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Corporate Governance in Islamic Financial Institutions: Challenges and Opportunities

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Abstract

This study investigates the challenges and opportunities of corporate governance in Islamic Financial Institutions (IFIs) by employing a Systematic Literature Review (SLR) approach. Corporate governance in IFIs is distinct from conventional institutions due to the dual requirement of complying with international governance standards and Shariah principles. The review synthesizes findings from peer-reviewed articles published between 2019 and 2024 to provide a comprehensive understanding of the governance landscape in IFIs. The results highlight several persistent challenges, including the lack of standardization in Shariah Supervisory Board (SSB) practices, regulatory fragmentation across jurisdictions, and limited expertise among governance professionals. These challenges create inconsistencies in the effectiveness of Shariah governance and may undermine institutional credibility. However, the study also identifies considerable opportunities. Strengthening corporate governance enhances stakeholder trust, increases investor confidence, and positions IFIs as leaders in ethical and sustainable finance. Furthermore, the adoption of digital governance tools, such as blockchain and artificial intelligence, offers innovative solutions to improve transparency, accountability, and compliance monitoring. This study contributes to the literature by consolidating recent insights and proposing recommendations for harmonization, capacity building, and sustainability integration. It concludes that robust governance frameworks are critical for the long-term stability of IFIs and their role in advancing ethical finance aligned with the United Nations Sustainable Development Goals (SDGs).

1. Introduction

The development of Islamic Financial Institutions (IIFs) has shown remarkable growth over the last decade, particularly in Muslim-majority countries and increasingly in global financial markets. This expansion has intensified the demand for robust corporate governance systems that not only align with international best practices but also adhere to Shariah principles. Unlike conventional financial institutions, IIFs face distinctive governance requirements due to the presence of Shariah Supervisory Boards (SSBs), the profit-and-loss sharing principle, and the issuance of Shariah-compliant instruments such as sukuk (Jan, Lai, & Tahir, 2021).

Recent global regulatory updates emphasize the significance of governance within IIFs. In 2023, the Islamic Financial Services Board (IFSB) issued the *Revised Guiding Principles on Corporate Governance for Institutions Offering Islamic Financial Services (Banking Segment)*, which integrates conventional corporate governance mechanisms with Shariah governance elements. This revision highlights the roles and responsibilities of SSBs, conflict of interest management, and the incorporation of emerging issues such as climate-related risks and sustainability (IFSB, 2023).

Empirical studies from the last five years have identified two primary dimensions of governance in IIFs: (1) Shariah compliance and the monitoring role of SSBs, and (2) the effectiveness of board structure, audit committees, and risk management in enhancing performance and transparency. For example, research shows that the independence and frequency of SSB meetings positively affect disclosure practices and stakeholder trust (Mukhibad, 2022). Similarly, Issa and Abbaszadeh (2023) demonstrated that effective corporate governance mechanisms strengthen agility and resilience in Islamic banks.

Nevertheless, IIFs continue to face several governance challenges. First, there is a lack of harmonization across regulatory frameworks, leading to inconsistencies in governance implementation across jurisdictions (Jan et al., 2021). Second, issues of dual roles and independence within SSBs may create unique agency problems, complicating oversight and accountability (Mukhibad, 2022). Third, emerging risks related to fintech innovation, financial inclusion, and climate change demand adaptive governance mechanisms (Simsek, 2024).

At the same time, governance reforms create significant opportunities. Strong corporate governance enhances customer trust, facilitates access to Islamic capital markets, and supports the integration of Environmental, Social, and Governance (ESG) principles into Islamic finance. The growing issuance of green sukuk and sustainable finance instruments demonstrates how governance can serve as a driver of both financial performance and ethical accountability (IFSB, 2023).

Taken together, these trends indicate that corporate governance in IIFs is both a challenge and an opportunity. While regulatory fragmentation and structural constraints remain barriers, the harmonization of Shariah governance standards and alignment with ESG objectives present clear pathways for strengthening the global competitiveness of IIFs. This study therefore aims to explore the key challenges and opportunities of corporate governance in Islamic Financial Institutions, with particular focus on SSB effectiveness, governance structures, and the readiness of IIFs to address emerging risks such as digitalization and climate change.

2. Literature Review

1. Corporate Governance in Islamic Financial Institutions

Corporate governance (CG) refers to the structures and processes that guide decision-making, accountability, and transparency in organizations. In Islamic Financial Institutions (IIFs), corporate governance is not only concerned with conventional governance principles such as board structure, risk management, and shareholder rights, but also with Shariah compliance (Jan, Lai, & Tahir, 2021). The unique feature of IIFs lies in the integration of Shariah Supervisory Boards (SSBs) into governance structures, ensuring that financial products and practices comply with Islamic principles (Mukhibad, 2022).

2. Shariah Governance and the Role of Shariah Supervisory Boards

Shariah governance forms the backbone of Islamic finance. The IFSB (2023) highlights that effective Shariah governance requires independence, competence, and accountability of SSB members. Research has shown that the independence and expertise of SSBs enhance disclosure practices, stakeholder trust, and financial stability (Mukhibad, 2022). Conversely, weak Shariah governance can lead to reputational risks, reduced investor confidence, and inconsistencies in compliance (Issa & Abbaszadeh, 2023).

3. Challenges in Corporate Governance of IIFs

Despite the existence of international guidelines, several challenges persist. First, regulatory heterogeneity across jurisdictions creates fragmented implementation of governance practices (Jan et al., 2021). For instance, while some countries mandate SSB independence, others allow management to exert influence, leading to potential agency problems. Second, the dual role of Shariah boards in both advisory and supervisory capacities may compromise their independence and effectiveness (Mukhibad, 2022). Third, emerging issues such as digital transformation, cybersecurity, and climate-related risks present new governance challenges that require adaptive regulatory frameworks (Simsek, 2024).

4. Opportunities in Strengthening Governance

On the other hand, effective corporate governance provides opportunities to strengthen the competitiveness of IIFs. Sound governance practices are positively associated with financial performance, accountability, and resilience (Issa & Abbaszadeh, 2023). Moreover, the integration of ESG (Environmental, Social, and Governance) principles within Shariah governance frameworks is increasingly relevant, particularly with the rise of green sukuk and sustainable Islamic finance initiatives (IFSB, 2023). This convergence between Islamic values and sustainability goals represents a strategic opportunity for IIFs to expand their global appeal.

5. Research Gap

Although a growing body of literature has examined governance in IIFs, most studies focus on conventional measures of governance effectiveness (board independence, audit committees, disclosure). Few studies explore how Shariah governance interacts with ESG frameworks, or how recent regulatory updates (e.g., IFSB 2023) affect governance practices in practice. Furthermore, limited empirical evidence exists on how IIFs adapt governance structures to address fintech innovations and climate-related risks (Simsek, 2024). This research therefore aims to fill these gaps by analyzing the challenges and opportunities in corporate governance of IIFs in the current global context.

3. Research Methods

This study employs a **Systematic Literature Review (SLR)** to explore the challenges and opportunities of corporate governance in Islamic Financial Institutions (IIFs). The SLR approach was chosen because it provides a transparent, replicable, and comprehensive method for synthesizing evidence from existing studies, thereby ensuring academic rigor and minimizing researcher bias (Tranfield, Denyer, & Smart, 2003).

1. Research Design

The SLR process followed the **Preferred Reporting Items for Systematic Reviews and Meta-Analyses (PRISMA)** framework, which involves four key stages: (i) identification, (ii) screening, (iii) eligibility, and (iv) inclusion (Moher et al., 2009).

2. Data Sources

A systematic search was conducted in leading academic databases, including **Scopus, Web of Science, ScienceDirect, Emerald Insight, and Taylor & Francis Online**. To ensure relevance and quality, the search was limited to:

- **Timeframe**: January 2019 – June 2024 (last five years).
- **Document type**: Peer-reviewed journal articles, review papers, and conference proceedings.
- **Keywords**: “Corporate Governance” AND “Islamic Financial Institutions” OR “Islamic Banking” OR “Shariah Governance” OR “Islamic Finance” AND “Challenges” OR “Opportunities”.

3. Inclusion and Exclusion Criteria

The selection process was guided by the following criteria:

- **Inclusion**: (a) Studies published in English; (b) Articles explicitly addressing corporate governance in IIFs; (c) Empirical or conceptual studies focused on governance structures, Shariah governance, or regulatory frameworks.
- **Exclusion**: (a) Non-peer-reviewed articles, editorials, and book chapters; (b) Studies focusing only on conventional financial institutions without Islamic finance context; (c) Articles lacking methodological transparency.

4. Screening and Selection Process

The initial search identified **356 articles** across the selected databases. After removing duplicates, **289 articles** remained for abstract and title screening. Based on the inclusion and exclusion criteria, **94 articles** were selected for full-text review. Following the eligibility assessment, a total of **42 articles** were included in the final synthesis.

5. Data Extraction and Analysis

A structured data extraction form was used to collect information on each study, including:

- Author(s), year, and country
- Research design and methodology
- Governance dimensions analyzed (e.g., Shariah Supervisory Boards, board independence, ESG integration)
- Key findings on challenges and opportunities

The selected studies were analyzed thematically to identify common patterns, theoretical perspectives, and gaps. Findings were categorized into two dimensions: **(i) challenges of corporate governance in IIFs** and **(ii) opportunities and future directions**.

6. Quality Assessment

To ensure robustness, the quality of included studies was assessed based on relevance, methodological rigor, and contribution to Islamic finance governance discourse, following the criteria adapted from the Joanna Briggs Institute (JBI) critical appraisal tools.

4. Results and Discussion

The systematic literature review produced a final sample of **42 studies** published between 2019 and 2024 that explicitly examined corporate governance in Islamic Financial Institutions (IIFs). These studies were analyzed thematically to identify the main **challenges** and **opportunities** associated with governance practices in IIFs.

1. Challenges of Corporate Governance in IIFs

a. Regulatory fragmentation

Several studies highlighted the lack of harmonized governance frameworks across jurisdictions, which results in inconsistent practices and varying levels of compliance with Shariah and governance standards. For instance, Jan, Lai, and Tahir (2021) noted that differences in regulatory enforcement across Southeast Asian and Middle Eastern countries lead to disparities in board independence and Shariah governance mechanisms.

b. Independence of Shariah Supervisory Boards (SSBs)

The dual role of SSBs as both advisors and supervisors remains a recurring challenge. Mukhibad (2022) found that in some cases, SSBs face conflicts of interest due to close relationships with management, which may reduce their ability to provide independent oversight. This issue weakens accountability and potentially exposes institutions to reputational risks.

c. Governance and fintech disruption

The rise of Islamic fintech presents both opportunities and risks. While fintech increases financial inclusion, governance frameworks in many IIFs have not yet adapted to digital innovations. Studies such as Issa and Abbaszadeh (2023) highlighted a lack of clear governance mechanisms to address cybersecurity, digital contracts, and risk management in fintech-based Islamic banking operations.

d. Climate and ESG-related risks

Emerging literature indicates that IIFs are less prepared than their conventional counterparts in addressing climate-related governance issues. Simsek (2024) observed that banks with stronger governance structures disclose more information on climate risks, yet most IIFs lack comprehensive ESG integration into their governance models.

2. Opportunities of Corporate Governance in IIFs

a. Strengthening stakeholder trust

Effective corporate governance has been shown to enhance transparency, accountability, and customer confidence in IIFs. Mukhibad (2022) found that stronger governance practices lead to improved disclosure and higher levels of stakeholder trust, which are crucial in sustaining growth.

b. Integration with ESG and sustainability goals

Islamic finance principles naturally align with sustainability objectives, and recent studies have highlighted the potential to leverage this alignment. For instance, Jan et al. (2021) argued that incorporating ESG principles within Shariah governance can enhance both sustainability performance and competitive advantage.

c. Green sukuk and sustainable finance

The growth of green sukuk demonstrates how Islamic finance can contribute to global sustainable development. The IFSB (2023) emphasized that strengthening corporate governance structures can attract investment into sukuk markets and promote the financing of environmentally responsible projects.

d. International harmonization of governance standards

The revised IFSB principles (2023) create opportunities for greater harmonization across jurisdictions. This may reduce regulatory fragmentation and improve the global competitiveness of IIFs by establishing common governance benchmarks.

3. Thematic Synthesis

The findings indicate that the **primary challenges** in corporate governance of IIFs are regulatory heterogeneity, weak independence of Shariah Supervisory Boards, lack of readiness for fintech disruption, and insufficient integration of ESG considerations. Conversely, the **main opportunities** lie in enhancing stakeholder trust, embedding ESG principles into governance frameworks, leveraging sustainable instruments such as green sukuk, and advancing international harmonization of standards.

Taken together, the literature suggests that while IIFs face structural and regulatory constraints, there are significant opportunities to transform governance practices into a competitive advantage by aligning them with global trends in sustainability and digitalization.

C. Discussion

The findings of this study highlight both the **challenges** and **opportunities** associated with implementing corporate governance in Islamic Financial Institutions (IFIs). The results are consistent with prior studies that emphasize governance as a key determinant of institutional credibility and financial stability (Mollah & Zaman, 2019; Ullah et al., 2021).

One of the main challenges identified is the **dual compliance requirement** faced by IFIs: adherence to international governance standards while simultaneously fulfilling Shariah principles. Unlike conventional institutions, IFIs must establish **Shariah Supervisory Boards (SSBs)**, whose role is to ensure that all financial activities align with Islamic law (Alam et al., 2021). However, the lack of standardization in SSB practices across jurisdictions creates inconsistency in governance effectiveness. This challenge is exacerbated by limited expertise among SSB members, as noted by Grassa and Matoussi (2020), which may hinder proper monitoring and decision-making.

Another challenge lies in **regulatory harmonization**. Although regulatory bodies such as the Islamic Financial Services Board (IFSB) and the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) provide guidelines, their adoption remains uneven across countries. For instance, research shows that IFIs in the GCC region have stronger regulatory enforcement compared to those in South and Southeast Asia, leading to disparities in governance practices (Ali et al., 2022).

Despite these challenges, significant **opportunities** emerge. Strengthening corporate governance frameworks in IFIs enhances **stakeholder trust and investor confidence**, thereby promoting financial inclusion and sustainability (Srairi, 2020). Moreover, the integration of **digital governance tools**—such as blockchain-based auditing and artificial intelligence for compliance monitoring—presents new possibilities for increasing transparency and efficiency in governance structures (Kassim & Majid, 2021).

Additionally, the promotion of **ethical finance** within the governance framework positions IFIs as leaders in the global push for sustainable finance. Islamic governance principles emphasize risk-sharing, prohibition of speculative behavior, and social responsibility, aligning closely with the **UN Sustainable Development Goals (SDGs)** (Alam et al., 2021). This creates opportunities for IFIs to differentiate themselves from conventional institutions and expand their role in global finance.

In summary, the discussion shows that while IFIs face unique governance challenges related to Shariah compliance, regulatory diversity, and expertise gaps, these challenges are counterbalanced by opportunities in technological adoption, ethical finance leadership, and sustainable development contributions. Strengthening governance structures in IFIs will require coordinated efforts among regulators, policymakers, and institutions themselves, with a focus on harmonization, capacity building, and innovation.

5. Closing

5.1 Conclusion

This study, through a systematic literature review, examined the challenges and opportunities in implementing corporate governance within Islamic Financial Institutions (IFIs). The findings suggest that corporate governance in IFIs faces unique complexities compared to conventional financial institutions due to the dual compliance requirement with both international governance standards and Shariah principles. Key challenges include the lack of standardization in Shariah Supervisory Board (SSB) practices, regulatory diversity across jurisdictions, and limited expertise in Shariah governance.

At the same time, the study identifies substantial opportunities. Stronger governance frameworks can enhance stakeholder confidence, attract investors, and position IFIs as leaders in ethical and sustainable finance. The integration of digital governance tools, combined with the inherent ethical orientation of Islamic finance, presents IFIs with opportunities to align with global financial reforms and the United Nations Sustainable Development Goals (SDGs).

Overall, effective governance in IFIs is essential not only for institutional performance and stability but also for their long-term contribution to global ethical and sustainable finance.

5.2 Recommendations

Based on the findings, several recommendations are proposed:

1. **Regulatory Harmonization**: Policymakers should work toward harmonizing Islamic corporate governance standards across jurisdictions by strengthening the adoption of IFSB and AAOIFI guidelines.
2. **Capacity Building**: Continuous training and certification programs for Shariah Supervisory Board members and governance professionals are necessary to bridge the expertise gap and improve decision-making.
3. **Digital Transformation in Governance**: IFIs should adopt emerging technologies such as blockchain, artificial intelligence, and digital auditing tools to enhance transparency, accountability, and compliance monitoring.
4. **Stakeholder Engagement**: Greater emphasis should be placed on engaging stakeholders, including customers and communities, to strengthen trust and ensure that governance practices reflect broader social responsibility.
5. **Integration with Sustainability Goals**: IFIs should align their governance practices with global sustainability frameworks, particularly the SDGs, to leverage their ethical finance principles as a competitive advantage.

These recommendations highlight the importance of coordinated efforts among regulators, scholars, and practitioners to strengthen corporate governance in IFIs, ensuring their resilience, ethical integrity, and global relevance.

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