Determinants of *Shari'ah* Disclosure in Islamic Banking Institutions

Muhammad Ismail Rasheed
PhD Scholar, Institute of Management Sciences

Shafiullah Jan
Assistant Professor, Institute of Management Sciences

Karim Ullah
Assistant Professor, Institute of Management Sciences

Abstract

Disclosure is one of the fundamental principles of *Shari'ah* governance (SG) in Islamic Banking Institutions (IBIs). Furthermore, the religiously committed financial investors, depositors, and customers strongly consider the Islamic bank's *Shari'ah* related disclosure and transparency prior to any financial decisions. In the established Islamic corporate governance and *Shari'ah* governance related literature, dearth of information is available concerning *Shari'ah* disclosure arrangement. Therefore, the study is an attempt to fill this gap by exploring the *Shari'ah* elements that are considered by the Islamic banks' financial investors and customers. The purpose of the research is to explore the crucial *Shari'ah* determinants that need to be disclose by IBIs and which shape the decisions and perceptions of banking customers and general public towards Islamic banks. The nature of the inquiry is purely qualitative, where, phenomenology is used as a research strategy. In addition, the scope of the study is limited to the views of Islamic banking and finance academicians which serves IBIs as well. Apart from the existing explored elements of *Shari'ah* reporting and disclosure in the available literature, the study finds that, IBIs need to disclose their investment avenues and its proof of Islamicity, *Shari'ah* appraisal of the adopted products and services, and disclosure of the Islamic bank's contribution toward the *Maqasid al-Shari'ah* to the pertinent customers and general public at large. Furthermore, Islamic banks need to adapt their *Shari'ah* disclosure by considering the native school of *Shari'ah* interpretation/ *madhab* and simple native language. Similarly, to ensure good *Shari'ah* disclosure and transparency, IBIs also need to disclose their *Shari'ah* compliance position through actual *Shari'ah* based actions and practices.

Key Words: Customer Perception, Islamic Banking, *Shari'ah* Disclosure, *Shari'ah* Governance.

1. Introduction

Globally, Islamic financial practices started from twentieth century when almost all Muslim countries got independence (Ahmed, 2011). Initially, Islamic financial institutions (IFIs) were established in Egypt, Malaysia, Saudi Arabia, Jordon, Sudan, Kuwait, etc. These institutions were practiced without having a proper *Shari'ah* board, which advice and consult them on *Shari'ah* doctrines of finance and banking. During these initial years, most *Shari'ah* scholars were not familiar with techniques, contracts and procedures of modern financial institutions and markets, as they were trained neither in economics and finance nor in contemporary business law (Nienhaus, 2007). Furthermore, when *Shari'ah* scholars got trained in contemporary economics and finance, the concept of *Shari'ah* board emerged. The first *Shari'ah* board was established by Faisal Islamic Bank of Egypt in 1976. The practice then followed by Faisal Islamic Bank of Sudan and Jordon Islamic Bank in 1978, Kuwait Finance House in 1979, Bank Islam Malaysia Berhad in 1983, and Dubai Islamic Bank in 1999

(Hasan, 2012). After that, *Shari'ah* board has been considered a crucial part in the Islamic banks' corporate governance arrangement. *Shari'ah* supervisory board (SSB) is the backbone of *Shari'ah* governance framework. *Shari'ah* governance refers to the institutional arrangement to ensure *Shari'ah* compliance environment in IBIs (Hasan, 2012). Furthermore, IBIs certify their activities, operation, transactions, products, and services from their respective *Shari'ah* board.

Apart from that, somehow, IBIs also disclose the proof of Islamicity of their activities, operations, transactions, products, and services to their pertinent customers and somehow to general public as well. Furthermore, the financial investors, depositors, and general public make their investment decisions toward Islamic banks on the basis of IB's *Shari'ah* disclosure (Al-Mehmadi, 2004). According to Iqbal, Mirakhor, & Krichenne (2011), disclosure is one of the fundamental principles of *Shari'ah* governance in IBIs. The available Shari'ah governance literature covered much about governance design, importance, and procedure, however, *Shari'ah* disclosure is still a hidden area. So far, there is not a single literature available that guide us specifically about the *Shari'ah* information that need to be disclosed the Islamic banks' customers and general public, at all. The purpose of the research is to explore the crucial *Shari'ah* determinants that need to be disclose by IBIs and which shape the decisions and perceptions of banking customers and general public towards Islamic banks. To achieve the purpose of this study, this study set few objectives: i) to explore *Shari'ah* disclosure elements from the established literature, ii) to explore the experiences of Islamic finance academicians, who are affiliated with IFIs, concerning *Shari'ah* reporting, and iii) to make a detailed benchmark *Shari'ah* disclosure framework for IBI's.

The Conceptual scope of the study is limited to the views, opinions, and experiences of Islamic banking and finance academicians, which are somehow attached to the Islamic banking industry as well, related to the *Shari'ah* disclosure Islamic banking institutions. The reason of choosing Islamic finance academicians is that, they contribute to the *Shari'ah* governance framework through their research and publication. Moreover, the *Shari'ah* disclosure in this study refers to the disclosure of Islamic bank's *Shari'ah* information which shape the decisions and perceptions of pertinent customers particularly and general public as a whole. The study excluded the corporate governance disclosure requirements formulated by the Basel Committee for Banking Supervision, World Bank, European Council, International Organization for Securities Commission, Financial Accounting Standard Board, and for banking institutions.

2. Literature Review

One of the fundamental differences between Islamic banks and their conventional counterpart is, Islamic banks certify their products, services, contracts, operations, and activities with *Shari'ah*, while conventional banks do not go into any such certification mechanisms. *Shari'ah* governance is one of the crucial component under Islamic banks' corporate governance arrangement (Hasan, 2012), therefore, in this context, SG means, the mechanism through which the activities, operations, products, services, and contracts of a corporate entity such a company, financial institution, bank, etc. are complied with *Shari'ah*. Haqqi (2014) concluded that *Shari'ah* governance is simply the alignment of corporate governance with Islamic governance principles. Moreover, the Islamic principles on corporate governance are much broader than the conventional corporate governance principles because in Islamic corporate governance arrangement, person, institution, and organization is not only accountable to stakeholders but also to the Divine (Ginena & Hamid, 2015). In the context of Islamic banking, the requirements of *Shari'ah* as part of the corporate governance arrangement signifies the essence of maintaining the relationships between different stakeholders as well as the relationship with God (Hasan, 2012).

Iqbal, Mirakhor & Krichenne (2011) stated that, the participation of *Shari'ah* experts in corporate governance should be subject to five principles: independence; confidentiality; competence; consistency; and disclosure. The last principle of SG arrangements should promote transparency in *Shari'ah* rulings. It is also affirmed by Grais and Pellegrini (2006) that the participation of SSB in the governance process may raise the issue of disclosure of all information related to the Islamic bank's *Shari'ah* compliance environment. The Islamic bank's investment contractors, consumers, and other stakeholders keep great interest in the *Shari'ah* compliance environment of their concerned Islamic bank. Besides to confirm the Islamicity of Islamic bank's products and services, *"investors in Islamic banks are aware of the usefulness of the Shari'ah board's report when making investment decisions"* (Al-Mehmadi, 2004, p. 228). To sum up, to protect the religious commitment of their Muslim consumers and to survive in the market, adequate *Shari'ah* compliance disclosure is the essence of IBIs. The literature shows that there are various means through which bank accomplish their disclosure objective, such as bank own website and annual report. According to Ginena and Hamid (2015), it is crucial for IBIs to allow stakeholders to easily inspect *fatawa* along with juristic evidences and posted it to bank's website.

According to Grais and Pellegrini (2006), a transparent Islamic financial institution would ideally disclose the duties, decision making process, areas of competencies, the composition of its SSB, and all fatwas issued by their SSB. Hasan (2012) identifies four key function of SSB that should be disclose to the pertinent stakeholders and general public at all, these are: activities, duties, Shari'ah pronouncements, and declaration of bank's Shari'ah compliance environment. The content of Shari'ah disclosure should include more information, such as disclosure as to the defects in the products offered and recommendations to rectify the defects including actions taken by the management, basis of examination of the documents, declaration of Shari'ah compliance, and signatures of all Shari'ah board members (Haniffa & Hudaib, 2007). Besides other Shari'ah compliance requirements, the information related to charity account should be published through the annual Shari'ah advisors report (Rammal, 2010). Another prominent study conducted by Abdullah, Percy and Stewart (2013) on the Shari'ah disclosure of Malaysian and Indonesian Islamic banks, primarily focused on the disclosure of two factors which are Zakat and SSB's report.

The contents of Shari'ah disclosure in the State Bank of Pakistan (SBP) Shari'ah governance framework (SGF) for Islamic banking institutions are: initiation with the name of Allah, putting the statement that 'the BODs and executive management are solely responsible to ensure that the operations of the bank are conducted in a Shari'ah compliant manner at all times', disclosure of the Shari'ah compliance report issued by the external Shari'ah auditor, and SSB's opinions related to (a) whether or not the bank follows the issued fatwas, regulations, (b) whether or not the bank has a comprehensive mechanism to ensure Shari'ah compliance in their overall operations, (c) detail of prohibited earning and its credit and utilization report in the charity account, (d) the level of awareness of bank BODs, management and staff with Islamic banking and finance, and (e) report of the outstanding Shari'ah related issues (IBD-SBP, 2015). AAOIFI (1997) formulated seven key elements of an annual Shari'ah report, which are: title, addressee, opening paragraph, scope paragraph describing the nature of the work performed, opinion paragraph containing an expression of the opinion on the compliance of the IFI with Shari'ah rules and principles, date of the report, and Shari'ah supervisory board's signature. Maali, Casson, & Napier (2006) suggested a more detailed information that an Islamic bank needs to report especially to their pertinent customers and generally to the general public, these information are: disclosure of Shari'ah supervisory board opinion, disclosure of unlawful transactions, disclosure of Zakah, disclosure of Quard Hassan, disclosure of charity and other social activities, disclosure of justly dealing with its employees, and disclosure of late repayments of insolvent clients.

3. Research Methodology

The strategic nature of the current study is qualitative while the analysis approach is inductive. The research design adopted for the present study is phenomenology. *"Phenomenology is a design of research in which the researcher describes the lived experiences of individuals about a phenomenon as described by participants"* (Creswell J. W., 2014, p. 42). In the case of present study, primary weightage given to the opinions of Islamic finance academicians which serve, somehow, different IFIs as well. Recommendations of the past research methodologists normally adopted in determining sample size of interviews in a novel qualitative research (Marshal, Cardon, Poddar, & Fontenot, 2013). Therefore, following sample size's recommendation, the present study is inspired from the study of Rashid, Noreen, & Rehan (2016) in which they conducted six interviews in there phenomenological inquiry. In the existing inquiry, unstructured interview method adopted for primary data collection. Unstructured/ less structured interviews are more open through which the respondent(s) provide their experience, opinions, and motivations (Tracy, 2013). The data are manually analyzed by following Connor & Gibson (2003) approach to qualitative data analysis procedure. According to Lester (1999), in manual qualitative data analysis procedure, the first step is to identify the key theme of the data, the next step is to extract the important point(s) and organize it, and comparing the extracted points with its juxtaposed headings is the last step in manual analysis technique. In qualitative studies, interpretation refers to the presentation of result or theme identified from the data. One way of reporting the findings in qualitative studies is direct quotes, in which the participant's words are quoted in embedded passage (Lester, 1999). The results/ data's themes interpreted in this study are in the form of quotations in embedded passages. The sample size of the present study is seven, followed the conventional practice of phenomenology based inquiries.

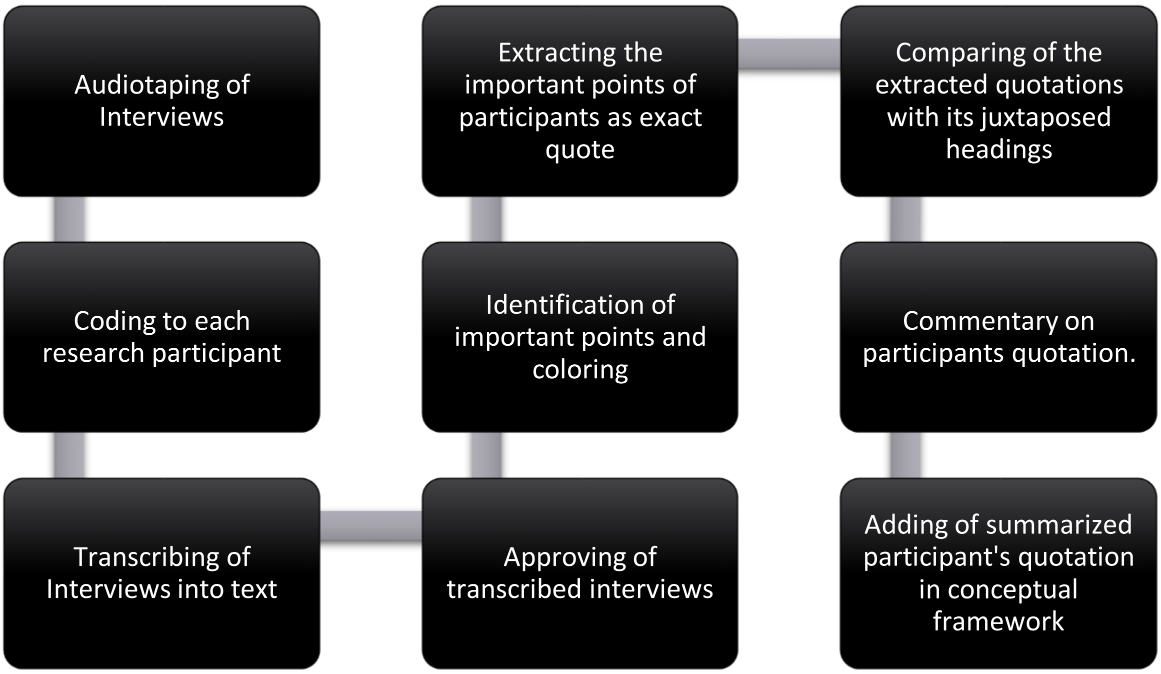

Figure 1: Analysis Process of the Study.

4. Analysis and Findings

Islamic banking is a unique kind of banking arrangement which is based on the religious stance and ideological commitment of a Muslim society. *Shari'ah* is the fundamental reason due to which the Muslim banking customers gradually converge towards the Islamic banks. Therefore, the customers of Islamic banks are very keen to know about the Islamicity of their entire operations, activities, and businesses. It is affirmed by a respondent, he argued:

"*One of the important factors which influences them [Islamic banks' customers] to come to the Islamic finance is because of the Islamicity of it, so they are very keen to know about whether they are really Islamic or not, to what extent they are [Islamic]" (P7).*

One of the fundamental difference between Islamic and conventional banks is that, Islamic banks involve real businesses and investment activities. Islamic banks invest the depositors' funds in halal investment avenues and the profit and loss then distributed on the basis of profit and loss that incurred in that particular business and investment activities. The study finds that, in respect of adequate *Shari'ah* disclosure, Islamic banks need to disclose their investment avenues and their proof of Islamicity which will provide evidence to their claim that Islamic banks really invested the depositors' funds in halal business activities. To support this argument, a respondent states:

"……Islamic banks need to disclose the information like the disclosures of investment avenues that where Islamic banks actually invest the funds of their customers, also the status and proof of their Islamicity" (P4)

Contemporary Islamic financial products and services are much vary from that of classical ones. They are more engineered and complexed, to fulfil the timely demand. Without reengineering and restructuring, survival for Islamic banks will be challenging in the present financial world. The people think that, there is no relation of the existing Islamic banking products and services with that of Islamic business products and services discussed in the classical jurisprudence volumes. Therefore, Islamic banks also need to disclose the *Shari'ah* appraisal of their adopted, engineered, modified, and compliant products and services. A respondent observed in this regards as:

"[Islamic banks need to ensure] Disclosure of Shari'ah appraisal of each adopted Islamic financial product and service, which means that how their adopted products and services related to the concern classical Islamic products and services" (P1)

Apart from the disclosure of product's Islamicity and contractual compliance, Islamic bank also need to disclose their contribution to the objectives of *Shari'ah*. As a respondent opinioned:

".....Another level of information are required for the disclosure is more towards the objective of Shari'ah, is see which one is missing [in the existing Shari'ah disclosure framework of Islamic banking institutions], when they [Islamic banks] talk about Shari'ah, on the first instance is, how the contract they are using are compliant? But also, how their activities are contributing to different Maqasid e Shari'ah? That will also be really important and would be a positive impact on that [decision and perception of customers and general public toward Islamic bank]" (P3)

Besides disclosure through different documents and media, the most effective means of *Shari'ah* disclosure would be showing *Shari'ah* disclosure through actions and practice.

Because, in Muslims majority countries, the people know about the basic creed of Islamic finance, therefore, they are well aware about the *Shari'ah* compliance financial activities. Therefore, when Islamic banks actually undertaking *Shari'ah* compliance activities and the pertinent customers and general public observing it, so it could be the ideal way to *Shari'ah* disclosure. In this context, a respondent stated that:

"Disclosure can be done by doing Shari'ah compliance, it means showing Shari'ah compliance through their actions, so for example, when they [Islamic banks] are doing Shari'ah compliance banking and people are seeing them doing banking that is also disclosure of what that they compliant" (P2)

It is crucial for the Islamic banks to disclose their *Shari'ah* compliance related information in a simple and easy language, because, it is observed that Islamic banks often use complex language and terminologies which a common man does not understand. Therefore, Islamic banking institutions should adopt native and easy language for their *Shari'ah* disclosure. A respondent viewed that:

"Islamic banks need to use easy language in their entire disclosure that is understandable to common man. Because I've seen that Islamic banks use complicated terms and vocabulary that are not understood by a lay man" (P5)

Another sub element of adaptability is disclosure through local interpretation of *Shari'ah*, which refers to *Shari'ah* disclosure by considering the local juristic school of thought/ *madhab*. Means, as there are different explanatory school of thought, which interpret the *Shari'ah* by considering the principles of their particular jurisprudence. Therefore, it may be possible, that a particular transaction is allowed in the eyes of native interpretive school of thought, but it may also be possible, that the said financial activity or transaction is not allowed in the eyes of another interpretive school of thought. Therefore, Islamic banks need to adapt their *Shari'ah* disclosure by considering the native or more followed (in their region) school of *Shari'ah* interpretation. A respondent expressed in this regard as:

"Disclosure of compliance in the local interpretations of Shari'ah. For example if you are offering that [Islamic financial products and services] to the region where there are different schools of thought, so how you are adapting your disclosure to that region? for example, if you are disclosing the same business activity in Iran, so, are you disclosing it's in their term, in their jurisprudence or not? So adaptability of the disclosure into different region and community to whom you are actually disclosing the information" (P6)

The above quotations are extracted from detailed narratives of seven respondents. These quotations are selected based on the thematic analysis approach in which the important themes are identified from the detailed narratives which are not previously identified in the established literatures. The quotations then summarized and grouped in their relevant themes. The summarized short themes then bolded, in the revised theoretical framework i.e. Figure 2, to show the contribution of the study to the established *Shari'ah* disclosure theory.

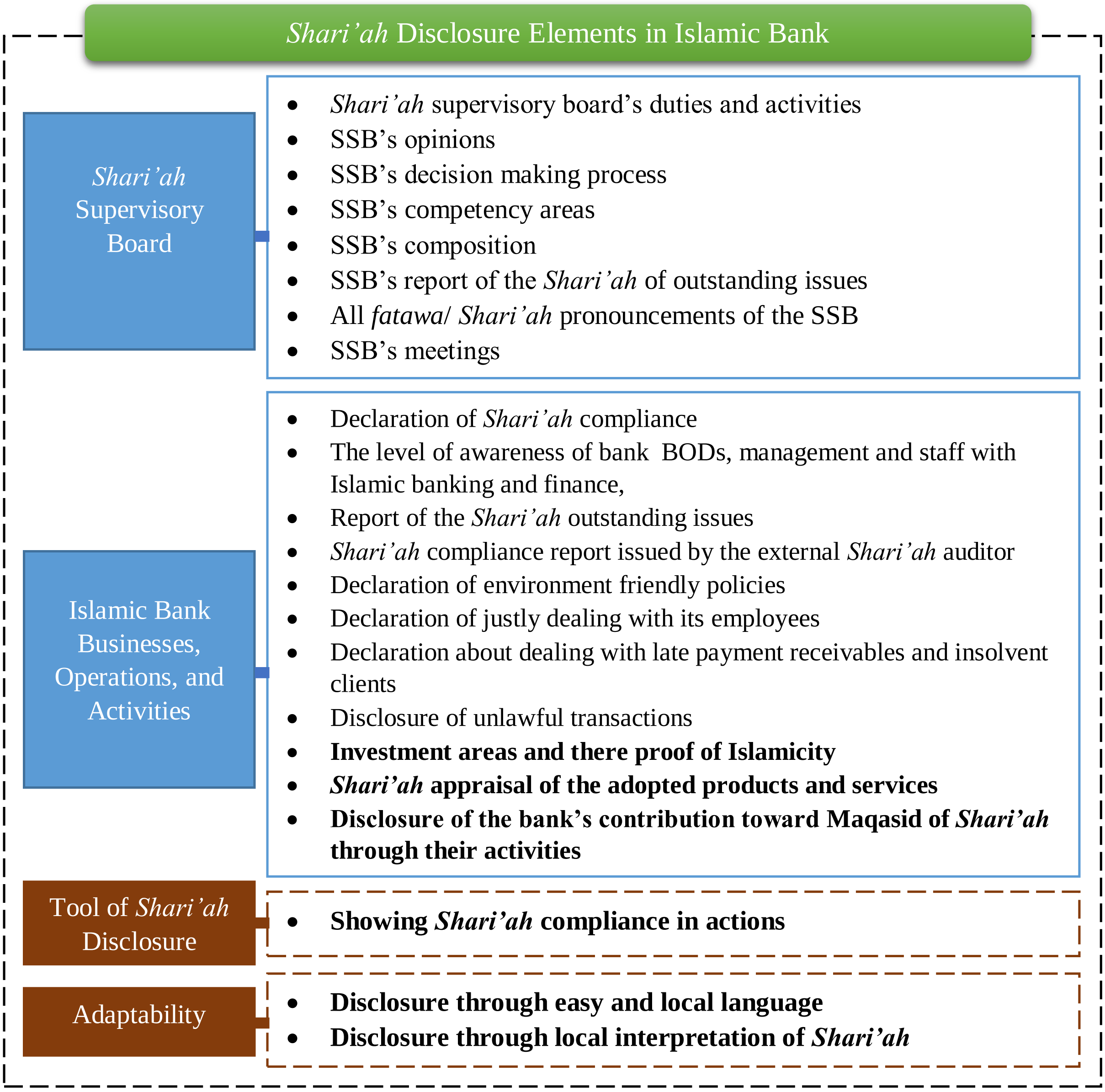

Figure 2: Elements of *Shari'ah* Disclosure in IBIs.

5. Conclusions

The study concluded that, *Shari'ah* is the fundamental reason due to which Muslim banking customers frequently converge towards Islamic banks, therefore, Islamic banks need to disclose sufficient information related to their investment avenues and there proof of Islamicity, *Shari'ah* appraisal of the adopted products and services, and disclosure of the Islamic bank's contribution toward *Maqasid e Shari'ah*. Furthermore, it is crucial for the Islamic banks to disclose their *Shari'ah* compliance related information in a simple and easy native language, because, it is observed that Islamic banks often use complex language and terminologies that a common man does not understand. Furthermore, there are different explanatory schools of thought, which interpret the *Shari'ah* by considering the principles of their particular jurisprudence. Therefore, it may be possible, that a particular transaction is allowed in the eyes of native interpretive school of thought, but it may also be possible, that the said transaction is not allowed in the eyes of another interpretive school of thought. Therefore, Islamic banks need to adapt their *Shari'ah* disclosure by considering the native or more followed, school of *Shari'ah* interpretation in their region. The most effective means of *Shari'ah* disclosure would be disclosure through actions and practice. Because, in Muslims majority countries, the people know about the basic creeds of Islamic finance, hence, they are well aware about the *Shari'ah* compliance financial activities. Therefore, when Islamic banks actually undertaking *Shari'ah* compliance activities and the pertinent customers and general public observing it, so it could be the ideal way to *Shari'ah* disclosure. To sum up, the study provides a *Shari'ah* information benchmark for IBIs. In addition to it, the study also provides benchmark for pertinent customers and potential investors who are making their investment decisions based on Islamic bank's *Shari'ah* disclosure.

Furthermore, any novel researcher interested in the pertinent area of *Shari'ah* disclosure may replicate the same for different geographical locations. The respondents of the present study were academicians that are associated to both Islamic finance academies and IFIs as well. However, to get more robust findings, it is strongly recommended to the emerging researchers to replicate the same study by considering the views of Islamic banks' customers, Islamic banks' management, and general public.

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