

Legal aspects of Shariah governance practices in Sri Lankan Islamic Financial Institutions: a literature review*

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ABSTRACT

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Purpose — *This study intends to examine the legal aspects and the actual practices of Shariah governance in Sri Lanka's IFIs. Further, it examines the law and regulations on Shariah governance as well as identifies the macro and micro level application of Shariah governance in Sri Lanka.*

Research method — *The literature observation and document analysis were applied to explore the relevant domestic and international regulation on Shariah governance in the country. As a qualitative study, the data were gathered through the primary sources such as the information derived from the interview with experts, legislations, international Shariah standards, annual reports and other institutional documents from the IFIs; and supported by the secondary data available in the literatures such as articles in journals, books, newspaper reports, the IFIs websites, and other sources.*

Result — *The findings of this study indicate that there is no legislation in Sri Lanka that legally enforces on Shariah governance framework at macro level. But, each IFIs has setup Shariah governance institutionally at micro level.*

Recommendation — *The recommendations are put forward to fill the gap found and to improve the legal status of Shariah governance in Sri Lankan Islamic financial industries.*

Keywords: *Islamic banking and finance, legality, shariah governance, Sri Lanka*

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BACKGROUND

The Shariah governance is an important mechanism in Islamic financial industry to ensure Islamic rules and regulations are followed throughout its operation. Without it, not only the industry's validity will be in question but also the public and stakeholders' confidence on the industry will be at stake. Shariah governance is one of the unique features of Islamic finance that discriminates it from its conventional counterpart. It guides Islamic Financial Institutions (IFIs) in all aspects of including management, administration, and other operational countenances to ensure that all the financial dealings are in compliant with Islamic principles and values. This can be achieved by the establishment of an efficient Shariah governance framework. The key concept of Shariah governance is to ensure Shariah compliance of entire business activities of IFIs.

The strategic element that distinguishes Islamic finance from its counterpart is Shariah. The whole operations of Islamic finance must be based on Shariah principles and objectives of Shariah (maqasid al-Shariah). It must be distinguishes from their conventional counterpart of which it must be free from interest (riba), uncertainty (gharar) and gambling (maysir) of which the latter are essentially based on. In order to ensure its Shariah compliance, the IFIs must, therefore, establish a designated system, tools or framework to towards achieving its Shariah objectives. As such, Shariah governance framework is developed and been followed by the IFIs across the world. The Shariah governance framework has now become the backbone and the foundation for the existence of Islamic banking ([Mizushima, 2013](#)). It becomes a crucial tool for ensuring and measuring competency and efficiency of Shariah compliance of Islamic financial operations.

However, the implementations of Shariah governance in IFIs of various countries show the different shapes of framework and diverse banking and financing models ([Hasan, 2011](#)). The degree of involvement of regulatory authorities in Shariah governance of IFIs also varies depending on the legislation of the respective countries. It should be verified in the legislations of Sri Lanka whether the regulations occupy greater or lesser influence or no influence at all for Shariah governance of IFIs in Sri Lanka. The growing number of Islamic windows in conventional banks and conventional leasing companies shows an emerging market of IFIs in Sri Lanka ([IFN News, 2016](#)).

The study aims to investigate the influence of Shariah governance in IFIs in Sri Lanka and to explain the current legislative and regulatory framework in order to explore the obstacles and challenges of effective implementation of Shariah governance. Since Shariah governance is fundamental for Islamic finance, it should have proper installation with enforcement and power. To attain positive development of certain level, Islamic financial industry needs to bring the industry under the authentic and proper Shariah governance framework which complies with the true principles of Islam ([Haqqi, 2014](#)). In an industry where Shariah governance is not legislated or regulated, there is a possibility that the players will go against Shariah compliance of their products and services. Thus,

this study has intended to explore the degree of legislative involvements towards Shariah governance practices.

LITERATURE REVIEW

Shariah governance has attracted the attention of many academicians and researchers in the field of Islamic finance. Many journal articles have discussed the models and structures of Shariah governance frameworks in various jurisdictions. In addition, books, presentations, and other publications that elaborate on Shariah governance and its legal status in various countries such as Malaysia, Pakistan, and GCC countries. [Hassan and Hussain \(2013\)](#) deliberate the Malaysian regulatory frameworks on Shariah governance and the impact of all relevant regulations regarding Islamic finance onshore and offshore to support their argument. There is another research carried out by [Kunhibava \(2015\)](#) on the regulations and the legal structure of Shariah governance in Malaysia whereby they found some legal issues on Shariah governance practices were identified by. Another article was published in 2015 by a group of researchers on the regulatory system of Islamic banks in Pakistan, Malaysia, Bahrain, and the United Kingdom (UK).

This paper analyzed the development of Islamic banks in the respective countries based on several elements such as regulation, especially regulators of Islamic banks, supervision, governance authorities, and others ([Tanveer, Shah, & Jamil, 2015](#)). Likewise, the issues and challenges of Shariah governance and Shariah supervisory system in Southeast Asia's and the Gulf Coast Countries' (GCC) models were discussed comparatively ([Grassa, 2013](#)). Arising from the analysis, he pointed out the importance to have Shariah governance with enforceability and legal power and he gave his view against voluntary enactments of Shariah governance in some jurisdictions. There is another research found that examined Shariah governance in Malaysia, the GCC countries (Kuwait, Bahrain, Qatar, Saudi Arabia, and the UAE), and the UK. The models and processes of Shariah governance and Shariah compliance in those countries were discussed and divided by the researcher into five approaches considering involvement of legislations of respective countries ([Hassan, 2011](#)).

However, although there are substantial researches the practice and the regulatory issues of Shariah governance have been discussed in various jurisdictions, but less attention has been paid in the Sri Lankan context. Sri Lanka still does not have enough researches on Shariah governance guidelines and barriers on implementation of such guidelines in the non-Islamic conventional domestic legislation of Sri Lanka. This necessitates the literature to propose the views and ideas of academicians and researchers to analyze Shariah governance practices in Sri Lanka in order to identify the obstacles and provide solutions to improve the practices within the existing legislations.

Country report of Sri Lanka elaborated the current scenario of the Islamic banking industry in Sri Lanka including all the legal and regulatory situations but

nothing was discussed about Shariah governance and its legal relevance (KPMG, 2011). However, Riyas Mihar wrote a chapter in a book published by Redmoney (2014) explaining the current scenario of the Islamic finance industry in Sri Lanka. He stated that one of the reasons behind less foreign investment in Islamic finance is non-availability of a central Shariah body to ensure enforcement of Shariah governance. Similarly, Nafees and Habeebullah (2016) discussed that Sri Lanka as a common law jurisdiction has enabled to offer Islamic financial products legally and they further, insisted on the necessity of a central SSB to enhance Shariah governance practices in the country. However, they did not focus the legal status of Shariah governance in Sri Lanka.

Hilmy and Mazahir (2014) presented a paper on Shariah governance of Sri Lankan IFIs in a conference held in Sri Lanka. This is the only research paper the researcher had found that directly discussed Shariah governance in Sri Lanka in an academic literature. It discussed the issues of Shariah governance in Sri Lanka and made recommendations mainly for the establishment of a national Shariah council and the need of a Shariah school to encourage teaching of Islamic finance to serve the industry. Since the extended abstract was published in conference proceedings, the legal and legislator arrangement of Shariah governance and the extent of Shariah governance practices in the country had not been elaborated.

The concept of Shariah governance

Shariah governance has become an area of research in Islamic finance literature. A number of writings in Islamic finance has discussed the Shariah governance and Shariah governance framework, structures, models, characteristics, and importance. The international standard setting bodies such as Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), Islamic Financial Services Board (IFSB) and the Bank Negara Malaysia (BNM) have issued guidelines on Shariah governance, but none of them provided clear definitions for Shariah governance, with the exception of the IFSB (Hasan, 2011).

Consequently, the definition of Shariah governance should be reflecting in terms of Shariah as well as governance.

Hence, the IFSB-10 defined Shariah governance in the context of the IFIs as:

“A set of institutional and organizational arrangements through which Islamic financial institutions ensure that there is an effective independent oversight of Shariah compliance over the issuance of relevant Shariah pronouncements, dissemination of information and an internal Shariah compliance review” (IFSB, 2009, p.2).

The definition provided by the IFSB-10 implies that there are three main features of Shariah governance that IFIs are bound to follow. Firstly, a body should be arranged institutionally as a special and independent body (Rooly, 2021) which refers to the Shariah Supervisory Board (SSB) and its relevant departments such

as internal Shariah review, Shariah audit, Shariah research, Shariah compliance department, and etc. Secondly, that body should provide independent supervision that confirms Shariah compliancy. This refers to the compositions of the board and its competency to serve efficiently towards Shariah compliance. It depends on the freedom and the powers of the body rendered by the IFIs. Thirdly, it denotes the entire process of the body such as Shariah review, Shariah pronouncements, and dissemination of information among the staff as well as to the public (Marjan & Ahmed, 2016).

Further, Marjan and Ahmed (2016, p.727) define Shariah governance “as unique type of governance in financial architecture as it is concerned with the religious aspects of the overall activities of the IFIs” and emphasized that the necessity of having Shariah governance differentiates IFIs from conventional financial institutions by having additional institutional arrangements for governance practices. Shariah governance is an institutional arrangement to safeguard IFIs from non Shariah compliant risk. If these arrangements are recognized and advised by the regulators, then the shape and the status of Shariah governance in each legislation will be different from the other depends on the involvement of regulators. Therefore, Shariah governance practices from different legislations are distinguishable from each other and bring different models and structures.

The legal, regulatory, judicial, and legislative systems are the heart of institutional arrangement which can play a vital role in setting the foundation for prudent Shariah governance and monitoring its functioning. If the adoption of Shariah governance is mandated by regulations such as banking laws or Acts, there should be strong Shariah governance system (Ginena & Hamid, 2015). Thus, having proper Shariah governance framework should be imposed by the regulators in order to fulfil the requirements of Shariah conformity of IFIs in a country. However, the countries where IFIs are in practice show the diverse practices Shariah governance depends on legal enforcements. Different jurisdictions have different approaches and diverse practices and models of Shariah governance system. Some of them show a greater involvement of regulatory authorities with comprehensive legislative arrangement such as national council and institutional board for Shariah supervision (Hasan, 2010). Therefore, all the legislation enables IFIs to be practiced in the state does not design the models of Sharaih governance framework. Some regulatory authorities have established Shariah advisory council which is the highest authority to ascertain Islamic law related to Islamic finance in their legislation while imposing all the IFIs to establish Shariah board for their respective institutions such as Malaysia on the other hand some does not have any intervention regarding Shariah governance but it has been left for IFIs’ own risk though it is the backbone of IFIs such as Kingdom of Saudi Arabia and the UK. (Hazizi & Kassim, 2016).

The evolution of Islamic finance practices in Sri Lanka

Understanding background of Sri Lanka, its legal system, stand point of Islamic law and Muslims in the country and the regulatory arrangements will help to find out the legality of Shariah governance of IFIs in the country. The financial sector in Sri Lanka comprises 24 licensed commercial banks, 9 licensed specialized banks, 47 licensed finance companies, along with specialized leasing companies, primary dealers, pension and provident funds, insurance companies, rural banks, stockbrokers, securities market intermediaries, unit trusts, and thrift and credit cooperative societies ([IFN forum SriLanka, 2014](#)).

The financial sector of Sri Lanka, either Islamic or conventional finance is governed by three jurisdictions at macro level legal arrangements:

1. Statute law or enacted legislation by the country's legislature.
2. Case law, consisting of determinations made by the Supreme Court of Sri Lanka, which is the highest legal authority in the country.
3. Regulatory determinations made by regulators of the financial services industry such as the Central Bank, Security Exchange Commission (SEC), and the Insurance Board of Sri Lanka (IBSL).

Among the above three legal arrangements the state law is very significant as it is enacted by the Parliament of the country and compliance of such laws is mandatory. Many laws have however been enacted by the Parliament over time, which have a bearing on operations of financial institutions. The significant ones are the Banking Act, Companies Act, Insurance Act, Bills of Exchange Act, Sale of Goods Act, Partnership Act, the laws of Agency, the law of Trusts, Leasing Act, law of contracts, etc.

There is no special provision in the above laws to undertake Islamic financial services. However, these laws have rooms to offer Islamic financial products and services without violating the existing laws. The establishment of Amana Investment Limited indicates the possibility of establishment of Islamic finance by the companies in Sri Lanka before the amendment of the Banking Act took place in 2005. There is no restriction in Companies Act of Sri Lanka to establish a company to offer Shariah based operation unless it contravenes other components of the Act ([Nafees & Habeebullah, 2016](#)). The Banking Act No. 30 of 1988 of Sri Lanka have been amended in 2005 in order to facilitate Islamic financial products by enabling commercial banks to involve in partnerships and sale-based businesses. On the other hand, the Banking Act itself is couched in non-partisan neutral language. It does not go beyond stating the permissibility of the product in broad outline and leaves the operating processes to be determined by the bank offering the service.

Nevertheless, Islamic finance in Sri Lanka has a history of two decades by the establishment of Amana Investment Limited in 1997 which became a full-fledged Islamic bank in 2010 and named as Amana Bank. Currently the country has 44 participants in Islamic financial industry which consist of banking and finance, takaful, consultancy and advisory, education, software and IT and Islamic

microfinance. (IFN News, 2016). The industry comprises a full-fledged Islamic bank, full-fledged takaful companies, as well as investment and leasing companies. A number of conventional players have started Islamic windows (Rooly, 2021). The Islamic financial services industry has gained much popularity among service providers and the public. Many financial services institutions, including state and private banks, have established Islamic financial service divisions, catering to the growing demand for this emerging service line (Redmoney, 2014). The market value of the Islamic banking sector in Sri Lanka is estimated in 2014 at LKR300 billion (US\$2.3 million), however the current market share is one fifth of the estimated value which is around LKR60-70 billion (US\$460.32-537.04 million) (IFN forum SriLanka, 2014).

RESEARCH METHOD

Since this study is exploratory in nature whereby the examination will take place on the law and regulations of Shariah governance Shariah governance practices of Sri Lanka, the qualitative method seems to be the most appropriate methodology to carry out this study. The data for this study were gathered from Sri Lankan state law on banking, finance, and commercial dealings. These data were collected mainly from the Acts, circulars issued by Central Bank of Sri Lanka (CBSL) and Insurance Board of Sri Lanka (IBSL), legal books, and other state reports from recognized official websites. In addition, the data required for this research will be gathered in various ways such as observation, library literature, and statement of professionals which need long descriptions and interpretations rather than numerical statistical data. Other than these, the required information regarding current regulators and its enforceability on Shariah governance along with some recommendation for the best application of Shariah governance will also be accrued from interviews with banking professionals from selected IFIs.

RESULT AND DISCUSSION

The methodology adopted to attain the objective of this study is literature examination and critical analysis of the laws and legislations of Sri Lanka that govern entire financial activities. The literature review that are discussed above elaborates the Acts and regulatory system of Sri Lanka such as Companies Act No. 07 of 2007, Banking Act No. 30 of 1988, regulatory bodies such as the CBSL, IBSL and their guidelines and circulars issued from time to time have enforceable controls on financial institutions. These laws and legislative arrangements in the country facilitate Islamic finance to operate in Sri Lanka although the Muslims are a minority group. There is no element in the law that prohibits establishing any business entity to provide Shariah based products and services unless it is against the country's laws. Establishing Shariah based business entities does not violate common law of the country except in a few occasions. The reason is that Sri Lanka is a common law jurisdiction where English law is applied to all matters except for a few issues that are governed by Roman-Dutch laws and personal laws such as Kandian and Muslim personal laws. Researchers have proven that

English common law and Roman-Dutch law are influenced by Shariah law as declared by the High Court of Justice of Sri Lanka (Weeramantry, 1988; Nafees & Habeebullah, 2016). This has been proven by the establishment of IFIs such as Amana Investment Limited in 1997 and ATL in 1999. Statements of providing services based on Shariah principles that fully adhere with the country's laws are also permissible in Sri Lanka.

The obstacles of offering Islamic financial products and services by the commercial banks have been removed by the amendment in Banking Act No. 30 of 1988 that took place in 2005. This amendment has enabled commercial banks to offer products and services based on partnership using PLS mechanism and sale-based products. However, all licenses obtained by IFIs in Sri Lanka are nonpartisan and common for IFIs and conventional institutions such as the commercial banking license for Amana Bank, which is a full-fledged Islamic bank. Although it is permitted by the law to offer certain Islamic banking products, in legal sense it is still a commercial bank. Circular No. 12.5 of 2005 issued by the CBSL under the title 'Introduction of Products based on Islamic Principles' implies the recognition of Islamic finance in Sri Lanka. However, the contents of the circular are more on stability of the IFIs by maintaining separate books of account for Islamic and conventional banking businesses and by mandating strict adherence to existing banking laws of the country.

The above observations show that Sri Lankan legislation facilitates Islamic financial operation. However, none of the laws, provisions, circulars, or guidelines issued by the regulatory authorities emphasized on Shariah governance. Circular of CBSL No. 12.5 of 2005 on Islamic banking products does not imply anything to ensure Shariah compliance but emphasizes on strict compliance with existing laws of the country. Therefore, Shariah governance in Sri Lankan IFIs has been adopted at micro level though it cannot be enforced legally.

Thus, the study has found that:

- i. There is a gap in the legislation of Shariah governance framework of IFIs in Sri Lanka that should be rectified by either enacting a new Act or by amending of the relevant Acts or by issuing any circulars or guidelines by the regulatory bodies such as CBSL and IBSL. This shall enforce the IFIs to ensure proper Shariah compliancy.
- ii. There is no centralized Shariah council established by the law to supervise whole IFIs independently which was preferred by all the respondents. This facilitates consistency of Shariah governance practices in IFIs.
- iii. All IFIs have setup their own SSB to ensure the Shariah compliancy as it is concurred by all respondents, annual report and official websites.
- iv. All IFIs follow international standards such as those issued by the AAOIFI and IFSB as decision taken by the management and SSB of IFIs.
- v. Articles of Association of Amana Bank and ATL specified that the entire business activities shall be in accordance with Shariah law. This effort mandates these two IFIs to strictly follow Sharia law and cannot go beyond

since it was stated in the article. This is because, only these two IFIs are established as full-fledged Islamic institutions at their inception, whereas the rest are windows or units in conventional entities. However, there is no reference in the legislation to define exactly what is Shariah law.

Shariah governance has not been mandated by the regulators but it is an unavoidable quality of IFIs. Therefore, the responsibility lies on the Board of Directors (BOD) and management to ensure Shariah compliancy of the services. In this regard, all IFIs in Sri Lanka have established their own SSB to ensure Shariah compliance of their practices. The names of their SSB members have been published in their official websites, annual reports, and leaflets. Further, some institutions have declared that they strictly follow AAOIFI Shariah Standards (Marikar, 2016).

Since there are no attempts made by the regulators that emphasize the Shariah governance, the managements of each IFIs take over the responsibility of ensuring the Shariah compliancy of the operations. IFIs in Sri Lanka have structured their own Shariah governance framework whereby they have established individual SSB and other institutional arrangements of Shariah governance. The performances of IFIs are disclosed through annual report, brochures and official websites by having of SSB and Shariah governance practices at institutional level. Most of the IFIs in Sri Lanka follow AAOIFI standard for their Islamic financial transaction (Mazahir & Hilmy, 2013). Thus, Shariah governance has been practiced in Sri Lanka at micro level. Hence, there is a need to legalise Shariah governance in the country by law or regulation in order to strengthen Shariah compliance of IFIs along with promoting stability. The importance of this study is to recommend a stable platform to enhance Shariah governance in Sri Lanka. This matter requires urgent attention because there is a big gap in the legislation of the country on Shariah governance although Islamic finance has been recognized by the law.

Thus, from regulatory point of view as elaborated by Hassan (2011), Shariah governance model of Sri Lankan IFIs is similar to the passive approach whereby the regulations of the country treat IFIs as equal to their conventional counterparts, and there is no legislation pertaining to Islamic finance except an amendment to enable companies to offer Islamic banking products. Also, the regulators have not issued any guideline on Shariah governance except for one, which emphasizes on segregation of accounts for Islamic and conventional transactions. Further, there is no national Shariah advisory board or any institution to be the sole authoritative body in Islamic finance.

CONCLUSION

This research has been carried out to investigate the status of Shariah governance practices in IFIs in Sri Lanka. As a qualitative study, the data were gathered through primary and secondary sources related to the topic. The literature observation and document analysis were applied to explore the

relevant domestic and international regulation on Shariah governance. The semi structured interviews and discussion were conducted with practitioners as well as academicians to get their opinions and ideas.

It has been found that there are no legal arrangements from the regulators to monitor the Shariah governance though each IFIs in Sri Lanka have structured the Shariah governance practices within their institutions. This environment may bring challenges to the IFIs from the practical as well as Shariah perspectives. Thus, the researchers have analyzed this issue based on international practices and recommendations put forwarded to implement Shariah governance from both macro and micro level approach considering the state regulation.

RECOMMENDATIONS

In respect of legal relevance of Shariah governance in Sri Lanka, the following recommendations are presented. These recommendations have been divided into macro level and micro level.

Macro level

This subsection puts forward the recommendations to facilitate Shariah governance at the macro level whereby the establishment of proper Shariah governance framework will be mandated by the regulator.

1. The collective effort by the industry players
IFIs in the country could take collective action with the support of domestic and international academicians, lawyers, and politicians to enable the CBSL to understand the concept of Islamic finance along with Shariah governance.
2. Amending of relevant acts or issuance of any special circulars
Based on the request by the pressure group from the industry, the regulator may amend the relevant Acts such as Banking Act, Companies Act or Insurance Act to in order to enforce appropriate Shariah governance framework on IFIs. Otherwise, the regulators may issue circulars or guidelines that require IFIs to set up a SSB to ensure good Shariah governance, which will be mandatory on all IFIs. The UK can be taken as an example in this regard. It also is a secular state where the central authority does not differentiate IFIs from conventional institutions, whereby IFIs should comply with existing regulations, just as conventional institutions do.
3. National SSB
The regulators shall consider setting up a special division inside the CBSL with qualified scholars and other supportive staff to act as the Central or National Shariah supervisory body that harmonise and supervise Islamic financial operations regarding Shariah compliancy. This is the most common recommendation that has been insisted in most previous studies

such as by Hassan (2011), Hamza (2013), Hilmy and Mazahir (2014), and Grassa (2013).

4. Empowering third party as Central SSB

The regulators may also consider authorising a registered body in the country that is currently engaged in Islamic religious affairs to be responsible for supervising Shariah governance of IFIs. Two recognised bodies that can be considered are:

- i. The Department of Muslim Religious and Cultural Affairs, a government department which comes under the Ministry of Muslim Religious Affairs of Sri Lanka.
- ii. Al Ceylon Jamiyathul Ulama (ACJU) is the apex body of Islamic theologians in Sri Lanka incorporated under the Act of Parliament No. 51 of 2000. It is not a government authorised body but is well-known and widely recognized body among the Muslims in Sri Lanka since pre-independence time of 1924.
- iii. The CBSL can get the services of the ACJU in collaboration with the Department of Islamic Religious Affairs to supervise the Shariah governance of IFIs. This is possible because the ACJU has Shariah people from various committees and the Department of Muslim Religious Affairs has legal rights to involve in Islamic religious affairs. This composition may be able to provide better services due to combination of expertise and legal rights.

Micro Level

The above discussion highlighted some existing barriers that may interrupt the emergence of Shariah governance at macro level in Sri Lanka such as Muslims are a minority ethnic group and there have been some ethnic incidences recorded against Muslims in current political condition. Thus, Shariah governance has to materialise at micro levels, especially at the level of the BOD. A lot therefore depends on the sincerity and commitment of the BOD to enhance the quality of Shariah compliance in the activities of the IFIs. The IFIs should pay attention to Shariah governance though it has not been mandated by the legislation at the macro level. Thus, this section presents a few recommendations to improve Shariah governance at the micro level.

The Banking Act No. 30 of 1980, which is the governing law for the licensing and regulation of commercial banks and finance companies in Sri Lanka, has specifically laid down mandatory conditions for granting licenses to regulate financial institutions. An important condition is that applications for banking licenses are restricted only to limited liability companies. A limited liability company is a standalone legal entity that has recognition in law to enter into contracts and to sue and be sued in its own name. The constitution of this entity is laid down in two documents called the "Articles of Association" and the "Memorandum of Association". The Articles of Association lays down the rules for the internal administration of the company and the Memorandum of

Association spells out the broad contours for the interaction of this entity with the outside world.

As it is discussed above in the regulatory overview of Sri Lanka, there is no restriction in the Companies Act to state that a company will operate based on Shariah law, but it should still be subject to the country's existing laws. This circumstance has enabled the Shariah governance process to be positioned within the constitution of a limited liability company. Therefore, it is possible for the business entity to state in the objectives that it will observe Shariah law regarding its business while strictly following the country's existing legislation.

If the above statement were included in the Articles of Association, the entity cannot act against the objectives stated. The BOD cannot act outside the framework of the constitutional documents of the company although the BOD is the highest decision making body in all businesses and executive matters, as they are appointed by the shareholders of the entity. All business decisions taken by the BOD must be within the Articles and the Memorandum of Association of the company.

The situation of IFIs that operate an Islamic division as a window operation of the parent institution offering conventional finance is however somewhat different. The incorporation documents of these institutions have no reference whatsoever to Shariah compliance as these documents were submitted to the authorities long before the commencement of the Islamic window operations. Due to the amendment to the Banking Act of 2005, these IFIs have a perfectly valid legal existence by informing formally to the CBSL about the commencement of Islamic finance operations in their companies.

However, we recommend that the window operators push their parent company to amend their Articles of Association to state clearly the objectives of the Islamic division, which are following Shariah law and complying with recognised international or local governance standards while strictly adhering to the country's laws. By doing this, Shariah governance can emerge from the level of the BOD in the window operations as well. This will prevent the gap found in the RO2 whereby in some IFIs, the reporting line from the SSB is confined to the level of management.

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