Research Article

ISSN: 2770-2928

International Journal of Agriculture and Technology

Islamic Banking Perspective on Corporate Governance

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Received: 03 May 2023; **Accepted:** 11 Jun 2024; **Published:** 20 Jun 2024

Citation: Sharif M. Abu Karsh, Leena Mahareeq. Islamic Banking Perspective on Corporate Governance. Int J Agriculture Technology. 2024; 4(1): 1-7.

ABSTRACT

Relevance: *The Islamic banking industry has worked more effectively for decades during the era of Muslim civilization and has made a resurgence into a global platform. This in turns leads to efficient corporate governance in Islamic financial institutions, structured to fulfill the requirements and regulations of sharia.*

Purpose: *The purpose of the research is to determine Islamic Banking's perception on corporate governance.*

Method: *This paper presents a descriptive analysis on cooperate governance of Islamic Backing. The study reviewed articles on corporate banking systems, the Islamic banking system, the underlying structures that exist in both systems, their rules and regulations, and the relationship between both systems of banking.*

Result: *The study found that Islamic banking has well-structured corporate governance guided by different bodies, including a multi-layered organization comprising the Sharia Supervisory Board (SSB), board of directors, investors, and commissioners. The SSB sits at the top of the corporate governance ladder; it offers oversight of all the transactional operations and compliance of the Islamic banking system based on sharia law (rule and regulations) known as Super Authority. This has accelerated the growth of Islamic banks.*

Conclusion: *Islamic banking runs a multi-layered corporate governance whose primary transactional operation is guided by Sharia principles. This sole technique has contributed to the extensive growth on its corporate governance.*

Keywords

Corporate governance, Organization structure, Sharia, Financial dividends, Corporate regulation, Islamic bank, Corporate finance, Financial organization.

Introduction

During the era of Muslim civilization, the Islamic banking business performed more efficiently for decades and has made a comeback as a global platform. As the Islamic banking industry grows, significant attention is being paid to the fundamental structure of the banks in the corporate world [1]. Corporate governance involves worldwide rules and regulations and various parts of legislation to create a business environment for the corporation and its stakeholders. Corporate governance in Islamic financial organizations is designed to meet sharia rules and laws [2]. The sharia requirements have made the Islamic banking industry provide products and services to customers following the sharia requirements [3]. The most differentiating factor between Islamic and conventional banks in their business operations is that Islamic banks are regulated by the Sharia Supervisory Board (SSB) [2].

The SSB is a critical component of corporate governance in Islamic banking. It is regarded as a "Super Authority" by Choudhury and Hoque [4]. It is very important in the Islamic banking industry. In addition, the SSB adds another layer of governance to the existing boards, which include directors, commissioners, and other operational committees. In this approach, the SSB transforms Islamic bank governance into multi-layer governance, which does not exist in a single-layer conventional governance structure with a shared board of directors and executive committees.

Several studies on corporate governance have been undertaken using conventional banks as research cases. However, research in Islamic banking and corporate governance remains sparse. Furthermore, Islamic banking is a relatively young field in many countries, and as it grows, so does the need to comprehend its governance structure. As a result, this study investigates how Islamic banking perceives corporate governance. It will look at the elements of corporate governance in Islamic banking and how they contribute to the rapid expansion of Islamic banking.

Literature Review

Corporate Governance

Corporate governance in the banking business has been examined and researched more thoroughly in traditional banks [5]. There have been numerous discussions over the role of market discipline in the banking industry, which has been formed by shareholders and regulators to restrain hazardous methods to bank management. Similarly, there is growing interest in bank research since investors play an important role in corporate governance. In contrast, there is minimal literature on business governance from an Islamic perspective [6]. There is little information available on corporate governance structure in the context of Islamic banking. Nonetheless, Islamic banking has grown rapidly since the Muslim civilization, and there is an increasing presence of Islamic banks in the world's financial system. These banks have operations in Islamic countries, Europe, North America, and elsewhere. Islamic financing has piqued the curiosity of Western banks [5]. According to studies, the Islamic banking industry marks a radical break from traditional banks and corporate finance perspectives; Islamic banking encompasses good attributes based on Islamic financing.

The tremendous development in Islamic banking has progressed in Islamic member states and western countries. Studies have revealed that the operation of Islamic banks theoretically differs from those of conventional banks based on commitment and involvement in social equity; as such, Islamic banks are required to remain compliant with the sharia laws [7]. The main feature of Islamic bank is the SSB, which help to ensure that the operations of the Islamic banks comply with the sharia principles. Interestingly, during the early age of Islam, Muslims established a financial system that was free of interest through various modes of financing, such as the mudharaba and the musharaka [8]. Although there is no empirical evidence of a financial system in the early days of Muslim culture, historical evidence provides literature on the existence of such a system. Furthermore, such a financial structure supplied sufficient evidence that Islamic banking had been in place since the early Muslim era. According to studies, the question of corporate governance was less important in the Saraffs and Djabadh than it is now in Islamic banks [6]. However, factors such as the economic environment, Islamic principles, and the legal framework for trade continued to influence corporate governance in Islamic banking [9]. By then, the financial system was also reinforced by the judiciary's independence and vigor, which resulted in economic stability in Islamic states since the early Muslim era [10]. Corporate governance as a control mechanism did not arise during the Sarrafs and the Djahbadh hence scholars' lack of debate and theoretical framework [11].

The Characteristics of the Islamic Banking System

The corporate governance structure in an Islamic bank should be governed by Shariah principles. An important feature in the Shariah-based corporate governance system is the distribution or division of shares to create an equal share between all shareholders [4,12]. The corporate governance structure must be structured in such a way that it can implement Shariah principles in the everyday operation of an Islamic bank. This implies that its board must also be Shariah-based and capable of operating according to the principles of Shariah.

The primary objective of Islamic banking is to achieve financial stability by managing the risk and uncertainties related to corporate assets [13]. The corporate governance structure should ensure this by being based on the principles of Shariah and having a board that can act accordingly. Although corporate governance structure cannot prevent all risks and uncertainties, corporate governance structure must ensure that all actions taken by the bank are based on Sharia [14]. It is important to note that Islamic banking requires certain risk management instruments. Consequently, one may argue that to achieve an effective corporate governance structure, it is necessary to have a board with a well-balanced composition where members are better equipped to understand and implement legislation such as Shariah. The board is the most important component in the corporate governance structure. The board of directors’s duty is to supervise and control the corporation's management and safeguard its shareholders' interests [15,16]. To achieve this, it should be composed of individuals with a wide range of expertise, representative of all shareholders in terms of their interests, and able to defend their interests. The corporate governance structure is responsible for enforcing Islamic regulations and laws and implementing Shariah in a way that properly aligns the interests of shareholders [17]. As a fundamental decision-making body, the board should be accountable and responsible by forming a system that motivates potential directors to do their work.

The absolute authority belongs to Allah in His Book (Al-Qur'an). As for what belongs to the legislative process of the company, it belongs to the board of directors. The legislative process does not include the laws and regulations regarding how the company is run. This is a Corporate Governance in which the corporate governance structure has complete authority to make decisions on behalf of all shareholders [17,18]. It is responsible for making decisions based on written laws and regulations. On top of that, it makes decisions not only legally bound but also in line with Shariah principles [19]. This depends completely on Allah (SWT). Based on the above reasons, many scholars and researchers claim that to implement an effective corporate governance structure, it is necessary to have a board with a well-balanced composition where members are better equipped to understand and implement legislation such as [20].

The board of directors’s duty is to supervise and control the corporation's management and safeguard its shareholders' interests. To achieve this, it should be composed of individuals with a wide range of expertise, representative of all shareholders in terms of their interests, and able to defend their interests [21]. On top of that, it makes decisions not only legally bound but also in line with Shariah principles. This depends completely on Allah (SWT) [22]. Based on the above reasons, many scholars and researchers claim that to implement an effective corporate governance structure, it is necessary to have a board with a well-balanced composition where members are better equipped to understand and implement legislations such as Shariah [14,23,24]. The board of directors's duty is to supervise and control the corporation's management and safeguard its shareholders' interests. To achieve this, it should be composed of individuals with a wide range of expertise, representative of all shareholders in terms of their interests, and able to defend their interests.

Theoretical Framework of Islamic Banking

Islamic banking is based on management principles, laws, and rules derived from the Qur'an and Sunnah. The central feature of this system is its prohibition of riba' (usury or interest) in all forms. For this reason, Islamic banks cannot have riba' as a component in their activities or products [25]. Islamic banking has three distinctive features: interest-free banking, rejecting speculative activities, and using only real assets as collateral [26]. Profit-loss sharing is a flexible form of financing that can be applied in areas where financial needs do not require using debt instruments. It is compatible with the rules and limitations of Islamic law regarding the collection and redistribution of wealth [26]. Profit-loss sharing allows partners to share both profits and losses equally.

The scope of Islamic banking includes all assets, business types, and financial transactions [18,26]. In general, Islamic banking encompasses activities that are not permitted under the rules of conventional finance [25]. The objectives and structure of Islamic banking are different from that of conventional banking. The focus is to prevent the emergence and accumulation of wealth in a few hands instead of facilitating access to financial assets for the many [27]. This system believes in fair wage and shared distribution among employees to guarantee their welfare. Islamic banking also seeks to develop the real economy to maintain equilibrium and balance among the economy, politics, and ecology [22].

Scholars provide corporate governance from an Islamic perspective regarding western corporate governance structure [6]. Corporate governance has two structures, namely the European and the Anglo-Saxon. The Anglo-Saxon corporate governance structure is the most dominant and is widely used by Western countries [6]. Western countries dominate the use of these models in corporate governance; of central focus is the Islamic approach toward corporate governance in the Islamic banking sector. Effective corporate governance within the Muslim framework is regarded as the epicenter of Islamic banking to protect the interest of the shareholders [23]. However, from an Islamic context, the interest of the shareholders goes beyond profit maximization or the financial return associated with an investment in Islamic banks; it covers the element of sharia requirements and principles of the Tawid.

Although Muslim scholars agree that Tawid is the philosophical foundation of Islamic economics, it is observed that there is little evidence of discussion or publications o the issue of corporate governance, particularly in Islamic banks [11]. However, according to Muslims, the basis for corporate governance is perceived to have emanated from this concept (Tawhid). As such, Islamic countries must follow the sharia principles in practice and policy. Sharia controls issues relating to the economy, politics, accounting: and all regulations [6]. In addition, sharia laws are formulated on the principles of justice. Studies also suggest that knowing how sharia regulation operates is often difficult hence the need for SSP, which plays an extensive role in the corporate governance of Islamic banking. The SSB provides the framework for Islamic banks to comply with the sharia requirement and policies [27].

The perspective of Islamic Banking

From the Islamic banking perspective, corporate governance is considered a fundamental component of an economic system that is secure and stable, ensuring transparent, effective, and efficient operation for corporations [6,27]. Effective corporate governance process involves the existence of an effective corporate governance structure that can fulfill the running of a corporation with justice, efficiency, and transparency [28]. The basic concept of corporate governance can be stated in the following way: a decision-making process (that is, the board of directors) that upholds the interests and values of a corporation's shareholders, rather than solely those of corporate management, is critical to the long term success and sustainability of a corporation.

The importance of corporate governance structure varies depending on its applied context. In the context of Islamic banking, since the main goal of corporate governance is to help ensure the sustainability of the corporate assets and profitability, based on the Islamic concept of banking, there must be Islamic banking-oriented board members that can monitor and advise on the implementation of the assets [29]. Thus, one may argue that to achieve an effective corporate governance structure, it is necessary to have a board with a well-balanced composition where members are better equipped to understand and implement legislations such as Shariah [30]. The purpose of corporate governance structure is to provide an organization with transparency, accountability and management expertise. As a fundamental decision-making body, the board should be accountable and responsible by forming a system that motivates potential directors for their work [31]. The whole board should have all the vital skills required to achieve the corporation's goals.

The structure of corporate governance in an Islamic bank

A successful corporate governance structure depends on the ability of a bank to effectively manage and monitor its financial health, risk management, liquidity, and investments. The board should be able to monitor all critical vulnerabilities of the bank [27]. To effectively monitor financial health, it is necessary to maintain an ongoing relationship with all stakeholders to maintain an accurate view of their needs and how they are being addressed. The quality of the corporate governance structure is based on the quality of the makeup of its members [32]. The effectiveness and expertise of individual board members depend on their understanding and knowledge regarding the bank's operations and management. To have a well-balanced board, bank directors must be experts in different fields, such as finance, accounting, risk management, economics, and law [33]. Directors should also have a good understanding of the management style of the top executives. There should be a mix of private sector experts, government representatives, and independent members. This ensures greater transparency in decision-making and represents all stakeholders adequately.

Components of Corporate Governance in Islamic Banking

Joint stock companies- A joint stock company is an organization that consists of shareholders who contribute capital and participate in the ownership, management, and profits of the company. All members assume the liabilities of a joint stock company without limits [32]. The stockholders decide the number of shares they wish to own [32]. The primary function of the corporate entity is to conduct business activities open to all shareholders. Using sharing profits and losses, all shareholders will benefit equally as long as participation in share ownership remains active [14].

Islamic Banking- A financial instrument based on profit-loss sharing used to finance projects with limited profitability and risks. The principle behind this is that the returns will be earned by all the investors rather than a few. The profit-loss sharing aims to give all investors an equal share of profits and losses. The amount of profit or loss is determined by the profit-loss sharing formula [14].

Common Stock- Has limited rights compared to other important corporate objects such as bonds and shares. There are three ways of selling Common Stock:
Etiquette of Selling Common Stock- Because Islamic banking prohibits speculation and gambling, the concept of investing in shares is prohibited in Islam. In addition, there is no concept of joint stock companies in Islamic banking. The only method that follows the Islamic rules is "profit-loss sharing" [30]. It requires a contract between the investor and the issuer that guarantees to give the investor full compensation if losses are incurred due to default by the issuer [16]. The Investment Contract: Islam, the religion of Muslims, and Islamic economics represent the fundamental principles of a government and a nation. The aim is to achieve an economic system that provides the basic elements of life to all citizens according to Islamic rules [31]. In this contract, both parties are committed either by investment or loan.

Sharia- Cash equivalents like treasury bills and certificates of deposits are prohibited in Islam because they provide no interest [31]. Islamic banks usually have a higher rate of return than conventional banks. However, the return is based on profit-sharing rather than interest. Another difference is that the Islamic bank does not pay dividends to its shareholders. Because there is no interest on loans taken by the company, Islamic banks cannot pay interest to their depositors either [31]. This differs from conventional banks, which pay interest on deposits. In addition, the Islamic bank cannot and does not pay any commission or brokerage to its brokers.

The main component- Financial institutions face many challenges to comply with the principles of Islamic finance and of them is that they usually have a higher rate of return than conventional banks. However, the return is based on profit-sharing rather than interest. Another difference is that the Islamic bank does not pay dividends to its shareholders. Because there is no interest on loans taken by the company, Islamic banks cannot pay interest to their depositors either. This differs from conventional banks who pay interest on deposits. In addition, the Islamic bank cannot and does not pay any commission or brokerage to its brokers.

Islamic Banking has become an important tool in managing risk by encouraging profit-sharing principles in areas such as real estate finance. The main difference between conventional and Islamic banking is that the latter does not allow interest. Banking, as a product, should be viewed from the perspective of the service it provides to its client and not from the point of view of whether or not interest is charged on loans.

Islamic banking helps to develop financial and social services for Muslims worldwide. It also helps to fulfill the needs of Muslims by offering financial products consistent with their religious beliefs. Thus, Islamic banking can be considered an alternative to conventional banking. Islamic banking is a good alternative and the only way to develop financial institutions for the Islamic religion. For example, it may be difficult for a Muslim investor to invest in American or European markets. In order for Islamic banking to become an accepted form of finance, one of the following two things must happen: First, governments of countries with large Muslim populations must allow Islamic banks to operate in their countries. This is unlikely to occur because governments currently run financial systems based on conventional banking. A second possibility is that formal financial institutions must begin to accept Islamic finance as the only alternative.

Generalization of the main Statement

The findings indicate that corporate governance has a major impact on the financial success of the Islamic banking sector. The Sharia Supervisory Board (SSB) of the Islamic banking industry is critical in supervising the commercial operations of Islamic banks, particularly their financial performance. The table below summarizes the descriptive statistics utilized in the investigation.

Corporate governance has an impact on financial performance measures such as the NPF, ROA, and CAR of Islamic banks [34]. This study supports the premise that organizations with well-structured corporate governance are more likely to be progressive and efficient and effective in their operational performance. Nurkhin and colleagues [35] According to the models, the performance of the commissioner of the board, SSB, the composition of the board of commissioners, and the performance of the board of directors can all have a beneficial impact on the rate of return in Islamic banks [35]. According to the results of the first model, Islamic banks that have implemented corporate governance have a positive Rate of Return as evaluated by the banks' ROA [36]. Higher ROA implies more profitability and higher positive financial performance.

The performance of the SSB and the board of directors are negatively influenced by the NPF [37]. The finding may suggest the impact of implementing corporate governance in Islamic banking. Specifically, the performance of the SSB and board of directors may lower the risk of non-performance in the Islamic banking sector [35]. The finding also suggests that the board of commissioners takes full responsibility for improving the bank's financial performance by creating external connections between the bank and the stakeholders. The scores of adjusted estimates in the model also indicated that the variable affected the performance of Islamic banks in terms of NPF, ROA, and CAR [34]. This confirms that corporate governance has a significant impact on the financial performance of Islamic banks.

Discussion

The findings in the LR presented two types of systems for corporate governance in Islamic banking. These models are i) The Ango-Saxon and ii) the European models. The anglo-Saxon corporate governance model is perceived as the most dominant in such countries as the US and the United Kingdom. Primarily, effective corporate governance within the framework of Islamic banking is to protect the shared interests of the shareholders at large. In the context of Islamic banking, Elasrag [38] points out that the shareholders' interests go beyond profit maximization but also cover such elements of faith as ethics, which is Sharia law and the principle of oneness.

Tawhid and Shura Based Models of Corporate Governance

According to Choudhury [4], Islamic banking is a legal entity with principles equal shares of the firms being owned by shareholders based on equity participation as well as profit sharing ratios defined at the onset. Tawhid is Islamic banking lays the foundation of corporate governance as it originates from Allah, Al-Quran. In Al-Quran, verse 3:191offers the vital element of governance where Allah created everything, through the world's vicegerent. Through His trust in humankind as a vicegerent, Allah actively monitors and is aware of everything at all times.

In line with this, the principle of Tawhid lays the foundation for corporate governance model in Islam. Choudhury [4] points out that corporate governance deals with the legal and organizational structure that govern the internal operations of a firm with the aim to define and attain the objectives by understanding the different variables that support policies, program as strategic coalitions. In Islamic banking, corporate governance is distinct from that of Western culture in four different instruments that govern, i) Tawhid extension of unity of knowledge through interactive, integrative as well as evolutionary process, ii) the principle of justice iii) productive engagement principle and iv) the principle relating to economic activities as well as recursive intentions [4].

In this model is corporate governance in Islamic culture, there are two key institutions such as Sharia board and the constituent of involving participants from Shura's groups, made up of all the stakeholders [11]. Sharia board plays a crucial role in ensuring that all the activities are in line with the Sharia principles. Additionally, the shareholders play a significant role in ensuring that active participants as well as conscious stakeholders are involved in decision making as well as policy framework through consideration of interests of both direct and indirect stakeholders instead of exclusively maximizing the profits. The community, which form part of the stakeholders as well play a significant role of providing mutual cooperation with the aim of protecting the interest in general, and to stimulate the well-being of the society. All of these processes are centrally geared towards fulfilment of the ultimate objectives of Islamic corporate governance.

Stakeholders Based Model

According to Chapra & Ahmed [39] Islamic banking corporate governance places emphasis on equitably protecting the rights of the shareholders regardless of holding equity or not. Islamic law in this regard recognizes the principle of property rights and commitment to explore the explicit as well as the implicit agreements of a contract that govern both economic and social behavior of an individual, and the state. These two are the guiding principles to the stakeholder-oriented model of corporate governance in Islamic banking.

The Islamic banking based on the findings by Hasan [11] has seen the development of the Islamic Financial Services Board, whose development is founded on three guiding principles to help in the strengthening of governance structures as well as processes in different segments of the Islamic financial services, and in accordance to the mandate to promote sound and stable financial systems in the Islamic banking.

Sharia Supervisory Boards

From the findings, Islamic banks have to comply with the Sharia principles in every aspect of their operations, product offering, practices as well as management [38]. According to Elasrag [38] Sharia supervision plays a critical role in the corporate governance of Islamic banking, and it forms the key component of governance framework. One of the key roles of the SSB is to offer advice to the Islamic Banking on matters sharia rules to ensure conformity with the rules throughout its operations. SSB also endorses and validates relevant documentation relating to the product offering of Islamic financial institutions. From the findings by Hasan [11] the significance of Sharia stems from five distinct resources including i) religious ii) social iii) legal iv) economic and iv) governance. i) Religious power- derived from the ability to interpret and understand Sharia principles regarding corporate governance. ii) Social power- implies the social power in which the supervision from the SSB offers the stakeholders the confidence on the legitimacy of all the transactions and operations within their financial institutions. iii) Economic power- the SSB's economic power is seen from the profits from the Islamic banking, which primarily depends on the performance of Sharia scholars. iv) Legal power- is derived from different sources across countries. v) Governance- the hierarchy of

SSB under the shareholders of Islamic banking places emphasis on the authority over other bodies of governance therefore giving them the authority to develop internal policy including but not limited to operations, responsibilities relations with other governing organs such as board of directors, committees within the Islamic banking. Governance in Sharia refers to all the elements that points to the active role of Sharia board, as well as compliance with Sharia's fundamental regulations.

The prerogatives of SSB is in five key areas [27]. These include i) certification of financial instruments permissible through fatwas, ii) verification of all transactional operations to ensure compliance with stipulated fatwa, iii) calculation as well as payment of zakat, iv) disposal of non-sharia payment compliant earnings and v) offer advice regarding income distribution as well as expense of the shareholders and investors. Each SSB issues certification reports on Sharia compliance by all financial transactions. Additionally, Islamic banks based on the findings from Hasan [11] shows that Islamic financial institutions created another internal governance structure called, Sharia Review Units, which are independent units undertaking internal audit as well as control of departments.

Conclusion

The study sought to ascertain Islamic banking's perception of corporate governance. Based on the findings, Islamic banking has evolved to establish a sound corporate governance system. The corporate governance of Islamic banking is based on Sharia law principles, which include, but are not limited to:

i) Wealth must be generated through legitimate trade and asset-based investments,
ii) The social and ethical aspects to wider society
iii) Risk should be shared equally, and
iv) Haram should be avoided.

The employment of an SSB, which is a supervisory board that adds a layer of governance to existing boards such as directors, commissioners, and other operational committees, has a direct impact on Islamic Banking's corporate banking. The SSB is responsible for five key functions:

i) Certification of financial instruments permissible through fatwas
ii) Verification of all transactional operations to ensure compliance with stipulated fatwa,
iii) Calculation and payment of zakat,
iv) Disposal of non-sharia payment compliant earnings, and
v) Advice on income distribution and expense of shareholders and investors.

In conclusion, all of this contributes to the extensive growth of Islamic banking, which is based on a firm basis in corporate governance.

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