

Comparative Analysis of Regulation and Supervision of Islamic Banking between Malaysia and Saudi Arabia

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Abstract

Monitoring the activities of Islamic banks is a key objective of Sharia requirements. Malaysia and Saudi Arabia are major players in the Islamic banking industry, particularly in Sharia supervision. This study addresses the lack of clarity in legal provisions on Sharia supervision in both countries. Using an inductive, analytical, and comparative approach, the findings reveal that Saudi Arabia's legal provisions are more detailed and comprehensive than Malaysia's.

Research Objectives: The research aims to achieve the following objectives: Firstly, shedding light on the efforts and measures taken by the Central Bank in both countries. Secondly, explaining the similarities and differences between the legislations of the Sharia supervision in the Islamic banking in both countries.

Research Methodology: First, the the researcher employed the inductive approach to gather information on the significance of Sharia supervision in the central bank and its crucial role in the success of Islamic banking. This involved studying the regulatory frameworks and laws of Islamic banking in both Malaysia and Saudi Arabia. Furthermore, the researcher utilized the analytical method to analyze the findings obtained from legal materials related to this topic. Lastly, the researcher used a comparative method to compare the legislation governing Islamic banks in Malaysia and Saudi Arabia.

Research Contribution: Shedding light on the measures taken by both the Central Bank of Malaysia and the Kingdom of Saudi Arabia will enhance the duties of Sharia supervision in Islamic banks industries. It will also assist the specialists in the Islamic banking industry to benefit from the experiences of the two countries on Sharia supervision.

Keywords: Governance, Consultant, Board, Oversight

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Introduction

The importance of maintaining the integrity of one's beliefs and adhering to the principles of Islamic law in various aspects of life, including financial transactions, is emphasized in Islamic teachings. Consequently, within the context of Islamic banking institutions, there is a recognition of the need to establish Sharia committees and bodies tasked with ensuring the conformity of the services provided to the public with Islamic law. However, occasional breaches or violations may occur within these institutions, unbeknownst to the Sharia committee, due to various factors such as relevant regulations or other reasons. This necessitates the presence of an independent and authoritative Sharia authority that oversees all Islamic banking transactions in the country. In this regard, the Central Bank of Malaysia took the lead by enacting many acts to manage the Islamic banking. Similarly, the Central Bank of Saudi Arabia has issued the Sharia Governance Framework for local banks operating in the Kingdom of Saudi Arabia in 2020. These collective efforts to emphasize the importance of an independent body who is responsible for the safeguarding of Islamic banking procedures.

Definition of Sharia supervision:

Sharia supervision has been defined in different ways by scholars and financial institutions, but most of them have a similar meaning based on the view of the role played by the Sharia board. The following are the most famous and prominent of these definitions:

1. Sharia supervision is one of the newly established departments of Islamic banks to assist in achieving their goals. This definition is criticized for being too brief and not clearly stating the tasks of Sharia supervision.

2. It is one of the departments of Islamic banks that protects them from violating the provisions of Islamic law through their practices and provides them with Sharia-compliant solutions, thus giving them an Islamic character. This definition regards Sharia supervision as a subordinate to the bank, which is contrary to reality since Sharia supervision sometimes operates independently of the bank.

3. Sharia supervision is the regulatory elements and activities used to ensure that the operations of an Islamic bank comply with the Sharia. (Abu Ma'mar 1995)

After reviewing all these definitions, the researcher believes that the most appropriate definition of Sharia supervision in Islamic banks is it must verify the activities and services provided by Islamic banks, Islamic institutions and takaful companies that can be either a

subsidiary or independent of the Islamic bank. Its tasks also include reviewing contracts concluded between the bank and other external parties to ensure their conformity with the principles of Islamic law, and educating employees of Islamic banks on the fundamentals of Islamic transaction.

Firstly: Sharia supervision and Regulation in Malaysia.

The Malaysian legislator was keen to ensure that Islamic banking operations conform to the provisions of Sharia by issuing several legal legislations. It is notable that there are several acts regulating the Sharia supervision in Islamic banks or Islamic institutions in Malaysia. Among other: firstly, Islamic Financial Services Act 2013, secondly, Central Bank of Malaysia act 2009 and Banking and Financial Institutions Act 1989.

1- Islamic Financial services act 2013¹

This act is providing the regulation and supervision of Islamic financial institutions, payment systems and other relevant entities and the oversight of the Islamic money market and Islamic foreign exchange market to promote financial stability and compliance with Sharia and for related, consequential, or incidental matters. Regarding Sharia supervision, the Malaysian legal system obligated Islamic financial institutions to establish a Sharia department in Article Thirty of the act.

Establishment of Sharia committee

(1) A licensed person shall establish a Sharia committee for purposes of advising the licensed person in ensuring its business, affairs and activities comply with Sharia. while a licensed person is referring to a person licensed under section 10 to carry on licensed business.

(2) For the purposes of subsection (1), where there is more than one licensed person within a financial group, one of the licensed persons may apply to the Bank for the establishment of a single Sharia committee within the financial group and the Bank may approve the application in writing if the Bank is satisfied that the Sharia committee so established is capable of ensuring compliance with Sharia by all licensed persons within the financial group.

(3) The Bank may require an approved person or operator of a designated payment system to establish a Sharia committee for purposes of advising the approved person or operator of a designated payment system in ensuring their business, affairs and activities comply with Sharia.

¹ See the details in <https://www.bnm.gov.my/documents/20124/8102422b-e6dd-d149-8db0-e3637e89ed5c>

Appointment of Shariah committee member:

Article 31. No person shall be appointed, reappointed, or accept any appointment as a member of a Shariah committee unless such person meets the requirements as set out in any standards as may be specified by the Bank under subparagraph 29(2)(a)(ii) and has obtained the prior written approval of the Bank.

Duties of Shariah committee and its members:

Article 32. A Shariah committee and every member of the Shariah committee shall have such duties and functions set out in any standards as may be specified by the Bank under subparagraph 29(2) (a) (i).

2- Central Bank of Malaysia Act 2009

This act is providing the establishment of a Sharia Advisory Council to be as a reference for all Islamic banks and financial institutions that provide Islamic banking services and Takaful companies in the country. (Laws of Malaysia, 2009).

Sharia Advisory Council (SAC):

The researcher will shed light on the history of the establishment of the Sharia Advisory Council SAC, as well as the legal materials related to the work of the SAC and what is related to it.

The establishment of the SAC in the Central Bank of Malaysia.

The SAC of Central Bank of Malaysia was established in May 1997 as the highest Sharia authority on Islamic financing operations in the country. The SAC has been granted the authority to verify the soundness of applying the provisions of Islamic transactions in Islamic banking operations, operations conducted by Takaful companies, Islamic financing businesses, Islamic development financing operations, or any other operations that are subject to the supervision and regulation of the Central Bank of Malaysia. The SAC is considered the primary reference for the Central Bank of Malaysia in Sharia matters, in addition to the responsibility for verifying the validity of all services and products provided by Islamic banks, and the products of Takaful companies to ensure their compatibility with the principles of Islamic Sharia. Central Bank of Malaysia Act of 2009 regarding Sharia Advisory Council is consisting of eight articles related to the establishment of the Sharia Advisory Council.

Details of the Sharia Advisory Council articles.

In this Sub-topic, the researcher will detail the legal materials related to the Sharia Advisory Council, and comment on them.

Article Fifty-one:

This article indicates the desire of the Malaysian legislator to add more control over the activities of Islamic financial institutions in the country, and not only to be content with the sharia committee of Islamic banks, where the SAC is the final reference in cases of any dispute. Also, this article granted the SAC the right to establish appropriate procedures for its actions without any pressure from any party.

Article Fifty-two:

In this article, the law confirms the functions of the SAC, which are as follows:

1. to ensure the application of the rules of Islamic financial transactions in all financial transactions and cases referred to them.
2. providing Sharia advice to the Central Bank concerning its transactions and activities.
3. providing advice for the benefit of Islamic financial institutions, or to any party that wishes to do so.
4. any other tasks assigned by the Central Bank.

Note that the term "judgment" is meant for any judgment issued by the SAC for the purpose of confirming the integrity of Islamic financial transactions.

Article Fifty-third:

Appointment of members of the SAC, clause one of the article states that the Yang di-Pertuan Agong (the King) may, on the advice of the Minister after consultation with the Bank, appoint from amongst persons who are qualified in the Sharia or who have knowledge or experience in the Sharia and in banking, finance, law, or such other related disciplines as members of the SAC.

In the second clause of the article, it is stated that if a judge of the High Court, the court of Appeal, Federal court, or a judge of the Sharia Appeal court of any state or Federal Territory, is to be appointed under subsection (1), such appointment shall not be made except:

Acquiring approval of the Central Bank after consultation with the Chief Justice.

In the case of a judge of the Sharia Appeal Court of any state or Federal Territory, after consultation by the Central Bank with the Chief Sharia Judge of the respective State or Federal Territory, as the case may be.

It is noted in this article that the Malaysian legislator emphasize on the issue of appointing a member of the SAC of the Central Bank, so that the appointment comes from the king of the country, and after consultations with the minister of Finance, in order for Central Bank to ensure the eligibility of this candidate for membership of the SAC, and this is

a good indicator in fact as it complies with the principles of Sharia, which guided us to a strong honest choice when appointing governors. In addition, this is an indication of the Malaysian legislator's care to ensure the safety of Islamic banking transactions by appointing competent people to the SAC. Noted that, the services scope of the SAC of the Central Bank is not limited to Islamic institutions only, but also extend to other institutions that want to benefit from the council's services, such as the halal industry and others.

Also, the fourth clause of the article stipulates that the members of the SAC are entitled to bonuses for their performance, and it was determined by the board of directors of the Central Bank.

Fifty-fourth article:

The article grants the authority for the Central Bank to establish a special secretariat of the SAC, or the establishment of specialized committees to assist the SAC in its tasks. The Central Bank also has the right to appoint any of its employees to the secretariat of the SAC or to specialized committees to assist the council.

Fifty-fifth article:

This article stipulates that the Central Bank is obliged to consult the SAC in every matter related to Islamic financial transactions, specifically when conducting any tasks related to Islamic transactions. Institutions that provide Islamic financial services should also refer to the SAC's decisions or seek advice from it.

Article Fifty-sixth:

This article stipulates that; courts judges and arbitrators are obliged to refer to the decisions of the SAC and consider their decisions in matters related to Islamic financial transactions. By virtue of being a reference for them in Islamic financial matters. The inquiries shall be submitted to the SAC through the secretariat's office.

Article Fifty-Seventh:

It made the decisions of the SAC on Islamic banking binding on all financial institutions that provide Islamic banking services in accordance with article fifty-fifth, as well as the mandatory reference of courts judges and arbitrators to the decisions of the SAC in accordance with article Fifty-Sixth.

This article is one of the articles that were amended from the previous law of 1958, which stipulated that the courts consult the Sharia Council before issuing any decision and did not have to abide by the decisions of the council.

3- Banking and Financial Institutions Act 1989

The objective of the Banking & Financial Institutions Act², 1989 (BAFIA) is "to provide new laws for the licensing and regulation of the institutions carrying on banking, finance company, merchant banking, discount house and money-broking business, for the regulation of institutions carrying on certain other financial businesses, such as Islamic windows, and for the matters incidental thereto or connected therewith"

Article 24. (3) stated that any licensed institution carrying on Islamic banking business or Islamic financial business, in addition to its existing licensed business may, from time to time seek the advice of the Syariah Advisory Council established under subsection (7), on the operations of its business in order to ensure that it does not involve any element which is not approved by the Religion of Islam.

(4) Any licensed institution carrying on Islamic banking business or Islamic financial business shall comply with any written directions relating to the Islamic banking business or any other Islamic financial business, carried on by such licensed institution, issued from time to time by the Bank, in consultation with the Syariah Advisory Council.

(5) Any licensed institution carrying on Islamic banking business or Islamic financial business shall be deemed to be not an Islamic bank.

(6) This Act shall not apply to an Islamic bank.

Secondly: Sharia supervision and Regulation in Saudi Arabia.³

The Saudi experience in the Islamic banking in general and in Sharia supervision in particular, has come a long way in recent years. Perhaps the latest step that has been taking by Saudi Central Bank- formerly the Saudi Arabian Monetary Agency – to issue the special framework for Sharia governance for local banks and other banks operating in the kingdom as evidence of the high attention by Saudi authorities to review the transaction of Islamic banking in the country to be more transparent and stable. It is notable that there is no special body for Sharia supervision of Islamic banks that follows the Saudi central bank, there was also no special system that regulates and defines the work of the Sharia supervisory committee in banks that provide Islamic products, and perhaps the Sharia governance framework for Islamic banks operating in the country, which was issued in 2020, is considered the first step to develop a clear and transparent policy for the Islamic banks in the kingdom.

² See also <https://www.bnm.gov.my/documents/20124/8102422b-e6dd-d149-8db0-e3637e89ed5c>

³ See also [Shariah Governance Framework for Local Banks Operating in Saudi Arabia.pdf \(sama.gov.sa\)](#)

Mandatory development of a framework for Sharia governance

The second article of the Sharia governance has stressed the importance of promoting the principle of transparency and effective management in the Islamic banks activates. The Central Bank has mandated for each Islamic banks to develop its own a Sharia governance, such as the bank's policy, procedures that explain the structure, roles and responsibilities, the tasks of the relevant departments and the mechanism of communication between them.

With regard to the of Sharia control, the fourth clause of the same article requires the bank to establish mechanism controls to ensure that the objectives and operations of the banking activities carried out by the bank comply with the provisions and principles of Sharia in all cases. The sixth clause also stressed conducting a continuous assessment of the level of compliance of the bank with the provisions and principles of Sharia.

Formation of the sharia committee in Islamic banks:

The Sharia governance framework for local banks and banks operating in the kingdom has approved in its seventh article, which is considered a guiding article, as it must be officially applied starting from the year 2023 (the Central Bank of Saudi Arabia, 2020) the formation of Sharia committees in banks and banks operating in the country. Its members are appointed by a decision of the board of Directors of the bank on the recommendation of the Nominations and Remuneration Committee of the board, after obtaining written approval by the central bank.

Perhaps one of the most important points that raises the discussion about Sharia supervision is the extent of the independence of the supervision tasks. It's remarkable that, the Saudi regulator has not overlooked this aspect, in the third paragraph of Article VII, governance has identified cases in which the independence of a committee member is not achieved, as follows:

1. If the member owns five percent or more of the bank's shares or in one of the bank's subsidiaries.
2. If he is a representative of a person in a legal capacity who owns five percent or more of the shares of the bank or one of the bank's subsidiaries.
3. If he is related to any board members or senior executives of the bank or in one of the bank's subsidiaries.
4. To be a member of the board of Directors of one of the bank's subsidiaries nominated for membership of its Sharia committee.

5. If he was an employee or former employee during the past two years with the bank or any party dealing with it or one of the bank's subsidiaries as auditors and major suppliers.

6. If he has a direct or indirect interest in the activities and contracts of the bank. Receiving financial reward from the bank in addition to the remuneration or remuneration of his membership in the committee.

7. Having a credit relationship with the bank (credit cards, credit facilities, guarantees, etc.) in his name or in the name of one of his relatives, exceeding of three hundred thousand Saudi riyals.

8. Participating in a business that would compete with the bank or involving in business that is similar of bank's activity.

9. If the member has spent more than six continuous years or nine separate years as a member of the committee.

10. The governance also prevented any bank from appointing any member of the committee who being in the sharia committee of another bank operating in the kingdom, to ensure the concentration of the Member, avoid conflicts of interest and maintain the confidentiality of information.

Responsibilities and tasks of the sharia committee.

The Central Bank of Saudi Arabia has explicitly clarified the responsibility and tasks of the Sharia committee affiliated with its banks in Part Five. According to the instructions, the Sharia committee is accountable for making decisions concerning Sharia issues and is required to fulfill the following duties:

1. the Sharia committee supervises the extent to which the bank's Islamic banking transactions comply with Sharia principles. By reviewing Sharia compliance reports and conducting internal Sharia audits, the committee identifies any issues that require attention and proposes corrective measures to the bank's board of directors if necessary. This ensures that the Sharia committee has full authority over all the bank's transactions and access to its operations, with no hiding of transactions from the committee by the bank's management.

2. the committee issues resolutions on Sharia matters to ensure the bank's compliance with Islamic law. This restriction prevents interference in any Fatwas related to financial transactions.

3. The committee ensures that the Sharia policies and procedures prepared by the bank align with Sharia principles. This emphasizes the bank management's obligation to consult the Sharia committee to ensure the integrity of its procedures.

4. The Central Bank has provided the Sharia committee with a supervision mechanism to ensure the integrity of the bank's procedures. This includes the committee's obligation to adhere to the regulations and conditions outlined in forms, contracts, agreements, and other legal documents. Additionally, the committee endorses product guides, marketing advertisements, explanatory brochures, and publications used to introduce products.

5. The committee evaluates the bank's activities and conducts internal Sharia audits to ensure compliance with Islamic law. This evaluation is an integral part of the committee's responsibility in submitting reports related to Sharia compliance. This shows the authority of the Sharia committee in reviewing all transactions conducted by the bank's management.

6. The concerned parties within the bank, such as the legal adviser, external auditors, or advisory bodies, may seek advice from the Sharia committee on legitimate issues related to the bank's operations. The committee provides necessary assistance in this regard. It is worth noting that the clause does not specify whether the Sharia committee can charge a fee for these services.

7. The committee must inform the bank's board of directors of any violations related to the bank's activities and recommend appropriate measures to address the situation. This clause necessitates the establishment of a direct and special communication channel between the Sharia committee and the bank's board of directors to avoid any external influences.

8. Briefing to the Central Bank on cases in which Islamic bank's activities are not in accordance with the provisions and principles of Islamic law, are not effectively and adequately addressed, or has not taken any corrective measures in this regard.

This clause comes as emphasizing by the Central Bank of the safety of the products and services provided by Islamic banks. In addition to encouraging the bank to provide a high-quality product or service. This also requires a special communication channel between the parties away from any influences from other parties.

9. Finally, the sharia committee should prepare an annual report on the compliance of the bank's Islamic banking activity with the provisions and principles of Islamic law and submit it to the bank's Board of directors.

Independence.

The independence of the Sharia committee in Islamic banks from any interference or external influences is a crucial aspect that Islamic banks must prioritize. Failure to do so would disrupt the committee's tasks and create uncertainty in its resolutions. As a result, the Central Bank of Saudi Arabia has emphasized the importance of maintaining the independence of the Sharia committee in Islamic banks within the country. Article XIII of the regulations specifically addresses this independence, requiring the bank's board of directors to ensure that the committee is not influenced by any external factors that may hinder its ability to issue objective Sharia resolutions regarding transactional matters. Importantly, the organizational chart of the Sharia committee should directly link to the board of directors, preventing any undue influence from other parties. Moreover, in the third clause, the resolutions and rulings issued by the Sharia committee are granted power, safeguarding them from being modified or disregarded without the committee's consent.

Third: Short summary of the differences between the two countries

No	Topic	Malaysia version	Saudi Arabia version
1	Syariah supervision/ committee	Shariah committee exist in BNM and in each Islamic bank.	Shariah committee exists in Islamic bank only.
2	Appointment of the member of the Sharia Committee.	Member of the Sharia Committee at the Central Bank appointed by the King upon a recommendation of the Minister of Finance and the Central Bank. / Member of the Sharia Committee at the Islamic bank appointed by the Bank's Board of Directors after the approval of the Central Bank and the Sharia Advisory Council of the Central Bank. .	Member of committee of the Islamic bank appointed by decision of the Bank's Board of Directors upon a recommendation from the Board's Nominations and Remuneration Committee, and after obtaining the permission of the Central Bank.
3	Validity of membership in the Sharia Council	Unlimited	Three years

No	Topic	Malaysia version	Saudi Arabia version
4	Independent member	Prohibited from appointing a member if he is a judge in the Supreme Court, or in the Sharia Court of Appeal, except under certain conditions.	The Central Bank of Saudi Arabia has established eleven provisions to achieve the independence of the member in the Sharia Committee of the Islamic Bank.
5	Responsibility of the Sharia Committee in the Islamic Bank.	<p>The bank management should make sure in general, to transfer all transaction to Shariah committee.</p> <p>1-Providing advice to the Central Bank regarding Islamic banking transactions or activities supervised by the bank.</p> <p>3- Providing Sharih advice to Islamic financial institutions or any other party.</p>	<p>1-Expanding the scope of the Sharia Committee's services to include other parties, whether internal or external parties, to provide advice.</p> <p>2-The committee has the right to inform the bank's board of directors and recommend appropriate measures to address the situation if it is proven to the committee that the bank's employees have practiced Islamic banking activities that are not compatible with the provisions and principles of Sharia</p> <p>3- Informing the Central Bank of cases in which Islamic banking activities that are not compatible with the provisions and principles of Sharia are not dealt with effectively or adequately, or in which the bank does not take any corrective measures regarding them.</p> <p>4-Preparing an annual report on the compatibility of the bank's Islamic banking activity with the provisions and principles of Sharia for the Board of Directors.</p>
6	Committee independence	The Malaysian regulator did not address the issue of independence clearly, but rather left the matter to the bank.	The Central Bank of Saudi Arabia has established specific procedures to ensure the independence of the Sharia Council from any external interference.

Conclusion

It is crucial to have a legitimate body with broad authority to supervise Islamic banking operations in the country. To achieve a high level of transparency, it is essential for the authorities of Islamic banks to pay special attention to the performance of Sharia supervision. After reviewing the experience of supervision of Islamic banking in Malaysia, it can be said that it is exemplary in terms of degrees of supervision. This is evident in the mandatory presence of a special Sharia supervisory authority within the bank that provides Islamic banking services, as well as the presence of a Sharia board that serves as a reference for all Islamic banks under the Central Bank's jurisdiction.

On the other hand, the Saudi Central Bank has recently issued the Sharia Governance Framework for local banks and banks operating in the country. Some legal experts consider this step to be overdue, given Saudi Arabia's economic position and its status in the Islamic world.

The Sharia Governance Framework covers all necessary aspects of Sharia control, ensuring that the matter is not left to the discretion of the bank's management in developing specific control policies.

Recommendations:

The proposed procedures to enhance Sharia supervision in Islamic banking are indeed significant steps toward strengthening this crucial aspect of the industry. The collaboration between the Central Bank of Malaysia and its counterpart in Saudi Arabia, especially regarding Sharia supervision at the organizational and legal levels, would provide a robust framework for ensuring compliance with Sharia principles across borders.

Additionally, establishing a unified reference for Sharia supervision in Islamic banking would create consistency in the application of Sharia rules and regulations. This would be particularly beneficial in reducing discrepancies and promoting a more standardized approach to Islamic finance globally.

Ensuring that members of the Sharia Supervisory Board are well-versed in both Sharia and finance is essential for informed decision-making. Board members with a solid understanding of accounting, analytical, and economic aspects can better evaluate the compliance of financial products and operations with Sharia law.

Organizing joint conferences and seminars would provide a platform for experts to share knowledge, discuss challenges, and align their perspectives on Sharia supervision. Such

events would help mitigate disagreements and promote a unified approach to Sharia supervision.

Lastly, training bank employees on the principles of Islamic financial transactions would ensure that the operational staff is also aware of the Sharia requirements, thus fostering a culture of compliance within the institution. This holistic approach, combining top-down supervision with ground-level training, would significantly enhance the effectiveness of Sharia supervision in Islamic banks.

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