

**RESEARCH PAPER****Evolution and Development of the Sharī'ah Governance Framework for Islamic Banks****¹Moazzam Ali * ² Dr. Tahira Ibraq and ³ Noor-ul -Ain Yaseen**

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ABSTRACT

This study aims to explore the regulatory and Sharī'ah frameworks that govern Islamic banking, focusing on their historical evolution, key regulatory bodies, instruments, and the challenges encountered in ensuring compliance and integrity within the industry. Islamic banking operates under distinct principles that require a specialized governance framework. This framework is critical for ensuring adherence to Shariahah guidelines and maintaining the integrity of financial practices within Islamic financial institutions. Understanding this framework is essential for developing effective governance mechanisms and regulatory compliance. The research employs a comprehensive literature review and qualitative analysis of regulatory documents and historical records related to Islamic banking. Interviews with key stakeholders from regulatory bodies, Islamic banks, and Sharī'ah advisory councils were conducted to gather insights into the operational challenges and compliance practices. The findings highlight the complex interplay between historical context and current regulatory practices. The study reveals that the State Bank of Pakistan (SBP) plays a pivotal role in overseeing compliance, alongside various bank-specific bodies that ensure adherence to Sharī'ah principles. Challenges identified include the need for harmonization of guidelines across different jurisdictions and enhancing the capacity of regulatory bodies to effectively monitor compliance. To address these challenges, the study recommends the establishment of a unified regulatory framework across jurisdictions to enhance consistency. Furthermore, increasing training and capacity-building initiatives for regulatory bodies and Islamic banks is crucial. Finally, fostering collaboration between regulatory authorities and Sharī'ah advisory councils will promote better compliance and strengthen the governance framework of Islamic banking institutions.

KEYWORDS: Financial, Framework, Governance, Instruments, Islamic Banks, Regulatory, Sharī'ah, State Bank of Pakistan**Introduction**

The regulatory framework for Islamic banks aims to monitor and regulate Islamic banks. The regulatory framework provides set of rules, guidelines, standards, and regulations to govern the operations of Islamic financial organizations as well as to ensure the adherence of held operations and practices to Sharī'ah principles (Ayub, 2007). Islamic banking is grounded on the unique doctrines of Sharī'ah law. The core principles of Islamic finance includes prohibition of ribā, risk and return sharing, assets backed financing, and ethical financial transactions (Usmānī, 2010). Sharī'ah requires all the activities and transactions undertaken by the Islamic banking must follow Islamic banking principles. The observance of Islamic banking activities through Sharī'ah principles requires the existence of a separate regulatory framework aims to regulate Islamic banks based on their distinct features and underlying principles (Vogel, 1998). In most countries by the existence of Islamic banks (IBs), the default regulatory framework is provided by the Basel Committee on Banking Supervision (BCBS). However, many jurisdictions enhance this framework by incorporating ideals from the Islamic Financial Services Board as well as the Accounting and Auditing Organization for Islamic Financial Institutions to ensure compliance with Sharī'ah law (Wasim, 2023). The regulatory framework based on the divine principles of Sharī'ah is

established to achieve objectives such as ensuring financial stability by preserving sound Islamic financial system and preserving the sanctity of Sharī'ah conduct.

The overall purpose of Islamic governing structure is to guarantee the growth and sustainability of Islamic banking sector while keeping adherence to the Sharī'ah principles and ethical standards as the prime goal (Delorenzo, 2001). Regulatory framework for Islamic banks requires Islamic banks to adhere to the international regulatory and Sharī'ah standards and prudential regulations pertaining to assets capability, liquidity, in addition to risk controlling which ultimately ensure the soundness of Islamic financial organizations plus overall monetary system. The regulatory framework ensures that Islamic banks adhere to Sharī'ah principles, which include the prohibition of ribā (Ususry), uncertainty (Gharar) and speculation (Maysir), and adherence to ethical and moral standards (Al-Baz, 1998) (Al-Jazīrī, 1973). It ensures access to transparent information to the customers (Al-Khafīf, 1996). It includes providing disclosure of the rules and regulations, practices and operations of the Islamic institutions and compliance to the Sharī'ah principles (Sheikh, 1992). Islamic regulatory framework promotes integrity of the Islamic financial markets by ensuring application of Islamic ethical and moral standard in letter and spirit and discouraging fraudulent activities (Balala, 2011). Regulatory framework encourages standardization of the practices of Islamic financial institutions to ensure credibility of Islamic banking transactions and to promote cross-border operations. Regulatory framework requires the establishment of Sharia advisory boards to ensure the development of Islamic financial products and instruments fully adheres to Sharī'ah principles. The Islamic regulatory framework aims to encourage the growth of innovative Islamic economic products, instruments plus services by financial institutions that align with Sharī'ah principles.

Historical Context of Islamic Banking Regulation

The need for the Islamic regulatory framework felt by the launch of Islamic banking. The establishment of entities truly designated to standardize plus supervise Islamic financial bodies started along with the growth of Islamic banking. The roots of Islamic banking regulation can be traced back to the 1960s and 1970s when the first modern Islamic banks were established. During 1970s to 1980s, financial institutions based on Islamic banking were established across different parts of world. The creation of Dubai Islamic in year 1975 then Islamic development bank in year 1976 in Saudi Arabia paved way for the foundation of Islamic banks at global level. This recognition in the Islamic banking sector increases the demand of Sharī'ah compliant Islamic financial products and instruments (Karim, 2013). With the increase in the demand of financial services the need for regulatory framework to govern Islamic financial transactions and institutions increases. In the 1970s and 1980s, countries with significant Islamic banking presence started devising regulation to monitor and oversee Islamic financial institutions and to guarantee the adherence of transactions to Sharī'ah doctrines. In the 1990s and beyond, international standard-setting organizations and accounting and auditing bodies emerged to provide guidelines and standards for Islamic finance. In 1991, Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) was established which develops Sharī'ah, accounting, and auditing standard for Islamic finance industry globally. In 2003, Islamic Financial Services Board (IFSB) was established as a universal benchmark organization devises monitoring and controlling guidelines for Islamic financial bodies.

With the establishment of IFSB and AAOIFI, countries have formulated and devised regulations for Islamic financial institutions at national level. It includes regulations pertaining to the establishment and licensing of full-fledged Islamic financial institutions and Islamic banking businesses and Islamic banking windows of traditional banks. Central bank of the countries having Islamic banking devise clear cut guidelines for the Islamic banking operations in their jurisdictions. Islamic financial institutions maintain Sharī'ah supervisory boards or advisory boards whose main function is to ensure compliance of Islamic banking practices to the Sharī'ah principle. Shariah Advisory Boards are designed to

provide necessary guidance to the administration in addition to the staff of the Islamic banks for compliance with Shariah requirements.

The primary benchmarking organizations for regulating Islamic financial bodies are as follows;

Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)

This organization was formed in Bahrain in the year 1991. AAOIF is a global corporate entity that organizes bookkeeping, auditing, governance, principles, plus Shari'a standards intended for Islamic financial institutions. Membership of AAOIFI includes Islamic financial institutions, regulatory institution, and central banks from over 45 countries. The prime purpose of establishment of AAOIFI is to standardize and harmonize the practices and financial reporting of Islamic financial institutions according to Shari'ah principles. Moreover, they also provide standards and guidelines to the Islamic financial institutions to boost the growth and prospects of Islamic banking industry.

Islamic Financial Services Board (IFSB)

IFSB was formed in 2003 in Malaysia. IFSB is a global standard setting organization that provides worldwide sagacious regulations and regulatory codes for the regulation plus supervision of Islamic financial institutions. Originally it was made to provide supervisory and regulatory services to central bank and regulators of Islamic banking regulators. However, a few years after their establishment their scope extended to insurance and securities markets (ACIB, 1993). The key functions of IFSB include standard development, guidance and research, coordination with regulatory authorities, policy advocacy, review and assessment, monitoring, and reporting. IFSB ensure transparency of Islamic financial transactions by devising international standard consistent with *Shari'ah* principles. IFSB sets standards for Risk management in close collaboration with Bank for international settlement (BIS) for Islamic Banks.

Moreover, International Islamic Financial Market (IIFM), IIFM is established in year 2002 in Bahrain. It is a global standard-setting body for Islamic financial institutions. The prime focus of IIFM is to standardize and harmonize Shari'ah compliant financial products and product structures all over the world. It also provides guidelines for Shari'ah compliant financial documentation, Islamic financial services industry (IFSI) and product confirmations.

Regulatory Framework for Islamic Banks in Pakistan

The regulatory framework for Islamic banks in Pakistan employs specific policies and guidelines to ensure Shari'ah compliance. These regulations are issued by the SBP in the form of circulars and circular letters, which serve to issue, update, and amend instructions and guidelines periodically. These guidelines include;

- Benchmarks and instructions for establishing an Islamic banking subsidiary by prevailing profitable banks.
- Rules and standards for establishing a stand-alone Islamic banking office by a conventional bank
- Guidelines and standards for inauguration of Shari'ah compliant trade and processes by a development finance institution (DFI)
- Guidelines related to revenue & loss sharing in addition to pool management for Islamic banking organizations
- Risk management guidelines for Islamic banking institutions for managing their portfolios

- Adoption of Accounting and Auditing Organization for Islamic Financial Institutions' Sharī'ah Standards.
- Sharī'ah Governance Framework (SGF) for Islamic Banking Institutions (IBIs)
- Enhanced Training & Capacity Building Measures for Islamic Banking Institutions (IBIs)
- Guidelines for Conversion of a Conventional Bank into an Islamic Bank
- Criteria For Conversion of Conventional Banking Branches into Islamic Banking Branches
- Instructions and Guidelines for Sharī'ah Compliance in Islamic Banking Institutions
- Sharī'ah Non-Compliance Risk Management System ”.

Sharī'ah Governance Framework for Islamic Banks

This framework consists of a set of managerial structures that Islamic financial institutions implement to promote real surveillance, obligation, and liability among the board of directors, administration and Sharī'ah commission. It includes guidelines, processes, and structures developed by these institutions to guarantee that their operations, products, and services comply with Sharī'ah principles. This framework, which sets Islamic banking apart from conventional banking, is designed to instill confidence in the public and financial markets regarding the credibility of Islamic finance operations.

The objectives of Sharī'ah governance framework are to;

- Provide system and structure to govern each and every functioning of the Islamic financial institutions to confirm adherence of Islamic law principles in all the transactions.
- Allow Islamic financial institutions to be recognized and admitted as Sharī'ah compliant by the participants as well as the community.
- Ensure operations plus processes of Islamic financial institutions are fair and transparent.
- Ensure timely disclosure of accurate information and Sharī'ah status of the products of Islamic financial institutions by comprehensive documentation of Sharī'ah board meeting, rulings and compliance reports.
- Minimize Sharī'ah related disputes and promote harmony regarding the Sharī'ah compliance.”

Key Elements of Sharī'ah Governance Framework for Islamic Banks

Sharī'ah Governance framework consists of following two main components at regulatory and supervisory authority level and Islamic financial institutional level.

- i. Central Sharī'ah Board
- ii. Institutional Sharī'ah Governance Framework.

Central Sharī'ah Board (CSB)

The Central Sharī'ah Board is the Sharī'ah board at regulatory and supervisory authority level. It is established by the country's central bank. Its purpose is to harmonize Islamic banking plus economics trends within the authority in accordance with Shari'ah precepts. This board is composed of a diverse group of qualified Sharī'ah scholars, as well as experts in banking, law, and accounting.

“Central Shari'ah Board performs the following functions;

- Adoption of AAOIFI Sharī'ah standards and/or other widely accepted Sharī'ah standards which do not conflict with AAOIFI Sharī'ah standards.
- Provision of principles, rulings, guidelines and other functional support to Islamic financial institutions and Regulatory and Supervisory Authority (Central Bank) in their respective jurisdictions.
- Advise central bank in preparing and implementing prudential regulations for Islamic financial institutions.
- Advises and provides guidance to the central bank regarding the Sharī'ah compliance and conformity of Islamic financial institutions products, services, instruments, contracts, and transactions.
- Advises central banks on Sharī'ah rulings and help them minimizing Sharī'ah related conflicts that arises due to conflicting Sharī'ah opinions.
- Advises central bank regarding the emerging challenges and regulatory requirements due to changing business landscapes.
- Provide guidelines for the standardization of Islamic financial products offered by all the Islamic financial institution e.g. legalizing merchandise structures and its papers, provisions in addition to instruments.
- Devise a criterion for the appointment of Sharī'ah board members of Islamic financial institutions.
- Conduct Sharī'ah audits and review to assess Islamic financial institution ongoing compliance.
- Providing fatwas and rulings relevant to its scope of work, such as endorsing sukuk structures and the associated documentation for independent and government sukuk.
- Resolving any disputes or differing viewpoints between the Islamic financial institution and the regulator, involves overseeing and advising on the Sharī'ah obedience, reviews and monitoring conducted by the supervisory body.

Institutional Sharī'ah Governance Framework

Islamic financial institution needs to have a basic Sharī'ah Governance Framework at institutional level that includes the following key components

Sharī'ah Supervisory Board (SSB) An Islamic financial institution (IIFS) must establish a self-governing, capable, authorized and sufficiently funded Sharī'ah Supervisory Board (SSB). This board should consist of Sharī'ah scholars who are professionally involved by the IIFS to offer supervision and oversight providing Islamic verdicts on goods, trades as well as processes. SSB consists of no less than three Islamic law experts specialized in Islamic commercial law.

Sharī'ah Compliance Function It ensures that an Islamic financial institution's (IIFS) commercial agreements, deals as well as businesses adhere to principles of Islamic law. As a key component of administrative and power structure, it supports management in maintaining Sharī'ah compliance across all business activities, operations, and transactions on a daily basis. The Sharī'ah compliance function involves implementing mechanisms, authorizations as well as procedures in addition to establishing a Sharī'ah compliance department. It is enduring procedure that continuously monitors the institutions general actions and observance of Islamic atmosphere.

Internal Sharī'ah Audit Function The internal Sharī'ah audit function is a crucial control component of a financial institution, operating independently of administration. Its main goal is to assure the board of directors and the Sharī'ah Supervisory Board (SSB) that the IIFS complies with the principles of Islamic law. The internal audit evaluates the

competence as well as usefulness of controls designed to ensure observance to Islamic law guidelines.

Independent External Sharī'ah Audit IESA provides an impartial third-party guarantee to participants of Islamic financial institutions regarding adherence to Sharī'ah principles and regulations. This initiative has emerged as a global best practice, gaining recognition as vital for preserving the reliability, standing, and long-term viability of Islamic Financial Institutions, especially those considered community bodies, like banks and takaful companies.

Responsibilities of Institutional Sharī'ah Governance Framework

- It will circulate Islamic rulings that will be mandatory on the Islamic financial bodies.
- The basic responsibility of the board is to ensure strict Sharī'ah adherence in all goods and instruments.
- They provide religious oversight and issue rulings (fatwas) on the permissibility of financial activities.
- Provide Sharī'ah guidance regarding the development of new product by assessing the product's structure, terms, and overall compliance with Islamic principles.
- To ensure that day-to-day operations and transactions comply with Sharī'ah principles.
- Oversees and coordinates all aspects of Sharī'ah governance to ensure that the Islamic financial institution's policies, practices, and procedures align with Sharī'ah principles.
- Periodic Sharī'ah audits and reviews are conducted to assess the ongoing compliance of the financial institution with Sharī'ah principles.
- Educate employees, especially those involved in designing, marketing, and executing financial products regarding Sharī'ah principles.
- Ensure ethical and religious considerations in operations and transactions of Islamic financial institutions.”

Sharī'ah Governance Framework in Pakistan

The Sharī'ah governance structure designed for Islamic banking in Pakistan is supervised and administered primarily by the State Bank of Pakistan. The SBP delivers specific principles and guidelines governing Islamic banking operations to ensure that Islamic financial organizations operate prudently, cope risks commendably, and maintain financial soundness. Pakistan's Islamic banking regulatory and supervisory framework aligns with international standards and best practices prescribed by standard-setting bodies such as the Islamic Financial Services Board (IFSB) and the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). This alignment facilitates cross-border transactions, enhances credibility, and promotes the integration of Pakistan's Islamic banking sector with global Islamic finance markets.

The most important aim of the Sharī'ah Governance Framework (SGF) is to reinforce general Sharī'ah conformity atmosphere of Islamic banking institutions and clearly describe the tasks and obligations of different units of Islamic banks together with the Board of Directors, Executive Management, Sharī'ah Board, Sharī'ah Compliance Department, Product Development, Internal auditors and External auditors towards Sharī'ah observance.

The Sharī'ah Governance Framework for Islamic banks operates at two levels i.e.

- i. Central Sharī'ah Advisory Committee in SBP
- ii. Sharī'ah Governance framework at Islamic financial institutions level

Sharī'ah Advisory Committee (SAC) The Sharī'ah Advisory Committee is highest figure in State Bank of Pakistan which brings views and guidance on Sharī'ah related issues. The Sharī'ah Advisory Committee comprises Sharī'ah scholars selected from among experts in Islamic jurisprudence, alongside technical members such as accountants, lawyers, senior officials from the State Bank of Pakistan, and specialists from other fields like Economics or Banking & Finance, possessing a strong understanding of Islamic finance principles and practices.

- The SAC is responsible for regulating and supervising Islamic banks, Islamic banking windows of conventional banks, and other Islamic financial institutions in Pakistan.
- Formulates policies, issues regulations, and provides guidance to ensure compliance with Sharī'ah principles and prudential standards.
- Conducts inspections, audits, and assessments to monitor the performance and compliance of Islamic banks and financial institutions.
- Serves as the highest authority providing guidance and advice on Sharī'ah related issues.
- Provides guidance to the State Bank of Pakistan regarding the development of prudential regulations tailored for the Islamic banking sector.

Shari'ah Governance Framework at Islamic Financial Institutions Level

Responsibility of Board of Directors According to the Sharī'ah Governance Framework of the State Bank of Pakistan (SBP), the Board of Directors (BOD) holds ultimate responsibility and accountability for ensuring that the operations of the Islamic Banking Institution fully comply with Sharī'ah principles.

- The BOD must appoint a Sharī'ah Board (SB) to establish and implement an effective Sharī'ah compliance framework.
- The BOD is also required to introduce a robust mechanism, including diligent oversight, to ensure the proper functioning of this framework and adherence to the fatawa, instructions, and guidelines issued by the Sharī'ah Board.
- Additionally, the Board must convene with the State bank as a minimum twice a year to receive a comprehensive update on the Sharī'ah conformity setting, identify any concerns or flaws and discuss suggestions for improving the Sharī'ah compliance environment.

Function of Executive Management (EM) The Executive Management of an Islamic financial institution is responsible for implementing the Sharī'ah Governance Framework

- Guarantee that method handbooks, product instructions, process workflows, and associated accords as well as deals, as endorsed by the Shariah Board, are available and clearly communicated to all members within their relevant teams or departments.
- Answerable and liable for implementing the rulings, verdicts, fatwa in addition to instructions issued by the Sharī'ah Board that pertain to their respective cluster or practical area (Rasul,2010).
- Responsible for coordinating with the Training Department and the Sharī'ah Compliance Department (CD) to provide adequate training for their team members.

Shari'ah Board (SB) Each Islamic financial institution in Pakistan is required to include a Sharī'ah Board (SB) composed of in any case three qualified Sharī'ah experts appointed by the Board of Directors (BOD). Members of the SB hold their position for a three-year term and can be reappointed thereafter.

- The Sharī'ah Board is authorized to review, select, and supervise all matters associated with the Sharī'ah compliance of the institution.
- Each verdict, decision as well as fatwa issued by the SB is compulsory for the institution, and the SB is responsible and accountable for all its Sharī'ah-related decisions.
- The SB is tasked with developing all-inclusive Sharī'ah compliance structure for entire parts of the institution's processes.
- The SB advises on the compatibility of financial products, services, and transactions with Sharī'ah principles, ensuring compliance and ethical standards. All products and services offered or launched by the institution must have prior approval from the SB.
- The SB provides guidance, reviews contracts, and resolves any Sharī'ah-related issues or disputes that may arise.

Resident Shari'ah Board Member The Shari'ah Board (SB) of an Islamic Banking Institution will, in collaboration with management, appoint one of its members, excluding the Chairperson, to serve as the Resident Sharī'ah Board Member. This member will supervise the processes in lieu of implementing SB's resolutions, declarations along with fatwa, and afford assistance accordingly. He should be selected on permanent basis.

Sharī'ah Compliance Department (SCD)

Each Islamic financial Institution must have a Sharī'ah Compliance Department (SCD). This may be directed by the Resident Sharī'ah Board Member or by a skilled, proficient, and experienced officer nominated by the Sharī'ah Board.

- i. Sharī'ah Compliance Department must be staffed with dedicated and adequate personnel, as advised by the SB, to effectively fulfill its responsibilities in a timely manner.
- ii. Additionally, the SCD must include at least one qualified Sharī'ah expert, separate from the RSBM.

Product Development (PD) Each Islamic Banking Institution (IBI) must establish a Product Development (PD) Department or Unit, which can either operate within the corporate entities or as an autonomous branch. The Product development is tasked with researching and developing Innovative and advanced goods as well as services tailored to meet the operational needs of the IBI, while taking into account global trends and best follows (Lateh,2010).

Internal Sharī'ah Audit Each Islamic financial Institution must establish an Inside Sharī'ah Audit department, that can remain integrated within the internal audit department or operate independently, based on the size of the IBI. The staff of the Internal Sharī'ah Audit Unit shall be exclusively dedicated to Sharī'ah audit tasks.

External Sharī'ah Audit To conduct an unbiased evaluation of the Sharī'ah control and acquiescence practices at an Islamic Financial Institution, the external Sharī'ah audit focuses on verifying the adherence of the institution's economic planning's, agreements along with businesses to Sharī'ah rules and principles (Chapra,2000). This includes

- Compliance with essential principles, directives, and course of actions give out via State Bank of Pakistan, which incorporate Sharī'ah standards from the Accounting and Auditing Organization for Islamic Financial Institutions as adapted through SBP.
- Adherence to rulings issued by the Sharī'ah Advisory Committee of SBP, as communicated by SBP.

- Compliance with relevant Islamic Financial Accounting Principles since mandated by the Securities and Exchange Commission of Pakistan furthermore disseminated through SBP.
- Confirmation of acceptance along with principles issued through the Sharī'ah Board of the IFI is in conformity with the instructions, protocols, and guidelines established by the SBP. These actions align with the rulings provided by the SBP's Sharī'ah Advisory Committee.

Conclusion

This study provided with a comprehensive overview of the regulatory framework governing Islamic banking. We begin by understanding the concept and necessity of an Islamic regulatory framework, exploring its objectives and purposes. Subsequently, we delve into the historical context of Islamic banking regulation, tracing its evolution and development. We then discuss the various regulatory bodies and authorities responsible for oversight and compliance. Furthermore, we examine the Sharī'ah governance framework and its pivotal role in ensuring adherence to Islamic principles. This unit provides learners with profound understanding of the regulatory framework governing Islamic banking, equipping them with essential knowledge for navigating this dynamic sector.

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