Shariah Corporate Governance and Risk Management in Saudi Arabian Banks

Tahani Hussain Mahsoon

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Supervisors **: Professor Emmanuel Adegbite and Dr. Ja Kim**

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بسم الله الرحمن الرحيم

DECLARATION

I, Tahani Mahsoon, hereby declare that I am the author of this thesis entitled *Shariah Corporate Governance and Risk Management in Saudi Arabian Banks*. It contains no material that has been submitted or accepted previously for any academic degree.

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Tahani Mahsoon **Data**

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Abstract

Shariah Corporate Governance and Risk Management in Saudi Arabian Banks

This thesis investigates the role of Shariah corporate governance on risk management in both full-fledged and window Islamic banks in Saudi Arabia. Since the availability of data and information on Shariah corporate governance and risk management practices is limited, this study is conducted using semi-structured interviews with Islamic banking experts in the field of Shariah corporate governance and risk management. Therefore, the study provides an in-depth discussion regarding the various types of risks that Islamic banking faces in Saudi Arabia, as well as Shariah-compliant risk management practices. Furthermore, the author highlights the challenges that Islamic banks confront when managing each type of risk (i.e., credit, liquidity, market, operational and Shariah non-compliance risk). These factors are crucial when grasping a comprehensive view of risks and risk management in Islamic banking.

In addition, as the central bank of Saudi Arabia released the first mandated Shariah governance framework in 2020, this study examines the state of Islamic banks before and after this issuance. It also highlights the strengths and weaknesses of the framework that must be addressed or improved. Additionally, it is examining how the adherence with the Shariah corporate governance framework changes when comparing full-fledged Islamic banks and window banks or whether it is the same.

Following separate investigations into risk management and Shariah corporate governance, the thesis delves deeper into the impact of Shariah corporate governance on risk management. Specifically, the author examines the Shariah committee, Shariah compliance and Shariah audit as the primary actors in the Shariah corporate governance framework and determines how each one affects risk management. Finally, exploring each viewpoint, the author focuses on understanding the role of risk management in developing an effective Shariah corporate governance framework in Saudi Arabia.

The interesting findings in this study reveal that the role of Shariah corporate governance in risk management is to ensure that risk management does not create a Shariah non-compliance risk, since this type of risk can be entangled with any other type of risk. Thus, risk management plays an important part in Shariah regulations; without risk management, there will be no solid Shariah corporate governance. Without the latter, there is no sound risk management in Islamic banking.

It is expected that this thesis will contribute to the emerging literature on the role of Shariah corporate governance in risk management, and to the broader literature on the Shariah corporate governance framework and Shariah-compliant risk management practices. The consequences of these thesis reach beyond the academic community and into the field of Islamic banking, where several policy proposals can be made that enhance and improve the current Shariah corporate governance system.

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Chapter 1: Introduction

1.1 Background

The recent global financial crisis in 2008 has drawn the attention of investors, who were dissatisfied with conventional banks, to Islamic banking (Jones et al., 2014). During the financial crisis, Islamic banks had improved performance compared to conventional banks for a variety of reasons, including a less visible liquidity risk (Ali, 2020; Kassim and Abdulle, 2012), improved credit and asset growth systems, which contributed to the economic and financial stability (Hasan and Dridi, 2011), more prudent risk management behaviour, and higher solvency (Aslam et al., 2020; Aslam and Haron, 2020; Chazi et al., 2018). Islamic finance is characterised as a distinct type of finance that demands Shariah Corporate Governance (SCG) due to the fact that the standards diverge from conventional Corporate Governance procedures and structures (Abu-Tapanjeh, 2009). Islamic Banks are required to have a Shariah governance mechanism that oversees their Shariah compliance (Mesliera et al., 2020). Shariah compliance is of the utmost importance; therefore, regulatory authorities and Islamic financial institutions should prioritize the Shariah governance framework. In fact, the significance of Shariah compliance and Shariah governance framework is universally acknowledged, even though Shariah governance frameworks vary by country. According to Saba (2018) , Malaysia and Pakistan, for example, have a very rigorous and robust Shariah governance framework. New entrants in the Islamic finance industry, such as Turkey, are focused on constructing a solid and resilient Shariah governance framework.

Compliance with Shariah principles strongly distinguishes Islamic banks from their conventional counterparts. Whereas conventional banking uses interest-rate strategies to conduct its operating activities, Islamic banking relies on the concept of profit-and-loss sharing, i.e., neither charges nor pays interest. Islamic banking transactions differ in structure from conventional banking since they are founded upon a physical or tangible asset (Hassan et al., 2018). In the absence of such a governance system, conflicts may arise that result in both financial and non-financial losses (Alam et al., 2021). Therefore, SCG is essential to the stability of the Islamic finance framework. In fact, implementing SCG in Islamic banks acts as a legal necessity that offers a sound Islamic financial service and practice (Zain and Shafii, 2018).

Islamic banks acting as financial intermediaries not only have to manage the common risks found in conventional banks (i.e., credit risk, market risk, liquidity risk and operational risk) but also other risks exclusive to Islamic banks, such as Shariah non-compliance risk. Shariah non-compliance risk is the risk that will result from the violation of Shariah rules. Failure to comply with this principle will result in the transaction being voided, and consequently, the income or loss cannot be recognized (Dar and Masood, 2013). Therefore, any failure to comply with the Shariah will have a negative impact on the credibility of Islamic finance and the trust of market participants, including depositors and investors (Salman, 2018). Islamic finance must ensure that this unique risk, i.e., non-Shariah compliant risk, is properly audited and managed; otherwise, it will obscure the distinction between Islamic and conventional finance (Salman, 2018). In short, managing Shariah non-compliance risk is essential for establishing an efficient Shariah governance system (Bhatti, 2019). However, risk management for Islamic banking financial products is one of the most challenging issues that many conventional and Islamic banks confront today. The central issue is the impact of Shariah compliance on the risk management system (Aldoseri and Worthington, 2016). Thus, SCG act as a monitor for Shariah non-compliance risk and other risks that are similar to those encountered by conventional banks. The existence of non-Shariah compliant features leads to a loss of trust and confidence among stakeholders, particularly the Muslim community that entrusts the institution with managing its funds or investments in accordance with Shariah principles (Khamar et al., 2017).

As a result, Islamic banks have established the Shariah Supervisory Board (SSB) to ensure general conformity with Shariah principles as their backers and promoters (Nomran et al., 2018; Mollah and Zaman, 2015; Hamdallah, 2012). Actually, the same body of distinguished Shariah scholars is meant by the terms "Shariah Board," "Shariah Committee," and "Shariah Supervisory Board" (Alam. et al., 2020). A Shariah board (SB) is one of the internal governance mechanisms that monitors and controls the IB's activities to ensure Shariah compliance (Khalil and Taktak, 2020). Consequently, Islamic financial institutions (IFIs) are subject to a dual governance structure with both the Shariah Board (SB) and the board of directors (BODs), making their governance framework more robust than that of conventional financial institutions (Alam et al., 2020). Almutairi and Quttainah (2020) note that the SB approves banking transactions and services, while the BOD is accountable for the overall corporate governance. Thus, the BOD and the SB enhance the stakeholders' credibility and confidence (Khalil, 2021) . whereas the Audit committee's crucial role emerged from its function of achieving the IFIs' primary objectives. This is accomplished by enhancing the transparency and scope of financial disclosures, thereby strengthening confidence in the IFI's compliance with Islamic law (AAOIFI, 2015). This underlines the point that the SCG framework emphasises fairness towards all stakeholders through strong transparency and accountability (Ahmad and Chapra, 2002).

From an Islamic perspective, corporate governance stems from Islamic accountability. Hameed (2000) defines Islamic accountability as dual accountability, consisting of primary accountability due to a trustee of Allah's resources and secondary accountability due to a contract between the owner or an investor and a manager. Accountability in the Islamic economy is required to ensure true and fair disclosure and transparency (Abu-Tapanjeh, 2009). Consequently, the Shariah committee is not only responsible for resolving any Shariah concerns on behalf of the Islamic bank, but it is also responsible for disclosing Shariah non-compliance issues within the institution (Masruki et al., 2020). As a result, customers should have unrestricted access to accurate financial facts and information. In fact, even Islamic finance board members have more duties than conventional board members. Second-tier responsibility is what sets it apart. It ensures that the Islamic finance industry operates within Shariah (Kasim et al., 2013). Rosnia and Zurina (2013) argue that dual accountability is a difficult responsibility for corporate leaders to fulfil, as they must explain to God (Allah SWT) in addition to other involved parties.

Despite asserting the desire for a robust and reliable SCG as a significant part of corporate governance in Islamic banks, there is a considerable gap in the literature on SCG and risk management – this thesis addresses this gap. This topic is necessary because the concept of risk and corporate governance in banks, particularly following the recent financial crisis, has received considerable attention from policymakers, bankers, stakeholders and academics. On the one hand, evidence suggests that banks with poor governance take excessive risks (Kirkpatrick, 2009; Chen and Lin, 2016; Díaz and Huang, 2017). On the other hand, risk management failures have specifically been highlighted as one of the primary causes of financial crisis and distress in financial institutions in general (Hussain and Al-Ajmi, 2012).

However, while risk management practices have been explored extensively throughout the years, banks operating within emerging nations and, in particular, Islamic banks have received little attention (Al-Tamimi, 2002; Al-Tamimi and Al-Mazrooei, 2007; Hassan, 2009). Of particular interest is the role that SCG plays in risk management, particularly in mitigating (i.e., credit risk, market risk, liquidity risk, operational risk and Shariah non-compliance risk) in both fully-fledged and window Islamic banks. This thesis uses Saudi Arabia to investigate the matter.

Saudi Arabia has experienced phenomenal developments in its Islamic banking sector. This is in line with the rapid global expansion of the Islamic banking system, as well as in response to the widespread public demand for the system. While Islamic banking has made considerable progress in Saudi Arabia over the previous three decades, there is a shortage of studies/papers that cover important aspects of Islamic banking in the Kingdom. Saudi Arabia, the world's largest oil producer, has a robust and efficient banking system that was unaffected by the recent global financial crisis (Javaid and Alalawi, 2018). This feature prompted the whole globe to investigate the Islamic banking system, which is underpinned by Shariah law.

Since its inception in 1975, Saudi Arabia's Islamic banking sector has performed admirably, with Shariah-compliant assets accounting for 50% of the Saudi banking sector's assets and Saudi Arabian banking products accounting for about 20% of all Islamic banking products internationally. There are currently 12 conventional banks in Saudi Arabia, four of which are fully-fledged Islamic banks that provide Islamic banking and financial services in line with Shariah principles (Alanazi and Lone, 2016). While the rest are Islamic windows that offer a combination of Shariah compliance and conventional financial products. Islamic and conventional banking operate side-by-side in Saudi Arabia under a single regulator, i.e., the Saudi Arabian central bank (Hassan et al., 2018).

Although Saudi Arabia has experienced a great deal of success using Islamic banking, implementing a mandated Shariah governance framework is new in the country. Since February 2020, the central bank has released (for the first time) the Shariah governance guideline for banks that provide Islamic products in the Kingdom. This initiative was associated with the growing development of Shariah banking products in Saudi Arabia and around the globe. Therefore, it is essential to establish sets of rules for Shariah requirements so that all Islamic financial institutions can adhere to them and be regulated by the Shariah committee and the regulatory body (Abdullah and Rahman, 2017). Working in this direction, it would be useful to explore the role of the SCG framework on risk management in the banks operating in Saudi Arabia.

1.2 Research Motivation and Research Significance

The motivation of this study, when investigating the role of SCG in risk management in Saudi Arabian Islamic banks, is due to the following reasons.

First, this is the first study of its kind to undertake a comprehensive and in-depth investigation of the various types of risks, both common and unique, that confront Islamic banks in Saudi Arabia. In addition, this study is distinctive since it investigates the recent SCG framework in Saudi Arabia, whereas previous studies evaluated the self-regulatory framework adopted by all banks. This study particularly discusses the key features of the recent SCG. Specifically, objectives of the Shariah governance framework, composition of the Shariah governance framework, responsibilities of the board of directors, responsibilities of the executive management, formation of the Shariah committee, responsibilities of the Shariah committee, and internal control.

Second, the Islamic banking industry in Saudi Arabia is categorized as a dual banking system, in which Islamic and conventional banking operate in parallel. However, most of the research on Islamic banking in Saudi Arabia has so far concentrated on the performance of the four fully-fledged Islamic banks and has consistently excluded Islamic windows. Therefore, this study seeks to fill this gap by including the entire Islamic banking industry – both fully-fledged and windows.

Third, Saudi Arabia is the world's leading Islamic finance market and presents a very useful case study in the research on Islamic finance. Saudi Arabia is one of Islamic finance's most successful and powerful markets and the largest of the Gulf Cooperation Council (GCC) countries, holding 20.4 percent of the global Islamic banking assets (IFSB, 2018). Consequently, corporate governance and risk management in Saudi Islamic banks is a matter of significant interest to multiple stakeholders including shareholders, creditors, depositors, employees and policymakers.

Fourth, Saudi Arabia adheres to Shariah rules (Alshamrani, 2014), and Islamic values profoundly impact everyday life in Saudi society, including in business, law, economics and politics (Abu-Tapanjeh, 2009; Kamla, 2009). Therefore, the characteristics of Islamic governance are clearly underpinned by such principles as accountability, equity, fairness, generosity, morality, justice, philanthropy, social responsibility, transparency and truthfulness (AbdulRahman, 1998; Sarker, 1999). Additionally, the Saudi Arabian legal system is based on a duality approach, with the principles of Shariah on the one hand and the principles of civil law on the other (Alkahtani, 2016). Thus, the legal system in Saudi Arabia, which is a significant feature of corporate governance (Falqi, 2009), presents an interesting scenario to explore, especially the practices of corporate governance in both conventional and Islamic settings (Lewis, 2005; Safieddine, 2009).

Ultimately, this research is significant because its scope extends beyond Saudi Arabia to include Islamic financial institutions (IFIs) worldwide. Considering the global expansion of Islamic finance and the complexity of the roles and responsibilities of various stakeholders, a sound and appropriate Shariah governance system must be in place (Saba, 2018). Therefore, it is essential for IFIs to strengthen the function of Shariah governance in risk management. In other words, IFIs are urged to implement a system of oversight and accountability to identify any vulnerabilities in their internal control systems and to update any outdated internal control practices (Rahman and Anwar, 2014).

1.3 Research Aim and Objectives

This thesis seeks to fill a gap in the existing literature on SCG and risk management in both fully-fledged and Islamic windows banks. It emphasises from the outset that Islamic banking has its own distinctive method of implementing SCG and risk management. This thesis aims to investigate and examine the role of the SCG framework in risk management in Saudi Arabian banks by evaluating key areas of the SCG framework: (i) The legislative structure and rules of operation; (ii) Shariah committee roles and obligations; (iii) Shariah audit and compliance roles. This research investigates whether the current SCG framework in Saudi banks is efficacious and delivers effective approaches for managing the risk or whether it needs further enhancements.

The following specific objectives are established in the fulfilment of the defined research aim:

1. To assess the existing state of Islamic banking in Saudi Arabia from the perspective of practitioners and Islamic banking professionals.
2. To examine the various risks that face fully-fledged and Islamic window banks in Saudi Arabia, including credit, market, liquidity, operational and Shariah non-compliance risks. In addition to the fundamental principles of risk management in Islamic banks.
3. To investigate Islamic banking prior to and after the implementation of the SCG framework.
4. To examine the current regulatory framework of SCG and the internal rules in banks that offer Shariah-compliant products.
5. To analyse the roles and responsibilities of the Shariah committee and the extent to which the Shariah committee members might be involved in the risk management process.
6. To explore the role of the Shariah control department, especially the participation of the Shariah audit and Shariah compliance function in the process of risk management.

1.4 Research Question

The main objective of this study is to address and respond to one primary research question, which was derived from the study's aims and objectives. The research question was designed to explore and further understand the unique relationship between Shariah corporate governance and risk management in Islamic banks. In light of this, the following research question discusses the main components of Shariah corporate governance in risk management.

1. How does the Shariah corporate governance framework influence risk management in terms of credit risk, market risk, liquidity risk and operational risk (especially Shariah risks) in fully-fledged Islamic and window banks in Saudi Arabia?

1.5 Research Importance and Contributions

Given the lack of any comprehensive and detailed work on the field of SCG and risk management, this study has particular importance as it attempts to provide a detailed overview of current Shariah – compliant risk management practices in Islamic banks under Shariah governance framework in Saudi Arabia. This study will address the risk management of credit, market, liquidity, operational risks and Shariah risks. Most of the research on Islamic banking in Saudi Arabia has focused on the performance of the four fully-fledged Islamic banks, excluding Islamic windows (Baeshen and Shaheen, 2021; Hassan et al., 2018; Tabash and Dhankar, 2014). Due to a lack of research in Saudi Islamic banking, for both full-fledged and Islamic window banks, an in-depth and comprehensive study of the risks facing the Saudi Islamic banking industry is necessary to ensure that regulators, managers, investors, and shariah scholars receive the appropriate information.

Prior research on Shariah governance in Saudi Arabia has focused on the absence of a central bank-mandated Shariah governance framework. With the issuance of a Shariah governance framework that is mandatory for all banks that offer Islamic products, including both full-fledged Islamic banks and window banks, the situation has changed. Therefore, this study investigates the first ever Shariah governance framework from the opinions of the real participants under this framework, which is vital for enhancement and growth. Therefore, the findings of this study will be beneficial in providing information on the frameworks and practices of Shariah corporate governance and risk management of Islamic banks in Saudi Arabia and other countries that have adopted the dual banking system, in which both fully-fledged and window Islamic banks function together.

Furthermore, to clarify the relationship between Shariah corporate governance and risk management, this study incorporated agency and stakeholder theory. As a result, it is expected that this thesis will contribute not only to the literature on Shariah corporate governance and risk management, but also to research on agency and stakeholder theory in Islamic financial institutions.

After researching the corporate governance literature in general and, in particular, for conventional and Islamic banks, it was observed that most of the literature examines the relationship between corporate governance issues and firm performance (see, for example, Yermack, 1996; Coles et al., 2008; Aebi et al., 2012; Mollah and Zaman, 2015). This research typically contributes to the literature by extending current literature (for example, Abedifar et al., 2013; Haqqi, 2014; Ismail et al., 2014; Chowdhury et al., 2015; Makiyan, 2008; Safiullah et al., 2018; Ginena, 2014; Embi and Shafii, 2018; Reyad et al., 2022) on Shariah governance and risk management in Islamic banks. Hence, the contribution of this study is two-fold. First, this research is the first, to our knowledge, to investigate the role of Shariah corporate governance in risk management in both fully-fledged and windows Islamic banks in Saudi Arabia. Second, the research contributes methodologically by analysing how Shariah corporate governance mitigates the risk via the use of semi-structured interviews with senior Islamic banking professionals, which enabled more room for interviewees to express and share their experience in a less formal and more open manner compared to a structured interview. The interview sample is also well-diversified. In fact, this varies from previous research studies that only employed quantitative approaches in the first place. Imagine the advantages to finance if we extend our empirical data sources to cover what people say about the subject, thus assisting us to examine the complex reasoning behind these conversations (Kaczynski et al., 2014).

1.6 Research Scope

The scope of this study is limited to the Shariah governance framework of Islamic banks and conventional banks that offer Islamic financial products and services. This research concentrates on Saudi Arabia, where Shariah-compliant banks function under a single regulatory authority called the Saudi Arabian Monetary Authority (SAMA) in parallel with conventional banks. As a result, this research will cover all 12 Saudi Arabian banks: four full-fledge and eight conventional banks that provide Islamic products. This research focuses on the Shariah governance mechanism of these banks, since they implement distinctive models and strategies for managing and mitigating risk.

This research involves various groups of stakeholders who play an important role in the Shariah governance structure and influence the risk mitigation and management process, such as the Shariah board, Shariah auditors, risk managers, regulators and Shariah scholars.

1.7 Overview of the Research Methodology and the Data Collection

The selection of appropriate research methodologies is a precondition for successful research, whether social or scientific; it is also necessary for ensuring the originality and quality of the study. In response to the research question discussed above and to attain the aim of the study, the present author employs a qualitative research approach. In fact, in view of the limited sample size and scarce details, a qualitative approach should be able to meet the research goals and the question and objectives as well as provide accurate results for the study area (Silverman, 2004). This study uses semi-structured interviews since it is the most effective approach for achieving research objectives. It is also essential to note that this study mainly focuses on the primary data obtained through interviews, exposing the participants' precepts and opinions. The primary data in this research was gathered through semi-structured interviews with leading Islamic banking professionals and Shariah scholars (to directly examine their views on selected aspects of Shariah governance). Semi-structured interviews permit a researcher to vary the sequence of questions, and ask additional questions, whenever she deems it necessary (Bryman, 2001). A detailed description of the research process is presented in Chapter 3.

1.8 Structure of the Thesis

The thesis is organised into seven chapters as follows.

Chapter 1: Introduction

This chapter describes the research background, research motivation, research aims and questions, significance of the study, prospective contributions and, ultimately, an overview of the research methodology. It describes the overall direction of the research and the core of the study within the field of Shariah governance and risk management.

Chapter 2: Literature Review

This chapter reviews a wide range of literature in a substantive and critical fashion. The literature review covers a conceptual framework of corporate governance from a conventional perspective. This includes conceptual definitions and major theories as well as an overview of corporate governance in a Saudi context. The chapter then details the Islamic CG; primarily, this part highlights the definitions of Shariah governance, its importance, challenges and the main pillars. The review is extended to risk and risk management in Islamic banks. This chapter also discusses the lacuna in the existing literature on the subject of Shariah governance and risk management in Islamic banking.

Chapter 3: Methodology

The third chapter describes the methodology of the thesis. The methodology is the cornerstone of this thesis; it is essential to highlight the ontological and epistemological positions. This chapter further presents the paradigms, designs and methods adopted for this study. The empirical data was gathered through interviews with 35 respondents from four fully-fledged Islamic banks and eight Islamic Windows banks in Saudi Arabia with various positions (for example, risk managers, regulators, Shariah auditors and Shariah scholars).

Chapter 4: The Status of Saudi Islamic Banking System and their Risk Management

This is the first findings chapter. It focuses on the first and second themes, the current state of the Saudi Islamic banking industry and the risks and risk management in Saudi Islamic banks.. Thus, this chapter provides an insightful overview of the existing situation of Islamic banking in Saudi Arabia from the viewpoint of industry professionals and practitioners as well as offers in-depth coverage of each risk category for both fully-fledged Islamic and window banks. Following this, the challenges that Islamic banks confront in managing various types of risk are addressed.

Chapter 5: Examining the Shariah Corporate Governance Framework in Saudi Arabia

This is the second findings chapter, focused on the third theme. This chapter aims to investigate the first-ever Shariah corporate governance framework in Saudi Arabia. It then continues to identify the weaknesses and strengths that need to be addressed and improved. Finally, it examines whether the degree of adherence in applying the Shariah governance framework varies, or is the same, between fully-fledged Islamic banks and window banks.

Chapter 6: The impact of Shariah corporate governance on risk management

This is the third findings chapter, which focuses on the fourth theme. In this chapter, the author examines the impact of Shariah corporate governance on risk management. Therefore, this chapter covers the core question of the thesis: What role does Shariah corporate governance play in the management of common risks (i.e., credit risk, market risk, liquidity risk and operational risk) and Shariah risks?

Chapter 7: Conclusion and contributions

Finally, the thesis concludes with a summary of the thesis, significant highlights and recommendations, theoretical contributions, implications and recommendations for various stakeholders, limitations and ideas for future research.

Chapter 2: Literature Review

2.1 Introduction

This thesis encompasses various topics on Islamic banking, including religion, Islamic products, Shariah corporate governance, risks and risk management. This chapter will address these vast components found in the literature since they relate to the objectives of this thesis. Given the volume of potentially relevant studies, it was essential to make several decisions concerning the scope of the literature review. Thus, this review aims to provide a conceptual framework for underpinning the research structure and to guide the researcher in determining how far the topic on the issue has been performed in the instance of Saudi Arabia. Therefore, this chapter reviews previous research conducted in four primary areas: conventional corporate governance, Shariah corporate governance, risk management in Islamic banks and the role of Shariah corporate governance in risk management in Islamic banks. These leads to an answer to the main thesis question:

How does the Shariah corporate governance framework influence risk management in Saudi Arabian banks?

2.2 Corporate Governance from Conventional Perspectives

2.2.1 What is Corporate Governance?

Due to its importance to the financial system and the globalization of the economy, corporate governance (CG) has become an increasingly popular area of study in the fields of accounting and finance in the last decade (Sencal, 2017). Over the last few decades, corporate governance has received considerable attention from researchers, practitioners, investors, regulators and theorists. The major reason for this interest has been the main failures in the business world, from Enron and WorldCom (USA), Nortel and Crocus (Canada), Parmalat and Royal Ahold (EU), the Asian financial crisis in 1997–1998 and HIH Insurance in Australia, and other scandals in the MENA region such as United Arab Emirates (Gul and Leung, 2004; CSR, 2010; Bremer and Ellias, 2007; Mirshekary et al., 2005).

There are abundant arguments regarding the definition of corporate governance. According to Turnbull (2000), there are no agreed-upon definitions or limits for investigating corporate governance. Similarly, Solomon (2004) states that there is no globally accepted definition of corporate governance, which has generated a sense of intellectual vertigo in the discussion over corporate governance reforms (Pound 1993).

Regarding the diverse definitions, the academic literature on corporate governance identifies different aspects of the topic; for instance, a narrow or a broad manner, as discussed by Solomon (2004). From a narrow viewpoint, corporate governance can be seen as a limited relationship between a company and its shareholders. Monks and Minow (2004) highlight that corporate governance is related to the relationship between various players to determine a company's direction and performance. The main players are (1) the shareholders, (2) the management, and (3) the board of directors. Moreover, Shleifer and Vishny (1997) define governance as a mechanism that ensures that shareholders receive a return on their investment. Thus, corporate governance has traditionally invoked a narrow focus on management-shareholder relations, as mediated by the board of directors (Bradley et al., 2000).

From a broad viewpoint, the definition of corporate governance was presented by Sir Adrian Cadbury (1992), head of the Committee on the Financial Aspects of corporate governance in the United Kingdom, as "the system by which companies are directed and controlled". This concept was broadened by Steiner and Steiner (2012), who defined corporate governance as an effective control mechanism within firms in which managers follow business objectives and plan to maximise shareholder wealth. Therefore, regardless of the form or size of the business, accountability, openness, fairness, disclosure and responsibility are the primary concerns of corporate governance.

In fact, the discussion over the definition and substance of corporate governance is gradually becoming revitalised, and participants are beginning to be increasingly concerned with the meanings of the phrases "corporate governance" and "good corporate governance" (Adegbite, 2010). A good corporate governance structure is one that "selects the most able managers and makes them accountable" (Tirole, 2001). Consequently, not only will this structure guarantee that executives respect the rights and interests of stakeholders, but it also ensures that stakeholders act responsibly with regard to the invested and created resources by the business (Filatotchev et al. 2006). Therefore, good corporate governance reflects a company's principles, culture and policies with respect to its stakeholders, as well as the company's dedication to these ideals (Murthy 2006). Good corporate governance can be highly advantageous and beneficial for businesses, while bad corporate governance is costly (Adegbite, 2010). According to Pitelis and Clarke (2004), good corporate governance generates wealth while simultaneously managing risk. As a result, if a corporation's good at corporate governance, it is likely to perform well in accounting and risk management tasks as well (Milne 2006).

On the other hand, several Islamic scholars attempted to explain CG from an Islamic point of view. According to Elasrag (2014), the Islamic concept of CG does not differ much from conventional CG, except for the prohibition of certain products and practices. It also concerns all stakeholders rather than just the shareholders and, thus, can be seen as a special case of a larger theory of decision making that employs the Islamic socio-scientific epistemology, which is premised on divine God oneness (Choudhury and Hoque, 2006).

2.2.2 Corporate Governance Theories

As seen by the variety of definitions, CG is a subjective notion that is influenced by the scholars' background and field. Different approaches to CG illustrate the absence of a single concept of CG. There are currently two major schools of thought in CG: the Anglo-Saxon "shareholder-focused approach" and the European "stakeholder or socially oriented approach". This indicates that several theories of CG have been developed from various assumptions on human nature in relation to CG. In the next part, conventional CG theories will be addressed. There are three theories in the current literature to clarify and explain the basis of corporate governance, which were considered primarily as explanatory in this work, including agency theory, stakeholder theory and stewardship theory (Donaldson and Davis, 1991; Shleifer and Vishny, 1997; Clarke, 2004).

Agency Theory

Agency theory is viewed as the first step toward understanding the theoretical framework for corporate governance (Baird, 2006). According to Jensen and Meckling (1976), agency theory is a relationship contract between the managers (agents) and the shareholders (principals); both parties attempt to maximise their utility and the principal delegate the decision-making process to the agents. Agency theory centres on the problem of separation of ownership and control. It is subject to conflicts of interest initiated by people with different motives to raise personal wealth at the principal's expense, usually through moral hazards (Shleifer and Vishny, 1997; Tricker, 1994).

The agency problem occurs when the principal hires an agent to conduct diverse services on his behalf, which involves delegating specific decision-making authority to the agent (Jensen and Meckling, 1976). The decision-making power granted to the manager creates an information advantage for the agent and, therefore, an information disadvantage for the shareholders; this is called information asymmetry (Jensen and Meckling, 1976). Managers may have more business knowledge and managerial expertise than owners and may not be tracked. Consequently, managers may make self-interested decisions that do not act in the investor's best interest.

Information asymmetry allows managers to follow their interests rather than those of the owner, creating a conflict of interest between the owner and the manager (Obid and Naysary, 2016). Healy and Palepu (2001) claim that voluntary disclosure in financial reports could minimise asymmetric information between owners and management. Moreover, Fathi (2013) states that to minimise agency conflict, managers should provide the company's performance information report, assert their role for shareholders and investors, and be more transparent when issuing financial statements.

Hill and Jones (1992) argue that, given the assumption of self-interest in pursuing behaviour in human actions and the technical impossibility of creating an ideal agreement to cover every potential conflict of interest among managers and owners, it is essential for owners to build a control system in the company for the management. Donaldson and Davis (1991) argue that managers will not optimise shareholders' returns unless proper governance mechanisms are implemented to protect shareholders' interests. Therefore, agency theory argues that the object of corporate governance is to mitigate managers' ability to behave in a manner contrary to shareholders' interests (Mulili and Wong, 2011).

According to Brennan (2006), among the various control mechanisms, the corporate board is the main and most powerful internal corporate governance system capable of controlling management's conduct when promoting investors' interests. The board of directors plays an important role in controlling management behaviours. Fama and Jensen (1983) argue that Non-Executive Directors (NEDs) play a crucial role in controlling executives because they are independent and are concerned about their reputations. Moreover, the board of directors is considered the strongest internal monitor since the board has the power to hire, fire and compensate top-level management (Fama and Jensen, 1983). In short, agency theory separates control duties from ownership. Therefore, agents are always less likely to work in the interests of directors. A good corporate governance system would avoid conflicts of interest between the investors and management.

According to Mallin (2007), one of the advantages of the agency theory is that it "identifies the relationship where one party, the principal, delegates work to another party, the agent". In addition, Mallin (2007) specifies that the board of directors (BOD) serves as a crucial monitoring tool to mitigate any issues pertaining to the principal-agent relationship. Fathi (2013) states that to reduce the agency dilemma, managers should demonstrate their role to shareholders and creditors by creating more transparency when issuing financial statements. Htay et al. (2012) posit that the agency theory offers guidelines for a good CG framework. A high degree of transparency in business organisations may be preserved by allowing managers to disclose information adequately to ensure that the company pursues the desires of all stakeholders. During times of economic crisis, system risks for management teams increase, which necessitates an effective CG structure to safeguard their corporate image (Htay et al., 2012).

Successful solutions to this issue include having a board of directors that regulates the management's decisions and ensuring that these decisions reflect the principal's interests (Allen and Gale, 2000). Accordingly, the board of directors helps reduce the cost of the agency (Fama, 1980; Fama and Jensen, 1983; Shleifer and Vishny, 1986; McKnight and Weir, 2009).

Stewardship Theory

While the theory of agency has been the foundation of several corporate governance studies, it also has its limitations (Perrow, 1986; Eisenhadt, 1989; Donaldson and Davis, 1990). In particular, it is an understanding of human actions and encouragement. Stewardship theory was developed to include psychological elements of human beings (Obid and Naysary, 2016). Such a theory has its foundations in psychology and sociology and has been developed for researchers investigating circumstances in which managers are compelled to act in the best interests of their leaders (Donaldson and Davis, 1989). Davis et al. (1997) define stewardship theory as "a steward protects and shareholders wealth through firm performance because by so doing, the steward's utility functions are maximised."

The stewardship theory takes a different approach to the agency theory. Instead of acting as efficiency maximisers, as proposed by the agency theory, stewardship theory considers management to be stewards instead of agency theory, which requires incentives or a control mechanism to maintain harmony (Alatassi and Letza, 2018). According to Keay (2017), the stewardship theory maintains that directors have a different motivation from that posed by the agency theory, which is based on organisational theory and psychological and sociological studies. Directors are regarded as loyal to the company under the stewardship theory. While agency theory posits individualism, stewardship theory adheres to collectivism. The stewardship concept, therefore, attempts to find another reason for the relationship between the principal and agent (Clark, 2004). Davis et al. (1997) assert that the theory of stewardship and the theory of agency complement one another and that there is no single optimal path of thinking on this subject; therefore, no ideal theory exists. Nonetheless, reconciliation is necessary to discern between the two theories and to be able to determine which one is best suited to the circumstances of the organisation to obtain the optimal outcome for the major shareholders (Alatassi and Letza, 2018).

Under stewardship theory, corporate governance trusts in the relationship between the shareholders and managers, where the latter are known as stewards who behave in the best interest of shareholders. This is contrary to agency theory, which assumes that managers and shareholders have a conflict of interest. However, Obid and Naysary (2016) claim that individuals need a certain level of independence to show their skills and competencies more effectively. Thus, to improve stewardship behaviour among leaders, they must be allowed some degree of independence (Gibson, 2000; Aduda et al., 2013).

Stakeholder Theory

In the early 20th century, corporations focused only on maximising shareholder capital and other stakeholders were overlooked (Bhasa 2003). This type of argument contributed to the stakeholder theory that companies would seek to maximise stakeholders' interests rather than concentrate on shareholders' advantages. The stakeholder theory, introduced by Freeman (1984), argues that all parties with legitimate interests in the business should benefit and that there is no priority in these interests and benefits (Donalds and Preston, 1995). Freeman (1994) defines stakeholders as "any group or individual who can affect, or is affected by, the achievement of a corporation's purpose."

According to Gray et al. (1995), agency theory deals with the relationship between management and shareholders, while stakeholder theory considers the relationship between management and all other stakeholders, including employees, shareholders, customers, suppliers and government. Solomon (2010) argues that businesses are so vast and have such a pervasive impact on society that they need to be accountable to far more segments of society than just their shareholders. Not only are stakeholders impacted by companies, but they also affect companies in some other ways. The central argument of stakeholder theory is that companies should always be run with respect to the needs of all their members, not just the interests of the shareholders.

The stakeholder philosophy of corporate governance fits perfectly with the view of an organisation that aims to provide its multiple stakeholders with sustainable value (Wheeler and Davies, 2004). Corporate governance considers stakeholders as a tool to successfully achieve the company's objectives. Freeman (1994) argues that managers react to pressure from stakeholders since it provides them with credibility and importance. Christopher (2010) claims that the theory of stakeholders is central to corporate governance theory because it allows for a foundation for managers that considers and balances the diverse needs of the large stakeholder base alongside the different purposes of the company. Stakeholders influence corporate performance since their involvement in corporate decision-making increases profitability, productivity and corporate value (Turnbull, 1997). It is, therefore, anticipated that the participation of the stakeholders in corporate management will significantly contribute to the corporation's efficiency.

Stakeholder theory was criticised for being single valued (Jensen, 2001), deviating the company from its priorities by concentrating on the stakeholders (Ansoff, 1987). In response to these criticisms, Roberts (1992) suggests that companies should prioritise their stakeholders based on their importance, power and dependency, and plan their strategy accordingly. In contrast to agency theory, stakeholder theory does not focus on information asymmetry but emphasises the importance of stakeholder participation in decision-making and stresses the importance of the firm's accountability to its stakeholders through regular reporting and open communication.

Three main theories explored in the preceding sections can demonstrate the corporate governance framework. Agency theory, for example, may be useful in context but is ultimately limited by the problem of conflicts of interest between shareholders and managers. As such, it must balance both cost and efficiency. Caring for the intersection of interests between stakeholders, stakeholder theory argues that there is no trade-off between stakeholders. Businesses must protect the rights of diverse stakeholders, including shareholders (Clarke, 1998; Edgley et al., 2010). The stewardship theory views managers as selfless rather than self-interested individuals who find success by assisting the company in achieving its objectives.

2.3 Research Theoretical Framework

This section describes the CG theories employed to investigate the influence of SCG on risk management. A solid and comprehensive Shariah corporate governance framework is necessary to monitor the Islamic banking system and enhance the social confidence of stakeholders and social welfare (Grais and Pellegrini, 2006). In analysing Shariah corporate governance, the agency and the stakeholder theories have been included in prior research (Al-Nasser Mohammed and Muhammed, 2017; Alam et al., 2020a; Alam and Miah, 2021). Many corporate governance studies (Turnbull, 2000; Dühnfort et al., 2008; Elena, 2012; Yusoff and Alhaji, 2012) have shown that adhering to one theory to explain the corporate governance phenomenon is inefficient. Therefore, it is proposed that a combination of different theories is optimal for defining efficient and sound Shariah corporate governance practices.

The most influential theories on the evolution of corporate governance are agency theory, which focuses on the relationship between the managers and shareholders, and stakeholder theory, which considers a broader group of stakeholders (Mallin, 2007). The principal-agent relationship has been examined in the context of Islamic organisations (Haque and Mirakhor, 1986; Bashir, 1996). The agency theory emphasises the importance of establishing robust supervision measures to control the opportunistic tendencies of top-level management, such oversight is essential to protect the interests of shareholders and increase their wealth (Najwa et al., 2019). However, Islamic organisations face an additional cost for an agency when all transactions must be Shariah-compliant (Safieddine, 2009). Accordingly, rigorous supervision may be necessary to evaluate managerial performance in an Islamic business. According to Mollah and Zaman (2015), Shariah supervisory boards function as an additional layer of corporate governance in Islamic banks. They can act as an effective oversight mechanism, particularly in cases of moral hazard (Najwa et al., 2019). This may promote a shift in agency behaviour and reduce the problem of managers pursuing their own self-interest (Shapiro, 2005). Indeed, managers in Islamic firms should be accountable not only to the company, its shareholders and all stakeholders, but also to Almighty Allah in order to improve the welfare and growth of society (Siddiqui, 2008; Abu-Tapanjeh, 2009). The Shariah board has a significant impact on the outcome of any strategic decision-making; consequently, extra layers of internal and external Shariah audits are necessary to prevent opportunistic behaviour and eliminate information asymmetry in financial reporting (Abdul Rahman and Haneem, 2006).

Stakeholder theory is extremely useful for explaining the phenomena that occur in Islamic banks (Vegirawati et al., 2019). According to Grais and Pellegrini (2006), there are two main corporate governance responsibilities that are unique to Islamic financial institutions (IFIs). To begin, stakeholders must be assured that their actions are fully compliant with Shariah principles. Second, stakeholders must be confident that IFIs intend to continue and improve growth and are capable of demonstrating their efficiency, stability and trustworthiness. Islamic banks include consumers, local communities, employees, managers, regulators and Shariah oversight boards (Agriyanto, 2015). The Shariah supervisory board is a set of stakeholders unique to Islamic banks (Vegirawati et al., 2019). This board ensures that products and services provided to clients and investors are compliant with Shariah regulations and principles (Hamza, 2013). According to Dusuki (2008), stakeholders anticipats that the Islamic Bank would prioritise the promotion of Islamic values and this way-of-life among its employees, customers and the general public.

Using Shariah principles in banking operations influences the nature of financial product risks and introduces certain new risks (Basiruddin and Ahmed, 2019). Shariah non-compliance risk arises from failing to comply with Shariah rules and principles established by the Shariah board or the relevant body in the jurisdiction in which the Islamic bank operates (IFSB, Islamic Financial Services Board, 2005). As a result, a failure to comply with Shariah law in the management and operation of an Islamic bank leads to the noncompliant transaction being declared void and, thus, the income from such activities or products is not recorded in the bank's records and is donated to charity. As the income from these activities is excluded from the bank's revenues, but the costs are incurred, the bank incurs net losses on these unsought transactions (Basiruddin and Ahmed, 2019). Chapra and Ahmed (2002) discovered that a significant proportion of the depositors and investors of Islamic financial institutions would move their accounts to other banks if Shariah violations persisted over time; thus, the Islamic bank's goal is to maximise shareholder value by complying to Shariah law (Grais and Pellegrini, 2006; Safieddine, 2009). A high standard CG is required to manage the risk management related to Islamic banks (Reyad et al., 2022). Therefore, rigorous monitoring reduces the probability of excessive risk-taking by limiting the executives' authority to make decisions based on their own interests (Najwa et al., 2019).

Thus, Shariah corporate governance as a control mechanism in Islamic banks seeks to mitigate the agency problem in relation to Shariah issues. Accordingly, granting transparent and accurate information regarding the compliance of Islamic bank functions with Shariah principles can minimise the information asymmetry and ultimately increase the confidence of the public and investors. Therefore, it accommodates the needs of a wide range of stakeholders, including employees, clients, suppliers and the general public.

Hence, this study adopts a combination of agency and stakeholder theories to understand the role of the Shariah corporate governance framework in risk management in Islamic banks. The agency theory is adopted for this study due to its dominance in corporate governance disclosure literature. Moreover, Shariah corporate governance acts as a unique monitoring tool that can minimise agency problem by producing a report on the Shariah compliance of banks, which reduce the information asymmetry among management, shareholders, investment account holders and the Muslim community regarding Shariah matters (Obid and Naysary, 2016).

While stakeholder theory is adopted as a complement to agency theory (because of the accountability nature of stakeholder theory), one way of conducting this accountability is by transparency and reporting on the firm's functions (Obid and Naysary, 2016). Accordingly, from an Islamic point-of-view, stakeholders expect Islamic banks to undergo reporting and transparency, which are imperative when discharging the firm's accountability to its stakeholders (Obid and Naysary, 2016). Therefore, the underlying premise of this study involves an integration of the arguments of agency and stakeholder theories into the Shariah corporate governance system that influences the risk management process. This, in turn, enhances Shariah compliance and decreases the information asymmetry on Shariah matters between the Islamic bank and the various stakeholders, thus, fostering stronger relationships between the two.

2.4 Corporate Governance in the Developing Countries

World Bank studies have identified good governance as one of the most important drivers of sustainability, economic growth and prosperity (Saidi, 2004). For developing countries, which are typically marred by inadequate institutions, there is a comparative lack of literature on the subject despite the possibility of a promising debate (Adegbite, 2015). According to Singh (2003), most emerging markets are not active corporate-control markets in the Anglo-Saxon sense. These emerging markets are likely to be vastly imperfect and suffer from higher information deficits compared to US and UK markets.

In Africa, corporate governance issues are frequently discussed in the context of corruption, which has impeded social, economic and political growth on this continent (Adegbite, 2012). Thus, African corporate and capital markets regulators view good corporate governance and accountability as one of the most effective strategies to combat corporate corruption (Mensah et al., 2003). Nigeria, the largest economy in Africa (The Economist, 2014), presents a relevant empirical context due to the differences between its corporate governance structure and the commonly studied Anglo-American system (Adegbite, 2015). The Securities and Exchange Commission (SEC) Code (2003), which was principle-based and applicable to all listed businesses, marks the commencement of effective corporate governance regulations in Nigeria (Nakpodia et al., 2018). Nevertheless, despite the benefits generated by this Code, its implementation and enforcement have presented numerous obstacles (Ofo, 2010). Adegbite (2012) found that the code relied on inputs that were developed and more relevant in different institutional environments. In a non-conducive environment, adopting corporate governance rules that are best suited to Western and less corrupt countries can be unproductive (Soludo, 2006; Okike, 2007).

Interest in corporate governance is not a new phenomenon in the Middle East's transition economies (Braendle, 2013.). Even though most MENA countries have developed codes of good governance, the majority do not adhere to specific shareholder- or stakeholder-oriented CG models (Farah et al., 2021). Rather, many have their own distinctive CG characteristics, representing a hybrid model with an Islamic focus that is reflected in the Shariah law that governs commercial transactions (Foster, 2006). Moreover, MENA countries have substantial governance vacuums in terms of institutional rules and enforcement, causing greater rates of corruption and economic instability (Aguilera et al., 2019).

Several recent corporate scandals in Asian emerging markets (AEMs), such as the expropriation of minority shareholders in Chinese companies like Meierya or Snjiu (Bai, Liu, Lu, Song and Zhang, 2004) and the Satyam scandal, one of the largest fraud cases in India (Chen, Li and Shapiro, 2010), highlight the importance of instituting strong control mechanisms. In fact, AEMs are distinguished by a specific setting of weak, dynamic and diversified institutions, which influences corporate governance in these countries (Oehmichen, 2018).

The consideration of CG implementations in developing countries is motivated by the desire to foster investor confidence, i.e., attracting foreign and domestic investment and enhancing trade (Abhayawansa and Johnson, 2007). Mobius (2002) believes that the adoption of CG was stimulated by the notion that the financial crisis, which hit Southeast Asian stock markets during 1997 and 1998, was partly due to the region's weaker CG. According to Monks and Minow (2011), this has resulted in governance reforms in developing economies to restore trust among investors by providing a stable institutional forum to create investment markets. However, Singh (2003) claims that although there may be deficiencies in corporate governance in many developing countries, which has led to emerging countries having dynamic product markets (a part of the external corporate governance mechanism), they can demonstrate almost as much competition strength as in advanced countries.

2.4.1 Overview of Saudi Arabia

This section focuses on the fundamental overview of Saudi Arabia, such as the political, social and economic aspects and the legal structure of Saudi Arabia as an essential part of corporate governance.

2.4.1.2 Saudi Arabia: Religious Context

In 1932, King Abdul Aziz Ibn Abdul Rahman Al-Faisal Al-Saud succeeded in consolidating the Kingdoms of Nejd and Hejaz to establish the Kingdom of Saudi Arabia's independent Islamic monarchy after three decades of intermittent warfare (Al-Habshan, 2017). Saudi Arabia has a significant place in the Islamic world, including the holiest Muslim locations in Mecca and Medina. The value of the religion of Islam in Saudi Arabia is apparent and has a broad influence on all forms of everyday life in Saudi Arabia. This Kingdom is a developing country; its economy relies on oil exports, which are the primary source of national revenue (90 – 95% of total national income and 35 – 40% of GDP) (Falgi, 2009). Saudi Arabia is noteworthy among the emerging Islamic countries since it enjoys strong political stability, provides its private business sector with liquidity and financial incentives and has a robust infrastructure, affordable workforce and low tax rates. Besides having the highest Middle East stock exchange, Saudi Arabia has become one of the world's largest developing markets (Piesse et al., 2012). Saudi Arabia is considered a key member of the world's 20 largest economies (G20) (Al-Filali and Gallarotti, 2012). It is regarded as an Islamic nation in which Islamic values influence cultural norms, business practices and daily practices. Consequently, any structure implemented, including the corporate governance framework, is modified to one that is Islamic and socially acceptable.

2.4.1.2 Saudi Arabia: Legal Context

The governance structure of Saudi Arabia is a monarchy that is restricted to the male descendants of King Abdul-Aziz. Saudi Arabia has a centralised system in which the King is the head of the Council of Ministers; this means that he oversees the Kingdom's domestic and external affairs and coordinates the different parts of the government.

The Saudi Arabian legal system is based on a duality approach, with the rules of Shariah on the one hand and civil law on the other (Alkahtani, 2016). Since Saudi Arabia is an Islamic country, its rule of law generally adheres to Islamic laws. The two primary origins of Islamic law are the Qur'an (the Book of God) and the Sunna (Prophet Muhammad's practices, peace be upon him). Shariah-based law, derived from these two sources, is Islamic legislation that specifies both the code of conduct and Islamic law.

The laws of Saudi Arabia are classified into two groups (Cassell and Blake, 2012). One group is built upon the laws of Islamic law (Shariah), especially the law on personal status, criminal law and the law on property. The other is focused on modern rules, especially those relying on international conventions or universal guidelines. The government of Saudi Arabia is composed of three authorities: the executive, legislative and judicial authorities. However, the King has the power to make a final decision about the laws to be enforced by these three authorities (Saudi Arabian Basic Law of Government, 1992, Chapter 6, article 44).

The discovery of oil in 1938 demonstrated the need to follow a new collection of statutory laws and legislation controlling and overseeing the relations of Saudi Arabia with other nations, particularly the Western ones (Alkahtani, 2016). Correspondingly, the Saudi Government has made significant progress in updating parts of its laws and legislation between 1957 and 2006. Since 1965, Saudi Arabia's legislative law has primarily played a crucial role in activities such as commerce, the banking industry, labour, taxation, arbitration and resolution of trade and securities disputes (Alkahtani, 2016).

2.4.2 Overview of Corporate Governance in Saudi Arabia

In the last two decades, Saudi Arabia has experienced political, social and economic transformations (Al-Filali and Gallarotti, 2012; Al-Matari et al., 2012). The recent economic changes have led to an improvement in Saudi Arabia's economic position. Corporate governance reforms are a significant aspect of economic reforms in Saudi Arabia. The Saudi government initiated corporate governance reforms in the early 2000s as a part of the general economic reforms (Al-Matari et al., 2012). These reforms were associated with the growing attention given to corporate governance after the collapses and scandals in developed nations, such as the United Kingdom and the United States (e.g., Barings Bank, Enron and WorldCom), and developing countries, like the Asian economic crisis of 1997/1998 (Haniffa and Hudaib, 2006; Hussainey and Al-Najjar, 2012; Ntim et al., 2012).

Until the early 2000s, the significance of corporate governance was little appreciated in the Arab world in general and in Saudi Arabia in particular (Al-Motairy, 2003). Prior to 2006, there were no clear corporate governance rules in Saudi Arabia (Ali, 2019). International bodies such as the World Bank, the International Monetary Fund (IMF) and the Organisation for Economic Co-operation and Development (OECD) have generally motivated developing countries (especially Saudi Arabia) to prioritise corporate governance, particularly facilitating the introduction of good corporate governance codes (Rwegasira, 2000; Clarke, 2004; ROSC, 2009).

In 2003, as a result of increasing domestic and international pressure, the Saudi government formed the Capital Market Authority (CMA) (Al-Nodel and Hussainey, 2010). The creation of the CMA was a major move forward and has (by far) been viewed as the most successful corporate governance reform in Saudi Arabia.

However, the Saudi stock market crisis in 2006 was a historic point in the Kingdom's economic and political life. According to Alkhaldi (2015), the crash was caused by a combination of factors, including a lack of investor knowledge of investment and securities, a shortage of readily available financing from financial institutions, which encouraged individuals to continue investing money they could not afford to lose, and a lack of transparency and disclosure by listed companies, banks and some governmental agencies involved in the stock market. Consequently, a governance code was urgently required that could help improve practices in corporate governance among listed Saudi companies (Alshehri and Solomon, 2012). Therefore, the CMA was charged with creating a set of good practice regulations, and the resulting document: “Corporate Governance Regulations in the Kingdom of Saudi Arabia,” was released in November 2006. The key goal of CMA was to restore confidence in the market and protect investors (Al-Abbas, 2009). Compliance with this code’s regulations is compulsory (Al-Smadi, 2013). The amendments to the code, in 2009 and 2010, were significant for the transitional CG practices in the country (Gashgari., 2017). The most recent Corporate Governance Regulation amendment in 2017 aimed to promote accountability, transparency and investor capital stewardship (Ali, 2019).

Corporate Governance in Saudi Banks

Local banks in Saudi Arabia are listed on the stock exchange and, thus, comply with the corporate governance regulations of the Capital Market Authority (CMA) and the market trading laws. Saudi Arabia’s commercial banks play a significant role in the country’s economy. In response to this, the Central Bank and the Banking Supervisory Authority, SAMA, have played a leading role in improving corporate governance in the banking sector in Saudi Arabia. SAMA operates as a player in Saudi Arabia’s corporate governance legislation and regulatory framework for banks. In past decades, SAMA has issued numerous corporate governance directives, including the powers and responsibilities of the board of directors of commercial banks in Saudi Arabia, the qualifications for appointment to senior positions in Saudi Arabian banks, the internal management rules and the professional ethics code for employees’ board (Al-Smadi, 2013).

In 2012, SAMA issued guidance on corporate governance for banks operating in Saudi Arabia. It has issued these standards in order to carry out the growth of the banking system in the light of increasing external interest and to help banks strengthen their structure for corporate governance. In 2014, SAMA published the latest version of the Corporate Governance Standards for Banks operating in Saudi Arabia. This complements the laws, guidelines and circulars previously issued by SAMA on key corporate governance standards and the compulsory corporate governance code issued by CMA in 2006 to improve financial sector performance (AlSagr et al., 2018). This framework covers corporate governance for Saudi Arabian banks but excludes Islamic banking, which has distinct work bases, philosophies, and committees (Al-Twairesh , 2021).

Consequently, in February 2020, a Shariah governance framework was established to regulate and enhance the work of Islamic banks and Islamic windows within other banks. In fact , this Shariah Governance Framework is the first step towards establishing a foundation level of Shariah compliance in the Islamic banking industry, clarifying the roles and responsibilities of the board of directors, executive management, shariah committee, and internal control functions, and enhancing compliance with Shariah provisions and principles.

2.4.3 Financial Regulation and Supervisory Authorities

Capital Market Authority (CMA)

The capital market authority is the financial regulatory authority of the Saudi Government responsible for capital markets in Saudi Arabia. The CMA is a government agency that maintains complete financial, legal and administrative independence and has direct connections with the Prime Minister (CMA, 2020). The duties of the CMA are to regulate and develop Saudi Arabia's capital market by providing the rules and regulations needed to enforce the capital market law provisions. The fundamental aims are to build a satisfactory investing environment, enhance confidence, strengthen transparency and disclosure standards in all listed companies, and protect investors and dealers from illegal market activity (CMA, 2020).

The Saudi Arabian Monetary Authority (SAMA)

The banking and finance activities in Saudi Arabia are controlled by the SAMA, established as the central bank of the Kingdom of Saudi Arabia (KSA) in 1952, which functions under the 1966 Banking Control Law as amended by Decree 2/1391 (Pepper, 1992). The Saudi government established SAMA to preserve the consistency of banking performance and control their financial activities. SAMA's key roles include issuing national currency, serving as a lender to the government, supervising all local banks and insurance firms, monitoring foreign exchange reserves, conducting monetary policy to preserve equilibrium in the exchange rate and promoting growth in the financial sector (SAMA, 2012).

To achieve its objectives, SAMA is committed to implementing internationally applicable best practices and preserving (and continually improving) highly qualified human resources that are assisted by sophisticated and advanced technology. SAMA has an independent internal audit department. The internal audit department's role involves assessing risk management practices, internal control, information technology and governance processes. SAMA's internal audit department adopts a risk-based approach. In this strategy, audit resources and efforts are targeted at key risks and are directed towards the most significant tasks for developing the annual plan or the planning and performance of audit functions (SAMA, 2020). Moreover, SAMA has incorporated in its strategy the principle of risk management and compliance with the goal of preserving a culture characterised by a high level of expertise and an understanding across a scientific and technological basis (SAMA, 2020).

2.5 Corporate Governance from Islamic Perspectives

Having discussed CG from the conventional point of view, the following section introduces an overview of CG from the Islamic perspective.

2.5.1 What is Shariah?

Shariah is strongly connected to Islamic law. Generally, the term "Islamic law" refers to the entire system of law and jurisprudence associated with the religion of Islam (Al Faruqi, 1986). Many scholars interchangeably use the words Islamic law and Shariah (Haddad and Lummis, 1987). In Arabic, Shariah means the way or the path to the source of life. Shariah is defined as "a code of law or divine injunctions that regulate the conduct of human beings in their individual and collective lives" (Ayub, 2013). Shariah is a code of conduct that acts as the foundation of a Muslim's life (i.e., social, economic and political).

2.5.2 Legal Sources of Shariah

There are two prime sources of Shariah Law, primary and secondary. The primary sources of Shariah Law are the Qur'an (Muslim's Book of God), the first and principal foundation of Islamic jurisprudence. In addition, there is the Sunnah (Deeds and Reports of Prophet Muhammad ﷺ). Secondary sources of Islamic law are available, but only two are used in Saudi Arabia as a basis for legal principles, namely the Ijma and the Qiyas (Al Shalhoub, 1999). Issues involved in these sources are not discussed in the Qur'an and Sunnah. Secondary sources are significant because the primary sources do not cover human life's economics, finances, interest and other financial aspects (Al Faruqi, 1986).

2.5.3 Islamic Banking Fundamentals

Islamic banking theory derives from the holy Qur'an, which forbids trading money as a commodity. Islamic Banks must comply with Shariah regulations and ensure that their practices, products and management are in accordance with Shariah rules. Thus, Islamic banking is a framework consistent with Shariah concepts that are guided by Islamic economics. In other words, Islamic banks are Islamic financial institutions that develop more creative consumer products and services. Therefore, it is essential to understand the principles of Islamic banks and the specific characteristics of each concept.

The Prohibition of Interest (Riba)

The Prohibition of Interest is the most distinctive and influential characteristic of Islamic banking. Therefore, the essential feature of Islamic banking is that it is interest-free. According to Chapra (1984), “Riba technically refers to the premium that the borrower must pay to the lender along with the principal amount as a condition for taking the loan.” Riba simply means “excess” and applies to any unjustifiable capital increase through loans or sales (Van and Iqbal, 2007).

Islamic banks should not charge or pay interest. Uusmani and Us̱ mānī (2002) clarify that, in contrast, to traditional financial systems, Shariah does not add an intrinsic value to capital, meaning that it does not consider money trading as a transaction. Money is considered only to pay for goods and services in trade. When it changes hands, it does not increase in value. Nevertheless, individuals can earn a profit by exchanging one currency for another and buying and selling goods.

The Prohibition of Gambling (Qimar and Maysir)

Gambling in the Islamic financial system is another foundational ban. The message underlying the Shariah prohibition on gambling is to encourage the acquisition of wealth through hard work. A ban on gambling means an agreement is unlawful if it has a gambling component, since it requires speculation and an effort to accumulate wealth without adding any productive effort into it (Jabbar and Faridah, 2009). This ban means an Islamic fund cannot invest in casinos, online lotteries, lottery draws and betting transactions (Jamaldeen, 2012).

The Prohibition of Uncertainty (Gharar)

The Prohibition of Uncertainty applies technically to the sale of items whose likely existence or characteristics are uncertain or a sale featuring excessive risk or moral hazard. For example, it is prohibited to sell fish from the ocean that has not yet been caught (Chong and Liu, 2009). Therefore, before being caught, Gharar is associated with any undefined financial activity, such as a bird trade or fishing. To prevent Gharar in Shariah financial agreements, contracts should be free of unnecessary ambiguity and the goods should be specified, achievable, clearly known to the contracting parties and agreed (Ayub, 2007). Otherwise, on suspicion of uncertainty (Gharar), goods and services would be invalidated (Venardos, 2010).

2.5.4 Islamic Financial Contracts

Islamic financial contracts are a unique set of financial contracts, including Murabaha, Ijara, Salam, Mudarabah and Musharakah, that adhere to Shariah’s rules and principles (Jabbar and

Faridah, 2009). Such Shariah contracts encourage efficient economic activity without betraying the core Islamic values, unlike certain other conventional financial products (Jamaldeen, 2012). The Islamic contract must legally include legal subject matter, be advantageous to the Muslim and be concise enough to prevent uncertainty and doubt. For the purposes of this study, we will discuss the primary Islamic financial contracts used by most Islamic banks, namely Murabaha, Musharakah, Mudarabah and Ijarah.

Murabaha (mark up or cost plus)

Murabaha is the most famous and growing style of Islamic finance in contemporary Islamic banks. In a cost-plus contract, the Islamic financial institution sells a product to the customer for its cost-plus profit margin, and both parties are aware of the cost and profit beforehand. Deferred payments are made by the buyer (Jamaldeen, 2012). Murabaha's key ingredient is that all parties know the cost of the goods to be sold and the profit on the sale. The Murabaha price may be paid on time or in a lump sum after a certain time. Indeed, it is used for providing Islamic financing services in numerous and diverse sectors. For example, the purchase of consumer goods, vehicles, household appliances, housing finance, machinery, equipment and raw materials.

A Murabaha contract is the most widely known contract used in Islamic finance, i.e., it is approximately 59% of the total value of Islamic banking products (Lee and Ullah, 2007). This is because Murabaha is less risky than other financial contracts, such as Musharakah and Mudarabah, and the time period for payment between seller and buyer is agreed upon in advance (Al-Shamrani, 2014). The only distinctive feature that defines Murabaha from other forms of Islamic financing is that the bank explicitly informs the customer on how much cost it has caused and how much profit it will charge in addition to the cost.

Musharakah (joint venture or PLS)

A profit-and-loss sharing (PLS) model is a unique feature that differentiates Islamic banking from conventional banking (Chong and Liu, 2009). Musharakah is a contract whereby the Islamic Bank and the customer agree to combine their financial resources to set up or run a business or project, or undertake any type of business (Ayub, 2007).

A Musharakah contract includes a partnership between two or more parties and is based on capital at work (Jabbar and Faridah, 2009). The Islamic system allows for an equal distribution of risks and profits between the parties involved in a financial transaction. This contract forms a joint venture in which both parties provide funds for investment, entrepreneurial expertise and labour; both share the business' profit or losses (Jamaldeen, 2012). In addition, the proportion of profit to be distributed between the partners must be determined and agreed upon at the time of the contract. If not, the contract would not be legitimate.

Mudarabah (PLS)

Mudarabah is the most commonly known Islamic contract. It is a profit-sharing contract where one party (Rab al Maal) provides funds, and the other party (Mudarib) provides management knowledge and experience. The provider will find a person with good experience to manage the project and an entrepreneur who uses his skills and expertise to invest the capital as decided (Ayub, 2007). The profit is distributed between the two parties based on the ratio agreed upon at the time of the contract (Ayub, 2007). Financial losses, if any, are the responsibility of the capital owner and the manager then loses his share of the expected profits. The fund manager will lose the value of the investment's time and effort. Nevertheless, if the loss arises from negligence, the fund manager takes fiscal responsibility (Jamaldeen, 2012).

Ijara (leasing contract)

Ijara is a concept of Islamic jurisprudence. It means providing something for rent (Kettell, 2011). It is an Islamic financing practice involving the use of assets without ownership criteria. This form of Islamic financing is used to fund the purchase of properties on Shariah-compliant terms. Ijara is to transfer to another person the usufruct of a particular property in exchange for a rent claimed by him (Kettell, 2011). However, unlike a conventional lease contract, Shariah requires the leaser to be responsible for all injury, repairs insurance and leased asset depreciation. The leaser should also bear the risk of uncertainty associated with the leased asset's useful life (Khan and Bhatti, 2008). Under Ijarah, the Islamic bank purchases the asset from the seller, after which the Islamic bank leases it to the purchaser at the agreed price plus profit at a fixed rental rate for a certain duration (Newell and Sieracki, 2009).

2.5.5 What is Shariah Corporate Governance?

The phenomenon of Shariah corporate governance originated in the 19th century after the advent of Islamic banking and finance. Shariah corporate governance has received much interest in the Literature of Islamic Institutions, especially the banking sector. The increase in the number of companies that comply with Shariah has contributed to the formulation of guidelines on corporate governance per Islamic law (Muneeza and Hassan, 2014). Shariah corporate governance originates its principles from the origins of Islamic law.

Numerous studies utilise the phrase "Shariah corporate governance", but few clearly define it (Hasan, 2011). Since the phenomenon remains new, there are very few comprehensive definitions. According to Hassan (2010), Shariah corporate governance is a system conducted by Shariah principles, managed and controlled by an effective religious board to ensure that IFIs are per Shariah codes. Gianna and Hamid (2015) define Shariah corporate governance as the system that oversees the conformity of the operations and transactions of Islamic banks and financial institutions with Shariah principles. Compliance with Shariah corporate governance is encouraged by international institutions of regulations like the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) and the Islamic Financial Services Board (IFSB) (Hamza, 2013). Founded in 1991 and based in Bahrain, the AAOIFI is the leading international non-profit organisation primarily responsible for creating and issuing guidelines for the international Islamic financial sector. The AAOIFI does not define Shariah corporate governance even though they have established the Shariah governance standards (Kasim et al., 2013).

However, the Islamic Financial Service Board (2009) defined Shariah corporate governance as a combination of the institutional and organisational frameworks by which Islamic financial institutions and bodies ensure that there is efficient independent supervision of Shariah regulation over Shariah pronouncements, distribution of information as well as an internal Shariah compliance audit. This seems to be the most detailed definition of Shariah corporate governance (Kasim et al., 2013). Ultimately, Shariah corporate governance varies from conventional governance in that accountability is not only to stakeholders but also to God (Allah) (Abu-Tapanjeh, 2009; Widiyanti et al., 2011). However, the meaning of the Shariah corporate governance system is crucial because it is critical to clearly understand its meaning and structure.

2.5.6 Importance of Shariah Corporate Governance for Islamic Banks

Managing and controlling Islamic banking necessitates the presence of frameworks and legislations that attempt to regulate the boundaries of Islamic banking on the theoretical, contractual and legislative levels from the perspective of Islamic law (Al twairesh, 2021). The Islamic financial sector is the backbone of the Islamic economic system (Mushafiq and Sehar, 2021). In particular, the rapid development of IFIs has stressed the need for Islamic finance policy to develop a Shariah corporate governance framework (SCGF) that can serve domestic and international financial structures (Archer et al., 2010). Moreover, the lack of Shariah principles in the current corporate governance business operations is a major factor towards why SCGF is so important.

According to Abu-Tapanjeh (2009), the Islamic financial system cannot be a complete and comprehensive governance system if it lacks genuine moral and ethical features. Nevertheless, the distinctive peculiarities of Islamic banks necessitate a Shariah corporate governance framework that guarantees the adoption of Shariah principles in the banks' operations (Haridan et al., 2018). In other words, all Islamic banking products must adhere to Shariah's principles. To evaluate the legitimacy of Islamic banking products, Islamic banks require a Shariah corporate governance system. Consequently, Shariah corporate governance serves as an additional layer of governance expressed by the Shariah board to safeguard the Islamic banks' integrity and guarantee the products' legitimacy. According to Wilson (2009), Shariah corporate governance is essential when maintaining balance and fairness in Islamic financial transactions. In this respect, Shariah corporate governance is important because it improves public trust in IBs and their compliance with Shariah laws. Conflicts may arise without such a governance system, resulting in financial and non-financial losses (Alam et al., 2021).

Islamic banks, as financial intermediaries, must handle not only the common risks associated with conventional banks but also risks that are unique to Islamic banks (Embi and Shafii, 2018). Therefore, another major importance when implementing the Shariah governance framework is that such a framework is a risk management mechanism for reducing the Shariah non-compliance risk. According to the Guiding Principles on Risk Management (IFSB, 2005), Shariah risk is one of the operational risks that can be handled through a robust and effective Shariah governance structure. Saba (2018) argues that the Shariah governance system is essential for managing non-compliance risk and reducing reputational risk. Therefore, this indicates the importance of adopting specialised governance for this unique industry.

2.5.7 Shariah Governance Standard-Setting Bodies

The two-leading standard-setting bodies in Islamic finance, the AAOIFI (Accounting and Auditing Organisation for Islamic Financial Institutions) and the IFSB (Islamic Financial Services Board), provide the predominant guidelines for Shariah governance.

AAOIFI Shariah Governance Principles

The AAOIFI has released a total of 97 standards for international Islamic finance in the fields of Shariah, accounting, auditing, ethics and governance. Of which 57 are on Shariah, 26 are the accounting principles, 5 are the audit guidelines, 7 are the governance principles and 2 are the codes of ethics. Without any corporate governance structure for IFIs, the AAOIFI undertook the first steps (in the late 1990s) to establish basic guidelines for Shariah governance in the governance criteria Nos. 1-5. These five criteria should not be reviewed individually since they complement one another (Hasan, 2012). AAOIFI is mandatory in countries such as Bahrain and Oman and is supported by 200 institutional members from 45 countries, including central banks, Islamic financial institutions, and other participants from the international Islamic banking and finance industry (Ullah et al. 2018).

IFSB Shariah Governance Standards

The IFSB has released 22 guidelines for IFIs that cover areas in capital adequacy requirements, risk management, governance, disclosure and supervisory review process. The primary objective of the IFSB is to support the Islamic finance industry in terms of legislation, guidelines, training, research, databases and best practices, and to encourage greater consistency.

The IFSB-10 Standard was issued in 2009; it began with a clear explanation of Shariah governance and guidelines for applying the standards. The need for a Shariah governance structure has already been discussed in the IFSB-1 and IFSB-5, both of which strongly suggest that IFIs develop sound policy and institutional arrangements for managing operational risks, specifically Shariah-compliance risks, as well as defining the supervisory review process (Hasan, 2012). The fundamental premise of IFSB-10 is to encourage best practices in Shariah governance by highlighting five guiding principles. The five guiding principles include the general approach to the Shariah governance system, competency, independence, confidentiality and consistency.

In fact, Islamic banks are not required to adhere to IFSB and AAOIFI standards; compliance is entirely voluntary. Although the guidelines and governance standards of the AAOIFI and the IFSB are not legally binding, policymakers and practitioners do take the principles outlined in these documents into account (Hasan, 2011). According to Ullah (2018), compliance with AAOIFI and IFSB standards is crucial for Shariah compliance risk management, operational risk mitigation, and transparent financial reporting. Majid and Ghazal (2012), argue that Islamic banks are in their infancy, and Basel II compliance has become an essential element for gaining international recognition. Furthermore, as long as AAOIFI and IFSB recommendations are included in Basel II, the regulatory framework will bring standardization for Islamic banks.

2.5.8 Shariah Corporate Governance Main Pillars

Five dimensions shape the Shariah corporate governance practice: Shariah committee, three control functions – Shariah risk management, Shariah review and Shariah audit, as well as transparency and disclosure (Bank Negara Malaysia 2017). The Shariah corporate governance framework is diverse and differs from country to country due to distinct sociocultural and political conditions (Alam and Miah, 2021). Shariah governance ensures that all transactions and bank functions comply with the guidelines mandating that Islamic banks keep distinct departments, including a Shariah Supervisory Board (SSB), Shariah Executives, Shariah Secretariat and Shariah Audit Review and Research Units (Alam et al. (2020). In practice, this depends on the size and activities of the bank.

The Shariah Supervisory Board (SSB)

The Shariah Committee (SC), also known as the Supervisory Board, is an independent committee that serves as an oversight body for the operations of the IBs and business concerns (Masruki et al., 2020). Therefore, the Shariah Board, Shariah Committee and Shariah Supervisory board refer to the same group of distinguished Shariah scholars (Alam. et al., 2020). These different designations vary from country to country. However, the purpose is mutual: the AAOIFI (2005) defines a Shariah board as "an independent body entrusted with the duty of directing, reviewing and supervising the activities of IFIs for Shariah compliance and issuing legal rulings about Islamic banking and finance."

Shariah corporate governance in Islamic banks is characterised by the presence of the Shariah Supervisory Board, which is responsible for assuring stakeholders of the bank's compliance with Islamic law (Grais and Pellegrini, 2006). Thus, a key element of IBs is the existence of SSBs to ensure conformity with Shariah principles (Mollah and Zaman, 2015). To minimise management's opportunistic behaviour, the SSB acts on behalf of the stakeholders and is responsible for verifying and supervising all financial contracts and bank activity (Abdesalam et al., 2016). Therefore, Shariah corporate governance needs another layer to ensure Shariah compliance of the IBs. Indeed, a Shariah Supervisory Board is established in IFIs as an additional yet critical component of their CG process (Nomran and Haron, 2019). Studies have demonstrated that the supervisory function and the establishment of SSB positively affect the performance of Islamic banks (Nomran et al., 2018; Mollah and Zaman, 2015). Furthermore, the size, composition, qualifications, education and understanding of Islamic jurisprudence alongside contemporary and Islamic finance expertise all positively influence the performance of IFIs (Almutairi and Quttainah, 2017). Likewise, highly qualified SSB members contribute to increased profits and accomplishments (Nomran et al., 2017). Khan et al. (2017) further indicate that knowledge of Shariah by SSB members with accounting, finance or economics degrees significantly correlates with Islamic banks' performance and profitability.

Additionally, prior studies have shown the important role of SSB, which has maintained and improved the credibility of IFIs and functions as a monitoring mechanism to control the activities and operations of the IFIs in relation to complying with Shariah principles (Iqbal, 2002; Briston and El-Ashker, 1986). Upon completion of the assessment, the SSB must report on the level of Shariah compliance, which is then included in Islamic banks' annual reports (Briston and El-Ashker, 1986; IFSB, 2006; Haniffa and Hudaib, 2007; Ullah et al., 2016).

Given the significance of the SSB's function, researchers have advocated for the true independence of its members and have revealed the governance issues caused by involvement in member independence quality (Garas and Pierce, 2010; Najeeb and Ibrahim, 2014; Othman and Ameer, 2015; Hassan, 2012; Ullah et al., 2016). According to Alam et al. (2020), SSB members are not permitted to work diligently because they greatly rely on BOD members and management.

Shariah Department

Every Islamic bank has a distinct Shariah department or an inspection and compliance division that supports the SSB's operations and helps them create, manage and present the paperwork (Alam et al., 2019). Shariah officers under this department's functions are critical in Islamic Shariah corporate governance systems (Alam et al. 2019). Shariah officers undertake research, audits and compliance reviews, and generate additional documents depending on the results (Alam et al., 2022). Thus, Islamic banks established a Shariah department that comprises many executives that assist the Shariah supervisory board (SSB) in executing and monitoring Shariah rules and regulations (Abdullah and Rahman, 2017). Since SSB members do not practice oversight of the functioning of Islamic banks, rather than analysing Shariah officers' reports, the Shariah officers act as middlemen between the SSB members and report to them (Alam et al. 2022a). As a result, their tasks and functions are critical in carrying out Shariah governance functions (i.e., review, compliance, auditing, reporting and supervision) (BNM, 2019; IFSB, 2009).

Shariah Compliance

The Shariah compliance and review function is referred to as a Shariah review by the AAOIFI, although some researchers use the latter word and others use Shariah compliance. The author favours the terminology Shariah compliance. Indeed, Shariah compliance is the foundation of Islamic finance; without it, the entire industry would be jeopardised. According to Masruki et al. (2020), a Shariah review is a periodic assessment of Islamic bank activities that guarantees conformity with Shariah standards. Thus, it plays a significant role in ensuring all the activities of the IBs align with Shariah rules, fatwa, guidelines and rulings issued by the SSB (Bahari and Baharudin, 2016). Due to their sensitive role, the Shariah compliance department should have a committed team and at least one Shariah specialist who meets academic requirements (Saba, 2018).

Shariah Audit

Shariah audit is the periodic evaluation that provides an independent review and objective assurance meant to add value and increase the degree of compliance with the IFIs' business activities (BNM, 2017). The Shariah audit's primary goal is the establishment of a robust and effective internal control system for Shariah compliance (Embi and Shafii, 2018). Therefore, Shariah auditing is performed at three levels: financial statement audit, compliance audit on organisational structure, personnel and processes, and examination of Shariah governance process adequacy (Masruki et al., 2020). However, Saba (2018) argues that the Shariah audit may be performed in certain areas based on the amount of risk and the material consequence of Shariah non-compliance. At least once a year, a Shariah audit on essential areas should be performed.

Some jurisdictions implement an external Shariah audit process to assess Shariah compliance independently. The External Shariah Audit (ESA) is a control system that allows an independent Shariah audit team to make an impartial opinion regarding the duty of Islamic banks' (IBS) management, employees and other divisions in relation to Shariah compliance (Alam et al. 2022b). The external auditors must prepare a report for the BOD outlining their opinions on the overall Shariah compliance environment, the associated risks, the risk management system's ability to manage these risks, the executive management and BOD's level of awareness in managing these risks and any other significant issues (Saba, 2018).

Shariah Risk Management

Failure to ensure Shariah compliance exposes Islamic banks to Shariah non-compliance risk (Zurina et al., 2013). The latter might occur at several stages during Islamic bank operations and activities (Hassan and Hassan, 2010). According to Hassan et al. (2017), the risk at each level may result in distinct outcomes. First, the risk may be present if the contract includes components of interest, gambling or uncertainty. Second, the area of the product's formulation and execution method may also be vulnerable to Shariah non-compliance risk. Third, the risk may occur if the structured product's process is not implemented in accordance with the Shariah board's regulations.

Therefore, the Shariah risk management function entails detecting the potential risk, determining the amount of risk, monitoring and supporting effective risk management and preventing the occurrence of Shariah non-compliance risk (Ismail et al. 2016). In other words, Shariah risk management identifies and manages Shariah non-compliance risks to allow Islamic banks to run efficiently without excessive risk. Although risks cannot be avoided, the objective of Shariah risk management is to limit the risks, and critical risk management must be compatible with Shariah standards (Masruki et al., 2020). Therefore, this technical and sophisticated duty will be performed by qualified and experienced risk officers. Hassan (2015) insists that the risk management officer should be aware of the internal and external variables that might result in a Shariah non-compliance risk. As a result, the Shariah risk management control function will be included in the Islamic bank's risk management framework (Saba, 2018).

Figure 2.1 Source of the Shariah risk management process (Hassan, 2015)

2.5.9 Shariah Corporate Governance Challenges

The lack of qualified Shariah scholars and the high concentration of a few top-level scholars who serve the market are two of the major problems of the Islamic finance sector. There are also issues with contemporary scholars regarding their skills and experience to effectively face the demands and relations of a modern economy (Farook and Farooq, 2011). Rahman (2006) debates that limiting product awareness and practical banking exposure may generate difficulties for Shariah scholars in achieving synchronisation between financial products and activities. Moreover, there is a major challenge in operating the Shariah governance framework since there is a general lack of human capital in the Islamic finance industry. Alam et al. (2020) reveal that management hires inexperienced and general background executives for the Shariah department. In contrast, those with knowledge of Shariah have a limited understanding of banking and finance Islamic banking practice (Abdullah and Rahman, 2017).

Abdullah and Rahman (2017) noticed that Islamic banks do not have distinct departments for Shariah compliance/review and Shariah risk management. Both of these responsibilities are undertaken in part by Shariah auditors. Due to the lack of Shariah executives, Islamic banks cannot comprehensively audit all their investments and commercial operations (Ullah, 2014). Therefore, governments and Islamic banks must begin investing in Shariah scholars and Shariah executives to meet the ongoing developments in this field. According to Abdullah and Rahman (2017), talent development programs can be designed to achieve this goal. Under such programs, banks can hire a variety of Shariah graduates for a set period. During this time, participants are rotated among various divisions of the bank to familiarise them with the various operations and activities of an Islamic bank.

2.6 Saudi Islamic Banking Industry: An Overview

The Islamic banking industry in Saudi Arabia is comparatively small compared to conventional banking. There are only four fully-fledged Islamic Banks: Al-Bilad, Al-Inma, AlJazira Bank and Al-Rajhi, which solely offer Islamic banking and investment services. Yet the trend in the banking sector to offer Shariah-compliant services in Saudi Arabia is growing as demanded by this banking structure (Hassan et al., 2013). However, the other eight banks in the Kingdom are called conventional banks but also serve their Islamic banking customers by establishing their Islamic window or branch. Most of them have their own Shariah committee to create and administer the Islamic products made available to their clients. Lone and Alshehri (2015) state that almost all the banks in Saudi Arabia provide Islamic banking services. Islamic banking in Saudi Arabia is characterised by its function within a dual banking system, which means that the same regulatory body, the Saudi Central Bank, regulates Islamic and conventional banks. Considering this fact, Islamic banks directly compete with conventional banks in Saudi Arabia (Lone et al., 2017). Shariah-compliant banks have maintained a steady performance since they are well-capitalised, sound and profitable (Iqbal and Molyneux, 2005). Indeed, since its inception in 1975, Saudi Arabia's Islamic banking sector has performed admirably, with Shariah-compliant assets accounting for 50% of the Saudi banking sector's total assets and Saudi Arabian banking products accounting for about 20% of all Islamic banking products globally.

2.6.1 Shariah Corporate Governance practice in Saudi Arabian Banks

The fully-fledged and window Islamic banks in Saudi Arabia used to have their own Shariah governance framework. In other words, the Shariah corporate governance framework in Saudi Arabia involved self-regulation. According to Fatmawati et al. (2020), Saudi Arabia has taken a "flexible approach", in which decisions on Shariah corporate governance structures and processes are left to the discretion of individual IBs. Saudi Arabia used to consider Islamic banks to be equivalent to their conventional counterparts, thus allowing them to establish their own Shariah corporate governance structure. However, since February 2020, the Saudi Arabian central bank has released a mandated Shariah corporate governance framework for fully-fledged and window Islamic banks. The Saudi Arabian central bank issued this framework as a minimum for supervisory and monitoring requirements relating to Shariah governance practices when implementing practical Shariah governance requirements for banks. Therefore, this framework aims to improve the environment for compliance with the Shariah rules and Shariah values of the banks in general and identify the roles and responsibilities of the board concerning the implementation and management of internal audit, risk management, compliance management, the Shariah Committee and executive management. As a result, the topic of implementing Shariah governance in Saudi Arabian banks is, to some extent, new.

In fact, there has been little research on Shariah governance that utilises a sample of Middle Eastern Islamic banks, particularly from Saudi Arabia (Hassan et al., 2021). In addition, all available research on Shariah governance in Saudi Arabia was conducted prior to the issuance of the mandatory Shariah governance framework (Hassan et al., 2021; Fallatah et al., 2019; Azid and Alnodel, 2018; Ezzine, 2018; Hasan, 2011).

Saudi Arabia is implementing a decentralised Shariah governance structure, in which each Islamic bank has its own in-house SSB that makes Shariah ruling judgments and monitors Shariah compliance operations. In contrast, Kuwait, Malaysia and Qatar intend to establish a centralised Shariah board. Typically, the SSBs of the Saudi IBs follow the Shariah standards issued by the Islamic Fiqh Academy (Hamza, 2013). However, individual IBs in Saudi Arabia may offer Islamic financial products and services based on the fatwas of their SSBs, which occasionally contradict those of the Islamic Fiqh Academy (Fatmawati et al., 2020). Islamic banks in Saudi Arabia do not follow the AAOIFI standards; however, they are full IFSB members.

Although Saudi Arabia has a decentralised Shariah governance structure with no national Shariah board, and each IB has an SSB that takes Shariah compliance decisions, the Islamic banking sector in the country has experienced spectacular revenue, profitability and asset development (Fatmawati et al., 2020). According to a recent study by Fatmawati et al. (2020), fully-fledged Islamic banks in Saudi Arabia have indicated that they have a dedicated Shariah compliance department/unit while assigning Shariah audit functions primarily to their SSBs. However, Alahmadi et al. (2017) discuss that Shariah audit in Saudi Islamic banks (both fully-fledged and windows) are still confusing due to the lack of standards and guidelines that define the foundations and principles for conducting the profession, which may raise Shariah non-compliance risk.

In terms of the Shariah board, according to Alkhamees (2013), AL Rajhi Bank (which is regarded as the largest Saudi Islamic bank and the second largest Islamic bank in the world) has clarified its stance on the SSB's authority by stating that SSB decisions are binding on the institution's departments and management. In addition, all the executive directors are accountable for executing SSB resolutions. Any violation of SSB pronouncement when offering products or services without previous board authorisation is strictly prohibited, and all offenders will be penalised. Penalisation is made because the bank's General Assembly appoints the Shariah board of Al-Rajhi; thus, it is considered independent of all other organs of governance, such as the management and BOD (Hasan, 2009). Wilson (2005) claims that IBs in Saudi Arabia made portfolio selections primarily based on the recommendations of the Shariah board.

The Al-Rajhi Shariah board has four key tasks to oversee and promote Shariah compliance. To begin, with the support of the Shariah Control Department, the Shariah board must supervise operations and the execution of Shariah rulings. The Shariah board's second responsibility is to assist the bank in developing products that are compliant with Shariah law and suitable for use in domestic and international markets. Moreover, the Shariah board is responsible for raising awareness of Islamic finance among employees and customers. The most significant characteristic of the Al-Rajhi Shariah board's job description is to ensure the correct selection of employees, especially for top-level management. In contrast to other Shariah boards, Al-Rajhi has authorised the Shariah board to help select capable and competent employees to apply the Islamic banking practice (Hasan, 2009).

Although the Shariah Board has been assigned vital functions, Alahmadi et al. (2017) reveal that most Shariah scholars had specialised academically in Islamic jurisprudence (i.e., Fiqh), with just a limited percentage having a background in law or economics. Interestingly, approximately 90% of the Shariah board members were discovered to be graduates of religious colleges for which foreign language proficiency and banking expertise were not a requirement (Asaad, 2007).

Regarding the Shariah audit, Alahmadi et al. (2017) discover that all Shariah audits in fully-fledged IBs in Saudi Arabia are completed by the Shariah department. On the other hand, Islamic windows may hire particular internal auditors with the necessary Shariah qualification or experience to conduct the Shariah audit. Consequently, each bank develops its own Shariah audit regulation, which results in different levels of Shariah compliance. According to Khokhar and Bukhari (2014), there is no clear distinction between conventional and Islamic banks in Saudi Arabia. In addition, in the eyes of Saudi clients, Islamic window bank activities were only moderately compliant with religious standards and, hence, they strongly opposed conventional banks' use of Islamic windows.

Regarding Shariah compliance, Alahmadi et al. (2017) argue that Islamic window banks in Saudi Arabia must exert more effort compared to fully-fledged banks, since fully-fledged IBs have a larger number of Shariah board members. Ginena (2014) states that Islamic window banks are more vulnerable to Shariah non-compliance risk. As a result, Islamic window banks in Saudi Arabia require more attention and supervision, especially since the value of Islamic banking assets owned via IB windows in Saudi Arabia is estimated to be over US$80 billion (Song and Oosthuizen, 2014). In contrast, Sharma and Senan (2019) discover that the SABB (window) bank has the most robust control environment, whereas the Alinma (fully-fledged) bank has a weak control environment.

In a recent study, Alahmadi et al. (2017) conclude that each fully-fledged or Islamic window in Saudi Arabia primarily relies on self-made regulations by individual SBs on Shariah-compliant operations; hence, the level and degree of compliance varies amongst fully-fledged or Islamic window banks. Thus, investor confidence decreases and the likelihood of tensions between banks and investors is raised. Based on the preceding discussion, there are substantial variations in the efficacy of internal controls amongst the selected Saudi banks (Sharma and Senan, 2019). Specifically, there are variations in the Shariah governance practices and the Shariah compliance levels of Saudi Arabia's fully-fledged and Islamic window banks. Put simply, the central bank has made the correct decision by mandating Shariah governance in all fully-fledged and window banks; it provides a minimal standard for decision making.

2.6.2 Risk management in Saudi Arabian Islamic Banks

Risk management is not a new practice in Saudi banks. According to Saudi Central Bank regulations, a higher emphasis should be placed on handling major risks, such as market, credit and operating risks (SAMA, 2014). Indeed, these regulations on corporate governance highlight the relationship between corporate governance and risk management. According to the central bank (2014), an effective corporate governance framework requires that a general control process be developed with internal control and risk management systems, an internal audit, a compliance function and an external audit. Saudi banks followed the Basel III regulatory framework. They maintained their high capital adequacy and liquidity position by exceeding the Basel III agreement's capital and liquidity standards (Elbadry, 2018). Nonetheless, the central bank has enacted additional regulatory and macroprudential measures that strengthened the sector's resilience, ensured its stability in the case of any unforeseen financial crisis, and reduced Saudi banks' risk exposure (SAMA, 2014).

However, when considering Islamic banks, the central bank is silent on the issuing of a risk management framework for the Islamic banking practice. However, Ismail (2014), who investigated the board involvement in risk management practices in Saudi Arabian banks (in four fully-fledged IBs and eight banks with Islamic windows), found that banks in Saudi Arabia have an efficient risk management mechanism, a good understanding of risk management and a risk recognition method. His study also affirmed that Saudi banks were dedicated to implementing Shariah-compliant risk management practices. Furthermore, he discovered that the board actively participates in the efficient evaluation, review, monitoring and management of risks, and they are highly effective in risk management.

Reyad et al. (2022), who examined risk management and corporate governance of Islamic banks in GCC countries, found that there is an integration of Islamic beliefs with risk management methods in commercial activities. The Islamic banks' business practices have infused Shariah principles to satisfy stakeholders' requirements and desires. Sharma and Senan (2019) examine the internal control system in the Saudi banking sector and found that, in terms of risk assessment, Al Rajhi Bank (a fully-fledged bank) has a strong aptitude for risk assessment analysis; however, Alinma Bank (also fully-fledged) was deficient in this area. Indeed, the literature on the topic of risk management in Islamic banks in Saudi Arabia is, in fact, limited.

2.7 Risk Management in Islamic banks

2.7.1 An Overview

Islamic banking has experienced an astronomical expansion in recent years, yet the existing literature on risk management is limited (Mokni et al., 2014). Islamic banks operate with products that do not exist in conventional banks; thus, their risk exposure is increased (Khalid and Amjad, 2012). The operations of Islamic banks make risk management one of the primary concerns of supervisory authorities; therefore, it is necessary to maintain the financial system's stability in a global financial environment characterised by increased risks. Risk management practices have been explored extensively throughout the years. However, banks operating in emerging countries, particularly Islamic ones, have received little attention (Al-Tamimi, 2002;Al-Tamimi and Al-Mazrooei, 2007; Hassan, 2009). Risk management in Islamic banks can be viewed as a Shariah requirement since one of Shariah's objectives is to preserve money, and a failure to take the necessary measures and procedures to protect money from risks is a violation of Shariah law since it results in money wastage that Shariah forbids (Abdelkarim and Mohammad, 2019).

The Basel Committee on Banking Supervision (2001) describes risk management as a sequence of four processes: recognising incidents in one or more specific risk categories, evaluating risk using data and risk models, tracking and reporting on timely risk assessments and tracking these risks by senior management. Kozarević et al. (2014) stated that the risk management system in Islamic banks consists of five stages: risk identification, risk and capital quantification, risk collection or merging, previous risk controls and monitoring. According to Hassan (2009), when considering the most essential methods used by Islamic bankers in risk identification, the results show that the most important factors are inspection by Shariah supervisors, executive and supervisory staff, audit and physical inspection, financial statement analysis and risk survey. Van Greuning and Iqbal (2008) and Iqbal and Mirakhor (2011) assert that a comprehensive risk management framework is equally appropriate for a conventional or an Islamic bank. However, Khan and Bhatti (2008) state that, due to their commitment to Shariah law, Islamic banks face an additional critical issue in developing their risk management methods and corporate governance. As a result, this should influence Islamic banks' risk management regarding particular applications, focus and inclusion or exclusion (Hussain and Al-Ajmi, 2012). Arrifin et al. (2008) found that Islamic banks are typically exposed to the same types of risks as conventional banks but at different risk levels; Islamic banks are typically viewed as employing less technically advanced risk measurement techniques than the ones most frequently used, such as maturity matching, gap analysis and credit ratings. Islamic banks do not extensively utilise the most technically sophisticated risk-measuring tools, such as Var, simulation techniques, estimations of worst-case scenarios and RAROC (Mokni et al., 2014). The fundamental cause of this omission relates to the fact that Islamic banks are still in their infancy. Namely, they lack the infrastructure and experience to use more technically advanced procedures. However, according to multiple studies, Islamic banks fully understand risk and risk management, risk monitoring and credit risk analysis (Hassan, 2009; Hassan, 2011; Khalid and Amjad, 2012; Hussain and Al-Ajmi, 2012).

2.7.2 Risks in Islamic banks

Similar to conventional banks, Islamic banks face several risks during their banking activities, such as credit risk, market risk, liquidity risk, operational risk and Shariah non-compliance risk. For Islamic banks, nevertheless, the essence of some of these risks is significantly related to their particular business framework and accordance with the Shariah rules. Hassan and Lewis (2009) argue that Islamic banks can be expected to face risks comparable to conventional banks as well as risks that are unique to Shariah compliance. Moreover, the contractual position of Islamic banks must be given attention because the relationship between the parties during the contract's lifetime provides Islamic finance with a different risk orientation (Eid and Asutay, 2019).

Credit Risk

Credit risk is the most common source of risk for banks, both Islamic and conventional (Ahmed, 2010). In an Islamic bank, credit risk occurs when one party during a transaction pays money or provides assets before receiving assets or currency, which exposes them to potential losses (Khan and Ahmed, 2001). Most conventional financing instruments utilised by Islamic banks carry credit risk, particularly Musharakah and Murabaha (Al-Wesabi and Ahmad, 2013). Consequently, the anticipated risk associated with these contracts stems from the failure of debtors to satisfy their financial obligations on maturity dates. Aldoseri (2021) assert that Murabaha and equity transfer contracts, like Musharakah and Mudarabah, could enhance credit risk in Islamic banking. According to Javaid and Allawi (2018), they are riskier because Saudi Islamic banks rely heavily on debt financing (Murabaha). While profitable to some extent, they may be severely impacted during recessions. Additionally, Al-Jarhi and Iqbal (2001) reveal that most GCC Islamic banks favour fixed return modes, particularly Murabaha, which are the most common financing. Therefore, Islamic banks must be operationally ready to manage credit risks to maintain their performance and achieve expansion (Al-Wesabi and Ahmad, 2013).

A robust credit culture is a must for a credible credit risk management system; Islamic banks are no exception. Shariah permits collateral that is deemed to be secured against debt risk to be used to reduce credit risk. In addition to the loan loss reserve (LLR), third-party guarantees have been used to prevent credit risk (Al-Wesabi and Ahmad, 2013). The absence of well-developed credit risk assessment processes, and accompanying expertise for Islamic banks, increases exposure to such risk (Khan, 2003).

Market Risk

Identical to conventional banks, Islamic banks are also prone to market risks but with variations due to specific Shariah compliance requirements. Market risk is the change in the net asset value resulting from changes in underlying economic factors such as equity, commodity prices and currency rates (Hasan and Antoniou, 2004). The IFSB reports that market risk applies to "the potential impact of adverse price movements on the economic value of an asset," resulting in a "loss in on- and off-balance sheet positions." Market risk for IFIs may be categorised into the following categories: markup risk, rate of return risk (i.e., profit rate risk), commodities price risk and currency risk.

Khan and Ahmed (2001) examine the risk management practices in 17 Islamic financial institutions in 10 nations; the results reveal that Islamic bankers consider the markup (interest rate) risk to be the most significant. Mokni et al. (2014) argue that there might be several reasons for ranking markup risk as the greatest issue owing to the risk posed by Murabaha contracts, which cannot be hedged using conventional banking instruments such as interest rate swaps and other derivatives tools, which obstruct risk management in Islamic financial institutions.

Hassan (2011) examined the risk management practices and techniques of conventional and Islamic banks in the Middle East. He discovered that interest rate risk is the most significant risk facing Islamic banks. Even though Islamic financial institutions do not deal with interest rates, they use it as a pricing benchmark for some financing products, such as Murabaha and Mudarabah. In Murabaha transactions, the market risk exposure may be fairly high if the client's promise to purchase the ordered products is not binding. In a volatile market, prices may significantly fluctuate even during the short period between when the bank obtains the desired product or equipment from the vendor and when it sells it to the customer (Obaidullah, 2003).

Liquidity Risk

Liquidity risk refers to the current and future loss incurred by Islamic financial contracts due to a failure to fulfil their liabilities or fund asset increases since they fall without incurring unacceptable costs or losses (Greuning and Iqbal, 2007). In other words, this risk exists because banks failed to pay their debts and other commitments. It is technically considered one of the most significant causes of bank collapse or bankruptcy. Boukhatem and Djelassi (2020) claim that the nature of Shariah-compliant contracts increases liquidity risk, especially if the traditional financial infrastructure is maintained. Several authors contend that the success of Islamic banks throughout the subprime financial crisis can be attributed, in part, to their greater reliance on highly liquid assets. Bello et al. (2017) argue that the liquidity problems of Islamic banks are not a result of liquidity coverage but rather a deficiency of instruments. There are three liquidity risk sources for Islamic banks: the type of contracts available to Islamic banks, Shariah prohibition on the selling of debt and inadequate financial infrastructure (Ahmed, 2005; Ali, 2013; Iqbal and Molyneux, 2005). Javaid and Allawi (2018) found that Saudi banks have significant liquidity risks in Saudi Arabia. This risk is due to the extensive use of Murabaha; Boukhatem and Djerassi (2020) found that when the average duration of deposits is shorter than the average maturity of Murabaha contracts, the bank is unable to sell this debt instrument on the secondary market and, hence, liquidity risk arises. Jedidiah and Hamza (2015), who examined the determinants of liquidity risk in Islamic banks, found that Musharakah and Modaraba reduce the exposure to liquidity risk since they are founded on the notion of sharing between the Islamic bank and shareholders.

Therefore, it is obvious that liquidity risk management in Islamic banks is a challenging task. According to Alzoubi (2017), the constraints imposed on Islamic banks make liquidity management more complex due to the following:

1. Islamic banks are not permitted to invest in short-term financial instruments, such as treasury bills, since they generate interest revenue that Islam prohibits.
2. They are also not able to borrow from other banks or financial institutions since this implies paying interest on loans, which is also prohibited for Islamic banks.
3. Even the possibility of borrowing from central banks is problematic since interest must be paid on these loans.

Thus, Islamic banks may have to hold more cash assets and reserves, while sacrificing numerous potential investment possibilities to prevent liquidity risks. In the study conducted by Hussain and Al-Ajmi (2012), it was discovered that the high liquidity risk faced by Islamic banks might result from the inactive money markets for Shariah-compliant money market products. Access to short-term funding options accessible to conventional banks is constrained, so Islamic banks are required to keep substantial cash holdings out of current account balances to cover customer withdrawal requests (Iqbal and Mirakhor, 2011).

Operational Risk

The operational risk in Islamic banks, according to the IFSB, is correlated with the loss resulting from "inadequate or failed internal processes, people and system, or from external events, including losses resulting from Shariah non-compliance and the failure in fiduciary responsibilities".

Due to Islamic banks' unique contractual characteristics, operational risks are expected to be more critical for Islamic financial institutions. Additionally, failure to comply with Shariah is also an operational risk. If the Islamic bank fails to do so, it will compromise investor confidence and should, therefore, be responsible for the lost revenue (El-Hawary et al., 2004).

Shariah Risk or Shariah Non-compliance Risk

Shariah risk is an operational risk unique to Islamic banks and financial institutions. According to Archer and Haron (2013), Shariah compliance risk is "the risk of non-compliance resulting from a failure of an Islamic bank's internal systems and personnel". The IFSB defines it as a Shariah non-compliance risk and recognises it as "the risk that arises from an IFIs' failure to comply with the Shariah rules and principles determined by the Shariah board of the IFIs or the relevant body in the jurisdiction in which the IFIs operate".

Islamic banks are also vulnerable to fiduciary risk. The IFSB defines fiduciary risk as the risk that results from the inability of Islamic banks to meet their fiduciary responsibilities in compliance with explicit and implicit requirements. Shariah risk may result in legal and compliance risks, which are always synonymous. The legal risks resulting from non-standard practices are considered due to their various arrangements in different jurisdictions (Mirakhor and Iqbal, 2007). Shariah risk can also lead to compliance risk, such as a bank that neglects to establish prudent internal governance arrangements even though the regulator requires it. In this situation, the bank may be fined for its violations or lose its operating license (Ginena and Hamid, 2015). Islamic banks are also vulnerable to the reputational risk caused by a lack of governance, corporate strategy and processes. The Basel Committee on Banking Supervision

(BCBS, 2009) defined reputational risk as "the potential that adverse publicity regarding a bank's business practices and associations, whether accurate or not, will cause a loss of confidence in the integrity of the institution."

2.8 Impact of Shariah Corporate Governance on Risk Management

As financial intermediaries, Islamic banks must handle the common risks found in conventional banks and additional risks specific to Islamic banks (Embi and Shafii, 2018). Nonetheless, a strengthening of the risk management policies in the complex banking sector could be difficult without good support from corporate governance practices (Abdul Rahman et al., 2013). Therefore, corporate governance is a vital element in the risk management of financial and non-financial institutions worldwide (Embi and Shafii, 2018). Previous studies identified a close link between risk management and corporate governance (Kaen, 2005) and describe the board of directors as the ultimate risk manager (Greuning and Bratanovic, 2009).

Following most banking rules, the Basel Committee on Banking Supervision (BCBS, 2006), the Islamic Financial Service Boards (IFSB, 2005) and the Saudi Arabian Monetary Authority (SAMA, 2020) specify that the board of directors must effectively oversee the activities of risk management in Islamic banks. In particular, the IFSB Risk Management Guiding principles clearly define Shariah risk as one of the operational risks that a proper and robust Shariah governance structure should manage. The Shariah Supervisory Board (SSB) is a significant device for SCG. As mentioned earlier, Shariah boards are responsible for evaluating whether the IB's activities comply with the Shariah laws and principles. It can, therefore, be asserted that SCG can play a major role in the decision making of Islamic banks, particularly those relevant to risk management (Elamer et al., 2020).

Elamer et al. (2019), who examined the impact of multi-layer governance on bank risk disclosure, found that the existence of a Shariah supervisory board is positively connected to the degree of risk disclosure. Similar results by Abdul Rahman et al. (2013) report that the increased participation of boards in risk management improves the risk management process significantly, which in effect contributes to substantially higher risk management activities in Islamic banks. Furthermore, boards will also take clear responsibility for developing, maintaining and regularly reviewing the banks' risk management culture. As discussed by Nugraheni and Muhammad (2019), the role of the SSB (relating to risk management) is to review the risk management strategy, which needs to comply with Shariah principles, and determine the accountability of the board of directors, who are required to implement risk management in line with Islamic principles. Moreover, Nugraheni and Muhammad (2019) found that the corporate governance framework is a tool that influences risk management in Islamic banks; it constructs appropriate policies and procedures for identifying and monitoring risks.

2.9 Chapter Summary

This chapter provides an extensive literature overview of the relevant contextual and empirical research and theories. Understanding the theoretical and conceptual underpinnings of corporate governance is crucial for this research because it provides insight into future discussions on corporate governance from an Islamic viewpoint. Therefore, the literature review first covered the conventional CG, influential CG theories, CG in developing nations (particularly Saudi Arabia) and Saudi Arabia’s legal system. Next, the chapter reviewed the underlying philosophical assumptions of Islamic CG followed by Shariah governance importance, challenges, international standard setting and the main pillars. The study then examined both the risk and risk management in Islamic banking and the role of Shariah governance on risk management. The literature review process revealed the strengths and limits of the concepts, strategies and challenges, as well as gaps in the literature. In conclusion, the examination of the relevant literature revealed:

I. Shariah corporate governance is characterised by a number of distinguishing traits and elements that set it apart from the conventional model.
II. The Shariah Committee is an integral part of the Islamic banking system’s governance structure, ensuring that all aspects of the bank’s operations are conducted in accordance with Islamic law.
III. The uniqueness of the Shariah corporate governance mechanism (i.e., the SSB, Shariah audit and compliance function) and its ability to enable or limit the risk management process.
IV. Islamic banks face credit, market, operational and liquidity risks identical to conventional banks. However, due to their unique business model requiring Shariah compliance, IFIs face additional risks such as Shariah risks.
V. Since Islamic banks follow Shariah laws in all their operations and products, the degree and exposure to risk are significantly linked to the type of Islamic financial instrument used.
VI. For Islamic banks, risk management presents a far more complicated challenge compared to conventional banks.

VII. Shariah governance practices and Shariah compliance levels vary among Saudi Arabia’s fully-fledged and Islamic window banks.

VIII. The commonly held views of agency and stakeholder theories can have limitations when understanding Shariah governance in the context of Islamic finance. The content of this study can help to extend and enrich these theories by incorporating the unique relationship between Shariah governance and risk management.

To the best of the author’s knowledge, the impact of Shariah corporate governance on risk management in the setting of the Saudi Arabian banking system, following the release of the first-ever Shariah governance framework, has not been the subject of any prior research. As a reminder, the main research question is: ***How does the Shariah corporate governance framework influence risk management in terms of credit risk, market risk, liquidity risk and operational risk (especially Shariah risks) in fully-fledged Islamic and window banks in Saudi Arabia?***

Based on a review of the relevant literature, no prior research has studied the influence of Shariah corporate governance on risk management from a holistic perspective. In terms of investigating the five primary risks (i.e., credit risk, market risk, liquidity risk and operational risk and, in particular, Shariah risks) in Islamic banks, both fully-fledged and window banks are analysed. Previous studies, such as Embi and Shafii (2018), examine the impact of Shariah governance on the risk management practices of local Islamic banks and foreign Islamic banks operating in Malaysia. While Hassan et al. (2017) examine the regulatory requirements of the Shariah risk management process for Islamic financial institutions that operate in Malaysia. The topic of risks and risk management practices in Islamic banks have also been examined in various prior studies (Al-Tamimi and Al-Mazrooei, 2007; Hassan, 2009; Khalid and Amjad, 2012; Khattak et al., 2013; Rashidah et al., 2013; Rashidah et al., 2014; Eid and Asutay, 2019).

However, there have been no attempts to examine the influence of Shariah corporate governance on risk management in Islamic banks, particularly in Saudi Arabia. There is a lack of studies that examine the difference between fully-fledged and windows Islamic banks operating in Saudi Arabia with respect to Shariah corporate governance and risk management. As a result, the author believes that this work is the pioneering study of its kind, which thoroughly investigates this issue by adopting the first mandatory Shariah governance framework and relying on the understandings and interpretations of various participants. The following Chapter discusses the research methodology and the data collection processes.

Chapter 3: Research Methodology and Data Collection

3.1 Introduction

The comprehensive literature review in the previous chapter, and the assessment of other studies in Shariah corporate governance and risk management, have inspired the research methodology adopted in this study. This chapter outlines the research philosophy, design, methods and methodology employed in this study to answer the research question and provide insights into the key themes explored. Since the subject of the relationship between Shariah corporate governance and risk management is still undergoing research, the research method adopted is qualitative and involves the undertaking of semi-structured interviews. Qualitative research methods are appreciated for the development of knowledge, the investigation of experience and context, the interpretation of many views on a subject or issue and the comprehension of the complexity of a phenomenon (Morse, Swanson and Kuzel, 2001; LeCompte and Schensul, 1999; Creswell, 1998; Yin, 1994).

The rest of this chapter has seven sections: Section 3.2 presents the research philosophy; Section 3.3 introduces the research methodology; Section 3.4 describes the data collection; Section 3.5 explains the data analysis procedures; Section 3.6 details the ethical considerations; Section 3.7 discusses the limitation of thematic analysis and, finally, Section 3.8 concludes this chapter.

3.2 Research Philosophy

The research philosophy consists of a collection of beliefs that concern the nature of the reality being studied. In other words, the research philosophy is associated with the source, nature and development of knowledge (Bajpai, 2011). The research philosophy is examined in terms of two positions 'ontology' and 'epistemology'. Ontology refers to "the reality that researchers investigate", while epistemology is associated with "the relationship between that reality and the researcher, and methodology is the technique used by the researcher to investigate that reality" (Healy and Perry, 2000). In summary, ontology may be defined as what is believed to be true, while epistemology is what is known to be true (Creswell, 2007); research methods are based on how the researcher actually examines what they believe can be known (Blanche et al., 2006). This section considers the ontological and epistemological concepts that deliver a connection between the objective of this research and the issues concerning data collection and analysis.

3.2.1 Epistemology

Epistemology is a belief in how knowledge about reality is generated, interpreted and communicated (Surisumiantri, 1986). Epistemological assumptions are associated with knowledge and how researchers can acquire and approach that knowledge. It also deals with the nature, possibility, scope and general basis of knowledge (Hamlyn, 2013). There are different ways to create knowledge, for example, via positivist, interpretative, post-positivism and pragmatism epistemology methodologies (Creswell, 1998; Ryan et al., 2002; Creswell, 2003).

From the perspective of positivism, which acts as a way to obtain truth, the researcher constructs knowledge on an appropriate theory and rationale foundation (Schrag, 1992; Baker, 2000; Johnson & Onwuegbuzie, 2004). Positivist knowledge is validated by the use of measurable observation methods, which provide a statistical analysis (Merriam, 1991; Guba & Lincoln, 1994; Giddings & Grant, 2007).

The interpretative approach involves focusing on the participant/researcher conversation to discover subjugated knowledge and link it to social behaviours. Therefore, knowledge is constructed through the researcher's standpoints, who mediate reflectively about the given research problem (Agger, 2007; Carter & Little, 2007). Furthermore, post-positivism epistemology is the modified version of objectivism in which the researcher feels that the existence of pure objectivity is not conceivable in the real world; thus, the investigation results may be true or "probably true". (Creswell, 2009). Compared to the aforementioned epistemologies, pragmatic epistemology adopts a pluralistic stance to determine common ground between conflicting perspectives and bodies of work and the researcher's own prior knowledge (Guba & Lincoln, 1994; Sprague & Kobrynowicz, 2006).

3.2.2 Ontology

Ontology is concerned with the nature of reality (Saunders et al., 2007) and "raises basic questions about the nature of reality and the nature of the human being in the world" (Denzin & Lincoln, 2005). It focuses on whether reality exists by itself or whether humans create it (Burrell & Morgan, 1979; Sayer, 2000; Ryan et al., 2002; Bahari, 2010). Burrel and Morgan (1979) demonstrate that ontology assumptions are presumptions about "the core of the phenomenon being studied", that is, the nature of reality (Nugrahanti, 2018). Bryman (2001) distinguish between the two main ontological positions: objectivism and constructionism.

As described by Crotty (1998), objectivism is the assumption that reality and meaning are within an object; they are independent of human subjectivity. Therefore, objectivism is strongly related to positivism and the natural sciences since it describes logical links between variables and states that a social phenomenon can be viewed as a physical entity that is independent of social actors (Maxwell, 1992; Bernstein, 2011). However, constructionism is closely related to an interpretative approach that studies how people provide meaning to their social realities. Social actors are seen as having a role in the creation of social phenomena (Bryman, 2001; Bryman, 2008).

3.2.3 Philosophical Assumptions Underpinning this Study

The aforementioned epistemological and ontological assumptions have direct implications for this study's methodology (Burrell & Morgan, 1979; Hopper & Powell, 1985; Laughlin, 1995; Collis & Hussey, 2009). In addition to the highlighted main objective of this study, as stated in Chapter 1, the purpose of this research is to investigate the influence of Shariah corporate governance on risk management in Saudi Arabian banks. As a result, there are numerous and various truths that could be discovered, which may not correspond with the positivist or post-positivist views.

However, interpretivists embrace and consider various meanings and forms of understanding, for which there is no single correct path or approach to knowledge (Willis, 1995). Creswell and Clark (2011) noticed that interpretivism seeks to investigate, explain and construct an understanding that illustrates the significance of the concepts. This study investigates the role of Shariah governance on risk management in Islamic and window banks; such a framework is based on Shariah compliance with Islamic principles. It is associated with the players involved, such as Shariah scholars, Shariah supervisory boards and risk managers, who cannot be separated from the Shariah governance structure. Interpretivists believe that reality is not objectively determined but is socially constructed (Husserl, 1965). This theory underlies that, by locating individuals in their social environments, there is an improved chance of understanding the perceptions of their own actions (Hussey and Hussey, 1997). This research adopted a qualitative interview that assumed what the participants felt about reality. Considering this point, interpretivism is the most suitable epistemological standpoint for this research. As this research embraces an interpretative stance, and since the research participants are the ones who are experiencing the phenomenon and have their own perceptions of it, it corresponds with the ontological standpoint of constructionism, i.e., that humans can influence the social world.

3.3 Research Methodology

The research methodology presents a detailed summary of the data collection methods and data analysis techniques that are the focus of the methodological assumptions.

3.3.1 Research Approaches and Techniques

Deductive and inductive reasoning

There are two main research approaches in social research: deductive and inductive reasoning. In the deductive approach, the study begins with a theory on the subject to be studied and is then narrowed to a more precise hypothesis that requires further examination. This eventually enables the researcher to test the hypothesis with specific data to obtain a decision supporting or denying the hypothesis (Creswell, 1994). This research strategy is designed to test the hypothesis based on the gathered data (Saunders and Lewis, 2009). The deductive method is often used in quantitative research (Bryman and Bell, 2007).

Furthermore, the inductive path traverses from particular observations or results to wider generalisations and theories. In other words, as depicted in Figure 3.1, the data is based on the phenomenon that is collected and evaluated and, as a result, a theory is developed (Bryman and Bell, 2003; Babbie, 2016). Therefore, inductive research is a way of thinking that enables researchers to view their study with an open mind and waits for a set of patterns and processes to identify key variables, progressively establishes theories and typologies and provides detailed explanations of their findings (Gilgun 2001).

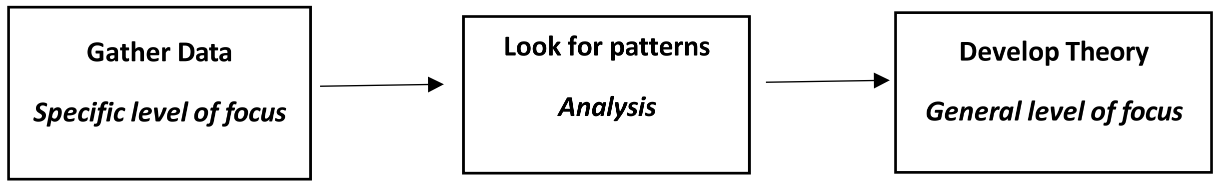

Figure 3.1 Description of inductive research. Source: adapted from Blackstone (2012).

As discussed in Chapter 1, this research aims to examine the impact of a Shariah corporate governance system on risk management in full-fledged and window banks in Saudi Arabia. To achieve this objective, the researcher has chosen an inductive approach based on the philosophical viewpoints previously discussed in this section and the ontological and epistemological underpinnings of this research. Therefore, due to the relatively new nature of the research subject, an inductive approach was thought to be more appropriate since the study focuses on the specifics rather than the general issues. This approach is most often associated with qualitative methods (Bryman, 2004). In addition, several scholars indicated that an inductive approach is one of the most widely used approaches in qualitative research (Bryman and Burgess, 1994; Dey, 2003). In the current study, an inductive approach frames the primary goal, which is to understand the participants' interpretations of the impact of Shariah governance on risk management in Saudi Arabia (Dilthey, 1977; Smith, 2007).

Business research can be separated based on the methods employed (e.g., interviews, surveys and experiments) or the function (the nature of the problem that determines the choice of method) into three forms: exploratory, descriptive and experimental analysis (Zikmund, 2003).

Exploratory research is conducted to gain knowledge and insights into the problem and situation faced by the researcher. It enables the researcher to solve a problem that has not been thoroughly analysed previously. In this situation, work is required to provide relevant insights and a deeper view of the aspects of the problem.

The primary aim of *descriptive research* is to explain something relating to characteristics, functions or phenomena. It is applied to describe what exists. This is also an analysis method in which researchers use past events to clarify the current measurable evidence. This contributes to a more structured study design consisting of multiple plans and statistical methods (Bryman, 2008).

Explanatory research recognises cause-and-effect relationships between variables in the problem structure, characterised by a detailed design and a significant amount of planning. Some of the disadvantages of the explanatory analysis are its high expense and its creation of administrative difficulties (Creswell and Clark, 2007).

By discussing the three previously mentioned forms of study design, selecting a research approach is not a simple choice. The optimal solution is to rationalise the chosen designs by evaluating the problem. Then, the preferred design should be relevant to the investigated question, and the research approach should be economically feasible and realistic. The nature of this thesis and the options available to the researcher would, therefore, significantly impact the design of the research.

The researcher chose an exploratory research design as the optimal choice for this study. An exploratory research description is most fitting here since it is helpful in new or under-explored areas where there is a lack of sufficient theory and principles to define, evaluate and explain what is occurring (Robson, 2002).

Qualitative and Quantitative Techniques

According to the literature, there are two types of research techniques: quantitative and qualitative. The quantitative approach aims at drawing conclusions based on numerical results. Quantitative data can be obtained using four primary methods: surveys questionnaires, interviews, tests/measures and observations (Easterby-Smith et al., 2002). Quantitative research aims to establish mathematical models and hypotheses that are applicable to a specific domain.

On the other hand, as defined by Van Maanen (1983), the qualitative method is an array of interpretive techniques that seek to explain, decode, translate and otherwise convey the significance, not the frequency, of certain phenomena occurring more or less naturally within the social world. Similarly, Maree (2012) defines qualitative research as research aimed at gathering rich descriptive data about a given phenomenon, which is used to attain insights into what is observed or studied but does not actually prove a hypothesis.

Typically, the qualitative methodology is used to gain a thorough understanding of the research subject using various tools (Easterby-Smith et al., 2002). According to Creswell (1994), these tools include interviews, observation, case studies and focus groups. Besides this, a qualitative approach is the most appropriate methodology for understanding participants' perspectives and interpretations of a specific phenomenon (Walliman, 2006). According to McNulty et al. (2013), a qualitative research design elicits information on how governance actors and institutions currently participate in governance activities.

As previously stated, the philosophical viewpoint of this research is more interested in how participants interpret reality rather than the objectivity of that reality. As a result, qualitative approaches were used in this study to generate a rich dataset suitable for qualitative analysis.

The procedure concludes with analytical comments that integrate extracts from participants with a body of literature and a variety of theoretical views on Shariah governance and risk management in Saudi Arabia.

The Rationale for Qualitative Approach

Firstly, since data and information on Shariah governance and risk management practices in Islamic banking in Saudi Arabia are limited, this research is classified as exploratory. Using a qualitative approach facilitates the exploration of new phenomena and an investigation into a little-known or poorly understood phenomenon that has gained little attention in the literature (Robson, 2002; Corbin and Strauss, 2008). Thus, this task may be difficult to accomplish when using a quantitative method.

Secondly, since this study is primarily concerned with the participants' thoughts and practices, using a qualitative approach enables the analysis of their freely expressed views. Additionally, this method allows researchers to contrast and compare different participant perspectives (Myers, 2009). This issue is significant since this research involves a diverse group of participants who have a range of different job experiences (i.e., practitioners, regulators, scholars and academics). Thus, qualitative research assists in understanding the similarities and discrepancies between their viewpoints.

To meet the research objectives and taking into consideration the research philosophy perspective, this research adopts the qualitative approach of semi-structured interviews as the method for collecting primary research data.

3.4. Data Collection

3.4.1 Interview Approach

"The qualitative research interview is a construction site of knowledge" (Kvale, 1996). Qualitative interviews are necessary if the ontological status implies that the knowledge and experience of a person will provide answers to the questions and will significantly contribute to the study. Experiences and beliefs are the meaningful characteristics of the social reality that research questions intend to investigate. Qualitative interviews are selected from an epistemological perspective, which enables conversations to become a credible source of obtaining data by interacting with individuals, posing questions to achieve their articulations and evaluating their discussions. From a philosophical and epistemological viewpoint, qualitative interviews are ideal for researchers seeking insight into participants' perceptions of the world and their experiences (Holloway, 2005).

The interview, as the primary data collection tool in this research study, consists of three main categories: structured interviews, semi-structured interviews and unstructured interviews (Easterby-Smith et al., 2002; Saunders et al., 2003).

Structured interviews employ statistical techniques that are useful in explanatory studies. In a quantitative analysis, this form of interview is usually used to obtain quantitative or numerical data. To use structured interviews, the researcher asks closed-ended questions and then waits for interviewees to choose from set answers, such as those displayed on a survey (Saunders et al., 2007).

Semi-structured interviews, according to Robson (2002), consist of predetermined questions in which the order may be changed based on the interviewer's interpretation of what seems most suitable. Therefore, participants are welcome to talk informally (Madill, 2011), freely and openly about their own experience in the field (Smith, 2011). The researcher uses this interview method to create a list of questions to identify new concerns or explore information about specific phenomena. When this type of interview is used, the same planned questions are employed as much as possible, instead of boundary questions that arise from what the interviewer feels is required at a given time (Easterby-Smith et al., 2002). A semi-structured interview allows the respondent to raise specific additional themes suited to the study objective and research questions (Holloway, 2006).

Unstructured interviews unlike structured and semi-structured interviews, which are often used with pre-list questions (Arksey and Knight, 1999), is one in which questions are not pre-arranged. Although researchers often have specific ideas about what areas or themes they may focus on.

The Rationale for Conducting a Semi-Structured Interview

This research employs a semi-structured interview as the primary method of gathering empirical evidence on the Shariah governance and risk management practices in the Islamic and window banks of Saudi Arabia. One of the aims of this study is to gather authentic and credible first-hand knowledge from participants in Islamic banking and its governance. The use of a qualitative method, such as semi-structured interviews, is asserted as an efficient approach for understanding complex phenomena (Eisenhardt, 1989), such as Shariah governance and risk management within Islamic banks. Semi-structured interviews are used to develop a thorough understanding of corporate governance phenomena (e.g., Haniffa and Hudaib, 2007; Liew, 2007; Johl et al., 2012; Piesse et al., 2012; Soobaroyen and Mahadeo 2012; Bailey and Peck, 2013). This approach is employed to understand the perspectives, knowledge, beliefs and experiences of top-level employees of Islamic banks. For the following reasons, it has been ascertained that semi-structured interviews are to be the sole approach used in this study.

Firstly, this study is exploratory in nature. Saunders et al. (2007) stated that a semi-structured interview is especially useful in exploratory research studies. Therefore, semi-structured interviews enable researchers to explore more about a subject or issue by asking participants to elaborate or clarify their responses (Smith, 2011).

Secondly, the semi-structured interview was selected because it facilitates the development of rapport, encourages participants to think, talk and be heard; it is well suited to in-depth and personal conversations (Reid et al., 2005). During this type of interview, participants are encouraged to converse informally as if they were speaking with friends rather than strangers (Madill, 2011). This develops a strong rapport with each interviewee, allowing them to talk freely and openly about their lived experiences (Smith, 2011) while staying within the research area.

Finally, the flexibility of this approach is one of the key reasons for using a semi-structured interview as the main method of collecting data in this study. In this matter, Kumar (2005) explains that the flexibility of the interview relies on how easily the interviewer can ask questions raised by the issues investigated during the interview, whereas if the interviewer follows strictly organised questions the interview will be inflexible. Reis and Judd (2000) note that semi-structured interviews provide more space for the participants to react, enabling more flexibility and providing a rich source of knowledge. Consequently, this type of interview allows participants to express their viewpoints on Shariah governance and risk management without being restricted to a specific area. It is noteworthy that, since this study is conducted by interviews with experts, the objective is to ascertain what is important from their perspective, which might include information that the researcher had not considered previously. In this research, interviews with 35 participants are a vital source of knowledge because they provide rich and in-depth information about Shariah governance and risk management in Islamic and window banks in Saudi Arabia and allow the researcher to 'dig deeper' into the topic through their experiences.

3.4.2 Interview Guide

In semi-structured interviews, an interview guide is used to organise the questions for the study (Corbin and Strauss, 2008). Therefore, the semi-structured interview guide acts as a framework for addressing the topics and themes. The researcher began the interview guide by extracting general themes from the relevant literature review. Table 3.1 outlines the primary themes that emerged from the literature review and how they are incorporated into the design of the interview questions. In order to help the researcher structures the interview guide, the table also indicates the scope of interview questions associated with each theme.

Table 3.1 Major themes from the literature review.

Theme	**Interview Questions Scope**	**Existing Literature**
Shariah Corporate Governance Framework	Requires discovery of the main actors and structure of Shariah governance, as well as an examination of the current practice of SCG in Saudi Arabia. Questions include: What is the role of the Shariah Board?	Grais and Pellegrini, 2006; Alkhamees, 2013; Mollah and Zaman, 2015; Abdesalam et al., 2016; Abdullah and Rahman, 2017; Embi and Shafii, 2018; Fallatah et al., 2019; Alam et al., 2020; Fatmawati et al., 2020; Alam and Miah, 2021.
Risks and Risk Management in Islamic banks	Requires examination of the types of risks that are faced by IBs, including the mitigation procedure and the extent to which these approaches comply with Shariah law. Additionally, the most significant issues confronting Islamic banks in terms of each risk are discovered. Questions include: Does the degree of risk differ with Islamic financing contracts?	Khan and Ahmed, 2001; Arrifin et al., 2008; Van Greuning and Iqbal, 2008; Iqbal and Mirakhor, 2011; Ginena and Hamid, 2015; Mokni et al., 2014; Eid and Asutay, 2019; Boukhatem and Djelassi, 2020; Aldoseri, 2021.

Shariah Corporate Governance and Risk Management	Investigation into the role of Shariah corporate governance in risk regulation and management, especially for notable key players such as the Shariah committee. Questions include: How familiar is the Shariah committee with the risk management policies?	Abdul Rahman et al., 2013; Hassan et al., 2017; Embi and Shafii, 2018; Nugraheni and Muhammad, 2019; Elamer et al., 2020.

Based on the themes derived from the literature review, the researcher created six main categories for the interview guide (see Table 3.2), which investigates the impact of Shariah corporate governance on risk management. The questions under each category were constructed to enable the collection of relevant and appropriate responses from the interviewees (see Appendix 2). Each participant was asked the same set of demographic and common questions. In addition, depending on the type of participant, the questions aimed to determine the influence of Shariah corporate governance on their roles while dealing with risk management, Shariah control, audit or compliance on a regular basis.

Table 3.2 Interview guide main themes.

1	**Shariah Corporate Governance and Risk Management**
2	**Credit Risk**
3	**Market Risk**
4	**Liquidity Risk**
5	**Operational Risk – Shariah Non-Compliance Risk**
6	**Shariah Supervisory Committee**

Further questions were asked that addressed issues pertaining to various Shariah control styles in full-fledged and Islamic windows, as well as the internal perception of Islamic banking in Saudi Arabia and the present concerns posed by the new Shariah governance structure. The interview and follow-up questions thoroughly provided the research questions that could be important to the study (Hair et al., 2007; Bryman, 2008).

3.4.3 Sampling

To examine the impact of the Shariah corporate governance system on risk management in Islamic banks in Saudi Arabia, a set of interviews were conducted with 35 main participants. As the quality of the findings depends on the quality of the data (Sekaran, 2003; Saunders et al., 2007), the criteria used to choose the research sample for this study was based on a diversification of experience, knowledge and sector.

The criteria for selecting participants were carefully created to include all individuals associated with the phenomenon (Haniffa and Hudaib, 2007). The participants covered three key areas: first, the practitioners were selected from the 12 Saudi banks, 4 of which are fully-fledged Islamic banks and the other 8 are Islamic window banks. This enabled the researcher to attain expertise and informed opinions and experiences (Bailey and Peck, 2013). The selected practitioners are Shariah risk managers, Shariah auditors, risk managers and Shariah advisors. The second set is from the regulatory authority. Finally, the Shariah scholars, researchers and academics are included to elicit information about the research topic.

The sample size allows the researcher to achieve a good representation of both types of Islamic banks (i.e., full-fledged and window). The findings of the study may be utilised to derive conclusions about how different Islamic banks within the same country can have variations in the implementation of Shariah governance in their bank's activities.

As shown in Table 3.3, these individuals were chosen because of their significant contributions to the decision-making, oversight and interpretation of the business environment and operational context of Islamic banks. For example, participants in the Shariah department serve as a liaison between the Shariah Committee and the bank's Executive Management. It has the same rights as the Shariah Committee in terms of acquiring data, information, explanations and inspection of all regulations, systems and instructions it considers essential to accomplish its duties. The senior management of these banks, for example, is tasked with the management of the financial institutions toward their stated objectives. As a result, the groups of interviewees chosen for this study were suitable to answer the research question being examined. In fact, the researcher discovered opinions that were both conflicting and complimentary in relation to the topic being investigated because of the wide variety of responsibilities and positions held by people who participated in the interviews. This, in turn, enhanced the credibility and trustworthiness of the results. All the participants in the sample had extensive work experience, in-depth knowledge of the context and appropriate roles (as shown in Table 3.3), all of which contributed to the collection of reliable data.

This research focuses on the quality of data via the careful selection of interviewees, rather than choosing a large number of interviewees (Haniffa and Hudaib, 2007). The selected participants enabled the researcher to answer the research questions and enhance the reliability of the data and, thus, fulfil the aims and objectives of the research. This, therefore, enables the triangulation of responses across the interviewees in various roles and perspectives. Using multiple data sources for the qualitative research model can develop a comprehensive understanding of the phenomena under examination (Patton, 1999). Saunders et al. (2007) indicate that this method of sampling is widely used when dealing with small samples and that the researcher should seek to select cases that are full of rich information. This aligns with the inductive approach used in this research study.

3.4.4 Access

Qualitative research relies on the researcher building effective relationships that enable the collection of high-quality data (Ritchie et al., 2013). The initial access was through the researcher's personal connections to several risk managers in Saudi Arabian banks, through an online social networking service (i.e., LinkedIn). The researcher used the telephone and e-mail to communicate with the proposed participants and provided a letter that explained the study. This included an introduction to the researcher and the research topic, along with its aim and objectives and how confidentiality would be guaranteed. Furthermore, the participants were provided with a copy of the interview questions. The aim of these preliminary procedures was to enhance the credibility of the project and heighten the willingness of individuals to participate in the research (Bailey and Peck, 2013). It is noteworthy that obtaining good access to the research participants provides the researcher with the opportunity to gather high-quality information and, thus, significantly contributes to the current knowledge in the literature (Renzetti and Lee, 1993).

Snowball sampling was also used in this research as an informal approach that reached several Shariah practitioners and experts in Saudi Arabia. Snowball sampling has been used extensively in qualitative sociological research as a process capable of yielding appropriate participants who are, to some extent, linked to each other (Biernacki and Waldorf, 1981). Since this research study is mainly exploratory and qualitative, snowball sampling provides practical advantages (Hendricks et al., 1992).

3.4.5 Pilot Study

In exploratory research, a pilot study is a research experiment that pre-tests selected research methods on a smaller sample and scale (Zikmund, 2003). According to Scott and Marshall (2003), a pilot study used in qualitative research seeks to “identify and rectify logical and analytical difficulties in the research design, ambiguous questions and incorrect routing”. Consequently, the implementation of a pilot study is a significant stage that enables the researcher to detect any flaws in the study when running a trial using the selected method and then making the necessary adjustments. Accordingly, this research was performed in two phases: a pilot study and the main study.

A small-scale pilot study was conducted with one participant in February 2021, who was working (and has respected knowledge) in the field of Shariah corporate governance, Islamic banking and risk management. The main study was conducted in February, March and April of 2021. During the pilot study, the interview questions were pre-tested to decide whether the questions were accurate, comprehensible and straightforward. During this phase, the participant helped the researcher to add, rephrase or omit questions (Arksey and Knight, 1999). It is noteworthy that the researcher was well-informed on the limitations of the pilot study. Not all the research aspects can be discovered on such a small-scale trial, since it would not be able to predict all the prospective concerns. Notwithstanding this issue, the pilot study outcomes were highly informative and undoubtedly enhanced the quality of the interview questions.Table 3.3 : Participants’ Details

#	Sector	Position	Experience
1	Shariah advisory Firm	Founder & CEO	16 years
2	Academia	Assistant Professor Islamic banking	10 years
3	Bank/full-fledge	Shariah compliance manager	11 years
4	Bank/Window	Head of Islamic Banking	15 years
5	Bank/Window	Operational Risk Manager	10 years
6	Islamic advisory Firm	Director	15 years
7	Bank/Window	Head of Shariah Department	16 years
8	Bank/Window	Shariah Assurance, Shariah Advisory & Governance	16 years
9	Bank/Window	Shariah Review and Control Senior Manager	18 years
10	Bank/Window	Senior Credit Reviewer & Risk Manager	12 years
11	Bank/full-fledge	Head Of Risk Management	11 years
12	Bank/full-fledge	Shariah Advisory Consultant	16 years
13	Bank/full-fledge	Islamic finance Expert	15 years
14	Bank/full-fledge	Sharia Control Officer	5 years
15	Bank/Window	Head of Islamic Banking	20 years
16	Bank/full-fledge	Risk Management Specialist in islamic finance	14 years
17	Bank/Window	Shariah Advisory Officer	12 years
18	Bank/Window	Islamic Banking|Expert	21 years

19	Confidential	Risk Management| Islamic Banking| Specialest	11 years
20	Bank/full-fledge	Islamic finance, Islamic law, compliance & Shariah Audit,Expert	18 years
21	Confidential	Governance, Risk, Islamic Finance Expert	12 years
22	Bank/Window	Internal Audit - Risk, Finance and Treasury	8 years
23	Bank/Window	chief risk officer	14 years
24	Bank/Window	Risk manager	13 years
25	Bank/full-fledge	Shariah Board Secritary	21 years
26	Bank/full-fledge	Head Of Risk Management	15 years
27	Bank/Window	Credit risk managemnt	9 years
28	Islamic Finance advisory Firm	Islamic Finance Advisor	10 years
29	Bank/Window	Credit risk managemnt	8 years
30	Bank/Window	Shariah Supervisory Manager	12 years
31	Bank/Window	Market risk manager	15 years
32	Confidential	Expert in Islamic Economy & Finance , board member	15 years
33	Bank/full-fledge	Director of operational risk management	18 years
34	Bank/Window	Governance manager	13 years
35	Bank/Window	Shariah compliance officer	14 years

3.4.6 Virtual Interviews

The ongoing COVID-19 pandemic has generated a slew of changes in our everyday lives. Shaped by government measures, countries around the world have restricted physical contact to enhance the ability to contain the contagion. As a result, all 35 interviews were conducted virtually through either Microsoft Teams, Zoom meetings or WebEx; these are just a few of the many options for real-time face-to-face contact enabled by internet technology (Nehls et al., 2015). Real-time communication with both audio and video is made possible in video-conferencing environments (Mann & Stewart, 2000). This is similar to a traditional interview, except that the interviewer and the participant are in different locations (Nehls et al., 2015). Virtual interviews enable the interviewer to ask questions and the participant to instantly answer online, much like conventional face-to-face interviews; the interviews lasted as long as it was deemed necessary. On average, these research interviews lasted between 30 – 120 minutes, which allowed for as much input from the participants as possible without causing them to lose concentration. When interviewed online, most of the participants in the study were at their work or at home. Four of the 35 interviews were conducted via voice only, rather than combined with video, at the request of the participants (the details are provided in Table 3.4).

Table 3.4: The Interviews Details

#	Date	Sector	Platform	Position	Length	N/R	VIDEO/VOICE
1	20/02/2021	Shariah advisory Firm	Microsoft Teams	Founder & CEO	40 min	Recording	Video
2	23/02/2021	Academia	Microsoft Teams	Assistant Professor Islamic banking	46 min	Recording	Voice
3	27/02/2021	Bank/full-fledge	Microsoft Teams	Shariah compliance manager	47 min	Recording	Video
4	03/03/2021	Bank/Window	Microsoft Teams	Head of Islamic Banking	35 min	Recording	Video
5	03/03/2021	Bank/Window	Microsoft Teams	Operational Risk Manager	80 min	Recording	Video
6	04/03/2021	Islamic advisory Firm	Microsoft Teams	Director	45 min	Recording	Video
7	07/03/2021	Bank/Window	Microsoft Teams	Head of Shariah Department	35 min	Recording	Video
8	10/03/2021	Bank/Window	Microsoft Teams	Shariah Assurance, Shariah Advisory & Governance	75 min	Recording	Video
9	11/03/2021	Bank/Window	webex	Shariah Review and Control Senior Manager	40 min	Recording	Voice
10	11/03/2021	Bank/Window	Microsoft Teams	Senior Credit Reviewer & Risk Manager	40 min	Recording	Video
11	12/03/2021	Bank/full-fledge	Microsoft Teams	Head Of Risk Management	60 min	Recording	Video
12	13/03/2021	Bank/full-fledge	webex	Shariah Advisory Consultant	85 min	Recording	Video
13	14/03/2021	Bank/full-fledge	Microsoft Teams	Islamic finance Expert	43 min	Recording	Video
14	14/03/2021	Bank/full-fledge	Microsoft Teams	Sharia Control Officer	120 min	Recording	Video
15	15/03/2021	Bank/Window	webex	Head of Islamic Banking	55 min	Recording	Video
16	16/03/2021	Bank/full-fledge	Microsoft Teams	Risk Management Specialist in islamic finance	40 min	Recording	Video
17	16/03/2021	Bank/Window	Microsoft Teams	Shariah Advisory Officer	40 min	Recording	Video
18	17/03/2021	Bank/Window	Microsoft Teams	Islamic Banking|Expert	50 min	Recording	Video
19	17/03/2021	Confidential	Microsoft Teams	Risk Management| Islamic Banking| Specialest	45 min	Notes	Video
20	18/03/2021	Bank/full-fledge	Microsoft Teams	Islamic finance, Islamic law, compliance & Shariah Audit,Expert	50 min	Recording	Video

21	19/03/2021	Confidential	Microsoft Teams	Governance, Risk, Islamic Finance Expert	30 min	Notes	Voice
22	19/03/2021	Bank/Window	Microsoft Teams	Internal Audit - Risk, Finance and Treasury	30 min	Recording	Video
23	19/03/2021	Bank/Window	Microsoft Teams	chief risk officer	50 min	Recording	Video
24	20/03/2021	Bank/Window	Microsoft Teams	Risk manager	45 min	Recording	Video
25	22/03/2021	Bank/full-fledge	Zoom meeting	Shariah Board Secritary	43 min	Notes	Voice
26	22/03/2021	Bank/full-fledge	Microsoft Teams	Head Of Risk Management	55 min	Recording	Video
27	22/03/2021	Bank/Window	Microsoft Teams	Credit risk managemnt	30 min	Notes	Video
28	22/03/2021	Islamic Finance advisory Firm	Zoom meeting	Islamic Finance Advisor	40 min	Recording	Video
29	24/03/2021	Bank/Window	Zoom meeting	Credit risk managemnt	45 min	Recording	Video
30	24/03/2021	Bank/Window	Zoom meeting	Shariah Supervisory Manager	35 min	Recording	Video
31	24/03/2021	Bank/Window	Zoom meeting	Market risk manager	45 min	Recording	Video
32	25/03/2021	Confidential	Microsoft Teams	Expert in Islamic Economy & Finance , board member	60 min	Recording	Video
33	05/04/2021	Bank/full-fledge	Microsoft Teams	Director of operational risk management	30 min	Recording	Voice
34	08/04/2021	Bank/Window	webex	Governance manager	70 min	Recording	Video
35	11/04/2021	Bank/Window	Zoom meeting	Shariah compliance officer	60 min	Recording	Video

Key Guide:

Length: duration of the interview.

N/R: type of data taking (notes taking/voice recording).

Video/Voice: type of conducted interview (video call/voice call).

3.5 Data Analysis

Data analysis is an essential procedure used to interpret the obtained data and to make inferences to answer the research questions (Tashakkori and Teddlie, 1998). A qualitative data analysis aims to uncover patterns, insights and understandings (Patton, 2002). A thematic analysis has been used in this study to derive, analyse and interpret qualitative data gathered from the interviews (Boyatzis, 1998; Bailey and Peck, 2013). The procedure is described in more detail in the following.

3.5.1 Thematic Analysis: Rationale for Selection

The use of thematic analysis in this study enables a more in-depth examination of the impact of Shariah corporate governance systems on risk management in Saudi Islamic and window banks (Boyatzis, 1998; Bailey and Peck, 2013). Namey et al. (2008) elaborate on thematic analysis techniques by stating:

"Thematic analysis moves beyond counting explicit words or phrases and focuses on identifying and describing both implicit and explicit ideas. Codes developed for ideas or themes are then applied or linked to raw data as summary markers for later analysis, which may include comparing the relative frequencies of themes or topics within a dataset, looking for code co-occurrence, or graphically displaying code relationships".

For the following reasons, a thematic analysis was more appropriate for this study's primary research purpose. Firstly, since qualitative interviews are the principal method used in this study, they allow participants to reflect in new directions on a variety of subjects related to Shariah governance and risk management (Folkestad, 2008); it provides new perspectives into a social phenomenon. Thus, a thematic analysis enables the researcher to create connections between Shariah governance, risk management, the Islamic banking sector and the participants' experiences. It also helps the researcher interpret the variations and similarities that emerge before and after the data collection (Creswell, 2009). Secondly, this research has a phenomenological stance. The basis of this assumption is that the study involves lived, human phenomena that occur from the viewpoint of those who experienced them (Titchen and Hobson, 2005). As a result, a thematic analysis was chosen because it is concerned with making sense of people's lived experiences (Guest et al., 2012). Finally, since this study is inductive and seeks to enhance understanding of a little-understood phenomenon, a thematic analysis was used to arrange data in a simple manner by identifying and reporting patterns within the discourse (Braun and Clarke, 2006).

3.5.2 Thematic Analysis Process

The process of thematic analysis in this study was directed by Aronson (1994) and Braun and Clarke (2006). They provided valuable guidance on how to perform thematic analysis, which is discussed in detail below.

Step 1: data collection. 35 participants were interviewed using semi-structured interviews. Analyses of qualitative data, such as interview analysis, follow a step-by-step process that entails preparing data by transcribing and writing word-by-word the recorded interviews (McLellan et al., 2003; Halcomb & Davidson, 2006). Out of the total of 35 interviews, only 4 were note-taking interviews. Furthermore, just 2 of the 35 r interviews were in English, while the rest were in Arabic. This meant that the author had to initially write the interview in Arabic before translating it into English. Getting the data ready for the next phase was a long and difficult process that took two months.

Step 2: familiarisation with the data. The researcher printed out each interview, after it was written in a Word document, and began to become immersed in the data by reading it, re-reading it and then writing down initial ideas. The purpose of this phase was to become thoroughly familiar with the dataset's content and to begin noticing points that might be important to the research question. Comments were made on both the entire dataset and individual transcripts. At this point, note-taking was more observational and casual rather than systematic and comprehensive.

Step 3: generating initial codes. The transcripts were imported into the software NVivo 12. NVivo was used to assist with the analysis of the vast amount of text typically used in qualitative research because it enables more in-depth analysis and offers more advanced tools for data visualisation (Patton, 2002; Gibbs, 2002). This data management and analysis tool allowed the researcher to replace the old 'paper and pen' method. The transcripts were read systematically to enable the identification of the textual elements relevant to the research question. Each interview transcript was coded line-by-line and in 'chunks' of meaningful text, where the meaning or relevance of a comment became apparent only in relation to future responses. These text extracts were labelled or "coded". This involved an iterative process; if new codes occurred in one transcript, the researcher re-read the transcript from the entire dataset in search of the pertinent information that might become associated with the new code. The number of codes that can be created at this point is limitless. As a result of the immense amount of data, the coding step was divided into a three-stage coding procedure. The following three models, depicted in Figures 3.2, 3.3 and 3.4, reflect these three steps.

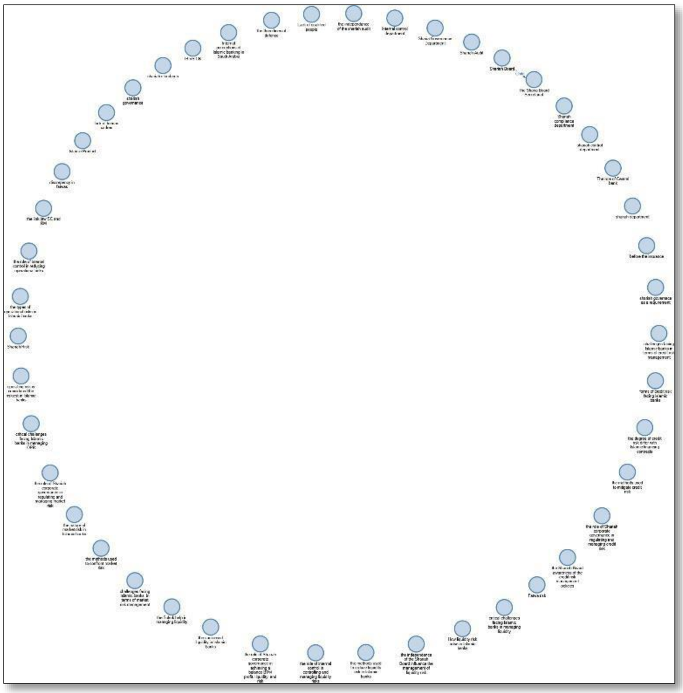

Figure 3.2 Model representing the first codes

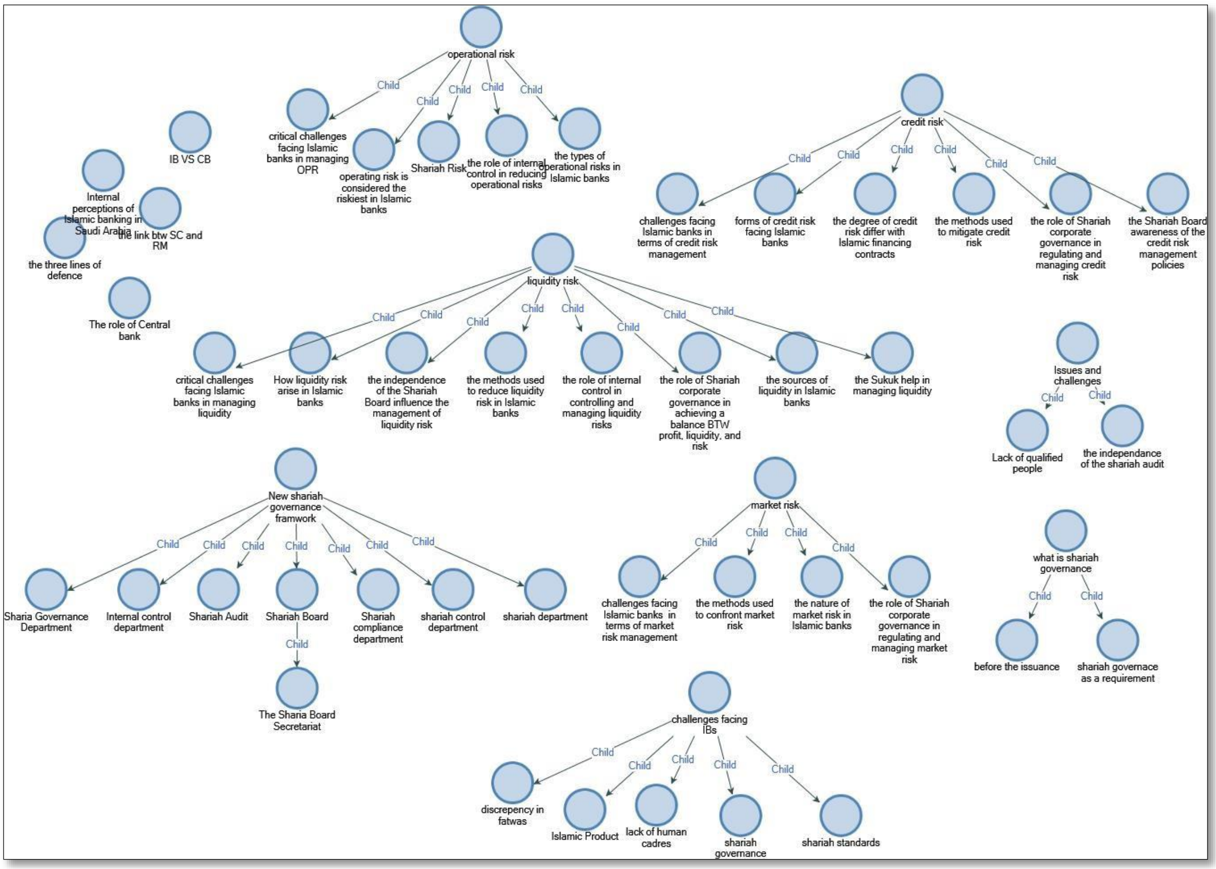

Figure 3.3 Model representing the second codes

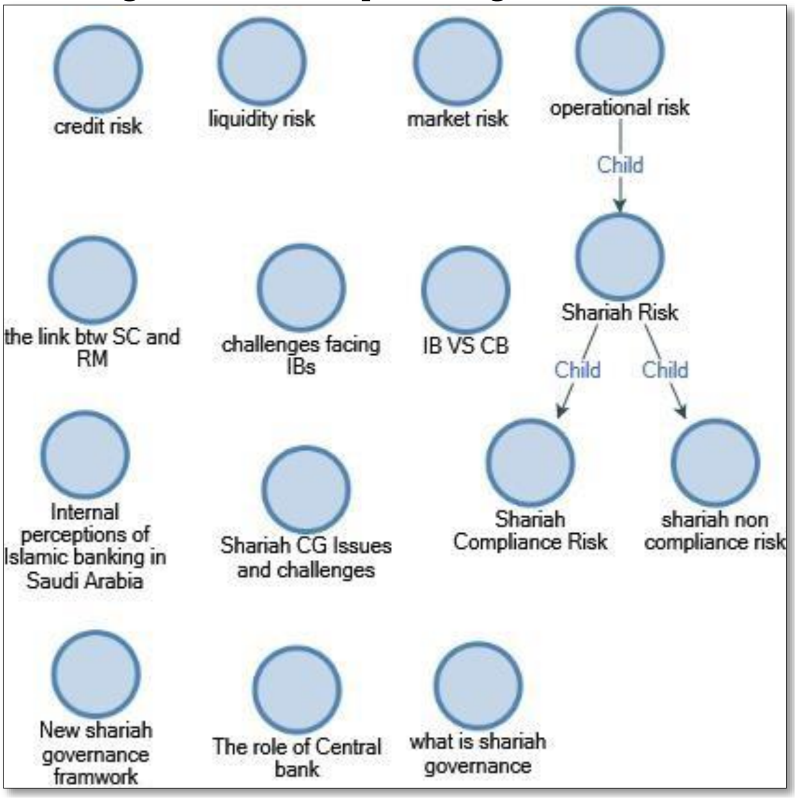

Figure 3.4 Model representing the third codes

Step 4: searching for themes. The analysis begins to shift from codes to themes, combining related codes into potential themes. As part of an iterative procedure, it was considered how several codes might be combined to produce the overarching themes. Another critical aspect of this stage is the beginning of the exploration of the relationships between the themes and the consideration of how these themes can operate together to create a story about the data.

Step 5: reviewing themes. This phase involves a review and refinement of the themes (Braun & Clarke, 2006). Each produced theme was compared to the coded text extracts to determine if it was based on the codes.

Step 6: identifying and naming themes. Revisiting and re-reading the themes multiple times, which allows for revisions, ensures that the story that is told is clear and reliable. This also helped in the development of theme names. Moreover, the use of NVivo software in the study assisted in the development of sub-themes and main themes that were utilised to organise the interview material for analysis. Overall, four main themes and 16 sub-themes were identified through the process of coding and thematising (as shown in Figures 3.5 and 3.6). An example of a main theme is 'The Shariah Governance system in Saudi Arabia', which has the sub-theme 'what is Shariah governance, new Shariah governance framework, the role of the central bank, Shariah CG issues and challenges.

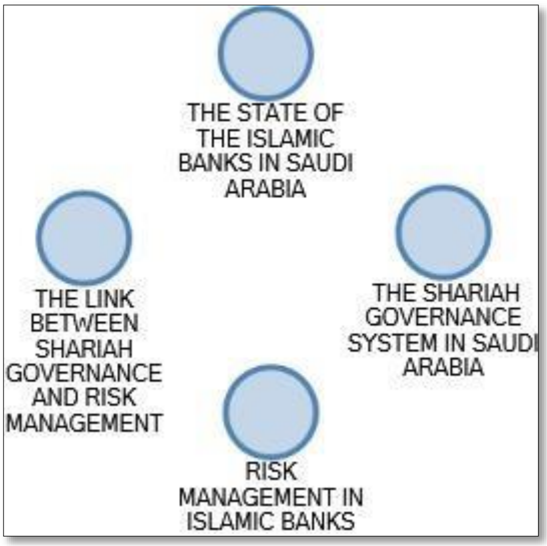

Figure 3.5 Main themes

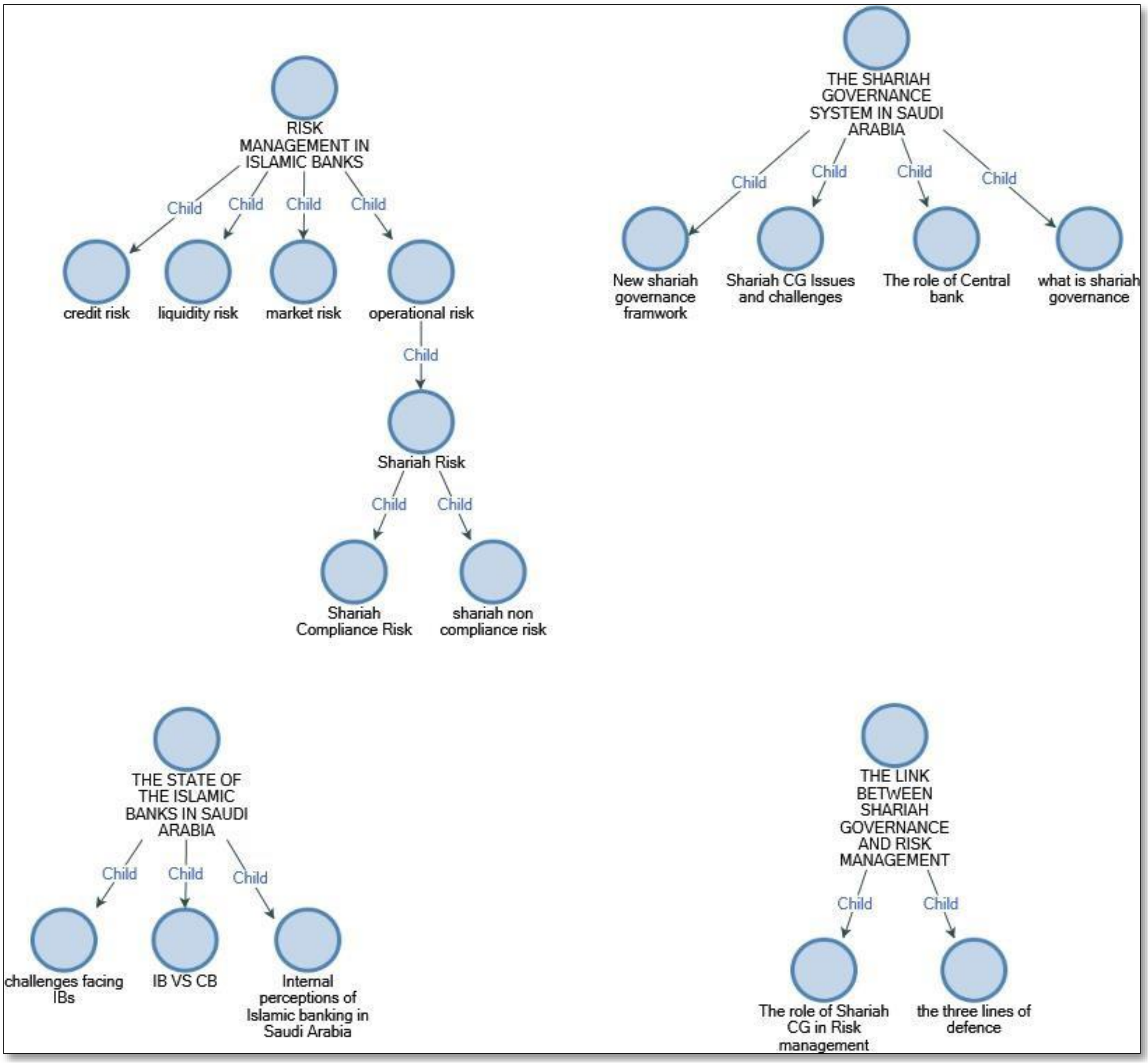

Figure 3.6 Sub-themes

3.6 The Limitation of Thematic Analysis

Thematic analysis is a powerful method for analysing data that enables researchers to summarise, highlight, and interpret a wide variety of data sets (Kiger and Varpio, 2020). However, there are a few limitations to thematic analysis. The researcher conducting a thematic analysis must analyse the text phrase by phrase or line by line. In research, sometimes the phrase does not accurately portray the concept. Therefore, as a phrase-based technique, it is incapable of capturing the meaning of the term fully and completely. Therefore, the process of thematic analysis is not quick. As a phrase-based analytical method, it necessitates a significant amount of time to examine each line and extract its true meaning. This challenge becomes more apparent in unstructured interviews because there is no structure to adhere to.

While thematic analysis is flexible, this flexibility can lead to inconsistency and lack of coherence when constructing themes obtained from the study data (Holloway and Todres, 2003). Consistency and cohesion can be enhanced by using and making explicit an epistemological viewpoint that can logically support the empirical claims of the investigation (Holloway and Todres, 2003).

3.7 Ethical Considerations

To ensure the credibility and the ethical consideration of the research participants, the researcher interviewed participants with backgrounds, qualifications and experience in the research subject, which are essential to the credibility of the data collected (Shenton, 2004). Furthermore, because this study was directly tied to religious activities, special attention was taken when conducting the interviews that made sure that any possibility of offending the interviewers' religious beliefs was avoided.

Prior consent was obtained from the participants that assured approval for their participation. Furthermore, the researcher required permission from the participants to record the interviews: the majority approved the recording, while a minority preferred not to record the interview. Hence, it was not recorded unless the participants attained the necessary consent. Real names were not used; instead, with permission from the participants, only the job title and the type of bank (such as a full-fledged Islamic bank or a window Islamic bank) were mentioned. Others preferred to refer to other alternative specific information instead, such as an expert in Islamic banking. These factors ensured the confidentiality of the research participants. Moreover, the researcher adhered to the rules governing research within the University of Nottingham.

3.8 CONCLUSION

The research methodology utilised to perform this study was thoroughly explained in this chapter, and supporting statements were provided. This study's approach and methods are generally consistent with the expanding body of literature on Shariah corporate governance and risk management in Islamic banking in developing countries (Sakti et al., 2016; Ullah and Khanam, 2018; Hassan and Haridan, 2019; Alam et al., 2021; Reyad et al., 2022; Alam et al., 2022; Alam et al., 2023). Since the topic of SCG, as well as the implementation of this system in nations such as Saudi Arabia, are still in their infancy, qualitative methodologies are ideally suited to capturing and visualising the topic's varied configurations. Chapters (4 to 6), which follow, present the findings of this research.

CHAPTER 4: The Status of Saudi Islamic Banking System and their Risk Management

Introduction

Saudi Arabia has seen phenomenal growth in Islamic banking as a result of significant public demand for the system, paralleling the system's global rapid expansion. While Islamic banking has progressed significantly in Saudi Arabia over the last three decades, there is a scarcity of studies and papers covering critical areas of Islamic banking in the kingdom. To fully realise the potential of Islamic banking, it is necessary to examine the current state of the Saudi Islamic banking industry.

Islamic banks are distinct not just in terms of their operating principles but also in terms of risk (Al Rahahleh et al., 2019). Islamic banks are not immune to risks, whether they are related to Islamic financing formulas or risks they share with conventional banks. Due to the fact that Islamic banks adhere to Shariah rules in all of their operations and products, the study of risks and risk management is seen as a critical issue in the Islamic financial industry. In fact, risk management in Islamic banks can be viewed as a shariah requirement, as preserving money is one of the shariah's objectives, and failing to take the necessary measures and procedures to protect money from risks is a violation of the shariah as it results in money waste, which the shariah forbids (Abdelkrim and Mohammad, 2019). This makes risk management in Islamic banks one of the fundamental priorities of supervisory authorities, as it is sufficient to ensure the stability of the financial system in a global financial environment characterised by an increase in the volume of risks.

Therefore, this chapter discusses the various risks that confront full-fledged and window banks in Saudi Arabia, as well as the Shariah-compliant risk mitigation practices. As a result, it highlights both the risks that Islamic banks share with conventional banks (such as credit, liquidity, market, and operational risk) and the risks that Islamic banks confront alone (namely, Shariah risks). Additionally, this research sheds light on the challenges that Islamic banks face when managing different forms of risk. This is imperative for a complete understanding of the risks and risk management in Islamic banking, especially in countries in which Islamic and conventional banking operate in parallel, such as Saudi Arabia, Malaysia, and many other Muslim countries (Khan et al., 2018).

As stated in Chapter 2, the majority of research on Islamic banking in Saudi Arabia has concentrated on the performance of the four fully-fledged Islamic banks but has consistently excluded Islamic windows (Baeshen and Shaheen, 2021; Hassan et al., 2018; Tabash and Dhankar, 2014). Due to a research gap in Saudi Islamic banking, for both full-fledged and Islamic window banks, an in-depth and comprehensive study of the risks confronting the Saudi Islamic banking industry is required to ensure the appropriate information distribution among regulators, managers, shariah scholars, investors, and customers.

This chapter focuses on the first and second themes, the current state of the Saudi Islamic banking industry and the risks and risk management in Saudi Islamic banks. Semi-structured interviews with Islamic banking experts revealed information on these themes. This chapter relies on data that was collected from individual interviews with Islamic banking experts. The objective is to discover the interviewees' responses to the existing situation of Islamic banking in Saudi Arabia as well as the various types of risks experienced at their banks. In discussing the findings, the raw extracts (in italics) from the data are used. The following is how this chapter is to be organized: The first section of this chapter analyses the existing state of Islamic banking in Saudi Arabia from the perspective of practitioners and Islamic banking professionals. The second section analyses the various types of risks that Islamic banking faces in Saudi Arabia.

4.1 Current state of the Islamic banking in Saudi Arabia

Overview

The Saudi banking system consists of eight conventional banks and four full-fledged Islamic banks: Al Rajhi Bank, Al Jazira Bank, Al Bilad Bank and Alinma Bank. It is worth mentioning that the eight conventional banks also provide Islamic products via specialized branches or units inside these banks and, thus, are referred to as Islamic window banks. Accordingly, the 12 banks are currently strongly oriented with Islamic banking (Figure 4.1).

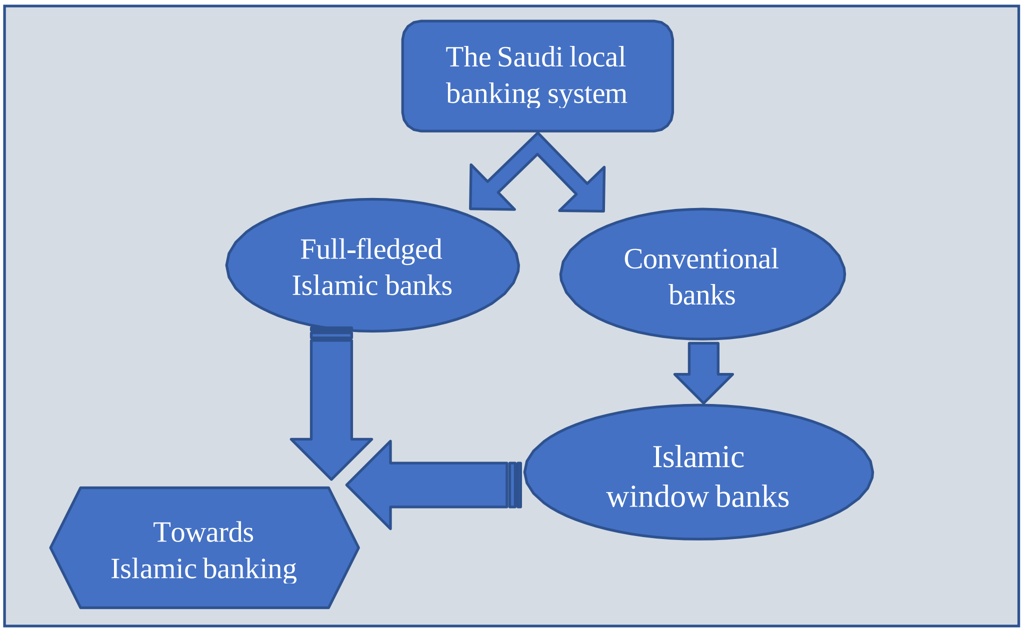

Figure 4.1. Flowchart illustrating the current Saudi banking system.

The main difference between full-fledged Islamic and Windows banks is the corporate structure of the bank. The Islamic window structure is the simplest Islamic bank structure since it is integrated into a conventional bank branch and offers Islamic-compliant funding, financing, and banking services with appropriate financial management separation between Islamic and conventional banks (Zaman and Movassaghi, 2002). In other words, Islamic Windows is an approach to operating a conventional bank in which a specialised staff armed with appropriate Shariah knowledge provides Islamic banking products and services via conventional branches. The operating structure for Islamic window banks should be consistent with Shariah laws and principles as defined by the Shariah Board. In order to achieve more credibility, these banks formed an independent Sharia board to monitor the integrity of the application and its compliance with the provisions of Islamic law.

In terms of the structure of Islamic window bank, the Head of Islamic Banking at Islamic Window bank clarified that:

"*There are three parties in window banks: the Sharia committee, which report to the board of directors, and the Islamic banking department, which corresponds to the bank's management. With regards to the Sharia audit, it is subordinate to the Islamic banking department in terms of promotions and vacations, but they present their reports directly to the Sharia committee without consulting the Islamic banking department*".

On the other hand, full-fledged Islamic banks are distinguished by the presence of a shariah department, which is conducted under the supervision of an independent Shariah board. This acts as a safety mechanism, preventing Islamic banks from departing from their founding principles and assisting them in attaining higher transparency and credibility. According to a shariah compliance manager at full-fledged Islamic bank:

"*The shariah executive management which is represented by (the Sharia department) typically consists of three divisions: shariah research and studies, control and audit, and product development. Naturally, each division has its own work policy*".

As a result, the Sharia committee is an integral part of banks that provide Islamic goods and services. Additionally, a connection between the Sharia committee and the bank is required. This is accomplished via the performance of the Sharia committee's secretary. whether it is a full-fledged or window bank, there is a department under the Sharia Committee that is responsible for managing Sharia operations in the bank, and it is the connection between the Sharia Committee and the bank. Related to the full-fledged bank there is the Shariah department, and its leader is the Shariah Committee's Secretary. In the case of window banks, the Islamic Banking Department is in charge, or there is a Sharia Committee Secretary who serves as a liaison between the Sharia Committee and the bank. as illustrated in the following comments: A Shariah Affairs Officer at the Islamic window stated:

"*The Sharia Board Secretariat acts as a link between the Shariah committee and the bank, so the Shariah affairs officer is responsible for transferring all Shariah committee rulings to the bank. Any decisions that come from the bank to the Sharia committee must first pass through the Sharia Board's secretariat. Before being handed over to the Sharia committee, the secretariat reads the document, filters it, summarizes it, and then delivers it to the Sharia committee, after obtaining their approval, the document is delivered to the concerned* *department*".

Similarly, a Shariah Board Secretary at a full-fledged bank stated:

"*The Sharia Committee's Secretariat attends meetings and communicates fatwas, and decisions to the relevant department when they are approved by the Committee.*"

Ultimately, the findings from this study indicate that Islamic banking is in strong health and is undergoing rapid growth, which is expected to lead to a bright future. As discussed by a board member:

"There are a great developments and initiatives from the Central Bank and from all relevant authorities in creating a real shift in Islamic banking industry".

With the launch of the Saudi Arabia's Vision 2030, which aims to restructure the Saudi economy and diversify its sources of income, Islamic banking is now considered a significant part of the financial sector in Saudi Arabia. As a risk management and Islamic Banking specialist dealers:

"When the Central Bank developed its plan for the years 2020-2023, Islamic finance was a cornerstone of the strategy, and it was also one of the aims of a financial sector development programme included in the Kingdom's Vision 2030. There was a strong emphasis on Islamic finance in the Kingdom, as Islamic financial assets account for 23 percent of worldwide assets".

Since its inception in 1975, Saudi Arabia's Islamic banking sector has performed admirably, with Shariah-compliant assets accounting for 50% of the Saudi banking sector's assets and Saudi Arabian banking products account for about 20% of all Islamic banking products internationally.

4.1.1 Towards a full-fledged Islamic banks

This study reveals that the movement of the Saudi Arabian banking industry toward Shariah-compliant services is growing, which is coordinated with the demand for this type of banking system. As stated clearly by the Head of Islamic Banking at Islamic window bank:

"Saudi Arabia is regarded as a pioneer in the field of Islamic banking, and there are new banks that have switched to Islamic banking or at least in the process of fully transfer".

Although fully fledged Islamic banks have only recently emerged globally, their growth in Saudi Arabia has been phenomenal. Saudi Islamic banks capture more than half, i.e., 51.3% of the total assets of the banking sector (Hassan et al., 2018). Taking these factors into consideration, Saudi Islamic banking has enormous potential for growth. According to Lone and Alshehri (2015), this is because the market is structured in such a way that Islamic principles take precedence over all other considerations, and Islamic banks are very profitable in Saudi Arabia. According to the Islamic Development Bank's 2020 annual report, Islamic finance assets in Saudi Arabia reached an astounding USD 879.2 billion by the end of 2018, making the Kingdom the world's largest Islamic finance market in economies with dual financial systems that include both conventional and Islamic financial sectors. Within a few years, it is anticipated that every bank in Saudi Arabia would be completely Islamic, and forms of conventional banking will come to an end in the country. This clearly demonstrated in the following quote by senior advisory consultant at a full-fledged Islamic bank:

"I have studied the balance sheets of window and Islamic banks. In many of them, the percentage of Islamic activities ranges between 60 to 80% of them within the scope of retail banking, while the non-Islamic products are limited to treasury products, bonds, and securities".

Similarly, a Sharia compliance manager at Islamic window bank added that:

"Commercial and investment banks now conduct 70 to 90 percent of their business in Sharia-compliant transactions, while conventional transactions involving interest are rarely used".

Whereas the primary goal of the Islamic banks is to prevent usury and develop an Islamic economic system, the objective of Islamic windows is to benefit from the opportunity to join a new market and make potential profits (Khreis, 2014). The emergence of Islamic banking as a legitimate alternative to conventional products has attained the fascinated interest of the majority of conventional banks, who are considering the adoption of a dual banking system that engages in Islamic financial activities to meet the demands of their customers seeking Shariah-compliant products and services via Islamic windows. Commenting on this phenomena, Operational Risk Manager at an Islamic window bank declares that:

"Our bank is on the transformation phase to be a full-fledge Islamic bank, and we have as a bank all the main parts of the Shariah governance framework (Shariah board, Shariah control and Shariah audit)".

In fact, this trend is seen as an acknowledgement by the conventional banks of the importance and success of Islamic banking, as well as a motivator for their conversion to an Islamic bank. Saudi Arabia has already seen the conversion of a conventional bank to an Islamic bank, when Aljazeera Bank accomplished a complete conversion to Islamic banking (Alani and Yaacob, 2012). Since most Saudi banks compete in the Sharia-compliant market, this work is divided between full-fledged Islamic and window banks.

1.4.2 Internal perceptions of Islamic banking in Saudi Arabia

Multiple previous studies, such as (Bley and Kuehn, 2004; Haque et al., 2009; Subhani et al., 2012; Khokhar and Sillah, 2014), examined the consumer perceptions of Islamic banking. However, this study focuses on the prescriptions of individuals who are actively involved in Islamic banking in Saudi Arabia, Evidently, the structure of the Saudi Muslim community makes dealing with Islamic banking straightforward, natural, and compatible with its doctrine.

The study reveals that there is an obvious and desired need for Islamic banks in Saudi Arabia. This need originates from the client to the investor and the supplier (a third party), as well as Islamic bank personnel.

Based on this case, a Shariah Assurance, Shariah Advisory & Governance specialist in Islamic window banking, who used to work in Saudi Arabia but now acts as the Head of Shariah at the second largest Islamic banks in Malaysia, declared that:

"In Saudi Arabia the public demand a certain level of Shariah compliance, that maybe in other country like Malaysia the public not necessarily demand but in Saudi the public specifically in the consumer space they want Shariah compliance".

In line with this reasoning, Khokhar and Sillah (2014) studied the consumer perceptions on Islamic banks in Saudi Arabia and they discovered that individuals in Saudi Arabia perceive Islamic banks as a distinct alternative to conventional banks, while their choice of Islamic banks is mostly driven by religion. Indeed, the concept of a legitimate banking alternative is prominent in Saudi culture, as the participants made apparent in their interviews. As confirmed by an Islamic banking expert, who has more than 20 years in the field of Islamic finance in Saudi Arabia,

"Of course, it is an alternative because the banking system controls an important sector of the economy, the financial sector, and so the conventional banking sector plays an essential role in the economy. It is reasonable that if the banking sector does not follow Islamic Law, we will disrupt the economy. As a result, we must develop an alternative banking sector, namely the Islamic banking sector, which must provide all the services that the conventional banking performs with greater efficiency in terms of costs and operations".

The author believes that consolidating Islamic banking as a legitimate alternative to conventional banking products has facilitated clients and accelerated their acceptance of

Islamic banks. In other words, Islamic financial products must be functionally identical to conventional financial products; otherwise, the banking regulators in both Islamic and non-Islamic nations would refuse to authorise them (El-Gamal, 2006). Indeed, it is a double-edged sword in that it has exposed Islamic banks to new risks as a consequence of the Islamic product formula being reformulated into a conventional form. A board member, declared that:

"The problems of Islamic banks are their attempts to mimic conventional banks and putting names without understanding the implications of this formula. These formulas have effects on risks, which increase or decrease. Such as when using the ijarah contract and treating it as a product in a conventional bank, such as the case in a mortgage".

The original motivation for spreading the message that Islamic banks are a legitimate alternative to usurious (conventional) banks was to achieve financial inclusion. Economic and financial policymakers are interested in Islamic finance as a viable channel for expanding financial inclusion; they are utilizing it to satisfy the requirements of businesses and people who do not presently utilize conventional financial services for religious or ethical reasons (Shaikh et al., 2017). This issue was raised by a participant, who is an expert in Islamic Economy & Finance and a board member, who argued that:

"We know that one of the reasons for the development of Islamic banking and allowing regulators to build Islamic institutions, even in non-Islamic nations, is to increase financial inclusion. For example, some communities are opposed to the banking system because it is perceived as conflicting with religious beliefs; as a result, countries have provided financial tools that are consistent with their religious beliefs. As a result, Islamic financing was introduced in order to improve financial inclusion".

The author believes that we cannot overlook the equitable foundations upon which the Islamic bank is founded, or more accurately, the Sharia's objectives (i.e., Maqasid al Shariah) of achieving a set of economic and social goals consistent with Sharia's principles. The objective of Islamic banks is not only maximizing profits, but also the implementation of the Islamic approach to transactions that contribute to the overall development of society. However, have Islamic banks deviated from Sharia's objectives in order to conform to the economic and financial system?

A Shariah Control Senior Manager at an Islamic window bank provided an example of such a deviation:

"Islamic banks are classified into two categories: Shariah-based Islamic banks or compliant with Maqasid al Shariah and Shariah-compliant Islamic banks. The majority of existing ones

are Shariah-compliant Islamic banks, which means they offer products that do not contain usury and do not finance anything that violates Sharia".

Specifically stressing that, in terms of Sharia's objectives, the bank's idea was first considered as incompatible with Sharia's objectives, since Sharia prohibits debts and the bank's concept was originally based on spreading debts, with loans being the bank's assets. Without loan sales, the bank would lose money, and Sharia forbids borrowing unless in the most severe circumstances. This line of argument is supported by the results revealed by Zainol et al. (2016), who found that, from a Shariah perspective, the requirements for incurring debt vary depending to the circumstances. Debt should be incurred only in extreme circumstances when the lack of debt would be harmful to the person in need. In general, acquiring debt for the aim of obtaining more benefits and embellishment is still permissible but discouraged.Therefore, he concluded this point by stressing that:

"To be honest, we cannot declare that an Islamic bank is now compatible with Sharia's objectives in light of world legislation and existing standards. Certainly, these international banking regulations have an effect on risks, as the bank's acceptable risk framework sets the risks that the bank cannot exceed; therefore, Islamic products must also adhere to this risk framework".

Today, Islamic banks effectively meet the financial demands of their customers. This is a confirmed fact; however, what Islamic banks are expected to do today is to appear in a new direction in order to accomplish Sharia's objectives. Islamic banks can fulfil Sharia's objectives by adding value via economic growth, community development and job creation. Maqasid al Shariah in finance not only encompasses the prohibition of riba but also the circulation of wealth within society and the continuity of investment of wealth, achieving economic prosperity for the entire society by meeting basic human needs, financial transparency to eliminate disputes and the permissibility of private and public wealth ownership (Hurayra, 2015).

In summary, people's perceptions of Islamic banks vary; some believe they are a saviour from the usurious system; others believe that they are a legitimate alternative that is compatible with their beliefs and religion; yet another group considers that no banking system can be established without interest. Accordingly, a Co-Founder of Shariah advisory Firm asserted that:

"Despite my more than 17 years of experience in this field, there are still people in Saudi Arabia who do not believe in the concept of Islamic banks on the grounds that it is not possible

to apply Sharia rules in business and make them purely Shariah compliant operations".

By the end of this section, one may be convinced that the shariah-compliant transaction spirit dominates the Saudi banking sector, whether via the four full-fledged Islamic banks or through the other conventional banks' windows. We can agree that there are people who deal with Islamic banking and believe in it. Thus, this industry must be accepted and respected, and in order to do so, it needs to be portrayed in a natural way rather than being made into an industry that is limited to certain people because it truly benefits everyone.

4.2 Risks and risk management in Islamic banks in Saudi Arabia

Through interviews with experts and practitioners in the fields of Islamic banking and risk management, all types of risks that are faced by Islamic banks in Saudi Arabia were covered, including those shared with conventional banks, as well as those unique to Islamic banks. The study revealed that Islamic banks in Saudi Arabia are vulnerable to two categories of risks: common risks, which include credit, market, liquidity and operational risks, and Shariah risks, which include Shariah compliance and Shariah non-compliance risks (Figure 4.2).

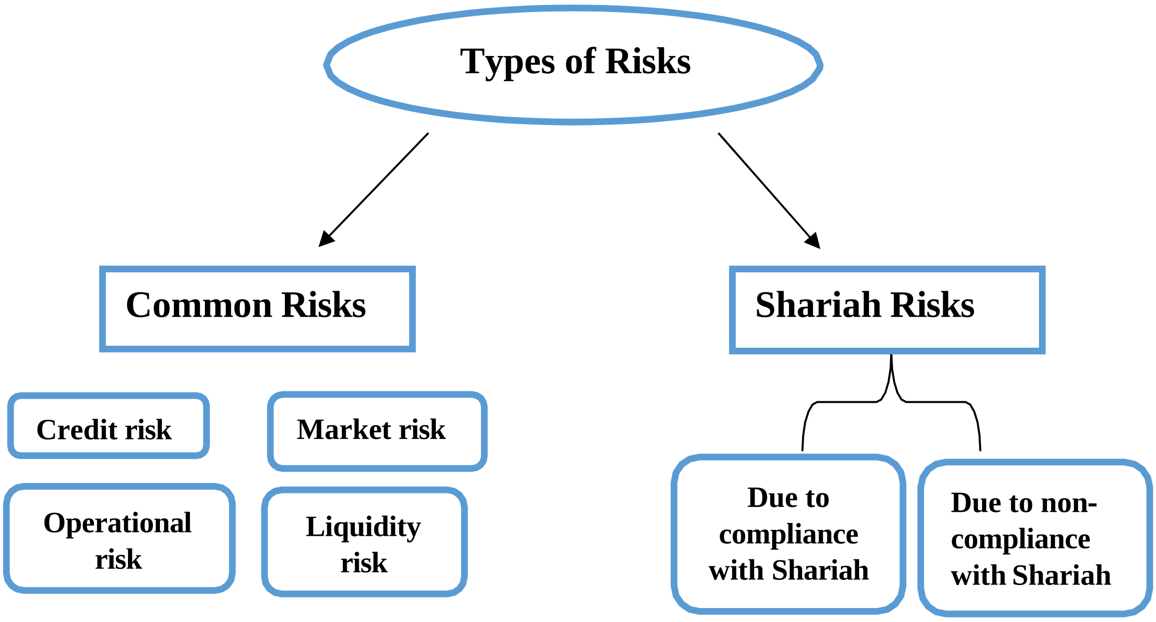

Figure 4.2. Depiction of the types of risks in Islamic banking.

The subsequent sections examine the common risks in detail, highlighting the mitigation procedure as well as the challenges that Islamic banks in Saudi Arabia have in controlling these risks. Second, the study discusses a significant finding in terms of shariah risks. Furthermore, concentrating on the implications of these specific risks and who is responsible for managing

Shariah non-compliance risk, as this was an issue raised throughout the interviews. Finally, addressing the Shariah non-compliance risk mitigation protocol.

4.2.1 Common Risks

Participants agree that Islamic banks face the same risks as conventional banks, and they refer to it as a common risk. According to Shariah Control Senior Manager at Islamic window bank:

"There is a common risk that does not differ between an Islamic bank and a conventional bank. For example, credit risk or the customer defaulting on payment, since the customer may default in both banks".

Therefore, common risks that Islamic banks share with their conventional counterparts derive from the nature of banking operations (Abdelkarim and Mohammad, 2019).

4.2.1.1 Credit Risk

Forms of credit risk facing Islamic banks

Credit risk is one of the most significant risks held in common by conventional and Islamic banks since it is a cornerstone of any banking activity, which prompts banks to place importance on their credit risk management. Credit risk is a significant financial risk that is included under default risk, which accounts for more than three-quarters of the risks in an average Islamic bank's asset portfolios in the banking book (Chapra and Khan, 2000; Khan and Ahmed, 2001). For instance, Operational Risk Manager at an Islamic window bank stated that:

"The basic risk in risk management is the credit risk, before when anyone was talking about risk management, they were talking about credit risk. Always the chief risk officer and the head of the risk group, his concern is credit risk".

The study found that because the Islamic banks in Saudi Arabia generally use debt-based products such as Murabaha, they face credit risk similar to conventional banks. In fact, Islamic banks are exposed to credit risk in the meanwhile by using Murabaha financial transactions. The risk arises when the bank delivers the commodity to the customer on the agreed-upon date but does not receive payment on the agreed-upon date. As a result, credit risk refers to the inability to repay (Yusuf and Sabri, 2014). Therefore, credit risk in the Islamic bank system relates to the possibility that a customer would default on a capital and profit commitment incurred via Islamic banking products. As clarified by Assistant Professor in Islamic banking:

"In Murabaha financing, the customer may fail to pay instalments which include both capital and profit".

Once the bank concludes the Murabaha transaction, it establishes a debt relationship with the customer to pay on time and, of course, Murabaha will not allow a bank to take a profit in case of payment delay. When a payment is late in a conventional bank, a late fee is imposed; however, no late fees are imposed in Islamic banks. The Head of Risk Management at a full-fledged Islamic bank clarified this point in the following statement:

"When a payment is late in an Islamic bank, Tawarq is calculated on the leftover sum. In this case, the client has agreed from the start that in the event of late payment, a fine of two and a half percent will be imposed through the Tawarq process on the remaining amount".

Tawarq is the act of purchasing a product on a deferred basis and subsequently selling it at a reduced price to someone other than the original seller, in order to obtain cash. A group of Sharia scholars considers this process to be forbidden. It is prohibited since the buyer paid more than the agreed-upon amount.

Degree of credit risk among the Islamic financing contracts

Credit risk can exist in all forms of Islamic financing (Ahmed and Khan, 2007). The credit risk in an Islamic bank that provides a debt-based product, such as a Murabaha contract, is primarily at the risk of non-payment. However, in the case of profit-sharing financing (such as Mudarabah and Musharakah), the credit risk is the entrepreneur failing to pay the bank's share when it is due (Ahmed and Khan, 2007). The risks inherent in these contracts originate from the inability of the debtors' to meet their financial commitments on the maturity dates (Bourakba and Zerargui, 2015).

The study found that the degree of credit risk differs with Islamic financing contracts. In other words, credit risk is influenced by the type of Islamic financing structure in existence. How et al. (2005) argued that the risk associated with Murabaha finance is far lower than that associated with other Islamic financing forms. This is because, under the Mudarabah and Musharakah, the financier risks the full amount of capital that is provided as well as the opportunity cost of capital for the entire time until the money is repaid. In contrast, the Murabaha and ijara contracts provide banks with a somewhat predictable income stream, while the bank retains ownership of the leased asset (Ahmed and Khan, 2007). Consequently, Al-Jarhi and Iqbal (2001) found that the majority of the Islamic banks choose fixed-return forms of financing, particularly Murabaha, which is the predominant way of financing.

In commenting on this matter, a Shariah Control Senior Manager of a window bank stressed that:

“Unfortunately, 80 percent of Islamic banks rely on short-term sales such as Murabaha and forward sales for a variety of reasons:

To begin with, its risks are low, with the exception of credit risks in the case of the Musharakah and Mudarabah contracts, where the bank carries risks that exceed those covered by the Murabaha contract. Second, since the banking system likes debts and loans, and because the banking system was established on lending to people, banks favour Sharia contracts that result in debt. Third, since the buying and selling operations are quick”.

Thus, although risk variation exists, it is all about how risk is managed inside the bank's system and how losses connected with these products are allocated. As suggested by the Director of Islamic Financial Advisory. In his words:

“And if Islamic banks have a strong risk management team and a strong product structure, they will not have a negative impact on credit risk”.

For example, if a customer defaults on a payment, the bank will allocate losses by taking a credit risk provision.

Credit risk mitigation methods

The widespread opinion among the interviewees was that credit or default risk are the same in Islamic and conventional banks. They did emphasise, however, that the mitigation procedure is distinct and must adhere to Shariah laws. Moreover, the mechanism for measuring credit risk in the two banks is the same because it relates to the customer, his reputation, his ability to manage his cashflow, and his capability to pay regardless of the financed asset, whether it is a car or real estate. The credit risk mitigation process given by the interviewees include a credit assessment system for establishing a potential customer's credit worthiness, collateral and guarantees. This is aligned with Farhan *et al.* (2020) examining the credit risk management (CRM) system of Islamic banking institutions (IBIs) of Pakistan. Therefore, the IBIs in Pakistan manage the credit risk by conducting evaluation of a customer’s credit history and make an assessment regarding their reliability, appropriateness and adequacy of provided guarantees and collaterals.

As a result of the above, credit risk hedging in Islamic banks may be described as preventing a potential loss owing to the customer's or debtor's failure to satisfy his obligations via the use of specialised instruments, which must comply with Shariah laws.

Credit assessment is the first crucial step in a credit risk mitigation process as declared by a VP-Risk Manager at an Islamic window bank, who says:

"Before giving financing, a bank always studies the customer ability to repay or to be more specific, they make a credit assessment".

A credit assessment is critical for banks; they must verify that borrowers are capable of repaying their instalments prior to approving them for a loan (Mandala et al., 2012). Credit assessments in general involve the bank investigating a customer from a variety of angles:

a) **Credit seeker's character** is determined by the moral characteristics of the customer, which impact the degree to which he will commit to his or her financial commitments to the bank. The adjectives "honesty" and "transparency" relate to the degree to which a person feels accountable for his actions and, hence, compelled to pay his debts. However, although objective standards make it impossible to validate these attributes, they might be predicted from the client's prior transactions and reputation. It is critical for banks to deal with customers that have a good reputation and are creditworthy. As a result, banks must manage credit risk not just across their whole credit portfolio, but also across each individual credit or transaction (Singh, 2013).

b) **Repayment capacity** means the ability to pay off the debts on time. Assessing a borrower's capacity to repay is a critical talent for bank credit officers to acquire, as credit evaluation and analysis is a dynamic process that is critical for identifying loan weaknesses as early as possible (Salem, 2019).

c) **Capital**, which refers to the client's financial status as reflected in the financial statements.

Therefore, credit must be provided to a customer who has a good reputation, adequate self-resources and the relevant studies demonstrate the adequacy of his predicted cash flows to satisfy his financial and future commitments.

All interviewees confirm that the credit assessment process is similar to the ones used by conventional banks, indicating that the first stage in mitigating credit risk is to analyse the customer's credit capacity and ability to repay.

According to a Head of Shariah Division at Islamic Window bank:

"Credit is credit. It has nothing to do with the financing formulas used. As a result, when assessing credit, you look at the customer's suitability and ability to pay regardless of the formula used, which is why I said it is similar to conventional banks".

In fact, the majority of professionals have emphasised the critical significance of Islamic banks focusing on the necessity of completing a full credit assessment on the customer prior to issuing credit. A co-founder of a Shariah advisory firm argued that:

"Islamic banks face the same credit risks as conventional banks, but there is one critical point I would like to make, if the bank lends more due to the fact that this product complies with Shariah, the bank presents it to customers in an unconsidered manner. This will almost certainly result in increased credit risks. Therefore, as with any commercial bank, a study of the customer's solvency and credit history must be conducted".

This suggests that credit risk must be managed by an Islamic bank through the adoption of a sound credit risk management policy, which states the rules and regulations that govern the method of assessing and approving credit requests, defining the types of activities that can be financed and the credit ceilings that should not be exceeded. Regarding this, an interesting point is raised by a Senior Advisory Consultant at a full-fledged Islamic bank:

"Credit risks come only from credit policies. This is generally not only in Islamic banks, meaning if the bank has balanced credit policies and considers the segment of customers covered by the bank, this reduces 90% of the credit risk and vice-versa if the bank has weak credit policies and has problems, credit risk increases".

As a result, the most important principle to reduce risks is to know your customer, as well as the principles of customer selection and a study of the customer's credit history. This is consistent with Chen (2020), who emphasised the importance of know your customer (KYC) data in assisting banks with risk assessment by identifying consumers who are more likely to default on a loan. In fact, this principle is implemented by Saudi banks, as declared by a Senior Advisory Consultant at a full-fledged Islamic bank:

"This is an important principle that is strictly and well applied in Saudi Arabia by SIMAH (Saudi Credit Bureau), and it has reduced 99 percent of credit risks".

Guarantees/Collateral is the method through which the bank avoids the loss caused by a default by the customer. The bank requires two sorts of guarantees when lending: personal guarantees and actual guarantees. Personal guarantees are based on intangible assets such as reputation, which is proven throughout the credit assessment's work. While the actual guarantees involve actual assurances, such as pledging tangible property as collateral for a mortgage.

Collateral is one of the first methods of credit risk management, having a long history of use in Islamic banking (Lekpek, 2018). In fact, it is an essential instrument that banks employ to manage the risk of client default (Hussain and Ali, 2017). The concept of collateral is drawn from the Rahn concept (i.e., pawning). Rahn refers to the pledging of an asset or property as security in order to acquire a loan or finance from a pawnshop (Adamu, 2018).

Collateral requirements prior to Islamic bank financing did not distinguish it from conventional bank lending or financing (Adamu, 2018). By obtaining valid collateral, the borrower demonstrates not only his economic strength, but also his dedication to the financed project and a deep conviction in its success (Bebczuk, 2003, p. 22-23). In practise, collateral might take the shape of either tangible assets, such as real estate and vehicles, or financial assets, including bonds, sukuk and shares (Hussain and Ali, 2017).

Therefore, in Islamic banking, credit risk must be mitigated before entering any transaction to avoid future credit risk. According to the Head of Risk Management at a full-fledge Islamic bank:

"In Saudi Arabia, all banks give loans to individuals based on their salary, so credit risk is almost mitigated, so the collateral here is the client salary".

As a result, in Saudi Islamic banks, the collateral for an individual is the salary, or in the sense that the salary must be transferred to the same bank to enable an offer of a loan, but recently some banks have begun to provide loans without transferring the salary because the Saudi Credit Bureau (SIMAH) is regarded as a credit register. For corporations, the collateral is frequently real estate or equity, and the acquiring equity is risky due to market volatility. All these rules can be found in the bank's credit policies, in which there is a section dedicated to Islamic banking.

Challenges facing Islamic banks in terms of credit risk management.

The study revealed that credit risk management for Islamic banks is challenged by factors not encountered by conventional banks. This is due to the complexity of the structure of the Islamic financial products offered by Islamic banks, which varies from one product to another. Additionally, they must adhere to and reflect Shariah rules in the credit risk management process. This clearly indicates that the capacity of the Islamic banks to manage credit risk is constrained. For example, the nature of the product in the event of obtaining a conventional loan, i.e., the bank lending money to the customer. Here, the type of contractual relationship becomes the right of the customer, whether the loan is for a car or a house, while the bank has no access to the commodity; mostly, in this case, the risk between the bank and the customer is only a credit risk as it is a debt relationship. But the situation for an Islamic bank is different due to the nature and structure of the Islamic product, meaning that when the bank is financed in Murabaha, it differs from a financing in Musharakah, ijarah or Mudarabah.

Through analysis of the interviews, it was determined that only practitioners from both full-fledged Islamic and window banks responded to this question. This demonstrates that their response is based on their actual experiences with credit risk management on a regular basis. Therefore, Issues for Islamic banking in credit risk management include:

1. Credit risk management at Islamic banks is challenging in terms of guarantees, as they are constrained by Shariah requirements. Lekpek (2018) argued that credit risk management in Islamic banks is a complicated and time-consuming procedure. Although Islamic banks use collateral in the same way that conventional banks do, acceptable collateral instruments given by the customer must be Sharia-compliant. This is emphasised by the VP, Shariah Assurance, Shariah Advisory & Governance of an Islamic window bank, who stated:

"When a bank accepts collateral that is not Shariah compliant, this creates an operational risk that might develop into a credit risk, exposing the bank to greater risk than they anticipated".

In the same vein, the head of an Islamic banking department at an Islamic window bank insisted that:

"Credit risk management at Islamic banks is challenging in terms of guarantees, as they are constrained by Shariah requirements. There are Shariah-compliant shares and Shariah-incompatible shares".

Accepting collateral as a credit risk mitigation method in Islamic banks is a delicate task that requires knowledge of Shariah laws, and it frequently involves a Shariah board issuing a fatwa on the mortgaged asset submitted by the customer, which indicates whether it is compliant with Shariah laws and thus accepted, or not compliant and therefore rejected. Highlighting these matters, an Islamic banking expert provided the following real example:

"If the bank wants to finance the customer and the client does not have land to pledge as a guarantee or mortgage, but he does have a deposit with the same bank, he pledges the deposit to obtain the financing. Even the deposit must be Sharia-compliant, however if the customer only has a conventional deposit, in this case, if the customer defaults on payment, the bank takes only the deposit's capital and not the interest".

2. The Shariah laws restriction on collecting interest or imposing penalties is considered a further challenge. Islamic banks are not permitted to charge interest or impose penalties, except in cases of purposeful procrastination (Greuning and Iqbal, 2008). Hence, the clients of Islamic banks may benefit from delayed payment given that the Islamic bank does not impose additional fees or charges (Ahmed, 2023). A recent study by Aldoseri (2021) found that the levels of credit risks faced by Islamic banks in Saudi Arabia are found to be significantly higher than those faced by conventional banks; therefore, the capital of the Islamic banks is struck owing to unproductive use of their capital, which puts pressure on these banks due to a non-payment of depositor returns and raises the bank's rate of return risk.
3. There is a lack of knowledge and skilled personnel capable of managing this sort of risk in this industry. The research participants unanimously affirmed that Islamic banks need qualified risk management personnel. Developing and training new risk management cadres for Islamic banks is an urgent need. This will help minimise and control the risks that Islamic banks face and advances the wheel of growth, continuity and development and, hence, creates new opportunities for local and international investment (owing to the strong reputation of the banks for risk management).
4. For two reasons, the differences in credit risk between Islamic products is also a challenge. To begin, the risk management capabilities of Islamic banks may lack experience and competence. Second, developing Islamic products other than Murabaha provides a low degree of credit risk in comparison to others, which is a somewhat distant step.
5. Finally, Islamic banks try to replicate conventional banks, which results in an increased credit risk that cannot be measured or managed.

4.2.1.2 Liquidity Risk

Sources of liquidity in Islamic banks

Financial resources are the lifeblood of all banks in general, but they are especially important for Islamic banks. The latter cannot perform its functions unless it has accumulated the necessary financial resources, which serve as the cornerstone for its operation. Nikolaou (2009) highlighted three common sources of liquidity for banks that may be used by both Islamic and conventional banks: the depositor, the market via asset sales and the securitization. Other options include the interbank money market or direct access to the central bank. These three factors are similar to what the interviewees have covered, but they provided additional resources pertaining to the nature of Islamic banking. Figure 4.3 depicts the liquidity sources available to Islamic banks.

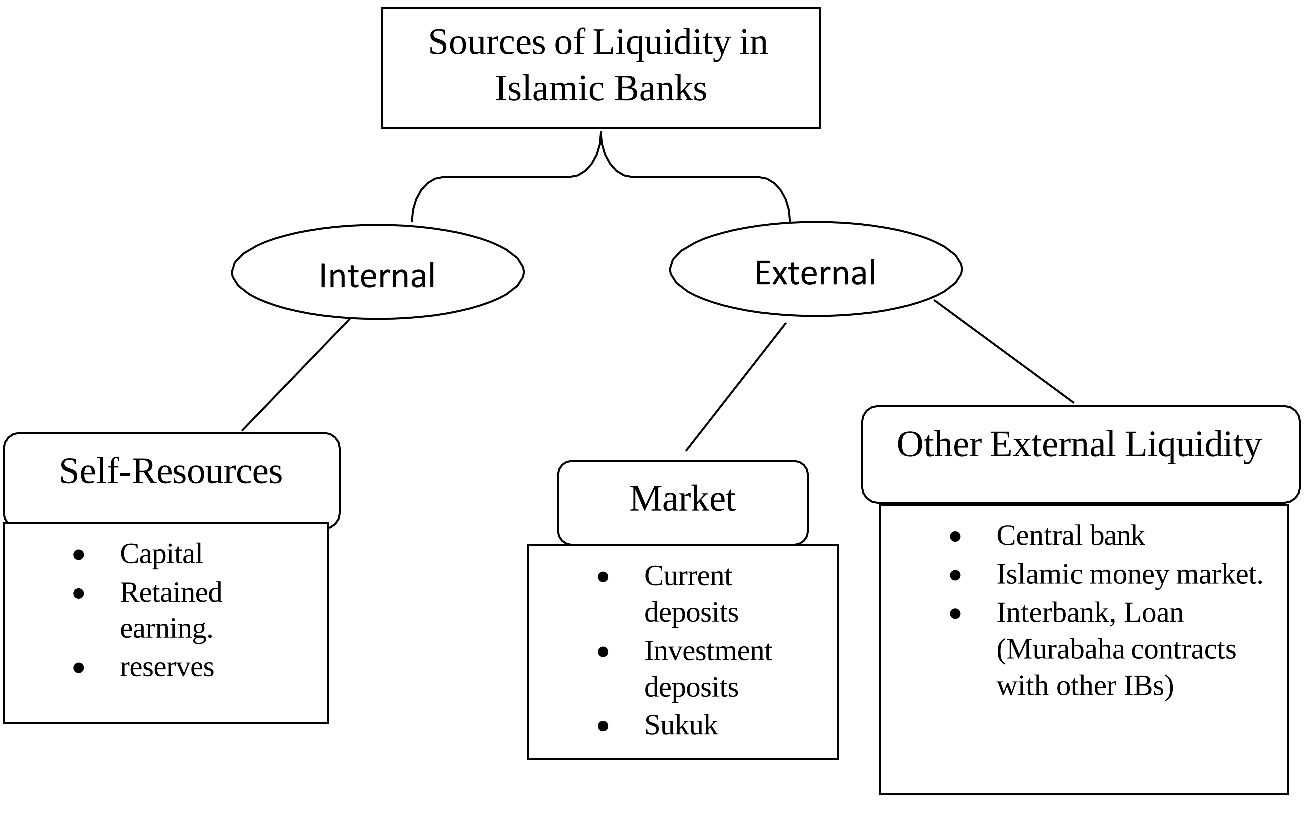

Figure 4.3. Flowchart illustrating the sources of liquidity in Islamic banks.

According to Figure 4.3, the internal sources of liquidity in Islamic banks represent a small portion of the overall sources of funds. In fact, Accepting deposits is a vital activity for Islamic banks, since they rely primarily on the funds of depositors for their funding (Mounira and Anas, 2008). A head of the Shariah department at a windows bank claimed that:

"Unfortunately, deposits are likely to be a major source, and I believe that Islamic banking must find solutions".

Due to the nature of Islamic bank deposits, the two fundamental categories of money providers are current accounts and investment accounts (profit and loss accounts). Many of the deposits that the bank must be prepared to satisfy are current deposits, which create no profit; they are seen as a debt or a loan that will be paid immediately upon request. This is opposed to the investment deposits from which withdrawals are happened in limited circumstances, such as when the rate of return on the deposit is less than expected, or when an Islamic bank violates Islamic Sharia. The opinion of Bencharles and Abubakar (2020) is that Islamic banks are, thus, confronted with the difficulty of maintaining the appropriate level of liquidity since they also hold customer position deposits and other short-term liabilities. Therefore, Islamic banks that invest in long-term assets continue to confront liquidity issues because most of their deposit liabilities are relatively short-term, which results in a significant shortage of liquidity.

No doubt, liquidity management has been a critical component of conventional and Islamic financial services. Interestingly, the primary difference between the two relates to the instruments available to them for managing liquidity according to their own guidelines. Conventional banks have full rights to instruments such as interbank deposits, repo transactions, foreign currency swaps and commercial papers. In contrast, Islamic banks do not have exposure to these financial assets owing to their interest-bearing nature, which is banned by Shariah law. Consequently, Islamic banks would especially need to develop a variety of instruments of liquidity management that adhere to Islamic rules and values.

According to a co-founder of Shariah advisory firm:

"We can say that deposits are the primary source of liquidity in Islamic banks, along with sukuk, which is viewed as a tool for managing liquidity in Islamic banks".

Indeed, sukuk is the best Shariah-compliant debt instrument for short-term liquidity needs, since it is a highly tradable asset with a minimal degree of market risk (Ghafoor et al., 2018). As a result, the worldwide issuance of corporate and sovereign Sukuk is booming. In 2017, Saudi Arabia issued the largest sovereign international sukuk to date, totalling $9 billion. Notably, this issue meets Basel III's definition of a high-quality liquid asset (Smaoui et al., 2020).

The extent to which sukuk help in the management of liquidity

According to the Head of Risk Management at a full-fledged Islamic bank:

“It is huge currently, sukuk is massive in the business world today, and the majority of banks and companies can issue sukuk to use as a source of liquidity and to minimize risks on their financial statements”.

Thus, sukuk assist Islamic banks in managing liquidity risk; the more sukuk, the more banks can either deploy them and earn returns when there is surplus liquidity, which means a larger number of deposits, or they can sell sukuks promptly when the bank requires additional liquidity. A director of an Islamic finance advisory firm states:

“This is why the demand for sukuk is quite strong and almost every sukuk subscription worldwide is usually oversubscribed”.

Addressing alternative liquidity sources, the Interbank and repo market, for example, is a source of liquidity in conventional banks. Bello et al. (2017) illustrated that the Islamic money market offers a mechanism for banks to manage liquidity by injecting surplus funds or acquiring funds to cover deficiencies. It may act as a platform for interbank market liquidity operations, a trading platform for money market instruments and a clearing platform for cheques.

Repo or repurchase, means that a sale is made and then repurchased, and it is frequently completed with the central bank but may also be done with other parties. The central bank is the lender in the repo process, and the commercial bank is the borrower. In contrast, in reverse repo, the lender is the commercial bank, and the borrower is the central bank, and the transaction is completed in a single day.

An Islamic banking expert, with over two decades of experience in the area of Islamic banking in Saudi Arabia, commented on this by stating:

“Every day, at a specific hour, the bank calculates available liquidity and transfers it to the central bank for a one-day period, following which it withdraws the amount with profits. This is a non-Shariah-compliant transaction because it involves interest-bearing loans”.

As a result, the Islamic bank's liquidity risk is that it lacks Shariah channels through which to invest this liquidity, resulting in stagnant liquidity and a decrease in liquidity management efficiency. Therefore, creating financial tools to manage liquidity in a Shariah-compliant manner is one of the Shariah functions.

Hence, there has been an increase in attempts by the Saudi Islamic banks to manage short- and medium-term liquidity. One of the banks created "Islamic repo", which was approved by the Central Bank and deployed. The "Islamic repo" instrument has been known as the repo with the corresponding promises. It was implemented as the first of its type in the Saudi banking industry. In fact, this newly produced Islamic instrument is regarded as the most significant large event performed in the Islamic financial industry. However, according to the head of the Shariah department at an Islamic window bank:

"Interbank is present in Islamic banking, but it is in its infant stages. A Sharia-compliant repo has been developed as a Shariah alternative to conventional repo, and repo provides inexpensive liquidity to Islamic banks, and international banks have now begun use Shariah repo as an alternative solution".

In the Islamic repo market, sukuk or stocks are used, with sukuk being more commonly employed because it is less volatile than stocks. With the existence of the Saudi Islamic repo market, sukuk is the major contributor to providing liquidity to banks, which allows these sukuk to be resold in the market, thereby creating high liquidity for them. If the bank requires liquidity, it must invest in sukuk, as the bank must have highly liquid assets to meet the Basel criteria for capital buffers.

In a nutshell, when a bank needs liquidity, it sells its sukuk and then repurchases them. Thus, the terms of the transaction may be as short as one day, the cost of liquidity is low, and it competes with conventional repo. According to the head of the Shariah department at Islamic window bank:

"Sukuk have existed and been utilised in the Kingdom for a long time; banks were forced to invest in sukuk while the market was weak, posing a risk to the bank's liquidity; but the presence of the Islamic repo market will significantly increase sukuk liquidity".

The liquidity risk in Islamic banks

Traditionally, liquidity risk is when "there are timing differences between cash inflows from the businesses and cash outflows for business requirements and maturing debt obligations" (Bello et al., 2017). The liquidity risk might occur as a result of a maturity mismatch in which liabilities have a shorter tenor than assets (Ariffin, 2012). On the asset side, the liquidity risk is determined by the bank's capacity to quickly convert assets to cash. On the liability side, the risk derives from the unexpected recall of deposits (Jedidia and Hamza, 2015). As a result, failing to manage these two extremes, along with a lack of external funding, is what causes liquidity risks in Islamic banks.

Two of the interviewees (the head of the Shariah department at an Islamic window bank and the director of an Islamic finance advisory firm) agreed that liquidity risk occurs in Islamic banking in the same way that it does in conventional banking. Namely, when banks are unable to meet their financial obligations on time, which results in significant losses. In this vein, Ariffin (2012) stated that as banking institutions, Islamic banks (like their conventional counterparts) must meet their liquidity needs and obligations to maintain the smooth operation of their businesses. However, the unique nature of Islamic banks, with their purpose of avoiding all forms of riba (interest), necessitates the solution of extra challenges in relation to satisfying their liquidity needs in a Shariah-compliant fashion. Furthermore, according to Hassan (2013), a substantial difference between conventional and Islamic banks lies in the contract, i.e., conventional banking liquidity instrument are based on debt, while Islamic banking liquidity instrument are based on equity.

While according to an Assistant Professor in Islamic banking:

"Liquidity risk is the same as the conventional one, it can arise into two forms: to meet the regular demand or to meet the irregular demand. For example, in Saudi Arabia during Ramadan the demand for cash will be higher than the normal base, so banks should be ready with enough cash with them".

Islamic banks rely heavily on current accounts, which are demand deposits that may be withdrawn at any moment (Iqbal and Mirakhour, 2007). Thus, depositor funds are either callable on demand or need short notice periods for withdrawal. As a result, the probability of an Islamic bank experiencing a liquidity shortage is relatively considerable in the case of a rapid increase in borrowers withdrawing deposits (Ariffin, 2012). According to Al-Sadah (1999) various Islamic banks in Bahrain consider the amount of liquidity on each type of account (i.e., investment, saving and current accounts) to fulfil investor withdrawals. The liquidity requirements established by regulatory authorities for Islamic banks have an impact on the amount of liquidity. Each Islamic bank employs a different liquidity policy to accomplish the same goal; a portion of the funds in the accounts serves as a liquidity cushion to cover unexpected withdrawals. This allows Islamic banks to fulfil unexpected liquidity requests from the current and investment account holders, which avoids the potential of a bank run.

In contrast, just one of the interviewees (an Islamic banking expert with over two decades of expertise in the field of Islamic banking in Saudi Arabia) believes that liquidity risk exists in Islamic banks, due to a lack of flexible instruments upon which the bank can manage its short and medium liquidity, since short liquidity might last one or two days and so far Shariah tools are not as flexible in allowing banks to manage this liquidity. This is aligned with (Khan and Ahmad, 2001; Ariffin, 2012; Mohammad, 2013) who insisted that the liquidity risk in the Islamic banking sector stems from a lack of Shariah-compliant liquid instruments.

Liquidity risk is more serious for Islamic banks compared with their conventional counterparts (Ahmad and Khan, 2001). The lack of a lender of last resort (central bank) adds another source of risk to the liquidity of the Islamic banking industry (Boukhatem and Djelassi, 2020). Indeed, if we examine conventional banks, they receive support from the central bank and can obtain short-term loans for one or two days, or they can obtain short-term loans through interbank transactions between other banks. However, Islamic banks cannot attain these types of short-term loans and, if they do, they must structure a product or have a permanently structured product in place. Thus, this presents a liquidity issue for Islamic banks. This is consistent with Ray (1995), who highlighted liquidity as a significant issue for Islamic banks and he argued that this issue occurs for two reasons: (i) a gap may arise between the central bank and the Islamic bank, with the former refusing to lend money on any basis other than interest, and (ii) the limited variety of Shariah-compliant financial instruments. In the same vein, Boukhatem and Djelassi (2020) states that a lack of Sharia-compliant liquidity management tools and an inadequate financial infrastructure are two of the biggest causes of liquidity risk for Islamic banks.

In summary, although perspectives on the causes of liquidity risk in Islamic banks in Saudi Arabia vary, they are, nevertheless, all attributable to the following reasons, which are seen as the most realistic and acceptable in light of the present situation. One of the primary causes of

Islamic banking's liquidity risk is the restricted availability of Shariah-compliant money markets and intrabank markets. Moreover, there is a lack of liquidity management solutions that are both flexible and clearly Shariah-compliant.

Liquidity risk management in Islamic banks

We can observe from the preceding paragraphs that Islamic banks are having difficulty managing their short-term liquidity fluctuations (Al-Muharrami and Hardy, 2013). This is because liquidity management for Islamic banks is unique and significantly more difficult because the majority of current liquidity management instruments are interest-based and, hence, not Shariah compliant (Ariffin, 2012). Islamic liquidity management is similar to conventional liquidity management in terms of objective and reasoning but requires the use of alternative instruments due to Sharia compliance considerations (Önal, 2013).

Liquidity stress can be managed both internally and externally in Islamic banks (Mohammad, 2013). Internally, according to IFSB's guiding principles of liquidity risk management (2012), there should be a sound and comprehensive liquidity risk management framework integrated into the enterprise risk process, to ensure that there is sufficient liquidity to meet daily funding requirements and to cover both expected and unexpected deviations from normal operations for a reasonable period of time. Mohammad (2013) argued that as a major entity inside the bank, the BOD should establish a liquidity risk management strategy in collaboration with senior management, alongside other bodies, and personnel. In fact, the effective internal control system enhances the liquidity management policy. In this context, an Assistant Professor of Islamic Banking, underlined the critical function of internal controls in mitigating liquidity risk as follows:

"Basically, Islamic banks should have a maximum limit of funds, ex investments by the customers can vary between 3 months to 6 months, so if the customer wants to withdraw the investment before the maturity, the penalty should be high so the customer will get a low profit. Also, when customers invest for three months so banks will take this investment as financing forms for other customers, therefore there should be ALM asset and liability management in case all customers come and ask for their money".

More precisely, this discussion sheds light on the asset-liability management (ALM) function's role in controlling liquidity risk. Recently, asset-liability management has placed a greater emphasis on mitigating financial risks (Malhou and Maimoun, 2021). Asset-liability management (ALM) is defined by Greuning and Iqbal (2008) as a collection of strategies and procedures used by banks to assess and manage all elements of their assets and liabilities. It entails producing the best possible investment of assets, while both meeting present and future obligations (Novickyt and Petraityt, 2014). Thus, asset-liability management risk emerges from the maturity mismatch between a bank's assets and liabilities.

According to Malhou and Maimoun (2021), who investigated the connection between liquidity risk and asset-liability management in Islamic banks, Islamic banks (like conventional banks) face an asset-liability mismatch risk. This risk is magnified for Islamic banks, since they operate in an extremely difficult environment, owing primarily to the lack of Shariah-compliant money markets and interbank markets. While Sun et al., (2014) found that the assets and liabilities of conventional banks are of higher quality compared to their Islamic counterparts. This is because Islamic banks employ short-term borrowings and deposits to invest in longer-term loans and assets.

Regarding asset-liability management practices of Islamic banks, (Chattha and Alhabshi, 2018; Rehman et al., 2017) have highlighted the critical role of the ALM Committee in developing new instruments and innovative risk management solutions, such as profit-and-loss sharing contracts that minimise the asset-liability gap. Furthermore, Mun and Thaker (2016) stated that the Asset Liability Management Committee (ALCO) has the responsibility to monitor the implementation of the asset liability management system, as well as create a balance sheet policy for the banks based on a comprehensive assessment of risk and return trade off. Thus, the internal process for managing liquidity risk begins with the bank's Board of Directors formulating policies, which are then operationally implemented by the Asset Liability Management Committee (ALMC), which functions as an internal control system for implementing and arranging the policies at a lower level.

Externally, liquidity risk is managed by the Islamic financial market system, which is stimulated by regulators and connected to actual economic operations (Ismal, 2008). Islamic banks are required to maintain liquidity using a variety of Islamic financial instruments (Mohammad, 2013). According to a risk management specialist in Islamic finance:

"The methods used in Islamic banks to mitigate liquidity risk, sukuk is one way, and interbank transactions between IBs to help each other are another".

In this matter, Ayub (2017) argued that an efficient liquidity management system for Islamic banks would centre on the orderly development of a Shariah-compliant interbank, and sovereign and corporates sukuk.

It is imperative to highlight the commodity Murabaha as one of the Islamic financial instruments that most Islamic banks have employed as a short-term liquidity solution. Based on the concept of the Murabaha contract, this short-term financing arrangement is often utilised for the sale of commodities on the international market when liquidity requirements arise (Abdul Majid, 2003). Shawky and Bourqaba (2011) noted that most Islamic banks currently use Murabaha to manage short-term liquidity in the international commodities markets, notably the London Metal Exchange (LME).

In this matter, a Senior Advisory Consultant at full-fledge Islamic bank stated that:

"Short-term liquidity is managed by performing commodities sales through Murabaha in international markets (commodity brokers such as the London Metal Exchange (LME) and the palm oil exchange in Malaysia), although I prefer to manage it through Mudarabah products and investment agencies".

As discussed earlier, Islamic banks struggle to manage their short-term liquidity volatility. Accordingly, self-insurance to maintain a high level of liquidity may be a necessary decision in the absence of Sharia-compliant high-quality liquid assets, an absence of active secondary market trading and an inadequate tool for monetary authorities to provide liquidity assistance to Islamic banks (Abdelmagid, 2020).

In line with this statement, the Head of Risk Management at a full-fledge Islamic bank asserted that:

"Provisions and massive capital allocation are included in the liquidity risk management scenarios, and this is seen as a critical first step".

This view was confirmed by Abdelmagid's (2020) recent findings on the factors affecting the liquidity of Islamic banks in Saudi Arabia. He discovered that the liquidity of Saudi Islamic banks is highly and positively related to their capital adequacy ratio. This means that a high level of capital enables the generation of more liquidity.

Despite the high level of capital adequacy ratio in Saudi Islamic banks, a director of an Islamic finance advisory firm clarified that:

"Liquidity risks occur when banks are unable to meet their financial obligations in a timely way, which could result in significant losses. Therefore, we must bear in mind that liquidity is not synonymous with profitability; a bank may be quite lucrative, but its liquidity risk is extremely high, and it may lose everything".

Indeed, the study of Abdelmagid (2020) indicated that the liquidity of Saudi Islamic banks had a negative and statistically insignificant relationship with the return on equity. In other words, profitability helps a bank's solvency issue but does not assist the Islamic banks' liquidity shortage problem. This is because liquidity is required for day-to-day operations, while profitability relates to a longer period of time. As a result, Islamic banks should be very well-capitalised in order to keep liquidity healthy. In line with this thinking, Boukhatem and Djelassi (2020) stated that capital consequently functions as a buffer against risky liquidity generation. In the case of Islamic banks, the negative liquidity position in the money market must be covered by bank capital. For example, the bank may employ the commodities Murabaha in the money market covered by bank capital and continue to produce liquidity while being solvent.

Overall, it is obvious from the preceding discussion that the liquidity risk in Islamic banks is more significant than in conventional banks, since it does not end at balancing the two parts of stability and profitability, but rather relies on the level of its dedication to Islamic Sharia regulations and principles.

Challenges facing Islamic banks in terms of liquidity risk management.

We can summarise the current concerns and challenges encountered by Islamic liquidity management from the preceding discussion and the contributions of the interviewees:

1. It is noteworthy that Islamic banks are also facing a liquidity risk as a result of the increase of debt-based financing formulae – primarily Murabaha – which cannot be traded since they equate to selling debt, which is prohibited under Shariah law. Since Murabaha receivables are a debt that are due on maturity, they cannot be sold in the secondary market at a price different from the face value. Ali (2004) argued that this creates a liquidity risk for the bank, especially if the average term of deposits is less than the average maturity of the Murabaha contracts or if the deposits are market sensitive. Henceforth, we shall refer to the liquidity risk associated with Murabaha as the 'principal liquidity risk' because of its non-resell ability. In fact, this is a source of liquidity mismatch for Islamic banks (Bello et al., 2017).
2. The primary source of liquidity is client deposits, which behave similarly to demand deposits and they have a short-term maturity because consumers may withdraw their funds at any time. On the other hand, on the asset side, the Islamic banks use debt-based contracts such as Murabaha and ijarah, which have a similar function to conventional debt financing. Thus, the maturity mismatch between asset and liability persists, and the Islamic bank will still face potential liquidity problems just like conventional banks (Rizkiah, 2018). Perhaps this is one of the reasons why Islamic banks are encouraged to diversify their investments

by enabling Mudarabah and Musharakah. According to Sobol (2013), an ideal Islamic bank that operates on a profit-and-loss sharing basis should be more stable and avoids liquidity issues.

3. There is a lack of liquidity management solutions that are both flexible and clearly Shariah-compliant. As stated by an Islamic banking expert:

   "The lack of Shariah compliant, flexible financial instruments related to short term *liquidity, as well as the absence of efficient instruments, which means that an efficient instrument has lower risks, lower costs, and higher profits. Because Islamic banks in Saudi Arabia use Murabaha and face high risks".*

4. Since there is no lender of last resort (i.e., a central bank), Islamic banks are required to maintain a high level of liquidity, which has a direct influence on their profitability and the profit of the investment account holders.

5. Sukuk has proven itself as the best liquidity management tool. However, the volume of issuance is still quite small (Rizkiah, 2018), and according to the head of the shariah department at Islamic window bank:

   "The sukuk market is considered in its early stages".

   Therefore, market liquidity is often regarded as the primary obstacle to the creation of an integrated Islamic financial system.

4.2.1.3 Market Risk

The nature of market risk in Islamic banks

Generally, market risk is arguably more pronounced in Islamic banking than in conventional banking, as one of Islamic banking's distinguishing features is its asset-based nature, with more evident links to the economy than conventional banking. As a result, Islamic banks must engage in economic activities to make a profit, whether through sales or leasing agreements; all of which raise their exposure to market risk. As a result, market risk exists naturally in Islamic financial markets throughout the life of Islamic contracts (Eid and Asutay, 2019).

According to the Head of Risk Management in a full-fledge Islamic bank:

"With respect to the market risk in Islamic banking, when a bank gives a loan, it will follow up on the economy, news, interest rate, systematic and unsystematic risk".

However, when discussing market risks in Saudi Arabia, most of the participants attempted to gloss over them or simply state that they are not one of the most significant risks confronting Islamic banks in this country. According to a VP-risk manager at an Islamic window bank:

"In general market risk it is not significant in Islamic bank comparing to other risks. However, we cannot say it is free of market risk".

With that considered, the researcher's analysis of the interviews indicates that this is due to the following:

- First, and for most, Islamic banks in Saudi (full or windows) limit themselves to dealing with specific Islamic products such as Murabaha, Ijarah and Tawarq. Market risk is quite significant in most financial instruments. However, it is represented at its lowest levels in Murabaha, which is regarded as having the lowest market risk, followed by Ijrah (Ahmed and Khan, 2007).
- therefore, the lack of conversation among participants stems from a lack of specialised understanding in this kind of risk in this type of industry. According to a Senior Advisory Consultant at a full-fledged Islamic bank:

"Most of the focus in risk departments in banks is now that most of them are non-Muslims and many of them are not Sharia specialists, thus, they measure products on a debt basis, they are sometimes unable to understand the nature of Islamic banking financing through equity-based products such as Mudarabah or Musharakah. I hope that through your research you will call for Sharia specialists in risk management or cooperate with them".

- Eventually, there are no Sharia-compliant market risk management products. According to the Chief Risk Officer in a full-fledge Islamic bank:

"In terms of market risk, Islamic principles prohibit hedging, which is why Islamic banks lack a sizable market and portfolio, as well as a lack of derivatives exposure, which breaches Shariah. So, the market risk portfolios are not significant in Islamic banks".

However, the research participants unanimously agreed that Islamic banks in Saudi Arabia face the following categories of market risks: benchmark risk, rate of return risk (i.e., profit rate risk), commodities price risk and currency risk. These factors are discussed in the following.

1. Benchmark risk/ mark-up rate risk

It may appear that Islamic banks do not face market risks from interest rate movements, since they do not deal with interest rates whatsoever. In the absence of an Islamic benchmark rate, in practice, Islamic banks use the interest-based benchmark to price their financial instruments. Thus, Islamic banks mark up their financial instruments using the conventional benchmark rate. For instance, in the Murabaha contract, the mark-up rate is set by adding the risk premium to the benchmark market rate, such as the London Interbank Offered Rate (LIBOR) and remains constant during the contract's life (Zainol and Kassim, 2012). In the context of Saudi Arabia, the SAIBOR (Saudi Arabian Interbank Offered Rate) is the benchmark that is chosen by most of the Islamic banks in Saudi Arabia.

According to a VP-risk manager in an Islamic window bank:

"The fluctuation rate considers to be a market risk in Islamic bank since it is related to the changes in product prices and the benchmark rate (SAIBOR rate)".

The change in the benchmark rate is expected to influence the rate of return that Islamic banks anticipate earning on their borrowings and on the interest, they pay to depositors (Ariss and Sarieddine, 2007). In other words, Murabaha is a form of fixed-return finance. It is exposed to interest rate risks by nature. Due to this, the majority of Murabaha contracts offered by Islamic banks are short-term. Thus, fixed-income agreements cannot be changed if the benchmark interest rate changes. Therefore, the influence on the profit rate is the implication of Islamic banks adopting the LIBOR/SAIBOR as a benchmark rate to mark up their Murabaha products. Ultimately, Benchmarking risk exposes Islamic banks to the problems of conventional banks, namely the risk of interest rate fluctuations (Archer and Karim, 2019).

Rate of return risk (profit rate risk)

Eid and Asutay (2019) argued that Islamic banks do not face "interest-rate risks" since interest is not permitted by Shariah. They are, however, subject to possibly much more complex rate of return and benchmark risks. In this matter, an Assistant Professor in Islamic banking clarify that:

“Market risk in Islamic banking is about the profit rate, the Islamic bank benchmark against conventional interest rate or in Saudi Arabia they call it SAIBOR”.

Islamic Banks are subject to a rate of return risk as a result of utilising market interest as a benchmark for determining the rate of return on deposits and also the financing rate. Rate of return risk, as defined by the IFSB, is the uncertainty surrounding the returns received by Islamic banks on their assets. For example, if the financial instrument is flexible, such as ijarah, and the contract is renewed annually (rent plus SAIBOR), this will have an influence on the rent collected by the bank.

According to Lee (2008), Islamic banks do not function in a closed economy; if interest rates rise significantly in comparison to mark-up rates, deposits will flow from Islamic banks to conventional banks and vice-versa. As a result, Islamic banks will face the issue of asset-liability mismatch (Bacha, 2004). This has raised an interesting point by the Head of Risk Management at a full-fledged Islamic bank:

“In the banking industry, liquidity risk is always viewed as a market risk since there is a correlation between market and liquidity risk, which indicates that market risk is the source of liquidity risk or the primary risk indicator for liquidity risk. If today's market risk situation occurs, banks usually face liquidity, credit risks”.

Likewise, according to a VP-risk manager in an Islamic window bank:

“There is a link between credit, market and liquidity risk, once risk arises in any of them, risk will arise in another. Let’s take COVID as an example, due to COVID, to manage liquidity, credit and market risk, banks start to give a short-term borrowing and waive a lot of fees”.

This is supported by Boukhatem and Djelassi (2020), who stated that liquidity risk can occur directly from the Islamic financing and investment contract's nature or indirectly as a result of the realisation of other risks, such as default risk and market risk. For instance, the volatility of the modaraba profit rates paid to savings account holders may encourage customers to switch from Islamic to conventional banks. Moreover, Khadijah (2014) stated that liquidity risk is frequently referred to as a sub-category of market risk, since it is connected to a bank's capacity to service depositors' demands for withdrawal of their deposits.

2. Commodity and price risk

Ariss and Sarieddine (2007) stated that commodity price risk exposure incurred by Islamic banks, as a consequence of the acquisition of various physical assets, is recorded in the Islamic bank's banking book. Therefore, Islamic banks are directly exposed to commodity price risk. This is because Islamic banks carry inventory items, for instance, for mark-up or leasing transactions (Makiyan, 2008). Commodity price risk is a risk that a bank bears by owning physical assets (commodities) before trading or selling them (Akkizidis and Khandelwal, 2008).

Murabaha, Salam, Istisna and ijarah contracts all carry a risk of commodity price fluctuation. Fluctuation in commodity prices exposes Islamic banks to market risks when prices negotiated with customers diverge from the prevailing price with suppliers, as a result of the timing differential between the customer and supplier transactions. For example, Murabaha contracts are financed by the bank based on a profit margin applied to the initial commodity price. The difference between the agreed and the future market prices of the commodity represents the real exposure of banks to the relevant risk, at least theoretically (Eid and Asutay, 2019). In practice, the bank bears commodity risk for a few seconds as it buys and sells commodities to commodity brokers (Eid and Asutay, 2019). This is consistent with the following clarification from a Senior Advisory Consultant of a full-fledged Islamic bank:

"When commodity brokers such as the London Metal Exchange (LME), DDCAP and FALCON entered the market, banks began to sell and purchase commodity, and when the commodity was in place, the risks became much lower".

Role of commodity brokers in reducing the commodity risks

Islamic banks' use of commodities brokers in the managing and mitigating commodity risks was often addressed during the interviews. It should be emphasized that an important Islamic financial principle is the connection between financial transactions and the actual economy. There must be an asset to enable justification for the generation of profits under Shariah. To avoid any kind of ambiguity (gharar) throughout the sale, the asset must be clearly recognised. Since there is a Shariah regulation that states **no reward without risk**, which means that no-one can expect to make a profit without linking it with risk in his undertakings. Why are loans forbidden in Islam? This is because it is a monetary deal with no risks, which means that the bank provided money for the borrower and almost certainly gained a profit.

As a result, the use of commodities to ease Islamic financial transactions was a novel idea. Islamic banks, on the other hand, are subject to commodity risks, such as changes in agricultural yield or production, as well as climate change, which can also influence the supply of commodities. Operational risk, which is linked to the trading system, must also consider crucial Shariah criteria, in particular the sequencing of operations such as offer and acceptance.

According to a Senior Advisory Consultant of a full-fledged Islamic bank:

"This risk could last for a limited period, meaning it is for one or two days, meaning that the bank, for example, has now bought the commodity and before selling it to the customer, the commodity perished, or any problem occurred".

This situation was always faced by Islamic banks in letters of credit. For example, Islamic banks bought goods from Britain by sea, and the ship sank. In this case, the bill is in the name of the bank. If the ship sank before selling the commodity to the customer, the bank bears the risks. A real example is provided by a Senior Advisory Consultant of a full-fledged Islamic bank:

"I personally faced this case when I was working in Dubai Islamic Bank, which is a bank based on trade. When the commodity is damaged before selling it to the customer, the bank is the one who bears the risks. Of course, there is an insurance company, but the bank who requires and pursues the insurance, not the customer".

As a result, commodity brokers emerged, making it easier to acquire and sell commodities while also lowering the related risks. The English were the first to enter this business in 1980, they have now worked in this area for forty years and have earned large commissions, thus, they told Islamic banks: "We will take you out of the commodities risks".

Previously, buying and selling was completed via fax and e-mail. It has now evolved into an online platform, such as DDCAP. In Saudi Arabia, window banks utilise this product primarily because it is very convenient for them; with the click of a mouse, they can buy and gain.

According to a Senior Advisory Consultant of a full-fledged Islamic bank:

"Beginning in 2017, one of the Kingdom's largest Islamic banks began dealing with commodity brokers. Previously, the bank worked in automobile and shares Murabaha, but when an American took over as CEO, the bank moved to using commodity brokers due to the bank's massive volume of activities".

The palm oil exchange in Malaysia is now a competitor in the market for this product. Of course, it is well-known that Malaysia has a large supply of palm oil. Since this stock exchange contains approximately $5 billion worth of palm oil per day, they have built an online platform to sell this oil. The palm farmers come to this platform and sell the oil to the traders in this stock exchange, and the traders sell the oil to various companies that utilise this oil in the production of many commodities such as soap, candies, shampoo, and others. Therefore, before selling oil to companies and industries on the stock exchange, they have positioned Islamic banks as the middleman. The commodity is sold to Islamic banks, who then sell it on credit to their customers, who then sell it to factories and companies; this means that Islamic banks act as intermediaries between clients, companies, and factories.

According to a Senior Advisory Consultant of a full-fledged Islamic bank:

"For example, in the treasury department in which I work, when a client comes and wants, for example, a million riyals of financing, the bank goes to the platform and buys with one million riyals palm oil, and the platform issues us a certificate of possession. In fact, their system is amazingly easy to use. This is considered a constructive possession".

Based on Shariah guidelines, there are two types of possession: physical possession and constructive possession. Constructive possession is the process of holding legal rights to an asset without actually possessing it. Physical possession, on the other hand, is the physical possession of an asset and the legal rights to control it. For a Murabaha contract to be valid and permissible from a shariah perspective, for instance, the seller must have physical or constructive possession of the object of Murabaha. Material proof of an effective transfer of ownership or receipts such as warehouse receipts are required to establish constructive possession.

These palm oils are within tanks and, when bought, they write the number of the purchased tank and provide an ownership certificate with the tank number and a truck can be used to take delivery of the purchased oil. Afterwards there are two choices: either the customer enters the platform and sell it by himself, or he assigns the bank to complete the selling transactions; this is the general process.

In Saudi Arabia, there is an online platform for selling Indian rice, which uses the same idea. The bank entered this platform before it sells Indian rice to factories. The bank buys rice and then sells it to its customers on credit, and then the customer assigns the bank to sell rice on the platform to factories, which are individual businesses.

According to a Senior Advisory Consultant of a full-fledged Islamic bank:

"With the development taking place in the Kingdom in terms of Islamic banking, I expect the occurrence of a market or commodity exchange that will be in the form of an online platform. The same market in Dubai, and I personally was part of the team that established this exchange in 2012, the Dubai metal and Commodities Centre (DMCC), the same idea of Malaysians, these are all called Tawarq products".

Most Sharia scholars have stated that Tawarruq, also known as the commodity Murabaha, is a fictitious commodity. In numerous conferences, they have urged Islamic banks to avoid these products and instead concentrate on actual commodity financing. This is because tawarruq is designed to mimic the characteristics of conventional products, which contradicts the notion that IFIs provide an authentic alternative to traditional finance. Thus, IFIs' chances of solving conventional finance's economic issues are fading. Ali and Hassan (2020) argue that tawarruq is prone to Shariah non-compliance risk events on the operational side, since it entails a series of sale transactions completed in succession. Consequently, there is an essential demand for Islamic Banks to establish more cautious and transparent operational procedures for Tawarruq-based financial instruments.

3. Foreign exchange rate risk

The foreign exchange rate may be defined as the quantity of domestic currency exchanged for one foreign currency unit (Al-Hamzawi, 2004). When the foreign currency rate fluctuates unexpectedly, these risks arise. Technically speaking, foreign exchange risk is a financial risk that arises because a financial transaction is valued in a currency different from the main currency. By using Murabaha, ijarah, Salam or Istisna contracts denominated in a foreign currency, the bank will suffer exchange rate risk. When the bank's main company invests or is owed in a foreign currency via Mudarabah and Musharakah contracts, the bank is also exposed to exchange rate risk (Akkizidis and Khandelwal, 2008). Exposure of Islamic banks to foreign exchange risk can be harmful (Eid and Asutay, 2019). According to an Islamic Finance Advisor:

"Currency risk is considered as challenge to Islamic banks".

Since Islamic banks are prohibited from using products like swaps and other forms of hedging, the position for Islamic banks is more difficult. In Shariah, the exchange rate used is the spot rate (Akkizidis and Khandelwal, 2008). In this regard, a Risk Management Specialist in Islamic finance stated:

“Islamic banks have a limited product offering; they do not provide swaps or hedging; instead, they use the spot exchange rate there is no speculations”.

Market risk management

Islamic banks must first be able to precisely measure the market risk to enable effective management of it. One of the challenges that Islamic banks confront in measuring risk is a shortage of data to serve as a measurement foundation; market risk requires a large quantity of historical data (Akkizidis and Khandelwal, 2008). Indeed, this is what the market risk manager, who has expertise with both full-fledged and window Islamic banks, stated:

“The most critical approach for measuring market risk is the value at risk (Var). All banks in Saudi Arabia, without exception, use historical data in this way”.

The procedure under Var involves taking one year's worth of historical data (250 days), identifying the five worst-case scenarios that occurred over the year and then averaging scenarios 2 and 3. Clarify this point, a market risk manager provided an example:

“Let's say an Islamic bank has a 100-million-riyal investment portfolio; to calculate the Var, I will take the previous year's historical data and take the 5 worst case scenarios and average the case 2 and 3, and then I will state that 99 percent, the loss will not exceed one million riyals; the remaining 1% is what we call market risk”.

Some Islamic banks employ Var by using Excel spreadsheets via a visual basic application, but others use more sophisticated IT systems.

Market risk mitigation methods

The discussion of market risk management during interviews was both restricted and challenging. As noted earlier, market risk is not one of the primary concerns of Islamic banks in Saudi Arabia. Most of the participants agreed that, in terms of market risk, Islamic products typically have less exposure than conventional products because, when entering into an Islamic product, an individual must agree on the profit because it does not consider the floating market or speculations; this is considered mitigation. Another form of mitigation, according to the Head of Risk Management at a full-fledged Islamic bank, is:

“Keep up with what's happening in the market such as change in the interest rate. For example, during the pandemic, Islamic banks in Saudi Arabia had to reschedule payments at the same profit rate (extend the period with a new contract)”.

Another criticism addressed by the participants is that, in terms of market risk, Islamic banks in Saudi Arabia have limited offerings in terms of using Islamic derivatives, such as swaps.

According to a Risk Management Specialist in Islamic finance:

"The scope of market risk management is quite limited. However, if we consider Malaysia, which is advanced in terms of product variety, the market risk is quite significant".

In this regard, Alshamrani (2014) argued that while many countries, such as Malaysia and Singapore, strive to be the greatest example of Islamic financial derivatives. Saudi Arabia is still not participating despite the growing desire, even though it has the ability, expertise, Islamic scholars, financiers, and Islamic standing in the hearts of Muslims to be in this position. Therefore, this absence is due to the lack of regulation for the conventional and Islamic derivatives markets.

However, this does not imply that Islamic banks in Saudi Arabia do not utilise hedging to mitigate market risk. Sharia-compliant risk mitigation is required for market risks, such as fluctuating prices and currencies. To mitigate currency risks, for example, Islamic banks need Shariah-compliant hedging contracts or derivatives with particular conditions. According to a VP-operational risk manager:

"Islamic Banks can do hedging by using Salam contract while in conventional bank they are using forward contract".

Salam is a contractual agreement between two parties to carry out a transaction at a later (maturity) date, but at a price specified and paid in full today. As a result, the Salam can be considered similar to conventional forward contracts (Alshamrani, 2014).

4.2.1.4 Operational Risk

Scope of operational risk in the Islamic banks

The last category of risk that Islamic and conventional banks share is operational risk. The Islamic Financial Services Board (IFSB) has included operational risk issues in its corporate governance guidelines, since its formation in 2002, after Basel II and the growing awareness of Basel III. In terms of operational risk, the study found that Islamic banks in Saudi Arabia adhere to the Basel operational risk framework, which requires them to examine the entire banking industry's operating platform. Specifically, they focus on four risk drivers: people, process, system, and externals. Whatever risks may arise from these drivers, they focus on, assess, and implement the appropriate controls.

The participants agreed when describing the four drivers of operational risk in Islamic banks as follows:

Process risk (the structure) occurs if the bank's processes have a problem, such as it not being automated or does not include segregation of duties (no Maker or Checker) or a validation process. According to an Operational Risk Manager at a window Islamic bank:

"As we know banks issues loans, does the executions of loans performed in a satisfactory manner. These examples know as inadequacy of process".

Since Islamic banks have different policies and procedures, in this regard, the rulings of the Shariah committees are an extra necessity. These decisions must be reflected in the processes and the rules that regulate the services and products of Islamic banks.

System risk is a well-designed system to detect or prevent any control failure. The processes are completed manually since human intervention is considered an operational risk. For example, while deducting bank commissions, an employee deducts 10,000 from a customer's account instead of 100,000. However, the auto-detect system is set-up in such a way that when a bank issues a loan to a client, say, for $10 million, the system deducts the bank's fee. As a result, designing an automated platform that handles and manages the end-to-end process is one method by which operational risk is reduced. This factor refers to operational losses linked with information technology, which are the result of or are related to software or hardware malfunctions (Soprano et al., 2010).

There are 4 main risk strategies: 1 - *Mitigation* (when the bank's system prevents the risk) by setting a set of controls that prevent risk. Ex if unqualified customer applies for a loan, based on the set of controls, the system prevents this loan application. Or if the bank's employee tries to approve loan application without receiving approval from the system, it will prevent this step until the correct form of approval is used. 2 - *Avoid* (avoiding the risk by refusing to introduce products in the market). 3 - *Accept* (representing Appetite) ex banks accept this risk to attain a profit. 4 - *Transfer* (transfer the liability to another parties).

According to an expert in Islamic Economy & Finance and a board member:

"Banks must take operational risks seriously in the sense that they reflect the basics of the contract for the Islamic product in the bank system, for example, the bank employee cannot provide the Murabaha product to the customer and make him sign the contract before the bank buys the house first. This is a violation of a basic condition of Murabaha".

People risk has two types: intentional or lack of knowledge. Rhanoui and Belkhoutout (2018) argued that people risk is substantially higher in Islamic banks than in conventional banks because employees must be knowledgeable about both Islamic and conventional banking.

Externals is the risk posed by external occurrences such as external fraud, regulatory regime change, computer hacking and other reasons outside the Islamic bank's control (Dar et al., 2013). Therefore, the operational risk confronting Islamic banks is unsurprising, given that Islamic banks operate in a comparable structure and environment to conventional banks (Arif et al., 2016). Khan & Ahmed (2001) argued that, since the contracts of Islamic banks are unique in that they require more precise stages and qualified personnel with Shariah expertise to include Shariah at every step, Islamic banks are subject to extra operational risk compared to conventional banking unlike market or credit risk. In line with this view, a Head of Operational Risk Governance discussed the following:

"As I view it, it forms the foundation for the occurrence of the majority of other risks, implying that operational risks are dependent on performance. If we have a credit risk issue, for example, we look at the root cause; was it a process failure or a design failure?".

In other words, credit risk, for example, is about authorities designing systems for approvals, setting the limit, granting loans and developing criteria for admitting customers, all of which occur during the design phase. Next comes performance, it is here where operational risk enters the picture; no matter how well designed the product, it is meaningless if it does not have the right control environment in place to execute it in an effective regulated way.

A similar perspective is provided by the Head of the Shariah Department at an Islamic window bank:

"According to my experience, operational risk is regarded the riskiest in Islamic banks when compared to credit risk and market risk since they are risks related with people. They will certainly make errors if you do not provide them with solid governance and effective control".

Contrary to the previous discussions, an Assistant Professor of Islamic banking and the author of Islamic Finance for Dummies stated that:

"Its low compared to credit risk because operational risk deals with the bank not with outsiders".

The author believes that each type of risk has its own influence on Islamic banks. However, operational risk is crucial and has a key relationship with Shariah risk (which will be explored in the next Sections). This is because the operational risk is dependent on the process, and such a process should include measures to comply with Shariah guidelines. For example, the authentication and validation of the third party in the case of Murabaha, meaning that when the bank chooses a third party it should make sure that the third party exists and should verify this task by visiting the warehouse of the third party. The processes and procedures should cover all the steps that make sure that operations are conducted in the correct manner (a proactive approach), which leads to the preparation of a risk assessment for every product and process, and how it is implemented and how it deals with any potential issues.

Failure to follow such a guideline result in the transaction being cancelled, meaning that the income or loss will not be recognised. Therefore, the emergence of this type of risk allows for other risks to arise, such as fiduciary risk and reputational risk. Fiduciary risk is the risk that develops because of Islamic banks failure to execute operations in line with explicit and implicit requirements related to their fiduciary duties IFSB (2005). Consequently, failing to maintain fiduciary responsibilities affects the reputation of the Islamic banks (Hamidi, 2006). A damage in reputation might ultimately lead to a withdrawal of money, resulting in a liquidity crisis. It may also cause clients to no longer seek funding from Islamic banks, the inevitable outcome of which is a drop in its profitability (Dar et al., 2013).

Operational risk management challenges in Islamic banks

Operational risk management relates to the maintaining of a highly efficient environment for platform operations on a day-to-day basis. According to the Head of Operational Risk Governance at an Islamic window bank:

"There are four controls in the internal control that contribute to the enhancement of processes, people, and systems, hence assisting operational risk management in complying to Shariah rules. Choosing between these controls is determined by the risk's cost-benefit analysis".

Directive control, which is simply a policy and procedure, is a written activity to instruct individuals on how to accomplish their work. Most banks employ *preventive control* to measure the effectiveness of the control framework, to see how preventive a framework is in avoiding problems from happening. The objective of a *detective control* is to detect something that has already occurred so that the possibility of errors re-occurring can be reduced. Eventually, *corrective* control means that once something has occurred, it could be corrected.

Islamic banks have many financing contracts that make operational risks appear easily. In this view, due to the unique and sophisticated contractual characteristics of Islamic banks, as well as the growing demand for different products in the Islamic banking industry, managing operational risks for Islamic banks is challenging (Rhanoui and Belkhoutout, 2018). The following present the main challenges as provided by the participants:

1. In terms of the process, Islamic banks unlike the conventional banks have to provide multiple products for example (Musharakah, Murabaha, Tawarq, Istisna, Salam etc.) so they are required to deal with too many contracts.
2. In terms of the system, conventional banks look for the latest technologies and banking systems, such as Oracle or SAP, but if they want to implement their ERP into Islamic banks, they must customise it to fit the structure of contracts, which is one of the difficulties; so those people should be familiar with Islamic banks.

According to Assistant Professor Islamic banking:

"Personally, sometimes I give a consultant service to IBs when they design IT systems for a new product or service. Ex if there is a profit and this profit should be distributed with investors so there is a pool then how they are taking the money from the pool and how they distributed with the stakeholder and the depositors which is a complicated task, these companies (ORACLE and SAP) have this operational problem of technology that support IBs structure".

Therefore, Islamic banks need to start paying attention to the infrastructure of the bank's system, a Shariah product is sophisticated and depends on a third party. So Islamic banks need to structure a specific system to adopt the Shariah product feature. According to an Operational Risk Manager at a window Islamic bank:

"According to Shariah governance formwork by the central bank, all banks should have a system that manage all bank's activities plus monitoring that activities".

This entails a fully automated framework. There are also discussions on real-time monitoring (through system employees can check if this product is Shariah compliant or not).

3. In terms of people, in Islamic banks, a shortage of qualified personnel will eventually result in increased people risk (Karim and Archer, 2013).

According to an Operational Risk Manager at a window Islamic bank:

"Window banks need more specialised people in Shariah (Shariah is not easy, not any person has the capability to understand it fully and link it to banking activities)".

4.2.2 Shariah risks

Sharia risk differentiates Islamic banks from conventional banks. Most of the literature equates Shariah risk with Shariah non-compliance risk. Both phrases refer to the same meaning: the risk arises because of a violation of Shariah rules or decisions by the regulator (Hassan et al., 2017). However, the study found that Shariah risk stems from two causes: compliance with Shariah and non-compliance with Shariah. A member of the internal Shariah committee stated:

"Shariah risks are classified into two types: risks associated with Shariah compliance and risks associated with non-compliance with Shariah requirements".

4.2.2.1 Shariah compliance risk

Shariah compliance risk is related with the distinctive structure of Islamic products, but has no influence on Sharia compliance; hence, this risk develops because of an adherence to Shariah principles and guidelines. However, this is not in line with the definition of Sharia compliance risk provided by Abdullah et al. (2011): "Shariah compliance risk – that is: risk relating to potential non-compliance with Shariah rules and principles in the bank's operations".

According to a co-founder of an Islamic finance firm:

"Islamic banks face risks that are distinct from those faced by traditional banks in that they are associated with the formulas of Islamic products, such as Murabaha and the degree to which they are market- and reality-sensitive".

For example, while financing a client using a Murabaha contract, there are conditions that must be followed, such as purchasing the commodity before selling it to the client on credit. In other words, to enable compliance with this requirement, the items must be acquired before being sold to the customer. There are risks associated with meeting this requirement, such as damage to the items upon delivery to the client or the consumer change his mind, exposing the bank to market risks. These are the risks that the bank faced because of its adherence to Shariah standards. Therefore, these risks occur due to the nature of Islamic products, and they have no effect on Sharia compliance.

4.4.2.2 Shariah non-compliance risk

The definition (its more than just a definition)

The Shariah non-compliance risk is defined in a significant amount of literature. All such risk, in fact, revolves around a single, vague point: a failure to follow Shariah norms and principles. However, Lahsasna (2014) added more to the picture by stating that: "Shariah non-compliance risk is the risk that arises from Islamic bank's failure to comply with the Shariah principles determined by the Shariah board, or the failure of the Shariah board to offer a sound resolution due to the deficiency of information provided to them or due to other reasons".

Additional information on this explanation had been offered by the head of the Islamic banking department at an Islamic window Bank:

"In brief, these are risks that arise as a result of non-compliance with Shariah committee decisions and Shariah regulations".

The following is an illustration of the difference between them. The Shariah committee is given a product or a contract to examine and approve, such as an Islamic credit card. When the product was submitted for implementation, the employee added additional fees or a condition. In this case, the employee followed the Shariah Board's decision, yet he violated Shariah provisions.

According to the head of the Islamic banking department at an Islamic window bank:

"It is frequent when changes or developments occur after the product has been released. Most of them occur as a consequence of the employee's personal effort, rather than on purpose".

It is noteworthy that each bank has its own set of policies and processes. As a result, the employee not only violated the Shariah board's decisions, but also the bank's policies and procedures, which is regarded a crime at the bank level and may result in a dismissal.

In this regard, a risk MGMT Islamic banking specialist declared that:

"We have a problem in the Islamic banking sector, which is the risk of failure to comply with Shariah committee decisions".

This indicates that the Shariah committee issues a fatwa or a Shariah ruling on a certain product, but the commitment to its application is weak, affecting not just the bank, but also the members of the Shariah committee who issue the fatwa. Thus, Shariah non-compliance risk includes everything, whether operational or decision-related; it is intrinsically linked to the Islamic bank's mandates.

While according to a director of an Islamic finance advisory firm:

"Shariah non-compliance risk is the risk of a reduction, loss or decrease in earnings or value of a financial institution as a result of Shariah non-compliant products, activities or transactions".

In response to that, Shariah non-compliance risk is the risk constantly faced by Islamic banks especially when not fulfilling the requirements of Shariah principles regarding products, policies and procedures. Basically, it is the risk associated with non-adherence to Shariah mandates, and once adherence to Shariah mandates is achieved, it is a hyperlink to many issues such as the structure of Shariah products, which should be designed based on Shariah requirements. The implementation of providing this product to the public must also follow Shariah mandates.

Eventually, the author believes that Shariah non-compliance risk can be classified as regulatory risk, which is a risk that has a zero tolerance; namely, either bank adheres or not to Shariah laws, in other words it is black or white but not grey. Shariah risks are related to clear laws and regulations. Therefore, these regulations do not include the permission not to apply them, and no-one can manipulate not applying these forms of regulations. For example, a Murabaha contract cannot be complete without a third party, which is a fundamental part of the Murabaha contract. This is a critical point related to Shariah non-compliance risk, which is neither grey nor has any sort of grey zone. Either bank complies with Shariah, and it is made sure that all regulations are applied, or they do not comply with it. Consequently, a violation of Shariah principles would result in a loss because of the potential of financial loss, reputational damage, or even regulatory penalties due to failing to respect Shariah principles.

Ramifications of the emergence of Shariah non-compliance risk

Reputational and legal risk

The Shariah non-compliance risk is directly reflected in the reputational and legal risk. Thus , when answering the question: Why are we afraid of the Shariah non-compliance risk? It is because there is a legal and moral obligation that affects three parties.

The first party, the customer, have chosen this bank because the bank has the slogan of compliance with Islamic law in all its operations. This is considered a legal and moral obligation on the part of the bank towards the customer to provide products and services that comply with Islamic law. It is possible that the customer left another bank who were providing services at a lower cost because this bank claims to be committed to Islamic law.

The second party affected is an employee of an Islamic bank who refused to work for a conventional bank because it does not adhere to Islamic laws. Because the bank claimed to be an Islamic bank, the employee has formed a contractual relationship with it. In short, it could have a significant impact on the contractual relationship between employer and employee.

The investor is the third party. The investor made an investment with the Islamic bank because the bank claimed that it implemented Islamic law. Therefore, the Shariah non-compliance risk converts into reputational and legal risks, which affects the company's profitability, the profitability of the Islamic banking industry as a whole, the level of financial stability and financial inclusion. Commenting on this, a board member stated that:

"We know that one of the reasons for the development of Islamic banking and allowing regulators to build Islamic institutions, even in non-Islamic nations, is to increase financial inclusion. For example, some communities are opposed to the banking system because it is perceived as conflicting with religious beliefs; as a result, countries have provided financial tools that are consistent with their religious beliefs. As a result, Islamic financing was introduced in order to improve financial inclusion".

Thus, the appearance of Shariah non-compliance risks reflects in a variety of ways: reputation, financial inclusion, and financial stability – i.e., a domino effect arises. As explained by a board member:

"The first risks affected are reputation and legal risks, and then other risks, respectively".

The Shariah non-compliance risk has a significant impact on the Islamic bank's credibility and reputation. If it is discovered that an Islamic bank offers products that are claimed to be Shariah-compliant but are not, this would considerably damage the bank's reputation.

With regards to legal risk, a board member asserted that:

"There is a strong correlation, which is not widely discussed, between Shariah requirements and legal risks, because the courts in the Kingdom apply Islamic law".

For instance, if the employee and the bank violate the terms of the contract or a Shariah board-approved formula, this is therefore an operational risk. This may lead to a dispute between the customer and the bank, and the matter may proceed to the courts and the bank may lose. As a result, these are deemed to be significant legal risks associated with non-compliance with Sharia.

Purification

According to the head of the Shariah department at an Islamic window bank:

“Shariah non-compliance risks associated with non-compliance with the Shariah board's decisions, which may result in financial losses, damage to the bank's reputation or invalidation of the bank's operations”.

In terms of the bank's operations being invalidated, when there is a case of non-compliance with Shariah, a note is created and then forwarded to the Shariah Committee to be resolved. This remark contains profits that stem from the Shariah violation. Accordingly, purifications are profits that are created by a bank's Shariah non-compliant operations, which are impure and must be purified.

According to a Senior Advisory Consultant at a full-fledge Islamic bank:

“All operations that were carried out incorrectly and in violation of Sharia law are purified, and their profits are kept aside in a separate account known as the purification account. Some banks deduct millions from their profits”.

In fact, this aspect is in the best interests of society, because Islamic banks distribute their purified profits among the community, which is considered part of corporate social responsibility. They are spent on charitable causes, such as donations, education, and prisons. The Shariah Board's require that these activities not be advertised, which means that the bank does not announce where they have made donations.

According to a member of the internal Shariah committee, an emphasis has been placed on the fact that:

“One *of the Shariah criteria for the purifying funds is that they are not used in a manner that favours the bank”.*

Shariah non-compliance risk management

Who would be responsible for managing Shariah non-compliance risk?

Risk management deals with credit, liquidity, market, and operational risk. In addition, when examining Islamic banks, there is Shariah non-compliance risk, which is primarily the core factor, and it covers the product and the overall function of the bank. Furthermore, the risk management and Shariah should work hand-in-hand to guarantee that the risk of Shariah non-compliance is properly mitigated and controlled. Hence, the risk management should operate parallel with the Shariah governance framework. Indeed, during discussions with either Shariah or risk management professionals, a significant debate has arisen about the management of Shariah non-compliance risk.

As discussed in previous chapters, the Saudi central bank recently issued, for the first time in 2020, the Shariah governance framework. According to this framework, the Shariah non-compliance risk must be managed as part of the bank's overall risk management strategy. Because of the technical nature and complexity of the process of managing the Shariah non-compliance risk, this duty should be performed by a risk officer with adequate and sufficient expertise in this area. This indicates that Islamic banks must have a specialist division under the risk management to enable the construction of a complete framework for managing Shariah non-compliance risks.

According to a Shariah compliance manager at an Islamic window:

"From my experience, the risk management is unaware of the definition of Shariah non-compliance risk, and when the Risk Management Department was requested to manage this risk, the response was that this type of risk falls under the purview of the Sharia Department".

In response to this claim, the head of the Shariah department at an Islamic window stated that:

"The central bank, when issuing that Shariah non-compliance risks managed by the risk management, the framework is considered very good; however, if all those present in it are only Shariah or Shariah management, they do not know what the risks are, nor do they know what risk management is, nor do they understand the difference between the risk and the cause of the risk".

Indeed, risk management is a science with its own set of fundamentals and terminology. Without a doubt, those with a pure Shariah background will struggle to integrate into it. Similarly, managing such a considerable risk is also a difficulty for risk management. Without prior exposure to the nature of Islamic banks, a person with specialised skills in pure conventional banks will be unable to quantify the risks and dimensions associated with them. For example, since he does not distinguish between loan, lease and Murabaha, he will be unable to build mechanisms to measure the risks associated with these products.

Commenting on this argument, a board member stated that:

"The solution, in short, is either to train and qualify people from a Shariah background in governance, compliance and risk, or either train or qualify people who have a background in the governance, compliance and risk in Shariah product and structure. As simple as that, where is lost point and enhance it".

To this effect, many bankers who lack Shariah knowledge are presently pursuing the CSAA (certified shariah advisers and auditors) designation from AAIOFI. Thus, they may possess both knowledge and completeness as individuals and as a department.

In fact, we must differentiate between two concepts: risk management processes in general and risk management processes for Shariah non-compliance risk. The risk management process in itself has nothing to do with Shariah, which refers to the technical methodologies for risk measurement; thus, this is not a Shariah-related activity. But the method in which the risk management applies, measures, and controls the mitigation to these risks must be Shariah compliant.

Supporting this statement, a risk manager at an Islamic window bank claimed that:

"We, as risk management, have a KRI and a risk control and self-assessment (RCSA) framework that is applicable to all banks, conventional or non- conventional. This risk control and self-assessment framework considers the proper implementation of Shariah principles in the bank without allowing for any potential violation of Shariah principles. While in the KRI, one of the high importance and top KRI is Shariah non-compliance risk".

Additionally, according to a director of an Islamic finance advisory firm:

"In practice, the Shariah compliance team will not come and question risk management why you placed the risk at 10% rather than 20%, or whether the chance is high or low. In fact, this takes into consideration the expertise of the subject matter expert".

However, a Shariah department can say: "Okay, you categorised it however you want, but the controls you are proposing, such as requiring the client to sign this agreement or adding this charge, are where the Shariah compliance input is located.". Hence, it would be ideal if someone on the risk management team was specially trained in Shariah compliance and risk management.

According to the Shariah Compliance Manager at a full-fledge Islamic bank:

"Prior to the framework's issuance, the bank had a risk profile that included Sharia-related and other risks, and the department responsible for this profile is operational risks. However, after the issuance, our bank created a new position under the operational risk and added new responsibilities to manage the Shariah non-compliance risk, specifically named, managing the risks associated with not complying to the Shariah Committee's rulings, because they are binding according to the framework".

In fact, one of the pillars of the Sharia governance framework's development is managing Shariah non-compliance risk. However, the framework only says that this risk must be managed as part of the bank's overall risk management. This statement is too vague; it should be made clearer to banks if it expressly stated that it is managed by operational risk, which allows them to begin implementing this request without hesitation.

According to a Shariah Advisory & Governance at a full-fledge Islamic bank in Malaysia:

"In Malaysia, Shariah risk management is primarily set on operational risk, as there are several processes involved in Islamic banking. For example, we must ensure that there is an inventory if we are doing Tawarq. As a result, Islamic banking includes a number of operational risks that are not present in conventional banking".

The Shariah non-compliance risks are related to the bank's operations, as each product has two divisions: sales and operations. Under the operational risk it is handled by establishing controls, such as automating procedures and connecting bank systems between commodities suppliers and purchasers, which makes the process of tracking and controlling activities easier.

According to the head of the Shariah department at an Islamic window:

"Currently, the Shariah department manages Shariah non-compliance risk in collaboration with the bank's Operational Risks Department, ensuring that this type of risk is mitigated. Perhaps in the future it will have its own department".

A Shariah review and control manager at an Islamic window also stated that:

"There is a Department of Islamic Financial Services. It is included under risk management. Among the department's responsibilities is the management of Shariah non-compliance risks. It consists of ten individuals that are qualified to perform this function".

This form of risk was not included in the ABCs of Islamic banking. Consequently, when organising and managing this sort of risk, the central bank produced a draft on the Sharia non-compliance risk framework, which has not yet been approved but has been circulated to banks for feedback. This is where risk management comes into play in terms of implementing and overseeing this framework, which is feasible via collaboration with the bank's Sharia department.

To summarise, the risk of Shariah non-compliance could be managed by the risk management team in liaison with the Shariah department, or vice-versa. Alternatively, as mentioned in the Shariah governance framework, a specific division focusing on risk management could be formed containing a Shariah trained risk officer. The risk management officer must be aware of both internal and external factors that might result in Shariah non-compliance (Hassan, 2015).

Shariah non-compliance risk mitigation protocol

Shariah compliance should be a shared obligation for all stakeholders in an Islamic bank. Sharia non-compliance risks may be mitigated first and foremost to please God. Individuals who violate Sharia rules will be held accountable by Allah. This is a risk that may not be researched scientifically, but it is one that must always be considered.

Indeed, minimising Shariah non-compliance risk may take the three following forms.

1. Meeting the minimal criteria of an Islamic bank, such as not funding forbidden activities under Shariah. To this aim, most activities have been automated to minimise the Shariah non-compliance risk, and the system must be approved by the Shariah committee to verify that the measure is Shariah compatible. According to the head of the Shariah department at an Islamic window bank:

   "If there is a problem with the system, the system must be developed, and we are now in the digitalisation era. The steps must be automated in accordance with the Shariah board's decisions and controls".

As an example, the sale does not occur prior to the transfer of ownership. This is considered a risk-reduction measure. Since for a Murabaha contract, the staff may require that the customer sign the papers prior to the bank acquiring the commodity. According to a Senior Advisory Consultant at a full-fledge Islamic bank:

"Before, the Shariah risk were more than now, but now with the presence of the online platform, the bank buys the commodity and owns it, and then it is sold to the customer, so all transactions are online, this reduced the presence of a Shariah risk".

2. Operational compliance, which involves internal control. According to the head of the Shariah department at an Islamic window bank:

"This is the responsibility of Shariah control, which, of course, works to reduce operational risks".

It should be emphasised here that Shariah supervision is both fundamental and important. Shariah non-compliance risk is the most significant element for the Shariah function, because it is the focus. The Shariah auditor is concerned with these risks, which means that the Shariah auditor is looking for this type of risk when auditing. The operational risk focuses on loss, namely financial loss, and any failure that results in a financial loss to the bank. However, the Shariah audit may not result in a financial loss to the bank but can result in noncompliance with Shariah standards; therefore, they are two distinct scopes. According to a Shariah compliance manager at an Islamic window bank:

"As with the financial auditor, the Sharia auditor has the right to see all papers that are relevant to the control process".

The procedure of the audit is performed by obtaining a sample of the offered products. For example, if 1,000 Islamic credit cards are offered, 100 contracts are examined and audited, or 10% of each offered product is taken. According to a Shariah compliance manager at an Islamic window bank:

"If there is a lack of compliance in the credit cards, in the following audit process, the percentage of the sample is increased to determine the extent of the compliance".

According to the Head of Operational Risk Governance at an Islamic window bank:

"There is a section in the bank's framework where the function of Shariah audit works with operational risk management".

When a new product is released into the market, within 6 months of its initial release, the Shariah auditor must audit and review the product by taking samples of the provided product. They then ensure that the transactions and product are provided in accordance with Shariah regulations.

3. Product risk, which includes reviewing the design of a new product. According to the Head of Operational Risk Governance at an Islamic window bank:

   "It is all about designing the product, and when designing the product, we design the process associated with it".

   The role of an internal control is to investigate how the operational risk management department maintains the performance of this process in a very controlled manner. With no differences in practice for each process, ensuring that there are controls, when finalising with the customer all the signatures before closing the deal, guarantees that these controls are in place and that they are monitored in the expected manner. Some aspects of product design are easy to automate, while others are more complicated.

   Since the employee may change and move to another place, there is a risk mitigation handbook that the employee returns to, reads and follows so that he does not make errors that lead to profit purification and increased reputation risk.

Conclusion and Summary

The findings of this chapter contribute to the current literature on the primary risks experienced by Islamic banks and the shariah-compliant risk management strategies. .In relation to the presented results, the first Section discussed the current state of Islamic banking industry in Saudi Arabia. Among the interviewees, it was generally believed that Islamic banking in Saudi Arabia is in good health, preforming rapid growth and expected to experience a bright future. Although there remain challenges that must be overcome to enable this industry to thrive and make Saudi Arabia the world's primary Centre for Islamic banking.

The findings indicated that the **credit risk** or default risk are the same for Islamic and conventional banks. However, the mitigation procedure is distinct and must adhere to Shariah laws. **Liquidity risk** is a more serious complication for Islamic banks compared to their conventional counterparts. Consequently, Islamic banks struggle to manage their short-term liquidity volatility. The findings also showed that **market risk** is arguably more pronounced in Islamic banking than in conventional banking, as one of Islamic banking's distinguishing features is its asset-based nature. Due to the widespread use of mark-up' or cost-plus-sale contracts such as Murabaha and Ijarah, Islamic banks in Saudi Arabia are exposed to benchmark risk, which contributes to the rate of return/profit risk.

The last risk category, which Islamic and conventional banks share, is **operational risk**. The findings revealed that each type of risk has its own influence on Islamic banks. However, operational risk is crucial and has a key relationship with Shariah risk. **Shariah risk**, which differentiates Islamic banks from conventional banks, the findings revealed that shariah risk stems from two causes: compliance with Shariah and non-compliance with Shariah. In summary, the findings showed that credit, liquidity, market, and operational risks could lead to shariah non-compliance risk. After discussing each type of risk in both full- fledged and Islamic window banks, the findings indicate that the exposure to risk varies between these two banks, due to the high volume of Islamic products provided by full-fledged banks compared to Islamic window banks. Ultimately, the findings show that, overall, Islamic banks are performing rather well in terms of general risk management, but they are still conservative when it comes to using sophisticated risk-management techniques.

As the findings of this chapter show, all risks faced by Islamic banks must be managed in a shariah-compliant manner to avoid shariah non-compliance risk. As a result, risk managers, internal control, the shariah committee, and the Islamic bank itself work towards this aim of shariah compliance. Thus, this chapter's findings are consistent with the stakeholder theory.

The Islamic perspective on the stakeholder theory offers a comprehensive validation of stakeholders' abilities and the responsibilities that both the firm and their numerous stakeholders must fulfil in order to achieve the appropriate guidelines (Al-Nasser and Muhammed, 2017). These guidelines are recognised in the Islamic principles of property rights and contracts stated by Iqbal and Mirakhor (2004). Moreover, according to the stakeholder theory, parties other than shareholders and managers, such as customers and suppliers, exert influence over an Islamic bank. In fact, the findings indicate that the consequence of shariah non-compliance risk may result in reputational risk—the loss of clients who engage with Islamic banks for religious motives. As a third party in an Islamic financial transaction, suppliers can also quit cooperating with Islamic banks if they violate shariah.

Chapter 5: Examining the Shariah Corporate Governance Framework in Saudi Arabia

Introduction

This chapter illustrates that Shariah governance is a fundamental need at two levels: at the level of the central bank or regulators and as an internal Shariah governance at the level of the commercial bank itself. The internal Shariah governance of the bank is of the vital significance, since it must cover components not specified in the Shariah governance at the central bank level. This type of governance as a framework is required to address a variety of issues, including the governance of Shariah committees, the governance of the bank's board of directors and senior management and the governance of the Shariah department in banks, windows, or full-fledged Islamic banks; this is a critical point. As noted in Chapter 2, all prior research on Shariah governance in Saudi Arabia has addressed the lack of a mandated Shariah governance framework from the central bank. Nonetheless, the situation has changed with the issue of a Shariah governance framework that is mandatory for all banks that offer Islamic products, including both full-fledged Islamic banks and window banks.

Considering this issue, this chapter aims to investigate the first ever Shariah governance framework in Saudi Arabia. As stated in Chapter 2, this framework was initially issued in February 2020. As a result, it is worthwhile to investigate the state of Shariah governance before and after the issuance, highlighting the strengths and weaknesses that need to be addressed and improved, as well as examine whether the degree of adherence in implementing the Shariah governance framework varies or is the same between full-fledged Islamic and window banks. This chapter focuses on the third theme, which is the Shariah governance framework. Primary data on the Shariah governance system were collected via semi-structured interviews with practitioners operating under the Shariah governance framework at fully-fledged or window Islamic banks, as well as experts from outside the Shariah governance framework. This enabled a presentation of their insights and opinions on Shariah governance framework-related issues. The following is how this chapter is to be organised. First, the author outlines the need to define the shariah governance. Following on, the author examines the period prior to the implementation of the mandatory Shariah governance framework. The author also investigates to what extent Shariah corporate governance has become a requirement for an effective Islamic banking industry in Saudi Arabia. In the conclusion, the author analyse the first – ever Shariah governance framework.

5.1: What is Shariah corporate governance?

The literature on Shariah governance is still in its infancy, as seen by the paucity of research. Chapter 2 has discussed the aforementioned. Before the release of the Guidelines on Shariah Governance framework (IFSB-10) by the Islamic Financial Services Board, there was no formal or precise definition of Shariah governance (Haqqi, 2014). The AAOIFI Governance Standard No. 1-5 lacks a definition as well. Even the current Shariah governance framework released by the Saudi Central Bank omits the definition and instead lists just the objectives.

These factors create ambiguity and confusion about what is Shariah governance. The word 'Shariah governance' needs to be fully clarified and its true meaning understood to avoid confusion (Haqqi, 2014). This implies that the first question in the interview should be on the meaning of Shariah governance, so that those engaging in the Shariah governance framework may voice their opinions on it. In fact, this question was addressed to all 35 participants, who had a diversity of perspectives on the term based on their own experiences and backgrounds.

For instance, the Shariah Control Officer at a full-fledge Islamic bank stated that:

"Shariah governance is the structure that controls the relationship between Shariah committees, executive management and the board of directors in general".

Shariah governance is not only concerned with the relationships between shareholders, directors, management, and stakeholders, but also with ensuring an initial relationship with God. Therefore, Shariah governance has a substantially greater scope than conventional governance. Moreover, the head of an Islamic banking department at Islamic window bank added that:

"Shariah governance refers to the rules that regulate how Shariah work procedures are carried out inside the institutions that operate under the Central Bank's supervision".

Additionally, a Senior Advisory Consultant at a full-fledge Islamic bank clarified that:

"It is the system of controlling the Shariah approval processes and verifying their proper application in the Islamic financial institution, through which it is ensured that the applied product in all of its procedures and stages is in accordance with Shariah decisions as decided by the financial institution's Shariah committee"

Shariah governance has been defined in various ways by participants who were interviewed, but the general consensus is that it is the mechanism of regularly monitoring and supervising the transactions of full-fledge Islamic and windows banks, in such a manner that it is able to make a “consistent” Shariah decision. In addition, offering a product that is developed from A to Z in compliance with Shariah principles. As the Shariah Board Secretary at a full-fledge Islamic bank stated:

“Shariah governance refers to the laws and legislation that guarantee Islamic products follow the regulations of Shariah committees. Deviation from these regulations is considered Shariah non-compliance”.

In fact, some participants argued that Shariah governance merely exists to mitigate the Shariah non-compliance risk, as stated by the director of an Islamic finance advisory firm:

“When we talk about Shariah governance, I always like to mention why we have Shariah governance in the first place, we have a new type of risk called Shariah non-compliance risk, which is why we need Shariah governance”.

Chapter 4 discussed in depth the concept of Shariah non-compliance risk and noted that this risk derives primarily from the basic rationale for the existence of Islamic banks, which is Shariah compliance. In fact, Shariah compliance is the purpose of the Shariah governance system and a major priority for all Islamic banks. Shariah compliance is the unique separation line between traditional governance and Shariah governance, so if it is not the primary objective of Shariah governance to ensure Shariah compliance within the bank, then the Islamic bank should adopt only traditional governance and, as a result, would have no need for Shariah governance. Cheong (2021) defined Shariah compliance as the practice of adhering to Islamic Law or Shariah. To have credibility in the Islamic banking industry, there must be full compliance with Shariah requirements, which is accomplished by implementing Shariah governance.

According to an Islamic finance expert:

“I see Shariah governance the same as classic governance, but with the addition of the Shariah committee's duties and the identification of the roles of Shariah supervision, auditing and Shariah compliance. These are the elements that define Shariah governance in general”.

Most participants assume that Shariah governance is synonymous with the Shariah committee and fail to recognise that Shariah governance is a joint effort between the board of directors, senior management, the Shariah committee, the internal control department and risk management. All of those fit into the overall Shariah governance, the purpose of which is to ensure that Shariah regulations are adhered to inside the bank (i.e., Shariah compliance).

Why is corporate governance necessary in the first place? The author prefers to consider how the Shariah governance relates to corporate governance. The bank is an institution that influences economies and separates ownership and management duties. It has become apparent that a governance structure, which is really a system, is required to manage these conflicts of interest.

Similarly, in Shariah governance, we need a complete framework that establishes a set of appropriate measures, arrangements, and policies for Islamic banks to ensure that Shariah rules are adhered to in all respects. Due to the lack of Shariah principles in all business processes, the existing corporate governance does not meet the requirements of the Islamic financial institutions' governance structure (Alam et al., 2021). Thus, to guarantee that Shariah compliance is enforced inside Islamic banks, the governance structure of Islamic banks requires a second layer of governance, namely Shariah governance.

As stated in Chapter 2, the agency theory is one of two theories that are adopted. Therefore, from the author's perspective, the definition of Shariah governance originates from those who initiated the work of governance, and it has the aim of monitoring and controlling the consequences of the agency. In short, they wanted to ensure that the system does not allow those with authority or powers to misuse it. Misuse, in the author's perspective, can be intentional or unintentional, while the wrong usage results from possessing powers. Thus, Shariah governance is the formation of regulations and laws that prevent the intentional or unintentional misuse of power and has the authority to guarantee compliance with Shariah law in all bank activities. The absence of such a governance structure may cause disputes that could lead to financial and non-financial losses. Hence, Shariah governance has been created by various regulators and countries for regulating the operations of IFIs and decreasing the disputes among the various parties (Alam et al., 2021).

While the second theory adopted in this study is stakeholder theory, which is widely accepted by Islamic scholars since it focuses on the interests of all stakeholders, rather than focusing on shareholders. Therefore, the Islamic corporate governance framework is more strongly aligned with stakeholder theory by stressing integrity, accountability, and transparency (Bhatti and Bhatti, 2009).

Indeed, according to Islam, the desired behaviour of a bank is identical to that of any other member of society. In other words, the economic and moral behaviour of a bank is moulded by its managers working on behalf of the owners, and it is their fiduciary obligation to manage the bank as a trust for all stakeholders, not just the owners. Consequently, it will be the responsibility of the managers to guarantee that the bank's conduct adheres to the Shariah's norms and regulations, or simply assure shariah compliance.

Therefore, after addressing the various definitions of Shariah governance from the perspectives of interviewees, and illustrating the meaning of Shariah governance from the theoretical viewpoints (i.e., agency and stakeholder theory), the author arrives at the following definition for Shariah governance:

"Shariah corporate governance is a religious and control system that provides effective and independent shariah supervision. This is done by a shariah committee, whose main goal is to ensure Shariah compliance for all stakeholders. As such, it includes a set of internal rules, policies, and procedures that specify the tasks, functions, and obligations of different stakeholders within an institution, such as the BOD, senior managers, a Shariah auditor, Shariah compliance, and risk management.".

5.2 Examination of the phase before and after the issuance of the Shariah governance framework

This section highlights the findings related to the issues that existed before the issuance and the major amendments applied to the new Shariah governance framework. The author shows in (Table 5.1) two columns highlight the phase before and after the issuance of the shariah governance framework.

Table 5.1: Summarization of the phase before and after the issuance of the shariah governance framework

Before the issuance	After the issuance
The shariah governance framework	
No binding shariah governance framework	A mandatory shariah governance framework
Shariah board	
• Recognized as shariah board. • Lack organization (appointment, characteristics).	• Recognized as shariah committee • It has established guidelines for the appointment and characteristics.

• Enjoy independence (report to the shareholder). • Advisory role in Windows banks • Advisory and supervisory to some extent in full-fledge	• The committee shall report directly to the board. And have the right to contact the central bank directly. • Unify the shariah committee responsibilities in Islamic banks (full-fledged and window),

Internal shariah control

• Internal shariah audit and shariah compliance was existed in full-fledge • Some Windows banks had internal shariah audit, while others did not and merely have external shariah auditors on an annual basis. • Shariah compliance was present in some Windows banks, but not in others. • Neither full-fledge nor window banks have a division dedicated to shariah noncompliance risk.	• The framework covered three fundamental functions under the internal control: ✓ Shariah compliance ✓ Shariah audit ✓ Shariah non-compliance risk

The independence of the internal shariah control

• There was no independence grant it to shariah audit nor Shariah compliance. • The shariah audit report only needs to be submitted to the shariah board.	• The framework called for the shariah audit independence only, but offered no indication of how they would obtain it • The shariah audit report needs to be submitted to both the board audit committee and the Shariah committee.

External shariah audit

• Islamic window banks utilised external Shariah auditor as a substitute for the internal Shariah auditor. • Full-fledge Islamic banks don't utilise external shariah auditor.	• the framework was silent on the application of the external shariah audit.

It was evident that the absence of the obligatory Shariah governance framework was the root cause of the predominance of issues. This does not imply, that there was no shariah compliance, which is the cornerstone of Islamic banking. To put it simply, the central bank took the correct action by mandating Shariah governance in all full-fledged Islamic banks and window banks and establishing a minimum decision-making criterion. The subsequent sections describe each phase.

5.2.1 Before the issuance of the Shariah governance framework

As previously indicated, the Shariah governance framework in Saudi Arabia is seen as a novel achievement. Therefore, it is essential to shed light on the period prior to the implementation of the mandatory Shariah governance framework to determine whether the current Shariah governance requires improvements to resolve prior issues. As a result, the following issues were revealed during interviews: no shariah governance framework, discrepancy between the window banks and full-fledged Islamic bank, Shariah committee, the independence of the shariah internal control department, and the external shariah auditors .

1. ***No Shariah governance framework***

The absence of an obligatory supervisory Shariah governance framework was the fundamental cause for a prevalence of issues. Participants from window banks mentioned this issue more often. In other words, we may argue that the full-fledged Islamic banks were the only ones that adopted Shariah governance to some degree, and it is seen as a personal effort by the bank. In fact, most of the literature (Hasan, 2011; Hasan and Sabirzyanov, 2015; Kasim et al., 2016; Saba, 2018) addressed the subject of Saudi Arabia's silence on the issuing of a mandated Shariah governance framework, which was a self-initiative on the part of full-fledged or window banks. According to Shariah Board Secretary at a full-fledged Islamic bank:

"There was no Sharia governance in the banks prior to the framework's release. They followed conventional governance and did not intervene with any Sharia-related issues".

Additionally, the VP for Shariah Assurance, Shariah Advisory & Governance at an Islamic bank in Malaysia stated that:

"Unfortunately, there was no Shariah governance framework when I was working in Saudi Arabia; this was one of the criticisms that we had internally, and we used to look at Malaysia as sort of the gold standard. So, in my opinion, Malaysia was the most regulated country in Islamic finance, whereas Saudi Arabia was the least regulated".

In other words, the central bank did not engage in Islamic banking regulation, and the matter was left up to each bank, either by appointing Sharia boards or authorising certain products; it was based on the bank's desire, but not according to a general Shariah governance framework. As he clarified that:

"When I was there definitely the bank took it very seriously, I mean the Shariah compliance, to the extent that if there was a transaction that violate Shariah, a donation from the profit from that transaction is a mandate, as well as the bank invest in automation, they would invest in people to ensure that Shariah implemented properly. They invested a lot in the Shariah scholars by having the leading Shariah scholars who are the advisors of the king. But when it comes to investing in the Shariah governance aspects, they never spare any expense".

This clearly indicates that there was a Shariah compliance, which is the foundation of any Islamic service or transaction.

2. Discrepancy between the window banks and full-fledged Islamic bank

The Shariah governance framework plays a significant role in credibility and transparency, which means that prior to issuing and requiring Sharia governance, there was a significant discrepancy between the window banks and full-fledged Islamic banks. Two aspects clearly arise, which were addressed by most of the participants:

Employees and department size and existence

One of the most serious concerns expressed by the participants from window banks, which arose prior to the release of the Sharia governance framework, is that you could find two window banks that are approximately the same size in terms of assets and capital, but one bank had 25 staff, and the other only two, in the Shariah department. Commenting on this, a Shariah Review and Control Senior Manager at a window Islamic bank claimed:

"This indicates that Shariah is not a priority for the bank's internal management or the board of directors".

Additionally, he stressed that:

"We have uncovered flaws in a full-fledged bank despite the strict supervision processes used by them. What is the case with window banks when just one individual does the Sharia audit? It is almost certain that he will not be able to perform the auditing duties effectively".

A Shariah audit is essential, since one of its functions is to identify flaws and errors from a Shariah perspective, create a comprehensive report, and submit it to the Shariah committee's secretariat before transmitting it to the Shariah committee. Even though the volume of operations at window banks is small compared to full-fledged banks, it is unrealistic for one person to undertake the Shariah audit role.

According to a Sharia Control Officer at a full-fledged Islamic bank:

"A Shariah audit department works under the Shariah control department and has an annual base plan used to pick a sample of products and start inspection against Shariah policy. The findings report is sent to the Shariah board and the business department to be signed and this report has a target date for the remediation and correction plan. And all that is a kind of supervisory role".

This demonstrates that a full-fledged Islamic bank has a dedicated department focused on Shariah supervision and audit, while the window banks lack such a department. They either employ a single Shariah auditor or rely on external auditors who conduct yearly inspections. As stated by a Shariah Affairs Officer at an Islamic window bank:

"We do not have an internal Shariah audit; instead, we employ an external Shariah audit to audit our Shariah operations. Similarly, some of the window banks do not have an internal Shariah audit; instead, they all conduct yearly external auditing".

Confirming this point, the head of the Islamic banking department at an Islamic window bank stated that:

"In the past, most banks did not have a Shariah audit. Because it was a personal concern for the bank, the fatwa was on one side and the implementation was on the other. This is an extremely dangerous point".

The existence of the Sharia Compliance Department was also a distinguishing factor. A Shariah compliance function is the process of reviewing policies and processes for products to ensure that they adhere to the shariah policies. The Shariah Compliance Department acts as another supervisory department inside the Islamic bank. However, according to a Shariah Affairs

Officer at an Islamic window bank:

"We do not have a Shariah Compliance Department. We do not need it, in my opinion, because its function is shared by the Sharia Governance Department, Sharia Audit and the Sharia Board Secretariat".

He further argued that the Shariah Compliance Department duty is to guarantee that the central bank's framework is implemented within the bank, as well as that the policies implemented inside the bank are consistent with the Shariah committee decisions, and they are updated on a regular basis in accordance with their rulings. This function is performed by the Sharia Governance Department, and it is completed more broadly in terms of policies and procedures. In fact, some of the participants at the window banks believed that the Sharia Compliance Department should be made available to full-fledge Islamic banks due to the high volume of activity and rulings issued by the Shariah committee, with the latter updated on a regular basis. However, they claimed that the window banks do not require such a department because they do not have a high volume of activity or rulings issued by the Shariah committee, meaning that their Sharia Governance Department can easily handle it.

The author believes it is important to emphasise the difference between a Shariah audit and Shariah compliance, since it seems that banks combine the two tasks. According to the Head of Shariah Compliance at an Islamic window banks:

"The Shariah audit function is not part of the Shariah compliance function; it is an independent function that reports directly to the Shariah committee".

First, Shariah compliance is a top priority in any Islamic bank, and it must be highlighted that Sharia compliance is a shared obligation among all the bank members, including management and those responsible for governance. AAOIFI's latest governance standard no. 9, relating to the Shariah compliance function (2021), describes Shariah compliance as all notions that covers the mechanism for guaranteeing Shariah compliance, the controls and related processes, and the establishment of a Shariah compliance administrative unit.

According to the Head of Shariah Compliance at an Islamic window bank, the Shariah Compliance Department responsibilities include:

1. Reviewing the bank's policies and processes, as well as all Islamic products inside the bank, for compliance with Shariah committee decisions, and advertising campaigns for conformity with Shariah committee decisions.

2. Guaranteeing that the bank's operations conform to the Shariah committee's regulations.
3. Providing consultations and surprise inspections to check Shariah compliance and to produce a report on the subject.
4. Acting as an adviser for potential Shariah risks and to offer recommendations for mitigating them.
5. Providing initial approval on Islamic products.

Therefore, a Shariah Compliance Department must exist. In addition, a Shariah audit and Shariah compliance are different Shariah governance tools, but their shared purpose is to verify Shariah compliance.

The extent of Shariah control and operational activity

Traditionally, internal control is the responsibility of the bank. In Islamic banks, the Shariah internal control is the integration of the operations, plans, attitudes, policies, and efforts of the bank's personnel to provide reasonable assurance that the institution will achieve its desired objectives in a Shariah-compliant manner. Moreover, the existence of Shariah supervision facilitates the fulfilment of Shariah governance criteria. Prior to the mandatory Shariah governance structure, the extent of Shariah control varies between full-fledge Islamic and window banks. This issue was often discussed by participants from both banks.

According to the Head of Islamic Banking at an Islamic window bank:

"In full-fledged Islamic banks, for instance, departments are afraid of the Shariah Supervision Department; for instance, if a note is given to a specific department or division, it is immediately amended. However, in a windows bank with a similar situation, operations may be conducted without consulting the Shariah committee".

The author believes that the absence of a Shariah governance framework is a non-negotiable factor that creates a lack of organisation and control over Shariah activities, in addition to the Shariah audit role. The internal Shariah audit is one of the most essential components of the Shariah control system in Islamic banks. Its major duty is to assess the bank's compliance with fatwas and rulings issued by the Shariah committee.

The study found another significant issue that was a major difference between the full-fledge Islamic and window bank, which is the cost of issuing a fatwa. It costs approximately 200 thousand riyals for the full-fledge Islamic bank to issue a fatwa, as the process involves several stages and departments, such as the Sharia Studies Department and the Product Development

Department, before it reaches the Sharia committee for approval. As a result, it consumes a significant amount of time, effort, and money. In contrast, when the windows bank seeks a fatwa for a specific product, the bank contacts the Sharia scholar and informs him about the product and asks if he believes it is Sharia-compliant. If he responds affirmatively, the bank issues the product; a fatwa here costs the bank two riyals for the phone call. Commenting on this issue, the Shariah Review and Control Senior Manager at a window bank stated:

"This demonstrates the operational distinction between full-fledge Islamic and window banks. Full-fledge Islamic banks operate under rigorous Shariah regulations on an internal level".

From the author's point-of-view, this significant discrepancies in the practice of Islamic finance between the window banks and full-fledged Islamic bank may limit the development of its vision, reliability, and reputation.

It is worth mentioning that the degree of Shariah control also varies between full-fledge Islamic banks. According to the Shariah Compliance Manager at a full-fledge Islamic bank:

"According to my experience in the field of the Shariah Control Department in more than one full-fledge Islamic bank in the Kingdom, the degree of control and compliance varies in banks".

This is owing to the strength of the Shariah Control Department itself, since practically all products and fatwas are the same across all banks. However, the Shariah control and executive management have the primary responsibility; it will attain the necessary compliance if it is robust and has enough resources. Nevertheless, if there is a lack of sufficient resources for verification and control, it stands to reason that its control will be weaker than that of other banks.

3. Shariah committee (independence, appointment, characteristics, and recognition)

This third major issue was often highlighted during the interviews since it was a concern before the mandated Shariah governance framework. A definition of the Shariah committee is necessary before discussing its issues. A Shariah committee, according to most of the participants, is an independent group of Sharia experts, the majority of whom are university professors. This independent committee separates the bank's management from the client to accomplish the best interests of both parties. Because the bank's management does not implement a product, and claims that it is compatible with Shariah rules, it must present this product to an independent committee for approval. Therefore, Islamic banks have a Shariah board, which is a unique feature that sets them apart from their conventional counterparts

(Ulussever, 2018; Buallay, 2019; Mansoor et al., 2019).

According to a Shariah Review and Control Senior Manager at an Islamic window bank:

"In Saudi Arabia, there is a Shariah committee, which is an advisory committee, not an oversight committee".

In the analysis of the interviews, the study identifies three main Shariah committee functions:

The first is the **fatwa function**, which will provide a Shariah compliance certification and approvals for the product structures and associated documentation, which ensures that whenever a product is produced, a fatwa is also produced. A Senior Credit Reviewer & Risk Manager at Islamic window bank clarified that:

"The Shariah Committee issues a fatwa or shariah decision, however this decision must be supported by economic and accounting concerns, as well as risk assessment, and committee members must be aware of this".

Second is the **advising function**, in which the Shariah board works on providing clarifications or opinions on specific Shariah-compliant matters, in collaboration with the Shariah department.

The final one is the **supervisory function**, which is not technically performing the audit but rather it is leading the ongoing Shariah verification or audit. This involves approval of the audit methodology and scope of the audit plan, and then reviewing the Shariah audit report produced by the Shariah auditors. Based on their review of the Shariah audit report, they can issue an annual Shariah compliance report. According to the VP of a Risk Manager, Operational Risk at an Islamic window bank:

"Their existence is to ensure that every product and service are complying with Shariah, including review and approval of purifications amounts".

Thus, their periodic meetings include:

- All Shariah issues,
- A review of processes and procedures,
- A review and approval of any new product or a renew of existing product,
- Raising awareness by educating all people involved within the bank, and customers too, with the Shariah regulations and structure of the Shariah product.

As a result, Shariah boards play a significant role in all Islamic banks since they make the ultimate judgement on whether the bank complies with Shariah. According to Ahmed (2011), the major duty of the Shariah board is to act as a gatekeeper to oversee the implementation and compliance to Shariah in their organisations. In addition, the Shariah board serves as an internal control mechanism, overseeing the operations of an Islamic bank and issuing fatwas (Ajili and Abdelfettah, 2018).

Prior to the release of the Shariah governance framework, the Shariah committee lacked organisation and they were not recognised as one of the board of directors' committees. As stated by the Shariah Review and Control Senior Manager at an Islamic window bank:

"The Shariah committee was thought to be one-to-one with the board of directors in Islamic banks".

As a result, the Shariah board's presence constituted a voluntary effort and commitment on the part of the owner. Moreover, the selection of the Shariah board was based on who is most well-known in the field and has membership in most banks. According to a head of Islamic banking department at an Islamic window bank:

"In the past, the appointment of a Shariah Board member was open and uncontrolled. It is possible to designate a Shariah member who is not an expert".

A board member, who is a specialist in Islamic Economy & Finance, claimed that the Saudi public influences the nomination of certain Shariah board members:

"Many Islamic banks appoint members of the Shariah board who are known for their good reputation in the community because many customers come to the bank because of their trust in the members of the Sharia board".

The Shariah committee was appointed by the shareholders' general assembly, which was preferred since it assured the Shariah committees complete independence. However, this independence was not enough since there was no compulsory Shariah governance framework to govern this independence. As stated by a Shariah compliance manager at a full-fledge Islamic bank:

"We know that the ultimate power belongs to the shareholders if they do not support Islamic banking, the Shariah board and supervisory department efforts will be fruitless if the board of directors and shareholders do not set the goal".

While another picture is provided by Shariah Assurance, Shariah Advisory & Governance at an Islamic window bank:

"In Saudi the ultimate authority was the Shariah scholars, and they really had an ultimate

authority, the central bank did not interfere much, did not really get involved, everything was really relied on Shariah scholars, and the scholars are seen to be the vanguard".

In either case, we could conclude that the Shariah board was independent prior to the implementation of the Shariah governance framework; but this independence was not apparent and relied on shareholder preference and decision.

Alahmadi et al. (2017) found that, in Saudi Arabia, religious compliance decisions for transactions and activities are made solely by each bank's Shariah board. This means, each full-fledge or Islamic windows banks rely primarily on the Shariah boards' self-made regulations. However, when governance is applied, no attention will be given to the strength of the board of directors or the desire of the owner, and the bank's condition will be well-governed. As a result, regardless of the purpose, the bank is constrained by a governance framework that must be obeyed in front of the central bank.

During the interviews, the lack of independence of the Shariah board members was also highlighted as a concern prior to the required Shariah governance framework. In Saudi Arabia, many banks share the same chairman and members of their Shariah committees. Indicating that the members of the Shariah board were not independent. In other words, there was a kind of exclusivity club developing between the Shariah scholars in the Islamic banks.

Commenting on this issue, a Shariah Compliance Manager at an Islamic window bank declared:

"For instance, one of the Islamic banks in the Kingdom had a member who was a member in 100 Gulf firms and banks".

A similar viewpoint is provided by a director at an Islamic finance advisory firm:

"There are ten Shariah scholars advising all Islamic banks in Saudi Arabia, and there is no succession planning for this, unless new Shariah scholars are onboarded and assigned to these functions, therefore, there will be some sort of rotation".

Regarding the execution of the Shariah board's independence, several criticisms have been raised at Shariah scholars for their involvement in numerous banks. Independence essentially implies financial independence; hence, they are not a shareholder in the bank. In addition, independence from a management standpoint, for instance, their relative cannot be the CEO, and independence from a competitive standpoint are compulsory.

Most participants argued that while Shariah scholars provide valuable insights and effort, they cannot possibly cover everything and, according to Sharia standards, the duties of the Shariah committee exceed the time available to scholars. For instance, they are unable to complete the tasks assigned to twenty Shariah committees and it is, therefore, limited to expressing Shariah opinions; as such, it is open to criticism. However, according to the co-founder of a Shariah advisory firm.

"The practical reality is that there are insufficient Shariah scholars".

The author believes that the problem is not with the member who is in 100 Shariah bodies, but rather with the market, which has not created suitable individuals to appoint them for this profession.

The participants highlighted that the current Shariah board members lack valuable criteria as products and technology evolve, the Shariah board members must stay current of all developments in Islamic banking, as this will undoubtedly aid them in issuing Shariah decisions that are consistent with the developments and needs of society. According to a co-founder of a Shariah advisory firm:

"The most prominent example is financial technology, which they must understand in order to evaluate it and make appropriate decisions about it".

Therefore, a Shariah board member should be aware of and conversant with the most recent industry developments. If, for instance, a digital currency product is provided, and the Shariah board lacks vision and comprehension of the developments, he will be unable to provide a Shariah opinion. A member of the Shariah board who lacks English proficiency is a further crucial concern. Shariah boards must now be able to speak English, in addition to being aware of the most recent changes in technology or the financial sector in general. Moreover, they must rely on independent specialists to explain any new products that correspond to recent developments.

Expressing this matter, a Shariah Affairs Officer at an Islamic window bank stated that:

"I believe they must have English language because the majority of the bank's transactions are in English, such as treasury transactions and transfers between banks around the world".

Most of the existing members, or those who joined before the framework's release, do not speak English; hence, the materials are translated into Arabic for them. However, this does not explain their lack of understanding of the banking transactions.

4. The independence of the Shariah Internal Control Department

The fourth issue found relates to the phase before the issuance of the shariah framework is the independence of the shariah internal control function. The Islamic bank's transactions are particularly precise, as any minor error can lead to a Shariah non-compliance risk, which in turn leads to the purification of all the profits resulting from it, if we speak from a purely financial perspective that is of interest to the shareholders. To oversee these operations, the Islamic bank requires multiple control mechanisms, such as the Shariah audit and the Shariah compliance function. However, their mere presence is insufficient; their independence must be ensured to maximise their performance.

It was evident from the interviews that, prior to the issuing of the framework, there was a deficiency in the role of Shariah audit in the performance of its duties as an applied part of the Shariah internal control. The goal of the Shariah internal control is to provide a reasonable assurance to the Shariah committee of the compliance of the Executive Management or the Sharia department with the Shariah board's instructions.

According to a Shariah compliance manager at a full-fledge Islamic bank:

"The Shariah Control Department or the executives, in my opinion, are the ones who play an important role within the framework of Shariah governance, so it must have independence because it reports now to the CEO, unlike the Compliance and Internal Audit Departments, which reference directly to the Board of Directors without referring to the CEO".

An independence in auditing fosters objectivity in the performance of audits with a minimum of bias connected with the issue and review of auditing reports (Arens et al., 2008), which allows management to have a complete trust in the audit findings and recommendations (Pickett, 2010). Thus, while appointed by the management, the internal Shariah auditor is tasked with examining the conduct of the same management. Possible conflicts of interest, to which the internal Shariah auditor may be vulnerable, compromise his independence when performing his duties (Khalid and Sarea, 2020). Internal Shariah audit effectiveness could be jeopardised if the management exerts undue influence on him, which could compromise the objectivity of the auditing outcomes (Agarwal and Medury, 2014). With no substantial independence, the internal auditor is integrated into the management team, losing the potential to provide a fresh point-of-view through an objective review (Flesher and Zanzig, 2000).

The same applies to the shariah compliance function, which entails providing a regular shariah review evaluation to the board of directors and the shariah committee regarding the state of

Shariah compliance at the Islamic bank. Consequently, if the Shariah Control Department is unable to function independently, it will have an impact on Shariah's audit and compliance reports, as well as the overall effectiveness of Shariah governance.

5. External Shariah auditors

The final concern prior to the publication of the shariah governance framework was the necessity for external shariah auditors. Shariah governance and audits are an essential part of a business since it promotes the values of accountability, transparency, and Shariah assurance to IFIs' stakeholders (Shafii et al., 2015). To ensure their banks adhere to Shariah law, Islamic financial institutions, whether they are full-fledged or window banks, have generally established a Shariah internal control department to monitor Shariah compliance of their banks. Moreover, internal Shariah auditing provides stakeholders with a limited level of assurance. Thus, an additional layer of Shariah compliance assurance provided by an external, independent entity will increase the confidence of Islamic bank stakeholders.

In other words, the external Shariah auditor provides additional assurance that the Shariah Compliance Officer, the Shariah internal audit and the entire Shariah department have fulfilled their responsibilities in accordance with Shariah. Reasonable assurance is achieved by conducting an audit on a sample of the typical procedures conducted, rather than a quantitative analysis. However, as previously mentioned, in Saudi Arabian Islamic window banks an external Shariah auditor is utilised as a substitute for the internal Shariah auditor, but not as a form of secondary confirmation. In addition, even full-fledge banks in Saudi Arabia have not employed external Shariah auditors to carry out their principal responsibility. As stated by a Senior Advisory Consultant at a full-fledge Islamic bank:

"We rely solely on the internal Shariah audit as there is no external Shariah audit".

The author believes that the absence of an external Shariah audit is a lack of reasonable certainty that there are no Shariah violations. A Shariah Compliance Manager commented on the Shariah control responsibilities:

"No one can review 100%, but we can reach a certain assurance that the bank has a general Shariah compliance".

In summary, the author believes that both the Islamic bank and the external Shariah auditor must understand that the purpose of an external Shariah audit is not to identify the mistakes of Islamic banks in order to impose sanctions by the central bank, unless there is a deliberate failure to comply with the Shariah principles and the issued fatwas. Importantly, it is to identify the shortcomings that prohibit an Islamic bank from being fully compatible with Islamic law, and then to provide recommendations to the Board of Directors on how to overcome these challenges one-by-one. Therefore, the management of an Islamic bank should utilise this independent service to improve Shariah compliance within the bank and thereby eliminate errors.

5.2.2 After the issuance of the Shariah Governance Framework

1. Shariah governance as a requirement

Following the discussion of the major challenges that existed before the issuing of the Shariah governance framework, this Section examines to what extent Shariah corporate governance has become a requirement for an effective Islamic banking industry in Saudi Arabia.

The research findings reveal that participants generally agreed that Shariah governance has become a need in the Kingdom's Islamic banking industry due to the existence of several considerations. The Kingdom is recognised as one of the world's first centres in terms of assets. The Kingdom has depth in terms of asset size, Islamic product diversification, and the presence of transcontinental Islamic institutions with branches, presence, and clients, alongside the existence of cross-border products, such as the issue of listed sukuk, with investors from around the world. All these facts highlight the need and urgency of having a Shariah governance framework. According to a Shariah Advisory Officer at an Islamic window bank:

“Definitely required. We're talking about 72 percent of the financial industry in the Kingdom being Shariah-compliant, and the Kingdom holds a quarter of the world's Islamic banking assets”.

Consequently, despite all the existing success factors, one of the greatest obstacles to the development of the Islamic banking industry in the Kingdom is the significant weakness in the Shariah governance framework, which must be made mandatory by the government and the relevant legislative and supervisory bodies.

According to a Shariah Supervisory Manager at an Islamic window bank:

“Yes, unquestionably a necessity, as there were practices in the past that were not regulated, and some parties gained from the phrase "Islamic banking." Consequently, a Shariah governance structure must be implemented in order to develop an Islamic banking industry”.

Therefore, the author believes that Shariah governance is one of the most significant tools for regulating the Islamic banking sector, because any sector will be characterised by randomness if it does not have clearly specified governing frameworks. Because Shariah is core to Islam, Islamic finance must prioritise Shariah governance in terms of adhering to certain fundamentals, especially in terms of transaction methodology, documentation, and the sequence of Islamic finance transactions; consequently, these factors must be adhered to properly.

In reality, the practice of governance in banks is more complex than what is described in banking theories or the central bank's framework. Deposit insurance, capital adjustments and borrowers' provisions are elements that do not exist in any other industry, making bank governance more complex than any other governance sector. The funding sources of banks, which include deposits and short- and long-term loans, make this industry the most complex. This is applicable to both conventional and Islamic banks. Therefore, the importance of governance is magnified in banks more than in any other sector because banks are the hubs of the state's financial activity.

In summary, Shariah governance is now mandatory. The author believes that we have passed this stage (to what extent) because the framework has been issued and approved. We can ask this question before the Shariah governance framework is issued, and we can say that it is important for the Islamic banking of the Kingdom and all that. Nonetheless, it was necessary to ask this question to the participants to enable a determination of the degree to which this industry requires obligatory governance. But now that the framework has been issued and applied, it is evident that the Kingdom is committed to the expansion and consolidation of Islamic banking, and it is working towards making Riyadh the capital of Islamic banking.

The evidence suggests that Shariah governance is a must, it was a must previously, and it is certainly a must now. People, particularly consumers in Saudi Arabia, will not accept a conventional bank product. Typically, the more consumer-focused the bank, the greater the emphasis on public disclosure of fatwas and having famous names of Shariah scholars on Shariah committee; in other words, a greater public display of Shariah compliance.

One of the reasons that Saudi Arabia is shifting towards Shariah governance is that Islamic banking is systemically important in Saudi Arabia, and when something is that vital to the entire system, a crisis of faith has to be avoided; having a weak governance can lead to this scenario and it may harm the entire country.

2. The first ever mandatory Shariah governance framework

An overview

Islamic finance has gained popularity, and the Saudi Central Bank has responded by issuing a Shariah governance framework that will regulate this industry and promote fair competition in the market between those who adhere to Shariah and those who do not; hence, the situation has now become organised, whereas it was not earlier. The fundamental legislation of Saudi Arabia is governed by Islamic law, however there was considerable debate as to whether the banking industry adheres to these principles.

According to a Shariah Assurance, Shariah Advisory & Governance at an Islamic window bank:

"If we look at Saudi Arabia's central bank guidelines, they effectively say something to the effect that there is no interest, even if we look at the accounting standards in Saudi, they don't use the word interest but rather special commission. So, it's a bit of a juggle trying to figure out how much of the system is conventional and how much of it is actually riba. I am not judgmental of this way or another".

Consequently, this initiative by the central bank is a crucial step toward demonstrating to the world that Saudi Arabia is significantly enhancing the overall Shariah governance. In other words, the central bank decided to intervene in the regulation of Islamic banking, meaning that individual banks no longer self-regulated, whether this be via appointing Shariah boards or licencing certain products based on the bank's desire; in short, a system of general governance was applied. As it stands, Shariah regulations established by AAOIFI are implemented by Islamic banks worldwide, and each country has begun to regulate Islamic banking within its borders. In its capacity as a supervisory authority, the Central Bank of Saudi Arabia is taking an admirable step towards supervising Islamic banking operations within the Kingdom.

The study reveals that the work on implementing the Shariah governance framework began in 2017 but was delayed until 2020 because it was passed to more than one committee, both banks and Shariah committees, to provide their opinion on the framework. As clearly expressed by a risk management and Islamic banking specialist at a confidential sector:

"Studies and preparations for the Shariah governance framework's adoption began in 2017, but it wasn't put into effect until 2020".

The view of the banks, or the specialised sector, is taken because the central bank is a supervisory body that may require technical opinion from this specialised sector. Moreover, the IFSB (Islamic Financial Services Centre) standards were reviewed, and the central bank has adopted nine of them, since any central bank interested in expanding the financial and banking sectors will prioritise the first pillar, which is to conform with international standards.

According to a risk management and Islamic banking specialist at a confidential sector:

"Furthermore, when benchmarking studies and comparisons with Malaysia are performed, Malaysia is recognised as a leader in Islamic banking, despite the fact that the ratio of Islamic banking to conventional banking is seen as a small percentage, as is the case in the UAE, Oman, and Bahrain. In contrast, we are in the Kingdom. Islamic assets have a high value. This industry, on the other hand, is unregulated. This will be regarded as a problem".

In fact, the participants were optimistic about the announcement of the Shariah governance framework; the following are a few of their reactions. According to a Shariah Control Officer at a full-fledged Islamic bank:

"It is better to arrive late than never, it is an excellent framework for a first step. Now we can say that Islamic banking is the vital nerve of the Saudi banking system".

A co-founder of an Islamic finance advisory firm stated that:

"It is, without a doubt, a late step, but thank God that it was issued. It is a major step because all markets that work in Islamic banking have a Shariah governance framework, but the central bank is now actively working in the sense that it has issued the Shariah governance for banks and will soon issue the framework for Islamic financial institutions. All of this indicates that we are on the right track".

A Shariah Review and Control Senior Manager at an Islamic window bank argued that:

"All the region has Shariah governance: Kuwait, UAE, Oman. We are considered the last country to issue the framework of Shariah governance".

In fact, most of the participants believed that it is a late move. Nonetheless, the release of the Shariah governance framework provided Islamic banking in the Kingdom with hope, and there is strong confidence that additional steps will be undertaken to improve it until the Kingdom becomes a leader in Islamic banking. A Vice President and Head of Shariah Division at an Islamic window bank clarified that:

"It is, of course, considered late. It should have been released a long time ago. However, it is regarded as a good first version, and the central bank is interested in developing Islamic banking".

Until recently, there was no distinction between a conventional bank and an Islamic bank in the Kingdom; both are banks. A standpoint was formed when the Shariah governance framework was established. As a result, there is now clear differentiation between a full-fledge Islamic bank, a conventional bank, and a window bank. This framework has become binding for all the banks that provide Islamic banking products and services. Consequently, Shariah governance is now becoming mandatory, in the sense that it must be followed if fines are to be avoided.

Analysis of the new Shariah governance framework

The mandatory implementation of the Shariah governance framework serves as the nucleus for the organisation of Islamic banking in Saudi Arabia, and it is the bare minimum required for Islamic banking governance in the Kingdom. Shariah governance, at least for the moment, will oblige banks to move and act in this area.

Despite all the positive perceptions toward the release of this framework, the majority of the participants agreed, in addition to the previous analysis of the most significant problems that existed prior to the issuance of the framework, that the current framework did not resolve all of the previous problems, but only addressed some of them.

A Shariah Review and Control Senior Manager at an Islamic window bank claimed that:

"It is regarded as an excellent first step, but the framework requires significant development".

Accordingly, the framework will now be analysed and discussed, together with its issues and possible improvements, with respect to the previously highlighted problems that existed before its release. The framework consists of eighteen articles, a significant selection of which are now to be examined.

Article 2: Objectives of the Shariah governance framework

The framework begins with a discussion on the significance of the Shariah governance, which has become a necessity in the Islamic banking industry. As a result, the central bank issued this framework as a minimum requirement for Shariah governance practices oversight and control. As was stated earlier in this chapter, the framework lacked a definition for Shariah governance and merely provides the framework's objectives.

For the Shariah governance framework's objectives, it is clear and precise in its representation of the structure of the Shariah governance framework and in its presentation of the responsibilities of each responsible element within this framework. In other words, the objective of the Shariah governance framework is to enhance the role of the board of directors, executive management, Shariah committee, compliance department, risk management department and internal audit department. In addition, the objectives section underlines that, in order to develop a Shariah-compliant environment, the bank's board and executive management must have a solid understanding of Shariah concepts and their comprehensive application to Islamic finance.

It is expected that the Shariah committee has appropriate knowledge of financial and banking aspects in general and Islamic finance in particular to enable comprehension of the Shariah issues introduced into it. As a result, the committee is expected to regularly learn about Shariah and financial concerns and laws, join relevant training programmes, and keep up to date with the newest advancements in Islamic finance. This is also consistent with the Shariah governance framework announced by the Bank Negara Malaysia (BNM) on 22 October 2010, which stipulates that all IFI's major organs and functions in Shariah governance must have the required competency based on their respective responsibilities. In addition, they must continuously expand their knowledge of Shariah alongside knowing the most recent advances in Islamic finance.

In fact, this is a significant shift in the appointment of the Shariah committee. Since, before the issuance of the framework, the selection of the Shariah board was based on who is the most well-known member in the field and who has membership in the most banks. However, the framework provides rules for selecting Shariah committee members that is not based on these criteria.

Article 4: Composition of the Shariah governance framework

This article demonstrates that the bank must design a Shariah governance framework that emphasises the most essential functions and elements for the framework's effective execution. In fact, this article defines the nine steps for constructing a Shariah governance framework. The author will now discuss the major ones.

- It is emphasised that there are three fundamental pillars in the development of the framework of Shariah governance:

- the board and management duties and effective execution of responsibilities,
- independence and qualifications of the Shariah committee members,
- Shariah compliance, Shariah non-compliance risk management and Shariah internal audit are the internal control functions.
- Controls will apply by the bank to identify and mitigate any potential Shariah non-compliance risk that arises from Islamic banking activities.
- To ensure that Islamic banking activities and operations adhere strictly to Shariah principles and laws, a Shariah internal audit must be performed on a regular basis.
- A department or unit inside the bank should be formed that is responsible for conducting research and studies on the subject of Shariah, alongside a coordination between the management and the committee and a distribution of Shariah-related decisions to all bank stakeholders and those acting as secretariat to the committee.

The study found that Shariah non-compliance risks are significantly emphasised by the framework, as can be seen via the aforementioned factors. As well as enhancing the concept of Shariah compliance, it also demonstrates that there are two distinct functions: Shariah compliance and Shariah internal audit (both are tools of internal controls). Finally, a solution has been reached to the problem of banks who choose not to have internal audits and a Shariah compliance officer, which was highlighted as issues before the issuance of the framework.

Confirming this point, the head of an Islamic banking department at an Islamic window bank stated that:

"In the past, there was an issue with Shariah supervision and audit since most banks did not have a Shariah audit. Because it was a personal concern for the bank".

Therefore, the Shariah governance framework has enabled regulation of the Shariah audit subject and it has emphasised the role of a Shariah compliance function.

Article 5: Responsibilities of the board of directors

Regarding the board of directors (BOD), the framework clearly indicates that the board of directors is primarily responsible for implementing the Shariah governance framework. Therefore, if a bank wishes to offer Islamic products, the board of directors is responsible for ensuring that these products operate in line with the Shariah governance framework. Additionally, the board is responsible for approving all the Shariah policies of the bank and supervising their successful implementation. Moreover, it provides the essential procedures and techniques for risk management that safeguards the interests of profit-loss sharing account holders. In other words, the BOD is accountable for all Shariah-related matters, administrative duties and the implementation of Shariah committee's decisions in order to safeguard and satisfy the needs of the interested stakeholders (BNM, 2010, 2013; AAOIFI, 2010; IFSB, 2006).

In addition, article 5 also stipulates that the board remunerates Shariah committee members based on the nomination and compensation committee's proposal. Such compensation must be commensurate with duties and responsibilities and be in accordance with Central bank's guidelines. A formal mechanism, proposed by the nomination and remuneration committee, must be adopted to evaluate the Shariah committee members' competence, expertise, contribution, and effectiveness.

Article 6: Responsibilities of the Executive Management

The executive management is the second essential organ under the Shariah governance structure. The framework assigns them duties, the most essential of which is the implementation of Shariah decisions issued by the Shariah committee in a timely manner. This involves identifying and referring any Shariah issues to the Shariah committee for their decision and supplying the committee with the appropriate information and disclosures. As an integral part of the day-to-day operations of the IFIs, the management is viewed by the IFSB-3 as an essential body for ensuring that the organisation's direction, and all business transactions, comply with Shariah requirements and serve the interests of all the stakeholders (IFSB, 2006). As a result, the management will guarantee that all the Islamic banking operations are conducted in accordance with the bank's Shariah policies and procedures, and it shall continually evaluate and update these policies and procedures to account for market trends and developments.

According to the Shariah governance framework, if a Shariah violation is discovered, the executive management must immediately inform the board of directors. In fact, the term "management team" refers to the CEO and other members of the bank's management staff. In the eyes of the board of directors, the management team bears both the responsibility and accountability. The CEO and the members of his management team are chosen by the BOD. To ensure that the board of directors has access to relevant and accurate information, the CEO and executive members should be accountable for delivering it. However, the Shariah Review and Control Senior Manager at an Islamic window bank argued that:

"In the event of a Shariah violation, the Shariah governance framework mandates that the bank's executive management must notify the board of directors immediately. But the question here is whether the executive management will report itself in the event of a violation?".

The management is an agent (or wakil) of the BOD and operates as a trustee for the BOD, shareholders, and other stakeholders. Consequentially, it is essential for the management to remain trustworthy at all times and in all situations (Hasan, 2009).

Article 7: Formation of the Shariah committee

The Shariah committee is a crucial actor in Shariah governance since they are regarded as an exceptional element of Islamic organisational structure. Before the issuance of the framework, the Shariah board lacked organisation and was not recognised as one of the board of directors' committees. However, in the context of Shariah governance framework, it has become known as a Shariah committee, not a body because it is considered a committee affiliated with the BOD. As stated by the Shariah Review and Control Senior Manager at an Islamic window bank:

"The Shariah committee was thought to be one-to-one with the board of directors in Islamic banks".

However, the Shariah governance framework demonstrates that the Shariah committee is the same as the audit and risk committees and, thus, the board members are asked to review the Shariah committee's performance.

It is worth mentioning that there are two major components in the framework that are to become mandatory in 2023: the formation of the Shariah committee and the separation of accounts. However, the Shariah Review and Control Senior Manager at an Islamic window bank argued that:

"To be honest these are the heart of Shariah governance".

In the past, the Shariah committee was appointed by the general assembly of the shareholders, but the framework now states that they could be appointed by the board of directors after obtaining the central bank's written approval. In other words, the bank makes the selection and then seeks approval from the central bank. According to a Senior Advisory Consultant at a full-fledge Islamic bank:

"In my perspective, the first situation was preferable because it guaranteed the Shariah Committee's entire independence".

At the same time, the framework states that the bank, whose appointment, and dismissal procedures are determined by the general assembly, abides by its policies. In this case, the framework provides banks with the option of appointing the Shariah committee through the general assembly or the board of directors. Committee membership is limited to three-year periods, and committee members will be selected as follows:

1. The number of members must be proportional to the size and nature of the bank's activity, with a minimum of three and a maximum of five.
2. The committee chairperson must be an independent member.
3. The number of independent committee members cannot be fewer than two-thirds of the total membership.
4. The bank shall not appoint to its committee any member of the Shariah committee of another Saudi Arabia-based bank. This is to ensure that the committee members are more focused, avoids conflicts of interest and keeps material confidential.

In fact, the framework's request for the independence of the Shariah committee members was a crucial feature. However, on 1 January 2023, the criteria for appointing a Shariah committee member will be implemented. This is a concern since it is probable that at this date, all Shariah committee members will resign, as most of them have worked for the bank for more than ten years. Therefore, most banks have already begun adding one or two new members to the Shariah committee to familiarise them with the bank's operations throughout the next year and a half until the start of 2023, to prepare them to lead the Shariah Committee in future.

According to a Shariah Advisory Officer at an Islamic window bank:

"Although the Shariah governance structure mentions a Shariah committee member's independence, there are currently insufficient scholars to occupy these positions".

To resolve this issue, a Shariah Affairs Officer at an Islamic window bank revealed that his bank had initiated a programme for the Shariah committee members. He stated:

"We now have a programme in place within the bank to qualify for members of the Shariah committee, we stand out from other banks because we attracted Shariah professionals, and the programme was a success".

This programme is an intensive one-year and ten-month course that incorporates financial incentives. It comprises business and banking courses, as well as a rotation strategy for the bank's 13 departments. It includes the attendance of Shariah committee meetings as a listener and the enrolment into an intensive English language learning course. Afterwards, following the attainment of his expertise in Shariah, he is qualified for a role on the Shariah committee.

A Shariah Affairs Officer at an Islamic window bank stated:

“We currently have four Shariah committee members, one of whom was in the Shariah committee members' programme”.

The chosen candidates have sufficient years of knowledge of Islamic law; for example, the first group contains three Shariah professors at the university and one judge. The bank has completed the first group, which resulted in one person becoming appointed to the Shariah committee.

Article 8: Membership of the Shariah committee

It is argued that the ideal Shariah board members are Shariah and law experts, particularly in the areas of Fiqh al mumalt and usul al Fiqh (Hasan, 2009). However, the Shariah governance framework clearly specifies the qualifications and knowledge of banking and finance that a member of the Shariah Board must possess. Commenting on this issue, a Vice President and Head of Shariah Division at an Islamic window bank claimed:

“In addition to Shariah knowledge, he possesses business and finance knowledge necessary to perform their primary role in the bank effectively”.

In fact, the author believes that the framework's mention of this point is a clear indication that the role of the Shariah Committee has expanded beyond the function of issuing fatwas, as it was formerly known for, and has become a larger and more effective role in the Islamic Bank. Namely, it has become more involved, and its scope has expanded to become a supervisory role.

In response, the participants were asked, based on their experiences with members of Shariah committees, what characteristics a Shariah committee member must possess. They reached a consensus on this matter as follows:

1. The first requirement is a Shariah qualification, and they should be scholars who specialised in transaction jurisprudence, because it is close to the practical reality of

Islamic banks, and there are scholars who specialise in religious principles. This is regarded as a specialty that is somewhat unrelated to Islamic banking. Therefore, their role is critical because the Shariah governance framework, or the central bank, does not specify what is permissible or not permissible, and it is the Shariah board who determines what is right or wrong from a Shariah perspective.

2. They must comprehend the mechanism of how the banks function, i.e., what the bank is, what its structure is, what its assets are, how the bank runs, what its obligations or accounting issues are, and what its objectives and risks are, alongside the mechanism of the products. Therefore, if they are presented with information, they will be aware of it.

There are certain criteria that must be followed, while selecting the Shariah committee members listed in the framework:

- **Leadership**, a committee member must possess leadership abilities and be able to delegate authority in a manner that stimulates performance, implements best practices in the field of effective management and adheres to professional principles and ethics.
- **Independence**, it is the capacity of a committee member to make decisions without being influenced by the organisation's management or other external forces.
- **Competence**, this is demonstrated by the degree of education, training, skills, and willingness to keep learning, as well as at least five years of diverse experience in a variety of sectors, including Islamic banking, compliance and Shariah audit of financial transactions.
- **Shariah and financial knowledge**, in addition to the ability to read and comprehend financial figures and reports, a member must have basic Shariah understanding.

Article 10: Responsibilities of the Shariah committee

The Shariah board's ideal tasks include ex ante and ex post parts of Shariah governance, such as Shariah pronouncements, oversight, and review (Hasan, 2009). During the interviews, the discussion over the responsibilities and duties of the Shariah committee was extensive and rather contentious. The general consensus was on the first and most crucial role, which is to issue Shariah decisions and fatwas as well as serve on the advisory committee. As stated by a Shariah Review and Control Senior Manager at an Islamic window bank:

"In Saudi Arabia, there is a Sharia committee, which is an advisory committee, not an oversight committee".

Regarding the supervisory role, the answers varied and, by evaluating the responses, it became obvious that within the full-fledge Islamic banks the Shariah committee's responsibility extends beyond that of a mere consultant since it included supervisory duties as well. According to a Senior Advisory Consultant at full-fledge Islamic bank:

"The Shariah committee oversees the Shariah department, which works within the bank".

To unify the Shariah committee responsibilities in Islamic banks (full-fledged and window), the framework addresses the following:

- The committee will be held accountable for all Shariah-related decisions. The board must rely on the committee to issue Shariah decisions concerning Islamic banking activity.
- It oversees Shariah-compliant Islamic banking transactions. Shariah compliance reports and internal audit observations should help the committee identify flaws and provide solutions.
- It is responsible for ensuring that the Shariah policies and procedures implemented by the bank are in accordance with Shariah principles and standards.
- The following must be approved by the committee, so that Shariah compliance for Islamic banking products is assured:
    - The terms and conditions contained in the forms, contracts and agreements used to execute the transactions.
    - The product's instruction manual, marketing adverts, illustrative booklets and brochures.
- It is the committee's responsibility to evaluate the Shariah compliance and the internal audit activities in order to guarantee that Shariah needs are fulfilled. Submission of the reports on Shariah compliance requires this kind of assessment.
- The bank's legal consultant, external auditors or consulting entities can request advice from the Shariah committee on Shariah-related bank activities. The committee shall provide the appropriate assistance.
- If the committee determines that the bank has participated in non-Shariah-compliant Islamic banking activities, it must alert the board and recommend corrective actions.
- The committee must notify the central bank when Shariah-incompatible operations are

not efficiently or adequately addressed or when the bank takes no corrective action.

- An annual report on the bank's compliance with Shariah principles and rules shall all be submitted to the board of directors for review.

When addressing the roles of the Shariah committee outlined in the framework with the participants, the most crucial areas on which they argued were as follows:

1. According to the above, the Shariah committee examines all Shariah matters, major and small. However, the Shariah committee often does not examine every detail in reality as stated by the Head of Islamic Banking at an Islamic window bank:

   "The Shariah department or the Shariah Research Department is the one that searches, as they are constantly present in the bank. The Shariah committee is a consulting group that makes monthly or bimonthly visits to the bank".

   In fact, the Shariah department is frequently mentioned in the interviews, and the analysis of the responses revealed that the Shariah department inside the Islamic bank acts as the executive management of the Shariah committee. As referred by the Shariah compliance manager at a full-fledge Islamic bank:

   "The Shariah committee's executive management (the Sharia administration department)".

   The Shariah department normally does not report to the board of directors and has no relationship with them, but they do report to the Shariah committee. Depending on the size of the bank, the Shariah department's divisions may vary, but it typically involves three divisions: Shariah research and studies, control and audit, and product development (Figure 5.2) .

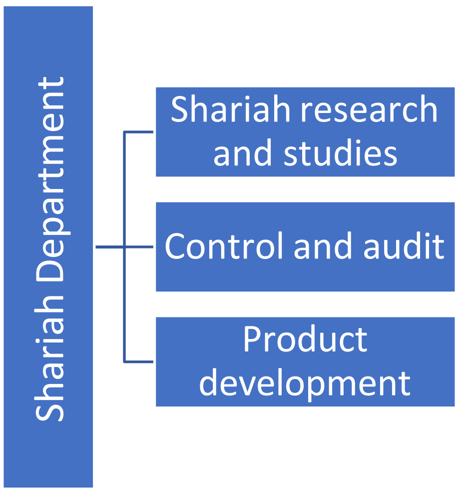

Figure 5.2. Flowchart illustrating the Shariah department's divisions

Naturally, each sector has its own work policy. In this way, the Shariah department serves to coordinate the various issues and procedures related to the Shariah governance process.

The study revealed that the strength of the Shariah department in banks is what creates the difference between the banks in Saudi Arabia. For example, if there is an active Shariah supervision and control department, this is due to the executive management (the Shariah department). According to a Shariah board secretary at a full-fledge Islamic bank:

"The Shariah department is considered bank employees, yet their declaration of the decision must be heard".

2. It is worth noting that the Shariah governance framework grants the Shariah committee the authority to address the central dank directly, which means that if the BOD ignores the Shariah committee's observations, the Shariah committee may address the central bank directly. While this may signify independent to an exceptional degree, according to a Shariah Review and Control Senior Manager at an Islamic window bank there are, however, still issues:

   "My concern is how the Shariah committee will know there is a problem inside the bank?".

   There is an explicit call to grant the Shariah department independence because, as demonstrated in the preceding paragraph, they are the executing body for the Shariah committee's decisions. As asserted by the Chief Risk Officer at a full-fledge Islamic bank:

   "One of the Shariah department's primary functions is to engage with other departments while performing good management, most notably the risk department".

3. There was widespread consensus that the Shariah committee does not develop the policies and procedures. According to VP Risk Manager of Operational Risk at an Islamic window bank:

   "The Shariah committee do not prepare the policies. However, under the Shariah committee is the Shariah department who review this credit policy and if there any inquiry or any conflict or labs and need more clarification then they will send it to the Shariah committee".

   The thoughts of the participants on this matter are shaped by the fact that the Shariah committee does not include bankers who review policies and procedures. They are not expected to do so, since it is the responsibility of the Department of Shariah Compliance and the Department of Sharia Audit. Therefore, they take the Shariah committee's decisions and fatwas and transform them into policy, or they make sure that the other departments' policies and procedures are consistent with Shariah principles as well as the Sharia committee's decisions.

Article 13: Independence

The independence of the Shariah committee is crucial because our efforts to implement the Shariah governance framework will be meaningless without it. The IFSB-10 defines the independence of the Shariah board as the capacity to exercise sound judgement following a fair evaluation of all the relevant information and perspectives, without management influence or inappropriate outside interests. However, the key factor here, and the major challenge, is how to achieve the Shariah committee's independence. This Section is concerned with the Shariah committee's independence in carrying out its duty to provide impartial and reliable Shariah decisions. The independence of the Shariah committee must always be maintained as follows:

- The board must acknowledge the committee's independence and protect it from any interference that would prevent it from making objective Shariah decisions while deliberating matters.
- The committee shall report directly to the board.
- Without the committee's consent, the Shariah rulings it issues should not be set aside or altered.
- The management must provide accurate and complete information to the Shariah committee. The committee may request additional information from management if the information supplied is insufficient.
- Lastly, if the committee is not given the information needed, the board must be notified, and suitable measures must be taken to address the problem.

The above points show that the Shariah committee's independence is respected by the framework, but many of the participants argued that the committee could be even more independent if it reports to the shareholders instead of directly to the board of directors. As declared by an expert in Islamic Economy & Finance and a board member:

> *"I believe that the Shariah committee within the bank should report to the shareholders, giving it greater independence, more authority and keep it free of conflicts of interest".*

Considering that it is impossible to establish a Shariah governance system without the existence of the Shariah committee, the granting of unrestricted independence to the Shariah committee by allowing it to report to the shareholders would have a significant impact on reducing the agency problems, promote the objectivity of Shariah decisions and boost the confidence of interested parties. Freedom and objectivity in performing its duties are hallmarks of an independent Shariah committee, as described by El-Khelaifi (2005).

Abidin et al. (2020) argued that the Shariah committee's independence is under risk due to its reliance on remuneration and renewal terms established by IFIs. To ensure the integrity of Shariah compliance standards and investor confidence in IFIs, it is crucial to establish a Shariah committee that has complete independence.

The author believes that, with regards to compensation and rewards, we know that the Shariah committee takes its remuneration from the same Islamic bank in which it performs the role of control and supervision. Even internal or external Shariah audits takes their reward from the institution, in addition to the persons in the Shariah compliance and legal departments, as well as those in the credit ratings position who play a very important role in providing an impartial and independent opinion. Undoubtedly, this weakens objectivity and is sensitive in terms of the true independence of these parties, which provide important and dangerous opinions on the decision of the investor or the client.

Undoubtedly, as much as we have been able to enhance the independence of these bodies, including the Shariah committee, we can reach more accurate and more effective results.

Article 16: Internal Control

Shariah control is one of the most essential components of an Islamic bank's structure since it constitutes a fundamental pillar. Every organisation, including IFIs, acknowledges internal control as one of the most important processes or procedures (Kamaruddin and Ramli, 2018). Specifically, this is because effective internal control aids in the management of possible risks, coordinates organisational activities and facilitates sound decision-making (Devi et al., 2007). The study revealed that there was a hole in the internal control before the release of the framework inside the window banks, which means that the level of internal control at Saudi Arabia's Islamic banks varies from one bank to another.

The framework covered three functions under the internal controls, these are examined below.

Shariah Compliance

Compliance with Shariah is a top priority for every Islamic financial institution. However, the level of compliance differs from institution to institution depending on the robustness of an Islamic bank's internal control system. The study found that Shariah compliance is not an essential function for some window banks, as it is integrated with Shariah auditing. However, describing the Shariah governance framework for internal control tools, and naming the Shariah compliance function as the first tool that demonstrates its significance, involves a distinct function with its own objectives, responsibilities and policies. According to the framework, the Shariah compliance function refers to the regular evaluation of the bank's Islamic activities and operations to ensure that they comply with Shariah.

Shariah compliance, in the words of a Shariah Control Officer at a full-fledge Islamic bank, can be understood as:

"Shariah compliance is the process of reviewing policies and processes for products to ensure they adhere to the shariah policies".

While according to a VP of Shariah Assurance, Shariah Advisory & Governance at an Islamic window bank:

"Shariah compliance is the Shariah assurance, which is goes around ensuring that whatever fatwas issued by scholar are implemented in the bank and specifically products".

The framework states that there are two main Shariah compliance functions:

I. Assuring the bank's compliance with Shariah principles and rules, as well as corrective actions to solve non-compliances and control mechanisms to prevent recurrences.
II. The bank's overall Islamic banking operations, includes the development of Shariah-compliant products, beginning with the product structuring and ending with the product offer to consumers.

The study discovered that Shariah compliance is an integral part of the Islamic product life cycle, which takes the form of three phases:

B**efore implementing the product**, ensuring that the product has been approved by the Shariah committee and that the contracts, procedures, and regulations are completed appropriately and in accordance with Shariah.

During the implementation, continually examine the mechanism for conducting operations and interfering with systems. Since this is the age of automation, make sure that the systems associated to the product are properly programmed.

The final stage is auditing, which involves checking the operations that have been implemented, because each Islamic product has its own procedures and steps. For example, in sales contracts, it must first be ensured that the bank actually bought and owns the commodity before selling it to the customer, so this process must be carried out in a legitimate and correct sequence. It is incorrect for a step to come before or after another step since it impacts the transaction's legitimacy.

According to the Head of Shariah Compliance at a full-fledge Islamic bank, the Shariah compliance responsibilities can be summed up as follows:

1) Reviewing the bank's policies and procedures, as well as all aspects of the life cycle of Islamic products, including advertising campaigns, to guarantee conformity with Shariah committee decisions.
2) Ensuring that the bank's operations comply with the Shariah committee's regulations.
3) Conducting consultations and surprise inspections to determine Shariah compliance and generate a report on the matter.
4) Acting as an advisor on potential Shariah risks and provide recommendations for their mitigation.

Shariah non-Compliance risk management

In Chapter 4, the author provided a comprehensive discussion on the Shariah non-compliance risk, including its definition, classification, associated consequences and management. This previous discussion was from the perspective of risk; now, we will examine it from the viewpoint of the Shariah governance framework. As discussed earlier, there was a debate among the participants regarding who is responsible for managing the Shariah non-compliance risk: some believed it was the responsibility of the Shariah department, while others thought it should fall within the Risk Management Department's scope.

The study revealed a clear correlation between the Shariah committee, internal control, and the Shariah non-compliance risk. This means that the Shariah committee issues a fatwa or a Shariah decision on a particular product, but the commitment to its implementation is very weak. This is due to the bank's weak internal control system, which affects not only the bank's reputation but also the reputation of the members of the Shariah committee who issued the fatwa. Managing the risk of Shariah non-compliance requires the oversight of the Shariah committee; in other words, the Shariah scholar is only delivering decisions and issuing fatwas, while there should be effective communication with the Shariah department.

According to the framework, Shariah non-compliance risks can be mitigated by systematic risk management and adapting to the following:

- The bank's Shariah non-compliance risk management function must be viewed as an integral element of the institution's overall risk management strategy.
- It is imperative that risk officers with appropriate qualifications and expertise in the field handle the responsibility of managing the Shariah non-compliance risk because of the sophistication and complexity of the task.

Therefore, the framework expressly specified that a risk officer should be accountable for managing the Shariah non-compliance risk, thereby ending the debate of who is responsible for managing this risk. The evidence suggests that it is effective to be included in risk management, and more specifically in comprehensive risk management, as it is the bank's comprehensive framework and must be consistent with the board-approved risk appetite of the bank. But risk management and the Shariah department should work cooperatively to ensure that Shariah non-compliance risk is managed and mitigated appropriately; thus, risk management should operate in parallel with the Shariah governance framework. Consequently, Islamic banks must have a specialist division under the risk management that enables the creation of a complete framework for managing Shariah non-compliance risks.

In response, the participants were asked about who is currently managing the Shariah non-compliance risk. The following are some of their responses.

A Senior Advisory Consultant at a full-fledge Islamic bank claimed:

"We do not yet have a department specialised in Shariah risks, The Risk Management Department is the one who manages all kinds of risks, knowing that all employees in this department do not have any Shariah background".

A Shariah Review and Control Senior Manager at an Islamic window bank stated:

"There is a Department of Islamic Financial Services. It is included in risk management. Among the department's responsibilities is the management of Shariah non-compliance risks. It consists of ten individuals that are qualified to perform this function".

A Vice President and Head of Shariah Division at an Islamic window bank declared:

"The Shariah department manages Shariah non-compliance risk in collaboration with the bank's Operational Risks Department, ensuring that this type of risk is mitigated. Perhaps in the future it will have its own department".

As stated in Chapter 4, controlling this type of risk involves first a comprehensive understanding of Islamic products and then risk management. Consequently, it is necessary to start develop a shariah risk officers.

Internal Shariah Audit

The final and most critical point is the Shariah audit. The Shariah auditor checks everything related to Shariah, annually or semi-annually. They review all processes, particularly the product process, to ensure their Shariah compliance. The framework defines the Shariah audit as an independent assessment undertaken to provide objective assurance that adds value and increases the level of compliance regarding the bank's Islamic operations and activities, with the objective of creating a strong and effective internal control system for Shariah compliance.

Furthermore, the following should be considered:

- Internal Shariah audits on areas of relative importance must be performed at least once a year, depending on the bank's risk profile.
- The board audit committee shall define the deliverables of the internal Shariah audit function following consultation with the Shariah committee.
- The Shariah audit function must be carried out by internal auditors who have received suitable Shariah-related training and knowledge.
- Internal Shariah audit results and observations must be presented to both the board audit committee and the Shariah committee.

In the past, internal Sharia audit reports were solely sent to the Sharia committee. However, according to the framework, a copy of this report will be sent to the Shariah Committee, and a second copy will be sent to the Internal Audit Committee, which was appointed by the Board of Directors. The author believes that this is a major step because the Shariah Committee examines the report purely from a Shariah perspective, determining whether it is compatible with Shariah or not, for example, if there is a purification for profits, or a decision to discontinue a specific product, or, for example, a warning to the employee who caused the Shariah mistake.

However, the Internal Audit Committee considers risks in a broader and more general sense, which is a method of mitigating risks in all ways. As a result, the Internal Audit Committee has gotten involved in the Sharia report audit and oversees the Sharia risks.

In fact, the subject of Shariah audit was an issue that was greatly discussed within the interviews; it was concluded that the framework did not address it as expected. The existing

Shariah governance framework does not address several critical issues, such as:

1. Shariah auditing is important, and its independence is required, as is the independence of the internal and external audits. Unfortunately, the Shariah governance framework called for the Shariah audit independence but offered no indication of how they would obtain it. In commenting on this issue, the Shariah Review and Control Senior Manager at an Islamic window bank said:
   "To this day, window banks lack Shariah auditing independence! The Shariah audit must be independent under the given framework. What does the term "independent" mean? In other words, there is no detailed explanation of the mechanism provided".
2. In the Shariah governance framework, it is stated that the Shariah audits are to be performed on departments of 'relative importance'; what does relative importance mean? There is no mention of it in the framework. It is likely that the bank will only audit one department per year and declare that this is the sole department of relative importance in the bank.
3. The framework does not address the administrative hierarchy, which means that who, for example, audits the Shariah audit employee? The presence of a Shariah auditor does not imply that Shariah governance has been achieved; it must be supervised, as it is natural for the auditor to make mistakes.
4. Lastly, the framework was silent on the application of the external shariah audit. In other words, the central bank has not requested an external shariah audit. Commenting on this, Shariah Advisory Officer at full-fledge Islamic bank:

"There must be a shariah external auditor, because one of his responsibilities is to evaluate the internal auditor, or to evaluate the Sharia governance controls".

Article 17: Islamic Window Operations

The study's findings demonstrated a clear distinction between full-fledge Islamic banks and Islamic window banks in terms of Shariah control, the number of specialist employees, credibility and transparency, organisational structure, and general compliance environment. In fact, this indicates that Shariah is not a priority for the bank's internal management or the board of directors. Thus, the central bank must impose mandatory Shariah governance to ensure that the issue is equal in all full-fledge and window banks and to set a minimum limit for the issuance of decisions.

This article presumed that window banks provide Islamic products under the following conditions:

- The bank is required to maintain separate accounting records for Islamic banking operations and to ensure that these records are kept properly.
- The bank must prepare separate financial statements for its Islamic banking operations, alongside its periodic financial statements, at least monthly.
- Internal audits must be performed at least once a year to ensure that the bank is following the standards outlined in paragraphs 1 and 2 of the frameworks.

Hence, this article will be enforced starting from 1January 2023.

Conclusion and Summary

This chapter's findings contribute to the existing literature concerning the influences of shariah governance on the development of the Islamic banking industry in Saudi Arabia. In addition, the chapter outcomes contribute novel value to the body of knowledge on Shariah governance in full-fledged Islamic and window banks. Also, the author develops a new definition of shariah governance that combines agency and stakeholder theories to enrich scholarly discussion in the field of shariah governance.

Further, the study has significant contributions to the central bank and Islamic banks in Saudi Arabia. In particular, the research findings will be beneficial to the central bank and Islamic banks to enhance existing shariah governance systems. Since the study advocates the use of Sharia governance within each bank, or internal Shariah governance, which means that any issues not covered by the central bank's Sharia governance framework must be addressed by the bank itself.

This Chapter has attempted to examine Shariah governance in Saudi Arabia comprehensively. This evaluation enabled a closer inspection of the situation of Islamic banking prior to and after the issuance of the first-ever Shariah governance framework, identifying the strengths and weaknesses that must be addressed and improved. It also examines whether the degree of adherence in implementing the Shariah governance framework varies or is the same for the full-fledged Islamic and window banks.

The findings of this chapter are consistent with the stakeholder theory. According to the stakeholder theory, all stakeholders that influence a company's performance are crucial to its success (Al-Nasser and Muhammed, 2017). In the study context, the firm is the Islamic bank, and the study reveals that the Shariah committee plays a significant role in the Islamic bank; therefore, they are considered to fit into the stakeholder theory. This is in fact consistent with other research results (Ramly et al. 2018; Khalil and Taktak, 2020; Almutairi and Quttainah, 2020). The research, however, finds that, under the shariah corporate governance structure, other stakeholders are fundamental to Islamic bank performance, specifically the shariah internal control division, which includes a shariah audit and a shariah compliance division. Moreover, the findings of this chapter are consistent with the agency theory. This study advocates that the Shariah Board is a substitute for the conventional board of directors (Ghayad, 2008) in order to ensure shariah compliance and, therefore, minimise the shariah non-compliance risk. The shareholders and managers have asymmetric information and divergent interests; therefore, the existence of an independent body named the Shariah Committee guarantees that the maximisation of profit is done in a shariah-compliant manner. Agency problems arise in Islamic banks due to the divergent goals of the BOD, managers, and shariah committee (Basiruddin and Ahmed, 2020). As a result, the study recommends affording the Shariah committee complete independence by enabling it to report to the shareholders, which would have a substantial influence on eliminating agency problems. To this extent, the next chapter will answer the thesis's main question.

Chapter 6: The Impact of Shariah Corporate Governance on Risk Management

Introduction

It is generally accepted that risk management practices must be supported by robust corporate governance standards, particularly in complicated businesses such banking. The concept of risk and corporate governance in banks, particularly following the recent financial crisis, has received considerable attention from policymakers, bankers, stakeholders, and academics. Evidence suggests that banks with poor governance framework undertake excessive risks. Regarding Islamic banks, Shariah governance is a risk management mechanism for Islamic banks.

In Chapter 4, the forms of risks faced by full-fledged and window Islamic banks in Saudi Arabia were examined, whereas in Chapter 5, the Shariah governance framework in Saudi Arabia was investigated. This chapter covers the core question of the thesis: What role does Shariah governance play in the management of common risks (i.e., credit risk, market risk, liquidity risk, and operational risk) and Shariah risks?

This chapter focuses on the fourth theme, which is the shariah governance and risk management. Primary data were collected via semi-structured interviews with practitioners from both shariah governance and risk management. In addition, the findings of Chapters 4 and 5 improved the examination of the unique relationship between shariah governance and risk management. The following is how this chapter is to be organised. First, the author explains the three lines of defence concept and how it applies to Islamic banking, and then the author reveals the three lines of defence model in Islamic banks. In addition, the role of Shariah governance in risk management is examined. In this section, the author describes shariah governance in relation to each type of risk, namely credit, liquidity, market, operational, and shariah noncompliance risk. Finally, the role of risk management in forming an effective Shariah corporate governance framework is discussed.

6.1 The application of the three lines of defence concept to risk management in Islamic banks

Shariah governance implies adherence to Shariah regulations. Deviation from these regulations is considered a Shariah non-compliance risk. In other words, Shariah governance exists as a monitoring mechanism for Shariah compliance. From an industry standpoint, Shariah governance and compliance have a number of functions. To understand this issue, it is imperative to shed light on the three lines of defence model. This provides a simple and effective method for organisations to delegate and coordinate control system, risk management and independent assurance responsibilities in a systematic manner (IIA, 2013). However, the author believes that the aim of the three lines of defence in Islamic banks is to make sure that Shariah mandates are enforced throughout the structure of the bank. Furthermore, it spreads the word that Shariah compliance is not an isolated task but rather a multi-step procedure.

Despite the importance of this topic, studies on lines of defence in Islamic financial institutions is limited (Hakim, 2017). During interviews, most risk managers refer to this model when discussing the presence of Shariah governance in the banking control system. As confirmed by a VP-Risk Manager of Operational Risk at Islamic window bank:

"Any bank around the world has three lines of defence (this is the language that all people in banks knows about)".

The study found that, in practice, **the first line of defence** is the business unit (personal finance or front offices who interact with the clients) or the team and personnel who sell and operate the Islamic products. To enable them to be empowered to fully fulfil their role in Shariah compliance, they must receive the necessary training, coaching and guidance as needed, as well as obtaining internal documentation.

According to a credit risk manager at Islamic window bank:

"In the first line of defence every single document in the bank (policies and procedures) must be reviewed from a Shariah standpoint".

To have the necessary internal controls, the manual and procedures should be reviewed from the standpoint of Shariah compliance. For an Islamic window bank, it is the Head of Islamic Banking that will be leading the first line of defence. According to a Head of Risk Management at a full-fledged Islamic bank:

"Inevitably, all these team members must have received training on Shariah compliance, and all the operational manuals must contain all Shariah compliance measures".

In line with this comment, to accomplish their tasks efficiently, Hakim (2017) argued that the first line of defence must be to consistently improve their skills and knowledge in Shariah. Additionally, it is the responsibility of the first line of defence to deal with any possible risks that can arise while doing business, including Shariah non-compliance risk.

According to an Internal Audit - Risk, Finance and Treasury Manager at an Islamic window bank:

"First defenders have the duty to alert the second line if there is any Shariah non-compliance risk".

Therefore, **the second line of defence** consists of the Shariah research and advisory, which advises the bank as required, and the Shariah compliance team, which assists with day-to-day operations. Some banks may have a Shariah non-compliance risk officer, who may be part of the risk management department or the Shariah compliance department. Consequently, as the second line of defence, they must assure that the first line of defence is effectively managing all risks including the Shariah non-compliance risk (Hakim, 2017).

According to a VP-Risk Manager of Operational Risk at an Islamic window bank:

"The second line include three critical elements; Shariah compliance, risk management and Shariah department (review and ensure the design of Islamic product, the structure and give signs of pre launching)".

In fact, this second line of defence is part of the Shariah governance who must approve each single Islamic product (even the renewal of the product).

The third line of defence is the Shariah audit function, which could be under the Shariah department or the audit department. The Shariah audit should be in coordination or consultation with the Shariah committee and the audit committee. The Shariah audit (independent department), as a third lines of defence, monitor the implementation of risk management. They make sure that the bank's policies and procedures and the mandates of the central banks are followed and implanted. Their review includes the governance practices, committees' responsibilities, review product and the applied system. After a Shariah auditor begins an inspection against Shariah policy, the findings report is sent to the Shariah committee, audit committee and the business department to be signed; this report has a target date for the remediation and correction plan. This acts as a kind of supervisory role. According to a Shariah Control Officer at a full-fledged Islamic bank:

"The third line of defence is critical since it represents an independent assurance".

Consistent with this reasoning, Hidayah (2016) highlighted that the third line of defence consists of independent assurance of the most important controls, which adds value and improves the efficiency of the institution's operations including the aspect of Shariah compliance.

To summarise, the goal of the Shariah audit is to provide a reasonable assurance to the Shariah committee and the board of directors of the compliance of the executive management or the Shariah department with the Shariah committee's instructions. In other words, they provide assurance about the Shariah compliance of the 1st and 2nd line of defence. Figure 6.1 displays a depiction of this process.

Following an analysis of the interviews with the risk managers, Shariah auditors, Shariah compliance officers and other specialists in the field of Islamic banking, the author proposes a three lines of defence model for Islamic banks. The model is based on the fatwa and decisions of the Shariah committee, the bank's policies and procedures, and the central bank's mandates. This framework should govern the responsibilities and duties of every line of defence.

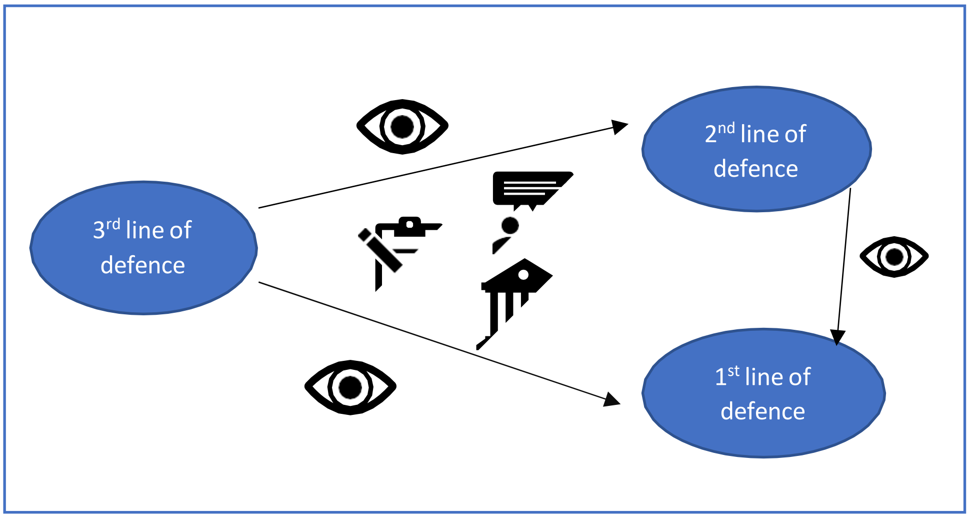

Figure 6.1. Three lines of defence in an Islamic bank.

6.2 The role of Shariah corporate governance in risk management

The study revealed that Shariah governance and risk management are intrinsically connected. This section examines the role that the Shariah governance framework plays in risk management, focusing on the role of the key participants in Shariah governance (i.e., the Shariah committee, Shariah compliance and Shariah audit). The study found that the role of Shariah governance in risk management is to ensure that risk management does not create a Shariah non-compliance risk, since Shariah non-compliance risk can be entangled with any type of risk. In fact, during the interviews most of the participant agreed that the purpose of the Shariah governance is to mitigate the Shariah non-compliance risk, as stated by Head of a Shariah Division at an Islamic window bank:

"Shariah governance, as a framework, has nothing to do with credit risk; rather, it is concerned with managing the Shariah noncompliance risk".

However, after examining Chapter 4, i.e., the forms of risks faced by full-fledged and window Islamic banks in Saudi Arabia, alongside Chapter 5, the Shariah governance framework in Saudi Arabia, the findings show that Shariah governance, as a framework, influences all risks including credit, liquidity, market, and operational risks. This is because non-compliance with Shariah during the mitigation and product development processes contributes to a Shariah non-compliance risk. Shariah non-compliance risk, as defined by the author in Chapter 4, is a regulatory risk that bears a zero-risk tolerance: either a bank adheres to Shariah laws, or it does not (there are no shades of grey). Shariah risks are associated with specific laws and regulations. As a result, these regulations do not offer authorisation not to apply them, and no-one may manipulate not applying these requirements. Therefore, Shariah governance takes effect in terms of product structure, definition, development, price, and risk management; even lending purposes should be Shariah compliant, such as the exclusion of alcohol and tobacco.

6.2.1 Shariah governance and credit risk

Credit risk refers to an uncertainty over whether a debtor will pay off their debt. As a result, the risk management team will use measures like collateral, mortgages and guarantees to mitigate the risk. The research findings revealed that the relationship of the Shariah Committee with credit risk is remarkably close and effective, whether for the purpose of financing or coverage. This is consistent with the results of Aslam and Haron (2021), who found that a Shariah board has a positive and significant relationship with credit risk.

The Shariah committee's role here is to issue fatwas that involve taking Shariah compliant guarantees. For example, if the bank wants to finance the customer and the client does not have land to pledge as a guarantee or mortgage, but he does have a deposit with the same bank, he pledges the deposit to obtain the financing. However, even the deposit must be Shariah compliant and if the customer only has a conventional deposit and later defaults on payment, in this case, the bank seizes only the deposit's capital and not the interest. All these rules can be found in the bank's credit policies, in which there is a section dedicated to Islamic banking. Moreover, to show how the Shariah governance reflects on the credit policies, according to a Risk Manager at an Islamic window bank:

"In the credit policy of the bank there is a part that discusses the credit policy for the Shariah product, the structure of the product and the risk treatment".

Another example illustrates the Shariah committee's relationship with the credit risk management policies, as stated by Shariah Supervision and Shariah Compliance manager at an Islamic window bank:

"I personally witnessed this case, a large company wanted large financing, but when the guarantees were submitted, they were in the form of shares, which were not compatible with Shariah, so the Shariah Committee rejected the guarantee provided because these shares cannot be a cover for this finance or debt".

In other words, risk management when developing credit risk management policies considers the Shariah rules, because they cannot take collateral that is not Shariah compliant. As a result, the relationship between the Shariah regulations and credit policy is evident and influential. Therefore, the Shariah committee are aware of the credit risk mitigation process since they are engaged in the structure, documentation, and approval of various risk mitigation measures. According to the chief risk officer at an Islamic window bank:

"In an ideal situation, they should be aware, because when a credit policy is implemented, it is approved by the Shariah committee, in other words, the credit policy is appraised by the unit money laundry and reviewed by the compliance department to ensure compliance with bank regulations, as well as referred to the Shariah committee to ensure compliance with Shariah regulations. Finally, they ensure that it complies with operational risk, which includes risk assessment and control tasks".

As a result, the Shariah committee do not prepare the policies. However, the Shariah department review this credit policy and if there are any inquiries or conflicts that need more clarification, they will send them to the Shariah committee. As clarified by the manager of the Shariah compliance department at a full-fledged Islamic bank:

"The Shariah committee are not bankers who review policies and procedures. This is not their role. This is the role of the Shariah Compliance Department and the Shariah Audit Department within the framework of Shariah governance".

Specifically, they take Shariah decisions and fatwas from the Shariah committee and turn them into policies or verify that these policies and procedures will be prepared by different departments in a manner consistent with Shariah principles and Shariah committee's decisions. According to a Risk Manager at an Islamic window bank:

"The Shariah committee are aware of the credit risk policies especially when it comes to penalties".

In the event of a default, if a customer fails to pay, for instance, for two months, the Islamic bank is not able to charge an additional amount unlike conventional banks. However, they must charge a penalty that is donated to charity. Shariah governance, or more specifically the Shariah committee, will become part of this process as they must decide how they will cover the default payment. According to the Head of Shariah Compliance at a full-fledge Islamic bank:

"The Shariah committee plays a direct and supervisory role in establishing the regulations for collecting delay penalties and allocating these fines to the appropriate parties".

To demonstrate a mitigation that increases the Shariah noncompliance risk, consider the following example. If someone on the risk management team states: "If the client is late, we will add additional charges and don't call it interest charges, call it administrations charges", it is a mitigation process from the credit risk management perspective. However, from a Shariah standpoint, this administration charge should be reviewed to ensure that it truly reflects the administration cost and not a cost of opportunity because ideally the bank should not charge anything. Although, in reality, if there are some actual charges in following up by sending letters to the client or employees who spend extra hours filling out forms to be sent to late clients, the bank does have the right to charge a fee to cover these costs, but the bank has no right to profit from someone's financial difficulties.

Another example is the case of Murabaha financing, in which a customer buys a house and ownership is transferred to the customer. If there is a default payment, what are the repercussions, given that ownership has already been transferred to the customer? To avoid such a problem, the role of the Shariah committee in this situation is to require a guarantor at the beginning of the contract. Consequently, Shariah governance has a mechanism to regulate and manage credit risk, which demonstrates a strong relationship between Shariah governance and risk management.

To create a robust Shariah governance system that represents a sound risk management, the Shariah committee cannot perform the mission alone; namely, Shariah compliance and Shariah audit departments must provide constant supervision and oversight.

6.2.2 Shariah governance and liquidity risk

The study found that Islamic banks in Saudi Arabia face a liquidity risk due to a lack of flexible instruments to manage short- and medium-term liquidity. Short liquidity may last one or two days, and Shariah instruments are less flexible. Accordingly, Islamic banks' liquidity issues are caused by a lack of instruments rather than a lack of liquidity coverage (Bello et al., 2017).

In addition, Islamic banks lack Shariah investment channels, resulting in stagnant liquidity and reduced liquidity management efficiency. Therefore, Islamic banks are unable to manage this liquidity efficiently. Thus, creating financial tools to manage liquidity in a Shariah-compliant manner is one of the Shariah functions. In fact, there has been no research on whether or how the Shariah committee effect the liquidity creation of Islamic banks (Safiullah et al., 2020).

During the interviews, there was consensus that liquidity risk is primarily associated with risk management, and that Shariah governance has a limited effect on liquidity risk compared to credit risk. According to a Risk Management Specialist in Islamic finance:

"In fact, I cannot see that Shariah governance has an effect on managing liquidity risk".

Similarly, Head of Shariah Division at an Islamic window bank stated:

"Shariah governance has nothing to do with liquidity management; rather, it discusses Shariah non-compliance risk and NOT discussing credit, market or liquidity risks in detail".

In general, the participants believed that the reason is that Islamic banks do not have a mechanism like conventional banks, where their investors' money must be retained with the capital plus interest, however, Islamic banks are based on the concept of partnership. This means that, if the investment loses money, Islamic banks do not have to pay money to the other party. Additionally, if consumers make a deposit, this money will be returned to them at some point; this is a safekeeping promise. Moreover, the investment is substantially less risky than conventional banking. Consequently, this is essentially regular risk management.

Safiullah et al., (2020) found that the presence of a Shariah committee can ensure prudent liquidity generation by resolving Shariah-related operational difficulties and it indirectly supports the expansion of Shariah-compliant financial products and the scope of liquidity creation. Therefore, the author believes that, while the study found that Shariah governance has a limited impact on liquidity risk, this does not rule out its presence. Shariah governance plays a crucial role, given that Islamic banks are prohibited from taking speculative positions such as futures and options, which violates Shariah. As a result, the Shariah compliance and audit departments should have control over how liquidity risk is managed, because a failure of the internal control system to detect such a breach would result in Shariah non-compliance risk, which could result in purification or reputational risk. Consequently, investment funds would be withdrawn, resulting in a liquidity crisis (Hamidi, 2006).

However, the Head of Risk Management at a full-fledge Islamic bank has a different view regarding the role of internal controls in controlling and managing liquidity risks in Islamic banks:

"No, it has nothing to do with liquidity management; the internal control department is just an audit and review function, and here the difference between risk management and audit always arises. Risk management is the day-to-day management of operations, if a substantial risk exists, it submits a report to related department to mitigate or avoid that risk, and then submit a report back to risk management with corrective action. However, if the department does not take action to mitigate the risk, risk management sends the report to the Risk Committee".

The implication of this statement is that Shariah governance may not interfere with the management of liquidity risks, but it does certainly interfere in monitoring the management of liquidity risks so as not to result in Shariah non-compliance risk.

6.2.3 Shariah governance and market risk

Market risk, by definition, necessitates regular managerial attention and adequate analysis (Van Greuning and Iqbal, 2008). Market risk is an ever-present concern for Islamic banks and a constant companion to their Islamic products. By offering Islamic financial products, banks are exposed to market risk that affects the value of assets for the duration of the contracts (Akkizidis and Khandelwal, 2007). Islamic banking is distinguished by its asset-based basis, which has stronger ties to the economy than conventional banking. To generate a profit, Islamic banks must engage in economic activities, such as sales or leasing contracts, which increases their exposure to market risk. However, the study discovered that the scope of market risk in Saudi Islamic banks is limited. According to a Risk manager at an Islamic window bank:

"In general market risk, it is not significant in Islamic bank compared to other risks. However, we cannot say it is free of market risk".

The study found that Islamic banks in Saudi Arabia (full or windows) only deal with certain Islamic products like Murabaha, Ijarah and Tawarq. Market risk, according to Ahmed and Khan (2007), was at its lowest in Murabaha and then Ijarah. In terms of mitigating the market risk, it requires a mitigation process that is Shariah compliant. To illustrate this point, when an Islamic bank buys a commodity through the London Metal Exchange, and it has a broker agreement that states that it can buy an asset and return it within 48 hours if the Islamic bank would not complete the transaction with the client. Hence, there is a market risk here but because of this control (i.e., the 48 hours) it is mitigated in a Shariah compliant way. In fact, this control demonstrates the participation of the Shariah committee in market risk management. As confirmed by the Shariah Advisory Officer at a full-fledge Islamic bank:

"The Shariah committee has a part in offering these risk-reduction strategies, such as the client's promise of purchase, as well as the margin of seriousness, as well as an agreement with the supplier of the goods to give the bank a term to return the items if the customer changes his mind".

However, a Market Risk Manager at an Islamic window bank stated:

"When the risk management team designs a market risk mitigation process, the Shariah department must review it to ensure that the mitigation process is also Shariah compliant to avoid future consequences".

Future repercussions associated with the possibility of Shariah non-compliance risk, when there is a Shariah non-compliance risk, can include profit loss, loss of credibility and reputation, or penalties. When considering the above discussion, it can be determined that the Shariah committee provides a fatwa on risk mitigation or risk evaluation from the Shariah perspective, and the Shariah department guarantees the fatwas execution. In fact, participants agreed that the Shariah department acts as the Shariah committee executive management. Furthermore, they indicated that managing market risk requires continuous oversight and transparency from the market risk manager. According to a Market Risk Manager at an Islamic window bank:

"Managing market risk in Islamic banks is sensitive, that require a high degree of control… it is about numbers, one can easily play with numbers".

Reyad et al. (2022) found that market risks in Islamic banks can be eliminated through effective governance, proper training, and constant monitoring of price movements in the market, as well as timely decisions. According to agency theory, an effective Shariah board can reduce agency conflicts and information asymmetry between management and shareholders by providing beneficial and impartial supervision of the Shariah-compliant products and operations (Safieddine, 2009). It is important to have effective governance from both the Shariah control department and the Shariah committee to ensure that all the rules and regulations outlined in Shariah are followed. The Shariah committee oversight is critical when controlling the risk; in other words, the Shariah committee only provides their judgments and issue fatwas, while there should be effective communication with the Shariah department. Aligned with this view, Safieddine (2009) asserted that the Shariah committee's major functions and responsibilities include developing Shariah-related rules and overseeing compliance. These responsibilities of the Shariah committee make Islamic banks more secure and less risky (Nguyen, 2021).

For the Shariah committee, if the oversights are to be effective, they should be equipped with the right knowledge. According to the Chief Risk Officer at a full-fledged Islamic bank:

"Market risk is highly related with an interest rate such as SAIBOR, and commodities prices and FOREX, so the Shariah committee have to be highly technical on this subject".

Safiullah and Shamsuddin (2018) found that advanced academic qualifications can help the Shariah committee members to appropriately assess the risk implications of Shariah-compliant banking and then provide recommendations for the development of internal risk-hedging procedures. Consequently, Shariah governance will be effective when managing market risk; however, the Shariah committee should be highly competent in both conventional and Islamic banking, as market risks include benchmark risk, rate of return risk (profit rate risk), commodity price risk and currency risk. These are extremely technical phrases that must be understood. The Shariah governance framework or the central bank does not indicate what is either acceptable or not permissible, so it is the Shariah board's task to evaluate what is acceptable or not from a Shariah standpoint. Accordingly, in addition to Shariah expertise, they must also possess the business and finance skills need to efficiently fulfil their primary role in the bank.

6.2.4 Shariah governance and operational risk

Since Islamic banks have unique regulations and procedures, in this regard operational risk is substantial and has a direct correlation with Shariah risk. In addition, the rulings of the Shariah committee represent an extra requirement. These decisions must be reflected in the policies and procedures governing the products of Islamic banks. According to an Operational Risk manager at an Islamic window bank :

"Operational risk depend on the process and this process should specify steps to comply with Shariah requirements".

The study discovered that the Shariah audit is crucial for the monitoring of operational risk. The role of Shariah auditing is to verify how the operational risk management maintains the performance of the product process in a very controlled manner, with no differences in the practice of each process, which ensures that they have controls before finalising all signatures with the customer when closing the deal. Specifically, checks that controls are in place, which are constantly monitored to meet expected levels, are continually undertaken. As confirmed by Operational Risk manager at Islamic window bank:

"There is a point where the function of Shariah audit works with operational risk management".

When a new product is released to the market within six months of its initial development, the Shariah auditor must audit and review the product by taking samples of the provided product and ensuring that the transaction and product are provided in accordance with Shariah regulations. Furthermore, the effectiveness and efficiency of the operational risk procedures are critical. Control testing, which is prepared by the Shariah audit department, is the main focus in terms of product performance, and it compares the process to the current operations. This is to ensure that Shariah governance is applied to every step.

As a result, when examining operational risk, Shariah auditing is essential. According to Zurina et al. (2010), the primary purpose of the Shariah audit is to control operational risks inside IFIs. Since it visits departments, obtains samples, and monitors activities, it also reviews how Shariah committee decisions are applied in these operations. If there is any conflict with the Shariah committee's decisions, the Shariah audit presents this issue to the Shariah Committee, and the department is then offered a guide to address the issues or reflect it on the department's procedures and policies. If no policies and procedures exist, it will be created by the relevant department so that the employees can refer to them. Since the employees may change jobs and move to another location, there must be a manual on risk mitigation that the employee returns to, reads, and follows so that mistakes are not made that lead to the purification of profits and the reputation risk. If there is a problem in the system, a new scheme that is compatible with Shariah should be developed under the supervision of the Shariah Control Department. According to a Head of Shariah Division:

"We are now in the digitalisation era. The steps must be automated in accordance with the Shariah committee's decisions and controls. This is the responsibility of Shariah control, which, of course, works to reduce operational risks".

The preceding discussion makes the role of the Shariah audit in operational risk management apparent and evident. Since the Shariah auditor acts as a third line of defence, who examines all Shariah-related matters annually or semi-annual. Moreover, the shariah compliance has a critical role as illustrated by the Senior Shariah Advisory Consultant:

"The Shariah Compliance Department, during the implementation of the product, keep an eye on the mechanism for conducting operations and interfering with electronic systems, which makes sure that the systems associated to the product are properly programmed".

Therefore, Shariah compliance as a second line of defence, is the ongoing practice of reviewing product policies and procedures to guarantee their conformity with Shariah.

6.2.5 Shariah governance and Shariah non-compliance risk

As stated previously, most of the study participants agreed that the Shariah non-compliance risk is the rationale for the Shariah governance framework. This implies that the implementation of a sound Shariah governance framework will mitigate the Shariah non-compliance risk. In fact, the subject of Shariah governance and Shariah non-compliance risk is new to the current literature; yet they all agreed that strong Shariah governance can minimize Shariah non-compliance risk (Hidayat, 2012; Nawal and Rosnadzirah, 2018). As confirmed by the director at an Islamic finance advisory firm:

"We have a new type of risk called Shariah non-compliance risk, which is why we need Shariah governance".

The researcher found that Shariah non-compliance risk is connected to several different types of risks beyond just operational risk. This is because Shariah non-compliance risk is the risk of not adhering to Shariah regulations, and the phrase "adheres to Shariah regulations" is a hyperlink to multiple concerns, including "during the designing process of the Islamic product", "risk mitigation measures", and "the implementation of providing this product to the public must also follow Shariah mandates". Thus, Shariah non-compliance risk integrates everything, whether operational or decision-related; it is related to the Shariah principles.

The present fact is that the good and bad implementation of Sharia principles in the Islamic banking industry will have a negative influence on the Islamic religion's good name (Ramdani, and Kamal, 2023). Another truth is that if an Islamic bank stumbles over a case of Sharia non-compliance, the public will not only blame the bank in question but will also label all current Islamic banks as having questionable levels of sharia compliance (Mardian, 2015). Therefore , Sharia compliance is a guideline that all Islamic financial institutions must follow. This is a manifestation of the fulfilment of all Shariah principles that Islamic financial institutions must own (Musyafa et al., 2018).

Shariah non-compliance risk is the most significant element for the Shariah function because it is the focus. According to the Shariah Control Officer at a full-fledged Islamic bank:

"Shariah non-compliance risks are discovered by the Shariah Audit Department".

In fact, this led to the interesting question of whether the operational risk management or the Shariah audit division is responsible for discovering the Shariah non-compliance risk?

The study found that the internal audit department discovers the Shariah non-compliance risk and audits the Shariah department in general and makes sure that its procedures are carried out properly. It then writes a Shariah control report for the audit committee, which reports directly to the board of directors, and a second report is sent to the Shariah board. As discussed by the Shariah Affairs Officer at an Islamic window bank, who stated:

"Shariah audit is a third line of defence, one of its roles is to uncover flaws and mistakes from a Shariah view, create a thorough report and submit it to the Shariah committee".

When the report reaches the Shariah committee, it oversees the mitigation of these risks. For example, it states that it will stop operating with certain products if it has detected that they are being used incorrectly. The Shariah committee requests the bank's management either correct the way in which the product operates or stop working with this product altogether, and they may even decide to set aside profits as purification.

In fact, the relationship between a Shariah audit and Shariah non-compliance risk is also evident in a previous study by Zurina et al. (2010), which indicates that a Shariah audit framework must be implemented to reduce the Shariah non-compliance risk in the products and operations of Islamic banks. Additionally, multiple studies have claimed that an effective Shariah audit will increase the coordination of Shariah practice and reduce the Shariah non-compliance risk (Rahman, 2008; Shahwan et al., 2010; Uddin et al., 2013).

The above discussion provides an in-depth examination of the role of the Shariah governance framework in controlling the Shariah non-compliance risk. However, we must also consider the wider picture. There is a strong possibility of Shariah non-compliance risk, if the bank does not adopt sound governance practices, which would make the fatwa and decision given by the Shariah committee weak and ineffective. What makes Shariah governance binding and effective is the integration of the board of directors and risk management, as the board is accountable for the Shariah governance framework of the bank and the compliance of its Islamic banking activities with Shariah principles and rules. In addition, the board shall oversee the bank's adherence to, and implementation of, the Shariah decisions given by the Shariah committee. Basiruddin and Ahmed (2019) asserted that the BODs manage Shariah non-compliance risk through the Shariah auditing function. We expect that high-quality directors would require more monitoring from the Shariah committee, including additional Shariah audits. However, this study revealed that Shariah committees in Islamic banks in Saudi Arabia play a more advisory role than a monitoring role, and that the Shariah audit department carries out this function.

When discussing the influence of the Shariah committee on the management of Shariah non-compliance risk, it is essential to understand its origins, because when we say Shariah non-compliance risk, we mean that the Shariah committee has already issued the fatwa and decided how the product should function. Then, when it is discovered that the product did not function in accordance with the Shariah committees' decision, this indicates either a deficient Shariah supervision role or unqualified personnel, or both.

In the context of the new Shariah governance framework, it is essential to highlight that it clarified the supervisory role, so that the Shariah committee will supervise the compliance of Islamic banking transactions with Shariah principles and rules. Using Shariah compliance reports and the results of an internal Shariah audit, the Shariah committee should be able to identify problem areas and, if necessary, propose corrective measures.

To put it simply, an Islamic bank is defined by its Islamic products. However, due to its religious underpinnings, it is complicated. A continuous function of supervision is needed for Islamic products across their whole lifecycle, due to the study's result that all types of risks associated to the Islamic product might lead to a Shariah non-compliance risk. As a result, we need to consider the following:

A. During the development of the product, when a new product is introduced, the Business Department first contacts the Shariah Research and Studies Department to ensure that the product is compatible with the Shariah committee's decisions. A Shariah compliance manager at a full-fledged Islamic bank stated:

   “The Shariah research and studies department conducts a thorough analysis of the product”.

   The second line of defence (Shariah compliance, risk management and Shariah department) must be included at this early stage, along with the Shariah committee. To review and verify the design of the Islamic products and ensure that it adheres to Shariah regulations.

   According to the VP-Risk Manager of Operational Risk at an Islamic window bank:

   “In 2019, the central bank mandates a new committee know as new product and services NPS, this committee is headed by risk and compliance, the members are the Chief Risk Officer and Head of Compliance”.

   This committee concentrates on new product features that have never been introduced to the market. Hence, this committee cannot proceed with or accept any product unless the Shariah department provides its input, in the form of a risk assessment report that contains a list of risks such as the potential Shariah non-compliance risk. This report serves as an overview from a Shariah perspective. After receiving permission from the Shariah department, this new product proposal is sent to the central bank. The bank is unable to launch the product unless it receives approval from the central bank.

B. Following the launch of the product, a control of the product begins. Is the product offered in accordance with the Shariah Committee regulations or are there any mistakes? At this stage, the second line of defence plays a crucial function in monitoring the system for conducting operations and delivering the product to the public. According to the Operational Risk manager at an Islamic window bank:

"The risk management as a second line of defence make sure that the first line of defence (business) manages the associated risks properly".

Additionally, a Shariah compliance manager at a full-fledged Islamic bank stated:

"The Shariah compliance department reviews all Islamic products to guarantee Shariah compliance and to report any product concerns".

This implies that the second line of defence verifies whether or not the implementation followed the Shariah committee's vision and decisions. The Shariah auditor, as a third line of defence, has the right to see all papers that are relevant to the control process. The extent to which employees or business departments are committed to the Shariah committee's guidelines and decisions is identified by reviewing contracts and statements. As a Shariah Control Officer at a full-fledged Islamic bank asserted:

"The audit procedure is carried out by obtaining a sample of the offered products. For example, if 1,000 credit cards are presented, 100 contracts are examined and audited, or 10% of each offered product is taken".

To summarise, the Islamic product manager develops the processes for selling the product, the operations department implements these actions and Shariah supervision ensures that the product is used correctly.

Shariah supervision interacts with or exerts control over Shariah non-compliance risk. While emphasising the importance of Shariah supervision in mitigating the Shariah non-compliance risk, most of the participants highlighted the issue of the lack of qualified individuals within the Shariah supervision process. Specifically, a person who combines the knowledge in Shariah with finance and banking, which is rare.

Interesting comments from a Head of Islamic Banking include:

"Now you asked for an interview with me, and at the same time I am offering you a job within Shariah supervision. This is evidence that there is scarcity in this specialty".

From the above discussions, the author believes that the reasons why Shariah non-compliance risk occurs is due to the following:

1. *weak governance,*
2. *unqualified personnel to manage Shariah products,*
3. *lack of a supervisory role,*
4. *immature infrastructure to accommodate the Shariah mandates.*

To conclude, to activate the supervision mechanism, the Shariah governance structure must be followed, and all departments must fully implement their responsibilities. Inadequate governance causes poor implementation of the roles assigned to the entity itself. Sound governance benefits investors and shareholders, as well as the country. When depositors and savers have faith in his country's financial centers, it creates a general reassurance for all.

6.3 The role of risk management in forming an effective Shariah corporate governance framework

In the previous section, it was demonstrated how Shariah governance as a framework does have an effect on risk management in Islamic banking. The Shariah adds a new dimension to the risk management system as a whole. This is achieved by the incorporation of Shariah non-compliance risk into the overall risk management structure. As clearly explained by the Head of Risk Management at an Islamic window bank:

"Risk management has a function in a specific area of Shariah governance, which is controlling the Shariah non-compliance risk, as indicated in the Shariah governance framework, Article 16, Chapter Seven".

Accordingly, the participants were questioned about the role of risk management in forming an effective Shariah corporate governance framework in banks in Saudi Arabia. The study found that risk management is critical in Shariah governance, since risk management must quantify, track, and manage risks before they reach the central bank or the point of profit purification, as the amount may reach millions. As clearly stated by the Head of Islamic Banking at an Islamic window bank:

"Risk management clearly plays a role, and the Shariah governance framework specified that there must be risk management specialists to monitor, track and analyse risks, and advise the bank when there is a risk".

Aligned with this finding, Chahine and Dagher (2008) argued that for Islamic banks risk management is a crucial component of corporate governance. It is even more significant than in conventional banking. Therefore, Islamic banks require a risk management system that allows them to identify, monitor, regulate and anticipate the various risks they may face.

The Head of Risk Governance at an Islamic window bank clarified that the risk department is accountable for the Islamic bank's risk appetite and risk acceptance of the board of directors, in addition to assessing the policies and procedures based on the bank's business scope and the submission of monthly risk reports to the board of directors. The risk report must encompass all Shariah, reputation, market, credit and operational risks. In line with this finding, Ginena (2014) argued that it is essential for the board of directors to provide a direction on risk management, adopt a thorough risk management policy, foster a culture that emphasises the significance of Shariah compliance and comment properly on risk policies and controls in annual reports.

Most of the participants believed that risk management cannot be separated from a bank or a financial entity; it must always be in line with it, as banking and finance are risk-based businesses. In the context of Islamic banking, risk management deals with credit, liquidity, market and operational risk. The addition is the Shariah non-compliance risk, shariah compliance is primarily the core of Islamic banking, since it covers the product and overall function of the bank. Furthermore, risk management and Shariah should operate hand-in-hand to guarantee that the Shariah non-compliance risk is properly mitigated and controlled. Hence, risk management should operate parallel with the Shariah governance framework.

The study revealed that since the Shariah department is not involved in the day-to-day operations of the business, the risk department is aware of any incidents that occur among all the business departments. If there is an incident that is related to Shariah non-compliance and there is a need for an alternative to mitigate the risk, the risk department sends a notification to the Shariah department asking for their review and feedback. Then, the Shariah department reviews and provides their suggestions, and sometimes they respond by saying they do not have a decision yet and need to return to the Shariah committee to obtain their approval on the issue. This indicates that the risk department operates as a key link between the business and the other departments. In this context, the Head of Risk Management at full-fledged Islamic bank asserted that:

"Risk management facilitates work for all departments, and there is occasionally a misunderstanding between risk management and audit; consequently, one of the messages we send to departments is that risk management is a facilitator, not an auditor".

Most of the risk managers believed that risk management interferes directly with the Shariah governance framework when operating with product risk measurement, such as when the product development department creates an Islamic product. This product is forwarded to risk management, which will determine the associated risks and offer an opinion. However, a credit risk manager at an Islamic window bank highlighted a concern over the current risk management tool:

"In my opinion, risk management should establish mechanisms and tools to measure the risks of Islamic products, because they currently rely on a program purchased from American or European companies. These programs assess debt risks (debt-based products), but not equity-based products".

In fact, the concern is not only related to the system in place, but also to the fact that the risk professionals in the risk department are either unsuitable for the Islamic risk culture or have difficulty adapting to it. As argued by a Senior Shariah Advisory Consultant at a full-fledged Islamic bank:

"Most of employees in risk departments in banks are non-Muslims and many of them are not Shariah specialists. Accordingly, they measure products on a debt basis, they are sometimes unable to understand the nature of Islamic banking financing through equity-based products such as Mudarabah or Musharakah".

Consequently, the chance of Shariah violation in this case is likely to be considerable. In return, Shariah compliance monitoring and Shariah auditing must be intensified. In fact, these unqualified elements from the department of risk management clarify the lack of variety in Islamic products offered in Saudi Arabia, which was a concern raised earlier in Chapter 4. Due to the inability to manage the risk associated with Islamic products, most of the Saudi banks offer only Murabaha and Ijarah financing and avoid equity-based products such as Mudarabah and Musharakah. Confirming this discussion, the Senior Shariah Advisory Consultant at a full-fledged Islamic bank commented that:

"As a result, the product development team sometimes creates equity-based solutions that are close to the core of Islamic banking, Islamic purpose and Islamic economics. However, sometimes risk management rejects it".

To enable the Risk Management Department to effectively interfere with Shariah governance, they must have a minimum understanding of Islamic finance so that Shariah risks can be prevented while measuring the Islamic product risks. As asserted by one of the participants, the Head of Risk Management at an Islamic window bank asserted that:

"They have both knowledge of Shariah and risk management, and in terms of Shariah they have the very minimum (which is what is allowed and not allowed)".

Therefore, before reviewing any product, the risk management should meet with the Shariah team to obtain their understanding and feedback. This is because sometimes the Shariah team suggests something, but it is a considerable risk from a risk management standpoint. *Thus, risk* *management plays an important part in Shariah regulations; without risk management, there will be no solid Shariah governance. Without Shariah governance, there is no sound risk management in Islamic banking.* In this context, several interviewees mentioned that the Saudi Arabian Central Bank is working on producing a risk management framework for Shariah compliant banking that demonstrates the crucial role of risk management in executing Shariah governance. This is described by the Head of Islamic Banking at an Islamic window bank:

"Risk management is critical, which is why the Central Bank is now working on developing a risk framework for Islamic banks in Saudi Arabia".

Further, a Vice President and Head of Shariah Division at an Islamic window bank added that:

"Now the Central Bank has issued a draft concerning the framework of Shariah non-compliance risk, which has not yet been approved, but has been sent to the banks for their opinion on it. Here comes the risk management responsibility in implementing and supervising this framework, which is possible with the collaboration with Shariah department of the bank".

In conclusion, *risk management and Shariah governance interact to control the risks of Shariah non-compliance.* Therefore, the role of risk management in Shariah governance is critical, since risk has a part in the product's concept, development, structure, approvals, documentation and sale. Even when the product is released, risk management is still essential because the product must be monitored until the conclusion of its life cycle. This is explained by the Chief Risk Officer at a full-fledged Islamic bank:

"A process known as cross monitoring, while the product is active, ensures that nothing goes wrong".

Therefore, the first step is to determine if the product's design adequately manages the risk component while following Shariah principles; if the product is improperly constructed, risk will occur. Second, determine the need for the four pillars: risk quantification, risk measurement, risk management and risk governance. Risk governance, as defined by the Senior Credit Reviewer & Risk Manager at an Islamic window bank, is described as:

"The risk governance talks about identifying what are the potential sources of risk".

Consequently, given the purpose of risk governance and Shariah regulation, which is to ensure that Shariah principles are not violated, the greatest obstacle is how the objectives of Shariah principles and risk management are to be married. The aim is, therefore, to create Islamic products in such a way that they generate a profit while minimising risk. Ultimately, the most important factor is Shariah governance; a bank with an effective governance system would have good risk management.

Conclusion and Summary

This Chapter acts as a contribution to the growing body of literature on Shariah corporate governance and risk management in Islamic banks. This Chapter examines the central question of the thesis: to what extent does Shariah governance affect risk management in Islamic banks? The role of important actors in Shariah governance (i.e., Shariah committee, Shariah compliance and Shariah audit) in risk management were also investigated. First, the chapter sheds light on the three line of defence model and how it is applicable to Islamic banks. The author goes even further by suggesting a three-line defence system for Islamic financial institutions. The Shariah committee's fatwa and decisions, the bank's policies and procedures, and the central bank's regulations all influence the model. The tasks and obligations of each line of defence should be governed by this framework. The discussion of the three-line defence concept is, in fact, the starting point for exploring the role of Shariah governance in risk management. The study found that Shariah governance is equivalent to Shariah compliance and, to accomplish this, the Shariah governance framework must mitigate Shariah non-compliance risk. This is a type of risk that can interact with any other type of risk, such as credit, liquidity, market, and operational risk. Consequently, the effect of Shariah governance on each type of risk has been investigated. Importantly, the role of risk management in the formation of an effective Shariah corporate governance framework was also discussed to provide for a comprehensive understanding of the topic.

As a result, the research question posed in Chapter 1 has been satisfactorily resolved by the findings shown here and in Chapters 4 and 5.

How does the Shariah corporate governance framework influence risk management in terms of credit risk, market risk, liquidity risk and operational risk (especially Shariah risks) in fully-fledged Islamic and window banks in Saudi Arabia?

This chapter's results are in line with the stakeholders' theory and the agency theory. The results demonstrate that all risks, including credit, liquidity, market, and operational risks, are affected by Shariah governance as a framework. This is because a Shariah non-compliance risk appears if Shariah is not followed during the risk mitigation and product creation phases. Since Shariah non-compliance risk can be entangled with any risk, it is the responsibility of Shariah governance to prevent risk management from generating such a risk.

The study reveals a clear correlation between the Shariah committee, internal control, and Shariah non-compliance risk. The establishment of shariah committees in all Islamic financial businesses is a strong indication of the emphasis on risk management in Islamic finance (Abdullah, 2019). The Shariah committee, as a key control player with shariah internal control (shariah audit and shariah compliance), ensures that the managers run the Islamic bank in a shariah-compliant fashion. As a result of such stringent controls, the risk of shariah non-compliance is reduced, lowering the purification amount, and thus satisfying the shareholder's goal of maximising profits by applying Shariah principles, as well as enhancing stakeholder confidence and maintaining the Islamic bank's integrity.

CHAPTER 7 – Conclusion and Contributions

7.1 Thesis summary

In Chapter 1, the author presented an overview of this thesis, which included the rationale for this study and introductions to the key themes to be investigated in this research. The author also highlighted the study's major research question and objectives. In Chapter 2, the author attempted to shed light on conceptual and theoretical concerns that are associated with the term "corporate governance" from a conventional perspective, as well as corporate governance in developing countries such as in Saudi Arabia in particular. The author then proceeded to perform a thorough literature review on Shariah governance. In addition, the reviewed literature underlined the significance of Shariah governance in Islamic banking, risk management in Islamic banks, and the role of Shariah governance in mitigating the numerous risks faced by Islamic banks. The discussions provided here revealed that the studies on the topic of Shariah governance and risk management remained limited. Therefore, the author adopted a qualitative research methodology, as detailed in Chapter 3, to enable an investigate into the special connection between Shariah governance and risk management in one of the most significant Islamic financial markets – namely, Saudi Arabia.

To understand the unique relationship between Shariah governance and risk management, the author started a detailed investigation of risks and risk management in Saudi Islamic banks in Chapter 4. Here, the author argued that it is important to first assess the current state of Islamic banking in Saudi Arabia from the perspective of practitioners and Islamic banking specialists to enable an examination and identification of risks in Saudi Islamic banks. Subsequently, the author offers an in-depth coverage of each risk category for both full-fledged Islamic and Window banks. In this discussion, the author addressed the risks that Islamic banks share with conventional banks (such as credit, liquidity, market and operational risk) alongside the risks that Islamic banks face exclusively (i.e., Shariah risks). In addition, the challenges that Islamic banks need to confront in managing various types of risk are highlighted. This is crucial when attempting to grasp the comprehensive view of risks and risk management in Islamic banking.

Since the Shariah governance framework was issued for the first time in February 2020, the author examined in Chapter 5 the evolution of Shariah corporate governance in Saudi Arabia through the lens of the participants. Therefore, it was beneficial to compare the situation of Islamic banking before and after this issuance, showing the strengths and weaknesses that need to be addressed and improved. In addition, it was determined if the degree of adherence when applying the Shariah governance structure varies between full-fledged Islamic banks and window banks, or whether it is the same.

After examining risk management and Shariah governance respectively in Chapters 4 and 5, the author addresses the principal question of the thesis in Chapter 6. Namely, “What part does Shariah governance play in the management of common risks (i.e., credit risk, market risk, liquidity risk, and operational risk) as well as Shariah risks?” The author examined the impact of Shariah governance on risk management in this chapter and, to comprehend this unique relationship, the author sheds light on the three lines of defence model from the perspective of Islamic banking. The author also developed a three-line Shariah compliance defence model that promotes the message that Shariah compliance is a multi-step process rather than a single assignment. Therefore, the author examined the Shariah committee, Shariah compliance, and Shariah audit as the primary actors in the Shariah governance framework and uncovers how each one affects risk management. Ultimately, the author has concentrated on determining the function of risk management in establishing an effective Shariah corporate governance framework, by examining the link from every angle.

Overall, this research has yielded significant findings and it has accomplished all of its aims and objectives. This research has benefited immensely from the interviews conducted with the main participants who work within the framework of Shariah governance (i.e., Shariah committee, Shariah compliance, Shariah audit, and risk management) and contributors from outside this framework (i.e., academics and regulators) in a manner that facilitated useful conclusions. It also ensured a clearer link between the existing literature and the results from research and analysis. The question then becomes “What can we do with this information?”

7.1 Major highlights and recommendations

7.1.1 Risk management in Islamic banks

All risks faced by Islamic banks in Saudi Arabia were evaluated, including those shared with conventional banks, such as credit, market, liquidity, and operations risks, as well as Shariah-specific risks (both Shariah compliance and Shariah non-compliance). Indeed, the in-depth examination influences the formation of a comprehensive perception of the risks associated with Islamic products that have been explicitly analysed through interviews with specialists and professionals in Islamic banking and risk management. Based on the findings presented in this thesis, it is clear that risk management practices in the banking sector of Saudi Arabia are well developed. This is evident ; nonetheless, the function of combining risk management and Shariah law remains unfulfilled. The findings show that the Shariah factor is present in all types of risk.

In terms of **credit risk**, the results of the semi-structured interviews confirmed that Islamic banks in Saudi Arabia suffer credit risk comparable to that of conventional banks, due to the widespread use of debt-based products such as Murabaha. Therefore, the primary credit risk is the risk of non-payment. How et al. (2005) claimed that the risk associated with Murabaha finance is significantly less than that for Mudarabah and Musharakah. Therefore, the development of Islamic products other than Murabaha, which have a relatively low credit risk compared to the other financial instruments, remains a distant goal. This is due to the lack of knowledge and skilled personnel capable of managing this sort of risk in the Islamic bank industry. Considering the credit risk mitigation procedure, it must be distinct and adhere to Shariah laws. Consequently, credit risk management at Islamic banks is challenging in terms of its guarantees and collateral. It is regarded as a delicate task that involves an understanding of Shariah laws and frequently involves a Shariah committee providing a fatwa on the customer's submitted mortgaged asset.

With regards to **liquidity risks**, they are similar to those encountered by conventional banks; they occur when banks are unable to meet their financial obligations in a timely manner, which could result in significant losses. However, the liquidity risk is more serious for Islamic banks compared to their conventional counterparts. This study revealed that the primary causes for Islamic banking's liquidity risk in Saudi Arabia are the restricted availability of Shariah-compliant money markets and intrabank markets. Moreover, there is a lack of liquidity management solutions that are both flexible and obviously Shariah-compliant. Respondents also identified that deposits are likely to be a major source of liquidity in Islamic banks. Ariffin (2012) claimed that a quick increase in the borrowers withdrawing deposits increases the likelihood of a liquidity shortage in an Islamic bank. As a result, Islamic banks may struggle to manage their liquidity volatility in the short term. Furthermore, because Islamic law prohibits the sale of debt, the rise of debt-based financing formulae, most notably Murabaha, poses a liquidity risk for Islamic banks. The inclusion of provisions is a vital first step in controlling the liquidity risk, and significant capital allocation in the various scenarios is considered. Overall, it is obvious from the preceding text that the liquidity risk in Islamic banks is more significant than in conventional banks, in which it does not end at balancing the two parts of stability and profitability, but rather includes the level of its dedication to Islamic Shariah regulations and principles. The author believes that for this type of risk Islamic banks will undoubtedly face more issues and restrictions in their management compared to conventional banks.

Other risks include the possibility that if adequate controls and risk management are in place they can have comparable positions, but liquidity risk must be carefully managed. Islamic banks require a broad and deep liquidity market in the jurisdiction, which is extremely market-specific; by liquidity market, the author means the infrastructure available to an Islamic bank for managing its liquidity. There are two crucial aspects including the interbank money market, in which the more Islamic banks are in the market, the more developed this infrastructure becomes. Without a doubt, in any market, conventional banking has a more developed infrastructure, since there are approximately 20 conventional banks and 5 Islamic banks. This explains why liquidity management is more challenging for Islamic banking. The second aspect is the sovereign liquidity management instrument, in which the government issues Sukuk to assist Islamic banks in managing their liquidity and the central bank issues additional liquidity management facilities, which allows the central bank to lend or borrow money from Islamic banks in a Shariah-compliant manner. The more of this infrastructure is available, the easier it is to manage the liquidity risk. As discussed in Chapter 4, there have been efforts to improve liquidity management; one of the banks created “Islamic repo”, which was approved by the central bank and employed.

Analysing the **market risk**, the finding shows that market risk is arguably more pronounced in Islamic banking than in conventional banking, as one of Islamic banking’s distinguishing features is its asset-based nature. However, most of the participants agreed that market risk is not one of the most significant risks that confronts Islamic banks in Saudi Arabia. The researcher’s analysis of the interviews indicates that this is due to the following:

- First and for most, Islamic banks in Saudi (full or windows) limit themselves to dealing with specific Islamic products such as Murabaha, Ijarah and Tawarq. Market risk is fairly significant in the majority of financial instruments. However, it is represented at its lowest levels in Murabaha, which is regarded as having the lowest market risk, followed by Ijrah (Ahmed and Khan, 2007).
- Second is the lack of conversation among participants, which stems from a lack of specialised understanding in this kind of risk in this type of industry.

- Few market risk management products comply with Shariah law. In terms of the use of Islamic derivatives such as swaps, Islamic banks in Saudi Arabia have limited use. However, if we consider Malaysia, which is advanced in terms of its product variety, the market risk is quite significant. This further confirms the findings from the research conducted by Alshamrani (2014), who asserted that the lack of regulation on conventional and Islamic derivatives markets limited Saudi Arabia from using Islamic financial derivatives like Malaysia and Singapore.

It is imperative to highlight that Islamic banks in Saudi Arabia use SAIBOR as benchmark to price the mark up contracts such as Murabaha and Ijarah, therefore they are facing interest rate risk . In fact , the majority of Islamic banks in significant regions of the globe use interest-based benchmarks as a pricing reference (El-Gamal , 2006; Ayub, 2007; Archer and Karim, 2019). Due to the intense competition, Islamic banks operating within a dual banking system consistently imitate and match their prices with their interest-based conventional counterparts (Chattha and Alhabshi , 2018). Even though benchmarking interest rates in Islamic banking does not violate Shariah law, it has several implications. According to Nouman et al. (2022), If not properly managed, the benchmark rate risk could pose a significant threat to Islamic banks' capital base, financing, and earnings. In addition, it can cause systemic risk and financial instability in the market. Hence, this thesis proposes the necessity of a collaborative effort among prominent Islamic jurisdictions to create an exclusive Sharia-compliant benchmark that is independent of conventional benchmarks and can function as a secure gauge of the anticipated cost of short-term interbank financing in the Islamic financial market.

Islamic banks in Saudi Arabia face commodities risks due to their extensive use of Murabaha financing, but they effectively manage these risks through the use of commodity brokers, most notable in Saudi Arabia is an online platform for selling Indian rice or London Metal Exchange (LME); the palm oil exchange in Malaysia is now a competitor in the market for this product.

This leaves **operational risk** as the final type of risk shared by both Islamic and conventional banks. The findings demonstrate that Islamic banks in Saudi Arabia follow the Basel II operational risk framework, which mandates a comprehensive review of the banking underlying infrastructure. In particular, they pay attention to four risk drivers: people, process, system and externals. Regardless of the potential risk posed by these drivers, they evaluate, analyse and implement the applicable controls. While, according to Abdullah et al. (2011), even though the fundamental Basel II core concepts of effective banking supervision are applicable to and ideal for Islamic banking institutions, risk measurement and risk management practices nevertheless require unique adaptations to accommodate the operational features of Islamic banks. Indeed, Islamic financing contracts are based on the following predefined laws and regulations, which makes operational risk appear more easily. Therefore, the increasing demand for various products in the Islamic banking market makes it challenging for Islamic banks to manage operational risks. Until the following obstacles are resolved:

- Shariah products are complex and reliant on a third party, necessitating that Islamic banks need to focus on the infrastructure of the bank's system. Therefore, Islamic banks must build a system that incorporates the Shariah product features, which implies a fully automated structure. Specifically, we are referring to online monitoring (through a system employee checking if this product is Shariah compliant or not). As a result, the auto-detected systematic setup is viewed as a feature for avoiding operational risk, which is achieved by designing an automated platform that controls and manages the end-to-end process.
- Islamic banks in Saudi Arabia, specifically its windows, needs skilled Shariah specialists.

Since staff of Islamic banks must be familiar with both Islamic and conventional banking, the risk posed by their lack of specialisation, as stated by Rhanoui and Belkhoutout (2018), is far higher than that of conventional banks.

As a result, the operational risk that Islamic banks face is expected; the author believes that each category of risk has its own impact on Islamic banks. However, operational risk is critical and is closely related to Shariah risk. Since the operational risk is dependent on the process, this procedure should include measures to comply with Shariah guidelines. For example, the authentication and validation of the third party in the case of Murabaha: when the bank chooses the third party, the bank makes sure that the third party exists and makes warehouse visits. The processes and procedures should cover all the steps that make sure that operations are conducted in the correct manner (in a proactive approach), which leads to the preparation of a risk assessment for every product and process, how it is implemented and how it deals with any potential issues. Failure to follow such a guideline will result in a cancelled transaction, meaning that the income or loss will not be recognised. Therefore, the emergence of this type of risk allows for other risks to arise, such as fiduciary risk and reputational risk. Fiduciary risk is the risk that develops as a result of Islamic banks failing to execute in line with explicit and implicit requirements related to their fiduciary duties (IFSB, 2005). Consequently, failing to maintain fiduciary responsibilities affects the reputation of Islamic banks (Hamidi, 2006). A reputational damage might ultimately lead to a withdrawal of money, resulting in a liquidity crisis. It may also cause clients to stop seeking funding from Islamic banks, resulting in a drop in profitability (Dar et al., 2013).

Regarding **Shariah risk**, which differentiates Islamic banks from conventional banks, the study found that Shariah risk stems from two causes: compliance with Shariah law and non-compliance with Shariah. **Shariah compliance risk** develops because of the adherence to Shariah principles and guidelines. In fact, these risks are inherent in Islamic products and have no effect on Shariah compliance. These risks are viewed as the responsibility of the risk management; since they must first understand the nature of these products before they can control these risks. Thus, risk departments at Islamic banks should focus their efforts in this area. Respondents identified that such risks pose a significant challenge. Obviously, this is due to the fact that there are currently no experts in this type of risk. When the customer promises to buy under the Murabaha contract between the bank and the customer, what is the legal strength of the promise, in other words, what happens if the customer breaks the promise? In fact, the bank faces the risk of not being able to dispose of the commodity profitably, resulting in a financial loss (Abdullah, 2010). The question is, where is the proper risk management? These factors are risks associated with the Islamic product that are not at all related to Shariah law. It is, thus, unreasonable to expect a Shariah specialist in a bank to address these risks. The study strongly recommends that these aspects should be managed by someone who is knowledgeable about Shariah and risks.

In terms of **Shariah non-compliance risk**, when the bank violates Shariah regulations it invalidates the transaction, and the profits are transferred to the purifying account. This study revealed that Shariah non-compliance risk is associated with all forms of risks, not just operational risks. According to the evidence, non-compliance with Shariah law will result in the purification of profits, which results in financial losses and affects the expenses of the bank, thereby altering the bank’s effectiveness rate and the dividends distributed to the shareholders (thereby affecting the bank’s stock price). The findings of the study indicate that Islamic banks operating in Saudi Arabia are exposed to the risk of non-compliance with decisions made by the Shariah committee, which poses a significant risk to their operations. The aforementioned statement suggests that the Shariah committee proffers a fatwa, however, the adherence to its implementation is feeble, thereby impacting not only the credibility of financial institutions but also the Shariah control mechanism for issuing the aforementioned fatwa.

The study found that Shariah non-compliance risk can be classified as regulatory risk, which is a risk that has a tolerance of zero since either the bank adheres or does not comply with Shariah laws, in other words it is black or white not grey. Shariah risks are related to clear laws and regulations. Therefore, these regulations do not include permission not to apply them, and no-one can manipulate not implementing these regulations.

Regarding the management of this unique risk, the study suggested it could be managed by the risk management team in conjunction with the Shariah department. Alternatively, as specified in the Shariah governance framework, a distinct division under the risk management with a Shariah-trained risk officer. The author believes that it must be included in risk management and, more precisely, in comprehensive risk management, because it is the bank's comprehensive framework and must be consistent with the bank's risk appetite as agreed by the bank's board of directors. More precisely, Islamic banks should begin training and qualifying individuals with a Shariah background in governance, compliance and risk, or either train or qualify people who have a background in the governance, compliance and risk in Shariah product and structure.

Above all, Shariah compliance should be a shared responsibility for all the stakeholders in an Islamic bank. Shariah compliance is not about being risky; rather, it is about entering into Shariah-compliant contracts and having product arrangements. While Islamic banking is more risky than conventional banking in terms of Shariah compliance, this does not mean that Islamic banking should be limited. In the long run and economically, conventional banking is riskier because it is not governed by ethics or, as is sometimes said, works without ethics. This contrasts with Islamic banking, which is governed by Shariah law and the principle of reasonable profit. The latter does not cause conflicts and, most importantly, Islamic banking is banking for all societies. However, this study does not declare that Islamic banking is the riskier form of banking; this question has many angles, for which it is difficult to provide a general answer. In terms of the nature of the conventional bank, it is dependent on several long-term risks, and its concept contains errors and risks. In the conventional banking any transaction can be structured.

When we examine the 2008 global financial catastrophe, it was all due to an excessive amount of risk taking. As for the Islamic bank, since excessive risk-taking is prohibited by Shariah law, this does not imply that Islamic banks are completely risk-free. Islamic formulas involve a higher risk than the concept of lending money and receiving it back with interest, by which I certainly mean a conventional form of banking. For example, an Ijarah contract has an ownership by the bank; therefore, the risk is held by the bank and any damage or destruction of the original is carried by the bank. This is a straightforward explanation for why Islamic formulas involve a higher risk, implying that they diminish profits for the bank, but they actually assist both the bank and the consumer from a moral value position. As such, Islamic banks feel that Murabaha is the most secure and safest Islamic financing tool.

In other words, when you wish to invest in general, you may ask, “What is the best investment?” and the answer is, “What is your risk appetite?” In fact, there is no such thing as bad or good risk; it all depends on your strategy, appetite, and goals. As a result, there is no definite response as to whether this is risky or that is riskier, but we can state that the higher risk is when we are unable to provide the appropriate governance structure and a risk management scheme compatible with this and that system. There are three critical points to remember here: the establishment of a framework that is compatible with the nature of the system being followed, the application of the framework with a thorough grasp of the financial system or institution, and effective control, auditing, and regulation.

After thoroughly examining each risk category, for both full-fledged Islamic and Window banks, it becomes evident that the forms of risks are all same; yet the levels of the risk vary. Unlike window banks, full-fledged Islamic banks have a larger volume of Islamic products; therefore, the level of risk exposure is higher. Moreover, there is a difference in the cadres responsible for the management of risk. In other words, most of the risk managers interviewed worked in window banks, and the majority of the responses to risk management questions came from the practitioners operating in Islamic window banks. This demonstrates that there is a lack of qualified risk managers in full-fledged Islamic banks and all of the hired or existing risk managers in full-fledged Islamic banks are employees of conventional banks.

Finally, numerous previous studies have investigated the factors that contribute to the emergence of risks in Islamic banks and whether they differ from those in conventional banks. After two decades, the author believes it is now past a time to stop questioning whether they are different from or similar to the risks associated with conventional banks, since they most certainly are different due to their unique operating principles and product structures. Without a doubt the risks they confront, and the reasons for their existence, are diverse. The manner in which these risks are managed is always unique.

7.1.2 Shariah governance framework

A comprehensive look at Shariah governance was conducted both before and after Saudi Arabia implemented its first ever Shariah governance framework. Shariah governance aims to organise the operations of Islamic banks and to enhance Shariah supervision. Overall, there was no Shariah governance in the banks prior to the framework's release. In fact, the respondents categorise banks in Saudi Arabia prior to the release into three groups:

1. Full-fledged Islamic banks, which are fully committed to the laws and the execution of Shariah governance.
2. Full-fledged Islamic and window banks that implement basic Shariah governance.
3. Window banks that do not have Shariah governance.

Even the Shariah board in the two types of banks lacked organisation, and it was not recognised as one of the boards of directors' committees. As a result, the Shariah board's presence constituted a voluntary effort and a commitment on the part of the owner. The study found that in terms of Shariah governance there was a clear discrepancy between window banks and full-fledged Islamic banks. Specifically, the level of Shariah control vary between the banks. Shariah control, as represented in Islamic banks, involves two functions: Shariah compliance and Shariah audit. The study revealed that full-fledged Islamic banks have a section dedicated to Shariah supervision and audit, whereas window banks do not. They either employ a single Shariah auditor or rely on external auditors to conduct the annual audits. In fact, the central bank issued a framework for Shariah governance to regulate banking operations and ensure fair competition in the market. The situation has now become organised, whereas previously it was not.

Although the Shariah governance framework mentions a Shariah committee member's independence as a kind of inheritance of experience and acts as a circulation and transfer of knowledge between generations, rather than just a limitation to a specific category so that Islamic banking does not become the monopoly of a specific group. However, there are currently insufficient scholars to occupy these positions. The implementation of this factor was initially planned for 2020 but was pushed back to 2023 because of this deficiency. This is currently considered a great challenge for Saudi banks, as they now have until January 1, 2023, to qualify and train a group of bankers who can be members of the Shariah committee.

Basically, it is possible to find someone who possesses significant Shariah knowledge, but they often lack experience in finance, risk management, banking, and economics. This is why there are so few Shariah scholars working in Islamic finance since it requires understanding of law, finances, and accounting. However, this study revealed that Shariah committees in Islamic banks in Saudi Arabia play a more advisory role than a monitoring role. It is more the responsibility of the bank's Shariah compliance and control team; they should be working day and night with bankers and accountants, liaising with the Shariah committee, and obtaining their reviews. Typically, the Shariah committee reviews legal agreements, but ideally, they should review all of these documents. In practice, the Shariah department is responsible for this task and, thus, must be trained to do so.

Indeed, the Shariah department is frequently cited in the interviews, and an analysis of the responses showed that the Shariah department within the Islamic bank served as the executive management of the Shariah committee. This discussion highlighted that it is essential for Shariah scholars to be proactive rather than reactive. This means that while some Shariah scholars are constantly seeking additional information and attempting to increase their involvement with the bank, others are more reactive and will only act if asked to do so. Nevertheless, since the Shariah governance framework mandated that the Shariah committee undertakes a supervisory function and oversees the Shariah-compliant Islamic banking transactions, this matter will hopefully be resolved soon.

As a matter of fact, the issuance of the Shariah governance framework offers several advantages, including the organization and regulation of Islamic banking activities. This enhances client confidence in the provided product, and it creates new banking jobs while also supporting the Kingdom's Vision 2030. However, the new Shariah governance framework is deemed to be loose. Therefore, additional development is necessary in future. The following recommendations shall be considered in terms of the framework and for general Shariah governance:

1. The framework provides the Shariah committee with independence by having it report directly to the board of directors. It also grants the Shariah committee the authority to address the central bank directly, which means that if the board of directors ignores the Shariah committee's observations, the Shariah committee may address the central bank directly; this is independent to an excellent degree. However, will the Shariah committee approach the central bank with a complaint? In fact, the participants agreed that they do not anticipate this occurring; based on previous experience, they have never witnessed a Shariah committee file a complaint with the central bank. What is the Shariah committee's maximum reaction if the bank violates Shariah? They will likely resign and create a serious matter, given that there are 10 additional persons interested in working on the Shariah

committee. Members of the Shariah committee are attempting to treat issues with kindness in various ways and, frankly, they do not want to lose their jobs. It is noteworthy that, prior to the issuance, the Shariah committee enjoyed ultimate independence because it immediately reported to the shareholders. Therefore, if power and independence are achieved through Shariah governance, the Shariah committee would, in fact, not need to file a complaint with the central bank.

2. The Shariah governance framework grants the Shariah audit independence but does not specify how this would be achieved. In other words, how will the Shariah committee know about the bank's risks? This relates to Shariah internal control, which includes the Shariah audit and Shariah compliance. For example, if the Shariah internal control department audits risk management and discovers unjustifiable observations, can they report these immediately to the Shariah committee? At the same time, the Shariah governance framework states that the executive management of the bank must notify the board of directors immediately in the event of a Shariah violation. Still, the question here is whether the executive management will report itself in the event of a breach. Therefore, the study suggested that the most significant independence that must be achieved is the independence of the Shariah internal control department, which delivers observations to the Shariah committee and avoids agency problems. If the independence of the Shariah internal control departments is not obtainable and senior management prevents observations from reaching the Shariah committee, then there is no gain from the Shariah committee's independence. Therefore, if the audit and compliance functions are not independent, the Shariah committee may not receive non-compliance issues. This is a significant factor because some jurisdictions focus so much on Shariah scholars and want these scholars to function as auditors. However, these individuals (who have spent their entire lives studying Fiqh and Shariah laws) are not familiar with audit methodology or procedures.
3. The central bank has now imposed a requirement that each Shariah committee member be a representative of only one bank. As a result, there may be disagreements about fatwas in future. Previously, the member could be a representative of eight banks, and they would issue an identical fatwa to all eight banks. However, each member will now issue a different fatwa. As a result, these representatives require a point of reference, thus the study suggested that the central bank adopt a national fatwa mechanism to unify or standardise the fatwas issued among Saudi Arabia. For example, adopting AAOIFI standards and, in addition to implementing the Islamic Fqih Council's decisions, establishing guiding principles that ensures no fatwa is issued in violation of these principles. Critically, similar

to other countries such as UAE, Bahrain, Malaysia, Kuwait, Pakistan, and Oman, there could be an establishment of a supreme Shariah board within the central bank. In fact, the supreme Shariah board is responsible for supervising Islamic banking at the state level, not at the level of individual banks, as well as resolving disputes between banks when there are discrepancies in fatwas. In addition, since Islamic Research and Ifta is a legitimate governmental entity, this supreme board could be established under its supervision and serve as a reference for banks. Therefore, there is no doubt that having a centralised governance structure, related with the central bank, provides a solid Shariah stamp that unifies the source of the fatwa and enables Shariah committees to participate in a standard development rather than simply issuing fatwas. Thus, Islamic banking will develop into a practice similar to conventional banking and it will become a standard-setter, which contributes to the establishment of worldwide norms. Thus, regional, and worldwide recognition of Islamic products.

4. When examining Islamic windows bank, the framework lacks information regarding the question: What is the location of the Islamic banking department? To be precise, there is currently nothing in the Shariah governance framework that provides information about the structure of the Islamic banking department. Does the department report to the CEO or the Head of Risk, for example? The structure needs to be both specific and clear.
5. Internal control is the responsibility of each bank, however a central bank inspection that monitors the execution of the Shariah governance framework is required. In fact, the central bank plays it wisely in the sense that it requests the gradual application of their framework, not immediately so not to damage the banks. For instance, it did not initially compel banks to appoint Shariah board members under particular conditions, since it allowed banks the time to begin the training to qualify Shariah board members. To protect the bank's entity and reputation, this issue requires a logical sequence and the transmission of information in a natural manner, without causing any shocking impacts to the banks. It is imperative to mention that, according to the study participants, the audit by the central bank does not currently exist. This is for two reasons. The first is that there are items under the Shariah government framework whose implementation will begin in 2023; namely, the formation of the Shariah board and the separation of accounts. The second reason is the Covid pandemic. However, there are initiatives from the central bank that will create a control plan over banks that ensures compliance with the Shariah governance framework. Ultimately, the fact that the Shariah governance framework is compulsory is a significant contributor to its strength. However, the implementation should be subject to oversight and

follow-up.

6. Moreover, it is vital to have an external Shariah auditor because it provides further confidence that the Shariah Compliance Officer, the Shariah internal audit and the entire Shariah department have performed their duties in line with Shariah law.
7. AAOIFI standards in Saudi banks are non-mandatory and serve as guidelines. The Adoption of AAOIFI is intended to create "an extraordinary score of consistency as well as transparency of financial statements, and thus a productive functioning of the IFIs market" (AAOIFI 2022). One of the biggest obstacles that IFIs are now experiencing is the creation of financial statements under multiple accounting standards, which can lead to issues with comparability, reliability, and compliance level measurement (Sarea and Hanefah, 2013). It is potential that in a developing Muslim nation like Saudi Arabia, compliance with globally recognised Islamic accounting standards may play a key role in increasing global investors' interest in the local market. Therefore, for Islamic banking and finance to succeed, it is recommended that all global authorities mandate conformity with Shariah accounting standards like the AAOIFI accounting standards (.Mohammed and Hanefah, , 2013). As the primary purpose of AAOIFI is to prepare and develop accounting, auditing, governance, and ethical standards pertaining to the activities of IFIs, adopting AAOIFI will prevent heterogeneity in the Islamic finance industry on Shariah-monitoring, particularly in Shariah governance of institutions.

8. Ultimately, the establishment of an efficient Shariah governance framework necessitates the prompt resolution of the inadequacy of Shariah experts, encompassing Shariah committees, shariah auditors, and Shariah risk managers. In fact, this topic is frequently discussed in the Islamic finance literature. based on the conducted interviews, Saudi Arabia is facing this threatening issue.

The preceding recommendations led us to identify the Shariah governance framework's components. There are primarily 5 key tools:

1. Shariah board or committee (or an institutional Shariah board) that is part of the bank. In short, its role is to examine contracts and products and make sure that they comply with Shariah law.
2. Compliance department. They operate before the Shariah committees, their job is to take the product from the product development department, work with them to develop it and then present it to the Shariah committee in the proper manner.
3. Internal Shariah Audit. This is a unique type of audit; their role is similar to that of the

internal audit, but it is limited to ensuring that Shariah rulings have been correctly applied in the bank's various activities and operations. They collect samples and conduct field inspections, as well as monitor the products movement in the banking system and they create a periodic report, which they submit to the Shariah committee for review. This report, for example, includes an explanation of the thirty field visits that uncovered a problem in the business department or the treasury. In a nutshell, they will submit a thorough report. Based on this statement, the Shariah committee will rectify any inequalities, impose appropriate sanctions or taking corrective actions. As the Shariah auditors, their responsibility is to ensure that each product, before it is introduced to the market, is presented to the Shariah committee, and receives their permission to proceed.

4. External Shariah audit. Some countries have started applying an external Shariah audit, which means that a third party, for example, KPMG, acts in an overseer role. They are specialized in Shariah auditing and, thus, provides more confidence, independence, and impartiality.
5. Central Shariah board. As far as this study is aware, thirteen countries around the world have started implementing the central Shariah committee. This is typically a Shariah committee that is headquartered in the central bank, which implies that it is at the national level. Its role does not replace the job of Shariah committees in the banks, but it produces a form of harmony that exists in the country at the public body level. It also has an administrative responsibility in the sense of hiring and dismissing persons on Shariah boards of the banks, since it knows who is competent enough to be on the Shariah committee, or not, at a national Shariah board; this ensures that such boards are comprised of individuals with extensive experience. Furthermore, as a central Shariah committee, they are responsible for reviewing annual reports from all the Shariah committees in the banks. It is also their responsibility to review national Islamic products, such as national Sukuk issued by the country.

These are the five tools that create the Shariah governance framework. They improve efficiency and enable reflections on credit, liquidity, market, operational and Shariah non-compliance, legal risks, and other risks if they are effectively mastered and abided to.

Although the five pillars of the Shariah governance framework have now been discussed, currently, the Saudi Arabian Shariah governance framework only applies three of the five pillars. Does this mean that we are recommending the other two pillars? In fact, the Shariah governance framework of Saudi Arabia, which was released in February 2020, is the first version; the central bank has assigned a time limit to begin implementing it. However, this initial edition is not the end of the road towards fulfilling all five pillars. In most circumstances, the application must have a gradation in every situation since it is unreasonable to apply everything all at once.

Without a doubt, the author believes that the presence of a central Shariah board will add value to the Islamic banking industry in Saudi Arabia. However, considering its scope, responsibilities and functions, it is critical that it be carefully selected and positioned. It is sometimes preferable not to have a central Shariah board if it is given the wrong instruments, scope and chosen individuals; all of these aspects are critical. Regarding the application of a Shariah external audit, the author does not see a urgency to appoint them at present, but it is an essential step that will hopefully be included in the coming phases.

Clearly, we cannot call them Islamic financial products without the presence of the three pillars of Shariah governance that are currently applied in Saudi Arabia. Namely, the Shariah committee in the bank or Islamic financial institution, internal Shariah audit and Shariah compliance. Without these three pillars, it is fundamentally incorrect to produce and label these products as Shariah compliant. Clients should not be exposed to risks arising from an institution that sells Shariah-compliant products that do not meet the minimum Shariah governance requirements (i.e., the three pillars).

7.2 Contributions and implications

A brief search of scholarly, practice and policy articles on Shariah corporate governance and risk management in both full-fledged and window banks in Saudi Arabia (and other countries) would indicate an astonishing gap in the literature. In this thesis, the author investigated the role of Shariah governance in managing different types of risks namely credit, liquidity, market, operational and Shariah non-compliance risks in Saudi Arabia, one of the most essential Islamic financial markets.

This thesis examined Shariah corporate governance and risk management in Islamic banks and adopted a qualitative research approach that used semi-structured interviews. If the researcher does not penetrate the Islamic banking industry through conducting interviews, the research will be theoretical and unrelated to market applications. Deep insights into the nature, practice, and complexity of the phenomena of Shariah corporate governance, and the distinctive risk management practices of Islamic banks, contribute to the richness of this thesis. It has also inspired a more in-depth discussion of the topic, particularly as it applies the agency theory and stakeholder theory to highlight the unique relationship between Shariah governance and risk management.

The implications of the results of this thesis extend beyond the academic community to the world of Islamic banking. Through a non-normative, multi-theoretical investigation of the literature, the author provided an extensive discussion on the decisive purpose of Shariah corporate governance as a framework and its function in risk management in Islamic banking.

The present findings contribute significantly to the discussions on Shariah corporate governance in Saudi Arabia's substantial and expanding Islamic banking sector. Specifically, the current study is unique because it investigated the case of Islamic banking before and after the issuance of the Shariah governance framework, whereas previous studies discussed the status of Islamic banking without the existence of a mandatory Shariah governance framework; they always advocated for its issuance.

Since the country's first Shariah corporate governance framework was established in 2020, there have been only a few research papers on the subject. However, neither before nor since that time have any studies explored the influence of Shariah corporate governance on risk management, even though this link is now a common topic of discussion regarding the effectiveness of the Islamic banking industry; the current study fills this gap in the literature. In particular, the present findings contribute to the knowledge of the subject by investigating the practical and theoretical relationship between Shariah corporate governance and risk management in the Saudi Islamic finance sector. In addition, this research contributes to the expanding body of literature on the subject of shariah risks, specifically by proposing a novel definition of shariah non-compliance risk that differs in certain respects from the existing literature.

This thesis has added to the current literature on shariah governance by proposing a new definition of shariah governance that integrates agency and stakeholder theories to enrich scholarly discourse on the subject of shariah governance. In this respect, it is anticipated that discussions will add not only to the Shariah governance and risk management literature but also to the research on agency and stakeholder theory in Islamic financial institutions. The second contribution to the broad literature on stakeholder theory in Islamic corporate governance; according to stakeholder theory, all stakeholders who affect a company's performance are vital to its success (Al-Nasser and Muhammed, 2017). The findings show that the Shariah committee plays a key role in Islamic banks. Indeed, this is consistent with other research results (Ramly et al. 2018; Khalil and Taktak, 2020; Almutairi and Quttainah, 2020). The research reveals, however, that under the shariah corporate governance structure, other stakeholders are crucial to Islamic bank performance, particularly the shariah internal control division, which consists of a Shariah Audit division and a Shariah Compliance division.

The last contribution to the stakeholder theory is that, according to the stakeholder theory, individuals other than shareholders and managers exert influence over an Islamic bank, such as consumers and suppliers. In fact, the findings show that the outcome of shariah non-compliance risk may be reputational damage and, consequently, the loss of clients who engage with Islamic banks for religious reasons. In addition, as a third party involved in an Islamic financial transaction, suppliers can stop working with Islamic banks if they breach shariah.

This study combined the two theories to explain the relationship between the Shariah governance and risk management. Basically, the study followed Iqbal and Mirakhor (2004), who had the view that the corporate governance model in Islamic economic system is a stakeholder centered model, in which the governance style and structures protect the interest and rights of all the stakeholders rather than the shareholders. The study also adopted the ideas of Obid and Naysary (2016), who believed that, in accordance with the principles of agency theory, Shariah governance is a monitoring system that is employed by IFIs to solve the agency problem in Shariah-related matters.

The study found that the role of Shariah governance in risk management is to ensure that risk management does not create a Shariah non-compliance risk, since Shariah non-compliance risk can be entangled with all types of risk. Moreover, the findings show that shariah corporate governance equal to shariah compliance. Accordingly, the Shariah Board is proposed as a replacement for the conventional board of directors to ensure shariah compliance with the assistance of two key stakeholders: the Shariah Audit and the Shariah Compliance Division. This level of oversight reduces the risk of Shariah non-compliance and the amount of purification, while also satisfying shareholders by maximising profits by adhering to Shariah rules and boosting stakeholder confidence and Islamic bank integrity.

Therefore, by combining the agency and stakeholders' theories (Figure 7.1), the Shariah committee has the accountability feature that allows it to perform as the primary actor within the Shariah governance framework, acting as the principal-agent relationship between the shareholders and managers. The Shariah committee's role is to provide transparent and accurate information on whether or not Islamic bank operations have complied with Shariah principles. Accordingly, a decrease in the information asymmetry and an enhancement of the trust and confidence of stakeholders and shareholders can arise. Specifically, the Shariah committee, through its oversight role and based on the Shariah compliance report produced by the internal Shariah control (i.e., Shariah audit and Shariah compliance), can:

1. Reduce the risk of Shariah non-compliance and, thus, lower the purifying amounts and increase the profit offered to shareholders, while ensuring that a profit is achieved in a Shariah compliant manner.
2. Guarantee that the management is running the Islamic bank in accordance with Shariah principles.
3. Verify that the Islamic products offered to consumers are in accordance with Shariah principles.
4. Ensure that employees, who have a contractual relationship with Islamic banks, are working in a Shariah-compliant environment.

Nonetheless, this thesis has extended this concept into an Islamic framework, which is a major theoretical addition. Ultimately, to accomplish this task effectively, the author advocated that the Shariah committee within the bank should report to the bank's shareholders, thus awarding it with greater independence and more authority, which helps prevent conflicts of interest.

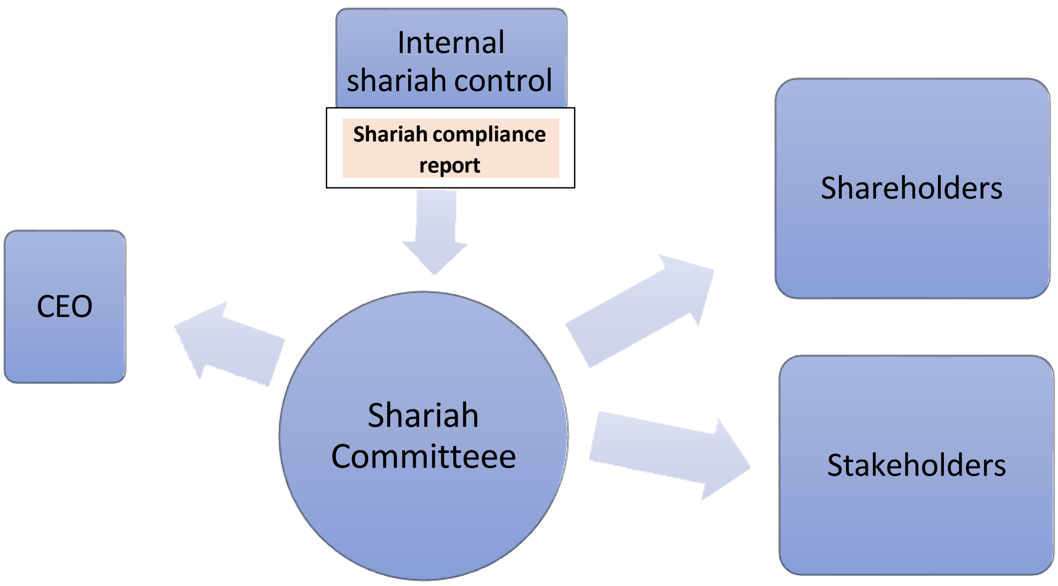

Figure 7.1. Depiction of a combination of the agency and the stakeholder theory.

According to the knowledge of the researcher, the current study is the first attempt to explore the links between Shariah corporate governance and risk management. Specifically, this study investigated the role of Shariah governance in each type of risk. This research has also increased our knowledge of how Shariah corporate governance frameworks are seen in the Saudi Islamic financial sector, as well as how Shariah-compliant banks interact with the official code.

Due to the paucity of literature on this topic, this study provided both valuable and useful information on the conceptual framework of Shariah governance by analysing the roles of the key participants in risk management within this framework. Understanding the fundamentals of Shariah governance in the context of Islamic banks is crucial for analysing and exploring its actual implementation.

Furthermore, the study provides a thorough evaluation and analysis of Shariah-compliant risk management practices and Shariah governance in full-fledged and window Islamic banks. This significantly contributes to the enhancement of the current Shariah governance structure. In addition, the study highlighted particular forms of Shariah governance and risk management challenges and revealed deficiencies and flaws in the current Shariah governance practices and on each type of risk.

By developing a three-line defence model for Islamic banks, this thesis has contributed to the practise of implementing Shariah governance and compliance. Noting that the purpose of the three lines of defence in Islamic banks is to ensure Shariah mandates are implemented throughout the bank's structure, In addition, it disseminates the notion that Shariah compliance is not a single-step process, but rather a multi-step process.

This study is expected to fill a gap in the thorough assessment of risk management in Islamic banking from a practical perspective. In other words, this research dives into the little-explored topic of risk management in Islamic banking. Furthermore, this work includes interviews with both full-fledged and windows Islamic banks in the field of risk management, so that the researcher can achieve more precise results by performing significance tests on the differences between the groups.

Finally, based on the data analysis, the study provided a number of policy proposals and recommendations, all of which require the complete participation and attention of all the parties that are concerned. The conclusions of this study, which are based on a thorough evaluation of the study's findings, advise that Islamic banks, the central bank, practitioners, and Shariah scholars should refine and strengthen Shariah governance and risk management best practices.

7.3 Limitations and Future Research

Although the author has made every attempt to produce thorough, credible, and significant research on Shariah governance and risk management in Islamic banking, there are several limitations to the study that cannot be ignored. First, there is a limitation owing to the paucity of literature, which has made it difficult to develop the conceptual framework of Shariah governance. Moreover, the literature on risk management in Islamic banking was also scarce, which had an effect on the number of references in this thesis.

Second, the researcher acknowledges that the number of respondents to the semi-structured interviews in the field of risk management in full- fledged Islamic banks was limited in comparison to the number of respondents in the windows bank. Likewise, the number of respondents on the topic of Shariah governance framework was generally low for two reasons: First, it is difficult for female researchers to conduct interviews in Saudi Arabia, particularly with Shariah committee/ SSB. Second, the new framework was published in 2020, while the interviews took place in 2021. Nonetheless, it is predicted that this thesis will contribute to the growing resources that are available for future research on Shariah-compliant corporate governance and risk management in the field of Islamic banking. Lastly, since the basis of the research is religion, which is a sensitive topic, any critical comment may be perceived by some as a critique of a religious belief or practise. Therefore, the researcher wants to underline that she views Shariah principles as just and socially advantageous. She also believes that the intention of establishing Islamic banks is to create a comprehensive economic system that promotes Sharia- compliant economic growth and social development.

Alternate approaches may be utilised in future studies to support or refute these findings. Future researchers can justify these findings by applying qualitative methodology to examine the impact of shariah governance on risk management, assessing the efficacy of the shariah governance framework by measuring the purification amounts resulting from shariah non-compliance risk. These influences can also be studied in the context of other Islamic organisations, such as those in the insurance and real estate sectors. Researchers can also focus on the role of the BOD, since the shariah governance framework clearly indicates that the board of directors is primarily responsible for implementing the shariah governance framework.

Further, future studies could use techniques like focus groups by arranging sessions of several SSB members of the same banks to discuss their views on the role of the Shariah governance in risk management or specifically the Shariah non-compliance risk as this study revealed that all risks could lead to shariah non-compliance risk. Further research can be conducted in various developing nations in Asia to yield interesting findings, given that each country has its own distinct shariah governance and risk management practices that are primarily influenced by economic conditions, competition, and regulations. Moreover, this study is founded on stakeholder and agency theories. However, there are other theoretical views, such as institutional theory and legitimacy theory, which can help us better comprehend the distinctive characteristics and practises of Islamic banks, as well as their contribution to the broader risk management and Islamic corporate governance literature.

7.4 Concluding Remarks

The research demonstrates that risk management is integral to Shariah governance and that Shariah governance has a significant impact on risk management. Shariah non-compliance risk is unique to Islamic banks; if the bank becomes non-shariah compliant, it will have an effect on its reputation, resulting in reputational risks and legal risks; and when legal risks occur, they will be reflected in price, competition, sustainability, and even credit and liquidity risks. When legal risks emerge, for example, they will have an impact on the extent of the contract between the bank and the customer. There will be no credibility for Islamic banks; therefore, risk management is strongly related to Shariah governance, particularly with regard to unique risks. And because it is considered a circle when an Islamic bank starts offering an Islamic product, the profit must also be Shariah-compliant; if it is not, it is not considered a profit. Therefore, Shariah adds another level to the entire risk management framework. Certainly, this is challenging, especially considering the lack of personnel with Shariah expertise and risk management experience.

Ultimately, we cannot say that risk management is the only part that influences shariah governance, though, because this full circle includes regulators, executives, the board of directors, the shariah committee, the audit committee, the risk committee, and compliance management. All of these parties, with their broad frameworks, are components of an integrated system. A part of it develops the requirements; another part implements them; and a third part monitors or participates in two of them. The regulators are primarily responsible for determining the governance framework, and sometimes there is self-initiative, which implies that the institution can add other elements to the governance framework that reflect the organization's professionalism.

After examining all the risks Islamic banks in Saudi Arabia face, it is necessary to comment on the widespread use of Murabaha in all Islamic banks in Saudi Arabia and worldwide. Since Murabaha is a sale-based product, the profit return is fixed, and the risk profile is assumed to be similar to that of a conventional loan. Nevertheless, the risk profile of Murabaha financing is complicated and not as straightforward as is commonly believed. More crucially, Murabaha and ijara, which are debt-based financing, are certified to be Shariah-compliant products but not truly Shariah-based ones. A higher priority must be given to the values represented by Islamic financial organisations. If they fail in their mission, they will no longer be able to maintain their status as a unique kind of bank. Therefore, this banking model has to be revised to increase participatory financing (Mudarabah and Musharakah) and remain faithful to the original intent of Islamic banking.

Saudi Arabia has a decentralised structure in which there are no national fatwa mechanisms. Further, the AAOIFI standards have no legal enforcement by the central bank yet are used as supportive guidance. Therefore, Islamic banks function according to various Shariah standards within the same context. (Ayedh and Echchabi, 2015). In fact, one of the most important issues that Islamic banking has is a lack of effective harmonisation of Shariah rulings within the same jurisdictions and across various countries (Bhuiyan et al.2020). It is causing public confusion regarding Islamic banking (Kermeli, 2000; Khan, 2007; Khan, 2010). The use of divergent standards among multiple Islamic banks creates difficulties for investors intending to engage in international ventures, impedes the effective implementation of advanced Islamic finance instruments, and reduces clients' faith in Islamic financial products (Bhuiyan et al.2020). As a result, there is a critical need for Islamic financial institutions to unite and standardise their Shariah rulings, which could aid in the worldwide expansion of the Islamic banking sector.

On a final note, the presence of a Shariah expert alone may not be sufficient to meet the expectations of the Islamic banking sector. It is imperative to incorporate the expertise of university graduates who possess knowledge in both Shariah and banking to enhance the Islamic finance business process. In almost all areas of Islamic finance, there is a paucity of effective manpower, which is one of the primary obstacles to the expansion of the Islamic banking system. To address this issue, it is necessary to promote the development of manpower in these areas. This should be accomplished by establishing training institutions not only in the Middle East but also throughout the rest of the world.

Leveraging technological advancements can enhance compliance measures, for instance, through the adoption of compliance shariah monitoring software, streamlining compliance reporting procedures, and utilising data analytics to detect potential non-compliance risks. The combined effects of proficient shariah auditing and periodic oversight by the Shariah Committee constitute sound shariah governance. These two functions have the potential to reduce shariah non-compliance risk levels. The incorporation of these elements, coupled with the involvement of board directors and other committees, including risk and audit committees, is intended to enhance the Shariah governance in Islamic banks and provide reassurance to all key stakeholders that all investments and activities adhere to Islamic principles.

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Appendix 1: Request for Interview

Research title: Shariah Corporate Governance and Risk Management in Saudi Arabian Banks.

Researcher: Tahani Mahsoon **Email:** tahani.mahsoon@nottingham.ac.uk **Student ID:**20201740

Dear Sir/Madam,

I am writing to you to introduce myself as doctoral student on research undertaken at University of Nottingham, UK and sponsored by Saudi Arabia ministry of education scholarship. This research is carried out to fulfil the research requirements of the PhD in Finance and Risk at the University of Nottingham.

This study examines the impact of Shariah corporate governance system on risk management in Islamic banks and banks offering Islamic products in Saudi Arabia. The uniqueness of my research springs from the lack of sufficient research on the matter of Shariah corporate governance and risk management in Saudi Arabia, this study thus aims to explore the role of a Shariah corporate governance system on risk management in the banks operating in Saudi Arabia. This study aims to enrich the literature in the current risk management literature, particularly regarding Islamic banks, by demonstrating the need for unique adaptation of risk assessment and risk management methods due to the nature of Islamic banks. Moreover, this research contributes to Sharia corporate governance by examining its main components. Various stakeholders such as decision makers, board members, top management and risk management executives of banks providing Islamic products may utilise the results to mitigate credit, market, liquidity, and operational risks.

I would be grateful should you be interested in participating in this research. Your participation is entirely voluntary, and if you agree to take part, it will involve a 40-60-minute interview. Your personal details will be kept confidential at all times, and the material will safely be stored on the University of Nottingham password-protected OneDrive. Some quotes from your interview may be used in subsequent publications, and they will be adequately anonymized to make sure they cannot be attributed to you. The interview generally be recorded, if recording not permitted notes taking will be done.

Confidentiality will be respected subject to legal constraints and professional guidelines, as received ethical approval from the UON

Please feel free to contact me via e-mail should you have questions about my research. Please let me know if you would like to see the interview questions in advance.
Your participation in this project is highly appreciated.

Yours sincerely,

Tahani Mahsoon

Nottingham University Business School, Jubilee Campus, Nottingham NG8 1BB

Appendix 2: Interview guide for the study

	Demographic Questions
	What is your background?
	How many working experiences do you have in the field of Islamic finance/banking/risk management?
1	**Shariah Corporate Governance and Risk Management**
1.1	In your opinion, what is Shariah corporate governance?
1.2	What is your view on the new Shariah corporate governance framework for banks in Saudi Arabia?
1.3	To what extent has Shariah corporate governance become a requirement for an effective Islamic banking industry in Saudi Arabia?
1.4	Under the framework of Shariah corporate governance, what is the role of the risk management?
1.5	What is the role of risk management in forming an effective Shariah corporate governance framework in banks in Saudi Arabia?
2	**Credit Risk**
2.1	What are the forms of credit risk facing Islamic banks?
2.2	To what extent does the degree of credit risk differ with Islamic financing contracts?
2.3	What is the role of Shariah corporate governance in regulating and managing credit risk?
2.4	What are the methods used to confront credit risk?
2.5	To what extent do these methods comply with the Shariah law?
2.6	To what extent is the Shariah Supervisory Board (SSB) aware of the credit risk management policies?
2.7	What is your opinion on the most important challenges facing Islamic banks in Saudi Arabia in terms of credit risk management?
2.9	To what extent would the competence of the Shariah Supervisory Board influence the management of credit risk?
3	**Market Risk**
3.1	What is the nature of market risk in Islamic banks?
3.2	How does market risk affect Islamic financing contracts?
3.3	What are the methods used to confront market risk?

3.4	To what extent do these methods comply with the Shariah law?
3.5	What is the role of Shariah corporate governance in regulating and managing market risk?
3.6	What is your opinion on the most important challenges facing Islamic banks in Saudi Arabia in terms of market risk management?
3.7	To what extent would the competence of the Shariah Supervisory Board influence the management of market risk?
4	**Liquidity Risk**
4.1	What are the sources of liquidity in Islamic banks?
4.2	To what extent do the Sukuk help in managing liquidity?
4.3	What is the role of Shariah corporate governance in achieving a balance between profit, liquidity and risk reduction?
4.4	How does liquidity risk arise in Islamic banks?
4.5	What are the methods used to reduce liquidity risk in Islamic banks?
4.6	What is the role of internal control in controlling and managing liquidity risks in Islamic banks?
4.7	What are the most critical challenges facing Islamic banks in managing liquidity?
4.8	To what extent would the competence of the Shariah Supervisory Board influence the management of liquidity risk?
5	**Operational Risk**
5.1	What are the types of operational risks in Islamic banks?
5.2	To what extent does the diversity of Islamic financing contracts influence the emergence of operational risks?
5.3	Under Shariah corporate governance, what is the role of internal control in reducing operational risks?
5.4	Why do you think that operational risk is considered the riskiest in Islamic banks compared to credit risk and market risk?
5.5	In your opinion, what is the definition of the Shariah risk?
5.6	To what extent does the emergence of this type of risk allow for other risks to arise, such as reputational risk?
5.7	In your opinion, do you think that Shariah risk is the most significant because it is linked to the core component of Islamic finance?
5.8	In your bank, is there a separate department that specialises in Shariah risk?

5.9	What are the methods used to manage the Shariah risk?
5.10	What are the most critical challenges facing Islamic banks in managing Shariah risk?
5.11	To what extent would the competence of the Shariah Supervisory Board influence the management of Shariah risk?
6	**Shariah Supervisory Board**
6.1	Under the framework of Shariah corporate governance, what is the role of the Shariah Supervisory Board?
6.2	How is the Shariah Supervisory Board selected and formed?
6.3	What are the characteristics that must be met in an effective Shariah control?