CHAPTER 17

Risk management and Shari'a challenges

17.1 Introduction

The Islamic finance industry has expanded rapidly. It now branches out into non-Muslim countries in Europe, North America and Asia/Australia and the recent financial crisis has brought it much international attention. Although Islamic finance has proven to be a success story, a closer look reveals that the industry faces a number of operational challenges and structural weaknesses. This chapter analyses these challenges in light of some recent incidents in the industry. It also focuses on some interesting products launched by some of the industry players, without or before proper regulatory and Shari'a frameworks were developed for such products.

A number of studies point to the stability and resilience of an Islamic banking system, but it must be understood that applying Islamic formalism in practice is neither a guarantee for commercial success nor a shield against an economic crisis. For example, it seems that the Islamic Bank of Britain and HSBC Amanah started their operations in the UK with optimistic forecasts about the size of the Islamic banking market in the country and demand for Islamic financial services by the UK Muslims. However, these two initiatives (and indeed others) in the country have yet to attract any significant business from their targeted population. Islamic Bank of Britain has so far attracted only 50,000 customers out of a Muslim population of 2.5 million in the UK. The bank received a boost in demand for its home finance product during the crisis, but was limited by the lack of capital – this was remedied most recently with a capital infusion of GBP 20 million by the Qatar International Investment Bank. This is an example that Shari'a-compliance alone is not sufficient and that it cannot completely escape market conditions and economic reality.[1]

Regarding the resilience of Islamic banking and finance during the last financial crisis: It is correct that Islamic banks performed better than those conventional banks (in particular investment banks) which were highly leveraged and deeply involved in speculative trading activities. Most of the largest global players fell into this category. But what is often ignored is the fact that besides Islamic banks, also a large number of conventional banks were unaffected in the first round of the crisis (2007-2008), which led to the downfall of the more iconic investment banks. Many banks in emerging markets with limited international exposure fared pretty well, as did banks with a strong deposit base, prudent lending policies, no speculative trading activities and a strong regional commitment. Most Islamic banks share these economic characteristics, and these characteristics along with the formal Shari'a-compliance of instruments and contracts explain the resilience of Islamic banking and financial institutions in the first round of the crisis.

In the second round of the crisis (2009) however, IFIs were also hard hit by the crisis, with some banks carrying problems from the first round. A recent working paper of the IMF[2] found for a sample of Islamic and conventional banks, that the profitability of Islamic banks was better than that of conventional banks in 2008, but after a sharp decline of profits of Islamic banks, the picture reversed in 2009 in most countries.

It is encouraging that a default of an Islamic bank has been avoided so far, although several bailouts and debt restructurings have already taken place. Some prominent cases of bailouts or restructurings are The Investment Dar (Kuwait), Gulf Finance House (Bahrain), the Islamic mortgage providers Tamweel and Amlak (Dubai), Noor Islamic Bank (Dubai) as well as the intervention of the Central Bank of Qatar in favour of Islamic banks there. Some critics also argue that the bailout of Citigroup and AIG by the US government has also saved their Islamic

[1] See *Mohammed Amin*: The UK Islamic Banking Scene, in: Islamic Finance News 7 (2010) 35 [1 September], pp. 14-15.

[2] See Maher Hasan and Jemma Dridi: The Effects of the Global Crisis on Islamic and Conventional Banks: A Comparative Study. IMF Working Paper, WP/10/201. Washington 2010.

businesses – which gave rise to some adverse comments from anti-Islam movements in the US.

Further, there has been a considerable number of sukuk defaults hitting the headlines most recently:[3] 15 defaults were recorded in 2009 and 6 until September 2010. 12 of these cases occurred in Malaysia, 4 in Pakistan, 4 in the GCC and 1 in the USA.

To summarise, although Islamic banking and finance tends to be hit by a crisis with a lag, the current crisis has hit Shari'a-compliant financial products hard. Therefore, it is fair to assume that Islamic banking and finance is connected with its conventional counterparts and that they share each other's gain and pain.

17.2 Regulatory challenges

Many individuals and institutions have analysed the causes of the financial crisis and published proposals on how such a crisis could be prevented in the future. Two documents are of high relevance for the Islamic finance industry:

The first is a report published jointly by the IFSB, the IDB and IRTI[4]. This report identifies shortcomings in the Islamic finance industry and indicates steps that should be taken to enhance its resilience and stability. The report mainly reflects the perspective of the inter-governmental role of IDB and of regulatory authorities of Muslim states, who are the member states of IFSB.

The second is the report of the Basel Committee to the G20.[5] The proposals made in this report (supplemented by a number of reports on particular aspects) – known as Basel III – have been adopted by the G20 as the basis for the reform of banking regulations.

17.2.1 Islamic finance industry: building blocks for financial stability

IFSB, IDB and IRTI have identified in their report eight building blocks to strengthen the financial stability of the Islamic financial system, which are detailed below:

- The development of a comprehensive set of cross-sectoral prudential standards covering banking, takaful and capital markets.

- The development of a liquidity management infrastructure.

- The strengthening of financial safety net mechanisms (Shari'a-compliant lender of last resort facilities, emergency financing mechanisms and deposit insurance schemes).

- The development of a reliable crisis management and resolution framework (comprising bank insolvency laws, arrangements for dealing with non-performing assets, asset recovery, bank restructuring and bank recapitalisation).

- The implementation of accounting, auditing and reporting standards, supported by adequate governance arrangements.

- The development of a macro-prudential surveillance framework and financial stability analysis to address system-wide stress resulting from common exposures of financial institutions,

- The strengthening of the rating processes to improve the transparency of risk profiles.

- The stronger involvement in capacity building and talent development to address the human capital deficiencies in the Islamic finance industry.

The basic premise of the IFSB/IDB/IRTI proposals is that Islamic finance is an integral part of the global financial system. Therefore Islamic solutions must be compatible with the general regulatory system designed for conventional finance. Thus reforms of Islamic finance regulations have to take up the reform agenda of Basel III. Specificities of Islamic finance have to be considered, and some rules and regulations may be adjusted (or at least deliberated) by regulatory authorities and banking supervisors. This means that Basel III will be relevant for Islamic finance (as was Basel II and still is). The application of Basel III rules and regulations pose several challenges to IFIs.

17.2.2 Global reforms: Basel III

The core of Basel III is the tightening of global capital adequacy rules and liquidity regulations. In addition, transparency shall be increased and risk management must be improved.

17.2.2.1 Capital requirements

The new Basel III capital requirements are as follows (in full force only on 1 January 2019, i.e. after a long phase-in period):

- The minimum ratio for common equity capital (= core Tier 1 capital which has the highest loss absorbing quality) will be raised from 2% to 4.5% of total risk weighted assets.

- The total Tier 1 capital ratio will be increased from 2% to 6%, and the total minimum capital will remain at 8%.

- A capital conservation buffer of 2.5% for the absorption of losses during periods of financial and economic stress will be introduced. It must be funded by common equity which brings the required core Tier 1 capital ratio to 7%. Total capital plus conservation buffer adds up to a minimum ratio of 10.5%.

- An additional countercyclical buffer of common equity or other fully loss absorbing capital in a rage of 0 to 2.5% shall be implemented according to national circumstances. This buffer shall become effective only in periods of excess credit growth that results in a system wide build-up of risk.

- In addition to these risk-based ratios (capital as per-

[3] See Mohammed Khnifer, Alarming Rise in sukuk Defaults, in: Islamic Finance News, 7 (2010) 39 [29 September], p. 20.

[4] See IFSB, IDB and IRTI, Islamic Finance and Global Stability Report. Kuala Lumpur and Jeddah: IFSB, IDB and IRTI, 2010, http://www.ifsb.org/docs/IFSB-IRTI-IDB2010.pdf.

[5] See Basel Committee on Banking Supervision: The Basel Committe's Response to the Financial Crisis: A Report to the G20. Basel, October 2010 [http://www.bis.org/publ/bcbs179.pdf].

centage of risk-weighted assets), an internationally harmonized non-risk-based leverage ratio shall be introduced to contain the build-up of excessive leverage in the system. During a first test period, the ratio shall be set at 3% with high-quality capital as the numerator and on- and off-balance-sheet assets (including derivatives) as the denominator.

Unless national laws and regulations prescribe otherwise, these capital requirements should be applied to both conventional and Islamic banks.

Meeting the capital requirements may be a challenge, in particular for smaller Islamic banks. The tightened standards may induce mergers of smaller banks or support the establishment of larger institutions in the future. It seems that raising capital is – in principle – not a major issue for IFIs, and the capital of many Islamic banks exceeds today's minimum requirements by far. Thus it can be assumed that most Islamic banks will be able to meet the new capital requirements. Similarly, most Islamic banks are far less leveraged than conventional banks (in particular investment banks) and should not have a problem with the leverage ratio.

While the capital requirements are no particular threat to Islamic banks in general, a number of specific issues have to be considered and negotiated with regulators and supervisors. For example:

- What is the status of sukuk with respect to capital requirements? Depending on the structure of the sukuk and in particular the priority of sukuk holders' claims over designated assets in default cases, a sukuk without priority for claims of sukuk holders may be considered as subordinated debt, i.e. as Tier 2 capital. But in this case, the structure of the sukuk is seemingly asset based and not asset backed which could be challenged from a Shari'a perspective.

- Similar questions come up regarding the status of investment accounts or mudaraba deposits. It seems that many regulators, in particular in non-Muslim countries – which now are targets for expanding IFIs – treat investment accounts and mudaraba deposits not differently from conventional deposits.

However, if the risk bearing qualities of investment accounts and mudaraba deposits were considered more seriously (both by regulators and Islamic banks), this could have far reaching systemic implications. (see below section 17.2.2.4)

17.2.2.2 Liquidity standards

The financial crisis demonstrated that a strong capital base is necessary but on its own not a sufficient condition for stability. It must be supplemented by strong bank liquidity. Basel III introduces as a measure for global minimum liquidity standards, the liquidity coverage ratio (LCR) that requires banks to hold sufficient high-quality liquid assets to withstand a stressed funding scenario that is specified by the national supervisors.

Many Islamic banks hold extremely large cash reserves (reportedly up to 90%) so that they should be able to meet the LCR. Large cash reserves however, can be seen as underutilized liquidity, which should be reduced. But by converting cash into other Shari'a-compliant liquid assets, the question of specific risks (especially market risks) comes up, and along with it the question of asset quality. The present liquidity infrastructure of the Islamic finance industry is such that in terms of liquidity and security (= quality) no Shari'a-compliant substitutes for government bonds exist in most jurisdictions.

Commodity murabaha or tawarruq generate liquid assets, but if they conform to Shari'a rules as laid out by the OIC Fiqh Academy, these instruments are subject to specific market risks, which probably will disqualify them as high-quality liquid assets. However, if they meet the conventional quality requirements (i.e. avoid the specific market risks), they may not meet strict Shari'a interpretations because the trading component and the associated risks are in practice factually eliminated.

The deficiencies in the liquidity management infrastructure lead to an absence of medium to long-term financings. This is a serious impediment regarding the transformation function of Islamic banks. If medium to long-term financing is provided, it is often accompanied by substantial maturity mismatches. Medium-term and illiquid assets are financed by short-term liquid funds – which implies a considerable liquidity risk.

Although it has long been recognised that the underdeveloped liquidity infrastructure is the achilles' heel of Islamic finance, only a few central banks of Muslim countries (notably Malaysia, Sudan and Bahrain) provide instruments for an effective liquidity management of IFIs (such as regularly issued liquidity sukuk). To overcome the deficits in the liquidity infrastructure of the Islamic finance industry, IFSB facilitated the recent establishment of the International Islamic Liquidity Management Corporation (IILM).[6] Eleven central banks and monetary authorities[7] and two multilateral organisations[8] signed the Articles of Agreement on 25 October 2010. IILM shall issue high quality Shari'a-compliant financial instruments at the national level and across borders.

17.2.2.3 Risk management

Basel III refines some risk management requirements as spelled out in Basel II, and it adds a few new aspects with limited relevance for Islamic finance (in particular regarding re-securitization). The main challenge for IFIs is thus not new: It is the observance of the Basel II standards. Basel II underlies IFSB's first published standard on risk management in 2005,[9] but this standard is only a recommendation and is not enforced in most jurisdictions.

It is reported that many Islamic banks still struggle with the implementation of Basel II (in its original version or adapted according to the IFSB standard). Some of the near defaults of IFIs indicate that the risks of high leverage combined with maturity mismatch have not been assessed and addressed properly (with dangerous consequences during the economic downturn). Other cases indicate an overconcentration of financing and assets in one sector such as real estate (in particular a problem in some but not all GCC countries).

[6] See IFSB, Press Release of 25 October 2010.

[7] Indonesia, Iran, Luxembourg, Malaysia, Mauritius, Nigeria, Qatar, Saudi Arabia, Sudan, Turkey, United Arab Emirates.

[8] Islamic Development Bank and the Islamic Corporation for the Development of the Private Sector.

[9] The next IFSB standards dealt with capital adequacy (December 2006), corporate governance (December 2006) and disclosures to promote transparency and market discipline (December 2007).

IFIs with claims against other troubled IFIs discovered a new dimension of the credit or counterparty risk, namely the legal uncertainty and doubtful enforceability of (clauses in) Shari'a-compliant contracts and the lack of recognized restructuring and resolution procedures.

A lack of precision in the documents of Islamic products caused much concern regarding the ranking, recourse and remedies of creditors in cases of (near) default. Other unclear or misunderstood clauses in Shari'a-compliant contracts and products (e.g. sukuk) gave rise to lawsuits. There it became apparent that the legal qualities of many Shari'a-compliant contracts had not been tried and tested in courts (and also not the enforceability of court rulings). It was learned that the lack of established procedures makes the restructuring of Islamic debt instruments more cumbersome than conventional restructurings: Not only have commercial interests to be reconciled. The restructuring plan needs an approval by the Shari'a board of the obligor and the Shari'a board (or boards) of the creditor (or creditors). Given the multitude of Islamic law restrictions for further negotiations and revisions of concluded contracts, it may easily happen that different boards adhere to different Shari'a interpretations and come to an understanding only after time consuming debates.

In addition to these difficulties, a new type of Shari'a risk has become visible in the case of Blom Development Bank vs. The Investment Dar (TID). TID argued at court that a wakala arrangement was not in compliance with Shari'a and therefore was void because it went beyond the corporate powers of TID. The company was bound by its constitutional documents to Shari'a-compliant transactions only. What is relevant here is the fact that the Shari'a-compliance of the wakala arrangement was quite successfully disputed by the management of TID although it was initially approved by the company's own Shari'a board.[10]

So far Shari'a risk meant that the opinion or fatwa of a Shari'a scholar or a Shari'a board could be challenged successfully by another scholar or board so that the claim of Shari'a-compliance cannot be upheld. The new quality in the Blom vs. TID case is that a declaration of Shari'a-compliance by a Shari'a board was challenged by the management of the company, i.e. by people who themselves are no Shari'a experts (but seemingly had good arguments).

One could pass over such an incident if the Shari'a approval were given by a board composed of inexperienced beginners. But this is not the case for the Shari'a board of TID: Today it comprises four scholars who were all board members in 2007 when the disputed wakala agreement was approved.[11] This board is by no means a Shari'a lightweight – on the contrary: The chairman, Sheikh Ahmad Bazeia Al-Yaseen, is at the same time chairman of the Shari'a board of KFH and member of 12 other boards (as chairman in 11 of these 12).[12] The three other members[13] hold between 18 and 21 Shari'a board positions, and two of them are also active members of the AAOIFI Shari'a board.[14]

The management of TID made things worse by bringing the case to the court only after they faced financial distress. This has happened for the first time in the short history of Islamic banking and finance. Other notable legal cases like the Islamic Company of the Gulf (Bahamas) Ltd vs Symphony Gems (2002) and Beximco of Bangladesh vs Shamil Bank of Bahrain (2003) had the same nature of attacks on Shari'a compliancy made by the management of the companies, which sought fatwas from their respective Shari'a boards and subsequently attempted to discredit them when things went wrong from from a financial viewpoint. Although the text of the judgment[15] may suggest to many that experienced scholars were negligent in recognising that the wakala agreement was the formal cover for an interest transaction in substance, the more important issue is related with the bad intent of the management of such IFIs. Nevertheless, many observers have speculated about various reasons – but all have quite unpleasant implications and are seemingly biased against the scholars.

- Maybe the scholars did not have enough time to study the documents in depth and with the necessary diligence. A large number of board positions of scholars and voluminous or complicated documentations do not go together well, especially if the management presses for a swift decision. But then, why did the board approve the arrangement without a thorough examination?

- Maybe the scholars did not fully comprehend the economics behind the contractual arrangements. This may be due to insufficient or biased information given by the management. But then, does it mean that the assessment of the Shari'a-compliance depends on the circumstances in which a contract is executed? More pointed, could it be that a contract is Shari'a-compliant in one situation and non-compliant in another one?

- Maybe the scholars have intentionally faded out all economic substance and based their approval on purely abstract considerations. But then, where to stop the formalism? It is always possible to decompose more complex contracts into smaller and smaller pieces until one reaches a level of granularity where the 'contractual atoms' are all Shari'a-compliant in themselves because they are assessed in isolation, i.e. without caring for the interconnectedness of and interrelations among the individual elements. Then "everything goes". This cannot be a convincing position. Therefore the connections and relations must be brought back into the picture. They are the bridges from pure logic to the real world, and from legal form to economic substance.

The full significance of the new dimension of Shari'a risks is to be explored. But even now a number of very serious conceptual questions arise. The following are just some examples and by no means exhaustive:

- What is the value of a Shari'a-compliance fatwa of a high calibre Shari'a board if it can be challenged (even in court) by the management of the own company (which certainly understands the commercial or economic substance of a contractual arrangement)?

- If there is a dispute about the Shari'a-compliance, who will decide the case – especially in countries without explicit Shari'a courts?

[10] See Khalid Howladar: Shari'a Risk: Understanding Recent Compliance Issues in Islamic Finance, in: Moody's Investor Service - Structured Finance, 10 May 2010.

[11] TID's Annual Report 2007 lists Sheikh Dr. Mohammad Fawzi Faidullah as a fifth member who is no longer on the Shari'a board.

[12] As of 1 April 2010; see Murat Ünal: Shari'a Scholars - A Network Analytic Perspective, Version 4.0, 12. April 2010. Kronberg: Funds@Work, 2010, p. 6.

[13] Khaled Al-Mathkour, Ajeel Al-Nashmi, Esam Al-Enizi; see TID's Annual Report 2007.

[14] As of 31 July 2010; see Murat Ünal: The Small World of Islamic Finance: Shari'a Scholars and Governance - A Network Analytic Perspective, Version 5.0, 5 October 2010. Kronberg: Funds@Work, 2010, p. 17.

[15] The text of the High Court decision in The Investment Dar Company K.S.C.C v Blom Developments Bank S.A.L can be downloaded from http://www.allenovery.com/AOWeb/binaries/55080.PDF.

- In reaction to the Blom vs. TID case it has been proposed to include clauses in contracts, which make initial Shari'a board approvals final and prevent a company from raising objections later, against fatwas issued by its own Shari'a board. This may be a solution for individually negotiated contracts, i.e. mainly in investment banking. But what are the implications for retail clients who have to accept contract forms designed by the bank?

The new dimension of the Shari'a risk has also far reaching implications for disclosure and transparency requirements as well as for corporate and Shari'a governance. Further, it gives an additional stimulus to consider more radical ideas for a reform of the regulatory regime of the Islamic finance industry.

17.2.2.4 Transparency and market discipline

The basic idea underlying Pillar 3 of Basel II, is that banks have to disclose sufficient information so that market participants (e.g. depositors) could make informed choices and, for example, 'punish' banks with poor risk management practices. Market discipline would force banks to improve their risk management practices and thus contribute to more stability in the financial system. Basel III has tightened and extended the disclosure requirements in particular with respect to (re)securitization exposures and off-balance sheet vehicles. IFSB has adapted Pillar 3 of Basel II to the specificities of Islamic banking in its standard on "Disclosures to Promote Transparency and Market Discipline".[16]

The first challenge for IFIs is to adapt their disclosure practices to Basel II (and III) and IFSB requirements: In view of the risk sharing qualities of (mudaraba based) investment accounts, Islamic banks should disclose to the investment account holders (IAHs), for example, their general investment objectives and policies as well as business strategies and risk-sharing policies, and the sources of returns paid out to investment accounts (actual investment income, release of investment risk and profit equalisation reserves, reduction of the profit share of the bank).

In a (probably not representative, but nevertheless not irrelevant) survey of 22 IFIs, Hawkamah found that "14 IFIs (63.4%) recognize the IAHs right to monitor the performance of their investment and the associated risks and 13 IFIs (59.1%) inform ex ante IAH of the risk profile of the institution, investment strategy and associated risks. Only 54.6% of IFIs make adequate and timely disclosure to IAH and the public of material and relevant information on the investment accounts that they manage."[17]

But even if the information were made available on time and by all Islamic banks, it is very questionable whether they would be processed efficiently by the market (i.e. the IAHs). The major concern and challenge is that IAHs seemingly do not appreciate correctly the risk exposure of their funds. They may even ignore completely that their funds are at risk – irrespective of what clauses in deposit contracts they have signed. IFIs, and in many jurisdiction the regulators, contribute to this risk ignorance.

Investment accounts are often treated by regulators as deposits, and they require the cover by a deposit insurance scheme. If IAHs see their funds in analogy to conventional savings or term deposits, they will most probably overlook the limited range of the deposit insurance. Deposit insurance protects the principal only in the case of a bank default (and not in cases of losses from poor investments). If a conventional bank suffers heavy losses on its asset side, this may cause a bank default because of fixed deposit liabilities. In contrast, an Islamic bank can pass on the losses from the asset side to the liability side of the balance sheet (if all mitigating techniques are exhausted). This would save the Islamic bank from default but reduce the principal of the IAHs since the deposit insurance is triggered only by a bank default.

If IAHs were aware of this, rumours of the expected passing on of losses could lead to a bank run. Deposit insurance is effective as a remedy for bank runs only in conventional banking, but not in a Shari'a-compliant system. This implication is often overlooked and hardly reflected in the capital requirements for investment accounts. Capital requirements should be higher for IFIs than for conventional banks not in spite but just because of the loss-sharing capacity of investment accounts: The deposit insurance is largely redundant; only Tier 1 capital has an effective loss absorbing capacity in IFIs.

The risk ignorance of IAHs is strongly supported by the practice of Islamic banks. Islamic banks usually advertise anticipated rates on return for investment accounts, and the actual rates have hardly ever fallen short of the anticipated rates. In order to meet the expectations, Islamic banks have developed several instruments such as investment risk reserves and profit equalisation reserves, which are built up in good years with high profits, and drawn down in years with unexpectedly low profits. If these reserves are insufficient to beef up the disbursed 'profits' (i.e. income from operations [especially investments] plus liquidation of reserves) to the level expected by the IAHs (and determined by the market rate of interest for [risk free] conventional savings and term deposits), then shareholders can abandon parts of the profit shares due to them.

Reserves as well as 'voluntary sacrifices' in favour of the IAHs (which prevent a bank run and thus protect primarily the shareholders' capital) are practices approved as Shari'a-compliant by individual Shari'a scholars as well as institutions such as AAOIFI and IFSB. However, the effects are a reduction or elimination of the risk awareness of the IAH, and a transformation of profit-sharing accounts with variable returns (which are known in absolute amounts only ex post) into quasi-deposits with de facto predetermined returns (which are 'known' ex ante).

As long as this practice of Islamic banks continues and is supported by regulatory regimes, market discipline will hardly become effective in Islamic banking even if disclosure practices were improved massively.

17.3 Corporate and Shari'a governance

[16] See IFSB: Disclosures to Promote Transparency and Market Discipline for Institutions Offering Islamic Financial Services (Excluding Islamic Insurance (Takaful) Institutions and Islamic Mutual Funds. Kuala Lumpur, December 2007. [http://www.ifsb.org/standard/ifsb4.pdf].

[17] Hawkamah Task Force: Policy Brief on Corporate Governance of Islamic Banks and Financial Institutions in the Middle East and North Africa Region. Working Draft. Dubai, August 2010 [http://www.hawkamah.org/sectors/task-forces/files/Draft_Policy_Brief-July%2029-2010.pdf], p. 23.

[18] AAOIFI: Governance Standards for Islamic Financial Institutions Nos. 1 (adopted 1997), 2 (1998), 3 (1999), 5 (2005).

[19] IFSB: Guiding Principles on Shari'a Governance Systems for Institutions Offering Islamic Financial Services. Kuala Lumpur, December 2009. [http://www.ifsb.org/standard/IFSB-10(14%20Dec09).pdf].

[20] Bank Negara Malaysia: Shari'a Governance Framework for Islamic Financial Institutions - Updated 26 October 2010. Kuala Lumpur 2010. [http://www.bnm.gov.my/guidelines/05_Shari'a/02_Shari'a_Governance_Framework_20101026.pdf]

[21] Hawkamah Task Force: Policy Brief on Corporate Governance …, op. cit.

[22] OECD: OECD Principles of Corporate Governance. Paris 2004. [http://www.oecd.org/dataoecd/32/18/31557724.pdf].

[23] European Commission: Green Paper - Corporate governance in financial institutions and remuneration policies. COM(2010) 284 final. Brussels, 2 June 2010. [http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2010:0284:FIN:EN:PDF]

[24] Basel Committee on Banking Supervision: (1) Enhancing Corporate Governance for Banking Organisations. Basel, February 2006 [http://www.bis.org/publ/bcbs122.pdf]; (2) Principles for Enhancing Corporate Governance. Basel, October 2010 [http://www.bis.org/publ/bcbs176.pdf].

[25] The AAOIFI Governance Standard No. 1 (adopted in 1997) on "Shari'a Supervisory Board: Appointment, Composition and Report" prescribes: "The Shari'a supervisory board should not include directors or significant shareholders of the Islamic financial institution." (para 7).

Corporate governance standards for IFIs in general, and Shari'a governance standards in particular have been published or drafted by several reputable institutions such as AAOIFI,[18] IFSB,[19] Bank Negara Malaysia[20] and Hawkamah.[21] In addition, one must not ignore governance principles of international institutions such as the OECD,[22] the EU[23] and the Basel Committee.[24] IFIs with the ambition to penetrate more Western markets will increasingly be confronted with the codes and standards of the host countries. Western countries do not have specific rules for Shari'a governance, but one can assume that regulators and supervisor will expect the application of their general principles to Shari'a boards, which are at the core of the organizational structure of IFIs.

17.3.1 Governance principles and Shari'a board practices

AAOIFI explicates in the Governance Standard No. 5 on "Independence of Shari'a Supervisory Board" that Shari'a Supervisory Board (SSB) members, "should be and appear to be free of any interest which might be regarded, whatever its actual effect, as being incompatible with independence, objectivity and integrity." (Appendix A).

- Therefore, "SSB members should not be employees of the same IFI." (para 7).[25]

- "The continuation of the same SSB member on a Shari'a supervision engagement over a prolonged period of time may pose a threat to independence." (Appendix A).[26]

- "Personal and family relationships… can affect independence. There is a particular need to ensure that an independent approach to any assignment is not endangered as a consequence of any personal or family relationship." (Appendix A).[27]

The Governance Standard No. 5 has great implications for the procurement of Shari'a advisory services by IFIs, as the rotation of members of Shari'a boards at present is not being practiced by any institution in the world. Furthermore, a small number of Shari'a scholars have for long dominated the industry, which is being perceived as unhealthy for the practice of Islamic banking and finance. There is also evidence of the members of the same family representing the Shari'a board of the same institution. Also, it is important that members of the Shari'a board of AAOIFI or the regulators do not advise individual institutions and transactions, a practice that is prevalent to some extent in Malaysia, but not elsewhere.

The Failaka "Shari'a Report 2008" lists 253 scholars,[28] and Funds@Work has identified 320 scholars in 2010.[29] The divergence of practices of Shari'a advisory from the newly-created Shari'a governance frameworks is understandable, as before these, no such guidelines were available and the individual institutions adopted a model that fitted well in their business plans and strategies. It must, however, be emphasised that the regulators in almost all countries, except Malaysia, have by and large failed to implement these standards. Without their accepting and implementing such guidelines, Shari'a advisory services will keep on attracting criticism from the industry observers.

The AAOIFI standards for Shari'a boards are supplemented by several recommendations of IFSB[30] such as the following:

- The number of Shari'a board memberships should not become too large. Shari'a board members with multiple appointments "must ensure that sufficient time and attention" is allocated to the affairs of each IFI.[31]

- IFIs should hire and nurture "young members of the Shari'a board with promising potential to expand the talent pool in the profession".[32] The Shari'a boards shall be composed of senior and junior members with different lengths of experience.[33]

- IFIs "shall specify and adopt a process for assessing the effectiveness of the Shari'a board as a whole, as well as the contribution by each individual member to its effectiveness. Members of the Shari'a board shall be notified of this assessment process at the time of their appointment, so that they have a precise idea as to what is expected of them."[34]

- The members of Shari'a boards shall possibly be trained in different schools of jurisprudence and comprise, where appropriate, different nationalities.[35]

A confrontation of these recommendations with the practice of Shari'a boards in most jurisdictions (with Malaysia as the most important exception) reveals striking differences.

For 370+ IFIs with a total of 1141 Shari'a board positions and 280 scholars, the top 20 of the scholars (= 7.1%) hold individually between 14 and 85 and as a group 621 board memberships (= 54.4%), while the remaining 260 scholars (= 92.9%) hold individually between 1 and 11 and as a group 520 board memberships (= 45.6%).[36] This raises serious doubts whether sufficient time and attention can be allocated to all IFIs. The nurturing of young scholars is still an exception to the rule, and performance assessments of Shari'a boards and individual board members are virtually non-existent. The composition of Shari'a boards seems to be guided more by a desire for homogeneity, rather than diversity of schools of jurisprudence and nationality. Board compositions have a strong country bias, meaning that the IFIs of a specific country include mainly top scholars from the same country.[37]

Another concern regarding transparency and accountability has been summarized by IFSB as follows:

"More often than not, a majority of Shari'a boards… mention in their Shari'a pronouncements/resolutions only whether a transaction…is permissible or non-permissible. Rarely…do they make available supporting evidence that could be examined by others".

"As a result, it is very difficult to improve public awareness in terms of understanding the basis of and justifications behind a Shari'a pronouncement/resolution."[38]

A leading Shari'a scholar forcefully endorsed this posi-

[26] The IFSB "Guiding Principles on Shari'a Governance Systems" add: "The Chairmanship should preferably be on a rotation basis, such as whenever there is a reappointment of the Shari`ah board." Appendix II, para 4.

[27] The text continues: "The kind of relationship that may impair independence is between the SSB member and a member of the Board of Directors, CEO or any other member of the executive/ management team of the IFI."

[28] Failaka: The Shari'a Report 2008, Dubai and Chicago 2008.

[29] Murat Ünal: The Small World …, op. cit.

[30] The recommendations in Hawkamah's Draft Policy Brief are mostly based on IFSB recommendations; see Hawkamah, op. cit., p. 24-27.

[31] IFSB: Guiding Principles on Shari'a Governance Systems …, op. cit., para 45. The IFIs "should decide if a member of the Shari'a board is able to and has been adequately carrying out his or her duties in serving his or her Shari'a board. Internal guidelines should be adopted that address the competing time commitments that are faced when members of the Shari'a board serve on multiple Shari`ah boards." Hawkamah found in its survey of 22 banks: "In the respect of mitigating conflict of interest in the event the Shari'a board member sitting in numerous SSB [SSBc], only 23.58% of IFIs impose restriction on multiple appointment, 52.4% require disclosure on Shari'a board member's information and also demand declaration in writing." (op. cit., p. 25).

[32] IFSB: Guiding Principles on Shari'a Governance Systems …, op. cit., para 19.

[33] Ibid., para 17. Similarly Hawkamah's Draft Policy Brief (op. cit.): IFIs "should aim for a Shari'a board with a mixture of experience and competencies." (para 35).

[34] Ibid., para 36. Similarly Hawkamah's Draft Policy Brief (op. cit.): "There should be a formal assessment of the effectiveness of the Shari'a board as a whole and of the contribution by each member to the effectiveness of the Shari'a board." (para 41).

[35] Ibid., para 17.

[36] See Murat Ünal: The Small World …, op. cit., pp. 6-7.

[37] This opinion is supported by country specific data for Kuwait, UAE, Saudi Arabia, Bahrain and Qatar provided by Murat Ünal: The Small World …, op. cit., pp. 11-15.

tion of IFSB (which is in accordance with best practice recommendations of Western institutions such as the OECD or EU).[39]

In total, the actual practices of the Islamic finance industry divert substantially from recommendations and best practice examples put forward by institutions such as AAOIFI, IFSB and Hawkamah. A continuous stream of graduates from reputed educational institutions increases the pool of available talents for Shari'a board positions, but without the will of the IFIs or the regulators to include them in their boards, the situation with all types of potential conflicts of interests will not change.

17.3.2 Accumulation of Shari'a board memberships and clusters of Shari'a scholars

Empirical research on Shari'a governance has started only recently. Therefore, it comes as no surprise that the number of questions still exceeds the number of answers by far. Two questions and provisional answers shall be put forward here (with some indications for further empirical research).

(1) Why is it that IFIs still chase the big names of the Shari'a scholars' guild? Scholars with 30+ Shari'a board memberships can devote only limited periods of their own working time to new board memberships, and if demand and supply determine the fees of scholars, the top names will be the most expensive choices.

One might argue that the wealth of experience and the permanent involvement in the development of advanced products and techniques can make up for the limited time. This could be a convincing explanation if most of the IFIs that form new Shari'a boards and appoint well established scholars were very innovative firms with fresh products and new techniques. A cursory screening of the product portfolios of some relevant IFIs gave rise to doubts about this explanation.

If the expertise of a top scholar is not the prime motivation to get him on the Shari'a board, then it could be his name that disseminates a positive signal to retail customers, other business partners and regulators. It would be interesting to learn how many retail customers know the Shari'a board members of their Islamic bank. It might be that this percentage is very low: The customers expect that the bank has a Shari'a board but are quite indifferent with regards to the members.

A third explanation might be that big names are a signal for business partners in the financial sector (other Islamic banks, institutional investors, rating agencies, etc.). However, the partners will hardly take big names on a Shari'a board as a sufficient guarantee for Shari'a-compliance according to their own standards. They will most probably check the Shari'a qualities of transactions or contracts by their own Shari'a boards. Therefore the signal is not that straightforward.

So what could be the rationale to engage a very expensive top scholar with serious time restraints? Maybe one can find an answer by considering why very busy scholars accept new assignments. For this purpose one could outline a model for the maximisation of income, prestige or intellectual satisfaction over the whole lifetime of a Shari'a scholar. However the model may be specified, it probably will show that the maximum cannot be reached by accepting each and every offer of a board membership; there is a critical number of boards one person can credibly serve. Once this number is exceeded, the credibility of the scholar and the assumed seriousness of work, loyalty and commitment will decline. As a consequence his market value (in terms of money and reputation) will start to decrease. If then top scholars cannot (in their own interest) accept every offer for a Shari'a board membership, the successful attraction of a top scholar signals to the business community (and to the public sector) that this Shari'a board membership is of special importance to him, and this disseminates the signal that this IFI is somehow 'superior' to others.

It has to be conceded that the outlined model does not have much explanatory power as long as one cannot specify the maximum number of credible board memberships (20, 30, 50, 100?). But it can draw the attention to a challenge for the Islamic finance industry, namely the long-term credibility of Shari'a governance systems with Shari'a boards only on the level of individual IFIs (in contrast to systems with a Shari'a board on the national level).

(2) The latest study on Shari'a scholars networks reveals that there are 'clusters' of top scholars who sit together on relatively large numbers of Shari'a boards of different IFIs.[40] How could this clustering be explained and what are its implications for the effectiveness of the Shari'a governance?

The emergence of clusters could be due to deliberate decisions of IFIs when they form a Shari'a board. Then it would be interesting to learn, what is the attraction of those combinations of scholars which can be found frequently: specific expertise or signals to the market?

An alternative explanation for the emergence of clusters could be that Shari'a scholars themselves prefer to cooperate in particular combinations: A top scholar will accept a Shari'a board membership only if the IFI includes other scholars of his choice. Given the limited time budgets of overloaded scholars and their profound knowledge of the special expertise of other scholars, it is sensible for them to bring in trusted and tried and tested partners in order to exercise an internal division of labour in the Shari'a board.

Such a specialisation and division of labour would narrow down the scope of different opinions articulated in the Shari'a supervisory system, and the challenge is to prevent the emergence of an oligopolistic opinion leadership. A remedy could be the better documentation of pronouncements/resolutions of Shari'a boards and the public access to supporting evidence. Then external experts and other scholars could analyse positions of leading scholars and challenge them. Young scholars would get the opportunity to test and prove their qualifications in an intellectual discourse (or dispute) with established scholars. Bright young scholars could gain recognition from top scholars as well as from market players through their contributions in seminars, conferences and publications. This should open the

[38] IFSB: Guiding Principles on Shari'a Governance Systems …, op. cit., para 59.

[39] See the summary of a conference paper of Mohamed Ali Elgari by Mushtak Parker: Shari'a Governance in Islamic Finance Industry, in: Arab News, 22 March 2010 [http://www.zawya.com/pdfstory.cfm?storyid=ZAWYA20100322032705&l=032700100322]; excerpts of this paper were recently published: The Shari'a Governance Way, in: Islamic Finance Asia, November 2010, pp. 31-32. Some of Elgari's main theses were summarized by Parker as follows: "i) Shari'a decisions must always be supported by a body of evidence; ii) Shari'a declarations must always be capable of being defended by those who issued them with the same vigor with which they were issued; … v) procedures for the reversal of fatwas [are needed] because Shari'a scholars are not infallible and they do mistakes which have to be retracted and corrected … vi) ethics of disagreement [is needed] where Shari'a scholars must learn to tolerate and respect opposing views which are also valid under the Shari'a". Item v) is also a concern of IFSB: IFIs "should ensure that the Shari'a board adopts a specified process for changing, amending or revising any Shari'a pronouncements/resolutions issued by it. Appropriate and timely disclosure shall be made to shareholders and/or the public whenever the Shari'a board and/or its members depart from or revise any of its Shari'a pronouncements/resolutions." IFSB: Guiding Principles on Shari'a Governance Systems …, op. cit., para 63.

[40] See Murat Ünal: The Small World …, op. cit., pp. 17-18.

door to Shari'a boards (maybe under the sponsorship of established scholars), and it will broaden the intellectual base of the Shari'a supervision system. However, under the actual disclosure and transparency practices, the oligopolistic opinion leadership is the more probable result. To change the rules of the game, the public sector has to modify the regulatory or legal framework.

17.3.3 Global certification of Shari'a-compliance?

Shari'a engineering creates increasingly complex structured products with approval by prominent scholars. At the relatively early stage of development of Islamic banking and finance, innovations were very often the result of reverse engineering of conventional products – an attempt to bring Western technologies into Islamic banking for purposes of risk management and product diversification. In the absence of industry-level standards for such innovations (which is quite natural as innovation almost always precedes regulation and standardisation), many of the innovations in Islamic banking and finance were mired by suspicion and distrust. At the core of many new Shari'a-compliant synthetic products is the concept of unilateral promise (wa'ad). Promises are not contracts and therefore not subject to restrictions such as the prohibition of gharrar (contractual uncertainty). Another recent innovation is the use of commodity murabaha or tawarruq to create savings accounts and term deposits with guaranteed principals and fixed returns for the depositors. This continues the tradition of modifying or supplementing old trade contracts in such a way that these products look similar to conventional products in their economic effects.

Consequently, an increasing number of articles and commentaries in Islamic finance journals and web blogs (many of them happen to be based on some ill-informed opinions) of the last few years, document a growing discomfort of many observers as well as industry practitioners with the spread of legal formalism and the neglect of economic substance in the Islamic finance industry. In addition, sometimes prominent Shari'a scholars or institutions articulate well founded concerns about this direction of the industry. Outstanding and widely noticed examples are

- the criticism of sukuk by Muhamad Taqi Usmani,

- the fatwa on Tawarruq by the OIC Fiqh Academy,

- the criticism of total return swaps by Yusuf Talal DeLorenzo.

Such controversies make it obvious that there is no consensus among leading scholars on basics of even widely used Islamic products (such as sukuk and tawarruq). Many more differences of opinion do exist among Shari'a scholars or Shari'a boards of IFIs, although less fundamental than in the three cases quoted above, but still relevant enough to become an impediment for a wider or even general acceptance of innovative products. The continuation of the fragmentation of the market is seen as an obstacle to the rapid global expansion of the Islamic finance industry. The call for more standardization of Islamic finance products is often heard – though not shared by all because some consider standardization as a hindrance of innovation.

Against this background the secretary-general of AAOIFI, Mohamad Nedal Alchaar, has announced in August 2009 an initiative "to do screening of all products available in the market and evaluate the adherence of those products and the compatibility the Shari'a principles and rules. We will identify those products that are in violation and we will voice it out to the public."[41] He further claims: "The most important enforcement form of our [Shari'a] standards is through our Shari'a scholars. … Those scholars are on the Shari'a boards of most financial institutions; therefore our standards are enforced through our Shari'a scholars in an indirect way."[42]

This statement must not be seen as a warning to Shari'a scholars, but rather to the management of the institutions offering Islamic financial services, as it is they who have in some cases failed to implement Shari'a guidelines as enunciated by their Shari'a boards.

- In the widely publicised case of Blom vs. TID, some industry observers put the blame on Shari'a scholars (two of them being active members of the Shari'a board of AAOIFI), but it is the management of TID that seems to have misused or abused the Shari'a in the event of financial distress. There were of course some more fundamental questions raised on the practice and products in Islamic banking and finance, which go beyond the scope of this chapter.

- Similarly, in case of the criticism of the use of wa'ad in structuring a total return swap by Deutsche Bank and approved by the Shari'a board of Dar Al Istithmar, the initial criticism came from some industry observers, primarily because of its new application in Islamic banking and finance, for which there was no prior Shari'a precedence. More importantly, products based on wa'ad are now widely accepted and are increasing in number and enterprise value. It is, therefore, crucial that proper Shari'a governance frameworks are developed to regulate such products. International Shariah Research Academy (ISRA) for Islamic Finance is working on creating such a framework.

- Indirect enforcement of AAOIFI standards has not worked in the past, but a number of Shari'a controversies has helped AAOIFI in becoming a more effective organisation for accounting, governance and Shari'a standards. The controversy on sukuk, for instance, highlights weaknesses of indirect enforcement of AAOIFI Shari'a standards, but it also points to a more effective role of the organisation in Shari'a and regulatory matters. The debate was spurred by Muhammad Taqi Usmani in 2007, who was and still is the chairman of the AAOIFI Shari'a board. Alchaar asserts that the AAOIFI standard for sukuk "is very clear". In particular, it "was also clear that when an issuer would like to buy back a sukuk, that should be done on the basis of the net value of assets, its market value, fair value or a price to be agreed, at the time of their actual purchase."[43] The AAOIFI Shari'a standard no. 17 on sukuk was issued in May 2003.[44] The hypothesis that Shari'a standards are enforced indirectly by AAOIFI's scholars in the boards of IFIs implies that no Shari'a board with at least one

[41] Mohamad Nedal Alchaar: Soon: AAOIFI Stamp for All Islamic Products, in: Islamic Finance News, 6 (2009) 31 [7 August], p. 15.

[42] Mohamad Nedal Alchaar: Soon: AAOIFI Stamp …, op. cit., p. 14.

[43] Mohamad Nedal Alchaar: Soon: AAOIFI Stamp …, op. cit., p. 15.

[44] Some supporting Shari'a standards (no. 5 on guarantees and no. 12 on Sharikah [musharaka]) are even older and have been issued in 2001 and 2002.

AAOIFI scholar should have approved a sukuk issue with a repurchase guarantee at face value or at the issue price since 2004 (and especially not after 2007). If a few sukuk could be identified which violate the AAOIFI standard but were approved by a board on which a AAOIFI scholars sits, the hypothesis of indirect enforcement is refuted. Therefore, it is required that the regulatory bodies in different countries must subscribe to a Shari'a framework as adopted by them.

- If the indirect enforcement of Shari'a standards cannot be taken for granted, then the awarding of a "Shari'a-compliance seal" gets a completely new orientation: It is not just the acceleration of a process that is going on anyway. On the contrary, it is the enforcement of one opinion against the resistance of others – it is an attempt to monopolize the power of definition.

This is diametrically opposed to the opinion of leading Shari'a scholars such as Elgari who is a member of the AAOIFI Shari'a board: "There are those who think that... consistency and predictability can be assured through the 'centralization of power' and monopolizing the authority to issue Fatwa by one body of scholars. Unfortunately, this did not and will not work because it goes against the egalitarian nature of the Islamic system. Scholars are just like the rest of us. There is no special power bestowed upon them. Hence, their authority is derived from political, and not Shari'a sources."[45]

[45] [Mohamed Ali Elgari:] The Shari'a Governance Way, op. cit., p. 31.