CHAPTER 18

Shari'a Governance In Islamic Finance

18.1. Introduction

Muslims around the globe are becoming increasingly aware of their obligation to conduct their financial dealings in accordance with Shari'a, even if it means paying higher fees or making a lower return. The recent availability of Islamic products originates from this demand, and we have witnessed a stampede of new entrants into this industry both by local eastern financial institutions, and larger western players from the corporate world. However, the Islamic financial industry's recent impressive annual growth rate of about 15% has been accompanied by growing pains in the area of human capital development. This is particularly true of the training and preparation of Shari'a scholars, who are sometimes subject to heavy criticism for the lack of uniformity in their decision rulings. In this section we focus on Shari'a governance at IFIs, challenges facing Shari'a scholars and solutions and recommendations.

18.2. Shari'a governance at Islamic financial institutions

Shari'a governance can be defined as the structures and processes that are put in place to ensure that principles and requirements of Islamic law are fulfilled in all contractual and operational aspects of an IFI, from the perspective of different stakeholders. This is emphasized by Grais and Pellegrini (2006a) who maintain that 'the core mission of any Islamic financial institution (IFI) is to meet its stakeholders' desire to conduct their financial business according to Shari'a principles'.[137]

While an IFI will have various bodies and processes in the governance system, a key component of this system is Shari'a supervision that ensures that Shari'a requirements are fulfilled. In order to reduce Shari'a non-compliance risks and ensure that the IFIs fulfil their fiduciary duties of conducting business according to Shari'a principles, the regulatory bodies can also opt to provide Shari'a governance framework and guidelines. Appraising the status of Shari'a governance and supervision for the Islamic financial sector would, however, require first identifying the stakeholders and Shari'a requirements of the Islamic financial industry.

18.3. Stakeholders

Grais and Pellegrini (2006b) identify the four stakeholders of IFI as shareholders, depositors, borrowers, and the socially vulnerable groups.[138] IFSB (2006, p. 27) identifies stakeholders for the Islamic financial sector in broad terms as employees, customers, suppliers, the community (Muslim Ummah), supervisors and the government. The different stakeholders of the Islamic financial industry are identified below.[139]

18.3.1. Shareholders

As owners of IFIs, the main objective of shareholders is to maximize their wealth. The Board of Directors (BOD) oversee the interests of shareholders by establishing the overall strategy and policies of the organization, and guiding the senior management to achieve this goal.

18.3.2. Depositors/investors

Depositors and investors provide the bulk of the funds in the form of demand and investment deposits. The funds are provided with an expectation of good service, competitive returns and compliance with the principles of the Shari'a.

[137] Grais, Wafik and Matteo Pellegrini (2006a), "Corporate Governance in Institutions Offering Islamic Financial Services: Issues and Options", World Bank Policy Research Working Paper 4052

[138] Grais, Wafik and Matteo Pellegrini (2006b), "Corporate Governance and Stakeholders' Financial Interests in Institutions Offering Islamic Financial Services", World Bank Policy Research Working Paper 4053

[139] IFSB (Islamic Financial Services Board) (2006), Guiding Principles on Corporate Governance for Institutions Offering Only Islamic Financial Services (Excluding Islamic Insurance (Takaful) Institutions and Islamic Mutual Funds), Kuala Lumpur: Islamic Financial Services Board, p. 27.

18.3.3. Customers/socially vulnerable groups

Other than clients who meet all the financial criteria of financing, the Islamic financial sector is also expected to serve economically disadvantaged groups. Khan (1997) maintains that the philosophical basis of the faith component of Islamic banks lies in adl (social justice) and ihsan (benevolence).[140] The implication of these concepts is 'taking care of those who cannot be taken care of by the market, who cannot play with economic forces or do not have access to economic means to enable them to exploit the economic opportunities around them'.[141]

18.3.4. Community

The community or Muslim Ummah is represented by individuals (political activists, academics, intellectuals, etc.), civil societies and organizations who desire a financial system based on Islamic values and principles. The aspiration of the community is to have a just, stable and resilient Islamic financial industry fulfilling the goals of Shari'a. While well-wishers of the industry include many individuals who are contributing to the industry, some organizations exist in the form of associations and academic bodies that serve different needs of the industry.[142]

18.3.5. Regulators

Llewellyn identifies three core objectives of regulation: 'to sustain systemic stability, to maintain the safety and soundness of financial institutions, and to protect the consumer'.[143] Regulators are external public institutions that ensure the stability and soundness of the financial system by providing guidelines related to internal controls, risk management, transparency, etc. and protects the stakeholders who are not taken care of at the organizational level.

18.4. Shari'a requirements

Grais and Pellegrini (2006a, p. 13) identify three aspects of Shari'a requirements for the Islamic financial industry.[144] The first requirement is to conduct financial transactions in accordance with Islamic law. Secondly, activities of the industry should foster social objectives by promoting social benevolence. Finally, developing an integrated Islamic financial system based on the principles and objectives of Shari'a. The Shari'a requirements for the Islamic financial industry can be expanded into the following categories.

18.4.1. Shari'a-compliant products

The products used by an IFI on the asset and liability sides should comply with the principles and goals of Shari'a. This would require contracts and all necessary supporting documentations including the legal papers, forms and processes to be Shari'a-compliant. After the product is launched in the market, there is a need to ensure that the procedures and processes are implemented in accordance with approved Shari'a guidelines. This is consistent with IFSB's Guiding Principles on Corporate Governance. For example, Principle 3.1 states that "IIFS shall have in place an appropriate mechanism for obtaining rulings from Shari'a scholars, applying fatwa and monitoring Shari'a compliance in all aspects of their products, operations and activities".[145] The recommendations made by the SSB are binding to the management of an IFI, thus no operation, service, product or transaction is allowed if the SSB opines that it is not Shari'a-compliant

18.4.2. Shari'a-compliant operations

There are several issues related to the operations of an IFI that must be compliant with the principles and goals of Islamic law. These include treatment of interest-based calculations, discounting, early and late payments, defaults, etc. To maintain the Islamic nature of the organization, separation of penalty income (in case of default) and interest income (if any) from the income of the bank, needs to be ensured. Any impure income has to be put into a special account and used for charitable purposes. Similarly, the payment of zakat as an institution (or on behalf of its clients) should also be implemented. Furthermore, all contractual obligations must be fulfilled by the IFI, so for example, the stipulations of the contract with depositors in terms of profit-sharing has to be fulfilled.

18.4.3. Products satisfying the objectives of Shari'a (maqasid al-Shari'a)

The proponents of the Islamic economic system have envisaged the true manifestation of the maqasid al-Shari'a.[146] The Islamic financial sector being an integral component of such an economy is expected to fulfil these goals. At the broadest level, objectives include growth (tazkiyah) and justice (qist)[147] (Siddiqi 2004). Kahf (2006) identifies some of the objectives at the transactional level to include upholding property rights, respecting consistency of entitlements with the rights of ownership, linking transaction to real life activity, prohibiting debt sale, etc.[148]

18.4.4. Fulfilling social goals

The broader maqasid perspective implies inclusion of social dimensions in Islamic finance. To achieve social goals, an IFI would not only avoid activities that are exploitative and harmful to the society, but also engage in ones that promote social welfare.[149] Given this characteristic, it is imperative for Islamic banks to include social dimensions in their operations along with normal banking practices.

18.4.5. Credibility and trust in the system

The stability and performance of an organization and industry depends on the trust and confidence that the stakeholders have in the system. This emanates from the nature of financial institutions, which act as 'fiduciary trustee' on behalf of the depositors and investors.[150] An important fiduciary duty in the case of IFI is to conduct all business in accordance to principles of the Shari'a. Thus, consistency of the practice of an integrated Islamic financial sector with the spirit and principles of Islamic law will build trust and confidence among the customers and the community, and ensure the sustainability and growth of the industry in the long-run.

Note that all the Shari'a requirements listed above are inter-linked. A key factor that determines Shari'a requirements is the type of products marketed by different IFIs. For example, the nature of the products offered will have implications regarding the fulfilment of maqasid

[140] Khan, M. Fahim (1997), "Social Dimensions of Islamic Banks in Theory and Practice," Islamic Research and Training Institute, Islamic Development Bank, manuscript. pp. 12-13

[141] ibid

[142] These would include fiqh bodies (such as Islamic Fiqh Academy, AAOIFI Shari'a Board, etc), academic and research institutions (such as Islamic Research and Training Institute of the Islamic Development Bank Group) and organizations representing the industry like CIBAFI an umbrella organization of the IFI.

[143] Llewellyn, David (1999), The Economic Rationale for Financial Regulation, Occasional Paper Series 1, Financial Services Authority, London p. 9

[144] Grais and Pellegrini (2006a) op. cit. , p. 13

[145] Abdel Karim, Rifaat Ahmed (2007), 'Guiding Principles On Corporate Governance of Institutions Offering Islamic Financial Services ("Iifs")', available at www.iobf.org/content/CGB/Papers. Retrieved October 28, 2009

[146] Siddiqi, M. Nejatullah (2006), "Shari'a, Economics, and the Progress of Islamic Finance: The Role of Shari'a Experts", Concept Paper presented at Pre-Forum Workshop on Select Ethical and Methodological Issues in Shari'a-Compliant Finance., Cambridge, Massachusetts, USA, April 21, 2006

[147] Siddiqi, M. Nejatullah (2004), Riba, Bank Interest and the Rationale of its Prohibition, Visiting Scholars' Research Series No.2, Islamic Research and Training Institute, Islamic Development Bank, Jeddah.

[148] Kahf, Monzer (2006), "Maqasid al Shari'ah in the Prohibition of Riba and their Implications for Modern Islamic Finance", Paper presented at IIUM International Conference on Maqasid al Shari'a, Malaysia, August 8-10, 2006.

[149] Grais and Pellegrini (2006a) op. cit.

[150] Ibid, p. 5.

al Shari'a and the direction the industry takes in the long-run. The types of products will determine whether the financial system will be stable and resilient. They will also shape the perceptions of the customers and community and determine the level of trust and credibility stakeholders have in the sector in the long-run.

18.5. Regulatory Shari'a supervision

IFSB (2008) proposed four aspects that a Shari'a governance system should entail.[151] These are issuance of Shari'a pronouncements, ensuring day to day compliance with the Shari'a pronouncements, internal Shari'a compliance review and audit, and annual Shari'a compliance audit to ensure that internal Shari'a compliance review has been properly carried out. To undertake these functions, IFSB identifies different Shari'a organs which include an in-house Shari'a compliance unit/department, internal Shari'a review/audit unit and SSB.

Qattan (2006) points out that Shari'a non-compliance can be a reason for reputation risk that can trigger bank failure and cause systemic risk and instability.[152] The same can happen if the perception of stakeholders about the Islamic products becomes negative causing a serious loss of trust and credibility.[153] Furthermore, as SSBs produce fatwa by interpreting different legal sources, the possibility of coming up with conflicting opinions exists. With the expansion of the industry, the likelihood of there being conflicting fatwa will undermine customer confidence in the industry.[154] This calls for harmonizing the Shari'a rulings at the national level to reduce legal risks.

The reputation and legal risks can be minimised at the regulatory level by establishing a National Shari'a Authority (NSA) which can oversee the Shari'a related aspects of the Islamic financial sector in general and products in particular. The NSA should ideally have members who are reputed Shari'a scholars and also people of other professions, like accountants and financial analysts who understand risk; and legal professionals who are aware of the country's laws and regulation. For example, IFSB (2008, p. 17) guiding principle 5.1 states that IFI 'should fully understand the legal and regulatory framework for issuance of Shari'a pronouncements/ resolutions in the jurisdictions where it operates' and 'should ensure that its Shari'a Board strictly observes the said framework…'.[155] While this cannot be ensured at the organizational level, the NSA can ensure that all other requirements are fulfilled.

18.6. Shari'a regulatory regimes

Shari'a regulatory regimes can be classified according to the relative roles of Shari'a supervision at the organizational and national levels. The Shari'a regulatory regimes can be broadly classified into four categories. The first type is one in which the national Shari'a supervisory authority is dominant with no role for a Shari'a Supervisory Board at the Institution level. An example of this system is the regulatory regime in Iran, where the products that can be offered by banks are identified by the Usury Free Banking Act of 1983. Individual banks do not have their own SSB, and the Council of Guardian acts as NSA providing guidelines to banks. In the second category, Shari'a compliance is left to the IFI and there is no regulatory oversight of the products being marketed by a NSA[156]. There are no central NSA or guidelines for establishing SSB at the organizational level. The system is market driven whereby new Islamic products are cleared by the SSBs at the organizational level. The practice of Islamic banking in countries like Bangladesh, Kingdom of Saudi Arabia, and UK fall into this category.

The third category includes Shari'a supervisory systems at both organizational and national levels. This category would include countries that do have NSA, but their role is passive and does not include approval of new products. Countries that fall in this category are UAE and Kuwait. The UAE Federal Law No. 6 of 1985 calls for the creation of a Higher Shari'a Authority comprising people with backgrounds in Shari'a, legal and banking, to ensure the legitimacy of the transactions according to the provisions of Shari'a. The law also requires the creation of Shari'a Supervisory Authority with at least three members at the IFI level to ensure that the transactions are in accordance with principle of Islamic law. Similarly, the Central Bank of Kuwait Law of 1968 stipulates that Islamic banks should have SSB of at least three members appointed by the General Assembly. A higher level Fatwa Board of the Ministry of Awqaf is consulted only in case of conflict of opinions amongst the members of the SSB. In both cases, there are no specific provisions in the law for the higher Shari'a body to either clear the products approved by the SSB at the organizational level, or issue directives to strengthen the structure and processes of Shari'a supervision at the organizational level.

The last category of countries has robust Shari'a regulatory regimes. Not only do the regulatory bodies provide detailed guidelines that strengthen the Shari'a supervision at the organizational level, the NSA also plays an active role in overseeing the industry. Examples in this category include Pakistan and Malaysia. The State Bank of Pakistan (SBP) established a central Shari'a Board (SB) to guide the Islamic financial sector and SBP regarding matters related to Islamic finance. Other than Shari'a scholars, the SB has members from various fields such as banking, accounting, law, etc. The roles of SB include reviewing and approving Shari'a-compliant products developed by the SBP. The SB provides the broad guidelines of the model agreements of various permissible products which all IFI must abide by.

The central bank of Malaysia (Bank Negara Malaysia or BNM) established a National Shari'a Advisory Council (NSAC) in 1997 as the highest authority for Shari'a related issues in Islamic banking and the takaful industry. Among others, the NSAC advises BNM on Islamic banking and takaful issues, coordinates Shari'a issues, and evaluates Shari'a aspects of new products submitted by the IFI. Each IFI has its own Shari'a Committee and is guided by the guidelines of the Governance of Shari'a Committee for the Islamic financial institutions provided by BNM. All new products developed must be submitted to BNM for scrutiny which includes review approval by the NSAC.

[151] IFSB (Islamic Financial Services Board) (2008), Exposure Draft Guiding Principles on Shari'a Governance System, Kuala Lumpur: Islamic Financial Services Board.

[152] Qattan, Muhammad A. (2006), "Shari'a Supervision: The Unique Building Block of Islamic Financial Architecture", in Tariqullah Khan and Dadang Muljawan (eds.), Islamic Financial Architecture: Risk Management and Financial Stability, Islamic Research and Training Institute, Islamic Development Bank, Jeddah, pp. 273-87.

[153] Chapra and Ahmed (2002) report that in a survey shows that 381 (or 81.4%) total number of 468 depositors from Bahrain, Bangladesh and Sudan will move funds to other banks due to non-compliance of Shari'a and a total 328 (70%) would move funds if they learnt that learn that income of the banks come from interest earnings.

[154] Grais, Wafik and Matteo Pellegrini (2006c), "Corporate Governance and Shari'ah Compliance in Institutions Offering Islamic Financial Services", World Bank Policy Research Working Paper 4054.

[155] IFSB (2008), op. cit. p. 17.

[156] Note that even though NSA may not exist, IFI may still have to get their new products approved by the regulatory authorities. The regulatory authorities check the risk features of the product before approving it and not the Shari'a related issues.

18.7. Qualifications of a Shari'a scholar

Wigglesworth (2009c) points out that a scholar needs to have a thorough knowledge of Shari'a and a decent understanding of finance as well as English language skills, since it is the common medium for most financial and legal documentation.[157] So far there is no official qualification process; usually a new scholar needs recognition by more established scholars, and a track record of research in Shari'a law and preferably Islamic finance as well.

Al Baik (2009) cites Dr Mabid Al Jarhi, President of International Association for Islamic Economics and Head of Training at Emirates Islamic Bank, who calls for Central Banks' establishment of rules and regulations that govern the membership and qualifications of an SSB.[158]

18.8. The responsibilities of a SSB

External scholars who are members of an Islamic financial institutions' SSB generally play two roles. They supervise the operations of an IFI to ensure Shari'a compliance. This may include existing products which have been previously approved by an internal Shari'a committee, or those which are currently on the drawing board. The objective here is giving an opinion on their Shari'a compliancy. This is where scholars play the role of consultants, according to Sheikh Nizam Yaquby.

As well as acting as external auditors, the SSB scholars function as consumer advocates by ensuring that IFI's transactions, products and service offerings are consistent with Shari'a law, thus respecting the wishes of the Muslim consumers.

Recently, Malaysia has been pioneer in establishing conventions. Assistant Governor of Bank Negara Malaysia Dato' Muhammad Bin Ibrahim (2009) reports that Bank Negara Malaysia is considering including a Shari'a committee member in the Board [of Directors] for Islamic financial institutions.[159]

Delorenzo (b) compared the responsibilities of a Shari'a supervisor to those of a financial auditor,

"Shari'a Supervisory Boards review compliance to Shari'a precepts. Independent audits are understood as ways to gain and maintain the trust of investors and consumers. Independent Shari'a supervision is the best way to gain and maintain the trust of Muslim investors and consumers".[160]

A description of a Shari'a audit by Delorenzo is presented in Appendix I.[161]

In the area of Islamic indexes and investment, S&P (2009), describes the role played by an SSB as overseeing construction and maintenance of compliant indices, including their structure, documentation, and related information services.[162] In addition to these activities, the SSB monitors the business activities and financial ratios of index components to ensure continuing adherence to Shari'a, and advises portfolio managers about rebalancing and review procedures.[163] Please refer to Appendix II for an alternative explanation of the role of Shari'a scholars/ advisors.

18.9. Organizations which support Shari'a governance at IFIs

The following are some of the organizations which promote and support Shari'a governance at IFI's.

• The IFSB is based in Kuala Lumpur; it advises Central Banks on the regulation of IFI's.

• The AAOIFI based in Bahrain. According to Wilson (2009), AAOIFI's Shari'a board has become "the most influential international fiqh body that focuses on the practical issues concerning Islamic financial products. To date, it has issued thirty Shari'a standards".[164]

• The Islamic International Rating Agency (IIRA) aims to provide IFI's with a rating system for Islamic financial products and transactions. It is well-recognized for the competence, objectivity, and impartiality of its professional staff, as well as the independence of its rating system.

18.10. Possible solutions for Sharia governance-related issues

18.10.1. Dealing with the scholar shortage problem through scholar training programs

Scholar training programs are now underway in several countries, some of which are listed below:

• In Malaysia, the International Centre for Education in Islamic Finance (INCEIF), has a trust fund of 500 million ringgits, and offers the world's first professional certification in Islamic finance (www.inceif.org).

• Malaysia's Central Bank, Bank Negara Malaysia, has allocated 100 million ringgits to the Shari'a Development Fund, which offers scholarships to qualified Shari'a advisors both local and foreign. www. bnm.gov.my

• CIMA Certificate in Islamic Finance offers Islamic Finance professionals a globally recognised qualification and aims to address the shortfall of skilled Islamic finance professionals.[185]

• The Chartered Institute for Securities and Investment in London recently announced a new scheme for training Shari'a financial scholars. The effort is being backed by the Lebanese Central Bank and some British politicians, who want London to grow to be a centre of Islamic finance.[186]

AAOIFI has a programme for training Shari'a auditors. The "Certified Shari'a Adviser and Auditor (CSAA)" program is designed to equip candidates with the requisite technical understanding and professional skills on Shari'a compliance and review processes for the inter-

[157] Wigglesworth R (2009) "Shari'a Boards: scholars Hold Sway over the Success of Products", The Financial Times Limited, May 5 available at FT.com. Retrieved October 28, 2009

[158] Al Baik Eman "scholars call for Shari'a board under Central Bank" June 21. http://www.business24-7.ae/ Articles. Retrieved October 28, 2009

[159] Bin Ibrahim Muhammad (2009), "Keynote Address" at the Conference on "Managing Shari'a Risks through Shari'ah Governance" Reuters10 August 2009 - London, UK.

[160] DeLorenzo Yusuf Talal (a) 'Shari`ah Supervision of Islamic Mutual Funds, 4th Annual Harvard Forum on Islamic Finance 3, available at http://www.djindexes.com/ mdsidx/downloads/delorenzo.pdf. Retrieved October 28, 2009.

[161] DeLorenzo Yusuf Talal (b) 'Shari'a Supervision in Modern Islamic Finance', available at http://nzibo.com/ IB2/Shari'ahsupervision.pdf. Retrieved October 28, 2009.

[162] S&P (2009), "Islamic Finance Outlook 2009", available at www.standardandpoors.com. Retrieved October 28, 2009.

[163] Ghoul, Wafica and Karam, Paul (2007), "Mutual Funds: A Comparison of Christian, Islamic (Morally Responsible Investing MRI), And Socially Responsible Investing (SRI) Mutual Funds", Journal of Investing, (USA, vol. 16, no. 2 (Summer 2007): pp 96–102, Retrieved October 28, 2009.

[164] Wilson Rodney (2009), "The Development Of Islamic Finance In the GCC", Working Paper, Kuwait Programme on Development, Governance and Globalisation in the Gulf States", May.

[185] Cimaglobal (2009) "International Shari'a expert calls for unified action to develop global Islamic Finance expertise", 13 October http://www2.cimaglobal.com/cps/rde/xchg/SID-0A82C289-195C1480/live/root.xsl/10675_35075.htm. Retrieved October 28, 2009.

[186] Tett (2006), op. cit.

national Islamic banking and finance industry". More information is given in Appendix III.

18.10.2. Internal Shari'a coordination units to reduce the scholar shortage problem

Another tactic to deal with the shortage of scholars is for an IFI to have an internal Shari'a Coordination /Audit unit, which would lighten the load for an external Shari'a Supervisory Board. This body would verify a newly developed product's compliance with Shari'a and with the guiding principles of IFSB and AAOIFI. This has been tried by DIB, however earlier in this paper we pointed out our reservations about the way DIB is doing things.

18.10.3. Shari'a finance consultancy services help to reduce the problems of scholar shortage

An emerging trend is the setting up of Shari'a advisory services, manned by Shari'a scholars, legal advisers and practitioners, to provide R&D and product development services, fatwa, as well as Shari'a audits and reviews.

18.10.4. Improving scholar dialogue as a step towards standardization

Another suggested solution is to make the product development process more efficient through standardization, which would reduce the need for each product to receive a separate scholarly fatwa.

Standardization will not be possible without better research and communication among scholars worldwide. Several organizations have been dealing with the issuance of fatwa and their consequences. These include the International Council of Fiqh Academy in Makkah, the Shari'a Committee of Rabitah (World Muslim Congress) in Makkah, and the Shari'a Committee of the AAOIFI in Bahrain. According to Tradingmarkets these are not training institutions nor do they have the capacity and independent governance structures to teach Fiqh Al-Muamalat.[187]

Along the same lines, in Malaysia the International Shari'a Research Academy for Islamic Finance (ISRA) is a dedicated research house for Shari'a matters in Islamic finance. It has been compiling a database of fatwa, and has a trust fund of 100 million ringgits.

Global Islamic Finance Forum (GIFF) and International Shari'a Scholars Dialogue are two initiatives in Malaysia that invite prominent international Shari'a scholars to participate in a series of intellectual discourse on Shari'a matters with respect to Islamic banking and finance. Their purpose being to facilitate mutuality about Islamic finance practices.

18.10.5. Opposing views about standardization

The call for standardization has had its fair share of proponents as well as opponents, although it appears that opponents are in the majority.

• Proponents of standardization

Richter quotes a BNP Paribas banker who argues that the growth of the Islamic fund industry is limited by "a lack of standardization in products' compliance with Islamic law".[188]

• Opponents of standardization

Opponents object to the idea of standardization and believe that it would restrain innovation.

Parker reports that the late Azharite Shari'a scholar, Zaki Badawi, used to stress that "it would be wise to remember that in Islam there is no Vatican. Diversity of Shari'a opinions is strength and not a weakness. Only that way the Islamic finance sector will thrive".[189]

According to Salman Younis, a former managing director of KFH (Malaysia) there are issues on Shari'a interpretation, but they are not a hurdle to the growth of Islamic banking. In fact, the belief is that Shari'a harmonization may kill innovation.[190]

KPMG (2006) cites industry participants who oppose standardization. They emphasize that any such standardization could only be driven by cross-border, quasi-governmental organizations, with the inevitable impact on choice and speed of innovation and activity within the industry.

Concerning the impact of standardization or the lack of it on the Islamic finance industry, Wilson (2009) reports allegations of critics that the lack of standardization of Islamic products could be leading to 'Shari'a arbitrage', meaning that Islamic banks and clients would shop around for the "least restrictive fatwa". He, however, doubts that there is a need to "shop around" since "bank management, often get the fatwa they want approved".

18.10.6. Adopting the scientific methodology in resolving Shari'a interpretation differences

As an alternative to standardization, Parker quotes scholar Elgari who is calling for the adoption of a scientific methodology in reaching their deliberations on Islamic finance.[191] Elgari is quoted:

"We have seen many mistakes where declarations have been issued. Only the correct resolutions will prevail. Shari'a is not a group of infallible people. It is a science. It requires methodology, and resolutions require peer review and market consultation."

18.10.7. A new development: Bank Negara Malaysia's Shari'a parameter references (SPRs)

Parker reports, that in August 2009 Bank Negara Malaysia started an effort towards standardization and harmonization of the Islamic finance industry.[192] It issued the first in a series of Shari'a references, named "Shari'a Parameter Reference 1" or Murahaba Parameter (SPR1). This outlines the main Shari'a requirements in the contracts and provides examples, methods and models for practical application of the contract, and is issued as guidance and reference to all IFIs. This is one serious step towards standardization.

18.10.8. Increasing scrutiny by AAOIFI

There are increasing efforts by AAOIFI towards consistency and standardization of Islamic products. AAOIFI

[187] Tradingmarkets (2009), "Islamic Banking Special Supplement: Shari'a governance a challenge to Islamic banking", Sat. October 10.

[188] Richter (2009) op. cit.

[189] Parker, Mushtak (2009) "Islamic Banking Special Supplement: Shari'a governance a challenge to Islamic banking", Arab News

[190] Asiamoney, (2007), 'Islamic finance - Gulf banks set out to stage an Asian invasion', Jul/Aug. pg 1

[191] Parker (2009) op. cit.

[192] ibid

recently announced that in the absence of an industry watchdog, it will start scrutinizing Islamic products and services. Mohamad Alchaar, AAOIFI's Secretary General, believes that the move would help to "homogenise the market".[193]

18.10.9. Establishing a global regulatory body or a higher local Shari'a council to reduce the divergence of Shari'a Interpretation

• A global regulatory body

El-Said and Ziemba suggest the establishment of an Islamic global regulatory body that presides over IFI's operations.[194] It would help issuers of securities cope with having "to manage different taxation and regulatory regimes which limit economies of scale". Such a body would facilitate cross-border marketing as well as acquisitions.

Considering the astronomical growth rate of the industry as far as both its size and sophistication are concerned, Delorenzo (b) suggests that what is really needed is 'more specialized Shari'a supervision, or supervision geared toward specific sectors within the Islamic finance industry instead of a single central Shari'a Supervisory Board'.[195]

• A local regulatory body

Bin Ibrahim reports that in Malaysia, all public and key pronouncements on Shari'a matters are made by the Shari'a Advisory Council of Bank Negara Malaysia, which represents a centralized Shari'a governance model.[196]

Thus Malaysia once again has led the way by establishing a Shari'a governance framework which aims "to ensure uniformity and harmonization of Shari'a interpretations aimed at strengthening the regulatory framework and promoting good governance within the Islamic financial sector".[197]

Wilson (2009) states that there are current efforts in the UAE, to establish a higher Shari'a Council whose purpose is overseeing the work of the Shari'a boards of the country's seven Islamic banks.[198] However, he voices critics' doubts about the value of governments' involvement in assuring Shari'a compliance.

• Resolving the lack of independence issue

Malaysia restricts Shari'a consultants to be allowed to serve on only one board; in sharp contrast, no such restrictions have been imposed by GCC regulators. Abdel Karim also reports that in Malaysia members of the Central Bank's National Shari'a Panel are in some cases prohibited from sitting on Shari'a boards of market players whom they oversee.[199] He confirms that the abovementioned restrictions aim to reduce conflicts of interest, preserve confidentiality, and ensures that the members of a Shari'a board are not over-extending themselves. There is now a growing call on other Muslim governments to follow in the footsteps of Malaysia.

Another suggestion for improving scholars' independence was reported by Al Baik, which is to compensate scholars from a 'central pool' rather than from their clients, in order to 'ensure neutrality, transparency and above-board decision-making'.[200]

18.11. Looking ahead

This chapter has discussed Shari'a governance in the Islamic financial industry with a special focus on Shari'a scholar issues.

Bin Ibrahim is of the opinion that establishing the overall governance framework is the responsibility of regulators.[201] However, he emphasizes that true governance can only be achieved through "the practices and combined actions of the Islamic financial institutions, [their] Boards of Directors, Shari'a advisors and management, guided by high ethical moral values as demanded by the religion".

To end on a good note, the present financial crisis has seen scholars take stock and reassess the Shari'a-compliance of some of the products that emerged in the boom years.

Appendix I Description of A Shari'a Audit

In order to avoid losing any of the technical details, we quote the description of a Shari'a audit by one of the top Shari'a scholars Delorenzo (a) who described an audit as follows:

"Generally speaking, if Shari'a supervisors are to certify a venture, they will insist on being a part of its development; or at least to having access to the details of whatever went into the development or structuring of the product, instrument, service, or enterprise. Moreover, once a product is launched, Shari'a supervision may take the form of ongoing monitoring through periodic audits. Such audits may be undertaken by means of site visits, document reviews, or consultation with management at regular intervals……. the certification of a product as Shari'a-compliant is generally documented in a formal fatwa (Shari'a position paper), which may be thought of as a form of due diligence."

Appendix II - The Role of Shari'a Advisors in the Development of Islamic Securities

The role of Shari'a advisors in the development of Islamic securities was discussed by Dr. Mohamad Akram Laldin; it can be summarised as follows:

1. Ensuring the products are developed using the acceptable principles of Shari'a. What is important in the development of a product is to ensure all aspects of the product comply with Shari'a requirements and not just the main structure.

2. Ensuring the underlying assets used in the issuance of the sukuk are in consistence with the requirements of Shari'a.

3. The Shari'a committee should ensure that securities being traded are asset backed

4. Ensuring the decision of the Shari'a advisor (committee) is understood by the issuer and implemented according to what has been decided.

5. Shari'a advisors must be competent enough to scrutinize the documents related to the issuance as there are many documents involved in the issuance.

[193] AAOIFI (2009), "AAOIFI to perform temporary watchdog role", www.newhorizon-islamicbanking.com, October 01, Retrieved October 28, 2009.

[194] El-Said Ayah and Ziemba Rachel (2009), "Stress-Testing Islamic Finance" Http://www.rgemonitor.com/economonitor-monitor/256697/stress-testing_islamic_finance. Retrieved October 28, 2009.

[195] Delorenzo (a) op. cit.

[196] Bin Ibrahim (2009) op. cit.

[197] Ibid

[198] Wilson (2009) op. cit.

[199] Abdel Karim, Rifaat Ahmed (2009), "Islamic Financial Services Board Keynote Speech" Conference on "Managing Shari'a Risks through Shari'a Governance" August 10, London, UK.

[200] Al Baik (2009), op. cit.

[201] Bin Ibrahim (2009), op. cit.

6. It is vital for the Shari'a advisors to have full knowledge about the purpose of the issuance and how the proceeds are going to be used and ensure that the proceeds are used for the purpose which comply with Shari'a requirements.

7. It is important for the Shari'a advisor to assess the economic implication of the issuance to the Ummah as a whole.

Dr. Laldin adds the following:

"The above brief account of the role of Shari'a advisors demonstrates the importance of determination, competency, alertness and seriousness which is expected from a Shari'a advisor. One important fact that needs to be realised is that Shari'a advisors are not a rubber stamp that will endorse whatever that comes to them. However, the endorsements have to be done after a full investigation and satisfaction that the product is in line with Shari'a requirements. On the other hand, the advisory process also requires the credibility and honesty of the practitioners to disclose all the operational and technical part of the issuance so that the Shari'a advisor will be able to make a correct and precise decision".

Appendix III - AAOIFI's Certified Shari'a Adviser and Auditor (CSAA)

The CSAA program is designed to equip candidates with the requisite technical understanding and professional skills on Shari'a compliance and review processes for the international Islamic banking and finance industry. Through the CSAA program, candidates will gain advanced knowledge on:

Roles and functions of various Shari'a compliance and review processes in financial institutions.

Correlation between a financial institutions' SSB and its internal Shari'a compliance and review processes

Mechanism to ensure Shari'a compliance in accordance to resolutions and fatwa (scholars' rulings) issued by SSB.

Technical review of banking and financial operations to determine Shari'a compliance.

Establishing the foundations to gain stakeholders' trust and confidence in a financial institution's adherence to Shari'a.