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Corporate Justice and Dispute Management in Islamic Banks and Financial Institutions

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Abstract

The ever-increasing growth of the Islamic banking industry and the proliferation of Islamic financial products in the global economy necessitate a framework for managing corporate disputes arising from internal differences and contractual relationships with third parties, particularly in banker-customer relationships. Quality management in Islamic banks and financial institutions can be sustained through appropriate measures in creating an ombudsman office (muhtasib) with renewed zeal to ensure compliance with administrative standards. Such a body will enhance the quality of governance structure of the financial institution. This paper examines corporate justice and dispute resolution within the framework of Islamic banks and financial institutions and the need to revive the administrative dispute resolution office of muhtasib. The paper presents a model for fusing such an independent office into the administrative structure of the financial institutions to promote good governance and corporate social responsibility, because instead of litigating petty claims against the financial institutions, such an office will be able to resolve such claims amicably. The paper concludes that such office, which is a form of corporate self-regulation integrated into the administrative structure of the financial institution, will promote sustainable excellence.

Keywords: corporate justice, dispute resolution, muhtasib, ombudsman, Islamic financial institutions.

Introduction

In a bid to globalize the functions of Islamic financial institutions (“IFIs”), there is a need for an internally driven dispute management mechanism to ensure corporate justice. In managing corporate governance, there must be concerted efforts to effectively manage internally originated disputes either among employees or between a client and the IFI. This paper examines dispute management as a means of promoting corporate justice with special reference to the dispute resolution mechanisms in Islamic law. The focus of this conceptual framework is the IFIs. The crystallization of Islamic financial products have rekindled the need for an effective governance structure to manage the increasing number of disputes, claims and complaints faced by many IFIs across the world.

Accordingly, the paper is basically divided into five major parts. The first part is the research methodology, while the second part consists of the conceptual framework which gives a detailed review of the relevant literature on the major themes in the paper. This is the kernel of the paper since it comprises major themes like the concepts of corporate justice and corporate governance, Sharī’ah standards on corporate governance, and the muhtasib framework in Islamic law. The third part dilates on corporate justice in IFIs. Following suit is the fourth part which gives the findings of the research. Furthermore, the fifth part of the paper gives the conclusion which comprises the research limitations and implications for future research, originality and finally the contribution of the paper to existing knowledge.

Research Methodology

The methodology adopted in this research is a critical review of a wide range of theoretical literature ranging from the primary literature on Islamic jurisprudence, relevant Islamic law literature to recent literature on corporate governance and effective dispute management. The relevant standards of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) on corporate governance and arbitration are carefully examined to propose a practical framework for the effective management of disputes through in-house mechanisms in IFIs. Besides, the IFSB Guiding Principles on Corporate Governance are examined with a view to determining whether there are elements of dispute avoidance and dispute resolution through the laid down guidelines. In addition, the Central Bank of Malaysia Guidelines on Islamic Corporate Governance for Islamic Banks will also be reviewed to ascertain whether there are relevant provisions on dispute avoidance or even dispute resolution in corporate matters affecting the management.

Literature Review

The Theory of Corporate Justice and Corporate Governance

Corporate justice is concerned with the promotion of corporate accountability through Corporate Social Responsibility ("CSR"). The twin concepts of corporate accountability and CSR form the foundation for corporate justice. While discussing the theory of "Corporate Justice", one may begin to think of how to fight back in the courtroom and protect one's company in a corporate dispute with a third party, but

there is more to the concept (Willis, 2006). Corporate justice extends to labour disputes within the company, customer-banker relationship disputes, and disputes with some other companies with whom one has transacted any business. However, due to the projected "big pay" which a company intends to realize from litigating a case in the court, most Chief Executives Officers ("CEOs") are blindfolded and thus head to the court. In the long run, it will be discovered that to fund lawsuits and pay damages will definitely be counter-productive and may singlehandedly result into the winding-up of the company (Oseni, 2009). The proliferation of bogus claims and grossly inflated damages with interest in many corporate disputes justifies the need for an alternative forum for effective dispute resolution (Willis, 2006). Litigating Islamic finance disputes and claims, especially in the modern civil courts, is a navigation through uncharted waters which is fraught with excessive risks and uncertainties. These business risks occasioned by lack of sufficient legal and regulatory framework in the IFIs justify the need for effective corporate governance. "This approach reconfirms that the quality of bank management, and especially the risk management process, are the key concerns in ensuring the safety and stability of both individual banks and the banking system as a whole" (Greuning & Bratanovic, 2003). What is observed nowadays in many conventional companies nowadays is the penchant for ombudsman within the management cadre to reduce risk of litigation (Rowe, 1987; Kolb, 1987).

The method or process through which a company is effectively directed, administered

and controlled is known as corporate governance. There is no generally acceptable definition of corporate governance but some experts have attempted to define the concept. A definition which emphasizes due process and effective management of challenges including disputes within a company was proffered by Solomon & Solomon (2004) and it is quoted with approval: “[C]orporate governance is the system of checks and balances, both internal and external to companies, which ensures that companies discharge their accountability to all their stakeholders and act in a socially responsible way in all areas of their business activity”. The concept of corporate governance has been a western concept used extensively as a western concept in the conventional financial institutions (Yunis, 2007). In fact, the existing models which some experts in Islamic finance have proposed to “Islamize” are the Anglo-American model and the Franco-German model. Without doubt, a close study of these models reveals some modicum of Islamic theory of justice, transparency and excellence in business activities. To begin with, these sacrosanct principles of law and commerce in the prime sources of the Shari’ah are essentially general outlines of the law (Kamali, 2002). The details of the applicable rules are required to be expounded by qualified jurists based on recognized rules and methodologies in Islamic jurisprudence (Hassan, 1993; Nyazee, 2006; Kamali, 2009).

Therefore, since the whole concept of Islamic banking and finance is relatively new, there has been no need to develop this aspect of corporate governance in Islamic

jurisprudence. This explains the level of flexibility in Islamic law, since jurists often come out with new specific rules based on the general rules in the prime sources of the Shari’ah, particularly in commercial transactions, to cater for novel issues (Archer & Karim, 1997). Sequel to this internally regulated mechanism in Islamic jurisprudence, many finance products have been developed in the twilight of the 20th century and the beginning of the 21st century which have been approved as Shari’ah-compliant products (Muda & Jalil, 2007).

Dispute Management and Notable Shari’ah Standards on Corporate Governance

AAOIFI Standards on Corporate Governance

In its Accounting, Auditing & Governance Standards (for Islamic Financial Institutions) issued in 2010, AAOIFI has 7 Governance Standards and 2 codes of ethics. The 7 Governance Standards are:

1. Shari’ah Supervisory Board: Appointment, Composition and Report.
2. Shari’ah Review.
3. Internal Shari’ah Review.
4. Audit and Governance Committee for IFIs.
5. Independence of Shari’ah Supervisory Board.
6. Statement on Governance Principles for IFIs.
7. Corporate Social Responsibility (AAOIFI, 2010).

A critical scrutiny of each of the governance standards listed above reveals concerted efforts towards improving corporate governance in IFIs to ensure excellent performance. However, a major aspect left out here is the dispute management

standard which should be regarded as part of corporate governance practices. The 7 Governance Standards listed above are geared towards dispute avoidance. However, AAOIFI provides for a mechanism for dispute resolution in the Sharī'ah Standard on Arbitration (taġġġm). This standard is No. 32 of the AAOIFI Sharī'ah Standards released in 2010 (AAOIFI, 2010). Considering the importance of dispute management in corporate governance, there is a need to operationalize the provisions in the AAOIFI Sharī'ah Standard on Arbitration by taking a step further to introduce the muhtasib model within the IFIs for early evaluation of disputes and dispute avoidance. Such should be the preliminary step before embarking on arbitration. It is therefore proposed that the dispute resolution clause in contractual agreements involving the IFIs and their clients should expressly provide for a three-tiered dispute resolution mechanism comprising muhtasib as an internal mechanism with an

independent tribunal set up to hear appeals from such body, arbitration, and when settlement is not reached, litigation.

IFSB Guiding Principles on Corporate Governance

In December 2009, the Islamic Financial Services Board (IFSB), a leading international standard-setting organization, issued the Guiding Principles on Sharī'ah Governance Systems for Institutions Offering Islamic Financial Services ("IFSB Guiding Principles"). The set of guiding principles are expected among others to "facilitate better understanding of Sharī'ah governance issues and how stakeholders should satisfy themselves that an appropriate and effective Sharī'ah governance system is in place" (IFSB, 2009). The following illustration is given in the IFSB Guiding Principles which shows how the Sharī'ah governance systems complements the existing structure in the conventional financial institutions.

FUNCTIONS	TYPICAL FINANCIAL INSTITUTION	ADDITIONS IN IIFS
Governance	Board of directors	Sharī'ah Board
Control	Internal auditor External auditor	ISRU External Sharī'ah Review
Compliance	Regulatory and financial compliance officers, unit or department	ISCU

Table 1: Guiding Principles on Sharī'ah Governance Systems for Institutions Offering Islamic Financial Services. Source: IFSB (2009).

An organ within the management of the IFIs in the Table 1 is the Internal Sharī'ah Compliance Unit/Department ("ISCU"). The

next subsection of this paper discusses the differences between ISCU and the office of the muhtasib. Even though the IFSB Guiding

Principles vests the powers of carrying out and implementing the Shari'ah governance system on the Shari'ah Board of IFIs, the office of the muhtasib will serve as a complementing organ of the company that investigates the level of implementation of the Shari'ah governance system and resolves disputes relating to some breaches of laid down procedures.

Differences between Muhtasib and the Internal Shari'ah Compliance Unit/Department

Though there are some elements of the office of the muhtasib in the ISCU, there are some remarkable differences in the two organs in the management of IFIs. On the basis of the modern role of muhtasib and its proactive functions as suggested by modern scholars, the following are some of the notable differences between the institution and the ISCU:

1. The ISCU reports to the Shari'ah Board while the muhtasib reports directly to the Board of Directors since the latter's terms of reference covers all the transactions and activities of the IFI, which includes the Shari'ah Board;
2. The Shari'ah Board cannot delegate its functions to the muhtasib, but can issue official directives to the office of the muhtasib to commence an investigation or a fact-finding process. However, the Shari'ah Board can delegate its functions directly to the ISCU.
3. The office of the muhtasib, though to be appointed by the Board of Directors, is an independent organ of the IFI. On the other hand, the ISCU is attached to the Shari'ah Board and in most cases, it is

considered as the secretariat for the Shari'ah Board.

4. The muhtasib office is an additive to other organs of the IFI such as the Legal, Audit or ISCU but it is practically independent from them.
5. Rather counter-intuitively, the muhtasib as an informal corporate justice channel is an employee of the IFI appointed by the Board of Directors, but it is not part of the IFI in the true sense due to its high level of independence.

Be that as it may, there are some areas of convergence between the functions of the officers of the ISCU and the office of muhtasib. The two organs disseminate information on new standards, pronouncements, resolutions to the operative personnel in the relevant departments of the IFIs. They both monitor the day-to-day compliance of the operative personnel with the Shari'ah standards in all the transactions carried out by the IFIs (IFSB, 2009).

Bank Negara Malaysia Guidelines on Corporate Governance

Bank Negara Malaysia issued the "Guidelines on Corporate Governance for Licensed Islamic Bank" (the BNM Guidelines) with the primary objective of promoting "the adoption of effective and high standards of corporate governance practices by Islamic bank and Islamic bank holding companies" (Islamic Banking & Takaful Department, 2007). The minimum standards required of Islamic banks and Islamic bank holding companies are clearly set out in the BNM Guidelines to ensure sound corporate governance. With 14 principles of corporate

governance dealing with Board matters, management oversight, accountability and audit, and transparency, the Guidelines is to be read together with enabling legislations such as the Islamic Banking Act 1983, the Companies Act 1965, and other relevant guidelines, regulations and circulars relating to corporate governance including the IFSB Guiding Principles. A careful study of the BNM Guidelines reveals the absence of a dedicated organ like ISCU saddled with the responsibility of ensuring compliance with laid down standards and resolutions. However, such duties which are part of the functions of the office of muhtasib are subsumed under the major responsibilities of the Board of Directors of IFIs. The Board of Directors may not be on ground to monitor such compliance, since it only acts based on reports brought before it and makes policy decisions. To this end, the Board of Directors should delegate this power to an independent organ to handle and effectively resolve such issues.

The Muhtasib Framework in Islamic Law

By and large, Islamic historians believe the institution of hisbah greatly influenced the modern ombudsman. Apart from the fact that the idea originated from the prime sources of the Sharī'ah and further developed during the golden era of the four rightly guided Caliphs as an administrative and grievance-remedial scheme for business and religious-related issues, it is believed that it had its first contact with Europe after the conquest of Spain in 711 C.E. Subsequently, hisbah was recognized as an institution for compliant-handling and conflict management in Spain. Even though there may not be specific reference to the institution of hisbah

in some historical references on Islam in Spain, it formed part of the administrative-cum-regulatory organ of the Muslim community (Khan, 1982). At the time of the conquest of Spain, the Umayyad Caliphate was at its zenith and this was the period where such Islamic institutions were consolidated (Watt & Cachia, 2007). However, in the western world, the history of ombudsman whose functions are not different from those of the classical muhtasib dates back to 1809 when it emerged in Sweden (Seneviratne, 1994; Seneviratne, 2002).

According to Hamdani (2008), the institution of hisbah has been an important Islamic institution during the medieval period and its functions have crystallized after some time (Zaidan, 2006). The underlying philosophy of the office of muhtasib is enjoining people to do good and forbidding them from wrongdoing (Ibn al-Ukhuwah, 1976). The muhtasib had the powers to make binding decisions in some cases and this is the reason why Al-Mawardī rightly pointed out that hisbah is the intermediate point between the powers of a court and the special tribunals of wrongs (mazālim) (Al-Mawardi, 1983; Al-Mawardi, 1996). According to Kamali (1998), muhtasib "lies at the root of many Islamic laws and institutions". The tripartite role of a muhtasib comprises dispute avoidance, dispute resolution and enforcement of due process within the Islamic financial institution. However, the functions of the classical muhtasib have been specifically identified by Al-Mawardi (1983):

1. Investigation of manifest immoral actions in order to have them reprehended and to

- look for any good conduct that has been abandoned in order to re-establish same.
2. Hearing appeals about reprehensible conducts by listening to complainants or informants;
 3. Questioning of individuals found in questionable or suspicious situations in the society;
 4. Employ and use his deputies to help in the corrective and investigative measures to be more effective in discharging the responsibility with which he is saddled.
 5. Empowered to penalize a minor violation which is evident but such must not reach the level of legal punishment.
 6. Freedom to exercise his independent judgment in conventional matters which are customary to a particular profession.

From the foregoing, it is obvious that the powers vested in the muhtasib are wider than those being enjoyed by the western Ombudsman since the powers of the former covers both mundane and spiritual matters (Rashid, 2004). This is a good meeting point between the relevance of the office of the muhtasib in both corporate governance and Sharī'ah governance of the IFIs which makes the two concepts inextricable.

Even though the classical muhtasib was more of market supervision, the principle of *siyāsah al-shar'iyah* allowed for gradual transformation of these classical functions (Al-Awa, 1975). Therefore, if rudimentary practices of profits and loss sharing through *mushārah*, *mudārah*, *ijārah* and other modes of financing that were in vogue during the time of the Prophet and the succeeding generations could be transformed to highly sophisticated Islamic financial products in the

modern world, it is equally possible to incorporate the institution of muhtasib into the corporate governance system to ensure corporate justice. As earlier emphasized, this will serve as an internal mechanism to promote due process, administrative efficiency, corporate excellence and effective dispute management through dispute avoidance and resolution (Garas & Pierce, 2010).

Proposed Framework: Corporate Justice in Islamic Financial Institutions

Several scholars have repeatedly emphasized the tremendous growth experienced in the Islamic finance industry in the modern world and the exponential growth of Islamic financial products in the global economy (El Diwany, 2010). The products have continued to grow in size and significance in spite of some initial challenges it faced (Siddiqui, 2010). With up to \$750 billion Sharī'ah-compliant assets and over 600 IFIs in over 75 countries across the world, corporate justice is an inevitable phenomenon which must be associated with sustainable growth (Khan & Shariff, 2009). One major thing every IFIs aims to achieve is certainty in its transactions, profits and dividends (Ayub, 2007; Hassan, 1999).

It is pertinent to note that the Qur'anic concept of corporate justice promotes the shareholder value-system, stakeholder value-system, and ultimately the underlying philosophy of corporate excellence which is in form of symbiotic relationship which brings about benefits to all (Beekun, 1996).

Proposed Functions of the Corporate Muhtasib of IFI

The need for reforms in the IFIs is steering at everybody's face in the ever-increasing phenomenal sophistication of modern businesses. In effect, the proposed framework for corporate justice through effective management of disputes and claims is based on the concept of hisbah. The independent organ established within the managerial cadre of the IFI should be saddled with the following responsibilities:

1. Investigation of compliance with laid down rules, regulations and industry standards;
2. Review of claims against the IFI by third parties, particularly customers and such mandatory preliminary practice should be incorporated into all contractual transactions of the IFI. No lawsuit should be filed by a customer over any claim without having the case reviewed by the corporate muhtasib.
3. Mediation of cases and claims against the company and rendering decisions. Any decision made by the muhtasib with regards to a claim or dispute against the IFI is binding on it but if such decision is against the customer, the decision is appealable to an Independent Financial Mediation Tribunal to be set up by a Memorandum of Understanding among IFIs in a country and duly coordinated by the Central Bank.
4. Hearing and determination of any claim or complaints by shareholders against the management of the IFI or by the minority shareholders against the majority shareholders in the event of some undue preferences.

5. Drafting of code of conduct for all staff of the IFI subject to the ratification of the Board of Directors.

What the foregoing responsibilities entail in a corporate setting is nothing but corporate justice embellished with elements of dispute resolution, dispute avoidance and enforcement of due process within the IFIs.

Stages of Corporate Justice Framework for Dispute Management

Figure 1 below shows the stages through which corporate claims, disputes and complaints should pass for effective dispute management to reduce the risk of litigation.

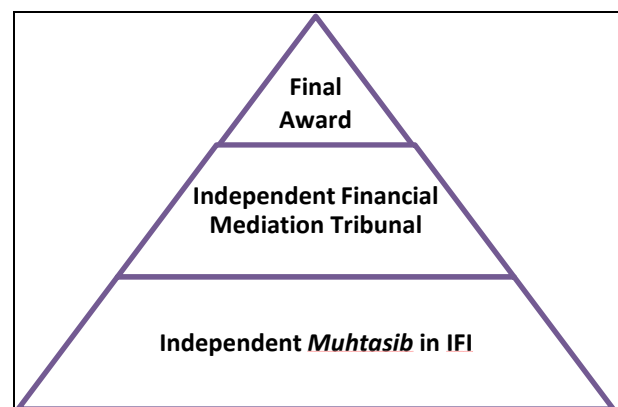


Figure 1: Stages of Corporate Justice Framework for Dispute Management

It is clear that the office of a muhtasib is critical to corporate governance, and specifically, corporate justice and risk mitigation in IFIs. An aggrieved party who has some complaints or claims against the IFI may go through the following stages to resolve the dispute amicably and responsibly:

1st Stage

Once a dispute arises either between a customer and the financial institution or between shareholders and the management,

the first step a complainant should take is to contact the muhtasib office of the IFI and lodge the complaint. The muhtasib will review the case and attempt to resolve the dispute amicably based on the laid down rules, regulations and industry standards. The decision of a muhtasib is enforceable against the IFI but not binding on the complainant.

2nd Stage

If the complainant is not satisfied with the decision of the muhtasib attached to the IFI, he or she can file an appeal at a separate Independent Financial Mediation Tribunal where experts will hear and determine the case accordingly. The Independent Financial Mediation Tribunal will review the case and work with both the IFI and the complainant to resolve the dispute through sulh (mediation or conciliation).

3rd Stage

In the event of a deadlock between the parties, the complainant and not the IFI, can proceed to a competent court to enforce his or her right. However, another adjudicatory option which is less formal is tahkim (arbitration) which the parties can explore for a binding decision. The AAOIFI Standard on Arbitration should be the guiding principles for the arbitration process.

Findings

The paper finds a high degree of inadequacy of the in-house mechanism for dispute management in most IFIs. A framework based on the muhtasib model is required to rescue the industry from litigious marauders who sometimes apply principles of common

law of contract in Islamic finance cases. In addition, in instances where the Shari'ah Board is being suspected of playing to the gallery in the ratification of new Islamic finance products, the muhtasib as a neutral, and independent organ, can commence a confidential investigation into such allegation and recommend appropriate steps to the Board of Directors or General Meeting of shareholders. This will definitely promote sustainable responsible business culture which is informed by some forms of corporate self-regulation integrated into the business of IFI. Beyond any iota of doubt, this will promote the CSR of the IFIs in the modern competitive business environment and will enhance sustainable excellence. Furthermore, the paper also finds some degree of dispute avoidance procedures in the corporate governance standards of AAOIFI, IFSB and Bank Negara Malaysia Guidelines respectively.

Conclusion

From the foregoing conceptual analysis coupled with the proposed framework for dispute management which covers both dispute resolution and dispute avoidance, it is crystal-clear that the crystallization of the Islamic finance products at the end of the first decade of the 21st century calls for certain reforms in the industry as proposed in this paper.

Research Limitations/Implications for Future Research: This paper only establishes a theoretical framework for the effective management of disputes in the Islamic finance industry which, as proposed, should be part of good corporate governance.

However, with regard to implications for future research, an empirical research may be conducted to review how selected world-class IFIs manage their disputes. In addition, specific guidelines for the duties of an independent muhtasib in IFIs should be formulated and adopted at the level of AAOIFI and IFSB as internationally recognized standards.

Originality/Contribution to knowledge: Be that as it may, this paper extensively contributes to the literature gap about effective dispute management in the Islamic finance industry through in-house mechanisms. Such framework is important at the early stages of disputes to avoid its eventual escalation into full-blown disputes that may pass through stringent hurdles of court litigation. For effective and high standards of corporate governance in Islamic banks, there is a need to inculcate dispute management mechanism into the process (Khan & Shariff, 2009). The issues discussed in this paper are by no means exhaustive but merely serves as a spring board for further research in this important aspect of management of IFIs.

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