SHARI’AH COMPLIANCE IN A EUROPEAN BANKING CONTEXT

Sevgi Osman
Varna Free University “Chernorizets Hrabar”
ORCID 0000-0002-5108-5476

Nedyalko Valkanov
University of Economics - Varna

Abstract: Compliance rules existed even before the earliest modern financial and banking regulations. This paper aims to compare compliance systems in terms of the principles of Islamic finance with those of conventional finance and to determine whether they can exist “under one roof”. It focuses on the importance of Shari’ah compliance in Islamic corporate governance and the main body for its assurance – the Shari’ah Supervisory board, which takes various shapes in different legal and regulatory systems. Using the content analysis method, Shari’ah compliance among European Islamic banks (or Islamic windows) was investigated and on this basis the conclusion was drawn that, with the help of internal and external efforts, an effective framework for Shari’ah compliance can be ensured even in traditional financial institutions. Such a framework is needed mostly for the clarification of Shari’ah rules and norms in societies with a vested interest in Islamic financial markets and products.

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Introduction

Islamic banking has entered into an increasing number of non-majority Muslim countries. This upward trend should not be overlooked given the oil wealth of majority Muslim countries. Indeed, Islamic financial markets in Gulf Cooperation Countries (GCC) and Southeast Asia will continue to accumulate wealth, and that is why Western nations should make ready different ways to attract international investors. However, in spite of the last several years’ rapid financial growth, many regulatory authorities and practitioners can not define the process by which Islamic banks could be introduced into a conventional system.

Islamic finance is based on "Shari'ah" principles established by rulings, known as *fatwas*, of qualified Muslim scholars. Some of the issues covered by these rulings can indeed be quite confusing, as a result of which the respective institutions often seek the assistance of experts in this field. Such issues have led to a common practice among Islamic banks to appoint their own boards of Shari'ah scholars.

Islamic banking relies on the support of regulatory authorities and legal provisions to a greater extent than in traditional banking compliance with Shari'ah law being paramount. To this end, Islamic banks have established robust corporate governance structures to oversee compliance with Shari'ah principles (Bouheni & Ammi, 2015).

These guidelines should not favour the progress of Islamic financial operations nor hinder their development; they should create prerequisites for the parallel existence and even effective competition of both conventional and Islamic forms of banking.

However, this does not mean putting an equal sign between them. When regulating Islamic banking institutions, regulators have to add over the existing traditional regulation practices.

Separation of Conventional and Islamic Banking – Emergence of Islamic Windows

According to Benaissa (2007), a regulator can determine how much can be divided between Islamic and conventional banking. Regulatory practices all around the world range from not allowing Islamic Financial Institutions (IFIs) to a fully Shari'ah-compliant banking sector. In the middle is a dual framework which encourages the development of Islamic banks by protecting them from their competition with conventional analogues offering Islamic products. Whether using one form or another, regulators must take into account the potential consequences this decision may have.

More and more, an effective structure called "Islamic windows" can be seen on the financial landscape. The Islamic bank window is a department of a conventional bank offering Islamic or Shari'ah-compatible financial products and services. In fact, the interconnection goes in two directions: this form could introduce conventional finance activities in Islamic markets or, by contrast, Islamic financial operations could be established in non-Muslim markets, e.g., in Europe. An Islamic bank window is valid only if it complies with the requirements set by the AAOIFI, the Accounting and Auditing Organization for Islamic Financial Institutions (Yaquby, 2005):

- Complete segregation of funds;
- Existence of a Shari'ah supervisory board (SSB);
- Management based fully on Islamic concepts;

- Safeguarding of Muslim investors' funds against negligence, trespass, and fraud;
- Compliance with AAOIFI standards.

The bulk of Islamic countries' regulators either do not favour the Islamic bank window or impose the separation of Islamic from conventional banks for two main reasons:

- to prevent the mixing of conventional and Islamic banking activities, which is "impermissible" under Shari'ah principles (International Monetary Fund, 2017);
- to mitigate different regulatory frameworks, the result of which is referred to as "regulatory arbitrage" risk (Hasan & Risfandy, 2021).

Despite the contradictions regarding these "windows", Islamic banks could benefit from the long-lived conservative operations of conventional banks. On the other hand, Islamic windows could enhance the competition on Islamic banking markets, which would reduce the cost of Islamic financial products. In addition, Islamic bank windows may contribute to the financial inclusion of Islamic banking in Western or other non-Muslim countries with a low demand for Islamic bank services (International Monetary Fund, 2017). Ratnasari (2021) has also found that Islamic windows were more efficient than full-fledged Islamic banks.

Islamic windows are more stable than fully Islamic banks because they rely on their counterparts' assets, operating in parallel under one roof with conventional banking institutions (Salami & Adeyemi, 2015). However, they are reported separately with their reports being consolidated within the main financial statements of parent banks. These banks have committees or other similar structures, which will be discussed a little later, that monitor the compliance of their operations with Shari'ah principles (Abdul Majid et al., 2011b).

Islamic finance windows of conventional financial institutions have become a notable trend as the Islamic finance industry continues to develop. With their wide-ranging acceptance and increased visibility, Islamic finance windows play a crucial role in expanding the availability of financial products and services compliant with Shari'ah principles and rules. However, having Islamic finance windows (versus full-fledged IFIs) results in additional risk factors for the Islamic finance industry as a whole, due to potentially weak Shari'ah governance and / or compliance and certain other risks unique to the windows model. It is of utmost importance to apply Shari'ah governance principles to Islamic finance windows in a holistic manner to ensure that their operations maintain integrity and Shari'ah compliance while fulfilling their fiduciary responsibilities towards all stakeholders in a fair and transparent manner.

Conventional vs Shari'ah Non-compliance Risk

Against this background, an attempt could be made to compare compliance systems in terms of the principles of Islamic finance described above with those of the conventional financial sector. Before that, a brief overview will be made of the emergence and evolution of regulatory compliance functions practiced by financial institutions. In its most general sense, compliance is the adherence to a pre-established set of norms and rules regarding business conduct. It should be noted that such practices existed even before the first modern financial and banking regulations. In this respect, the prototype of such activities can be traced back to the dawn of economic relations. The laws of King Hammurabi of Babylon (18th century BC) prescribing norms of good conduct in trade, the scriptures of the major religions (especially regarding interest), and the strict rules regarding the secrecy and quality of crafts practiced by medieval guilds are but a few illustrations of rules and standards of conduct resembling today's compliance (Valkanov, 2019).

In modern history, the emergence of practices with strict adherence to certain standards in business can be dated back to the introduction of mass production in the early 20th century. The resulting industrial and manufacturing corporations imposed their own systems to provide internal institutional tools to ensure compliance. A pioneer in this respect was the Toyota Motor Company, which in 1963 also formalised specific compliance requirements within the scope of its updated quality policy within the *total-quality-management* (TQM) framework. After the 1980s, compliance issues gradually entered the banking sector. Specific preconditions for this were several scandals related to improper securities transactions carried out by investment banks in the USA (particularly Salomon Brothers, Inc. and Kidder, Peabody & Co.). This was followed by the creation of specialised internal regulatory control units in both banks: a prototype of the modern regulatory compliance units present in the structures of any modern financial institution today. In 1993, again as a result of previous misconduct, the Swiss Schweizerische Bankverein (SBV) introduced a comprehensive compliance organisation.

These cases of misconduct have been accompanied by other major procurement abuses and corporate scandals in the USA, leading to the creation of relevant specialised legislation. An example in this regard is the US Foreign Corrupt Practices Act (FCPA) of 1977, considered the first piece of legislation to institutionalise issues of compliance. For example, after the famous Enron scandal, the Sarbanes–Oxley Act of 2002 introduced a number of requirements to increase financial transparency within publicly-held companies. Alongside this, the introduction of standards for ethical behaviour in large corporations and government institutions is gaining popularity.

In a European context, the UK was the first country to introduce a detailed corporate governance "code" and was also the first to include the "comply or explain" concept with the *Cadbury Report*, which contained the framework for a new set of rules. The code was fully launched in 1992 and has been copied in other national codes since. Other major regulatory initiatives introducing corporate governance principles and best practices for public companies are the French *Vienot Report* of 1995 (updated in 1999) and AFEP-MEDEF Code of 2023, the Spanish *Olivencia Code* of 1998 and Unified Good Governance Code of 2006, the Italian *Preda Code* of 1999, the German Corporate Governance Code of 2002, known as the *Cromme Code*, the Dutch Corporate Governance Code (*Tabaksblat Code*) of 2003, etc.

As a general incentive for the introduction of such regulatory initiatives, one can point to a number of cases of misconduct and significant corporate scandals involving large public companies like Enron (2001) and Parmalat (2003). The discussion remains why, despite the existence of such a regulatory framework, misconduct continues among large public companies, such as the UK GlaxoSmithKline bribery scandal of 2013 and Tesco Accounting Scandal of 2014, German Volkswagen Dieselgate of 2015 and Wirecard fraud of 2020, and Switzerland's Credit Suisse collapse of 2023 – with numerous cases of illegal activities like money laundering, tax evasion, and corporate espionage.

In evolutionary terms, six stages can be noted in the advent of compliance within the operational activities of financial institutions. The *introduction stage* went from the late 1980s to 1990s and mainly involved investment banks and the securities trading units of large banking groups. Internal compliance units like these were usually established in the aftermath of corporate scandals, fraud, and other misconduct. Prior to that time, compliance activities were still treated as ancillary to those of business ethics. These include professional ethical standards and codes of conduct, whistleblowing systems, the articulation of corporate social responsibility values, etc.

The *second stage* covers the period after the end of the 1990s and the first years of the new millennium. Compliance activities then entered the banking industry en masse and ethical compliance became unified with the compliance sphere. The war against terrorism also necessitated a fundamentally new look at the rules for identifying the customers of financial institutions and monitoring their transactions. Of key significance was the introduction of the United States' Patriot Act (2001), on the basis of which these policies became virtually mandatory both for domestic financial institutions and for all those linked to the US financial system.

In the *third stage*, compliance left the banking segment and became part of the structures of other financial institutions. There has been full integration of all anti-money laundering (AML) / countering the financing of terrorism (CFT) activities into the scope of compliance. The growing importance of money laundering issues and the active integration of the financial sector (mainly through the banking system) in the various preventive initiatives have made compliance activities a key countermeasure mechanism to be implemented through dedicated internal units within the structures of financial institutions.

The fo*urth phase* of compliance development included its regulatory institutionalisation through the introduction of key national and international regulatory standards formalising compliance as a stand-alone policy (US Sarbanes–Oxley Act of 2002; COSO standards, 2004; BCBS, 2005; IOSCO, 2006). Alongside this, an understanding of the importance of the compliance function was being formulated. At the organisational level, the first compliance committees were formalised; where they did not exist, compliance was positioned within risk or internal audit committees.

The *fifth stage* in the evolutionary development of compliance followed the global financial crisis of 2007–2008. The numerous cases of misconduct observed during that period, both at the individual and institutional level, prove that effective compliance in the financial sector is an absolute necessity. The many instances of various misconduct by financial institutions, followed by multi-billion-dollar fines and compensation awards, attest to the critical need for effectively enforced compliance policies within organisations.

The explosion of the latest technological innovations in informatics marks the *sixth stage* in the evolution of financial compliance. After the emergence of FinTech, the Regulatory Technology segment (RegTech) quickly stood out. The opportunity to share regulatory expertise to some extent has relieved the regulatory burden borne by the financial sector as a result of post-crisis regulatory changes. Technologies using artificial intelligence, big data, and even blockchain also have found their application in compliance practices.

In 2005, the Basel Committee on Banking Supervision published the paper *Compliance and the Compliance Function in Banks*, in which compliance is seen as a top-level activity that achieves its highest effectiveness within a corporate culture where the board of directors and senior management meet standards of honesty and integrity (BCBS, 2005: 7). Once more, *compliance risk* is defined as "the risk of legal or regulatory sanctions, material financial loss, or loss to reputation a bank may suffer as a result of its failure to comply with laws, regulations, rules, related self-regulatory organisation standards, and codes of conduct applicable to its banking activities" (ibid.). This broad definition implies moving compliance beyond its basic definition solely with the purely normative context. What is more, it would be fair to say that compliance is essentially a broad category (often illustrated as an "umbrella term"), encompassing both regular activities and those outside the purely legal framework.

In this respect, the following illustrative systematisation of banking operational activities relevant to compliance can be given (Valkanov, 2019, pp. 141–148): normative compliance activities; product compliance; AML (antimoney laundering) and sanctions compliance activities; control activities; risk identification; reporting activities; coordinating compliance activities; business and personal ethics; technological activities.

On first reading, no parallel should be drawn between the Shari'ah-based principles of Islamic finance and traditional compliance policies, insofar as the former are based on canonically set principles and restrictions, while the latter facilitate the application of formalised legal norms and business regulations. On a more detailed rereading, however, more than one or two points of contact can be found that might serve for a more thorough comparative analysis.

Adherence to formalised rules. In conventional compliance, their source can be written laws but also uncodified practices (e.g., internal regulations or perceived self-limitations within the financial institution itself). In Islamic finance, we again have a codified source of legal rule, the Shari'ah, and also scholarly interpretations (fatwas[1]).

Institutional subordination. An example of such is the Basel Committee on Banking Supervision's treatment of the compliance function mentioned above. Similar definitions are given by other supranational institutions with quasi-regulatory status (e.g., IOSCO). In Islamic finance, for its part, we can point to the AAOIFI and IFSB standards as examples.

Ethical problems. Perhaps this is the most pronounced point of mutual contact. Insofar as the foundation of Islamic finance rests entirely upon strictly defined norms of conduct (avoidance of excessive risk, prohibition of charging interest, etc.), from the perspective of conventional compliance, aspects relating to the principles of prudent conduct based on codes of conduct and professional ethics can be pointed out.

Self-regulation. On the face of it, self-regulation and compliance are mutually exclusive activities, especially against the backdrop of the major failure of self-regulatory practices in the financial sphere in the context of the recent global financial crisis. However, the implementation of effective compliance policies can also be a path to conscious self-regulation[2]. From the perspective of Islamic financial norms, refracting the perception of

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[1] Fatwas are legal opinions or rulings based on the teachings of the Quran.

[2] Self-aware regulation in finance is supported by Valkanov (2019). The aforementioned work supports the compliance thesis as an enabler of more effective self-regulation based on internal, individual financial institution-specific self-regulatory incentives and mechanisms. In this regard, the compliance function can also be seen as a softening buffer between the extremes of full self-regulation and total external regulation. Again, it is argued that conscious self-regulation acts as a preventive measure against the burden of over-regulation and constitutes a foundation for achieving qualitative internal self-control (Valkanov, 2019, pp. 219–221).

risk and rate of return through the prism of a codified moral and ethical worldview is in itself a justification for embedding a permanent functioning self-regulatory mechanism.

On the other hand, Shari'ah compliance means adherence to the rules arising from the Quran (Holy Book), Sunnah (the traditions or known practices of the Prophet Muhammad), Izma (Consensus, Qiyas (Analogy), and the decisions and conclusions of experienced Islamic scholars. Shari'ah is essential for earning and keeping the confidence and loyalty of stakeholders as well as society: thus, it is not by chance that it has been defined by Sarker (2022) as *"the backbone of Islamic banks"*.

An Islamic bank or IFI is recognised as Shari'ah-compliant if only its activities meet the Shari'ah pronouncements/resolutions issued by the respective Shari'ah boards. Therefore Shari'ah compliance is not only set by another type of compliance requirements but a philosophy of behaviour in an Islamic way. In countries whose central bodies like the national Shari'ah board or council have the power to issue such pronouncements/resolutions, IFIs must be compliant with them. These also have binding legal effects on all the IFIs within the concerned jurisdiction. Non-compliance will lead to voiding the underlying contracts of the Islamic bank or IFI and therefore to loss (Sarker, 2022).

Lailiya (2024) defines Shari'ah Non-Compliance Risk (SNCR) as "a risk associated with the inability or failure of Islamic financial institutions to comply with sharia provisions" (Oz et al., 2016). This risk category can be a threat for Islamic financial transactions and revenues (Mustapha et al., 2021) and even can cause the invalidation of contracts designed to be in accordance with Shari'ah principles (Ginena, 2014).

Obviously, Islamic banks are exposed to a very special kind of risk: "Sharia non-compliance risk distinguishes Islamic banks from traditional ones" (Che Azmi, 2021). Shari'ah compliance is a category considered to have higher priority (IBD, 2018) in the risk catalogue of Islamic banks. Shari'ah compliance across all products and services of Fis as well as their functions, activities, processes, roles, and responsibilities is essential (Ali, 2019).

This risk category is closely related to another: reputational risk. Investors and depositors could easily withdraw their funds after losing trust or in light of any doubts about their IFI's Shari'ah -compliance reputation (Basiruddin & Ahmed, 2020).

Academic questions mark the significance of this risk, but researchers still want to "dive deeper" so that all stakeholders, including managers, are aware of its importance. Only in this way it can be effectively managed and minimised (Lailiya, & Kusumaningtias, 2024).

Islamic banking customers continue to pose a major challenge to the industry by asking a highly relevant question, i.e., is the bank labelled as an "Islamic bank" really

Islamic? Consumers continue to have some level of scepticism towards the supposed Shari'ah compliance of Islamic banking businesses. According to Volker Nienhaus (2013, p. 40), the modern practice of Islamic banking is not fully embraced by all Muslims.

The answer to this question has many dimensions: standardising Shari'ah interpretations, forming primary markets of Islamic banks, establishing global Islamic liquidity centres, adding breadth and depth to the range of Islamic banking products, implementation of AAOIFI and IFSB Standards, strengthening the regulatory and legal environment, etc. The Islamic financial industry has tried to take some actions, but measuring Shari'ah non-compliance risk and defining the level of required capital to mitigate or prevent this risk is still limited due to the lack of a standardised Shari'ah risk rating model.

A bank based on Shari'ah ideology is expected to ensure, top-to-bottom and beginning-to-end, compliance which includes its aims, activities, operations, and management. Neglecting even a single stage of the Shari'ah compliance process could endanger the reputation of an Islamic bank. The IFSB defines SNCR as the risk that arises from an IFI's failure to comply with the Shari'ah rules and principles determined by the Shari'ah board of the IFI or the relevant body in the territory in which the IFI operates. Lack of good corporate governance, Shari'ah professionalism, and adequate control mechanisms are the biggest threats to Shari'ah compliance in Islamic banks. A study by Basituddin (2020) examines the link between corporate governance mechanisms and SNCR. The empirical results show that those banks with a smaller board and higher degree of independence are exposed to lessened Shari'ah non-compliance risk. Additionally, it is concluded that frequency of Shari'ah board meetings is negatively correlated with SNCR and banks with stable corporate governance environments have reduced SNCR (Basiruddin & Ahmed, 2020).

If an IFI has an adequate good governance system and means of control, the SNCR could be mitigated (Lailiya, 2024) because implementing Shari'ah governance can encourage trust in Islamic banks (Rahman El-Junusi, 2009), increase their market share (Rosestino & Kusumaningtias, 2022), and possibly be reflected in long-term customer loyalty (El Junusi, 2012). Good Islamic corporate governance is the best way to improve Shari'ah banking performance (Cahya & Kusumaningtias, 2020).

Oz et al. (2016 have categorised Shari'ah noncompliance risk as part of operational risk under the Basel III framework. Many authors are of the view that Shari'ah non-compliance is an additional dimension which is not comparable with the operational risk of conventional banks and should be treated as an additional risk under Pillar II of the Basel III framework (Ling et al., 2022).

Therefore, SNCR is a serious issue to consider as it may affect the sustainability of Islamic banks. The conscious implementation of Shari'ah governance is a good step in this direction.

Shari'ah Corporate Governance

Conventional and Islamic governance systems firstly differ in ideology: key stakeholders in the former are shareholders, while this circle is wider for the latter and includes employees, partners, public institutions, society, etc. In other words, all possible stakeholders could be included. There are ten different types of stakeholders in Islamic financial institutions (IFIs): shareholders, boards of directors, Shari'ah boards, managers, employees, current account holders, investment account holders, partners through *mudarabah* and *musharakah*, regulators, and external auditors (Hassan & Chowdhury, 2010) – all of whom operate within the economic, financial, legal, and accounting systems as well as with banking associations. Moreover, Islamic corporate governance guarantees the compliance of Islamic banks' operations with Shari'ah principles.

The critical importance of Shari'ah compliance in the Islamic corporate governance framework is also evident in the IFSB's "Guiding Principles on Shari'ah Governance Systems for Institutions offering Islamic Financial Services", whose main aim is the harmonisation of Shari'ah governance structures and procedures across different countries and legal systems. In this document, a Shari'ah governance system is defined "as a set of institutional and organisational arrangements through which an institution offering Islamic financial services ensures that there is effective independent oversight of Shari'ah compliance in its activities". According to the same document, good Islamic corporate governance assumes: (1) a series of organisational arrangements which combine effective IFI management with the interests of stakeholders; (2) incentives for governance structures like a board of directors, Shari'ah supervisory board, and management teams; and (3) compliance with Islamic Shari'ah rules and principles.

From the beginning, IFIs have been developing without a clear legislative or regulatory framework with enough legal force to even sanction them if necessary. Doubt and misunderstanding surrounding their conceptualisation, and different Islamic practices are an obstacle for organisations and regulatory authorities to take meaningful initial steps for applying legislation and regulation. That is why many countries have developed their own standards, making efforts at harmonising practices through the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), the Islamic Financial Services Board (IFSB), the International Islamic Rating Agency (IIRA), the International Islamic Financial Market (IIFM), and the Liquidity Management Center (LMC).

Islamic Shari'ah governance (SG) principles emphasise clear corporate governance (CG) standards and structures, transparency, reporting, and adherence to those principles. No doubt, Islamic SG in banking provides a specific governance structure apart from that of traditional CG with Shari'ah boards on the top and in compliance with additional Shari'ah norms.

SG is as important for IFIs as traditional CG is for conventional financial institutions. The most significant consequence could be damaged reputations and decreased consumer trust in Islamic banks (Zada et al., 2017). Similar conclusions have been made by Chapra and Ahmed (2002) and Hasan (2009). The lack of an effective framework may cause *Shari'ah compliance shocks*, which will cause both financial as well as non-financial losses. Therefore "the Shari'ah tone" must be set from the top, flowing down the entire corporate leadership chain in all functions and operations of the Islamic bank or window. As mentioned above, the IFSB (2009) has defined Shari'ah governance as "a set of overall mechanisms by which IFIs assure Shari'ah compliance from its beginning to the end". Ginena and Hamid (2015) focus on SG's role in implementing Shari'ah principles throughout all organisational structures of IFIs. The SG framework must include guidelines for internal bodies from middle and operational management level.

Wardhany and Arshad (2012) also focus on a well-established SG framework and infrastructure. When IFIs have adequate governance structures and coordination between them, their Shari'ah compliance cannot be challenged. Hasan (2009) and (Hidayah, 2014) assume that pre- and post- Shari'ah compliance increases the trustworthiness, accountability, reliability, and credibility of IFIs.

According to the IFSB, Shari'ah governance must oversee compliance with the following: (1) the issuance of proper Shari'ah *fatwas*; (2) bringing them to the attention of middle and operational management; (3) an internal Shari'ah process of compliance; and (4) an annual review of Shari'ah compliance.

As mentioned at length already, IFIs have a specific corporate body called the Shari'ah board alternatively, "Shari'ah committee", "Shari'ah supervisory board", or "Shari'ah advisory board" whose main responsibility is to ensure the Shari'ah compliance of all their actions. Shari'ah compliance is a unique characteristic of IFIs and the main dividing line between conventional and Islamic corporate governance. The board of directors usually appoints three experienced scholars as members of the Shari'ah board, which exercises its duties thanks to its right to issue fatwas. However, a more important issue is the interpretation of fatwas, which is essential for providing clear and understandable information to stakeholders, especially Islamic finance investors.

The "Faces" of Shari'ah Boards in Different Legal Systems

It has been made obvious that Shari'ah governance practices in IFIs differ globally due to the lack of a standardised regulative approach to Islamic banking and finance.

The concrete responsibilities and functions of Shari'ah boards as well as the legal enforcement of their fatwas can be mainly understood within the respective regulatory framework. Islamic banking development depends on the suggested solutions of Shari'ah scholars to previously unknown problems. Therefore, there is no one or best interpretation of such problems: their fatwas occur in the course of IFIs' daily activities.

These issues put the following important questions in front of banks' governance: What are the minimum requirements for Shari'ah board members and their independence?[3] What innovation opportunities are being presented by Shari'ah boards? What about competition with conventional banks? Standardised interpretations across countries? These questions, however, still lack clear answers.

In their attempt to answer these questions, regulators have developed three methods: the first is the *regulation of Shari'ah boards*. The regulator itself chooses Shari'ah board scholars based on an assessment of their knowledge and competencies. This approach allows banks' boards the freedom to issue rulings while maintaining oversight. The second approach is *market-based regulation*. Here, the task to develop methods and standards falls on the shoulders of banks or other market participants. Regulators should consider making Shari'ah ratings mandatory. The third approach is the *centralisation of Shari'ah board approvals*, where a central Shari'ah board controls Shari'ah standards (Benaissa et al., 2007) and guarantees permissibility from an Islamic banking perspective.

Great care must be taken when regulators make compliance decisions so as not to limit banks' innovative capabilities. In other words, the golden middle between competition and innovation must be found.

There is no one regulatorily accepted model for Shari'ah governance systems (Di Mauro, 2013). In the first group of Muslim countries, Shari'ah governance is seriously regulated and a national Shari'ah body has to be established (Malaysia). In the second group of more liberal Muslim countries, IFIs and their internal Shari'ah compliance bodies have some degree of freedom. Finally, there are IFIs operating in non-Muslim

[3] Independence is one of the most important AAOIFI standards regarding Shari'ah scholars who serve on different boards because of their deficit.

countries, whose legal systems are not interested in any aspect of Shari'ah corporate governance.

In Muslim countries with an established regulatory system, the fatwas of Shari'ah boards are usually regarded as legally binding. In Muslim countries with less robust or not fully developed regulatory systems, the legal enforcement of rulings mainly depends on the corporate governance provisions about Shari'ah boards' activities and the validity of their fatwas. Lastly, in the third category of mixed countries with both legal systems functioning – state law and Shari'ah law – Islamic finance case studies are subject to the secular courts' assessment.

In such cases, there may be a conflict between the national legislation of a given country and Shari'ah law. For example, a court in an EU member state may not consider a financial transaction to be illegal, while it may on the other hand be contrary to Shari'ah principles. It is unsurprising that regulations issued in these countries can contradict Shari'ah law; thus, disputes are settled in such a way as to "force" the Islamic bank into Shari'ah non-compliance.

Shari'ah supervisory boards, independent of their internal positioning within the Islamic bank or externally, observe compliance with Islamic religious principles. Each board is able to design, develop, and issue Shari'ah-compliant financial products and instruments. The internal tasks of Shari'ah supervisory boards are supported by reliable Islamic financial organisations such as the IFSB and the AAOIFI (Di Mauro et al., 2013).

There are national, regional, and international organisations whose aim is to develop guidelines for Shari'ah boards. These are envisaged to ensure Shari'ah compliance in transactions but do not specify details about competent bodies. Shari'ah boards are responsible for: *ex-ante Shari'ah auditing* through issuing fatwas; *ex-post Shari'ah auditing* through verification of transactions with those fatwas; *zakat* calculations and payments; and distribution of non-Shari'ah earnings, income, and expenses among current account holders and investment account holders – the main two group shareholders in an Islamic bank. Each Shari'ah board must also report on the Shari'ah compliance of all its financial transactions (Ben Bouheni & Bellalah, 2012).

A Shari'ah supervisory board (SSB), also known as a Shari'ah committee (SC) or Shari'ah advisory council (SAC), is an important organ in IFI corporate governance (Clode, 2002). Abubakar (2022) states that though the type of Shari'ah committee is not mandated, its role in monitoring IFIs' Shari'ah compliance is always the same.

A key decision to be made is whether to establish a centralised SSB (in addition to

SSBs at bank level) to oversee the Shari'ah governance framework within IFIs. A centralised SSB has the advantage of harmonising Shari'ah-rulings, reducing compliance costs for IFIs. A centralised SSB could be set up by the regulator or, as they are encouraged to do, IFIs can collectively establish such a board (Mejia, 2014).

Shari'ah boards can be established at the *micro* or *macro level*.

Shari'ah boards at the micro level have operational responsibilities in product development and structuring activities, reviewing and approving tasks, issuing an annual Shari'ah compliance certification, issuing fatwas, Shari'ah auditing (McMillen, 2006), ensuring the Shari'ah compliance of investment transactions like shares, equities, and *sukuk* (Ayub, 2007), and *zakat* collection. In sum, the roles of a Shari'ah board could be grouped into three main areas: fatwa issuance, supervision, and review (Dusuki, 2011, p. 709).

At the macro level, Shari'ah boards can be part of the central bank or at regulatory authority level. Shari'ah boards at this level play significant regulatory roles and act as the highest Shari'ah authority of IFIs (ibid.: 708). The regulatory authority provides guidelines for IFIs, appoints institutional Shari'ah supervisory boards, and informs the central bank about Shari'ah matters. At the micro level, there can be an internal Shari'ah board, as in Islamic banks, or simply a Shari'ah advisory board.

Noordin and Kassim (2019) and Alam et al. (2021) have also classified Shari'ah governance into three diversified types of models *centralised, laissez-faire,* and *hybrid.* In the centralised structure, there is again a central Shari'ah supervisory board in the central bank with similar responsibilities as those described in the previous classification. This model is considered to be more stable and comprehensive compared to models in Malaysia, Sudan, Brunei, Indonesia, and Iran. The "laissez-faire" or decentralised SG model developed by individual SSBs of IFIs involves minimal regulator and market interference. In this model, IFIs and their SSBs ensure Shari'ah compliance independently, which may raise concerns about the quality of compliance, services, and fatwa resolutions due to varying interpretations of Shari'ah principles[4]. IFIs in the hybrid structure (e.g., in the UAE and Pakistan) are required to confirm their Shari'ah compliance and simultaneously must report to a central regulatory body (Noordin & Kassim, 2019; Alam et al., 2021).

Regulatory authorities rarely provide corporate governance frameworks especially concerning Islamic banks. Some regulatory frameworks burden the board of directors

[4] Typical for GCC countries like Saudi Arabia, Kuwait, and Qatar, as well as the UK, Germany, France, South Korea, Hong Kong, and Japan.

with additional Shari'ah compliance responsibility, since the board has the utmost authority in advising on Shari'ah matters. According to Song and Oosthuizen (2014), there are two possibilities: *setting up a national/central Shari'ah board* or *setting up a Shari'ah board in banks reporting to the central bank.*

The relationship of this Shari'ah board with the central bank is an advisory one. A Shari'ah board has to ensure coordination with the central bank and has the main responsibility for the Shari'ah compliance, which usually transmits it through clear guidelines to its senior management, who do the same and disseminate this information to operational management. Middle and lower management levels, on the other side, are supposed to ensure Shari'ah compliance in line with the guidance of the superior Shari'ah board on the top level.

The next important question is to which governance authority the Shari'ah board has to report. According to research by Song and Oosthuizen (2014), it could be the board of directors of the bank, the general assembly of the bank, the top management of the Islamic bank, the executive committee of the Islamic bank, or the bank itself. Another challenge is whether or not the Shari'ah board is accountable to the IFI's board of directors. In most cases, it seems that an advisory relationship exists between the banks corporate governance body and the Shari'ah board in order to ensure its independence.

Shari'ah scholars, who are very difficult to find and cultivate, contribute greatly towards the effectiveness of the Shari'ah governance system. Shari'ah boards play a key role in maintaining the reliability of IFIs, which is achieved by following "*collective jihad"* and the subsequently issued fatwas (Dusuki, 2011, p. 707).

Internally, Shari'ah compliance is usually conducted by Shari'ah auditors, which are structures within the Islamic bank. In countries where Shari'ah law is the first legal source (e.g., Iran, Pakistan, Saudi Arabia, and Sudan), including for banking and financial legislation, an Islamic bank's internal auditor has a statutory responsibility to ensure Shari'ah compliance. In others, an Islamic bank has to arrange a Shari'ah auditor or compliance officer, which must be approved by the bank supervisory authority.

The *external auditing process* in relation to Shari'ah compliance also depends on the applicable legal framework. An Islamic bank's external auditor has a statutory responsibility to control Shari'ah compliance in countries where Shari'ah law is the default source of all legislation. Where it is not, the Islamic bank's external auditor has no direct responsibility to assess or verify Shari'ah compliance by the Islamic bank.

Stable corporate governance systems are supported by appropriate arrangements with regulators and external companies for financial information services. What is more, these public rating agencies could create a positive financial infrastructure for Shari'ah compliance. Sufficient incentives should be found for these agencies which could effectively oversee Islamic banking in accordance with Shari'ah principles. "Islamic rating" has become an exclusive topic for such government-sponsored organisations as the Malaysian Rating Corporation and the International Islamic Rating Agency.[5]

Standards for Shari'ah Supervisory Boards

There are numerous types of financial activities, but who in the end decides whether those activities are Islamic or not? There are different standards in different countries. There is no unique set of rules that can be used to check if a financial activity is compliant. This may be surprising for non-Muslims, but it is a fact that there are more than 1.5 billion Muslims and yet no single set of Shari'ah rules in the Islamic world. Therefore, the absence of universal standards in the Islamic financial world is quite normal.

An adequate legal and regulatory framework is instrumental for ensuring the sustainable development of Islamic finance, according to Bedoui (2016). To standardise Shari'ah norms, various organisations have been established to develop international standards and guidelines.

The specialised international standard-setting agencies for Islamic finance are as follows[6]:

1. IFSB (Islamic Financial Services Board);
2. AAOIFI (Accounting and Auditing Organization for Islamic Financial Institutions[7]);
3. IIFM (International Islamic Financial Market);
4. IILM (International Islamic Liquidity Management Corporation);
5. IIRA (Islamic International Rating Agency).

The standards of who of these international Shari'ah supervisory bodies (the AAOIFI and IFSB) have been becoming more similar in recent years, and there is some slight

[5] In addition to Shari'ah boards, most Islamic banks have established a Shari'ah review unit.

[6] In most countries where Islamic banks are present, the conceptual regulatory framework of the Basel Committee on Banking Supervision (BCBS) is the "default framework".

[7] The AAOIFI developed the Governance Standard for Islamic Financial Institutions (GSIFI), which provides guidance on the definition, appointment, composition, and reporting of Shari'ah supervisory boards. When we talk about Islamic windows standards, there is a special draft for them which shall be the same as prescribed in the relevant AAOIFI standards for fully Islamic banks.

overlap between them. Collaboration of the AAOIFI and IFSB with the IMF and World Bank also helps establish unity in terms of standards. Nevertheless, it should be said that both supervisory boards have no power to impose sanctions when any Islamic institution does not follow those standards. There are many national- and institutional-level boards who can decide whether a financial product is Islamic or not. Transparency plays a crucial role in this case. Transparency attracts not only more capital from the Islamic world but also helps to eliminate the criticism that Islamic finance mimics conventional finance (Sekreter, 2021).

The Executive Board of the International Monetary Fund (IMF) approves the use of the Core Principles for Islamic Finance Regulation (CPIFR), which were developed by the Islamic Financial Services Board (IFSB) with the participation of the Basel Committee Secretariat on banking supervision.

In addition, Basel III standards establishing new capital and liquidity requirements for international banks have been announced, and the IFSB has produced updated standards and guidance specifically for Islamic banks. However, until now, no research has been undertaken on the implementation of the most recent publication, Revised Capital Adequacy Standard for Institutions Offering Islamic Financial Services. Based on the empirical literature of 23 papers published between 2013 and 2022, Ling (2022) suggests that Basel III has had a major impact on the Islamic banking sector's financial risk. It is recommended for future research to be undertaken to investigate current Islamic banking trends and how Basel III could align with Shari'ah standards.

Shari'ah Compliance in European Banks

The offer of European institutions is aimed not only at customers living in countries where Islam is the dominant religion. It is often highlighted that Islamic financial instruments are not exclusively addressed to Muslims but also others, both individual and corporate clients (Pistrui & Fahed-Sreih, 2010; Masiukiewicz, 2014). Islamic funds may also be attractive for retail and corporate investors. Transactions with such instruments are safe, since they are based on assets and offer higher rates of return than traditional deposits or government bonds. Due to the fact that the global population of Muslims was set to grow up to 2.2 billion by 2020making up over one third of the world population, further increased demand for Shari'ah-compliant banking and investments should also be expected (Zielewski, 2017).

The emergence of Islamic financial institutions is not due to pressure by a European

Muslim minority; rather, it is a consequence of strategies for financial markets adopted by authorities which include the creation of global financial centres. In addition, an infrastructural and educational supply network for such entities is being developed. In the future, offerings from Islamic financial institutions will probably also become more attractive for those customers who do not know much about and do not follow Shari'ah law but wish to use services from more trustworthy and ethical banks. It is expected for other Islamic banks to be established, the number of Islamic windows in conventional banks to increase, and further development of Islamic investment funds to take place in Europe (Masiukiewicz, 2017).

The existing Shari'ah governance systems vary across countries. Some of them are in favour of more regulative models while others prefer more liberal management. Certainly, one cannot determine which option is better. Perhaps it depends on the complex impact of many other factors such as the legal system, established relations between regulatory authorities, economic conditions, management practices in companies, etc.

A "reactive approach" is more common in non-Muslim regions like Europe and countries such as the United Kingdom and Turkey, where no regulatory measures have been taken regarding the Shari'ah governance framework. IFIs in these countries are regulated in a similar way as their conventional analogues (Hassan, 2009).

Taking into account that there is no specific legislation governing IFIs or any directive specifying a *Shari'ah governance framework*, regulators are supposed to take action only if there is a significant problem that could potentially have industry-wide consequences.

The research methodology used was content analysis[8] of reports and corporate governance statements of the selected banks. The following section will examine practices in European countries towards the Shari'ah compliance of conventional banks offering Islamic financial services (mostly through Islamic windows) and fully Islamic banks, too. For this purpose, the corporate governance models of the largest representatives will be analysed and presented in Table 1 to answer how well they meet the above mentioned criteria and whether Shari'ah compliance in conventional banks is possible.

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[8] A method which can be used qualitatively or quantitatively for systematically analysing written, verbal, or visual documentation.

Table 1. Corporate Governance of European Islamic Banks

	European Bank / IFI	Head-quarters	Main Shari'ah compliance authority	Type of bank	Internal Shari'ah compliance	Reporting to the board of directors	Board members' information
1	ADIB UK	UK	Internal Shari'ah supervisory committee	1	Yes	NI	Yes
2	Al Baraka Turk	Turkey	Unified Shari'ah supervisory board	1	Yes	No	Yes
3	Al Rayan Bank	UK	Shari'ah supervisory committee	1	Yes	No	Yes
4	Arab African International Bank	UK	Boards of directors	1	NI	No	Yes
5	Bahrain Middle East Bank	UK	Board of directors	1	NI	NI	Yes
6	Bank ABC Group	UK	Shari'ah supervisory board	1	Yes	Yes	Yes
7	Bank of London & the Middle East	UK	Shari'ah supervisory board	1	NI	No	Yes
8	Bosna Bank International	Bosnia and Herzegovina	Shari'ah board	1	NI	NI	Yes
9	Dar Al-Maal Al Islami Trust	Switzerland	Religious board at the board of supervisors level	1	NI	Yes	NI
10	EIIB	UK	Shari'ah supervisory board	1	NI	NI	NI
11	FWU AG	Germany	Compliance	1	NI	Yes	NI
12	Gatehouse Bank PLC	UK	Shari'ah supervisory board	1	Yes	Yes	Yes
13	Habib Bank (HBL)	UK	Shari'ah supervisory board	1	Yes	Yes	Yes
14	HSBC	UK	Shari'ah committee	1	No	No	No
15	J. Safra Sarasin	Switzerland	Shari'ah advisory board	1	NI	NI	NI
16	KT Bank AG	Germany	Ethical council	1	Yes	Yes	Yes
17	Munich Re	Germany	Shari'ah advisory board/ Central SSB of Malaysia	1	Yes	No	Yes
18	National Bank of Pakistan UK	UK	Shari'ah board	1	Yes	Yes	Yes
19	QIB UK	UK	Shari'ah board	1	Yes	No	Yes
20	QNB	UK	Shari'ah board	1	NI	NI	NI
21	Riyad Bank	UK	Shari'ah committee	1	NI	No	Yes
22	SAB	UK	Shari'ah committee	1	NI	Yes	Yes
23	Safa Investment	Switzerland	Shariyah Review Bureau	1	NI	No	NI
24	Solidarity Takafol S.A.	Luxemburg	Shari'ah supervisory board	1	NI	Yes	NI
25	Turkiye Finans	Turkey	Advisory committee	1	NI	Yes	Yes
26	Vakif Katilim Bank	Turkey	Advisory committee	1	Yes	Yes	Yes
27	Ziraat Bank	Turkey	Advisory committee	1	Yes	NI	Yes
28	ABC International Bank PLC	UK	Shari'ah supervisory board	2	Yes	No	NI
29	Ahli United Bank PLC	UK	Shari'ah supervisory board	2	Yes	No	NI
30	Bank of Ireland	UK	No Shari'ah compliance body	2	No	No	No
31	Barclays	UK	No Shari'ah compliance body	2	No	No	No
32	Citi Islamic Investment Bank	UK	Shari'ah supervisor board	2	Yes	NI	Yes
33	Deutsche Bank	Germany	Shari'ah custody	2	NI	NI	NI
34	IBJ International London	UK	No Shari'ah compliance body	2	No	No	No
35	J Aron & Co	UK	No Shari'ah compliance authority	2	No	No	No
36	Lloyds	UK	Shari'ah committee	2	No	NI	Yes
37	RBS	UK	Group board	2	No	No	No
38	Standard Chartered	UK	Shari'ah advisory committee	2	Yes	NI	Yes
39	UBS	Switzerland	Board of directors	2	No	No	No
40	United National bank	UK	Board of directors	2	No	No	No

Source: Authors' contribution.

A survey of Shari'ah corporate governance systems in 40 European banks offering Islamic products has been taken based on the "Islamic and Ethical Finance" list of the UK Government and the "Islamic Crowdfunding" website. The country break-down reveals that most Islamic finance is found in Great Britain and Turkey. These 40 banks that were examined belong to two groups: the first are fully Islamic banks and/or branches of banks with headquarters in an Islamic country, and the second are conventional banks offering Islamic financial products.

There is only one bank which ensures its Shari'ah compliance through a centralised external body (Munich Re). In the other banks, Shari'ah boards are situated at management level and are independent from the board of directors in most of them. In some cases, Shari'ah compliance is under the competence of an advisory committee to the board of directors or belongs to an ethical council, religious board, audit committee, etc. Almost half of the banks have internal Shari'ah units for implementing Shari'ah principles at senior management level. Such variety only in the placement and even in the names of the Shari'ah compliance authorities in European banks shows us that there is an urgent need for harmonisation and standardisation of Shari'ah compliance mechanisms at macro level just like in Muslim countries. An internal Shari'ah compliance structure is present in 16 of the total 40, and 11 report to the board of directors – about quarter, which is a small percentage. The question is whether this interferes with their independence, which is one of the most important AAOIFI standards for Shari'ah boards. Only 4 of the 12 banks from the second group have a structural unit for Shari'ah compliance. Most of the banks (nearly half) have provided information about the members of Shari'ah boards or similar structures. Most who have no information about them feature no such authority at all or lack sufficient accountability over their Islamic financial operations.

The other significant conclusion is perhaps that conventional banks offering Islamic financial products through "Islamic windows" unfortunately do not have a clearly defined structure for compliance with Shari'ah norms. The reason may lie in the fact that these large banks are generally organisationally quite complicated, this segment represents a small share of their operations, and/or they do not have a sufficiently cultivated human capital competent to interpret Shari'ah cases.

Conclusion

In summary, current practices for ensuring Shari'ah compliance rely mainly on Shari'ah supervisory boards. These structures struggle with many challenges relating to their independence, information confidentiality, and lack of competent Shari'ah scholars, as well as clear guidelines for their responsibilities. Some countries have sought the help of external institutions. However, this creates other difficulties for IFI groups operating in different legal systems and may be problematic for regulators in non-Islamic countries. Guaranteeing Shari'ah compliance through market mechanisms is in its infancy.

Despite the difficult combination of the two forms of financing, one thing is certain: this new alternative form has a promising future, and it is appropriate to look for ways to include both in traditional financing. After reviewing the literature, it can be concluded that supervisory or management boards are not competent to confirm or deny the Shari'ah compliance of a given financial institution. But this does not prevent them from working in parallel with their peers and complementing each other.

The results of the literature review, not only in the European region but also in the Middle East, confirm that regulations by a specific central authority would be most effective at least in cases of disputes in certain critical situations. At the moment, however, due to the lack of established regulatory legal frameworks at the national or regional level, compliance issues have to be resolved at the corporate management level by the institution itself. The question was whether the Shari'ah board, which is the most common structure for ensuring Shari'ah compliance, should be an independent body or instead be subordinate to a supervisory board with only advisory duties. The answer should depend mainly on the specific form of Islamic financial products and services provided – whether the bank is fully Islamic or these are provided through Islamic windows. In the first case, the Shari'ah board is supposed to have the main role, taking into account the reputational risk if there is a discrepancy with Islamic principles; and in the second case, it is supposed to be in the form of a committee with a consultative role subordinate to the corporate management.

Internal and external actions should begin with determining which synergistic effect could provide an effective framework for ensuring Shari'ah compliance. Such a framework could improve stakeholders' confidence and would enable innovation, leading to introducing some new Shari'ah-oriented products and services. In issuing its fatwas, the SSB must be guided by standardised contracts and practices emerging from international regulatory authorities. The review of transactions would mainly be entrusted to internal review units, which are in unison with Shari'ah principles at a higher management level and which are responsible to determine whether the IFI's activities meet its Shari'ah requirements. If this process is supported by reputable agents, like rating agencies, stock markets, financial media, and researchers who would channel signals to market players, it is expected that such a framework (including structures and processes, internal and external) could enhance public understanding about the requirements of Shari'ah. This process can be accelerated if more categorical frameworks and norms are introduced by the relevant regulatory authorities at the national or regional (e.g., European) level.

Contribution of individual authors

Sevgi Osman investigated Shari'ah compliance and European Islamic banking practices.

Nedyalko Valkanov carried out the research about compliance risk.

Conflicts of Interest

The authors have no conflicts of interest to declare.

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Sevgi Osman, PhD, is a Chief Assistant Professor at Varna Free University "Chernorizets Hrabar". ORCID 0000-0002-5108-5476, sevgi.osman@vfu.bg

Nedyalko Valkanov, PhD, is an Associate Professor at University of Economics – Varna, n.valkanov@ue-varna.bg

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