

The Compliance with *Shariah* Governance System of AAOIFI: A Study on Islamic Banks Bangladesh

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Abstract

The study examines the compliance levels of 17 private commercial banks, which operate Islamic banking in Bangladesh, with Shariah governance system of AAOIFI to understand their Shariah non-compliance risk management status. The results show that none of the Islamic banks in Bangladesh are full-compliant with Shariah governance system of the AAOIFI because none of them has audit and governance committee at board level. The average of Shariah compliance levels of the full-fledged Islamic banks is highest but it is medium and lowest against the banks, which operate Islamic banking through some Islamic bank branches and windows, respectively. However, the banks conduct Shariah audit and inspections by the Shariah Supervisory Committees (SSCs). Some limitations of the SSC have been observed. These are: some banks formed the SSC with both outsiders and insiders, but appointment of insiders is a complete deviation from the AAOIFI standards. Reports of the SSC have not been presented in a uniform way which creates confusion among the stakeholders regarding information. Though disclosure of doubtful income indicates operational efficiency of Shariah based banks, some reports of the SSC did not mention the amount of doubtful income at all. It has been hypothesised that if there is more compliance with Shariah so there shall be higher growth of Islamic banking. The study therefore suggests that the Shariah compliance levels should be increased by all banks. Moreover uniformity and transparency should be ensured in the reports of the SSCs. All of these shall not only help to mitigate Shariah non-compliance risk but also re-enforce the growth and company efficiency of the Islamic banks Bangladesh.

Key words: *AAOIFI Standard, Shariah based banks, Shariah governance, Shariah Supervisory Committees*

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Introduction:

The *Shariah* governance systemⁱ is meant to address a specific type of risk exclusive to Islamic financial institutions (IFIs); the *Shariah* non-compliance riskⁱⁱ. The significance of *Shariah* non-compliance risk to the Islamic finance industry can be illustrated in the case of declining *sukuk* issuances due to the statement made by the Chairman of the Accounting and Auditing Organisation of Islamic Financial Institutions (AAOIFI) *Shariah* board, the Organization of the Islamic Conference (OIC) *Fiqh* Academy's declaration on the impermissibility of *tawarruq*, and the Malaysian High Court's judgment on the issue of bay' *bithaman ajil* (BBA). All of these major cases indicate the very significance of *Shariah* governance system as a risk management tool to mitigate *Shariah* non-compliance risk (Dusuki, 2011). The Islamic financial Services Board (IFSB) Guiding Principles on Risk Management (IFSB-1) specifically classifies the *Shariah* risk as part of the operational risks which can be managed through a sound and proper *Shariah* governance system (IFSB, 2002). The *Shariah* governance system would help IFIs to mitigate *Shariah* non-compliance risk that may incur unimaginable potential of loss and negate an IFI's credibility. The AAOIFI has taken the initiative to provide basic guidelines for a *Shariah* governance framework in its governance standards No. 1-5 (AAOIFI, 2005). Bangladesh Bank (BB), in its 'guidelines for Islamic banking,' has also fixed responsibility for *Shariah* compliance (BB, 2009). In this perspective, three questions have been raised here: Is the *Shariah* governance system of Islamic banks Bangladesh as per AAOIFI standards? What are the levels of compliance with the *Shariah* Governance Standards of AAOIFI in Islamic banks Bangladesh? Is there any anomaly in the *Shariah* compliance?

Views expressed are those of the authors own and do not represent in any way the organizations in which they are employed.

Therefore the objectives of the study are as follows:

1. To depict the levels of compliance with the *Shariah* Governance System of AAOIFI in Islamic banks Bangladesh;
2. To understand their *Shariah* non-compliance risk management status;
3. Discuss the limitations of the *Shariah* Supervisory Committees (SSCs) of Islamic banks Bangladesh if any; and
4. Suggest the measures to increase the *Shariah* compliance level..

Significance

The philosophical foundation of corporate governance in Islam requires an additional layer of governance for the purpose of *Shariah* compliance. With this aspiration, corporate governance in IFIs needs a set of institutional arrangements to oversee the *Shariah* compliance aspect of their business and operations. In the absence of a specific model of corporate governance in Islamic literatures, the *Shariah* governance system was introduced to complement the existing corporate governance framework in IFIs. In this regard, a *Shariah* governance system is peculiarly exclusive and unique to the corporate governance framework in IFIs, unlike their conventional counterparts (Dusuki, 2011).

In parallel with the growth of the Islamic finance sector in Bangladesh and worldwide; and the complexity of duty and responsibility of the *Shariah* board towards different stakeholders, it is strongly indicated that there must be a sound and proper *Shariah* governance system. The *Shariah* governance system enhances and strengthens the function of the *Shariah* board and its related institution for the purpose of *Shariah* compliance.

Shariah governance is a unique kind of governance in financial architecture as it is concerned with the religious aspects of the overall activities of IFIs. The existing standard setting agencies such as the Organisation of Economic Cooperation and Development (OECD), the International Organisation and Securities Commission (IOSCO) and the Basel Committee on Banking Supervision (BCBS) have issued numerous guidelines on governance and risk management for financial institutions. The OECD has issued Guidelines on Corporate Governance, the IOSCO on capital market and the BCBS on Basel Committee I, II and III. Nevertheless these standards and guidelines failed to address specific issues of Islamic finance (Dusuki, 2011).

As the nature and model of Islamic finance are different with the conventional counterparts, the need for a standard-setting agency specifically for the Islamic finance was crucial and hence, with the initiative of several IFIs and regulatory authorities, the AAOIFI and the IFSB were established in 1992 and 2004 respectively. The AAOIFI has issued five governance standards while the IFSB has issued three Prudential Standards and one guiding principles on the governance in IFIs.

The difference between the IFSB Prudential Standards and the AAOIFI Governance Standards is that the IFSB approach is more concerned towards regulators while the

AAOIFI, to individual IFIs (Dusuki, 2011). The study therefore has been undertaken, based on the AAOIFI standards, to make a study on the *Shariah* governance system of individual commercial banks of Bangladesh.

Methodology and scope

A list of the banks under study is given in appendix table 1. The levels of compliance with *Shariah* in Islamic banks Bangladesh has been assessed based on the standards of *Shariah* governance system of AAOIFI. The *Shariah* based private commercial banks Bangladesh has been classified into three categories, such as:

- (i) **B1**: full-fledged Islamic Banks,
- (ii) **B2**: banks which are not full-fledged Islamic but operate Islamic banking through some Islamic bank branches, and
- (iii) **B3**: banks operate Islamic banking through some windows.

The findings therefore would reflect the levels of *Shariah* compliance with the standards of *Shariah* governance system of AAOIFI. The study used 'content analysis' to assess compliance with five standards of AAOIFI on *Shariah* governance of Islamic banks Bangladesh. Content analysis is a way to categorise various items of a document into a number of categories. It is an appropriate method to use where a large amount of qualitative data to be analysed. The use of content analysis has been supported by a number of authors for similar type of research (Boyatis, 1998; Krippendorff, 1980). It may be mentioned here that the main issue in content analysis is reliability. Milne and Alder (1999) identified different types of reliability and this occurs in the process of coding. The main problem that arises in coding is when more than one code is encoding the data. In the study, there are only five standards of *Shariah* governance system and 7 Islamic banking companies Bangladesh are involved. The five *Shariah* governance standards of AAOIFI addressed in the study are: (i) Governance Standard for IFIs No. 1: *Shari'ah* Supervisory Board: appointment, composition and Report; (ii). Governance standard for IFIs No. 2: *Sahriah* review; (iii) Governance standard for IFIs No. 3: Internal *shariah* review; (iv) Governance standard for IFIs No. 4: Audit and governance committee; and (v) Governance standard for IFIs No. 5: independence of the *Shariah* board.

In order to conduct the study, secondary data were collected from the annual reports of the banks under study. Annual reports for the year 2011 were collected from the head offices of the banks. In order to address the standards of *Shariah* governance system of Islamic banks Bangladesh, the five standards of AAOIFI has also been referred. Data of respective banks were analysed and compared with the requirements of the standards to interpret the findings. Without coding the five standards, the authors conducted a sentence by sentence analysis to determine compliance in the line

of the methods used by Shrives and Linsley (2003). To analyse find the limitations of the *Shariah* Supervisory Committees (SSCs), the annual reports 2011 of seven full-fledged Islamic banks have been studied carefully.

Literature Review and hypothesis

To develop a hypothesis of the study following literature has been reviewed:

Choudhury (2006) examined the mind-set of Islamic economics and finance organisations to show that the pursuit of capitalist globalisation is deep in their agenda. Thereby a narrow (Fiqhi) interpretation of the *Shariah* is followed, leaving aside the *Tawhidi* core. Much needs to be done along both the conceptual and applied perspectives of the Islamic worldview in economy, finance, society and the socio-scientific entirety.

Hassan and Chachi (2008) investigated the practices of corporate governance of Islamic financial service industry in Brunei Darussalam with a view to assess the level of compliance. The study has also focused the role of *Shariah* Supervisory Board (SSB) and how it adds value to the Board of Directors as well as to the corporate governance in the context of the Islamic financial institutions (IFIs). The main aim of this study was to bring in the research arena the state of corporate governance in the Islamic financial institutions in Brunei Darussalam drawing data from Islamic banks and Islamic Takaful companies.

Iqbal (2005) found that there is lack of uniformity in the religious principles applied in Islamic countries. In the absence of a universally accepted central religious authority, Islamic banks have formed their own religious boards for guidance. Islamic banks have to consult their respective religious boards, or *Shariah* advisors, to seek approval for each new instrument. Differences in interpretation of Islamic principles by different schools of thought may mean that identical financial instruments are rejected by one board but accepted by another. Thus the same instrument may not be acceptable in all countries. This problem can be addressed by forming a uniform council representing different schools of thought to define cohesive rules and to expedite the process of introducing new products.

Kayed and Mohammed (2009) argues that implementing Al *Shariah* compliant guidelines and procedures devised from the principle of Islamic finance would be an effective instrument in controlling these risks like systematic risks (the possibility of financial system or institution to collapse or fall down), credit risks (bad loans) and market risks (currency fluctuation) of Islamic modes of finance.

Pellegrini (2007) reviews Institutions Offering Islamic Financial Services (IIFS) corporate governance (CG) challenges and suggests options to address them. He first

pointed out the importance of corporate governance for institutions offering Islamic financial services, where it would require a distinct treatment from convention corporate governance and highlights three cases of distress of IIFS. He concluded that poor CG can carry heavy financial costs for IIFS' stakeholders. In addition, poor governance in IIFS would undermine their credibility as financial businesses offering services in compliance with *Shariah*. Given the fledging nature of the sector and its ethical foundations, the effects of a CG failure could be particularly damaging.

Sarker (2005) observed that in many cases, *Shariah* Councils of Islamic banks Bangladesh were disappointed at the inordinate delay in *Shariah* Implementation in the banking transactions or unwillingness to follow *Shariah* guidelines in banks by both the owners and management of the banks.

The review indicates that none of the authors studied the compliance of Islamic banks with *Shariah* governance system of AAOFI keeping in view the banking growth. It has been therefore hypothesised that if there is more compliance with *Shariah* so there shall be higher growth of Islamic banking. It appears that the study is virgin and shall contribute in the Islamic finance and banking literature.

Limitations

The study does not cover the state owned banks like Sonali, Agrani, and other private banks which have Islamic banking branches, windows or parallel system of Islamic banking due to non availability of data because these banks started Islamic banking recently. The study also does not cover some foreign banks which operate banking in Bangladesh and have Islamic bank branches or windows, as their annual reports are not available here. In future a study may be undertaken covering those banks.

Analysis and findings

It has been observed that there are 18 required issues, of the five standards of *Shariah* governance system of AAOIFI, to comply by the IFIs. Those are given in table 1: To depict the levels of compliance of Islamic banks Bangladesh with the issues of *Shariah* Governance System of AAOIF as mentioned above, collected data have been analysed in the following tables.

Table 2 represents the *Shariah* compliance levels of B1 banks in the year 2011. The average compliance level is 85%. All banks comply, more or less, with the requirements of all standards but standard 4 only. The highest compliance level is

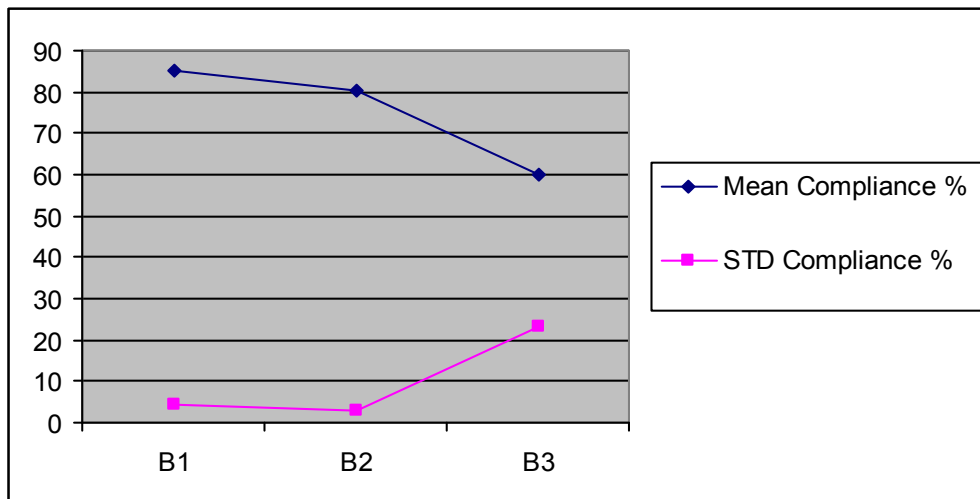
89%, which is achieved by only three out of seven banks, namely IBBL, SIBL and FSIB. On the other hand, the lowest compliance level is 78% which is achieved only by Al-Arafah.

Table 3 depicts the compliance levels of B2 banks. Like B1 banks, all B2 banks also comply more or less with the requirements of all standards but standard 4 only. The average compliance level is 81% and the highest compliance level is 83%. Both of these are less than that of B1 banks. But the lowest compliance level is same. However, the highest level is achieved by only three out of six banks, namely ABL, SEBL and Dhaka bank. On the other hand, the lowest level is complied also by three banks, namely Prime, Premier and Jamuna bank.

One can understand the compliance levels of B3 banks reading table 4. All banks do not comply with all the standards. The average compliance level is 60%, which is less than those of both the banks B1 and B2. The highest compliance level is 83% which is complied by AB bank and the lowest compliance level is 17% which is achieved by Standard bank. All compliance levels i.e. highest, lowest and average of B3 banks are less than that of the banks B1 and B2.

Table 5 shows comparative levels of the banks B1, B2 and B3. Representing the table 5, graph 1 shows that the average level is highly decreased in case of B3 banks. The analysis of standard deviation (STD) shows that the volatility of the level of B3 banks have also been increased i.e. compliance level of the B3 banks has not been developed like banks B1 and B2. On the other hand, there is a little difference between banks B1 and B2 against both mean and standard deviation.

Graph 1: Compliance (%) with *Shariah* Governance Issues in B1, B2 and B3 banks



Source: Table 5

Besides, there are some limitations of the SSCs of full-fledged Islamic banks Bangladesh which are discussed below:

1. The SSCs are formed with different dignitaries like, *Moulana* (Religious leader), Mufti, Professor, Ph.D holder; Barrister, *Alhaj* (An individual who performed pilgrim at Makka, Saudi Arabia) and Mr (A modern educated person). They are also religious scholars, economists, lawyers and bankers. Almost all SSCs have been formed with combination of all such dignitaries. But it seems that these experts have been doing what their education equips them to do, and they have been doing it well but unfortunately they, perhaps, cannot contribute much to achieve *Maqasid Al Shariah*ⁱⁱⁱ (Goals of the *Shariah*) in circumstances, which are very different from the environment reflected in the books on *Shariah*, Islamic economics, money, banking and finance (Siddiqui, 2006).
2. Only a bank mentioned that a library has been established in the *Shariah* Council Secretariat having about 500 books on Quran, *Hadith*, *Fiqh*, Islamic economics and banking. Honourable members of the Council learn *Shariah* issues and guidelines to run the Bank's operations. They take necessary consultations and data from those books and conduct research and study. No other banks have been found reported with such a necessary backup in terms of fundamental research. But it is necessary because the trend of focusing on duplicating conventional financial products through a kind of Islamic financial engineering started in nineteen nineties and came to dominate the scheme in the new century. The most important areas seem to be *sukuk* (duplicating bonds) and *tawarauq* (duplicating bank-loans).
3. Some banks pave the way for independent opinions and suggestions of the SSC forming the SSC with the outsiders only. Their reports have been found transparent because those were presented under two major heads like i) Opinions, and ii) Suggestions. On the other hand, some banks formed the SSC with both outsiders and insiders. The Chairman, Vice Chairman, Director, CEO, *inter alia*, have been found as insiders. In a bank, there are 7 insiders out of 11 members of the SSC. Appointment of insiders in the SSC is a deviation from the AAOIFI standards 1(e) & 5(a).
4. Reports of the SSC have been presented in different ways, such as, some banks mentioned the issue of *Zakat* payment by the bank and the others remained silent. Stakeholders are generally interested to know whether the Islamic bank deduct the *Zakat* Payable by the depositors and shareholders from their accounts or not.

5. Compensation realized and interest incomes are two components of doubtful income of an Islamic bank. The SSC finds the amount of doubtful income important to indicate operational efficiency of *Shariah* based bank. But some reports of the SSC of the banks under study, did not mention the amount of doubtful income at all, although some of them mentioned it, only one bank detailed its doubtful income.
6. The *muraqib* conducts *Shariah* audit and inspections in the Islamic bank. Only one bank did not mention anything about the *Muraqib* and their operations.

Conclusion

Bangladesh is a Muslim country. Here Islamic banking was established by a PCB, namely IBBL in the year 1983. Now the NCBs and FCBS are also operating Islamic banking. Peoples of the country have accepted Islamic banking well due to its compliance with *Shariah*. The levels of *Shariah* compliance in full-fledged Islamic banks are higher than others. It may be concluded therefore that more compliance with *Shariah* contributes to higher growth of Islamic banking. The limitations of the SSCs have to be overcome to ensure more *Shariah* compliance. For this purpose, two suggestions, one for Islamic banks and another for the central bank, have been made below:

Firstly, Islamic banks should form SSC at board level; and

Secondly, Bangladesh Bank Guidelines for Islamic Banking may be aligned with the *Shariah* Governance System of AAOIFI.

Table 1: Required issues of the AAOIFI *Shariah* Governance Standards for IFIs

AAOIFI Standards	Required issues of the Standards	Total
The Governance Standard for IFIS No. 1: <i>Shari'ah</i> Supervisory Board: appointment, composition and Report:	<ul style="list-style-type: none"> a. The Shariah board is an independent body of jurists specialised in fiqh mu'amalat; b. Experts in the field of Islamic finance; c. Direct, review and supervise the activities of IFIs; d. Affirms the binding authority of the Shariah board upon the IFIs; and e. The directors or shareholders of the IFIs cannot be appointed as <i>shariah</i> board members even if they are qualified to do so. 	5
Governance standard for IFIs No. 2: <i>Sahriah</i> review	<ul style="list-style-type: none"> a. The Shariah board's authority to access all necessary information for the Shariah review b. The Shariah board is only responsible for forming and expressing opinions on the extent of shariah compliance c. The shariah review will be read at the AGM and issued to the management 	3
Governance standard for IFIs No. 3: Internal <i>Shariah</i> review	<ul style="list-style-type: none"> a. The internal <i>Shariah</i> review carried out by an independent department or part of internal audit division b. The management and the BOD gave full and continuous support to the internal <i>shariah</i> reviewers c. Head of internal shariah reviewers is accountable to BOD d. The internal <i>shariah</i> reviewer is proficient and have appropriate academic background and necessary training relevant to <i>shariah</i> review, particularly proficiency in <i>shariah</i> and <i>fiqh muamalat</i>. e. The head of the internal shariah review to discuss the findings with the management and the final report must be addressed to the BODs and copied to the <i>shariah</i> board and management. f. In the event of disputes between management and internal <i>shariah</i> reviewers, they are referred to the <i>shariah</i> board for determination. 	6
Governance standard for IFIs No. 4: Audit and governance committee	<ul style="list-style-type: none"> a. There is an audit and governance committee (AGC) at the board level^{iv}. b. The AGC would consist of a minimum of three members appointed by the BODs from its non-executive and independent board members who are knowledge about the affairs of the institution, applicable regulation and laws, including shariah rules and principles. 	2
Governance standard for IFIs No. 5: independence of the <i>Shariah</i> board	<ul style="list-style-type: none"> a. The <i>shariah</i> board do not comprise employees of the same IFI who are involved in managerial decisions and operational responsibilities. b. Upon assessment, the <i>shariah</i> board conducts continued assessment with the IFIs and does all things necessary to resolve any issues of independence impairment. 	2

Source: AAOIFI (2005)

Table 2: The Level of Compliance with *Shariah* Governance Standards of AAOIFI in B1 banks

Source: Annual Report 2011 of respective banks

Table 3: The Level of Compliance with *Shariah* Governance Standards of AAOIFI in banks B2

AAOIFI Standard No.	Required Issues in Standard (No.)	Compliance Level of the Banks						Mean	Standard deviation
		Prime (No.)	ABL (No.)	SEBL (No.)	Dhaka (No.)	Premier (No.)	JBL (No.)		
1	5	4	4	5	5	4	4	4.33	0.52
2	3	3	3	3	3	3	3	3.00	0.00
3	6	6	6	6	6	6	6	6.00	0.00
4	2	0	0	0	0	0	0	0.00	0.00
5	2	1	2	1	1	1	1	1.17	0.41
Total Compliance (No.)	18	14	15	15	15	14	14	14.50	0.55
Compliance %		78	83	83	83	78	78	81	3

Source: Ibid.

Table 4: The Level of Compliance with *Shariah* Governance Standards of AAOIFI in banks B3

AAOIFI Standard No.	Required Issues in Standard (No.)	Compliance Level of the Banks							Mean	Standard deviation
		IBBL (No.)	SIBL (No.)	SJIBL (No.)	Exim (No.)	ICB (No.)	Al Arafã (No.)	FSIB (No.)		
1	5	5	5	4	4	5	4	5	4.57	0.53
2	3	3	3	3	3	3	3	3	3.00	0.00
3	6	6	6	6	6	5	5	6	5.71	0.49
4	2	0	0	0	0	0	0	0	0.00	0.00
5	2	2	2	2	2	2	2	2	2.00	0.00
Total Compliance (No.)	18	16	16	15	15	15	14	16	15.29	0.76
Compliance %		89	89	83	83	83	78	89	85	4

AAOIFI Standard No.	Required Issues in Standard (No.)	Compliance Level of the Banks					Mean	Standard deviation
		StBL (No.)	Trust (No.)	Bank Asia (No.)	PBL (No.)	ABL (No.)		
1	5	3	2	4	2	4	3	.89
2	3	0	3	3	3	3	2.4	1.20
3	6	0	5	6	5	6	4.4	2.24
4	2	0	0	0	0	0	0	0.00
5	2	0	1	1	1	2	1	0.63
Total Compliance (No.)	18	3	11	14	11	15	10.8	4.21
Compliance %		17	61	78	61	83	60	23

Source: Ibid.

Table 5: Comparative compliance levels of banks B1, B2 and B3

Category of Banks	Mean		Standard deviation	
	Total Compliance (No.)	Compliance %	Total Compliance (No.)	Compliance %
B1	15.29	85	0.76	4.20
B2	14.50	81	0.55	3.04
B3	9	60	4.21	23.41

Source: Table 2, 3 & 4.

Appendix Table 1: List of Sample Banks

	Name of the Banks	Short Name
1.	Islami Bank Bangladesh Limited	IBBL
2.	Social Islamic Bank Limited	SIBL
3.	Shahjalal Islamic Bank Limited	SJIBL
4.	Export Import Bank of Bangladesh Limited	EXIM
5.	ICB Islamic Bank Limited	ICB
6.	Al-Arafah Islami Bank	Arafah
7.	First Security Islami Bank Limited	FSIB
8.	Prime Bank Limited	Prime
9.	AB Bank	ABL
10.	Southeast Bank Limited	SEBL
11.	Dhaka Bank Limited	Dhaka
12.	Premier Bank	Premier
13.	Jamuna Bank Limited	JBL
14.	Standard Bank Limited	StBL
15.	Trust Bank	Trust
16.	Bank Asia Limited	Bank Asia
17.	Pubali Bank Limited	PBL

Note

ⁱ The IFSB-10 define the *Shariah* governance system as “a set of institutional and organizational arrangements through which IFIs ensure that there is an effective independent oversight of Shariah compliance over the issuance of relevant Shariah pronouncements, dissemination of information and an internal Shariah compliance review” (IFSB, 2009, P.2).

ⁱⁱ The Islamic Financial Service Board (IFSB) defines *Shariah* non-compliance risk as “the risk that arises from Islamic Financial Institution’s failure to comply with the *Shariah* rules and principles determined by the *Shariah* board or the relevant body in the jurisdiction in which the IFIs operate” (IFSB , 2006, p. 26).

ⁱⁱⁱ The *maqasid al-shariah* have been either directly stated in the Qur’an and *Sunnah* or inferred from these by a number of scholars. All of these address the raison d’être of the *Shariah* which, as recognized by almost all the jurists, is to serve the interests of all human beings and to save them from harm (Chapra, 2008).

^{iv} On top of the *Shariah* board and the BOD, the AGC plays the specific functions of preserving the integrity of financial reporting process, safeguarding the interest of the stakeholders, providing additional assurance on the reliability of information and acting as an independent link between the management and other stakeholders (Section 3). (See Dusuki, 2011).

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