Although TCE has almost four decades of history as a science, important criticisms have emerged in the literature. To begin with, Williamson (1995: 33), himself criticize the lack of a clear definition for ‘transaction cost’ and ‘power’ by stating that “There is nonetheless a grave problem with broad, elastic and plausible concepts – of which ‘transaction costs’ is one and ‘power’ is another – in that they lend themselves to ex post rationalization. Concepts that explain everything explain nothing”.

Another important critique is the existence of opportunistic behaviour of the agents which constitutes one of the central concepts of Williamson’s theory. Although Williamson established his theory on the assumption of opportunistic behaviour, some researches (such as Ghoshal and Moran, 1996; Håkansson and Snehota, 1989) suggest the contrary. In addition to the theoretical critiques, researchers, among others, David and Han (2004) and Carter and Hodgson (2006) also investigated the empirical evidences and suggested that evidences are equivocal rather than triumphs the TCE. Although there are other strands of the theory contributed by prominent scholars such as North (1990) and Coase (1988), we limit this section with the Williamson’s theory of TCE due to being a well- developed theory and predominant usage by the researchers in the field of economics (Ghoshal and Moran, 1996).

### 2.2.5. Legitimacy Theory

Legitimacy theory is defined as “a generalized perception or assumption that the actions of an entity are desirable, proper, or appropriate with some socially constructed systems of norms, values, beliefs and definitions” (Suchman, 1995: 574). This implies that organisations aim to gain approval from society for the transactions and operations of an organisation in order to be accepted by the society (Kaplan and Ruland, 1991). Such a requirement stems from underlying assumption of a social contract between society and organisations. In other words, society grants permission to the organisation to operate in the society, which in turn renders it as accountable towards society (Deegan, 2004). The most salient feature of legitimacy theory, hence, accountability of an organisation towards society, which makes it subjective to general norms of a society and, therefore, relative from time to time and place to place. By considering the society in the operations of an organisation, legitimacy theory could be considered as a stakeholder approach.

It is important to note that although ICG system suggests an alternative corporate governance to conventional theories discussed above, it is still in the same paradigm due to the acceptance of the corporate or legal personality as a construct since that is the nature of existing IBs. Therefore, conventional corporate governance theories and their tools to overcome some of the problems within the governance structure of a corporate could be useful in ICG system as well. Furthermore, as ICG system assumes a dynamic human nature through *tazkiyah* process rather than a static one as agency or stewardship theories assume, in different stages of *tazkiyah* process, different theories might be useful. Agency theory, for instance, which assumes that people are self-interested, proposes certain governance strategies such as monitoring the managers and limiting their power to overcome a potential conflict of interest in the governance structure between the agent and principal. Such tools of monitoring and limiting might be of use for ICG system as well considering that at the initial period of *tazkiyah* process, a manager might be self-interested as well as in later stages. On the other hand, a manager might consider the interest of a company instead of his or her self-interest as stewardship theory suggests. In such cases, the tools and governance strategies of the theories identified above might be utilised. However, it should be noted that the tools and strategies of these theories might be utilised in the transition period, since the aim

of *tazkiyah* process, as discussed in below, is to develop individuals achieving the level of *khalifah* of the God in this world.

In concluding this section, it should be noted that some critical reflections on these theories are presented in a later section where their usefulness and proximity to ICG is discussed by mainly identifying the ontological difference and the way the stakeholders' relationship is perceived in ICG in contrast to CG.

### **2.3. CONSTITUTING ISLAMIC CORPORATE GOVERNANCE: THEORETICAL FRAMEWORK**

The above discussed theories are instrumental in substantiating CG system within a conventional framework based on the ontology derived from the enlightenment process. Since Islamic ontology has its peculiar nature, the knowledge constituting process in relation also to CG in Islam has to reflect upon such distinctiveness. However, in responding to the Islamic ontology, a theoretical framework of IPE structure with the underlying norm and moral requirements of IME can provide a consistent approach in developing ICG for IBs and other Islamically claimed corporations, as their operations must be *Shari'ah* compliant, which, therefore, requires that their structure should be shaped by the Islamic ontological positioning. Therefore, in the following sections, we aim to develop an IPE framework in which ICG as a system could be located in examining IBs.

#### **2.3.1. Islamic Order: Locating the Ontological Foundation of Islamic Corporate Governance**

Before exploring ICG as an alternative governance theory, in this section, we discuss Islamic order in which ICG is located as a system and connected to other systems through IME within IPE as the theoretical framework.

A 'system' is defined as the "functional components that together make certain sectors of the ethico-economic order work" (Choudhury and Malik, 1992: 15). In other words, a system refers to a complete and functional structure which operates along with other systems as part of an order. "An 'order' is, hence, a totality of several systems integrated together through the bond of ethical[ly defined normative world]" (Choudhury and Malik, 1992: 15), which implies that economic, social, political, sociological *etc.*

systems together constitute 'a system' of a particular order, in this case Islamic order. In constituting order, the individual systems are connected through moral economy of relationships defined by the abstract nature of ethicality. Political economy within an 'order' represents the theoretical framework of various systems relating to different spheres of everyday life. The 'economy' in political economy (and for that matter in moral economy) relates to social formation of a particular society, which can be expressed as the relationships and the normative world of that particular society in the sense as to how the society is organised. Thus, ontology shapes those relationships and hence the social formation which define the nature of political economy peculiar for that society (Nomani and Rahnema, 1994). Thus, political economy in a macro level identifies how the systems of an order are connected in normative and positive term. This implies that political economy reflects on the social formation of the society through macro and micro relationships to provide a frame through which the functioning of the society is defined and determined.

The underlying value system through which the actions of individuals are produced plays a vital role in social construction of the life and leads to differences in social life among different value systems (Asutay, 2007a); and such relationships in macro level leads to peculiar social formations. For instance, a market based social structure and social formation would be different than socialist social structure in terms of definition of modes of production, distribution of wealth and concept of just wage among other things. Economic systems are not an exception of socially constructed life, since "economic systems ... do not function within a vacuum [either]. They are significantly affected and shaped by a set of 'influential factors': the level of economic development; social and cultural factors; and the environment" (Bornstein, 1979: 7). As the discussion indicates, in referring to social construction, Islamic political and moral economy is constructed in a deductive manner through the ontological sources of Islam as well as by the articulation of Islamic epistemology, social constructivism of the historical knowledge, practice and institutions, and the contemporary needs and realities (Asutay, 2007a).

Islam, therefore, should be considered as an order in which several systems function such as economic system, legal system, political system, system of religious practice, *etc.* As mentioned, all these systems within Islamic political economy are connected to

each other through IME, which constitutes the substance of the order. Although Choudhury and Malik (1992) consider IPE as the study of the relationships between policy, economics and politics along with integration of ethical and philosophical concerns, the authentic notion of Islamicness cannot be limited with the ‘economy’ and ‘polity’, as the *tawhidi* (God’s unity and sovereignty) or unitary and complementarity nature of Islamic knowledge, and hence order, through *tawhid* requires analysing systems as an integrated whole to reflect the everyday construction of life. Despite the fact that Choudhury and Malik’s (1992) definition of IPE relegates it to the relationship between economics and politics in the sense of Virginia School of Public Choice, this study opts for the 1960s and 1970s conceptualization of political economy aiming to discover and understand social formation as constituted by Islamic order of normativeness.

The interconnectedness of each system in Islamic order stems from the *tawhid* axiom of IME. This axiom suggests that every system of the order should work in a complimentary manner and should be subservient to God’s rulings alone. In other words, IME demands harmony in the everyday operation of the society. Reciprocal relationship of the systems leads to mutual exchange between the systems, which in turn leads to extraction and contraction of each system depending on the nature of exchange. The systems, hence, are not static in nature, but adopt dynamically to the changes and aims to converge towards expanded nature of each of the system in realising the maximised notion of aspirational and normative worldview of Islam, which is the objective of *Shari’ah*, namely to achieve *falah* or salvation in individual level and *ihsan* or beneficence, as a social capital, as an outcome, in the society level.

Many contributors in the field of Islamic economics have attempted to establish the philosophical and conceptual foundations of IME to provide a coherent theoretical framework for an IPE such as Ahmad (1994, 2004; 1979), Chapra (1992, 2000), Naqvi (1981, 2013), Siddiqi (1981), Sirageldin (2000) and Asutay (2007a; 2007b; 2013). IME is articulated through a number of foundational axioms in constituting the Islamic knowledge, which can help to define and determine the norms, nature and structure of ICG. Building on such literature, we define these foundational axioms as follows:

First axiom is *Tawhid* (God’s unity and sovereignty), which constitutes the core of Islamic teaching and “expresses the concept that there is no deity except God Almighty

and that He alone is the Creator, Cherisher and Sustainer of the Universe. It also implies that none deserves to be worshipped and glorified apart from God” (Khan, 2012: 9). As a consequence of submission to ‘the one God’, individual emancipates from worshipping or serving things other than God and derive all the ethical principles and social norms from the epistemological sources that God provides, *i.e.* Quran and *Sunnah* (tradition of the Prophet of Islam) (Khan, 2012). In addition to ‘submission to the One true God’ by emancipating individuals from ‘submission to worldly things’, *tawhid* also lays the foundation for a “comprehensive worldview of life” (Choudhury and Harahap, 2009: 2), which leads to ‘complementarities’ among the parts and systems of ‘Islamic order’ (Choudhury and Harahap, 2009: 6). *Tawhid*, hence, represents a relationship of ‘vertical ethicality’ between individuals and God through which individuals have equal opportunity for access ‘to enjoy the bounties on Earth created by God’ (Asutay, 2012a: 95). As a result of being the One True God, He is the only sovereign which means God alone has the power to decide exceptions (Hallaq, 2012). Individuals, therefore, has no authority to suspend the rulings of God in His realm, even if he/she believes (delusionally) something is for the benefit of people. It is also important to state that complementarity nature of *tawhid* indicates, within Islamic order and system relationship, that everything in the world is connected and integrated and is part of an integrated whole. Such an approach has macro level and micro level consequences: as for the macro level consequence, it implies that every stakeholder should be considered in decision making process in constituting IPE at macro level such as nature and animals along with the direct stakeholders. Furthermore, a balance should be observed between their rights and responsibilities as well as considering the priorities among them as derived from the ontological and epistemological sources. Accordingly, capital cannot have priority over labour and vice versa, and, therefore, their interest should equally be represented in the operations. *Tawhid*, hence, constitutes the essence of shaping the ICG, which is further substantiated through other axioms, such as *rububiyah* and *tazkiyah* as discussed below.

As for the micro level articulation of complementarity of *tawhid* axiom, it refers to the necessity of superseding authority of principles derived from the ontological and epistemological sources of Islam over the rules and logic of a field. Following Bourdieu, a field could be defined as “a structured system of social positions—occupied either by individuals or institutions—the nature of which defines the situation for their

occupants” (Jenkins, 1992: 53). Individuals, therefore, constantly enter different fields such as ‘school’, ‘family’ and ‘work’, and each one of these fields, “by virtue of its defining content, has a different logic and taken for granted structure of necessity and relevance” (Jenkins, 1992: 52). *Tawhid* axiom, thus, suggest that if there is a contradiction between a logic or structure of a field and principles of Islam, the individual should not follow the logic of that field at the expense of ignoring the principles of Islam. In other words, *tawhid* axiom at micro level suggest that all the fields an individual enters should be considered as complementary of each other and should be guided by certain principles extracted from sources of Islam and articulated in practice by the Prophet Mohammad. Such universal principles of Islam are in a negotiation with particulars of fields to adopt these universals for different fields. For instance, a business person might be strict follower of capitalist principles and values at his or her firm in terms of time management or utilisation of resources, while at home in the field of family, as a father or husband, time management and utilisation of resources might be influenced by the rules of that particular field rather than capitalist principles. However, as an articulation of complementarity at micro level, *tawhid* axiom suggests that these different fields should be coherent and guided by Islamic principles. This dialectic inconsistency can perhaps be explained in the following example; for instance, if a business person is involved in the meat business, he or she should not rear the animal in unacceptable conditions and filling with hormones with the intention of efficiency and more profit while feeding a pet dog at home with the best possible dog food. Rather, this business person should consider the animals as a stakeholder which have certain rights bestowed upon them by the God and should act accordingly even at the expense of profit loss at the business which is dictated by the *tawhid*'s implications of recognising the rights of each stakeholders in a just manner. Hence, *tawhid* as the core normative principle at micro level aims to ensure the consistency between various fields one has to live through in everyday practice.

Second axiom is *rububiyyah*, which means “divine arrangements for nourishments, sustenance and directing things towards their perfection” (Ahmad, 1979: 12), namely divinely development path. This within *tawhid* implies that everything is created with a potential development path towards their individually defined perfection (Arif, 1985) or *fitrah*. Consequently, necessary opportunity space should be provided as a right for all the stakeholders to reach such perfection (Asutay, 2007a). The use of modern

concept of sustainable development relates to Islamic development path of *rububiyah* as an articulation of complementarity axiom in a proactive manner. Although this axiom implies potential for development and presents the ways and means to realise that potential, it provides only guidelines to reach a higher development stage. In order to accomplish development, concrete actions and establishment of institutions should be achieved which necessitate the *tazkiyah* axiom.

*Tazkiyah* (purification and harmony), being the third axiom of IME's substantive morality articulation, is "concerned with growth towards perfection through purification of attitudes and relationships" (Ahmad, 1994: 20) implying growth in harmony. Thus, individuals and other stakeholders are expected to grow according to their perfection in *fitrah* as identified through *rububiyah* axiom. However, the scope of *tazkiyah* is not limited to individuals but encompasses organizations and society as well. Thus, the growth and progress process, due to the complementarity axiom, has to be purified and therefore should be in harmony with the interests of all the stakeholders. Such as the case that economic growth cannot be at the expense of natural environment, as environment is considered as *amanah* or trust from the God and therefore its growth path in reaching its own perfection has to be recognised in the same way, *zakah* or Islamic alms or tax is an instrument to purify the wealth by returning the right of the society to society. *Tazkiyah* axiom is, hence, crucial for realising the objectives of other axioms such as *al-'adl* (justice) and *ihsan* (beneficence) and constitutes the theoretical foundations for these axioms. Non-obligatory charity, for instance, is a sign of going beyond what is 'just' and being beneficence towards others. To achieve such a high rank, the process of *tazkiyah* occupies an important place.

Fourth axiom is *al-'adl* (justice), which provides the practical guidelines for sustenance of all the things based on the ontological sources of Islam, which means granting the right to whom it belongs, and the rights of all entities are defined in Islam. *Tawhid*, hence, is a precondition of being 'just', through its vertical ethicality and complementarity, in the IPE's order. While *tawhid* provides the vertical dimension of Islamic ethicality, *al-'adl* provides the horizontal dimension of equality; equality among the individuals on earth in the sense that individuals by creation are equal to each other in terms of their access to the resources created by God (Asutay, 2007a; 2007b; 2012a; 2013). Thus, *al-'adl al-waajib* (obligatory justice) refers to the

minimum level of social relationships in a society where Islamic order prevails. In the path of perfection, hence, *al-adl* is only the first step and next axiom, *al-ihsan* or delivering beneficence takes the individual beyond that point through *tazkiyah* axiom. Thus, corporations and organisations are expected to establish their relationships with all the stakeholders within justice by definition of the IPE.

Fifth axiom, *al-ihsan* (beneficence), hence, complements *al-adl* (justice) to achieve higher goals in terms of moral values through which every system in the Islamic order connects to one another. *Al-ihsan* means treatment with the best manner from the one who is not obliged to do so towards the one who deserves that treatment. Therefore, individuals who reach their salvation or *falah* is expected to support others to reach to the same level implying that *ihsan* is to be expanded in the society in the form of social capital so that the *falah* reaching path as part of *rububiyah* can be established. This implies that organisations including corporations should also ensure the expansion of *ihsani* social capital through their direct engagement with the society in which they operate.

*Khilkiyya* (affirmed behaviour), the sixth axiom, refers to the characteristic features that becomes inseparable from an individual. In other words, what we term as *khilkiyya* is not calculated actions of an individual but rather actions which became part of his or her nature so that the aspirations of religion and the practice should be as equal as possible. There are two main sources which establish *khilkiyye* for an individual which could be classified as macro and micro level. First one which is at macro level is related to the society or community an individual is part of. As soon as an individual becomes a subject within a society, his or her character is shaped to a certain extent with the norms and values that society bears, which includes way of talking with others and how to act in various fields. These norms and values, as stated earlier, is expected to be derived from ontological sources of Islam within an Islamic order. If existing norms and values are not compatible with Islamic order, then, individuals are expected to strive to bring existing social formation closer to the norms and values of an Islamic order. Such process requires individuals, who, through individual *tazkiyah* process, have internalised such norms and values in their life and proactively interact with the existing structures to develop them. Development of such individuals necessitates the second source which is the individual *tazkiyah* process at micro level. As a result of

*tazkiyah* process, within Islamic order, being ‘just’ to other stakeholders becomes the minimum level of moral character that an individual should attain, which is a necessary condition for being vicegerent of the God on earth. Furthermore, through the process of *tazkiyah*, *ihsan* becomes an affirmed behaviour of the individual as well by going beyond being ‘just’ alone. The negotiation process between the prevailed norms and values in the society as a source of *tazkiyah* at macro level and individual *tazkiyah* process at micro level is crucial within the *tawhidi* framework, since such negotiation process provides the dynamic nature of *rububiyyah* axiom. In other words, individuals as active agents within the society strive to reshape the existing norms and values whether they are physical institutions for implementation of norms and values or abstract concepts. In order to get the norms and values prevailing in a society closer to the objectives of *Shari’ah* and converge towards an Islamic order, individuals should go through a correct *tazkiyah* process and engage with the existing structures to correct them while keeping and attaining the compatible norms and values. Topcu (2011) calls such a process as ‘ethics of revolt’ and it does not cease to operate until Islamic order is articulated at society level suggesting a dynamic and permeated process. However, the ultimate aim in such framework is not the goal but the process, which is defined as struggle for establishing Islamic order with its systems as a whole.

Seventh axiom is *ikhtiyar* (free-will), which as an axiom separates human-beings from other creatures, which is also the necessary condition for all the practical axioms such as *al-‘adl* and *al-ihsan*. Because without the choice of being ‘just’ or ‘unjust’, the individual could not be responsible for the outcome. Furthermore, freedom of individuals against the structures of the society, or the ability of actively engaging with the existing structures of a society, is also part of this axiom, which is important for sustaining the dynamic process of negotiation. For example, in the history of Islam, distance of some *Shari’ah* scholars to the rulers might stem from such fear of lack of freedom in practice in engaging with the existing structures of the society, as explored in a later chapter. Therefore, by freedom, we do not only refer to the theoretical free-will of human-being but also the necessity of having freedom of individuals intellectually and financially to engage freely with the existing structures.

The following axiom, *khilafah* (man’s role as God’s vicegerent on earth) defines the position of individual on earth. In other words, this axiom states the role and

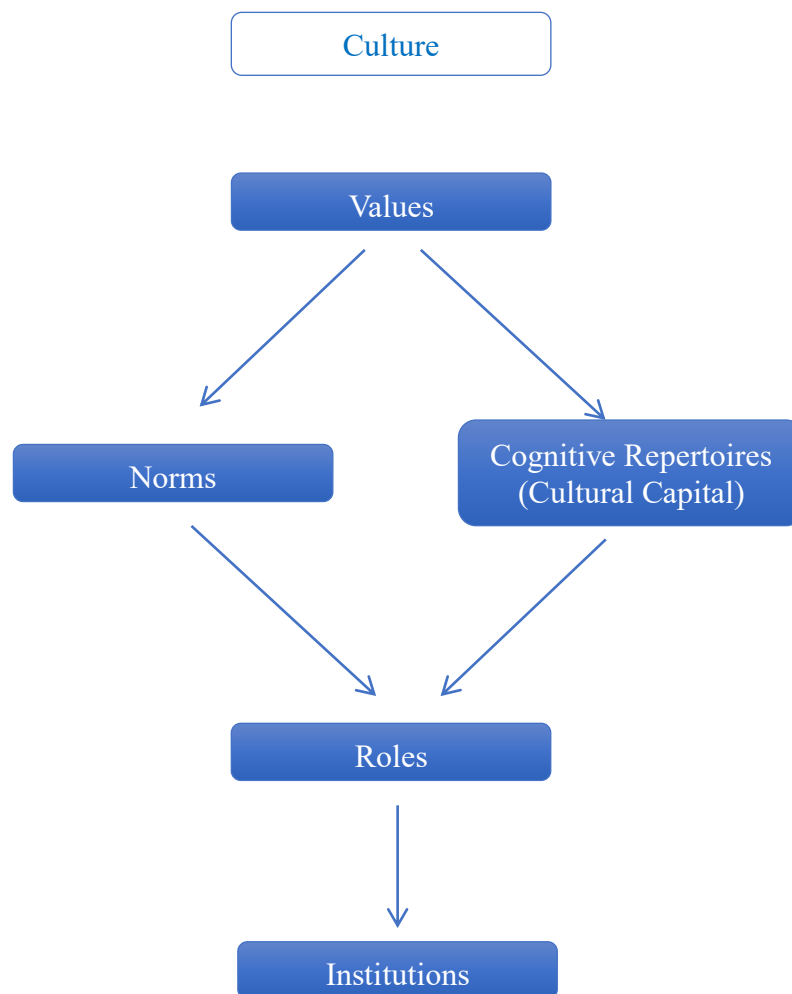
responsibilities of individual in relation to others and other things (Ahmad, 1979: 12). “His (or her) role, position and mission is described as *istikhlaf*, that is fulfilling God’s will on earth, promoting what is good, forbidding what is wrong, establishing justice (*’adl*) and promoting beneficence (*ihsan*), resulting in attaining high levels of good life (*hayat al-tayyebah*), both individual and collective” (Ahmad, 2004: 193). With the guidance of God as a result of *rububiyyah* axiom, *khilafah* axiom provides “the unique Islamic concept of individual’s trusteeship, moral, political and economic, and the principals of social organisation” (Ahmad, 1979: 12). In other words, *khalifah* axiom refers to individual capacity of achieving the normative world of Islam in everyday life as described by Islamic moral economy. In addition, it directly refers to moral and social accountability as a response to the identified *khalifah* responsibility; such as indicating ‘solidarity among people’ by articulating the complementarity of *tawhid* and beneficence of *ihsan*.

Based on the discussion above, in constituting ICG, IME, namely the substance of IPE, which constitutes the nature of the relationship between and within the systems of IPE, is the articulation of these axioms, which aim at realising the *maqasid al-Shari’ah* or the objectives of *Shari’ah*. In this, ‘the objective of *Shari’ah*’ is defined as human well-being at the individual and society level, which produces *falah* or salvation and *ihsan* or beneficence as the outcome of the process. Therefore, IME constitutes the nature and regulates the practice of ICG, being one of the systems under IPE, in line with other systems of IPE. IME, hence, is the substance which differentiate ICG from conventional CG theories. While IPE provides the *tawhidi* ontological paradigm and frame, IME’s substance nature determines the nature of CG by leading to ICG, such as suggesting an extended stake-holding, in which each stakeholder’s interest should be considered equally as growth has to be within harmony so that justice and beneficence can be achieved as an affirmed behaviour as it is the duty of individual to act according to the role given to them within *tawhid*.

### 2.3.2. Constituting Islamic Political Economy Frame and Islamic Moral Economy's Substance for Islamic Corporate Governance

The preceding section has laid the foundation for the emergence of ICG through IPE as a frame and IME providing the substance through the Islamic values and norms developed from Islamic ontology. Based on this, this section, therefore, presents the process of constituting the ICG as a process.

**Figure 2.1: Elements of Social Life**



Source: Portes (2010a: 54)

As shown in Figure 2.1, the roles are combination of normative part (obtained from norms in the society) and cognitive part (a cognitive repertoire of skills and ‘scripts’) (Portes, 2010a: 52) and “*Institutions* are the symbolic blueprint for organizations. They comprise the set of rules, written or informal, governing relationships among role occupants in organizations” (Portes, 2010a: 55). Among such institutions, we can consider the family, the schools and religion among others. Although arrows suggest a

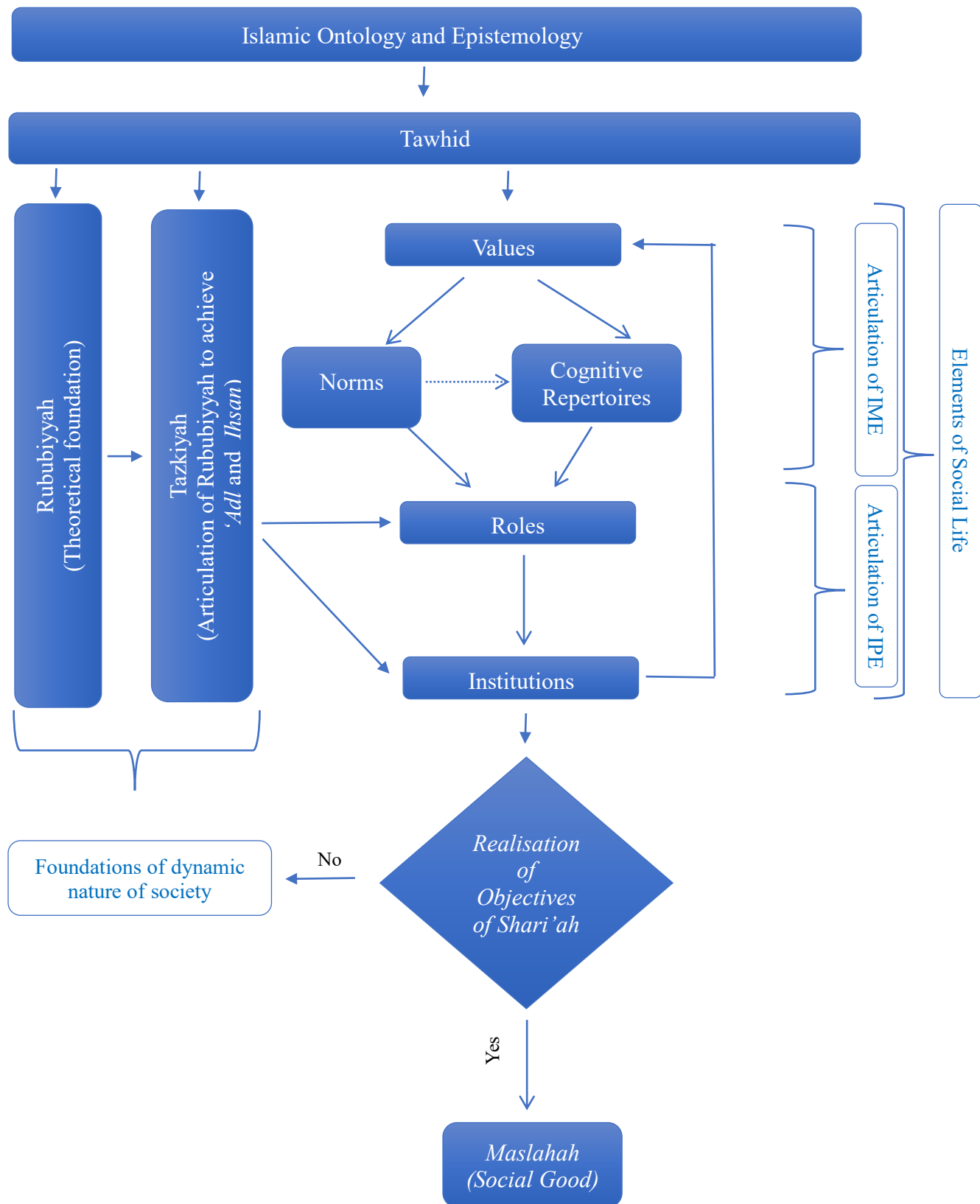
one-directional influence, Portes (2010b) emphasise the interaction between active agents as the occupants of the roles and institutions. These interactions take place at the surface level rather than a deep level, therefore, change at the society level is not effective. However, a change in the society which drastically affects the underlying values such as the emergence of a prophet may have long-lasting and more fundamental transformation in the society (Portes, 2010b).

Utilisation of such axiomatic framework facilitates to construct Islamic systems as the articulation of IPE, which are composed of roles and institutions with the underlying IME, which is norms and cognitive repertoires with underlying Islamic values. It is, therefore, important to explore the elements of social life and underlying foundations of roles and institutions in a society. It is important to note that the elements of social life displayed in Figure 2.1 are not differentiated from one another, as they simultaneously exist in the society (Portes, 2010b).

As depicted in Figure 2.1, values underlie the foundations of the norms and cognitive repertoires in a society. Based on these norms and cognitive repertoires, roles are constituted, which are the key analytical elements for individuals to become a member of the society. In addition, roles are part of the institutional framework (Portes, 2010a). Values are “concealed below everyday social life but fundamental for its organisation to ‘surface’ phenomena, more mutable and more readily perceived” (Portes, 2010a: 51). In other words, “values represent general moral principles, while norms embody concrete directives for action” (Portes, 2010a: 52). An individual must have a role in a society to enter ‘the social world’. This role, however, while offering the possibility to join ‘the social world’ on the one hand, it also limits individual’s behaviours in this social world as well as encouraging him or her to act in a certain way, on the other hand (Portes, 2010a: 52).

Figure 2.2, therefore, presents how emergence of a prophet and a new religion with its own ontology and epistemology influence the elements of the social life, namely Islam.

**Figure 2.2. Structure of IPE: Becoming Process- ever-Developing process**



As depicted in Figure 2.2, it integrates elements of social life within IPE framework with the objective of representing how IME with its axioms is utilised to construct an Islamic order within the society to achieve *falah* and *ihsan* and also restore the society to achieve the objectives of *Shari'ah*, namely human well-being. In order to show the influence of institutions on the values, we added an arrow showing that institutions influence the values as well which suggest a direct interaction with the surface level of the society and deep level.

In an Islamic order, 'general moral principles' are extracted directly by positing new principals or transforming the existing ones into compatible with Islamic principles, or indirectly by confirming an existing value in the society as culture either through explicitly stating or being silent about it, from the ontological sources of Islam, namely the *Qur'an* and *Sunnah*. In an Islamic order, therefore, values ('as general moral principles'), norms ('concrete directives for action') and cognitive repertoire of skills constitute the IME which underlies the guiding principles of a system and organise the relationship of each system with one another. In other words, IME, being extracted from epistemological sources of Islam, presents the guidelines for relationships of systems within itself and with one another. Since the actions of Prophet Mohammad, namely *Sunnah*, are considered as an epistemological source of Islamic values and realisation of general principals in practice, it affects cultural capital both through general principals, namely values, derived from *Sunnah* and through norms which is the embodiment of these values in practice in *Sunnah* due to its dogmatic nature. The reason for such a relationship is that Islam does not only set the general principals, but also posit the implementation of these values through the Prophet which are the part of norms of Islamic order. Language, whose role is self-evident in the cognitive framework, is an example of the effect of *Sunnah* as part of the norm on cognitive repertoires. An analysis of the language used by the Prophet in different circumstances such as in case of a trouble clearly shows how *Sunnah* through the realisation of general principles in practice shape the cognitive framework of individuals.

Each system, based on these guiding principles, creates the roles and institutions to fulfil its task in the society and communicate with other systems. For example, economic and financial system of an Islamic order should establish the roles and institutions in accordance with values such as justice, minimisation of uncertainty, *etc.*

and norms such as invalidity of interest (*riba*) and stating every clause of the contract as clearly as possible without leaving space for any dispute. Any financial institution in this system, for instance, should offer only interest-free products and services which necessitate roles such as entrepreneurs to establish such institutions, product innovators to produce interest-free alternatives, field researchers to reveal the needs of customers, *etc.* Educational system as another system in Islamic order, should establish institutions based on the values and norms of Islamic order with the purpose of providing educated individuals to fulfil the roles within the order without treating human only as an input in a production process, namely human capital. A vital role, therefore, in this order is to sustain the consistency and harmony of all systems working together which is undertaken by IPE theoretical framework.

As depicted in Figure 2.2, *tawhid* is the primer axiom which is derived from the epistemological and ontological sources of Islam. *Tawhid* provides the values, which are general moral principles of the society. It is important to note that such values are articulation of *tawhid* axiom and derived from Islamic ontological and epistemological resources. Utilisation of Islamic values within the frame of *tawhid* axiom has macro level and micro level consequences. As for macro level consequence, these values should be implemented for all stakeholders rather than for a specific group, due to its complementary nature. As for the micro level, these values are valid and have priority over other values for all roles and institutions in all fields of social life. A financial institution within this framework, for instance, cannot utilise capitalist principles over Islamic principles claiming that one is business and should not be interfered with Islamic principles. *Tawhid*, furthermore, constitutes underlying foundation of the dynamic nature of society through the normative guidelines as provided by *rububiyyah* axiom, which suggests that God created everything with a potential for development.

*Rububiyyah* axiom, therefore, provides the underlying foundation of the dynamic nature of the society through the guidelines for the development path. The ultimate aim of *rububiyyah* axiom is to establish roles and institutions in the society to realise the objectives of *Shari'ah*. Since the passing of time and expansion of space leads to emerging needs within the society, existing roles and institutions might not be sufficient to respond realisation of objectives of *Shari'ah*. In such cases, in order to respond the dynamic nature of the society, *rububiyyah* axiom along with *tazkiyah* axiom as its

articulation produce the necessary roles and institution as a result of a negotiation process with ‘norms’ and ‘cultural repertoires’.

Although *rububiyyah* with the objective of providing guidelines for a sustainable development to achieve the objectives of *Shari'ah* is an important axiom to respond the changing time and place, it is also instrumental to restore Islamic values in a society to establish an Islamic order as a result of a drastic change in core values due to an external influence. Imposition of principles of modernity along with its roles and institutions to the colonial world which includes Muslim societies as well, had such an impact on societies. Colonial process, as claimed, aimed to transform ‘irrational’ values of those Muslim societies with ‘rational’ values through a top-down approach of modernity project with the help of imposed roles and institutions in those societies, which eventually, influenced the underlying values of the society. For instance, when institutions of modernity such as bank have been established in non-modern societies, underlying values regarding money and time have changed. As Giddens (2013) suggests, ‘time’ became a concept which could be wasted in such modern societies. Islamic bank as an institution, therefore, might be considered as an outcome of *tazkiyah* axiom in response to the modern institutions of capitalism with the objective of restoring Islamic values in the society.

As an articulation of *rububiyyah* axiom, roles and institutions emerging as an outcome of *tazkiyah* axiom leads to establishment of new roles and institutions as a result of negotiation with existing norms and cognitive repertoires to respond to changes in society and restore Islamic principles. Such a dynamic process is sustained through negotiation of the individual as an active agent in the society and structures and institutions as the articulations of norms and values (Thornton and Ocasio, 2008). *Tazkiyah* axiom, therefore aims to realise the potential of development within every member of the society to elevate each individual to a status of *khalifah* or reaching to the quality of being vicegerent of God on earth. To realise this objective, teaching of justice and benevolence is crucial to achieve IME, since justice and benevolence towards every creature has different forms and needs to be learned. For instance, the highest level of benevolence towards Allah stated in the *hadith* (sayings of the Prophet Mohammad) as “That you worship Allah as if you see Him, for if you don’t see Him then truly He sees you” (Muslim ibn al-Hajjaj, Abd al-Baqi, and Nawawi, 1995).

However, towards a neighbour, *ihsan* might be considered as sharing a plate of food one prepares for his or her family. However, an abstract knowledge without implementation does not develop a society based on IME, which is why *tazkiyah* axiom for the purification of individual and realisation of potential of development path in the sense of establishing justice and attaining *ihsan* requires at least two institutions: (i) institutions for teaching justice and *ihsan* towards others, and (ii) institutions for implementation of theoretical knowledge in society. Both of these institution groups ensure development through theoretical and practical progress at individual level. However, to provide progress at society level and conservation of individual progress, Islamic principles should become underlying values of the society. This development process of individuals from injustice towards benevolence and negotiation of individual with the structures and institutions of the society is a dynamic and never-ending process. Realisation of objectives of *Shari'ah* as an outcome of this dynamic process, hence, also fluctuate. Therefore, the existence of roles and institutions, therefore, to evaluate the realisation of objectives of *Shari'ah* with the objective of providing necessary feedback to *tazkiyah* process to bring the society closer to the ideal state is also a crucial component of IPE. However, it is important to note that IPE may not achieve such an ideal state. The goal, indeed, is not only to achieve a high level of development, but also to struggle to achieve such level as a 'becoming process' in the form of an ongoing journey. Therefore, as long as IPE system works properly and aims to establish the objectives of *Shari'ah* in an Islamic order, the goal, at least partially, is being achieved.

In the next section, ICG based on the aforementioned axioms, narrative and the illustrations is discussed. Then, current situation due to the paradigm shift at the very foundation of Islamic order will be discussed.

### **2.3.3. Constituting Islamic Corporate Governance**

As it is explored above, CG, briefly, is a system which is responsible from directing and controlling corporates. ICG, therefore, is also a system. However, as a result of being part of an 'Islamic order', it is located in IPE and having IME as the underlying value structure. In other words, by definition, ethical norms and principles derived from the epistemological sources of Islam should be embedded in ICG system. The controlling and directing mechanisms of ICG, hence, are based on the axiomatic

framework of IME. Through these foundational axioms, a primarily human-focused, complementary CG system is aimed (Asutay, 2007a; 2007b).

This section attempts to develop an ICG system within Islamic order by locating it as a system, which is connected to the other systems of Islamic order through IME within IPE as the theoretical framework.

As a direct result of having IME as underlying value norms and cognitive repertoires in its aspirational and theoretical frame, ICG aims at fulfilling ethical norms of Islam in all human affairs whether they are economic or non-economic matters that are related to corporate governance. In order to achieve morally-embedded ICG so that it can function effectively and in harmony with other systems, it is crucial to locate ICG within the axiomatic framework of Islamic order. Thus, in terms of the roles and institutions constructed through Islamic values, ICG is an alternative for mainstream CG approaches (Choudhury and Hoque, 2004). Next section, therefore, presents the implementation of axiomatic framework to ICG.

#### **2.3.3.1. Implementation of axiomatic framework to ICG**

*Tawhid* axiom (Oneness of God), as it is stated above, lay the foundation for other axioms and play a decisive role regarding the relationships of systems within Islamic order as well as parts of systems in each system through complementarity within unitarity. As a direct result of *tawhid*, each and every part of a system functions as complimentary to each other by working in harmony to permeate the Islamic order. ICG, hence, as a system within the Islamic order, and as composed of various roles and institutions, necessitates that all stakeholders should be included in consideration in governance structure. In ICG system, hence, there should be roles to ensure such inclusion of stakeholders such as experts to report impact of decisions on various stakeholders such as environmental impacts and social impacts. There should also be institutions, for instance, to ensure that IME is articulated in everyday practice of the corporates. Consequences of such an approach at macro level is, therefore, consideration of other stakeholders, such as nature, workers and even raw materials. Workers, hence, should not be considered only as a means to produce product or a cost for the company, but should be treated as a human-being who has been bestowed rights by Islam and articulated through IME. Accordingly, nature is not considered as a raw

material that corporates can process without considering the consequences for the system, even for the order, but it is considered as a stakeholder and corporates have a certain limit to utilise and benefit from it according to IME. As for the systems, it is more evident that such relationship between various systems is crucial for any order. For example, while education system produces skilled workers for the corporates, legal system aims to keep corporates under control within the current capitalist order. However, within the Islamic order, these systems should be utilised to articulate the Islamic principles such as keeping the corporates operating within the constraints of Islamic ethical order, which is based on the objectives of *Shari'ah* as well as educating the individuals with the aim of their emancipation, not only as skilled workers as an input to a production process.

Complementarity or *tawhidi* nature of Islamic order also has micro level consequences for ICG. Although a corporate has a legal personality, it still enters different fields. Through training programs within the corporate for the employees, for instance, it enters into the field of education. In addition, due to its physical location in various places, it becomes a resident in a neighbourhood. Based on the *tawhid* axiom, it is expected that a corporate governed by ICG should be guided by the objectives of *Shari'ah* in all these fields rather than following other principles or rules alone such as capitalist principles. As a neighbour, for instance, certain rights and responsibilities should be undertaken as a resident of a neighbourhood in terms of environmental issues or respecting local customs rather than following a profit-maximising approach whatever the cost is or undertaking certain social responsibilities with pure intention of profit-making instead of considering these initiatives as a responsibility in return of being a resident within that neighbourhood.

Second axiom, *rububiyyah*, which as mentioned, is defined as divine arrangements for nourishments, sustenance and directing things towards their perfection, requires ICG to develop itself towards perfection, as it grows as a legal personality similar to real personalities. As it develops, due to the complementarity nature of the system, all the parts of ICG develops as well. Relationship of the board with management, management with employees, employees with customers are all interrelated and should develop and direct toward perfection in all sense such as moral values and principles of Islamic order as well as every day operations of the corporate, where the perfection

means the internalisation of the highest level of *ihsan*, implying Islamic ethical values and principles which leads to embeddedness of moral values in everyday lives. Through *tazkiyah* process, individuals and corporates have the potential of traversing from injustice towards *ihsan* level which produce the objectives of *Shari'ah* at the society level.

Third axiom, *tazkiyah*, is the key axiom through which individual (or legal personality) can internalise the IME and realise his potential for being the *khalifah*, God's vicegerent on earth. In order to achieve *tazkiyah*, training and auditing process should be followed to achieve a perfect state of morality. Through training, such as learning the moral values and principles of Islamic order and auditing, namely monitoring the implementation of these principles in practice, corporates can internalise IME in everyday operations of company. Thus, since *tazkiyah* suggests growth in harmony, the growth of each stakeholder within the *rububiyah* has to be facilitated by the corporations. As a result of this axiom, *al-adl* and *al-ihsan* become one of the corporate characteristics. Required roles and institutions to achieve such level should be developed and integrated based on this axiom. Social investment or green investment, for instance, could be considered to a certain extent outcome of such a process. Those companies, through research and training attained a character, namely 'social' or 'green'. Based on this character, they shaped all their operations and product and services. Similarly, a company governed by ICG implying that it has character of being 'Islamic' and should organise and operate the company accordingly which includes 'social' and 'green' characters and go beyond that.

*Al-adl* (justice) is the minimum level of morality that an individual (legal personality) should implement, as below justice, there is injustice. That is why, secular or Islamic law, in most cases, enforce justice. However, what is 'just' may differ from one order to another. Just wage, for instance, can be interpreted differently in a communist order and Islamic order. This axiom, therefore, requires the implementation of justice based on the ethical norms and principles derived from the ontological sources of Islam, namely *Qur'an* and *Sunnah*. Based on this axiom, corporations within ICG system should be just towards each and every part of the system described by Islamic moral economy. Environment, for instance, should be treated justly. This might be achieved through taking necessary precautions to minimise the adverse effects of a production

process. In the same manner, for example, shareholders might be treated justly by utilising their investment in the best possible way. Although being just is the minimum level, since most of the ICG operate under capitalist order rather than an Islamic order, to be ‘just’ means going beyond obligatory regulations and taking voluntary steps to operate justly according to IME.

Fifth axiom is *ihsan* (beneficence) which means ‘going beyond just’ and ‘giving more than necessary’ to the one who deserves that. As the meaning of *ihsan* suggest, it is a voluntary act. As a good and morally acceptable practice, ICG, hence, could realise *ihsan* in its everyday practice. However, lack of *ihsan* also means the lack of perfection or disembeddedness of IME and incompleteness of *rububiyyah*. The axiom of *ihsan*, hence, is an advanced level of development, especially compared to the *homoeconomicus* individual of capitalist order. Hence, IME considers *homoeconomicus* as deficient and inadequate due to not being embedded in the moral values and principles of Islam; as *homoeconomicus* produces performing individual whose rational solution would not stretch to *ihsani* level.

Sixth axiom is the *khilafah*, implying individual’s role as God’s vicegerent on earth. This axiom describes the potential of individual (in the case of ICG, legal personality) to fulfil his or her role as *khalifah* or God’s vicegerent on earth by achieving the normative world of Islam in everyday life (in the case of ICG, in everyday practice of corporate). In this frame, *tawhid* axiom provides the relationship of parts within a system in the form of complementarity relationship, *rububiyyah* and *khilafah* provides the theoretical and abstract framework for individuals or legal personalities. As a direct result, *khalifah* assumes that all the stakeholders are *amanah* or trust from God and, therefore, they have to be treated in the given normative world of Islam. ICG, therefore, should aim to function in harmony with all the ‘trusted’ stakeholders and entities while moving towards perfection in every direction to fulfil its potential as God’s vicegerent on earth in the form of achieving the normative world of Islam in everyday life.

Seventh axiom is *khilkiyyah*, which is defined as affirmative action and behaviour. Through *tazkiyah* process in the path of *rububiyyah*, ethical norms and values are internalised and became part of the corporate culture. In other words, social responsibilities towards the community and other stakeholders of a company governed by ICG becomes part of the nature of the company rather than actions performed as a

result of calculation of profit or other motives. Protecting the environment within ICG, for instance, is not as a result of subsidies, but due to the moral values derived from Islamic principles. It is important to distinguish internal and external forces in the formation of *khilkiyyah* for a company. By external forces, we refer to the norms and values prevailing in a society whether they are derived out of Islamic principles or not. For instance, embracing ‘multiculturalism’ and valuing equally all human beings regardless of their religion, ethnicity, nationality, gender, class, disability and cultural background might be a norm in a society such as the experience in the UK. As a result of such norm, companies attain these attitudes as part of their main characteristics. Such principles, if they are in compliance with the IME, should be internalised as it is a requirement of IME as well. However, if there is a contradiction, methods to overcome such contradiction to sustain IME character should be developed. As for the internal sources, these might be different than prevailing norms within a society and may represent even further articulations of benevolence through research and training within a corporation. As a result, through internal development mechanisms as an articulation of *rububiyyah* axiom, corporations within ICG can transform Islamic principles as part of their affirmative action and behaviour, namely their corporate code.

As regards to the articulation of *ikhtiyar* (free-will) axiom in producing ICG, it is the necessary condition to achieve perfection and internalisation of IME in the operations of a corporation. If there is no free-will, *tazkiyah* process would not be accomplished, since every voluntary act would be regulated or there would not be any chance to choose *tazkiyah* in the path for *ihsan*, due to the lack of free-will. Free-will, hence is the condition of possibility to internalise IME and develop towards becoming *khalifah* or God’s vicegerent on earth through actualising *khilkiyah* process.

As a result of implementation of this axiomatic framework by ICG system, *maqasid al-Shari’ah* or objectives of *Shari’ah*, which is defined as human well-being in whatever is done, would be achieved in corporates at micro level and through their effect at the macro scale, in a wider level for all stakeholders. In practice, however, ICG is failed to achieve such aspirational goals as it is evident from the current convergence of Islamic banking sector towards conventional banking which led to the observed social failure of Islamic banking (Asutay, 2007a; 2012a) as a result of share-holder oriented entities

in their CG structure (Hasan, 2011), whereas they should internalise ICG approach as a result of IPE framework since it is ethical and moral value oriented (Hasan, 2009).

This study argues that such failure is first and foremost due to the paradigm shift in ontological sources which led to a change in the values and norms of societies. As a result of this shift, IBs, albeit being Islamically oriented in terms of their financial transactions being *Shari'ah* compliant, conduct their operations mostly based on values and norms derived from neoclassical axioms, which is a product of modernity, and Islamic sources are utilised to provide legitimacy, not to channel the way these institutions operate their everyday transactions. In other words, instead of being located in an Islamic order, ICG is located within a capitalist order which causes a convergence in terms of roles and institutions which is a result of lack of fulfilment of axioms of IME.

Failure of Mit Ghamr Bank of Egypt, the first Islamic (social) bank established in 1963, in the long run could be considered as an example of such paradigm shift. Mit Ghamr Bank, a hybrid saving bank which aimed to combine structure of a modern banking institute, namely saving banking, with values of an Islamic order, failed to last long enough to provide an alternative banking system due to the pervasive norms of modernity in the society and business sectors; yet it led to the emergence of modern IBs which operate according to the neoclassical economic axioms, yet seek for legitimacy from Islamic sources through utilisation of *Shari'ah* scholars.

#### **2.3.4. Convergence and Divergence between Islamic Conception of Corporate Governance and Conventional Corporate Governance**

Although conventional CG theories have been instrumental in explaining the practice in the conventional sector, they do not fit into Islamic CG frame due to difference in approaches towards human nature, source of legitimacy and stakeholders emerging from ontological differences. Therefore, in the preceding section an attempt is made to construct a distinctive ICG to develop within IPE theoretical framework.

In comparison, agency and stewardship theory, for instance, are different in their appeal, yet they share a common feature: making judgements regarding the human nature and assuming that these judgements are stable and do not change. However, as

an articulation of *tazkiyah* (purification and harmony) axiom, IME is “concerned with growth towards perfection through purification of attitudes and relationships” (Ahmad 1994: 20), which suggests a dynamic process in the sense that Islam suggests ‘a becoming process’ in reaching *falah* and *ihsan*. An agent may be a self-interested individual, and agency theory, hence, could be useful to explain behaviour in such a case. Nevertheless, through training, education and other forms of *tazkiyah* (purification) process such an individual should develop and internalise IME principles in an embedded manner and act accordingly. Such a dynamic process requires training in multiple dimensions, not limited to training for professional life but also includes ethics. Stewardship theory, on the other hand, represents the other side of the spectrum; instead of a self-interested manager, it relates to a manager type who works for the good of a corporation. Hence, it might be suitable in explaining the later stage or the consequence of progress, followed by the successful application of *tazkiyah* process in one’s life in the initial stage. Nevertheless, both of these conventional theories suggest that managers do not consider the stakeholders of the corporation in the decision-making process: in agency theory, agency consider him/herself, while in stewardship theory, agent considers the company. On the other hand, IME suggests that ICG should take all the stakeholder into account with the objective of maximising the overall well-being of stakeholders without compromising the interest of one for another, as an articulation of *tawhid* or the complementarity and unitary axiom within a holistic approach. In other words, it suggests the optimisation of the interests of all stakeholders in a process.

TCE theory shares the similar problems with agency theory since the underlying theory is similar, yet TCE looks at the firm from a contractual perspective which makes it different. As for legitimacy theory, the most important difference between legitimacy theory and ICG is mainly ontological. According to legitimacy theory, firms strive to gain legitimacy from the public. In ICG, however, by definition, firms should have Islamic legitimacy by conducting business according to *Shari’ah* as an articulation of *tawhid* axiom. In other words, in both ICG and legitimacy theory, gaining legitimacy has a crucial role. However, the direction of causality is different: in legitimacy theory, it goes from public to firm, while in the case of Islamic ontology, legitimacy deductively provided by *Shari’ah* in form and substance. Therefore, *Shari’ah* governance plays a

crucial role in IBs since they testify *Shari'ah* legitimacy of products and services which is communicated to the stakeholders by *Shari'ah* annual reports or SAR.

We can argue that the closest CG theory to ICG is stakeholder theory due to its comprehensive nature in taking into account the interest of all the stakeholders within the surrounding (Iqbal and Mirakhor, 2004). However, despite the observed proximity, there are still ontological differences. First and foremost, the cause of comprehensiveness is different: stakeholder theory takes stakeholders into account in order to gain competitive advantage. Since the motive behind such a comprehensive approach is competition, a stakeholder which does not contribute to the shareholder value might be excluded. However, comprehensive nature of ICG stems from IME as an articulation of *tawhid* axiom, which, as mentioned, suggests that all the stakeholders complement each other implying that exclusion of one or another stakeholder would violate the running of the whole system (Choudhury, 1986). For example, climate change and other environmental problems stem from, we argue, from the lack of such a complementarity approach; as they are not included as a stakeholder until the damage given to environment bounced back and start to influence capitalist system. In ICG, such comprehensiveness is not due to the pragmatic nature of ICG, but complementary nature of the governance.

In sum, there might be convergence in the practice of conventional CG and ICG, and therefore we might benefit from the existing theories. However, the issue is the ontological nature of how we perceive, understand and conceptualise CG and place of *Shari'ah* governance in the CG. Therefore, an Islamic based CG or ICG understanding is crucial for IBs so that consistency can be achieved within these institutions since by definition, the working mechanism of these institutions, namely IBs, should be determined by the same ontological paradigm. In other words, having their financial instruments being subjected to *Shari'ah* compliancy is not enough with IPE, as IME has to determine the nature of their existence and governance so that *tawhid's* complementarity can also be achieved in the integral working and governance of an organisation.

### 2.3.5. *Shari'ah* Governance: A Piecemeal Approach to ICG

A crucial component of ICG is *Shari'ah* governance which is expected to be determined by IPE frame and IME's substantive morality, through which IBs secure that the operations within IBs are in line with the objectives of *Shari'ah*. Existing *Shari'ah* governance structure, however, ensures a piecemeal approach in ICG, as it relegates ICG solely to *Shari'ah* compliancy in financial aspects of the operations and hence prevents an integrated approach in as essentialised by ICG.

The most important unit in *Shari'ah* governance is SB, which is composed of *Shari'ah* scholars who are knowledgeable in Islamic law and mechanism of economics and finance charged with the duty for achieving form and substance requirement of IME. Main responsibilities of SB are (Banaga *et al.*, 1994; Hassan, 2012):

- (i) provision of legal opinions based on Islamic law;
- (ii) control and review of the operations within the company to monitor *Shari'ah* compliancy of the firm;
- (iii) preparation of contracts.

SB, hence, is the core department which renders the Islamic identity of these institutions. As Ibrahim *et al.* (2009: 233) also evidence, demand for IB institutions stem from offering *halal* or Islamically legitimate products and services as more than 95% of the respondents suggested that “compliance with *Shari'ah* law is a fundamental requirement in terms of ‘*halal*’ type of investment and investment structure”.

The role of *Shari'ah* scholars in IBs within ICG framework is to ensure and demonstrate that IBs are legitimate institutions according to *Shari'ah* frame and operate within IPE framework with the objective of fulfilling the ethical expectations of IME. Therefore, ICG system demands that SARs of SBs should provide the necessary disclosure to convince all the stakeholders, particularly disclosure of not only form oriented partial compliancy but also moral compliancy.

In practice, however, SBs mostly follow the *Shari'ah* standards issued by AAOIFI rather than pursuing a more comprehensive and holistic approach in terms of supervision within the framework of IPE. Considering that AAOIFI *Shari'ah* standards

were issued, as it is stated by the Chairman of *Shari'ah* Board of AAOIFI, “in order to provide a reference for Islamic banks and financial institutions to comply with *Shari'ah* in their transactions and products and to harmonize various Fatwas issued by different *Shari'ah* Supervisory Boards (SSBs)” (AAOIFI, 2015: 10), it is clear that AAOIFI *Shari'ah* standards do not provide the necessary means to achieve articulation of IME in IBs. As part of the *Shari'ah* governance standards of AAOIFI, standards for SAR suffer from a similar shortcoming as guidelines for SAR suggest a form-oriented and summary disclosure which reveals that essentialisation of the morality of *Shari'ah* in IBs is not a ‘standard’.

Although it is a fact that AAOIFI based CG and *Shari'ah* governance is an important step in the right direction in shaping the operations of Islamic banks, as this study has argued so far, *Shari'ah* compliancy should not be relegated to form oriented understanding in mimicking the conventional practice as the practice of IBs so far suggests. Instead, IBs must also develop their operations and governance within theoretical ICG as developed in this study to ensure that they have macro level compliance as well in the sense that *the entire operations of IBs fulfils form oriented Shari'ah and moral expectations of IME and structure dynamics of IPE*.

In an attempt to identify the distinctions between form oriented ICG that prevails in the IB industry and IME enhanced theoretical ICG developed in this study, this study identifies two sets of indices in examining the communicated information in the SAR of IBs. The first one relates to AAOIFI's expectations, while the second one relates to further ethical compliancy required by ICG so that a consistent and integrated approach should be developed, as the latter aims to articulate the normative requirements of IME in the operations of IBs. Such a frame is expected to reveal the ‘Islamic’ in IBs operations. Next chapter, hence, explores an analysis of SARs published as part of the annual reports of the sampled IBs with the intention of revealing to what extend *Shari'ah* scholars fulfil this mission.

#### **2.4. ISLAMIC MORAL ECONOMY FOUNDATIONS OF ISLAMIC FINANCE**

The preceding section presents an ICG system constituted through IPE's theoretical paradigm and its moral substance articulation in the form of IME. Since this study

relates to application of CG or ICG in particular the performance of SBs and *Shari'ah* scholars, it is also important to identify the IME foundations of Islamic finance and banking beyond its *fiqhi* or form-based practice. This is important as this study argues that IBs have diverged from their original objective function as expressed by IME by converging towards conventional finance and banks under the hegemony of market system which pre-empts the roles of *Shari'ah* scholars. Therefore, it is important to understand the Islamic normative constructs of IBs in understanding the observed divergence and the role played by *Shari'ah* scholar, as one of the main thrust of this research is on the changed role of *Shari'ah* scholars in relation to the historical experiment.

While in its modern version, IBs and IFIs emerged in first as a social bank in the case of Mith Ghamr bank, the model adopted from 1975 onward is the commercial banking model based on shareholder value paradigm within neo-classical economics objectives. Within the dual banking system, with the initial capital and liquidity provided by the emerging wealth from petro-dollars, IBs and IFIs have become important financial players all over the world due to the financial liberalisation policies pursued in the 1990s in most of the Muslim countries in particular and in world economies in general. In addition, the authentic Islamic identity search and construction has played an important role in the emergence of Islamic economics movement in the post-colonial period (Asutay, 2013). The Banker (2017) indicates that the assets size of IBs has passed USD 2 trillion, while Thomson Reuter (2017) states that the entire *halal* markets (the *Shari'ah* compliant goods and services markets) including IBs and IFIs has already passed the USD 5 billion. As both of the sources indicate, it seems that most of the countries in the world, now, have one way or another affected and involved in IBs and IFIs or *halal* industries.

The dual banking paradigm has facilitated the diffusion of IBs along with other macroeconomic and policy factors (Imam and Kpodar, 2010; 2013). However, with the internationalisation of IBs and IFIs since the 1990s, the industry has experienced a convergence towards conventional financial sector in its instruments, products and operations, which has received criticism in many academic and professional circles (among others *see*: El-Gamal, 2007; Khan, 2010; Asutay, 2007b; 2012a). This criticism is based on the fact that Islamic banking and finance industry essentialises forms of

*Shari'ah* in responding to market requirements in increasing efficiency, cost minimisation and increasing the shareholders' value in contrast to Islamic ideals of contributing to social good and social justice as identified through IME.

As identified in Chapter 1 and discussed in detail in Chapter 6, the modern IBs and IFIs work within the parameters of negative screening imposed by *Shari'ah*, namely prohibition of *riba* (interest), *gharar* or excessive uncertainty, gambling or *maysir*, speculation, limited debt in business (as debt of a business should not exceed 33%), and avoidance of certain business sectors which are considered harmful to human well-being. While IBs and IFIs operations in contemporary times is shaped by these forms based negative screenings developed from *Shari'ah*, SBs in these institutions are expected to ensure such screening process is robustly implemented.

The IBs and IFIs are expected to utilise certain financial instruments historically available to ensure the *Shari'ah* compliancy, while these instruments and the new product developments have to fulfil the *Shari'ah* conditions stated above. While literature provides detailed understandings of these instruments, they are mainly classified as Profit-and-Loss Sharing (PLS) instruments which are mainly equity-based financing (such as *musharakah* and *mudarabah*) and Fixed Income or Debt-Based instruments, which are mainly mark-up priced and deferred payment-based instruments (such as *murabahah*, *ijarah*, *salam*, *istisna*) can be mentioned in the most traditional forms of Islamic financing<sup>2</sup>. In recent years, as discussed in detail in the following chapters, *tawarruq*, a short-term liquidity instrument, is heavily utilised in its organised *tawarruq* form (rather than the traditional *tawarruq*) in the operations of IBs and IFIs. The expansion of Islamic finance sector has also witnessed the emergence of Islamic

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<sup>2</sup> The following definitions are developed from Asutay (2015a: 13–14), Iqbal and Mirakhor (2011) and Ayub (2007).

*Musharakah*: A profit and loss sharing contract whereby two or more partners contribute capital to set up a company/project with the intention of generating profit.

*Mudarabah*: A special type of partnership whereby one party provides the capital while the other party provides the expertise.

*Murabahah*: A sale contract whereby the seller discloses to the buyer both the cost of the subject matter and the profit margin realised by the seller through the sale transaction.

*Ijarah*: A lease contract whereby the usufruct of a subject matter is let from the lessor to the lessee for an agreed period and consideration.

*Salam*: A sale contract involving spot payment of the sale price and deferred delivery of subject matter.

*Istisna*: A sale contract whereby the seller, based on the request of the buyer, makes, manufactures or constructs a subject matter according to agreed specifications to be delivered on future date.

capital markets, and therefore *sukuk* or Islamic bond have become an essential instrument for project and infrastructure financing.

As discussed above, however, Islamic economy including banking and finance should be formed within IME as structured by IPE. As discussed in detail, IME paradigm within IPE framework emerged as a counter hegemonic movement and a double movement as articulated by Polanyi (1957) to overcome the hegemony of capital by rescuing land, labour and capital and essentialising human well-being or *maqasid al-Shari'ah* with the objective of reaching *ihsani* (beneficence) society so that the aim of emancipating and empowering individual can be achieved (Asutay, 2017a). Therefore, through its own system (Asutay, 2007a), it requires not only the form or *fiqh* related matters to be essentialised in the operations of IBs and IFIs but also the substance of IME as an essential condition to be fulfilled. Thus, Islamic banking and finance should not only be governed and regulated by *fiqh* and also by the moral economy conditions and requirements of Islam.

Since IME's substantive morality and its constituents and articulations are discussed above, it is not repeated here. However, their implications for Islamic financing is important to state. Thus, Islamic financing and hence IBs and IFIs are expected to perform with the social formation of Islam as identified by IME, which suggests that they should be embedded in the social formation of societies in which they are operating, as and hence should be organically linked to the value system of Islam in their construct and operations. Therefore, IME suggests that economic and financial activity should also be determined by non-economic factors alongside their economic and financial rationale. With such a feature, they are expected to contribute to the social good in developing the *ihsani* social capital as a social formation of societies as detailed above. Thus, IME suggests a sharing and collaborative economy (Asutay, 2017a).

IBs and IFIs, thus, in an aspirational sense, are expected to articulate the axiomatic consequences in their operations in serving interest of all the stakeholders defined by *tawhid*. Such embeddedness also requires IBs and IFIs directly relate to real economy by avoiding financialisation; and hence each transaction, by definition, should be backed by an asset to prevent financialisation. Therefore, equity-based financing in the form of PLS is considered as the main thrust of Islamic financing with the objective of limiting the debt-based financial system, as debt is discouraged.

In shaping Islamic financing, IME relates the prohibition of *riba*, *gharar* and *maysir* to define a particular modes of production in the society through a sharing economy so that the domination of one factor of production, such as capital, should be overcome as complementarity within unitarity of *tawhid* suggests that the interests of all the stakeholders should be considered (Asutay, 2017b). As a consequence of such a mode of production based on sharing-economy, an important feature of Islamic financing is the essentialisation of ‘risk-sharing’. Therefore, *takaful* or mutuality is essentialised in IME, and Islamic financing is expected to essentialise *takaful* as a property of IME, too; and this should not be limited to Islamic insurance or *takaful*. Furthermore, in line with the IME principles, Islamic financing is expected to prevent commodification and fictitious commodities in the sense that one cannot sell what he/she does not have. Moreover, IME essentialises the distributive mechanism as part of its search for good society as identified by *ihsani* society objective. Therefore, not *zakat* (mandatory alms giving) is essentialised as a *fiqhi* duty, but individuals are expected to contribute to the *ihsani* society with their proactive participation. Such a sharing economy as well as PLS and risk sharing nature refers to the development of ‘participatory society’ project.

While IME’s aspirational principles provides a moral economy base for IBs and IFIs in their operations, such principles are in contrasts with the hegemonic and prevailing economic stricture and capitalist modes of production and its political economy. IBs and IFIs, as a result, should be considered as solutions towards fulfilling certain aspects of Islamic economy so that finance related Islamic behaviours can be authenticated in the modern capitalist economy, as they, by definition, cannot operate under IME while regulated and operating within capitalist economy, as the hegemony (capitalist political economy), by definition, does not allow a counter hegemony (IPE and IME) to emerge. Therefore, as a solution, IBs and IFIs in the form of commercial banking and financial institutions model have been encouraged to work within dual banking system by convergence process as discussed in detail in the following chapters.

As part of the convergence, Islamic banking and finance industry is marked with financialisation and increased use of debt-based instrument and financing, and hence equity financing in the form of PLS has been withered away (Nagaoka, 2007; Asutay, 2012a; Aggarwal and Yousef, 2000; Avdukic, 2016). As a consequence, risk sharing paradigm has been replaced by risk-shifting strategies as we see in conventional finance

and banking. Furthermore, commodification and creation of fictitious commodities has become important part of IBs and IFIs (Aksak and Asutay, 2015). Moreover, as stated in Chapter 1, in CG of IBs rather than ICG as theorised in this study, CG is structured through shareholder value.

In conclusion, IBs and IFIs are considered as hybrid institutions of the prevailing economic order rather than working within their IPE structure and IME foundations through the convergence process leading to 'social failure' (Asutay, 2007b; 2012a). One of the important sources of the convergence is attributed to *Shari'ah* scholars and their facilitatory role in legitimising the mimicry and convergence through their 'rational-legalistic and form-based' approach to *Shari'ah* compliancy by ignoring that substance and moral foundation of Islam as described by IME, which should also be part of the *Shari'ah* compliancy process. The rest of this research, hence, focuses on the role of *Shari'ah* scholars in IBs and how their role has evolved throughout history, which seems to end with being signified by modern IBs and IFIs (rather than *Shari'ah* scholars signifying them). The next chapter, thus, aims to provide an empirical analysis on the SBs to identify how *Shari'ah* scholars relinquish their *Shari'ah* compliancy duty in IBs by disclosing information on the nature of *Shari'ah* compliancy in their respective IBs.

## **2.5. CONCLUSION**

This chapter is an attempt to develop a theoretical framework to locate systems including but not limited to corporate governance within an Islamic order, namely IPE which is interlinked with IME as its substance. Existence of roles and institutions emerging as articulation of IPE and values, norms and cognitive repertoires as IME is essential to sustain consistency and harmony within Islamic order.

Since, by definition, Islamic banking sector suggests a particular ontology and epistemology, namely Islamic, constructing an ICG system within IPE framework with IME as the underlying substance is crucial for the everyday practice of IBs and their compliancy with Islamic order. In IPE, *tawhid* axiom requires a complementary approach for each stakeholder at macro level and articulation and prioritisation of values of IME in each and every field of actors within the society. *Tawhid* axiom, therefore, requires ICG system to develop roles and institutions to ensure its macro and micro level articulations with the objective of producing individual *falah* and *ihsan* at

societal level as an outcome. *Shari'ah* governance as an institution and *Shari'ah* scholarship as a role serves for such a goal in IBs.

Since society is a dynamic entity, new problems might emerge due to the internal or external factors. In terms of *Shari'ah* governance, for instance, due to the transformations between pre-modern and modern period, role and status of *Shari'ah* scholars have changed in the society, which, in some cases, leads to inadequacy of SBs in terms of protecting objectives of *Shari'ah* in IBs. *Rububiyyah* and *tazkiyah* axioms, in such cases, sustain the dynamic nature of IPE by responding to such emerging problems through constructing new roles and institutions in compliance with the existing norms and cognitive repertoires in the society.

Introduction of national *Shari'ah* boards to oversee the operations of IBs in some countries due to the inadequacy of firm level *Shari'ah* governance, for instance, could be considered as articulation of these axioms. However, despite the amendments and introduction of roles and institutions to locate IBs within ICG system, due to the underlying capitalist values at the society level in majority of Muslim societies, IBs are stuck in a conflict between ICG as their governance system and having IME as the underlying value system derived from Islamic ontological and epistemological sources and hegemony of conventional banking sector having modern and capitalist values as the foundation which are derived from a positivist ontology.

Since the role of *Shari'ah* scholars in IBs within ICG framework is to ensure and demonstrate that IBs are legitimate institutions according to *Shari'ah* frame and operate within such framework in the sense of following a *tawhidi* axiom, which requires approaching all the stakeholders as a complementary part of corporate, it is expected that their SARs should reflect such an approach and provide necessary disclosure to convince stakeholders, particularly customers to this.

The next chapter (Chapter 3), therefore, explores and examines the level of disclosure in SARs through two indices one reflecting the general practice through AAOIFI standards, while the second index aims to capture the some of the imaginations of IME expectations.

## CHAPTER 3

# THE STATE AND THE DETERMINANTS OF ISLAMIC GOVERNANCE DISCLOSURE IN ISLAMIC BANKS: ANALYSIS OF *SHARI'AH* ANNUAL REPORTS

### 3.1. INTRODUCTION

Islamic banks (IBs), as discussed in Chapter 2, have emerged to provide *Shari'ah* compliant financing products to overcome the observed financial exclusion due to religious reasons. In its origin, IBs are expected to fulfil IME objectives of serving an extended stakeholding interest, as the model developed in Chapter 2 identifies. However, due to piecemeal strategy of introducing IBs within the existing financial systems as hybrid institutions as part of the dual banking system, the *Shari'ah* compliancy of the financial instruments and products provided by IBs should be ensured, as they are not embedded in Islamic value system and Islamic Corporate Governance (ICG) System essentialised in Chapter 2. As part of such a contemporary need, as discussed in Chapter 2, *Shari'ah* Board (SB) as an institution has been innovated and constructed to operate within IBs.

SB is one of the most important and distinguishing features of ICG in IBs. The role of SB is to assure that operations of IBs are in compliance with *Shari'ah* rules and principles through directing, reviewing and supervising financial transactions and activities within an IB (Malkawi, 2013). Alongside with providing customers with confidence in *Shari'ah* compliancy of products and services of IBs in their everydayness, as AAOIFI (the Accounting and Auditing Organisation for Islamic Financial Institutions) standards identify, SBs are expected to issue an annual report, *Shari'ah* Annual Report or SAR to communicate and disclose the necessary information to ensure stakeholders that the operations of IBs are conducted according to *Shari'ah* rules and principles. Although SB's annual report is the most important

intermediary between SB and stakeholders, the extent of disclosure of SBs vary among the IBs considerably as it is determined by individual SB's efforts and transparency.

Although SB is the most crucial division of CG in IBs in terms of securing the 'Islamic' identity of these institutions, their most important communication instrument, namely SAR has not been explored sufficiently. As discussed in the literature review section in the following section, there are two important gaps in the literature in terms of exploring and examining SARs: small sample size and inadequate index construction. As for the small sample size, the studies conducted so far contended mostly with one or two years of analysis, which hinder the opportunity of observing the change in level of disclosure in SARs throughout the sampled years. Furthermore, the sampled IBs have been selected from a small number of countries apart from El-Halaby and Hussainey's (2016) study, which extends the study to eight countries, but considering, however, only one year. The second important gap in the empirical literature relates to index construction due to being disclosure analysis-based studies. As discussed in the following section, the empirical studies available in the literature either explored SARs with a small number of index items, or at best, with extended index items but limited to the AAOIFI guidelines. In other words, the indices have been constructed on the assumption that AAOIFI guidelines regarding the SARs are the best practice, since it is assumed that AAOIFI represents the main standard setting body.

This study, however, takes a critical approach towards AAOIFI guidelines and construct a more demanding and extended index based on IME's substantive morality derived from theoretical framework of IPE, which is developed in the preceding chapter (Chapter 2). This is rationalised on the ground that IBs' Islamic compliancy should not be limited with 'legal and form' matters but also with 'substance', as Islam suggests a comprehensive and integrated view of the world (Naqvi, 1994; Asutay, 2007a; 2007b). This research, consequently, employs two different indices; first index is constructed based on AAOIFI guidelines for preparing SAR and second index extends AAOIFI guidelines according to the theoretical framework of IPE as it is articulated through substance of IME, which essentialises more detailed level of disclosure due to its emphasize on ethical outcomes such as transparency along with other features based on the substantive morality argument of IME. This constitutes a significant and critical conceptual contribution of this study in relation to the existing body of knowledge.

In order to fill the identified gap in the literature, as the aims, objectives and research questions identified in Chapter 1, this empirical study aims at examining the extent of disclosure in the SBs' annual reports or SARs in the case of 41 Islamic banks from 15 different countries for the period of 2007-2014 by employing two different indices in capturing form as well as form and substance related disclosure. In addition, this study also examines the determining factors of disclosure performance through bank level and country level variables. The empirical contribution is also significant as this study provides the largest sample size for SAR based disclosure analysis.

The rest of the chapter is developed as follows: Section 2 provides a survey of empirical literature; while Section 3 discusses methodology of the study and data. In section 4, we present the empirical findings of disclosure analysis. Section 5 provides the concluding remarks.

### **3.2. SHARI'AH GOVERNANCE: A SURVEY OF EMPIRICAL LITERATURE**

In recent years, we have witnessed the burgeoning research and publication in Islamic finance and also in Islamic accounting related areas including CG in IBs. However, as indicated by the literature, the available studies within disclosure related research in IBs neglect to analyse *Shari'ah* annual reports (SARs) issued by SBs, and, they mostly focus on the level and determinants of disclosure of corporate social responsibility (CSR) or other aspects of CG in IBs (*see: Al-Baluchi 2006; Darmadi 2013; Farook et al., 2011; Hameed and Sigit, 2005; Rahman et al., 2010; Hassan and Harahap, 2010; Aribi and Gao, 2010; Mallin et al., 2014*). Therefore, literature focusing on the level of disclosure in SARs is scarce and rudimentary, if any. For instance, Md Rahin (2009) analyses disclosures on the SBs by only investigating their existence without examining contents of the SARs. Nonetheless, there were researchers who aimed to fulfil this gap: Haniffa and Hudaib (2007), for instance, incorporated SB related disclosures in annual reports of IBs including but not limited to some SAR components as further dimensions into their ethical identity index with a sample of seven IBs over a three-year period. Although *Shari'ah* Board dimension of their study includes only 11 index items, only three out of seven SBs were found to be communicative with an average above 50%.

In country level study, Hameed (2009) conducted a research on SARs of IBs with a sample of IBs from Malaysia, Bahrain and Pakistan in 2005 and 2006. Even though this study does not employ a disclosure index, it provides some insights regarding SARs. As Hameed (2009) reports that there is a big gap in the disclosure level between SARs of Pakistani and Malaysian IBs, Pakistani IBs being the most comprehensive in contrast to Malaysia.

In a more detailed analysis of SARs compared to Hameed (2009), Abdullah *et al.* (2013) investigated disclosures of the SBs of 23 IBs from Malaysia and Indonesia by employing a modified version of disclosure index proposed by Maali *et al.* (2006). Although Abdullah *et al.*'s (2013) study is more detailed compared to the Hameed (2009), their study was limited to only two countries. Their results demonstrate that SB-related disclosure performance of the sampled banks is very limited, which is even true for the disclosure of sensitive and highly necessary information. As for the factors affecting disclosure related SBs, cross-membership with other SBs and the expertise of SB members in finance related subjects are found to be influential (Abdullah *et al.*, 2013).

In his detailed analysis of the *Shari'ah* governance in Malaysia, GCC and the UK, Hasan (2012) also examined SARs as part of *Shari'ah* governance framework with a sample of SARs published in annual reports of 2007 and 2008 of several Islamic Financial Institutions (IFIs), albeit not in depth. In his questionnaire based study, Hasan's (2012) study demonstrates drastically low scores regarding the disclosure of duties and services of the SB: 45% of IFIs in Malaysia and 11.1% of IFIs in GCC countries disclosed information about duties and services. In addition, these scores decrease further when the disclosure of the SB activities are concerned (5% of IFIs in Malaysia and 7.4% of IFIs in GCC countries and none of the IFIs in the UK). Based on these scores, Hasan (2012) concludes that majority of IFIs in Malaysia, GCC countries and the UK did not operate according to AAOIFI format of the SARs.

In a recent and comprehensive study, El-Halaby and Hussainey (2016) examined the disclosure practice of 43 IBs that adopted AAOIFI standards for the year 2013. They explored the *Shari'ah* Supervisory Board disclosure in addition to corporate social responsibility and financial disclosures. Although their study is not exclusively for SARs, as the authors claim, it is the most comprehensive analysis of SARs based on

AAOIFI guidelines. El-Halaby and Hussainey (2016) found a relatively high disclosure level (68%) based on their index in which age, size and existence of internal *Shari'ah* department were found to have significant impact on such level of disclosure along with SB characteristics.

### 3.2.1. Econometric Specifications for Measuring the Determinacy of Disclosure in SARs

As mentioned above, in addition to identifying the level of disclosure in IBs, this study also aims at empirically testing the factors determining the disclosure in SARs. As detailed above, two disclosure indices are developed and calculated, namely  $SDI_{General}$  and  $SDI_{AAOIFI}$  indices, to fulfil the initial aim. The former is based on the index elements defined in Table 3.2 representing a larger number of items based on more stringent definition of disclosure, while the latter is defined through AAOIFI standards and composed of items 1-18 in Table 3.2. As responding to the second aim, in order to determine the factors affecting  $SDI_{General}$  and  $SDI_{AAOIFI}$  indices calculated through the data generated by disclosure analysis, the following two econometric model specifications are estimated:

$$\begin{aligned}
 SDI_{General,t} = & \alpha_0 + \alpha_1 x SDI_{General,t-1} + \alpha_2 x Crisis2009_{i,t} + \alpha_3 x NoofMembers_{i,t} \\
 & + \alpha_4 x PopularityofMembers_{i,t} + \alpha_5 x AverageEducation_{i,t} + \alpha_6 x InternalSAD_{i,t} \\
 & + \alpha_7 x AgeofShariah_{i,t} + \alpha_8 x IsCountryAAOIFI_{i,t} + \alpha_9 x Leverage_{i,t} \\
 & + \alpha_{10} x IndependentAuditor_{i,t} + \alpha_{11} x LogSize_{i,t} + \alpha_{12} x ROA_{i,t} + \alpha_{13} x \\
 & CPI_{i,t} + \alpha_{14} x GDPGrowth_{i,t} + \alpha_{15} x RegularityQuality_{i,t} + \alpha_{16} x \\
 & VoiceandAccountability_{i,t} + \alpha_{17} x CEODuality_{i,t} + \alpha_{18} x BoardSize_{i,t} + \varepsilon_{i,t}
 \end{aligned} \tag{1}$$

$$\begin{aligned}
 SDI_{AAOIFI,t} = & \alpha_0 + \alpha_1 x SDI_{AAOIFI,t-1} + \alpha_2 x Crisis2009_{i,t} + \alpha_3 x NoofMembers_{i,t} \\
 & + \alpha_4 x PopularityofMembers_{i,t} + \alpha_5 x AverageEducation_{i,t} + \alpha_6 x InternalSAD_{i,t} \\
 & + \alpha_7 x AgeofShariah_{i,t} + \alpha_8 x IsCountryAAOIFI_{i,t} + \alpha_9 x Leverage_{i,t} \\
 & + \alpha_{10} x IndependentAuditor_{i,t} + \alpha_{11} x LogSize_{i,t} + \alpha_{12} x ROA_{i,t} + \alpha_{13} x \\
 & CPI_{i,t} + \alpha_{14} x GDPGrowth_{i,t} + \alpha_{15} x RegularityQuality_{i,t} + \alpha_{16} x \\
 & VoiceandAccountability_{i,t} + \alpha_{17} x CEODuality_{i,t} + \alpha_{18} x BoardSize_{i,t} + \varepsilon_{i,t}
 \end{aligned} \tag{2}$$

where  $i$  denotes individual banks and  $t$  denotes the time dimension. While the first equation uses 17 explanatory variables to explain the variation in  $SDI_{General}$ , the second equation uses the same variables to explain the variation in  $SDI_{AAOIFI}$ .

### 3.2.2. Hypothesis Development

In order to determine the factors affecting the level of disclosure in SARs,  $SDI_{General}$  and  $SDI_{AAOIFI}$  are used as dependent variables to assess the impact of country-level and bank-level factors.

In modelling, 5 country-level and 12 bank-level independent variables were utilised to measure the variation in the level of disclosure of SBs. In determining the independent variables, the existing empirical papers, among others, Mollah and Zaman (2015), Abedifar *et al.* (2013) and El-Halaby and Hussainey (2016) were consulted. Table 3.1 provides a list of all independent variables.

As it can be seen in Table 3.1, first set of indicators are themed as ‘Regulatory Quality and Voice and Accountability’, for which data were obtained from The Worldwide Governance Indicators (WGI) Project which is available online. In the literature, it is argued that a higher regulatory quality requires a greater transparency (Ernstberger and Grüning, 2013; Leuz *et al.*, 2003), therefore, it is expected that there should be a positive relationship between regulatory quality and the level of disclosure.

As for the ‘voice and accountability dimension’ of WGI, it is suggested that a high level of voice and accountability leads to ability to pressurise public administrations to prevent corruption (Apaza, 2009), which is related to the level of disclosure as a method of preventing the corruption through transparency (Wang *et al.*, 2004). A high level of voice and accountability, thus, is expected to have a positive impact on disclosure level of SBs. We hypothesise, therefore:

*H<sub>1</sub>: There is a positive relationship between regulatory quality of the country and level of disclosure in SAR.*

*H<sub>2</sub>: There is a positive relationship between voice and accountability of the country and level of disclosure in SAR.*

‘Corruption Index’ which is calculated and provided online by Transparency International is also included as an independent variable for the disclosure level of SBs. This is because, as mentioned above, it is suggested that transparency through disclosure of information is a way to tackle the problem of corruption (Wang *et al.*,

2004), and, therefore, a higher score of corruption index, meaning the cleaner the country is in terms of corruption, is expected to be related with a high level of disclosure.

*H<sub>3</sub>: There is a positive relationship between corruption index score of the country and level of disclosure in SAR.*

**Table 3.1: List of Independent Variables**

Country Level Independent Variables		Definition	Source
1	Regulatory Quality	Regulatory quality captures perceptions of the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector development.	WGI Project
2	Voice and Accountability	Voice and accountability captures perceptions of the extent to which a country's citizens are able to participate in selecting their government, as well as freedom of expression, freedom of association, and a free media.	WGI Project
3	Corruption Index	Corruption is defined as the abuse of entrusted power for private gain.	Transparency International
4	Adoption of AAOIFI	Adoption of AAOIFI Governance Standards at the country level.	AAOIFI
5	GDP Growth Rate	The growth rate of GDP of a country.	World Bank online system
Bank Level Independent Variables			
6	Size	Logarithm of total assets which is used as a proxy for size.	The Banker Special Issue
7	Profitability	Return on assets as a proxy for profitability.	The Banker Special Issue
8	Leverage	Ratio of total liabilities to total assets which is used as a proxy for leverage.	The Banker Special Issue
9	Type of Auditor	Dummy variable is used to measure the impact if external auditor is one of Ernst & Young, Deloitte, Pricewaterhouse Coopers and KPMG.	Annual Report
10	Existence of Sharia auditing department	Dummy variable is used to measure the impact if IB has an internal <i>Shari'ah</i> auditing department.	Annual Report
11	Crisis Dummy	Dummy variable to locate year 2009 as a break point to measure the impact of the financial crisis of 2007.	Year 2009
12	Age from <i>Shari'ah</i> Compliancy	Number of years passed since the <i>Shari'ah</i> compliant activities has started.	Annual Report
13	Number of SB members	Number of <i>Shari'ah</i> scholars in a SB in a particular year.	Annual Report
14	Average level of education in SB	The variable is calculated by giving a score to each <i>Shari'ah</i> scholar in a SB (1 for undergraduate; 2 for master; and 3 for a PhD degree), and then calculating the average of the scores.	Annual Report and Thomson Reuters Database
15	Popularity of SB	If a <i>Shari'ah</i> scholar in a SB has a place in the list provided by Unal (2010), we give a score of 1, and 0 otherwise. Then, calculate the average of all scholars in a SB.	Unal (2010)
16	Board Size	Number of members in the Board of Directors.	Annual Report
17	CEO Duality	Dummy variable is used to measure the impact of CEO duality which is the case that CEO is also the chairman of the Board of Directors.	Annual Report

‘Adoption of AAOIFI standards at country level’ is another independent variable included in this study. As El-Halaby and Hussainey (2016) argued, a formal adoption of AAOIFI standards increases the level of disclosure in SAR. Since adoption of these standards for IBs at country level are expected to have a positive impact on the disclosure of SBs at firm-level. Currently, there are four countries in our sampled dataset which adopted AAOIFI Governance Standards at national level: Bahrain, Qatar, Jordan and Sudan.

*H<sub>4</sub>: The level of disclosure of SAR is expected to be higher in IBs located in countries which adopts AAOIFI standards than in countries that do not adopt AAOIFI.*

The last country level variable is macro-economic factors, namely ‘GDP growth’ which is provided by World Bank online system. Based on the empirical evidence from El-Halaby and Hussainey (2015b) and Wong (2012), we expect that GDP growth has a positive relationship with level of disclosure since growth of the country should have a facilitator role in terms of disclosure practices. Therefore, we hypothesise that:

*H<sub>5</sub>: There is a positive relationship between GDP growth of the country and level of disclosure in SAR.*

As for the bank-level independent variables, 12 determinants are selected, which are explained below:

First bank-level indicator is the ‘logarithm of total assets’, which is used as a proxy for size. Size of the banks is included in the study, since it is expected that as the size of bank increases, the number of shareholders increases as well, who are concerned with the activities of the company (Cormier *et al.*, 2005). In addition, larger firms would require to further legitimise their activities which leads better disclosure practices (Brammer and Pavelin, 2004). Therefore, we hypothesise that:

*H<sub>6</sub>: SAR of large IBs are more likely to disclose more information than small IBs.*

Although agency theory expects a positive relationship between the profitability and corporate disclosure with the objective of revealing the good performance of the agent with the shareholders (El-Halaby and Hussainey, 2016), the empirical findings in the literature on the impact of profitability of a firm on social disclosure is indecisive (Aras *et al.*, 2010; Gray *et al.*, 2001). We, therefore, included return on assets as a proxy for

profitability to see if there is any relation between level of disclosure of SB and profitability. Therefore, we hypothesise that:

*H<sub>7</sub>: There is an association between profitability and the level of disclosure.*

Leverage is another financial indicator of a company which, according to literature has a positive relation with the level of disclosure (Jaggi and Low, 2000; Elshandidy *et al.*, 2013; Jensen and Meckling, 1976). This is because it is expected that high level of disclosure will reduce the monitoring costs (El-Halaby and Hussainey, 2015b). Hence, we test as to whether high leverage in terms of ratio of total liabilities to total assets has an impact on disclosure of SBs. Therefore, we hypothesise that:

*H<sub>8</sub>: There is a positive relationship between leverage of IB and level of disclosure in SAR.*

Selection of independent audit firm is also expected to have a positive association with the level of disclosure (Firth, 1979; Haniffa and Cooke, 2002) since it provides credibility to the corporate, particularly in terms of financial status (El-Halaby and Hussainey, 2016). For this, dummy variable is used to find out if hiring an auditing firm among four big companies, namely Ernst & Young, Deloitte, Pricewaterhouse Coopers and KPMG, has any explanatory power on SDI score.

*H<sub>9</sub>: The level of disclosure of SAR is predicted to be higher in IBs audited by the Big 4 auditors than in IBs that are audited by non-Big 4 auditors*

We also included existence of an internal *Shari'ah* auditing department or unit in IB as an independent variable, since this department is directly related in preparation of SB reports. In the literature, it is also empirically shown that there is a positive relationship between existence of an internal auditing department and level of disclosure (Gordon and Smith, 1992; Schneider and Wilner, 1990). In order to determine the existence of an internal *Shari'ah* auditing unit, we examined the annual reports to find a direct proof of existence of such a unit.

*H<sub>10</sub>: There is a positive relationship between existence of internal Shari'ah Auditing Department of IB and level of disclosure in SAR.*

In order to discern the impact of the recent global financial crisis on the extent of disclosure, crisis dummy variable is utilised. Since the impact of the crisis is expected to be reflected on the disclosure in a lagged manner not before 2009 annual report, we selected 2009 and later as crisis period. As Haji and Ghazali (2012) empirically showed that the voluntary disclosure has increased after the global financial crisis. Considering the reduced trust to the financial institutions after the crisis, voluntary disclosure influence positively on the public image of a corporate.

*H<sub>11</sub>: SAR of IBs after the crisis are more likely to disclose more information than pre-crisis period.*

For the effect of experience in terms of *Shari'ah* compliance, the longevity or age of the IB is considered as an independent variable having an impact on the nature of corporate and *Shari'ah* disclosure. It is hypothesised that the old IBs should have a better disclosure mechanism due to the expected established practices which is developed through the years. Furthermore, the older IBs are expected less to incur a competitive disadvantage (El-Halaby and Hussainey, 2016). The positive relationship between the age and the level of disclosure also shown in the literature empirically (Cormier *et al.*, 2005; Hossain and Hammami, 2009), despite some exceptions (Alsaeed, 2006). Since multicollinearity problem may arise in the case of including both the age of starting operations and being *Shari'ah* compliant, we only included age calculated from the year of *Shari'ah* compliancy, as age of the bank must be equal to the years elapsed since the beginning of *Shari'ah* compliancy.

*H<sub>12</sub>: Older IBs are expected to disclose more information in SAR than younger IBs.*

In our analysis, we also evaluate characteristics of SBs, and further analyse attributes of SB members separately in order to identify the effects of these different attributes of *Shari'ah* scholars have on the extent of disclosure of SB's SARs, rather than using an index score for a SB as a whole as Farook and Lanis (2007) did. Three main indicators, namely number of members in SB, average level of education of the members and average popularity of members of SB, are included. It is expected that if the number of members increases, the report should be more detailed since higher size of the board might decrease the uncertainty and lack of information (Birnbbaum, 1984) as well as reduce the asymmetric information problem (Chen and Jaggi, 2000), hence disclose

more information (El-Halaby and Hussainey, 2016). This is also true for the level of education due to familiarity with preparing written documents. This is because a higher level of education might result in a deeper understanding of the working mechanisms of IBs and disclosure procedure. As for the popularity of *Shari'ah* scholars, El-Halaby and Hussainey (2016) argued that due to deep comprehension of modern banking and disclosure structures, popular *Shari'ah* scholars might disclose more information in the SARs. In order to measure popularity of the members, we use the list published by Unal (2011) which provides the top 20 scholars based on their overall positions in terms of the number of *Shari'ah* boards they have been sitting in. Unal (2011) used the data available on 31 December 2010, which is the mid-point for the sample period of this study, and hence his estimation should be considered as relevant for this study, as *Shari'ah* scholarship in IBs represent a monopoly (Unal, 2011) and therefore there would hardly be any change in the identified positions in Unal (2011). If a *Shari'ah* scholar in the sampled banks has a place in this list, we give a score of 1, and 0 otherwise. Based on this, we hypothesise the followings:

*H<sub>13</sub>: There is a positive relationship between size of SSB and level of disclosure in SAR.*

*H<sub>14</sub>: There is a positive relationship between average level of education of SB members and level of disclosure in SAR.*

*H<sub>15</sub>: There is a positive relationship between popularity of SSB and level of disclosure in SAR.*

Size of the board of directors is another variable explored in the literature in terms of its impact on level of disclosure. As it is discussed in the size of SB, a higher board size is expected to influence the disclosure positively (Birnbaum, 1984; Chen and Jaggi, 2000). However, the empirical findings are mixed. While some studies suggest that a large board size has a positive impact on level of disclosure due to potential availability of diversified expertise opinions (Hidalgo *et al.*, 2011; Gandia, 2008; Abeysekera, 2010; Allegrini and Greco, 2013), there are also studies which suggest a negative impact on level of disclosure due to inefficiency and lack of supervision ability (see: Herman *et al.*, 1981; Lipton and Lorsch, 1992). Furthermore, there are empirical studies, such as Arcay and Vazquez (2005) and Prado-Lorenzo and Garcia-Sanchez

(2010), that find an insignificant association between board size and level of disclosure. Following Samaha *et al.* (2015), therefore, we formulate the following hypothesis:

*H<sub>16</sub>: There is an association between the board size and level of disclosure in SAR.*

Although it is argued that independence of the chairman of the board of directors provides a better monitoring experience of the managers (Fama and Jensen, 1983), empirical evidence regarding the CEO duality is mixed (Samaha *et al.*, 2015). Although some studies evidence a negative relationship between level of disclosure and CEO duality (Allegrini and Greco, 2013; Li *et al.*, 2008), there are studies which found either an insignificant or positive relationship. Therefore, we formulate the following hypothesis:

*H<sub>17</sub>: There is an association between CEO duality and level of disclosure in SAR.*

After defining the econometric specifications and describing the variables, the next section presents the methodological framework and data collection process.

### **3.3. METHODOLOGICAL FRAMEWORK AND DATA DEVELOPMENT FOR DISCLOSURE ANALYSIS**

Based on the theoretical debate and theory development attempted in the preceding chapter, in developing the empirical section of this study, this research utilises SARs issued by IBs as secondary data in order to measure the extent of disclosure practice in relation to an index which is composed to represent the best *Shari'ah* governance practice. Similar to the other studies on accounting disclosure, this study employs content analysis method and is designed as an exploratory case study. In this approach, published SARs are subjected to a disclosure index.

The composed index for SARs can be found in Table 3.2, which implies that the best practice of SARs is expected to disclose information about the items listed in the table. In utilising the constructed index, the existence of an index item in SARs, irrespective of its length, is used to determine disclosure on that particular index item. It should be noted that in this analysis, headings in SARs are not included as a unit of analysis. As can be seen in Table 3.2, items 1-18 are constructed through AAOIFI standards for SARs. In constructing these index items, AAOIFI Governance Standard for Islamic

Financial Institutions No. 1: *Shari'ah* Supervisory Board: Appointment, Composition and Report is referred (AAOIFI, 2010). In this standard, the content of a SAR provided by a SB is described. According to this standard, a SAR should be composed of seven parts: (i) The title of the report; (ii) The addressee of the report – addresses the intended recipients of the report; (iii) Opening paragraph – refers to the purpose of the engagement; (iv) Scope paragraph – describes the scope of the work performed, clarifies management's responsibility towards *Shari'ah* compliance, and confirms that the appropriate tests, procedures, and review were performed; (v) Opinion paragraph – states the extent of compliance of the institution with *Shari'ah* in its activities; (vi) Date of report – documents the period covered by the report and the date of issuance; (vii) SSB's signature – presents the approval of members of the SB on contents of the report (Ginena and Hamid, 2015: 353). The index items 1-18, therefore, constructed in a way to include all requirements of this standard, even if they are trivial items such as 'Report has an appropriate title' (Item 1). The rest of the items, namely items 19-34, are included as part of the ICG best practice to quantify additional information such as details of general disclosures including the details of violations of *Shari'ah*. The additional index items are developed through the available theoretical (as above) and empirical literature to locate the detailed aspects of the issues beyond the initial general items. In construction of the expanded disclosure, disclosure analysis studies in the literature are also benefitted such as El-Halaby and Hussainey (2016) and Abdullah *et al.* (2013).

Methodologically, reliability is one of the most important elements of content analysis (Haniffa and Hudaib, 2007). Regarding ensuring the reliability of the coded data and dataset, Milne and Adler (1999: 238) suggest that "the most usual ways in which this is achieved is by demonstrating the use of multiple coders and either reporting that the discrepancies between the coders are few, or that the discrepancies have been re-analysed, and the differences resolved". To ensure the reliability of the content analysis conducted in this research, therefore, we employed two methods. Firstly, the coding process was repeated after ten months with a sample of randomly selected 10% of the dataset (30 SAR). The consistency of two coding process with a delay in time between two showed that coding process was not under the influence of external factors of that particular time and, therefore, is reliable. Secondly, the same sample was given to an independent coder.

**Table 3.2: Disclosure Index Items**

1	Report has an appropriate title
2	Report has been appropriately addressed
3	Report has identified the purpose of the engagement (opening paragraph)
4	Report has identified the nature of the work performed (scope paragraph)
5	Report has identified the management's responsibility
6	Independent judgment in carrying out its responsibilities is disclosed.
7	The role and responsibilities of the board are disclosed.
8	Confirmation that the SB has performed appropriate tests, procedures and review work as appropriate
9	Confirmation that the transaction and dealings are in compliance with Shari'ah rules and principles - scope
10	Treatment of all earnings realized from sources prohibited by Shari'ah is disposed to charitable causes-opinion
11	Compliance of <i>zakah</i> calculation with <i>Shari'ah</i> is disclosed. -opinion
12	Statement on the endorsed conformity of <i>Shari'ah</i> compliance is disclosed -Opinion
13	Distribution of profits and losses comply with Shari'ah is disclosed.
14	Report on the violations of Shari'ah compliance (if any) is disclosed.
15	Period covered is disclosed
16	Date the report as of the completion date of the review is disclosed
17	Report signed by all members.
18	The report is published in the annual report
19	Report signed by chairman
20	Names of members are disclosed.
21	Name of the chairman is disclosed
22	Pictures of members are disclosed
23	Examination of product development ex ante is provided.
24	Examination of product development ex post is provided.
25	Holding meetings during the year is disclosed.
26	The training information of the employees is disclosed.
27	The Shari'ah auditing department in the bank is disclosed.
28	SB adopted one of the standards as guidelines (AAOIFI or IFSB).
29	Report discloses that the management supplies the Shari'ah board with complete, accurate and adequate information in a timely manner
30	Holding meeting with BOD
31	Number of meetings during the year is disclosed.
32	Details of the training information of the employees is disclosed.
33	Details of the violations of Shari'ah compliance (if any) is disclosed.
34	Details of treatment of all earnings realized from sources prohibited by Shari'ah is disposed to charitable causes is disclosed

In doing so, the index items of *Shari'ah* disclosure index were explained to the independent coder and was asked to assess the content of SAR and assign related scores. Then, the scores given by the independent coder and the original scores were compared. Outcome of the reliability test suggest that discrepancies between the coders are insignificant. Consequently, the reliability of the coding process was assured.

In terms of locating the identified items or sought information in the SARs, by scoring them, this study employed dichotomous approach: score '1' is given if the item is disclosed and score '0' otherwise. The total score that each SAR earned is calculated additively with equal weight (Haniffa and Hudaib, 2007). If an item is not relevant for a specific report, such as if there is no violation of rules, the index item to disclose details of violation is considered not valid for that particular report; and hence, that item is not considered as part of the disclosure index, and therefore it is removed from both numerator and denominator.

Following the modified version of Haniffa and Hudaib's (2007) equation, as below, this study presents the score of disclosure level in the form of an index, namely the *Shari'ah* Disclosure Index (SDI) which is calculated as follows:

$$SDI_j = \frac{\sum_{i=1}^{n_j} X_{ji}}{n_j}$$

where  $SDI_j$  is the *Shari'ah* disclosure index for  $IB_j$  and  $X_{ji}$  is 1 if the item  $i$  in the SAR of  $IB_j$  is disclosed and 0 otherwise. Each item in the disclosure index has an equal weight to avoid subjective interpretations of index items. Total score is, then, divided by the number of relevant disclosure items (as mentioned above, irrelevant items removed from calculation when the case arose), namely  $n_j$ , which in this case is equivalent to 34 (the total number of index items), as in Table 3.2. After calculating index value for each SAR of each IBs, inferential analysis is considered to make sense of the results. For example, higher index value means SB report is closer to the best possible disclosure practice level. In other words, if the index value is closer to 1, SB is successfully and effectively managed to use SAR to communicate with its stakeholders and inform them substantially about the *Shari'ah* compliancy of the institution.

In order to explore the impact of AAOIFI standards for SARs, as mentioned above, index items 1-18 in Table 3.2 are constructed in line with the AAOIFI standards.  $SDI_{AAOIFI}$  score, therefore, indicates to what degree SBs of IBs adopt AAOIFI standards in SARs. Such an indicator provides the influence of standardisation on level of disclosure in SARs. Especially, considering the fact that 66% of the sampled IBs in this study are not obliged to follow AAOIFI standards,  $SDI_{AAOIFI}$  score also shows the impact of standardisation on voluntary disclosure.

However, AAOIFI standards for SARs demand the disclosure of information at a general level without providing details of activities regarding monitoring or supervising, such as number of meetings or training of the staff as well as the details of violation of *Shari'ah*, if there is any. This is the reason why we included an additional 16 index items to construct a more general disclosure index termed as  $SDI_{General}$  to explore to what degree SBs disclose voluntary information regarding the details of their activities and *Shari'ah* compliancy of IBs without any standards by AAOIFI. Considering transparency as an important ingredient of IME,  $SDI_{General}$  score provides to what degree IBs proactively achieve such dimension in their SARs. Thus, an attempt is made to actualise IME oriented expectations in the measurement albeit in a limited manner, as empirical operation of IME oriented ICG may require further development of standardisation beyond this study.

In composing the data, annual reports of 41 Islamic banks from 15 countries are examined in relation to the identified SDI to reveal the level of disclosure of SBs which are published between 2007 and 2014, making in total a collection of 328 SARs. However, due to the unavailability of 23 *Shari'ah* annual reports within the sample period, this study has a sample of 305 instead of 328 SARs.

As for the sampled Islamic banks, the sampling is based on criteria that they were established in 2007 or before and have published SARs, which are available online and should be in English or Arabic language for the period of 2007-2014. 2007 is selected as the beginning period since the number of established IBs before 2007 decrease swiftly; hence, to prevent further decline in the sample size, we opted for 2007. Since 2007 is also the initial period of global financial crisis, sampling through 2007 can help to locate the crisis and post-crisis impact on disclosure practice. Also, we did not select a more recent year with the objective of testing the impact of the global financial crisis

of 2007 which should have been reflected in the annual reports around 2009 due to lag. In addition, only fully fledged IBs with 100% *Shari'ah* compliant assets were considered for the sample. *The Banker: Special Issue for Islamic Financial Institutions* was utilised as a guidance in sampling Islamic banks. If an Islamic bank does not provide more than two annual reports between 2007-2014, we exclude that Islamic bank from the sample. In the sample selection process, therefore, some major Islamic banks are not included in the sample due to lack of available *Shari'ah* annual reports such as Alinma Bank, Albilad Bank and Al-Rajhi Bank. Also, Islamic Bank of Britain is located as Al-Rayan Bank since it has changed its name in the sample period. Table 3.3 lists all the sampled Islamic banks in this study.

**Table 3.3: Sampled Islamic Banks**

No	Country	Islamic Bank	No	Country	Islamic Bank
1	<b>Bahrain</b>	Al Baraka Bank	22		Bank Islam Malaysia Berhad
2		Al Salam Bank	23		Bank Kerjasama Rakyat Malaysia
3		Bahrain Islamic Bank	24		Bank Muamalat Malaysia Berhad
4		KFH Bahrain	25		Hong Leong Islamic Bank Berhad
5		Khaleeji Commercial Bank	26	<b>Pakistan</b>	Bank Islami Pakistan
6		ABC Islamic Bank	27		Burj Bank
7		Bank al-Khair	28		Meezan Bank Limited
8	<b>Bangladesh</b>	EXIM Bank of Bangladesh	29	<b>Qatar</b>	Masraf Al Rayan
9		Islami Bank Bangladesh Limited	30		Qatar International Islamic Bank
10	<b>Egypt</b>	Al Baraka Bank Egypt	31		Qatar Islamic Bank
11	<b>Indonesia</b>	Muamalat Indonesia	32	<b>Saudi Arabia</b>	Bank Al Jazira
12		PT Bank Syariah Mandiri	33		Jadwa
13	<b>Jordan</b>	Islamic International Arab Bank	34	<b>South Africa</b>	Al Baraka South Africa
14		Jordan Islamic Bank	35	<b>Sudan</b>	Al Baraka Bank Sudan
15	<b>Kuwait</b>	Boubyan Bank	36		Faisal Islamic Bank
16		KFH	37	<b>UAE</b>	Abu Dhabi Islamic Bank
17	<b>Lebanon</b>	BLOM Development Bank	38		Emirates Islamic Bank
18	<b>Malaysia</b>	Affin Islamic Bank Berhad	39	<b>UK</b>	Al-Rayan Bank
19		Al-Rajhi Bank Malaysia	40		European Islamic Investment Bank
20		KFH Malaysia	41		Bank of London and The Middle East
21		Asian Finance Bank Berhad			

In calculating the SDI, secondary data for disclosure analysis is, hence, gathered from online published annual reports of the IBs on their official websites. As for the data for regression analysis, *The Banker Special Issues for Islamic Financial Institutions* and Datastream is utilised to obtain independent variables for the regression analysis along with annual reports of IBs.

In general, the cross-sectional aspect and the sampling makes the findings easier to accept as results of an explorative effort rather than falsifications of numerous potential theoretical claims. Therefore, we prefer an econometric analysis with the available dataset. Deciding the most suitable estimation method for the available dataset is a crucial part of the analysis. Since constructed disclosure indices as dependent variables are determined by more than one independent variable, simple regression is not a suitable method. Among the multiple regression methods, one-step system generalized method of moments (GMM) approach is utilised in determining the factors affecting disclosure level of SBs. One-step GMM is selected over two-step GMM due to the small sample size which leads to problem of over-fitting in two-step GMM and makes asymptotic standard errors not suitable for hypothesis testing (Beck and Levine, 2004). System GMM approach also resolves the endogeneity of regressors while avoiding dynamic panel bias (Uddin *et al.*, 2017). In this model, bank level explanatory variables are treated as endogenous and their past values are utilised as their instruments. As in Mollah and Zaman (2015), country level and macro level independent variables, on the other hand, are treated as exogenous. In the next section, we present the empirical analysis and findings.

### **3.4. EMPIRICAL ANALYSIS AND FINDINGS**

This section presents the empirical analysis and findings in relations to the disclosure performance of the selected IBs and the determining factors of the observed disclosure level

#### **3.4.1. Analysis of Disclosure Index Scores**

In the first part of this section, we examine  $SDI_{General}$  and  $SDI_{AAOIFI}$  results of sample data. Table 3.4 presents the  $SDI_{General}$  scores for each bank between 2007-2014. In terms of average score over the eight years, as can be seen in Table 3.4, Bahrain Islamic Bank has the highest score with 72%, which is followed by Meezan Bank Limited of Pakistan

with 63% disclosure score. ABC Islamic Bank and Bank alKhair are third and fourth in the rank having 62% and 61% score, respectively. As depicted in Table 3.4, 66% of the sampled IBs achieved a disclosure level between 40-59%. At the bottom of the list, a Malaysian bank, Al-Rajhi Malaysia is found to have the least disclosure score of 24% on average. Relatively high scores of Bahraini IBs might be due to the influence of AAOIFI standards which is developed in Bahrain. Furthermore, the relatively low scores of Malaysian IBs in average are mostly due to the poor disclosure performance in 2007 and 2008, which show a gradual increase throughout the sample period. Even, Bank Islam Malaysia Berhad disclose the highest level along with Bahrain Islamic Bank in 2014. It is also interesting that despite close proximity of Qatar to Bahrain and adoption of AAOIFI governance standards at country level, all three IBs in our sample from Qatar perform very poorly in terms of disclosure. When we examine the individual SARs of each IB during the sample period, we observe that the reports were written shortly without any detailed information. In the search of possible explanations for such similarity among the three IBs, it is noticed that two *Shari'ah* scholars dominated the SBs of three IBs for the majority of the sample period, namely Waleed Bin Hadi and Abdul Sattar Abud Ghuddah. Considering the close structures and disclosure levels of SARs of each IB, this fact shows how individual scholars might be influential in preparation of SAR and the level of disclosure it involves.

In terms of temporal analysis, we observe an increase in average  $SDI_{General}$  score of all sampled IBs from 40% disclosure level in 2007 to 50% in 2014. Furthermore, although  $SDI_{General}$  score of an IB does not change substantially between 2007-2014, in some IBs, we notice substantial change in disclosure level.

Especially IBs in Malaysia exhibit sharp increases in their disclosure level such as Affin Islamic Bank Berhad (from 15% in 2008 to 38% in 2009), Al-Rajhi Bank Malaysia (from 21% in 2012 to 44% in 2013), Asian Finance Bank Berhad (from 15% in 2007 to 41% in 2008), Bank Islam Malaysia Berhad (from 15% in 2007 to 65% in 2008), Bank Kerjasama Rakyat Malaysia and Bank Muamalat Malaysia Berhad (both from 15% in 2010 to 44% in 2011) in Malaysia and KFH of Kuwait (from 32% in 2009 to 50% in 2010), Abu Dhabi Islamic Bank (from 29% in 2007 to 56% in 2008) in UAE, Bank Al Jazira (from 24% in 2012 to 41% in 2013) in Saudi Arabia.

**Table 3.4: SDI for General Index for the Sampled Banks**

	2007	2008	2009	2010	2011	2012	2013	2014	Average
<b>Bahrain</b>									
ABC Islamic	0.62	0.62	0.62	0.62	0.62	0.62	0.62	0.62	<b>0.62</b>
Al Baraka Bank	0.56	0.53	0.59	-	0.59	0.59	0.59	-	<b>0.57</b>
Al Salam Bank	0.53	0.53	0.53	0.62	0.62	0.56	0.56	0.56	<b>0.56</b>
Bahrain Islamic Bank	0.74	0.77	0.71	0.71	0.71	0.71	0.71	0.71	<b>0.72</b>
Bank alKhair	0.58	0.61	0.56	0.62	0.62	0.62	0.62	0.62	<b>0.61</b>
KFH Bahrain	0.44	0.44	0.47	0.62	0.65	0.62	0.62	0.62	<b>0.56</b>
Khaleeji Commercial Bank	0.47	0.50	0.53	0.53	0.53	0.53	0.53	0.53	<b>0.52</b>
<b>Kuwait</b>									
Boubyan Bank	0.29	0.32	0.32	0.32	0.41	0.41	0.44	0.53	<b>0.38</b>
KFH	0.32	0.32	0.32	0.50	0.50	0.62	0.62	0.56	<b>0.47</b>
<b>Malaysia</b>									
Affin Islamic Bank Berhad	-	0.15	0.38	0.41	0.59	0.59	0.59	0.59	<b>0.47</b>
Al-Rajhi Bank Malaysia	0.15	0.15	0.18	0.15	0.15	0.21	0.44	0.47	<b>0.24</b>
Asian Finance Bank Berhad	0.15	0.41	0.47	0.56	0.44	0.44	0.44	0.38	<b>0.41</b>
Bank Islam Malaysia Berhad	0.15	0.65	0.62	0.65	0.65	0.62	0.62	0.71	<b>0.58</b>
Bank Kerjasama Rakyat Malaysia	-	0.15	-	0.15	0.44	0.56	0.53	0.56	<b>0.40</b>
Bank Muamalat Malaysia Berhad	0.15	0.15	-	0.15	0.44	0.44	0.47	0.47	<b>0.32</b>
Hong Leong Islamic Bank Berhad	0.41	0.35	0.35	0.35	-	0.41	0.65	0.65	<b>0.45</b>
KFH Malaysia	0.50	0.50	0.50	0.47	0.50	0.53	0.53	0.62	<b>0.52</b>
<b>Pakistan</b>									
Bank Islami Pakistan	0.29	-	0.38	0.44	0.35	0.41	0.41	0.41	<b>0.39</b>
Burj Bank	0.29	-	0.44	0.58	0.47	0.53	0.56	0.56	<b>0.49</b>
Meezan Bank Limited	0.59	0.62	0.62	0.62	0.62	0.65	0.65	0.65	<b>0.63</b>
<b>Qatar</b>									
Masraf Al Rayan	-	-	0.32	0.32	0.32	0.32	0.26	0.26	<b>0.30</b>
Qatar International Islamic Bank	-	-	0.44	0.44	0.44	0.44	0.29	0.29	<b>0.39</b>
Qatar Islamic Bank	0.35	0.35	0.35	0.35	0.32	0.32	0.26	0.26	<b>0.32</b>
<b>Saudi Arabia</b>									
Bank Al Jazira	-	0.24	0.41	0.53	0.53	0.44	0.44	0.44	<b>0.43</b>
Jadwa - Investment Bank	-	0.44	0.44	0.41	0.41	0.41	0.41	0.41	<b>0.42</b>
<b>UAE</b>									
Abu Dhabi Islamic Bank	0.29	0.56	0.56	0.56	0.62	0.62	0.62	0.62	<b>0.56</b>
Emirates Islamic Bank	0.47	0.56	0.50	0.56	0.53	0.53	0.53	0.53	<b>0.53</b>
<b>UK</b>									
BLME	0.42	0.42	0.42	0.42	0.42	0.44	0.42	0.42	<b>0.42</b>
EIIB	0.41	0.47	0.47	0.47	0.47	0.47	0.47	0.47	<b>0.46</b>
Islamic Bank of Britain	0.35	0.35	0.35	0.35	0.47	0.47	0.53	0.53	<b>0.43</b>
<b>Bangladesh</b>									
EXIM Bank of Bangladesh	0.44	0.44	0.44	0.44	0.44	0.38	0.38	0.38	<b>0.42</b>
Islami Bank Bangladesh Limited	0.50	0.53	0.53	0.50	0.50	0.50	0.50	0.50	<b>0.51</b>
<b>Egypt</b>									
Al Baraka Bank Egypt	-	-	0.26	0.26	0.26	0.26	0.29	0.41	<b>0.29</b>
<b>Indonesia</b>									
Muamalat Indonesia	0.26	0.26	0.26	0.26	0.26	0.32	0.32	0.32	<b>0.29</b>
PT Bank Syariah Mandiri	0.26	0.26	0.38	0.38	0.41	-	0.41	0.41	<b>0.36</b>
<b>Jordan</b>									
Islamic International Arab Bank	-	0.50	0.53	0.53	0.59	0.59	0.56	0.59	<b>0.55</b>
Jordan Islamic Bank	-	0.53	0.56	0.56	0.56	0.56	0.56	0.56	<b>0.55</b>
<b>Lebanon</b>									
BLOM Development Bank	-	0.59	0.53	0.56	0.59	0.56	0.59	-	<b>0.57</b>
<b>South Africa</b>									
Al Baraka South Africa	0.59	0.56	0.62	0.59	0.59	0.59	0.59	0.59	<b>0.59</b>
<b>Sudan</b>									
Al Baraka Bank Sudan	0.41	0.41	0.41	0.38	0.38	0.38	0.38	0.41	<b>0.40</b>
Faisal Islamic Bank	-	0.44	0.44	0.44	0.44	0.44	0.44	0.44	<b>0.44</b>
<b>Average</b>	<b>0.40</b>	<b>0.44</b>	<b>0.46</b>	<b>0.46</b>	<b>0.49</b>	<b>0.49</b>	<b>0.50</b>	<b>0.50</b>	

On the other hand, in the case of some other IBs, no change is observed in their  $SDI_{General}$ , such as ABC Islamic Bank of Bahrain (stable at 62% during the sampled period) and Faisal Islamic Bank of Sudan (stable at 44% during the sampled period).

Table 3.5 presents the  $SDI_{AAOIFI}$  scores for each bank between 2007-2014. In terms of average score over the eight years, ABC Islamic Bank and Bank alKhair of Bahrain shares the highest score with 94%. BLOM Development Bank of Lebanon follows them with 92%, while Bahrain Islamic Bank of Bahrain has a 90% score, which also has the highest score in  $SDI_{General}$ . Muamalat Indonesia is at the bottom of the list with 32% score, while Al-Rajhi Bank Malaysia with 37% is the second worst performer, which has also the worst score in  $SDI_{General}$ .

In the performance over the sample period, we observe an increase on average  $SDI_{AAOIFI}$  scores from 55% in 2007 to 71% in 2014. Hence, we can argue that although there is a general increase in disclosure level of SBs, compliancy with AAOIFI guidelines is progressed better throughout the years as compared the results with  $SDI_{General}$ .

As can be seen from the results for average  $SDI_{General}$  scores at country level in Table 3.6, Bahraini IB sample has the highest score with 60%, while Egyptian Islamic banking sample has the lowest score with 29%. Considering that only sample from Egypt is Al-Baraka Egypt which is a foreign subsidy of a Bahrain bank, namely Al-Baraka, this shows the impact of local factors on  $SDI_{General}$ , as the Egyptian subsidiary has a considerable lower score despite being part of the same group. Although Al-Baraka Egypt scores very poor in terms of  $SDI_{General}$ , they provide a one-page long SAR. However, throughout the sample period, they do not disclose any information beyond AAOIFI guideline for SAR. Even though they follow the template prepared by AAOIFI for SAR to a certain extent, they do not disclose every item in that template either. Some of the items they do not disclose are technical items such as ‘Report signed by all members’ or ‘Date the report as of the completion date of the review is disclosed’. However, they also skip some of the important parts of the template as well such as ‘Treatment of all earnings realized from sources prohibited by Shari’ah is disposed to charitable causes’, ‘The role and responsibilities of the board are disclosed’ or ‘Report has identified the management's responsibility’ which are disclosed in SAR of Al-Baraka of Bahrain.

**Table 3.5: SDI for AAOIFI Index for the Sampled Banks**

	2007	2008	2009	2010	2011	2012	2013	2014	Average
<b>Bahrain</b>									
ABC Islamic	0.94	0.94	0.94	0.94	0.94	0.94	0.94	0.94	<b>0.94</b>
Al Baraka Bank	0.89	0.83	0.89	-	0.89	0.89	0.89	-	<b>0.88</b>
Al Salam Bank	0.56	0.56	0.61	0.72	0.72	0.67	0.67	0.67	<b>0.65</b>
Bahrain Islamic Bank	0.94	0.94	0.89	0.89	0.89	0.89	0.89	0.89	<b>0.90</b>
Bank alKhair	0.94	0.94	0.89	0.94	0.94	0.94	0.94	0.94	<b>0.94</b>
KFH Bahrain	0.67	0.67	0.67	0.89	0.94	0.89	0.89	0.89	<b>0.81</b>
Khaleeii Commercial Bank	0.67	0.67	0.72	0.72	0.72	0.72	0.72	0.72	<b>0.71</b>
<b>Kuwait</b>									
Boubyan Bank	0.33	0.39	0.39	0.39	0.56	0.56	0.61	0.78	<b>0.50</b>
KFH	0.35	0.35	0.35	0.67	0.67	0.72	0.72	0.67	<b>0.56</b>
<b>Malaysia</b>									
Affin Islamic Bank Berhad	-	0.28	0.72	0.78	0.78	0.78	0.78	0.78	<b>0.70</b>
Al-Raihi Bank Malaysia	0.22	0.22	0.22	0.22	0.22	0.28	0.78	0.78	<b>0.37</b>
Asian Finance Bank Berhad	0.22	0.67	0.78	0.89	0.72	0.72	0.72	0.72	<b>0.68</b>
Bank Islam Malaysia Berhad	0.28	0.83	0.83	0.89	0.89	0.83	0.83	0.89	<b>0.78</b>
Bank Kerjasama Rakvat Malaysia	-	0.28	-	0.28	0.72	0.83	0.83	0.89	<b>0.64</b>
Bank Muamalat Malaysia Berhad	0.28	0.28	-	0.28	0.83	0.83	0.83	0.83	<b>0.60</b>
Hong Leong Islamic Bank Berhad	0.67	0.61	0.61	0.61	-	0.67	0.89	0.89	<b>0.71</b>
KFH Malaysia	0.83	0.83	0.83	0.78	0.78	0.83	0.83	0.94	<b>0.83</b>
<b>Pakistan</b>									
Bank Islami Pakistan	0.28	-	0.33	0.39	0.39	0.44	0.44	0.39	<b>0.38</b>
Buri Bank	0.33	-	0.44	0.67	0.56	0.67	0.67	0.67	<b>0.57</b>
Meezan Bank Limited	0.56	0.61	0.61	0.61	0.61	0.67	0.67	0.67	<b>0.63</b>
<b>Oatar</b>									
Masraf Al Rayan	-	-	0.44	0.44	0.44	0.44	0.33	0.33	<b>0.41</b>
Oatar International Islamic Bank	-	-	0.61	0.61	0.61	0.61	0.33	0.33	<b>0.52</b>
Oatar Islamic Bank	0.50	0.50	0.50	0.50	0.50	0.50	0.39	0.39	<b>0.47</b>
<b>Saudi Arabia</b>									
Bank Al Jazira	-	0.33	0.67	0.78	0.78	0.67	0.67	0.67	<b>0.65</b>
Jadwa - Investment Bank	-	0.67	0.67	0.61	0.61	0.61	0.61	0.61	<b>0.63</b>
<b>UAE</b>									
Abu Dhabi Islamic Bank	0.44	0.89	0.89	0.89	0.94	0.94	0.94	0.94	<b>0.86</b>
Emirates Islamic Bank	0.67	0.67	0.67	0.67	0.67	0.83	0.83	0.83	<b>0.73</b>
<b>UK</b>									
BLME	0.65	0.65	0.65	0.65	0.65	0.67	0.65	0.65	<b>0.65</b>
EIIB	0.67	0.72	0.72	0.72	0.72	0.72	0.72	0.72	<b>0.72</b>
Islamic Bank of Britain	0.5	0.5	0.5	0.50	0.72	0.72	0.78	0.78	<b>0.63</b>
<b>Bangladesh</b>									
EXIM Bank of Bangladesh	0.56	0.56	0.56	0.56	0.56	0.50	0.50	0.50	<b>0.53</b>
Islami Bank Bangladesh Limited	0.61	0.67	0.67	0.61	0.61	0.61	0.61	0.61	<b>0.63</b>
<b>Egypt</b>									
Al Baraka Bank Egypt	-	-	0.50	0.50	0.50	0.50	0.56	0.78	<b>0.56</b>
<b>Indonesia</b>									
Muamalat Indonesia	0.28	0.28	0.28	0.28	0.28	0.39	0.39	0.39	<b>0.32</b>
PT Bank Svariah Mandiri	0.33	0.33	0.44	0.50	0.50	-	0.50	0.50	<b>0.44</b>
<b>Jordan</b>									
Islamic International Arab Bank	-	0.61	0.72	0.72	0.78	0.78	0.72	0.78	<b>0.73</b>
Jordan Islamic Bank	-	0.83	0.89	0.89	0.89	0.89	0.89	0.89	<b>0.88</b>
<b>Lebanon</b>									
BLOM Development Bank	-	0.94	0.89	0.89	0.94	0.89	0.94	-	<b>0.92</b>
<b>South Africa</b>									
Al Baraka South Africa	0.83	0.83	0.89	0.89	0.89	0.89	0.89	0.89	<b>0.88</b>
<b>Sudan</b>									
Al Baraka Bank Sudan	0.61	0.61	0.61	0.56	0.56	0.56	0.56	0.61	<b>0.58</b>
Faisal Islamic Bank	-	0.50	0.50	0.50	0.50	0.50	0.50	0.50	<b>0.50</b>
<b>Average</b>	<b>0.55</b>	<b>0.61</b>	<b>0.64</b>	<b>0.65</b>	<b>0.69</b>	<b>0.70</b>	<b>0.70</b>	<b>0.71</b>	

As a summary, it can be seen that Islamic banking sample in 11 out of 15 countries scored within 40-59% range which shows that index scores are relatively close to each other and indicate rather low performance in disclosure.

**Table 3.6: SDI<sub>General</sub> Index by Country Level**

	2007	2008	2009	2010	2011	2012	2013	2014	Average
Bahrain	0.56	0.57	0.57	0.62	0.62	0.61	0.61	0.61	<b>0.60</b>
Kuwait	0.31	0.32	0.32	0.41	0.46	0.51	0.53	0.54	<b>0.43</b>
Malaysia	0.25	0.31	0.42	0.36	0.46	0.47	0.53	0.56	<b>0.42</b>
Pakistan	0.39	0.62	0.48	0.54	0.48	0.53	0.54	0.54	<b>0.52</b>
Qatar	0.35	0.35	0.37	0.37	0.36	0.36	0.27	0.27	<b>0.34</b>
Saudi Arabia	-	0.34	0.43	0.47	0.47	0.43	0.43	0.43	<b>0.43</b>
UAE	0.38	0.56	0.53	0.56	0.57	0.57	0.57	0.57	<b>0.54</b>
UK	0.39	0.41	0.41	0.41	0.45	0.46	0.47	0.47	<b>0.43</b>
Bangladesh	0.47	0.49	0.49	0.47	0.47	0.44	0.44	0.44	<b>0.46</b>
Egypt	-	-	0.26	0.26	0.26	0.26	0.29	0.41	<b>0.29</b>
Indonesia	0.26	0.26	0.32	0.32	0.34	0.32	0.37	0.37	<b>0.32</b>
Jordan	-	0.51	0.54	0.54	0.57	0.57	0.56	0.57	<b>0.55</b>
Lebanon	-	0.59	0.53	0.56	0.59	0.56	0.59	-	<b>0.57</b>
South Africa	0.59	0.56	0.62	0.59	0.59	0.59	0.59	0.59	<b>0.59</b>
Sudan	0.41	0.43	0.43	0.41	0.41	0.41	0.41	0.43	<b>0.42</b>

When we calculated the average SDI<sub>General</sub> score of the banks over the years in total, we clearly observed an increase in SDI<sub>General</sub> score throughout eight years. However, when the average is calculated for each country instead of total average, this pattern is lost. Although average score of all banks throughout the sampled years suggest a pattern of increasing disclosure in SARs in terms of SDI<sub>General</sub> score, we cannot claim a similar pattern at country level. Kuwait, the UK and Egypt are the only exceptions at country level which exhibit an increasing SDI score over the years. Nevertheless, we can argue that most of the countries have a higher score in 2014 compared to the 2007 on average with the exceptions of Qatar and Bangladesh. When we examine SARs of IBs in Qatar closely, we observe a change in the template of the reports in three IBs in 2013 and 2014 which decreased the number of required disclosed items, as in 2014, items 5-8 from AAOIFI standards as listed in Table 3.1 were removed resulting into lesser disclosure. This result could be attributed to the change in the composition of SB or the change in the behaviours of *Shari'ah* scholars. However, we observe that the only substantial change in SB composition is the addition of *Shari'ah* scholar Ahmad Ahmin in 2012 to Masraf Al Rayan and Qatar International Islamic Bank and in 2013 to Qatar International Bank; while *Shari'ah* scholars Waleed Bin Hadi and Abdul Sattar Abud Ghuddah were the permanent members of all three SBs in Qatar between 2010 and 2014. Such a change in template which decreases the level of disclosure without a

substantial transformation in SB bring along questions about the impact of *Shari'ah* scholars on the preparation of SARs. As for Bangladesh, the cause of decrease in the level of disclosure is more surprising. Although Islami Bank Bangladesh Limited exhibited a stable performance throughout the sampled period, in the case of EXIM Bank Bangladesh, the level of disclosure decreased between 2012 and 2014, which is due to the non-disclosure of items 2 and 31. Although item 31, namely disclosure of number of meetings is an important detail, item 2 seems a trivial detail which is the report being addressed appropriately. These structural changes without necessarily providing a refinement for reporting suggests the existence of bank-level factors beyond SB such as internal *Shari'ah* auditing departments, as it is shown in panel data analysis in the next section. Such bank-level impact might also explain the fluctuations between 2007 and 2014 in most of the sampled countries, most of the countries could not achieve a gradual progress.

The average  $SDI_{AAOIFI}$  scores for the countries where the sampled banks were drawn are displayed in Table 3.7. As can be seen from the results, based on average scores, Lebanon is the top scoring country with 92% of disclosure score, while South Africa is the second with 88% of the AAOIFI required items being disclosed in the SARs. Although Bahrain has two IBs with highest  $SDI_{AAOIFI}$  score in our sample, namely ABC Islamic and Bank Alkhair, at country level, it achieved the highest third  $SDI_{AAOIFI}$  score with 83% on average. One of the important reasons for such an outcome is the difference in the sample size for each country. While Bahrain is represented by seven IBs, Lebanon and South Africa are represented with only one IB each. Therefore, although Bahrain has two highest scoring IBs in SDI, due to the other IBs in sample, its average score is declined by bringing the country level average to third place. Indonesia is located at the bottom of the list with a 38% score. In overall, unlike  $SDI_{General}$ ,  $SDI_{AAOIFI}$  score of countries is dispersed between 38% and 92% without clustering within a small range.

To further investigate the characteristics of country-level SDI scores, Table 3.8 and Table 3.9 presents descriptive statistics for  $SDI_{General}$  and  $SDI_{AAOIFI}$ , respectively. In terms of mean value, all countries lay in the range of 40-59% score level with the exception of Qatar (34%) and Egypt (29%). Bahrain and South Africa have the highest

mean values with 59% while Egypt has the lowest mean value with 29%, almost half of the highest mean value.

**Table 3.7: SDI<sub>AAOIFI</sub> Index at Country Level**

	2007	2008	2009	2010	2011	2012	2013	2014	Average
Bahrain	0.80	0.79	0.80	0.85	0.87	0.85	0.85	0.84	<b>0.83</b>
Kuwait	0.34	0.37	0.37	0.53	0.61	0.64	0.67	0.72	<b>0.53</b>
Malaysia	0.42	0.50	0.67	0.59	0.71	0.72	0.81	0.84	<b>0.66</b>
Pakistan	0.39	0.61	0.46	0.56	0.52	0.59	0.59	0.57	<b>0.54</b>
Qatar	0.50	0.50	0.52	0.52	0.52	0.52	0.35	0.35	<b>0.47</b>
Saudi Arabia	-	0.50	0.67	0.69	0.69	0.64	0.64	0.64	<b>0.64</b>
UAE	0.56	0.78	0.78	0.78	0.81	0.89	0.89	0.89	<b>0.80</b>
UK	0.60	0.62	0.62	0.62	0.70	0.70	0.72	0.72	<b>0.66</b>
Bangladesh	0.58	0.61	0.61	0.58	0.58	0.56	0.56	0.56	<b>0.58</b>
Egypt	-	-	0.50	0.50	0.50	0.50	0.56	0.78	<b>0.56</b>
Indonesia	0.31	0.31	0.36	0.39	0.39	0.39	0.44	0.44	<b>0.38</b>
Jordan	-	0.72	0.81	0.81	0.83	0.83	0.81	0.83	<b>0.81</b>
Lebanon	-	0.94	0.89	0.89	0.94	0.89	0.94	-	<b>0.92</b>
South Africa	0.83	0.83	0.89	0.89	0.89	0.89	0.89	0.89	<b>0.88</b>
Sudan	0.61	0.56	0.56	0.53	0.53	0.53	0.53	0.56	<b>0.55</b>

In further analysing the data, as can be seen in Table 3.8, Malaysia has the highest standard deviations with 0.17. Although Malaysia has the highest number of observations (59 out of 305) which might also play a role in such dispersion, based on Table 3.6, we can argue that increase in SDI<sub>General</sub> throughout the sampled period and sharp jumps in SDI<sub>General</sub> score of individual banks in different years play the most important role in the observed high standard deviation. On the other hand, Pakistan which is represented by three IBs in this study, owes its relatively high standard deviation score mostly to the heterogeneity of sampled IBs among themselves rather than a progress within eight years. Although Bahrain has the second highest number of observations (54 out of 305), with a 0.07 standard deviation, it exhibits uniformity in disclosure practices within IBs in Bahrain and throughout the sampled period, which is also evident from the results displayed in Table 3.4 and Table 3.6, which may be explained by the fact that AAOIFI is located in Bahrain. As can be seen, the lowest standard deviation belongs to Lebanon and South Africa (0.02) which are represented in this study by only one IB each. However, while Egypt is also represented by one IB,

it has standard deviation of 0.06 which shows that the number of IBs is not the only explanation for standard deviation as Bahraini case proves.

**Table 3.8: Descriptive Statistics by Countries for General Index**

	Mean	Std Dev.	Kurt	Skew	Range	Min	Max	Observation
Bahrain	0.59	0.07	0.14	0.16	0.33	0.44	0.77	54
Kuwait	0.43	0.11	-1.25	0.48	0.32	0.29	0.62	16
Malaysia	0.43	0.17	-0.95	-0.51	0.56	0.15	0.71	59
Pakistan	0.51	0.12	-1.19	-0.40	0.35	0.29	0.65	22
Qatar	0.34	0.06	-0.49	0.68	0.18	0.26	0.44	20
Saudi Arabia	0.43	0.07	5.09	-1.37	0.29	0.24	0.53	14
UAE	0.54	0.08	6.23	-2.10	0.32	0.29	0.62	16
UK	0.44	0.05	-0.29	-0.21	0.18	0.35	0.53	24
Bangladesh	0.46	0.05	-1.06	-0.44	0.15	0.38	0.53	16
Egypt	0.29	0.06	5.12	2.25	0.15	0.26	0.41	6
Indonesia	0.32	0.06	-1.60	0.46	0.15	0.26	0.41	15
Jordan	0.55	0.03	0.24	-0.53	0.09	0.50	0.59	14
Lebanon	0.57	0.02	-0.30	-0.86	0.06	0.53	0.59	6
South Africa	0.59	0.02	3.50	0.00	0.06	0.56	0.62	8
Sudan	0.42	0.03	-1.55	-0.43	0.06	0.38	0.44	15
Total	<b>0.47</b>	<b>0.13</b>	<b>-0.16</b>	<b>-0.49</b>	<b>0.63</b>	<b>0.15</b>	<b>0.77</b>	<b>305</b>

Excess kurtosis statistic shows the peakedness of the data where a normally distributed data should have a kurtosis of 0. As depicted in Table 3.8, higher values suggest heavier tails for the distribution compared to normal distribution such as the case for Saudi Arabia, UAE Egypt and South Africa, while the lower values suggest lighter tails such as the case for Indonesia, Sudan, Kuwait and Pakistan. Although rest of the countries do not have exactly a kurtosis of 0, they are relatively close to 0.

As an indicator for the symmetry of the distribution, if the data is symmetric, value of skewness should be close to 0, while the degree of skewness increases as it gets further away from 0. While a negative value for skewness suggests the data is skewed to the left, a positive value suggest the opposite. According to Table 3.8, Egypt is the only country with a strong right skewed distribution, while Qatar, with a less than half value of skewness, also display a similar picture. As the results depict, the countries with strong negative skewness are UAE and Saudi Arabia. Although most of the countries are skewed to the left (9 out of 15), the value of skewness of these countries are not far away from 0.

In further giving meaning to the descriptive statistics, the scores in Table 3.8 depict that Malaysia has the highest range with 0.56, which is followed by Pakistan with 0.35. The lowest ranges also belong to Lebanon and South Africa.

Table 3.9 presents descriptive statistics for  $SDI_{AAOIFI}$ . In terms of mean value, countries are dispersed within a long range of mean values, namely 38-92% score range, while 9 out of 15 countries are clustered between 53-66% score range. Lebanon has the highest mean value with 92% disclosure score, while Indonesia has the lowest mean value with 38%. As the results show, South Africa, Bahrain, Jordan and UAE achieve a higher  $SDI_{AAOIFI}$  score by exceeding 80%. In terms of standard deviation, Malaysia has the highest value with 0.24, being followed by Kuwait (0.16) and UAE (0.15). The lowest standard deviation scores for  $SDI_{AAOIFI}$  observed in the case of Lebanon and South Africa (0.03), as it is also the case for  $SDI_{General}$ .

**Table 3.9: Descriptive Statistics by Countries for AAOIFI Index**

	Mean	Std Dev.	Kurt	Skew	Range	Min	Max	Observation
Bahrain	0.83	0.12	-0.92	-0.74	0.39	0.56	0.94	54
Kuwait	0.53	0.16	-1.78	0.06	0.44	0.33	0.78	16
Malaysia	0.66	0.24	-0.67	-1.00	0.72	0.22	0.94	59
Pakistan	0.53	0.13	-1.36	-0.47	0.39	0.28	0.67	22
Qatar	0.47	0.10	-0.92	0.12	0.28	0.33	0.61	20
Saudi Arabia	0.64	0.10	6.09	-1.85	0.44	0.33	0.78	14
UAE	0.80	0.15	0.25	-0.90	0.50	0.44	0.94	16
UK	0.66	0.08	0.14	-0.97	0.28	0.50	0.78	24
Bangladesh	0.58	0.05	-0.76	-0.05	0.17	0.50	0.67	16
Egypt	0.56	0.11	5.13	2.25	0.28	0.50	0.78	6
Indonesia	0.38	0.09	-1.59	0.26	0.22	0.28	0.50	15
Jordan	0.81	0.09	-0.23	-0.72	0.28	0.61	0.89	14
Lebanon	0.92	0.03	-3.33	0.00	0.06	0.89	0.94	6
South Africa	0.88	0.03	0.00	-1.44	0.06	0.83	0.89	8
Sudan	0.54	0.05	-1.55	0.43	0.11	0.50	0.61	15
Total	0.66	0.20	-0.74	-0.39	0.72	0.22	0.94	305

Unlike  $SDI_{General}$ , as descriptive statistics for  $SDI_{AAOIFI}$  show, the only countries with higher excess kurtosis values are Saudi Arabia and Egypt, while Indonesia, Sudan, Kuwait, Lebanon and Pakistan all have excess kurtosis values lower than a normal distribution. However, South Africa, which has a high positive excess kurtosis for  $SDI_{General}$ , has exactly an excess kurtosis of 0 in the case of  $SDI_{AAOIFI}$ , while other countries are relatively close to 0.

According to the results for  $SDI_{AAOIFI}$  as depicted in Table 3.9, Egypt is the only country with a strong right skewed distribution, as it is also the case with  $SDI_{General}$ , while Saudi Arabia, South Africa and Malaysia has strong negative skewness. Although most of the

countries are skewed to the left (9 out of 15), the value of skewness of these countries are not far away from 0.

As the comparative results between Table 3.8 and 3.9 show, range values for  $SDI_{AAOIFI}$  is similar to  $SDI_{General}$ . While Malaysia has the highest difference between minimum and maximum values, Lebanon and South Africa have the lowest range. However, range of disclosure scores of UAE, Saudi Arabia and Kuwait are relatively high for  $SDI_{AAOIFI}$  as compared to  $SDI_{General}$ . This suggests that some IBs in these countries achieved a higher compliancy with AAOIFI standards for SARs in terms of level of disclosure during the sample period compared to the general index of this study, while Malaysia, Lebanon and South Africa follows a stable pattern in both  $SDI_{General}$  and  $SDI_{AAOIFI}$ .

Table 3.10 displays the annual mean disclosure scores of all sampled IBs for individual items as part of SDI. In order to develop a better snapshot, results depicted in Table 3.10 are classified as scores between 0.71-1.00, 0.50-0.70, and scores less than 0.50. These are highlighted in Table 3.10.

**Table 3.10: SDI by Individual Items**

	2007	2008	2009	2010	2011	2012	2013	2014
1 Report has an appropriate title	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
2 Report has been appropriately addressed	0.47	0.47	0.56	0.58	0.58	0.58	0.56	0.54
3 Report has identified the purpose of the engagement (opening paragraph)	0.37	0.53	0.49	0.50	0.50	0.55	0.56	0.62
4 Report has identified the nature of the work performed (scope paragraph)	0.60	0.64	0.79	0.78	0.83	0.80	0.78	0.79
5 Report has identified the management's responsibility	0.53	0.56	0.67	0.65	0.75	0.80	0.73	0.77
6 Independent judgment in carrying out its responsibilities is disclosed.	0.43	0.47	0.54	0.53	0.63	0.68	0.66	0.69
7 The role and responsibilities of the board are disclosed.	0.50	0.56	0.64	0.63	0.70	0.80	0.73	0.77
8 Confirmation that the SB has performed appropriate tests, procedures and review work as appropriate	0.37	0.47	0.54	0.58	0.68	0.68	0.73	0.72
9 Confirmation that the transaction and dealings are in compliance with Shari'ah rules and principles	0.47	0.61	0.64	0.63	0.70	0.70	0.76	0.74
10 Treatment of all earnings realized from sources prohibited by Shari'ah is disposed to charitable causes	0.50	0.50	0.59	0.58	0.65	0.63	0.68	0.67
11 Compliance of <i>zakat</i> calculation with <i>Shari'ah</i> is disclosed. -opinion	0.47	0.56	0.56	0.53	0.60	0.63	0.61	0.62
12 Statement on the endorsed conformity of <i>Shari'ah</i> compliance is disclosed	0.90	0.97	0.95	0.98	0.98	0.98	0.98	0.97
13 Distribution of profits and losses comply with Shari'ah is disclosed.	0.37	0.44	0.54	0.58	0.65	0.68	0.71	0.69
14 Report on the violations of Shari'ah compliance (if any) is disclosed.	0.40	0.36	0.31	0.35	0.30	0.33	0.34	0.36
15 Period covered is disclosed	0.90	0.94	0.92	0.93	0.90	0.90	0.90	0.90
16 Date the report as of the completion date of the review is disclosed	0.47	0.53	0.51	0.48	0.50	0.48	0.49	0.46
17 Report signed by all members.	0.30	0.42	0.38	0.48	0.53	0.53	0.56	0.54
18 The report is published in the annual report	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
19 Report signed by chairman	0.63	0.64	0.64	0.65	0.75	0.75	0.73	0.74
20 Names of members are disclosed.	0.50	0.61	0.62	0.65	0.63	0.65	0.66	0.64
21 Name of the chairman is disclosed	0.83	0.83	0.85	0.83	0.88	0.88	0.88	0.85
22 Pictures of members are disclosed	0.10	0.11	0.10	0.13	0.13	0.10	0.15	0.15
23 Examination of product development ex ante is provided.	0.13	0.14	0.23	0.20	0.23	0.18	0.20	0.21
24 Examination of product development ex post is provided.	0.00	0.00	0.03	0.03	0.00	0.00	0.00	0.05
25 Holding meetings during the year is disclosed.	0.13	0.19	0.18	0.20	0.18	0.20	0.24	0.26
26 The training information of the employees is disclosed.	0.23	0.17	0.18	0.18	0.20	0.18	0.17	0.18
27 The Shari'ah auditing department in the bank is disclosed.	0.37	0.42	0.49	0.48	0.53	0.53	0.51	0.51
28 SB adopted one of the standards as guidelines (AAOIFI or IFSB).	0.07	0.08	0.08	0.08	0.08	0.08	0.07	0.08
29 Report discloses that the management supplies complete, accurate and adequate information in a timely manner	0.10	0.11	0.10	0.10	0.10	0.08	0.07	0.08
30 Holding meeting with BOD	0.07	0.08	0.10	0.08	0.10	0.08	0.07	0.08
31 Number of meetings during the year is disclosed.	0.13	0.17	0.15	0.15	0.15	0.15	0.17	0.18
32 Details of the training information of the employees is disclosed.	0.07	0.08	0.08	0.08	0.05	0.05	0.07	0.10
33 Details of the violations of Shari'ah compliance (if any) is disclosed.	0.20	0.14	0.13	0.15	0.15	0.13	0.17	0.15
34 Details of treatment of all earnings realized from sources prohibited is disposed to charitable causes is disclosed	0.10	0.08	0.08	0.08	0.10	0.13	0.15	0.15
<b>Average</b>	<b>0.40</b>	<b>0.44</b>	<b>0.46</b>	<b>0.46</b>	<b>0.49</b>	<b>0.49</b>	<b>0.50</b>	<b>0.50</b>

In general, we observe an increase in item or dimension score from 2007 to 2014, which suggests a refinement in each year. Furthermore, the disclosure level of items determined by AAOIFI standards is considerably greater than custom items. This difference especially evident for the items 22-34. However, considering the fact that index items 19-21 are subset of index item 17, we can claim that all index items which are not derived from AAOIFI standards for SAR are disclosed considerably low in sampled IBs in this study. This suggests that AAOIFI guidelines for SARs have an impact on the preparation of the reports, even for the IBs which did not officially adopt AAOIFI standards. This further suggests that majority of SBs do not prefer to disclose detailed information regarding their activities and monitoring processes.

Index item or dimensions 1 and 18 have a perfect full score in each year of the sampled period which are included in both  $SDI_{AAOIFI}$  and  $SDI_{General}$ . However, since annual report of IBs was the only tool to obtain SARs of these IBs, this item is tautological and does not provide information, which are included only due to being part of AAOIFI guidelines. The third highest score belongs to the item 12 which is 'Statement on the endorsed conformity of *Shari'ah* compliance is disclosed'. This item actually is the core of the SAR, since it legitimises the IBs' activities in the sight of customers; therefore, even the shortest SARs (*e.g.* 3-4 sentences long) are observed of consisting of this item. However, it is important to note that this item only checks the consent of SB without looking for any justification for such consent or expecting an explanation of the methodology how SB is convinced of such compliancy.

Similar to the report title, another technical detail is the period covered by the report which has also a high disclosure level throughout years. Another high disclosure score is found with item 21, which is the disclosure of name of the chairman. However, when it comes to disclosure of names of all members of SB (item 20) or signatures of the chairman and members (item 19 and 17), the disclosure level decreases for all the sampled years. Item 14, which is 'Report on the violations of *Shari'ah* compliance (if any) is disclosed', stays relatively low level of disclosure compared to the other AAOIFI standards required items, 1-18.

In this item, we checked whether there is any disclosure for the violations even if the income generated from such transaction is disposed to charitable causes. Although most

of the banks disclose the fact that they disposed impure income to charitable causes, they do not disclose the existence of violation of *Shari'ah* in the report. We believe, in terms of rhetoric, this is an important distinction. Furthermore, for those who disclose the violation of *Shari'ah* in relation to this particular item, the nature of violation is mostly omitted and contented within the disclosure of violation only.

Another point to note is the progress over time. It is evident that in general, there is a refinement in the reports from one year to the other in relation to the AAOIFI items. However, we cannot observe such a positive change in non-AAOIFI items with some exceptions such as item 19 and 27. Considering that the latter items indicate pro-activity beyond voluntary disclosure and transparency, it seems that IBs are not necessarily prepared to act in a pro-active manner in disclosing the expected items in their SARs.

#### **3.4.2. Analysis of Qualitative Data from SARs**

Although statistical findings help us to reflect on the degree *Shari'ah* scholars pay attention to the substantive morality articulated by IME, qualitative analysis of the published SARs through textual analysis reveals further details which cannot be detected in the statistical analysis. In this section, therefore, we focus on the content of SARs to show how *Shari'ah* scholars might be contented with approval of *Shari'ah* compliancy without substantiating it through any disclosure, and the concerns and the warnings of *Shari'ah* scholars raised in SARs are being ignored by the top-level management, which evidences the lost legitimacy and lost negotiating power of *Shari'ah* scholars and the hegemony of the market system in shaping their decision-making process.

SAR published by *Shari'ah* board of Affin Islamic Bank of Malaysia in 2008, for example, shows that how *Shari'ah* committee expects stakeholders to have trust in their judgement without disclosing any details of how the operations in Affin Islamic Bank were conducted. The following paragraph was the content of whole SAR in 2008:

We, DR. HAILANI MUJI TAHIR and DR. MD. KHALIL RUSLAN, two of the members of the Shariah Committee of AFFIN Islamic Bank Berhad, do hereby confirm on behalf of the Shariah Committee, that in our opinion, the operation of the Bank for the financial year ended 31 December 2008 have been conducted in conformity with the Shariah principles.

Although Malaysian Islamic banks have increased the level of information disclosed after 2008 as evidenced in this empirical research, such a short report of Affin Islamic Bank was not an exception in Malaysia during 2007 and 2008. Such reports imply that the trust on *Shari'ah* scholars' supervision of IBs does not stem, in most of the cases, from substantiated knowledge communicated through SARs or other channels but directly trusting on the existing of a SB and their approval of the operations. Thus, *Shari'ah* scholars have been using their position imposing themselves on the stakeholders by use of *Shari'ah* hegemony, while working towards enhancing the shareholders' interest under the hegemony of market mechanism. In other words, they work within the institutional logics of market system as represented by IBs and expect stakeholders to have trust in the outcomes and process of IBs as part of market system, by definition, due to being a *Shari'ah* scholar.

In terms of the influence of *Shari'ah* scholars in affecting the everyday operations of IBs, the content of SARs of Bank Al-Khair from Bahrain evidences the lack of power of *Shari'ah* scholars, at least for some IBs. It is not common to see that *Shari'ah* scholars warns management in terms of the lack of *Shari'ah* compliancy publicly, such as through SARs. However, SB of Bank Al-Khair disclosed the lack of *Shari'ah* compliancy of a project, namely Taj Mall project in their SAR in 2010. However, the SARs of the following years suggests that the management did not exit from the project as soon as possible, but the bank increased its involvement in other non-*Shari'ah* compliant projects (*such as*: Open Silicon and Logistics & Warehousing) along with the continued Taj Mall project. This was mainly due to the fact that they did not submit the projects to the approval of the SB in advance, but non-*Shari'ah* compliancy issues later revealed by the SB. The following is the excerpt of the related section from the SARs of Bank Al-Khair between 2010-2014 (the emphasis in the quotations are added):

*2010*: The contracts, transactions and dealings entered into by the Group during the year ended 31 December 2010 are in compliance with the rules and principles of Islamic *Shari'ah*, except the investment in **Taj Mall project** which the *Shari'ah* Board advised in a previous resolution to exit as soon as possible.

*2011*: The contracts, transactions and dealings entered into by the Group during the year ended 31 December 2011 are in compliance with the rules and principles of Islamic *Shari'ah*, except the investment in **Taj Mall project** which the *Shari'ah* Board advised in a previous resolution to exit as soon as possible.

*2012*: The contracts, transactions and dealings entered into by the Group during the year ended 31 December 2012 are in compliance with the rules and principles of

Islamic *Shari'ah*, except for the investment in **Taj Mall** which the *Shari'ah* Board advised in a previous resolution to exit as soon as possible.

2013: The contracts, transactions and dealings entered into by the Group during the year ended 31 December 2013 are in compliance with the rules and principles of Islamic *Shari'ah* except part of the investment in **Taj Mall project, Open Silicon and The Independent For Logistics & Warehousing** which were not submitted to the *Shari'ah* Board for approval before its execution, and appear later to be having explicitly non-*Shari'ah* Compliance issues.

2014: The contracts, transactions and dealings entered into by the Group during the year ended 31 December 2014 are in compliance with the rules and principles of *Shari'ah* except part of the investment in **Taj Mall project, Open Silicon and Logistics & Warehousing** which were not submitted to the *Shari'ah* Board for approval before its execution, and appear later to be having explicitly non-*Shari'ah* Compliance issues.

As it is clear from the above excerpts and examples, top-level management does not always act in line with the advice of SB. Considering that the non-*Shari'ah* compliant projects have increased in later years, this attitude is not due to the constraint of one particular project but approach of the management towards SB in general, namely they impose market conditions on the *Shari'ah* scholars and expect from them *Shari'ah* legitimacy in return for a place in their SB. As discussed in the following chapters, due to *Shari'ah* scholars' legitimacy is being drawn from their affiliation with a particular SB, they do not have negotiation power beyond giving advice. Since the top-management at IBs are aware of the attractiveness of SB posts among *Shari'ah* scholars, *fatwa* shopping, *fatwa* re-positioning (Ullah *et al.*, 2016), *Shari'ah* arbitrage (El-Gamal, 2007) facilitates the process imposing the market requirements and institutional logics of the bank on the *Shari'ah* scholars as conditions.

In summing; these qualitative analyses show the role and status of *Shari'ah* scholars in modern IBs as we will further evaluate in later chapters. In other words, the mere existence and approval of IB instruments and transaction by SB without substantiating with evidence can sustain the 'Islamic' identity of an IB, while their role of supervision does not have a significant impact on the everyday practice of an IB, at least in some IBs.

### **3.4.3. Results of Econometrics Analysis**

After presenting and discussing the statistical findings in relation to the disclosure scores and obtained qualitative data from SARs, this section focuses on the findings in

relation to the determinants of disclosure level established for  $SDI_{General}$  index and  $SDI_{AAOIFI}$  index in the previous section by using system-GMM analysis.

The pairwise correlation matrix of independent variables, as depicted in Table 3.11, suggests, in general, a low correlation among the pair of variables and there is no perfect multicollinearity among them. The result in Table 3.11, therefore, shows that we can conduct our system-GMM analysis with these variables. Table 3.12 and Table 3.13 presents the results for two models where we consider  $SDI_{General}$  and  $SDI_{AAOIFI}$  as dependent variables, respectively.

#### **3.4.3.1. Discussion of Results of $SDI_{General}$**

Tables 3.12 and Table 3.13 display the system-GMM test results. As the tables indicate, the number of observation is decreased to 179 from 305 in both models. This decrease is related to the internal process of system-GMM calculations which uses lagged values of variables, and therefore decreases the number of observations utilised. As for the independent variables, lag of dependent variable and popularity of *Shari'ah* scholars are significant variables in both models. The influence of previous year's report on the present year is clear since accumulation of knowledge and experience affects the later periods. However, while lag of dependent variable is significant at 10% for General index, it is significant at 5% significance level for AAOIFI index. As for the popularity of *Shari'ah* scholars, it is significant at 10% significance level in both models. Significance of popularity of *Shari'ah* scholars in both models suggests that sitting on multiple chairs positively influence the preparation of *Shari'ah* annual reports. This result suggests that if a SB is composed of *Shari'ah* scholars who have positions in multiple boards, level of disclosure in SAR increases, especially in terms of providing details. This might be due to the exposure to different reporting and disclosure styles in different boards. In other words, there might be a knowledge transfer from one institution to another where a *Shari'ah* scholar has a chair in both. Another explanation for the significance of this variable might be due to the prestigious status of these *Shari'ah* scholars who, in line with their reputation and experience, wants to issue quality reports with high disclosure level. This finding is also consistent with the finding of El-Halaby and Hussainey (2016) who argued that exposure of reputable *Shari'ah* scholars to modern banking and disclosure structures might help to produce higher level of disclosure. Considering that the measure of popularity in this study is

occupying a high number of chairs in multiple IFIs, in terms of policy making, placement of *Shari'ah* scholars in multiple chairs might be promoted to increase the level of disclosure.

Since the coefficient of lag of dependent variable for AAOIFI index (0.416) is almost twice as much as lag of dependent variable of General index (0.285), we can argue that while previous reports have a positive impact on the current year's report in both models, this positive influence is more evident in the AAOIFI index score. As for the popularity of *Shari'ah* scholars, both coefficients are close to each other (0.070 for General index and 0.094 for AAOIFI index).

**Table 3.11: Pairwise Correlation Matrix of Independent Variables**

Name of the Variable	No of Members	Leverage	Ind. Auditor	Internal SAD	Size	ROA	AgeOf Shariah	CPI	GDP Growth	Reg Quality	VandA	IsCountry AAOIFI	PopularitySB	Crisis Dummy	Av. Education	Board Size	CEO Duality
No of Members	1.00																
Leverage	0.05	1.00															
Ind. Auditor	0.04	0.04	1.00														
Internal SAD	0.15	0.25	-0.24	1.00													
Size	0.36	0.41	-0.13	0.25	1.00												
ROA	0.04	0.17	0.12	0.08	0.29	1.00											
AgeOfShariah	-0.02	0.27	0.00	0.17	0.22	0.24	1.00										
CPI	-0.04	-0.39	-0.29	0.05	0.10	-0.17	-0.21	1.00									
GDPGrowth	0.15	0.09	0.00	0.12	0.30	0.32	0.11	0.09	1.00								
RegQuality	0.03	-0.40	-0.36	0.06	0.00	-0.26	-0.33	0.89	0.01	1.00							
VandA	-0.19	-0.30	-0.06	-0.36	-0.33	-0.29	-0.27	0.56	-0.28	0.57	1.00						
IsCountryAAOIFI	-0.14	-0.10	-0.08	0.23	-0.05	0.20	0.42	-0.03	0.23	-0.11	-0.51	1.00					
PopularitySB	-0.02	-0.39	-0.40	0.16	-0.17	-0.22	-0.22	0.35	-0.17	0.32	0.16	0.06	1.00				
CrisisDummy	0.03	0.08	0.01	0.20	0.25	-0.10	0.17	-0.02	-0.19	-0.01	-0.08	0.05	0.00	1.00			
Av. Education	-0.07	-0.19	-0.02	-0.10	0.08	-0.09	-0.05	0.08	-0.02	0.01	-0.16	0.24	0.07	0.09	1.00		
Board Size	0.24	-0.12	-0.07	0.14	0.00	0.10	0.27	-0.08	0.03	-0.11	-0.20	0.28	0.22	0.01	-0.23	1.00	
CEO Duality	0.23	-0.10	0.16	0.11	-0.21	-0.13	0.01	-0.04	-0.27	0.08	0.01	-0.14	0.16	-0.09	-0.16	0.11	1.00

**Table 3.12: System GMM Test Results for SDI<sub>General</sub>**

Variable	Coefficient	Robust Std. error	t	P> t
SDI <sub>General</sub> (Lag1)***	0.285	0.168	1.700	0.100
RegularityQuality	0.003	0.002	1.610	0.118
VoiceandAccountability	0.000	0.002	-0.150	0.883
CPI	-0.040	0.032	-1.240	0.224
IsCountryAAOIFI	-0.099	0.093	-1.060	0.296
GDPGrowth	-0.020	0.236	-0.080	0.934
CEODuality	-0.076	0.133	-0.570	0.572
LogSize	-0.029	0.044	-0.660	0.515
Leverage	-0.058	0.161	-0.360	0.720
ROA	-0.452	0.398	-1.130	0.265
IndependentAuditor	0.026	0.026	0.990	0.330
InternalSAD**	0.216	0.098	2.200	0.035
CrisisDummy	-0.009	0.020	-0.450	0.653
AgeofShariah	0.004	0.003	1.400	0.171
NoofMembers	-0.005	0.025	-0.180	0.855
AverageEducation	0.072	0.048	1.500	0.143
Popularity***	0.070	0.036	1.960	0.058
BoardSize	0.016	0.016	1.050	0.304
Constant	0.036	0.381	0.100	0.924
No of Obs.	179			
No of Groups	33			
No of Instruments	28			
AR(1)	0.048			
AR(2)	0.380			
Hansen Test (p-val)****	0.276			

Notes: \*p < 0.10; \*\*p < 0.05; \*\*\*p < 0.01; \*\*\*\* Since robust standard errors were utilised, we only report Hansen test result

Existence of an internal *Shari'ah* auditing department is the third and last significant variable for the first model. The findings show that having a dedicated *Shari'ah* auditing department in the bank also affects the level of disclosure and suggests that IBs with an internal *Shari'ah* auditing department disclose more (with an amount of 0.167) compared to the IBs without such department in terms of SDI<sub>General</sub> score while existence of internal *Shari'ah* auditing department is insignificant in terms of level of disclosure in SDI<sub>AAOIFI</sub> score. Positive impact of the existence of internal *Shari'ah* auditing department may stem from providing necessary information and reports to the SB for revision and helping them to compile more comprehensive annual reports. Considering the fact that SDI<sub>General</sub> contains detailed information over the AAOIFI guidelines, existence of such department might facilitate the flow of information to fulfil the expectation of such comprehensive index. This result is also consistent with

the empirical findings of the literature regarding the positive influence of an internal auditing department (Gordon and Smith, 1992; Schneider and Wilner, 1990). Furthermore, this finding suggests that regulatory authorities at the state level or independent institutions such as AAOIFI should pay more attention to establishment of internal *Shari'ah* auditing departments to increase the level of disclosure.

**Table 3.13: System GMM Test Results for SDI<sub>AAOIFI</sub>**

Variable	Coefficient	Robust Std. error	t	P> t
SDI <sub>AAOIFI</sub> (Lag1)**	0.416	0.187	2.220	0.034
RegularityQuality**	0.007	0.003	2.490	0.018
VoiceandAccountability	-0.005	0.003	-1.470	0.150
CPI	-0.026	0.043	-0.620	0.541
IsCountryAAOIFI***	-0.209	0.117	-1.790	0.083
GDPGrowth	-0.327	0.324	-1.010	0.319
CEODuality	-0.216	0.162	-1.340	0.191
LogSize	-0.073	0.064	-1.140	0.262
Leverage	-0.046	0.228	-0.200	0.840
ROA	-0.407	0.504	-0.810	0.425
IndependentAuditor	0.020	0.034	0.610	0.549
InternalSAD	0.069	0.171	0.400	0.691
CrisisDummy	-0.012	0.034	-0.340	0.736
AgeofShariah***	0.009	0.005	1.840	0.074
NoofMembers	0.021	0.041	0.510	0.613
AverageEducation	0.000	0.088	0.000	0.998
Popularity***	0.094	0.052	1.790	0.083
BoardSize	-0.005	0.020	-0.270	0.790
Constant	0.900	0.664	1.360	0.185
No of Obs.	179			
No of Groups	33			
No of Instruments	28			
AR(1)	0.122			
AR(2)	0.169			
Hansen Test (p-val)****	0.338			

Notes: \*p < 0.10; \*\*p < 0.05; \*\*\*p < 0.01; \*\*\*\* Since robust standard errors were utilised, we only report Hansen test result.

### 3.4.3.2. Discussion of Results of SDI<sub>AAOIFI</sub>

As it can be seen in Table 3.13, there are three independent variables unique to the second model, namely Regularity Quality, isCountryAAOIFI and AgeofShariah variables. RegularityQuality has a small positive impact with a coefficient of 0.007, which suggests that regularity quality of a country increases the level of disclosure

according to AAOIFI standards, which is meaningful since AAOIFI standards for SARs are also part of regularity framework. This result is also consistent with the literature in which regulatory quality has a positive impact on disclosure level (Ernstberger and Grüning, 2013; Leuz *et al.*, 2003). This suggests that to improve the transparency and level of disclosure at IBs in line with the governance standards of AAOIFI, it is also important to consider country level factors such as regulatory quality and strive to develop them further at country level.

Adoption of AAOIFI standards at the country level is also significant in the second model as it is expected. However, the sign of the coefficient is expected to be positive suggesting that IBs in countries adopted AAOIFI guidelines receive a higher score of  $SDI_{AAOIFI}$  compared to the other countries, as El-Halaby and Hussainey (2016) suggested, since a formal adoption of AAOIFI standards at country level creates a regulatory pressure to comply with the AAOIFI standards at bank level. The sign of the coefficient, however, is negative. Although at first sight, this seems contradictory, when we examine Table 3.7, the reason becomes more obvious. Out of four countries adopted AAOIFI governance standards, while Bahrain and Jordan have a high level of disclosure (0.83 and 0.81, respectively), Sudan and Qatar perform quite poor (0.55 and 0.47, respectively). On the other hand, countries such as the UAE, South Africa, Lebanon, UK and Malaysia perform very well and above 65% despite not adopting AAOIFI standards at country level. This shows that adoption of AAOIFI governance standards at country level does not yield the same result in all cases as Bahrain and Qatar, both adopting the standards and being neighbour countries, produce very different outcomes in terms of disclosure level. This requires further analysis of country or bank level determinants. As mentioned earlier, one such reason might be *Shari'ah* scholars employed at IBs and their personal influence in SARs as all three IBs in Qatar have the same chairman in SBs.

As for the *ageofShariah* variable, it is significant at 10% significance level with a coefficient of 0.009. This indicates that as the IB gets more experience in *Shari'ah* compliancy, it fulfils the guidelines of AAOIFI more. This finding is consistent with Cormier *et al.* (2005) and Hossain and Hammami (2009).

In providing a brief conclusion, Table 3.14 summarises the results of hypotheses testing process by presenting the results together.

**Table 3.14: Summarising the Results through Hypotheses**

Hypothesis	SDI <sub>General</sub>	SDI <sub>AAOIFI</sub>
<i>H<sub>1</sub>: There is a positive relationship between regularity quality of the country and level of disclosure in SAR.</i>	Rejected	Failed to Reject**
<i>H<sub>2</sub>: There is a positive relationship between voice and accountability of the country and level of disclosure in SAR.</i>	Rejected	Rejected
<i>H<sub>3</sub>: There is a positive relationship between corruption index score of the country and level of disclosure in SAR.</i>	Rejected	Rejected
<i>H<sub>4</sub>: The level of disclosure of SAR is expected to be higher in IBs located in countries which adopts AAOIFI standards than in countries that do</i>	Rejected	Failed to Reject ***
<i>H<sub>5</sub>: There is a positive relationship between GDP growth of the country and level of disclosure in SAR.</i>	Rejected	Rejected
<i>H<sub>6</sub>: SAR of large IBs are more likely to disclose more information than small IBs.</i>	Rejected	Rejected
<i>H<sub>7</sub>: There is an association between profitability and the level of disclosure.</i>	Rejected	Rejected
<i>H<sub>8</sub>: There is a positive relationship between leverage of IB and level of disclosure in SAR.</i>	Rejected	Rejected
<i>H<sub>9</sub>: The level of disclosure of SAR is predicted to be higher in IBs audited by the Big 4 auditors than in IBs that are audited by non-Big 4</i>	Rejected	Rejected
<i>H<sub>10</sub>: There is a positive relationship between existence of internal Shari'ah Auditing Department of IB and level of disclosure in SAR.</i>	Failed to Reject **	Rejected
<i>H<sub>11</sub>: SAR of IBs after the crisis are more likely to disclose more information than pre-crisis period.</i>	Rejected	Rejected
<i>H<sub>12</sub>: Older IBs are expected to disclose more information in SAR than younger IBs.</i>	Rejected	Failed to Reject ***
<i>H<sub>13</sub>: There is a positive relationship between size of SSB and level of disclosure in SAR.</i>	Rejected	Rejected
<i>H<sub>14</sub>: There is a positive relationship between average level of education of SB members and level of disclosure in SAR.</i>	Rejected	Rejected
<i>H<sub>15</sub>: There is a positive relationship between popularity of SSB and level of disclosure in SAR.</i>	Failed to Reject ***	Failed to Reject ***
<i>H<sub>16</sub>: There is an association between board size and level of disclosure in SAR.</i>	Rejected	Rejected
<i>H<sub>17</sub>: There is an association between CEO duality and level of disclosure in SAR.</i>	Rejected	Rejected

Notes: \*p < 0.10; \*\*p < 0.05; \*\*\*p < 0.0

### 3.5. CONCLUSION

The previous chapter aimed at constituting a model of ICG system, which essentialises an extended stakeholding model with its unique knowledge base, that is Islamic ontology. However, it acknowledges the divergence in the practice of IBs from the identified ideal or aspirational model. Building on the theoretical model presented in Chapter 2, the empirical attempt in this essay explored and examined the level of disclosure in SARs of 41 IBs from 15 countries throughout an eight-year period and the factors affecting the level of disclosure. In addition, to assess the influence of AAOIFI standards for SAR related disclosure, we constructed two indices, one is completely based on AAOIFI standards (SDI<sub>AAOIFI</sub>), while the second index (SDI<sub>General</sub>) has 16

additional items to explore as to whether SARs disclose any further information through pro-active behaviour beyond the AAOIFI standards to provide transparency with the objective of identifying voluntary disclosure in line with IME expectations.

Based on the scores of  $SDI_{General}$  and  $SDI_{AAOIFI}$ , we can argue that  $SDI_{AAOIFI}$  scores are considerably higher than  $SDI_{General}$ , which suggests that published guidelines of AAOIFI standards regarding SARs are influential in the preparation of the reports regardless of the commitment of the country to AAOIFI standards. Especially, detailed analysis of SARs shows that most of the SBs use the template provided by AAOIFI close to mimicry level. Also, for both indices, the results demonstrate that there is a gradual increment in disclosure practice year on year within the sampled period. Nevertheless, this is not valid for some IBs, since there are some examples where the level of disclosure decreases. As for the  $SDI_{General}$  score, in general it has scored lesser level of disclosure compared to the  $SDI_{AAOIFI}$ . This result suggests that going beyond the general statements to inform stakeholders about the activities and *Shari'ah* compliancy issues of IBs with the aim of providing transparency as an articulation of IME in Islamic finance sector is highly neglected. Thus, it seems that there are some positive developments in voluntary disclosure in the sense of complying with AAOIFI standards for SAR; however, as discussed above, 'substantive morality' related expectations in IB industry are not fulfilled in disclosure practice either. Hence, the recent debate focusing on 'form vs. substance' indicating that IBs have focused on form compliance and neglected the substantive morality in their operations seems to be relevant for disclosure practices as well. As the discussion on ICG indicates, IBs need to operate within ICG in order to have consistency between their *Shari'ah* complaint operations and their governance structure, which may help to overcome the observed problems relating to the lack of substantive morality. Since this study aimed at essentialising such a comprehensive understanding of governance in IBs, we developed  $SDI_{General}$  beyond the compliancy or form oriented nature of AAOIFI standards as expressed in  $SDI_{AAOIFI}$ . However, the scores for  $SDI_{General}$  compared to  $SDI_{AAOIFI}$  are indication of the mentioned neglect on substance related issues despite the fact that  $SDI_{General}$  index did not impose essential ethical requirement as expected from IME augmented ICG.

It should be noted that the findings of this empirical analysis based on the disclosure analysis of SAR is not only a matter of difference between two sets of indices one being more detailed than the other, but a symptom of a serious paradigm shift. This paradigm shift refers to a shift from the initial imagination of Islamic morality-based understanding of Islamic economics and finance by the founding fathers towards a form-oriented everyday practice of IBs through the negative screening process applied by the SBs. Disclosure level in SARs, in this regard, should be considered as a symptom of this problem and could be treated only through the implementation of IPE theoretical structural framework at the CG level, which means adoption of an ICG system as constituted by the substance of IME within IPE structure.

As for the content analysis, SARs revealed two pieces of information. In communicating with the shareholders, SBs of some IBs, particularly in Malaysia, contented with only approval of *Shari'ah* compliancy rather than disclosing any further details. This indicates that some SBs expect from shareholders to have a full trust in their decisions. Considering that such limited disclosure practice do not have a negative impact on 'Islamic' identity of respective IBs, we can argue that they succeed in holding the Islamic identity by mere existence of a SB. Secondly, the example of Bank Al-Khair from Bahrain, for example, reveals that the advice of a SB on the operation of an IB might have very limited impact on the everyday operations. This is an important matter in terms of considering that Islamic economics movement in its origin aimed creating an alternative authenticated through Islamic ontology.

In terms of factors affecting the level of disclosure, we can conclude that lag of dependent variable and popularity of *Shari'ah* scholars are two significant variables for both  $SDI_{General}$  and  $SDI_{AAOIFI}$ . While existence of an internal *Shari'ah* auditing department has some explanatory power for  $SDI_{General}$ , it disappears in the case of  $SDI_{AAOIFI}$ . On the other hand, we observe three new factors influential in  $SDI_{AAOIFI}$  score: adoption of AAOIFI standards at the country level, regulatory quality of country and age of *Shari'ah* compliancy which might indicate that these three variables are particularly deterministic in terms of complying with AAOIFI standards for SARs.

These results indicate that disclosure of SB members in their annual reports by itself does not contain adequate details to convince stakeholders to *Shari'ah* compliancy of the institution. However, their explicit approval for *Shari'ah* compliancy of the

institution in these reports without disclosing details of their analysis seems a sufficient condition for the stakeholders considering the high growth rate of the Islamic banking sector during the last decades. Therefore, it is necessary to explore *ifta* (issuing a ruling) institution further in its historical trajectory to reveal how such trust has been gained and whether similar conditions are valid for *Shari'ah* scholars employed in modern Islamic banking sector today, which is the topic of the fourth and fifth chapters.

Before investigating historical trajectory of *ifta* institution, however, it is necessary to analyse relationship between IBs and conventional banks which especially became a matter of concern and has revealed itself in everyday practice of IBs after the entrance of IBs to the global financial market in which they have to compete with conventional banking sector in terms of efficiency and minimisation of cost. *Shari'ah* scholarship in facilitating this process is considered as a new dynamic leading to compromise. We can frame the emerged relationship between Islamic banking sector and conventional banking sector and the role of *Shari'ah* scholars in this process within postcolonial theories which is the topic of next chapter.

## CHAPTER 4

# EXPLORING INSTITUTIONAL AND PRODUCT EMERGENCE IN ISLAMIC BANKING SECTOR: A POSTCOLONIAL PERSPECTIVE

### 4.1. INTRODUCTION

For a long time, it is believed that modernity as it developed in the West represents a single and universal truth towards which each society is expected to converge. The consequent modern society that is originated in Europe has its unique structures and institutions which distinguishes it from the rest of the world. In the process, the West constituted a binary relation with the rest of the World, such as the West/the East, rational/irrational, developed/underdeveloped, *etc.* determined by the modernist benchmarks. In order to ensure homogenous development trajectory, the West undertook the ‘civilising mission’ in order to transmit structures and institutions of this unique paradigm to ‘the other’ to complete their ‘civilising mission’, which was facilitated by the emergence of ‘colonialism’ as a strategy. However, this encounter between the colonizer (the West) and the colonised (the other) did not always result into the expansion of ‘civilising’, as colonial subjects did not always accept ‘the universal truth’ presented by the colonial powers.

Thomas Babington Macaulay contended that in order to bring the Western knowledge and the power of reason to colonised subjects, they needed intermediators who look similar to colonised subjects but think and act according to the Western principles at the same time. Their mission would be to carry the Western knowledge to colonised subjects (Young, 1952). Macaulay, in his infamous *Minute on Education* stated that (as cited by Young, 1952: 729):

We must at present do our best to form a class who may be interpreters between us and the millions whom we govern, - a class of persons Indian in blood and colour, but English in tastes, in opinions, in morals and in intellect. To that class we may leave it to refine the vernacular dialects of the country, to enrich those dialects with

terms of science borrowed from the Western nomenclature, and to render them by degrees fit vehicles for conveying knowledge to the great mass of the population.

This education program, however, did not result always in conveying ‘knowledge of the West’, as it exists in the West: sometimes, it led to generation of emergent hybrid structures and institutions which can be marked as ‘in-between’ of this binary encounter resulting from the negotiations between the coloniser and the colonised as a form of resistance against the domination of the West (Bhabha, 1994).

These hybrid institutions were inevitable consequences of the observed ‘break’ in the imagination of universality of the Western modernity. Consequently, instead of accepting the knowledge of the West as ‘the only truth’, colonised subjects adopted it according to their own knowledge and culture through an adaption process (Eisenstadt, 2000). In relation to Muslim societies, such a ‘break’ resulted in the Islamisation of knowledge (of the West) in a ‘battle against unbelief’ to revive Islam against the hegemony of the global (Tibi, 1995).

One of these hybrid institutions is Mit Ghamr Saving Bank, a pioneer institution in Islamic banking, which was founded in Egypt in 1963. During his graduate study in West Germany (as it was known by then), Ahmed Najjar, the founder of Mit Ghamr Saving Bank, witnessed the role of local saving banks in the development of West Germany after the World War II. He believed that structure of local saving banks could be utilised to increase saving rate in Egypt which in return could help to increase rural development as the increased deposits could be used to finance small entrepreneurship leading to development. With this intention in mind, he contacted local authorities to transmit knowledge with the objective of actualising of this Western institution in line with local characteristics of Egypt. Since Egypt is a country with Muslim majority population, in order to be accepted by rural people, Najjar reconstructed the German local saving bank model in accordance with Islamic principles by ensuring *Shari’ah* compliancy including prohibition of interest (Mayer, 1985). Through the formation of Mit Ghamr Saving Bank, Najjar aimed to combine a Western institution, namely German local saving banks, with Islamic principles such as prohibition of interest and profit-loss sharing. As a result of this effort, this institution became an example of multiple modernities by forming a financial institution (rural saving bank) through reshaping conventional local saving bank from Germany according to Islamic principles in the sense that the operations of an institution based on ‘rational ontology’

is re-shaped according to 'Islamic ontology' leading to 'multiple modernities' as contended by Eisenstadt (2000).

Although experience of Islamic banking started as a local institution in 1963 with the objective of facilitating rural development as part of Islamic economics movement, the second phase of Islamic banking development set in with the global diffusion and expansion after the 1990s, as private Islamic banks extended their services to international markets (Khan, 2009). In order to compete with conventional financial institutions at international level, contrary to the local markets, it was inevitable to encounter with capitalist hegemony. Due to the entrance of Islamic banking sector to international markets which has been dominated by neo-classical principles, another colonial process has emerged between capitalist hegemony and Islamic banks (IBs). Consequently, a dichotomy between capitalist principles and Islamic principles has been formed as rational (conventional banking)/irrational (Islamic banking) binary relation. In this colonial process, Islamic banks could be considered as a colonised subject by hegemonic power of conventional banks. Hence, in order to be 'civilised' or to be 'rational', Islamic banking sector had to follow capitalist principles alongside *Shari'ah* compliancy process instead of entirely working with the substantive moral principles of Islam in its operations and institutional level. This is due to the fact that in this process, capitalist principles are believed to be universal and should be accepted and implemented by all financial institutions, including Islamic banks. As part of the double sword, at the same time, Islamic banks are expected not to cross the borders of Islamic law to protect its 'Islamic' identity as ensured by the *Shari'ah* compliancy process.

In competing with conventional banking sector, employees of Islamic banking sector (financial innovators, *Shari'ah* scholars, managers, *etc.*) are exposed to capitalist principles and heavy financial engineering instruments of conventional banks through education (such as university education) with the aim of Islamisation of these instruments, and, then, adaptation to Islamic banks. As a result of 'education' and through other channels, 'interpreters' have translated 'opinions', 'morals' and 'intellect' of capitalist principles into Islamic law to let Islamic banking sector to 'mimic' the dominant power, namely conventional banking sector to the extent that 'Islamic capitalism' has been uttered as 'a paradigm' regardless of the ontological

inconsistencies (*such as*: Cizakca, 2011). Consequently, the new instruments and procedures were developed based on capitalist principles rather than Islamic principles with an added filtering mechanism in order to ensure *Shari'ah* compliancy. In other words, mimicking of conventional financial institutions has been accomplished through Islamisation of knowledge, in this case, Islamisation of knowledge of conventional banking sector. As a result of this mimicry, Islamic banks have converged to its conventional counterpart with an increasing pace. In this process, mimicry of Islamic banks, consequently, created a recognisable 'other of conventional banking', as Bhabha (1994: 86) states:

Colonial mimicry is the desire for a reformed, recognizable Other, as a subject of difference that is almost the same, but not quite. Which is to say, that the discourse of mimicry is constructed around an ambivalence; in order to be effective, mimicry must continually produce its slippage, its excess, its difference.

Although Islamic banks act according to capitalist principles, there is always an excess that does not fit to capitalist principles and makes Islamic banks different that is the obligation of being *Shari'ah* compliant. Therefore, this 'recognizable other' is also a threat for the dominant power, namely conventional banking sector, since "mimicry is at once resemblance and menace" (Bhabha, 1994: 86). This is because customers of Islamic banks have not only started to enjoy similar conditions with conventional banks (such as similar rate of returns and mark-up fees) due to mimicry, but also have the privilege of using *Shari'ah* compliant instruments. Therefore, this mimicry has become a 'menace' for conventional banks since their customers may be attracted by this excess, namely being *Shari'ah* compliant.

Following this process, conventional banking sector moved to a new state indicating the third phase of Islamic banking development. In this state, conventional banks began copying Islamic banking structures and instruments, in particular *Shari'ah* supervisory board unit, by adopting it to its modern framework. Hence, this mimicking entailed another hybrid structure, a banking institution, namely Islamic banking, which is established in a modern framework and is shaped by positivist ontology, and at the same time, through a window, acts according to Islamic law and is bound by *Shari'ah* scholars' rulings instead of 'reason' to meet the requirements of Islamic finance institutions.

This chapter, therefore, argues that development of modern Islamic banking sector can be divided into three stages:

- (i) first stage starts with establishment of the first Islamic bank as a hybrid institution within the multiple modernities framework and extends to the entrance of Islamic banking sector into competition at the global scale;
- (ii) second, convergence of Islamic banking institutions to conventional banking and finance institutions due to competition at the global scale;
- (iii) lastly, convergence of conventional banking towards Islamic banking through copying Islamic banking structure and its instruments and adopting them into its modern framework in order to attain customers of Islamic banks and to keep its existing ones by instituting Islamic windows.

In the next section, we discuss the establishment of Islamic banking as an example of multiple modernity. The third section presents the convergence process of Islamic banks towards conventional financial institutions through mimicry due to the competition in international markets. In the fourth section, how this mimicry has led a new hybrid institution in the conventional banking is discussed. Finally, we present concluding remarks.

## **4.2. FROM MODERNITY TO MULTIPLE MODERNITY: EMERGENCE OF INSTITUTIONS**

With the aim of spreading the universal social formation of modernity, hegemonic colonising powers travelled to many corners of the world with the objective of transmitting the modernist project to every society. However, the goal of imposing modernity as one and the only universal guide failed due to various factors including the resistance of local power leading to the emergence of ‘post-modernity’ suggesting that each ontological existence can lead to develop their own social formation (Euben, 1997). However, due to the hegemonic domination of Eurocentricity, the experience has proven that modern is still produced by reference of various cognitive rationalities leading to multiple modernities (Eisenstadt, 2000). In other words, resistance of local societies against ‘the universal truth’ of modernity led to the local interpretations of the Western modernity. Consequently, instead of accepting the project of the Western

modernity as it is, every society, which has been imposed with the principles and institutions of modernity, adopted them in many cases according to local characteristics of the society leading to multiple modernities through a particular blending process (Eisenstadt, 2000). Such a drastically change in the underlying values of the society, as a result, led to the long-lasting and fundamental transformations in the society (Portes, 2010b), as Portes (2010a) argues that in its origin, organic institutions emerges from the social formation of the respective societies (as explained in Chapter 2).

#### **4.2.1. IBF as an Example of Multiple Modernities**

During the 1960s, Muslims' search for an Islamic identity and strive for establishing Islamic institutions in modern world accelerated the adoption process and creation of hybrid institutions in the sense of 'modernising' Islamic institutions as a product while keeping the process as 'Islamic' (Warde, 2000). Pioneering example of Islamic banking, Mit Ghamr bank, was established in 1963 as a result of such quest through the hybridisation of saving banking institution of capitalist financial system with Islamic principles (Dar and Presley, 2003) to provide financing for small entrepreneur with the objective of capacity development. The theoretical justification for such transformation is provided by the 'Islamisation of knowledge' movement (Haneef, 2005). Despite being a successful experiment in multiple modernities, Mit Ghamr was closed, mostly due to the political reasons, as capacity development through civil society initiative beyond the power of the Egyptian centre was not allowed (Mayer, 1985). Nevertheless, relatively successful prototype of Islamic banking led to the initiation and development of Islamic commercial banking as the new institutional formation operating with Islamic principles (El-Ashker, 1990).

Islamic banking institutions have been established as part of an alternative financial sector to its conventional counterpart with the aim of operating according to the principles of *Shari'ah* rather than capitalism. The most salient feature of Islamic banks is, therefore, to provide *Shari'ah* compliant products and services, mainly with the purpose of fulfilling the demands of Muslim customers in the capitalist financial system without contradicting with the principles of *Shari'ah*. However, since they operate under the secular nation states, which cannot provide any legitimacy regarding the *Shari'ah* compliancy, they needed to employ jurist-consults or *Shari'ah* scholars as experts on Islamic law and seek for legitimacy through their approval of the product

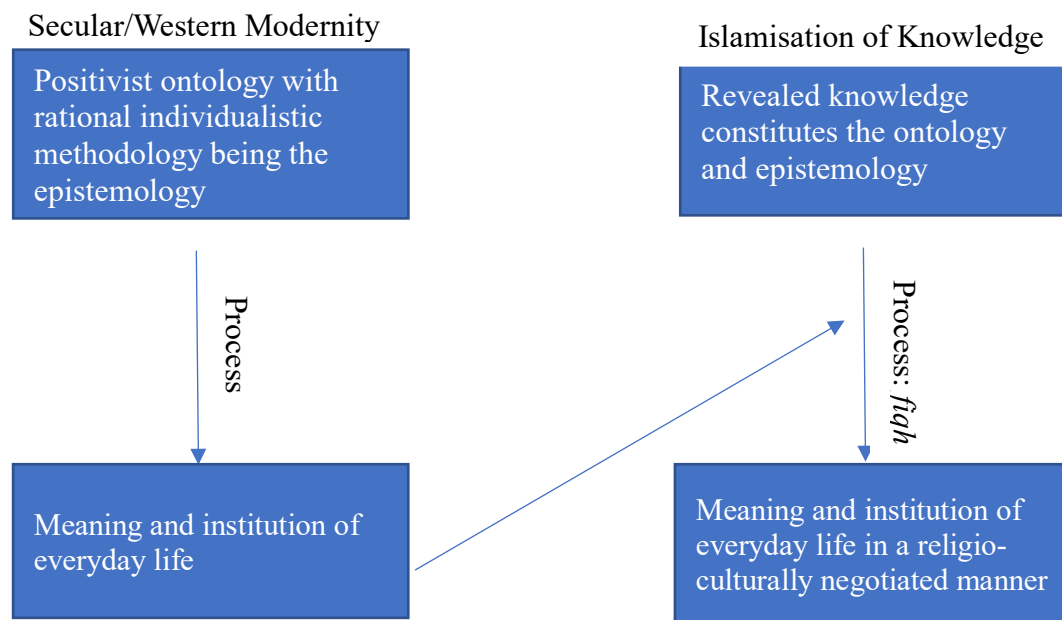
and services operating in the Islamic banks. Although each Islamic bank might use a different strategy (employing a consultancy firm in *Shari'ah* or having a *Shari'ah* Board division), at the end, each one of them has to seek consent from *Shari'ah* scholars to sell *Shari'ah* compliant products and services. *Shari'ah* Board structure in particular and *Shari'ah* governance of Islamic banks in general, hence, aims to monitor and investigate the operations to legitimise Islamic banks in the eyes of the stakeholders, particularly the customers. *Shari'ah* governance of Islamic banks can be labelled as “its excess, its difference”, as Bhabha (1994: 86). Islamic banks, hence, represents an emergent pattern within the multiple modernities framework due to its adherence to a modern institution, namely the bank, and aiming to operate such institution with Islamic principles to comply with local norms and values. The nature of emergent pattern of IB is due to the fact that in their current form they only represent the repetition of banking practices with Islamic excess; however, if IBs were to develop new structures, instruments and operations in organic manner as argued by Portes (2010a), then the nature would have been emergence<sup>3</sup> (Asutay, 2012b). Thus, emergent pattern nature fits into multiple modernity explanations, while emergence would have been the consequence of post-modernity in terms of developing entirely new (non-replicated) paradigm as a novel construct(Asutay, 2015b).

Figure 4.1 depicts the emergence of Islamic banking institution as a result of Islamisation of knowledge process. Islamization of ‘meaning and institution of everyday life’ constructed based on positivist ontology through a filtering process of *fiqh* (Islamic law), resulted into a negotiated, hybrid institution. The religio-cultural interpretation of Islam in a rational manner by adopting the norms and institutions of modern reality locates Islamic finance in multiple modernities; as it is no longer attached to the emergence of Islamic moral economy, which is part of postmodern due to its claim for alternative modes of production leading to an Islamic social formation.

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<sup>3</sup> Further discussion on emergence and emergent pattern distinction can be found in the literature such as: Harper and Lewis (2012); Martin & Sunley (2012); Harper and Endres (2012).

**Figure 4.1: Modern Becoming Islamic: Islamisation Process**



Source: Asutay (2009)

Although Islamic banking sector has started as local banking and has been striving with the political problems due to the secular nature of the modern nation-states, it has expanded all over the world, especially during the last decades as a result of the facilitatory force of the globalisation (Imam and Kpodar, 2010). Due to the entrance of Islamic banks to the competition with conventional banking sector in the global financial markets, Islamic banks have been pressurised with the hegemony of conventional banking to run with capitalist principles in the everyday practice which resulted in a convergence towards capitalist principles, while striving to keep ‘Islamic’ identity intact, which we discuss in the following section in detail.

#### **4.3. MIMICRY OF ISLAMIC BANKING: GLOBALISATION OF ISLAMIC BANKING AND ITS CONVERGENCE TOWARDS CONVENTIONAL BANKING**

Compared to the early stages of Islamic banks, we observe a convergence towards prioritising principles of capitalism internalised through *Shari'ah* compliancy process in product design and everyday practice of these institutions during the last decades rather than essentialising Islamic moral economy objectives (Asutay, 2012a). The most influential reason in this observed convergence is the increased competition between

Islamic banks and their conventional counterparts especially after the 1990s due to internationalisation of Islamic banks in entering into the world markets (Warde, 2000).

As a result of entering into competition with the conventional banking sector, neoclassical principles and concepts such as ‘efficiency’, ‘low transaction cost’, ‘profit maximisation’ and ‘shareholder corporate governance model’ have gained dominance in the operation and diffusion of Islamic banking institutions for keeping pace with conventional banking due to the competition process, which has been in contrast with the initial imaginary and authenticated moral economy of Islamic aspirational position aiming to create alternative institutions with their authenticated working mechanisms and objectives (El-Gamal, 2006; Asutay, 2007; 2012a). In other words, while Islamic moral economy aims at creating a particular paradigm through its own worldview by considering Islamic banks as an instrument of that paradigm (referring to post-modern), Islamic banks have found refuge in neo-classical operational principles plus the form compliancy according to *Shari’ah* (Asutay, 2007; 2012a).

Considering the form compliancy of product and services as sufficient condition for ‘Islamic’ identity, *fiqh* or codified Islamic law-based filtering process of Islamisation of knowledge produced efficient, low transaction-cost products and services for Islamic banks as an outcome of the mimicking process. In other words, conventional products are subjected to *Shari’ah* filtering mechanism to ensure their form-based compliancy. This convergence suggests that morality of capitalism and principles and values of conventional banking have become more dominant in Islamic banking sector instead of substantive morality of Islam. This paradox in current times leads to the distinction between ‘*Shari’ah* compliant Islamic finance’ vs ‘Islam based Islamic finance’ (Asutay, 2012a).

It is important to note that this study does not claim that all the products and services of Islamic banks have been mimicking conventional banking and have been conflicting with the objectives of *Shari’ah*. On the contrary, as mentioned earlier, Islamic banking sector has emerged based on Islamic principles with an imagination to establish an alternative sector to conventional banking by representing an emergence science rather than emergent pattern (Asutay, 2012b). However, product innovation processes of last decades show that high utilisation of certain instruments such as organised *tawarruq*, an Islamic financial instrument for meeting the short-term liquidity need, with the

objective of providing competitive products in the banking industry resulted in the prioritisation of efficient products and services with minimum transaction-cost over fulfilment of the objectives of *Shari'ah* (Khniifer, 2010).

Although *Shari'ah* scholars cannot or do not prevent this convergence, they still need to reconcile the products and services of Islamic banking sector with Islamic law through the compliancy process to keep the 'Islamic' identity intact. In the next section, hence, we explore 'organised *tawarruq*' utilised by Islamic banks as an instrument for solving short-term liquidity problem faced by Islamic banks, with the intention of revealing the justification of this instrument in terms of *fiqh* or Islamic law. The reason of selection of this instrument is twofold; firstly, it constitutes the backbone of Islamic banks' liquidity and underlying mechanism of many recently developed products and services which requires liquidity facilitation (Khniifer, 2010). Secondly, International Council of Fiqh Academy (ICFA), an independent and international forum of *Shari'ah* scholars declared that it is impermissible according to *Shari'ah* in its 19th session in 2009, yet it is heavily used in Islamic banking sector (Msatfa, 2011). A scrutiny of organised *tawarruq* reveals that two methods of reconciliation are employed in terms of justification: (i) transformation of exception into the norm and (ii) delusional *maslahah*.

The following sections discuss two reconciliation methods of *Shari'ah* scholars in order to mimic conventional products while justifying them on the ground of Islamic law. Considering the widespread usage and constituting the backbone of Islamic banking sector, organised *tawarruq* seems to be the most appropriate innovation for this purpose. However, before exploring these two methods, we first explain the classical and organised *tawarruq*.

#### **4.3.1. Classical and Organised *Tawarruq*: A Case Study**

Classical *tawarruq* is employed with the objective of obtaining cash money, especially for short-term needs within Islamic financing activity. In this financial transaction, firstly, *mutawarriq* or seeker of cash purchases a commodity from a seller on deferred payment. In the next step, *mutawarriq* sells this commodity in the market on cash for a lower price to a third party (Dusuki, 2010). It is important to note that since *mutawarriq* engage in these separate transactions personally, it is required to have a

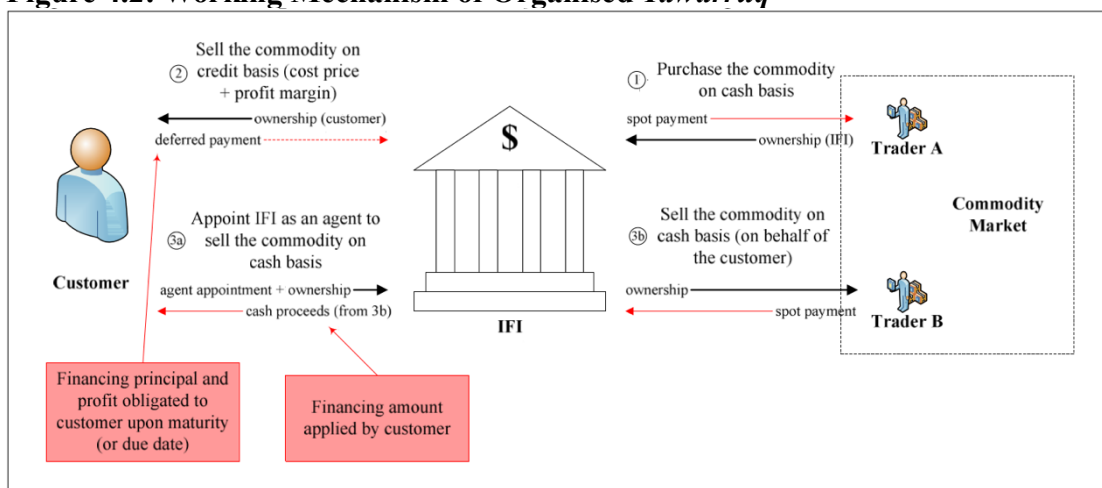
certain degree of involvement with the market to achieve the intended goal, namely liquidity. Such an involvement promotes a certain degree of embeddedness with the surroundings, which makes a distinction with its organised counterpart as it is applied in the modern Islamic banking sector.

Although utilisation of classical *tawarruq* has been a topic of debate by jurists due to its substance which is considered as an interest-like instrument despite its form-compliancy, organised *tawarruq* was constructed in a more controversial structure to increase the efficiency and decrease the transaction cost to attain liquidity, as it is depicted in Figure 4.2.

The most important difference between classical and organised *tawarruq* is the removal of *mustawriq*'s or seeker of cash involvement in the process and transferring intermediary steps to Islamic bank. In order to construct such an efficient and low-transaction cost instrument, an exception, which is the delegation system, is transformed into a norm. In other words, delegation of engaging in a contract (buying and selling of the same product) to other agents is institutionalized, which should be carried out by the individual himself under normal circumstances. Therefore, Islamic bank as an institution of market system acts as a proxy to achieve customer's goal without any direct involvement of the customer with the market except Islamic banks.

Figure 4.2 depicts the working mechanism of organized *tawarruq* as it is implemented in Islamic banks:

**Figure 4.2: Working Mechanism of Organised *Tawarruq***



Source: Ghazali (2014: 70)

Al-Suwailem (2009) points out there are three differences between classical and organized *tawarruq* as follows:

- (i) While the original seller does not play any role in the final transaction in classical version of *tawarruq*, in organised *tawarruq*, original seller which is Islamic bank, plays an intermediary role between the customer and brokers in LME;
- (ii) While the customer obtains the cash from the final buyer in the case of classical *tawarruq*, in organized *tawarruq*, the customer acquires the cash from the original seller which is Islamic bank;
- (iii) While the original seller which is Islamic bank might have a pre-agreement with the final buyer with the objective of evading fluctuation of the price, in classical *tawarruq*, this is not the case.

In the next section, we explore how ‘transformation of exception into norm’ is utilised to construct organised *tawarruq* as an instrument in IBs.

#### **4.3.2. Transformation of Exception into Norm**

We argue that to reconcile Islamic law or *fiqh* with the products and services that have been engineered based on the capitalist principles such as efficiency and low transaction cost as a result of mimicking behaviour of Islamic banks, ‘transformation of exception into norm’ is utilised as a facilitator. In particular, first two items of the differences between classical and organized *tawarruq* stated by Al-Suwailem (2009) show how Islamic banks acts as an intermediary in this process to decrease additional transaction costs with the intention of making the product more efficient in compliance with the capitalist principles.

By ‘exception’ in the case of organised *tawarruq*, we refer to the delegation (*wakalah*) system, where transformation of exception into norm is realised through the institutionalisation of ‘delegation of an activity to another agent’. This is considered as an exception since under normal circumstances, the activity should be carried out by the individual; but due to the pursuit of efficiency and low transaction cost, such institutionalisation is deemed necessary. In other words, such institutionalisation has

emerged to achieve the most efficient application of means to a given end, in this case seeking liquidity.

In classical *tawarruq* which is considered as permissible by ICFA, *mutawarriq* buys and sells the product himself to obtain cash, and hence, he has to involve with the market in person to achieve his intended goal, which promotes submergence with the surroundings. However, by institutionalising the delegation in Islamic bank, all the responsibility of buying a commodity with instalment and to find a buyer to sell that commodity on cash basis is handled by an Islamic bank. This implies that all the interaction in the market is replaced by exchange of commodities without any involvement of the customer. Therefore, Islamic bank as an institution of market system acts as a proxy to achieve customer's goal without any direct involvement of the customer with his or her surroundings. It is also important to note that Islamic banks use LME base metals as an asset, since they meet all the required criteria for a commodity related transactions to be *Shari'ah* compliant, which helps to realise the organised *tawarruq* process efficiently and with minimum transaction cost (Fahmy *et al.*, 2008). This process, however, does not produce any consequence in real economy in terms of responding to a demand or contributing to production other than providing liquidity demand of the customer through fictitious transactions. Hence, from the perspective of customer, organised *tawarruq* is no different than having an interest-based loan. However, latter is a direct interest-bearing contract, while the former is a buy and sell transaction conducted within minutes through agency of an Islamic bank; this indicates a difference in the form and not in the substance. 'Transformation of exception into norm', hence, has played a facilitator role to comply with necessities of modern life and fulfilling the form of Islamic law. We can particularly observe high utilisation of this method of compliance in contemporary practice of Islamic banking and finance, especially considering the central role that organised *tawarruq* plays in these institutions for many years (Khan, 2009). For example, the financial report of Bank Negara states that 22.4% of financing by *Shari'ah* contracts is composed of *tawarruq* as of 2016 and application of *tawarruq* contract has increased in value by 104% from 2014-2016 (Bank Negara, 2017). This in itself is an indication of how organised *tawarruq* is becoming a 'norm' in the operations of financing in IBs, which is an evidence of the enormity of the problem in terms of convergence towards 'capitalist norms' of debt-based financing.

Furthermore, organised *tawarruq* as an instrument is constructed as an exception within the Islamic law as well, since it is ruled as impermissible by ICFA. Hence, as a legal device, it could be justified to be employed in exceptional cases where there is no alternative but organized *tawarruq* to solve the observed liquidity problem, especially as a short-term solution. However, it is a fact that sometimes such ‘exceptional’ instruments become the ‘norm’ in Islamic banks. In evidencing this, a member of the *Shari’ah* Advisory Board of Bank Negara Malaysia, or the central bank of Malaysia, states that the Islamic finance instruments, which derived through *maslahah* (or necessity) continued to be employed even after there is no need for it anymore (interview conducted by Hassan, 2012: 361):

Some people say we are liberal. I will say that, before any decision is made, there is a thorough study of the particular issue. We might prefer certain views to others and, in certain circumstances, the bank can go for the exception but the bank is given a time limit for that. However, sometimes the exception has become the default.

Thus, as the statement from this particular *Shari’ah* scholar indicates, ‘exception’ as a rule in *Shari’ah* has become default in Islamic finance and its operation with the blessing of the *Shari’ah* scholars.

Organised *tawarruq*, as an essential financial instrument of the Islamic banking sector, therefore, is constructed and utilised extensively through the implementation of transformation of exception into norm with a double process. In the first step, a legitimate but exceptional action, namely delegation, utilised as a norm to construct the organised *tawarruq*. In the second step, this exceptional product which is considered as impermissible by ICFA elevated from the status of exception to the backbone of the sector by turning an exception into norm.

It is important to note that in particular after the unfavourable ruling of ICFA on organised *tawarruq*, justifying it on the grounds of Islamic law has become a point of concern as well. While some *Shari’ah* scholars acknowledge problematic nature of this constructed product by limiting its usage to extreme necessity and offering alternative products under normal circumstances (Ahmed and Aleshaikh, 2014), there are scholars who might be considered as embedded into the banking and finance sector, justifying its implementation based on *maslahah* principle (Islamic Finance Resource, 2009). We argue, however, such a justification of *maslahah* is not compatible with its original

meaning and even contradicts with its intended goal, which is why it should be considered as a ‘delusional’ *maslahah*.

Some jurists have utilised delusional *maslahah* in case of a necessity which requires extraordinary precautions to ensure so-called benefits of people where these precautions cannot be extracted from the two main sources, namely the Quran and Sunnah. Such a state of necessity is similar to a state of exception as defined by Schmitt (2005: 6). We argue, therefore, the jurist who applies delusional *maslahah* decides an exception in the Islamic law. This state is considered as an exception since appealing delusional *maslahah* means suspending the verses of the Qur’an and the sayings of the Prophet Muhammad, which are the cornerstones of the Islamic law. Schmitt (2005: 5) states that “Sovereign is he who decides on the exception”. Hence, by issuing a *fatwa* based on delusional *maslahah*, jurist becomes ‘sovereign’. Furthermore, in reality, jurist does not issue this *fatwa* by his own will, rather it is the enforcement of the capitalist market system which leads the jurist to issue such a *fatwa* based on delusional *maslahah*. Consequently, we can argue that it is the capitalism and its unceasing demand rather than the *Shari’ah* scholars, remains sovereign over Islamic law in such state of exception.

In order to explore the rationale behind ‘delusional’ *maslahah*, in the next section, we explore the emergence of the concept of *maslahah* and explain why justification of organised *tawarruq* through *maslahah* should be considered as delusional *maslahah*.

#### **4.3.3. Delusional *Maslahah***

In order to comprehend the concept of ‘delusional *maslahah*’ and its position within the Islamic legal theory (*uṣūl al-fiqh*), we need to, first, discuss the emergence of concept of *maslahah* and its development within the framework of legal theory. Islamic legal theory has appeared by the end of the 8<sup>th</sup> century in its elementary form and reached its maturity by the beginning of the tenth century (Hallaq, 1999: 2). The aim of the Islamic legal theory was to reach new legal norms for unexampled situations or to rationalise existing cases by specialising in methods of interpretation and reasoning (Hallaq, 2009: 177–78). In Islamic legal theory, almost all school of thoughts (*madhab*) are agreed upon four core sources through which law might be derived: the *Qur’an*, *Sunnah* (the tradition of the Prophet Muhammad), *ijma’* (consensus) and *qiyas* or analogy.

Additionally, there are subsidiary legal principles which are not agreed upon by all schools of thoughts yet utilised in legal theory. *Ulama* or the Islamic scholars employed these principles to deal with changing conditions in the society and for the cases which application of *qiyas* may lead unwanted consequences due to several reasons. Juristic preference or *istihsan* regard for the public interest or *istislah*, and custom or '*urf*' might be considered as the most important and widely used principles. Even though we can trace the rulings based on *maslahah* (public good), as one of these subsidiary legal principles, as far back to the 8<sup>th</sup> and 9<sup>th</sup> century, Abu Hamid Muhammad al-Ghazali (1058-1111) is the first scholar who defined the *maslahah* in a tangible manner (Opwis, 2005).

#### **4.3.3.1. *Maslahah* in pre-modern period**

According to Opwis (2005), jurists followed four different models to utilize *maslahah* principle in the process of ruling during the middle period of Islam. First model is proposed by the *Shafi'i* jurists al-Ghazali and Fakhr al-Din al-Razi (d. 606/1210), who identified *maslahah* with suitability (*munasaba*) and employed it to detect *ratio legis* ('*illa*) of scriptural ruling. By this process, they employed concept of *maslahah* in the frame of legal analogy. Shihab al-Din Ahmad b. Idris al-Qarafi (d. 684/1285), a *Maliki* jurist, formulated the second model. Following al-Ghazali, al-Qarafi used *maslahah* principle within the legal analogy. In addition, al-Qarafi went one step further by applying the concept of *maslahah* as a means to extend the law through legal precepts (*qawa'id*). By doing so, he justified precepts such as eliminating pretexts to illegal ends (*sadd al-dhara'i*). As a result of the extension proposed by al-Qarafi, validity of a ruling depends on its compliance with *maslahah* which in return declare *maslahah* as an independent standard. A third model was introduced by the *Hanbali* jurist Najm al-Din al-Tufi (d. 716/1316), who utilized the concept of *maslahah* in a different manner by rejecting his predecessors' method. He acknowledged *maslahah* as an independent criterion in deriving rulings rather than as a part of legal analogy. He defended a theory in which bringing *maslahah* or averting harm equalized with the purpose of law. Therefore, a ruling that attains *maslahah* or avoids harm should take precedence over a contradictory ruling; even if this ruling is based on the scripture. However, he excluded acts of worship from this method. The last model of *maslahah* is represented by *Maliki* jurist Abu Ishaq Ibrahim b. Musa al-Shatibi (d. 790/1388), who argued that bringing

*maslahah* and avoiding harm at the level of necessities (*dharuriyah*), conveniences (*hajiyyah*), and embellishment (*tahsiniyah*) is a universal source of the law. This implies that *maslahah* could be employed in a situation where it does not have any textual evidence based on the suitability of *maslahah* with the law. As a result of acceptance of *maslahah* as a universal source, al-Shaitibi prioritises the *maslahah* unless there is a contradiction with the epistemological sources of Islam, namely the Qur'an and the Sunnah. Therefore, by limiting the domain of *maslahah*, he followed a different method as compared to al-Tufi (Opwis, 2005). As it is clear from the historical trajectory of *maslahah*, although its utilisation has been expanded throughout time, it is bounded by the scriptural text with the exception of al-Tufi. However, this exception, in modern period, started to become the norm in the process of seeking response to the emerging problems of the Muslim societies in modern period.

#### **4.3.3.2. *Maslahah* in modern period**

With the birth of the modernity, offering solutions within one school of thought became inadequate to respond social change. Consequently, jurists have started to issue rulings for new cases based on different schools of thoughts and, sometime combining different school of thought in one ruling. As a method, this is called *talfiq* and is devoid of a consistent internal methodology to issue a *fatwa* or ruling, and, it is employed to respond to an emerging case (when the need arises) in the sphere of Islamic law based on various schools of thoughts. Although utilisation of *talfiq* is not unique to the modern period (Ibrahim, 2015), we can claim that it is the abundant usage of this technique that separates it from the pre-modern period. However, even this method became insufficient to answer the emerging conflicts between the modern social formation and demands of modern values and Islamic law. In responding to this, some *ulema* argued that since the traditional legal system not efficiently responding to the demand of the modern period, they proposed reform in legal theory, and procured a new method to handle arising problems of modernity, namely *maslahah* or public interest (Hallaq, 1999).

Hallaq (1999) categorizes main reformist movements into two groups: 'religious utilitarianism' and 'religious liberalism'. Both reformist groups aim to restructure legal theory in order to respond to the needs of modern world and changing society in the limits of basic values of Islam. However, they use substantially different methods. The

religious utilitarian, as argued by Hallaq (1999), employs public interest (*maslahah*) and expand its limits to the point that *maslahah* occupies a central position in their legal theory. They considerably manipulated the concept of *maslahah* to fit into the modern period. On the other hand, the religious liberalists dispose of the principles of the traditional legal theory and propose a new hermeneutic to adopt modern world (Hallaq, 1999). For the present study, we are only concerned with the first group of reformist movement, namely religious utilitarianism<sup>4</sup>.

Muhammad Abduh (1849 – 11 July 1905), being the first religious reformer in the modern period in the Muslim world, may be considered as the founding father of both reformist groups. Among the religious utilitarianists, Rashid Rida (1865-22 August 1935) is the first follower of Muhammad Abduh. The theory of *maslaha* developed by al-Tufi (1271-1316) and al-Shatibi (1320-1388) constitutes the core of Rida's doctrine. He totally rejects the traditional legal theory and adhere to the concepts of necessity and interest which traditionally has a limited use. In his legal theory, human need, interest and necessity have priority over any revealed text in case of a contradiction (Hallaq, 1999: 219). Following Rida, many jurists advocated the priority of *maslahah* in legal theory, 'Abd al-Wahhab Khallif, 'Allal al-Fasi, Hasan Turabi to name a few. In these reformist movements, particularly al-Tufi's effect can easily be noticed. In classical period, jurist used *maslahah* principle in the boundaries of the Qur'an and the *Sunnah* with the exception of al-Tufi. In contradiction, modern times witnessed a paradigm shift; instead of mainstream understanding of *maslahah* principle some modern jurists interpret *maslahah* in a Tufian manner.

We may argue that popularity of al-Tufi's ideas regarding *maslahah* in modern period is due to the publication of Jamaledin al-Qasimi (1866-1914), namely *Majmu' Resail fi Usulil Fiqh* (1906). In the very same year, Rashid Reza, another reformist jurist, used his journal, *al-Manar*, as a medium to disseminate opinion of al-Tufi with the help of al-Qasimi's footnotes (Kayadibi, 2007). Reintroduction of Tufi's approach to the *maslahah* by these reformist scholars led to the birth of a new method for the solution of modern problems, which became popular during last decades, particularly in the area of Islamic finance. This method is employed to respond to the modern problems of Muslim individuals, which none of the schools of thoughts issued a *fatwa* as a practical

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<sup>4</sup> For a detailed study of religious utilitarianism and religious liberalism, see: Hallaq (1997:214 -253).

solution. The most important feature of this method is that it can be contrary to the verses of the Qur'an or the *hadith*, sayings of the Prophet Muhammad. Nonetheless, as long as jurists consider this solution as '*maslahah*' for public, it is considered as a valid ruling. Following Ramadan al-Bouti (2005: 208), we may call this kind of *maslahah* as *delusional maslahah (maslahah mutawahham)* due to its contradictions with the verses of the Qur'an or the *hadith*. Some jurists have utilised *delusional maslahah* in case of a necessity, which requires extraordinary precautions to ensure the so-called benefits of people where these precautions cannot be extracted from the two main sources, namely the *Quran* and *Sunnah*. We can easily notice the effects of this in the religio-legal interpretation of Islamic norms in relation to Islamic banking.

Based on the discussion presented, this study argues that ruling on permissibility of organised *tawarruq* ruled by some *Shari'ah* scholars in the field of Islamic banking is on the basis of '*delusional maslahah*', since according to the ruling of ICFA and AAOIFI, it contradicts with the scriptural sources. Nevertheless, in a Tufian manner, despite such conflict, some *Shari'ah* scholars approved its everyday implementation, even defended it as an efficient tool. In order to substantiate our claim that organised *tawarruq* is justified on the ground of *delusional maslahah* rather than a legitimate *maslahah* according to the *Shari'ah*, in the following sections, we present the ruling of ICFA, AAOIFI and members of SBs and we will, then, assess the rulings.

#### **4.3.3.3. Ruling of ICFA and AAOIFI on organized *tawarruq***

In responding to the controversial nature of *tawarruq*, ICFA in Mecca in its 19th Circle in 2009 ruled that the new form of *tawarruq*, namely the organized *tawarruq*, is prohibited unlike traditional form, which is called classical *tawarruq* and ruled as permissible in 1998, in the 15th Circle. Khan (2009) suggests that although AAOIFI's *Shari'ah* Standard 30 on *tawarruq* may lead to impression that it is allowed to use *tawarruq* as an instrument in Islamic banking, by imposing strict conditions, it comes to same conclusion with ICFA. While ICFA specifies what cannot be done, AAOIFI's *Shari'ah* Standard 30 states what 'should' be done in order to use it as a financing method. Hence, both judgement complement each other, rather than contradicting.

In ‘*The Resolution of the Islamic Fiqh Academy Regarding Tawarruq as It Is Currently Being Practiced by Banks*’, jurists at the ICFA stated the following three reasons for prohibition (Al-Suwailem, 2009):

- (i) The commitment of proxy to sell the commodity to another buyer makes this instrument similar to ‘*inah* transaction which prohibited;
- (ii) In practice, the violation of fulfilment of ownership transfer leads to invalid sale transactions since one cannot sell a commodity without taking the possession of that commodity first according to Islamic law;
- (iii) As it is discussed earlier, organised *tawarruq* is missing important characteristics of classical *tawarruq* which was ruled as permissible by ICFA. Especially, while classical *tawarruq* involves real market transaction whose outcome is not predetermined, in organised *tawarruq*, it is ‘organised’ by Islamic bank to have a predetermined outcome which is certain.

As it is stated in this rationale for the prohibition of organised *tawarruq*, this engineered and constructed instrument is considered similar to the already prohibited instruments by *fiqh*. Furthermore, it directly contradicts with the principles of Islamic law and its end goal since it is quite similar to the interest-based loan transactions of conventional banks. Nevertheless, there are *Shari’ah* scholars who strive to justify organised *tawarruq* despite such essential concerns.

#### **4.3.3.4. Rulings of SB members on organized *tawarruq***

ICFA’s ruling on prohibition of organized *tawarruq* has deeply affected Islamic financial industry, which was aiming to expand the use of this facilitatory financial instrument. As a response to prohibition of organized *tawarruq* by ICFA, as reported by Khnifer (2010), a group of *Shari’ah* Board members stood up and rejected prohibition, as they appealed to the principle of (delusional) *maslahah* to legitimise the use of organised *tawarruq*. They advocated utilisation of organised *tawarruq* due to its position of providing short-term liquidity as a backbone of the Islamic financial institutions, and suggested that it should be permissible based on social usefulness or social needs of the *ummah* (Khnifer, 2010). In an interview with Reuters (Islamic Finance Resource, 2009), one of the leading *Shari’ah* scholars defended the use of

organised *tawarruq* on the basis of lower transaction costs, as he argued that carrying out the process of selling the assets through a bank helps to minimise the transaction cost. He also stated that “How can Sharia allow something which is burdensome on a person ... and not allow something which is organised and well done, and this man who is in dire need for cash will not suffer a lot”. On the other hand, due to the controversial nature of organised *tawarruq*, some Islamic banks started to avoid organised *tawarruq* in countries such as Saudi Arabia (Parker, 2009) or using it without advertising, while Malaysia has not shunned away from extensively using it.

#### **4.3.3.5. Assessment of the ruling**

As explained, ICFA ruled the prohibition of organized *tawarruq* in 2009. However, instead of disallowing it directly, AAOIFI set stringent conditions for *tawarruq*, which must be fulfilled by the Islamic banks to be accounted as permissible. As Khan (2009) argues, in practice, some of these standards (such as articles 4/5, 4/7, 4/8, 4/9 and 4/10 of Standard 30) are not fulfilled by Islamic banks, which make organised *tawarruq* as it is implemented in practice impermissible.

Islamic banks are, in essence, capable of conducting a particular type of *tawarruq*, which complies with all the conditions of AAOIFI, but it would be unfeasible for the Islamic banks to utilise such an instrument due to the inefficiency of the instrument stemming from the increased transaction costs. At this point, some *Shari'ah* board members appealed to *maslahah* principle and defend the position that lower transaction cost and efficiency by means of organised *tawarruq* should be considered as a *maslahah* or public good despite the fact that there are other alternatives of organised *tawarruq* which fit all the conditions of AAOIFI and are not announced impermissible by ICFA, albeit not as efficient as organised *tawarruq* and riskier, such as *salam* (Khan 2009). It should be noted that *salam* is a contract in which the payment of the money is made in advance and the products are delivered in a later date according to certain conditions.

We can easily trace the effect of this way of reasoning in other instruments of Islamic banking sector as well. Since hegemonic nature of the capitalist economy favours the risk-free instruments, such as interest-based loan, it enforces Islamic banks to employ instruments which are the least risky. If the least risky instruments cannot be engineered within the boundaries of *Shari'ah*, *delusional maslahah* becomes instrumental in

constructing instruments with such features. This implies that engineering for such a low risk instrument is not due to the absence of other alternatives, but rather capitalist economic system rules out other alternatives to be utilised due to its efficiency paradigm and enforces Islamic banks and *Shari'ah* scholars to engineer products, which fit to the nature of the capitalism. In substantiating its hegemonic nature in not allowing any other practice beyond its own in the economic and financial sphere, it subjugates its own operational system on the *Shari'ah*-determined Islamic financial instruments whereby 'new forms' of Islamic financial instruments are generated.

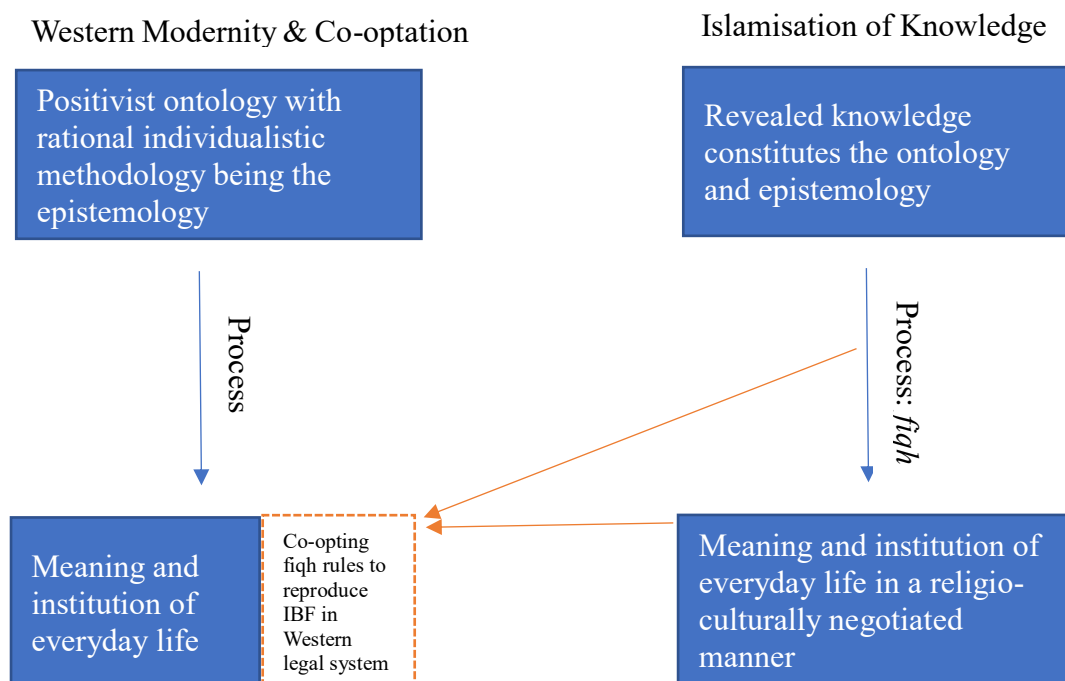
Since financial function of organized *tawarruq* is similar to interest-based borrowing transaction (Siddiqi, 2006), which is the corner stone of capitalist economic system, Islamic banks, under financial pressure and competition, feel that they have to utilise organised *tawarruq*. As a consequence, in responding to the 'needs' of Islamic banks, as a facilitation function, *Shari'ah* scholars feel obliged to announce it legitimate based on *maslahah* even if it is not in the boundaries of Islamic law. Thus, the sources of the motivation to use organised *tawarruq* are necessitated by the capitalist operation of the system rather than an Islamic moral economy which essentialises asset-based financing or embeddedness. Therefore, we argue that *Shari'ah* scholars' justification for organized *tawarruq* through *maslahah* principle suggesting that it is for public good due to the low transaction cost is an example of 'delusional *maslahah*' and hence devoid of Islamic norms on the matter.

As a result, *Shari'ah* scholars managed to keep 'Islamic' identity of Islamic banks through such controversial methods despite mimicking conventional banking sector. Resulting outcome is a recognisable 'other'. However, "mimicry is at once resemblance and menace" (Bhabha, 1994: 86). This recognizable 'other', therefore, also constitute a threat for the conventional banking sector since customers of Islamic banks have started to enjoy similar conditions with conventional banks and privilege of using *Shari'ah* compliant instruments. Therefore, this mimicry has become a 'menace' for conventional banking too, since its customers may be attracted by this excess, namely being *Shari'ah* compliant.

#### 4.4. REVERSE MIMICRY: CONVENTIONAL BANKING ADOPTING ISLAMIC FINANCE OPERATIONS

Mimicry of Islamic banks to the conventional banking sector produced a recognisable ‘other’, as we discussed in the previous sections, which resulted in both ‘resemblance’ and ‘menace’. This menace led conventional financial institutions to a new state. In this new state, conventional banking started copying Islamic banking structures and instruments, especially *Shari’ah* board unit, and adopted it to its modern framework through establishing Islamic windows. Resulting outcome has been a banking institution which is established in a modern framework and shaped by positivist ontology, and at the same time, through a window acts according to Islamic law and is bound by *Shari’ah* scholars’ rulings to meet the requirements of Islamic finance principles instead of insisting on ‘enlightenment’s reason’ for window operations. In other words, the pragmatist expansion of the legal sphere of rational law in the secular systems developed an inclusionary strategy (as opposed to earlier modernity position) in the form of co-optation by providing the re-interpretation of Islam in a rational manner by adopting the norms of non-modern reality of Islam generating multiple modernities.

**Figure 4.3: Co-optation of Islamic hybridity into modern**



Source: Asutay (2015b)

Figure 4.3, hence, depicts the process of reverse mimicking of conventional banks. As can be seen, Islamic banking structure, which has emerged as a result of a negotiation process between the positivist ontology and Islamic principles, is reproduced within the non-Muslim legal system (such as European legal system) through co-opting *fiqh* process. Resulting outcome is another hybrid institution which aims at benefiting from the ‘excess’ of the recognisable ‘other’, namely Islamic banks.

The conventional banks with Islamic windows, hence, through inclusion of *Shari’ah* compliant products and services within the non-Muslim legal system strive to eliminate the thread emerging from the recognisable ‘other’. Through co-optation process, *Shari’ah* compliant financing is made available in a structure (namely, conventional banking), which is a product of an institutional logic derived from Enlightenment’s positivist notion of rationality and operating on neo-classical notion of efficiency resulting into reverse mimicry with additional transaction costs. This is due to the fact that initial conventional product is Islamised through *Shari’ah* compliancy in a ‘mimicking’ process with ‘excess’ in the form of additional transaction costs while the converted or mimicked product is co-opted in the initial setting namely in the conventional banks through reverse mimicry whereby a circle is completed.

#### **4.5. CONCLUDING REMARKS**

This chapter explores the emergence and development of Islamic banking sector within postcolonial discourse with the objective of explaining the reasons of the observed convergence of Islamic banking with the conventional banking through negotiating the nature of its operations.

In doing so, this paper explored the progress of Islamic banks in three stages. First stage is composed of emergence of Islamic banking sector as a hybrid institution with the objective of offering an alternative banking sector to conventional banking through prioritising profit-loss sharing instruments and adhering to Islamic principles. We consider such institution as hybrid, since it is an outcome of a negotiation process between a modern institution, namely European saving bank and Islamic principles. However, the consequence of Islamic banking sector as a hybrid institution - rather than an authentic institution based on ontological and epistemological sources of Islam – results in “renounce[ing] the dream of ambition of rediscovering any kind of ‘lost’

cultural purity” (Hall *et al.*, 1992: 310) implying that the divergence or ‘losing its cultural purity’ between the realities of Islamic finance and the aspiration of Islamic moral economy will prevent the emergence of its authentic and aspired form in the future.

As an outcome of losing the imagination of constructing Islamic financial institutions based on aspirations of Islamic economics and entering into competition with conventional banks at the global scale, Islamic banking sector entered into second stage. In this stage, we observe a hegemonic relationship between underlying principles of conventional banking sector and Islamic banking sector due to the competition in which hegemony of capitalist principles in market system suppressed Islamic principles to the extent that Islamic banks started to adhere the form of Islamic law mostly rather than aiming to fulfil the objectives of *Shari’ah*. A clear mimicry of conventional banks is evident at this stage. However, “mimicry repeats rather than re-present” (Bhabha, 1994: 88), but representation is what Islamic banks should do in fulfilling the objectives of *Shari’ah*, not repeating. Resulting outcome is, therefore, a recognisable ‘other’ due to the convergence of Islamic banks towards conventional banks. However, it also means the loss of authentic identity and hope for an alternative sector.

In the third and last stage, we witness a reverse mimicry. Due to the ‘menace’, as a result of the first mimicry, conventional banks were afraid of losing their existing customers to the recognisable ‘other’ since these Islamic banks could provide almost everything conventional banks can do with an excess, namely *Shari’ah* compliancy of the operations. In this stage, therefore, we observe another hybrid institution which aims to benefit from the ‘excess’ of the recognisable ‘other’. The outcome of this reverse mimicry is, therefore, a banking institution with an Islamic window which is shaped by positivist ontology, and at the same time is bound by *Shari’ah* scholars’ rulings.

As the discussion so far indicates, both Islamic banking and conventional banking has utilised a pragmatist approach to be successful in their respective sectors. Although such an approach might bring growth in Islamic banking sector, it lacks the adherence to the initial goals of Islamic economics and finance which aimed at establishing an alternative sector based on Islamic ontological and epistemological sources within financial system rather than just mimicking the conventional sector. In this regard, unexpected high growth rate of Islamic banking sector during the last decades cannot

justify the convergence towards conventional banking sector. However, indications demonstrate that there is not a real search or movement for other forms of banking in compliance with Islamic substantive morality beyond ‘lamenting’ as many papers have done.

It is expected that *Shari’ah* scholars serving in the SBs of IBs should be able to hinder the convergence, as they ensure the *Shari’ah* compliancy, yet the reality proves otherwise. In order to reveal the reasons behind the lack of ability of *Shari’ah* scholars to prevent the observed convergence, in the next two chapters, we investigate the role and status of *Shari’ah* scholars in the society through exploring the *ifta* institution in its historical trajectory starting from the emergence of Islam until the present day.



## CHAPTER 5

### AN INQUIRY INTO PUBLIC POLICY AND *SHARI'AH* SCHOLARSHIP IN THE MAKING: HISTORICAL PERSPECTIVES

#### 5.1. INTRODUCTION

In Chapter 3, we explored and examined the level of disclosure by *Shari'ah* Boards (SBs) in their annual reports, or SAR, and factors affecting it. The analysis revealed that the level of disclosure in detailed aspects of *Shari'ah* compliancy is limited in comparison to AAOIFI based expectations. Although level of disclosure increases when we limit our disclosure index to AAOIFI guidelines for SAR, the expected information according to these guidelines are mostly general statements claiming only that 'everything is according to *Shari'ah*' without further justification. SB members, therefore, expect from stakeholders to trust in their monitoring, controlling and supervision processes in relation to the *Shari'ah* compliancy without disclosing the details of these processes.

We can, hence, argue that legitimacy of products and services provided by an IB in the eyes of stakeholders is not achieved through detailed disclosure to prove *Shari'ah* compliancy of IB, but rather achieved through a general consent of SB members on *Shari'ah* compliancy of operations in IB, as somehow stakeholders do not have much expectations in terms of detailed disclosure beyond trust. We can even claim that by mere existence of a SB division in an IB could be enough to substantiate 'Islamicity' of IB since most of the stakeholder might not bother to read *Shariah* annual reports. It seems that IB stakeholders being "socially and politically conservative, seeking individual piety and social mores built around traditionalist compliance with *fiqh*, and looks to social and political improvements mainly as a result of that" (Vogel and Hayes 1998: 27, footnote), they leave everything to the presence of a SB in expressing their trust in the operations of IBs. In other words, it seems that existence of a SB and/or

their general approval for *Shari'ah* compliancy is sufficient condition for being considered as an 'Islamic' institution in the eyes of stakeholders.

Indeed, considering the fact that a jurist-consult or *mufti* extracts his ruling by interpreting the religious text and, therefore, his ruling has the effect of a direct authorisation, such position of stakeholders is not unusual in the historical context of *ifta* institution. However, it is important to note that the role and status of a *mufti* as an individual in pre-modern context are different than the role and status of SB as a division in IBs. Hence, approaching to *ifta* institution (institution of act of giving *fatwa* or legal opinion) in a de-historicised manner would lead to miscontextualise the role and status of members of the SB in modern IB sector (Caeiro, 2006).

In order to explore such transformation within *ifta* institution, this chapter aims to critically explore the emergence of *ifta* institution in Muslim societies with the intention of tracing back the historical roots of SB division of IBs to reveal the transformation it has been through since the pre-modern period by particularly emphasising the role and status of *muftis* (jurist-consults) as part of the governance structure in the society and as a source of legitimacy for elite-ruling class. By revealing such transformation points, we aim to show the reasons behind the failure of *Shari'ah* scholars in SBs to prevent the convergence of IBs towards conventional banks and to fulfil the objectives of *Shari'ah* in these IBs.

In this chapter, we explore the role and status of jurist-consults within the pre-modern context, particularly first five centuries after the emergence of Islam. Since being a jurist-consult, by definition requires a deep knowledge of *Shari'ah* as a requirement of being a *mujtahid*, we do not discuss these scholars' knowledge of *Shari'ah*. Our focus of attention, hence, is to explore the embeddedness of jurist-consults into the society during pre-modern period and outcome of such embeddedness in terms of their role and status in the society and influence of this embeddedness on legal rulings. In the following sections, therefore, we will discuss embeddedness as a concept and critically evaluate the consequences of the embeddedness of jurist-consults in the legal sphere. Then, we will analyse how embeddedness as a process elevated the positions of jurist-consult as civil leaders in the society and bestowed upon them a negotiation power with the ruling authority.

## 5.2. *IFTA* INSTITUTION AND ITS OPERATION: CONCEPTUAL DEFINITION AND HISTORICAL TRAJECTORY

*Ifta* denotes clarifying God's law for a problematic legal case (*nawazil*) based on some textual legal evidence (Al-Ashqar, 1976: 9). Issuer of a *fatwa*, or legal opinion, namely *mufti*, derives the source of opinion in forming *fatwa* from the major source of law in Islam: (i) *Qur'an* and (ii) the *Sunnah*, namely Prophet Muhammad's traditions, sayings, actions and tacit approvals, and (iii) through consensus (*ijma*), namely agreement of the creative jurists, the *mujtahids* on a legal matter as well as (iv) utilising legal reasoning or *qiyas* (Hallaq, 1999). Other methods of deriving a ruling includes *istihsan* (juristic preference), *istislah* (public interest), *istishab* (presumption of continuity), and *'urf* (customary precedent) (Abdalla, 2011).

As it is defined by prominent scholars of Islam such as Imam Shihab al-Din al-Qarafi al-Maliki (1228-1285) and al-Qayyim al-Jawziyyah (1292-1350), a *mufti* is analogous to that of a translator of the speech of God or is one who essentially signs on behalf of God (Al-Ashqar, 1976: 18). However, it is important to note that rulings of a *mufti*, namely his *fatwa* is not binding in itself and *mustefti* (the one who seeks *fatwa*) is free to reject a particular *fatwa* and favouring another *fatwa* issued by a qualified *mufti* (Masud *et al.*, 1996). *Ifta* as an institution, therefore, is directly related to the *mufti*, *mustefti* (the one who seeks *fatwa*) and decision process of the *mufti*.

We can trace the history of *ifta* institution back to Prophet Muhammad, as he was being the first *mufti* (Hallaq, 1999). In addition, historical records suggest that His companions and disciples had also issued *fatwas* in his lifetime and later (Nurbain, 1996). During the sultanate period in Islam, namely after the rightly guided caliphs' period<sup>5</sup>, *ifta* institution became more institutionalised having *muftis* as legal consultants for legal officers such as judges and governors (Masud *et al.*, 1996, 9), while Abbasid caliphs tried to exploit this institutionalisation to control *muftis* which was unsuccessful thanks to the resistance of independent *muftis* (Abdalla, 2011).

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<sup>5</sup> The Rightly Guided Caliphs were first four immediate successors of Prophet Mohammad, namely Abu Bakr (632–634 AD), Umar ibn al-Khattab (634–644 AD), Uthman ibn Affan (644–656 AD) and Ali ibn Abi Talib (656–661 AD).

It is important to note that *ifta* institution emerged as a civil society based movement responding to everyday questions of people by *ulema* (Islamic scholars), as learnt scholars with deep understanding and knowledge in *Shari'ah*, especially where an 'intimate familiarity' with everydayness of life was desired (Crone, 2004: 43).

Such intimate relationship with the everyday people along with immersed knowledge of *Shari'ah* helped these scholars to understand everyday practice of life. However, it "is the degree of perfection of his way of life" which bring him "reputation" (Winter, 2009: 21) to be a respected scholar. Moreover, they were independent from the governance structures of ruling authority (Goitein, 1960; Cohen, 1970), which is also an essential feature for acting as a bridge between the ruler and the ruled as a representative of the ruled against the ruler (Hallaq, 2005).

In evidencing the independence of the *Shari'ah* scholars, historical account identifies that the past *Shari'ah* scholars were mostly 'private scholars' in the sense of being independent who sustained themselves through trade or other means of income generation instead of working for and/or under the rulers and the ruling class (Cohen, 1970; Hallaq, 2005; Bligh-Abramski, 1992). These *Shari'ah* scholars "were not a distinct class, but a category of persons overlapping other classes and social divisions permeating the whole society" (Lapidus, 1984: 108). However, in the pursuit of legitimacy, governments of dynasties such as Umayyad and Abbasids strove to co-opt them within the legal system, or to negotiate with them as civil leaders of the society to attain legitimacy through their approval to strengthen their authority (Tsafirir, 1998; Bligh-Abramski, 1992).

This need for legitimacy of governments arose as a result of paradigm shift in the political authority in the post-rightly guided *khalifah* period; as during the rightly guided *khalifah* period, there was no barrier between the ruling authority and everyday Muslims due to the fact that ruling authority was directly embedded in the everyday life of the people. In addition, *khalifah* in the period in question were also considered as authority in legal matters. However, in the sultanate period, a ruling class was formed which led to the separation of ruling authority and the rest of the people. Hallaq (2005: 180) explains this paradigm shift in stating that:

Whereas the caliph 'Umar I, for instance, led a life that many Arabs of his social class enjoyed, and mixed with his fellow believers as one of them, Umayyad caliphs lived in

palaces, wielded coercive powers, and gradually but increasingly distanced themselves from the people they ruled.

We can term this paradigm shift as ‘lack of embeddedness into the society’ after the rightly guided *khalifah* period ended, whereas ‘Umar the First had known the Muslim society and its members through living among them and Muslims knew him as well implying that the ‘governance system’ had been ‘an organic entity’. This direct embeddedness had changed during the ‘sultanate state’ first emerged with the Umayyad dynasty resulting into a gap that had emerged between the Umayyad caliphs and people they ruled. This gap or disembeddedness had been maintained by the following dynasties proceeding the Umayyad period; and, hence, the emerged governance system in disconnectedness with people had shaped the political culture and administrative practice. Since, “it was one of the salient features of the pre-modern Islamic body-politic that it lacked systematic control over the infrastructures of the civil populations it ruled” and, as a result of such gap between ruler and ruled, “the government was in dire need of legitimization which they found in the circles of the legal profession” (Hallaq, 2009: 130). With the help of *ulema* who directly or indirectly approved the government, ruling class could attain – and indeed attained – legitimacy in the eyes of people, which helped a sustained authority whereby *Shari’ah* scholarship became instrumental within the administrative structure (Hallaq, 2009). However, thanks to the power of legists attained by the support of people and their independence, rulers could not interfere with legal rulings (with some exceptions which strictly protested by *Shari’ah* scholars) (Hallaq, 2005). This relationship lasted in many dynasties, which had been ruled by *Shari’ah*-based law until the emergence of modernity and adoption of Western secular law system instead of *Shari’ah*.

After the emergence of modernity, majority of *ulama* continued as private scholars similar to the early periods of Islamic law, since there was no necessity for legitimacy of *Shari’ah* anymore in newly constructed secular nation-states, even, in specific cases such as Turkey and some of the North African countries, inclusion of *ulema* into the state-related matters was avoided, as society and politics in these countries were shaped in line with French modernism project since the late 19<sup>th</sup> century (Daver, 1988; Ruedy, 1996) and “the elimination of Islamic sources of power and legitimacy was seen as essential for strengthening political authority” of secular nation-state (Azak, 2010: 9).

The following section hence focuses on the nature of embeddedness. In order to substantiate embeddedness of these scholars and how it influenced their legal and non-legal affairs, we first explain the concept of embeddedness and explore the nature of jurist-consults' embeddedness. Then, we show how such embeddedness influenced their evaluation of judicial cases. In order to substantiate this point, books of legal opinion of jurists-consults are examined with the intention of revealing how these scholars; (i) incorporated the realities of society into the decision process of law making; (ii) used legal tools to find a solution/cure for the emerging problems; (iii) and considered the outcomes of their rulings for the society before issuing any legal decision. After investigating the embeddedness of these prominent scholars in the early period of Islam and its impact on legal process, we explore the relationship between ruling authority and scholars and ruling class' strive for legitimacy through these scholars

### **5.3. EMBEDDEDNESS AS A CONCEPT**

Following Polanyi's seminal work, *The Great Transformation* (GT) (1957), embeddedness as a concept became popular, especially in economic sociology, despite the fact that the term was not at the centre of his book (Beckert, 2007). Due to the ambiguities of the concept with its usage in GT, several research strands in explaining modern capitalism appeared in the literature in relation to embeddedness, such as 'always embedded markets', 'varieties of capitalism' and 'entanglement', referring to different levels and natures of embeddedness (Krippner and Alvarez, 2007). In reflecting on the emergence and transformation of embeddedness, Granovetter's (1985) critics of 'undersocialised view of neoclassical economics', and 'oversocialised view of Parsonian sociologists' towards individual, resulted in a different meaning of embeddedness, as Granovetter (1985) re-defined embeddedness as a structural relationship among networks beyond the mentioned attributes and nature. In his attempt, instead of adopting the macro analysis of Polanyi, Granovetter (1985) focused on micro and meso-level relations among organisations, and defined such relationships as embeddedness (Krippner and Alvarez, 2007). Although, structural embeddedness articulated by Granovetter has led to another research field which is mostly investigated through organisational relationships, Zukin and DiMaggio (1990) expanded the

dimensions of embeddedness by suggesting three further embeddedness dimensions, namely political, cultural, and cognitive embeddedness.

The similarity of all these different interpretations of embeddedness, and various research strands, is that they all analyse the impact of different dimensions of embeddedness of social actors in economic actions. In order to provide a better understanding, Table 5.1 summarises various dimensions of embeddedness and provides short definitions (Marx, 2004: 65).

As evidenced from the definition column, studies related to embeddedness mostly focus on social actors and their economic action rather than using it in a wider sense, such as examining its impact on all actions. However, as Beckert (2003: 769) suggested, embeddedness “points to the indissoluble connection of the actor with his or her social surrounding”. Therefore, all the dimensions of embeddedness, which focus on the relation of social actors and economic actions, constitute one part of embeddedness, since the connection of actors with his/her social surrounding is not limited to an economic activity.

**Table 5.1: Studies on the Dimensions of Embeddedness**

<b>Dimension</b>	<b>Definition</b>
Relational	Relational embeddedness refers to the quality of the relationship and highlights the effects of cohesive ties between social actors on their economic actions
Structural	Structural embeddedness captures the impact of the structure of relations around social actors on their economic actions
Positional	Positional embeddedness captures the impact of the position social actors occupy in the overall structure of the network on their economic actions
Cognitive	Cognitive embeddedness refers to the ways in which common mental models or a shared vision among social actors impact their economic actions
Cultural	Cultural embeddedness captures the impact of ideologies of markets, industry cultures and management logics on the actions of the social actors
Political	Political embeddedness refers to the impact of power struggles and sanctioning mechanisms on the economic actions of the social actors

*Source:* Marx (2004:65)

In this chapter, in order to encompass, both economic and non-economic, relationships between social actors and their surroundings, namely society, we prefer to use embeddedness in a wider meaning, and use the definition of embeddedness as Beckert

(2003: 769) defined: “indissoluble connection of the actor with his or her social surrounding”.

Since we cannot imagine an individual who is completely isolated from his/her surroundings, we, therefore, cannot claim the existence of a disembedded individual. However, embeddedness of individuals varies across time and space, and therefore we can speak of degrees of embeddedness (Lillte and Leach, 1999). In other words, every society has its own unique social formation based on its ontological existence, which leads to different degrees and ways to articulate the connection of social actors with their surroundings. For example, in terms of Muslims and their relationships with their surroundings in pre-modern period, we understand that ethical principles of Islam encouraged individuals to have direct engagement with their surroundings as part of articulating religious norms in everyday practice leading to a moral economy. On the other hand, market societies in modern times offer a different kind of embeddedness, in which social actors may engage with their surroundings efficiently through markets. In such a facilitation, with the help of agencies of the market, manageable intermediary steps enabled, for example, at an expense of a fee. In this regard, following sections will explore relationship of *Shari'ah* scholars with their surroundings during the early periods of Islam.

### **5.3.1. Embeddedness of Legists in Pre-Modern Period**

There are two major factors in embeddedness of jurist-consults into the society, namely environment of education and their profession after the formal period of their education. A salient feature of Islamic scholars in the early periods of Islam was that they received religious education in the institutions established by civil society<sup>6</sup> such as circles of prominent scholars (such as companions of the Prophet Mohammad and those who came after them) at the mosques (Makdisi, 1979) without any interference of ruling authority. In other words, learning environment of religious knowledge was part of everyday life of people. Furthermore, unlike higher education in Europe, *ijaza* (certificate) system in Muslim world was completely individualistic, namely between master and student, hence, there was no need for a religious or governmental approval to earn a certificate beside the master (Makdisi, 1970). These features of education

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<sup>6</sup> By civil society, we refer to the non-governmental, non-elite institutions which are emerged within the society.

enabled *ulama* to be submerged into the society and become independent from ruling authority and other elite classes which enabled them intellectual independence.

After completing their education and obtaining *ijaza*, *ulama*, mostly, continued to be independent of ruling class or other elite classes financially by supporting themselves through various occupations. Cohen (1970) analysed the occupations of 4,200 jurists and traditionalists in the first 470 years of Islam. Based on his extensive research through biographies and other literature sources, he concluded that Muslim scholars in the first five centuries came from all layers of the society whereas majority was merchants and craftsmen. He further suggested that dynamic structure of Islamic law stems from such a proliferated and embedded relationship of Muslim scholars and society instead of emanating from a particular stratum of the society. The findings of Cohen's (1970) study implies that jurist-consults' direct relationship with society continued after their formal education through their professions to support themselves along with their role as Islamic scholars. Furthermore, having state-independent income for living expenses provided financial independence for those scholars, which, along with intellectual independence, is an important factor to resist any dominance from the rulers and ruling class and strengthening their negotiation power against them. Such independence is an articulation of *ikhtiyar* or free-will axiom as explained in Chapter 2 which is crucial in realising the objectives of *Shari'ah* in the society.

However, with the establishment of *Nizamiya Madrasa* (*Nizamiya School*) in 11<sup>th</sup> century at the time of Seljuqs, religious educational institutions delved into close relationship with rulers (Levy, 1928). Especially during the Ottoman period, *madrasa* system followed a specific curriculum and mainly educated people with the intention of graduating qualified people to employ in governmental structure after the 16<sup>th</sup> century (Atçil, 2010). These transformational changes, eventually, led to decrease in intellectual and financial independence of scholars. It is important to note that although majority of scholars had an embedded relationship with the society due to the aforementioned reasons during and after their education, this study does not generalise embeddedness of *ulama* to encompass all of them, neither does it argue that embeddedness of each *ulama* articulated in their legal rulings in a similar manner. As considering broad range of time period and geographies Muslims have been residing, such claim would be impossible. *Zahiris*, a historical school of Islamic thought, for

example, represented an extreme point, which deviated from the mainstream legal tradition by rejecting the principle of analogy (Makdisi, 1979) by “advocacy of literal meaning” (Melchert, 1997, 4:179). In addition, scholars such as al-Tufi at another extreme, who, in some cases, nullified the scriptural texts to prioritise *maslahah* of the people (Kayadibi, 2007). These two positions indicate a wide range of diversified legal opinions in the history of Islamic legal tradition during pre-modern period.

We can, however, argue that majority of the jurist-consults, or *muftis* especially who succeed to be a civil leader in their local community, managed to keep their relationship with the society in an embedded manner and such embeddedness were reflected in their legal and non-legal affairs. Indeed, disappearance of *Zahiri* school of thought (Melchert, 1997) and absence of the followers of Tufian *maslahah* approach until the modern times (Opwis, 2005) suggest that these school of thoughts did not represent the mainstream approach of *ulama* and did not find a room in the society.

#### **5.4. IMPACT OF EMBEDDEDNESS ON LEGAL SPHERE**

Embeddedness of jurist-consults influences their decision-making process in issuing a *fatwa* (legal ruling). Having an embedded relationship might result in *fatwas* with three important features:

- (i) integration of realities of the sphere being embedded into decision process (integration),
- (ii) responding to the problems of the sphere with a solution within the boundaries of Islamic law (solution), and
- (iii) consideration of the short-term and long-term outcomes of the *fatwas* in the decision process (anticipation).

As a result, along with ‘form’, an embedded jurist-consult considers the ‘substance’ as well and uses available sources in legal theory such as custom (*urf*), juristic preference (*istihsan*), preventing the harm (*sedd-i zera’i*), legal devices and public interest (*maslahah*) to achieve the most suitable outcomes.<sup>7</sup>

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<sup>7</sup> Nevertheless, since not every jurist-consult is equipped with such a perspective and ability, there are differences in the ruling and impact on the society.

In this section, hence, we present three areas of articulation of embeddedness of jurist-consults into the society in legal sphere:

- (i) integration of realities of the society into decision process;
- (ii) responding to the problems of the society with a solution within the boundaries of Islamic law;
- (iii) consideration of the short-term and long-term outcomes of the *fatwas* for the society in the decision process.

These are discussed in detail in the following sections.

#### **5.4.1. Integration of Realities of the Society into Decision Process**

Udovitch (1970) surveyed the Islamic law books in *Hanefite* school of thought to show that Islamic law or *fiqh* is not a theoretical branch of science which does not consider the everyday practice of people. On the contrary, he claims, it was shaped by the practice of people in the society. Islamic law, therefore, is not a theoretical intellectual product with a solid basis. However, jurist-consults or *muftis* emerged from the society, were trained within the society and had professions as any individual in the society which helped them to have strong ties with various strata of local community. One of the articulations of such a relationship is to issue *fatwas* (legal rulings) in accordance with the realities of the society. Actually, without making reference to the everyday practice of people, namely custom as one of the sources in *ijtihad*, it is impossible to provide a dynamic Islamic law, which could be implemented through centuries and in vast geographies (Shabana, 2010).

It is important to note that ‘man's economy, as a rule, is submerged in his social relationships’ according to historical and anthropological researches (Polanyi, 1957: 46), which makes economic activities such as partnerships as part of the everyday practice of people. In order to show that jurist-consults in pre-modern context had knowledge of different spheres of everyday practice of people such as establishing partnerships and other affairs of individuals, we utilise the following example of validation of partnership agreement between a craftsman and a stall-owner through utilisation of juristic preference (*istihsan*) due to the continuous use of such partnership

agreements among the people without any disapproval in the Muslim societies (Udovitch, 1970). However, according to analogy (*qiyas*) as a method, such agreement should have been ruled as invalid. The nature and content of this contract is as follows: “A stall- owner offers the use of his stall to an artisan on the condition that the latter do all the work while sharing his profits equally with the stall-owner” (Udovitch, 1970: 117). Furthermore, Udovitch (1970: 117) lists the reasons why such a partnership could not be ruled as valid according to the analogy:

By analogy, this arrangement should be invalid on a number of grounds. The investment of the stall-owner consists of intangible property (viz., the use of his stall), and intangible property by itself is not suitable for investment in a partnership. The arrangement cannot be valid as a hire contract, since the sum that would correspond to the wage — not specified. Nor could it qualify as a valid lease contract, since the sum that would correspond to the rent is also unknown. In spite of the considerable theoretical objections to its practice this particular form of partnership nevertheless declared valid by the Hanafite jurists.

Explanation of reasons of utilization of juristic preference in this ruling is also important for us to demonstrate how jurists evaluate cases, and consider the custom in the process as well as consequences of the *fatwa* in the society (Udovitch, 1970: 117–18):

By exercising juristic preference (*istihsan*), he [*i.e.*, Shaibani] permitted this arrangement because of its continuous use in the affairs of men without any disapproving voice being raised against it. Objecting to transactions which are in common use among the people is in itself a type offense. In order to avoid this offense, this contract is permissible. For there is no explicit text nullifying it, and the people have a need for this contract. For example, if an artisan arrives in a certain town, its inhabitants would not know him and would not entrust him with their merchandise. They would, however, entrust their merchandise to the stall-owner, whom they do know. As a rule, the stall-owner would not gratuitously provide the likes of this service to the artisan. The validation of this contract achieves the desired ends of all parties concerned. The artisan receives compensation for his labor; the people derive the benefits of his services; and the stall owner receives compensation for the use of his stall. The contract is permissible. The stall-owner is entitled to a share of the profit because he has taken the artisan into his stall and given him some help with his merchandise. He may perhaps help in some aspect of the work, as for example, a tailor who accepts cloth, oversees its cutting, and then hands the material over for completion of the tailoring to another on the basis of half profit. For these reasons, the stall-owner is entitled to a share of the profit.

Moreover, jurist-consults do not directly transfer other rulings from other places or other times since every place and every time has its own custom; instead they reinterpret them according to local practice. Hence, Islamic law may have different implementation in terms of ruling even within the same school of thought according to the place and time which provides its dynamic nature (Shabana, 2010). As the above *fatwa* depicts, jurists take the everyday practice of people into account in their rulings and even consider

ruling against the everyday practice as a type of offense. In literature, we can find further examples to substantiate this point where dynamic nature of Islamic law and the role of custom in Islamic law-making is discussed (Libson, 1997; Gerber, 1999; Masud, 2009; Shabana, 2010). Such considerations, we argue, are only possible through the embeddedness of jurist-consults into the society. Nevertheless, it is also important to note that everyday practice of people should be compatible with the core principles of Islamic law in order to be integrated which is why many customs were disapproved by jurist-consults since the time of Prophet Mohammad (El-Awa, 1973).

#### **5.4.2. Finding Solutions/Cures to the Emerging Problems in Everydayness**

Since being integrated into the realities of the society or embeddedness is crucial to attain law-making, in occasions scholars needs to appeal to legal tools such as custom or juristic preference in responding to a judgement for a practical issue. In other words, in everyday practice of people, there might be issues which could not be responded within the proper limits of a school of thought. In such cases, a problem arises due to the gap between the practice of people and the theoretical framework of law-making of a school of thought. In such cases, jurist-consults utilised 'exits' (*makharij*) to provide 'remedies for those who sought them' which is known as legal devices (*hiyal*) (Horii, 2002: 312) among other methods such as *takhayyur* (selection) and *talfiq* (amalgamation) (Hallaq, 2009). In this section, we provide an example to show that how jurist-consults find solutions to the problems of people emerging from theoretical framework of a school of thought and strive not to interrupt everyday practice as long as it does not contradict with the core values and principles of Islamic law.

For example, as an Islamic commercial principle, sale of unripe fruit on a tree is impermissible due to the inherent uncertainty of such a sale contract (Hamoudi, 2008). Therefore, even if there is a demand for unripe fruits, such a sale transaction would be void. Abu Yusuf (738-798), considering such a demand, suggested a solution for this voidable contract within the Hanefite school of thought, one of the leading main school of thought. His suggested solution is to sell the immature fruits along with the leaves of the tree. Since the leaves are considered as good, there is no issue regarding its sale contract and immature fruits would be collected along with the leaves as a by-product process. In this example, as it can be seen, Abu Yusuf was aware of the need of the society and found a solution for the problem within the rules of the Hanefite school of

thoughts. As Ibrahim (2015) discusses in his book, *Pragmatism in Islamic Law*, such a pragmatic approach to find solutions of the problem of arising in everyday practice of people through legal devices or *tafiiq*, which was not exception, unlike initial norms, but the general method, especially after the 11<sup>th</sup> century.

#### **5.4.3. Foreseeing Consequences of the Legal Rulings for the Society in Short-term and Long-term**

Another aspect of being embedded in the society is the estimating the consequences of a given *fatwa* for the society in the short-term and long-term in the process of *ijtihād*. In particular, two principles in the legal theory were used to justify rulings in this approach: *maslahah* (public interest) and *sedd-i zera'i* (preventing the harm). Although these two principles are interrelated since preventing harm is also for the public interest and acting based on public interest might prevent a potential harm for the society, in some cases prevention aspect outweigh the public interest and *vice versa*. These two principles and other principles in the same category are utilised to follow a consequentialist approach in the process of *ijtihād* and considering macro level outcomes as well as micro level outcomes of a *fatwa*. Below are examples of such consequentialist approach at two different levels, namely macro (or global) and micro (or local) levels.

Impermissibility of selling weapons to the enemies is an example of considering the outcomes at the global level. In terms of merely considering the form of such a contract, namely selling a permissible product to a person or company, such sale contract should be valid, since it does not violate any of the 'terms' or *arkan* (sg. *rokn*) of the contract. However, based on the expected consequences of such a selling agreement, which is empowerment of enemy and resulting harm for Muslim population at large, *Shari'ah* scholars prohibited selling lethal weapons to the enemies (Bhala, 2011). This example might be considered as a prevention of a general harm from the public, in other words, protection of Muslims in general since the empowerment of enemies affects and threatens all Muslims. However, scholars have not only considered general impact of legal rulings on whole Muslim population but also local implications such as the following example.

Second example is about purchase of goods by traders at the outskirts of the town resulting in discouraging desert dwellers to reach the market, namely *talaqqi al rukban* (an exploitative commercial arbitrage) (Khan, 1994). The local traders were motivated by paying less than the market value through taking advantage of the dessert dwellers' lack of knowledge about the price prevailing in the market (Saleem, 2012). However, such a contract is prohibited by the Prophet who urged the community not to go to meet the caravans on the way, which is another example of the consequentialist approach pursued by *Shari'ah* scholars of the time (Saleem, 2012). In justifying the position, it was explained that since desert dwellers did not know the actual price prevailing in the market, the purchasers would take advantage of such asymmetric information by meeting those dessert dwellers outside of the town to buy their produce cheaper than market price (Saleem, 2012). Another possible reason might be to eliminate the third-party involvement in trade, namely between the local people and desert dwellers (Saleem, 2012). Furthermore, this prohibition also protects other traders who decided to wait the arrivals of the sellers in the market (Saleem, 2012). Although, in terms of fulfilling 'form', such an agreement should be deemed as legal, however, it is prohibited since the resultant agreement is against *maslahah* of villagers and even the local people (Saleem, 2012). The justification of taking a decision based on *maslahah* in the case of villagers is obvious; as instead of selling at a prevailing price in the market, they had to sell their produce cheaper and hence they faced loss in producer's surplus. As for the local people, *maslahah* relates to the opportunity cost for the customers created by the traders by denying the goods to come to market and villagers, hence, selling at a cheaper price to the traders, which results in loss in consumer surplus, as the villagers would have sold their produce in the market at the same price level or cheaper than the traders. In a similar way, reprehensibility of selling of grapes to wine producers to prevent a potential harm might also be considered under this category. Grape, as a permissible produce, is permitted to be sold to anyone. However, as the intention of the wine producers in buying grapes is obvious, which is producing an impermissible product, namely wine, Imam Abu Yusuf and Imam Muhammad go beyond the form of the sale contract and rule it as reprehensible (*makrooh*).

These examples clearly show that in order to prevent a harm or acquisition of public good, legists nullify a permissible contract in terms of form or at least deem it as reprehensible to draw attention to the resulting potential damage for the society.

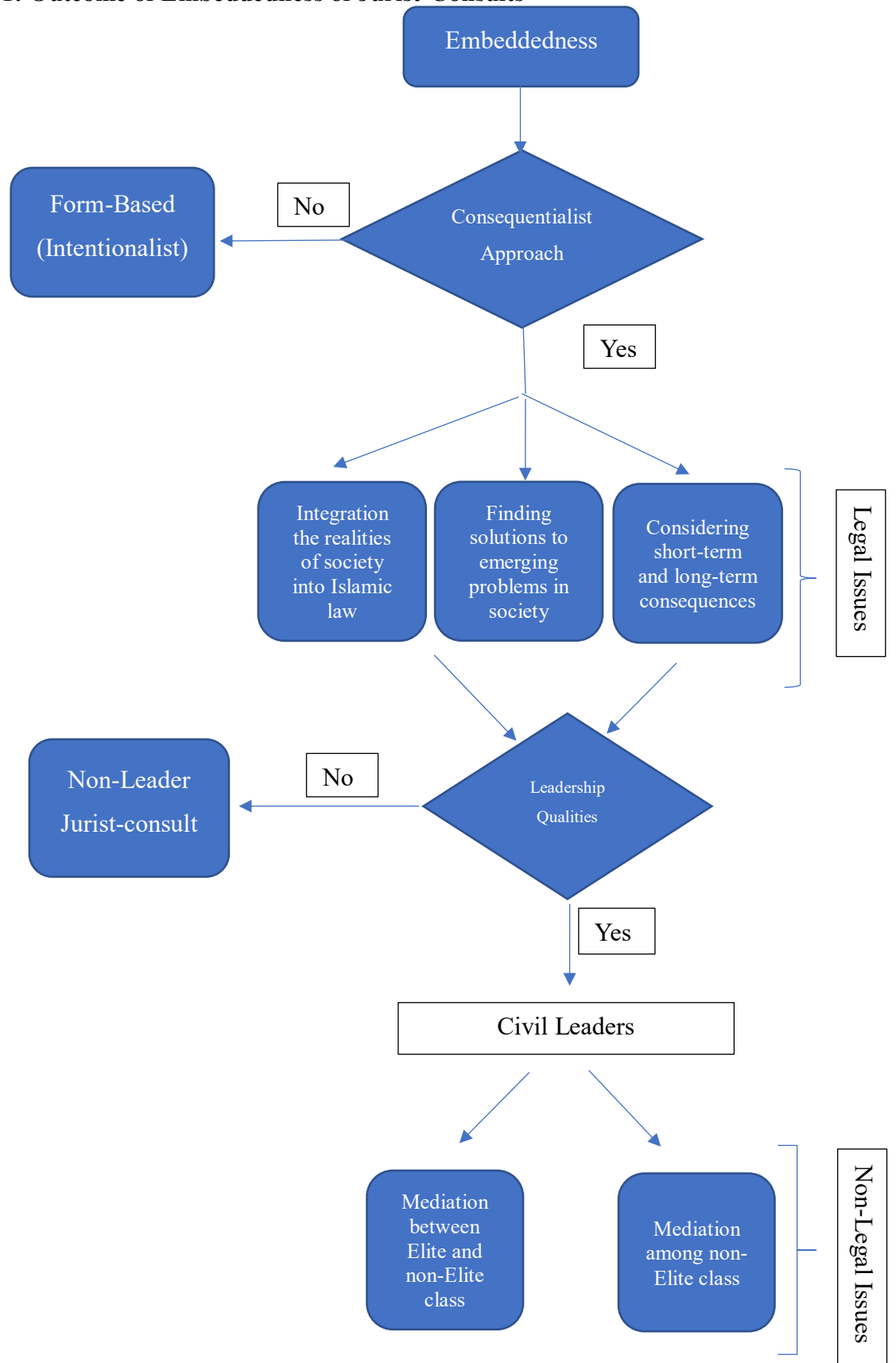
## 5.5. JURIST-CONSULTS AS CIVIL LEADERS IN SOCIETY

Jurist-consults' deep knowledge in *Shari'ah* related matters along with their submergence into the society and having a direct relationship with their surroundings, which also have shaped their process of *ijtihad* or independent reasoning provided them with religious authority over the local people. This religious authority comes along with a social authority, since Islam "is the basis of the family, the society and the economy" (Winter, 2009: 22). It should, however, be noted that not every jurist-consult has qualities to lead people and become their representatives by going beyond executing *ijtihad* and teaching Islamic sciences. Nonetheless, as historical records show that many of *ulama* were accepted as civil leaders and undertook the mission of acting as a bridge between the elite class and non-elite class to confront the rulers and other authorities on behalf of the community (Hallaq, 2005; Hoexter *et al.*, 2002). These roles and responsibilities suggest that, these jurist-consults were beyond the point of *fatwa* giving chair, but also acted as "the guardians and protectors of the disadvantaged, the supervisors of charitable trusts, the tax-collectors and the foremen of public works... and established themselves as the intercessors between the populace and the rulers" (Hallaq, 2005: 183), which constituted their distinctiveness; and this is something expected from the contemporary *Shari'ah* scholars.

Figure 5.1 summarises how the process of embeddedness of jurist-consults led them to be civil leaders of the society. Although embeddedness is a necessary condition to attain civil leadership, it is not a sufficient condition.

An important step to attain civil leadership is to articulate embeddedness in the legal sphere to produce a dynamic and practical Islamic law, which requires to follow a consequentialist approach. As depicted in Figure 5.1., by following a consequentialist approach, we refer to issuing a *fatwa* without neglecting the requirements of the form of the text, but also considering the outcome of possible rulings, and, if necessary, judging according to the needs and expectations of society. In other words, it is expected that the outcome of such a consequentialist approach in the legal sphere is to integrate the realities of the society into the legal sphere, providing remedies for emerging problems and considering short-term and long-term consequences of a given *fatwa*. Such process should lead to attaining a religious authority among the Muslim individuals.

**Figure 5.1: Outcome of Embeddedness of Jurist-Consults**



After obtaining religious authority, *ulama* with leadership qualities are embraced as the civil leaders of the society who act as a bridge between ruler and ruled as well as among the populace. These civil leaders were indispensable for ruling authority in terms of attaining legitimacy in the eyes of the population. In order to prove that ruling authority is ruling with justice, they had to negotiate with *ulama*, if they fail to co-opt them. In the next section, we analyse the relationship of *ulama* and the ruling class and how their relationship was shaped in the pre-modern period.

## **5.6. JURIST-CONSULTS AS A SOURCE OF LEGITIMACY: RELATIONSHIP BETWEEN MUSLIM GOVERNMENTS AND LEGAL JURISTS IN PRE-MODERN PERIOD**

This section analyses the observed paradigm shift in the governance structure of Muslim populations after the leadership of rightly guided *khalifah* period where a gap emerged between the ruler and ruled and, the role and status of jurist-consults as an instrument to ensure legitimacy of the ruling authority by filling this gap.

As discussed above, there was an evident change in the way ‘rightly guided’ *khulafha* or caliphs were leading the Muslims and the way the sultanate-caliphs did after them, starting with the Umayyad caliphs; the main distinction being the ‘lack of embeddedness into the society’ in the later periods. The lack of embeddedness into the society and resultant gap between the ruler and the ruled raised the issue of legitimacy for the ruling authority. *Ulama*, with their “highly influential position in society” had the capacity to provide required legitimacy to the ruling authority (Kamali, 2001; Gellner, 1983). This position, in return, helped them to become a bridge between the ruling authority and ruled masses and ensured the legitimacy for the ruling authority as a consequence of negotiation process between the rulers and *ulama* as civil leaders (Hallaq, 2005).

In that process, the ruling authority strove to attain legitimacy through *ulama* in two main ways: either integrating them into the legal system of dynasty or attaining their support as a result of a negotiation process with local *ulama*.

*Ulama*, unless involved in a trade or other kinds of revenue generating businesses such as Abu Hanifa, worked as judges or *qadis*, relied on ‘royal and government patronage’

in the form of the ‘scholars of palaces and high places’ for their financial well-being, which also shows that both parties benefited from this relationship and live in cooperation with each other (Hallaq, 2005: 182). However, as it is stated earlier, especially during the first five centuries, majority of *ulama* were self-funded (Cohen, 1970). Therefore, we argue that negotiating with local figures was the dominant form of attaining legitimacy in the eyes of populace.

In addition to negotiating with *ulama*, ruling class also strove to integrate them into the system, even in some cases attempting to punish them upon their refusal of the offers for governmental posts such as *qadi* position (Hallaq, 2005: 180–81; Awass, 2014) such as Abu Hanifa, who despite being one of the most revered scholar or *alim*, were prisoned by the so-called *khalif* for rejecting to become *qadi*. Nevertheless, legal system worked as independent of ruling authority (despite some exceptional cases), which shows the power of *ulama* against a potential pressure from ruling authority, even if they were part of the official governance system (Hallaq, 2005:191; Burak, 2013).

We argue that the source of such negotiation power, whether working as an official in government or acting as a civil leader, stemmed from the embedded nature of *ulama* within the society which made them a source of legitimacy and forced the ruling class to negotiate and if necessary, compromise against *ulama* to attain legitimacy in the eyes of people.

## **5.7. LATE PRE-MODERN PERIOD: RELATIONSHIP OF JURIST-CONSULT AND SOCIETY**

Two main sources of *mufti*'s or *ulama*'s embeddedness in society, namely intellectual and financial independence, had been started to change after the 11<sup>th</sup> century with the establishment of *madrasa* which is an educational institution for the study of many subject areas including but not limited to the religious knowledge (Hefner and Zaman, 2007). The *madrasas* were supported by *waqfs* (endowments) for accommodation and living expenses as well as necessary educational environment (Blanchard, 2007). *Madrasa* remained as an important transformational point in terms of the role and status

of *ulama* in the society. Starting with the establishment of *Nizamiyah madrasas*<sup>8</sup>, which was found by Seljuq vizier, Nizam al-Mulk, in Baghdad, Iraq during the middle of the 11<sup>th</sup> century (Blanchard, 2007), education model of scholars had been transformed from the circles at the mosques or from master's houses to the *madrasas*. These *madrasas*, beside transforming the learning environment of students of knowledge and the future *ulama*, also aimed at producing educated men for the bureaucracy (Blanchard, 2007), which would further decrease *ulama*'s embeddedness into the society. Allowances provided by *madrasa* linked *waqfs* such as food and accommodation (Makdisi, 1970) laid the foundation for isolation of students from the society and submergence into the *madrasa*.

In terms of profession, thanks to the expansion of Muslim dynasties such as Ottoman Empire, *muftis* and other private scholars had the opportunity to dedicate their full time to study and teach Islamic sciences by working in *madrasas* as professional teachers or governmental positions or relying on the patronage of wealthy people (Atçil, 2010) and the pious endowments (Awass, 2014). Comparing to the earlier period of Islam and considering *ulama*'s involvement in everyday practice as a merchant or trader, we may argue that such a transformation in profession led to a further decrease in their embeddedness into the society. Especially after the 16<sup>th</sup> century when the Ottoman Empire expanded its territories to the majority of Sunni Muslim world, the need for Islamic scholars graduated from *madrasas* increased to fill the state-appointed religious positions such as jurists and jurist-consults (Atçil, 2010) so that the religious legitimacy of the state can be sustained.

Although these two important changes in *muftis*' life do not suggest that they are disembedded from society, it certainly suggests that there is a decline in terms of degree of embeddedness compared to the earlier periods. Moreover, involvement of political figures in *madrasa* system as financial supporters after the 11<sup>th</sup> century and being key figures for appointment of *madrasa* teachers as well as for religious positions in government such as state-appointed jurists and jurist-consults resulted in a heterogeneous nexus between rulers and *ulama* (Atçil, 2010). However, in terms of independence, especially until the 15<sup>th</sup> century, jurist-consults were mostly managed to

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<sup>8</sup> Although some authors suggest that there were previous examples of *madrasa* in 10<sup>th</sup> century, *Nizamiyah madrasa* is important since it establishes a close relationship between political rulers such as Vizier Nizam al-mulk and scholars.

stay independent of the ruling authority (Burak, 2013) and were highly respected in society and were considered as important figures during and after the late pre-modern period (Zaman, 2002). However, the role and status of Islamic scholars have drastically changed during modern period with the prevalence of enlightenment philosophy and secularisation of the nation-states in the Muslim world. Yet, the emergence of Islamic banking institutions marked the beginning of a new period for Islamic scholars amid their vanished presence in the formal lives in the Muslim world, as we discuss in the next chapter.

## 5.8. CONCLUSION

This chapter explored the role and status of jurist-consults during the pre-modern period, especially during the first five centuries. While first four *khalifah* or caliphs were embedded into the society as a result of the simplicity of life and lack of ruling class as a separate entity from the society, after the rightly guided caliphs' period, a gap had emerged between the ruler and the ruled due to the lack of embeddedness of ruling authority into the society. In the pursuit of legitimacy, ruling class utilised the legists or Islamic scholars to gain legitimacy and employed them as a bridge between two entities, namely the ruler and the ruled. Due to their intellectual and financial freedom, the scholars managed to submerge into the society rather than constituting an elite class or being part of ruling class. Their religious and social authority over the populace made them capable of fulfilling the need of legitimacy of the ruling authority by means of their embedded relation with society and prioritising the well-being of the common individuals. Having the support of people as their negotiation power, jurist-consults managed to defend the social good against any transgression of ruling authority for the benefit of themselves at the expense of the populace. However, due to the transformations in *ifta* institutions starting from the 11<sup>th</sup> century, especially in terms of education of *muftis* and conversion to full-time occupation, *muftis* started to lose their intellectual and financial freedom and, eventually, their level of embeddedness into the society has diminished. Especially with the emergence of modernity and its staunchly application and rise of nations-states in the Muslim world as secular state, their role and status within the society further marginalised. In the next chapter, we explore how emergence of Islamic banking institution and its quest for *Shari'ah* legitimacy provided a new role and status to the jurist-consults within the society and institutional

framework representing a new transformation, as corporation in the form of banks have become the new source of legitimacy for *Shari'ah* scholars while they provide Islamic legitimacy for the operations of Islamic banks. This is despite the fact that *fiqh* or Islamic law does not recognise corporation as an entity, which brings the entire legitimacy issue into further question.

## CHAPTER 6

# REFLECTING ON THE ROLE OF *SHARI'AH* SCHOLARS IN ISLAMIC FINANCE INDUSTRY: TRANSFORMATION OF IFTA INSTITUTION IN MODERN PERIOD

### 6.1. INTRODUCTION

This chapter aims to critically explore the transformation of *ifta* institution (institution of act of giving *fatwa* or legal opinion) in general and the role and status of *muftis* or jurist consults in the Muslim societies during modern period with a special focus on the period after the emergence of nation-states in the Muslim majority territories. Importance of the rise of nation-states in the current study as a point of transformation lies in the emergent secular nature of their governmental structure, and, consequent change in the legal system in these states. As a product of the enlightenment, nation-states have been constructed mainly through secular norms, and are governed by rational laws instead of laws derived from revealed knowledge, resulting into man-made laws replacing laws based on revealed text. Such a shift in governance paradigm has directly affected the role and status of jurist-consults and jurists since they are no longer considered as a legitimate source of knowledge in the new setting or paradigm; as this would directly contradict with the crux of nation-state structure which is a product of the modernity.

With the emergence of Muslim nation-states, the ruling authority in Muslim majority states halted the process of seeking legitimacy through religious authorities despite the fact that the latter has been a source of legitimacy for centuries for the Muslim dynasties of the past. In modern times, in some of the Muslim countries, democracy, as a form of governance and method of constituting the ruling authority, therefore, has been used as the essential source of providing legitimacy for the ruling class (Buchanan, 2002), while in some other modern Muslim countries legitimacy is sought through traditional means of patrimonialism. Nevertheless, such a paradigm shift in Muslim

societies in which Islam had been playing a central role in the society for centuries, led to the complex structures of relationships between the state and *ulama* or *Shari'ah* scholars. In Turkey, for instance, the Directory of Religious Affairs was established, as an undersecretary under Primerminister's Office, to centralise all religious affairs with the objective of attaining control over the religious affairs through a top-down approach (Baskan, 2013), while President Nasser in Egypt in the 1950s transformed *al-Azhar*, the traditional leading Islamic learning centre and university, into a state-controlled monopoly in religious affairs (Zeghal, 2011). However, even in such cases where the religion has been incorporated and even co-opted by the state at the governmental structure, *Shari'ah* scholars have not been permitted to play a decisive role in the governance system (Ahmad, 1991; Baskan, 2013; Zeghal, 2011). Attaining legitimacy for the modern nation-states, hence, is ensured through non-religious channels, while in the pre-modern Muslim dynasties, religion played an essential role in providing the required legitimacy by co-opting *Shari'ah* scholars as the source of such legitimacy or through negotiating with them as the civil leaders of the society, as explained in the previous chapter in detail.

In the modern era, the constitutions of Muslim nation-states are based on the principles of modernity such as replacing God as the source of knowledge with the outcome of Enlightenment philosophy such as rationality and pursuing universal laws extracted by human as a top-down construction which has not found complete acceptance among the population in some Muslim societies (Hallaq, 2012) leading to tensions in those societies. *Muftis* or jurist-consults, hence, although being dislocated from previous prestigious positions in the newly established modern states, have still remained as a source of legitimacy and a point of consultation in terms of everyday religious affairs among the population by facilitating their role and enjoyed a high status in the society, especially at the earlier periods of the paradigm shift (Zaman, 2002).

Since the law in these nation-states is no longer constituted by religious knowledge anymore but secular knowledge, the role of integrating the realities of the society into the law, finding solutions to the existing and emerging problems of people and thinking short-and-long-term consequences of rules and regulations have been undertaken by the governing institutions such as the state and modern judiciary among others. This shift, hence, led contraction of the opportunity space available for jurist-consults to

conduct their function in the private sphere, since they no longer have the authority to change or negotiate the regulations and everyday practices of modern life in most of the Muslim nation states (Sutton and Vertigans, 2005).

Weakening of faith in universal truths of modernity and interrogation of its institutions' validity since the 1960s, however, led to the formation of hybrid institutions which combines modernity with local features through multiple modernities (Eisenstadt, 2000). As discussed in Chapter 4, we argue that the emergence and operation of Islamic banking sector is an articulation of the multiple modernities framework (Asutay, 2009); as Islamic bank (IB) is a product of a combination of banking structure which is a product of modernity with the Islamic principles of revealed knowledge of blended with the rules and regulation of the state.

Amid all such developments and the paradigm shift, the emergence of IBs in a secular governance structure, however, has posed the question of Islamic legitimacy of these institutions. Since these IBs, by definition, have to ensure compliancy with *Shari'ah* principles, they have to provide the necessary evidence for this claim. As a result of pursuing *Shari'ah* legitimacy in our post-modern times in a similar fashion to historical times which had aimed to include jurist-consults into the official legal system or negotiate with them as civil leaders of local communities to legitimise their authority, IBs aimed to employ jurist-consults, especially those specialised in economics and finance (*fiqh al-muamalat* or the law of transactions in the sense of Islamic commercial law) to attain legitimacy in the eyes of the stakeholders, particularly, the customers (El-Gamal, 2006). In terms of operationalising *Shari'ah* compliancy, IBs have invented *Shari'ah* Board (SB) or *Shari'ah* Supervisory Board by employing a number of *Shari'ah* scholars. In a later stage, AAOIFI (Accounting and Auditing Organisation for Islamic Financial Institutions) has provided voluntary level standards for the operation of IBs and in some countries central bank regulates these IBs.

Before delving into discussion, it should be noted that three major transformations have taken place in terms of the role and status of *Shari'ah* scholars between pre-modern period and in modern period as practised in IBs, which are discussed as follows:

Firstly, in the pre-modern period, *ulama* were submerged into the society whereas *Shari'ah* scholars in SBs submerged into the IBs in particular and IB sector in general

more due to the nature of their profession compared to their submergence into the society.

Secondly, in the pre-modern period, *Shari'ah* scholars attained their 'civil leader' status through their deep knowledge in *Shari'ah*, sustaining an exemplary way of life and having an embedded relationship with the society, which bestowed upon them individually rather than as a class of 'learned people', the power to negotiate on behalf of people with the elite-ruling class. However, negotiation power of the *Shari'ah* scholars in SBs, compared to the pre-modern period, has lessened, since *Shari'ah* scholars in SBs attain their source of legitimacy by being appointed to a specific SB rather than deriving their negotiation power directly from the society. As a result, they get their salaries from the banks and financial institutions in whose SB they sit. This implies that they do not have the functional independence.

Thirdly, complexity of the society and everyday practices of people changed drastically compared to pre-modern era in the Muslim world implying that roles and cultural repertoires have changed alongside expectations from *Shari'ah* scholars.

In the next section, we explore how the importance of religious authority of *Shari'ah* scholars has declined due to the emergence of modernity and how they lost their status of civil leadership to a certain degree. Following this discussion, we investigate three transformations between the pre-modern and modern period in terms of the role and status of *Shari'ah* scholars in detail in understanding the current state of *Shari'ah* scholarship *vis-à-vis* IBs. By doing so, this paper aims to explore the sources of the observed current tension in the operation of IBs in relation to *Shari'ah* compliance and the role and status of *Shari'ah* scholar, as the latter has become a constant debate in Islamic banking related discussions. This debate should be contextualised also in line with the empirical evidence produced in Chapter 3 and the narrative provided in the previous chapters.

## **6.2. DECLINE OF THE IMPORTANCE OF RELIGIOUS AUTHORITY AND THE DISAPPEARANCE OF JURIST-CONSULTS AS CIVIL LEADERS IN THE MUSLIM WORLD**

Enlightenment movement had a huge impact on everyday life of people by locating rationality at the centre of knowledge creation and as a reference point of any action by replacing God (Honneth, 1987). Although the enlightenment had emerged in the West, its ideas and principles were conveyed to the other parts of the world, including Muslim majority lands, with the help of various means, among which the colonisation process being the most effective and efficient of them (Tripp, 2006). The West aimed to shape the world according to these principles with the intention of raising other people to the modern level by emancipating those ‘uncivilised’ people from the chains of traditions and irrational beliefs (Scott, 2011; Said, 1979) as modernity claimed ‘the universal truth’ expected that all the societies would ultimately converge towards the universal truth of modernity in a linear development model. As an outcome of this process, “reliance on either revelation or mystical illumination” was considered invalid in this paradigm and replaced by “natural faculties of the human mind” (May, 1991: 162).

The modern period starting with the enlightenment process, therefore, had two important consequences for jurist-consults or as they now known as *Shari'ah* scholars, in the Muslim lands: (i) the decline of the importance of their religious authority at the governance level due to secularisation of the state; and (ii) losing their role as civil leaders (Hallaq, 2012).

Secularization, as one of the pillars of the enlightenment philosophy and governance model of modern nation-states, dislocated the religious figures from governance of the state<sup>9</sup> (Daver, 1988; Ruedy, 1996). In the pre-modern period, Islam was the way of organizing everyday life for both subjects of Islamic dynasties and the elite-ruling class, and *ulama* were important figures in terms of legitimising the governance of ruling class thanks to their religious and social authority in the society (Winter, 2009). However, due to the secularisation process in the modern period, ruling class is no longer need to attain such a legitimacy from *ulama* anymore (Siam-Heng and Liew,

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<sup>9</sup> Although secularisation process affected all religions and their relationships with states, this chapter is limited to discuss the impact of secularization on religious authority of jurist-consults (*muftis*) in Muslim majority societies due to their relationship with the IFIs.

2010). Consequently, the importance of religious authority of jurist-consults has declined with the removal of *Shari'ah* as a way of governance method and mechanism. Even though *Shari'ah* as a governance system no longer plays an important role in Muslim secular nation-states, most of the citizens of these countries implicitly implement *Shari'ah* in their everyday practice, especially in relation to worshipping, namely their relationship with God, since in Muslim majority societies, Islam “is more than a doctrine, more than a private belief or worship. It is also a culture and an institutional framework governing all aspects of interpersonal relations” ( Taylor, 1988: 32; Ardic, 2012). In other words, although knowledge of jurist-consults has no meaning at the level of governance of state and in public sphere in contemporary times, and they cannot bestow any legitimacy for the ruling class anymore, they are still considered as a religious authority and source of legitimacy in personal relationships among the members of the society, namely in private sphere. Therefore, although religious authority had an important status within the private sphere in the Muslim societies and communities, the power of negotiation of *Shari'ah* scholars with the elite-ruling class diminished substantially due to the decline in the importance of their religious authority at the governance level. Nevertheless, as civil leaders of the society, it is expected that jurist-consults or *muftis* should have continued to hold the negotiation power with the elite-ruling class. As in pre-modern period, the power of negotiation held by the *muftis* was not only due to their authority to legitimise the affairs of elite-ruling class as *ulama* but also due to having support of people and acting on behalf of them as civil leaders.

This brings us to the second consequence of the emergence of modernity, which is disappearance of jurist-consults as civil leaders in many parts of the Muslim societies. Although, due to the secularisation, the importance of religious authority of jurist-consults declined in the public sphere, they kept their religious authority in the private sphere (Sikand, 2005; Gupta, 2012). Such a status, of course, brings the power of negotiation with the ruling elite class on behalf of the society. In other words, even though governance of the state is shaped in line with secular rulings, in order to persuade the population for serenity, ruling class still had to negotiate with religious scholars as representatives of the people, especially in the early stages of the secularisation if not using their religious influence to expand their policies in the private sphere.

Having stated these, the reforms in the newly emerged nation-states, consciously or unconsciously, transformed the status of jurist-consults in the society as civil leaders drastically as well. First and foremost, in the modern period, everyday life has not been shaped around religion. Consequently, along with the secondary role of religion in this transformed social formation, *Shari'ah* scholars also lost their central position even at the private sphere. For example, alphabet and language reforms for Westernisation and modernisation purpose in a number of Muslim societies further dislocated *ulama* from a highly respected status in the society. In particular, reforms which resulted in replacement of the existing alphabet system with a new, Latinised script, transformed literate, educated class as illiterate as in the case of Turkey and Indonesia (Chao, 1968). Such a transformation in the language system affected the role and status of jurist-consults or *Shari'ah* scholars and rendered them as obsolete in the era of 'modern' nation-state. As a result, the jurist-consults were mostly limited as a source of knowledge in terms of giving advice on the relationship between individuals and God solely, rather than acting as a civil leader in the society.

Consequently, these transformations, particularly in the governance of the state and structural reforms in everyday life such as language and education resulted in the decline of the importance of religious authority of jurist-consults, which implied relinquishing their role as civil leaders in the society. Although such consequences prevailed in Muslim societies, there were also exceptional individuals who kept their role and status as civil leaders within the society such as Said Nursi in Turkey (Mardin, 1989), Mawdudi in Pakistan (Ahmad and Ansari, 1979) and Ahmad Dahlan in Indonesia (Clarke and Beyer, 2009), among others. These figures and other examples became leaders in their respective societies in the search of an Islamic identity in the modern nation states by opposing the enforced and imposed secular modernity which has resulted in hybrid institutions of multiple modernities framework in these countries. As we explored in Chapter 4, one of the outcome of such quest was the emergence of Islamic banking sector and the rising of the importance of religious authority of *Shari'ah* scholars in modern times. However, compared to the pre-modern times, as stated earlier, there are three main differences in the role and status of jurist-consults or *Shari'ah* scholars in modern period in relation to IBs. In the following sections, we examine each one of these three differences and their impact on the operations of IFIs.

### 6.3. JURIST-CONSULTS AS EMBEDDED AGENTS

As discussed in the previous chapter, Polanyi's (1957) concept of embeddedness is a useful frame to contextualise the role and status of jurist-consults in pre-modern period. Considering their intellectual and financial independence along with submergence into the society helped us to understand their process of *ijtihad* and the negotiation power *vis-à-vis* the ruling authority. What was implicit in this debate was the influence of religion as an institution, namely morality of Islam in terms of shaping the mindset of jurist-consults due to its esteemed and central position within the society (Hallaq, 2012). In other words, their submergence into the society led them to take *maslahah* or public interest into account in the process of *ijtihad*, where the definition of public interest is derived from the morality of Islam.

This implicit debate, however, is particularly important for the role and status of jurist-consults in the modern period due to the transformation of the prevailing institutions in the society as well as the social formation of Muslim societies. Regarding our discussion of *ifta* institution and the role and status of *Shari'ah* scholars in SBs in the modern period, we can observe that *Shari'ah* scholars submerged into the corporate culture in the form of IBs, more than the society due to the high influence of corporates in the modern period (Thornton and Ocasio, 2008). Furthermore, the norms and values of the capitalist markets have become more influential in terms of shaping their *fatwa* (legal ruling) process compared to the morality of *Shari'ah* whereby Islamic morality has been relegated into instrumentality in rationalising the operations and instruments of Islamic banks. This refers to the hegemonic role of capitalism, which shapes the behaviour and fatwas of the *Shari'ah* scholars in IBs.

It should be noted that hegemonic role of capitalism is well articulated in the literature including by Friedland and Alford (1991), who argue that the capitalist market is the key institutional order of inter-institutional system of Western societies along with bureaucratic state, democracy, nuclear family, and Christianity whereby a market system social formation is referred. However, within historical contingency, "modern societies have greater emphasis on corporate and state influences and earlier societies in general emphasized family and religion to a larger extent" (Thornton and Ocasio, 2008: 108). Since the capitalist market system has expanded beyond the Western societies and has also become dominant mechanism of organising the political economy

in Muslim societies, we can extend Friedland and Alford's (1991) argument to the Muslim majority societies in seeing the increased importance attached to capitalist market system through corporations such as Islamic banks and financial institutions and *halal* markets despite the dilemma that Islamic law or *fiqh* does not recognise corporation as an entity. Thus, historical contingency in modern times resulted in a similar trajectory with the West, however, with an extension, namely Islamic compliancy. Consequently, capitalism's hegemonic power has overcome the Islamic ontologically constructed meaning of economy, finance and banking by creating new versions through hybridity.

Since historical contingency suggests a shift towards market capitalism in Muslim societies with the help of *Shari'ah* compliancy, the role and status of *Shari'ah* scholars in IBs can be explored in understanding the observed shift through the use the concept of 'institutional logics', particularly its assumption of embedded agency, since contemporary IBs are established with a Western-style modern corporate model with an additional claim of *Shari'ah* compliancy legitimised by SBs under capitalist market system. It is important to note that the corresponding institutional form of *Shari'ah* compliancy in market system is SBs, which is the organisational form of individual *Shari'ah* scholars fitting into the corporate nature of market system.

As mentioned, the observed shift can be explained by institutional logics, which is defined as "the socially constructed, historical patterns of material practices, assumptions, values, beliefs, and rules by which individuals produce and reproduce their material subsistence, organize time and space, and provide meaning to their social reality" (Thornton and Ocasio, 2008: 804). As a concept, institutional logics does not suggest claiming of the ultimate authority of institutions in terms of shaping individuals and organizations in a unidirectional way, rather it acknowledges that individuals and organizations are also active in shaping the institutional logics (Thornton and Ocasio, 2008). Due to such bi-directional relationship, institutional logics establishes a link between institutions at macro level and actions of individuals and organisations at micro level (Thornton and Ocasio, 2008). In terms of articulation of such a link between macro and micro levels, emergence of the capitalist market system leading to 'great transformation' in the society might be considered (Polanyi, 1957). While such emergence led to transformation of prevalent institutional logics in the society

(Thornton and Ocasio, 2008), individual and organizational level counter hegemonic movements led to the emergence of various institutional logics, Islamic banking sector, particularly at its initial period, being one of them, as discussed in Chapter 4.

Regarding our discussion on *ifta* institution, we can observe that while morality of *Shari'ah* was influential in pre-modern Muslim societies (Hallaq, 2012), after the emergence of market system, we witness the high influence of the capitalist market in organising the everyday practice of the society. Time, for instance, after the industrial age, “became a commodity that could be ‘saved,’ ‘spent,’ or ‘wasted’” which was different than the perception of time during the pre-modern periods (Adas, 1990: 242). In other words, creation of land, labour and money as fictitious commodities to facilitate the market has transformed the meaning of social reality (Polanyi, 1957) by creating market based social formation.

Another important change has been the predomination of instrumental reasoning in the modern times, as opposed to the prevalence of substantive morality in terms of organising everyday operations of institutions, particularly financial institutions such as conventional and Islamic banks. Instrumental reason is a way of thinking, which prioritises maximum efficiency and the best cost-output ratio to evaluate success of an action (Taylor, 1991) and hence suggests performing economy and behaviour in a utilitarian sense. In other words, an individual or organisation guided with instrumental reasoning ought to act according to the most efficient economic application of means for a given end. Therefore, if a behaviour has a high transaction cost compared to another, the behaviour with a lesser transaction cost should be preferred, according to instrumental reasoning. Organised *tawarruq* as discussed in Chapter 4 is, indeed, an articulation of this way of reasoning in *fatwa* process.

As a result of emergence of the capitalist market order with its own institutional logics such as its unique organisation of time, creation of fictitious commodities and prioritisation of instrumental reasoning in shaping everyday life of the individuals as well as organisations, we can observe the transformation of *ifta* institutions under the influence of this prevalent institutional logics. This is due to embeddedness of *Shari'ah* scholars as individuals and IBs as organisations into the capitalist market system. However, as discussed above, *Shari'ah* scholars as individuals and IBs as organisations are not passive agents in this framework, but active agents and influence the

institutional logics as well. In our analysis of IBs, this is evident in the transformation of corporate culture which is derived from a positivist ontology having no room for revelation in terms of operating business affairs, yet its institutional logics are shaped and reproduced due to influence of individuals and organisations. Thus, *Shari'ah* governance framework, SBs, *Shari'ah* auditing departments *etc.*, are all articulations of such influence. In other words, such *Shari'ah* compliancy institutions regenerate the capitalist institutional logics with the blending of Islamic law; and therefore, the multiple modernities frame explains the emergence of IBs.

Nevertheless, embeddedness of *Shari'ah* scholars in IBs and embeddedness of IBs in the capitalist market system influenced *ifta* process in IBs. Embedded agency assumption claims that “the interests, identities, values, and assumptions of individuals and organizations are embedded within prevailing institutional logics” (Thornton and Ocasio, 2008: 103). By ‘prevailing institutional logics’ in the case of IBs, we refer to the institutional logics of the capitalist market order. In Chapter 4, through postcolonial analysis of IBs, we discussed how IBs have been mimicking conventional banks in terms of product and services as well as principles such as prioritising the low transaction cost and efficiency over the objectives of *Shari'ah*, such as equity and profit-and-loss sharing and risk sharing, leading to the convergence towards conventional banking. We can demonstrate embeddedness of IBs as organisations and embeddedness of *Shari'ah* scholars in SBs as individuals into the capitalist market order as reason to such mimicking behaviour. Consequently, while primary norms and values of IBs are shaped by embeddedness into the capitalist market because of entrance to competition in global financial markets after the 1990s, embeddedness of *Shari'ah* scholars into the capitalist markets *prevented* them to hinder the convergence of IBs towards conventional banks, or at least moderating the outcome of such convergence. While active agency of *Shari'ah* scholars still produce a gap between Islamic vs. conventional banking sectors, recent decades witness the closure of this gap rapidly.

We do not argue that institutional logics of capitalist market system is the only logic in IBs since embedded agency assumption acknowledges that actions of individuals are shaped by different societal sectors (Thornton and Ocasio, 2008). Society as the inter-institutional system allows logics of different societal sectors to be influential in a context (Thornton and Ocasio, 2008). In the context of IBs, therefore, Islam as a

religion and its institutional logics is also influential. Existence of *Shari'ah* scholars by itself is an indication of influence of Islam on IBs. Nevertheless, the dominant nature of the capitalist market causes religion to have only partial impact on the everyday practice of IBs in allowing *Shari'ah* to facilitate market-based system. In other words, rather than having IBs as articulation of morality of Islam and fulfilment of 'the objectives of *Shari'ah*' in society, we observe, in majority of the cases, replication of conventional banks in everyday operations with the same institutional logics with an excess of fulfilment of 'the form of *Shari'ah*' to keep the 'Islamic' identity intact in the eyes of the stakeholders. Although we do not claim that every *Shari'ah* scholar in SBs has such embeddedness, it is a useful concept to explain part of social failure (*see*: Asutay, 2007b; 2012a) in Islamic banks along with other two explanations, namely transformation of source of legitimacy of *Shari'ah* scholars and complexity of the modern period. We, therefore, claim that under the high impact of the capitalist market system, some *Shari'ah* scholars have been influenced by the values and norms of the capitalist market system in their *fatwa* (legal ruling) process in IBs, since these IBs themselves have also been shaped by the very same norms and values beyond any other factors. This resembles Polanyi's (1957) explanations as to how the emergence of self-regulated market system disrupted and overcome the moral economies of the past with a distinction that again in Polanyian sense Islamic economics movement emerged to disrupt the capitalist hegemony by aiming to rescue land, labour, human and capital from commodification.

In the next section, we present the articulation of embeddedness of *Shari'ah* scholars into the capitalist market order under three main categories corresponding to their pre-modern processes.

#### **6.4. EMBEDDEDNESS OF JURIST-CONSULTS INTO THE IBs**

The emergence of IFIs after the 1970s and their need for *Shari'ah* compliancy has resulted in the constitution of a new profession called *Shari'ah* scholarship in a SB, which is a new institution developed in modern times, in IFIs including IBs (Kahf, 2004). *Shari'ah* scholars through SBs are needed to provide legitimacy to the institutional form, products, instruments, and operations of IBs and IFIs by providing *Shari'ah* compliancy within capitalist economy and secular political culture. It should be noted that most of those individuals turned *Shari'ah* scholars did not have modern

economics or finance related education despite dealing with such matters in modern manner in IBs and IFIs, while they were educated in Islamic sciences including the legal aspect of financial transactions and economic issues. However, emergence of this particular field of practice in the form of banking and finance has created opportunity spaces for those (modern) jurist-consults with specialism in Islamic sciences to act as point of reference for *Shari'ah* compliancy.

Since the emergence of this profession was not foreseen beforehand, with the IBs starting to proliferate and diffuse, especially after financial liberalisation and financialisation in the 1990s, a shortage of *Shari'ah* scholars has emerged (Askari *et al.*, 2011; Nathan and Pierce, 2009). In this process, pioneers of *Shari'ah* scholarship in IBs and IFIs, who have by now gained experience in the Islamic banking sector since the inception of first Islamic commercial bank in 1975, have also been preferred for the SBs in the newly established IBs due to their reputation and the experience they developed. This has resulted in individual *Shari'ah* scholars occupying multiple chairs in different institutions (Unal, 2011; van Greuning and Iqbal, 2008). Table 6.1 demonstrate the result of the network analysis on *Shari'ah* scholars which clearly reveals how chairs in SBs in different IBs and IFIs were occupied by a small number of *Shari'ah* scholars (Unal, 2011).

**Table 6.1: The Top Six *Shari'ah* Scholars as of 2010**

Rank	Name	No. of Positions
1	Sheikh Nedham Yacoubi	78
2	Shaikh Dr Abdul Sattar Abu Ghuddah	77
3	Dr Mohamed Ali Elgari	65
4	Sheikh Abdullah Sulaiman Al Manee'a	38
5	Dr Abdulaziz Khalifa Al-Qassar	38
6	Dr Mohammad Daud Bakar	38

Source: (Unal, 2011)

**Table 6.2: The Top Six *Shari'ah* Scholars as of 2017**

Rank	Name	No. of Positions
1	Shaikh Dr Abdul Sattar Abu Ghuddah	81
2	Dr Mohamed Ali Elgari	76
3	Sheikh Nedham Yacoubi	69
4	Dr Abdulaziz Khalifa Al-Qassar	42
5	Sheikh Abdullah Sulaiman Al Manee'a	38
6	Dr Mohammad Daud Bakar	32

Source: Thomson Reuters Eikon Database

As Table 6.1 suggests a small number of *Shari'ah* scholars, who were actively engaged in the sector, occupied the majority of the available positions in SBs and developing skills through working in the sector in 2010. Furthermore, after seven years of the initial distribution in 2010, we find a similar picture in terms of number of positions top scholars occupy. As Table 6.2 depicts the distribution of SB chairs occupied by the scholars in 2017, the top six scholars remain the same as in 2010, despite the change in the order in comparison to 2017.

Such a trajectory suggests that these *Shari'ah* scholars are highly preoccupied with Islamic banking sector, which makes them highly aware of the realities of the industry but at the same time helps to question the quality of *Shari'ah* compliancy that can be provided as a result of working for such a large number of SBs at once. In other words, *Shari'ah* scholars have learnt the institutional logics of banks and financial institutions and found SBs as opportunity spaces for exercising their Islamic knowledge and skills in ensuring the efficient running of IBs and IFIs. Since IBs and IFIs work within capitalist norms of efficiency plus *fiqhi* determination of *Shari'ah* compliancy rather than Islamic moral economy, *Shari'ah* scholars by definition have become familiar and specialised on the particularities and demand of capitalist financial systems. This hence facilitates the embeddedness of *Shari'ah* scholars into the capitalist system by definition of being embedded into IBs and IFIs through SBs.

It should be noted that factors such as modern education system promotes the capitalist principles, which most of the *Shari'ah* scholars are exposed during their education (White *et al.*, 2008) regardless of their Islamic sciences based education. In addition, well-paid salaries of *Shari'ah* scholarship (Irfan, 2015) also plays an important role to facilitate their embeddedness into the capitalist financial system.

Embeddedness of *Shari'ah* scholars in IBs helps them to integrate the realities of the sector into the *fiqhi* legal decision process, and, to find solutions to the problems of sector-specific issues emerging from capitalist practices resulting into mono-directional causality, while keeping the *Shari'ah* compliancy intact as well as taking the short-term and long-term consequences of issued *fatwas* into account for Islamic banking sector. While the pre-modern era scholars contributed to *Shari'ah* compliancy, they were embedded into the society as discussed in the previous chapter. An important consequence of being embedded into the Islamic banking sector in the present times is

that some *Shari'ah* scholars have prioritised the market values and capitalist principles dominant in the banking sector over objectives of Islamic moral economy resulting in furtherance of the social failure of the IBs in a subaltern manner (Asutay, 2007b; 2012a).

Based on this exploration, following three subsections presents the examples of the impact of embeddedness in Islamic banking sector on the legal or *fiqhi* decision process. It should be noted that although some *Shari'ah* scholars give their consent on the following cases, this does not necessarily mean that they are embedded in Islamic banking sector since they may approach these cases from different perspectives such as considering them as a temporary solution for the current period while suggesting an alternative solution to be implemented in near future or accepting such ruling under extreme necessity situations while rejecting widespread implementation. On the other hand, rationalisation of such *fatwas* through *maslahah* or public interest or claiming that these *fatwas* are valid due to the demands of modern life are articulations of intended embeddedness in the IBs and IFIs and hence in capitalist financial system.

#### **6.4.1. Integration of Realities**

One of the important articulations of embeddedness of a scholar into a field is to integrate the realities of that field in the *ijtihad* process and issuing a *fatwa* considering the given circumstances. Determination of the benchmarks for *Shari'ah* screening criteria for financial transactions is a good example of articulation of embeddedness of *Shari'ah* scholars into the finance sector.

Ruling of the ICFA, a multilateral organisation, on the permissibility of investment in common stocks of companies whose activities do not violate the *Shari'ah* principles in 1992 led to the new investment opportunities for Muslim investors (Wilson, 2004). Although the ruling of ICFA led to the new opportunities in Islamic finance sector, the scholars involved in the ICFA did not go further to delineate the criteria of the companies for being considered as *Shari'ah* compliant. Following that ruling, global rating agencies such as Dow Jones and FTSE began to construct Islamic indices in the late 1990s. As Islamic index providers, they established certain benchmarks for stock markets to determine the *Shari'ah* compliancy of the stocks with the objective of constructing their pool of Islamic indices with the help of *Shari'ah* scholars employed

by these service providers. Although such *Shari'ah* screening process is widely accepted and trusted in the sector, they are mostly approved by *Shari'ah* scholars at firm level rather than by a credible and independent *Shari'ah* authority such as the ICFA or Islamic Financial Services Board (IFSB) (Mahfooz and Ahmed, 2014).

**Table 6.3: *Shari'ah* Screens Industry Survey – Quantitative (Financial) Screens**

Eligibility if £	DJIM	FTSE	S&P	MSCI	HSBC	Amiri	DIB	Azzad	Meezan
<b>Liquidity Ratios</b>									
$\frac{AR_i(t) + CSI_i(t)}{TA_i(t)}$					50%				80%
$\frac{AR_i(t) + C_i(t)}{TA_i(t)}$		50%				70%			
$\frac{AR_i(t)}{TA_i(t)}$				70%					
$\frac{AR_i(t)}{MC_i(t)}$	33%		49%					45%	
$\frac{CA_i(t) - CL_i(t)}{TCS_i(t)}$									
<b>Interest Ratios</b>									
$\frac{TI_i(t)}{TR_i(t)}$		5%			5%				5%
$\frac{CSI_i(t)}{MC_i(t)}$	33%		33%						
$\frac{CSI_i(t)}{TA_i(t)}$		33%		33.33%		33%			
$\frac{SI_i(t) + LI_i(t)}{TA_i(t)}$							30%		33%
$\frac{SI_i(t) + LI_i(t)}{MC_i(t)}$							30%		
$\frac{C_i(t) + AR_i(t) + SI_i(t) + LI_i(t)}{TA_i(t)}$									30%
$\frac{C_i(t) + AR_i(t) + SI_i(t) + LI_i(t)}{MC_i(t)}$									30%
<b>Debt Ratios</b>									
$\frac{TD_i(t)}{TA_i(t)}$		33%		33.33%	30%	33%	30%		40%
$\frac{TD_i(t)}{MC_i(t)}$	33%		33%				30%	33%	
<b>Non-Permissible Ratio</b>									
$\frac{NPI_i(t)}{TR_i(t)}$		5%	5%						5%
$\frac{NPPI_i(t)}{TR_i(t)}$						5%	5%		

Source: Derigs and Marzban (2008:290)

Table 6.3 presents the quantitative and Table 6.4 depicts the qualitative *Shari'ah* screening criteria employed by various Islamic index providers, respectively (Derigs and Marzban, 2008). As it is clear from the differences of the criteria employed by different Islamic index providers, there is no consensus on how to decide whether a common stock of a company is *Shari'ah* compliant or not.

**Table 6.4: *Shari'ah* Screens Industry Survey – Qualitative (Sectorial) Screens**

	DJIM	FTSE	S&P	MSCI	HSBC	Amiri	DIB	Azzad	Meezan
Alcoholic Beverages	■	●	■	●	●	●	●	■	●
Biotechnology(Genetic&Foetus)					●				
Broadcasting & Entertainment	■	●	■	●	●	●	●	■	●
Conventional financial services	■	●	■	●	●	●	●	■	●
Gambling	■	●	■	●	●	●	●	■	●
Hotels	■	●	■	●		●	●	■	
Insurance	■	●	■	●	●	●	●	■	●
Meat Production								■	
Media Agencies*	■		■		●			■	●
Pork-related products	■	●	■	●	●	●	●	■	●
Restaurants & Bars	■	●	■	●	●	●	●	■	●
Tobacco	■	●	■	●	●	●	●	■	●
Trading of Gold & Silver			■						
Weapons & Defence	■	●		●	●	●	●	■	
● core business ■ any involvement *except newspapers									

Source: Derigs and Marzban (2008:289)

One of the common features of the quantitative *Shari'ah* screening criteria presented in Table 6.3 is the permissibility of inclusion of the companies with 5% or less prohibited income, such as interest or *riba* income. Under the normal circumstances, *Shari'ah* scholars should not allow a company with 5% impermissible income, yet it is a fact that such companies are rare since most of the companies currently traded in stock markets, even if their line of business is permissible, they invest their surplus money in investment tools which earns interest income such as bonds and securities (Usmani, 2007). The permissiveness of *Shari'ah* scholars in determining the thresholds for such quantitative screening criteria, therefore, show that *Shari'ah* scholars takes the realities of the sector into consideration when they issue a ruling. However, diversity of rulings among the *Shari'ah* scholars signify that the degree of permissiveness or criteria varies

from one scholar to another, due to various reasons, the level of embeddedness of a scholar being among the reasons.

Furthermore, the level of flexibility in deciding the permissibility of a line of business also varies from one provider to another based on considering different realities of the market as well as *ijtihad* of individual SB. Table 6.4 shows the permissible line of businesses according to the index providers, which suggests that there is a wide range of opinions in terms of permissibility of some businesses. Although most of the index providers do not allow any involvement in prohibited businesses, some index providers relax that ruling as well by including mixed companies, too, into their Islamic index.

Malaysian Security Commission's *Shari'ah* Advisory Council (SAC), for instance, by considering the local realities of Malaysian market and limited universe of investment opportunities in local stock market, ruled on permissibility of investment to the companies with mixed activities, namely companies whose core business is permissible but involved in impermissible businesses through subsidiaries such as hotels serving alcohol, if they fulfil certain additional criteria (Najib *et al.*, 2014). Considering the fact that 60% of all companies listed on Bursa Malaysia, namely the Malaysian stock exchange, are part of mixed company category as of 2013, such relaxation is considered as crucial for Muslim investors in Malaysia (Najib *et al.*, 2014).

The rationale behind such ruling also indicates the level of awareness of *Shari'ah* scholars about the market and their effort to relax the conditions for permissibility of a company under the conditions of market realities regardless of the Islamic permissibility. Among the rationales of SAC of the Securities Commission, in this section, we only list three related items in relation to the embeddedness of *Shari'ah* scholars (Salleh, 2011):

- (i) Considering the situation of mixed companies within the context of *'ulum al-balwa*, or common plight, since impermissible activities of such companies are difficult to trace, and permissible and impermissible elements are inseparable;
- (ii) Based on the principle of the preservation of property (which is one of the objectives of *Shari'ah* or *maqasid al Shari'ah*, large companies with permissible core businesses are considered to be important for the strength of Muslim investors and not lagging behind the non-Muslim investors;

(iii) Based on the *Shari'ah* maxim: 'It cannot be denied that change in ruling is caused by change in time', and also referring to the *maslahah* of the people, SAC suggest that, contrary to the traditional views of scholars, under the realities of the time and environment, mixed companies should be allowed.

Besides allowing the inclusion of mixed companies in their Islamic index, SAC also did not employ any financial benchmarks until 2013 contrary to the universal index providers such as FTSE and Dow Jones. This approach further expanded Islamic investment opportunities in Malaysia by virtue of liberal approach in *Shari'ah* screening (Najib *et al.*, 2014). Such differences in *Shari'ah* screening criteria result in non-compliance of a *Shari'ah* compliant stock in Malaysia under different benchmarks. For example, based on SAC's approved companies on October 26, 2006, Abdul Rahman *et al.* (2010) showed that only 35% of the stocks deemed *Shari'ah* compliant under SAC criteria are found to be *Shari'ah* compliant according to Dow Jones's quantitative screening.

While ruling of ICFA opens a window for new investment tools, the efficiency of these new tools, namely portfolios, depends on the screening criteria set by *Shari'ah* scholars. Since *Shari'ah* scholars' approach in determining screening criteria suggest a certain level of embeddedness into the market system determined finance sector, this is particularly articulated in the rationale provided by SACs. However, further embeddedness into financial system through *Shari'ah* scholars' facilitation implies further disembodiedness from the intended objectives of *Shari'ah* based financing as identified by Islamic moral economy.

#### **6.4.2. Finding Solutions to the Problems**

Another feature of embedded *Shari'ah* scholars is to find solutions to the existing problems of the entity they are embedded to. As we discussed in the previous chapter, *Shari'ah* scholars in pre-modern period, especially during first five centuries in which they had been dominantly submerged into the society, strove for finding solutions to the legal problems of the society in which they had lived. In modern times, some *Shari'ah* scholars in SBs, similarly, strive for finding solutions to the problems of Islamic banking sector which is mostly related to increasing efficiency of the products and services as well as decreasing the transaction cost as imposed by the capitalist

market economy. Even if they do not come up with the exact solutions in some cases, they strive to justify proposed solutions based on Islamic law through different tools, *talfiq* and *maslahah* being the most popular of all.

Considering the competitiveness of IBs with conventional banks in terms of price and market, it is important to remove any additional risk and transaction cost which conventional banks do not incur while IBs do. *Shari'ah* scholars, with the intention of fulfilling this objective, permitted, for example, the utilisation of organised *tawarruq* which is a modified version of classically implemented *tawarruq* instrument, as explained in detail in Chapter 4. The problem with classical *tawarruq* implementation is the inefficiency of transactions where a customer buys a product on instalments and sells it on the market for cash with a lower price with the intention of overcoming his or her liquidity shortage. As discussed, although organised *tawarruq* is ruled as impermissible by the ICFA, most of the *Shari'ah* scholars allow their utilisation in Islamic banking operations. The advantage of organised *tawarruq* is that although it uses an intermediary asset in 'buy and sell contract' to provide *Shari'ah* legitimacy, it does not require any genuine demand for any asset. Thus, it removes the necessity of a genuine commodity as the underlying structure of the transaction and bring it closer to the conventional loan transaction thereby, as a consequence, the customer portfolio expands. IBs, for instance, cannot use *murabahah* contract to offer credit for a honeymoon of a newly married couple, while through utilisation of organised *tawarruq*, they can provide credit as in conventional sense. Through allowing the utilisation of organised *tawarruq*, therefore, *Shari'ah* scholars help IBs to overcome the inefficiency problem inherent in *murabahah* or classical *tawarruq* contracts as well as expand the potential customer range by removing the necessity of a genuine commodity as part of the contract; however, the question is whether this is the concern of substantive morality articulated by IME as opposed to efficient market theorem.

#### **6.4.3. Considering the Short and Long-Term Consequences**

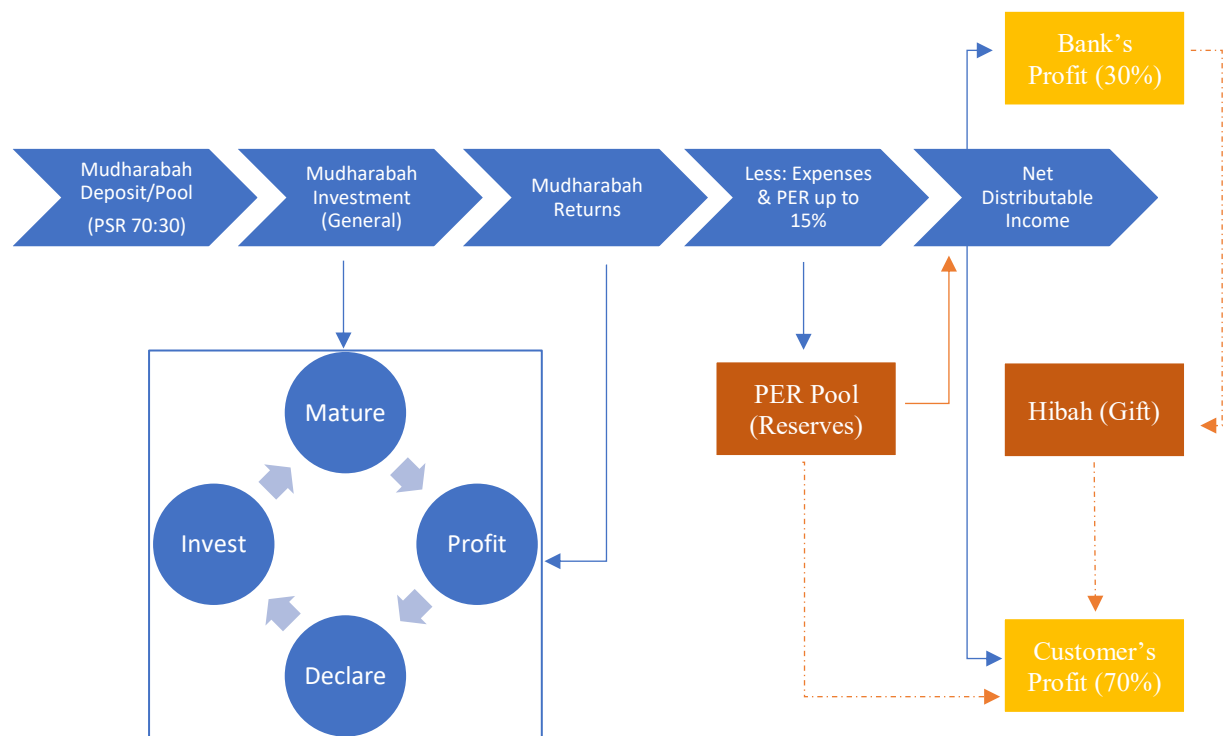
Taking the consequences of a ruling in the short-term and long-term into account during the *ijtihad* process is an important feature of a *Shari'ah* scholar. Previous chapter demonstrated how *Shari'ah* scholars in the pre-modern context foresaw and considered the consequences of their *fatwas* for the society and ruled accordingly due to their embeddedness into the society. Members of SBs, besides integrating the realities of

market system as well as offering solutions to the problems of IBs, also consider, in most of the cases, short-term and long-term consequences of their *fatwas* for Islamic banking sector and adjust accordingly.

One commonly utilised instrument introduced as an outcome of such articulation of embeddedness is Profit Equalising Reserves (PER) to adjust profit distribution to smooth their returns for deposit accounts in Islamic banks according to the prevailing interest based deposit returns with the intention of competition with conventional banks (Taktak *et al.*, 2010; Htay and Salman, 2013), while deposit account holders in IBs enter into profit-and-loss sharing agreements with their respective IBs over their deposit accounts. Figure 6.1 displays how PER works (Alfatakh, 2014). Without PER pool, only expenses should be deducted from *mudharabah* deposit returns before distributing the return between IB and depositors, as this should be according to the profit-and-loss based share agreement. However, in the short-term, this might lead problems such as withdrawal risk (Rajhi and Hassairi, 2012), as the return determined by the business cycle can be instable and lower from the fixed income based conventional bank deposit accounts. Competitive return rates with conventional banks, and particularly with other Islamic banks, therefore, is an important reason for customer preference as evidenced by Mohd-Karim (2010). Moreover, stability of return rates is also significant since research conducted by Mohd-Karim (2010) reveals that the participants expect a stable return with a mean score of 4.03 out of 5 indicating a signal for the Islamic banks to provide a stable return. PER, therefore, “was created and approved by the *Shari’ah* scholars with the intention of protecting the banks from withdrawal risk” (Mohd-Karim, 2010, p. 373) and utilised by almost all IBs currently (Taktak, 2011). In this system, a certain amount of return generated from the investments in which deposits are invested is reserved in a pool, namely PER pool; if obtained profit is higher than the return distributed by conventional banks, the excess is transferred to PER to utilise in periods when profit is less than the interest-based market return rate. In less-profitable periods, PER pool is utilised to top-up the profit in IB deposit accounting to the market rate so that stability in returns can be ensured in a competitive environment. If PER pool is not sufficient to equalise, IB transfers certain amount of money from its profit to the customer as a gift (*hibah*) in addition to PER pool. PER system, therefore, is instrumental in adjusting profit rate of IBs which might fluctuate due to business cycle according to the interest rates prevailing in the market and the resultant conventional

banking return (Rajhi and Hassairi, 2012). As a result, utilisation of PER leads convergence of profit-loss sharing schema of IBs into conventional saving account, while preventing the fluctuations of deposit amounts during business cycles. Although PER instrument is not compatible with the definition of *mudharabah* contract which requires sharing of profit and loss directly, *Shari'ah* scholars allowed its utilisation considering the short-term consequences of *mudharabah* contract for IB sector in the sense that IBs may lose out due to competition and low return. Hence, while normally PER could not be considered as *Shari'ah* compliant, due to *maslahah* and stability, *Shari'ah* scholars deemed it to *Shari'ah* compliant. In a *mudharabah* agreement being a partnership between depositors and IB, with PER as an additional reserve account as practised in Islamic banks, the awareness of both parties of the conditions is crucial, yet empirical research suggest that most of the depositors are not aware of such conditions of the partnership agreement and not happy with lack of disclosure regarding the meaning and mechanism of PER as they behave as rational self-maximising Muslims (Mohd-Karim, 2010).

**Figure 6.1: Working Mechanism of PER**



Source: Alfatakh (2014)

#### **6.4.4. Reflections on the Three Articulations of Embeddedness**

The three articulations of embeddedness of *Shari'ah* scholars into the banking and finance sector, as explained above, directly indicate the awareness and knowledge of *Shari'ah* scholars about the environment, namely Islamic finance sector, which is the necessary condition for conducting *ijtihad* in that sector so that IB sector's growth and its sustainability can be ensured. However, we do not suggest that such level of awareness and knowledge about the subject at hand for issuing a ruling is the source of observed convergence towards conventional finance sector. On the contrary, such awareness and knowledge is a necessary condition for any *Shari'ah* scholar to issue a ruling in this sector. Rather, it is the internalisation of institutional logics of the capitalist market systems by *Shari'ah* scholars and giving precedence to the principles of the capitalist market system over the morality of *Shari'ah* that facilitate the convergence of IBs towards conventional banks. What we refer as embeddedness of *Shari'ah* scholars into the market system in general and banking sector in particular, therefore, is deviation of *Shari'ah* scholars from the traditional *fatwas* of *Shari'ah* scholars and rulings of credible international institutions such as ICFA based on the justification through capitalist principles, even in certain cases against the actual interest or *maslahah* of society. Such level of embeddedness of *Shari'ah* scholars in SBs facilitates the convergence of Islamic banking and finance sector towards conventional banking and finance due to essentialising the same banking related operational principles tuned with Islamic concerns. However, we acknowledge that there are scholars, albeit very limited numbers, with the necessary knowledge level and awareness of the market system who strive to continue to implement objectives of the *Shari'ah* rather than capitalist principles in Islamic banking sector. However, there are other important transformations affecting the struggle of these *Shari'ah* scholars adversely which are discussed in the following sections.

#### **6.5. TRANSFORMATION OF SOURCE OF LEGITIMACY OF SHARI'AH SCHOLARS**

As we discussed in the previous chapter, *ulama* were civil leaders of the society during pre-modern period, and, hence, ruling authority was in need of approval of these scholars to prove to the society that they were ruling justly and according to *Shari'ah* which led to a negotiation process between *ulama* and the ruling class. The most

important underlying source of power to negotiate with the ruling authority was due to *ulama*'s embeddedness into the society and resulting support of people implying that *ulama* drew their legitimacy from the recognition they received from the public. Furthermore, this power to negotiate stemmed from their individual relationship with the society, not due to any kind of abstract title or membership to a certain class or institution. On the other hand, *Shari'ah* scholars in SBs of IBs are not embedded into the society in a similar way as their pre-modern counterparts did, yet they are still respected due to their title of being *Shari'ah* scholar and provide confidence to the people in terms of *Shari'ah* legitimacy by virtue of which they provide *Shari'ah* compliancy to the operations and instruments of IBs. This might be considered as a transformation of source of legitimacy. While ruling authority had to negotiate with certain individuals as civil leaders and religious authorities of the society to attain legitimacy in the eyes of populace, in modern IBs, top level management only needs to have a SB composed of individuals selected and employed by an IB without any involvement of wider public. In other words, while actual individual scholar *per se* provided the legitimacy to the ruling authority in pre-modern period, it is the 'abstract' notion of existence of SB as part of the modern governance mechanism that provides the legitimacy of IBs. By 'actual' individuals, we mean those individuals who were known by the people in person, since their way of life played an important role in their reputation for being a scholar (Winter, 2009), while 'abstract' concept of SB only represents a group of knowledgeable people without necessity of referring to any particular individual public figure or important scholar. Although it is a fact that some IBs employ publicly known figures in SBs with the purpose of gaining trust of stakeholders, neither this is the norm, nor it contradicts the fact that existence of SB bestows the *Shari'ah* legitimacy without signifying any 'concrete' individual.

Since the *Shari'ah* legitimacy in IBs stems from the 'existence' of SB, rather than the individual scholar's 'substantive knowledge, position and relationship with society', it is easier for these institutions to replace a member of SB with another *Shari'ah* scholar in order to reach their organisational objective of ensuring profit maximisation and efficiency without attracting any attention whereby fatwa shopping or *Shari'ah* arbitrage is considered as source of concern (El-Gamal, 2007).

Achieving legitimacy through the existence of SB in IBs directly affects the power of resistance of modern *Shari'ah* scholars against the top-managements of IBs. In the relationship of top-management of IBs with members of SBs, modern *Shari'ah* scholars have a limited ability to resist to power of management, since they could be replaced by another *Shari'ah* scholar in case top-management considers their position as 'unattainable'; and hence 'rent-seeking behaviour' becomes dominant in the behavioural norms of *Shari'ah* scholars. In other words, they are powerless against the pressures from the top-management of commercial IBs compared to the power of *Shari'ah* scholars in pre-modern period against ruling authority. For example, the following statement of a *Shari'ah* research officer of an Islamic bank evidences this argument (Ullah, 2012:119):

In some cases, when the management really insists us not to do something, we become lenient because there are only two options in that case; either to quit or to obey. Some Shari'a advisors quit in such situations and there have been instances of resignations. But some still stay for the Maslihat that if they quit, the management will bring in someone else who will be lenient event more. So if a strict Shari'a advisor quits in such situations, it gives management the chance for fatwa shopping.

The main reason behind the lack of the necessary power to resist against the implementation and prioritisation of capitalist principles over the *maqasid al-Shari'ah* shaped moral expectation is that the source of their ability to provide legitimacy for IBs is the 'title' they have that is being *Shari'ah* scholar of an IB, which is bestowed upon by top-management of an IB. In other words, top-management of an IB has the *Shari'ah* arbitrage as long as there is a SB or a form of *Shari'ah* governance independent of individual characteristics of those who compose it. Such a relationship, as a result, makes the *fatwa* shopping an option for the top-management which breaks the resistance of *Shari'ah* scholars against the demands of top-management and has forced them to comply with the expectation of the capitalist market system. However, in early periods of Muslim 'governance structure', private scholars and jurist-consults attained their legitimacy through their characteristic features and status in the society as an individual, not from their title or rank in the government. As a result, they could not be replaced by the Muslim governments easily in case of a conflict. In IBs, on the other hand, replacement of a *Shari'ah* scholar, who pursue the implementation of objectives of *Shari'ah*, with another *Shari'ah* scholar who inclines to issue legal rulings based on the expected outcome and capitalist principles would not affect the legitimacy of IBs since most of the customers would not even be aware of such a change.

In his autobiography, *Shari'ah Scholar's Mind*, Bakar, a leading *Shari'ah* scholar and an academic, mentions a dialogue with a participant after his presentation regarding *Shari'ah* scholarship in IFIs. In Bakar's words, the participant explains the perception of *Shari'ah* scholarship by customers as follows (Bakar, 2016, 68):

...the public is aware that any Islamic financial product must be endorsed by a group of scholars for it to be 'halal'. However, they know nothing about the scholars and the process that they go through before issuing a Shariah resolution or approval. In short, the public expects the Shariah scholars to be more visible, particularly through platforms that the public has easy access to. He even stated that Shariah scholars have an air of 'elitism' around them, to the extent that sometimes the community feels that these scholars are not approachable. This is not a good remark indeed.

In other words, most of the customers in the contemporary times do not evaluate the *Shari'ah* scholars individually and then decide whether he is eligible to provide legitimacy for the products and services of a particular IB. Instead, they have trust in *Shari'ah* compliancy, mostly, due to the existence of an SB at that institution which is composed of '*Shari'ah* scholars' since "socially and politically conservative, seeking individual piety and social mores built around traditionalist compliance with *fiqh*, and looks to social and political improvements mainly as a result of that" (Vogel and Hayes 1998: 27, footnote). It can, indeed, be argued whether this is an organic trust or due to the imposed traditional *Shari'ah* hegemony in the Muslim societies embedded from early ages in Muslim mindset.

As the quotation by Ullah (2012:119) disclose the nature of the situation in SBs, *Shari'ah* scholars who want to fulfil objectives of *Shari'ah* might need to settle down with a lesser implementation to prevent the worst case scenario. This demonstrates that although private scholars and legists in both pre-modern period (for governments) and modern period (for IBs) are utilised as source of legitimacy, the power of resistance of modern *Shari'ah* scholars is limited compared to their pre-modern counterparts.

Aforementioned conflicts between the top-management and members of SB presupposes a *Shari'ah* scholar who is not embedded into the financial system; however, most of the *Shari'ah* scholars have been embedded by definition of sitting in a SB. This is due to the fact that management aims to maximise the profit of IB while achieving a minimum level of *Shari'ah* compliancy to preserve their 'Islamic' identity of IB at the expense of compromising the realisation of objectives of *Shari'ah*. However, if an IB prioritise the objectives of *Shari'ah* over the capitalist principles and

aims to provide *Shari'ah*-based products and services or considers that fulfilling the objectives of *Shari'ah* is more profitable for the institution, then, the negotiation process becomes completely different. Since the goal of realisation of objective of *Shari'ah* would be shared by both members of SB and top-management, they would collaborate to offer products and services accordingly. Nevertheless, even such a shared perspective between the management and SB may not result in realising the objectives of *Shari'ah* in such institutions due to the difficulty of anticipating and evaluating the objectives of *Shari'ah* for products and services in the complexity of modern world. In the next section, therefore, we examine how complexity of modern world limits the fulfilment of the objectives of the *Shari'ah* by *Shari'ah* scholars in the absence of a collaboration with scholars from other disciplines.

## **6.6. COMPLEXITY OF MODERN PERIOD**

Top-level management and their aim of maximising profit is not the only obstacle in front of the members of SBs to realise the objectives of *Shari'ah* in Islamic banking sector. Even if *Shari'ah* scholars are not embedded into the banking sector and sharing same ideals with top-level management in terms of fulfilling the objectives of *Shari'ah*, complexity of modern life and interdependency of institutions still makes it rather difficult to achieve the moral objectives of *Shari'ah* or *maqasid al-Shari'ah* as an outcome of the given *fatwas* which makes the interdisciplinary consultation as a necessity condition rather than enhancement.

In exploring the complexity of society and interdependence of institutions in modern times, it should be noted that industrial revolution and emergence of market system has had an immense impact on the social formation of the societies by changing the modes of productions and their articulation in the political economy of the societies (Polanyi, 1957). Contrary to the lifestyle and social relations of the pre-modern, lesser-interdependent and lesser-complex societies, modern period exhibits high complexity through urbanisation and increased division of labour in society.

Financialised economy and the emergence of self-regulated market economy, particularly, led to the production of fictitious commodities by commodification process and creating a wedge between real economy and financial world and also removing normative value system from impacting the economy, hence, resulting into

disembeddedness of the economy from the society, which played an essential role in the construction of present complicated social formation and social structures (Polanyi, 1957). In addition to the complexity of economic and social structures of modern nation-states, globalisation in the post-industrial society transformed the world into a village, building even more complex networks among the countries and individual firms around the globe. As a result of such transformation, any decision or action taken in one country has consequences on another country, even if they are not neighbours.

In a historical reflection, it can be seen that life in pre-modern period was simple which had rendered an embedded relationship possible between *ulama* and populace, since the size of the population and the structure of society had made the involvement of *ulama* into the society easier (e.g. education method, necessity for religious consultation and having a profession to earn living expenses). This simple structure, hence, had rendered an environment for *ulama* to have an embedded relationship, which helped them to take the custom of the society and short-term and long-term consequences of the legal ruling into account during the process of *ijtihad*. However, the current state of affairs among the individuals in modern societies as well as firms in countries of the globalised world requires interdisciplinary studies in order to explore the custom of people and estimate the outcomes of decisions and actions to examine their compatibility with the objectives of *Shari'ah* by also endogenising Islamic moral economy principles. The complex structure of the modern globalised world, hence, does not allow *Shari'ah* scholars to estimate the outcome of their rulings and level of fulfilment in terms of realisation of objectives of *Shari'ah* unless they collaborate with other disciplines. This situation, therefore, leads many *Shari'ah* scholars to be contented with form-based *Shari'ah* compliance without assessing the substance of the legal rulings, as their academic capacity and professional experience enforces upon them. In other words, since they do not have such a vast multi-discipline knowledge they opt to seek for form-based *Shari'ah* compliancy. This has led to the current debate on the 'form vs. substance' or '*Shari'ah* compliant finance vs. Islam based finance' (Asutay, 2012a) indicating their prioritisation of form or intention as a priori as opposed to consequentialism.

Consequently, even though a *Shari'ah* scholar in a SB, by himself, may desire to follow a consequentialist approach to essentialise Islamic norms and engage in negotiation

with top-management, necessity of specialisation in disciplines in modern period due to the expansion of each discipline obliges such a *Shari'ah* scholar to involve in the interdisciplinary collaboration. In other words, complexity of the modern society makes it difficult to issue a legal ruling in compliance with objectives of *Shari'ah* without cooperating with other disciplines such as sociology, economics and cost-benefit analysis aiming to measure the social costs and benefits of projects with including all stakeholders into consideration as *tawhidi* axiom, or complementarity and unitary nature of Islamic knowledge suggests. However, in realising such a structure, *Shari'ah* scholars are expected to contribute to the development of necessary capacities and capabilities with other sectors and disciplines to predict the consequences of their approved products and services on the society as well as suitability for the various custom of Muslims individuals.

For example, in pre-modern period, the damage of a product on environment due to the air pollution might not be an issue to consider due to the simplicity of the products or non-urgency of an environmental issues. However, in today's sustainable development world, depending on the size of the project, it could cause lasting damages both on nature and people. Therefore, announcing a project as *Shari'ah* compliant requires evaluation of the hazard level of a project for the society and environment, which cannot be completed or assessed individually by *Shari'ah* scholars alone, yet the outcomes of such reports is considered as their responsibility.

Zamzam Tower is a good example to substantiate this claim further, which is a hotel complex located adjacent to the Kaabah in Makkah, Saudi Arabia, which is the holy site of Islam since Prophet Abraham and is the geographic direction of prayers in Islam and the centre for pilgrimage. However, the heavy modern construction of the buildings is having an impact on Kaabah. Since the constructions and transformation is fully financed with *sukuk* (Ahmed, 2004), an Islamic securitisation instrument similar to bonds, it provides an example for disembeddedness nature of Islamic finance.

From a pure capitalist approach, the location of the Zamzam tower is perfect for investment, since that location is one of the most valuable location and attracts high-net-worth pilgrimages. However, building such a luxury hotel and shopping mall next to the Kaabah should not be in compliance with the objectives of moral augmented *Shari'ah*, as, by definition, Kaabah is a place of equality such that everyone should be

equal and should have equal opportunities in worshipping. Furthermore, due to such (mis)development, spirituality as well as the historicity of the area is destructed, which implies consequences of the project was not endogenised in the financing decision by the *Shari'ah* scholars who approved the financing for such project, as project commodifies the entire *umrah* and *hajj* or pilgrimage process in addition to undermining equality in the holy site.

In order to evaluate the impact of such a massive shopping mall and hotel adjacent to the most sacred Islamic place on earth for Muslims requires the examination of the sociologist and other experts to discover both spiritual and material impact (Sardar, 2014). Therefore, reports and analysis from other disciplines should guide the decision process of *Shari'ah* scholars in the negotiation process with top-management to come closer to fulfilment of the objective of *Shari'ah* rather than the capitalist principles in the process of *Shari'ah* compliancy, especially in complex projects where interdisciplinary collaboration is essential. However, since their legitimacy does not come from the society but rather due to their appointments by the IBs into SBs, their role is relegated only to ensure compliancy for financial efficiency; and therefore, *Shari'ah* scholars involved in the approval process for *sukuk* for the development of such buildings around Kabaah see the projects as positive business and investment areas and as provision of most-needed accommodation regardless of recognising the consequences. As efficiency and profit-oriented share-holder governance oriented IBs aims to utilise the '*Shari'ah* hegemony' of *Shari'ah* scholars to get their financial instruments and products receive popular acceptance, as having such scholars on board through SB renders positive signals in the form of signifier to the individuals to consider the products and instruments of the respective IB as *Shari'ah* compliant. Hence, rather than *Shari'ah* scholars negotiating with IBs management to ensure form and substance compliancy, they submit to the expectations of capitalist system in facilitating *Shari'ah* compliancy. This process is sustained through the *Shari'ah* arbitrage process, as *Shari'ah* scholars know that they can be replaced if they do not facilitate the process, which reveals the importance of a 'proper regulatory framework' (El-Gamal, 2007; Oseni, 2017). This is also evidenced by the different *fatwas* given by the same *Shari'ah* scholar on the same issue in different SBs (Derigs and Marzban, 2008).

## 6.7. CONCLUSION

This chapter investigated the transformation of the role and status of *Shari'ah* scholars from the pre-modern times to modern times and current position of *Shari'ah* scholars as members of SBs in IBs with the intention of exploring the reasons behind the failure of *Shari'ah* scholars in preventing the convergence of IBs towards conventional banking sector by giving up the Islamic moral economy expectations. We argue that there are three main transformation points in *ifta* institution leading to such outcome which is examined in this chapter by providing various potential explanations of this failure for different cases.

First reason behind the failure is embeddedness of *Shari'ah* scholars in capitalist principles based financial system, which leads to internalisation or endogenisation of such principles and giving them priority over the objectives of *Shari'ah* for the sake of efficiency, competition and stability without questioning such objectives. By embeddedness and internalisation of capitalist principles, we mean advocating capitalist principles on Islamic grounds and interpreting the objectives of *Shari'ah* in a way to converge towards capitalist principles. For those who are not embedded in the conventional financial system and strive to realise the objectives of *Shari'ah* in Islamic banking sector, transformation of the source of legitimacy still pose an obstacle. Decline of negotiation power of *Shari'ah* scholars against top-level management compared to the negotiation power of the pre-modern scholars against ruling authorities alleviates the resistance of *Shari'ah* scholars in SBs and forces to compromise on the objectives of *Shari'ah* in case of domination. Although this lack of negotiation power might not lead to failure of realisation of objectives of *Shari'ah* if top-level management shares the same idealistic Islamic views with SB, complexity of modern world still might lead to unwanted outcomes in terms of objectives of *Shari'ah*. Furthermore, complicated nature of products and services in modern times and interconnected structure of financial products and services obliges *Shari'ah* scholars to collaborate with other disciplines to reveal the most suitable rulings according to the objectives of *Shari'ah*. Without such interdisciplinary collaborations, contrary to the pre-modern period, it is difficult to realise the objectives of *Shari'ah* in Islamic banking sector even with good intentions from both management and *Shari'ah* governance structures due to difficulty

to foresee the short-term and long-term consequences of the products and services as well as macro level impacts.

We argue that these transformations from the pre-modern period to modern period and lack of regulations proposed considering these transformation resulted in determination of the morality of *Shari'ah* by capitalist hegemony which leads to social failure of IBs in relation to Islamic moral economy aspirations and convergence towards conventional banking sector (Asutay, 2007b; 2012a; El-Gamal, 2007). The role of capitalist hegemony in social failure of IBs is particularly evident in the process of deciding the exception in Islamic law. As we discussed above, in general, *Shari'ah* scholars utilises necessity or *maslahah* of people to appeal for an exception to adjust according to the needs of the sector which is ruled by the principles of capitalist market system. Deciding the exception, therefore, is the crucial point in which capitalist hegemony reveals itself. That is the reason why Schmitt (2005) advocates that it is the Sovereign who decides what 'the exception' is and how to act in 'the state of exception' (Schmitt, 2005: xii). Considering the fact that it is the capitalist hegemony that decides what should be the exception and how should be acted, it would not be wrong to claim that it is the capitalism who is the Sovereign in the current affairs of Islamic banking sector including the *Shari'ah* governance.

## CHAPTER 7

### AN INTERPRETATIVE DISCUSSION AND CONCLUSION

#### 7.1. CONTEXTUALISING THE FINDINGS: AN ATTEMPT IN DISCOURSE AND MEANING MAKING

In this study, we explored the role and status of *Shari'ah* scholars in IBs and the reasons behind the lack of ability of *Shari'ah* scholars to prevent the divergence of IBs from its foundational objectives, namely Islamic Moral Economy (IME). To achieve this aim, in Chapter 2, in constituting Islamic Corporate Governance (ICG), we developed an IME framework as the substance of ICG system, which is proposed as the expected corporate governance system of IBs and other Islamic corporations. Such an attempt is essential to provide an integrated approach to knowledge and practice; because IBs claim 'Islamic' identity in the form of '*Shari'ah* compliancy' in their financial operations through SBs, they should have their own CG frame to sustain their (Islamic) consistency. In other words, since their financing is ensured Islamicity, their governance and management structure should also reflect the Islamic identity, which rationalises the importance of constructing ICG.

The IME based framework is utilised to determine whether SBs conduct their responsibility of directing, supervising and monitoring Islamic banking operations and instruments in line with IME and informing the stakeholders regarding these tasks through disclosure in their most important communication channel, namely *Shari'ah* annual report (SAR). Our analysis of SARs of 41 IBs from 15 countries over the period of 2007-2014 revealed that SBs are away from fulfilling the expectations of AAOIFI let alone IME framework regarding the disclosure practice. As the empirical analysis and findings in Chapter 3 demonstrate, their disclosure is mostly limited to the general statements to disclose the consent of SBs in *Shari'ah* compliance of product and services of IBs without elaborating the process in detail and the efforts they put forward to provide *Shari'ah* compliance. Based on such disclosure practice, we argued that it is not the detailed disclosure of SBs in terms of *Shari'ah* compliance that keeps the

'Islamic' identity of IBs intact but more importantly, the very existence of *Shari'ah* scholars in IBs as part of *Shari'ah* governance division, and their general approval on the *Shari'ah* compliance that provides an 'Islamic' identity to the IBs. In supporting this, as evidenced in the classical legal opinion books of *Shari'ah* scholars, being content with a general approval of a *Shari'ah* scholars or a short response without detailed explanation was also the practice of the pre-modern period as well. However, the role and status of *Shari'ah* scholars in society and against the ruling authority during the pre-modern period and their role and status in modern IBs against the top-level management in the contemporary times are significantly different. To understand the role and status of *Shari'ah* scholars in modern IBs, first, we had to explore the emergence and development of Islamic banking structure within multiple modernities framework with the help of postcolonial concepts of hybridity, mimicry, menace and reverse mimicry.

As it is discussed in Chapter 4, the emergence of Islamic banking as a modern institution with the initial aspirations of IME went through different phases until the contemporary commercial and competitive oriented Islamic banking structure has emerged. Especially after the 1990s with internationalisation phase of Islamic banking, with the entrance of IBs into competition with conventional banks, we witnessed the convergence of products and services of IBs towards their conventional counterparts filtered through a *fiqhi* mechanism to make them *Shari'ah* compliant. This process, consequently, took IBs further away from the initial aspirations being an alternative and Islamically authenticated 'financing institution'. Although even the initial IB was also established as a hybrid institution as result of a mixture of conventional saving bank model with Islamic principles as in the case of Mith Ghamr example, the aspirations of IME were more evident compared to the contemporary shareholder value-oriented Islamic banking model. Thus, Chapter 4 demonstrates the process through which IBs have gone through the process of convergence from having the claims of being alternative to hybridity and now mimicry approaching towards mirroring phase resulting into giving up IME claims and relegating the Islamic identity of IB and its governance to only financial compliance under the market pressure.

After analysing the emergence and development of modern Islamic banking institutions, in Chapter 5 and Chapter 6, we explore and compare the role and status of

*Shari'ah* scholars during the pre-modern period and contemporary times, respectively. Such an exploration and comparison is important in revealing the nature of transformation in *ifta* institution from pre-modern period to modern period. In this study, we located three main transformations regarding the role and status of *Shari'ah* scholars:

Firstly, in the pre-modern period, *Shari'ah* scholars were submerged into the society whereas *Shari'ah* scholars in modern SBs submerged into the Islamic banking sector more due to the nature of their profession compared to their submergence into the society. Behind such transformation, there also lies the influence of capitalist ideology in education, urbanisation and city structure and other institutions of modernity in the sense of modernity as a way of life and project and social formation, which hinder submergence of *Shari'ah* scholars into the society. In other words, some *Shari'ah* scholars in SBs have become embedded into the modern financial system and internalised the rules and principles of capitalism as a result of the process they have gone through in a modern society (particularly education system). We can observe traces of such embeddedness in the *fatwa*-giving process of such scholars who essentialise the principles of capitalism such as efficiency, low-transaction cost and shareholder value to justify their rulings and prioritise them in the case of a contradiction between Islamic law and these principles. This, as explained in Chapter 4, can be evidenced by, for example, through the practice of organised *tawarruq* in IBs despite the resolution of the ICFA.

Secondly, in the pre-modern period, *Shari'ah* scholars attained their 'civil leader' status through their deep knowledge in *Shari'ah*, sustaining an exemplary way of life and having an embedded relationship with the society, which bestowed upon them the power to negotiate on behalf of people with the elite-ruling class individually rather than as a class of 'learned people'. In other words, in the pre-modern period, jurist-consults attained their status individually, which could not be replaced by another scholar easily. Therefore, replacing these local leaders was not a viable option with the intention of increasing negotiation power of ruling authority. However, negotiation power of the *Shari'ah* scholars in SBs, compared to the pre-modern period, has lessened, since *Shari'ah* scholars in SBs attain their source of legitimacy by being appointed to a specific SB and by being paid by the respective IB rather than deriving

their negotiation power directly from the society. In other words, due to change in the social formation and social structure, leading to new social contract beyond the influence of *Shari'ah* scholars, they have lost the negotiating power and therefore they have become exogenous 'variables' and 'unit' within the existing governance system including in IBs. This asymmetry, hence, leads to inadequate negotiation power of members of SBs with top-level managements in IBs. Unlike pre-modern periods, as explained, members of SBs attain their legitimacy to direct, monitor and supervise the operations of the IB institution by being appointed by the board of directors of an IB as a member of SB, and by being salaried by a respective IB, not due to his or her role and status in the society. This situation makes members of SBs replaceable without any disruption, even maybe without any notice of any stakeholders. This is because customers usually do not seek information regarding members of SBs, since for them, the existence of a SB is sufficient condition for *Shari'ah* compliance of an IFI. Consequently, this transformation in the source of legitimacy of jurist-consults as well as the lack of awareness about the composition of SBs by the demand side in the modern IBs diminishes the negotiation power of members of SB with top-level management and prevents the articulation of the claims for Islamic authenticity in a robust manner.

Thirdly, the complexity of the society and everyday practices of people changed drastically compared to the pre-modern era in the Muslim world. In pre-modern period, market exchanges and their expected outcomes as well as the transaction structures were simpler. Moreover, since "man's economic action was submerged into the society" (Polanyi, 1957: 40), jurist-consults were aware of the content of these exchanges as the examples in Chapter 5 also demonstrated. On the other hand, capitalism has produced complex and interdependent products and services. Especially due to the globalisation, impacts of economics and financial decisions are not limited within a certain border but might have synchronised effect in the global markets. Therefore, while foreseeing the consequences of legal rulings were easier during the pre-modern period and could be undertaken by individual scholars, interdependent and complex nature of modern world obliges *Shari'ah* scholars to work in collaboration with other disciplines such as sociology, economics, politics, *etc.* Thus, while confirmation of a *Shari'ah* scholar for a certain product or service is a necessary condition to fulfil the form of or namely compliance with the scriptural text, it is not sufficient condition to achieve objectives of the *Shari'ah*. Realisation of the objectives of the *Shari'ah* requires collaboration and

approval of other disciplines as well developing the capacity to foresee the long-run and short-run outcomes of the decisions in the society. This is crucial to attaining Islamically required comprehensive and holistic approach that can be developed as an articulation of *tawhid* axiom as suggested by IPE frame and IME substance as opposed to the narrow definition of Islamic finance.

These three main transformations between the pre-modern and modern period suggest that a general approval of *Shari'ah* scholars on *Shari'ah* compliance of everyday operations is not sufficient in modern IBs due to embeddedness in Islamic banking sector, lack of negotiation power and complexity of the products and services. Consequently, it is expected from *Shari'ah* scholars in SBs to disclose detailed information regarding their process of providing *Shari'ah* compliance and share with the stakeholders their understanding of *Shari'ah* compliance since such understanding might be different from one SB to another due to the variety of interpretations of *Shari'ah* as a result of discussed transformations.

The implications of the above findings are twofold. Firstly, in terms of level of information disclosed in SAR, AAOIFI-based index, namely  $SDI_{AAOIFI}$ , has a relatively high score in general compared to more demanding, IME-based index, namely  $SDI_{General}$ . This implies that although there is a lack of IME-based approach to disclose detailed information about the operations and practices of IBs in relation to *Shari'ah* governance, AAOIFI governance standards are influential in the preparation process of SAR. Furthermore, considering the fact that adoption of AAOIFI governance standards by each jurisdiction also has a positive impact in the disclosure level, it is important pay attention to the development of AAOIFI governance standards. In other words, in order to increase IME-based understanding in IBs, developing AAOIFI governance standards in line with IME-based approach might be useful. In addition, it will be beneficial to strive to encourage the jurisdictions to adopt AAOIFI governance standards in terms of increasing the level of disclosure in IBs. At bank level, the existence of an internal *Shari'ah* auditing department and employment of experienced and popular *Shari'ah* scholars are other factors to increase disclosure level.

Secondly, as stated in Chapter 4, the modern Islamic banking experience can be considered as part of the colonisation process, IBs as colonised subjects. As a result, there are important transformation points in terms of *ifta* institution between SB

structure as it exists in modern Islamic banking sector and *Shari'ah* scholarship as it existed in pre-modern Muslim societies. In policy making process, such transformations should be taken into account to prevent the convergence of IBs towards conventional banking sector in terms of the products and services as well as everyday operations.

Building on the findings of this thesis, we have two main arguments: (i) the trap of the form-based *fiqhi* approach which has facilitated the convergence of IBs towards conventional banks, and (ii) the necessity of a civil society based regulatory mechanism to evaluate the *Shari'ah* compliance of IBs by going beyond the form-compliance and considering IME or substance approach as well.

As Hallaq (2012) argues, the central domain of *Shari'ah* is morality, namely IME which is the articulation of axiomatic framework as discussed in Chapter 2. Being constituted by the morality of *Shari'ah*, ICG system demands IBs and *Shari'ah* scholars in SBs to fulfil the articulation of axioms in the everyday operations of IBs by directing, supervising and monitoring over such operations. Islam as a religion was one of the main institutional logics prevalent in Muslim societies during pre-modern era, and its morality was internalised by *Shari'ah* scholars and theorised by different school of thoughts in Islamic law, implemented and protected by *Shari'ah* scholars thanks to their financial and intellectual independence, as discussed in Chapter 5. *Shari'ah* scholars as embedded agents of the society had sustained the relationships among the people in line with the morality of *Shari'ah* and dynamic realities of the society by considering both universals of the *Shari'ah* and particulars of the society. In places where the form of *Shari'ah* would not produce the moral outcome, namely the substance, as it is understood by *Shari'ah* scholars, they appealed to legal methods such as *istihsan*, legal devices or custom to adjust the form to the moral nature of the *Shari'ah*, without going beyond the borders of scriptural text. The benchmark of the legal reasoning process of *Shari'ah* scholars, however, was not the will of people or ruling authority but the morality of the *Shari'ah*, since it was determining all the secondary domains. Prevalence of the morality of *Shari'ah* in the everyday practice of people, submergence of *Shari'ah* scholars into the society and their financial and intellectual independence played a facilitator role in producing morality, namely IME, as an outcome of the process of issuing a legal ruling.

It is important to note that this approach does not suggest that the form is insignificant and only substance has value. Rather, as Gazzali (1988) emphasised in *Revival of the Religious Sciences*, we point out that there are external (*zahir*) and internal (*batin*) aspects of behaviours in general and economic and financial behaviours in particular such as paying *zakat* or involving in trade which could be considered as form and substance. It should, therefore, be noted that both aspects are important. While abolition of form might lead to a Tufian understanding of *maslahah* or public utility in which scriptural texts are interpreted or abrogated according to *maslahah* understanding of contemporary people, abolition of substance might lead to a form-based *fiqhi* approach in which *Shari'ah* scholars are contended with a legal support from previous scholars in terms of legitimising a legal ruling without pondering upon the context and potential outcomes in contemporary period. In the current practice of *Shari'ah* scholars of SBs, we observe the latter being the dominant strategy, while the former has been utilised as well in cases where the form-based approach has not been sufficient to legitimise a certain product or service. However, consideration of both form and substance, substance being the morality of *Shari'ah*, has been the minority practice in the everyday practice of IBs.

The reason behind such a transformation regarding the legal ruling, namely from 'form and substance' to 'form-based' approach, we argue, is the transformation in the underlying institutional logics of the society. As discussed in Chapter 6, while the prevalent institutional logics in the society was religion during the pre-modern period, capitalist market system and state bureaucracy became the dominant institutional logics during the modern era. Consequently, religion or Islam in our case, and Islamic law as its articulation in the everyday practice of Muslim individuals and religion-based institutions have been reshaped with the principles of capitalism's dominant institutional logics such as efficiency, low-transaction cost and shareholder value resulting into a 'blending'. In other words, using Hallaq's (2012) terminology, the central domain of modern Muslim societies has become capitalist market system and state bureaucracy rather than the morality of *Shari'ah* resulting into hegemonic nature of capitalism overcoming Islamic substance. Resulting transformation in the central domain, hence, consequently, influenced the *ifta* process. To comply with the principles of capitalism and state bureaucracy, in other words, *Shari'ah* scholars have been forced to utilise a form-based and *maslahah* oriented approach. Consequently, *maslahah* is

being defined according to the principles of capitalism rather than according to IME objectives, in this case.

Hallaq (2012) gives the concept of corporate juristic personality as an example of such change., While Kuran (2012) claims that absence of corporate juristic personality in Islamic law along with the stagnant nature of Islamic law has been one of the reasons that led to the divergence of Middle East from the West and lagging in terms of economic growth, Hallaq (2012: 153) argued that “the corporation and all that it represents as a virulent capitalist enterprise is not only amoral and often immoral, it is also the epitome of anti-*Shar'ism*”. Hallaq (2012), therefore, argues that it is the morality of *Shari'ah* rather than any other intrinsic character of Islamic law that cause the lack of emergence of corporate juristic personality concept. Nevertheless, as one of the crucial concepts of capitalism, the corporate juristic personality has been accepted as legitimate in Islamic law after the 1960s and we witnessed the efforts of *Shari'ah* scholars to justify its acceptance based on the historical institutions such as *waqf* or pious trusts and *beyt-ul mal* or public treasury. It is evident, then, it is the influence of changing institutional logics that led to change in understanding of Islamic law as well. However, due to the conflicts of such modern concepts and principles with the morality of *Shari'ah*, *Shari'ah* scholars had to follow a form-based approach by disregarding the substance, namely the morality of *Shari'ah* in some cases to comply with the everyday practice of the modern period.

To further substantiate this argument with an example, acquisition of language might be considered. Language acquisition of a child in a society is not as a result of learning the grammar rules; rather it is through living in the society the child acquires the language and learns how to talk. Although the grammar rules are written in books, they are prepared based on the practice rather than *vice-versa*. In a similar manner, schools of thoughts in Islamic law have been developed according to the ‘living experience’ of the Prophet and His companions and following generations and are formulated based on their practices in line with the morality understanding of the founder of a particular school of thought of *Shari'ah*. The grammar of the Islamic law, in a manner, is morality of *Shari'ah* which was present in the society and internalised by individuals as well as *Shari'ah* scholars and determined the *fatwa* process. With the emergence of modernity, however, the grammar of Muslim societies has been changed drastically. As Hallaq

(2012: 3) rightly puts it, “the political, legal, and cultural struggles of today’s Muslims stem from a certain measure of dissonance between their moral and cultural aspirations, on the one hand, and the moral realities of a modern world, on the other—realities with which they must live but that were not of their own making”. They must speak, namely regulate everyday practice in the society, with a grammar of which was not of their own making, such as the case of capitalist logic determining the operations of IBs with the blessings of *Shari’ah* scholars. This may be the reason behind the close familiarity of Islamic financial institutions with conventional financial institutions but at the same time, their distance to Islamic values. Although the words belong to Islam such as *sukuk*, *mudarabah*, *musharakah*, *murabahah*, *etc.*, the grammar namely the underlying structure of these products, such as efficiency, transaction cost, shareholder value, *etc.*, does not belong to Islam but an articulation of capitalist market system and state bureaucracy. We argue, therefore, that *Shari’ah* scholars’ approach in embracing form-based and *maslahah* oriented approach is an outcome of the efforts to reconcile Islamic law as it has been utilised in IBs with the underlying institutional logics of the capitalist market system and state bureaucracy. As we discussed in Chapter 6, due to the transformation of *ifta* institution between the pre-modern period and contemporary times, we argue that it is highly unlikely to produce an outcome which is in line with IME, despite the existence of *Shari’ah* scholars as the guardians of objectives of *Shari’ah*.

In the second argument, therefore, we propose a potential way out, at least a way to moderate the outcomes of IBs and IFIs as expressed as ‘social failure’ and bring the existing institutions closer to the initial aspirations, namely IME. As outlined above, there are three main obstacles of contemporary *Shari’ah* scholarship to realise the objectives of *Shari’ah* as members of SBs, namely embeddedness of *Shari’ah* scholars in capitalist market systems, lack of negotiation power relative to the pre-modern period and necessity of interdisciplinary collaboration due to the complexity of products and services in the modern period. These obstacles make the approval of SBs on *Shari’ah* compliance of IBs without elaborating and substantiating the compliance as unreliable. Although there are solutions proposed to increase the independence of *Shari’ah* scholars and making *Shari’ah* governance more effective, such as the creation of national or central SBs in Malaysia and some other countries, they are still within the institutional logics of the capitalist market system or state bureaucracy. Central SBs at

the national level, for instance, to supervise and supersede the firm level SBs is an articulation of state bureaucracy and efforts to centralise *Shari'ah* governance further in ensuring the hegemony of capitalism's institutional logics.

As an alternative solution, this study suggests a civil society based regulatory mechanism to evaluate *Shari'ah* compliance of the products and services of IBs. This regulatory mechanism does not substitute but complements the role of SBs. This regularity system should go beyond the binary opposition of *halal/haram* or permissible/impermissible and implement a fuzzy logic approach towards IME. In other words, rather than solely deciding whether a certain product is *halal* or *haram*, this mechanism should go beyond that and aim to decide to what degree a certain product or service is compatible with IME in different dimensions such as environment, employee-employer relationship, production process, *etc.* by endogenising morality through positive screening along with form oriented negative screening. The labelling such as 'suitable for vegetarians' or 'fair trade', for instance, are examples of binary dichotomies whereas energy efficiency rating of houses on a scale of 1-100 is an example of the fuzzy logic approach. As for IBs, hence, in addition to determining whether a product or service is *halal* (with a binary approach), we can also measure its fulfilment of certain dimensions of IME with a fuzzy logic approach to evaluate to what degree it is compatible with IME by going beyond the *halal/haram* dichotomy. For example, a product can be deemed *halal* through *fiqhi* process, but with fuzzy logic approach when it is rated in terms of fulfilling the IME expectations, its substantive morality score could be 58%, or 63%, 75% or 100%. Such a rating could give those investors seeking pre-dominance of IME in their financial and economic transactions an opportunity to go beyond the initial *halal* sphere to the *tahsinayah* or embellishment sphere in essentialising aspirations of IME. For this, ICG system, based on extended stakeholding understanding, within the *tawhidi* knowledge system will be essential in determining the 'best practice' in terms of highest objective level as explained by the pendulum between *halal* (the minimum 'must) and *taqwa* or piety (the highest beneficence level to reach *ihsan*).

Such a regularity mechanism has two superiorities over the existing SB driven *Shari'ah* governance mechanism. Firstly, a civil society-based mechanism would convert the negotiation process from top-level management vs. SB into IB vs. stakeholders. This

shift would help to solve particularly first two obstacles, namely embeddedness and lack of negotiation power. In the first case, the conflict between top-level management and SB would be minimum, since both groups are driven with similar institutional logics which is expected to produce conformist behaviour of *Shari'ah* scholars towards the expectations of top-level management, which is mostly profit-maximisation oriented demands. In the second case, although SB resists the demands of top-level management with the objective of realising an IME oriented outcome, due to lack of negotiation power, they may settle down with a moderate solution. As we mentioned in Chapter 6, these two cases are specific to IBs in which top-level management prioritise the profit over the implementation of IME. If the opposite is the case, namely a harmony with the top-level management, then SB should be able to implement IME apart from the complex cases where interdisciplinary collaboration becomes a necessity. By shifting the regularity mechanism for *Shari'ah* governance partly to the civil society, the issue becomes no longer only to get the approval of SB on a certain product or service in terms of permissibility but requires going beyond that and convince the civil society that *Shari'ah* compliance is genuine by disclosing the relevant information related to the dimensions of IME. Therefore, the *Shari'ah* compliance is no longer a binary decision of *halal/haram* but also, after it is approved as *halal*, to what degree it is compliant with IME. Utilisation of such a civil society-based mechanism, therefore, solves the obstacles of embeddedness of *Shari'ah* scholars and lack of the negotiation power since it is also the stakeholders that IBs must convince rather than *Shari'ah* scholars alone.

Second superiority mainly solves the third obstacle, which is the complex nature of product and services in IBs. As mentioned in Chapter 6, even if embeddedness and lack of negotiation power would not be a problem for a *Shari'ah* scholar regarding the realisation of the objectives of *Shari'ah*, the complexity of the products and services and necessity of interdisciplinary collaboration in such cases might lead to an obstacle. A civil society-based regularity mechanism would be instrumental in such a case by evaluating the product or service in various dimensions of IME such as environmental or social impact by using the information provided by the IB. In such mechanism, the information provided by IBs would be used as an input to evaluate the degree of compliance with IME for the products and services approved by SB as permissible. Based on the input, civil society organisations would have the opportunity of providing

a score on a scale of 1-100 regarding IME in projects such as ZamZam Tower or other *sukuk* projects. Such a rating process would also have an impact on pricing and compensate the cost of fulfilling IME requirements, which will further encourage IBs and investors to comply with a higher score of IME. Such encouragement is especially important since, in the absence of such a feedback mechanism on a higher compliance of IME and compensation in exchange for the efforts of IB, there would not be any incentive for an IBs to implement IME. In a similar manner to Gresham law which argues that bad money drives out good money; having the same face values, namely being '*halal*' or permissible, IBs with higher compliance of IME would be driven out from the market. A fuzzy logic based civil society evaluation mechanism, therefore, would provide a unique value for each product or service in line with their score in compliance with IME. While *Shari'ah* compliant products and services with a low IME score would find customers who only concerned with the form of *Shari'ah*, the product and services with higher IME scores would be compensated and survived in the market as well. It is due to such aspirational expectations that in recent years, a number of studies emerged to examine the *maqasid al-Shari'ah* (the higher objective of *Shari'ah* being the human well-being) performance of IBs (*see*: Aksak and Asutay, 2015; Asutay and Harningtyas, 2015; Mohamada *et al.*, 2016) with the objective of locating the moral outcome of IBs through disclosure studies. However, since there is no attempt by IBs to disclose such information due to not necessarily conducting such activities, the findings of such studies are rather disappointing. Therefore, the solution provided by this study would necessitate IBs to conduct Islamic morally acceptable outcomes and disclose the necessary information.

It is important to note that it is not expected that every IB would aim a high score on the scale since every range within the scale of 1-100 would have a certain market share. However, this mechanism would provide an opportunity to open a niche market for those who aim to invest or to do business with IBs which achieve a high score regarding IME compliance. After the emergence of such a market, it is also the responsibility of civil society to promote and extend the share of stakeholders who aims for a higher score. We can term such an effort as endogenisation of IME since the goal is to convince people to care about IME and involve with IBs which achieve a higher score.

Such a process resembles the process led to the emergence of ‘ethical investing’ or ‘socially responsible investment’, which represents the market responses to the demands emerged from the civil society to have their savings to be invested in ‘ethically acceptable and social impact areas’. The successful expansion of such investing areas is an indication of the power of the civil society but also indicates the flexibility of market system for making additional inroads through market segmentation. In a similar manner, such segmentation as explained above through fuzzy logic will serve the expectations of ‘further morally inclined Muslim individuals’. Such a power of the civil society would undermine the imposed *Shari’ah* hegemony and further democratise Islamic finance. This might also help to overcome the observed ‘*Shari’ah* arbitrage’ (El-Gamal, 2007). It is also important to recall the *hisbah* (market regulation body through examining the moral consequences of market) experiment in the Muslim world as per civil society, an articulation of which being *ahilik* (brotherhood) system in the Ottoman Era in the form of guild system can provide authentic examples of developing new structures to essentialise Islamic normativeness and substantive morality of Islam.

This study, however, acknowledges the difficulties and limits of a civil society-based regularity mechanism based on fuzzy logic. First and foremost, the disclosure practices of IBs regarding the details of the products and services which is required as input to a potential IME index is insufficient, as indicated by the *maqasid al-Shari’ah* performance of IBs related studies. Therefore, it requires a strong civil society with the required awareness on the topic to pressurise the companies with an affirmed action to enhance the level of disclosure. Secondly, dimensions and potential index items should have been investigated for IME. Considering that such theoretical studies attract less attention, this might be a challenging task to achieve. Nevertheless, studies related to the construction of *maqasid*-index might be a good starting point to develop an IME index. Thirdly, such a civil society based regulatory mechanism requires a certain degree of awareness on demand side which is necessary to sustain IME compliant products and services in the market and compensate their additional expenses to provide such product and services. Demand for sustainable products and services, organic food and fair trade suggest that such a demand for IME-based products and services is not unlikely but required effort to raise awareness.

Despite these limitations, however, it is important to strive to realise IME in a decentralised manner and maybe with several alternative IME-based rating mechanisms to bring the IBs and other financial institutions closer to the initial aspirations of IME. This is crucial to provide and sustain a human-centred development path by going beyond economic growth obsession so that *falah* or individual salvation could be achieved and *ihsan* or societal beneficence can be attempted in this world, which constitutes the objective of being ‘*khalifah*’ (being vicegerent) of Allah in this world.

## **7.2. LIMITATIONS AND FUTURE RESEARCH**

Despite having conducted a novel research, this study does not go without limitations; and therefore, two important limitations can be mentioned. Firstly, the number of observation in the empirical part of Chapter 3 was planned to be higher. However, due to the language barrier and relatively young age of IBs in the sector have limited the number of observation with 305. As for the language barrier, we conducted our analysis with SARs published in English and Arabic. This led to exclusion of most of the IBs in Indonesia which publish their annual reports in Indonesian’s Bahasa language. As for the age of IBs, we could not extend our sample earlier than 2007 since that would result excluding many IBs due to the fact that most of them have been established around 2007 and later. Furthermore, some unpublished online SARs by IBs has further decreased the number of observations.

Second limitation relates to the use of primary data; as collection of primary data through interview survey method with the leading *Shari’ah* scholars in the Islamic finance sector industry was considered. However, due to the difficulty of reaching the leading *Shari’ah* scholars, with the objective of not ‘wasting further time’, the research has resigned to the fact of using secondary data and discourse method. As we mentioned in Chapter 6, a small number of *Shari’ah* scholars occupies the majority of the chairs in SBs, resulting in high preoccupation with *Shari’ah* board related issues. This, as a result, makes arranging interviews with the leading *Shari’ah* scholars a challenge. This is the reason why we relied on the interviews with *Shari’ah* scholars conducted by other researchers as a secondary source to reflect their positions in the discussions.

Based on the research conducted in this thesis, we can move forward by developing this research further. Firstly, conducting interviews with established as well as new generation *Shari'ah* scholars can be considered so that the arguments developed in this research through secondary material can be debated and substantiated. As this will help to reveal the cause of social failure in their respective institutions as we discussed in the previous chapter, namely embeddedness, lack of negotiation power and lack of collaboration. With a representative sample of *Shari'ah* scholars, such an interview would also reveal the role and status of *Shari'ah* scholars in Islamic finance and banking sector but also it can help to see whether there is any change in the views of established and young scholars in relation to the emerging challenges in the sector.

Second research area is related to the development of IME based index to measure the performance of IBs. In other words, through the exploration of the IME dimensions attempt can be made to develop of an index based on IME framework to measure the products and services of IFIs with the objective of disclosing to what degree they are compatible with IME beyond being '*halal*' or *Shari'ah* compliant. It is important to note that exploration of dimensions of IME and construction of an index requires extensive research and collaboration of multiple disciplines such as Islamic studies, sociology, economics, history, anthropology, organisational study, etc. Particularly, it requires consulting the published works of earlier generations to investigate pre-modern ideas and perspectives. Despite the challenges, such a transdisciplinary work can nevertheless, be an achievable goal.

Lastly, as mentioned in passing, the concept of corporation is a challenging issue for *fiqh* or Islamic law; as corporation is not considered as an entity by *fiqh*; and therefore, among others, such as Kuran (2003, 2004) claims that the lack of corporation is one of the main reasons for the underdevelopment in the Muslim world. While this argument opens for critical debate on the nature of different political economies and the inevitability of corporations, nevertheless, financial corporations in the form of IBs and non-financial Islamically oriented corporations as part of the emerging *halal* industry and *Shari'ah* complaint stocks is a reality in the contemporary Muslim world. Thus, pragmatism of *Shari'ah* scholars can be seen in their treatments of corporations in Islamic law, as they approve the products and operations of IBs as corporations, but they rule out the idea of imposing *zakah* on IBs on the ground that *fiqh* on *zakah* does

not consider corporations as responsible to pay *zakah* as *fiqh* on *zakah* can only be given by individuals. Hence, due to the market efficiency and to increase their competitiveness, *zakah* is ruled out in their new injunctions or *fatwas* as a possibility for IBs which in essence can fit into IME's objective of *ihsan* or beneficence, as corporations has additional eligibility and affordability such as the case with corporate tax in addition to personal income tax in the modern tax system. Under such conditions, therefore, the SBs' remit is limited with product approval, while the CG issues are excluded from the sphere of *Shari'ah* scholars let alone shaping the IBs and other corporations around ICG. Since shareholder interest can easily be dealt with *fiqh*, *Shari'ah* scholars have ruled out stakeholder based CG, which, as an attitude and strategy, rules out pursuing ICG in IBs and IFIs. As can be seen, there are challenges to develop ICG and even shaping the nature of corporate social responsibility (CSR) in the case of IBs due to the challenges faced in *fiqh* due to the unresolved issue of corporations. Regardless of such a fact, even the standards setting agencies such as AAOIFI issues CG and CSR standards and IFSB issues regulations. Given the context that both of these organisations have *Shari'ah* scholars to shape such standards and regulations, the denial of such paradoxes can be considered as important reasons of the observed convergence and social failures. Therefore, existential issue facing the industry is the development of ICG within *fiqh*; as this study has provided the IME based ICG within the theoretical frame of IPE. However, since ICG's application and articulation can only be possible with the provision of *fiqh* base, it is important that the theoretical system proposed in this study should be matched with its *fiqhi* base so that consequentialist oriented process (based on IME) developed in this study can have its form or intention base as expressed by *fiqh*. Therefore, an essential future study in the form of methodological study can aims at developing an integrated whole with its IME within IPE framework as well as *fiqh*, as *tawhidi* knowledge base require complementarity between different spheres of knowledge. This will also help to provide an embedded CG as well as CSR base for IBs and IFIs as well as other emerging corporations in the Muslim world within Islamic ontological determined social formation. Despite the paradoxical denial we observe around us by different stakeholders as mentioned above, this will remain an important project to shape the development of Islamic banking and finance industry.

### 7.3. EPILOGUE

This research aimed at exploring the role and status of *Shari'ah* scholars in IBs and the reasons behind the lack of ability of *Shari'ah* scholars to prevent the social failures of IBs. In order to achieve this, we explored three main topics in five chapters; (i) examination of supervisory role of SBs through *Shari'ah* Annual Reports (SARs) within IME framework; (ii) investigation of the process of divergence of IBs from initial aspirations of IME within postcolonial framework; and (iii) exploration of paradigm shifts in *ifta* institution's *raison d'être* after the Rightly Guided Caliphate period with the objective of tracing the roots of SB as a modern *ifta* institution to reveal main reasons behind the inability of *Shari'ah* scholars in SBs to prevent the divergence.

In our analysis in four empirical and discursive research-oriented chapters, this research has fulfilled its aim and objectives as stated in its research questions in Chapter 1. Through empirical and theoretical analysis and utilisation of secondary data, the research provided a holistic view of the main question. Furthermore, building on the empirical and theoretical research of this research, we offered some policy suggestions that can prevent the convergence of IBs towards conventional banks in terms of product and service development.

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