

# The Visionary Philosophy of Shariah Governance in Islamic Financial System: Pioneering Green Finance for a Sustainable Future

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To Link this Article: <http://dx.doi.org/10.6007/IJARBSS/v14-i8/22487>

DOI:10.6007/IJARBSS/v14-i8/22487

**Published Date:** 19 August 2024

## Abstract

In an era where sustainability is pivotal, the Visionary Philosophy of Shariah Governance in Islamic finance is more relevant than ever. Shariah governance not only ensures compliance with Islamic principles but also supports broader environmental and social goals. This innovative approach aligns seamlessly with the principles of green finance, fostering a financial system that prioritizes sustainability and ethical investment. In the context of Shariah governance principles in the Islamic financial system, this study discusses the relationship between Islam, muamalat, and Islamic finance from a philosophical perspective. A clear and accurate understanding of these three subjects is crucial for grasping the connection between Islam as a religion based on divine revelation, fiqh muamalat in general, and the Islamic financial system in particular. Following this discussion, the philosophy of Shariah governance and its importance as the main pillar supporting the Islamic financial system is also revealed using a descriptive philosophical approach and a qualitative approach through document review. This approach is necessary to identify ideas, theories, and legal techniques that have emerged based on current knowledge.

**Keywords:** Islamic Finance, Philosophy, Value, Green Finance, Shariah Governance.

## Introduction

Islam is a term derived from the Arabic vocabulary. The word Islam is a verbal noun or derivative that originates from the root word *sa-li-ma*, which means submission, obedience, surrender, peace, safety, and tranquility (Zaki, 2023). Literally, the definition of Islam encompasses two aspects. The first aspect is worship, which involves submission, obedience, and surrender to Allah, the Almighty as the Creator. This concept of worship is expressed

through acts of devotion as revealed. The second aspect refers to the concept of worship, i.e., practices that connect humans as creations to Allah. The characteristics of peace, safety, and tranquility can only be achieved by adhering to all the commandments and avoiding the prohibitions as revealed. Therefore, based on the literal terminology, the word Islam from the Shariah perspective is defined as total submission and surrender to Allah with full awareness and willingness, without compulsion, to comply with all that has been revealed and to avoid all that He has prohibited (Fakhrurrazi et al., 2024).

Islamic finance is one branch of the Islamic financial system, created to provide financial facilities and services grounded in Shariah law as the main pillar, particularly for Muslims (Arifin, 2021). This system refers to the operations and activities of Islamic financial institutions with the aim of implementing economic and financial principles that align with and are consistent with the values outlined by Islam in the industry (Mohd Izzat et al., 2013). The Islamic financial system represents a successful innovation that greatly benefits Muslims as it serves as an alternative to the conventional system, offering essential financial services needed for their daily life.

The most distinct difference between the Islamic financial system and the conventional one lies in the principles underlying these two systems. The Islamic financial system is a subset of Islamic financial jurisprudence, which is firmly bound and cannot be separated from the core values and philosophy of Islam (Abasimel, 2023). This epistemological aspect is something that receives less attention in discussions on Islamic finance. The term epistemology refers to a part of philosophy that discusses the origins of something. Although there is much literature and scholarly material on various aspects of Islamic finance, there is very little academic discussion from the jurisprudential aspect (Zulkifli Hasan, 2008). Compared to the conventional financial system, which is based on a 'secular approach' and 'humanistic approach,' the 'faith-based epistemology' is the foundation of the Islamic financial system (Jha, 2013).

### **The Philosophy of Shariah Governance in the Islamic Financial System**

Literally, the word "philosophy" originates from the Greek language, where "*philien*" means love or appreciation, and "*sophia*" means wisdom, truth, and knowledge (Gupta, 2021). The combination of these two words conveys the meaning of loving truth and wisdom or knowledge (Ishak, 1995). In terms of terminology, the Kamus Dewan Third Edition (1997) refers to the word "philosophy" as knowledge concerning meanings considered part of the highest forms of science, serving as the foundation for other sciences. Plato delineates philosophy as the knowledge of the existence of all things, while Titus (1959) propounds the detailed meaning of philosophy as the investigation and method of reflective thinking about the nature of life and the universe, beginning with understanding problems and subsequently deep contemplation in the pursuit of truth. This definition aligns with the description provided by the prominent Islamic philosopher Al-Farabi, who defines philosophy as the knowledge of the existing world with the aim of investigating its true nature. However, Ibn Rushd adds the goals of research, thought, and truth to the definition of philosophy, which he described as the investigation of the existence of the universe and viewing it as a means to discover the Creator of all creation, while Ibn Tufayl emphasises that philosophy is an effort to seek happiness through thought (Urvoy, 2020). A philosophical approach to a system is crucial because it serves as the guiding principles for it. From the foundation of philosophy, the

approach to that system will be formed, influencing its development and leading to the creation of mechanisms that support the spirit of that philosophy (Nik Mustapha, 1994). Philosophy plays a role in guiding a person to first identify the root of a problem, classify it, and then open their mind through discussion on each concept. Philosophy encourages the development of skills in critical, logical, systematic, organised, and detailed thinking, free from emotional disturbances such as bias and sentimentality. In summary, based on the definitions of the word "philosophy" above, it can be comprehensively concluded that philosophy is the process of careful and in-depth thinking and research into a particular science or knowledge to understand its true nature.

In the context of Shariah governance, the primary focus is on understanding everything related to the aspect of "governance" and its relationship with "Shariah." One method of gaining an understanding of these two aspects is by analyzing the definitions of each relevant terminology and evaluating the guidelines that have been outlined and issued by existing standard-setting bodies.

The term "Shariah governance" is a modern terminology that is not found in any classical texts. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) also does not provide a specific definition for this term in its "Governance Standard No. 1-5 (AAOIFI 2005 a-e)." However, the Islamic Financial Services Board (IFSB) has taken a progressive step by defining Shariah governance through its "Guiding Principles on Shariah Governance System in Institutions Offering Islamic Financial Services (IFSB-10)" as follows:

"a set of institutional and organizational arrangements through which Islamic financial institutions ensure effective independent oversight of Shariah compliance in any announcements, dissemination of information, and internal Shariah compliance reviews."

The Islamic Financial Services Board (IFSB) was officially established on November 3, 2002, and operates on March 10, 2003, based in Kuala Lumpur. IFSB is an international standard-setting body consistent with Shariah principles for regulation and oversight to ensure the sustainability and stability of Islamic financial services, including finance, takaful, and capital markets. Legally, the standards provided by IFSB do not have binding power; hence, they serve as recommendations for implementation.

According to Zulkifli Hassan (2012), the Shariah governance system comprises three main components:

- a) A set of institutional and organisational arrangements referring to the Shariah board related to the respective Islamic financial institution, including the internal audit unit and the Shariah division.
- b) Independent and effective oversight and supervision reflecting the aspiration of the Shariah governance system to establish efficient and effective mechanisms for full Shariah compliance. The aspect of independence is a key component of a good governance system.

c) Announcements, dissemination of information, and internal Shariah compliance review reports. This involves the entire Shariah governance system, covering both ex-ante and ex-post aspects of the Shariah compliance framework.

From the definitions provided, it is observed that the Shariah governance system is a harmonisation of two interrelated concepts: the philosophy of good corporate governance and the concept of Shariah compliance. The principles of corporate governance are general principles that can be applied to most sectors, while the concept of Shariah compliance is the fundamental principle enabling Islamic financial activities to operate in Islamic financial institutions.

Based on the definitions of Shariah governance presented by IFSB and Hassan (2012), it is found that these definitions are not comprehensive enough to be applied in the context of Islamic financial law in Malaysia, which practices a dual-level Shariah governance system. This is because the given definitions refer to the internal Shariah governance system at the level of Islamic financial institutions and not at the level of Bank Negara.

To understand the definition of Shariah governance at the level of Bank Negara, particularly involving the Shariah Advisory Council, an analysis of the Islamic finance regulatory laws, including the Islamic Financial Services Act 2013, the Central Bank of Malaysia Act 2009, and the Shariah Governance Framework for Islamic Financial Institutions 2010 issued by Bank Negara Malaysia, reveals that no specific definition of Shariah governance is provided. However, an analysis of sections 27 to 36 of the Islamic Financial Services Act 2013 explains the relationship between Shariah governance and Shariah compliance. The Shariah committee is a body statutorily required to be established by every institution conducting Islamic financial business, whether under the provisions of the Islamic Financial Services Act 2013 or the Financial Services Act 2013. In a comprehensive Shariah governance system for the Islamic financial industry, the role of the Shariah committee is connected to the Shariah Advisory Council through section 28 of the Islamic Financial Services Act 2013 and section 55 of the Central Bank of Malaysia Act 2009.

In conclusion, an examination of the statutory role and legal status of the Shariah Advisory Council under the Central Bank of Malaysia Act 2009 clearly shows that the Shariah governance system at the central level is an important mechanism to ensure the sustainability of *muamalat* principles in the Islamic financial system. Referring to sections 51 to 59 of the Central Bank of Malaysia Act 2009, the main components of the Shariah governance system at the central level include:

- a) Advisory services on Shariah issues in Islamic financial transactions and operations.
- b) A single body to ensure Shariah rulings for Shariah issues in Islamic finance.
- c) The application of consistent Shariah rulings across the entire Islamic financial industry.
- d) Binding Shariah rulings for the institutions involved.

### **Core Values of Shariah Governance System**

The implementation of governance practices emphasises the values of transparency, accountability, fairness, and independence. The integration of these values in institutional governance significantly impacts public trust, particularly among Islamic finance customers

and shareholders, in the Islamic financial industry (Sekreter 2013). This practice was emphasised by the seventh Governor of Bank Negara Malaysia, Tan Sri Zeti Akhtar Aziz (Amsyar et al., 2019). The main characteristic of the Islamic financial system lies in its high ethical values, which support the governance and business operations of Islamic finance. With the rapid growth of this industry and an increasingly complex and challenging environment, realising a robust and resilient financial system requires a strong governance structure for Islamic financial institutions. Essentially, the challenge is to develop strategies that promote the implementation of sound and effective corporate governance practices that also support business innovation and operations. A key aspect of this shared vision is to establish a comprehensive governance framework for financial institutions and to design suitable Islamic implementation strategies that meet the needs of a dynamic industry while enhancing confidence and stability in the Islamic financial system.

The values of transparency, fairness, accountability, and independence are universal values embedded as the foundation of the Shariah governance system because Islam fully supports all forms of positive governance that are consistent with Islamic principles (Muhammad & Samian, 2012).

### **Transparency**

Transparency refers to a state or quality of being straightforward with nothing hidden or doubted (Dewan, 1997). In Islamic financial operations, transparency is mandatory, particularly when disclosing information in reports related to activities and operations, such as reports on Shariah non-compliance (Sekreter, 2013). For example, detailed and comprehensive information regarding the status of contracts in financial products should be clearly stated. On the contrary, any discrepancies or issues arising in the practice of an Islamic financial product should not be concealed. Transparency in information is also crucial in financial operations to ensure that Islamic financial customers receive clear and accurate information about the financial products offered to them. This can be achieved if Islamic financial businesses operate transparently by providing accurate and correct information.

Therefore, the practice of information transparency will streamline financial operations and indirectly protect the interests of all parties involved, including shareholders and customers. This is important for investment account holders who can influence Islamic financial institutions if they have sufficient information about investment strategies, investment outcomes, and the rates of return used. For example, the Shariah Advisory Council was consulted regarding the proposal to issue tradable Islamic Debt Certificates based on the concept of *bai' al-'inah* contracts. The use of *bai' al-'inah* contracts as a basis for Islamic financial products has sparked various debates and opinions regarding the compliance of this contract with Shariah law. The *bai' al-'inah* contract is highly controversial, leading to criticism of the operation of Islamic financial institutions in Malaysia for prioritizing profits over Shariah compliance. The Shariah Advisory Council, in its first meeting on July 8, 1997, decided that the issuance of financial facilities based on *bai' al-'inah* contracts is permissible under Shariah. In line with the decision presented, all foundational evidence leading to the legal ruling was transparently and clearly attached. The Shariah resolution included evidence from the Quran and the views of recognized schools of thought. The impact of the Shariah Advisory Council's decision was that *bai' al-'inah* contracts were not only recognized as valid for use in any Islamic financial product, but they also increased public confidence in using financial facilities

related to *bai' al-'inah*. The transparency of the Shariah Advisory Council in issuing decisions has alleviated the doubts surrounding this contract (Mohd Izzat Amsyar Mohd Arif and Ruzian Markom 2017).

### **Justice**

Literally, the word 'justice' means 'precise in judgment and opposed to oppression' (Hailani, 1974). From a *fiqh* perspective, justice refers to equality, balance, and placing things in their proper place (Mustafa, 2012). Islamic financial institutions are responsible for achieving *maqasid al-shariah* to establish social and economic justice in the use and distribution of wealth (Adawiyah, 2008). The concept of justice in Islam is closest to piety in the religion of Islam (Quran, Al-Maidah, 8). It also forms a fundamental distinction between the Islamic financial system and the conventional one. The practice of interest or *riba* in conventional banks is seen as oppressive because it represents a form of capitalist oppression, particularly for those who are less fortunate or unable.

The Shariah governance framework must consider the various roles played by Islamic financial institutions and provide fair treatment to all relevant stakeholders, including shareholders and investment account holders. Additionally, the Shariah Advisory Council has been positioned appropriately within the context of its acceptance as the sole Shariah authority for the Islamic financial sector. However, it is considered more just if all stakeholders in the Islamic financial system are given equal rights to refer any Shariah issues to the Shariah Advisory Council. Currently, Sections 55 and 56 of the Bank Negara Act 2009 still limit the parties who can make references to the institution, namely; Bank Negara, Islamic financial institutions, courts, and arbitrators.

### **Accountability**

Accountability is the quality of being responsible for an action or decision, along with the willingness to provide explanations and justifications (Dewan, 1997). The Shariah governance framework has established the functions of each component, namely; Shariah advisory, Shariah review, Shariah audit, Shariah risk management, and Shariah research to ensure accountability within each jurisdiction, with appropriate division of power to avoid potential conflicts of interest. The value of accountability is closely related to the value of integrity. Integrity, including honesty, is the essence of the governance framework for Islamic financial transactions, which heavily depends on trust relationships. The importance of this core value is clearly stated in the Quran and the Sunnah.

As an institution that handles public funds, the financial institution must act honestly and accountability for the benefit of all stakeholders. The application of accountability in contemporary Islamic finance can be seen through justifications where the Shariah Advisory Council must present resolutions on Shariah issues referred to it by including arguments, evidence, and *fiqh* methodologies that support the issued decision (Kunhibava, 2015).

### **Independence**

Independence refers to "the ability to make a sound decision about something after careful consideration of all aspects, including relevant information and opinions, without influence or interference from administrators or anyone else" (IFSB 2009). An effective monitoring system refers to a set of organizational and institutional arrangements that ensure the

independence of supervision and effective monitoring to ensure Shariah compliance within the Islamic financial system. While performing their duties, every member of the Shariah board; whether it is the Shariah committee or the Shariah Advisory Council, must always possess a high level of moral and intellectual integrity, and most importantly, professional independence. This principle of independence must be upheld in all conditions and situations, without being tied to any party or event.

### **Shariah Compliance in the Islamic Financial System**

Shariah compliance refers to the adherence of Islamic financial institutions to the principles of muamalat in conducting Islamic financial activities (Antonio, 1999). It also refers to a firm conducting business activities within the boundaries stipulated by Islamic law (Haseeb et al., 2022). Section 28(2) of the Islamic Financial Services Act 2013 defines Shariah compliance as "compliance with any decision of the Shariah Advisory Council regarding the conduct, business, affairs, or activities of finance." Therefore, the law mandates that all Islamic financial institutions operate in line with Shariah requirements. Any Islamic financial activities and operations found not to comply with the requirements under Section 28 must be reported to Bank Negara and the Shariah committee for further action. The Shariah committee must then develop a plan to rectify the non-compliance.

The primary reason for the existence of Shariah compliance terminology in the context of the Islamic financial industry can be traced back to the historical development of Islamic banks. The Islamic financial system in Malaysia was initiated due to the awareness and desire of the Muslim community, along with the government, to free themselves from financial systems tainted by usury and conventional principles (Anshori, 2012). Consequently, there was pressure from the Muslim community to shift all financial activities to be based on the Quran and the Sunnah. Thus, it is clear that the concept and principles of Shariah compliance are the backbone of the implementation of the Islamic financial system.

Now that the Islamic financial system has successfully gained a foothold in the country, ensuring Shariah compliance in all aspects of Islamic financial activities, including the management of customers' funds by the institutions involved, is of utmost importance and cannot be taken lightly. The implications of non-compliance with Shariah law in any Islamic financial activity include legal risks, such as fines and imprisonment, as well as reputational risks to Islamic finance (Adawiyah, 2012). Section 259 of the Islamic Financial Services Act 2013 prescribes the form of punishment for offenders under any provision of the act, which includes imprisonment for 1 to 10 years, fines ranging from RM5 million to RM50 million, or both.

A study conducted by Chapra and Ahmad (2002) on the impact of Shariah non-compliance in Islamic financial operations surveyed 463 Islamic bank customers from 14 Islamic financial institutions in Bahrain, Bangladesh, and Sudan. The study found that 288 respondents, or 62%, indicated that they would transfer their funds to another Islamic bank if they believed or suspected a Shariah violation in the operations of their current Islamic bank. The findings of this study highlight that adherence to Shariah principles must be a primary focus and continuously emphasized by Islamic financial institutions, as it significantly influences customer choice in selecting an Islamic bank that meets their needs and requirements.

Comprehensive compliance with Shariah principles will also strengthen public and financial market confidence in the credibility of Islamic financial operations.

In conclusion, governance philosophy is closely related to *maqasid Shariah*. The concept of governance philosophy based on *maqasid Shariah* is believed to provide a unique identity to the Islamic financial system and enhance the understanding of corporate governance within Islamic financial institutions.

### **Conclusion**

Tan Sri Zeti Akhtar Aziz, the former Governor of Bank Negara Malaysia, emphasized in her speech at the Second Islamic Financial Services Board Conference, held on May 24, 2005, at the Sheraton Doha, that the main characteristic of the Islamic financial system lies in its high ethical values which support the governance and business operations of Islamic finance. This industry is rapidly growing in an increasingly complex and challenging environment. In the Islamic financial system, strong corporate governance values, transparency, information disclosure, and strict adherence to Shariah principles are highly emphasized. Therefore, a robust and sustainable Shariah governance framework is necessary to build a resilient and competitive Islamic financial system.

Shariah governance acts as a core and boundary that distinguishes Islamic finance from conventional finance. Fundamentally, through Shariah governance, Islamic financial institutions can ensure that all operations and activities conducted within the Islamic financial industry comply with Shariah principles. Moreover, Section 28(1) of the Islamic Financial Services Act 2013 states that any financial institution shall at all times ensure that its aims, operations, business, affairs, and activities comply with Shariah. This provision imposes a mandatory requirement on all Islamic financial institutions operating in the country to comply with Shariah principles, norms, and standards as determined.

In aiming for an Islamic financial system that is always at the forefront and serves as an example for countries offering Islamic financial services, the key to achieving this vision is to establish a comprehensive Shariah governance framework for financial institutions and to design appropriate Islamic implementation strategies that meet the needs of a dynamic industry while enhancing confidence and stability in the Islamic financial system.

Shariah governance encompasses all aspects, including the framework, policies, and operational manuals. The objective of this governance is to serve as a guideline that consistently ensures and oversees that the business operations environment always aligns with and meets Shariah requirements, while also integrating principles of green finance. In general, as a guarantee of Shariah compliance for all operations carried out by Islamic financial institutions, Bank Negara has established the Shariah Advisory Council, comprising scholars who are experts and highly experienced in this industry. This Shariah Advisory Council is one of the important and key components of the Shariah governance system within the Islamic financial industry. For effective Shariah governance, the Shariah Advisory Council plays a dual role: consultation and supervision. The effectiveness of this role, supported by the Shariah advisory board, depends on two factors, namely legal position and legal jurisdiction. Additionally, the success of this governance is supported by four key values: transparency, fairness, accountability, and independence. These values ensure not only adherence to



Shariah principles but also the integration of green finance principles, promoting environmentally sustainable and socially responsible investment practices. As such, sustainable development objectives must be considered when developing this integration (Suaree et al., 2022). This alignment with green finance enhances the ethical foundation of Islamic financial practices by adhering to the pillars, conditions, and principles advocated by Islam, while also contributing to environmental sustainability and responsible stewardship of resources.

### **Acknowledgement**

This research is funded by Universiti Kebangsaan Malaysia under Geran Universiti Penyelidikan (GUP) titled, " The Development of a Comprehensive Legal Framework and Regulatory Oversight for the Application of Islamic Fintech" (Project Code: GUP-2023-024).

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