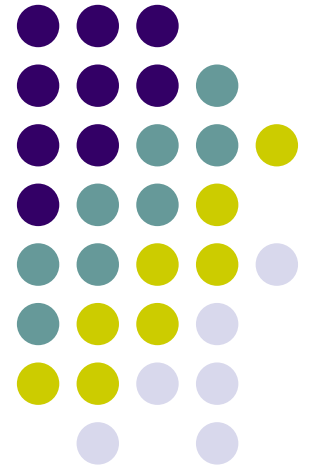


OPTIMAL SHARIAH GOVERNANCE IN ISLAMIC FINANCE

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Section 1

The Importance of Shariah Governance in Islamic Banking and Finance

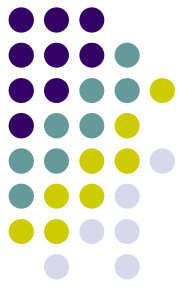
Shariah governance within the ambit of corporate governance...



- ❑ Corporate governance refers to the method by which a corporation is **directed, administered or controlled**
- ❑ Since Islamic FI in many ways is similar to the conventional FI, the existence of a **proper framework** of corporate governance is **a matter of dire necessity**
- ❑ However, different from conventional FI, Islamic FI has the responsibility **to ensure the compliance with the Shariah principles** in its products, instruments, operations, practices, management etc

Shariah governance within the ambit of corporate governance...

contd.



- Hence, Shariah governance is another component that is peculiar **exclusively** to Islamic FI
- Principle 3.1 of the “**IFSB Guiding Principles on Corporate Governance**” states that an **appropriate mechanism** must be created **to ensure the compliance with the Shariah principles**
- Similarly, Principle 7.1 of the “**IFSB Guiding Principles on Risk Management**” states that Islamic FI shall have in place **adequate systems and controls**, including Shariah Board/advisor **to ensure compliance with the Shariah principles**

The importance of Shariah governance in Islamic banking & finance...



- ❑ Shariah compliance is the **backbone of Islamic banking & finance**
- ❑ It gives **legitimacy** to the practices of Islamic banking & finance
- ❑ It also boosts the **confidence of the shareholders and the public** that all the practices and activities are in compliance with the Shariah at all times

The importance of Shariah governance in Islamic banking & finance... *contd.*



- ❑ The existence of non-Shariah compliant element would not just **affect the confidence** of the public to Islamic banking & finance
- ❑ But might also **expose Islamic FI to risks** e.g. fiduciary and reputational risks
- ❑ The compliance with the Shariah principles will be achieved by **having a proper Shariah governance framework**



Section 2

Models of Shariah Governance: Selected Countries

Models of Shariah governance from selected countries...



MALAYSIA Model

PAKISTAN Model

KUWAIT Model

BAHRAIN Model

U.A.E. Model

QATAR Model



1) Malaysia Model

- ❑ The establishment of **Shariah Advisory Council** at Bank Negara Malaysia by virtue of **section 16B** of the **Central Bank of Malaysia Act 1958 (CBA)**

- ❑ The SAC is **the final authority** in matters relating to—
 - ❑ Islamic banking business,
 - ❑ takaful business,
 - ❑ Islamic financial business,
 - ❑ Islamic development financial business, or
 - ❑ any other business which is based on Shariah principles and is supervised and regulated by Bank Negara Malaysia



Malaysia Model

contd.

- ❑ The SAC of BNM will be referred to by the court or arbitrator in disputes involving Shariah issues in Islamic banking & finance and takaful
- ❑ In the case of the arbitrator, the SAC's resolution "shall be binding" on the arbitrator (obligatory)
- ❑ In the case of the court, the SAC's resolution "shall be taken into consideration" on the court (advisory)



Malaysia Model

contd.

- BNM also issued “**Guidelines of the Governance of Shariah Committees for Islamic Financial Institutions (BNM/GPS1)**” which provides that –
- A Shariah body which is to be known as a “**Shariah Committee**” is to be established by each and every Islamic banks, Islamic windows & takaful operators
- Relationship – all these **Shariah Committees** play a **complementary role** to the SAC of BNM



Malaysia Model

contd.

- ❑ **Restrictions** imposed –
 - ❑ Members of SAC of BNM are **not allowed to serve** in the Shariah Committee of any financial institutions (by virtue of s. **16B (6) of the CBA 1958**)
 - ❑ **One Shariah advisor** can only serve as a member of Shariah Committee in **one financial institution in the same industry** (Islamic banking and takaful are considered as different industries)



2) Pakistan Model

- ❑ The establishment of **Shariah Board** at the State Bank of Pakistan (SBP)
- ❑ **Shariah Board** is the **sole authority** in matters pertaining to Islamic finance
- ❑ **Requirement** for the establishment of **Shariah advisor** for the Islamic financial institution



Pakistan Model

contd.

- ❑ Any **member of Shariah Board** at the SBP is **allowed** to serve as **Shariah advisor of a financial institution** (different from Malaysian situation)
- ❑ Restriction imposed – a Shariah advisor is allowed to serve **only one financial institution**
- ❑ **No division of industries** as in the Malaysian situation has been made



3) Kuwait Model

- ❑ Kuwait is practicing **self regulation** of Islamic financial institutions
- ❑ There is **no Shariah Advisory Council** at the Central Bank of Kuwait
- ❑ **Section 10, Chapter 3, Central Bank of Kuwait Law 32/1968** provides that every Islamic financial institution shall have its own **Shariah Supervisory Board**



Kuwait Model

contd.

- ❑ In the case of **conflict of opinions** among members of the Shariah Supervisory Boards concerning a Shariah ruling, the **Board of Directors** of the designated Islamic FI may **transfer** the matter to the “Fatwa Board” in the **Ministry of Awqaf and Islamic Affairs** (this is not compulsory)
- ❑ **The Fatwa Board** in the Ministry of Awqaf and Islamic Affairs shall be the **final authority** on the matter
- ❑ This Fatwa Board is an **external body** to the Central Bank of Kuwait



Kuwait Model

contd.

- ❑ **No restriction** is mentioned/found in the law
- ❑ **From the existing practice**, it can be said that there is **no restriction** for the members of the Fatwa Board **to serve in any Islamic financial institution**
- ❑ Similarly, **there is also no limitation** to serve as a member of Shariah Supervisory Board of more than one Islamic financial institution



4) Bahrain Model

- ❑ Establishment of **National Shariah Board** of the Central Bank of Bahrain – to serve and to verify the Shariah compliance of **its own products only**
- ❑ All other Islamic financial institutions shall establish “**Shariah Supervisory Committee**” and comply with the AAOIFI's **Governance Standards for Islamic Financial Institutions No. 1 and No. 2**
- ❑ **No restriction** for the member of National Shariah Board to serve any financial institution, also **no limitation** to serve only one institution



5) U.A.E. Model

- ❑ Establishment of “Higher Shariah Authority” to supervise Islamic banks, financial institutions and investment companies (Art. 5, Federal Law No. 6 of 1985)
- ❑ This Authority shall be accorded the final authority in Shariah matters in Islamic banking and finance
- ❑ Formation of Shariah Supervision Authority at the financial institution level (Art. 6 of the same Law)
- ❑ Nothing is mentioned about any restriction



6) Qatar Model

- ❑ Practicing **self regulation** of Islamic banks
- ❑ **No Shariah Advisory Board** at Central Bank of Qatar. But has “**Supreme Shariah Council**” attached to Awqaf Ministry – any issue can be **directed to the Council** for clarification
- ❑ Central Bank of Qatar **appoints Shariah scholars** to solve any problem encountered on **case-to-case basis**
- ❑ **No restriction** on Shariah advisors to be a member of Shariah Board in more than one Islamic FI



In summary...

COUNTRY	SHARIAH AUTHORITY		FINAL AUTHORITY	RESTRICTION
	Central Bank	IFI		
Malaysia	SAC	SC	SAC	1) Members of SAC cannot serve IFI 2) One SA can only serve one IFI in same category (Banking & Takaful)
Pakistan	SB	SA	SB	1) Members of SB can serve IFI 2) One SA can only serve one IFI (no category mentioned)
Kuwait	n/a	SSB	SSB*	No restriction is mentioned
UAE	HSA	SSA	HSA	No restriction is mentioned
Bahrain	NSB	SSC	NSB	No restriction is mentioned
Qatar	N/A	SSB		No restriction is mentioned

*In case of dispute: Fatwa Board in the Ministry of *Awqaf* and Islamic Affairs



Personal Reflection...

- ❑ Restriction by not allowing–
 - ❑ Members of SAC to serve any Islamic FI (e.g. Malaysia)
 - ❑ Shariah advisors to serve more than one Islamic FI (e.g. Malaysia & Pakistan)

ADVANTAGES	DISADVANTAGES
<ul style="list-style-type: none">● Avoiding conflict of interest	<ul style="list-style-type: none">● Obsolescence of the knowledge of the members of SAC: Macro vs. Micro
<ul style="list-style-type: none">● Preserving secrecy and confidentiality	<ul style="list-style-type: none">● Depriving the market from good brains
<ul style="list-style-type: none">● Allowing for more new brains to enter the market	<ul style="list-style-type: none">● No interaction between experienced and inexperienced Shariah advisors

- ❑ The need to balance between “Pros” and “Cons”



Section 3

Governance Relating to Shariah Supervisory Board



What is “Shariah Supervisory Board”?

- ❑ An **independent** body of specialised jurists in **fiqh al-muamalat** (Islamic commercial jurisprudence). However, the Board may include a member other than those specialised in **fiqh al-muamalat**, but who should be an **expert in the field of Islamic financial institutions** and with the duty of directing, reviewing and supervising the activities of the Islamic financial institution in order **to ensure that they are in compliance with Islamic Shariah rules and principles**
- ❑ The **fatwa and rulings** of the Shariah Supervisory Board shall be **binding** on the Islamic financial institution



Among common practice...

- ❑ Appointment of “In-house Shariah Supervisory Board” members

- ❑ Some Islamic financial institutions have established their own dedicated “Shariah Review and Audit Department” or unit to support Shariah Supervisory Board

- ❑ Main responsibility of the SSB with the assistance of the department is on –
 - ❑ Ex-ante and ex-post Shariah rulings, and
 - ❑ Monitoring and supervising



Composition...

- ❑ The **AAOIFI Standard** requires at least 3 individuals

- ❑ Legal/statutory requirement varies—
 - ❑ From 1 individual, or
 - ❑ At least 3 individuals (Malaysia)

- ❑ In **contemporary practice**, most of the Islamic financial institutions appoint **between 3 to 6** members to the Board



Qualification... (MALAYSIA)

- ❑ A member of a Shariah Committee **shall be an individual**. A company, institution or body shall not constitute a Shariah Committee

- ❑ The member of the Shariah Committee shall at least either have **qualification** or possess necessary **knowledge, expertise or experience** in:
 - ❑ Islamic jurisprudence (*Usul al-Fiqh*); or
 - ❑ Islamic transaction/commercial law (*Fiqh al-Muamalat*)

- ❑ **Paper qualification** on the above **will not be mandatory** as long as the candidate has the necessary expertise or experience in the above areas



Qualification... (PAKISTAN)

□ Educational Qualification

- Degree from any recognized *Waffaqul Madaris (Darse-e-Nizami)* with a minimum of 2nd Class Bachelor Degree with Economics;
- Degree from any recognized *Waffaqul Madaris (Darse-e-Nizami)* with *Takhassus Fil Fiqh* and sufficient understanding of banking and finance; or
- Post Graduate Degree in Islamic Jurisprudence / *Usuluddin*, LL.M (Shariah), etc from any recognized university with exposure to banking and finance

□ Experience and Exposure

- Must have at least 3 years experience of giving Shariah rulings; or at least 5 years experience in research and development in Islamic banking and finance
- Reasonable knowledge of Arabic and English languages is necessary



Qualification... (PAKISTAN)

- ❑ State Bank of Pakistan, **at its sole discretion**, can give **relaxation** in respect of educational qualification and experience in **exceptional cases** where the person is otherwise **qualified** for giving Shariah rulings on banking and financial matters

- ❑ **Track Record**
 - ❑ The Shariah advisor must have an **impeccable track record** in social, economic and financial dealings

 - ❑ Has not been **terminated or dismissed** in the capacity of employee or director/chairman from any institution, firm or a company



Qualification... (PAKISTAN)

- ❑ **Solvency & Financial Integrity:**
 - ❑ Has not been associated with **any illegal activity** especially relating to banking business
 - ❑ Has not been **in default of payment of dues** owed to any financial institution and/or **default in payment of any taxes** in individual capacity or as proprietary concern



Qualification... (PAKISTAN)

- ❑ **Integrity, Honesty and Reputation:**
 - ❑ Has not been **convicted** in any criminal offence or involved in financial impropriety and moral turpitude
 - ❑ Has not been subject to any **adverse findings** or any settlement in **civil/criminal proceedings** particularly with regard to investments, financial/business, misconduct, fraud, etc
 - ❑ Has not **contravened** any of the requirements and standards of regulatory system or the equivalent standards of requirements of any regulatory authorities
 - ❑ Has not been **debarred for giving religious** rulings by any religious institution/body



Roles and Responsibilities...

- ❑ The Shariah in Islamic finance **has a crucial role** not only in **governing financial transactions** and operations, but also in **monitoring and supervising** the roles of all players within the financial system
- ❑ Hence, the role of the SSB mainly **must cover ex-ante** Shariah rulings **as well as ex-post** Shariah rulings
- ❑ Tasks include **reviewing and certifying the permissibility** of all contracts, documentation and products



Roles and Responsibilities... *contd.*

- ❑ **Execution** periods (interim)
- ❑ Confirming the **consistency and compliance** level of the practices **to Shariah rulings** made (Shariah audit)
- ❑ **Advising** and monitoring the manner of disposing the non-Shariah compliant earnings
- ❑ Issuing a **Shariah supervisory report** certifying that all transactions conducted by the Islamic FI **comply with Shariah** (normally incorporated in the **annual report** of the Islamic FI)



Some Concerns...

- ❑ A situation of **conflict of interest** may occur—
 - ❑ when a product or instrument of the Islamic FI is brought up for approval from the central bank's **higher Shariah body**,
 - ❑ where a Shariah advisor sitting in the central bank's higher Shariah body **also serves** that particular Islamic FI

- ❑ Issues of concern: **secrecy and confidentiality** of trade secrets when a Shariah advisor serves more than one Islamic FI in same industry



Section 4

Propositions for a Better Shariah Governance

The way forward in Shariah governance in Islamic finance industry...



- ❑ The need to apply the **best practices** in Shariah governance for the Islamic FI
- ❑ There is **no hard and fast rule**, no single model which is applicable for all
- ❑ Taking into account the **level and pace of Islamic finance development**, it may vary from one country to another

The way forward in Shariah governance in Islamic finance industry... *contd.*



- ❑ The Islamic financial services industry is notably still in its **infancy stage**
- ❑ Therefore, any **rigid, rule-based approach** adopted in haste aiming at strengthening the governance of the industry **may jeopardise** and hinder its potential and healthy growth
- ❑ However, some common elements that underlie good governance and best practices **may be drawn to facilitate the creation and optimise** a healthy and viable environment for Shariah governance without impeding further growth of the industry



Some thoughts for consideration...

- 1) Shariah Advisory Council vis-à-vis Shariah Supervisory Board of Islamic FI
- 2) Composition and Qualification
- 3) Scope of Supervisory Responsibilities
- 4) Internal & External Shariah Review/Audit

Shariah Advisory Council vis-à-vis Shariah Supervisory Board of Islamic FI



- ❑ The **establishment** of regulator's/central bank's Shariah Advisory Council **by way of promulgation of law**
- ❑ To accord the **final Shariah authority** to the Shariah Advisory Council in matters relating to Islamic banking and finance
- ❑ To appointment of its members **from various related background** e.g. Shariah, legal, economic, finance etc with the members **shall consist mainly** Shariah scholars

Shariah Advisory Council vis-à-vis Shariah Supervisory Board of Islamic FI *contd.*



- ❑ To allow the regulator's/central bank's Shariah Advisory Council members **to serve in the Islamic FI's SSB**
- ❑ However, to limit the membership in Islamic FI by appointing **only one Shariah advisor** from regulator's/central bank's Shariah Advisory Council to its SSB– in order **to avoid concentration**
- ❑ To classify the industries into **Islamic banking and takaful** and to allow Shariah advisor to serve only one Islamic FI in the same category



Composition and Qualification

- ❑ To consider a **combination** of **internal** Shariah advisor (Shariah personnel) as member secretary and **external** Shariah advisors

- ❑ External Shariah advisors **should not be less than 3**

- ❑ Qualification—
 - ❑ To identify the **criteria for recognising** a person as a qualified Shariah advisor in Islamic finance
 - ❑ To have a **professional body** or industry association that will set **professional standards** for Shariah advisors serving the Islamic financial services industry
 - ❑ To introduce **continuous professional development** and assessment (like CPD/CPE points) for Shariah advisors



Composition and Qualification *contd.*

- ❑ External Shariah firm can be consulted to develop products, but **permanent SSB is indispensable**

- ❑ To establish **procedures** in managing the SSB–
 - ❑ Appointment of members
 - ❑ Meeting and consultation procedures
 - ❑ Report on Shariah compliance review
 - ❑ Record & publication of Shariah rulings

- ❑ The SSB also could issue **recommendations** on how the institution could best fulfill its **social role** as well as promote Islamic finance



Scope of Supervisory Responsibilities

- ❑ Need to focus the Shariah supervisory process into both **macro as well as micro analysis** to the operations and practices of the Islamic FI
- ❑ Should not be limited only to **products development process** and its verification, but also to cover the banking practices and conduct of the Islamic FI as a whole
- ❑ It is noted that although almost all SSBs have **access to the ex-ante Shariah rulings**, but the **practice of ex-post Shariah rulings** is a matter of concern/not being looked into **thoroughly** by the SSBs of some Islamic FIs



Internal & External Shariah Review/Audit

- ❑ To perform a **Shariah compliance review**– both internal and external
- ❑ To give due emphasis and more focus on the conduct of external **ex-post Shariah compliance review**
- ❑ To have **close working relationship** between Audit Committee & the internal auditor/Shariah reviewer with the external auditor to enhance the external auditor's capabilities **in conducting such Shariah compliance review** as part of the audit works
- ❑ Need to have a **format for Shariah compliance review**



Section 5

Conclusion



In conclusion...

- ❑ The importance of Shariah governance in Islamic FIs is **undeniable**
- ❑ Proper mechanism & framework need to be created to enable **proper advisory and supervisory** role of SAC/SSB
- ❑ **Integration** between the SAC and SSB of Islamic FIs should be facilitated to provide a **conducive environment** for a better Shariah governance
- ❑ The scope of advice and supervision must include **both micro and macro issues** of Islamic FIs

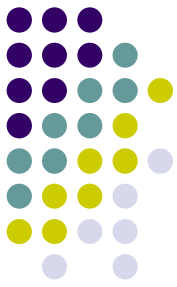


In conclusion...

contd.

- ❑ Proper framework should be put in place **to ensure optimal Shariah governance** of Islamic FIs—
 - ❑ on the appointment of SAC & SSB members, relationship between the two bodies, membership, procedures etc
 - ❑ on the scope of advice and supervision, it should be a **holistic approach, looking not only at particular contracts or structures, but on the operations of Islamic FI as a whole**, covering before, during and after the execution of all products and structures
 - ❑ on the **internal and external Shariah compliance review/audit**, there is dire need for a proper framework and guidelines

- ❑ **Constant enhancement** on the framework is necessary to ensure optimal Shariah governance in Islamic finance



Thank You
&
Wassalam