

The role of the Shariah board in the Islamic banks' governance

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Received: 26/04/2026

Accepted: 30/06/2026

Abstract

This paper aims to give an understanding of corporate governance in Islamic banking industry, outlines the responsibilities of the Shariah Board, and describes how they carry out their role to promote effective corporate governance in Islamic banks. A descriptive methodology was adopted based on literature review.

Keywords: governance, banking industry, Islamic banks, shariah board.

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Introduction

The issue of governance has received a great deal of attention and care from supervisory and regulatory authorities and international organizations, as well as from the banking industry at the regional and international levels, due to its major role in enhancing disclosure and transparency; and thus gaining the confidence of shareholders and interested parties. Islamic banks, like other financial institutions, have sought to apply corporate governance principles in order to ensure their financial performance.

The Islamic concept of corporate governance highlights the qualities that Allah (God) expects from individuals: accountability, transparency, and trustworthiness. In this framework, managers and employees are, by their personal commitment to religious principles, accountable not only to shareholders and customers but also to regulatory authorities and society as a whole.

From that, the purpose of corporate governance in Islamic banks differs from that of other firms. In Islamic financial institutions, corporate governance serves as a mechanism to ensure fairness for all stakeholders by promoting greater transparency and accountability in accordance with Islamic principles. According to **Ibrahim (2010)**, the corporate governance of Shariah-compliant businesses begins by examining the transaction structure to determine whether it includes elements that could invalidate profits or gains. This is because Shariah law focuses not only on the substance of business but also on its form.

Thus, the key aspect of corporate governance in an Islamic bank is ensuring compliance with Sharia principles. As a result, Islamic banks have a complex governance structure. In fact, Islamic financial institutions are subject to two internal governance bodies: the Board of Directors and the Shariah Supervisory Board (**Lewis, 2007**).

➤ ***Problem and objectives of research***

From the above, the following main problem can be raised:

What are the foundations of governance in Islamic banks? And what is the role of the Shariah board?

The objective of this research is to give some understanding of:

- corporate governance in Islamic perspective
- corporate governance in Islamic banks and its principles
- Shariah board and its function in Islamic banking governance

➤ ***Methodology and structure***

Given the theoretical nature of this paper, we employed a descriptive research methodology, primarily focusing on reviewing existing literature related to the conceptual, theoretical, and foundational frameworks of Islamic corporate governance models in banking industry with a reference to the role of the Shariah board.

From this, we structured the paper in five elements:

- Corporate governance in Islamic perspective
- Corporate Governance Framework in Islamic banks
- The Shariah board
- Stages of Shariah board supervisor in Islamic banks
- The role of Shaiah board governance in banking operations (selected products)

1. Corporate governance in Islamic perspective

According to **Aji Haqqi (2014)** « *Governance is a method that an organization adopts to ensure that components of the organization follow the set rules, regulations, policies and processes* ». OECD standards (well recognized by the international community) of Corporate Governance include (**OECD, 2004**):

- Ensuring the Basis for an Effective Corporate Governance
- Framework,
- The Rights of Shareholders and Key Ownership Functions,
- The Equitable Treatment of Shareholders,
- The Role of Stakeholders in Corporate Governance,
- Disclosure and Transparency, and
- The Responsibilities of the Board.

The concept of corporate governance from an Islamic perspective closely aligns with the conventional definition, as it refers to a system through which companies are directed and controlled to achieve their objectives while safeguarding the interests and rights of all stakeholders. However, within the Islamic framework, corporate governance presents unique characteristics and features that distinguish it from conventional systems. It is seen as a specific application of a broader decision-making theory, grounded in Islamic socio-scientific epistemology, which is based on the divine oneness of God. **(Choudury & Hoque, 2004)**

The corporate governance model in Islam has distinct features that set it apart from the Western concepts of the Anglo-Saxon and European models. It integrates elements of *Tawhid* (the Islamic principle of oneness), *Shura* (the concept of Islamic consultation), Shariah law, and upholds private objectives while also emphasizing the importance of social welfare duties. **(Zulkifli, 2009)**

Corporate governance in both Islam and the West plays a crucial role in achieving the specific goals and objectives of a corporation. However, Islam adds an additional layer of value by emphasizing the principle of *Maqasid Shariah*, which is not present in the Western concept. **(Choudury & Hoque, 2004)**

According to **Zulkipli (2009)**, the differences between Islamic and Western corporate governance highlight distinct approaches in style and structure. Islam rejects rationalism as the basis for corporate governance, instead emphasizing Tawhid (the oneness of Allah) as its guiding principle. While the Anglo-Saxon model focuses solely on shareholder value and the European model protects all stakeholders' interests, Islamic corporate governance aims to achieve the *maqasid Shari'ah*, which protects the rights of all stakeholders in accordance with Shari'ah law. The management of Islamic corporate governance is based on *Shura* (consultation) and a collaborative, evolving process, with the Shari'ah board

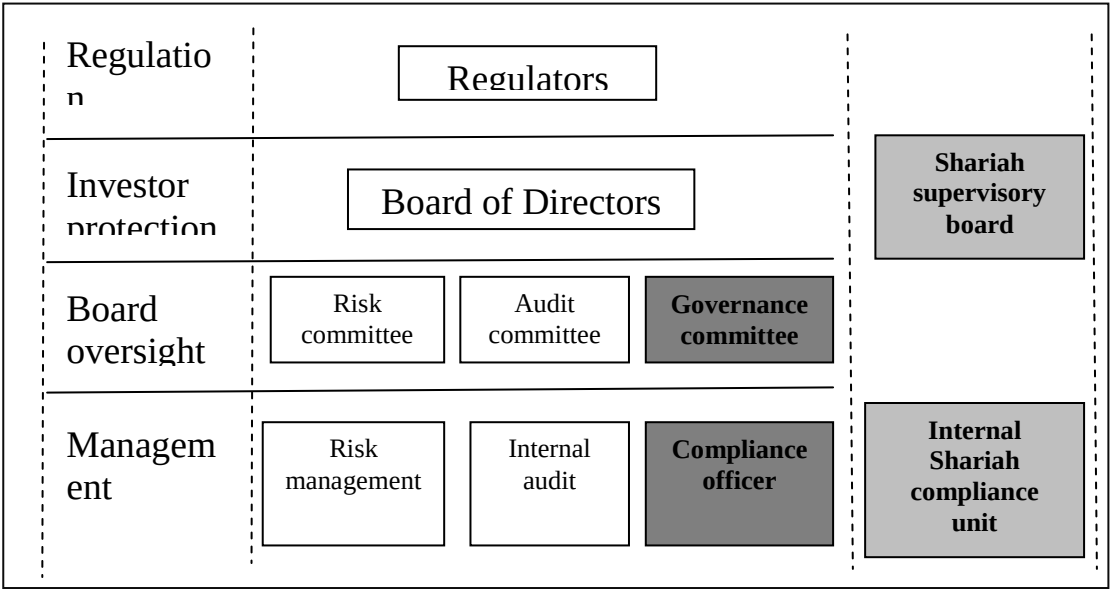
overseeing compliance with Islamic principles. Unlike Western models, Islamic governance includes both shareholders and investment account holders as rightful owners. Its unique features integrate Tawhid, Shura, Shari'ah law, and social welfare, balancing private and societal goals.

2. Corporate Governance Framework in Islamic banks

Corporate governance is essential for financial institutions and the banking sector as a whole. Banks and financial institutions play a vital role in the economy, and it is important for them to follow robust corporate governance standards.

Regulatory bodies and central banks in several countries have developed an Islamic corporate governance framework to promote effective governance practices and eliminate poor governance at Islamic financial and banking institutions. The important components of the framework are illustrated in figure 1.

Figure 1: Governance structure for an Islamic financial and banking institution



Source: Shanmugam & Zahari (2009)

Islamic corporate governance practices may mandate the disclosure of the composition of the Shariah advisory body and the publication of all fatwas (religious opinions) issued by the body. These public disclosures help enhance stakeholders' trust in the institution's assessment of its Shariah compliance.

Shariah governance in Islamic banks is a multifaceted process, which mainly includes the following sub-processes (*IFSB, 2009*):

- *Process for issuing legal opinions and compliance decisions.*
- *Process for disseminating legal opinions and decisions of the Shariah board.*
- *Internal audit process for compliance with Islamic finance principles* (operates under the supervision of the Shariah board in addition to the accounting audit committee).
- *External audit process for compliance with Islamic finance principles* (operates with an external audit and issues and publishes at the end of this process an annual compliance report during the accounting year).

Based on the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) standards, the Shariah governance framework is designed to meet the following objectives (*Istrefi, 2020*):

- Sets out the expectation of the Bank in Shariah governance structures, processes, and arrangements to ensure that all its operations and business activities are in accordance with Shariah.
- Provides comprehensive guidance to the board, Shariah committee, and management of the IFI in discharging its duties in matters relating to Shariah.
- Outlines the functions relating to Shariah review, Shariah audit, Shariah risk management, and Shariah research.

To achieve these objectives Shariah governance should follow seven important principles presented in the table 2.

Table 2: The seven principles of Shariah governance framework

Principle 1	The board of directors should establish their own IFI’s Shariah governance framework, where they are expected to understand the Shariah non-compliance risks associated with Islamic finance business and its possible implications to the respective IFIs.
Principle 2	The ultimate responsibilities on Shari’a compliance lie on the board of directors through the Shariah Committee plays a key role to ensure its compliance, where the Shariah Committee should comprise of a minimum of 5 members of which the majority is Shari’a experts
Principle 3	Outlines the importance of observing the independence of the Shari’a Committee in exercising their duties to make objective and informed decisions.
Principle 4	Pointed out the importance of right competency, understanding, and continuous knowledge enhancement on the Shari’a as well as keep abreast of the latest developments in Islamic finance
Principal 5	Outlines the importance of confidentiality treatment of information obtained by the Shari’a Committee
Principle 6	Illustrates the professional ethics, judgement, and consistency to be maintained in ensuring Shari’a compliance
Principle 7	Outlines on the need for a robust Shariah compliance function that comprised of review and audit functions, supported by risk management control process and internal research capacity.

Source: Istrefi (2020)

In order to ensure the proper implementation of governance in Islamic banks, a set of elements are required to assist this process, which are as follows

- Establishing strategic objectives and a set of criteria and principles to be followed, which should be well-known and accessible to all employees of the organization.

- Ensuring the competence of board members and their awareness of the responsibilities assigned to them in the governance process, while ensuring they are not influenced by internal or external factors.
- Ensuring that the incentive system aligns with the organization's rules, objectives, and environment.
- Ensuring transparency so that stakeholders are fully informed about the organization.
- The need for external auditing in various operational areas to ensure impartiality, integrity, and effective oversight.

3. The Shariah board

a. Definition and origin

From a historical perspective, the origin of the Shariah board is part of the activities of the so-called “*al-hisba*”, an ancient Islamic tradition, considered as the ethical authority of the markets and which was responsible for the verifications and control of measures and frauds in commercial transactions (**Ould Sass, 2010**). In modern times, the formal creation of three Islamic financial institutions, during the 1970s, namely: (i) *Dar Al-Maal Al Islami*, in Geneva, Switzerland (by Prince Muhammad Al-Faisal), (ii) *Bait al-Tamweel Al-Kuwaiti* – Kuwait Finance House, in Kuwait (by Sheikh Bazee al Yaseen), and (iii) *Dallah Al Baraka Group*, in Jeddah, Saudi Arabia (by Sheikh Saleh Kamel), was accompanied by a need to create a legal code in accordance with the principles of Islam (**Yahia, 2010**).

For this purpose, the creators of these institutions resorted to the highest religious authority of that time, the Al-Azhar Seminary in Cairo (Egypt), for the creation of the first Shariah board, with the contribution of Sheikh Mohammad Khater (the Grand Mufti of Egypt), Sheikh Muhammad Badr Abdel Basset

(among the elite of the Daar-Ul Uloom, faculty of the Ain Shams University in Egypt), and a group of jurists from Egypt, Syria, Sudan, Jordan and Saudi Arabia; and later from Malaysia, Pakistan and India. Over the years, the committee developed the terminology relating to Islamic banks, the rules and standards of operation, as well as the financing mechanisms and services compatible with Islamic law.

The Shariah board is defined, by the Governance Standard No. 1, of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) as: *« an independent body of specialized jurist in fiqh almuamalat (Islamic commercial jurisprudence) that is entrusted with the duty of directing, reviewing, and supervising the activities of the IFI in order to ensure that they are in compliance with Islamic Shariah rules and principles »*. The Shariah board is thus responsible for ensuring that all functions and transactions of the institution are compatible with Sharia, and is responsible for the certification of each product, financing model and service offered (**Yahia, 2010**).

The Shariah Board is responsible for guiding, reviewing, and overseeing the activities of Islamic banking Institutions to ensure compliance with Shariah principles. The significance of Shariah supervision stems from five key areas: religious, economic, legal, and governance considerations. To address issues related to agency theory, Shariah board members should serve on no more than three Islamic banks simultaneously, and they must not be selected from the institution's directors or majority shareholders. (**Istrefi, 2020**)

b. Functions and qualification of the Shariah board members

Banaga et al (1994) conducted on external corporate governance in Islamic banks and summarized the functions of the Shariah board as follows:

- Reviewing and revising all transactions and dealings between the bank and its clients to ensure compliance with Shariah. Transactions that contradict Shariah principles will not be approved.
- Holding regular meetings to address inquiries from management, with minutes of the meetings typically recorded.
- Collaborating with the bank's legal advisor to prepare contracts.
- Assisting in the preparation of drafts for decrees, decisions, and orders issued by the bank, and providing explanatory notes for them.
- Conducting studies and research to ensure zakat resources are directed to eligible recipients, and determining the rate or percentage of zakat that can be invested according to Shariah guidelines.
- Performing technical reviews and monitoring to ensure that Shariah compliance is maintained across the bank, its branches, and its affiliated companies.

In order to ensure the proper functioning of the Sharih Board, the election of its members is done according to a certain number of qualifications. **Lahsasna (2010)** outlined the qualifications for members of the Shariah Supervisory Board (SSB) as follows :

- A member of the Shariah Committee must be an individual; a company, institution, or organization cannot serve as a member.
- The individual proposed for the Shariah Committee must have at least one of the following qualifications, knowledge, expertise, or experience: a) Islamic jurisprudence (*Usul al-Fiqh*); or b) Islamic transaction/commercial law (*Fiqh al-Mu'amalat*).

A Shariah supervisor must have a background in classical Shariah sciences, specifically having studied *fiqh al-muamalat*. They should also be knowledgeable

in *Usul al-fiqh*. Additionally, it is considered beneficial if Shariah supervisors have contributed academic work or research on various aspects of these rules.

DeLorenzo (2010) emphasized that, in addition to the aforementioned qualifications, a Shariah supervisor should possess linguistic capabilities, particularly proficiency in classical Arabic, and the ability to interpret legal texts, glosses, and commentaries in that language. Furthermore, a solid understanding of modern finance, markets, and economics is essential. An effective Shariah supervisor must also be familiar with international business practices (urf) and have an understanding of regulatory environments. As such, proficiency in the English language is particularly important. Additionally, the supervisor should be capable of working effectively within a team.

4. Stages of Shariah board supervisor in Islamic banks

The Shariah board carries out its tasks according to three stages, which are as follows:

a. Preventive supervision (before implementation):

It is referred to as preventive supervision for transactions and projects that the bank management intends to implement. The Shariah board gathers all the necessary data and information, which is then presented to the Fatwa board for their opinion before the bank proceeds with implementation. If it is found to be in violation of Shariah principles, it is either excluded or modified to comply with Shariah rulings.

The topics and issues are presented to the board in advance, before the bank executes any transaction or activity. If the board approves the matter, the action is permitted; otherwise, it is abandoned. The board prepares and ensures that all

necessary elements are in place at the executive level to guarantee that operations are conducted based on Islamic principles, including models, contracts, documents used, policies, and the formulas for financing and investment applied by the bank, as well as the bank's relationships with clients, the central bank, and other banks.

Therefore, Shariah board at this stage should:

- Conducting Shariah review of contract formats and proposals for new investment methods.
- Ensuring Shariah compliance in the articles of incorporation and the bank's bylaws.
- Developing a practical Shariah guide.
- Identifying additional Shariah-compliant formats suitable for the Islamic bank to keep pace with advancements in banking methods and services.

b. Corrective supervision (during implementation):

It involves reviewing and auditing the banking and investment transactions that require a Shariah opinion. This includes Shariah monitoring of the bank's operations through various stages of implementation, ensuring the bank's full compliance with the issued fatwas, and continuously monitoring corrective actions. These processes occur alongside the performance and progress of the bank's operations, during board meetings and discussions with the general manager.

It also involves supervising how banking tasks are carried out by employees, including the following:

- Providing Shariah opinions on transactions referred to the board.

- Requiring the board's approval before completing investment projects, prior to taking the final step in execution.
- Promptly investigating Shariah-related complaints during implementation and taking necessary actions.
- Reviewing reports from the Shariah audit board concerning the Shariah review of the bank's transactions.

c. Supplementary supervision (post-implementation) :

At the end of each year, the Fatwa board must evaluate the bank's operations from a Shariah perspective, as the foundation of the bank is based on applying the principles of Islamic banking. This requires the board to conduct continuous reviews of the bank's activities. This review is carried out through several means, including:

- Reviewing the files of investment transactions after implementation.
- Reviewing the general balance sheet and the auditor's report.
- Reviewing reports from external regulatory bodies, such as the central bank.

Based on this review, the board provides a periodic report expressing its opinion on the transactions carried out by the bank and its compliance with the fatwas issued by the board, as well as the guidelines and recommendations provided.

5. The role of Shaiah board governance in banking operations (selected products)

The Shariah board has a major role in developing banking operations by applying Shariah rules to the contract first, excluding what is contrary to Shariah rules second, and striving to find a Shariah alternative that is consistent with the rules, third.

Here is how the of the Shariah board supervises some transactions conducted by the bank:

a. Murabahah:

It is transferring what was owned in the first contract with an increase profit. The Shariah board shall have the following duties in murabahah transactions:

- Reviewing the Murabaha contract for purchasing between the bank and the client, which includes details about the goods, the profit amount, the payment method and its duration, the grace period, and any other conditions, and ensuring the contract's validity and that it is free of interest (riba).
- Reviewing the specifications and price of the goods requested for purchase (or the price quotation invoice).
- Reviewing the purchase invoice in the name of the Islamic bank, issued by the supplier, which includes details of the purchased goods.
- Verifying that the bank has paid for the goods.
- Reviewing the delivery receipt from the supplier to ensure the goods were delivered without defects, and reviewing the delivery report signed by the client according to the terms.
- Ensuring that the guarantees are in compliance with Shariah.
- Accounting for the portion paid by the client to the bank, and documenting the deferred promissory notes equivalent to the remaining sale value owed by the client (cost plus the agreed profit).

- Verifying the registration and transfer of ownership procedures.
- Ensuring the chronological order of transactions and verifying that the sale to the client occurred after the bank purchased and took possession of the goods, not before.

b. Salam sale

It is a sale of goods that are described in terms of quantity and quality, with a price paid in advance.

Shariah board shall have the following duties in salam transactions:

- Ensuring that the contract model has been approved by the Fatwa board.
- Verifying that the subject of the sale (the goods to be delivered) is known in terms of type, quantity, quality, and characteristics, to avoid ambiguity that could lead to disputes.
- Ensuring that the delivery of the goods is deferred to a known date.
- Verifying that the subject of the sale is not money, as money cannot be sold in this context.
- Ensuring that the goods are deliverable upon the agreed time.
- Verifying the location of delivery is known.
- Ensuring that both the price (money) and the goods to be delivered are free from elements of interest (*riba*).
- Ensuring that the contract is final and binding, with no option for cancellation by either party.
- Ensuring that the capital of the Salam sale is paid in full and delivered to the seller immediately in the contract session, before the two parties part ways.

- Verifying that the capital of the Salam sale is clearly stated and its amount is known.
- Ensuring that the guarantees are in compliance with Shariah.

Conclusion

Through this article, we have shown that corporate governance refers to the system by which a corporation is managed, directed, and controlled. While Islamic banking institutions share many similarities with conventional banking institutions, having an effective corporate governance framework is essential for their operations. However, unlike conventional banks, Islamic banks have the added responsibility of ensuring that their products, instruments, operations, practices, and management adhere to Shariah principles.

The Shariah board possesses unique governance features. Shariah governance, which is integral to Islamic banks, specifically addresses the religious aspects of their operations, distinguishing it from traditional corporate governance. Operating as part of the bank's internal governance framework, the Shariah board serves as an internal control body, boosting the institution's credibility with customers, shareholders, and other stakeholders.

Shariah governance safeguards not only shareholders but also all stakeholders involved in the operations. Therefore, Islamic corporate governance aims to resolve disputes among stakeholders by applying the Shariah principles set by the Shariah board. The Shariah board is responsible for overseeing and monitoring Islamic banking activities to ensure they stay within the boundaries of Shariah law. The board consists of experts with extensive knowledge in Islamic finance and Shariah jurisprudence.

However, the lack of a clear understanding of the concept of governance within the minds of the bank's management will lead to numerous problems for the board, especially when there is no clear methodology adopted by the bank's management for the Shariah board's operations. Among the problems faced by the Shariah board in Islamic banks are

- The scarcity of scholars specialized in banking transactions and contemporary economic issues.
- The rapid and significant development in economic transactions and the difficulty of keeping up with them through issuing fatwas and providing legal rulings.
- The lack of prompt response to the Shariah board's decisions by the bank's management.
- The pressures that the bank's management may exert on the Shariah board to approve some actions, and the management may rely on the authority's lack of full knowledge of the details of banking transactions.
- The Shariah board is narrow, as its role is often limited to a question-and-answer format, and it does not correct errors or provide a legal alternative.

Recommendations

The Shariah Board in Islamic banks plays an important role in regulating the practices of Islamic financial institutions in accordance with the provisions of Islamic Shariah. To activate its role, we suggest the following means:

- The mandatory nature of the decisions made by the Shariah board in Islamic banks.

- Training and educating employees in Islamic banks.
- Establishing a clear methodology for issuing fatwas, decisions, and recommendations.
- Not adhering to a single juristic school of thought, but rather choosing the opinions that achieve the best interest, in accordance with the established guidelines in this field.
- Taking into account the decisions of the global Islamic jurisprudence council and the standards of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI).
- This board must have complete independence from the management of the Islamic bank it operates in, in order to ensure the credibility of its decisions and fatwas.

It should be noted that some of these suggestions have been mentioned by specialists in their dedicated studies, but they have not been implemented in practice.

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