

STATE OF SHARI'A GOVERNANCE IN ISLAMIC FINANCE

Shari'a-compliance is the backbone of Islamic banking and finance. It not only gives legitimacy to the practices of Islamic banking and finance, but also boosts the confidence of the shareholders and the public that all the practices and activities are in compliance with Shari'a at all times. The existence of non-Shari'a-compliant element would not just affect the confidence of the public but might also expose Islamic financial institutions (IFIs) to fiduciary and reputational risks. Compliance with the Shari'a principles will be achieved through having a proper Shari'a governance framework in placed.

Despite the fact that many guidelines are provided on Shari'a governance, each country has their own coverage and differences based on specific countries culture or institution scope of enforcement and objectives. As a result, there are differences in regulations and guidelines for governance model and its disclosure between countries. This makes it difficult for Islamic banks to have a uniform benchmark for their practices. Many governments and regulatory bodies have been continuously exerting efforts to strengthen the Islamic finance industry. Internationally, the Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI) and the Islamic Financial Services Board (IFSB) have issued a number of governance and auditing standards and guidelines.

Shari'a Governance Framework

AAOIFI developed its Shari'a Standards for Islamic Finance Industry in 2002. A total of 7 standards were issued to this effect to include (1) Shari'a Supervisory Board: Appointment, Composition and Report, (2) Shari'a review, (3) internal Shari'a review, (4) audit and governance committee for Islamic financial institutions, (5) independence of Shari'a supervisory boards, (6) statement on governance principles for Islamic financial institutions, and (7) corporate social responsibility conduct and disclosure for Islamic financial institutions. The IFSB in 2009 issued the 'Guiding Principles on Shariah Governance Systems in Institutions Offering Islamic Financial Services' to ensure an effective independent oversight, through issuance and implementation of relevant pronouncements or resolutions that govern its whole operation. This is coupled with internal Shari'a compliance review and audit to verify that Islamic principles have been satisfied.

In addition, several central banks such as Bank Negara Malaysia, State Bank of Pakistan and Bank Indonesia; have issued and implemented their own respective governance and auditing guidelines. The Shari'a governance framework issued by Bank Negara Malaysia in 2011 is arguably by far the most comprehensive guidelines, setting out the Shari'a governance process for the Malaysian Islamic finance industry. The guidelines provide roadmap for IFIs to develop sound Shari'a governance and to reinforce the regulator's expectation on effective and efficient IFIs governance system. To this effect, the framework provides the general requirements, guidelines on Shari'a review and Shari'a audit as well as guidelines on the functions of Shari'a risk management and Shari'a research in Islamic finance. The State Bank of Pakistan issued its Shari'a governance framework for IFIs in 2015, which superseded the instructions and guidelines for Shari'a compliance which the central bank issued in 2008.

The lack of a standardised governance framework for product approvals in the international market has opened the Islamic financial industry to Shari'a arbitrage and adds another level to IFIs' operational risk. At present, there are distinctive models and approaches of Shari'a governance implemented across jurisdictions. For example, Malaysia and Pakistan is the proponent of a "Regulation-based Approach", Saudi Arabia adopts a "Passive Approach" and Qatar, UAE, Kuwait and Bahrain takes on a "Minimalist Approach". These different models and approaches are adopted mainly due to diverse legal environments and economic backgrounds.

Diversity of Shari'a Governance and Operational Issues

There is definitely a need for a more formalised Shari'a governance framework. For example, codified rules of governance might promote more coherent conduct to unconsciously enact religious compliance. To this end, regulators, both at international and national levels, could potentially play an important role in assisting Islamic banking and finance achieve its religious compliance principles. However, the regulatory appetite and related infrastructure linked to the monitoring of Shari'a governance implementation is both limited and diverse, even in predominantly Muslim countries, as evidenced in Table 1.

In countries with larger numbers of IFIs the likes of Pakistan, Malaysia, and Indonesia; the regulatory infrastructure is more mature as compared to other countries as evident in Table 1. The regulatory rules are more formalised in these countries and specific Shari'a compliance reports are deemed mandatory for IFIs, partly to fulfil the high demand of the religious imperatives, as well as to maintain their legitimacy as a global hub for Islamic finance. All three countries adopt a two-tier Shari'a governance framework where the national board sets general religious guidance for the Islamic banking and finance industry, whilst the in-house board of scholars produce religious pronouncements at the operational level. Hence, the diversity of Shari'a governance standards across countries provides a compelling case for creating best practices in Shari'a governance implementation.

The need to adopt a unified governance framework arises primarily because the rapid proliferation of Islamic banking and finance has not matched development in the industry's regulatory and supervisory architecture and infrastructure. Within the context of agency structure in Islamic banks, conflicts between agency mitigating mechanisms and Shari'a law

Table 1:
DIVERGENT SHARI'A REGULATORY FRAMEWORK

	OMAN	BAHRAIN	PAKISTAN	MALAYSIA	INDONESIA
SHARI'A SUPERVISORY BOARD (SSB)	BANK LEVEL	BANK LEVEL	TWO TIER	TWO TIER	TWO TIER
BINDING POWER OF INTERNATIONAL STANDARDS (AAOIFI)	MANDATORY	MANDATORY	NONE	NONE	NONE
COMPLY WITH OR EXPLAIN REPORT ON OVERALL REGULATORY REQUIREMENT	NONE	MANDATORY	MANDATORY	NONE	NONE
SPECIFY SHARI'A-COMPLIANCE REPORT	NONE	NONE	MANDATORY	MANDATORY	MANDATORY
LEGAL SANCTION FOR NON SHARI'A-COMPLIANCE	NONE	NONE	NONE	LEGAL FINE & IMPRISONMENT	NONE
RECTIFICATION PLAN OF SHARI'A NON-COMPLIANCE EVENTS	NONE	NONE	NONE	WITHIN A MONTH	NONE

Sources: Guidelines/Standards of AAOIFI, IFSB, Central Bank of Bahrain, State Bank of Pakistan, Bank Negara Malaysia, and Bank Indonesia

are apparent.¹ For example, a comprehensive Shari'a governance framework is required to encourage transparency and disclosure in decision-making, which is of paramount importance to investment account-holders in order to protect them against conflicts of interest as their funds are normally pooled together with those of shareholders.

The governance structures of IFIs are distinguished from conventional governance structures by the addition of a Shari'a advisory body. Playing their roles as in-house religious advisers who make up the Shari'a supervisory or advisory board, there are responsible to ensure that the institution's business practices and products conform to Islamic law, and to mitigate the institution's exposure to fiduciary and reputational risks related to Islamic standards of compliance. However, Shari'a governance is confronted by several issues.

1. Archer, S., & Karim, R. A. A. (2007). *Islamic Finance The Regulatory Challenge*. Singapore: John Wiley & Sons (Asia) Pte. Ltd.

Safieddine, A. (2009). *Islamic Financial Institutions and Corporate Governance: New Insights for Agency Theory*. *Corporate Governance: An International Review*, 17(2), 142-158.

Issues on Shari'a Board Performance

The Shari'a Supervisory Board (SSB) and audit activities are the key principles of corporate governance in Islamic banking and finance. The SSB plays a crucial role in reviewing products, instruments and policies on whether transactions and operations are religiously acceptable. Through their activities, SSB ensures constant surveillance and check-and-balance over IFIs operations. Both governance standards of AAOIFI (1999) and IFSB (2008) state that SSB is responsible to perform ex ante and ex post audit, which enables it to justify to what extent Islamic banks' operations comply with Shari'a principles. In this respect, SSB in each Islamic banks are required to monitor and confirm that the bank's transactions in structuring and developing product, as well as their daily operations are in conformity with the Islamic principles. Thus, SSB plays a vital and effective advisory, auditing and compliance role in IFIs.

For some IFIs, the role of SSB is seen as being similar to that of company auditors, while others believe that SSB has the duty to supervise the bank and confirm that its products and operations are in compliance with the precepts of Shari'a. It should be noted that SSB has no direct influence on the decisions of the managing board as it only deals with conformity and nonconformity of financial products. In cases of non Shari'a-compliant, SSB would highlight different ways to solve the problem so that the managing board can choose between different alternatives.²

However, SSB performance is at best mixed and not short of issues. First of all, Islamic banking and finance have been suffering from a severe shortage of experienced Shari'a scholars. Several studies conducted on the roles, functions and competency of SSB in Islamic banks in Malaysia and Indonesia point to the need to enhance the responsibility, independence and the importance of continuous training and courses to improve the competency of SSB.³

The SSB is constantly criticised for being lenient, hasty and incomprehensive in certifying new products because of lack of depth in the field of accounting and finance. Hence, having an internal Shari'a audit unit within Islamic banks may resolve such issues.⁴ Many Islamic banks have taken this proactive step of establishing a Shari'a internal audit as a part of their internal control system. The internal Shari'a audit functions would lighten the load of SSB, and subsequently enables standardisation of Shari'a interpretation with a view to harmonise the process of Shari'a compliance assurance in Islamic banking and finance. However, in practice issues of the effectiveness of this function is subject to further examination, as discussed in the following section.

2. Toufik, B.B. (2015). The role of Shari'a Supervisory Board in ensuring good corporate governance practices in Islamic banks. *International Journal of Contemporary Applied Sciences*, 2(2), 109-118.

3. Abdul Rahim, A. R., Abu Bakar, N. B. and Syafie, A. W., (2004). A preliminary study on the responsibility and independence of shariah advisors of Islamic banks, *Proceedings of IIUM Accounting Conference II, 2004*, Kuala Lumpur, Malaysia.

4. Ghoul, W. A. (2008). Shari'ah Scholars and Islamic Finance: Towards a More Objective and Independent Shari'ah Compliance Certification of Islamic Financial Products. *Review of Islamic Economics*, 12(2), 87-104.

Issues with Audit and Shari'a-Compliance Assurance

It is suggested that IFIs should have regular independent internal Shari'a audits to strengthen their confidence, as people are now experiencing a movement along a continuum from a society that trusts everything and audits nothing to a society that trusts nothing and audits everything.⁵ In order to ensure the effectiveness of the goals of Shari'a-compliance in IFI activities relating to the system, products, employees, environment and the society; the concept of auditing should be extended to the development of a useful and comprehensive audit framework.⁶

With the growing awareness among Islamic institutions that every institution should contribute towards achieving the objectives of the Islamic law or the Maq'asid Ash-Shari'a, Shari'a auditing is gaining paramount importance. Therefore, there is a need to develop a useful Shari'a audit framework to ensure effectiveness of the goals of Shari'a compliance in Islamic banking and finance, which in turn can contribute positively to the society at large. It is proposed that the concept of Shari'a auditing should be extended to activities relating to among others, the system, the products, the employees, the environment and the society.⁷ Nonetheless, it is important to formulate a philosophical foundation of the auditing theory from Islamic perspective as absence of a philosophical foundation would lead to the variation and lack of focus in the development of Islamic auditing as a discipline and in practice.⁸

The issues of Shari'a auditor's independence and accountability have been well documented. Issues include scope of Shari'a audit, framework of Shari'a auditing, gaps between "the desired" and "the actual" practice of Shari'a auditing, and qualification and competency of Shari'a auditors.⁹ One of the most important issues in Shari'a audit is that of the independence of Shari'a auditors, which is a fundamental concept in audit, be it conventional or Islamic. The independence of Shari'a audits has been highly debated in the literature. One of the issues put forward is the involvement of SSB members in audit as is practiced by some IFIs. In such cases they will be auditing their own work and thus raises the issue of independence as well as conflict of interest. For the role of Shari'a audit to be independent and hence effective, there is a need to have separation of duties between Shari'a auditors and SSB in performing their duties.

The second issue relates to the competence of SSB members when it comes to the performance of conducting Shari'a audit. Although members of SSB are well qualified in the task of issuing fatwas about the permissibility or otherwise of financial products, they may not have the necessary qualification and training to be a qualified auditor.¹⁰ In jurisdictions like Malaysia, the SSB is not involved in the Shari'a audit exercise as it does not fall within the ambit of their scope and job description. In cases where Shari'a audit functions are not performed by SSB members, the issue of competency is still in question. In addition to accounting qualifications,

5. Ghoul, W., & Karam, P. (2007). MRI and SRI mutual funds: A comparison of christian, Islamic (morally responsible investing), and socially responsible investing (SRI) mutual funds. *The Journal of Investing*, 16(2), 96-102.

6. Sultan, S. A. M. (2007). *A Mini Guide to Shari'ah Audit for Islamic Financial Institutions : A Primer*. Cert Publications.

7. Sultan, S.A. (2007). *Shariah Audit*. CERT Publication, Kuala Lumpur.

8. Harahap, S. S. (2003). The disclosure of Islamic values—annual report. The analysis of Bank Muamalat Indonesia's annual report. *Managerial Finance*, 29(7), 70-89.

9. Kasim, N., Ibrahim, S. H. M., & Sulaiman, M. (2009). Shariah Auditing in Islamic Financial Institutions: Exploring the Gap Between the "Desired" and the "Actual" *Global Economy & Finance Journal*, Vol. 2 (No. 2), 127-137

10. Hameed, S. (2008) The Case for Islamic Auditing. *International Accountant*. Source: <http://www.kantakji.com/fiqh/Files/Accountancy/v181.pdf>

Shari'a auditors must also be qualified professionals in Islamic financial and commercial relations (muamalat). Background in either Shari'a or auditing alone is not sufficient in conducting Shari'a audit. However, the lack of qualified professionals which has both conventional accounting and Islamic auditing qualification is a key challenge in the Islamic banking and finance industry.

Another issue pertains to the scope of Shari'a audit in IFIs. Distinct from conventional audit, Shari'a audit is a collective exercise encompassing financial statements, operations and the degree of the institutions' overall compliance to Shari'a.¹¹ In practice, however, most IFIs restrict their audit reviews to only product offerings and financial statements. It is also a common practice with many IFIs, either circumstantially or deliberately, to apply the conventional auditing framework in lieu of Shari'a auditing framework. It also argued that the current set-up does not permit Shari'a auditors to be independent as much as they wish to be or should be. Typically, Shari'a auditors have limited powers to exercise and make independent opinions on Shari'a-compliance reviews of IFIs' products or financial statements.¹² More often than not, they are influenced by the business. The challenge is on the management to execute their business strategies while supporting and upholding the findings passed by the Shari'a auditors.¹³

Conclusion: Notes for Further Improvements

Current IFI practices seem to be in conflict with societal expectations of IFI ethicality and philanthropic motivation. IFI's heavy reliant on the views of Shari'a scholars in the seal of approval of compliance and the diversity of interpretation most of the theological exegeses are considered a risk of certifier bias. The scholars' tacit knowlegde, independence, competence and effectiveness in scrutinising complex financial instruments become the main factors and challenges in the effectiveness of Shari'a governance. In the end, Shari'a inspires human to understand what is right and what is wrong, and eventually one's decision which path to be made. In another perspective, even though all normative and interpretive rules are available but at the end actors with their power, knowledge and reflexivity will govern their compliance behaviour.

11. Wafik Grais, Matteo Pellegrini (2006). Corporate Governance in Institutions Offering Islamic Financial Services: Issues and Options, World Bank Publications

12. Kasim, N., Shahul Hameed, M. I. & Sulaiman, M., (2009), Shari'ah Auditing in Islamic Financial Institutions: Exploring the Gap Between the "Desired" and the "Actual", Global Economy & Finance Journal, Vol. 2 No. 2, pp. 127 - 137.

13. Shahul Hameed, M. I. (2011), Issues in Shari'ah Auditing in Islamic Banking, IRTI, IDB, Jeddah.