

Sharia Assurance in Islamic Financial and Banking Industry:

An Analytical and Comparative Study

Dr. Ghalib Mohammad AL-Bulooshi

University of Bristol

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Ghalib Mohammad AlBulooshi

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ABSTRACT

This research aims to present a library-based study of the current institutional *sharia* governance and main national supervision frameworks in selected Muslim countries, namely, the Kingdom of Bahrain, the United Arab Emirates (Dubai), the State of Kuwait, the Sultanate of Oman, and the Federation of Malaysia.

Analysing and comparing diverse practices of important aspects of *sharia* governance and supervision, the study argues that the existence of a comprehensive framework for *sharia* assurance is essential at both institutional and national levels. It argues that the current institutional *sharia* governance and national *sharia* supervision, relying on internal tools, does not provide customers with sufficient compliance assurance of the financial institution and its activities with *sharia*. Instead, it potentially raises serious governance issues and operational concerns, mainly resulting from the shortage of *sharia* scholars, the scope of *sharia*-compliance supervision, the concept and use of external auditors, independence and conflicts of interest, the legal status of the SSB and its pronouncements, and the accountability of the SSB.

Further, the thesis underlines and discusses the efficacy of a number of practical solutions at institutional, national and international levels. These represent internal and external measures for *sharia* governance and supervision, mainly the segregation of roles of *sharia* scholars, the emergence of *sharia* consultancies, a global professional body for *sharia* scholars, the establishment of an international *sharia* rating system, and the emerging trend of centralisation.

In evaluation of the proposed solutions, the thesis notes and promotes the growing trend of centralisation of *sharia* governance and supervision at the national level, which is believed to help in minimizing the main concerns underlined. Nonetheless, it remains to be seen which emerging model of central *sharia* authority in the selected Muslim countries would prove to be more efficient in this regard.

Acknowledgements and DEDICATION

Before all, I would like to show gratitude to *Allah (SWT)* who enabled me throughout all the circumstances and challenges to finish and submit this study. I pray to him almighty to accept my humble effort and bless it to the benefit of the *ummah* (the Muslim community) and all humankind.

I wish to express my gratitude to the University of Bahrain for its support and sponsorship during my postgraduate studies, which greatly contributed to the successful completion of this study.

I would like to thank my supervisor Professor Keith Stanton for the cooperation and guidance provided during his supervision of this research.

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Last but in no way least, I would like to express my deep and sincere thanks and gratitude to my family for their consistent love and care. Without their long lasting patience and support, the completion of this work was not possible.

Finally, I would like to dedicate this work to all who care for Islamic Finance and Banking Industry Worldwide.

AUTHOR'S DECLARATION

I declare that the work in this dissertation was carried out in accordance with the requirements of the University's Regulations and Code of Practice for Research Degree Programmes and that it has not been submitted for any other academic award. Except where indicated by specific reference in the text, the work is the candidate's own work. Work done in collaboration with, or with the assistance of, others, is indicated as such. Any views expressed in the dissertation are those of the author.

SIGNED: .....Ghalib Mohammad Al-Bulooshi.....

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LIST OF ABBREVIATIONS

AAOIFI – Accounting and Auditing Organisation for Islamic Financial Institutions (Bahrain)

BOD – Board of Directors

BNM – Bank Negara Malaysia

CBB – Central Bank of Bahrain

CBK – Central Bank of Kuwait

CBO – Central Bank of Oman

DFSA – Dubai Financial Services Authority

DIFC – Dubai International Financial Centre

GCC – Gulf Cooperation Council countries

IFB – Islamic Financial and Banking industry/sector

IFR – Islamic Financial Business Module of the DFSA Rulebook

IFI – Islamic Financial Institution(s): This is used for both single and plural without adding (s) to the abbreviation (IFI)

IFSB – Islamic Financial Services Board (Malaysia)

ISAU – Internal *Sharia* Audit Unit

ISCU – Internal *Sharia* Compliance Unit

ISRU – Internal *Sharia* Review Unit

PLS – Profit and Loss Sharing

SAC – *Sharia* Advisory Council (Malaysia)

SSB – *Sharia* Supervisory Board(s): This is used for both single and plural without adding (s) to the abbreviation (SSB)

UAE – United Arab Emirates

CHAPTER ONE: INTRODUCTION TO THE RESEARCH

1.0 INTRODUCTION

Our modern lifestyle demands involvement with bankers, who currently play a variety of roles and engage in many activities.[1] It has become almost impossible to carry out any sort of commercial or even personal financial transaction without reliance on financial institutions, especially banks.

This constitutes the main reason behind the emergence of the regulatory trend, segregating the monetary policy framework of macroeconomic management from the microeconomic considerations of bank stability. As a result, bank supervision is separated from the monetary authority, and assigned to a specialised authority. The most significant example is the establishment in the United Kingdom in 1998 of the Financial Services Authority to take up the responsibilities of a 'mega supervisor'.[2] After the financial crisis of 2008, however, the supervisory functions were given back to the Bank of England.

Development in any country cannot be successful without the existence of a stable financial and banking system that ensures the efficiency of operation in the capital markets. Therefore, regulation and supervision is more important for banks than for other companies,[3] and banking companies are normally required to abide by the special rules prescribed by the financial regulators.

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[1] The multiple roles of banks were clearly evident in the 1980s. For more detail refer to Laurence Cecil Bartlett Gower, "Big Bang and City Regulation," *The Modern Law Review* 51, no. 1 (January 1988): P: 2–5.

[2] Muhammad Umer Chapra and Tariqullah Khan, "Regulation and Supervision of Islamic banks" (Occasional Paper No 3, Islamic Research and Training Institute of Islamic Development Bank, 2000), P: 30, http://www.scribd.com/doc/29418279/Regulation-supervision-of-Islamic banks; Abdul Ghafar Ismail, "Risk Based Supervision for Islamic Banking and Area of Concern" (Working Paper in Islamic Economics and Finance No. 1014, Research Center for Islamic Economics and Finance-Universiti Kebangsaan, Malaysia, October 2010), P: 6, https://www.academia.edu/4417389/Risk_Based_Supervision_for_Islamic_Banking_and_Area_of_Concern.

[3] Muhammad Umer Chapra and Habib Ahmed, "Corporate Governance in Islamic Financial Institutions" (Occasional Paper No 6, Islamic Research and Training Institute of Islamic Development Bank, 2002), P: 20, http://www.irtipms.org/pubtext/93.pdf.

Recently, Islamic finance and banking (IFB) has attracted much attention, in both Muslim and non-Muslim countries. Islamic assets were estimated at approximately $150 billion in the 1990s, and by 2011 IFB was valued at $1.14 trillion, growing at a rate of 10-15% according to the Global Islamic Finance Report. In fact, it is predicted to reach $2 trillion in the next 5-7 years.[4] The number of Islamic banks themselves grew from a relatively small number in the mid-1970s to several hundred today, operating in more than 50 countries.

The resurgence of Islamic finance suggests that the global financial order itself has entered a period of heightened uncertainty; Islamic economic thinking, with its emphasis on equity, risk sharing and participatory economic growth, could offer a fruitful starting point for a revision of global finance.[5]

From the regulatory perspective, the shift in financial regulators' attention resulting from the financial crisis is best expressed by Alan Greenspan, former chairman of the Federal Reserve in America, at a Congressional hearing: 'belief in deregulation had been shaken' and he admitted the 'need for tighter regulations' for the financial services industry.[6]

This actually coincides with interesting statements made by other high-ranking officials. In relation to deregulation of IFB, John Taylor (2004), the US Under Secretary of the Treasury for International Affairs, stated in a forum that, 'the lack of uniformity of standards for Islamic banking practices across Muslim countries makes it difficult to apply the same prudential regulatory standards across the board. This calls for more harmonisation of Islamic banking practices, which in

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[4] *Global Islamic Finance Report: Size and Growth of the Islamic Financial Services Industry*, May 2011, http://www.zawya.com/story.cfm/sidZAWYA20110505062447/Global_Islamic_Finance_Report_2011_Released.

[5] Lena Rethel, "Whose Legitimacy? Islamic Finance and the Global Financial Order," *Review of International Political Economy* 18, no. 1 (February 7, 2011): P: 95.

[6] Edmund Andrews, "Greenspan Concedes Error on Regulation," *New York Times*, October 23, 2008, http://www.nytimes.com/2008/10/24/business/economy/24panel.html?_r=0.

turn calls for harmonisation of *sharia* standards at the national and international levels.[7] Accordingly, William Rutledge (2005), the Executive Vice President of the Federal Reserve Bank of New York, speaking at a later conference, said that 'it is more important that we become more familiar with the principles and practices unique to Islamic finance in order to make our supervisory and regulatory judgments'.[8]

Given that the non-stop growth in IFB is not a result of demands coming only from Muslims but also from financiers and investors worldwide, a clear set of regulations to identify the unique aspects of this sector is required. Embodied frameworks are needed to ensure compatibility with Islamic teaching. To enable Islamic financial institutions (IFI)[9] to compete in both domestic and global financial markets, such regulations and frameworks should coincide with international standards, recognised and applicable at national as well as international levels.[10]

In this context, it is relevant to refer to Edward Kane's interesting concept of a 'regulatory dialectic', which may be especially useful in terms of IFB regulations. This allows for a dynamic interaction between the regulated and the regulator, where there is continuous action and reaction by all parties in a type of strategic

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[7] John Taylor, "Understanding and Supporting Islamic Finance: Product Differentiation and International Standards" (Forum on Islamic Finance Harvard University, Office of Public Affairs, U.S. Department of the Treasury, 2004), http://www.treasury.gov/press-center/press-releases/Pages/js1543.aspx.

[8] William Rutledge, "Regulation and Supervision of Islamic Banking in the United State" (*ABANA Conference on Islamic Finance: Players, Products & Innovations*, New York, 2005), http://www.newyorkfed.org/newsevents/speeches/2005/rut050422.html.

[9] This is used hereafter for both single and plural without adding (s) to the abbreviation (IFI).

[10] Chapra and Ahmed, "Corporate Governance in Islamic Financial Institutions," P: 74.

game. Kane suggests that Islamic financiers will find out by trial and error over a period of time what is acceptable and unacceptable to the regulators.[11]

1.1 RESEARCH STATEMENT

It is believed that a 'highly ethical, well regulated and beneficial Islamic financial architecture is possible'. However, the unique nature of Islamic financial services requires special discipline and therefore needs particular regulatory and supervisory attention. It requires 'more transparency in the work field, the existence of effective corporate governance, and better interaction with relevant international, regional and national institutions'.[12]

Being Islamic simply means that the character and conduct of the financial institution adheres to Islamic ethics and *sharia* law. This requires strong *sharia* governance within the corporate governance system of financial institutions.

This study aims to present a literature-based study of the existing institutional *sharia* governance system and the national *sharia* supervision frameworks of a number of Muslim countries. In this context, it will pay special attention to the implementation of the guidelines and standards issued by relevant international organisations, mainly the International Financial Services Board and the Auditing and Accounting of Islamic Finance Organisation.

Accordingly, it will address the legal position and role of the *Sharia* Supervisory Board (SSB),[13] and will evaluate the regulatory and supervisory efforts undertaken by the financial regulators. Analysing and comparing important

[11] Edward Kane, "Shadowy Banking: Theft by Safety Net" (*Financial Market Conference of the Federal Reserve Bank of Atlanta*, 2014). https://www2.bc.edu/edward-kane/Shadowy%20Banking.pdf.

[12] Sayyid Tahir, "Future of Islamic Banking" (*Discussion Paper for a Course Organized by the Central Bank of Iran and Islamic Research & Training Institute of the Islamic Development Bank*, March 2, 2003), P: 10, http://www.sbp.org.pk/departments/ibd/Lecture_8_Related_Reading_2.pdf.

[13] This is used hereafter for both single and plural without adding (s) to the abbreviation (SSB).

aspects of institutional *sharia* governance and national *sharia* supervisory frameworks, the research discusses and underlines the shortcomings in the system currently followed by financial institutions and the supervision undertaken by financial regulators.

The current institutional *sharia* governance system relies on tools internal to the financial institution, namely the SSB. Although their role is a much needed and very important one, it does not at present offer sufficient assurance that the financial institution and its activities are in full compliance with *sharia* principles and laws. Instead, the process of *sharia* governance raises serious governance issues and operational concerns, which this research will highlight.

Therefore, the thesis argues for centralising *sharia* governance and supervision through the appointment of a higher or final *sharia* authority, which should help to minimize the main governance issues and operational concerns.

1.2 IMPORTANCE OF THE STUDY

Historically, reliance on the conventional finance and banking industry and hosting conventional financial institutions and banks in Muslim countries was a legacy of the colonial influence. The absence of Islamic alternatives encouraged continuation of this situation. However, the coexistence of an Islamic financial sector alongside the conventional one after gaining political independence may, in the eyes of Muslim populations, have been unjustified. Unlike non-Muslim countries, Muslim countries are expected to promote the enforcement of *sharia* laws and therefore to encourage Islamic-based practices. In principle, they should preserve their Islamic identity and adhere to Islamic teaching at all levels, because they embrace Islam as the state religion and recognise *sharia* as an important source of its laws.

However, it appears that converting the dominant conventional financial system to a more strongly focused Islamic one is not yet a necessary priority for Muslim

governments and/or their financial regulators. Therefore, in addressing the standards and main aspects of the current institutional *sharia* governance system and national *sharia* supervision frameworks followed by Muslim countries, pioneer studies of IFB are indispensable to provide the understanding necessary for both individual Muslims and the *Ummah* (the Muslim community).

The importance of this subject matter is not based purely on religious grounds, but should also be seen from a business perspective. In terms of consumer protection, the expectations of customers from regulation is a matter of great relevance and weight. Consumers' expectations may apply not only to the relationship between financial institutions, but also to the relationship between the financial institutions and what the consumer expects of the regulatory system. There appears to be increasing recognition of the mismatch between what the law requires and what the consumer expects from the regulator.

The confidence of the public and, in particular, investors in the market place is crucial for the growth and survival of any industry. Since customers of IFB expect the financial institutions and their activities to comply with *sharia*, this needs to be taken into account by the policymakers and financial regulators. It is not only the desire to follow the religion and to support the *Ummah* that leads Muslims to demand Islamic financial services, but also the belief in Islamic wisdom.

Therefore, *sharia*-compliance has a high priority among identified risks. The survival of IFB, as an industry, depends largely on the confidence of customers and, most importantly, on its response to challenges to its identity. As fund providers seek *sharia*-compliant operations as a matter of principle, their perception regarding the financial institution's compliance with *sharia* principles is of great significance to the sustainability of the market place.

The governments and financial regulators under which IFI operate need to implement suitable governance and supervisory mechanisms to assure *sharia*-compliance. In terms of consumer protection, two types of regulation are

distinguishable: prudential and systemic. While the latter addresses safety and soundness for the purpose of avoiding systemic risk, the former is concerned with safety and soundness in relation to consumer protection and so can be applied, even if there is no question of systemic risk.[14]

In this context, the thesis identifies the shortcomings of the current *sharia* governance undertaken at the institutional level, and argues for further development of this system through the involvement and pro-active role of the national authorities to establish a more comprehensive *sharia* supervisory framework at the national level.

1.3 RESEARCH OBJECTIVES AND QUESTIONS

In consideration of the importance of the study, this research has the following main objectives:

- To determine the need for institutional SSB even in Muslim countries, and the efficiency of the current *sharia* governance system as implemented at the institutional level.

- To evaluate the ability of current *sharia* supervisory frameworks adopted by financial regulators of selected countries in minimising the governance concerns raised at the institutional level.

- To provide recommendations for a stronger *sharia* governance system at the institutional level, and a more efficient *sharia* supervisory framework at the national level, through the use of relevant internal and external measures.

- To discuss the nature of the challenges presented within the institutional *sharia* governance system and national *sharia* supervisory frameworks,

[14] Peter Cartwright, *Banks, Consumers, and Regulation* (Oxford and Portland Orgon, 2004), P: 1–6.

and the extent to which centralisation might be of help in minimising the issues or concerned raised.

In order to achieve these objectives, this research attempts to answer the following related questions:

- Does the current *sharia* governance system at the institutional level, backed by the different *sharia* supervisory frameworks at the national level, offer sufficient *sharia* assurance for the Islamic banking sector in the selected Muslim countries?
- What concerns and challenges do the current institutional *sharia* governance system and national supervision frameworks raise?
- How such concerns could be minimised?

1.4 METHODOLOGY OF THE RESEARCH AND ITS LIMITATIONS

A qualitative descriptive research methodology has been selected to achieve the main aims of this study. The research is literature-based, and library sources have been primarily used.

For the purpose of this study, academic and professional writings including books, journals, occasional papers, conference papers, working papers, research papers, surveys, theses and other materials are referred to. With regard to the countries under study, the primary data is from original sources such as regulations, legislation, rulebooks and reports.

Furthermore, a wide and comprehensive range of the publications of specialised bodies have been considered, such as the Organisation of Islamic Cooperation, the Islamic Development Bank, the International *Sharia* Research Academy, the General Council for Islamic Banks and Financial Institutions, and the Bahrain

Institute of Banking and Finance. In particular, the standards of the International Financial Services Board, the Auditing and Accounting of Islamic Financial Institutions and relevant publications issued by central banks are discussed.

LIMITATIONS OF THE RESEARCH

In completing this study, several limitations have arisen, one being the lack of available data. Firstly, there is limited literature on the subject matter. Secondly, data is unavailable or not accessible, as it is considered sensitive at both institutional and national levels. Nonetheless, the study benefits from informal interviews conducted by the researcher and discussions with workers, professionals, scholars, and officials who are involved in the field, and so certain knowledge has been obtained regarding the subject matter and the practical issues highlighted here.

Also, the research was interrupted by health and personal matters, and therefore was not able to take advantage of some of the research tools that the researcher had intended to use.

An empirical survey in support of the theoretical conclusion of this thesis was not possible or advisable for many reasons, including lack of time. Further difficulty was experienced in reaching the desired sample for a survey due to the high sensitivity of the subject. Nonetheless, the research benefits from some recent surveys into related subject matter, enhanced by the researcher's informal meetings with high-ranking staff, professionals and officials.

Taking these challenges into consideration, it was decided to maintain the theoretical nature of this research, with the aim that the focus of this study would open doors for other interested researchers to undertake further empirical studies.

Nevertheless, in the event of a future survey or formal interviews being carried out, the subjectivity of potential participants and the questionable accuracy of their responses should be taken into consideration.

1.5 RELATIONSHIP WITH LITERATURE AND ORIGINALITY

The views of earlier Islamic figures such as Syed Abul Aala Maududi (1903-1979), Sayyid Qutb (1906-1966), and Baqir Al-Sadr (1935–1980) laid the groundwork for later economists and *sharia* scholars concerned with modern IFB operations. Although they were Islamic thinkers and not specialist economists or financiers, their views greatly influenced the industry.

Although writings on modern Islamic economics were evident in the 1940s, none of these concentrated on the subject of interest-free banking. A number of publications appeared in the 1950s on interest-based and interest-free institutions, but it was not until the 1960s-70s that there was a significant increase in writing about Islamic banking itself.[15] The earliest references to the reorganisation of banking on the basis of profit sharing rather than interest are from the late 1940s, e.g. Anwar Qureshi (1946), Naiem Siddiqi (1948) and Mahmud Ahmad (1952), followed by more detailed reports from Mawdudi in 1950 (1961), and Muhammad Hamidullah (1944, 1955, 1957, 1962). In the late 1960s and early 1970s, Abdullan Al-Araby (1967), Nejatullah Siddiqi (1961, 1969), Al-Najjar (1971) and Baqir Al-Sadr (1961, 1974) were the main contributors. They had all recognised the dangers of earning interest in that enterprise, and proposed a banking system based on the concept of profit and loss sharing (see chapter two).

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[15] For a list of examples refer to Mohammad Nejatullah Siddiqi, "*Sharia*, Economics and the Progress of Islamic Finance: The Role of *Sharia* Experts," *Pre-Forum Workshop on Select Ethical and Methodological Issues in Shari'a-Compliant Finance, Seventh Harvard Forum on Islamic Finance*, April 21, 2006, http://www.siddiqi.com/mns/Role_of_sharia sharia h_Experts.htm.

A wealth of literature exists today on IFB; although writers use slightly different approaches, the subjects they address have much in common. For example, there is a strong focus on the Islamic vision of the economy and the Islamic financial system. Some writers approach the subject from the historical standpoint (e.g. Siddiqui 1982, Mirakhor 1995, Schoon 2008, Kuran 2004). Others highlight the contributions of prominent Islamic economists or scholars (e.g. Wilson 1998, Chapra 2004, Aziz and Mahmud 2009, Monzer Kahf 2005, Siddiqi 2006). However, the majority address the evolution and application of the Islamic economy or finance (e.g. Bjorvatn 1998, Iqbal and Mirakhor 1999, Iqbal 2005, Khan and Mirakhor 2005, El-Gamal 2006, Timur Kuran 2005, Choudhury and Hussain 2005, Ahmed 2010).

Literature on IFB operations discusses the *sharia* principles and laws with regard to finance, and addresses IFB methods. Authors mainly refer to the Islamic prohibition of *riba* and interpretations given regarding 'bank-interest' (e.g. Saeed 1996, Qureshi 2003, Siddiqi 2007, Kula 2008, Chong and Liu 2009). The legitimacy of profit in Islam is also touched on, in sufficient depth (e.g. Saleh and Ajaj 1992, Rammal 2004). In indicating the distinctive conceptual framework of IFB operations, the partnership model (e.g. Moore 1997, Siddiqi 2007), otherwise known as equity-financing (Akacem and Gilliam 2002, Yusof et al 2009), is underlined, and other instruments of Islamic finance are explored (e.g. El-Gamal 2000, Uthmani 2008, Jabbar 2009).

The similarity between Islamic and conventional banking operations forms a growing body of literature. The adherence of modern operations to the Islamic theory of finance forms the basis of a great deal of discussion (e.g. El-Diwany 2000, Ansari and Memon 2008, Maclean 2007, Yusof and Fahmy 2008, Warde 2009, Ahmad et al 2010). Also, the financial instruments that are used are often evaluated (e.g. Zaman and Movassaghi 2002, Anwar 2003, Arbouna 2007, Ali 2008).

The growth of IFB operations at the global level is widely acknowledged (Rodney Wilson 1995, Hamwi and Aylward 1999, Warde 2000, Archer and Karim 2002, Iqbal and Molyneux 2004, Monzer Kahaf 2004). Underlying the IFB operations at the international level are difficulties facing the establishment of an Islamic financial system, and legal issues related to Islamic operations (e.g. Iqbal, Ahmed and Khan 1998, Errico and Farahbaksh 1998, Chapra and Khan 2000, Sundararajan and Errico 2002, Iqbal and Mirakhor 1999, Memon 2007, Hassan and Lewis 2007, Karim and Archer 2007, Hesse, Jobst, and Sole 2008).

With regard to the legal environment in which IFB functions, implementation of Islamic practices in the conventional financial system forms a major area of study. Authors mainly discuss the legal position of Islamic banks in Western countries (e.g. Errico and Farahbaksh 1998, Sole 2007, Aldohni 2008, Abdul-Majid, Saal, and Battisti 2009, Lepetit et al. 2008, Khan and Porzio 2010).

However, there is a lack of literature addressing the Islamic financial and banking (IFB) sector and its legal position in Eastern countries, especially the Middle East. Although a small amount of literature exists in relation to Islamic banking in the Arab region (e.g. Ray 1995, Molyneux and Iqbal 2005, Hassan, Mohamad, and Bader 2009), and some sources are available on Gulf Cooperation Council countries (Hussain et al. 2002, Qahtani 2005, Ramanathan, 2007, Al- Al-Muharrami 2007, Chazi, Terra and Zanella 2010), they do not address the legal position of the IFB or the governing laws in sufficient detail.

Approaching the subject from the Islamic, economic, and legal aspect reveals a greater amount of material (e.g. Ali 1995, Al-Omar and Abdel-Haq 1996, Moore 1997, Vogel and Hayes 1998, Khan 2000, Iqbal and Mirakhor 2006, Hassan and Lewis 2007, Iqbal 2007, Lee and Detta 2007, Swee-Hock and Wang 2008, Blair, Walker, and Purves 2009, Haron and Nursofiza Yahia Abdul-Rahman 2010). However, the legal perspective is discussed less, and the regulatory process,

particularly at the national level, is not adequately covered, especially in Muslim countries.

With regard to legal concerns, the compliance of the financial institutions with *sharia* has recently received some attention. The necessity of appropriate corporate governance arrangements for Islamic banks and the implementation of SSB within the corporate governance structure have been the subject of some literature, although there is less literature on the *sharia* governance process than on conventional corporate governance.

Some studies address corporate governance from the Islamic perspective (e.g. Banaga et a 1994, Chapra and Ahmed 2002, Choudhury and Hoque 2006, Grais and Pellegrini 2006, Hameed 2007, Lewis 2009). A few others provide a comparative analysis of the Islamic and Western corporate governance concepts (e.g. Hasan 2009, Malekian Daryaei 2010).

However, most of the recent literature discusses the subject matter from a legal perspective, addressing challenges faced in implementing the *sharia* governance system (Yunis 2007, Karim and Archer 2007, Volker Nienhaus, 2007, Hassan, Saroni 2008, Salahudin 2008, Shanmugam and Perumal 2009, Hassan 2010). And interestingly, a number of recent writings discuss *sharia* supervisory models (e.g. Hasan 2007, Laldin 2011) with attention particularly being paid to the position and role of the SSB (e.g. Bakar 2002, Hassan 2010).

ORIGINALITY

The legal position of the IFB in Muslim countries is discussed less than in non-Muslim countries. Furthermore, the role of the supervisory boards in *sharia* governance is more frequently addressed than the role of the national authorities, including the financial regulators, in establishing proper *sharia* supervisory frameworks. Also, the role undertaken by the supportive international organisations, as the setters of standards, is given less attention in this regard.

The originality of this research lies in its aim to contribute to the subject of the institutional *sharia* governance system and national *sharia* supervisory frameworks in the IFB of selected Muslim countries, paying special attention to the role of the institutional SSB, the financial regulators, and relevant *sharia* authorities at the national level.

Confining the study to selected countries, namely the Kingdom of Bahrain, the United Arab Emirates (UAE), State of Kuwait, the Sultanate of Oman and the Federation of Malaysia is expected to be more productive, especially knowing that these countries apply different *sharia* supervisory frameworks and have led efforts in respect of the regulation of IFB when compared with the rest of the Muslim world. There is no study which discusses in detail their legal and regulatory perspectives in addressing national laws or discussing the financial regulators' contributions in assuring *sharia*-compliance within the IFB. Therefore, the selection of these particular countries for study further supports this research's originality.

The overall aim is to compile a useful literature base regarding the legal standing of IFB as an industry, and to provide a comprehensive review of the regulatory perspective of the *sharia* governance system and supervision frameworks in the selected countries. As they apply different *sharia* supervisory frameworks, monitoring the common institutional *sharia* governance system will result in a comparison of problems and similarities in practice. Hence, it is intended to present workable solutions for a potentially more efficient *sharia* assurance control.

As there is currently limited literature on this specific subject, this research will be a primary source for further studies in this area, and at the same time illuminate the way for future researchers.

1.6 PLAN OF CHAPTERS

The use of the aforementioned sources of data will vary from one chapter to another, depending on their nature and subject matter. Chapter one serves as an important introductory section for this research.

Chapter two first identifies the conventional financial system as current global practice and highlights the development of Islamic financial operations in the Islamic region without any special regulatory framework. This creates an argument for the establishment of organisational support needed to back up the sector, as discussed in a later section of this chapter. Covering this will enable understanding of the current legal standpoint of the IFI and Islamic banks and, more importantly, pave the way for evaluating the regulatory infrastructure that is currently in place to support their operations. Although of a historical nature overall, this chapter does include analytical sections and gives the necessary background relating to the importance of the institutional *sharia* governance system.

Chapter three explains the differences between Islamic and conventional financing. Firstly, it discusses the distinctive conceptual framework of Islamic financing by explaining the implementation of Islamic financial principles in modern banking operations. Then, the genuine differences between conventional products and the modifications applied to the original structures of classical financial instruments used in modern IFB are demonstrated. It is argued that Islamic products should fit seamlessly within the framework of the dominant conventional financial system. In comparing Islamic and conventional financing, the chapter argues that uniform Islamic financial interpretations are unlikely, therefore emphasising the relevance and importance of the existence and decision-making function of a *sharia* body such as the supervisory board within the governance structure of the financial institution.

Accordingly, Chapter four identifies the need for and the process of *sharia*-compliance supervision in modern Islamic states. It addresses firstly *sharia* governance as an additional layer of the corporate governance in IFI and banks, and its specific objectives compared to traditional corporate governance. It moves on to discuss the implementation of the SSB in the corporate governance structure, explaining the current *sharia* system usually adopted by such institutions following the guidance and the standards issued by the Islamic Financial Services Board and the Accounting and Auditing Organisation of Islamic Financial Institutions. This will provide the necessary basis for argument in the following chapters.

To evaluate the role and efficiency of the institutional *sharia* governance system discussed in the previous chapter, Chapter five introduces the national perspective of *sharia*-compliance supervision. Taking an analytical and comparative approach, it addresses the existing frameworks of *sharia* supervision as adopted in the selected Muslim countries: Bahrain, UAE, Kuwait, Oman and Malaysia.

Chapter six notes the reliance on the internal *sharia* governance system, and discusses the prime issues and practical concerns in regard to the current system.

Given the similarities and differences identified among the selected countries, chapter seven underlines the main practical solutions of the problems highlighted, and evaluates their efficiency.

Finally, chapter eight serves as an concluding summary of this study. It summaries the outcomes of the chapters providing answers for the raised research questions. Lastly, it recommends further research using this thesis as a basis on which to proceed.

1.7 CLARIFICATIONS OF TERMS

The thesis refers to a number of commonly used Islamic financial terms. As they are of Arabic origin, these words are shown in italic. An equivalent meaning in English is given in parentheses in their first appearance, and definitions of the terms are included in a glossary of Islamic terms in an Appendix.

CHAPTER TWO: HISTORICAL BACKGROUND

2.0 INTRODUCTION

In order to gain a thorough understanding of the current legal stance of Islamic banks, it is important to address the legal environment and difficulties which led to and accompanied its establishment within the contemporary systems of modern Islamic states.

Therefore, this chapter first identifies the conventional financial system as being the global financial system, and highlights the evolution of Islamic financial operations in the predominantly Islamic region free from any special regulatory framework.

This will help to argue for the establishment of the organisational support needed for the IFB, as discussed in the later sections of this chapter.

2.1 ROOTS OF MODERN BANKING AND ITS NATURE

The relationship between banker and customer is not a new one; similar relationships have long existed. For instance, storing valuable belongings with neighbours, trusted friends or respected persons was a widespread practice amongst people worldwide, especially when leaving home for a long journey or for any other private reason. Such practice was indeed recognised by Arabs before Islam, and was continued by Islamic communities, specifically when travelling for distant trade or work purposes.

Although the cornerstone of this relationship was trust, the traveller occasionally rewarded the trustee for safekeeping his belongings, especially if he was not bound by a family relationship. Even though a family member would usually guard possessions without expecting payment or reward, the owner tended to give something to compensate for any potential trouble. It is true that such a practice does not reflect today's banker-customer relationship; nonetheless, it

can be deemed as the concept from which banker-customer relationships evolved.

In fact, the safekeeping of valuables started to evolve as an organised institutional practice long before Islam and as early as the era of religious temples, going back to the third millennium BC.[16] This predated the invention of money, and deposits consisted of agricultural implements rather than precious metals such as gold.

After the invention of money, there is evidence of priests lending money to merchants in Babylon around the eighteenth century BC. The Hammurabi codes which were written in the same period regulated and organised practices similar to banking in ancient Mesopotamia. Obviously, such practices extended to traders and were no longer restricted to temples or priests.[17]

Other banking activities such as money exchange were evident before the appearance of Islam. Interest-free financial institutions also existed long before the existence of modern conventional banks and the establishment of the interest-based financial system. Documented history particularly refers to the Ajibi Bank established in about 700 BC i.e. during the Babylonian era, as the first interest-free bank.[18]

Banking operations became reliant on interest and thus acquired a commercial nature when trade began to flourish. The rising popularity of Christianity, which banned interest, at the time of the fall of the Roman Empire was initially behind the decline of banking in Europe. It was the weakening of the Catholic Church's

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[16] According to the Western calendar, BC refers to the date before the Prophet Isa (Jesus) was born. AD refers to the date after he was born.

[17] Natalie Schoon, "Islamic Finance–An Overview," *European Business Organization Law Review* 9, no. 04 (2008): P: 622.

[18] For more details refer to Salo Wittmayer Baron, *A Social and Religious History of the Jews* (Columbia University Press, 1969).

power in the Reformation which helped banking to reappear in Europe, with a commercial nature and dealing openly with interest.

With the declining role of the Church as the lender of money, merchants began to finance individuals and governments; some lent the capital deposited with them in addition to their own funds as merchant bankers. Over time, the no-interest principle was abandoned and an interest-based banking system evolved in its place. There are other factors behind the creation of an interest-based financial system in the West, including the change from agrarian to commercial economies, the move towards pricing on the basis of supply and demand, and the recognition of money as a factor of production.[19]

Indeed, it was the combination of many factual and legal elements that gave birth to the conventional financial system that we are familiar with today. Nonetheless, it was the legalisation of interest in the Middle Ages which placed the Western banking industry on the track to development which eventually produced the interest-based financial system. Although the history of charging interest is widely documented in different eras, the legalisation of interest that took place in Valencia in 1217 and in Florence in1403 is marked as having a major impact on the opening of the banking industry in Europe.[20]

Thus, banks in the modern sense, i.e. as financial mediators, were first identified in the West. In this respect, some documents indicate that Barcelona got its first chartered bank in 1401 and Genoa in 1407.[21] However, a bank named Monte dei Paschi di Siena, established in Italy in 1472, is claimed by some to be the world's

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[19] Joe DiVanna, "A Cloud Is a Promise, Fulfilment Is Rain," *NewHorizon*, 2008, http://www.newhorizon-islamicbanking.com/index.cfm?action=view&id=10627&section=features.

[20] Schoon, "Islamic-Finance–An Overview," P: 624.

[21] Stephan Epstein, *Freedom and Growth: The Rise of States and Markets in Europe, 1300-1750*, 1st edition. (Routledge, 2000), P: 66.

oldest bank,[22] although other writers refer to the establishment of the Banco Della Pizza at the Rialto in Venice in 1587.Conventional banking came into existence in England only in 1640, and the Bank of England was established in 1694.[23]

If we discuss modern banking practices, particular reference must be made to the goldsmiths of the seventeenth century who worked as depositories for their clients' plate and gold[24] and are the precursors of modern bankers.[25] In times of instability and danger, goldsmiths stored money and valuables for which they issued written receipts. Over time, these receipts began to be dealt with as promissory notes, which the holder was able to use to withdraw an amount equal to the original deposit. The practice developed through time. On one hand, promissory note holders started to settle their debts through these notes. On the other hand, deposits began to be used for personal investments and were refunded when demanded by the depositor.[26] The practice developed, eventually establishing what is recognised nowadays as the conventional banker-customer relationship.

It was established that these 'modern' banks usually paid interest to depositors. However, very few people considered opening and using bank accounts at this time, as it was only the wealthy who owned transferable property and wanted to write cheques.[27]

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[22] Stephen Valdez, *An Introduction to Global Financial Markets*, 5th edition (Palgrave Macmillan, 2006), P: 15.

[23] Sudin Haron and Wan Nursofiza, *Islamic-Finance Banking System*, 1st edition. (McGraw-Hill Professional, 2009), P: 44.

[24] Peter Ellinger, Eva Lomnicka, and Richard Hooley, *Ellinger's Modern Banking Law*, 4th edition. (OUP Oxford, 2005), P: 121.

[25] Tarek El-Diwany, "Is Islamic Banking Islamic?," *Islamic Research Foundation International*, June 2003, http://www.irfi.org/articles/articles_301_350/is_islamic_banking_islamic.htm.

[26] Lorne Crerar, *Law of Banking in Scotland*, 2nd Revised edition (Tottel Publishing, 2007), P: 187.

[27] Alastair Hudson, *Hudson Law of Finance*, 1st edition. (Sweet & Maxwell, 2009), P: 731.

Later on, so-called modern banking services became available to the wider public. Obviously, commercial gain was the main motivation for bankers to offer multiple services to ordinary individuals, and the necessity of using bank accounts and dealing through bankers imposed by modern life encouraged ordinary individuals to establish relationships with bankers.

Thus, the banking sector today is deemed to be a commercial one. The banker-customer relationship, although having some characteristics other than the purely commercial, has without doubt evolved into a business nature.

2.2 MODERNISATION OF SYSTEMS IN THE ISLAMIC REGION

The conventional financial system is over 800 years old,[28] and the institutional development of conventional banks is related to the economic growth of Europe over the past 500 years.[29]

The Islamic region had succumbed to Western colonisation by the tenth century after *Hijra* (the beginning of the Islamic calendar).[30] The commercial evolution of the Islamic region as an important trading partner with European companies motivated European institutions such as the Dutch East India Company to establish branches in the Middle East and Asia from early in the seventeenth century.[31] With the start of the industrial revolution, Western countries experienced a commercial transformation and enjoyed economic superiority, taking the lead in institutional and industrial developments, including the financial

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[28] John Foster, "How sharia sharia -Compliant Is Islamic Banking?," *BBC News*, December 11, 2009, sec. Business, http://news.bbc.co.uk/1/hi/business/8401421.stm.

[29] Aaron Maclean, "Islamic Banking: Is It Really Kosher?," *American Enterprise Institute*, April 2007, http://www.american.com/archive/2007/march-april-magazine-contents/islamic-banking-is-it-really-kosher/.

[30] Nicholas Ray, *Arab Islamic-banking and the Renewal of Islamic-Law*, 1st edition. (Springer, 1995), P: 19.

[31] Schoon, "Islamic-Finance–An Overview," P: 625.

and banking systems.[32] In this respect, the original Cairo branch of Barclays Bank, which opened in the latter half of the 19th century to process financial transactions related to the construction of the Suez-Canal, is understood to be the first commercial bank established in the Muslim world.[33] The conventional financial system was soon introduced into the Islamic region at large. For example, the Imperial Bank of Persia and the National Bank of Egypt were both British owned, and the Imperial Ottoman Bank began as an Anglo-French venture.

These imperial banks served the government and the trade of the European empires rather than the local business of Muslim communities. At the time, much of the financial mediation in the Ottoman territories was in the hands of the Greek Christians or Jews, rather than Muslims. Similarly, the finance of the cotton trade in Egypt was basically controlled by the Greek and Levantine merchants rather than the Egyptian Muslims. In Malaysia, the plantation workers of the rubber trade financed by the Hong Kong and Shanghai Bank were immigrants rather than indigenous Muslims.[34]

The West during this time enjoyed political as well as industrial superiority and therefore had an impact on the modernisation of the Islamic region. Its influence cannot be denied in the adoption of Westernised models, laws and systems.[35]

Obviously, the colonial masters managed the economies of most of the Islamic region and the population had in fact no input in choosing their own political and

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[32] Timur Kuran, "The Logic of Financial Westernization in the Middle East," *Journal of Economic Behavior & Organisation* 56, no. 4 (2005): P: 594.

[33] *Islamic Financial Services Industry Development: Ten Year Framework and Strategies* (Islamic Research and Training Institute of Islamic Development Bank and Islamic Financial Services Board, 2007), P: 2, www.ifsb.org/docs/10_yr_framework.pdf.

[34] Rodney Wilson, "Islamic Banking and Its Impact on the International Financial Scene," *Journal of International Banking Law*, no. 10 (1995): at 437.

[35] Frank Vogel and Samuel Hayes, *Islamic Law and Finance: Religion, Risk, and Return*, Student (CQ Press, 1998), P: 47.

economic systems. On one hand, the Muslim population needed to avoid dealing with Western commercial banks, in accordance with their faith and adherence to *sharia* principles and Islamic teachings. On the other hand, there was no other option but to use the facilities or services offered by the conventional financial institutions, despite serious reservations regarding their moral and ethical grounds,[36] and they remained cautious in their use of conventional financial services. For instance, some refrained from accepting interest or gave it away to charities,[37] while others confined their relationship with conventional banks to transactional activities such as money transfers or opened only current accounts.

Accordingly, the legalisation of interest, and the establishment of secular legal systems and secular courts were considered as necessary steps toward the formation of newly independent Islamic states.[38] Immediately after gaining statehood, governments, businesses and individuals had to deal with existing banks whether they liked it or not. In order to bring the financial and banking system closer to local traders and communities, local banks were then established. However, these banks were on the same lines as of the interest-based Western banks,[39] and the conventional system of finance and banking remained even after the Islamic region had gained its political freedom.

2.3 Demand for Islamic Alternatives

As governments believed religion had no role to play in commercial and financial matters, Western banks and their local counterparts in the Islamic region carried out interest-based business for more than fifty years after the independence of

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[36] Ausaf Ahmed, "The Evolution of the Concept and Practice of Islamic Banking-Part 1," *Council for Islamic banks and Financial Institutions*, April 26, 2010, http://www.cibafi.org/newscenter/english/Details.aspx?Id=7968&Cat=12.

[37] Munawar Iqbal, Ausaf Ahmed, and Tariqullah Khan, "Challenges Facing Islamic Banking" (Islamic Research and Training Institute of Islamic Development Bank, Occasional Paper No 1, 1998), P: 63, http://www.irtipms.org/PubText/80.pdf.

[38] Kuran, "The Logic of Financial Westernization in the Middle East," P: 593–594.

[39] A. L. M. Abdul Gafoor, *Interest Free Commercial Banking* (APPTEC Publications, 1995).

Islamic states.[40] The Islamic states compose only a small part of the world in which all countries interact in financial transactions as part of a long-established global economy with international financial markets. The wish to remain part of this network and the ability to participate in global commercial and financial transactions was influential when deciding on the legal and financial systems of the Islamic states.[41]

The financial relationships with the West motivated the adoption of civil and commercial laws instead of *sharia* laws. In this sense, full Islamisation of the legal systems or the country's economy, including the financial sector, was never a realistic option in the judgement of the newly appointed Muslim governments. This would have placed the newly independent Islamic states in a weaker legal and financial position in comparison to the rest of the world. Therefore, it was a logical, and maybe legally necessary, step that the secular legal and financial systems implemented during the colonial period needed to continue, at least without extreme change.

Most of the Islamic states have mixed legal systems in which the civil code is generally rooted in *sharia* laws and the commercial code is a more secular one. Family matters are the only sphere where *sharia* laws remain superior. Therefore, *sharia* does not have much significance in the laws and regulations concerning the commercial field, including the finance and banking sector.[42] The commercial code itself is a mix of legal traditions, mainly Anglo-Saxon common law due to the long influence of the British Empire in the Islamic region, and the

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[40] Rodney Wilson, "Islamic Finance in Europe," *Policy Paper No. 2007/02, Robert Schuman Centre for Advanced Studies*, 2007, P: 2, http://cadmus.eui.eu/bitstream/handle/1814/7739/?sequence=1.

[41] Kuran, "The Logic of Financial Westernization in the Middle East," P: 597.

[42] Lu'ayy Al-Rimawi, "Relevance of Shari'a in Arab Securities Regulation with Particular Emphasis on Jordan as an Arab Regulatory Model," *Company Lawyer* 27, no. 8 (2006): at 227–228.

codified laws of France introduced as these countries achieved statehood.[43] As far as commercial law is concerned, most countries use secular commercial statutes which are applied ahead of the civil codes and *sharia* laws.[44]

Obviously, the Muslim population and communities were dissatisfied with the services offered through the conventional financial and banking industry because of the suspicion surrounding the form in which they had developed in Europe, i.e. being interest-based. For instance, banks until the 1920s had been kept out of Saudi-Arabia by King Abdul Aziz, who believed that the practices of the Western banks could never be Islamically accepted. However, with the kingdom's development and the discovery of oil there were strong pressures to admit foreign banks.[45] Accordingly, the National Handelsbank of the Netherlands, the predecessor of ABN-Amro, was permitted to open a base in Jeddah providing money-changing services for pilgrims from Dutch Indonesia.

Also, the ruler of Bahrain in the 1920s instructed the Eastern Bank, the predecessor of Standard Chartered, that its branch would only be allowed to trade if it avoided all interest-based transactions.[46]

In fact, it was the involvement of Western banks in the Islamic region that resulted in demands for Islamic financing. As interest was openly utilised in several Islamic states, it was expected that Muslim believers would be likely to

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[43] Abdelaziz Chazi, Paulo Terra, and Fernando Zanella, "Theory versus Practice: Perspectives of Middle Eastern Financial Managers," *European Business Review* 22, no. 2 (2010): P: 197.

[44] Nabil Saleh, "The Law Governing Contracts in Arabia," *The International and Comparative Law Quarterly* 38, no. 4 (October 1989): at 776.

[45] Wilson, "Islamic Banking and Its Impact on the International Financial Scene," at 438.

[46] Rodney Wilson, "Financial Development of the Arab Gulf: The Eastern Bank Experience, 1917–50," *Business History* XXIX (1987): 178–98.

transfer all of their financial and banking transactions to the first available Islamic financial institution.[47]

Nonetheless, the emergence of IFB in Muslim nations, including the Gulf Cooperation Council countries (GCC), is a result of different factors of a religious, political and economic nature. They combined over a long period of time to develop Islamic banking principles from the theoretical to the practical level.[48]

In the late 19th and beginning of the 20th century, a strong Islamist movement emerged, stressing that the development of the Muslim world was reliant on the establishment of an authentic Islamic society, i.e. one which is free from non-Islamic elements,[49] and that Islam was capable of leading all aspects of human life.[50]

This movement fuelled opposition to the interest-based conventional finance and banking industry,[51] and called for economic reform as part of general political reform. This should be based on Islamic teaching and was not possible in the absence of an Islamic banking system. Therefore, the movement, otherwise known as 'neo-revivalism', had an influential role in developing Islamic banking theory via the interpretation of the ambiguous regulations and conditions that are

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[47] Abdul Samad, Norman Gardner, and Bradley Cook, "Islamic Banking and Finance in Theory and Practice: The Experience of Malaysia and Bahrain," *The American Journal of Islamic Social Sciences* 22, no. 2 (2005): P: 82.

[48] Abdul Karim Aldohni, *The Legal and Regulatory Aspects of Islamic Banking: A Comparative Look at the United Kingdom and Malaysia*, 1st edition. (Routledge, 2011), P: 9–10; Abdul Karim Aldohni, "The Emergence of Islamic Banking in the UK: A Comparative Study with Muslim countries," *Arab Law Quarterly* 22, no. 2 (2008): P: 181.

[49] Van Schaik, "Islamic Banking," *The Arab Bank Review* 3, no. 1 (2001): 45–52.

[50] Abdullah Saeed, *Islamic Banking and Interest: A Study of the Prohibition of Riba and Its Contemporary Interpretation* (BRILL, 1996), P: 7–8.

[51] Timur Kuran, *Islam and Mammon: The Economic Predicaments of Islamism* (Princeton University Press, 2004).

covered by the Islamic sources (i.e. Holy *Qur'an* and the *Sunnah*), more specifically the issue of *riba* (prohibition of interest).[52]

However, outlines of Islamic alternatives appeared only with the demise of colonial rule. Muslim communities had hoped that a lasting solution would appear when Muslim governments brought domestic laws and legal systems into conjunction with *sharia* laws, after gaining political freedom and statehood.[53] When the previous pledges were not actioned, the individual efforts of Muslims became directed to finding possible financial Islamic alternatives to the conventional financial and banking services.

Although the establishment of small-scale, limited-scope interest-free banks had been attempted before the1960s, one in Malaysia in the mid-1940s and another in Pakistan in the late 1950s, they were not successful.[54] Therefore, the true start of Islamic banking experiments is marked by the rise and fall of the Egyptian project of the Mit Ghamr Savings Bank established in the Nile delta during 1961-1964, considered the first ever successful initiative in modern Islamic banking.[55] In the same period Malaysia's Tabung Haji, i.e. Pilgrim's Management Fund, was set up by the Malaysian government in 1962, to help prospective pilgrims to save and profit. The Egyptian experiment led to the creation of the Nasser Social Bank in 1972, which is still operating but with more social objectives than commercial.[56] The Tabung Haji has flourished and become the oldest Islamic Financial Institution (IFI) in modern times.[57]

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[52] Aldohni, *The Legal and Regulatory Aspects of Islamic Banking: A Comparative Look at the United Kingdom and Malaysia*, P: 10–11; Aldohni, "The Emergence of Islamic Banking in the UK: A Comparative Study with Muslim countries," P: 182.

[53] Vogel and Hayes, *Islamic Law and Finance: Religion, Risk, and Return*, P: 21.

[54] See for instance Mervyn Lewis and Latifa Algaoud, *Islamic Banking* (Edward Elgar, 2001).

[55] Schaik, "Islamic Banking," P: 45.

[56] Gafoor, *Interest Free Commercial Banking*.

[57] *Islamic Financial Services Industry Development: Ten Year Framework and Strategies*, P: 3.

However, due to the failure of economic development in the Muslim world in particular and in the developing world in general, the institutional appearance of Islamic banks was not possible before the 1960s-1970s.[58] Modern Islamic banking had its debut in the 1970s with the establishment of more, for example, the Islamic Development Bank and the Dubai Islamic Bank (the first commercial bank) in 1975, the Faisal Islamic Banks in Egypt and Sudan in 1977, the Kuwait Finance House in 1977, the Jordan Islamic Bank in 1978, and the Bahrain Islamic Bank in 1979.[59] All were established and mandated to operate in adherence to *sharia* laws and Islamic teaching.

Since then, Islamic banking has made significant progress worldwide, particularly in South East and South Asia, the GCC, and the Middle East.

It must be noted that the Arab Gulf region is the origin or birthplace of Islamic banks. In particular, the GCC contributed to their development and helped in their reaching the international financial market. Therefore, the Gulf experience is an especially influential factor in the growth of Islamic banking. As the political and religious element formed the basis which encouraged investment in the field of Islamic finance, the role of the economic factors is a complementary one.[60] The 'Oil Revolution' in 1973-4 and the doubled price of oil in 1979 brought 'Oil Boom' wealth to the GCC, accompanying dramatic changes to their economies, and allowing them to play a central role in the global economy.[61] Accordingly, the surplus oil income was increasingly invested in the field of Islamic banking, and therefore, dealing with Islamic banks became more commonplace at the international level.

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[58] Maclean, "Islamic Banking: Is It Really Kosher?," P: 35.

[59] Wilson, "Islamic Banking and Its Impact on the International Financial Scene," at 439.

[60] Aldohni, *The Legal and Regulatory Aspects of Islamic Banking: A Comparative Look at the United Kingdom and Malaysia*, P: 11–12; Aldohni, "The Emergence of Islamic Banking in the UK: A Comparative Study with Muslim countries," P: 181–183.

[61] Hazem Beblawi, *The Arab Gulf Economy in a Turbulent Age*, 1st edition (London : New York: St Martin's Press, 1984), 3.

Knowing that the oil resource is a limited one, financial authorities in the oil-rich countries have turned their attention to other sectors, mainly investment and banking. Again this consideration encouraged development of the IFB industry.

Therefore, the rapid growth of Islamic banking is due to a mixture of elements: the very conservative Islamic ethos of the region complemented the overflowing cash from oil revenue and economic concern about the post-oil era.[62]

Nonetheless, the full establishment of IFB as an industry was not evident until the 1990s; this is addressed next.

2.4 THE REGULATORY ENVIRONMENT

As discussed above, for obvious reasons Muslim governments opted for the worldwide conventional financial system instead of building an Islamic one. Therefore, the elimination of interest was and still is out of the equation because it constitutes the backbone of the global financial system that is in use in both Muslim and non-Muslim countries.

This encouraged devoted Muslims to direct their individual efforts toward the creation of alternative Islamic mechanisms that could be adapted for operational use within the existing framework of the conventional financial system. However, attempts at Islamic banking in the 1950s-60s lacked the necessary regulatory support.[63]

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[62] Aldohni, *The Legal and Regulatory Aspects of Islamic Banking: A Comparative Look at the United Kingdom and Malaysia*, P: 12–14; Aldohni, "The Emergence of Islamic Banking in the UK: A Comparative Study with Muslim countries," P: 186.

[63] Wafik Grais and Matteo Pellegrini, "Corporate Governance in Institutions Offering Islamic Financial Services: Issues and Options" (Policy Research Working Paper Series No 4052, World Bank Publications, 2006), P: 2, http://elibrary.worldbank.org/doi/pdf/10.1596/1813-9450-4052; Dahlia El-Hawary, Wafik Grais, and Zamir Iqbal, "Diversity in the Regulation of Islamic Financial Institutions," *The Quarterly Review of Economics and Finance* 46, no. 5 (February 2007): P: 778–800.

Tahir (2003) correctly observed that 'Islamic banking did not start with a well-developed model covering fine details of the various banking matters'. Instead, it developed as the result of initiatives of resourceful Islamic economists, guided by influential *sharia* scholars in routine banking matters. Despite holding distinct visions and goals, they joined forces because of common concerns about bank interest. [64]

Obviously, Islamic banks were required to work within the regulatory rules of the conventional financial system.[65] To be recognised and accepted within that interest-based financial system, the structure of the Islamic banks and their operations were designed in ways which resembled conventional ones. As Islamic banks became successful, the central banks placed them under their control,[66] subjecting them to the same controls, conditions and regulations applied to the conventional banks.[67]

Since the conventional financial system was widespread inside as well as outside Muslim countries, it had gained the clients' trust and respect. It provided adequate reporting, monitoring of capital adequacy, risk management controls and customer disclosure. Applying such conventional standards to Islamic banks increased the acceptance of their services at the international level.[68] Despite the fact that Islamic banks fulfil the financial needs of Muslims, they are not religious institutions or charitable entities but companies that seek income. Nonetheless,

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[64] Sayyid Tahir, "Challenges Facing Islamic Finance: Research Areas" (*Distance Learning Program on Islamic Finance, Organized by Islamic Research and Training Institute of Islamic Development Bank*, 2006), P: 2, http://www.sbp.org.pk/departments/ibd/lecture_8_challenges_facing_isl_finance.pdf.

[65] Vogel and Hayes, *Islamic-Law and Finance*, P: 200.

[66] Delwin Roy, "Islamic Banking," *Middle Eastern Studies* 27, no. 3 (1991): 427–56.

[67] Iqbal, Ahmed, and Khan, "Challenges Facing Islamic Banking," P: 37–38.

[68] Simon Archer and Rifaat Abdel Karim, *Islamic Finance: Innovation and Growth 2* (Euromoney Institutional Investor PLC, 2002), Chapter 4, P: 44–45.

Islamic banks are based and operate on different grounds to the conventional ones,[69] as illustrated in the next chapter.

Therefore, the operation of Islamic banks within the sound regulatory framework provided by the conventional financial system is thought to be desirable and effective. Sound regulation can help ensure that problems of asymmetric information are overcome. If customers lack confidence in a financial institution then the result may be a financial panic: in the case of a bank a run on deposits may threaten the collapse of the institution.[70]

In the financial industry, regulators have a significant role to play in organising and controlling transactions and implementing fiscal policy for the whole country. As financial institutions, supervision of Islamic banks is as important as for conventional banks, and in fact certain features of Islamic banks require a degree of regulation similar to conventional banks. In this context, Errico and Farahbaksh (1998) include moral hazard, safeguarding the interests of on-demand depositors, and systemic considerations under such requirements.[71] Accordingly, the existence of appropriate corporate governance in Islamic banks is a matter of necessity, just as in the case of conventional banks.[72]

Nonetheless, Gafoor (1995) emphasises that for the most effective regulation, Islamic banks should be supervised by authorities who have extensive knowledge and experience of Islamic financing. However, he notes that most of the supervisory authorities lack the knowledge of *sharia* which is the

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[69] Munawar Iqbal, *A Guide to Islamic Finance* (Risk Books, 2007), P: 1.

[70] Rodney Wilson, "Regulatory Challenges Posed by Islamic Capital Market Products and Services" (International Organisation of Securities Commissions Organisations; Task Force on Islamic Capital Markets, Melbourne, 2003), P: 2, http://www.kantakji.com/media/8219/y136.pdf.

[71] Luca Errico and Mitra Farahbaksh, "Islamic Banking: Issues in Prudential Regulations and Supervision" (Working Paper No 98/30, International Monetary Fund, March 1998), P: 20, http://www.imf.org/external/pubs/ft/wp/wp9830.pdf.

[72] Mohammad Kabir Hassan and Mervyn Lewis, *Handbook of Islamic Banking* (Edward Elgar Pub, 2007), Chapter 9, P: 129–143; Aznan Hasan, "Optimal Shariah Governance in Islamic Finance," *Islamic Finance News* 4, no. 14 (2007): P: 2.

distinguishing feature of Islamic banking. Therefore, any assistance that may be required by Islamic banks for their operations will not be met, and any supervision and regulation will be based upon the experience gained from conventional banks.[73]

Thomas et al. (2005) state that there is nothing in this theory that makes central banks in an Islamic economy act differently from traditional ones. However, in reality the central banks of most Islamic states do not become involved in regulating Islamic banks and their activities. For instance, it is noticed that the accounting practices of Islamic banks are inconsistent and their financial statements are not transparent due to inadequate disclosure.[74]

Accordingly, Garas (2007) notes that the regulators' limited influence over Islamic banks and transactions actually led to limited recognition by investors of the IFB. As new players in the financial markets, the Islamic banks strove to compete with the existing system inside the Islamic states. Islamic banks are still expanding their regulatory systems and trying to contribute to national economies. They are always compliant with the regulations of any country within which they operate. Nonetheless, they also have their own set of regulations that facilitate the appropriate interaction with the *sharia*.[75]

The confidence of the public in the market place is crucial for the growth and survival of any industry, and the trust of the investors is earned by the building and maintenance of good governance and supervision of the adopted businesses. Iqbal et al. (1998) emphasise that the importance of regulation and supervision of IFB rests on *sharia* supervision.[76] Tahir (2003) also emphasises

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[73] Gafoor, *Interest Free Commercial Banking*.

[74] Abdulkader Thomas, Stella Cox, and Bryan Kraty, *Structuring Islamic Finance Transactions* (Euromoney Books, 2005), P: 207.

[75] Samy Nathan Garas, "Internationalization of Islamic Financial Institutions: Challenges and Paths to Solution," *Thunderbird International Business Review* 49, no. 2 (2007): P: 8–11.

[76] Iqbal, Ahmed, and Khan, "Challenges Facing Islamic Banking," P: 36.

that regulation and control are necessary to ensure that they remain financial institutions, ensuring that the survival of the industry depends largely on its economic viability, stability, the confidence of customers, and most importantly its response to challenges to its identity.[77]

Conventional standards do not necessarily satisfy the needs of the IFB operations. Unlike conventional banks, Islamic banks do not guarantee deposits and acquire assets from using the depositors' funds directly in business.[78] The fact is that existing conventional banking laws oppose this idea, with the requirement for deposits to be 'capital certain'; this constitutes a major difficulty in permitting an IFBO to trade within the conventional financial system.[79] This is a more obvious problem in non-Muslim countries as opposed to Muslim ones, and is usually circumvented by not calling the IFI a bank, or by mobilising funds in the form of mutual funds rather than investment accounts.[80]

However, because the legal systems of Islamic states and their financial systems are based on Western models, the issues and difficulties are similar. Although some Islamic states have issued special laws for Islamic banks, no country has formulated a law based entirely on *sharia* for its IFB.[81] It is evident that they are functioning merely as supplements to conventional ones,[82] and the financial

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[77] Sayyid Tahir, "Current Issues in the Practice of Islamic Banking" (*Discussion Paper for a Course Organized by the Central Bank of Iran and Islamic Research & Training Institute of the Islamic Development Bank*, March 2, 2003), P: 7, http://www.sbp.org.pk/departments/ibd/Lecture_8_Related_Reading_1.pdf.

[78] Gafoor, *Interest Free Commercial Banking*.

[79] *Islamic Financial Services Industry Development: Ten Year Framework and Strategies*, P: 18.

[80] Yusuf Karbhari, Kamal Naser, and Zerrin Shahin, "Problems and Challenges Facing the Islamic Banking System in the West: The Case of the UK," *Thunderbird International Business Review* 46, no. 5 (September 2004): P: 524.

[81] The earliest systemic *sharia law* related to business is Mejelle which developed during 1869-1876 and issued by the Ottoman Empire. Haron and Nursofiza, *Islamic Finance Banking System*, P: 250.

[82] Mahmoud El-Gamal, "Money Laundering and Terror Financing Issues in the Middle East" (Statement for US Senate Committee on Banking, Housing and Urban Affairs' Hearing, July 13, 2005), P: 20, http://banking.senate.gov/public/_files/gamal.pdf.

regulators do not always take into consideration the exceptional characteristics of Islamic finance.[83]

The regulators' willingness to support the Islamic banks varies across different countries, as do the necessary alterations to their regulatory and supervisory frameworks.[84] In the absence of globally accepted regulatory and supervisory guidelines and best practice standards that cater for the specifications of IFB, the regulatory authorities, with some amendments, regulate and supervise Islamic banks in the same way as conventional ones.[85]

Islamic banking laws or amendments made to conventional banking laws were not established to confer any advantages on Islamic banks vis- à-vis conventional banks, but in fact were designed to remove some of the obstacles hindering the operations of Islamic banks in an economy where interest-based transactions dominate the scene.[86]

2.5 THE DEVELOPMENT OF INSTITUTIONAL RECOGNITION

A critique of bank interest as being the prohibited *riba* was initiated by *sharia* scholars during the 1890s-1930s with the appearance of allegedly the first Western commercial banks in the Islamic region. However, the critique of interest from the Islamic economic perspective was developed during the 1930s-50s.[87]

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[83] Rodney Wilson, *Islamic Finance* (FT Financial Publishing, Pearson Professional Limited, 1997); Mostaque Hussain et al., "Accounting Standards and Practices of Financial Institutions in GCC Countries," *Managerial Auditing Journal* 17, no. 7 (2002): P: 181.

[84] Karbhari, Naser, and Shahin, "Problems and Challenges Facing the Islamic Banking System in the West: The Case of the UK," P: 524.

[85] Rifaat Ahmed Abdel Karim and Simon Archer, *Islamic Finance: The Regulatory Challenge* (John Wiley & Sons, 2007), Chapter 17, P: 310–341.

[86] Juan Solé, "Introducing Islamic Banks into Conventional Banking Systems" (Working Paper No 07/175, International Monetary Fund, 2007), P: 16, https://www.imf.org/external/pubs/ft/wp/2007/wp07175.pdf; Ziauddin Ahmad, "Islamic Banking: State of the Art" (Islamic Development Bank Prize Winners' Lecture Series No. 2, Islamic Research and Training Institute, 1994).

[87] *Islamic Financial Services Industry Development: Ten Year Framework and Strategies*, P: 2.

Prominent scholars and Islamic-thinkers such as Sayyid Qutb (1906-1966), Syed Abul Aala Maududi (1903-1979) and Muhammad Baqir al-Sadr (1935–1980), who were not specialist economists or financiers but Islamic thinkers, were among the ones favouring the establishment of a fully Islamic economic and financial system to replace the existing conventional one developed and imposed by the colonial masters.[88]

The earliest references to the reorganisation of banking based on profit and loss sharing rather than interest was found in the late 1940s. Besides the aforementioned Islamic thinkers, many others scholars recognised the dangers of interest in the enterprise and therefore the need for Islamic alternatives. The proposed mechanism was intended to replace the element of interest with profit, which is permissible in Islam.[89]

However, scholars were not able to offer any descriptions of an interest-free bank before the 1950s. They argued in the beginning for the two-tier *mudaraba* (trust financing) mechanism both for the collection of funds and the extension of financing, and later they argued that the financial mediation could be organised on a *wakala* (agency) basis as well, thereby laying the ground for an alternative structure.

It was the evolution of this proposed theoretical framework that triggered the institutional involvement for IFB in the early 1970s. Important events took place in the promotion and further development of the concept and mechanisms that could be of use in Islamic finance in the modern arena of banking.

For instance, the Conference of the Finance Ministers of the Islamic Countries was held in Pakistan in 1970, and the Egyptian study of 1972 about the *fiqhi* (Islamic jurisprudence) objections to conventional insurance was pronounced in

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[88] Taris Ahmad et al., *Islamic Banking and Finance: What It Is and What It Could Be* (1st Ethical Charitable Trust, 2010), P: 18.

[89] Schoon, "Islamic-Finance–An Overview," P: 625.

1975. The first International Conference on Islamic Economics was held in Makkah in 1976 and the International Economic Conference in London in 1977.

The subject matter of writings and conferences in the 1980s shifted from the concepts and possibilities of interest-free banking to the evaluation of their performance and their impact on the rest of the economy and the world. Their titles bear testimony to this and the places where they were held indicate the worldwide interest in the subject, for instance, the Conference on Islamic Banking: Its Impact on World Financial and Commercial Practices was held in London in September 1984, the Workshop on Industrial Financing Activities of Islamic Banks in Vienna in June 1986, the International Conference on Islamic Banking in Tehran in June 1986, the International Conference on Islamic Banking and Finance: Current Issues and Future Prospects in Washington, DC in September 1986, the Islamic Banking Conference in Geneva in October 1986, and the Conference Into the 1990's with Islamic Banking in London in 1988.

Also, the International Monetary Fund published working papers and articles on Islamic banking, while PhD research and other publications on Islamic banking were increasing in the West. The Fiqh Academy of the Organisation of Islamic Cooperation and other *fiqh* (Islamic jurisprudence) boards of Islamic institutions engaged in discussions and the review of financial transactions. As a result, Islamic mutual funds and other non-banking financial institutions emerged towards the middle of the 1980s, and the first *takaful* (insurance) company was established in 1979.

In the 1990s, IFI spread worldwide, over ninety banks being established during this period. Also during this decade, the Muslim world witnessed the full Islamisation of the whole financial system on a national level in Sudan, Pakistan and Iran.

Furthermore, the opportunity of profits and capturing new markets motivated conventional bankers to provide Islamic services,[90] in both Muslim and non-Muslim countries.[91] Therefore, an increasing number of conventional financial institutions in the Middle Eastern markets began to convert their operations either fully or partially on Islamic lines. This had been the case in Egypt for some time and was now applied in other countries such as Saudi Arabia and Malaysia. Also, fully independent Islamic banks were established, such as the ABC and the City Islamic Bank, by conventional financial entities.[92]

Although Islamic banks were initially launched to serve Muslims in countries where the majority of the population was Muslim, they extended to serve Muslims in countries where the majority of the population was non-Muslim. Today, Islamic banks exist in a number of Western countries including Australia, Denmark, India, Liberia, Liechtenstein, Luxembourg, Switzerland, Philippines, South Africa, Thailand, United Kingdom and the United States of America. It is the growth of the Muslim population in Western countries which was significant in recent decades, demanding the services of IFB.[93]

The public policy interest in IFB is growing worldwide including in several Western countries, which places the long-established legacy of the conventional financial system in question.[94] Interest in Islamic finance increased among Western academic circles, and the Harvard Islamic Finance Forum was established. The Dow Jones and Financial Times Islamic indexes were launched.

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[90] Alison Brooks, "Repo Market Crosses Line in the Sand," *Global Investor*, 1999, http://www.globalinvestormagazine.com/Article/2226793/REPO-MARKET-CROSSES-LINE-IN-THE-SAND.html.

[91] Muhammad Mansoor Khan and Muhammad Ishaq Bhatti, "Islamic Banking and Finance: On Its Way to Globalization," *Managerial Finance* 34, no. 10 (2008): P: 708–725; Heiko Hesse, Andreas Jobst, and Juan Solé, "Trends and Challenges in Islamic Finance," *World Economics* 9, no. 2 (2008): P: 127.

[92] Ahmad, "Islamic Banking: State of the Art."

[93] Wilson, "Islamic Banking and Its Impact on the International Financial Scene," at 440.

[94] Khan and Bhatti, "Islamic-banking and Finance: On Its Way to Globalization," at 710.

Several countries introduced legislation to facilitate Islamic banking and its regulation and supervision.

In consequence, the undeniable expansion of IFB at the international level drew the attention of policy makers at different levels to the standards and regulatory aspects of this growing industry. In turn, the rise and evolution of organisational efforts in support of the industry was evident. This is addressed in the next section.

2.6 GRADUAL DEVELOPMENT OF ORGANISATIONAL SUPPORT

Zaman and Movassagbhi (2002) state that business and commerce can only operate when the general practices and standards are clearly known and understood.[95]

The attention Islamic banks attracted operating within the requirements of conventional standards in fact encouraged the establishment of a number of regional and international bodies in order to promote adequate standards and harmonise the practices of the growing IFB. It was the support offered by certain bodies which enabled the rise of IFB in the form of an industry as they worked to provide the necessary regulatory infrastructures for the Islamic banks and their operations.

In fact, the establishment of such organisations resulted from the recognition that the specific conceptual foundations and the operational practices of IFB require regulatory discipline beyond the simple extension or amendment of the existing laws and conventional regulatory frameworks.[96] Nonetheless, the task is not to

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[95] M.Raquibuz Zaman and Hormoz Movassaghi, "Interest-Free Islamic Banking: Ideals and Reality," *The International Journal of Finance* 14, no. 4 (2002): at 2439.

[96] Grais and Pellegrini, "Corporate Governance in Institutions Offering Islamic Financial Services: Issues and Options," P: 2.

replace existing conventional standards and regulations, but rather to propose solutions whenever they fail to address the distinctiveness of IFBO.[97]

In the absence of an international *sharia* authority that is recognised and acknowledged at the global level, these organisations play a much needed role to harmonise the practices of IFI worldwide and cater for their specific needs and requirements.

2.6.1 INTERNATIONAL SUPPORTIVE BODIES

A number of international bodies are concerned with different aspects of IFB. To give an understanding of the position of the sector, the following section offers a chronological summary of the main bodies, identifying their objectives and services in relation to the IFI and Islamic banks.

In 1975, the Islamic Development Bank was established as an international financial institution whose purpose is to foster the economic development and social progress of member countries and Muslim communities, individually as well as jointly, in accordance with the principles of *sharia*. The present membership of the Bank consists of 56 countries, and the basic condition for membership is that the prospective member country should be a member of the Organisation of Islamic Conference/Corporation.[98]

In 1978, the first specialised research institution was established by the King Abdul Aziz University in Jeddah, named the International Centre for Research in Islamic Economics. The Centre seeks to be a leading institution for research, training and teaching of Islamic economics as well banking and finance. It tries to

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[97] Zulkifli Hasan, "Regulatory Framework of Shari'ah Governance System in Malaysia, GCC Countries and the UK," *イスラーム世界研究: Kyoto Bulletin of Islamic Area Studies* 3, no. 2 (2010): P: 2; Grais and Pellegrini, "Corporate Governance in Institutions Offering Islamic Financial Services: Issues and Options," P: 2.

[98] "The Islamic Development Bank," accessed January 30, 2015, http://www.isdb.org.

achieve its vision through the production and management of research/teaching and training programmes, doing research in the field of Islamic economics and participating in the translation of materials that serve the objectives of the Centre, monitoring and studying the actual implementations of Islamic economics, and organising training courses, workshops, conferences, seminars on Islamic economics.[99]

In 1981, the Islamic Research and Training Institute was established, offering consulting services to assist the Islamic Development Bank Group and other interested parties in resolving practical *sharia*-related issues and developing *sharia*-compliant financial products.[100]

In 1988, the International Islamic Fiqh Academy was inaugurated. This is an academy for the advanced study of Islam, based in Jeddah, and established specifically to unify Islamic *fatawa* (plural of fatwa) by publishing the opinions of a multitude of scholars rather than individual experts. Although the rulings and opinions pertaining to economic and financial matters issued by the Academy are not officially binding, they are highly respected and certainly considered by *sharia* scholars, IFB practitioners, and policymakers.[101]

In 1988, the Bahrain Bankers Training Centre, inaugurated in 1981, was renamed the Bahrain Institute of Banking and Finance. It provides training in the form of courses with special focus on the IFB. Today it is the leading provider of training, education and professional development programmes to the Industry in

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[99] "The Centre for Research in Islamic Economics," accessed March 23, 2014, http://www.islamiccenter.kaau.edu.sa/.

[100] "The Islamic Research and Training Institute," accessed January 30, 2015, http://www.irti.org.

[101] Shahzad Qadri, "Islamic-Finance: An Alternative," *Banking & Financial Services Policy Report* 28, no. 1 (January 2009): P: 9–11.

the Gulf region and the Middle East. Over 17,000 participants went through the Institute in 2010. [102]

In May 2001, the General Council for Islamic Banks and Financial Institutions, affiliated to the Organisation of Islamic Cooperation n, was established as a non-profit organisation, hosted in Bahrain. It currently claims to be the only official and reliable source of information about all the Islamic banks whose services and products comply with *sharia*. [103]

In 2001, the International Islamic Financial Market was founded collectively by the central banks of a number of Muslim countries as a neutral and non-profit organisation to facilitate secondary markets for Islamic financial instruments. Its objective is to provide a cooperative framework for the growth and promotion of the Islamic financial market, encouraging cohesion of *sharia* interpretations and the creation of the secondary market. [104]

In 2005, the Central Bank of Bahrain (CBB) established the Liquidity Management Centre for the purpose of facilitating the investment of the surplus funds of IFI and banks into high-quality short- and medium-term financial instruments structured in accordance with the *sharia* principles, i.e. providing secondary market buyers for *sukuk* (Islamic-bonds). It plays a key role in the creation of an active interbank market, which will assist IFI in managing their short-term liquidity. [105]

In 2005, the Bahrain-based Islamic International Rating Agency started operations, although its original set-up was in 2002 to facilitate development of the regional and national financial markets by delineating relative investment or

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[102] "Bahrain Institute of Banking and Finance," accessed January 30, 2015, http://www.bibf.com.

[103] "General Council for Islamic banks and Financial Institutions," accessed January 30, 2015, http://www.cibafi.org/.

[104] "International Islamic Financial Market," accessed January 30, 2015, http://www.iifm.net.

[105] "The Liquidity Management Centre," accessed January 30, 2015, http://www.lmcbahrain.com.

credit risk, and providing an assessment of the risk profile of entities and instruments, which can be used as one of the bases for investment decisions. It is soliciting recognition of its ratings by regulators and has received formal recognition from the CBB as an External Credit Assessment Institution, and is on the list of approved rating agencies of the Islamic Development Bank.[106]

In 2005, the International Islamic Centre for Reconciliation and Arbitration was founded as an international, independent, non-profit organisation, and began its activity in the beginning of January 2007. The establishment of the Centre resulted from concerted efforts of the United Arab of Emirates, the Islamic Development Bank and the General Council for Islamic Banks and Financial Institutions. The Centre settles financial and commercial disputes that arise between financial institutions and their clients, or between financial institutions and third parties who choose to apply the provisions of *sharia* law through reconciliation or arbitration.[107]

In 2008, the International *Sharia* Research Academy for Islamic Finance in Malaysia was established to promote applied research in the area of *sharia* and Islamic finance. It contributes towards strengthening human capital development in the areas of *sharia* and provides a platform for greater engagement amongst practitioners, scholars, regulators and academicians via research and dialogue, in both the domestic and international environment.[108]

All these international bodies work toward the development and promotion of different aspects of the IFB. However, the influence of their efforts on financial institutions varies, as will be discussed in later parts of this study.

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[106] "The Islamic International Rating Agency," accessed January 30, 2015, http://www.iirating.com.

[107] "The International Islamic Center for Reconciliation and Arbitration," accessed January 30, 2015, http://iicra.com.

[108] "The International Sharia Research Academy," accessed January 30, 2015, http://www.isra.my.

2.6.2 STANDARD SETTING INTERNATIONAL BODIES

The bodies described in the previous section are supportive of the IFB, but are not directly concerned with the governance and regulation of the IFI and Islamic banks, which is the subject matter of this thesis. This section will describe the two main international bodies that are focused on setting such standards, namely the Islamic Financial Services Board and the Auditing and Accounting of Islamic and Financial Institutions.

2.6.2.1 ISLAMIC FINANCIAL SERVICES BOARD

The central banks and national monetary authorities of Muslim countries officially inaugurated the Islamic Financial Services Board (IFSB) on 3 November 2002, and it started operating on 10 March 2003. As of December 2014, the 184 members of the IFSB comprise 59 regulatory and supervisory authorities, 8 international intergovernmental organisations, 112 financial institutions and professional firms as well as 5 self-regulatory organisations (industry associations and stock exchanges) operating in 44 jurisdictions. The efforts of the IFSB extend not only to the central banks of member states of the Organization of Islamic Conference/Corporation, but include a number of central banks from non-Muslim countries such as the United Kingdom, France, Luxembourg, South Africa, China, Thailand and Singapore.

The IFSB coordinates its activities closely with the Bank for International Settlements and includes entities like the International Monetary Fund and the Islamic Development Bank in its membership. It is argued that the work of the IFSB complements that of the Basel Committee on Banking Supervision, International Organisation of Securities Commissions, and the International Association of Insurance Supervisors. It strives toward adopting globally accepted prudential standards that smoothly integrate IFB with the conventional financial system, taking into account any specificities of Islamic finance. It

therefore ensures a level playing field between the IFI and conventional banking institutions.[109]

To empower and enable the IFSB to play its designated role, Malaysia, the host country of the IFSB, has enacted a law known as the IFSB Act of 2002. Under Article (7/1), the IFSB enjoys immunities and privileges that are usually granted to international organisations and diplomatic missions. As an international standard-setting body for regulatory and supervisory agencies, it ensures stability and soundness of the IFB by developing new, or adapting existing, global prudential standards and guiding principles for the industry that are consistent with *sharia* principles, and harmonising practices within the industry. These standards are broadly defined to include banking, capital markets and insurance sectors, and are mainly based on the identification, management and disclosure of risks relevant to Islamic products and operations.[110]

Since its inception, the IFSB has issued 16 Standards, five Guidance Notes and one Technical Note. A chronological list of the areas covered by the standards is:

- IFSB-1 (December 2005): Guiding Principles of Risk Management for IFI (excluding Insurance Institutions).
- IFSB-2 (December 2005): Capital Adequacy Standard for IFI (excluding Insurance Institutions).
- IFSB-3 (December 2006): Guiding Principles on Corporate Governance for IFI and Islamic Mutual Funds (excluding Islamic Insurance Institutions).
- IFSB-4 (December 2007): Disclosures to Promote Transparency and Market Discipline for IFI (excluding Islamic Insurance Institutions and Islamic Mutual Funds).

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[109] Hesse, Jobst, and Solé, "Trends and Challenges in Islamic-Finance," P: 190.

[110] "Islamic Financial Services Board," accessed January 30, 2015, http://www.ifsb.org.

- IFSB-5 (December 2007): Guidance on Key Elements in the Supervisory Review Process of IFI (excluding Islamic Insurance Institutions and Islamic Mutual Funds)

- IFSB-6 (December 2008): Guiding Principles on Governance for Islamic Collective Investment Schemes.

- IFSB-7 (January 2009): Capital Adequacy Requirements for *Sukuk*, Securitisations and Real Estate investment.

- IFSB-8 (December 2009): Guiding Principles on Governance for Islamic Insurance Undertakings.

- IFSB-9 (December 2009): Guiding Principles on Conduct of Business for IFI.

- IFSB-10 (December 2009): Guiding Principles on *Sharia* Governance Systems for IFI.

- IFSB-11(December 2010): Standard on Solvency Requirements for Islamic Insurance Undertakings.

- IFSB-12 (March 2012): Guiding Principles on Liquidity Risk Management for IFI.

- IFSB-13 (March 2012) Guiding Principles on Stress Testing for IFI.

- IFSB-14 (December 2013): Standard On Risk Management for Islamic Insurance Undertakings.

- IFSB-15 (December 2013): Revised Capital Adequacy Standard for IFI (excluding Islamic Insurance) Institutions and Islamic Collective Investment Schemes).

- IFSB-16 (March 2014): Revised Guidance on Key Elements In The Supervisory Review Process of IFI (excluding Islamic Insurance Institutions and Islamic Collective Investment Schemes).

As for the Guidance and Technical Notes, they were issued as follows:

- GN-1(March 2008): Guidance Note in Connection with the Capital Adequacy Standard: Recognition of Ratings by External Credit Assessment Institutions on *Sharia*-Compliant Financial Instruments.

- GN-2 (December 2010): Guidance Note in Connection with the Risk Management and Capital Adequacy Standards: Commodity Murabaha Transactions.

- GN-3 (December 2010): Guidance Note on the Practice of Smoothing the Profits Pay-out to Investment Account Holders.

- GN-4 (March 2011) Guidance Note in Connection with the IFSB Capital Adequacy Standard: The Determination of Alpha in the Capital Adequacy Ratio for IFI (other than Insurance Institutions)

- GN-5 (March 2011): Guidance Note on the Recognition of Ratings by External Credit Assessment Institutions Islamic Insurance and Reinsurance Undertakings.

- TN-1: Technical Notes on the Development of Islamic Money Markets.

As outlined in the IFSB Guidelines and Procedures for the Preparation of Standards/Guidelines, the standards preparation follows a lengthy process which involves, among other things, the issue of an exposure draft, and where necessary, the holding of a public hearing.

The role played by the IFSB is of particular importance to this study because it is responsible for the development and issue of standards for the effective supervision and regulation of the IFI. As its membership consists of central banks and monetary authorities, the adoption and implementation of the standards should be effective and direct the influence on the IFB worldwide.

As the list of standards suggests, the IFSB's working areas cover all the important regulatory aspects of the financial industry. However, this study is centred on *sharia* governance and supervision. Therefore, it focuses on discussing the standards most relevant to the research area: IFSB-3 on Guiding Principles on Corporate Governance for IFI,[111] IFSB-10 on Guiding Principles on *Sharia* Governance Systems for IFI,[112] and the more recent IFSB-16 on Revised Guidance on Key Elements in the Supervisory Review Process of IFI.[113]

The IFSB Standard no. 3 on Guiding Principles on Corporate Governance for IFI

This standard consists of guiding principles for prudential requirements in the area of corporate governance of IFI. They are divided into four parts:[114]

1) general governance approach of IFI;
2) rights of investment account holders;
3) compliance with *Sharia* rules and principles; and
4) transparency of financial reporting in respect of investment accounts.

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[111] "IFSB Standard No.3: Guiding Principles on Corporate Governance for Islamic Financial Institutions," December 2006.

[112] "IFSB Standard No.10: Guiding Principles on Sharia Governance Systems for Islamic Financial Institutions," December 2009.

[113] "IFSB Standard No.16: Revised Guidance on Key Elements In The Supervisory Review Process of Islamic Financial Institutions," March 2014.

[114] "IFSB Standard No.3: Guiding Principles on Corporate Governance for Islamic Financial Institutions," P: 1.

Given the focus of this research, only the principles under parts 1 and 3 of this standard will be addressed here.

Principle (1.1) states that the "IFI shall establish a comprehensive governance policy framework which sets out the strategic roles and functions of each organ of governance and mechanisms for balancing the IFI's accountabilities to various stakeholders. This includes the Board of Directors (BOD), its committees, the executive management, the SSB, the internal and external auditors, etc."

IFI shall embrace applicable recommendations from internationally recognised corporate governance standards such as the Organisation for Economic Co-operation and Development Principles and the Basel Committee on Banking Supervision. In addition, IFI shall comply with the existing prudential circulars/directives issued by supervisory authorities. Each IFI may tailor its governance policy framework to suit its business model; however, it should not ignore internationally recognised best practices such as the recommended best practices in the Guiding Principles.

According to the Recommended Best Practices, the BOD of each IFI, as the ultimate internal policymaker, shall be responsible for steering the establishment of the governance policy framework. The BOD shall set up a governance committee, comprising at least three members, to coordinate and integrate the implementation of the governance policy framework. This governance committee may comprise, for example: (i) a member of the audit committee; (ii) a *sharia* scholar (possibly from the IFI's SSB); and (iii) a non-executive director (selected according to the director's experience and ability to contribute to the process).

The governance committee shall be empowered to: (i) oversee and monitor the implementation of the governance policy framework by working together with the management, the Audit Committee and the SSB; and (ii) provide the BOD with reports and recommendations based on its findings in the exercise of its functions. The roles and functions of the governance committee shall not

duplicate or overlap with the roles and functions of the Audit Committee but should complement them.

Principle (1.2) states that the IFI shall ensure that the reporting of their financial and non-financial information meets the requirements of internationally recognised accounting standards which are in compliance with *sharia* rules and principles and are applicable to the Islamic financial services industry as recognised by the supervisory authorities of the country.

The importance of appropriate accounting processes for good governance should be appreciated by: (i) utilising the work of accountants and consultants, and the findings of auditors, in a timely and effective manner to address any problems identified by them; and (ii) maintaining the independence of internal and external auditors, as well as compliance function 9, Recommended Best Practices.

According to the Recommended Best Practices, the BOD of each IFI shall set up an Audit Committee comprising at least three members (a chairman and two other members) elected by the Board from those of its non-executive members with relevant and adequate expertise in the analysis of financial statements and documentation. The Audit Committee shall be mandated to: (i) review and monitor the entire accounting process of the IFI through close cooperation with the internal and external auditors; and (ii) provide the BOD with reports and recommendations with a particular reference to the IFI's compliance with internationally recognised accounting standards applicable to the Islamic financial services industry in reporting their financial and non-financial information. The Audit Committee shall communicate and coordinate with both the SSB and the governance committee to ensure that information on

compliance with *Sharia* rules and principles by the IFI is reported in a timely and adequate manner.[115]

Principle (3.1) states that the IFI shall have in place an appropriate mechanism for obtaining rulings from *sharia* scholars, applying *fatawa* and monitoring *sharia*-compliance in all aspects of their products, operations and activities.

Initiatives on harmonisation of *fatawa* should continue to be pursued and applauded, as the industry in particular, and the *ummah* in general, can benefit from common understanding and cooperation amongst *sharia* scholars.

As Recommended Best Practices, the BOD needs to establish a mechanism that can be mobilised swiftly and efficiently, as and when required, to obtain rulings from *sharia* scholars and monitor *sharia*-compliance. This mechanism shall cover: (i) both ex-ante and ex-post aspects of all financial transactions carried out by the IFI that is, to ensure *sharia*-compliance of the contracts and, later, the performance of obligations under the contracts; and (ii) operations of the IFI, including aspects such as *sharia*-compliance review, investment policies, disposal of non-*sharia*-compliant income, charitable activities, etc.

The *sharia* scholars may be external or internal, depending on the requirements of the IFI's business model. For internal *sharia*-compliance reviews, the SSB or *sharia* scholars of IFI shall work together with either a separate *sharia* control department or the designated internal auditors/*sharia* reviewers. This will enable the SSB or *sharia* scholars to advise the *sharia* control department or designated internal auditor/*sharia* reviewers on the scope of audit/reviews required. Being responsible for producing the internal *sharia*-compliance reports, they shall acquire the relevant and appropriate training to enhance their *sharia*-compliance review skills. For external *sharia*-compliance reviews, the Audit Committee shall ensure as far as possible that the external auditors are capable of conducting,

[115] Ibid., P: 3–5.

and do conduct, ex-post *sharia*-compliance reviews within their terms of reference.

To enhance public confidence in the *sharia* scholars sitting on the SSB, the supervisory authorities may wish to consider favouring the establishment of a professional organisation or an industry association for *sharia* scholars serving the IFI within their respective jurisdictions. Alternatively, supervisory authorities may establish a 'fit and proper' test that clearly and carefully sets out the criteria required prior to an IFI appointing a *sharia* scholar into its SSB. Again, the fit and proper criteria shall take into account factors that can strengthen public confidence in the SSB, such as academic qualifications, professional training, recognition by local and international peers of *sharia* scholars, etc.

Principle (3.2) states that the IFI shall comply with the *sharia* rules and principles as expressed in the rulings of the IFI's *sharia* scholars. The IFI shall make these rulings available to the public.

As Recommended Best Practices, an IFI shall make available to the public, upon request, an explanation of any decision to adopt a *fatawa* issued by its *sharia* scholars. Such explanation should be prepared in consultation with the *sharia* scholars. Similarly, an IFI should be prepared to provide a transparent clarification to the public should they decide to abandon a *fatwa* (a religious decree) issued by its *sharia* scholars. *Sharia* scholars serving IFI are encouraged to expose their *fatawa* to the scrutiny of fellow *sharia* scholars by publishing their detailed opinions. The IFI can also promote better awareness on the part of the public by publishing information on the *fatawa* of their *sharia* scholars on their websites. The IFI may also allow customers to access the *fatawa* issued by their *sharia* scholars as part of their customer services.[116]

[116] Ibid., P: 11–12.

The IFSB Standard no. 10 about Guiding Principles on *Sharia* Governance Systems for IFI

This standard defines the *Sharia* Governance System and its Scope. [117] Despite being commonly used within the IFB, the term '*Sharia* Governance System' has not been properly defined in any of the existing standards. It refers to structures and processes adopted by stakeholders in the IFB (from financial regulators to market players) to ensure compliance with *sharia* rules and principles.

However, according to this standard, '*Sharia* Governance System' refers to the set of institutional and organisational arrangements through which an IFI ensures that there is effective independent oversight of *sharia*-compliance over each of the following structures and processes:

a) Issue of relevant *sharia* pronouncements, i.e. juristic opinions on any matter pertaining to *sharia* issues in Islamic finance, given by the appropriately mandated SSB or the Central *Sharia* Authority such as the National *Sharia* Board or Fatawa Council, if any. Once it is decided that a *sharia* pronouncement/resolution should actually be implemented, it becomes a '*sharia* ruling' with full legal effect that binds the IFI.
b) Dissemination of information on such *sharia* pronouncements to the operative personnel of the IFI who monitor the day-to-day compliance with the *sharia* pronouncements vis-à-vis every level of operations and each transaction. Such a task would normally be undertaken by a designated Internal *Sharia* Compliance Unit (ISCU), or at least a *Sharia* Compliance Officer who is part of the IFI's compliance team. The IFI shall equip the ISCU with the appropriate compliance monitoring skills and relevant knowledge of the *sharia*. Also, it should ensure that the ISCU is separate and independent from the business units and departments.

[117] "IFSB Standard No.10: Guiding Principles on sharia Governance Systems for Islamic Financial Institutions."

c) An internal *sharia* compliance review/audit for verifying that *sharia*-compliance has been satisfied, during which any incident of non-compliance will be recorded and reported, and as far as possible, addressed and rectified. While the ISCU is part of the IFI's compliance team, the Internal *Sharia* Review/Audit Unit (ISRU) may be established to function in a similar manner to the IFI's internal audit team. The major difference is that while the internal auditor will usually report to the Audit Committee, the ISRU shall report to the *sharia* board. Where appropriate, the internal *Sharia* Review/Audit Reports shall require or recommend the management of the IFI to address and rectify any issues of *sharia*-compliance.

d) An annual *sharia* compliance review/audit for verifying that the Internal *sharia* compliance review/audit has been appropriately carried out and its findings have been duly noted by the SSB. The SSB which issued the *sharia* pronouncements can take charge of this process, having received feedback and reports from the ISRU. Alternatively, this task may be assigned to an appropriately competent external auditor or external *sharia* firm.[118]

The IFSB Standard no. 10 about Guiding Principles on *Sharia* Corporate Governance for IFI

This Standard consists of five guiding principles:

1) General Approach to the *Sharia* Governance System: whereby various ex-ante and ex-post processes considered as essential parts of good governance practices in other internationally recognised governance standards, such as the precise terms of reference for SSB, appropriate alignment of incentives, proper record-keeping, adoption of a professional

[118] Ibid., P: 1–4.

code of ethics, etc., are adapted in order to strengthen the *Sharia* Governance System.

2) Competence: suggests various measures to ensure reasonable expertise and skill-sets in SSB, and to evaluate their performance and professional development.
3) Independence: aims at safeguarding the independence of SSB, particularly from the management of IFI, by highlighting various issues arising from potential conflicts of interest and recommending how they should be managed.
4) Confidentiality: emphasises the importance of observing and preserving confidentiality by the organs of *sharia* governance.
5) Consistency: focuses on improving consistency in terms of the professionalism of members of the SSB, which would be crucial in enhancing their credibility and confirming their integrity through a set of best practices.[119]

Given the focus of this research, only the most relevant and important sections of these five principles will be addressed.

Principle (1.1) states that the *Sharia* Governance Structure adopted by the IFI should be commensurate and proportionate with the size, complexity and nature of its business.

This standard takes a no-single model or one-size-fits-all approach. It is duly acknowledged that there are various *sharia* governance structures and models that have been adopted in different jurisdictions where IFI are present. Some supervisory authorities permit IFI to decide for themselves what kind of *sharia* governance system to adopt, and therefore the market is left to determine freely which system lends sufficient credibility to the products and services that each IFI offers. Other supervisory authorities are concerned with 'market deficiencies' and

[119] Ibid., P: 5.

the need for client protection. Therefore, they require that each IFI should have a properly functioning *sharia* governance system in place. A few other supervisory authorities seem to take the view that SSB have a significant role to play in monitoring the health of IFI, therefore they impose a requirement that each IFI must have a certain minimum number of members of the Board, who must also meet certain fit and proper criteria – similar to the assurance sought when banks are appointing their BOD. In some jurisdictions, supervisory authorities have their own *Sharia* Board that works together with them in issuing standardised *sharia* pronouncements, as well as aligning relevant policy and regulatory frameworks with the *sharia*. Although they may be known by different names, such as National *Sharia* Advisory Council, National Fatawa Council, High *Sharia* Board, etc., their functions are similar – that is, to become the highest body issuing *sharia* pronouncements for the Islamic finance services industry in the country.

In terms of ex-ante considerations, i.e. at the product design/development stage, an IFI would want to ensure that its *Sharia* Governance System covers the relevant ex-ante processes, namely (i) issue of *sharia* pronouncements, and (ii) compliance checks, before the product is offered to customers. As for ex-post considerations, i.e. observing the product at the offer stage, an IFI would want to ensure that its *Sharia* Governance System covers the relevant ex-post processes – namely, internal *sharia* review and *sharia* governance reporting. Without such follow-up, the IFI would not be able to monitor the consistency of its *sharia*-compliance and effectively manage any *sharia*-compliance risk that may arise over time.

Principle (1.2) states that each IFI must ensure that the *sharia* board has clear terms of reference regarding its mandate and responsibility; well-defined operating procedures and lines of reporting; and good understanding of, and familiarity with, professional ethics and conduct.

The appointment letter, which becomes the contract for service for the members appointed to serve on the *Sharia* Board of the IFI, is the primary document that determines the form of relationship, level of fiduciary duties, and chain of accountability between the SSB, the IFI and its stakeholders.

As the legal framework in most jurisdictions holds the BOD as the body ultimately responsible with regard to the governance of an IFI, the SSB has to be clear on the limits of its own power. A clear set of rules and by-laws on how meetings shall be conducted, decisions made and recorded, and reports prepared and submitted, will provide much-needed direction for the SSB in understanding the level of their accountability.

It is strongly recommended that IFI develop an in-house capability by having a dedicated ISCU comprising *sharia* officers with appropriate qualifications and experience. Those in-house officers can, among other things: (i) become the first point of reference for *sharia*-compliance issues, with an advisory/consultancy role delegated by the SSB; (ii) handle the processing and secretarial matters relating to issues to be raised to the SSB; and (iii) provide input for executive decisions to be made by the senior management. There should be clear segregation of process and procedures between the ISCU and ISRU through a written standard operation manual and/or framework.[120]

Principle (2.1) states that the IFI shall ensure that any person mandated with overseeing the *Sharia* Governance System fulfils acceptable fit and proper criteria.

In view of the importance of the persons mandated with overseeing the *Sharia* Governance System in the decision-making process of IFI, it is appropriate that certain fit and proper criteria be imposed on members of the SSB as well as officers of the ISCU and ISRU. The BOD of IFI should consider the following

[120] Ibid., P: 7–10.

criteria when assessing the fitness and propriety of individuals to serve on the Supervisory Board, as well as officers of the ISCU and ISRU: (i) good character, that is, honesty, integrity, fairness and reputation; and (ii) competence, diligence, capability and soundness of judgement. It should be noted that the above list is not exhaustive and, accordingly, the BOD should consider all other relevant matters on a case-by-case basis, in particular, aspects that are relevant to the segments of the IFSI they are in, and the jurisdiction's legal and regulatory framework.

In assessing the competence and capability of a person, all relevant factors should be considered, including, but not limited to: (i) whether the person has demonstrated, through qualifications and experience, the capacity to successfully undertake the responsibilities of the position; (ii) whether the person is physically, mentally and emotionally fit to perform his or her duties; (iii) whether the person has ever been disciplined by a professional, trade or regulatory body, dismissed or requested to resign from any position or office for negligence, incompetence, fraud or mismanagement; and (iv) whether the person has a sound knowledge of the business and the responsibilities of the position. It follows that members of the SSB and officers of the ISCU and ISRU should at least possess the appropriate knowledge and skills for them to execute their duties and responsibilities adequately.

Principle (2.2) states that the IFI shall facilitate continuous professional development of persons serving on its SSB, as well as its ISCU and ISRU, if any.

When they are first appointed to the positions, the IFI shall ensure that members of the SSB and internal *sharia* officers receive appropriate training (including with regard to their role and responsibilities and how to discharge their duties). It is equally important that IFI allocate resources so that members of the SSB and the internal *sharia* officers can receive further relevant training, particularly on relevant new laws, regulations and changing commercial risks, from time to time,

as it is unfair and unrealistic to expect them to be knowledgeable about industry-specific issues unless they are adequately trained. IFI can tailor the types of training so that they are equipped with industry-specific knowledge in accordance with the latest trends and developments happening in the marketplace.

Principle (2.3) states that there should be a formal assessment of the effectiveness of the SSB as a whole and of the contribution of each member to the effectiveness of the Board.

Members of the *Sharia* 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. Such performance criteria, which allow for comparison with industry peers, should be developed together and in consultation with the SSB. These performance criteria should not be arbitrarily or unilaterally changed by the IFI, and where circumstances deem it necessary for any of the criteria to be changed, the onus should be on the IFI, through the BOD, to justify this decision.

An IFI may allow the SSB to carry out a self-assessment, based on pre-agreed criteria. Individual evaluation should aim to assess whether each member of the Board continues to contribute effectively and to demonstrate commitment to the role (including commitment of time for attending relevant meetings, drafting *sharia* pronouncements and performing any other duties).The performance assessment report should be submitted to the BOD for observation and constructive comments. [121]

Principle (3.1) states that the SSB should play a strong and independent oversight role, with adequate capability to exercise objective judgment on *sharia*-related matters. No individual or group of individuals shall be allowed to dominate the Board's decision-making.

[121] Ibid., P: 11–13.

IFI shall have in place an appropriate and transparent process for resolving any differences of opinion between the BOD and the SSB. This process may include having direct access (after duly informing the supervisory authority) to the shareholders as a "whistle-blower". The supervisory authorities may be involved in this process of resolving differences, without compromising the binding nature of the pronouncements of the Board.

A SSB can only be deemed independent when none of its members has a blood or intimate relationship with the IFI, its related companies or its officers that could interfere, or be reasonably perceived to interfere, with the exercise of independent judgement in the best interests of the IFI by the Board.

In addition, wherever a conflict of interest is unavoidable, the member of the Supervisory Board should declare it in writing to the IFI. They must similarly report any such conflict in regard to members of their family, business associates or companies in which they have an interest. Where there is such a conflict of interest, or a duty to another party, then they should abstain from participating in the relevant decision or action on behalf of the IFI.

When a member of the SSB has multiple *Sharia* Board responsibilities/appointments, he or she must ensure that sufficient time and attention is given to the affairs of each IFI. The IFI should decide if a member of the SSB is able to and has been adequately carrying out his or her duties in serving his or her Board. Internal guidelines should be adopted that address the competing time commitments that are faced when members of one SSB serve on other SSB.

Principle (3.2) states that in order to fulfil their responsibilities, the SSB should be provided with complete, adequate and timely information prior to all meetings and on an ongoing basis.

Information provided should include background or explanatory information relating to matters to be brought before the Board, copies of disclosure

documents, financial statements and risk assessment reports. As far as possible, such information should be tailored and presented in a manner that would assist the Board to analyse not only the form of, but also the substance surrounding, the issues brought before them.

Hence, the SSB should have separate and independent access to the company's senior management for all the information it needs, while adhering to obligations of confidentiality. Also, the Board should have separate and independent access to the ISCU and ISRU, respectively, to check whether internal control and compliance procedures have been appropriately followed and that applicable rules and regulations to which the IFI is subject have been complied with.

Principle (4.1) states that SSB members should ensure that internal information obtained in the course of their duties is kept confidential.

Confidential information here refers to information received by members of the Board in the course of their duties that is not public and is not authorised to be made public. This includes information received under seal, expressly marked or designated by the IFI to be kept confidential, or relating to the deliberative processes of the IFI. Information that is not considered confidential includes *sharia* rules and principles, reports and pronouncements of the SSB published by the IFI for public knowledge, and other information disclosed in public documents or proceedings.

The same rules of confidentiality should be imposed on internal *sharia* officers. Confidentiality obligations do not end when a member of the SSB ceases to serve an IFI or when a matter is completed or closed. Members of the SSB should observe the same restrictions unless they have obtained express authorisation from the IFI that relieves them from such an obligation. Every member of the Board should sign a non-disclosure agreement or a letter of undertaking affirming their obligation to observe confidentiality and secrecy in respect of business and market-sensitive information shared with them by the IFI.

In the event that the SSB or one of its members to leaking or revealing confidential or market-sensitive information to inappropriate parties, the IFI should at least have appropriate risk-management and control processes in place to limit the damage of such leakage. Wherever possible, the IFI should establish a process for taking disciplinary and/or other administrative actions against the Board or its members to ensure absolute accountability and appropriate remedy.[122]

Principle (5.1) states that the IFI should fully understand the legal and regulatory framework for issuance of *sharia* pronouncements in the jurisdiction where it operates. It should ensure that its SSB strictly observes the said framework and, wherever possible, promotes convergence of the *sharia* governance standards.

The intellectual property of such *sharia* pronouncements could actually be owned exclusively by the IFI, depending on the terms of reference of members of the SSB. In this respect, bearing in mind that the Board or its members, as free agents, are generally allowed to provide services to any client other than the IFI without any restriction, each IFI may need to establish additional safeguards to ensure that *sharia* pronouncements developed based on their business intelligence and internal information would not be exploited by inappropriate parties. In other words, the dissemination of the *sharia* pronouncements might have to be restricted based on terms and conditions set by the IFI.

In respect of the ex-ante stage, i.e. at the product design/development stage, in countries where there is a central authority issuing the *sharia* pronouncements, the SSB of the IFI is usually required to follow and adopt such *sharia* pronouncements as are issued by that Central *Sharia* Authority. In jurisdictions where there is no such body, it is recommended that the SSB follows and adopts the *sharia* pronouncements issued by internationally recognised bodies that issue authoritative opinions on *sharia* matters. If that is not possible, the SSB

[122] Ibid., P: 15–18.

should exercise its best efforts in documenting and publishing the *sharia* pronouncements so that they can be openly assessed by the industry's stakeholders (subject to the appropriate observance of confidentiality).

As for the ex-post stage, i.e. after the products have been offered to customers, from time to time, members of the SSB should participate in various seminars, workshops and meetings of the *sharia* scholars specialised in *fiqh-almuamalat* to present and debate existing and new *sharia* pronouncements. Members of the Board must also expect to answer questions from shareholders and the public in a general assembly or similar forum. For better recording and dissemination of information, it would be helpful if they were to produce in the annual reports a section on *sharia*-compliance by the IFI and *sharia* pronouncements issued by the Supervisory Board and/or its members, including clarification of the process governing how the Board reached its decisions [123]

The Principles of Corporate Governance in Standard no. 3 and Principles of *Sharia* Corporate Governance in Standard no. 10 are emphasised under the recent Standard IFSB-16 on Revised Guidance on Key Elements in the Supervisory Review Process of IFI.

The overall aim of IFSB-16 is to revise and replace IFSB-5 in setting forth guidance on key elements in the supervisory review process for authorities supervising IFI, taking into consideration the specifics of the IFI, the lessons learned from the global financial crisis, while complementing the existing international standards on the supervisory review process, in particular those of the BCBS. This document represents the views of the IFSB on (a) the IFSB Standards that the IFI are expected to observe; and (b) the practices that supervisory authorities are expected to apply. The areas addressed by this guidance include, inter alia: (a) regulatory capital requirements; (b) internal capital adequacy assessment process; (c) risk management, including enterprise

[123] Ibid., P: 20–21.

risk management; (d) corporate and *sharia* governance; (e) securitisation exposures; (f) concentration risk and counterparty credit risk; (g) assessment of the rate of return risk in the banking book; (h) sound stress testing practices; (i) Islamic windows operations; (j) consolidated and home-host supervision, and supervisory colleges; and (k) transparency and market discipline.[124]

Addressing the relevant aspects of corporate governance from the perspective of IFI in accordance with IFSB-3, IFSB-16 emphasizes that the general elements of governance in IFI include: (a) compliance with *sharia* rules and principles; (b) the role of the SSB in governance, the role of auditors in terms of independence and accountability, and the extent to which supervisory authority can rely on third parties; (c) the rights of the investment account holders: processes and controls in IFI (such as a governance committee) for protecting their rights; and (d) transparency of financial reporting in respect of investment accounts.

As there is no single model of corporate governance that works well in every institution or country, the supervisory authority needs to review the controls and the quality of internal governance that have been put in place to ensure that an IFI's control environment is (a) consistent with the general framework; and (b) commensurate with the size, complexity and nature of the business. Supervisory authorities should require IFI to have in place an appropriate mechanism for obtaining rulings from *sharia* scholars, applying *fatawa* and monitoring *sharia*-compliance in all aspects of their business operations. The establishment of an SSB or equivalent body in their governance structure is the usual step taken by an IFI to this end. The qualifications of the members of the SSB should be subject to the review of the respective supervisory authority. This requires supervisory authorities to outline and make available the evaluation criteria for the assessment of the qualifications and reporting responsibilities of the SSB. Also, supervisory authorities should require IFI in their jurisdiction to implement

[124] "IFSB Standard No.16: Revised Guidance on Key Elements In The Supervisory Review Process of Islamic Financial Institutions," P: 2.

both the requirements of IFSB-3 as regards the establishment and functioning of a governance committee (or some equivalent arrangement). [125]

Under the Risk Management and Risk Management Process, IFSB-16 stipulates that when evaluating the quality of internal controls of an IFI, the supervisory authority should give due consideration to reviewing the key elements set out in the IFSB guiding principles on risk management (IFSB-1), corporate governance (IFSB-3) and *sharia* governance (IFSB-10). [126]

Under General Principles, IFSB-16 states that while the primary responsibility for compliance with applicable *sharia* rulings rests with the management of the IFI, supervisory authorities have to satisfy themselves that it has an appropriate internal compliance system, with policies and procedures in place to ensure compliance. In this respect, supervisory authorities should ensure that IFSB-10 (on *sharia* governance) is being adhered to in their respective jurisdictions. [127]

In regard of IFI licensing, IFSB-16 refers to IFSB-10 and states that an institution applying for a licence as an IFI must ensure that its business and activities are fully *sharia*-compliant, and establish and maintain effective systems and controls to ensure that it complies with all applicable *sharia* requirements at all times. It also confirms that the framework established by the supervisory authority may include: (a) appropriate requirements when applying for licensing as an IFI; and (b) a broad framework governing applicable Islamic financial transactions, including appropriate governance structure and procedures in place to ensure compliance with *sharia* rules and principles. [128]

Under *sharia* governance, IFSB-16 again refers to IFSB-10 stating that its principles address the components of a sound *sharia* governance system,

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[125] Ibid., P: 16–18.

[126] Ibid., P: 19.

[127] Ibid., P: 3.

[128] Ibid., P: 6–7.

especially with regard to the competence, independence, confidentiality and consistency of *sharia* boards. Given the needs and requirements of different types of IFI from *sharia* governance, IFSB-10 acknowledges that there are various *sharia* governance structures and models that have been adopted in different jurisdictions where IFI are present, suggesting a no single model or one-size-fits-all approach. Supervisory authorities should require that each IFI has a properly functioning *sharia* governance system in place, which clearly demonstrates, inter alia: (a) clear terms of reference regarding the SSB's mandate, reporting line and responsibility; and (b) well-defined operating procedures and lines of reporting. The supervisory authority should satisfy itself that an IFI's *sharia* governance system covers the relevant ex-ante and ex-post processes. While the former concerns: (a) the issue of *sharia* pronouncements; and (b) compliance checks before the product is offered to the customers (ex-ante compliance), the latter is about internal *sharia* review and *sharia* governance reporting (ex-post compliance). Supervisory authorities should verify that the SSB or comparable body is provided with complete, adequate and timely information on any product or transaction on which a pronouncement is sought, including having its attention drawn to any areas of possible difficulty identified to the IFI's management. Supervisory authorities should also verify whether the following elements have been reflected by the IFI in the *sharia* governance mechanism: (a) issue procedures of relevant *sharia* pronouncements/ resolutions and dissemination of information on such *sharia* pronouncements/ resolutions to the operative personnel of the IFI who monitor the day-to-day compliance with *sharia* pronouncements; (b) an internal *sharia* compliance review/audit verifying that *sharia*-compliance has been achieved; and (c) an annual *sharia* compliance review/audit verifying that the internal *sharia* compliance review/audit has been appropriately carried out and its findings have been duly noted by the *sharia* board. Supervisory authorities should, at the least, enforce the implementation of IFSB-10 in their jurisdictions, and may wish to provide additional guidance on *sharia* governance to IFI, to facilitate their understanding and performance of

their roles in achieving *sharia* governance objectives, thereby promoting the soundness and stability of the Islamic financial services industry.[129]

The principles outlined in the standards set out above will be referred to and discussed throughout the thesis in accordance with their relevance to the subject matter of different chapters.

2.6.2.2 Accounting and Auditing Organisation of Islamic Financial Institutions

The Accounting and Auditing Organisation of Islamic Financial Institutions (AAOIFI) was established in accordance with the agreement of association signed by the IFI on 26 February 1990 in Algiers. It was registered on 27 March 1991 and based in Bahrain.

This organisation was the first element of the Islamic supervisory network. It is an independent industry body, dedicated to the standardisation and harmonisation of international Islamic finance practices and financial reporting, in accordance with *sharia*, providing Islamic finance markets with standards that can support the growth of the industry. [130]

From 1993, the organisation has produced standards in the areas of accounting, auditing, ethics, governance, and *sharia* for IFI. The *Sharia* Council of the AAOIFI has produced a substantial work on how to standardise financial reporting, including reporting on *sharia*-compliance. These standards are gaining wider acceptance and hence are being adopted by the financial regulators and applied by IFI worldwide. As such, they are compatible with the International Financial Reporting Standards.

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[129] Ibid., P: 19.

[130] "Accounting and Auditing Organisation of Islamic Financial Institutions," accessed January 30, 2015, http://www.aaoifi.com.

The AAOIFI has so far issued 40 accounting standards and 48 *sharia* standards with the purpose of bringing diverse *sharia* opinions to universally acceptable standards; seven standards were issued in May 2012. Overall, there are five Auditing Standards, seven Governance Standards, and two Ethics Standards. The AAOIFI Governance Standards for IFI cover the following areas:

- AAOIFI-1: SSB
- AAOIFI-2: *Sharia* Review
- AAOIFI-3: Internal *Sharia* Review
- AAOIFI-4 Audit and Governance Committee
- AAOIFI-5: Independence of SSB
- AAOIFI-6: Statement on Governance Principles
- AAOIFI Ethics: Code for Accountants and Auditors
- AAOIFI Ethics: Code for Employees

Given that this study is centred on *sharia* governance and supervision, it focuses here on discussing the relevant AAOIFI standards of governance for IFI: Governance Standard for IFI No. 1 on SSB: Appointment, Composition and Report,[131] Governance Standard for IFI No. 2 on *sharia* Review,[132] Governance Standard for IFI No. 3 on Internal *Sharia* Review,[133] and Governance Standard for IFI No. 5 on Independence of SSB.[134]

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[131] "AAOIFI Governance Standard No.1: Sharia Supervisory Board: Appointment, Composition and Report," 2008.

[132] "AAOIFI Governance Standard No.2: Sharia Review," 2008.

[133] "AAOIFI Governance Standard No.3: Internal Sharia Review," 2008.

[134] "AAOIFI Governance Standard No.5: Independence of Sharia Supervisory Board," 2008.

The Governance Standard for IFI No. 1 on SSB: Appointment, Composition and Report

AAOIFI Governance Standard No. 1 was previously an Auditing Standard and has been reclassified as a Governance Standard. It aims to establish standards and provide guidance on the Definition, Appointment, Composition and Report of the SSB in order to ensure the full compliance of IFI with *sharia*.

The standard provides the following definition for the SSB:

> "A SSB is an independent body of specialised jurists in *fiqh-almuamalat* (Islamic commercial jurisprudence). However, the SSB may include a member other than those specialised in *fiqh-almuamalat*, but who should be an expert in the field of IFI and with knowledge of *fiqh-almuamalat*. The SSB is entrusted with the duty of directing, reviewing and supervising the activities of the IFI in order to ensure that they are in compliance with *Sharia* Rules and Principles. The *fatawa*, and rulings of the SSB shall be binding on the Islamic financial institution". [135]

According to this standard, the appointment and dismissal of the SSB shall be made by the shareholders in their annual general meeting upon the recommendation of the BOD, taking into consideration the local legislation and regulations. In the event of an appointment, the BOD may be authorised by the shareholders to fix the remuneration of the SSB.

The SSB shall consist of at least three members, it may seek the service of consultants who have expertise in business, economics, law, accounting and/or others. However, they should not include directors or significant shareholders of

[135] "AAOIFI Governance Standard No.1: *Sharia* Supervisory Board: Appointment, Composition and Report," P: 4.

the Islamic Financial Institution. The SSB shall appoint from among its members or any other person a supervisor(s) to help it in performing its duties.[136]

The rest of this standard illustrates the basic elements of the SSB report, which should contain the following:[137]

a) Title
b) Addressee
c) Opening or introductory paragraph
d) Scope paragraph describing the nature of the work performed
e) Opinion paragraph containing an expression of opinion on the compliance of the IFI with *Sharia* Rules and Principles
f) Date of report; and
g) Signature of the members of SSB.

These elements clearly state that the management of the IFI is responsible for properly complying with *Sharia* Rules and Principles, and that the SSB has to perform appropriate tests, procedures and review work as appropriate to ensure such compliance.

Where appropriate, the SSB examines, on a test basis, each type of transaction and evidence to support that the transaction and dealings are in compliance with *sharia*. Accordingly, the Opinion Paragraph in the SSB's Report should include a clear statement that: the financial statements have been examined for the appropriateness of the *sharia* basis of allocation of profit between the equity holders and the investment account holders, that all earnings that have been realised from sources or by means prohibited by *sharia* have been disposed of to charitable causes, and whether the calculation of the *zakah* ((tax for the purification of wealth) is in compliance with *sharia*. Most important is that any

[136] Ibid., P: 4–5.

[137] Ibid., P: 5–7.

violations by the management of *Sharia* Rules and Principles, *fatawa*, or rulings and guidance issued by its SSB, need to be clearly stated in the Opinion Paragraph of the SSB Report.

The date and signatures of the SSB members on the Report should not be earlier than the Financial Statement that is approved by the management, and the Report shall be published in the annual report of the Islamic Financial Institution. Also, it is recommended that the IFI publishes the *fataws*, rulings and guidelines issued by its SSB during the year.[138]

The Governance Standard for IFI No. 2 on *Sharia* Review

This AAOIFI Governance Standard was previously Auditing Standard No. 1. It aims to establish standards and provide guidance to assist the SSB of IFIs in performing *sharia* reviews to ensure compliance with the rules and principles as reflected in the *fatwas*, rulings and guidelines issued by them.[139]

The standard provides the following definition for the *sharia* review:

> "*Sharia* review: is an examination of the extent of an IFI's compliance, in all its activities, with the *sharia*. This examination includes contracts, agreements, policies, products, transactions, memoranda and articles of association, financial statements, reports (especially internal audit and central bank inspection), circulars, etc.".

As with Standard No. 1, Standard No. 2 confirms that the responsibility for compliance with *sharia* rests with the management of an IFI (consideration should be given to the definition of management in relevant national legislation and regulations). To enable management to carry out this responsibility

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[138] Ibid.

[139] "AAOIFI Governance Standard No.2: *Sharia* Review," P: 14.

effectively, the SSB of the IFI shall assist by providing guidance, advice and training relating to compliance with the *sharia*.

The SSB is responsible for forming and expressing an opinion on the extent of an IFI's compliance with the *sharia*, and the *sharia* review of an IFI does not relieve management of their responsibility to undertake all transactions in accordance with the *sharia*.

It is the management's responsibility to provide the SSB with all information relating to the IFI's compliance with the *sharia*. If any restrictions are imposed, these shall be included in the *Sharia* Review Report to the shareholders. [140]

The rest of this standard illustrates *sharia* review procedures, in the following stages: [141]

- Planning review procedures
- Executing review procedures and preparation and review of working papers
- Documenting conclusions and report

The planning and designing of *sharia* review procedures shall allow its completion in an effective and efficient manner. It shall be adequately developed to include a complete understanding about the IFI's operations in terms of products, size of operation, locations, branches, subsidiaries and divisions. This shall include obtaining a list of all *fatawa*, rulings and guidelines issued by the SSB. Understanding the activities, products and management's awareness and attitude towards compliance with the *sharia* is essential and will have a direct effect on the nature, extent and timing of the *sharia* review procedures. The plan shall be properly documented including the sample selection criteria and sizes, taking into consideration complexity, and frequency of transactions. The review

[140] Ibid.

[141] Ibid., P: 15.

procedures shall cover all activities, products and locations. The procedures shall ascertain whether SSB-approved transactions and products have been undertaken and all related conditions have been met.

At the execution of the *sharia* review procedures and preparation stage, all the planned review procedures are implemented; they normally include:

- Obtaining an understanding of the management's awareness, commitment and compliance control procedures for
- Reviewing of contracts, agreements, etc.;
- Ascertaining whether transactions entered into during the year were for products authorised by the SSB;
- Reviewing other information and reports such as circulars, minutes, operating and financial reports, policies and procedures, etc;
- Consultation/co-ordination with advisors such as external auditors; and
- Discussing findings with an IFI's management.

Finally, the SSB shall document their conclusions and prepare their report to the shareholders based on the work done and discussions held, which then shall be read at the Annual General Meeting of the IFI. This report shall be based on the previously discussed AAOIFI Governance Standard No. 1, and a detailed report, when warranted, shall also be issued to an IFI's management.

In terms of quality assurance, the SSB shall implement adequate quality control policies and procedures to ensure that the review is conducted in accordance with this standard, which may include a review of all work papers to ensure that review procedures were properly understood and executed.[142]

[142] Ibid., P: 16.

The Governance Standard for IFI No. 3 on Internal *Sharia* Review

This AAOIFI Governance Standard, aims to establish standards and provide guidance on the internal *sharia* review in institutions which conduct business, in conformity with *Sharia* rules and principles; it covers the following aspects:[143]

- Objectives;
- Internal *sharia* review;
- Independence and objectivity;
- Professional proficiency;
- Scope of work;
- Performance of the internal *sharia* review work;
- Management of the internal *sharia* review;
- Quality assurance; and
- Elements of an effective internal *sharia* review control system.

According to the standard, the primary objective of the internal *sharia* review is to ensure that the management of an IFI discharge their responsibilities in relation to the implementation of the *Sharia* rules and principles, *fatawa,* guidelines and instructions determined by the SSB of the IFI. This review shall be carried out by an independent division/department or part of the Internal Audit Department, depending on the size of the IFI, to examine and evaluate the extent of compliance with *Sharia* rules and principles, *fatawa*, guidelines and instructions issued by the IFI's SSB.

As an integral part of its organs of governance operating under the policies established by the IFI, the internal *sharia* review division/department shall have a statement of purpose, authority and responsibility. Its charter shall be prepared by management, approved by the SSB of the IFI and issued by the BOD. [144]

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[143] "AAOIFI Governance Standard No.3: Internal *Sharia* Review," P: 22.

[144] Ibid.

The internal *sharia* reviewers are to have no executive authority or responsibility for the activities they review. Nonetheless, their organisational status shall not be lower than that of the Internal Audit Department/Internal Control Department. To enhance their organisational status, they shall have direct and regular communications with all levels of management, SSB and external auditors, with no limitation on scope or restriction of access to documents, reports, etc. The Head of the internal *sharia* review shall be responsible to the BOD, and shall ensure full *sharia* review coverage, adequate consideration of the review's reports, and appropriate action on recommendations.

To meet its objective, the staff of the internal *sharia* review shall be proficient and have appropriate educational background and relevant training. They shall possess the disciplines, knowledge and skills essential to the performance of internal *sharia* reviews. Proficiency in *Sharia* rules and principles in general, and *fiqh-almuamalat* in particular, is required.

Internal *sharia* reviewers shall exercise due professional care, which shall be appropriate to the complexities of their performance. In performing internal *sharia* reviews, they shall be alert to the possibility of intentional wrongdoing. The Head shall be responsible for providing appropriate supervision and ensuring that reviews are properly supervised, as appropriate evidence of supervision shall be documented and retained.

The scope of work of the internal *sharia* review shall encompass the examination of the adequacy of the system of internal *sharia* control to ascertain whether the established system provides reasonable assurance that the IFI objectives of compliance with the *sharia* rules and principles will be met efficiently; and evaluation of the effectiveness of the IFI's system of internal *sharia* control to ascertain whether the system was functioning as intended.[145]

[145] Ibid., P: 23–24.

The internal *sharia* reviewers' planning documentation shall include, but is not limited to, the following: [146]

- Obtaining background information about the activities to be reviewed, such as locations, products/services, branches, divisions, etc.
- Establishing internal *sharia* review objectives and scope of work.
- Obtaining SSB *fatawa*, guidelines, instructions for the year prior to the internal and external *sharia* review results; and relevant correspondence including with supervisory and regulatory agencies.
- Determining the resources necessary to perform the internal *sharia* review.
- Communicating with all individuals in the IFI who need to know about the internal *sharia* review.
- Performing, as appropriate, a survey to become familiar with activities, risks, and controls to identify areas of the internal *sharia* review and to invite reviewees' comments and suggestions.
- Writing the internal *sharia* review programmes.
- Determining how and when the internal *sharia* review results shall be communicated.
- Obtaining approval of the internal *sharia* review work plan from the concerned authorities including the SSB of the IFI.
- Examining and evaluating internal *sharia* review information.

Accordingly, information shall be collected on all matters related to the internal *sharia* review's objectives and scope of work, including examination of documentation, analytical reviews, inquiries, discussions with management, and observations. Information shall be sufficient, reliable, relevant and useful to provide a sound basis for internal *sharia* review findings and recommendations.

[146] Ibid., P: 25.

The Head of the internal *sharia* review shall discuss conclusions and recommendations with appropriate levels of management before issuing the final written report. As a minimum, a quarterly written report shall be prepared and signed by the head, addressed to the BOD and copied to the SSB and management.

The report shall present the purpose, scope and results of the internal *sharia* review, and it shall contain an expression of the reviewers' opinion. Also, it shall include recommendations for potential improvements and corrective action and acknowledge satisfactory performance, when appropriate.[147]

Consequently, all disputes between management and internal *sharia* reviewers on matters relating to *sharia* interpretation shall be referred to the SSB for ruling. The reviewers shall follow up to ascertain that appropriate action has been taken on their reported findings. In addition any other recommendations relating to *sharia* matters made by the SSB, external auditors, and regulatory agencies shall be followed up. The management is responsible for rectification of non-compliance, prevention of recurrence including their timing and extent of follow-up.[148]

The Head of the internal *sharia* review shall properly manage the review, and should perform the following:

- Establish plans to carry out the responsibilities of the internal *sharia* review;
- Provide written policies and procedures to guide the staff of the internal *sharia* review; and
- Establish a programme for selecting and developing the performance of the internal *sharia* review staff.

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[147] Ibid.

[148] Ibid., P: 26.

In addition, the Head should ensure that the internal *sharia* review's efforts are properly co-ordinated with any external review.[149]

The Governance Standard for IFI No. 5 on Independence of SSB

This AAOIFI Governance Standard aims to provide guidance for members of SSB of IFI pertaining to its independence, monitoring of such independence and ways to resolve issues of independence.[150]

The importance of the independence of SSB members emanates from the board's role in:

a) Enhancing public confidence in the IFI as compliant in its application of *sharia* rules and principles.
b) Achieving the fundamental objectives of an IFI by enhancing the independence and objectivity of its SSB.

Accordingly, this standard provides the following definition of independence:

> "Independence is an attitude of mind which does not allow the viewpoints and conclusions of its possessor to become reliant on or subordinate to the influences and pressures of conflicting interests. It is achieved through organisational status and objectivity. The principle of objectivity imposes obligations on SSB members to be fair, intellectually honest and free of conflict of interests (neutral)".

The standard defines objectivity as "an independent mental attitude which SSB members should maintain in performing *sharia* supervision. SSB members are not to subordinate their judgment on *sharia* supervision matters to that of others". Objectivity requires the SSB to perform *sharia* supervision in such a manner that

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[149] Ibid.

[150] "AAOIFI Governance Standard No.5: Independence of *Sharia* Supervisory Board," P: 44.

they have an honest belief in their work. SSB should avoid potential and actual situations that impair their ability to make objective professional judgements.

In this context, the standard provides restrictions which help to maintain the objectivity and independence of the SSB: [151]

- SSB members should not be employees of the same IFI
- SSB and its members should not be involved in any manner with regard to managerial decisions and operational responsibilities of the IFI
- When SSB members are or were within the engagement or immediately preceding an engagement period, an officer of a client or partner/employee of an IFI, the preceding period should be not less than three years.
- SSB members should continuously assess their relationships with their IFI to identify any situations that may impair independence and resolve it or report to the SSB such situations in which an issue of independence impairment is present or may reasonably be inferred, and how to resolve it.

It is essential to emphasise that the SSB independence standards and rules are derived from the *Sharia* rules and principles, as is the case of the AAOIFI Code of Ethics for Accountants and Auditors of IFI and the Code of Ethics for the Employees of IFIs. Accordingly, this standard should be read in conjunction with these two codes. However, this study will not cover the details of these two codes, although relevant sections will be referred to as needed.

This standard provides that when faced with a potential and/or actual issue of independence impairment, the SSB members should adhere to the following guidelines to resolve the issue:

a) Document the issue.

[151] Ibid., P: 44–45.

b) Review the issue internally within the SSB.
c) If the issue still exists after the internal review by the SSB, the SSB member with the issue of independence impairment must resign and the General Assembly of the IFI must be notified.
d) In all the above levels of conflict resolution, consideration must be given to local laws and regulations.

The principles outlined above in the AAOIFI Governance Standards No.1, No.2, No.3 and No.5 will be referred to and discussed throughout the thesis in accordance with their relevance to the subject matter.

2.7 Conclusion

The history of modern banking practices was addressed in this chapter, establishing that the conventional financial system remains dominant worldwide even in the recently emerged and reformed Islamic states. During the modernisation of the predominantly Islamic region, the legal, judicial, and financial systems were constructed similar to Western ones, as a rational decision made by Muslim governments.

However, Muslim communities disquiet led to the growth of Islamisation movements for political and economic change. In term of financing, individual attempts were made to establish Islamic banking in the 1940s-50s, and the first successful initiatives were those of the Mit Ghamr Savings Bank in 1961-1964 and Tabung Haji in 1962.

With rising numbers of Islamic banks, the central banks brought them under their supervision.[152] Because of the absence of special regulatory guidelines and best practice standards for the IFB, the regulatory authorities began to regulate and supervise the Islamic banks along the same lines as conventional banks, with

[152] Muhammad Umer Chapra, "Mawlana Mawdūd?'s Contribution to Islamic Economics*," *The Muslim World* 94, no. 2 (2004): 163–80.

few amendments.[153] The application of conventional standards to Islamic banks actually encouraged the acceptance of their operations at the international level.

The evolution of theoretical Islamic alternatives encouraged important events to tack place for the promotion of the IFB, and movements begin toward developing new regulatory and supervisory mechanisms and standards suitable for the special nature and needs of this industry.

In consequence, a number of bodies appeared supporting the unique requirements of the emerging IFB, each had a specific role contributing to the development of a proper framework and working environment at local, regional or international levels.

Although their effort is useful and undeniable, the role and influence of these bodies is actually limited. Despite, the acknowledgment that the IFB needs special attention, their work is not directed to establish new regulations and replace the existing conventional ones. In fact, they are confined to propose solutions when conventional standards fail to address the distinctiveness of the IFB.

In the absence of a global *sharia* authority, these organisations nevertheless play a much needed role in the identification and harmonisation of Islamic financial services worldwide. In fact, it is their efforts that are currently helping in the production and consistency of practices among IFI, bringing the regulatory and supervisory frameworks of Muslim countries closer to each other.

According to each organisation's nature and purpose, their influence over the IFI varies across nations. Some are founded to serve as information and training centres providing the industry with a well-trained workforce, such as the General Council of Islamic Banks and Financial Institutions, the Islamic Research and Training Institution, the Centre for Research in Islamic Economics and the

[153] Iqbal, Ahmed, and Khan, "Challenges Facing Islamic Banking," P: 37–38.

Bahrain Institute of Banking and Finance. However, their impact appears to be limited, as it is evident that the IFI and Islamic banks still recruit their employees from the conventional financial institutions.[154] Furthermore, the short courses offered by such bodies, although beneficial, do not offer sufficient training and knowledge in the field of IFB. Nonetheless, their combined efforts are helping to produce graduates and trainees with common background knowledge and similar patterns of thinking. In the long term, such thinking could bring standardisation to their work places in the IFB.

Other bodies are concerned with Islamic research and awareness of Islamic finance, aiming at the coordination of *fatawa,* such as the International Islamic *Fiqh* Academy and the International *Sharia* Research Academy. Such bodies, although carrying out the role of unifying *fatawa* or perhaps the process of *Ijtihad* (effort or exertion), are based in different regions and in fact are serving different purposes and market needs. This is supported by the fact that the bodies referred to next have established their own *sharia* committees.

A few bodies have been established to promote Islamic financial markets, namely, the Liquidity Management Centre, the International Islamic Financial Market, and the Islamic Development Bank. The role and services of these bodies differ as they serve different purposes and different markets. It is noticeable that there are overlapping functions and limitations. For instance, the International Islamic Financial Market still has limited access and representation in the Organisation of Islamic Cooperation countries. Although Bahrain is the host of this organisation, the central banks of countries other than the GCC are not members. In addition, the Liquidity Management Centre is controlled by the Bahrain central market and cannot take independent decisions.[155]

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[154] Garas, "Internationalization of Islamic Financial Institutions: Challenges and Paths to Solution," P: 8.

[155] Ibid., P: 10.

The rest are providing different regulatory and supervisory services for the IFB in a regional and international capacity. The main ones are respectively, the AAOIFI, the IFSB, the International Islamic Rating Agency, and the International Islamic Centre for Reconciliation and Arbitration. Despite the fact that the rulings and opinions pertaining to Islamic economic and financial matters of the *sharia* committees of these organisations are highly respected by stakeholders such as *sharia* scholars, banking practitioners and policymakers, they are not mandatory and therefore remain officially not binding.

Nevertheless, the *Sharia* council of the AAOIFI is arguably the most influential international fiqh body in the IFB today. Although, there is some overlap between its remit and that of the *Fiqh* Academy of the Organisation of Islamic Cooperation, the *sharia* council of the AAOIFI focuses more on the practical issues concerning Islamic financial products.

The *Sharia* council is composed of not more than 20 members appointed by the Board of Trustees for a 4 year term from among *fiqh* scholars who represent SSB in the IFI that are members of the AAOIFI, and the Sharia boards of central banks. The 20 members are among the best known contemporary scholars, coming from different backgrounds and countries; more than half are from the GCC, unsurprisingly given that the AAOIFI is based in Bahrain; others are from Malaysia, Sudan, Pakistan, Syria, Yemen, etc. All are appointed in a personal capacity and therefore are not representatives of their home countries. The powers of the *Sharia* council include the following:[156]

- Achieving harmonisation and convergence in the concepts and application among the SSB of IFI to avoid contradiction or inconsistency between the *fatawa* and applications by these institutions, thereby providing a pro-active role for the SSB of IFI and central banks.

[156] "Accounting and Auditing Organisation of Islamic Financial Institutions."

- Helping in the development of *sharia* approved instruments, thereby enabling IFI to cope with the developments taking place in instruments and formulae in the fields of finance, investment and other banking services.

- Examining any inquiries referred to the *Sharia* council from IFI or from their SSB, to give the *sharia* opinion in matters requiring collective *Ijtihad*, to settle divergent points of view, or to act as arbitrator.

- Reviewing the standards issued by the AAOIFI for accounting, auditing, code of ethics and related statements throughout the various stages of the due process, to ensure that these issues are in compliance with the rules and principles of *sharia*.

However, none of the *Sharia* committees of the aforementioned organisations, including the AAOIFI's, has actually been accepted as the ultimate or supreme *sharia* authority for the IFB at the global level.

Accordingly, the AAOIFI standards are referred to by most financial regulators as mere recommendations.[157] This is the case in some countries active in IFB, such as Saudi Arabia, Kuwait, Malaysia, Lebanon and Indonesia. In fact, so far only few Muslim countries have accepted these standards as mandatory; among those are Bahrain, Jordan and Sudan. The standards issued by the IFSB, although aiming to provide a favourable regulatory environment for IFI and banks, remain optional for central banks.

As this study is centred on the regulatory perspective of *sharia* governance and supervision, more attention is paid to the efforts of the AAOIFI and IFSB as standard setting bodies. It is of importance to recognise that both organisations agree on the need for more specific governance for IFB. Despite being

[157] M. Fahim Khan, "Setting Standards for Shariah Application in the Islamic Financial Industry," *Thunderbird International Business Review* 49, no. 3 (May 2007): P: 298–300.

independent international organisations, based in two different countries, their work needs to be seen as complementary to each other.

A close examination of the IFSB standards addressed in this chapter shows that the IFSB works toward the efficiency of regulation and supervision in regard to IFB. Therefore, it develops and issues standards that are based mainly on the identification, management and disclosure of risks relevant to Islamic products and operations. Its far-reaching publications help the establishment of IFI and the improvement of their corporate governance frameworks. Like the internationally recognised promoter of good governance, the Organisation for Economic Co-operation and Development, it takes the position that "No single model and No single cure" suits all the IFI globally, and that the effectiveness and soundness of a corporate governance will depend on the specificities of the individual IFI. Therefore, its guiding principles do not set out detailed prescriptions in addressing all corporate governance issues, leaving it to the supervisory authorities to review and adapt according to their specific needs any of the published recommendations.[158]

On the other hand, the AAOIFI standards addressed in this chapter are more closely related to the governance standards of the SSB of IFI, including but not limited to the definition, appointment, composition, report, and general duty to ensure *sharia*-compliance of transactions, as well as fixing remuneration, selection and dismissal of the members, and the incompatibility clauses for the avoidance of conflicts of interest.

The guiding principles and standards of both the IFSB and AAOIFI are considered and highly rated by IFI as well as regulatory authorities of Muslim countries. However, the fact that they are basically voluntary organisations renders their efforts and measures less effective in practice. This is because the

[158] "IFSB Standard No.3: Guiding Principles on Corporate Governance for Islamic Financial Institutions," P: 15; "IFSB Standard No.10: Guiding Principles on *Sharia* Governance Systems for Islamic Financial Institutions," P: 4–6.

guidance and standards issued by them are not necessarily adopted. They are not binding unless the regulatory authorities have chosen to implement and impose them, or the IFI willingly accepts them.

Therefore, the standards are typical of what is known as 'soft law'.[159] Despite the fact that some countries advise or require IFI to follow them, some of these countries do not fully adhere to or comply with the standards.

Ultimately, the integration of IFB with the global financial system and the development of the industry is largely dependent on the credibility of the work done by these two standard setting organisations. However, there must be strong mechanisms in place to guarantee the universal adoption of their standards.

The currently emerging power, knowledge and governance structures for IFB tend to emulate, and therefore largely to reproduce, the existing global financial order. It is the belief of Professor Rifaat Ahmed Abdel Karim, the Secretary General of the IFSB, that the membership of active Muslim countries in IFB such as Bahrain, Indonesia, Iran, Kuwait, Malaysia, Pakistan, Saudi Arabia and Sudan, together with the Islamic Development Bank, will certainly bring order to the system, mainly due to willingness on the part of Islamic bankers.[160]

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[159] Soft law has been widely used on the international financial scene, which certainly has its effects on any domestic legal and regulatory reform. Abdul Karim Aldohni, "Soft Law, Self-Regulation and Cultural Sensitivity: The Case of Regulating Islamic Banking in the UK," *Journal of Banking Regulation* 15, no. 2 (April 2014): 164–79.

[160] Faisal Nasim, "Prospects of Islamic Banking: Legal and Other Challenges and Issues" (LLM-Degree in Commercial Law, School of Law, University of Cardiff, 2003), P: 49.

CHAPTER THREE: ISLAMIC FINANCE

3.0 INTRODUCTION

In the historical context, charging a return on loans, or a penalty in the case of delayed repayments, is prohibited in the Holy Scriptures of several major religions including Islam, and these religions provide ethical instructions that have a significant bearing on economic and commercial activities, especially financial transactions.

Although interest-free financial activities and institutions were in evidence prior to the Islamic era, Islamic financial practices, which promote interest-free transactions, first emerged during the life of the Prophet Mohammad *(SAWS)* some 1400 years ago.

The practices of Islamic financial intermediaries in Islam can be traced back to the moneychangers and moneylenders who were especially active in the cities of the *Hijaz* region, such as Makkah and Medina, catering for the needs of pilgrims.[161] Nonetheless, the first formal example of a modern IFI is the *Bayt-ul-Mal* (the treasury of the Muslim State and Community) of the *ummah* during the medieval period.[162] Islamic trade instruments evolved and were extensively used in the Islamic civilisation era, which lasted from the late 6th to the early 11th century AD. This was also the period during which the guiding principles of *sharia* were defined and Islamic society developed.[163]

To further explain the need for the infrastructure provided by the supportive organisations described in the previous chapter, this chapter distinguishes between Islamic and conventional finance. Firstly, it discusses the distinctive concept of Islamic financing by explaining the implementation of Islamic financial principles in modern banking operations. Then, the genuine differences with

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[161] Wilson, "Islamic Banking and Its Impact on the International Financial Scene," at 437.

[162] Roy, "Islamic Banking," 427–456.

[163] Schoon, "Islamic Finance–An Overview," P: 625; Schaik, "Islamic Banking," P: 45–52.

conventional products and the modifications applied to the original structures of classical financial instruments used by the modern IFI and banks are demonstrated. It is argued that Islamic products need to fit seamlessly within the framework of the dominant conventional financial system.

3.1 DIFFERENT GROUND FOR FINANCIAL MEDIATION

As indicated in the previous chapter, modern IFI and Islamic banks had to have structures and operations similar to conventional ones in order to be recognised as financial institutions and thus able to work within the conventional financial system's standards and framework. That is, they evolved to provide services and perform functions similar to conventional ones.

Nonetheless, the ideology behind IFB being *sharia*-compliant actually contradicts the essence of conventional finance and banking. It is widely known that the prime function of conventional banks is financial mediation, in which the institution acts as a middleman between savers of funds (depositors) and users of funds (investors). To survive, the institution needs to generate income in order to cover its expenses. The conventional banks perform as lender-borrower institutions where interest is considered as the rental income on capital and actually forms the backbone of this intermediary function.[164] The financial mediation services are provided on the basis of interest rates (charged and paid) on both the side of assets and liabilities.[165]

Reliance on interest, to cover the financial intermediary's costs, banned in Islam, resulted in the idea that IFI cannot perform financial mediation and that an Islamic institution can only be 'sufficiently' Islamic if it operates as a trader, i.e. one which is involved directly in trade as buyer and seller. Therefore, the potential establishment of Islamic banks practising financial mediation was not

[164] Noor Ahmed Memon, "Islamic Banking: Present and Future Challenges," *Journal of Management and Social Sciences* 3, no. 1 (2007): 01–10.

[165] Iqbal, *A Guide to Islamic Finance*, P: 1.

foreseen. In fact, some *sharia* scholars as well Islamic economists still hold this opinion.[166]

Nonetheless, most Islamic scholars today agree that financial mediation is allowed in Islam,[167] and research, especially over the last two decades, has proved that Islamic banking is not only possible but is effective as a financial intermediary. For instance, Memon (2007) argues that confining the IFI to a direct-trade category is not beneficial because it means leaving the role of financial mediation to others. He sees the importance of the IFI performing as financial intermediaries for the benefit of the *ummah*.[168] Further, it is has been successfully argued that an interest-free Islamic financial system cannot only exist but is also able to fulfil the basic tasks required and, under certain circumstances, expected of it in functioning more efficiently than the conventional financial system.[169]

The roles and functions of banks are indeed highly useful and socially desirable; banks perform an important role in the economy regardless of whether the economy in question is secular or Islamic. Financial intermediaries, whether Islamic or conventional banks, are administrators of the economy's payments system. They were established to serve their customers' financial needs and to play a major role in the financial economy.

Like their conventional counterparts, the IFI and Islamic banks are essentially businesses that seek income and work toward increasing the wealth of their shareholders and investors. However, the only difference in the case of the IFI and Islamic banks is that they should comply with *sharia* and Islamic teachings.

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[166] See for example, El-Diwany, "Is Islamic Banking Islamic?"; Ahmad et al., *Islamic Banking and Finance: What It Is and What It Could Be*.

[167] M. Fahim Khan and Mario Porzio, *Islamic Banking and Finance in the European Union: A Challenge* (Edward Elgar Pub, 2010), P: 123.

[168] Memon, "Islamic Banking," P: 7.

[169] Iqbal, Ahmed, and Khan, "Challenges Facing Islamic Banking," P: 12–13.

As such, the operations of the Islamic banks are sustainably equitable, and exhibit considerable differences from those of conventional ones. Unlike a conventional bank, an Islamic bank is conceived for the financial intermediary function of mobilising savings from the public and advancing capital to entrepreneurs on a Profit and Loss Sharing (PLS) basis.[170] Therefore, Islamic banks in fact do not have a lender-borrower relationship with their customers, where paying and receiving interest forms the backbone of that relationship. Instead, Islamic banks and customers engage in a direct trading partnership with each other, where capital and management are joined together to create value.[171]

Islamic banks mediate as an attorney to the depositors by placing funds at the disposal of borrowers and towards profitable ventures using various interest-free instruments. They directly employ investors' funds through various investment channels, either in real product markets or in capital markets. In this capacity, an Islamic bank may enter into collective partnership agreements with the customer to finance joint ventures or to establish factories or workshops.[172]

Therefore, Islamic banks stand on a conceptual ground apart from conventional banks. Although, the former practise commercial and investment services similar to those of conventional banks,[173] all of their financial instruments, transactions, products, operations, practices, activities, facilities, dealings and services must conform to *sharia*. In all cases, they must ensure that like all transactions the money is invested only through Islamically accepted channels.[174]

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[170] Nasser Suleiman, "Corporate Governance in Islamic banks," June 18, 2009, http://www.al-bab.com/arab/econ/nsbanks.htm.

[171] See for example Saw Swee-Hock and Karyn Wang, *Introduction to Islamic Finance* (Saw Centre for Financial Studies, 2008), P: 61.

[172] Valerie Low and Ramin Cooper Maysami, "One Country, Two Systems: Banking in Malaysia," *Journal of International Banking Law* 13, no. 20 (1998): at 235.

[173] Archer and Karim, *Islamic Finance*, Chapter 4, P: 44.

[174] Karim and Archer, *Islamic Finance*, P: 400.

3.2 THE DISTINCTIVE NATURE OF ISLAMIC BANKING

There is no uniform definition of the Islamic financial system, nor a common definition for either Islamic bank or Islamic banking. A definition which is accepted by reputable organisations such as the Islamic Development Bank and the Organisation of Islamic Cooperation states is that the Islamic bank is 'a financial institution whose statutes, rules and procedures expressly state its commitment to the principles of *sharia* and forbid the receipt and payment of interest from any of its transactions'.[175] Similarly, Islamic banking is defined as 'a form of modern banking based on Islamic legal concepts developed in the first centuries of Islam, using risk sharing as its main method, and excluding financing based on a fixed, predetermined return'.[176] Accordingly, the Islamic banking system is described as 'a faith-based system of financial management, which derives its principles from *sharia*, promotes profit sharing in the conduct of banking business as well as prohibiting paying or receiving interest on any transaction'.[177]

Although these definitions are useful and mention the key characteristics and components of the IFB, they do not convey the full meaning or give an accurate description of Islamic banking. Therefore, the Islamic values and *sharia* principles that the Islamic banks are required to fulfil are addressed in the next section, to explain why IFB operations must conform to a whole set of consistent Islamic moral and ethical standards.

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[175] Ezry Fahmy Eddy Yusof, Jhordy Kashoogie, and Asim Anwar Kamal, "Islamic Finance: Debt versus Equity Financing in the Light of Maqasid Al-Shari'ah" (MPRA Paper No. 20722, International Islamic University Malaysia, February 2010), P: 15, http://mpra.ub.uni-muenchen.de/20722/1/MPRA_paper_20722.pdf.

[176] Schaik, "Islamic Banking," P: 46.

[177] Garas, "Internationalization of Islamic Financial Institutions: Challenges and Paths to Solution," P: 3–4.

3.2.1 REPLACEMENT OF BANK INTEREST WITH PROFIT

It is important to emphasise that sources of *sharia* law and Islamic principles do not expressly prohibit the charging or paying of so-called bank interest. In fact, there is no single clear piece of evidence in *sharia* that directly prohibits interest resulting from banking transactions. *Riba* is the act which Islam prohibits. *Riba* 'is an Arabic noun derived from the verb *raba* which means to increase, to grow, to exceed'.[178]

The word *riba* does not have an exact translation in English. A widely shared opinion is that 'usury' is a more accurate translation than 'interest',[179] and in legal writings it is often referred to as 'unlawful enrichment'. However, *sharia* explicitly states that *riba* does not refer to a single specific type of enrichment, and that it exists wherever certain circumstances occur.[180]

The subject of *riba* is a wide one and has been extensively discussed. As there is no accurate translation for the term, interest charged or paid by modern conventional banks has become an area of dispute among Muslim scholars.[181] For the purpose of this study, a brief discussion of bank interest follows.

The prohibition of bank interest, viewed as prohibited *riba*, actually comes from the Islamic perspective of money as a mere means of exchange and mediation. Money is not a commodity, it is not an item which can be bought or sold for a

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[178] Bilal Dannoun, "Prohibition of Riba," *Net Muslims*, March 30, 2006, http://forum.netmuslims.com/showthread.php?6162-Interest-(Riba-).

[179] Philip Moore, *Islamic Finance: A Partnership for Growth*, 1st edition. (Euromoney Publications, 1997).

[180] There are seventy three different types of Riba. See Mahmoud El-Gamal, *A Basic Guide to Contemporary Islamic Banking and Finance* (ISNA Islamic Banking & Finance Series, Rice University, 2000), P: 315.

[181] For more discussion about interest refer to Erhun Kula, "Is Contemporary Interest Rate in Conflict with Islamic Ethics?," *Kyklos* 61, no. 1 (2008): P: 45–64.

price.[182] Since money does not hold a value of its own, then no value should be attached to money itself. Charging interest, which is simply returning more money against the sum which has been lent, actually means giving a time value to the lent money, and this is unacceptable in Islam.[183] However, the counter-argument is that the reality goes against this concept and that money is no longer just a mere method of mediation. Practice proves that money today is considered a commodity in its own right, and like other commodities it can be saved or traded.[184]

Although the subject is addressed by many authors, the conclusions remain controversial, for example the belief of some *sharia* scholars that interest paid or charged by banks is not prohibited *riba.* Specifically, in an article published on 1 June 1989 by *Alahram* , Dr Abd-Al-Munim Al-Nimr (an ex-Minister of *Alwaqaf* in Egypt) stated that bank interest does not constitute *riba.* In this article, he argued that the reason behind forbidding *riba* is the harm caused to the debtor; this reasoning does not actually apply to bank deposits. On two further dates in the same year (in July and November) *Alahram* published the *fatwa* of Dr Muhammad Sayyid Tantawı (Sheik u-Al-Azhar) in which he permitted certain forms of bank interest. This *fatwa* was followed by a series of five *fatawa* published in May 1991, permitting all types of banking interest.[185] A widely shared argument among these scholars, in order to justify the permissibility of bank interest, is that depositing money would establish an agreement between the banker and the customer, by which the banker becomes eligible to invest the

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[182] Shelagh Heffernan, *Modern Banking in Theory and Practice*, 1st edition. (John Wiley & Sons, 1996), P: 113–114.

[183] See for example Muhammad Nejatullah Siddiqui, "Recent Works on History of Economic Thought in Islam: A Survey" (Research Series in English No. 12, International Centre for Research in Islamic Economics, King AbdulAziz University, 1982), P: 3, http://www.kantakji.com/media/4648/c373.pdf.

[184] Zaman and Movassaghi, "Interest-Free Islamic Banking: Ideals and Reality," at 2432.

[185] El-Gamal, *A Basic Guide to Contemporary Islamic Banking and Finance*, P: 29; See as well Mahmoud El-Gamal, *Islamic Finance: Law, Economics, and Practice*, 1st edition. (Cambridge University Press, 2006), P: 139–142.

deposited money on a *wakala* (agency) basis. Thus, the banker has to pay an agreed fixed-rate return to the customer, if his investments in general are profitable. This is regardless of the profitability of the project that the customer may have chosen to invest in, or where his money was actually invested by the banker on his behalf.

Regardless of the arguments and debates concerning the subject matter of bank interest, the majority of *sharia* scholars disallow the paying and charging of interest, considering it equivalent to *riba*; charging interest by attaching monetary value for time in money exchanges resembles conventional loans and simply means paying more money for less. Therefore, the commonly held conception is that Islamic banks should not engage, as do conventional banks, in interest-based transactions or business.

However, avoiding interest does not mean that Muslims are deprived of making investments and earning money. The Prophet Mohammad (*SAWS*) himself was a trader and engaged in commercial and financial activities. Muslims are not only allowed to be involved in trade and finance to seek legitimate gain, but they are actively encouraged to do so. It is necessary to understand that *sharia* is never against earning more money as long as these gains come from lawful resources and activities that conform to specific moral and ethical standards recognised by *sharia.*

Simple returns on money without the involvement of risk are unjustified in Islam and therefore charging or receiving bank interest is prohibited as it is guaranteed and involves no element of risk. The banker-customer relationship in Islamic banks is based on partnership or cooperation contracts which may result in either profit or loss.[186] The profit gained from a partnership is lawful and it is argued that it is in no way equal to the prohibited 'interest. In the context of this study, there is

[186] Archer and Karim, *Islamic Finance*, Chapter 2, P: 19.

no need to elaborate on the subject matter of Islamic *ribh* (profit) and its being different from prohibited *riba* (interest).[187]

The relationship between Islamic banks and customers is not debt-based but rather equity-based. The creditor-debtor concept is actually eliminated in Islamic banking and replaced by PLS[188] in which the depositors take the position of shareholders and face an uncertain rate of return. The value of their deposits is not guaranteed, and their gain or loss is reliant on the profits or losses the bank makes from the invested venture.[189] On the other hand, the bank as provider of finance deals on a partnership basis. Because the banker bears the risk of losing his money if the customer's financed project fails, he becomes eligible for profit if the project makes a gain. In such a relationship, the banker actually takes the place of an investor rather than being a mere lender of money. To assure that his money is wisely spent and the investment is a success, he therefore takes an active role in the financed project.[190]

Whilst the conventional banker seeks gain without risks in the form of guaranteed interest,[191] the Islamic banker relies on a PLS structure which associates profit with risk. Unlike a conventional banking relationship, Islamic banking does not totally eliminate risk or for this matter fully transfer the liabilities to customers, but works with the customer sharing the risks and liabilities.

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[187] For differences between interest and profit refer to, Hussain Rammal, "Bending the Rules: Guaranteeing Profits in the Islamic Financial System," *Ethics And Critical Thinking Journal* 18, no. 1 (2004): P: 36–42; Muhammad Nejatullah Siddiqi, *Partnership and Profit-Sharing in Islamic Law* (Islamic Economics Series, Islamic Foundation, 2007).

[188] Ahmed, "The Evolution of the Concept and Practice of Islamic Banking-Part 1."

[189] Mohammed Akacem and Lynde Gilliam, "Principles of Islamic Banking: Debt versus Equity Financing," *Middle East Policy* 9, no. 1 (2002): P: 128–130.

[190] Qadri, "Islamic Finance: An Alternative," P: 9.

[191] Iqbal, Ahmed, and Khan, "Challenges Facing Islamic Banking," P: 16.

3.2.2 OTHER SHARIA REQUIREMENTS

It is not surprising that *riba,* as an issue facing the IFB operations has been discussed more frequently in the literature than other single aspect of Islamic financing. To find Islamic alternatives for interest-based financial operations, it is essential to understand the extended role bank interest plays in conventional mediation.

However, 'interest-free' is not an accurate description of Islamic banking.[192] Replacing 'interest' with 'profit' does not automatically render the financial transaction an Islamic one. It is undoubtedly true that being interest-free is a core feature of IFB, but it is not the only one. A transaction, even if is interest-free, may still not be deemed Islamic. It can only be described as Islamic when it fulfils all *sharia* requirements and fully adheres to a comprehensive set of Islamic principles.[193] After all, *sharia* law is concerned with all aspects of the financial transaction, and in fact is the authority on both legal and spiritual issues. Therefore, Islamic principles constitute legal obligations as well as ethical values. For instance, the prohibition of interest is not just a legal issue, but embodies ethical, economic and social matters.[194]

Therefore, Islamic banking is a more general term than interest-free banking.[195] Islamic banks, besides eliminating interest, must adhere to other requirements and fulfil certain criteria demanded by *sharia.* These are to be equally identified and fulfilled if the financial practice is to be recognised as Islamic.[196] They must not be underestimated in the sense that they form and complete the set of

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[192] Mohsin Khan and Abbas Mirakhor, *Theoretical Studies in Islamic Banking And Finance* (Islamic Pubns Intl, 2005).

[193] Iqbal, Ahmed, and Khan, "Challenges Facing Islamic Banking," P: 16.

[194] Faisal Atbani, "Islamic Legal Authorities for Islamic Banking System: The Authorisation of Sharia Compliant Banks in the UK," *Company Lawyer* 27, no. 2 (2006): at 54.

[195] Fuad Al-Omar and Mohammed Abdel-Haq, *Islamic Banking: Theory, Practice and Challenges* (Zed Books Ltd, 1996), P: 21.

[196] Khan and Mirakhor, *Theoretical Studies in Islamic Banking And Finance.*

Islamic values and therefore should not be in any way considered of less importance.

3.2.2.1 GHARAR

In terms of the prohibitions other than *riba*, the next major prohibition is *gharar*. Unlike *riba*, the word is not mentioned in the Holy *Qur'an*, but it is the conclusion of *sharia* scholars that *gharar* is equal to vanity, which is clearly mentioned as being unlawful.[197] As with *riba*, there is no exact terminology that captures the specific meaning of *gharar*, which is derived from the verbal noun *taghreer* meaning deception or misrepresentation and refers in legal terms to 'unfair business conduct'. [198]

Although *sharia* does not justify profits if the element of risk is eliminated, the risk taken in Islamic commercial transactions should not result in the prohibited *gharar*. Risks and perils, which usually accompany commercial practice in its normal course, do not coordinate with uncertainty that constitutes the prohibited *gharar*. *Gharar al-yasir* (trifling *gharar*) may be accepted under some circumstances, but not *gharar al-kathir* (excessive *gharar*). There is also *gharar al-mutawassit* (average *gharar*) which falls between the two extremes, and may be judged differently under different circumstances.

The prohibition of *gharar* is undisputed, but it is much more difficult to detect than *riba*. *Gharar* basically signifies ambiguity, uncertainty or lack of specificity in the terms of a financial contract. Although *sharia* scholars have listed a number of situations where *gharar* is most likely to take place, and have formed useful guidelines to recognise prohibited *gharar*, identifying it remains a difficult task. Despite this, Islamic banks should avoid as much as possible prohibited *gharar*.

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[197] The Holy Qur'an (2:188, 4:161).

[198] Abdul-Rahim Al-Saati, "The Permissible Gharar (risk) in Classical Islamic Jurisprudence," *Islamic Economics* 16, no. 2 (2003): P: 6–7.

Islamic bankers therefore, must be careful in the sense that transactions they conduct neither generate *riba* nor imply *gharar*.

The debate on *gharar* goes on and on amongst *sharia* scholars, with a weight of literature. However, this is not central to this study, and it is enough to know that *gharar* is different from *riba*, although easily confused with other practices and in some cases hard to identify.

3.2.2.2 HALAL PRODUCTS AND SERVICES

Besides *riba* and *gharar*, the permissibility of the subject matter of Islamic transactions must be considered. In Islamic financing, the subject matter of transactions must be of value in Islam and therefore only what is known as being *halal* (permissible and lawful).[199] Since prohibited items or services do not hold a value in the eyes of *sharia*, they form invalid subject matter for IFB transactions. For instance, alcohol, pork, gambling, adult entertainment and tobacco are disallowed in *sharia*.[200] Hence, Islamic banks must not engage in commercial transactions which, directly or indirectly, relate to these prohibitions. They have to refrain from trading or investing in these prohibitions and as providers of financial services should not help or encourage businesses which show an intention to promote such items or services.

A restrictive application of this would mean that Islamic banks have to refrain from dealing with entities or companies which run a permissible business but have a relationship with other businesses that are dealing with prohibited items or services. For example, a company who produces glass bottles for alcohol or a cargo company that transports or distributes pork should not be a customer. Permissible practices in *sharia* such as trading, selling, buying and distributing become unlawful if attached to prohibited items or services. Obviously, this

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[199] Iqbal, Ahmed, and Khan, "Challenges Facing Islamic Banking," P: 16.

[200] Schoon, "Islamic Finance–An Overview," at 629.

negatively affects the investment opportunities of Islamic traders and bankers, especially in today's mixed markets and businesses. Markets are wide open to each other and businesses are undertaken by multi-national traders or investors who come from different backgrounds and have different business interests. The interaction of markets and businesses is evident at national as well as international levels, and restricting activities to fully Islamic business opportunities undoubtedly makes the survival of Islamic commercial entities, including banks, extremely hard.

Considering this, some *sharia* scholars have agreed on a solution derived from *sharia* which enables Muslims to be involved in trade and businesses within this arena.[201] They decided that it is acceptable to deal with businesses where the principal products or services are permissible in *sharia* and un-Islamic gains as a proportion of the total income of the business do not exceed 20%. Also, if the businesses are paying interest on loans, the total of the amount paid as interest shall not exceed 25-45% of its assets. However, it should be emphasised that *sharia* scholars have provided criteria and specific conditions which should be considered very carefully before deciding that investing in a business relationship with any such entity is permissible. Furthermore, it has been suggested that doubtful incomes are to be given to charity. However, other *sharia* scholars argue that disposal of prohibited income or bank interest by giving it to charity is not Islamically right and does not actually eliminate *riba*. For instance, a prominent Jordanian *sharia* scholar argues that penalty payments in *murabaha* (cost-plus financing) contracts constitute *riba*, even if they go to charity. [202]

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[201] Atif Hanif, "Islamic Finance: An Overview," *International Energy Law Review* 1 (2008): at 10.

[202] Jamal Abbas Zaidi, "Shari'a Harmonization, Regulation and Supervision". (*AAOIFI & World Bank Conference on Islamic Banking and Finance*, 2008), P: 2, http://www.iirating.com/Documents/PresentationSpeeches/speeches/sharia%20Harmonization%20Regulation%20and%20Supervision%20AAOIFI%20World%20Bank%2010-11%20November%20Manama%20Bahrain.pdf.

In banking terms, it is of importance that funds intended for *sharia*-compatible transactions or investments and their returns are not mixed with those associated with non-Islamic transactions or investments. Islamic banks must take all necessary precautions to ensure this standard is maintained, especially when involved with non-Islamic markets. In operational terms, this requires the bank to establish different capital funds, accounts and reporting systems for each type of activity. In this sense, when a conventional bank opens an Islamic window, to a large degree it is establishing a separate entity from the rest of the bank.[203]

To sum up, *riba*, *gharar al-kathir*, and *haram* (opposite of *halal*) items or services must all be avoided, in order to generate a financial transaction that is Islamically recognised and acceptable.

The next section discusses some of the main financial instruments that are used for IFB purposes.

3.3 ISLAMIC FINANCIAL INSTRUMENTS

Instruments used by conventional banks are not suitable for the use of Islamic banks. This is because the conventional products or services are structured to generate prohibited *riba* and normally imply *gharar* as well. Islamic banking practices, on the other hand, need to conform to the aforementioned set of Islamic values and principles besides being interest-free. Therefore, the structure of financial transactions and products offered by Islamic banks, although similar, do differ from conventional ones.[204]

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[203] Solé, "Introducing Islamic banks into Conventional Banking Systems," P: 5.

[204] Schoon, "Islamic Finance–An Overview," P: 631.

3.3.1 ALTERNATIVE FINANCING TECHNIQUES

Islamic banking is in many ways very similar to conventional banking, except that the contracts and transactions it undertakes must comply with *sharia* laws.[205] Financial instruments used by Islamic banks today are in fact a mixture or combination of those revived from the past and innovative ones.[206] Innovative interpretations of Islamic financial principles and traditional Islamic commercial transactions have been used in the design and use of a number of instruments for more complex financial tasks.[207]

Generally speaking, the operations of Islamic banks consist of the following two techniques: [208]

- Profit and Loss Sharing agreements: the relationship between the banker and customer under such instruments is one of partnership, where profit or loss resulting from the venture in which it is invested is shared according to a pre-agreed ratio. *Mudaraba* (trust financing) and *musharaka* (joint venture) are the main and only contracts of financing under this mechanism, which is otherwise known as equity-based financing.
- Leasing arrangement: *Ijara* (leasing) is where a property/machinery owned by the financial institution is leased out to the customer. The client makes rental payments to the financial institution for the use of the asset.

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[205] Zamir Iqbal and Abbas Mirakhor, *An Introduction to Islamic Finance: Theory and Practice*, 1st edition. (John Wiley & Sons, 2006).

[206] Hjh Siti Faridah Abd Jabbar, "*Sharia*-Compliant Financial Instruments: Principles and Practice," *Company Lawyer* 30, no. 6 (2009): at 184–185.

[207] Hassan and Lewis, *Handbook of Islamic Banking*, Chapter 9, P: 138; Jabbar, "Sharia-Compliant Financial Instruments: Principles and Practice," at 184–185.

[208] Rajesh Aggarwal and Takik Yousef, "Islamic banks and Investment Financing," *Journal of Money, Credit, and Banking* 32, no. 1 (2000): P: 96; Rammal, "Bending the Rules: Guaranteeing Profits in the Islamic Financial System," P: 2.

- Mark-up agreements: the banker charges the customers a cost plus a mark-up when selling back, usually to themselves or a third party, the asset bought on their behalf. Deferred contracts of exchange involving contracts of buying and selling assets are used under this mechanism,[209] which is otherwise known as debt-like financing.[210] The rest of Islamic financing contracts falls under this category, including *murabaha* (cost-plus financing), *bai-bithaman-ajil* or *bai-muajjal* (deferred payment sale), *bai-al-salam* (future delivery), *istisna* (a forward sale), *bai-al-ina* (sale and buy-back), *tawarruq* (the reverse of *murabaha*), and *bai-al-tawliya* (sale to facilitate or serve others).

The general role in Islamic theory regarding contracts of exchange is of permission. The PLS principle is unanimously accepted in the Islamic legal and economic literature as the cornerstone of financial transactions, and was widely envisaged to take over IFB operations. However, Islamic banks, after serious losses to their finances in the 1980s, moved from the use of PLS instruments to rely heavily on the debet-like transactions instead.[211] This latter model of finance was suggested by the late Dr Sami Humud,[212] who envisaged IFB closer to conventional ones and competing with them.[213] It has proved to be less risky and renders payments that are almost fixed for clients.[214] Therefore, sale- and lease-

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[209] Nik Norzrul Thani, Mohamed Ridza Mohamed Abdullah, and Megat Hizaini Hassan, *Law and Practice of Islamic Banking and Finance*, 1st edition. (Sweet & Maxwell Asia, 2003), P: 56–57.

[210] Aggarwal and Yousef, "Islamic banks and Investment Financing," P: 96; El-Gamal, "Money Laundering and Terror Financing Issues in the Middle East."

[211] Hassan and Lewis, *Handbook of Islamic Banking*, Chapter 9, P: 138.

[212] Mahmoud El-Gamal, "Islamic Bank Corporate Governance and Regulation: A Call for Mutualization" (Rice University, September 2005), P: 311, http://www.ruf.rice.edu/~elgamal/files/IBCGR.pdf.

[213] Archer and Karim, *Islamic Finance*, Chapter 4, P: 44–45.

[214] Roy, "Islamic Banking."

based methods of finance that employ mark-up price techniques started to become more popular than the PLS technique originally proposed. [215]

3.3.2 RESEMBLANCE TO CONVENTIONAL PRODUCTS

The design of Islamic products or services using mark-up mechanisms results in their resemblance to conventional ones. In order to compete in the dominant interest-based conventional financial system, Islamic banks needed to act cosmetically in their use of Islamic financing techniques, enabling continuance of the intermediary function while gaining the same benefits as interest-based banks.

Therefore, Islamic banks are failing to apply Islamic financing in its purest sense and only perform financial mediation in a modified Islamised manner.[216] As such, Islamic instruments are not employed in their traditional form.[217] Rather, their concept and structure are being used in reproducing Islamic financial transactions, which are easily compared to conventional ones. To this end, one or more Islamic contracts are employed so that Islamic products or services are comparable to conventional ones and are therefore used within the local conventional financial system.[218]

Although mark-up instruments are widely used, their acceptability under *sharia* is disputed because they could imply a fixed return. For this reason, some *sharia* scholars have argued that sale and lease contracts, being contracts of exchange, are in fact not appropriate for modern banking purposes. This is because they were originally designed for trade purposes, not intermediary financing, and as

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[215] Ibrahim Warde, "The Relevance of Contemporary Islamic Finance," *Berkeley Journal of Middle Eastern & Islamic Law* 2, no. 1 (2009): P: 166.

[216] Roy, "Islamic Banking."

[217] Hassan and Lewis, *Handbook of Islamic Banking*, Chapter 9, P: 138.

[218] Combining contracts generates forbidden interest. Tarek El-Diwany, "Holding Back the Tide," 2007. http://www.islamic-finance.com/item149_f.htm.

such their purpose is actually destroyed when they are used in modern-day banking operations. Another argument is that combining more than one contract in structuring a single financial transaction or product is likely to generate forbidden *riba*.[219] For instance, buying goods through an Islamic bank on a deferred payment basis is permissible, as is selling those goods for immediate cash to another third party. However, if these two sales were to be managed by one bank, i.e. the buyer in the first contract is the seller in the second, it would in practice constitute borrowing cash for interest. This is because the two contracts lost their original purpose when they were combined to perform this financial transaction,[220] with the intention from the beginning being to provide cash for the client.

However, the majority of scholars hold the opinion that, despite their similarities, Islamic banking remains basically different from conventional banking. They emphasise that mark-up agreements are no less Islamic than PLS instruments as long as they are constituted from contracts and transactions approved in *sharia*.[221] Their argument extends to the fact that Islamic financing is asset based, where all transactions including sale and lease are tied to real commodities.[222] This fact preserves the special nature of Islamic financial operations and sets apart Islamic banking from conventional lending-borrowing relationships.[223] Further, it has been stressed that the equivalence between debt financing and mark-up agreements is not because of prohibited interest.[224] The next section gives brief examples to illustrate the difference between Islamic and conventional banking operations.

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[219] Ibid.

[220] El-Diwany, "Is Islamic Banking Islamic?"

[221] Warde, "The Relevance of Contemporary Islamic Finance," P: 168–169; El-Gamal, *Islamic Finance: Law, Economics, and Practice*, P: 21–25.

[222] Iqbal, Ahmed, and Khan, "Challenges Facing Islamic Banking," P: 49.

[223] Zaman and Movassaghi, "Interest-Free Islamic Banking: Ideals and Reality," at 2438.

[224] Aggarwal and Yousef, "Islamic banks and Investment Financing," P: 97.

First, Islamic partnerships differ from conventional partnerships. Under an Islamic partnership, the ratio of profit sharing, although negotiable between parties, is determined from the beginning and losses are shared only to the extent of the financiers' contribution of capital.[225] This is contrary to the situation in a conventional partnership, where parties freely negotiate the ratios of capital participation with profit and loss distributions. In fact, this is the main difference between a *musaraka* partnership and a conventional sleeping partnership or preferred-shareholder contract.[226] Similarly, *mudaraba* contracts differ from conventional loans because the cost of capital to a bank's client takes the form of a pre-agreed ratio of profit rather than a fixed rate of interest.[227]

Although conventional futures and short selling bear some resemblance to *bai-al-salam*, they are not *sharia*-compliant. This is because *sharia* allows the deferment of either payment or delivery of the sold item, which is fungible, but not both. While both *bai-al-salam* and conventional futures are forward contracts, in the former only delivery is deferred, but under conventional futures both payment and delivery are deferred. On the other hand, both *bai-al-salam* and short selling involve the sale of something which is not in the possession of the seller at the time of sale, although in short selling, unlike *bai-al-salam,* this is non-fungible.[228]

In terms of mark-up agreements, concerns have been raised that such contracts in practice generate prohibited interest.[229] However, higher mark-up prices have been justified on the basis of the legal responsibilities and risks undertaken by

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[225] Muhammad Taqi Usmani, *An Introduction to Islamic Finance* (Quranic Studies Publisher, 2008), P: 2.

[226] Vogel and Hayes, *Islamic Law and Finance: Religion, Risk, and Return*, P: 3.

[227] Thani, Abdullah, and Megat Hizaini Hassan, *Law and Practice of Islamic Banking and Finance*, P: 49.

[228] Jabbar, "*Sharia* Compliant Financial Instruments: Principles and Practice," at 182.

[229] Especially where the mark-up is benchmarked to conventional interest rates. Mahmoud El-Gamal, "Overview Of Islamic Finance" (Occasional Paper No 4, Department of the Treasury Office of International Affairs-US, 2006), http://ncusar.org/programs/09-02-17-materials/08042006_OccasionalPaper4.pdf.

the parties. For instance, liabilities and risks under a *murabaha* contract are different from those under a conventional loan contract. In a *murabaha* contract, the bank bears both asset price risks and credit risks; the price risk is evident in the disposal of the goods not received by the customer at the due date and the credit risk is evident when the customer defaults on payment.[230]

A similar approach is taken in a *tawarruq* contract. Although the nature of a *tawarruq* contract is similar to conventional unsecured lending,[231] the risks borne by parties under an Islamic *tawarruq* transaction are not the same as those taken under a conventional interest-based lending transaction. Whilst the financier under the *tawarruq* contract is exposed to risks related to commodities (such as delivery risk) and the credit risk of the customer, the lender in a conventional lending transaction is only exposed to the credit risk of the borrower. In addition, a *tawarruq* transaction exposes the customer to commodities price risks.[232] However, *tawarruq* is still observed as the instrument to replace conventional loans easily for general purposes.[233]

Islamic *Ijara* financing is distinguished from a conventional finance lease,[234] i.e. the operating lease, in that the lessor, under a *Ijara* agreement would still be responsible for the major or structural maintenance needed for the leased assets during the lease period; this is because the lessor holds the ownership of the leased asset during the leasing period.[235] Also, the payable rent must be agreed

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[230] Thani, Abdullah, and Megat Hizaini Hassan, *Law and Practice of Islamic Banking and Finance*, P: 58; Archer and Karim, *Islamic Finance*, P: 32–33.

[231] El-Gamal, "Overview Of Islamic Finance," P: 5.

[232] Hanif, "Islamic Finance: An Overview," at 11–13.

[233] To enable conventional banks to declare that their operations would be "Islamised". El-Gamal, "Overview Of Islamic Finance," P: 5.

[234] There is an operating lease and a full-payout financial lease. Thani, Abdullah, and Megat Hizaini Hassan, *Law and Practice of Islamic Banking and Finance*, P: 46.

[235] Hanif, "Islamic Finance: An Overview," at 11–13.

in the form of fixed amounts or a benchmark rate before the rent commences.[236] In addition, there is a difference between conventional hire-purchase and *ijara-muntahia-bittamleek* (buy-back leasing); ownership at the end of lease period is transferred by way of *hibah* (gift), i.e. the promise to give the leased asset as a gift for no consideration or payment of the remaining instalments, which would not be binding in a conventional hire-purchase contract.[237]

Despite the existence of controversy among *sharia* scholars as to the use of Islamic instruments similar to conventional ones, they have approved them on different grounds. Some have basically argued for necessity, explaining that there is no other way but to accept and make use of instruments or products such as 'quasi *murabaha*' until a proper institutional set-up is built, at least to help promoting IFB in the initial stage.[238] Others have simply assured the legality of these instruments or products in *sharia*. For instance, one justification for back-to-back transactions in a mark-up sale or lease contract is that *sharia* does not require a minimum time interval to own the property before reselling or leasing it back. Thus, banks are allowed to own the property for only milliseconds before disposing of it. However, the counter-argument is also based on this very concept, as other scholars hold the view that if a typical interval is 'under a millisecond' then *murabaha* contracts in practice constitute a normal loan, i.e. a conventional loan. [239]

Nonetheless, it is equally important to point out that scholars have suggested that mark-up contracts should still be restricted, fearing that they might form a back door to prohibited Interest, as they could easily imply a fixed return on investments for

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[236] El-Gamal, "Overview Of Islamic Finance."

[237] Jabbar, "*Sharia* Compliant Financial Instruments: Principles and Practice," at 182.

[238] Iqbal, Ahmed, and Khan, "Challenges Facing Islamic Banking," P: 51–54.

[239] Maclean, "Islamic Banking: Is It Really Kosher?"

banks.[240] As a matter of fact, Islamic finance replaces interest on loans and pure debt instruments (e.g. bonds) with interest characterised as rent in leases or price mark-up in sales.[241] Therefore, some prominent Islamic economists and scholars fear that relying on Islamic modes of finance other than PLS endangers the authentic nature of Islamic-based finance and banking in the long run.[242]

Finally, some scholars regard replicating conventional structures or methods in order to offer similar products to conventional banks as window dressing,[243] which clearly eliminates the distinctive features of Islamic financing. Obviously, resemblance often adds confusion and makes it difficult to identify Islamic from conventional financial operations. In fact, this puts Islamic instruments or products under question for either appearing to guarantee interest or to eliminate risk.[244]

Accordingly, the Federal *Sharia* Court of Pakistan has declared the existing system of mark-up transactions to be interest based, and hence Islamically unlawful.[245] In particular, some of the prominent scholars have held banking transactions involving *tawarruq*, *bai-al-dayn* (debt financing) and *bai-al-ina* contracts as non-Islamic, arguing that they imply hidden *riba* or *gharar*. In their

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[240] Muhammad Nejatullah Siddiqi, *Issues in Islamic Banking: Selected Papers*, vol. 4, Islamic Economic Series (Islamic Foundation, 1983); Mohammad Kabir Hassan and Mervyn Lewis, "Islamic Finance: A System at the Crossroads?," *Thunderbird International Business Review* 49, no. 2 (March 2007): P: 151–160.

[241] Al-Rimawi, "Relevance of Shari'a in Arab Securities Regulation with Particular Emphasis on Jordan as an Arab Regulatory Model," at 230.

[242] Rammal, "Bending the Rules: Guaranteeing Profits in the Islamic Financial System," P: 36–42; Warde, "The Relevance of Contemporary Islamic Finance," P: 168–169.

[243] El-Gamal, *A Basic Guide to Contemporary Islamic Banking and Finance*, P: V; Chris Wright, "The Sharia Scholar Cartel," *AsiaMoney, Chris Wright Media*, September 2006, http://www.chriswrightmedia.com/asiamoney-sep06-sharia scholars/.

[244] Rammal, "Bending the Rules: Guaranteeing Profits in the Islamic Financial System," P: 36–42; Warde, "The Relevance of Contemporary Islamic Finance."

[245] Chapra and Khan, "Regulation and Supervision of Islamic banks," P: 31.

opinion, these contracts adopt Islamic principles in form only but not in substance, because of the way they are employed in banking.[246]

In *bai-al-ina,* the client would sell his asset to the bank for an immediate cash payment and the client would then buy back the asset from the bank on an instalment basis but at a higher price than the original price at which he sold to the bank. The difference between the lower purchase price and the subsequent higher sale price is the bank's profit.

In the view of some scholars, this is considered as merely a legal device to circumvent the prohibition of *riba.*[247] Because the intention from such sales is to obtain instant cash, this results in a contract of loan instead of being one of sale.[248] Accordingly, the *Maliki* Islamic school of thought considers that such contracts need to be avoided, applying the Islamic principle of *sadd-al-dhar* i.e. the prevention of legal artifice used to achieve illegal ends through legal means. Similarly, the *Hanbali* school of thought forbids *bai-al-ina* on Prophetic traditions.[249] Obviously, these two views involve the motive or intention of the parties when determining the legality or illegality of contracts.

On the other hand, *Shafi* and a faction of the *Hanafi* schools disregard the motive or intention of the parties in contracts. They allow *bai-al-ina* on the basis that the two sales are separately valid contracts of sale, unless the second sale is stipulated in the first one. As there is no existence of expressed intentions of

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[246] Syed Imad-ud-Din Asad, "Issues in Islamic Banking," *Dawn*, September 2, 2009, http://www.dawn.com/news/342476/issues-in-islamic-banking.

[247] The legal artifice for circumventing a prohibition to attain a desired legal outcome is known as Hiyal. Vogel and Hayes, *Islamic Law and Finance: Religion, Risk, and Return*, P: 39.

[248] Thani, Abdullah, and Megat Hizaini Hassan, *Law and Practice of Islamic Banking and Finance*, P: 68–69.

[249] El-Gamal, *Islamic Finance: Law, Economics, and Practice*, P: 21–25.

parties to the sale contracts, they cannot be prohibited merely on the basis of speculation. [250]

Such a divergence in opinion reflects the unacceptability of *bai-al-ina* in most Middle Eastern countries where the *Hanbali* school of thought prevails, while the widespread acceptance of this contract is evident in Malaysia where the *Shafi* school of thought dominates.[251]

Tawarruq is another controversial transaction, which is prevalent in the GCC.[252] This is because it is accepted only within the *Hanafi* and a faction of the *Hanbali* schools of thought. Basically, *tawarruq* is utilised by Islamic banks as a *sharia*-compliant mechanism to enable a client to obtain a loan from the bank, especially when his intention is not to buy an asset, but merely to get cash. [253]

The idea of using goods or commodities to generate cash is not a new one, as customers have been selling goods purchased by them under *murabaha* contracts to raise cash. However, the *tawarruq* structure puts this on a more formal footing and makes it easier for customers to generate cash as they do not have to take physical possession of the goods or commodities first and then find a buyer for them.

In general, a *tawarruq* transaction would involve the bank purchasing tradable commodities from a broker and selling them to the customer at a mark-up for deferred payment. The customer would then immediately sell on the commodities to the same or a different broker for immediate settlement in cash. This transaction is usually completed within a matter of minutes as the commodities are typically bought and sold through an exchange of warehouse warrants, with

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[250] Thani, Abdullah, and Megat Hizaini Hassan, *Law and Practice of Islamic Banking and Finance*, P: 68–69.

[251] Jabbar, "Sharia-Compliant Financial Instruments: Principles and Practice," at 183.

[252] Warde, "The Relevance of Contemporary Islamic Finance," P: 164–165.

[253] Jabbar, "Sharia-Compliant Financial Instruments: Principles and Practice," at 183.

the banker and the customer only holding title to the commodities for a very brief period. However, this structure is criticised by a number of *sharia* scholars as being nothing more than a disguised lending arrangement.[254] Others legalise this on the ground that the sale of the commodities by the customer is to a different broker from the one he purchased from.

It is clear that the similarity of *tawarruq* to conventional unsecured lending makes it easy for *tawarruq* to replace conventional loans for any purpose. On the other hand, this opens the door for some conventional banks to allege the Islamicity of their operations. Further, *tawarruq* has been criticised on the ground that such a practice exposes the banks to the risk of money laundering.[255] This argument, however, has been squarely rejected on a number of grounds which include the fact that IFI are subject to more stringent know-your-customer requirements, and that they are over-regulated. [256]

Bai-al-dayn, the sale of debt, is also controversial First, it needs to be established that the *sharia* allows the selling of debt for its equivalent in quantity and time of maturity by way of *hawalah* (debt transfer). This is accepted by all Islamic schools of thought on the condition that it is paid in full and gives no benefit to the purchaser, as deferred payment would involve the element of prohibited *riba* in the form of *bai-al-kali*.[257]

Sharia scholars *fuqaha* define *bai-al-dayn* as "a type of a sale contract in which the creditor sells his payable right against the debtor either to the debtor himself

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[254] Hanif, "Islamic Finance: An Overview," at 11–12.

[255] El-Gamal, *Islamic Finance: Law, Economics, and Practice*, P: 21–25.

[256] Jabbar, "Sharia-Compliant Financial Instruments: Principles and Practice," at 184.

[257] Ust Hj Zaharuddin Hj Abd Rahman, "Ruling on Debt Trading in Sharia ," *NST Business Times*, June 21, 2006, http://zaharuddin.net/senarai-lengkap-artikel/38/58--ruling-on-debt-trading-in-sharia.html?tmpl=component&print=1&page=.

or to a third party".[258] The subject matter of this sale (i.e. debet) is considered by most *sharia* jurists as *riba* bearing, because it is similar to money. Therefore, Middle Eastern countries, and in particular the GCC, do not practise *bai-al-dayn* as it constitutes what is known in Islam as *riba-al-buyu* which is also known as Riba-al-fadl (usury of trade).[259] In Malaysia, the principle of *bai-al-dayn* is used for transactions involving the sale and purchase of trade documents such as bills of exchange and bankers' acceptance. [260] This is similar to the principle of debt purchasing practiced in Iran.

The main issue that surrounds the difference of opinion among scholars is the ability to deliver the items sold as stated by Ibnu Taimiyyah and the four Islamic schools of thought. According to *Hanafi, Maliki, Shafi* and *Hanbali*, the sale of debt to the debtor is fully permissible. As the creditor has the right to waive or annul his debt at any point in time, he also has the same right to sell it to the debtor at any price he likes.

Other *sharia* scholars disallow *bai-al-dayn* to the debtor and third party alike. According to them, the debt may only be waived, and should not be sold. Selling of debt to a third party, i.e. the non-debtor, refers to a sale of debt at a discount price on a spot-payment basis, which implies that the creditor may not be willing to wait for the due date of the debt. Therefore, most *Hanafi, Hanbali* and *Shafi* jurists disallow the sale of *al-dayn* to a non-debtor or a third party.

Nonetheless, some *Shafi* and *Hanbali* thinkers, like Ibn al-Qayyim, hold the view that the creditor has the right to sell only confirmed debt to the debtor or to a third

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[258] Sano Koutoub Moustapha, *The Sale of Debt as Implemented by the Islamic Financial Institutions in Malaysia*, 1st edition (Kuala Lumpur, Malaysia: International Islamic University Malaysia, 2001).

[259] Sudin Haron and Bala Shanmugam, *Islamic Banking System: Concepts and Applications* (Petaling Jaya, Selangor Darul Ehsan, Malaysia: Pelanduk Publications, 2001).

[260] Sudin Haron, *Islamic Banking: Rules & Regulations* (Petaling Jaya, Selangor Darul Ehsan, Malaysia: Pelanduk Publications, 1997), P: 83.

party.[261] Also, *Maliki* and some *Hanafi* and *Shafi* jurists allow the sale of debt to a third party with certain conditions:

a) The ability of the seller to deliver the debt;

b) The debt must be confirmed and the contract must be performed on the spot;

c) The debt cannot be created from the sale of currency (gold and silver) to be delivered in the future and the payment is not of the same type as debt, and if it is so, the rate should be the same to avoid *riba*.

d) The debt should be goods that are saleable, even before they are received. This is to ensure that the debt is not of the food type which cannot be traded to the debtor. [262]

Some scholars argue that some forms of *bai-al-dayn* are permissible. The debt is created by the sale of goods and services through the sale-based modes of Islamic finance (particularly *murabaha*) which are permitted by the *sharia*. Therefore, the price includes the profit on the transaction and not prohibited Interest; when the bank sells such a debt instrument at a discount, the buyer actually receives a share in the profit, not prohibited interest. However, this was rejected by the majority of jurists on the basis that, when the commodity is sold, its ownership is passed on to the purchaser and it is no longer commodity of the seller. Therefore, the seller then owns only money, and if he sells the debt, it is regarded as the sale of money.

Also, it was argued that the sale of debt actually means the sale of rights on a debt and not the debt itself. In that sense, it is permitted to sell it to the third party

[261] Hanudin Amin, "An Analysis of the Classical and Contemporary Juristic Opinions on Bay Al-Dayn," *Labuan E-Journal of Muamalat and Society* 1 (2007): P: 30–33.

[262] Rahman, "Ruling on Debt Trading in Shariah."

with a discount or not. However, the majority of *sharia* scholars rejected this view as the right of the debt is still considered as the debt itself.

The Islamic *Fiqh* Academy, in its 16th convention at Mekka on 5-10 January 2002, again discussed the issue and stated that sale of debt is prohibited, including the following conditions: [263]

a) Sale of debts to debtors with a deferred payment plan exceeding the debt amount, as this can be considered as *riba riba al-fadl* and *riba an-nasiah* (usury debt).

b) Sale of debts to a third party with a deferred payment plan whether the debt is paid with the same kind or not, as this can be considered as sale of debt with debt (*bai' al-kali* which is clearly prohibited by Prophet Muhammad).

According to the Academy, the following financial transactions are disallowed because of the *riba* element in them:

- Commercial papers cannot be sold at a discount
- No dealing, issue, distribution or trade with *riba*-based bonds
- No dealing with debt notes in the secondary market as this involves discounts and sale of debts to third parties.

According to the Islamic *Fiqh* Academy, a *sharia*-approved alternative for discounted papers and sale and purchase of bonds is a sale in the form of goods; with a condition that the seller hands over the goods during contract, it is allowed even though the price of the goods is less than the value of the commercial paper.

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[263] Ibid.

Nonetheless, contemporary juristic opinions such as that of Moustapha (2001) hold the view that there is nothing wrong in the sale of debt and it should be considered as a legal sale. In his opinion, the IFI and banks in Middle Eastern countries need to reconsider their rejection of the sale of debt, as their arguments are not founded on solid ground. Moreover, they need to be more open to vital financial instruments based on the sale of debt.[264]

The development of debt discounting as an Islamic financial product is encouraged on the basis that it represents an important field of short-term and self-liquidating investment, because the terms of negotiable instruments do not in most cases extend beyond six months especially in trade-based debt discounting. Thani et al. (2003) note that *bai-al-dayn* at a discount is intensively applied to create liquidity through secondary trading. In bond trading, when a debt certificate is securitised, it becomes the property of the investor or a third party if a secondary market for the Islamic bond exists.[265]

In the Malaysian context, the debt securities instrument developed in accordance with the principle of *bai-al-dayn* is regulated by the Bank Negara Malaysia and the Security Commission *Sharia* Advisory Council to safeguard the rights of the parties involved. Therefore, the above conditions set by *Maliki* and *Hanafi* are overcome by the regulation and surveillance that protect the buyer's *maslaha* (benefit).[266]

Finally, it must be realised that that there is still room for *Ijtihad* in the *fiqh-almuamalat* as long as there is no *Ijma* (scholarly consensus) that forbids or condemns any particular practice or financial transaction. It needs to be equally noted that the consequence of diverse *fiqhi* opinions is not limited to the issuing

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[264] Moustapha, *The Sale of Debt as Implemented by the Islamic Financial Institutions in Malaysia.*

[265] Thani, Abdullah, and Megat Hizaini Hassan, *Law and Practice of Islamic Banking and Finance.*

[266] Amin, "An Analysis of the Classical and Contemporary Juristic Opinions on Bay Al-Dayn," P: 37–38.

of different *fatawa* by the SSB of IFI and Islamic banks. This is reflected in practice in the acceptance and offering of certain Islamic products in some markets when they are rejected in others.

As such, this proves to be challenging for *sharia* governance and supervision in regard of IFB operations not only at the institution or bank level, but also at the national and global levels. In this context, reference should be made to some of the important judgements or decisions that have been taken in cases involving Islamic products and services.

For instance, *Islamic Investment Company of the Gulf (Bahamas) Ltd v Symphony Gems NV and Ors*, which was decided in 2002, was the first case in front of English courts regarding Islamic finance.[267] The plaintiff agreed to finance the defendant via a revolving facility to purchase precious stones and gems on the basis of a *murabaha* agreement.

This case raised the question of the validity of the *murabaha* contract, as the defendant argued that it contradicted *sharia* principles. Two experts were called to testify, namely Dr Yahya Al-Samaan of the Saudi Law Firm of Salah Al-Hejailan and Dr Martin Lau of the School of Oriental and African Studies. Interestingly, both experts said that the underlying contract was not based on an actual *murabaha* transaction. Nonetheless, the court eventually held that the contract was entirely valid from the English law point of view and dismissed the argument of *sharia* non-compliance.

The case *of Shamil Bank of Bahrain v Beximco Pharmaceuticals Ltd & Ors* was the second case brought to English Courts.[268] Although this case mainly raised the issue of a Governing Law Clause, again the dispute involved *murabaha*

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[267] Investment Company of the Gulf (Bahamas) Ltd v Symphony Gems NV and Ors, [2002] All ER (D) 171, QB; Investment Company of the Gulf (Bahamas) Ltd v Symphony Gems NV & Ors, [2008] EWCA Civ 389, CA.

[268] Shamil Bank of Bahrain v Beximco Pharmaceuticals Ltd & Ors, [2004] 1 WLR 1784, CA.

contracts. The interesting implication of this case is the consideration by the courts of a commonly employed method of Islamic financing, and in particular the legal basis on which such agreements are founded.

In this case, the lender was the Islamic Shamil Bank of Bahrain, and the borrowers were Bangladeshi companies Beximco Pharmaceuticals Ltd and others involved in the manufacture, export and import of pharmaceuticals to and from Bangladesh. In 1995 the Bank agreed to provide the borrowers with a working capital facility taking the form of *murabaha* contracts under which the Bank utilised other techniques to extract profit instead of prohibited *riba*. The borrowers defaulted under the *murabaha* agreements, and the Bank issued formal court proceedings and made an application to the court for summary judgment.

The parties to the agreement agreed that the contract should be governed by English law subject to its consistency with *sharia* law. As a defence, the borrowers argued that the agreement was contrary to *sharia* principles and should be declared null and not enforceable. While they acknowledged that the application of *sharia* gave rise to disputes between different jurists as to the content of *sharia* itself, they argued that it was uncontroversial that *sharia* prohibited interest being charged on loans. As a consequence these *murabaha* agreements were invalid and unenforceable because they were in truth disguised loans charging interest.

The court held that the principles of *sharia* did not apply to the *murabaha* agreements. Accordingly, the High Court and Court of Appeal granted summary judgment to the Bank on its claims, concluding that the principles of *sharia* did not apply to the *murabaha* agreements, principally because that had not been the parties' intention.

In this case, it was concluded that the reference to the *sharia* in the governing law clause was not meant to replace the English law as the governing law but

was merely intended to reflect the nature of the plaintiff's business. The learned judge further stated that there could not be two separate systems of law governing a contract. The universe of Islamic finance is big, with numerous different views by various scholars and experts. In the absence of a clear codified law on Islamic finance, and without express clauses elaborating the principles agreed, it would not be practical to expect judges from English courts to determine and decide on Islamic principles.

In the case of *Investment Dar Co KSSC v Blom Developments Bank Sal*,[269] the defendant was the Islamic Investment Dar Company (TID) of Kuwait appealed against the summary judgement in favour of the claimant Blom Developments Bank (BDB) incorporated in Lebanon, which granted the latter some US$10.7million. Concerning their contract, both parties agreed that the *wakala* agreement entered into would be governed by English law subject to compliance with *sharia*. The main issues in this case involved trust and *sharia*-compliance. Interestingly, TID argued that the *wakala* agreement did not comply with *sharia* and was therefore void because it was against TID's constitutional documents, despite the fact that the *wakala* agreement had been approved by its own *sharia* board. On the other side, BDB argued that the transaction was *sharia*-compliant and had been duly certified by TID's own *sharia* board; any argument of the invalidity of such a deal was therefore void.

The judge in this case observed that the Islamic facility has already been approved by the *sharia* committee, and the *wakala* agreement was held to be valid and enforceable. Unlike in the case of *Investment Company of the Gulf (Bahamas) Limited v Symphony Gems*, the court in this case allowed the appeal and held that there was a triable issue on both claims. The learned judge agreed that the issue of *sharia*-compliance needed to go to trial for proper deliberation, but considering the deposit, TID still had to pay the amount deposited of

[269] Investment Dar Co KSSC v Blom Developments Bank Sal, [2009] EWHC 3545 (ch).

US$10,733,292.55 to BDB. For various reasons, TID finally withdrew from the case.

The controversy over Islamic financial contracts and transactions is not limited to Western non-Muslim countries. Some cases decided by the Malaysian courts and published in law reports are examined below.

Although some cases had already been looked at by the Malaysian courts, the court's intention to examine critically the underlying principles and financing facility offered by the IFI was only noticed in 2006; cases include *Affin Bank Berhad v Zulkifli Abdullah* and *Malayan Banking Berhad v Marilyn Ho Siok Lin*. Unlike the approach of the court in earlier cases, the court in these two cases further examined the compliance of practices of Islamic banking with *sharia*.

In the *Affin Bank Berhad v Zulkifli Abdullah* case, the defendant bought a house under *bai-bithaman-ajil* from the plaintiff. The financing was to be repaid over 18 years via monthly instalments. After making several payments, the defendant defaulted and the plaintiff took legal action. [270] The court granted the order for the sale of the property and held that the remaining balance had to be repaid by the defendant. The significance of this case lies in restricting the plaintiff from recovering the full amount of profit, as the court's decision was that the amount of repayment must be reduced as the termination was made earlier. This is because the court held that the Islamic contract of *bai-bithaman-ajil* was similar to a conventional loan and hence the Islamic bank could not claim the unearned profits because it was equal to a calculation of interest.

A similar decision was reached in *Malayan Banking Berhad v Marilyn Ho Siok Lin.*[271] Again the bank concerned was entitled to the sale price but not the unearned profit. The court said that it would be inequitable for any financial institution, Islamic or otherwise, to claim for the complete agreed profit when the

[270] Affin Bank Berhad v Zulkifli Abdullah, [2006] 3 MLJ 67.

[271] Malayan Banking Berhad v Marilyn Ho Siok Lin, [2006] 7 MLJ 249.

customer in fact never had the benefit of the full tenure. A similar conclusion was taken in *Malayan Banking Berhad v Ya'kup bin Oje & Anor.*[272]

Also of relevance in the *Affin Bank Berhad v Zulkifli Abdullah* case was the court's obiter on the role of the *Sharia* Advisory Council, as its feedback should be of great assistance. This case judgement has been cited in subsequent cases including, *Arab-Malaysian Merchant Bank Bhd v Silver Concept Sdn Bhd,*[273] *Tan Sri Abdul Khalid bin Ibrahim v Bank Islam Malaysia Bhd,*[274] and *Bank Islam Malaysia Bhd v Lim Kok Hoe & Anor.*[275] However, the court's discretion whether to refer to the *Sharia* Advisory Council or not changed with the introduction of the new Central Bank of Malaysia Act 2009, in which section 56 requires all proceedings relating to Islamic financial business to take into consideration the published rulings of the *Sharia* Advisory Council.[276]

The beginning of the pro-active attitude of the courts in examining the validity of Islamic banking practices was with the judgement of the High Court in the case of *Arab-Malaysian Finance Bhd v Taman Ihsan Jaya Sdn Bhd & Ors*, which encompassed twelve separate civil suits involving Bank Islam Malaysia Berhad and Arab-Malaysian Finance Berhad as the plaintiffs.[277] All twelve civil suits involved issues pertaining to the *bai-bithaman-ajil* facility, where the defendants were asked to pay the whole amount of the selling price in the event of default.

The High Court ruling in this case held that the application of *bai-bithaman-ajil* was contrary to the Islamic Banking Act 1983,[278] and the Banking and Financial

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[272] Malayan Banking Berhad v Ya'kup bin Oje & Anor, [2007] 6 MLJ 398.

[273] Arab-Malaysian Merchant Bank Bhd v Silver Concept Sdn Bhd, [2008] 6 MLJ 295.

[274] Tan Sri Abdul Khalid bin Ibrahim v Bank Islam Malaysia Bhd, [2009] 6 MLJ 416.

[275] Bank Islam Malaysia Bhd v Lim Kok Hoe & Anor and other appeals, [2009] 6 MLJ 839.

[276] *The Central Bank of Malaysia Act No (701) of 2009.*

[277] Arab Malaysian Finance Bhd v Taman Ihsan Jaya Sdn Bhd & Ors, [2008] 5 MLJ 631.

[278] *The Malaysian Islamic Banking Act No (276) of 1983.*

Institutions Act 1989.[279] However, this judgement was overturned by the Court of Appeal, which held that the contract was valid. This decision was followed in the case of *Light Style Sdn Bhd v KFH Ijarah House (Malaysia) Sdn Bhd*.[280]

Also of significance was the ruling, in the case of *Arab-Malaysian Finance Bhd v Taman Ihsan Jaya Sdn Bhd & Ors*, that a principle needs to be accepted by all four Islamic schools of thought in order to be considered as *sharia*-compliant. However, this was overruled by the Court of Appeal in the case of *Bank Islam Malaysia Bhd v Lim Kok Hoe & Anor and Other Appeals*.[281]

3.4 Conclusion

This chapter briefly addressed the inconclusive interpretation of the Islamic financial principles, arguing that uniform Islamic financial practices are unlikely. It also discussed the modifications applied to the original structures of classical financial instruments by the modern IFI and Islamic banks in order to fit seamlessly within the framework of the dominant conventional financial system.

On one hand, the similarity to conventional operations enabled Islamic banks to work in parallel with conventional banks under the dominant conventional financial system all over the world, and therefore helped to establish the view of Islamic financing as strongly competitive. More importantly, the existence of modern Islamic banks has at least given the *ummah* some choice, where previously there was none.[282] It is indeed a step forward that Muslims today in both the East and the West are able to use banking facilities that conform to the Islamic teaching they are obliged to respect and follow.

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[279] *The Malaysian Banking and Financial Institutions Act No (372) of 1989.*

[280] Light Style Sdn Bhd v KFH Ijarah House (Malaysia) Sdn Bhd, [2009] CLJ 370.

[281] Bank Islam Malaysia Bhd v Lim Kok Hoe & Anor and other appeals, [2009] 6 MLJ 839.

[282] Hjh Siti Faridah Abd Jabbar, "Islamic Finance: Fundamental Principles and Key Financial Institutions," *Company Lawyer* 30, no. 1 (2009): at 25.

On the other hand, the resemblance of the Islamic financial products to conventional ones questions the distinct nature and validity of IFB as an industry. Therefore, it is important to ensure that Islamic products evolve in such a way that they are no longer subject to criticism and stand on a clearly acceptable Islamic operating platform. This seems to be the only way for the continued development and evolution of the Islamic financial industry. Therefore, abandoning the modified Islamised manner of financing for one that is more authentic and *sharia* based is becoming more crucial each day, with the obvious expansion and interest in IFB operations worldwide.

The Muslim population, as well as some *sharia* scholars, remain sceptical about the IFB industry because the Islamic financial products do not look different from conventional products. In fact, the industry is still functioning within the conventional banking framework and therefore there is a lack of effort in bringing it closer to a *sharia*-based one. Parvez Ahmad (2010) cited findings in research by the Islamic Development Bank regarding the attitude of customers and bankers of the Islamic institutions. He reported that seven Muslims out of ten do not see the difference between the profit rate and interest, and seven out of ten are unwilling to patronise the Islamic financial institutions. because they feel there is no difference from the conventional banks. Harbhajan Singh (2008) noted that some level of scepticism is observed in managing the trust of the stakeholders, despite the tremendous growth of the industry. He relates the strength of *sharia* governance to the level of trust of the management and the BOD.[283]

Despite the acknowledgment of the distinct arena of Islamic financing, the descriptions and discussions above clearly show that there is no unanimous definition of Islamic banking. It is argued that Islamic banking covers interest-free

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[283] Ahmad Faizal Abdul Aziz, "Sharia Governance: Challenges Ahead" (MPRA Paper No. 47772, International Centre for Education in Islamic Finance, Malaysia, May 2012), P: 2, http://mpra.ub.uni-muenchen.de/47772/1/MPRA_paper_47772.pdf.

banking, but being interest-free alone does not ensure that a transaction is Islamic. The requirements for an acceptable Islamic financial product or transaction therefore exceed the fact that the practice must be free from interest. These requirements imply a consistent set of Islamic moral and ethical standards that Islamic banks need to adhere to in full, and that should not be undermined in any way in fulfilling their Islamic identity. Nonetheless, detecting Islamic prohibitions such as *riba* and *gharar* are always challenging, as is the case for recognising fully or partly productive and *halal* transactions in today's interactive international markets.

Although Islamic banking forms a cornerstone of the global financial system and is in high demand all over the world, efforts still need to be made toward the increased harmonisation and standardisation of Islamic banking activities.[284] It is notable that there are as yet no unified Islamic financial practices in existence, and that there is no complete separation in the regulations governing Islamic banks.[285] The absence of a globally accepted *sharia* authority makes conclusions about the Islamic permissibility of modern financial products or transactions an even more difficult task for IFI and banks. Unified practices would make the task of national and international regulatory bodies much easier. In consequence, this would convey a greater level of protection to the stakeholders, especially the customers or investors who normally place their belief and trust in Islamic financing above financial gain and other considerations.

Until a complete Islamic financial system is created and accepted at national and international levels, the design and use of innovative instruments requires more complex financing tasks and increases the requirement for *sharia*-compliant approval for the practices operated by Islamic banks. Usage of modified and innovative versions of the traditional Islamic financial instruments requires special

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[284] Hesse, Jobst, and Solé, "Trends and Challenges in Islamic Finance," P: 188.

[285] Tarek Zaher and Mohammad Kabir Hassan, "A Comparative Literature Survey of Islamic Finance and Banking," *Financial Markets, Institutions & Instruments* 10, no. 4 (2001): P: 187–188.

attention and in-depth interpretation of *sharia* as well as financial knowledge. Also, the fact that there remains a degree of controversy in terms of the exact meanings of the agreed Islamic prohibitions, conveys clearly the difficulty regarding this essential task.

It is argued that Islamic banks are the institutional vanguard of Islamic economics. "They have greater fiduciary duties and responsibility to their stakeholders than conventional banks" and they must comply with the *sharia* in all aspects of its operations and management.[286] Being subject to *sharia* law imposes special characteristics on Islamic banks and therefore emphasises the need to supervise them in a different manner from conventional banks.[287] Obstacles challenging this are not confined to structuring Islamic financial operations in a similar way to conventional ones. As underlined in this chapter, the reality of the inconsistency in the *sharia* pronouncements and *fatawa* results in greater diversity in modern Islamic financial practices.[288]

The judgments on different cases outlined above is proof of this. It is significant that most of the reported cases were in relation to debt-based financing. This is a consequence of the trend for offering IFB operations that resemble the conventional ones. Therefore, Islamic financial practices should be free from this domination of debt-based financing products and services, relying more on authentic Islamic financing based on partnership or PLS principles.

In most of the cases, the defence of *sharia* non-compliance was used by the defendants who defaulted on payment, despite the fact that they entered the contract knowing or acknowledging that it was an Islamic one. More interesting was the case of *Investment Dar Co KSSC v Blom Developments Bank Sal*,

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[286] Daud Vicary Abdullah and Ramesh Pillai, "Procedures for Reporting Financial Risk in Islamic Finance," *QFinance*, 2010, P: 1–5, http://www.financepractitioner.com/accountancy-best-practice/procedures-for-reporting-financial-risk-in-islamic-finance?page=1.

[287] Karim and Archer, *Islamic Finance*, P: 400.

[288] Khan, "Setting Standards for *Sharia* Application in the Islamic Financial Industry," P: 286.

where the defendant argued for the non-compliance of the contract which had been approved by its own *sharia* board.

Allowing such disputes jeopardises the competence and integrity of Islamic financial contracts. Further, it will negatively impact the image of the Islamic finance Industry, as investors will be hesitant in dealing with IFI.

Since IFB operations are on the increase, the assumption is that Islamic finance cases are also likely to increase. To mitigate the risk of *sharia* non-compliance, there is a need for a sound *sharia* governance. The regulatory authorities should give due attention to the suitability and procedures of *sharia* governance, particularly the legal status of *fatawa*, dispute-resolving mechanisms, monitoring and supervisory tools for *sharia*-compliance.

This draws attention to the relevance and importance of the existence and decision-making process of a *sharia* body at both local and national levels. This is addressed in the next part of this thesis; the following chapter is concerned with *sharia* governance and supervision at the local level, with discussion of *sharia* governance and supervision at the national level in subsequent chapters.

CHAPTER FOUR: SHARIA GOVERNANCE SYSTEM

4.0 INTRODUCTION

This chapter describes the need to implement the *sharia* governance and supervision system at the institutional level, even in the Islamic financial sector of modern Islamic states.

As discussed in the previous chapter, *sharia* permits a wide range of alternatives. However, not all are attractive business ideas and the desirable ones need to be examined for *sharia*-compliance. The process of adopting, modifying and applying business ideas in a format that is *sharia*-compliant requires a certain set of rules and procedures to be followed and continuous monitoring of the operations, in order to ensure systematic and sequential application.[289]

In this context, this chapter addresses *sharia*-compliance, as forming an additional layer of the corporate governance in IFI and banks, and discusses the important role undertaken by the institutional SSB and other internal departments, addressing the significance of their existence, functioning and unique legal position.

4.1 THE NEED FOR SHARIA GOVERNANCE AND SUPERVISION

When the traditional Islamic state existed, *sharia* formed the legal structure. Consequently, the implementation of the rulings of canon law of Islam resulted in the legality of practices being reliant on its permissibility or legitimacy under *sharia*. Therefore, all civil and commercial activities including finance were by default governed by Islamic principles and teaching. Accordingly, all systems and laws in the Islamic region have continuously been consistent with *sharia*.

As explained in chapter two, this is not the situation in today's legal systems and laws in predominantly Islamic regions. There is a wide discrepancy between the

[289] Zaidi, "Shari'a Harmonization, Regulation and Supervision," P: 6.

past legal situation, when it was dominated almost entirely by the canon law of Islam with its various *madahib* (Islamic juristic schools) and particular schismatic divisions, and the situation today.[290]

With the disappearance of the traditional Islamic state, the superiority of *sharia* as a legal system diminished. [291] In consequence, the legality of practices under positive laws does not necessarily means their acceptance or approval by *sharia*. In modern Islamic states, the legal certainty of any matter requires legislation. This is not to say that contemporary systems or positive laws of current Islamic states conflict with *sharia*, but to emphasise that the legality of a matter and its legitimacy under *sharia* become two distinct and separate issues in today's Islamic states.

In this regard, IFB operations are no different. As is the case with any other activity or practice, the establishment of Islamic banks and facilitation of their operations requires legislative and regulatory support.

The challenge for Islamic banks was to ensure the compliance of their transactions, products, documents and operations with the existing conventional banking laws, while not contradicting *sharia* principles.[292] One of the legal difficulties arising from this positioning of Islamic banks is the conflict of laws, which becomes evident in countries where *sharia* is not the ultimate legal authority.[293]

The disablement of the canon law of Islam as the governing law in modern Islamic states has led to further examination and encouraged the adoption of

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[290] Brian Russell, *Introduction to Business Law in the Middle East* (Oyez Publishing, 1975), P: 2.

[291] Yvonne Yazbeck Haddad and Barbara Freyer Stowasser, eds., *Islamic Law and the Challenges of Modernity* (Walnut Creek, CA: AltaMira Press, 2004), P: 21–53.

[292] Mei Pheng Lee and Ivan Jeron Detta, *Islamic Banking & Finance Law* (Petaling Jaya, Selangor Darul Ehsan: Pearson Longman, 2007), P: 129.

[293] Hasan, "Regulatory Framework of Shari'ah Governance System in Malaysia, GCC Countries and the UK," P: 107–109.

new legal approaches to *sharia*-compliance. This is illustrated specifically in the implementation of *sharia* governance and supervision system in the Islamic financial sectors and the establishment of the SSB within the corporate governance structure of Islamic banks.

The set of Islamic financial values and ethical standards are derived from a unique structure since the concept of *sharia* in itself offers a wider context than the existing laws.[294] Complying with *sharia* is the essence of the IFB. However, forming decisions on the compliance of IFI and Islamic banks and their transactions with *sharia* requires a special knowledge and careful attention, as addressed in the previous chapter.

This chapter explains how the institutional SSB were established for this very purpose. The next section identifies *sharia* governance and supervision within the context of the corporate governance. It is followed by a discussion on the use of the institutional SSB as the main tool in this regard.

4.2 CORPORATE GOVERNANCE

The separation between management and ownership in business has encouraged the need for internal and external control tools, by which the shareholders as owners are able to review the work of the managers. Also, the responsibility of governments to supervise businesses and companies, in order to prevent any misuse which negatively affects the national economy, has made this requirement paramount. The increasing importance of establishing efficient corporate governance and supervision is further required, so that companies are not viewed as mere economic tools and therefore expected to place financial gains above all other considerations.

The definition of corporate governance actually varies depending on the viewpoint of the policy maker, practitioner, researcher or theorist. Corporate

[294] Haron and Nursofiza, *Islamic Finance Banking System*, P: 224.

governance could encompass the area from a narrow concept as a mechanism of safeguarding investors' interests, to a broad concept advocating protection of all internal and external stakeholders' rights. [295]

The definition provided by Parkinson (1994) constitutes a good example for adopting a narrow concept: "the process of supervision and control intended to ensure that the company's management acts in accordance with the interests of shareholders."[296] This definition limits the scope of its objective to the protection of shareholders' interests. Shleifer and Vishny (1997) confine this very objective to material gain by defining corporate governance as "ways in which suppliers of finance to corporations assure themselves of getting a return on their investment." [297]

The broader concept is adopted by others, including Demb and Neubauer (1992), who define corporate governance as "the process by which corporations are made responsive to the rights and wishes of stakeholders".[298] Similarly, James Wolfensohn, ex-president of the World Bank, referred to 'fairness, transparency and accountability', as the purpose of corporate governance. Hence, the objective is to ensure 'fairness' for all stakeholders, to be attained through greater transparency and accountability.[299]

Obviously, the word 'stakeholder' has a broad meaning. Monks and Minow (2001) identify employees, customers, suppliers and the community as stakeholders,[300] and Alchaar (2006) includes supervisors and governments as stakeholders in

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[295] Jill Solomon, *Corporate Governance and Accountability* (John Wiley & Sons, 2011).

[296] John Edward Parkinson, *Corporate Power and Responsibility: Issues in the Theory of Company Law* (Clarendon Press, 1995).

[297] Andrei Shleifer and Robert Vishny, "A Survey of Corporate Governance," *The Journal of Finance* 52, no. 2 (June 1997): P: 737.

[298] Ada Demb and Friedrich Neubauer, *The Corporate Board: Confronting the Paradoxes: Confronting the Paradoxes* (Oxford University Press, 1992).

[299] Chapra and Ahmed, "Corporate Governance in Islamic Financial Institutions," P: 13.

[300] Robert Monks and Nell Minow, *Corporate Governance* (Chichester: John Wiley & Sons, 2011).

term of financial companies because of their unique role in national economies and financial systems.[301]

In its definition, the Organisation for Economic Cooperation and Development (2004) was more specific about the meaning of stakeholders:[302]

> "Corporate Governance is the procedures and processes according to which an organisation is directed and controlled. The Corporate Governance structure specifies the distribution of rights and responsibilities among the different participants in the organisation – such as the board, managers, shareholders and other stakeholders – and lays down the rules and procedures for decision-making."

As discussed in the previous chapter, the very nature of Islamic finance is that it cares for the implementation of the set of Islamic values and ethical standards that protect and benefit individuals and the whole society. It encourages investment in businesses that actually contribute to the ethical standards of Islam and the purification of bad profits. Therefore, the adoption of the broader concept of corporate governance in regard to IFI and banks is indispensable. This conclusion is supported by the existence of SSB and their essential role in preserving the Islamic identity of the financial institution through providing *sharia* governance, as will be addressed in this chapter.

In this context, Hassan and Dicle (2005) state that the main reason for the existence of Islamic banks is to be *sharia*-compliant and to offer Islamic financial alternatives for Muslim populations. Along the same lines, Rashid (2013) says

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[301] Mohamad Nedal Alchaar, *An Introduction to Islamic Banking and Finance*, 1st edition. (Securities & Investment Institute, 2006), P: 129.

[302] "Glossary of Statistical Terms" (European Central Bank, Frankfurt: The Organisation for Economic Cooperation and Development, 2004), http://stats.oecd.org/glossary/detail.asp?ID=6778.

that, IFI need to satisfy customers and other stakeholders, for the ultimate satisfaction of *Allah (SWT)*.[303]

As such, Muneeza and Hassan (2011) note that there are actually three main tenets regarding the corporate governance of IFI: first and foremost to God, then to the shareholders and then other stakeholders.[304] Besides protecting the commercial interests of the shareholders, corporate governance is concerned with the rights of the non-shareholding stakeholders.[305] Archer and Kaim (2010) include restricted and unrestricted investment account holders in the list of stakeholders.[306] Accordingly, Zubairi (2010) lists the following as a bank's stakeholders:[307]

- The shareholders (as owners)
- The BOD (a representatives of the owners)
- The bank's corporate entity (as *mudarib*)
- The management of the bank
- The account holders (depositors on a *mudaraba* basis)
- The *sharia* board (in a supervisory role as representative of owners and guardians of the rights of the stakeholders, more specifically depositors).

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[303] Mamunur Rashid, "Customer-Centric Corporate Social Responsibility: A Framework for Islamic banks on Ethical Efficiency," *Management Research Review* 36, no. 4 (2013): 359–78.

[304] Aishath Muneeza and Rusni Hassan, "The Legal Conflicts in Shari'ah Corporate Governance of Islamic Financial Institutions in Malaysia," *JKAU: Islamic Econ* 24, no. 1 (2011): 207–10.

[305] Abdul Karim Aldohni, "Islamic Banking Challenges Modern Corporate Governance: The Dilemma of Sharia Supervisory Board," *Sweet & Maxwell Ltd* 29, no. 5 (2008): at 158.

[306] Simon Archer, Rifaat Ahmed Abdel Karim, and Vasudevan Sundararajan, "Supervisory, Regulatory, and Capital Adequacy Implications of Profit-Sharing Investment Accounts in Islamic Finance," *Journal of Islamic Accounting and Business Research* 1, no. 1 (2010): 10–31.

[307] Sohail Zubairi, "Corporate Governance for Islamic Financial Institutions" (*Dar Alsharia Legal and Financial Consultancy*, U.A.E, 2010), http://www.daralsharia.com/Driver/Mcontent4/Mcnt20245270104655706.pdf.

Taking this broad concept of corporate governance into consideration, complying with *sharia* relates to the full set of Islamic values that promote social responsibilities for the benefit of the whole community. Therefore, the scope of *sharia*-compliance is actually not confined to products or services, but in fact extends to all aspects of the financial institution and its functions. It involves the protection of stakeholders' interests and rights from the corporation's actions and decisions, by taking into account *maqasid-al-sharia* (the objectives of the *sharia*).[308]

Accordingly, Aziz (2007) emphasises that every IFI should have an appropriate corporate and *sharia* governance mechanism in order to ensure the systems, policies and procedures are in compliance with Islamic principles and guidelines in all of its 'forms, spirit and substance'.[309] Similarly, Nahar and Yaacob (2011) define what is known today as *sharia* corporate governance to be "a formal system of accountability by the IFI's top management to their stakeholders and also to the Divine".[310]

According to IFSB Standard (IFSB-10, P: 1-4), explained in chapter two, the *sharia* governance system (i.e. *sharia* corporate governance system) refers to the "set of institutional and organisational arrangements through which an IFI ensures that there is effective independent oversight of *sharia*-compliance over each of the following:

a) Issue of relevant *sharia* pronouncements given by the appropriately mandated SSB or the central *sharia* authority (if any).

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[308] Zulkifli Hasan, "Corporate Governance: Western and Islamic Perspectives," *International Review of Business Research Papers* 5, no. 1 (2009): P: 288.

[309] Zeti Akhtar Aziz, "The International Dimension of Islamic Finance" (INCEIF Global Forum, Malaysia, 2007), P: 2, http://www.bis.org/review/r070903b.pdf.

[310] Hisham Yaacob Hairul Suhaimi Nahar, "Accountability in the Sacred Context: The Case of Management, Accounting and Reporting of a Malaysian Cash Awqaf Institution," *Journal of Islamic Accounting and Business Research* 2, no. 2 (2011): 87–113.

b) Dissemination of information on such *sharia* pronouncements to the operative personnel of the IFI who monitor the day-to-day compliance with the *sharia* pronouncements vis-à-vis every level of operation and each transaction.

c) An internal *sharia* compliance review/audit for verifying that *sharia*-compliance has been satisfied, during which any incident of non-compliance will be recorded and reported and, as far as possible, addressed and rectified.

d) An annual *sharia* compliance review/audit for verifying that the internal *sharia* compliance review/audit has been appropriately carried out and its findings have been duly noted by the SSB".

It should be emphasised that this standard rejects the single model and one-size-fits-all approach. It acknowledges that there are various *sharia* governance structures and models that have been adopted in different jurisdictions where IFI are present, as Principle 1.1 (IFSB-10, P: 7-10) clearly states.

4.3 SHARIA CORPORATE GOVERNANCE AND SUPERVISION

There is as yet no standard definition of *sharia* supervision. While the focus of some definitions is limited to the initial *sharia* supervision provided at the establishment of an IFI, some extend the scope of supervision to include new contracts and products, and others give a wider scope to supervision by including individuals in the process of *sharia* supervision.

However, given the definition of Islamic banking as a faith-based financial system, *sharia* supervision could similarly be defined as religion-based control or monitoring. It is the process of assuring that a financial product or service conforms with *sharia* law, either by affirming its conformity with an Islamic legal principle or by not contradicting or violating one. Ideally, this process will be part

of an Islamic product or service from the time of its development to its launch, and throughout the period that it is offered.

In its resolution number 177 (19/3) issued in April 2009, during its 19th meeting in the UAE, the International Islamic *Fiqh* Academy determined the role of *sharia* supervision in regulating the operations of Islamic banks, its importance, stipulations and the way it operates. This resolution states that *sharia* supervision means "issuing *fatawa* that are of relevance to the IFI activities following of its execution, and assuring its correct implementation".[311] Accordingly, Garas (2010) states that *sharia* supervision should cover the four following aspects: [312]

1) revision of the articles of association, along with all internal policies;

2) issue of *fatwa,* before the release of the products to the public, to ensure their compliance with *sharia*;

3) review of new products and contracts, during their execution, to ensure their compliance with *sharia*.

4) report to relevant parties, at the end of the financial period, to confirm that the income generated is legitimate (*halal*).

It is generally argued in terms of the regulation and supervision of financial institutions that over- or under-regulation should be avoided. On one hand, tightness of regulation could prove to be counterproductive. Wilson (2003) notes that over-restrictive regulations actually stifle product innovation and creativity, and potentially raise the costs of transactions and reduce the financial efficiency of the Islamic financial alternatives. Perhaps this is why many financial institutions

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[311] "International Islamic Fiqh Academy's Resolution Number 177 (19/3)," April 2009, http://www.fiqhacademy.org.sa/.

[312] Samy Garas, "The Role of the Shari'a Supervisory Board in the Governance of Islamic Financial Institutions in the Gulf Cooperation Council Countries" (Ph.D-Degree in Economics and Finance, School of Business Administration, Economics, Law and Social Sciences, The University of St. Gallen, 2010), P: 70.

prefer to operate in offshore jurisdictions such as Bahrain and Lebanon, where there are fewer stringent regulations. Wilson therefore argues that providing a degree of discretion for supervisors regarding how much legality to stipulate could be desirable.[313]

On the other hand, regulations need to be enforced by effective supervision. Accordingly, Chapra and Ahmed (2002) stress that for supervision to be effective, the objectives must be clear and the mechanisms appropriate. In this context, the degree of regulatory authorities' independence from governmental influence is important.[314]

A degree of discretion is also necessary for institutional organs involved in *sharia* governance, having a great impact on the scope of their responsibilities as well as their legal position. Here, reference should be made to those bodies regarded by the resolution of the International Islamic *Fiqh* Academy as the main components of *sharia* supervision: [315]

a) The SSB

b) The internal *sharia* supervisory department

c) Central *sharia* supervision

In terms of the approach selected by regulators for Islamic finance, El-Hawary (2007) notes that this, in fact, depends on the relationship between the secular laws of banking and the religious law in any given country.[316] Countries that maintain a greater separation between secular and divine laws of *sharia* may be reluctant to assign the *sharia* supervision task, as being of a religious nature, to

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[313] Wilson, "Regulatory Challenges Posed by Islamic Capital Market Products and Services," P: 2 & 11.

[314] Chapra and Ahmed, "Corporate Governance in Islamic Financial Institutions," P: 105.

[315] "International Islamic Fiqh Academy's Resolution Number 177 (19/3)."

[316] El-Hawary, Grais, and Iqbal. "Diversity in the Regulation of Islamic Financial Institutions."

its secular or liberal governmental authorities, such as the financial regulator. However, the case would be quite the opposite in countries with less separation.[317] While some countries demand direct involvement of the regulatory authorities in *sharia* supervision and placing *sharia*-based legal and supervisory requirements, this is not universally true.[318]

It should be remembered that, because of the influence and adoption of Westernised financial legal systems, as discussed in chapter two, the financial regulators in most modern Islamic States are in fact of a secular nature. They operate liberal financial policies, because of the co-existence of Islamic and conventional financial institutions under their financial systems. Therefore, at best they take an impartial position and try to provide equal treatment for the Islamic and conventional financial sectors. As Rethel (2011) emphasises, regulators obviously have to strike a difficult balance between ethical religious and regulatory financial practice.[319]

Hassan and Chowdhury (2004) and Wilson (2003) argue that financial services regulators and central banks cannot take on the responsibilities for *sharia*-compliance and therefore *sharia* supervision. Nonetheless, they should ensure procedures are in place to conduct these tasks. Hence, they should be aware of what *sharia* law implies and follow its developments in order to reach international *sharia* classification standards. In particular, regulators should concern themselves with issues of corporate governance, including examining the remit of the *sharia* advisors and their responsibility to end users and

[317] The separation between Islamic law and secular law was evident in writings which are at least 500 years old.

[318] Until now, it is still debatable what is more prevalent and appropriate. Zulkifli Hasan, "A Survey on Shari'ah Governance Practices in Malaysia, GCC Countries and the UK," *International Journal of Islamic and Middle Eastern Finance and Management* 4, no. 1 (2011): P: 83.

[319] Rethel, "Whose Legitimacy? Islamic Finance and the Global Financial Order," P: 88–89.

management. With the increasing internationalisation of IFB operations, regulators must focus on improved transparency.[320]

The current practices of the regulatory authorities in determining standards of *sharia* corporate governance for financial institutions follow one of two approaches. Either, the regulatory authorities themselves stipulate the *sharia* standards against which the financial institution must measure its services, or they specify the form by which the financial institution must do so. The first approach is recognised as the substantive model; the regulator's own *sharia* advisors are involved in deciding *sharia* standards and supervising the work of institutional SSB. The second approach is recognised as the formal model, in which scholars of the institutional SSB enjoy freedom in determining *sharia* standards and applying supervisory frameworks. Although the substantive model appears more attractive and reflects a direct approach to *sharia* supervision by the regulatory authorities, it is evident that the formal model is preferred and more widely practised.[321] The frameworks of *sharia* supervision under both models are further addressed in the following chapters, discussing the practices of selected countries.

This very fact is reflected in Principle 1.1 of IFSB-10 Standard. Some supervisory authorities permit IFI to decide for themselves what kind of *sharia* governance system (i.e. *sharia* corporate governance system) to adopt, and therefore, the market is left to determine freely which system lends sufficient credibility to the products and services that each IFI offers. Other supervisory authorities are concerned with market deficiencies and the need for client protection, requiring that each IFI should have a properly functioning *sharia* governance system in

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[320] Mohammad Kabir Hassan and Masudul Alam Choudhury, "Islamic Banking Regulations in Light of Basel II," *Proceedings of the Fifth Harvard Research Forum on Islamic Finance*, April 12, 2004, http://ibtra.com/pdf/journal/v1_n1_article1.pdf; Wilson, "Regulatory Challenges Posed by Islamic Capital Market Products and Services," P: 11.

[321] Michael Blair QC, George Walker, and Robert Purves, *Financial Services Law*, 2nd edition. (Oxford University Press, USA, 2009), P: 980–981.

place. A few other supervisory authorities seem to take the view that SSB have a significant role to play in monitoring the health of IFI, therefore imposing the requirement that each IFI must have a minimum number of members of the board, who must also meet certain fit and proper criteria; this is similar to the assurance sought when banks are appointing their BOD. In some jurisdictions, supervisory authorities have their own *sharia* board that works with them in issuing standardised *sharia* pronouncements, as well as aligning relevant policy and regulatory frameworks with the *sharia*. Although they may be known by different names, such as National *Sharia* Advisory Council, National *Fatawa* Council or High *Sharia* Board, their functions are similar, that is, to become the highest body issuing *sharia* pronouncements for Islamic finance services in their country.[322]

Whatever the adopted framework, the SSB plays a major and undeniable role in terms of *sharia* corporate governance. Principle 1.1 of IFSB-3, (P: 3-5) regarding the establishment of a comprehensive governance policy framework, identifies the SSB and auditors (internal and external) as the main organs of governance, emphasising that each IFI may tailor its governance policy framework to suit its business, taking into consideration international best practice.

The next section discusses the institutional SSB as the main tool of the *sharia* corporate governance system, supported by affiliated organs.

[322] "IFSB Standard No.10: Guiding Principles on Sharia Governance Systems for Islamic Financial Institutions," P: 7–10.

4.4 THE ROLE OF THE INSTITUTIONAL SHARIA SUPERVISORY BOARDS

Assuring compliance with *sharia* gives confidence to the public that the services of IFI and Islamic banks are permissible and actually different from the products offered by conventional banks.[323]

The practice of *faqih* (Muslim jurists) authenticating that instruments and services are *sharia*-compliant started only in the second half of the 1970s. The Faisal Islamic Bank of Egypt (1976), the Jordan Islamic Bank (1978) and the Kuwait Finance House (1979) each established a formal SSB and therefore gained credibility among potential clients. Thus, what started as ingenuity on the part of the IFI and banks to attract Muslim investors has now become a well accepted practice.[324] It is correct to say that, today, the management of nearly all the IFI and Islamic banks operate under the guidance of *sharia* experts.

These institutions, being subject to conventional standards and laws, have the same mechanism of controls as conventional ones. The formation process of Islamic banking companies is equivalent to that of conventional banks, which requires the existence of corporate governance for Islamic banks.[325] In this respect, the governance structures of Islamic institutions are similar to those of conventional ones.[326]

Of course, in the case of Islamic institutions, there is the additional dimension of *sharia* governance, to which they must pay particular attention;[327] the result is a

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[323] Chapra and Ahmed, "Corporate Governance in Islamic Financial Institutions," P: 50.

[324] Haron, *Islamic Banking*, Chapter 4.

[325] Karim and Archer, *Islamic Finance*, P:295–309.

[326] Hassan and Lewis, *Handbook of Islamic Banking*, Chapter 9, P: 129; Hasan, "Optimal Shariah Governance in Islamic Finance," P: 2.

[327] Grais and Pellegrini, "Corporate Governance in Institutions Offering Islamic Financial Services: Issues and Options," P: 2.

more intricate legal process to ensure that financial operations are not only economically and legally but also *sharia*-compliant.[328]

This extra advisory affiliation is exclusive to IFI and banks, with no counterpart in the corporate governance structure of conventional banks.[329] It is known by many names, including the *Sharia* Advisory Committee, *Sharia* Monitoring Committee/Board/Council, *Sharia* Supervisory and *Fatawa* Board/Panel, Religious Control Committee, *Sharia* Control Board, *Sharia* Council, and Religious Supervisory Board, but all will now be referred to as SSB.[330] The different terminology used for SSB suggests different characteristics (advisory, consultative, monitoring, supervisory and control) and different forms (committee, board, council and panel). However, the main purpose of its establishment is to help the management of the IFI and Islamic banks to adhere to Islamic principles and to comply with *sharia* requirements.

Although this religious board exercises a major role in assisting IFI compliance with *sharia*, its legal position and powers vary across countries and even in some countries from one bank to another. Nonetheless, it is the qualifications of these religious boards' members and their total professionalism and integrity that are the only warrant of *sharia* assurance and compliance.

The existence of the SSB is important not only for religious reasons but also for purely business considerations, because clients would not have confidence in the IFI operations unless certified by the SSB. By ensuring the correct implementation of *sharia* rulings, the SSB plays a vital role in creating trust between the institutions and their stakeholders, by disseminating timely and

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[328] Hasan, "Regulatory Framework of Shari'ah Governance System in Malaysia, GCC Countries and the UK," P: 2.

[329] Hasan, "Optimal Shariah Governance in Islamic Finance"; Hassan and Lewis, *Handbook of Islamic Banking*, Chapter 9, P: 129.

[330] See Haron and Nursofiza, *Islamic Finance Banking System*, PP: 269–271; Hjh Siti Faridah Abd Jabbar, "The Shari'a Supervisory Board: A Potential Problem in Islamic Finance?," *Company Lawyer* 29, no. 1 (2008): at 29.

sufficient information (financial and non-financial) regarding their operations and performance.[331] The SSB thus contributes to public awareness of the philosophical basis and the concept of IFB. In return, the confidence of the public and stakeholders helps to minimise any risks for the institution against claims that their products fail to comply with the principles of Islamic law and economics.[332] Against this background, the expertise of board members in understanding the pre-requisites of modern financial products and in evaluating these products is crucial.[333]

The current diversity in *sharia* interpretations, which is likely to continue in the absence of a Supreme *Sharia* Authority (SSA) that is accepted and recognised at the global level, encourages the reliance on the governance and supervision provided by the institutional SSB. In fact, Zaidi (2008) correctly states that the SSB are necessary whether *sharia* rules are standardised or not.[334] Recognising their vital role, some Muslim countries have made the existence of the SSB a statutory requirement for institutions offering Islamic finance services. [335]

4.4.1 DEFINITION AND FORMATION

There is no one conclusive definition for the SSB. Lahlou and Tanega (2007) define it as "a group of experts typically in the form of a committee made up of senior officers of the company and religious scholars who determine whether

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[331] Samy Nathan and Vincent Ribière, "From Knowledge to Wisdom: The Case of Corporate Governance in Islamic Banking," *VINE* 37, no. 4 (2007): P: 473.

[332] Qadri, "Islamic Finance: An Alternative," P: 9–11.

[333] Iqbal, Ahmed, and Khan, "Challenges Facing Islamic Banking," P: 36.

[334] Zaidi, "Shari'a Harmonization, Regulation and Supervision," P: 4.

[335] like Bahrain, Malaysia, Egypt, and Jordan. See Haron, *Islamic Banking*, Chapter 4.

certain transactions conform to *sharia*".[336] However, this is not a complete definition as it does not cover the unique nature and functions of the SSB.

Hemaish (2005) provides a more accurate definition stating that the SSB is "an independent body of *sharia* scholars and specialised economists who are responsible for the directing, controlling and reviewing of an Islamic-bank's activities to ensure their compliance with *sharia*. The SSB's *fatawa* and decisions are mandatory for the bank".[337]

This definition is close to the one given by the AAOIFI Standard (AAOIFI-1, P: 4-5) which, as explained in chapter two, gives the following definition:

> "A SSB is an independent body of specialised jurists in *fiqh-almuamalat* (Islamic commercial jurisprudence). However, the SSB may include a member other than those specialised in *fiqh-aimua'malat*, but who should be an expert in the field of IFI and with knowledge of *fiqh-almuamalat*. The SSB is entrusted with the duty of directing, reviewing and supervising the activities of the IFI in order to ensure that they are in compliance with *Sharia* Rules and Principles. The *fatawa*, and rulings of the SSB shall be binding on the Islamic financial institution".

As this definition clearly indicates, the membership of the SSB is not restricted to *sharia* scholars with knowledge of *fiqh-almuamalat.* Membership of experts in fields including business, economics, law and accounting is welcomed to supply the board with expertise it might lack. This should enable the SSB to perform its tasks at the highest level of efficiency. However, this standard does not require

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[336] Mohammad Saad Lahlou and Joseph Atangan Tanega, "Islamic Securitisation: Part II - A Proposal for International Standards, Legal Guidelines and Structures," *Journal of International Banking Law and Regulation* 22, no. 7 (June 20, 2007): at 366.

[337] Garas, "The Role of the Shari'a Supervisory Board in the Governance of Islamic Financial Institutions in the Gulf Cooperation Council Countries," P: 77–78.

specific qualifications for membership, other than being recognised as specialised jurists in *fiqh-almuamalat*. There is no clarification whether members need to have academic qualifications or other educational recognition.

Nonetheless, the SSB as a religious board must consist of a majority of Islamic commercial jurists. The AAOIFI standard states that a SSB should be composed of at least three members, only one of whom can be permitted with expertise other than *fiqh-almuamalat*.

The appointment and dismissal of the SSB members is a decision taken by shareholders at the general assembly meeting, on the recommendation of the BOD, who may be authorised by the shareholders to decide their remuneration. However, the standard omits to specify the duration of membership and the procedures required for dismissal from the board.

The relationship between the SSB and the BOD is a highly significant one, because it does not cease after appointment; members of the SSB usually attend the meetings of the BOD in order to discuss religious aspects of the institution's activities and services. On the other hand, cooperation between the SSB and other organs of the IFI, particularly the management, legal team and internal auditing committee, is necessary to reach a suitable form and structure of products or transactions that conforms to *sharia* laws and does not contradict the national laws and financial regulations.[338]

4.4.2 FUNCTIONS AND POSITION

Tahir (2003) correctly states that in the early phase Islamic banking models emerged as banking under *sharia* supervision. This is because professional bankers who took the lead were not well versed in the *sharia*, and therefore

[338] Atbani, "Islamic Legal Authorities for Islamic Banking System: The Authorisation of *Sharia*-Compliant Banks in the UK," at 54.

delegated authority for *sharia* matters to the respective SSB, absolving the bankers themselves of their responsibility for any *sharia* violations.[339]

Khan (2007) also makes the point that it is essential to separate this *sharia* authority from the executive authority, as it is considered undesirable to give the executive authority responsibility to ensure *sharia* compatibility of their operations, because this requires specialised *sharia* knowledge.[340] This is confirmed by AAOIFI Standard (AAOIFI-1, P: 4-5), which states that directors or significant shareholders of the IFI are not allowed to become members of the SSB.

The SSB members, unlike the BOD, are jurists who specialise in Islamic commercial jurisprudence. Thomas (2005) explains that transparency, trust, ethical behaviour and credibility, as well as the philosophy, values, and beliefs underlying Islam, *sharia* and *akhlaq* (morality), are among the main values brought by the SSB to the IFI.[341] This common background among the SSB members facilitates their communication and enables them to share and transform their tacit and explicit knowledge in a faster and clearer manner than the members of the BOD.

Therefore, the role of the SSB is totally different from the role of the BOD. Depending on the memorandum of association of individual IFI and the secular laws of the country hosting the IFI, the specifications of the legal position and role of the SSB may differ. However, there is no doubt that, overall, this religious board has a specific nature and a unique authority. This is evident from the roles and tasks given to it. According to the AAOIFI standard (AAOIFI-1, P: 4-5), the prime purpose of the SSB is to assure the compliance of the IFI and its operations with *sharia* rules and principles. In order to achieve this, "the SSB is

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[339] Tahir, "Current Issues in the Practice of Islamic Banking," P: 4.

[340] Khan, "Setting Standards for *Sharia* Application in the Islamic Financial Industry," P: 298.

[341] Thomas, Cox, and Kraty, *Structuring Islamic Finance Transactions*, P: 10.

entrusted with the duty of directing, reviewing and supervising the activities of the IFI". This actually encompasses a greater duty, of endorsing and approving the products, and moreover ensures their compliance through directing, supervising and most importantly reviewing the IFI's operations.

The SSB is recognised as an independent board because of its appointment by the shareholders (AAOIFi-1, P: 4-5). However, without an official legal position the powers of the SSB are not confirmed by existing laws and regulations, as is the case with the BOD.

As a matter of principle, the SSB should have the authority to impose its viewpoint on management. However, logistic considerations do not necessarily permit this, given the time constraints for vetting and monitoring all the banking operations. Therefore, there is an urgent need to identify the correct legal position of the SSB and its functions.

Some scholars, like Swee-Hock and Wang (2008), argue that the nature of the SSB is purely religious and its functions merely advisory, because it only considers the matters presented to it by the management from an Islamic point of view.[342] Yaacob (2012) adds that the roles of the *sharia* scholars are limited in influencing the decisions of the IFI because the BOD possesses the real power to change or take the important decisions and actually has the right to accept or reject the advice of the SSB.[343] In fact, Principle 2.1 of IFSB-10 (P: 7-10) agrees:

> "As the legal framework in most jurisdictions holds the BOD as the body ultimately responsible with regard to the governance of an IFI, the SSB has to be clear on the limits of its own power. A clear set of rules and by-laws on how meetings shall be conducted,

[342] See Swee-Hock and Wang, *Introduction to Islamic Finance*, P: 59; Hasan, "Optimal Shariah Governance in Islamic Finance."

[343] Hisham Yaacob, "Issues and Challenges of Shari'ah Audit in Islamic Financial Institutions: A Contemporary View," *Proceedings of 3rd International Conference on Business and Economics Research*, 2012, P: 2676, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2175700.

decisions made and recorded, and reports prepared and submitted, will provide much-needed direction for the SSB in understanding the level of their accountability".

Similarly, AAOIFI-1 (P: 5-7) while illustrating the basic elements of the SSB report, clearly states that "the management of the IFI is responsible for properly complying with *Sharia* rules and principles, and the SSB has to perform appropriate tests, procedures and review work as appropriate to ensure such compliance".

However, others like Jabbar (2008) hold the view that the SSB exercises both consultative and supervisory functions, so that it actually constitutes an extra layer of supervision in the governance of IFI. Unlike the advice of a legal adviser to a conventional financial institution, the advice of their SSB must be adhered to by the IFI.[344] In this respect, Principle 3.2 of IFSB 3, (P: 11-12) states that the IFI shall comply with the *sharia* rules and principles as expressed in the rulings of the IFI's *sharia* scholars. With firmer wording, AAOIFI-1 (P: 4-5) in its definition of the SSB states that "the *fatawa*, and rulings of the SSB shall be binding on the Islamic financial institution".

To achieve its purpose, the SSB encompasses the duty of endorsing and approving the financial products, and moreover ensures compliance through directing, supervising and most importantly reviewing the IFI's operations. This raises an important question about the legal status of the SSB, especially as it plays a crucial role in maintaining the unique Islamic character of the IFI.

According to Principle 1.1 of the IFSB Standard (IFSB-10, P: 7-10), in terms of the product design/development stage an IFI would want to ensure that its *sharia* governance system covered the relevant ex-ante processes, namely (i) issue of *sharia* pronouncements, and (ii) compliance checks, before the product is offered

[344] Jabbar, "The Shari'a Supervisory Board: A Potential Problem in Islamic Finance?," at 29.

to customers. As for observing the product at the offer stage, the IFI would want to ensure that its *sharia* governance system covered the relevant ex-post processes, namely internal *sharia* review and *sharia* governance reporting. Without such follow-up, the IFI would not be able to monitor the consistency of its *sharia*-compliance or effectively manage any *sharia*-compliance risk that might arise over time.

In respect of the legal and regulatory framework for issuing *sharia* pronouncements in the jurisdiction under which the IFI operates, Principle 5.1 of IFSB-10 Standard (P: 20-21) states that the IFI should fully understand and ensure that its SSB strictly observes the said framework. At the ex-ante stage, the SSB is usually required to follow and adopt *sharia* pronouncements as issued by the Central *Sharia* Authority (if one exists). If such an authority does not exist, the SSB is recommended to follow the *sharia* pronouncements issued by internationally recognised bodies that issue authoritative opinions on *sharia* matters. If this is not possible, the board should exercise its best efforts in documenting and publishing the *sharia* pronouncements so that they can be openly assessed by the industry's stakeholders (subject to the appropriate observance of confidentiality).

As for the ex-post stage, members of the SSB should participate in various seminars, workshops and meetings of *sharia* scholars specialised in *fiqh-almuamalat* to present and debate existing and new *sharia* pronouncements. Members of the SSB must also expect to answer questions from shareholders and the public in a general assembly or similar forum.

Given that the IFI delegates authority for *sharia* matters to its SSB, the SSB's dual role in performing ex-ante and ex-post *sharia* governance tasks is indispensable. In this regard, the core responsibility for the SSB is to prepare a *sharia* review, as explained below.

4.4.3 SHARIA GOVERNANCE

As discussed above, the IFSB and AAOIFI standards and guidelines give the IFI management responsibility for ensuring that the institution is operating in accordance with *Sharia* precepts and principles.

In this context, Principle 3.1 of IFSB-3 (P: 11-12) states that the appropriate mechanism should exist for obtaining rulings from *sharia* scholars, applying the *fatwa,* and monitoring *sharia*-compliance in all aspects of products, operations and activities of the IFI This mechanism shall cover: (i) both ex-ante and ex-post aspects of all financial transactions carried out by the IFI, that is, to ensure *sharia*-compliance of the contracts and, later, the performance of obligations under the contracts; and (ii) operations of the IFI, including aspects such as *sharia*-compliance review, investment policies, disposal of non-*sharia*-compliant income, charitable activities, etc.

The section on the basic elements of the SSB report in AAOIFI-1 standard (P: 5-7), explains that the responsibility of the SSB is actually confined to expressing an independent opinion, which is based on its observation of the financial institution's operations. Accordingly, standard AAOIFI-2 (P: 14) names the process taken to reach a decision on *sharia*-compliance as the *sharia* review, providing the following definition:

> "a *sharia* review is an examination of the extent of an IFI's compliance, in all its activities, with the *sharia*. This examination includes contracts, agreements, policies, products, transactions, financial statements, reports (especially internal audit and central bank inspection), circulars, etc."

Thus, the main requirement of a *sharia* review is to make certain that all the activities carried out by an IFI are truly in compliance with the *sharia* rules as reflected in the *fatawa*, rulings and guidelines issued by its own SSB. In this

sense, the *sharia* review process is similar to the company audit, but more focused on the compliance of the IFI with *sharia* requirements.

Standard AAOIFI-2 (P: 15) illustrates the *sharia* review procedure and contains the following stages:

1) Planning review procedures
2) Executing review procedures
3) Documenting conclusions and report

The planning and design stages allow completion of the *sharia* review procedures in an effective and efficient manner. They should be developed to include a complete understanding of the IFI's operations in terms of products, size of operation, locations, branches, subsidiaries and divisions. They should also include a list of all *fatawa*, rulings and guidelines issued by the SSB. Understanding the activities, products and management's awareness of and attitude towards compliance with the *sharia* is essential and will have a direct effect on the nature, extent and timing of the *sharia* review procedures. The plan should be fully documented, including explanation of the sample selection criteria and size, taking into consideration the complexity and frequency of transactions. The review procedures shall cover all activities, products and locations, and ascertain whether the SSB-approved transactions and products have been undertaken and all related conditions met.

At the second stages, all the planned procedures are executed; they normally include:

- Obtaining an understanding of the management's awareness, commitment and compliance control procedures for
- Reviewing of contracts, agreements, etc.;
- Ascertaining whether transactions entered into during the year were for products authorised by the SSB;

- Reviewing other information and reports such as circulars, minutes, operating and financial reports, policies and procedures, etc;
- Consultation/co-ordination with advisors such as external auditors; and
- Discussing findings with the IFI's management.

Finally, the SSB should document their conclusions and prepare their report to shareholders, based on the work done and discussions held, for reading at the Annual General Meeting of the IFI. This report shall be based on the previously discussed standards AAOIFI-1; a detailed report, when warranted, shall also be issued to the IFI's management.

4.4.3.1 THE USE OF INTERNAL TOOLS

Sharia corporate governance is a key element of governance in any IFI. However, it is only recently that awareness has grown for the requirement to implement a comprehensive framework to achieve the objectives of the *sharia*.

Although the SSB have a duty to provide assurance that all transactions of the IFI are actually in conformity with its verdicts, the reality is that members of the SSB are not full-time employees of the IFI. They are merely hired to provide their services, and actually attend a limited number of meetings during the financial year. As noted by Al-Sadah (2007), members of the SSB do not actually have either the time or sufficient number of staff to perform the task properly. [345]

This gave birth to the requirement for supplementary internal tools for assuring the compliance of the IFI with *sharia.* In this regard, the standard IFSB-10 (P: 1-4) refers to the following organs as significant tools in the *sharia* governance system:

- SSB

[345] Anwar Al-Sadah, "Corporate Governance of Islamic Banks, Its Characteristics and Effects on Stakeholders and the Role of Islamic Banks Supervisors" (Ph.D-Degree, School of Management, University of Surrey, 2007), P: 71.

- ISCU
- ISRU

The standard IFSB-10 (P: 4 & 7-10) strongly recommends that an IFI develop an in-house capability by having a dedicated ISCU comprising *sharia* officers with appropriate qualifications and experience. These in-house officers can, among other things: (i) become the first point of reference for *sharia*-compliance issues, with an advisory/consultancy role delegated by the SSB; (ii) handle the processing and secretarial matters relating to issues to be raised to the SSB; and (iii) provide input for executive decisions to be made by the senior management.

There should be clear segregation of process and procedures between the ISCU and the ISRU through a written standards operation manual and/or framework. While the ISCU is part of the IFI's compliance team, the ISRU may be established to function in a similar manner to the IFI's internal audit team. The major difference is that while the internal auditor will usually report to the audit committee, the ISRU reports to the SSB. Where appropriate, the ISRU reports shall require or recommend the management of the IFI to address and rectify any issues of *sharia*-compliance.

However, such distinction is not provided for by AAOIFI standards. AAOIFI-3 (P: 22-26) strongly recommends the establishment of an ISRU to assist the SSB in performing its vital role. This special department conducts the internal *sharia* review process (as explained above), provided that the members of the department are properly qualified and independent.

As an integral part of the organs of governance of the IFI operating under the policies established by the IFI, the ISRU should have a statement of purpose, authority and responsibility. Its charter should be prepared by management, approved by the SSB of the IFI and issued by the BOD.

Like the SSB, because of its religious nature, the ISRU has no executive authority or responsibility for the activities reviewed. Nonetheless, its organisational status should not be lower than that of the Internal Audit Department. To enhance its organisational status, it should have direct and regular communications with all levels of management, SSB and external auditors, with no limitation or restriction of access to documents, reports, etc.

As the ISRU is appointed by the BOD, its Head is responsible to the BOD, and should ensure full *sharia* review coverage, adequate consideration of its reports, and appropriate action on recommendations.

The Head is responsible for providing appropriate internal *sharia* review supervision and ensuring that reviews are properly supervised, as appropriate evidence of supervision should be documented and retained to:

- Establish plans to carry out the responsibilities of the internal *sharia* review;
- Provide written policies and procedures to guide the staff of the internal *sharia* review; and
- Establish a programme for selecting and developing the performance of internal *sharia* review staff.
- Ensure that the internal and external *sharia* review's efforts are properly co-ordinated, and establish and maintain an effective and efficient quality assurance programme to evaluate the operations of the ISRU.

The Head of the ISRU shall discuss the conclusions and recommendations with appropriate levels of management before issuing a final written report. Consequently, all disputes between management and the ISRU on matters relating to *sharia* interpretation shall be referred to the SSB for ruling. The ISRU shall follow this up to ascertain that appropriate action is taken on their findings. In addition, any other recommendations relating to *sharia* matters made by the

SSB, external auditors, and regulatory agencies shall be followed up. The management is responsible for rectification of non-compliance and prevention of recurrence, including of their timing and extent of follow-up.

At least quarterly a written report should be prepared and signed by the Head of the ISRU, addressed to the BOD and copied to the SSB and management. However, there is limited guidance on the format of the *sharia* review report. Similarly, standard IFSB-10 is relatively silent on the issue of qualified review opinions and does not provide guidance on the content or structure of the annual *sharia* review/audit report.

4.4.3.2 THE USE OF EXTERNAL TOOLS

There is no doubt that the IFB is currently reliant on internal tools for *sharia* governance. However, external tools to help in supervising the internal process of *sharia* governance deserve equal attention. The importance of the internal mechanism being in place to comply with *sharia* is unquestionable. Nonetheless, it needs to be backed or supported by external supervision to become more efficient and reliable.

Principle 3.1 of IFSB-3 (P: 4 & 11-12) previously referred to, concerning the appropriate mechanisms for *sharia* governance states that it shall cover both ex-ante and ex-post aspects of all financial transactions carried out by the IFI. According to Principle 1.1 of standard IFSB-10 (P: 7-10), ex-ante considerations include (i) issue of *sharia* pronouncements, and (ii) compliance checks, before the product is offered to the customers. Ex-post considerations include the internal *sharia* review and *sharia* governance reporting.

While ex-ante aspects are covered by the internal tools of *sharia* governance, as explained above, the ex-post aspects are to be covered by the external tools of *sharia* governance. For external *sharia*-compliance reviews, Principle 3.1 of IFSB-3 (P: 4 & 11-12) states that the Audit Committee shall ensure as far as

possible that the external auditors are capable of conducting, and do conduct, ex-post *sharia*-compliance reviews within their terms of reference.

In this context, standard IFSB-10 (P: 1-4) provides that an annual *sharia*-compliance review/audit shall verify that the internal *sharia*-compliance review/audit has been carried out correctly and its findings duly noted by the SSB. This standard further suggests that this task may be assigned to an appropriately competent external auditor or external *sharia* firm. Nonetheless, the SSB which issued the *sharia* pronouncements can take charge of this process, having received feedback and reports from the ISRU.

Standard AAOIFI-1 (P: 4), in defining that the SSB is an independent organ responsible for issuing an impartial opinion on the compliance of the IFI with *sharia*, suggests that the SSB act as an external reviewer. It requires that the SSB has to perform tests, procedures and review work as appropriate to ensure compliance with *sharia* and, where appropriate, the SSB is to examine on a test basis each type of transaction, in order to ensure that the transaction and dealings are in compliance with *sharia*. This is supported by the fact that the members of the SSB are appointed by the shareholders and report back to them and not to the BOD or management.

Karim (1990) emphasises that members of the SSB need to function as external auditors.[346] However, the reliance of the SSB on the findings of the ISRU's internal tools of *sharia* governance means that the ISRU questions the validity of its role as an external tool.

It is assumed that the external *sharia* audit shares similar functions to the company audit, but is focused more on the compliance of the IFI with *sharia*

[346] Rifaat Ahmed Abdel Karim, "The Independence of Religious and External Auditors: The Case of Islamic Banks," *Accounting, Auditing & Accountability Journal* 3, no. 3 (December 1, 1990): 34–44.

precepts and requirements. This raises the question of using service providers such as external chartered auditing and/or *sharia* firms to perform such tasks.

The guiding principles of IFSB-3 (P:2 & 11 & 23) addressing the relevant internal and external corporate governance controls from the perspective of the IFI, require that it must have the support of and be facilitated by the supervisory authorities in order for the framework to be effective.

The role of national authorities in this regard will therefore be addressed in the next chapter, discussing the frameworks of selected Muslim countries. It has been noticed that the conduct of external ex-post *sharia*-compliance reviews is generally lacking amongst IFI and is mostly carried out by their governing central banks on a limited scale.

4.5 CONCLUSION

With the disappearance of the traditional Islamic state, the canon law of Islam has lost its role as the governing law. In the modern Islamic states, the legality of a matter and its legitimacy under *sharia* are two distinct issues. Therefore, the need to comply with *sharia* to preserve the distinctive nature of IFB has encouraged the implementation of *sharia* governance within the corporate governance system of the IFI.

As proposed in chapter two, this chapter argued for the wider concept of *sharia* corporate governance. This aims to protect the interests not only of the shareholders, but also of all other stakeholders. Hence, the *sharia*-compliance arguably needs to be comprehensive regarding IFI and their operations.

It has been established that authority for *sharia* matters is delegated to the respective SSB, and the ISRU is a key pillar in the current *sharia* corporate governance system. The qualifications, professionalism and integrity of members constitute the only guarantee of *sharia*-compliance of the IFI with *sharia* laws.

The SSB in the public perception confirms the legality of a bank's practices from the *sharia* perspective and in fact constitutes the route to reaching Islamic wisdom in financial practices.[347] Respected *sharia* scholars appointed as members of an SSB reflect a certain image on the institution's business and only by believing that these scholars have Islamic wisdom will potential business customers be motivated to deal with that IFI, especially where the SSB members most closely reflect their chosen *madhab* (single of madahib).[348]

On one hand, compliance with *sharia* provides a distinct value proposition that not only gives a competitive advantage but is also the backbone of the industry. On the other hand, non-compliance with *sharia* implies not only the possibility of the legal dispute or financial loss, but more importantly questions the credibility and integrity of the IFI itself.[349]

Failure to comply with *sharia* would lead an IFI to lose its validity in the eyes of customers, who naturally would cease their dealings with it. Islamic characteristics are what attract Muslims to deal with specific IFI, and questioning these would result in withdrawals. Unlike failure in conventional banking, it is not the fear of losing money but the fear of non-Islamic usage of money that drives the withdrawal of deposits.[350]

This chapter addressed the definition, appointment, position and functions of the SSB and ISRU. As internal tools of *sharia* governance, they provide some degree of comfort in assuring compliance of the IFI with *sharia*. However, this is not enough to ensure high levels of *sharia*-compliance in the industry, as

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[347] Nathan and Ribière, "From Knowledge to Wisdom: The Case of Corporate Governance in Islamic Banking," P: 472–479.

[348] Julie Patient, "Islamic Finance in the UK Consumer Sector," *Journal of International Banking Law and Regulation* 23, no. 1 (2008): at 9.

[349] *Enhancing Shari'ah Assurance* (Islamic Finance Council & International Shari'ah Research Academy for Islamic Finance, September 2012), P: 4.

[350] Aldohni, *The Legal and Regulatory Aspects of Islamic Banking: A Comparative Look at the United Kingdom and Malaysia*, P: 107.

compliance is a more complex and detailed process than the existence of the SSB and ISRU.

To ensure the continuation of the IFI, higher levels of *sharia*-compliance must be maintained.[351] Assuring comprehensive *sharia*-compliance will give the confidence needed to the public that the IFI are contributing toward the promotion of the Islamic way of life, which seeks the ultimate benefit of individuals as well the whole society. It is not only the desire to follow religion and to support the community that leads Muslims to demand Islamic financial services but also the belief in Islamic wisdom.

Therefore, there is an urgent need to develop a more comprehensive *sharia* review and audit framework. The internal and external tools should complement each other in the process of assuring *sharia*-compliance. Also, the collective work and cooperation of regulatory and national *sharia* authorities is an essential requirement.

The belief that more active and direct involvement of regulatory and *sharia* authorities would bring greater public confidence and resolve important governance and supervision issues will be addressed in the following chapters, with emphasis on the independence, competence and consistency of practice amongst the *sharia* scholars participating in governance, whether in internally or externally .

A survey undertaken by the IFSB in 2008 showed that most of the *sharia* issues discussed here have not been resolved in many countries, including the pioneers and active players in the IFBI, such as Bahrain, UAE, Sudan and Malaysia.[352] In this context, some correctly argue that the instability of *sharia* rulings leads to instability in *sharia*-compliance. If *sharia* standards are not uniform, then it will be

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[351] Zaidi, "Shari'a Harmonization, Regulation and Supervision," P: 8.

[352] Hasan, "Regulatory Framework of Shari'ah Governance System in Malaysia, GCC Countries and the UK," P: 109.

difficult to define appropriate universal compliance practices. There is a belief that the existence of national *sharia* authorities (NSA), acting as a final reference point for the institutional SSB, would provide some remedy.

Therefore, the next chapter addresses the national framework of *sharia* supervision in selected countries. An understanding of the approach of national authorities to *sharia* supervision in the IFB will underline the issues raised from the current *sharia* governance system, described in chapter six. The possible use and role of external service providers, such as external *sharia* firms in *sharia* supervision, is discussed in chapter seven.

CHAPTER FIVE: NATIONAL FRAMEWORKS OF SHARIA SUPERVISION

5.0 INTRODUCTION

After identifying and discussing the *sharia* governance system from the IFI perspective, this chapter takes an analytical and comparative approach in addressing the different frameworks adopted to implement and supervise this process in selected Muslim countries, namely Bahrain, UAE (Dubai), Kuwait, Sultanate of Oman and Federation of Malaysia.

In these countries, conventional and Islamic banks coexist, and there is competition between them for *sharia*-compliant business. In fact, IFB is categorised separately by regulators allowing the financial institutions to comply with *sharia* laws.

In principle, *sharia* governance and supervision is the responsibility of the financial institution not the financial regulator, although this is not always true in practice. As will be explained below, some countries have established what is known as a Central SSB inside their central bank, and others have assigned a similar role to other authorities outside the central bank. Therefore, the legal position, functions, and accordingly their power of authority vary across countries.

This gives all the more reason to examine their supervisory frameworks and regulatory perspective. This chapter analyses and compares the frameworks of *sharia* governance and supervision adopted in the selected jurisdictions. This will offer an understanding of the position of the authorities at the national level, and the role played by different bodies in governing and supervising IFB.

5.1 THE KINGDOM OF BAHRAIN

5.1.1 THE POSITION OF SHARIA AND ITS INFLUENCE

Bahrain was a British colony until 1971 and was more exposed to the English system than other GCC. Its legal system is a combination of English common, codified French and *sharia* laws.

However, the *sharia* law is always sovereign. This is evident from the fact that the legal system preserves a specific place for the application of *sharia* principles, reflecting the early recognition by legislators of the irreplaceable role of *sharia*. Among the best examples is the provision of the Law Organising the Judicature System (1971), which states that: [353]

> "In the event the judge does not find an applicable provision of law; he shall deduce the basis of his judgment from the principles and prescriptions of the *Sharia* and in the absence of *Sharia* prescriptions, rules of custom shall be applied; a particular custom is to be preferred to a general one; and in the absence of custom tenets of natural law, equity and sound conscience shall be applied".

This superior position of *sharia* law is backed by the declaration made in the second Article of the constitution, emphasising the Islamic nature of the country and stipulating "*sharia* as a principal source for legislation". [354]

Accordingly, interest-based transactions would be illegal, so a number of positive laws were introduced to overcome this difficulty, most of which were based on or influenced by other secular codes, in particular the Egyptian civil code. The main positive laws of Bahrain which are relevant here are the Law of Civil and

[353] *The Bahraini Law Organising the Judicature System of 1971.*

[354] *The Constitution of Kingdom of Bahrain of 1973.*

gained political freedom. In particular, in 1923 the Eastern Bank (now Standard Chartered Bank) opened its first branch in Bahrain, the British Bank of the Middle East (now HSBC) opened a branch in 1945, and the National Bank of Bahrain, at first a locally incorporated bank, was opened in 1957.[356]

In the 1970s, Bahrain adopted the vision of growth and building a diverse economy. Instead of relying on the oil business, unlike other GCC Bahrain opted for policies to promote other sectors, especially trade and finance. This step was motivated by the reality of the limited oil resource in Bahrain, necessitating finding other supportive resources to enhance the national economy.

With this vision and unequivocal commitment, the government worked on attracting leading financial institutions and developing the sector through multilateral initiatives in order to establish Bahrain as a financial hub.[357] As such, it did not opt for the Islamisation of the whole economy and the financial system.[358] Instead, efforts have been made toward developing the country as a centre for conventional finance. This has allowed the country to accumulate rich experience in dealing with the sophistication that characterises the banking industry.

Notably, in 1975, the Offshore Banking Regulations were issued permitting foreign banks to deal only with non-resident customers, and therefore to operate without being subject to some of the existing banking regulations. Bahrain has therefore functioned as a regional financial centre since 1976, keeping its market open to foreign banks. Bahrain's financial sector development strategy succeeded in building a leading regional banking centre, which has become one

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[356] Jasim Al-Ajmi, Hameeda Abo Hussain, and Nadhem Al-Saleh, "Clients of Conventional and Islamic Banks in Bahrain: How They Choose Which Bank to Patronize," *International Journal of Social Economics* 36, no. 11 (2009): P: 1090.

[357] Solé, "Introducing Islamic Banks into Conventional Banking Systems," P: 17–18.

[358] Aldohni, "The Emergence of Islamic Banking in the UK: A Comparative Study with Muslim Countries," P: 189.

of the main engines of growth and sources of employment.[359] This achievement was supported by a number of competitive advantages: geographic location, a well developed infrastructure, a defined legal system and liberal trade.[360] These included a well developed telecommunications infrastructure, a strong regulatory framework with a tax-free environment, a well-trained labour force, and easy access to GCC markets and other countries in the region.

This rich experience in conventional banking helped in incorporating, in 1978, the Bahrain Islamic-Bank, first Islamic bank in Bahrain[361] and the third in the GCC after the Dubai Islamic Bank in the U.E and the Kuwait Finance House.[362] Bahrain perhaps presents one of the best offshore models of Islamic banking because the Bahrain Monetary Authority had *sharia* advisers to help with auditing, regulating and developing short-term financial instruments to provide liquidity for Islamic financial products.[363]

Bahrain has a comprehensive economic strategy that includes both conventional and Islamic banking systems, running a parallel system of finance and money markets on a comprehensive scale. Not only do the IFI operate alongside the conventional institutions, but the conventional financial institutions are permitted to offer Islamic services. Therefore, Bahrain functions in a different manner to some Islamic countries where only the IFI and Islamic banks are permitted to carry out Islamic operations (as is the case in Kuwait and Lebanon).[364] The IFB

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[359] David Grigorian and Vlad Manole, "A Cross-Country Non-Parametric Analysis of Bahrain's Banking Sector" (Working Paper WP/05/117, International Monetary Fund, 2005), P: 1, https://www.imf.org/external/pubs/ft/wp/2005/wp05117.pdf.

[360] Zaher and Hassan, "A Comparative Literature Survey of Islamic Finance and Banking," P: 172.

[361] Khan and Bhatti, "Islamic Banking and Finance: On Its Way to Globalization," P: 170.

[362] Al-Ajmi, Hussain, and Al-Saleh, "Clients of Conventional and Islamic-banks in Bahrain: How They Choose Which Bank to Patronize," P: 1090.

[363] Zaher and Hassan, "A Comparative Literature Survey of Islamic Finance and Banking," P: 172.

[364] Alchaar, *An Introduction to Islamic Banking and Finance*, P: 19.

services are carried out by fully fledged commercial banks, offshore banking units and investment banks, and by the Islamic 'windows' of the conventional financial institutions, which also adhere to the same standards as the fully fledged IFI.

Bahrain has rapidly become a global leader in Islamic finance, playing host to the largest concentration of IFI in the Middle East, with 24 Islamic-banks (6 retail and 18 wholesale banks), and 11 Islamic *takaful* (insurance) companies (7 *takaful* and 2 re-*takaful*), most of which serve the regional rather than the local market. In addition, a substantial number of firms, including 9 *takaful* companies, have licences limiting their business to outside Bahrain. Bahrain is also at the forefront in the market for Islamic securities (*sukuk*), including short-term government *sukuk* as well as leasing securities.[365]

Acknowledging the unique characteristics of Islamic-finance, the Bahrain Monetary Agency as the financial regulator in 2002 was the first to develop and issue the Prudential Information and Regulatory Framework for the IFI, which covered issues related to capital adequacy, asset quality, the management of investment accounts, corporate governance, earnings quality and liquidity management.[366]

While the supervision and regulation of the financial sector was initially assigned to the Bahrain Monetary Agency, these were transferred to the CBB by Decree Number (64) of 2006.[367] According to this decree, the CBB is responsible for:

- Implementing monetary policy
- Supervising and regulate the banking sector
- Acting as the government's fiscal agent

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[365] "The Central Bank of Bahrain," accessed March 22, 2015, http://www.cbb.gov.bh.

[366] Farah Khalid, "Bahrain as an International Centre for Islamic Banking" (Bahrain Monetary Agency, January 2004), P: 97.

[367] *The Bahraini Decree No (64) of 2006.*

- Encouraging the growth of Bahrain as a major international financial centre
- Managing the foreign currency cash reserves of the kingdom.

Although the CBB performs its administrative and financial functions independently, it is a governmental body. From the outset, the financial regulator aimed to provide equal treatment and opportunities for both Islamic and conventional financial institutions. Although banks, mutual funds, insurance and capital markets all fall within the regulatory powers of the CBB as a sole regulator, each comes under a specific department.[368] As such, different departments supervise conventional and Islamic financial sectors, whereas all the components of each system are dealt with through different sections belonging to these departments.

5.1.2 NATURE OF SHARIA AUTHORITY AND ITS ROLE

Although Bahrain has not yet enacted special laws for Islamic banking, it is well-known for its fully developed set of prudential regulatory guidelines.

A corporate governance code was issued by the Ministry of Industry and Commerce following long deliberation over more than a year, effective from 1 January 2011. Whilst this code promotes best-practice, it is nevertheless considered as the minimum standard, and companies may adopt higher standards of corporate governance. Industry regulators, in particular the, CBB, may issue additional directives or guidance as appropriate.

This code is intended to apply to all operating joint stock companies incorporated under the Bahrain Commercial Companies Law of 2001. In its initial form it applies to public companies, but it should be used as a model by all other companies where appropriate. According to Licensing Conditions (LR-2) under

[368] *The Central Bank of Bahrain and Financial Institutions Law of 2006.*

Volume (2) of the Central Bank Rulebook, section LR-2.1.1 provides that the legal status of an Islamic bank licensee must be: (i) a Bahraini joint stock company; or (ii) a branch resident in Bahrain of an Islamic bank incorporated under the laws of its territory and authorised as a bank in that territory. Therefore, Islamic-banks are obliged to follow this code, alongside other companies. However, it is expected that the Ministry of Industry and Commerce will issue revisions to apply the code directly to other types of company. The Ministry is responsible for administering the Company Law and this code, as well as the closely related Audit Law. It actively exercises its monitoring and penalty powers and works closely with the Central Bank and the Stock Exchange. As the body responsible for licensing and regulating financial institutions, the CBB also has an important role in monitoring and enforcement of the code, as do companies themselves (via their BOD and shareholders), and the courts.

This corporate governance code does not replace the Company Law but supplements it. It states nine fundamental principles, each of which is followed by one or more numbered directives for applying the principle. These principles and directives are broad and should be complied with by every company.

For the purpose of this study, Principle (9) of the corporate governance code is of particular importance. It states:[369]

> "Companies which are guided by the principles of *Sharia* have additional responsibilities to their stakeholders. Companies which refer to themselves as 'Islamic' will be subject to additional governance requirements and disclosures to provide assurance to stakeholders that they are following *sharia* principles. In ensuring compliance with *sharia* principles, each company should establish a SSB consisting of at least three *sharia* scholars".

[369] "The Central Bank of Bahrain."

The CBB has a detailed rulebook governing all financial activity in the country, and a separate volume (2) is specifically used to regulate Islamic-banks, which are defined by section (LR-A.1.4) under the Licensing Conditions (LR-2) as ones which:

- Undertake the activity of accepting *sharia* money placements/deposits, managing *sharia* profit-sharing investment accounts.
- Offering *sharia* financing contracts.
- Undertake any of the other activities falling within the definition of regulated Islamic banking services.

With regard to corporate governance, Principle (9) which is actually embodied in the High Level Controls (HC) No.9 named as The Principles of *Sharia*. HC-9.2.2 reads as follows:

> "Banks which refer to themselves as 'Islamic' must follow the principles of *Sharia*. Islamic bank licensees which are guided by the principles of *Sharia* have additional responsibilities to their stakeholders. Islamic bank licensees which refer to themselves as 'Islamic' are subject to additional governance requirements and disclosures to provide assurance to stakeholders that they are following *sharia* principles. In ensuring compliance with *sharia* principles, each Islamic bank licensee must establish an independent SSB consisting of at least three *sharia* scholars and complying with AAOIFI's Governance Standards for IFI No.1 and No.2".

As discussed in chapter two, Bahrain is the host country of AAOIFI, whose guidelines and standards are greatly respected by the authorities and IFI. As the sole financial regulator in the country, the CBB imposed the implementation of

such guidelines and standards by considering them as mandatory on financial institutions. In Principles of Business (PB) under Volume (2) of the Central Bank Rulebook, Principle 10 (PB-1.1.10) on Management, Systems & Controls of Islamic bank licensees emphasised that: "In particular, the CBB requires that banks comply with all AAOIFI issued accounting standards as well as the *sharia* pronouncements issued by the *Sharia* Board of AAOIFI.

This is a general reference to AAOIFI standards. There are many examples of more specific references in sections of Volume (2) of the CBB Rulebook. For instance, section (HC-9.2.2) just referred to adds to the embodied text of the corporate governance code regarding the establishment of an independent SSB the words: "and complying with AAOIFI's Governance Standards for IFI No.1 and No.2".

In term of *sharia* review, section (LR-1A.1.9A) was added to Licensing Conditions in October 2013. It states that:

> "The Head of *Sharia* Review in an Islamic bank licensee, dealing with Islamic products and services, is responsible for the examination of the extent of an Islamic bank licensee's compliance, in all its activities, with the *sharia*. This examination includes contracts, agreements, policies, products, transactions, memoranda and articles of association, financial statements, reports (especially internal audit and central bank inspection), circulars, etc. The objective of the *sharia* review is to ensure that the activities carried out by an Islamic bank licensee do not contravene the *sharia*".

Accordingly, section (HC-9.2.6) under High Level Controls (HC) requires that "The Islamic bank licensee must have a separate function of *sharia* review to verify compliance with the above. The internal *sharia* review must be carried out in accordance with AAOIFI governance standard

No.3. The *sharia* review function may be located in the internal audit function of the Islamic bank licensee.

From such provisions it is clear that the CBB is supporting the regulatory efforts of the AAOIFI, and therefore the financial institution must comply with the requirements of the CBB in accordance to the relevant AAOIFI standards. Failure to do so would result in a breach of the CBB's directives, which constitutes a ground for applying penalties and/or withdrawing the bank's licence. However, the specifics of those requirements are left to be determined by the licensed bank itself, which opens the door for a variety of best practices. Nevertheless, in such a case the bank should refer first to the guidelines and recommendations (if any) of AAOIFI. Hence, AAOIFI standards are to be considered where these is no clear provision on the matter in question.

For instance, there is no restriction on the membership of the *sharia* scholars, so individuals are free to be members of any number of institutional SSB. AAOIFI standards are silent on this matter. Although AAOIFI's definition of SSB states that *sharia* scholars must be knowledgeable in *usul-fiqh* (the origin of Islamic law), it does not provide any criteria for qualification. Mr Khalid Hamad, the executive director of banking supervision at the CBB confirms that:

> "the minimum qualification is a proper understanding of Islamic-finance, but we do not really spell out criteria to qualify for scholars. It will send a bad message if you say this scholar is not fit. We have not been facing any difficulties in this area in terms of the quality of the *sharia* board members".[370]

Perhaps, the exception is the Head of *Sharia* Review, who is considered to be in a controlling position, and needs to be approved by the CBB. Section (LR-1A.1.1) under Licensing Conditions (LR-1A) states that: "All persons wishing to undertake a controlled function in an Islamic bank licensee must be approved by

[370] Wright, "The *Shariah* Scholar Cartel."

the CBB prior to their appointment. Section (LR-1A.1.2) includes the Head of *Sharia* Review in the list of controlled functions.

Training and Competency Requirements for Controlled Functions, section (TC-1.1.1) states that "Individuals occupying controlled functions in an Islamic bank licensee must be qualified and suitably experienced for their specific roles and responsibilities. Section (TC-1.1.3) states that competence must be assessed on the basis of experience and relevant qualifications described in Appendix (TC-1) as a minimum. However, the CBB reserves the right to impose a higher level of qualifications as it deems necessary. Appendix (0TC-1) states that a Head of *Sharia* Review should:

a) Have appropriate level of knowledge in Islamic finance and *sharia* principles;

b) Have a good understanding of the banking industry and possess good knowledge of economics and finance; and

c) Understand how to interpret financial statements.

It further requires that the Head should have a minimum of five years' relevant experience in a bank or financial institution dealing with Islamic products and services. Also, he should:

a) Hold a bachelor's degree in *sharia*, which includes study in *usul-fiqh* and/or *fiqh-almuamalat*; or

b) Hold a university degree in banking and finance together with a qualification in *sharia* review.

In implementing this section (TC-B.1.7), individuals recruited to perform controlled functions should remain competent for the work they do and should be appropriately supervised. In this context, section (PB-B.2.1) under Principles of Business states that "Breaching a principle of business makes the Islamic bank licensee or approved person concerned liable to enforcement action. In the case

of a licensee, this may call into question whether they continue to meet the licensing conditions. In the case of an approved person, this may call into question whether they continue to meet the fit and proper requirements for the function for which they have been approved."

Obviously, the regulatory provisions do not entail detailed mechanisms for the implementation of AAOIFI standards or the *sharia* governance and supervision framework. The IFI and Islamic banks are left to decide their strategies in accordance with the AAOIFI governance standards, with little supervision from the financial regulator.

Having established that the CBB requires that Islamic banks comply with all AAOIFI-issued accounting standards as well as the *sharia* pronouncements issued by the *Sharia* Board of AAOIFI, it interesting that the CBB has a *Sharia* Board which is accommodated within its premises. This Board was created by the CBB itself to serve and verify the *sharia*-compliance of its own products. Therefore, it is on a par with any other institutional SSB, and does not hold any supervisory authority over other banks' SSB.[371]

Despite the fact that the CBB refers *sharia* matters to its own Board for consultancy and advice, it is not positioned as a higher *sharia* authority at the national level. Its role is confined to advising the Central Bank on *sharia* matters without any regulatory or supervisory power. Thus, financial institutions and Islamic-banks adhere to their own SSB *fatawa* and internal *sharia* governance in accordance to AAOIFI standards. Nonetheless, this step from the CBB as a financial regulator is an important one, because it shows a level of commitment and recognition of the significance of *sharia*-compliance.

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[371] Bernardo Vizcaino, "Bahrain to Develop Central Sharia Board for Islamic Banks," *Reuters*, December 3, 2014, http://www.reuters.com/article/2014/12/03/bahrain-islam-regulations-idUSL3N0TN1A020141203.

Lack of available information means that certain matters remain unclear. The authority of the Central Bank's *Sharia* Board remains undefined although, as for any institutional SSB, its pronouncements are binding on the CBB. What authority this Board has over the institutional SSB of other IFI and banks, , whether the AAOIFI governance standards are applicable to this *Sharia* Board, and if it must avoid pronouncements which contradict those issued by the *Sharia* Board of AAOIFI, all remain unclear

There are no restrictions on membership the *Sharia* Board of the CBB and, as for the institutional SSB, members are allowed to serve on any number of SSB. For example, eminent *sharia* scholars like Sheikh Nizam Yaqubi (Bahraini national) and Abdul Sattar Abu-Ghuddah (Syrian national) are members of the CBB's *Sharia* Board and also members of other local and international SSB.

There is no doubt that hiring members of the *Sharia* Board of the CBB is beneficial for local IFI and Islamic banks. However, this does give rise to serious concerns about the impartiality, credibility and independence of these scholars.

On the other hand, membership of several local, national or international *sharia* boards might minimise the contradictions among the *fatwas* of different SSB. Common membership would bring consistency to the legal opinions, and in to Islamic financial practices in local as well as international markets.

While, the governance and supervisory concerns will be further addressed in the next chapter, it remains to be seen if the CBB will take further regulatory steps to assign a supervisory role to its existing *Sharia* Board or to the establishment of a national Central *Sharia* Board. In fact, the governor of the CBB (Mr Rasheed Al-Maraj) recently announced a plan to set up a Central *Sharia* Board to help

oversee Islamic finance products nationally and to introduce new rules to strengthen governance in the sector.[372]

5.2 THE UNITED ARAB OF EMIRATES

5.2.1 THE POSITION OF SHARIA AND ITS INFLUENCE

The federal union of seven Emirates, namely Abu Dhabi, Dubai, Sharjah, Ajman, Umm Al-Quwain, Al-Fujairah and Ras Al-Khaima, was declared on 2 December 1970, giving birth to the UAE.

As with Bahrain, the constitution of the UAE (Article 7) stipulates that the religion of the country is Islam, recognising *sharia* as a main source of legislation.[373] Accordingly, Article (75) of the Federal Law No. (10) of 1973 states that:

> "the Supreme Court shall apply the provisions of the *Sharia*, the federal laws, and the other laws in force in the Emirates, that are members of the federation, and which are consistent with the provisions of the *Sharia*. Usages, the principles of natural law and of comparative law shall be applied inasmuch as they do not contradict the provisions of this *sharia*".[374]

These federal laws clearly show that *sharia* is a prime source of law. Unlike Bahrain, in the UAE *sharia* is the legal system. It applies ahead of other sources such as the principles of natural law and comparative law, the application of which shall be in conformity with the provisions of *sharia*. Accordingly, all types of interest are prohibited in transactions. This was true in regard of civil transactions according to Article (714) of UAE Federal Law No. (5) of 1985 concerning Civil

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[372] Ibid.

[373] *The Constitution of the U.A.E of 1971.*

[374] *The U.A.E Federal Law No. (10) of 1973 Concerning the Supreme Federal Court.*

Transactions,[375] which declared interest-based transactions to be void and unenforceable.

However, this situation was changed by Federal Law No. (1) of 1987 Concerning Civil Transactions,[376] which excluded commercial transactions from being governed by the Civil Transactions law.[377] Consequently, Federal Law No. (18) of 1993 concerning Commercial Transactions allowed charging and payment of interest in commercial and banking loans as per the rate agreed in the contract.[378] Thus, the charging of interest in commercial transactions and banking practices became permissible in the UAE, making the legislation similar to Bahrain's in terms of commercial transactions, where interest is allowed by the provision of relevant positive laws of commerce and banking and *sharia*'s influence in these fields remains insignificant.

With regard to regulating and supervising the financial institutions, Union Law No. (10) of 1980 Concerning the Central Bank, the Monetary System and Organization of Banking gave this authority to the Central Bank of the UAE, as Article (5) states:[379]

> "The Bank shall direct the monetary, credit and banking policy and supervise over its implementation in accordance with the State's general policy and in such ways as to help support the national economy and stability of the currency"

In respect of IFB, Federal Law No. (6) Regarding Islamic Banks, Financial Institutions and Investment Companies was passed in 1985. Article (1) of

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[375] *The U.A.E Federal Law No. (5) of 1985 Concerning Civil Transactions.*

[376] *The U.A.E Federal Law No. (1) of 1987 Concerning Civil Transactions.*

[377] Ibid.

[378] *The U.A.E Federal Law No. (18) of 1993 Concerning Issuance of the Commercial Transactions Code.*

[379] *The U.A.E Union Law No. (10) Of 1980 Concerning the Central Bank, the Monetary System and Organization of Banking.*

this Federal Law requires IFI to conduct their business in accordance with *sharia* according to the following definition: [380]

> "Islamic banks, financial institutions and investment companies shall mean those whose articles and memorandums of association include a commitment to abide by the provisions of the *Sharia* Law, and conduct their activities in accordance therewith".

According to Article (2/3), "these banks, institutions and companies shall be subject to the Central Bank's licensing, supervision and inspection in accordance with the provisions of Union Law No (1) of 1980". Further, Article (5) requires the establishment of a Higher *Sharia* Authority stating the following:

> "A Higher *Sharia* Authority shall be formed by a cabinet decision, incorporating *sharia*, legal and banking personnel to undertake higher supervision over Islamic banks, financial institutions and investment companies to ensure legitimacy of their transactions according to the provisions of *Sharia* law, and also to offer opinion on matters which these agencies may come across while conducting their activities. The opinion of the said Higher Authority shall be binding on the said agencies. This Authority shall be attached to the Ministry of Justice and Islamic Affairs".

However, the provision indicates that the Higher *Sharia* Authority is able to issue *fatawa*, which might result in conflict with institutional SSB. Although it can be argued that the opinions of the Higher *Sharia* Authority should prevail, other concerns do arise.

The candidates' names for the membership of institutional SSB should be presented to the Higher *Sharia* Authority for approval. This is stated in Article (6),

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[380] *The U.A.E Federal Law No. (6) of 1985 Regarding Islamic Banks, Financial Institutions and Investment Companies.*

which requires that each Islamic bank, financial institution and investment company should have a *Sharia* Supervisory Authority consisting of a minimum of three members to render their transactions and practices in accordance with the principles and provisions of *Sharia* law. The memorandum of association should clearly determine the way in which this authority shall be formed, the manner in which it will discharge its tasks and its other terms of reference.

This law does not put any restriction on the members of the SSB of financial institutions or of the Higher *Sharia* Authority. Therefore, it is possible for a *sharia* scholar to serve on any numbers of institutional SSB. Similarly, it appears that members of the Higher Authority are not confined to their role in the Authority, and could be members of other national or international organs. Nonetheless, they should not be members of institutional SSB because they have the power to approve membership of such boards, and because their opinions are binding as a result of the supervisory position they enjoy.

However, no such Higher *Sharia* Authority has yet been established. Currently, the financial institutions and banks rely on their own SSB to provide necessary guidance on whether any product, service or lending proposal is Islamic. Nonetheless, it is interesting to know that the Emirates Bankers Association has created an Islamic Banking Committee to view various governance models at the regulator's level,[381] and to propose a suitable model for the Central Bank to implement, which includes establishing a SSB at Central Bank level. As recently as 17 March 2015, in a meeting of the BOD of the UAE Central Bank, some of the recommendations that will expedite the process of setting up such an authority were approved.[382]

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[381] Mian Muhammad Nazir, "Sharia Governance at the Central Bank of UAE," October 30, 2012, http://www.iflr.com/Article/3110470/Shariah-governance-at-the-Central-Bank-of-UAE.html.

[382] Haseeb Haider, "Shariah Authority on Cards," *Alkhaleej Times*, March 22, 2015, http://www.khaleejtimes.com/biz/inside.asp?xfile=/data/uaebusiness/2015/March/uaebusiness_March255.xml&section=uaebusiness.

Given that the country is a federation, in which each emirate enjoys considerable autonomy, the introduction of a uniform legal or regulatory system is not in prospect. Regulation of the establishment and conduct of business in the UAE is shared at the federal and emirate levels, with the ultimate authority at the federal level on most matters. Many federal government functions, such as customs enforcement, are primarily the responsibility of emirate-level authorities, although this is not true of every regulatory aspect, including the financial sector and Islamic banking.

The Emirate of Dubai occupies a unique position in the UAE, leading the way as a centre for Islamic finance. For this study, attention will be particularly paid to the financial centre of Dubai, which has its own laws and regulations.

The Dubai International Financial Centre (DIFC) enjoys certain privileges and economic incentives from the government. All institutions and corporate entities under the jurisdiction of the DIFC fall under the regulatory powers of the Dubai Financial Services Authority (DFSA) as an independent regulator of all financial and ancillary services conducted through the DIFC (a purpose-built free-zone in Dubai) and subject to DIFC Laws, the DIFC Court and the DIFC Arbitration Centre.[383] DIFC Law No. (13) of 2004, and the Islamic Financial Business Module of the DFSA provide the legal framework for regulating Islamic financial business and *sharia* boards.[384]

5.2.2 NATURE OF SHARIA AUTHORITY AND ITS ROLE

The DIFC and DFSA were established by a synthesis of federal and Dubai law. First, an amendment was made to Article (121) of the Constitution of the UAE, which deals with the division of powers between federal and Emirati authorities

[383] "Dubai Financial Services Authority," accessed March 26, 2015, http://www.dfsa.ae/.

[384] *The Islamic Finance Rules Module of the DFSA Rulebook*, accessed March 25, 2015, http://dfsa.complinet.com/en/display/display_main.html?rbid=1547&element_id=13808.

and allows the Federation to enact a Financial Free Zone Law. According to this amendment, an Emirati government is permitted to create a financial free zone within its borders.[385] Federal Law No. (8) of 2004 Regarding The Financial Free Zones in the UAE allowed in Article (2) that a financial free zone be created in any of the Emirates by a federal decree, exempting it and financial activities from all federal civil and commercial laws according to Article (3/2).[386] Accordingly, Cabinet Resolution No (28) of 2007 in regard to implementing Regulations of Federal Law No (8) of 2004 was issued.[387]

In regard of the financial free zone in Dubai, it was the UAE Federal Decree No (35) of 2004 which established the DIFC.[388] At the Emirate level, Dubai Law No. (9) of 2004 In Respect of The Dubai International Financial Centre,[389] recognises the financial and administrative independence of the DIFC in Article (3/1). It states in Article (3/3) that the following bodies shall be established in the Centre:

a) Dubai International Financial Centre Authority;

b) Dubai Financial Services Authority; and

c) Dispute Resolution Authority

This law in Article (2) enables the Ruler of Dubai to appoint the President of the DIFC, who should create and chair the Higher BOD according to Article (3/4-5). Also, Article (5) states that a Governor shall be appointed by the Ruler of Dubai whose service conditions are determined by the President. The rest of this law details the authority of the DFIC over these bodies.

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[385] *The U.A.E Constitutional Amendment No (1) of 2003.*

[386] *The U.A.E Federal Law No (8) of 2004 Regarding The Financial Free Zones.*

[387] *The U.A.E Cabinet Resolution No. (28) of 2007 On the Implementing Regulations of Federal Law No (8) of 2004 Concerning Financial Free Zones.*

[388] *The U.A.E Federal Decree No (35) of 2004 to Establish Financial Free Zone in Dubai.*

[389] *Dubai Law No. (9) of 2004 In Respect of The Dubai International Financial Centre.*

There are 52 banks operating in UAE, 9 of which are Islamic-banks. All conventional banks are allowed to offer *sharia*-friendly products. DIFC Law No. (13) of 2004[390] requires in Article (9) that firms and institutions obtain an endorsed licence authorising them to conduct Islamic financial business as an IFI or by operating an Islamic window. Article (10) identifies Islamic financial business and financial institutions conducting such business as follows:

a) Conducting Islamic Financial Business means carrying on one or more financial services in accordance with *sharia*.

b) IFI means an Authorised Firm or Authorised Market Institution whose entire business operations are conducted in accordance with *sharia*.

c) An Authorised Firm or Authorised Market Institution, other than an Islamic Financial Institution, operates an Islamic Window if it conducts Islamic Financial Business as part of its overall business operations.

The requirements for conducting Islamic financial business are stated in Article (13):

1) An Authorised Firm or Authorised Market Institution which has an endorsed Licence authorising it to conduct Islamic Financial Business shall appoint a SSB.

2) The Council of the DFSA may make Rules prescribing the appointment, formation, conduct and operation of a SSB.

This Article (13/2) empowers the DFSA to make rules pertaining to SSB. The underpinning law regulating an SSB's appointment, formation, conduct and

[390] *Dubai International Financial Centre Law No. (13) of 2004.*

operation is the Islamic Financial Business Module of the DFSA Rulebook, known as the Islamic Finance Rule (IFR).[391]

In terms of *sharia* governance and supervision, section (IFR 3.4) of the Islamic Finance Rule requires an authorised person undertaking Islamic financial business to implement and maintain a policy and procedures manual which addresses: matters concerning *sharia*-compliance; functioning of the SSB; recording of the *fatawa*, rulings and guidelines disseminated and implemented and the internal *sharia* review undertaken; addressing disputes between the SSB and the authorised person in respect of *sharia*-compliance; the process for approving those internal systems and controls to ensure that the Islamic financial business is carried out in compliance with *sharia*; identifying and managing conflicts of interest; and the systems and controls to ensure the appropriate separation of the Islamic financial business of the authorised person operating an Islamic window from its conventional business.

In terms of the SSB, section (IFR 3.5.1) requires the authorised person in the appointment of the SSB to ensure the following:

a) the SSB to consist of at least three members;

b) the competence of the appointed members to perform their functions;

c) approval of any appointments, dismissals or changes in respect of members of the SSB by the governing body of the authorised person; and

d) no member of the SSB is a director or controller of the authorised person.

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[391] *The Islamic Financial Business Module of the Dubai Financial Services Authority [VER8/06-14].*

The guidance for the purposes of this section recommends that an authorised person should assess whether the proposed SSB member is competent to advise on the Islamic financial business to be undertaken by the authorised person, and thereby consider the previous experience and qualifications of such members. According to the next section (IFR 3.5.2), an authorised person must document its policy in relation to:

a) how appointments, dismissals or changes will be made to the SSB;

b) the process through which the suitability of SSB members will be considered; and

c) the remuneration of members of the SSB.

As the provision does not specify the organ of the financial institution which is responsible, the members of the SSB could be appointed or dismissed, assessed for qualification, and their remuneration decided by either the BOD or the shareholders.

In terms of documenting this procedure, section (IFR 3.5.3) requires an authorised person to establish and maintain for six years records of its assessment of the competency of the SSB's members, their appointments, dismissals or changes, qualification and remuneration. A further section (IFR 3.5.5), states that an authorised person must provide the DFSA with information on appointed or proposed SSB members with regard to their qualifications, skills, experience and independence (if requested).

To ensure appropriate functionality of the SSB, section (IFR 3.5.6) requires an authorised person and employees to take reasonable steps in providing such assistance as the SSB reasonably requires to discharge its duties, giving the SSB's right of access at all reasonable times to relevant records and information,

not to interfere with the SSB's ability to discharge its duties, and not to provide false or misleading information to the SSB.

In terms of *sharia* review, section (IFR 3.6.1) provides that an authorised person must ensure that all reviews are undertaken by the SSB in accordance with AAOIFI Governance Standard No (2). Accordingly, sections (IFR 3.7.1 - IFR 3.7.3) require both the IFI and Islamic windows to perform an internal *sharia* review in accordance with AAOIFI Governance Standard No (3), and that Islamic windows must document the manner in which it will conduct any part of the internal review that is not conducted in accordance with the named AAOIFI standard.

Finally, section (IFR 3.6.2) requires that the annual report from the SSB must comply with AAOIFI Governance Standard No (1), a copy of which must be submitted to the DFSA within 14 days of having received it. In terms of financial statements, section (IFR 4.2.1) provides that an authorised person carrying out Islamic financial business must ensure that its financial statements contain disclosures on the role and authority of the SSB in overseeing the business, and subject matters of *zakah* such as the calculation method, its paid amount, and sufficient information if *zakah* was not paid to allow a shareholder or other investor to compute the amount of his own liability to *zakah*. Further, section (IFR 4.2.2) requires an authorised person who operates an Islamic window to ensure that its financial statements contain the following disclosures:

a) a detailed statement of the funds mobilised according to *sharia* rules and principles and the assets financed by those funds;

b) a detailed statement of the income and expenditure attributable to its Islamic financial business; and

c) whether funds attributable to Islamic financial business are commingled with funds attributable to conventional financial services.

From the above laws and rulebook provisions, it is understood that the DIFC obtains a distinct position in the UAE and is regulated separately by the DFSA as an independent regulator. In terms of *sharia* governance and supervision of the IFI and windows, it considers itself as a *Sharia* Systems Regulator, not a *Sharia* Regulator. Therefore, the *sharia* governance system is guided by the DFSA without the imposition of any specific form. This means that any firm which conducts Islamic financial business must put systems in place to ensure that the business is conducted in accordance with *sharia*. This includes the appointment of a SSB. The firm must have systems in place to disseminate the SSB's rulings, conduct regular *sharia* reviews and also conduct an internal audit.

It is interesting that there is no Central *Sharia* Authority at the DIFSC level. Nonetheless, the DFSA's rulebook refers to some of the AAOIFI governance standards, as discussed above. However, this does not necessarily mean that the DIFC accepts them as mandatory, because the rulebook stipulates different provisions in some areas from those in the AAOIFI standard.

5.3 THE STATE OF KUWAIT

5.3.1 THE POSITION OF SHARIA AND ITS INFLUENCE

The Constitution of Kuwait, Article (2) states *sharia* as the main source of legislation and Islam as the official religion.[392] Accordingly, Article (547) of the Kuwaiti Decree No (67) of 1981 concerning Civil Code, which replaced the Ottoman *majallah* (the Ottoman version of a civil code), prohibited the practice of

[392] *The Constitution of Kuwait of 1962 (Reinstated in 1992).*

charging interest on loans, and Article (305) declares such transactions to be void. [393]

Further, Article (2) of the civil code states that in the absence of sufficient legislative provision a matter should be resolved according to Islamic jurisprudence and then custom. Placing *sharia* in this advanced position bears a similarity to UAE legislation, and proves the importance of *sharia* as a source of legislation in the State of Kuwait.

As *sharia* is a legal source and because the civil code provisions are in clear conformity with Islamic principles, interest-based transactions were illegal and invalid. However, Kuwaiti Decree Law No (68) of 1981 concerning Commercial Code resolved this difficulty and made dealing or charging interest on commercial loans expressly permissible by financial institutions.[394]

In Kuwait, the Ministry of Commerce and Industry is the principal ministerial authority for enforcement of commercial laws, and financial institutions are strictly required to comply with the Commercial Companies Law of 1961 (replaced by Law No. 25 of 2012).[395] Article (15) clearly states that companies engaged in Islamic practices must conduct their business in accordance with the provisions of *Sharia*. A company should form an independent body for *sharia* supervision to oversee a company's business. This body should consist of at least three members, appointed in the general meeting. The company's Memorandum of Association, should provide for the establishment of this body, the method of its formation and its function, and detail the means of discharging its functions. In the case of a disagreement between the SSB members about a *sharia* ruling, the company may refer the dispute to the *Fatwa* and Legislation at the Ministry of *Awqaf* and Islamic Affairs, which is the final authority in this regard.

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[393] *The Kuwaiti Decree Law No (67) of 1981 Concerning Civil Code.*

[394] *The Kuwaiti Decree Law Code No (68) of 1981 Concerning Commercial Code.*

[395] *The Kuwaiti Commercial Companies Law of 1960 (replaced by Law No. 25 of 2012).*

In terms of banking, the Central Bank of Kuwait (CBK) holds the authority to regulate and supervise Islamic banks.

5.3.2 NATURE OF SHARIA AUTHORITY AND ITS ROLE

According to Article (13) of Law No (32) of 1968 (amended by Law 130/1977) Concerning Currency, the Central Bank of Kuwait and the Organisation of Banking Business, the CBK was established as an independent public institution.[396] Article (15/4) of this law states that the CBK has the object of controlling the banking system in the State of Kuwait. Section (10), introduced under Law No. (30) of 2003, Articles (86-100) clearly vest in the CBK the power to regulate and supervise Islamic banks. .

Article (86) provides a general definition of an Islamic-bank as a business entity that exercises activities pertaining to banking business which should comply with *sharia* principles. It further states that Islamic banks ordinarily accept all types of deposits, and carry out all financial operations using *sharia* contracts. They provide various types of banking and financial services to their customers and to the public. They conduct financial and direct investment operations whether on their own account or on the account of other parties or in partnership with others.

However, the section does not entail definitions or explanation of Islamic contracts or transactions. Interestingly, Article (100) clearly provides for the supremacy of Islamic law, stating that "Islamic banks shall be subject to the provision of this law without prejudice to the *Sharia* principles."

In terms of *sharia* governance and supervision, Article (93) provides that:

> "Each Islamic bank shall have an independent SSB, comprising not less than three members appointed by the bank's General

[396] *The Law No (32) of 1968 Concerning Currency, the Central Bank of Kuwait and the Organisation of Banking Business.*

> Assembly. The Memorandum of Agreement and Articles of Association of the bank shall specify the establishment of the Board as well as its formulation, powers, and workings. In case of a conflict of opinions among members of the SSB concerning a *Sharia* rule, the BOD of the designated bank may transfer the matter to the *Fatwa* Board in the Ministry of *Awqaf* and Islamic Affairs, that shall be the final authority on the matter".

The establishment of the SSB and the determination of its functions by the Islamic-bank indicate the similarity of the Kuwaiti and UAE regulators. This provision is also similar to the text of Article (15) of the Commercial Companies Law of 1961 (replaced by Law No. 25 of 2012). Otherwise, this provision added that:

> "The SSB shall annually submit to the bank's General Assembly a report comprising its opinion on the bank's operations in terms of their compliance with the *Sharia* principles and any comments it may have in this respect. This report shall be included in the bank's Annual Report".

Thus, the SSB has the duty to submit a *sharia* report to the bank's general assembly. It is specified that the content of the report is to contain the SSB's opinion on the bank's operation in term of *sharia*-compliance, including comments and views on *sharia* issues. Also, this report must be included in the Islamic-bank's annual report.

Moreover, both of the above Articles provide that in the case of conflict of opinions among members of the SSB concerning a *fatwa*, the BOD of the designated Islamic bank may transfer the matter to the *Fatwa* Board in the Ministry of *Awqaf* and Islamic Affairs. Therefore, the CBK law recognises this *Fatwa* Board as the Final *Sharia* Authority for any dispute involving IFB.

However, the referral of issues or disputes to this Board is not mandatory, since the decision of referral in left to the discretion of the BOD.

Further examination of the nature and operational side of this process suggests that the power of being the Final *Sharia* Authority is more theoretical than actual, because referring matters to the ministerial *Fatwa* Board is limited to the case of a dispute, which might never occur. As the institutional SSB make their decisions on a majority basis, approval or rejection of any given product is made regardless of an individual member's opinions, so there could be no dispute to transfer to the *Fatwa* Board.

Also, the CBK law is silent about the status of the decisions that may be made by the *Fatwa* Board. This is not the case in the UAE, where the law clearly stipulates that the rulings of the Higher *Sharia* Authority are binding, regardless of the fact that no such authority yet exists and that, as in Kuwait, it is attached to the Ministry of *Awqaf* and Islamic Affairs.

There also appears to be no restriction on the members of the *Fatwa* Board or institutional SSB serving on any number of institutional SSB.

Further, there is no mention of *sharia* review, internal *sharia* review/audit, or competence and qualifications of *sharia* scholars. It is also evident that, unlike the case of Bahrain and Dubai, these laws and regulations do not refer to any of AAOIFI governance standards. Nor do the CBK Instructions for Islamic Banks cover these shortcomings, in particular Instruction No (2/IBS/100/2003) concerning the Rules and Conditions for the Appointment and Responsibilities of the SSB in Islamic-Banks.[397] The instructions establish a framework for the performance of SSB duties, providing independence for their members in expressing their opinions, and defining the role of the external auditor in relation

[397] "The Central Bank of Kuwait Instruction No (2/IBS/100/2003) Concerning the Rules and Conditions for the Appointment and Responsibilities of the Sharia Supervisory Board in Islamic Banks".

to the bank's compliance with the rules and principles of *sharia*. In brief, the nine instructions suggest the following:

1) The shareholders approve the SSB's members in the general meeting. They should be *Sharia* scholars of recognised efficiency and experience, especially in the area of transaction jurisprudence.

2) The SSB should consist of at least three members, and all three should attend meetings. Directors, executive management and shareholders of effective influence are not allowed to be members of the SSB.

3) The service of the SSB member shall end with his resignation or by a justified recommendation from the bank's BOD to be approved by the general meeting.

4) The SSB shall be responsible for providing opinions on the bank's compliance with the *sharia* rules in all its operations. It shall inspect all contracts, agreements, policies and transactions of the bank with the other parties.

5) Responsibility for complying with the *sharia* rules rests with the management of the bank. Therefore, it must present all the contracts, operations and transactions to the SSB in order to obtain its opinion on them, and must comply with the implementation of all *fatawa*, resolutions and guidelines issued by the SSB in this connection.

6) The annual report of the SSB required under Article (93) of the said law must include members' titles and addresses, the scope of the SSB's work, and the SSB's opinions.

7) Within the framework of verifying the compliance of the bank's management with *sharia*, the task of the external auditor includes necessary examination to ascertain that all the procedures followed by the

bank in launching new financial products or in modifying existing products, and all the products of the bank, have been examined by the SSB and confirmed as compliant with the rules and principles of the *Sharia*. In his report, the external auditor must indicate the extent of the bank management's compliance with the *fatawa*, resolutions and directives of the SSB in the transactions executed.

8) The Islamic bank shall publish the *fatawa* and resolutions passed by the SSB through booklets or bulletins and make them available to the public.

9) These instructions shall be implemented from the date of notification.

5.4 THE SULTANATE OF OMAN

5.4.1 THE POSITION OF SHARIA AND ITS INFLUENCE

As in other GCC, the Constitution of the Sultanate of Oman refers to *sharia* law. The Omani Royal Decree No (101/96) of 1996 (with Amendments through 2011) promulgating the Basic Statute of the State, is the Constitution of Sultanate of Oman, also known as Oman's Constitution of 1996.[398] Article (1) of this Omani Constitution states that the Sultanate of Oman is an independent Islamic state, and Article (2) provides that "the State's religion is Islam and *Sharia* is the basis for legislation".

Using the wording that *sharia* is "the basis for legislation" is a powerful statement that places *sharia* as the prime source of law in the Sultanate. This is different from the countries discussed above, which recognise *sharia* as *a* source of legislation, i.e. it is one source among others, allowing other positive laws to permit interest in commercial and banking transactions. In fact, there is no such provision in the Omani Royal Decree No (55/90) of 1990 Issuing the Commercial

[398] *The Omani Royal Decree No (101/96) of 1996 Promulgating the Basic Statue of the State.*

Law.[399] The more recent Royal Decree No (29/2013) of 2013 promulgating Civil Transactions Law, which consists of 1,086 Articles, is applicable to commercial as well as civil transactions. It provides in Article (1) that "any matter that is not specifically regulated by this Code, is to be governed by reference to, first, Islamic jurisprudence, secondly, the principles of *Sharia* and, thirdly, custom".[400] This re-emphasises the supremacy of *sharia* law in Oman.

Nonetheless, free zones are permitted by the Omani Royal Decree No (56/2002) of 2002 promulgating Free Zones Law.[401] The Salalah Free Zone was established in 2006 through Royal Decree No. (62/2006) of 2006 promulgating the Establishment of Salalah Free Zone.[402] According to this law, the government of Oman leases land for a period of 50 years to the Salalah Free Zone sole operator Oman Oil Company "SAOC", which is totally owned by the government.

Given the unique legal system of Oman and the supremacy of *sharia* as its law, nevertheless some legislation shows a considerable degree of Egyptian and civil law influence, while few statutes demonstrate a common law influence. This is particularly the case in relation to banking law.

5.4.2 NATURE OF SHARIA AUTHORITY AND ITS ROLE

Oman was the last nation of the six-member GCC to introduce Islamic finance, publishing rules for it in 2012. Its banking sector currently consists mainly of commercial, specialised and Islamic banks; Islamic windows; non-bank financial and leasing companies; and money exchange establishments. As at the end of 2013, the number of commercial banks stood at 16, of which seven were locally incorporated and nine were branches of foreign banks. The specialised banks

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[399] *The Omani Royal Decree No (55/90) of 1990 Issuing the Commercial Law.*

[400] *The Omani Royal Decree No (29/2013) of 2013 Promulgating Civil Transactions Law.*

[401] *The Omani Royal Decree No (56/2002) of 2002 Promulgating Free Zones Law.*

[402] *The Omani Royal Decree No. (62/2006) of 2006 Promulgating the Establishment of Salalah Free Zone.*

operated through a network of 23 branches. There were two fully fledged locally incorporated Islamic banks, namely Bank Nizwa and Al-Izz Islamic Bank. In addition, 11 commercial banks and one fully fledged Islamic bank had approval to engage in specific investment banking activities. Six of the seven locally incorporated conventional commercial banks were also offering Islamic banking services through dedicated windows. Thus, Islamic banks and windows operated with 29 branches.[403]

The numbers clearly show the dominant position of the commercial banks in the financial sector, unsurprising since Islamic banking was only allowed in the Sultanate in 2012.

All of the financial institutions operate under the licensing and regulation of the Central Bank of Oman (CBO), which began operation on 1 April 1975 after its establishment in December 1974, replacing the Oman Currency Board as the principal currency authority in Oman.[404] Article (1) of the Omani Royal Decree No. (114/2000) of 2000 promulgating Banking Law[405] empowers the CBO to maintain the stability of the national currency and ensure monetary and financial stability in a deregulated and open financial system. It is responsible for the supervision of banks and the banking business in the Sultanate and advises the Government on domestic and international economic affairs, Article (6) having established that the "Central Bank shall be a juristic person, which is financially and administratively independent".

Although provisions of this law regulate banking in the Sultanate and the role of the CBO, the law does not include any provisions about Islamic-banks. Their regulation and supervision is made possible by the Omani Royal Decree No (69/2012) of 2012 Amending the Banking Law promulgated by Royal Decree No

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[403] The Annual Report of the Central Bank of Oman for the year 2013.

[404] "The Central Bank of Oman," accessed March 28, 2015, http://www.cbo-oman.org/.

[405] *The Omani Royal Decree No. (114/2000) of 2000 Promulgating Banking Law.*

(114/2000),[406] as well as the CBO's Circular No (IB 1) of 2012,[407] which adopted the CBO's Islamic Banking Regulatory Framework of 2012.[408]

The amending Law of Banking (69/2012) added a new Chapter No (6) entitled Islamic Banking, which consists of six Articles that established the foundation of the Islamic banking system. Article (124) states that the banks licensed to practise Islamic banking shall conduct all transactions – without limitation – consistent with the provisions of *Sharia* law, and in particular the following:

a) Accepting deposits and management of joint or specific investment accounts with or without fees and profits.

b) Financing and investing in *mudaraba, musharaka, murabaha, Ijara, salam, istisna* or *Qardh-al-Hasan* (benevolent loan) and other *sharia* formulas.

c) Issuing instruments guaranteed by assets and projects, and the investment therein.

d) Dealing in real estate and movable property through buying, selling, investments, letting and leasing, subject to the restrictions set forth in the Banking Law and the relevant laws and Royal Decrees.

In terms of *sharia* governance and supervision, Article (126/1) requires a bank licensed to practise Islamic banking to have an SSB. Nonetheless, it leaves its composition, competence and work procedure, along with the requisite qualifications of its members, whose appointment and remuneration shall be decided by a resolution of the general assembly of the bank, to be determined by regulations.

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[406] *The Omani Royal Decree No (69/2012) of 2012 (Amending the Banking Law).*

[407] The Circular No (IB 1) of 2012 concerning Islamic Banking Regulatory Framework of "The Central Bank of Oman.

[408] *The Central Bank of Oman's Islamic Banking Regulatory Framework of 2012*, accessed March 25, 2015, http://www.cbo-oman.org/.

Thus, the form, prerogatives and functioning of these SSB are governed by the CBO's Islamic Banking Regulatory Framework of 2012,[409] which applies not only to the fully fledged domestic Islamic banks, but also to Islamic branches of foreign banks and Islamic windows of domestic conventional banks. All together are referred to as "licensees" in the framework, and regulated and supervised by the CBO.

Under Title 1 (licensing requirements), section (1.4.1), "A Licensee shall conduct all of its activities, operations and transactions in accordance with *sharia* rules and principles". Section (2: 2.1-2.7) specifies the Business of Authorised Islamic Banking as:

- Accepting deposits.
- Managing unrestricted investment accounts
- Managing restricted investment accounts
- Providing Islamic financial products
- Providing money exchange / remittance services
- Issuing / administering means of payment
- Other authorised business transactions, subject to specific approvals and conditions set by the CBO.

In terms of systems and controls, section (3.9.3) states that "Licensees shall maintain systems and controls that are adequate for the scale and complexity of their activities and operations", and section (3.9.5) that "the CBO shall focus on the *sharia* governance system proposed and applicants' preparedness in general of control capability and in particular of *sharia*-compliance capability in considering approvals".

[409] Ibid.

Concerning books of accounting, sections (3.11.2 and 3.11.3) require that "Separate books of accounts shall be maintained for an Islamic window", and they "must comply with the financial accounting standards issued by the AAOIFI, and where no relevant AAOIFI standards exist, with international financial reporting standards or international accounting standards.

Title 2 (General Obligations and Governance) is the main part of the IFB rules that regulate aspects of *sharia* governance and supervision. Sections (1.4.1-1.4.4) provide a clear and strong statement that "Licensees shall conduct their business in accordance with *sharia* principles and in line with contemporary professional standards". In this context, they identify Islamic banking as faith based, which means that conduct of business is based on strong ethical principles. Accordingly, Islamic banking is not just profit sharing but profit sharing with values, where principle comes before profit. The wider concept of *sharia* corporate governance is considered in terms of *sharia*-compliance, as this section clearly states that "there are many stakeholders, besides the shareholders, and including investment account holders, looking for and sensitive to *sharia*-compliance". Therefore, licensees are encouraged to follow the relevant and applicable standards of IFSB, namely IFSB-3 and IFSB-10.

According to sections (1.2-1.3 and 1.5), the required *sharia* governance structure is implemented by mandating each licensee to:

1) Provide that it conducts its business in accordance with *Sharia* principles, in its memorandum of association.
2) Establish and maintain appropriate systems and controls to ensure *sharia*-compliance of its practices
3) Appoint an SSB to oversee operations from a *sharia*-compliance perspective and prepare and present an annual *sharia*-compliance report to the Licensee's BOD, and
4) Implement a system of *sharia* governance (as specified in Title 2).

The *sharia* governance system referred to above is explained in Section (2), *Sharia* Governance. Section (2.1.1) defines it as "a system whereby an IFI attempts to comply with *sharia* in all its activities". The main objectives of *sharia* governance framework are to provide a structure and a system to govern all the business activities of the licensee in order to ensure *sharia*-compliance at all times and at all levels, and to enable the licensee to be perceived as *sharia*-compliant by the stakeholders including the general public.

According to section (2.1.2), the four key elements of *sharia* governance framework are the SSB of the licensee, the Internal *Sharia* Reviewer, the *Sharia* Compliance Unit and the *Sharia* Audit Unit. Nonetheless, Section (2.1.4) provides that maintaining a strong *sharia* governance framework is the ultimate responsibility of the BOD, which shall approve all the policies and procedures for the licensee related to *sharia* matters in consultation with the SSB and shall put in place a mechanism to ensure that such policies and procedures are effectively implemented. It is further stated in section (2.2.6.1-2.2.6.2) that the SSB is responsible for forming and expressing an opinion on the extent of a licensee's compliance with *sharia*. However, the responsibility for compliance rests with the management of the licensee, and the presence of SSB and the *sharia*-compliance function of a licensee does not relieve the management of its responsibility to undertake all transactions in accordance with *sharia*. Management shall be responsible for observing and implementing *sharia* rulings and decisions passed by the SSB.

It follows from section (2.2.1), that licensees must establish their own independent SSB. However, there is a limited outsourcing exception for small institutions, as approved by the CBO. The definition provided for the SSB does not fall far from that given by AAOIFI-1:

> "A SSB is an independent body of *sharia* scholars specialised in *fiqh-almuamalat*. The SSB may include additionally one or more

non-voting members who are not specialised in *fiqh-almuamalat* but have expertise in Islamic banking (or related areas like finance, economics, accounting, law, etc.) and possess basic knowledge of *fiqh-almuamalat.* The SSB is entrusted with the duty of directing, reviewing and supervising the activities of the licensee in order to ensure that they are in compliance with *sharia* principles. The *fatawa* and rulings of the SSB shall be binding on the licensees."

According to this section, each SSB must consist of at least three *sharia* scholars specialised in *fiqh-almuamalat*, whose appointment and remuneration shall be made in a general assembly and disclosed in the annual report. To develop Omani expertise in the field, Omani SSB members are preferred. In addition, non-scholars with the necessary professional expertise are allowed as non-voting members; voting power remains with the Scholars because of the very nature and purpose of the SSB.

Sections (2.2.4.1 to 2.2.4.3) provide that "Members of the SSB shall be appointed for a maximum initial term of 3 years which can be renewed for another 3-year term. An SSB member can serve a maximum of two consecutive terms in an institution". The SSB shall be independent, objective, competent and appropriately empowered to carry out its responsibilities. Independence is defined here as "an attitude of mind which does not allow the viewpoints and conclusions of its possessor to become reliant on or subordinate to the influences and pressures of conflicting interests. It is achieved through organisational status and objectivity".

The roles and responsibilities of the SSB are detailed in section (2.2.2). In this context, a charter shall be prepared by the licensee and approved by the BOD defining the SSB's scope of work. Nonetheless, this section clearly provides that "the SSB shall be the ultimate responsible authority within the licensee for all *sharia*-related matters", and the BOD shall rely on it for all such matters in the

normal course of business and operations. According to section (2.2.24), the responsibilities of the SSB shall include but will not be limited to the following:

- Advise the board and the management on *sharia* matters in the day-to-day business of the licensee;
- Review and approve all the policies and procedures, products, processes, systems, contracts and agreements for their *sharia*-compliance (to be ratified subsequently by the BOD);
- Review and approve product documentation (including product features, terms and conditions, underlying Islamic contracts, product manual, marketing, collateral, other legal documentation, etc.);
- Conduct *sharia* checks post-product approval to ensure implementation of the related guidelines as approved by the SSB review and approve the work carried out by *sharia*-compliance and *sharia* audit functions;
- Guide related parties on *sharia* matters (e.g. legal counsel, external auditor, etc);
- Provide written *sharia* ruling on matters brought to its attention by the management of the licensee through the internal *sharia* reviewer or taken up by the SSB itself;
- Submit a report to the BOD on the licensee's *sharia*-compliance, to be published as part of the annual report.

Importantly, section (2.2.3) under Title 2 of the IFB rules contains a number of required qualifications, called fit and proper standards, that are directed especially to SSB members; these do not exist in the countries discussed above.

According to this section, members of the SSB "have to be Muslim individual". Nonetheless, it is unclear whether this applies only to *sharia* scholars and/or to non-scholar members. Obviously, the word 'individuals' in this provision excludes

the use of *sharia* firms in the functions attributed to the SSB, and the word 'Muslim' excludes the use of non-Muslim experts as members of the SSB.

In terms of qualifications, the requirements for *sharia* scholar members are different from those for non-scholar members of the SSB. *Sharia* scholars must have an academic qualification in the field of *sharia* (a minimum of a bachelor's degree) that includes the study of *usul-al-fiqh* and *fiqh-almumalat* from "a recognised institution". They must demonstrate "an adequate understanding of finance/banking in general and Islamic finance/banking in particular", as well as an understanding of the legal and regulatory frameworks applicable to the functions of the licensee. In terms of experience, they must have accumulated overall experience of ten years or more (in teaching, research, issuing of *fatawa* and similar matters). Also, they must demonstrate a strong proficiency in Arabic, and it is recommended that they have reasonable understanding of English.

The non-scholar members of SSB must hold at least a master's degree, and must be "individuals generally recognised for their expertise in their respective field (e.g. banking, finance, economics, law, accounting, etc.)". They must have accumulated experience of 15 years or more in the relevant field, and demonstrate reasonable proficiency in English, and it is recommended they have some understanding of Arabic. Both *sharia* scholars and non-scholars "must be of respectable character and be of good conduct, particularly in terms of honesty, integrity and reputation in their professional business and financial dealings".

Sections (2.2.4.5–2.2.4.8) provide that "SSB members are solely and personally responsible for their own work as members of the SSB, and shall always strive to uphold fairness and equity for all the stakeholders. They shall exercise appropriate discretion in decision making by keeping in mind both the technical aspects of *sharia* and the objectives of *sharia* (*maqasid-al-sharia*). They should pay attention to both the legal and ethical dimensions of their decisions, and appreciate the diversity of opinion among various mainstream schools of thought

and differences in expertise among the fellow members of the SSB, and no one member should dominate the SSB decisions".

To support the independence of SSB members and avoid conflicts of interest, there is a restriction in the terms of SSB membership. Section (2.2.4.18) requires that:

> "No member can be on the SSB of more than one competing institution in Oman. However, an SSB member can be on the board of more than one non-competing institution (e.g. the SSB member of an Islamic bank can also sit on the SSB of a *takaful* company or an Islamic fund management company). Overall, no SSB member can be on the SSB of more than four institutions in Oman".

According to section (2.2.5.3-2.2.5.4), the dismissal of a member of the SSB shall require a recommendation by the BOD and be subject to the approval of the shareholders in a general meeting, and the licensee shall notify the CBO of any resignation or removal of an SSB member as and when it happens, stating the reasons and actions, including replacement proposed. In section (2.2.5.1), a range of "for cause" events is provides for the disqualification of an SSB member, which includes but is not limited to:

- cessation of good character and reputation or a position of respect among one's peers,
- failure to attend a substantial number of meetings without reasonable excuse (currently, 75%),
- association with any unethical or illegal activity, including contravention of any of the requirements and standards of the financial, banking or corporate regulatory system,
- conviction of any criminal offence, including financial impropriety or moral turpitude (except misdemeanours),

- dismissal as an employee or director from any entity on the grounds of fraud, misrepresentation or breach of trust,
- use of confidential and privileged information about the licensee or its clients obtained as a result of his position in a manner that is detrimental to the competitive interests of the licensee in the market place (but, apparently, not if otherwise in contravention of confidentiality requirements), or
- assumption of membership of the SSB of two or more competing financial institutions in Oman.

To fulfil its responsibility, the SSB shall use all available elements of the *sharia* governance framework, namely the Internal *Sharia* Reviewer, *Sharia* Compliance Unit, and *Sharia* Audit Unit explained below.

Internal *Sharia* Reviewer

According to sections (2.3.1-2.3.3), the appointment and termination of an Internal *Sharia* Reviewer shall be by the management in consultation with the SSB and approved by the board of the licensee. As the Internal *Sharia* Reviewer will be a full-time employee of the licensee, licensees are required to notify the CBO of any resignation or termination of such person immediately it occurs. He can only work for one licensee at a time in his capacity as Internal *Sharia* Reviewer, and cannot be a member of the licensee's SSB at the same time. He shall fulfil the fit and proper criteria for SSB membership as outlined above, except that the minimum experience requirement is five years.

The Internal *Sharia* Reviewer shall head both the *Sharia* Compliance and *Sharia* Audit Units of the licensee. He shall be a qualified *sharia* scholar, and assisted by a team of *Sharia* Compliance Officers and *Sharia* Audit Officers who shall have knowledge and experience of the banking business as well as a basic understanding of *sharia* (in particular *fiqh-almuamalat*) as applied to the banking and audit processes.

The Internal *Sharia* Reviewer shall work independently and report to the SSB, with administrative reporting to the CEO (of a fully fledged Islamic bank) or the Head of Islamic Banking (in the case of an Islamic window). He shall be responsible for providing *sharia* guidance and direction to the licensee's management in day-to-day matters, and may escalate an issue to the SSB to seek their guidance and approval if deemed necessary.

To discharge his duty and perform his role with efficacy, the Internal *Sharia* Reviewer and his team should have access to all records, documents and information from all sources, including professional advisors and the licensee's employees. The management will be responsible for providing him with all the information relating to the licensee's compliance with *sharia*.

The Reviewer will spend a significant percentage of his time, on an annual basis, in training the management and staff of the licensee, and other stakeholders, in *sharia* as it applies to Islamic banking. A log of his time spent on training should be kept by the licensee and will be made available to the CBO if required.

Sharia Compliance Unit

According to sections (2.4.1 – 2.4.2), the licensees are required to introduce a *Sharia* Compliance Unit, reporting to the Internal *Sharia* Reviewer, as part of their *sharia* governance framework. This unit will facilitate the management to ensure compliance with *sharia*, in accordance with guidelines and *fatawa* issued by the SSB and Islamic banking stipulations of the CBO on a day-to-day basis in all its business activities. This shall be done through review and approval of the contracts, agreements, policies, procedures, products, process flows, transactions, reports, etc. The Unit shall be consulted on new products and transactions which need to be formally approved by the SSB before their execution.

The *Sharia* Compliance Unit shall ensure that it receives regular updates from management information systems and confirmation from the business

departments and branches relating to the compliance of key transactions and the actions taken to resolve any observations raised by the Unit on operations, products or procedures. The purpose of this is to minimise the possibility of *sharia* non-compliance and rectify any such issues (where possible) during the year before the annual *Sharia* Audit.

Compliance shall also include *sharia* risk control, whereby an appropriate senior manager shall identify, measure, monitor, control and manage (with guidance from the Internal *Sharia* Reviewer) any real or perceived risk of *sharia* non-compliance by the licensee across the entire organisation, including fundamental (or primary) as well as peripheral (or tertiary) activities, operations and functions.

The *Sharia* Compliance Unit will participate in training the employees of the licensee – both management and staff – and other stakeholders. For this purpose it will conduct training courses, seminars, conferences, etc. It may also disseminate knowledge by publishing and distributing pamphlets, brochures, etc. explaining the principles of Islamic banking and the *fatawa*, guidelines and instructions issued by the SSB concerning the products and services offered by the licensee.

The *Sharia* Compliance Officers are required to have sound banking knowledge as well as an understanding of *sharia* principles in general and *fiqh-almuamalat* in particular. They should have an appropriate educational background and training relevant to their work. The licensee shall have a system in place which ensures that only qualified, experienced and committed employees are recruited and retained in the Compliance Unit. Their performance shall be regularly assessed and appropriate action shall be taken based on recommendations from the Internal *Sharia* Reviewer and the SSB. Their training should be arranged in consultation with and with significant input from the Internal *Sharia* Reviewer and the SSB.

Sharia Audit Unit

According to sections (2.5.1 -2.5.3), the licensee shall establish a *Sharia* Audit Unit as an integral part of the *sharia* governance framework operating under the policies established by the SSB, which is responsible for assisting and reporting to the Internal *Sharia* Reviewer and the SSB in forming or expressing an opinion on the extent of *sharia*-compliance in the licensee's operations. It will examine and evaluate the extent of compliance with *sharia* principles, *fatawa*, guidelines and instructions issued by the SSB through an actual audit of the business transactions. Its charter (i.e. statement of purpose, authority and responsibility) shall be prepared by the management, approved by the SSB and issued by the BOD. This charter shall make clear that *Sharia* Audit Officers shall have no executive authority or responsibility for the activities they audit. Nonetheless, section (2.5.2) requires that "Proficiency in *sharia* principles in general and *fiqh-almuamalat* in particular is required in performing internal *sharia* audit".

To perform their task efficiently, sections (2.5.1.5 - 2.5.1.7) provide that the Audit Officers shall have direct and regular communications with all levels of management, the Internal *Sharia* Reviewer, SSB and external auditors, and no limitation or restriction on access to documents, reports, etc.. They shall be objective and maintain an independent attitude in performing their Audit. In doing their work, they shall exercise due professional skills and be alert to the possibility of intentional wrongdoing.

In this respect, the Internal *Sharia* Reviewer is responsible for providing appropriate supervision throughout the Internal *Sharia* Audit, and evidence of supervision shall be documented and retained. He shall properly manage the Internal *Sharia* Audit by establishing plans to carry out the responsibilities of the audit, providing written policies and procedures to guide his staff and establishing a programme for selecting and developing their performance (sections: 2.5.1.7 and 2.5.1.18).

Section (2.5.1.17) states that the Internal *Sharia* Audit team shall discuss findings, recommendations and conclusions with the Internal *Sharia* Reviewer and appropriate levels of management before issuing the final written report, and a written report shall be prepared at least quarterly which must be signed by the Internal *Sharia* Reviewer, addressed to the SSB and copied to the management. Any difference of opinion between the management and the *Sharia* Audit Officers on matters relating to *sharia* interpretation shall be referred to the Internal *Sharia* Reviewer and the SSB (if required), and the SSB shall be the final authority on such matters.

The report prepared by the Internal *Sharia* Audit Unit (ISAU) shall be presented to the SSB of the licensee for consideration and appropriate action, and a copy shall be presented to the Audit Committee of the Board. This report shall present the purpose, scope and results of Internal *Sharia* Audit. Chiefly, it shall contain an expression of the Internal *Sharia* Auditor's opinion, and recommendations for potential improvements and corrective actions, and an acknowledgement of satisfactory performance when appropriate. *Sharia* Audit Officers shall ascertain that appropriate action has been taken on their reported findings and recommended corrective actions. In addition, any other recommendations relating to *sharia* matters made by the SSB, external auditors and/or regulatory agencies shall also be followed up. The management is responsible for rectification of non-compliance, its prevention in the future and ensuring that the agreed actions are carried out.

In addition, sections (2.5.1.21 – 2.5.1.24) provide that the CBO shall add *sharia* audit to its regular annual examination and audit of the licensees. The licensees shall engage an independent third party to conduct an annual external independent *sharia* audit, whose purpose is to add credibility to the Internal Audit through an independent endorsement. This is not meant to offer an opinion on the legitimacy of the SSB's decisions, but to assess only the extent of implementation by the licensee's management of the decisions given by the

SSB. The external independent *sharia* auditor shall submit his report to the BOD of the licensee and the CBO, with a copy to the SSB and management of the licensee.

Following explanation of the regulatory framework of financial institutions in respect of governance and supervision, as imposed by the Banking Law (and its amendment) and the Islamic Banking Regulatory Framework of the CBO, it is important to refer now to the body recognised as the High Authority for *Sharia* Supervision in Oman.

Article (126/2) of the amended Law of Banking No. (69/2012) requires the Board of Governors of the CBO to establish a "High Authority for *Sharia* Supervision", the aim of which is to ensure the compatibility of Islamic banking and *takaful* products with *sharia* principles. The CBO is to specify the High Authority's composition and members' competence, their work procedures, qualifications, and remuneration.

The High Authority is to be considered as the ultimate authority in *sharia* financial and banking matters. However, vesting such exceptional judicial or quasi-judicial authority in this body certainly raises the issue of the balance of power and authority between the courts and arbitrators and the High Authority. Currently, the status of the determinations of the High Authority vis-à-vis court and arbitrator determinations is unclear. However, Article (124) seems to indicate that Islamic banks must practise Islamic banking in accordance with the restrictions set by the Board of Governors, even where those restrictions might conflict with interpretations of the regular nature of the applicable *sharia* principles.

In forming the High Authority for *Sharia* Supervision, the BOD of the CBO decided in October 2014 to select five members (without naming them) to represent the apex bank at the Authority and approve nomination of a secretary. As a National SSB, the High Authority will advise the CBO on issues concerning *sharia*-compliant products. As a reference point for IFI, its members will be

sharia scholars.[410] The President of the CBO (Mr Hamood Sangour Al-Zadjali) was quoted, in March 2014, as saying that it would be made up of *sharia* scholars, some of them Omani with possibly one or two experts from outside Oman.[411] The High Authority will have direct oversight of Islamic banking institutions, similar to the approach taken by regulators in Malaysia and other countries.[412]

5.5 THE FEDERATION OF MALAYSIA

5.5.1 THE POSITION OF SHARIA AND ITS INFLUENCE

The Federation of Malaya received independence from the British in 1957. On September 1963, the 11 states of the federation, the former colonies of Sarawak and Sabah on the western coast of Borneo, and the State of Singapore united to form the Federation of Malaysia. However, Singapore seceded from this newly-formed federation to become an independent republic in August 1965. Malaysia, as it is known today, consists of the 11 peninsular states, Sabah and Sarawak. It is a federation with a constitutional monarchy whose head of state the Yang di-Pertuan Agong (i.e. King).

Malaysia is a multi-ethnic, multi-religious, and multi-cultural country; of its population of some 26 million, nearly 60% are Muslims (mostly Malays) and 40% non-Muslim (mostly Chinese and Indian).[413] The supreme law of the land is the

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[410] Bernardo Vizcaino, "Oman Sets up Central Sharia Board in Move to Boost Islamic Finance," *Reuters*, October 8, 2014, http://www.reuters.com/article/2014/10/08/oman-islam-financing-idUSL6N0S305J20141008.

[411] "Oman: Central Bank Appoints Sharia Board," *Issue 979, Gulf State News*, October 16, 2014, http://archive.crossborderinformation.com/Article/Oman+Central+bank+appoints+sharia+board.aspx?date=20141016#.

[412] Such as Pakistan, Morocco and Nigeria. Vizcaino, "Oman Sets up Central Sharia Board in Move to Boost Islamic Finance."

[413] Muslim Amin, "Islamic Banks: Contrasting the Drivers of Customer Satisfaction on Image, Trust, and Loyalty of Muslim and Non-Muslim Customers in Malaysia," *International Journal of Bank Marketing* 31, no. 2 (2013): P: 80.

Constitution of Malaysia, which sets out the legal framework and rights of Malaysian citizens.[414] Article (3/1) provides that "Islam is the religion of the Federation; but other religions may be practised in peace and harmony in any part of the Federation". There are no other provisions in the constitution with regard to *sharia* as a law or a source of legislation, and in fact Malaysia does not declare itself as an Islamic state, but merely refers to Islam as a religion in its Constitution. Therefore, the effect of *sharia* are confined to the areas of personal law such as marriage, divorce and inheritance.

This is because Article (4) of the Constitution provides that nothing in Article (3) shall deviate from any other provision in the Constitution. Islamic law is not expressly included in the definition of law in Article (160), and Article (4/1) provides that the Constitution is the supreme law. As a direct consequence of the colonisation of Malaya by Britain from the early 19th century to the 1960s, the country's law is largely based on the system of common law. Besides the Constitution, Federal laws enacted by the Parliament of Malaysia apply throughout the country while, state laws enacted by the State Legislative Assemblies apply in the particular states.

The Constitution provides for a unique dual justice system, headed by the Federal Court, i.e. secular laws (criminal and civil) and *sharia* law. According to Article (74), the Ninth Schedule of the Federal Constitution contains the Federal List and the State List, which set out the respective areas where the Federal Parliament or the State Legislatures can make laws. The jurisdiction of the *sharia* courts is based on State List No (2) of the Ninth Schedule and therefore falls under the administration of the states. It is practised in *sharia* courts and only pertains to family matters.

Banking as well as the incorporation and regulation of corporations falls within the Federal List, and therefore within the jurisdiction of the civil courts which

[414] *The Federal Constitution of Malaysia 1957.*

apply the common law principles. Under the Federal Constitution, Islamic banking is considered under the item 'finance', and accordingly falls within the jurisdiction of the civil courts. Nonetheless, a *muamalat* bench was specially implemented by the High Court Commercial - Division (4) to hear cases on Islamic banking filed under code (22A), according to the second paragraph of the Practice Direction No (1/2003).[415]

The commercial and economic development of the country stemmed from the discovery of tin ore in the Larut District (1848) and the Kinta Valley (1880) and the subsequent new found wealth that brought about rapid and significant expansion of the economy. With higher demand for banking services by businesses involved in the lucrative tin and rubber industries, as well as the financial requirements of local people, there was an urgent need for the expansion of banking. The Chartered Merchant Bank of India, London and China was the first commercial bank to establish a branch in Penang in 1859, followed by banks in Taiping and Kuala Lumpur. Although local entrepreneurs established the first domestic bank, the Kwong Yik (Selangor) Banking Corporation in 1913, until the early 1960s the banking scene remained largely dominated by foreign banks.[416]

In terms of the development of IFB, the Malaysian experience involved a distinctive form of relationships with the government. Despite the diversity of its population, Malay Muslims have always dominated the scene due to the pact they signed at the time of independence in 1957, which is revised each decade to ensure that the changing situation has not hindered its progress. The Malay

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[415] *Practice Direction No (1/2003) about the Establishment of Muamalat Bench in the High Court-Commercial Division (4).*

[416] Low and Maysami, "One Country, Two Systems: Banking in Malaysia," at 234.

Islamic model incorporated Islamic banking into the financial system and harmonised it with Western practice.[417]

Whilst the political arena in Malaysia was being prepared for independence in the early 1950s, the newly emerging self-rule government supported the idea of establishing an investment institution that catered for the needs of the Malay Muslims. The idea of financing *hajj* (pilgrimage) was very attractive to the Malay population, who were mainly rural peasants but had an increasing portion of the political power. A few years after Malaysia's independence in 1956, the Pilgrims' Administration Fund (*tabung hajji*) took its final shape as a government-sponsored and -supervised financial institution to collect savings for *hajj* and invest them in accordance with *sharia*. The Fund was enhanced by legislative support that requires all Malays to process *hajj* papers, and had an autonomous decision-making authority, with a government-appointed management and nominal honorary subordination to the Prime Minister's Office. It was able substantially to increase its share in the real estate, industrial and agricultural sectors, and developed ideas and procedures for its own Islamic financing. The procedures regarding *tabung hajji* were only presented to the Islamic Development Bank in 1981 during negotiations to establish an Islamic Bank of Malaysia.[418]

To ensure the orderly growth of the banking and financial system, the government established the country's central bank, the Bank Negara Malaysia (BNM), on 24 January 1959 under the Central Bank of Malaya Ordinance of 1958,[419] which empowered the BNM to supervise and regulate the activities of the banking institutions. In 1983, the Malaysian Government Funding Act No

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[417] Zaher and Hassan, "A Comparative Literature Survey of Islamic Finance and Banking," P: 172.

[418] Clement Henry and Rodney Wilson, *The Politics of Islamic Finance*, 1st edition. (Edinburgh University Press, 2004), P: 17–36.

[419] *The Central Bank of Malaya Ordinance of 1958.*

(275) was enacted to permit the government to issue investment instruments based on Islamic principles.[420] On 1 March of the same year, the first Malaysian Islamic bank, the Bank Islam Malaysia Berhad, was established under the Malaysian Islamic Banking Act No (276).[421]

Following the turbulent period faced by the banking sector in the mid-1980s, the need for drafting new and more comprehensive laws was evident. The development of the Islamic banking sector in Malaysia can be divided into two phases, 1983 to 1993 and 1994 onwards. The legal infrastructure consists of several statutes and directives, namely the Malaysian Companies Act No (25) of 1965,[422] the Islamic Banking Act No (276) of 1983 (, the *Takaful* Act No (312) of 1984,[423] the Banking and Financial Institutions Act No (372) of 1989 ,[424] the Securities Commission Act No (498) of 1993 ,[425] the Development Financial Institutions Act No (618) of 2002 ,[426] and the Capital Markets and Services Act of 2007.[427]

The more relevant and recent laws are: the Central Bank of Malaysia Act No (701) of 2009 ,[428] the Financial Services Act of 2013 ,[429] and the Islamic Financial Services Act of 2013 .[430] Given the focus of this study, the related provisions in these last three laws in particular will be discussed in detail, with some reference to provisions in some of the repealed Acts.

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[420] *The Malaysian Government Funding Act No (275) of 1983.*

[421] *The Malaysian Islamic Banking Act No (276) of 1983.*

[422] *The Malaysian Companies Act No (25) of 1965.*

[423] *The Malaysian Takaful Act No (321) of 1984.*

[424] *The Malaysian Banking and Financial Institutions Act No (372) of 1989.*

[425] *The Malaysian Securities Commission Act (498) of 1993.*

[426] *The Malaysia Development Financial Institutions Act No (618) of 2002.*

[427] *The Malaysian Capital Markets and Services Act No (671) of 2007.*

[428] *The Central Bank of Malaysia Act No (701) of 2009.*

[429] *The Malaysian Financial Services Act No (758) of 2013.*

[430] *The Malaysian Islamic Financial Services Act No (759) of 2013.*

5.5.2 NATURE OF SHARIA AUTHORITY AND ITS ROLE

Currently, there are 16 fully fledged Islamic-banks and four international Islamic-banks in Malaysia, plus and 11 *takafuk* operators. In Malaysia, conventional-banks are allowed to offer Islamic banking products and services under the dual-window concept. A dual-window bank is a bank with two windows under the same roof, one for conventional banking operations and the other for Islamic banking. At present, there are 27 commercial-banks with 8 dual-window banks operating in Malaysia alongside the local full-fledged Islamic banks.[431]

All of the financial institutions are regulated and supervised by the central bank, the BNM, pursuant to the Central Bank of Malaysia Act No (701) of 2009, which replaced the Central Bank of Malaya Ordinance of 1958,[432] providing in section (3/1) for the continued existence of the BNM. This Act gave greater clarity to the role of the central bank, vesting it with the necessary powers and instruments to achieve its mandate effectively. This mandate includes the exercise of the rights and performance of the obligations arising from Malaysia's membership of international organisations. Section (80) refers to membership of the International Monetary Fund (1957) and the IFSB (2002), and membership of Malaysia or the Bank of any international organisation in respect of which provision is made in any federal law.

Importantly, section (27) recognises the dual financial system of Malaysia, consisting of conventional and Islamic financial systems. It gives due recognition to the Islamic Financial System in Malaysia by providing the legal foundation for its development in the overall Malaysian financial system, as explained below. [433]

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[431] "The Central Bank of Malaysia (Bank Negara Malaysia)," accessed March 31, 2015, http://www.bnm.gov.my/.

[432] *The Central Bank of Malaya Ordinance of 1958.*

[433] *The Central Bank of Malaysia Act No (701) of 2009.*

In terms of Islamic banking, the Companies Act No (25) of 1965, Article (4/1) interprets the term "Islamic bank" or "Islamic banking business" as having the meaning assigned in the Islamic Banking Act (276) of 1983,[434] namely "any company which carries on Islamic banking business and holds a valid licence; and all the offices and branches in Malaysia of such a bank shall be deemed to be one bank". Section (3/1) states that "Islamic banking business shall not be transacted in Malaysia except by a company which is in the possession of a licence in writing from the Minister authorising it to do so". Section (11/2) lists the reasons for which a bank's licence may be revoked, including the bank's "pursuing aims, or carrying on operations, involving any element which is not approved by the Religion of Islam". [435]

However, the Islamic Banking Act was recently and replaced by the Islamic Financial Services Act No (759) of 2013, which provides in section (2/1) that "Islamic banking business" means the business of:[436]

a) accepting Islamic deposits on current account, deposit account, savings account or other similar accounts, with or without the business of paying or collecting cheques drawn by or paid in by customers; or

b) accepting money under an investment account;

c) provision of finance; and

d) such other business as prescribed under section 3 (authorised).

In terms of *sharia* governance and supervision, the Financial Services Act No (758) of 2013, Article (15/7), requires that the BOD of a licensed bank and an

[434] *The Malaysian Companies Act No (25) of 1965.*

[435] *The Malaysian Islamic Banking Act No (276) of 1983.*

[436] *The Malaysian Islamic Financial Services Act No (759) of 2013.*

approved person establish a *sharia* committee.[437] The same is required by the Islamic Financial Services Act No (759) of 2013, which further details the requirements of *sharia* governance, including the formation of a *sharia* committee. This is pursuant to sections (28-38), which mainly contain Part IV entitled "*sharia* requirements", discussed below.

Section (28) establishes that an institution shall at all times ensure that its aims and operations, business, affairs and activities are in compliance with *sharia*, and that compliance with any ruling of the *Sharia* Advisory Council (SAC) shall be deemed to be compliance with *sharia*. If an institution discovers that it is carrying out any of its business, affairs or activities in a manner which is not in compliance with *sharia* (i.e. it is not in compliance with the advice of its *sharia* committee or the advice or ruling of the *Sharia* Advisory Council), it should immediately notify the BNM of that act and cease carrying on such practices. Then, within 30 days it must submit a plan for the rectification of the non-compliance, on which the BNM may carry out an assessment as it thinks necessary.

For its role in *sharia* governance, section (29/1) provides that the BNM specify standards on *sharia* matters in respect of the practices carried out by an institution concerning Islamic law, with the advice or ruling of the *Sharia* Advisory Council, and giving effect to the advice or rulings of the Council. Further, it may specify standards on a number of matters that do not require the ascertainment of Islamic law, which according to section (29/2) could be:

a) *Sharia* governance, including functions and duties of the BOD, senior officers and members of the *Sharia* Committee in relation to compliance with *sharia*; fit and proper requirements or disqualifications of a member of a *sharia* committee; and internal *sharia*-compliance functions;

[437] *The Malaysian Financial Services Act No (758) of 2013.*

b) any other matter in relation to the business, affair and activity of an institution for the purposes of compliance with *sharia*.

This role is confirmed by section (59) of the Central Bank of Malaysia Act No (701) of 2009, which emphasises that an IFI shall comply with any such written circulars, guidelines or notices issued in accordance with the advice or ruling of the SAC and within such time as may be set out in them.[438]

As seen in the last two provisions of the Islamic Financial Services Act No (759) of 2013, there should be both a *Sharia* Committee in the institution and a SAC in the BNM. These are proposed as the main elements of *sharia* governance and supervision of the IFB sector in Malaysia, as discussed next.

Division No (2) of the Islamic Financial Services Act No (759) of 2013 is concerned with *sharia* governance. Section (30) requires that licensed persons "shall establish a *Sharia* Committee for purposes of advising the licensed person in ensuring its business, affairs and activities comply with *sharia*". In the case of a financial group, one of the licensed persons may apply for the establishment of a single *sharia* committee within the financial group.

In terms of the committee's membership and functions, sections (31 and 32) require that the person shall meet the requirements and shall have duties and functions as set out in any standards as may be specified by the BNM under section (29/2). Accordingly, section (33/1) provides that such a member should be disqualified pursuant to a failure to meet any of the standards specified by the BNM or if he no longer meets its fit and proper requirements, and section (34/4) requires the appointment of a new member on the *sharia* committee in accordance with section (31).

To enable the *sharia* committee to carry out its duties or perform its functions under this Act, section (35/1 and 35/2) stipulates that the institution and any

[438] *The Central Bank of Malaysia Act No (701) of 2009.*

director, officer or controller of such institution provide any document or information within its or his knowledge, or capable of being obtained by it or him, which the *sharia* committee may require, and that no member of a *sharia* committee shall disclose any such document or information to any other person. However, section (36) excludes a member of a *sharia* committee from liability for breaching his duty of confidentiality when he is: reporting to the BNM; or discharging his duties and performing his functions pursuant to any standards set by the BNM in good faith, as specified under section (29/2). Also, a member of the *sharia* committee shall not be sued in any court for defamation in respect of any statement made by him without malice in the discharge of his duties under this Act.

Division (3) of the Islamic Financial Services Act No (759) is concerned with audit on *sharia*-compliance. Sections (37 and 38) stipulate that the BNM may require an approved person to carry out an audit. Such a person is to be appointed and remunerated by the institution. Nonetheless, he "shall have such duties and functions as may be specified by the BNM and shall submit a report to it on the audit carried out. However, he shall not be liable for a breach of duty of confidentiality between such person and the institution in respect of matters reported to the Bank pursuant to an audit on *sharia*-compliance."

The role of the *sharia* committee is complementary to the SAC of the BNM, established pursuant to provisions of the Central Bank of Malaysia Act No (701) of 2009.[439]

Section (51/1) provides that the BNM "may establish a SAC on Islamic finance which shall be the authority for the ascertainment of Islamic law for the purposes of Islamic financial business; section (51/2) states that this Council may determine its own procedures.

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[439] Ibid.

Section (52/1) lists the functions of the SAC as being:

a) to ascertain the Islamic law on any financial matter and issue a ruling upon reference made to it;

b) to advise the BNM on any *sharia* issue relating to Islamic financial business, the activities or transactions of the Bank;

c) to provide advice to any IFI or any other person as may be provided under any written law; and

d) to perform such other functions as may be determined by the BNM.

For the formation and remuneration of the *Sharia* Advisory Council, sections (53/1 and 53/2) provide that upon the advice of the Minister after consultation with the BNM, the King may appoint members of the SAC who are qualified in *sharia* or have obtained knowledge or experience of it, and in banking, finance, law or other related disciplines.

Section (53/2) further requires that a judge (of the High Court, the Court of Appeal, or the Federal Court) shall only be appointed after consultation by the BNM with the Chief Justice. Likewise, a judge of the *Sharia* Appeal Court of any State or Federal Territory, shall only be appointed after consultation with the Chief *Sharia* Judge of the respective State or Federal Territory.

Under sections (53/3 and 53/4), members of the SAC are eligible for reappointment, and their remuneration and allowances shall be determined by the Board and paid from the funds of the BNM.

In terms of the authority of the SAC pertaining to *sharia* matters in Islamic financial business, sections (55 and 56) provide that the BNM, any financial institution, and any court or arbitrator shall take into consideration any published rulings of the *Sharia* Advisory Council. Also, questions may be referred by them to the Council through its secretariat. Section (57) states that any such ruling made by the SAC shall be binding on the IFI as well as on the court or arbitrator

which made the referral. Section (58) emphasises that the ruling of the Council prevails over any other different ruling given by a *sharia* body or committee constituted in Malaysia by an IFI.

Pursuant to section (59) of the Central Bank of Malaysia Act No (701) of 2009, the BNM issued Guidelines on the Governance of the *Sharia* Committee for the IFI of 2005, referred to as (BNM/GPS1), which was effective from 1 April 2005. It covers the following areas: (a) the establishment of a *sharia* committee; (b) its duties and responsibilities; (c) the duties and responsibilities of the IFI; (d) the working relationship between the SAC and *sharia* committees.[440] However, this guideline was superseded by the *Sharia* Governance Framework for IFI, which became effective from 1 January 2011.[441]

Section 1 Principle (1.2) of this framework recognises the two-tier *sharia* governance infrastructure of Malaysia, whose two vital components are a centralised *sharia* advisory body (the SAC of the BNM) and an internal *sharia* committee formed in each IFI.

The establishment and role of the SAC as identified in the Central Bank of Malaysia Act No (701) of 2009, Principle (2.1) of this section, provides among other objectives, a comprehensive guidance to the board, *sharia* committee and management of the IFI in discharging its duties in matters relating to *sharia*; and outlines the functions relating to *sharia* review, *sharia* audit, *sharia* risk management and *sharia* research. For the purpose of this study, the following discussion is confined to the establishment of the committee and the functions of the review and audit, as described by the *Sharia* Governance Framework for IFI in Malaysia of 2011. This is because they are referred to but not detailed in the

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[440] *The Guidelines on the Governance of Sharia Committee for the Islamic Financial Institutions in Malaysia of 2005.*

[441] *The Sharia Governance Framework for Islamic Financial Institutions in Malaysia of 2011.*

laws discussed above, but are left to be covered by the standards and regulations of the BNM.

Section 2, Principles (2.1-2.2) established that and IFI's BOD is ultimately accountable and responsible for establishing an appropriate mechanism for the *sharia* governance framework and *sharia*-compliance. In this context, it shall approve all policies relating to *sharia* matters after consultation with the *sharia* committee, and is expected to ensure that such policies are implemented effectively.

In forming its *sharia* committee, Principle (2.3-2.6) states that BOD shall appoint not fewer than five members upon the recommendation of its nomination committee, the majority of whom must possess a sound knowledge of *sharia* backed by appropriate qualifications. It is interesting, however, that, the Board may consider appointing at least one member of the committee as a member of the BOD, to serve as a bridge between the Board and the *sharia* committee. The Board shall remunerate the committee members appropriately as advised by its remuneration committee, which shall reflect, and be commensurate with, the accountability, duties and responsibilities of the *sharia* committee. Further, it is provided in (Appendix 2: Fit & Proper Criteria of the *Sharia* Committee) that:

1) A member of a *sharia* committee shall be a Muslim individual. A company, institution or body shall not constitute a *sharia* committee for the purpose of the framework.

2) The majority of members of the *sharia* committee shall hold at least a bachelor's degrees in *sharia*, which includes study in *usul-fiqh* or *fiqh-almuamalat* from a recognised university.

3) It is reasonable to expect that the majority of members of the *sharia* committee should be able to demonstrate strong proficiency and

knowledge in written and verbal Arabic, and have a good understanding of Bahasa Malaysia and the English language.

4) The *sharia* committee may comprise experts from relevant backgrounds such as finance and law, which could support the depth and breadth of the *sharia* deliberations. However, these members must not form a majority on the committee

5) The *sharia* committee preferably shall comprise members from diverse backgrounds in terms of qualification, experience and knowledge.

In addition, no committee member can be an employee of the IFI or any of its related companies for the current or the previous financial year, nor a member of another IFI within the same industry.

According to Principle (3.8) of section 3, all appointments, reappointments, resignations and removal of *sharia* committee members made by the BOD are subject to the approval by the BNM and the *Sharia* Advisory Council. The list provided in Appendix 2: Fit & Proper Criteria of the *Sharia* Committee includes the following grounds for disqualifying a member of the committee:

a) acted in a manner which may cast doubt on his fitness to hold the position as a *sharia* committee member;

b) failed to attend 75% of the *sharia* committee meetings in a year, without reasonable excuse;

c) declared a bankrupt, or a petition under bankruptcy laws is filed against him; found guilty of any serious criminal offence or any other offence punishable with imprisonment of one year or more; or

d) subject to any order of detention, supervision, restricted residence or banishment.

In terms of the *sharia* committee's responsibility and accountability, Principle (2.7-2.9) states that it shall be responsible and accountable for all its decisions, views and opinions related to *sharia* matters, which shall bind the operations of the IFI. It is expected to perform an oversight role on *sharia* matters related to the institution's business operations and activities through the review and audit functions, and is therefore expected to disclose sufficient information in the IFI's annual financial report on the state of compliance of the IFI. Appendix 4: Duties, Responsibilities & Accountability of the *Sharia* Committee provides that the main duties of the *sharia* committee are to:

1) Advise the BOD and provide input to the IFI on *sharia* matters in order for the IFI to comply with *sharia* principles at all times.

2) Endorse *sharia* policies and procedures prepared by the IFI and ensure that the contents do not contain any elements which are not in line with *sharia*.

3) Ensure that the products of the IFI comply with *sharia* principles by approving: i) the terms and conditions contained in the forms, contracts, agreements or other legal documentations used in executing the transactions; and ii) the product manual, marketing advertisements, sales illustrations and brochures used to describe the product.

4) Assess the work carried out by *sharia* review and audit.

5) Assist related parties of the IFI on *sharia* matters, such as its legal counsel, auditor or consultants who may seek advice.

6) Advise the IFI to consult the SAC on matters that could not be resolved.

7) Provide written *sharia* opinions in circumstances where the IFI makes reference to the SAC for further deliberation, or where the IFI submits applications to the BNM for new product approval.

According to Principle (2.11), management bears the responsibility for implementing the *sharia* rulings and decisions made by the SAC and the *sharia* committee respectively. Nonetheless, Principle (6.2), section 5, provides that members of the *sharia* committee are required to respect and observe the rulings published by the SAC and shall not go against the decisions of the committee that they represent in public.

Under Principle (3.1), the *sharia* committee is expected to make sound decisions on *sharia* matters in an independent and objective manner, and the BOD must recognise its independence and ensure that it is free from any undue influence. Nonetheless, Principle (3.2) requires the committee to present regular reports directly to the Board. According to Principles (3.6-3.7), the committee shall inform the Board and recommend suitable measures to rectify any situation of non-compliance which arises. If such non-compliant practices are not effectively or adequately addressed or no rectification measures made by the IFI, the *sharia* committee is to inform the BNM of this fact.

To perform its role in an effective manner, the members of the *sharia* committee need to be competent. Principles (4.1-4.2) under section 5 require that they have sufficient knowledge of finance in general, and of Islamic finance in particular. In this regard, the IFI shall develop a set of fit and proper criteria for the appointment of any *sharia* committee member, using the minimum criteria set by the BNM. However, the BNM may prescribe other criteria or requirements in addition to those set by the IFI, as and when considered necessary. According to Principle (4.4), the IFI is required to adopt a formal process of assessing the performance of its *sharia* committee members, which should be designed to evaluate individual performance based on the competence, knowledge, contribution and overall effectiveness of the members on *sharia* deliberations. The process should also identify relevant gaps to enable appropriate training for committee members.

In terms of *sharia*-compliance, Principle (7.1) under section 6 provides that this is to be carried out through the review and audit functions, supported by the risk management control function and internal research capabilities. For the purpose of this study, only the functions of *sharia* review and audit are detailed here, as the other two functions are not directly related to the role of the committee. Risk management control is a part of the IFI's integrated risk management framework (Principle 7.16), and internal research requires experts on legal, operational, and other related issues (Principle 7.22).

Sharia review function identified by Principle (7.3) as:

> "a regular assessment on *sharia*-compliance by qualified *sharia* officers (who hold at least a bachelor's degree in *sharia* including *usul-fiqh*), with the objective of ensuring that the activities and operations carried out by the IFI do not contravene *sharia* principles".

According to Principles (7.4-7.5), the scope of the *sharia* review shall cover the IFI's overall business operations, including the end-to-end product development process, which starts from product structuring and extends to product offering. This function involves the examination and evaluation of the IFI's level of compliance with *sharia*, remedial measures to resolve non-compliance, and control mechanisms to avoid recurrences.

The *sharia* audit function is identified by Principle (7.7) as:

> "the periodical assessment conducted from time to time, to provide an independent assessment and objective assurance designed to add value and improve the degree of compliance in relation to the IFI's business operations, with the main objective of ensuring a sound and effective internal control system for *sharia*-compliance."

According to Principle (7.8), the function shall be performed by internal auditors, who have acquired adequate *sharia*-related knowledge and training. In addition, these auditors may engage the expertise of the IFI's *sharia* officers in performing the audit, as long as the objectivity of the audit is not compromised.

Principles (7.11-7.12) state that the audit committee shall determine the deliverables of the *sharia* audit function upon consultation with the *sharia* committee, which shall be consistent with accepted auditing standards. The scope of *sharia* audit shall cover all aspects of the IFI's business operations and activities, including: (i) audit of financial statements of the IFI; (ii) compliance audit of organisational structure, people, process and information technology application systems; and (iii) review of adequacy of the *sharia* governance process.

In terms of the operational requirements, it is provided in Appendix 5: Operation Procedures for the *Sharia* Committee that:

1) Meetings shall be held regularly to ensure that: i) the *sharia* committee is kept sufficiently in touch with the business of the IFI; and ii) the operations of the IFI are not adversely affected because of difficulty in securing the committee's approval for policy and decisions.

2) The *sharia* committee's meetings shall be held at least once in every two months, and the members are expected to contribute and allocate adequate time and effort to discharge their duties effectively. They must attend at least 75% of the meetings held in each financial year; if necessary, the participation of the committee members can be facilitated by means of video or telephone conferencing. The number of meetings held in the year, as well as the attendance of every member, shall be disclosed in the IFI' s annual report.

3) The minimum quorum of a *sharia* committee meeting shall be two-thirds, with the majority of attending members having a *sharia* background. Likewise, decisions are to be made on the basis of two-thirds of the members present, with a majority of votes from members with a *sharia* background.

4) The chairman of the committee shall be a member with a qualified *sharia* background. In the event that the Chairman is unable to attend the meeting, the members shall elect one member among themselves, with a qualified *sharia* background, to become the alternate chairman to preside over the meeting.

5) The *sharia* committee shall put on record in its report or statements directed to the BOD its concerns over any *sharia* non-compliance issues.

5.6 CONCLUSION

To complete the discussion of the *sharia* governance system addressed in the previous chapter, this chapter has added a national dimension by examining the regulatory perspective of selected Muslim countries, where institutional SSB exists alongside different types of higher *sharia* authority.

Although the SSB provides some degree of comfort in assuring compliance of the IFI with *sharia*, its role does not convey the high levels of *sharia*-compliance needed in practice. To evaluate the role and efficiency of the institutional *sharia* governance system, chapter five analysed and compared the national frameworks of *sharia* supervision in selected Muslim countries in an attempt to understand and underline the possible issues raised from the current institutional *sharia* governance system. For the benefit of this study, the countries studied were chosen from those considered as pioneers in the industry and where Islamic and conventional banks co-exist, namely the kingdom of Bahrain, the United Arab Emirates (Dubai), the state of Kuwait, the Sultanate of Oman and

the Federation of Malaysia. The analysis and comparison was based on two main elements, the legal position of *sharia* in the country, and the existence of a higher *sharia* authority for the IFB.

In terms of the legal position of *sharia* and its influence, the thesis demonstrated the limited role and influence of *sharia* in IFB. It mainly explained the laws allowing interest in commercial practices including finance and banking, and the positioning or order of *sharia* in these positive laws. In Bahrain, *sharia* is a recognised source of law, which is only applied after other certain positive laws. In UAE, *sharia* is recognised as the prime source of law, and in Kuwait as the source of law. If fact, the CBK provides that Islamic banks should be subject to its laws without prejudice to *sharia* principles. In a more powerful position, Oman considers *sharia* as the basis of legislation. In Malaysia, however, *sharia* is not acknowledged as a source of law. In fact, the application and influence of *sharia* is confined in all these countries to family and personal matters.

Previously, Ibrahim (2012) described the GCC model of *sharia* governance as self-regulatory, because it is based on peer-review. Although financial regulators do not second-guess the opinions and rulings of their SSB, they remain subject to a peer-review that in consequence allows self-regulation. Ibrahim argued that "a country with an effective peer-review based culture of self-regulation may have a lesser need for centralised *sharia* supervision", admitting that increasing numbers of prominent *sharia* scholars encourage the consideration of centralised supervision.[442]

There is no doubt that the presence of renowned scholars on multiple SSB without restriction has helped to achieve, at least to some extent, consistency in *sharia* opinions and rulings. If a certain group of scholars was hired by different financial institutions, it is likely that they would give the same pronouncements on

[442] Adnan Ali Ibrahim, "Regulation of Shari'ah Governance," *The Review, Issue 30*, March 2012, http://www.cbb.gov.bh/assets/The%20Review/The%20Review%20March%202012.pdf.

sharia matters. In consequence, following the same *fatawa* would help in introducing a level of national consistency and uniformity in IFB operations.

Although, this proves beneficial, and could present a solution advantageous to countries with a minimum number of prominent and competent scholars, the multiple appointments of *sharia* scholars raises concern (discussed in next chapter). Nor does this help in making a universal Islamic product.

The deployment of a consistent and coherent regulatory framework for *sharia* governance is of great importance. Nonetheless, as demonstrated in this chapter, most of the regulatory authorities of the selected countries permit the financial institutions to develop their own framework without undue interference. There is freedom in deciding the *sharia* requirements and lack of restrictions on the work of the *sharia* scholars.

The recent developments in rules and regulation suggest that this model is being changed in favour of a more focused and centralised system of *sharia* governance and supervision. From the discussion of the selected countries' rules and regulation in this chapter, it appears that a centralised model is the developing trend in terms of *sharia* governance and supervision in IFB.

However, the legal status and regulatory powers of the various higher *sharia* authorities differ from one country to another. Interestingly, in Bahrain the higher authority does not have supervisory power over the institutional SSB. Despite being created at the central bank level, it serves as a consultant to the CBB without any supervisory authority. Bahrain thus forms a unique case in terms of non-central *sharia* supervision, with the higher authority playing only an advisory role. Nonetheless, the very existence of such a body is a positive indication of future interest in centralising *sharia* supervision. It remains to be seen whether supervisory powers will be given to the existing *sharia* board. As recently as December 2014, the governor of the CBB declared the intention of setting up a

central *sharia* board to help oversee Islamic finance products in the country and to introduce new rules to strengthen governance in the financial sector.[443]

On the other hand, Kuwait has no central *sharia* authority at central bank level, but refers to the *Fatwa* Board in the in *Awqaf* Ministry as the Final *Sharia* Authority in any dispute regarding IFB. However, the role of this Board is largely theoretical, given that an IFI has the power to transfer a dispute to it in the case of disagreement between members of the institutional SSB, when at the same time the SSB always pass their rulings by a majority of votes in cases of disagreement, making transferring a dispute to the *Fatwa* Board is unlikely to happen. Nonetheless, this step is an important one in the direction of centralisation of *sharia* supervision.

The UAE federal law allows for the establishment of a higher *sharia* authority. It is assumed that this authority possesses the power to issue *fatawa* at the national level. Unfortunately, the role and effect of this body is unknown as it has not yet been established. Nonetheless, it is interesting to know that the Emirates Bankers Association has created an Islamic Banking Committee to view various governance models at the regulator level and to propose a suitable model for the central bank to implement; on 17 March 2015, at a meeting of the BOD of the UAE Central Bank, some of the recommendations that will help expedite the process to set up such an authority were approved.[444]

Although Oman has the most recent experience in developing an IFB sector, its framework of *sharia* governance and supervision is thought to be more comprehensive and stronger than in its peer GCC. It is in advance of neighbouring countries, which are relatively more experienced in IFB, through its adoption of a clear and consistent *sharia* governance and supervisory system, although in terms of a centralised authority it remains at the same stage as the

[443] Vizcaino, "Bahrain to Develop Central Sharia Board for Islamic Banks."

[444] Haider, "Shariah Authority on Cards."

others. Only in October 2014 were names of scholars discussed to form a high authority for *sharia*. This authority is intended to be a reference point for IFI, and to have direct oversight of Islamic banking institutions. However, its actual role and authority remains unknown.

Since no higher authorities are yet functioning in the countries under discussion, it remains to be seen if any of them will be given extended regulatory and supervisory roles, and whether these would be similar to existing ones in countries such as Malaysia or others.[445] To date, there has been some discussion about establishing a United *Sharia* Supervisory Authority at the regional level serving the financial markets of the whole GCC. However, no obvious steps were taken in this direction yet.

In terms of the centralisation of *sharia* governance and supervision, Malaysia has without doubt the most comprehensively documented legislative framework for the IFB industry. Malaysia's *Sharia* Advisory Council, established by the BNM in 1997, is a higher *sharia* authority. However, its role as a final *sharia* authority was confirmed only with the issuing of the Islamic Financial Services Act of 2013.

The SAC is involved in such situations. While the task itself is undertaken by the BOD of the Malaysian IFI, the General Assembly of the IFI is responsible for this matter in the other countries. Members of the Malaysian SAC are prohibited from combining this membership with that of another *sharia* committee. Also, members of *sharia* committees are forbidden to serve on more than one committee of the same category of financial intuition. Thus, a member of the *sharia* committee of a bank, for example, cannot be appointed to the committee of another bank, although he could serve on the *sharia* committee of a *takaful* company, and vice versa. According to the provisions of the SAC, an additional restriction is placed on members of both committees and the SAC, that they

[445] Such as Pakistan, Morocco and Nigeria. Vizcaino, "Oman Sets up Central Sharia Board in Move to Boost Islamic Finance."

should be Muslim individuals and not institutions; this is also the case in the Omani model.

Restricting the appointment of members is the law of the land and all *sharia* advisors must comply with this. This measure has not led to any exodus of *sharia* scholars from Malaysia. On the contrary, it has given space for the emergence of a new generation of *sharia* advisors for the growing Islamic financial market.[446]

The only country to come close is, perhaps surprisingly, the Sultanate of Oman. Currently, in all the countries discussed, central bank approval is required for the appointment, re-appointment, and dismissal of institutional SSB members. Nonetheless, the recent announcements by regulatory authorities in Bahrain and the UAE are in favour of the imminent adoption of a centralised framework of *sharia* governance and supervision.

Until this is done, the current supervisory frameworks continue to permit financial institutions to develop their own framework without undue interference from the regulatory authorities. There is freedom in deciding the *sharia* requirements and a lack of restrictions on the work of the *sharia* scholars.

As demonstrated in this chapter, the CBB clearly promotes the AAOIFI governance standards. It requires the IFI to establish an independent SSB consisting of at least three members, in compliance with AAOIFI-1 and AAOIFI-2, as well as a *sharia* review function in compliance with AAOIFI-3.

Although not referring to AAOIFI standards, the IFR of DIFA requires the IFI to establish an SSB of at least three competent members, leaving it to the IFI to decide the appointment and dismissal mechanism. However, the IFR refers to AAOIFI-2 and AAOIFI-3 in terms of its *sharia* review function in compliance with

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[446] Mushtak Parker, "Are Shariah Advisories Becoming an Endangered Species?," *Arab News*, December 13, 2010, P: 1, http://www.arabnews.com/node/362902.

AAOIFI-3, and the annual report of the SSB should also be in compliance with AAOIFI-1.

Similarly, without reference to any AAOIFI standards, the CBK requires the IFI to establish an SSB consisting of three members of recognised efficiency and experience in the area of transactional jurisprudence, which will present an annual report to the general meeting.

On the other hand, Oman and Malaysia have a more controlled and comprehensive *sharia* governance system. Oman, however, refers to IFSB-3 and IFSB-10, which reflect the same requirements as the AAOIFI.

Noticing, similarity and reliance on internal tools of *sharia* governance in most of the countries, the next chapter highlights and discusses the main issues or concerns that are raised in practice.

CHAPTER SIX: OBSERVATIONS ON CURRENT SHARIA GOVERNANCE AND SUPERVISION

6.0 INTRODUCTION

Having discussed the internal arrangements of *sharia* governance and the regulatory frameworks of financial regulation in selected Muslim countries in the last two chapters, this chapter will address a number of legal and practical issues resulting from current *sharia* governance and supervision systems. Issues already addressed in the available literature will be examined, along with potential issues which have not yet been discussed.

6.1 THE SHORTAGE OF SHARIA SCHOLARS

The rapid evolution of the IFB worldwide has helped to highlight issues surrounding the *sharia* governance system in general, and the position and role of *sharia* scholars in particular. The shortage of competent *sharia* scholars is a problem which has faced IFB from the outset, and remains unsolved today.

It has been reported that, over the next decade, the Islamic banking sector in the GCC alone will require up to 30,000 new personnel who are well versed in Islamic finance as well as possessing considerable knowledge and experience of modern finance.[447] In this regard, Wright (2006) explains that there is no shortage of *sharia* scholars, as qualifications in *sharia* and Islamic jurisprudence are offered widely across the world. However, the challenge is to find scholars who also have knowledge and experience in finance and banking.[448] While young scholars are graduating, there is worldwide discussion about their ability to become SSB members.

This lack of knowledgeable people possessing the required skills and understanding the true character and needs of the IFB is said to be the main

[447] According to the Report of Andrew Thomas Kearney, (management consulting firm) in Nik Muhamad Hafiz Nik Hassan, "The Cry Is for More Islamic Bankers," 2007, http://www.ummah.com/forum/showthread.php?111465-The-cry-is-for-more-Islamic-bankers.

[448] Wright, "The *Shariah* Scholar Cartel."

reason behind many of the obstacles confronting the establishment of more confident and comprehensive *sharia* governance and supervision.

6.2 THE SCOPE OF SHARIA COMPLIANCE SUPERVISION

As discussed in Chapter Four, the wider concept of *sharia* imposes more objectives on *sharia* corporate governance and supervision. In turn, this widens the scope of *sharia*-compliance, which must be backed up by comprehensive *sharia* supervision.

However, the required level of *sharia* review/audit is not evident in practice. AAOIFI Standards No (1, 2 & 3), which are in force in Bahrain and the UAE, suggest a minimum level of overseeing the *compliance* of the financial institution with *sharia*. The situation is not much different in Oman and Malaysia, as their *sharia* governance systems are based on similar grounds and actually use IFSB and AAOIFI standards as guidelines. This is evident in several contexts:

1) The use of the word 'review' when a stronger or more precise term such as 'audit' could be in used instead in the definition of SSB and internal *sharia* review board as well as the function of the *sharia* review itself.

2) The responsibility of SSB and the internal *sharia* review board members is confined to forming and expressing an opinion on *sharia*-compliance.

3) Although the *sharia* review is suggested for examining all the activities of an IFI, the SSB may appear to carry out a review on a test basis. In fact, the functions of the *sharia* review are not carried out by the SSB, instead simply relaying the findings of the internal *sharia* review department. Equally, the review department's check on compliance is limited to the pronouncements of the SSB.

4) *Sharia* officers, regardless of their membership of SSB or review departments, are required to be qualified, competent to discharge their

duties, and independent. In practice, however, concerns have been raised with respect to their fulfilment of all these requirements.

5) The focus on auditing standards tends to be on financial statements rather than the broader concept of *sharia* audit, which involves the audit of all activities of IFI based on *maqasid-al-sharia* (the objectives of *sharia*). It is also evident that a *sharia* audit unit is neither an established practice nor an imposed requirement.

Although the above concerns essentially reflect and are related to the shortage of well qualified *sharia* scholars, at the same time they jeopardise the perceived validity of existing *sharia* governance systems.

The main concerns raised regarding *sharia* governance and supervision in general and *sharia* scholars in particular are discussed further below. Where appropriate, such concerns or remedies (if any) are mapped on to the countries selected for this study.

6.3 EXTERNAL AUDITORS

In chapter four, the use of the SSB as an external *sharia* reviewer was discussed briefly. According to AAOIFI standards, the SSB should be appointed by the General Assembly and not the BOD of an IFI. The SSB is not responsible to the Board or management, but is an independent organ of the IFI which reports directly to the shareholders.

Therefore, theoretically, the SSB is an external organ used by the IFI to review its compliance with *sharia*. In this sense, it is enabled to conduct ex-post reviews on the IFI's activities. In other words, it could fulfil the role of external *sharia* auditor, assuming that its members possess the necessary qualification and training in auditing.

As explained in chapter four, however, the SSB, do not in fact fulfil such a role at the moment. Instead of performing their own ex-ante and ex-post reviews of the IFI's activities, they normally rely on the findings of the review department, and may only conduct their own review through sample testing. Therefore, their opinion is largely dependent on the work conducted by the review department, which is an internal body.

For this reason, the use of external auditors has been encouraged and established in practice, in accordance with the guidelines of the IFSB (explained in chapter two). In the absence of *sharia* auditing firms, the only existing alternative is the use of normal auditing firms as part of their annual audit, to measure the effectiveness of the internal *sharia* controls and system.

Such chartered external auditors, and the more recently established *sharia* consulting firms, do not in any way question or discuss the *sharia* rulings and guidance issued by the IFI's SSB when undertaking a *sharia* audit; they only test the compliance of the IFI.

There is no doubt that there is an immediate need for external *sharia* auditors who are capable of making an independent judgement on the IFI's compliance with *sharia*, as part of their own comprehensive audit of all aspects of compliance. They should be concerned with elements of socio-economic justice in line with *maqasid-al-sharia*, even if this has not been previously dealt with by the SSB.

Therefore, again their role, in addition to their qualification and competence as external auditors, is questioned. While some argue that internal IFI bodies are more qualified and able to perform *sharia* audit, others hold the view that the

external auditors remain necessary because they act as an external control mechanism that ensures that the financial institutions are adhering to *sharia*.[449]

In a survey by Kasim et al. (2009 and 2013) of the expectation gap between the desired and the actual *sharia* audit practices, it was found that the framework, scope, qualification, and independence are the four main issues concerning the functioning of *sharia* audit. [450]

A distinction must be made between the *sharia* audit being argued for as an independent audit, preferably undertaken by external auditors, and the *sharia* review, which only amounts to self-assurance work performed by the management through the review department or internal auditors.[451]

Nonetheless, *sharia* audit could be performed by internal officers working under the audit committee, or by an independent *sharia* audit unit established for this purpose. In both cases, the *sharia* auditors would be independent of the SSB and review department, reporting their findings to the IFI's audit committee and shareholders.

In Bahrain, Article (61) of the CBB law requires that Islamic bank licensees appoint an external auditor, subject to the CBB's prior approval. It is provided in the CBB's rulebook, section (HC-3.2.1), that the audit committee is responsible for the selection, appointment, remuneration, oversight and termination where appropriate of the external auditor, subject to ratification by the Islamic bank

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[449] Hussain Rammal, "The Importance of *Shari'ah* Supervision in Islamic Financial Institutions," *Corporate Ownership and Control* 3, no. 3 (2006): P: 206.

[450] Nawal Bbinti Kasim, Shahul Hameed Mohamad Ibrahim, and Maliah Sulaiman, "*Shari'ah* Auditing in Islamic Financial Institutions: Exploring the Gap between the "Desired' and the 'Actual,'" *Global Economy and Finance Journal* 2, no. 2 (2009): 127–37; Nawal Kasim et al., "Assessing the Current Practice of Auditing in Islamic Financial Institutions in Malaysia and Indonesia," *International Journal of Trade, Economics and Finance*, 2013, 414–18.

[451] Abdul Rahim Abdul Rahman, "*Shari'ah* Audit: An Analytical Perspective" (*Proceedings of International Shari'ah Audit Conference*, Malaysia, 2011), http://www.kantakji.com/media/6184/es8.pdf.

licensee's Board and shareholders.[452] The external auditor reports directly to the committee. Section (HC-3.2.2) of the rulebook provides that the audit committee in its review of the systems and control framework must make effective use of the work of external and internal auditors. It must ensure the integrity of the bank's accounting and financial reporting systems through regular independent review (by internal and external audit). Audit findings must be used as an independent check on the information received from management about the bank's operations and performance and the effectiveness of internal controls. According to Section (HC-7.2.3), the Islamic bank licensee should require its external auditor to attend the annual shareholders' meeting and be available to answer shareholders' questions concerning the conduct and conclusions of the audit.

In addition, section (OM-3.7) on operational risk management generally prohibits Islamic bank licensees from outsourcing their internal audit function to the same firm that acts as their external auditor. However, the CBB may allow short-term outsourcing of internal audit operations to an Islamic bank licensee's external auditor, to meet unexpected urgent or short-term needs (for instance, on account of staff resignation or illness). Any such arrangement will normally be limited to a maximum period of one year and subject to CBB prior approval.

In Kuwait, Central Bank of Kuwait Instruction No (2/IBS/105/2003) concerning external auditors,[453] recognises that they present the financial position of banks in a manner ensuring the interest of shareholders, customers and stakeholders, where banks are viewed as some of the major financial institutions of the domestic economy. Therefore, it requires that the local auditing firm must have full membership of an international auditing firm whose policies and procedures are applied by the local firm. Further, it requires that the local auditing firm should have at least one partner and qualified employees experienced in auditing banks'

[452] "The Central Bank of Bahrain Rulebook," accessed April 18, 2015, http://cbb.complinet.com/cbb/display/display.html?rbid=1821&element_id=2509.

[453] "The Central Bank of Kuwait Instruction No (2/IBS/105/2003) Concerning External Auditors."

accounts. Employees in charge of auditing banks' accounts must have professional certificates and be given a minimum of 30 hours of training. Finally, it encourages Islamic and conventional banks alike to use the services of international or local external auditors according to the above criteria.

Again, there is no reference to an external *sharia* auditor. Nonetheless, Instruction No (2/IBS/100/2003) of the CBK concerning the Rules and Conditions for the Appointment and Responsibilities of the SSB in Islamic Banks, which was explained in chapter five,[454] (particularly in Instruction No (7)) provides that the task of the external auditor must include the necessary examinations to ascertain that all the procedures followed by the bank in launching new financial products, or in modifying existing products, include the proper steps for ensuring complete compliance with the rules and principles of *Sharia*. This included the review of such procedures by the bank's management and SSB. All of the bank's products must have been examined by the SSB and their compliance with the rules and principles of *sharia* confirmed. In his report, the external auditor must indicate the extent of the bank management's compliance with the *fatawa*, resolutions and directives of the SSB in the transactions executed.

In Oman, section (3.10) of the Licensing Requirements of the Islamic Banking Regulatory Framework[455] provides that Islamic banks must appoint an external auditor who is subject to the CBO's prior approval. As part of their review, external auditors shall certify that separate controls and systems have been maintained, including those to ensure that in the case of the Islamic window there is no commingling of funds with the conventional parent's.

Further, Title 3 about Accounting Standards and Audit Report in section (1.3.1) defines the external auditor as "an independent audit professional who conducts

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[454] "The Central Bank of Kuwait Instruction No (2/IBS/100/2003) Concerning the Rules and Conditions for the Appointment and Responsibilities of the *Sharia* Supervisory Board in Islamic Banks."

[455] *The Central Bank of Oman's Islamic Banking Regulatory Framework of 2012.*

an audit according to specific rules and standards. Section (1.4) provides that an external auditor conducts an audit of a licensee's accounts in accordance with auditing standards for IFI issued by the AAOIFI and the International Standards on Auditing and Assurance Board, where applicable. Pursuant to section (5.2), each licensee needs to submit to the CBO an annual report, audited by independent external auditors, pursuant to procedures established by the CBO at such times and in such form as may be prescribed by the regulations of the CBO. Here, too, there is no provision for external *sharia* audit.

In Malaysia, Division (3) of the Islamic Financial Services Act No (759) of 2013 is concerned with audit of *sharia*-compliance.[456] Nonetheless, sections (37 and 38), as discussed in chapter five, concern the internal *sharia* audit. It is interesting, however, that section (38) provides that the BNM may appoint any person to conduct a *sharia*-compliance audit if an institution fails to do so, or under any other circumstances as it deems appropriate. The appointed *sharia* auditor shall submit a report to the BNM on the audit carried out.

In terms of external audit, Division (4) concerns normal audit. Similarly, sections (76-78) stipulate that, subject to the prior approval of the BNM, every institution shall appoint an auditor for each financial year who meets the requirements set out by the BNM. The BNM may appoint an auditor for an institution if it fails to do so or under any other circumstances as it deems appropriate. The auditor carries out an audit of the business, affairs and books of the institution in accordance with the generally accepted auditing standards applicable in Malaysia, and submits a report of such audit to the members of the institution and the BNM. Such person is remunerated by the institution for the normal course of work as well as any extended assessments required by the BNM. According to section (81), the auditor shall not be liable for a breach of duty of confidentiality between

[456] *The Malaysian Islamic Financial Services Act No (759) of 2013.*

such person and the institution in respect of matters reported to the BNM pursuant to an audit.

Finally, the laws and Islamic Finance Rulebook in Dubai contain no direct provisions with regard to an external auditor. However, with regard to other financial institutions, similar provisions to the CBB's Rulebook exist. Nonetheless, as in the Bahraini approach, there is no direct reference in those provisions to external *sharia* audit firms.

6.4 INDEPENDENCE AND CONFLICTS OF INTEREST

The AAOIFI governance standard No. (5)[457] defines the SSB's independence as "an attitude of mind which does not allow the viewpoints and conclusions of its possessor to become reliant on or subordinate to influences and pressures of conflicting interests. It is achieved through organisational status and objectivity". Garas (2010) explains that this definition emphasises the two-fold elements of independence: internally (attitude of mind) and externally (organisational status). He further identifies three main groups of factors that can be used in classifying the SSB into dependent and independent: (a) the implementation of governance best practice within the IFI, (b) the SSB recruitment process of the SSB, and (c) the relationships between the SSB and other governance areas.[458]

As the attitude of mind is difficult to prove and address, the discussion in this section focuses on the organisational status of the SSB and the concerns about membership impartiality. The SSB's position as an independent part of the IFI should protect it from bias or undue influence of any kind. However, the current organisational structure of the IFI and therefore status of the SSB within the IFI may suggest otherwise.

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[457] "AAOIFI Governance Standard No.5: Independence of *Sharia* Supervisory Board."

[458] Garas, "The Role of the *Shari'a* Supervisory Board in the Governance of Islamic Financial Institutions in the Gulf Cooperation Council Countries," P: 94.

While all financial regulators of the case countries, as addressed in chapter five, define the SSB as an independent organ of the IFI and make it the responsibility of the IFI to preserve such independence, in practice, there is growing concern about the reality of that independence.

The independence of the SSB is largely derived from its organisational status, which is based on its appointment and dismissal mechanism. Related to this, it is the responsibility of the SSB to report to a specific organ of the IFI, which might emphasise its independent status differently from other organs of the IFI.

Nonetheless, the mechanism used in the appointment and dismissal of SSB members may involve an element of risk or 'factual dependency'. Normally, this responsibility is undertaken either by the shareholders in their General Meeting or by the BOD. The majority of Muslims seem to favour the former approach, which has been adopted in Bahrain, Kuwait and Oman. Other Muslim countries, including Malaysia, favour the latter approach. Dubai considers this as an internal matter leaving it to the IFI to decide the appropriate governing body to have such authority, and this could be the shareholders as well as the Board, as detailed in chapter five.

Perhaps it is thought that the appointment and dismissal of the SSB's members by the shareholders convey more confidence in the independence of the SSB's members. This is because they, like the Board's members, are appointed and dismissed by the same authority, i.e. the shareholders. However, if the BOD appoints the SSB's members, it may be assumed that the Board is in a superior position to the SSB, despite the SSB's proof of independence. This assumption is also supported by the fact that the SSB reports back to the directors in cases where they are appointed by them, and otherwise reports directly to the shareholders. Further, giving the authority to the BOD encourages the selection and appointment of only those *sharia* scholars who hold similar ideological views

to the directors, who may be less restrictive in their *sharia* views concerning any given suggestion coming from the Board.

In both mechanisms, however, concerns have arisen about the value and validity of the assessment made by the members of the SSB to the IFI on its operations. From one side, the contradiction is evident in allowing the payee to assess the business of their payer. From another side, the SSB is required to submit advisory reports on a regular basis to the IFI, whose conduct is under assessment.

Further, this contractual relationship between the SSB and the IFI could result in the risk of factual dependency. There are significant differences in the academic views as to the ideal length of the membership of the SSB. Some propose a 3-5 year term to enable scholars to advise throughout the progress of more lengthy financial transactions, while others feel that the contract should be for a year, taking into consideration the amount of work contact that is made during this period.[459]

In Bahrain, Kuwait and Malaysia, there is no mention of the duration of membership of the SSB. In fact, in Kuwait some of the IFI have open-ended contracts with their *sharia* scholars. However, in Dubai there is a requirement to establish and maintain records for six years of the SSB's members' appointments, dismissals or changes. Therefore, the duration of membership could be up to six years. Only in Oman is there a clear stipulation that SSB membership is for three years, which can be renewed for a further three years. A fixed period of reasonable length should be sufficient, and should allow a clear line of work and proper execution of the assigned role of the SSB.

Although the parallel existence of the SSB and BOD for the same period is argued to bring harmony to their relationship, the long contractual relationship

[459] Ibid., P: 91.

between the SSB and the IFI raises potential concerns of factual dependency. This is evident from the fact that *sharia* scholars who are interested in long contracts would seek reappointment by being less restrictive in their approval of products and transactions suggested by the directors or management. In turn, the directors would seek the approval of such scholars, either by directly appointing them if they have the authority to do so or by recommending such an appointment to the shareholders.

Moreover, the longer the term of contract, the greater is the expectation that a reappointment is possible. Therefore, more control by the national regulator is necessary in the process of approval, reappointment, and dismissal of the members of the SSB. This is important because the relevant international standard setters, i.e. the IFSB and the AAOIFI, are actually silent with regard to the duration of SSB membership, reappointment, and dismissal of members.

Nonetheless, it is generally assumed that the mechanism for termination of membership of an SSB should be the same as the one undertaken for appointment. Thus, the shareholders or directors are responsible for the normal termination of membership.

However, dismissal or removal from membership is an area which needs further attention, for it is a means of enhancing the status of the SSB's independence. In this regard, most of the countries studied refer to breaching the general fit and proper criteria and/or conflict of interests.

As in Kuwait where there is no direct provision in the instructions of the CBK,[460] in Bahrain there is no direct or special reference to the dismissal or removal of SSB members, despite the position of Bahrain as promoter of the AAOIFI standards which, as has been said, are silent in this respect.

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[460] "The Central Bank of Kuwait Instruction No (2/IBS/100/2003) Concerning the Rules and Conditions for the Appointment and Responsibilities of the *Sharia* Supervisory Board in Islamic Banks."

Nonetheless, there a general mention of the issue of conflict of interest. According to Volume 2 of the Rulebook of the CBB, [461] the head of *sharia* review is considered an approved person in a controlling position. As such, Section (LR-1A.2.4) shall apply to him, which requires that approved persons undertaking a controlled function must act prudently, and with honesty, integrity, care, skill and due diligence in the performance of their duties. They must avoid conflicts of interest arising whilst undertaking a controlled function. According to section (HC-2.3.1), each approved person must make every practicable effort to arrange his personal and business affairs to avoid a conflict of interest with the Islamic bank licensee. In determining whether a conflict of interest may arise, section (LR-1A.2.5) states that they may include whether: (a) a person has breached any fiduciary obligations to the company or terms of employment; (b) a person has undertaken actions that would be difficult to defend, when looked at objectively, as being in the interest of the licensee; and (c) a person has failed to declare a personal interest that has a material impact in terms of the person's relationship with the licensee.

In Dubai, section (3.5.4) in the IFR provides that the Manual of the Islamic Financial Business Policy and Procedures (maintained under section 3.4.1) of the authorised person obliges a member of the SSB to notify the authorised person of any conflict of interest, and if an authorised person is unable to resolve a conflict of interest as provided above, it must dismiss or replace the member as appropriate. [462]

However, there is a direct reference to the issue in Oman under Title 2 concerning General Obligations and Governance in the Islamic Banking Regulatory Framework.[463] Sections (2.2.4.9-2.2.4.10) provide that the SSB

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[461] "The Central Bank of Bahrain Rulebook."

[462] *The Islamic Financial Business Module of the Dubai Financial Services Authority [VER8/06-14].*

[463] *The Central Bank of Oman's Islamic Banking Regulatory Framework of 2012.*

members should continuously assess their relationships with the licensee to identify any situations that may impair independence, and agree on an action plan to resolve such issues. They should review the issue internally within the SSB and take any necessary steps to resolve it. If the issue still exists after the internal review, the SSB member with the issue of independence impairment must resign, and the General Assembly of the licensee be notified. Further, sections (2.2.4.11-2.2.4.13) state that the principle of objectivity imposes obligations on SSB members to be fair, intellectually honest and free of conflicts of interest, and to perform *sharia* supervision in such manner. In addition, section (2.2.4.15) requires that the directors shall undertake an annual check of SSB members for independence and conflicts of interest and submit their assessment report to the CBO. As an example, section (2.2.4.16) provides that a conflict of interest may arise where the SSB member acts contrary to his obligation and to his fiduciary duty towards the licensee, or if the SSB member exploits his position for his own personal and pecuniary benefit. Accordingly, section (2.2.4.17) provides that SSB members shall not have any relationship with the licensee that could possibly be seen to interfere or reasonably be perceived to interfere with the exercise of their independent judgement when delivering *fatawa* and rulings in *sharia*.

In Malaysia,[464] direct provision exists for removing SSB members. The Islamic Financial Services Act No (759) of 2013, section (33), lists a number of situations where the BNM may, by an order in writing, remove a member of a *sharia* committee, the main one being if the member has contravened any provision of this Act or failed to comply with any standards applicable to him. A person so removed from office is not entitled to claim compensation for the loss of office.

Restricting the membership of the SSB is another tool to enhance its independent status. Only Oman and Malaysia restrict membership, providing that

[464] *The Malaysian Islamic Financial Services Act No (759) of 2013.*

a *sharia* scholar cannot be a member of more than one SSB in the same industry. This needs to be considered alongside the above provisions concerning dismissal and conflicts of interest. Since there is this restriction on SSB membership, provisions resolving the issue of conflict of interest by dismissal or removal of the SSB's members are relevant to issues other than the multiple appointment of *sharia* scholars. For example, conflicts of interest should not concern multiple appointments because there is already a restriction on the SSB's membership which prevents multiple appointments.

Oman and Malaysia apply a further restriction, which is that a member of an SSB should be a Muslim. This means that *sharia* consulting firms are not allowed to act as or take the role of SSB. However, Oman along with Bahrain, Dubai and Kuwait, requires that SSB members should not enjoy executive power, and therefore should not be a director a member of the executive management, or shareholders of effective influence. Interestingly, Malaysia is the only country to allow one member of the BOD to sit as a member of the *sharia* committee, to serve as a bridge between the two bodies.

On the other hand, the non-restriction on SSB membership may result in multiple-appointment of *sharia* scholars, which obviously raises the issue of conflict of interest. This is particularly evident in countries which only require the IFI to obtain an Islamic legal opinion without forming a specialised religious authority, or do not prevent multiple appointments of scholars. This is common in the GCC, where there are no restrictions on *sharia* scholars serving in more than one financial institution.[465]

Therefore, prominent scholars are sought for membership of multiple SSB, presenting a potential problem in Bahrain, Dubai and Kuwait. This is because the shortage of highly qualified scholars has led IFI to seek the services of certain

[465] Rodney Wilson, "The Development of Islamic Finance in the GCC" (The Centre for The Study of Global Governance, Kuwait, 2009), P: 9, http://www.lse.ac.uk/middleEastCentre/kuwait/documents/Wilson.pdf.

knowledgeable scholars. This can also be argued as forming part of the marketing strategy of the IFI. As indicated above, the SSB members convey a certain image of the IFI, reflecting a specific *madhab* and attracting potential customers or investors.

It was established in 2010 that the top 20 scholars serve 621 boards globally.[466] More recently, 187 scholars were advising approximately 150 IFI worldwide, some of these scholars advising 40, 29, 25, 22 and 18 financial institutions respectively.[467]

Obviously, this raises serious questions regarding the workload of such scholars, and thus the accuracy of their judgements. In turn, this reflects negatively on the current *sharia* governance, which is reliant on the work of SSB. Complex institutions that offer a range of products require close attention and the workload involved in serving SSB across many countries causes possible concerns. For instance, Sheikh Nizam Yaquby and Abdul-Sattar Abu-Ghuddah are listed as serving on some 45 each, followed by Dr Mohammed Eid Elgari who is serving on 31 boards.[468]

The multiple appointment of *sharia* scholars therefore raises concern about inefficiency, independence and potential conflicts of interest, which could result in all parties being dissatisfied with the resultant judgements. It could also lead to inside information being shared, with the obvious impact on the competitive market.

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[466] Dana El-Baltaji and Haris Anwar, "*Shariah* Scholar on More than 50 Boards Opposes Limit Plan: Islamic Finance," *Bloomberg*, November 23, 2010, http://www.bloomberg.com/news/2010-11-23/shariah-scholar-on-more-than-50-boards-opposes-limit-plan-islamic-finance.html.

[467] Hassan, "The Cry Is for More Islamic Bankers."

[468] "*Shariah* Scholar in the GCC-A Network Analytic Perspective," *Funds@Work*, 2008, www.funds-at-work.com.

In fact, there is scepticism regarding IFI appointing scholars who could be sympathetic to the institution's needs.[469] Multiple appointments, it could be argued, could generate the abuse known as 'renting a sheikh'.

In this context, Wilson (2009) notes that, in practice, the members of the boards have been constructive rather than restrictive and have been willing to approve new types of deposit and finance facilities.[470] Further, El-Gamal (2006) states that the lack of *fatawa* standardisation across different SSB has been criticised. In practice, finding an appropriate Arabic name for the 'Islamic analogue product' is exercised. Further, insisting on using such products to 'justify and lend credibility to the Islamic brand name' is noted.[471]

In fact, a survey by Rashid (2013) covering Bangladesh, Malaysia and the Arabian Gulf region, favours such a claim, as reports on selected Islamic banks show that they are too customer-centric and efficiency driven, and that their commitment to basic Islamic rules falls far below the average. Its conclusion was that Islamic-banks are becoming more customer friendly and efficient, although sadly this is happening at the cost of Islamic belief and faith in *Allah (SWT)*. Therefore, it is suggested that Islamic-banks should focus on becoming fully conversant with Islamic principles.[472]

The expansion of conventional-banks into providing Islamic financial services raises similar concerns. According to Rushi Siddiqui, director of Dow Jones Islamic Market Index, Western institutions entering Islamic financial market are reliant on the initial reputation of their SSB.[473]

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[469] Aziz, "Shariah Governance: Challenges Ahead," P: 10; Foster, "How Sharia-Compliant Is Islamic Banking?"

[470] Wilson, "The Development of Islamic Finance in the GCC," P: 8.

[471] El-Gamal, *Islamic Finance: Law, Economics, and Practice*, P: 20 & 26–45.

[472] Rashid, "Customer-Centric Corporate Social Responsibility: A Framework for Islamic-banks on Ethical Efficiency," P: 368.

[473] Hassan, "The Cry Is for More Islamic Bankers."

Khan (2010) further explains that accommodating scholars are often enticed by high remuneration from multi-national and national financial institutions eager to gain *sharia* certification.[474] For instance, Morais (2007) reports that the worldwide top *sharia* scholars can earn between US$20,000 and $30,000 per board annually.[475] Other reports state that individual scholars have earned $150,000–$500,000 from certifying large capital market transactions, often by translating technical financial terms in complex Western financial instruments into classical Arabic before issuing *sharia*-compliant certification.[476] This is highly alarming.

The Egyptian scholar Sheikh Hussain Hamid Hassan, now the most prominent scholar in Dubai, made waves recently when he suggested that US$300,000 was not an unusual fee for advice on a complex transaction. Others suggest that the retainer for an international bank would be in the region of US$150,000 to $250,000, and one source quoted US$100,000 just to get *sharia* approval for a fund, after all the product development had taken place.[477]

Naturally, in a market with such large financial gains, it can be argued that scholars renowned as particularly strict in their interpretation are unlikely to receive much attention.[478] Therefore, there are calls for new regulatory principles aimed at avoiding extensive multiple appointments. Despite the size of the workload, for any scholar to hold the excessive number of positions previously quoted cannot be acceptable if high Islamic standards are to be maintained.

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[474] Feisal Khan, "How 'Islamic' Is Islamic Banking?," *Journal of Economic Behavior & Organization* 76, no. 3 (December 2010): 805–20.

[475] Richard C. Morais, "Don't Call It Interest," *Forbes*, July 7, 2007, http://www.forbes.com/forbes/2007/0723/122.html.

[476] Gillian Tett, "Banks Seek Islamic Scholars Versed in Finance," *Financial Times*, May 19, 2006, http://www.ft.com/intl/cms/s/0/81425438-e75f-11da-9046-0000779e2340.html#axzz3WNYdD6Vn; Hassan, "The Cry Is for More Islamic Bankers."

[477] Wright, "The Shariah Scholar Cartel."

[478] Khan, "How 'Islamic' Is Islamic Banking?," P: 817–818.

It is notable that, in the pursuit of maintaining the reputation of the SSB, some countries have restricted the membership of *sharia* scholars. As discussed in chapter five, Malaysia (and more recently Oman) is a key example of this practice, introducing comprehensive regulations for all participating scholars, whatever their nationality or status.

However, to date, other countries in general and the GCC in particular have not considered this route, and *sharia* scholars have strongly resisted any potential restriction.[479] Moreover, some of the top *sharia* scholars have reportedly spoken out against any efforts to restrict their membership of SSB. In justification of their SSB membership earnings, Sheikh Hussein Hamid Hassan, one of the highest earning scholars in Dubai, has argued that the fees reflect a shortage of Islamic scholars who understand modern finance. The monetary gain is payment for analysis of the lengthy documentation. Further, he finds that teachings of the Holy *Qur'an* are not against *sharia* scholars being excluded from compensation.[480]

The time devoted to accomplishing a task differs between experienced and junior scholars, so it is unfair to judge one person's capability against another.[481] Sheikh Yusuf Talal DeLorenzo, a highly paid scholar in the USA, argues that the ability of scholars differs and is reflected in the time required to reach a conclusion. Nonetheless, he cautions his colleagues in the Gulf to resist "wrap[ping] a non-*sharia*-compliant underlying investment in a *sharia*-compliant structure", and he is deeply sceptical of Dubai Islamic Bank's hedge fund.[482]

Despite these widespread, documented concerns, Sheikh Nizam Yaquby argued that they are exaggerated, emphasising that the IFI require the highest standards

[479] Wright, "The Shariah Scholar Cartel"; Khan, "How 'Islamic' Is Islamic Banking?," P: 818.

[480] Hassan, "The Cry Is for More Islamic Bankers."

[481] Rushdi Siddiqui, "A *Sharia* Scholar's Place on the Board," *Gulf News*, December 5, 2010, http://gulfnews.com/business/sectors/features/a-sharia-scholar-s-place-on-the-board-1.625445.

[482] Morais, "Don't Call It Interest"; Wright, "The Shariah Scholar Cartel."

from the *sharia* scholars they employ and that 'renting a sheikh' is not a viable option.[483] The controversy continues, with some scholars maintaining that their multi appointment does not necessarily result in conflicts of interest. Such risks or concerns are mitigated, in their opinion, by the high ethical standards of *sharia* scholars, and the risk is further reduced by the damage that a damaged reputation would have on a scholar and therefore the IFI.[484]

In this context, Casper (2012) argued that where a scholar is simply judging the conformity of a financial product to *sharia* law, it should be possible to allow this scholar to sit on competing boards. However, if the advisory function of the SSB is of greater significance then there should be rules banning membership of SSB of institutions that are in direct competition.[485]

Grais and Pellegrini (2006) argue that, by discouraging *sharia* scholars from sitting on multiple SSB, confidentiality concerns could be eliminated, although this suggestion may not prove acceptable to some of the recently quoted scholars. Nonetheless, they further state that following such a practice could cause other problems. Firstly, it may result in a scarcity of *fiqh-almuamalat* jurists resulting in a publicly perceived lack of competence. Secondly, any lack of economic appeal for such positions would, in their view, prevent the functioning of an efficient labour market for *sharia* scholars. Thirdly, they argue that impartiality could be undermined by creating a symbiotic relationship between the scholar and a particular financial institution.[486]

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[483] Aziz, "*Shariah* Governance: Challenges Ahead," P: 10.

[484] Suleiman, "Corporate Governance in Islamic-banks."

[485] Matthias Casper, "*Sharia* Boards and *Sharia* Compliance in the Context of European Corporate Governance" (Working Paper of the Center for Religion and Modernity, Munster, 2012), P: 6, http://www.uni-muenster.de/imperia/md/content/religion_und_moderne/preprints/crm_working_paper_012012_casper_neu1.pdf.

[486] Grais and Pellegrini, "Corporate Governance in Institutions Offering Islamic Financial Services: Issues and Options," P: 10.

Kantakji (2010) stresses that arguments in favour of scholars remaining free of membership restrictions are actually invalid. In this context, reference is made to voluntary membership as a possible alternative, where scholars fearing *Allah (SWT)* serve in the SSB without payment in order to eliminate the main concerns. However, such an experiment caused a major problem in Saudi Arabia and was not successful.[487]

On the other hand, not receiving any recompense is still no guarantee that advice is unbiased or free from conflicts of interest, as these concerns could still exist even with scholars serving on SSB as volunteers. Obviously, this suggestion of voluntary membership is unrealistic and impractical in today's financial industry. IFI would be safer with the implementation of appropriate regulations and restrictions.

6.5 THE LEGAL STATUS OF THE SSB AND ITS PRONOUNCEMENTS

When providing advice about religious matters concerning products or services, the SSB becomes, albeit indirectly, involved in the setting of current and future business policies of the IFI. Although the institution's management and directors are responsible for setting the business policy, the views of the SSB should obviously be taken into consideration.

In this context, Jabbar (2008) states that, whilst the advice of a legal adviser is not binding on a conventional institution, the advice of an SSB must be adhered to by a financial institution offering Islamic products and services.[488] The IFI holds the responsibility for complying with *sharia*, and to attain this position it needs to adhere to the views of the SSB. It is therefore the SSB which enables the IFI to

[487] Parker, "Are *Shariah* Advisories Becoming an Endangered Species?"

[488] Jabbar, "The *Shari'a* Supervisory Board: A Potential Problem in Islamic Finance?," at 29.

maintain in practice the *sharia* perspective in business and preserve its Islamic label.

However, the legal effect of the opinions or decisions (ex-ante or ex-post) issued by the SSB are largely reliant on its legal status, according to the memorandum of association of the institution or the laws of the country. In other words, the legality and importance of opinions or decisions that the SSB imparts depend on its position in the governance structure of the IFI. Since there is no uniformity of law governing the IFI around the world, this results in variation within and between countries and highlights the need for uniform regulatory and legislative intervention.

In Bahrain, the SSB is established by the shareholders and the *Sharia* review department is established as an independent organ or integrated part of the audit committee, in accordance with the AAOIFI standards. As such, the SSB is an independent organ of the IFI, but the review department is structured under the management. Nonetheless, according to the standards the rulings of the SSB should be binding on the IFI.

In Dubai, the SSB is established by the governing body of the financial institution. As such, a clear position is not established, as any financial institution may provide such authority to different governing bodies. Nonetheless, this authority is usually given to either the shareholders or the BOD. However, there is no direct provision for the status of the SSB's rulings, and if they are binding on financial institutions are required to adhere to AAOIFI standards in terms of *sharia* review. Therefore, the IFI should also establish a review department.

In Kuwait, the SSB is appointed by the shareholders, and there are no direct provisions regarding the status of its rulings. Nor are there any references to AAOIFI standards, and therefore, no requirement to establish a review department. However, disagreements on *sharia* matters can still be referred to the *fatwa* board.

In Oman, the SSB is appointed by the shareholders, and its rulings should be binding on the IFI. In addition, an independent internal *sharia* reviewer, who reports to the SSB with administrative reporting to the CEO, is responsible to the head of the review and audit units, both of which are considered as integral parts of the *sharia* governance framework in establishing the *sharia*-compliance of the IFI.

In Malaysia, the BOD is responsible for appointing the SSB, and the SSB actually reports back to the Board. As such, the Board seems to be in a superior position to the SSB. In terms of *sharia* governance, reference is made to the functions of *sharia* review and audit: the latter to be performed by internal auditors whose work is decided by the audit committee.

For the most part, SSB play only an advisory role in the current governance systems and supervisory frameworks. In practice, the SSB exercise their ex-ante functions, but in exercising the ex-post functions the actually rely on the findings of the review and/or audit units.

The regulatory structures of the countries being studied indicate that the prime duty of the SSB is to ensure that the IFI's operations remain *sharia*-compliant, by providing a just and unbiased opinion on the compliance of the IFI with *sharia*. Nevertheless, it is the IFI which bears the final responsibility for complying with *sharia*.

By appointing review and/or audit units, the IFI helps the SSB to make sure of this compliance. Nonetheless, these units remain within the realm of management, not of the SSB. Although the SSB is considered to be an independent organ and issues binding rulings on *sharia* matters, the follow-up on such rulings is undertaken by internal units of the IFI, which work with but not under the authority of the SSB. It is important to realise that these units are not formed by the SSB itself but the IFI through its directors or management. As such, the real role of the SSB is confined to advising the IFI on *sharia* matters,

and following the work of the review and audit units. The practical issue remains, whether the SSB could undertake by itself the ex-post role, and whether it has the necessary independent qualified staff and empowered mechanism in place to do so. This explains the requirement from some regulators to establish an internal *sharia*-compliance unit.

This may lead to questioning the enforceability of the *fatawa* issued and therefore the efficiency of the *sharia* governance system which is the SSB's raison d'être. In turn, this could create *sharia* governance issues in terms of the extent to which the rulings prescribed by *sharia* scholars are being complied with.

As previously mentioned, any decision made by the SSB affects the interests of a wide range of stakeholders, given the diversity of *maqasid-al-sharia*, and therefore the distinct meaning and scope of *sharia* governance, as explained in chapter four. To reiterate, although the opinions of the SSB are on purely religious matters, the consequences extend to IFI management, especially if an opinion has the power to correct or terminate transactions that are found to be non-compliant with *sharia* principles. Therefore, pronouncements of the SSB not only influence depositors' interests but also affect the welfare of shareholders, especially if the decision is a controversial one.

Moreover, customers' confidence in IFI and their services could be at risk in the event of disagreements between the SSB and the IFI, represented by the directors or management, concerning the proper interpretation as well as execution of their *fatawa*. The commercial interests of the shareholders are put in jeopardy if depositors decide to withdraw their savings, fearing any involvement in non-compliant transactions.

Therefore, it is argued that *sharia* governance should be a shared responsibility. The IFI primarily ensures that its activities are *sharia*-compliant through its internal governance mechanism. Nonetheless, determining the adequacy of this mechanism and supervising the governance standards should be the

responsibility of a financial regulatory body or higher *sharia* authority. The establishment of a stronger framework for IFB, including strong *sharia* governance, therefore requires the joint effort and integrated work of all the IFI including their SSB and the national authorities.

6.6 ACCOUNTABILITY OF THE SSB

Because of the importance of *sharia*-compliance, the SSB is placed in a position of unparalleled influence from the view of the shareholders. The active role and regular reporting enables the SSB to direct and supervise the institution, even though in theory the BOD is in control of the operations and bears the ultimate responsibility within the IFI for compliance with *sharia*.

In other words, the BOD could put the financial success of a product in front of a negative ruling by the SSB.[489] It was proposed that, in such an unlikely financial scenario, the IFI would theoretically have no option but to dispense with the non-compliant product.[490] Nonetheless, this approach is both simplistic and unrealistic. In a survey conducted by Warde (1998), it was revealed that in such cases a matter is normally reviewed by the Board and decisions already made by management are implemented.[491] Interestingly, Warde (2000) questions the requirement for institutional SSB. He argues that employees of financial institutions are now able to access the latest research into Islamic finance, and undertake training programmes from various organisations. Hence, the SSB are

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[489] Yaacob, "Issues and Challenges of *Shari'ah* Audit in Islamic Financial Institutions: A Contemporary View," P: 2676.

[490] Hussain Rammal and Lee Parker, "Audit and Governance in Islamic Banks: Selection and Training of *Shari'ah* Advisors" (University of Sydney, 2010), P: 8–9, http://apira2010.econ.usyd.edu.au/conference_proceedings/APIRA-2010-268-Rammal-Audit-and-governance-in-Islamic-banks.pdf.

[491] Ibrahim Warde, "The Role of *Shari'ah* Boards: A Survey" (IBPC Working Papers, San Francisco, 1998).

only a formality and their role as an active body of control should be questioned.[492]

It has been established that the ultimate responsibility for *sharia*-compliance is shouldered by the IFI. In practice, while the SSB may give their opinions only on *sharia* matters, the IFI will make the final decision on the subject matter. Therefore, the role of *sharia* scholars has only limited influence since the directors and managers are considered to be the final decision makers, on whether to accept and apply the proposed changes to transactions.

The scope of responsibility and accountability of the SSB members is therefore arguable, especially its authority to disallow or disapprove practices which are not *sharia*-compliant. As explained in chapter two, the AAOIFI governance standards require the SSB only to "form unbiased and independent opinion" on *sharia*-compliance.

In principle, members of the SSB are free to express their views, and they can approve or reject any practices or products according to their own convictions, based on their knowledge of *sharia* rules and principles. In ensuring the conformity of their IFI's activities with *sharia*, they are accountable only to *Allah (SWT)*. Nonetheless, they have a duty to report to either the shareholders or directors, according to the mechanism adopted by the IFI in any given country.

It cannot be denied that the directors and management must ensure that the IFI's activities adhere to the views of the SSB, as this enables the IFI to obtain its certificate of *sharia*-compliance. As the SSB acts as a consumer watchdog for the Muslim public wishing to invest in *sharia*-compliant transactions,[493] its views are of great value to management, upholding the credibility of the institution's reputation to the shareholders.

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[492] Ibrahim Warde, *Islamic Finance in the Global Economy* (Edinburgh University Press, 2000).

[493] Morais, "Don't Call It Interest."

Casper (2012) asks whether there is liability if the *sharia* conformity of a product is not given in the product's prospectus, either from the very beginning or later during its life cycle. This raises the question of responsibility for the interpretation of religious principles or laws and therefore the responsibility for this type of risk.[494] Casper argues that in the case of non-compliance, neither the investor nor the IFI should bear total liability. He believes that in the case of a legitimate interpretation, which is proved to be within accepted *sharia* legal boundaries, then the prospectus should include an indemnity clause or disclaimer.

A different perspective of SSB rulings is taken by Rachagan (2005), who queries the power of the courts to question the validity of an SSB approved document used by an IFI in a banking transaction, i.e. whether a court has the power to challenge the *sharia* approval or the later compliance of products, and whether such a challenge would mean that the courts can also review the *fatawa* of SSB.[495]

In response, Hodgins (2010) notes that suing *sharia* scholars for malpractice or negligence would make them reluctant to sit on SSB. Consequently, suing scholars should be considered only in extreme cases, where it could be demonstrated that the *sharia* scholar was focused on other concerns, such as his own financial remuneration, and did not give genuine consideration to the *sharia*-compliance of the product such as being focused on receiving.[496] In such a case, consideration should be given to the fact that it is unlikely that *sharia* scholars pay compensation from their own pockets, especially if they are proved not to be negligent and provided an interpretation that does not fall outside the generally

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[494] Giving the example of Sukuk product. Casper, "*Sharia* Boards and *Sharia* Compliance in the Context of European Corporate Governance," P: 14.

[495] Shanthy Rachagan, "Islamic Banking in Malaysia," *Journal of International Banking Law and Regulation* 20, no. 2 (2005): at 94.

[496] Peter Hodgins, "*Shariah* Disharmony in Collabrative Sukuk Report," *Zawaya*, 2010, http://www.kslaw.com/imageserver/KSPublic/Library/publication/Zawya-Feb-2010-JawadAli.pdf.

accepted norms of Islam and principles of *sharia*. If suing *sharia* scholars is allowed, consideration should be given to taking out insurance policies.

Muneeza and Hassan (2011) suggest that the SSB should not be immune from legal action, but should be exposed to civil and criminal liabilities similar to the BOD since they are selected according to certain standards based on knowledge and capacity.[497]

As discussed in chapter four, the scope of *sharia* governance is wide, aiming to protect the interest of all stakeholders, not just shareholders. Accordingly, Yaccob (2012) argues that the *sharia* scholars should be held more accountable because of their duty to all stakeholders, including the *ummah*.[498] However, above all they are accountable to *Allah (SWT)* for every action and for their inaction. It is this accountability that should make them more responsible and recognise their duty of care to all stakeholders.

The accountability of the *sharia* scholars is an important area that needs to be examined further. The stakeholders, especially customers and investors, should have a legal right of appeal regarding the *fatawa* and rulings of the SSB. SSB members should also be held responsible if their decision results in a non-Islamic transaction, and is disputed through the courts, causing financial loss and costs. Only through the adequate protection of their rights and continuing competitive opportunities is it possible to provide the necessary level playing field for the IFI. However, the special nature of their responsibilities and therefore liabilities requires credible and supportive supervision and regulation that accommodates its specifics. At present, however, no such supportive regulatory environment exists.

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[497] Muneeza and Hassan, "The Legal Conflicts in *Shari'ah* Corporate Governance of Islamic Financial Institutions in Malaysia."

[498] Yaacob, "Issues and Challenges of *Shari'ah* Audit in Islamic Financial Institutions: A Contemporary View," P: 2676.

The current position is that laws and regulations concerning IFB in Muslim countries, including those under study, are silent on the consequences of malpractice and the liability of SSB members.

The grounds for the dismissal or removal of SSB members, discussed above, may include their being impartial and/or not exercising their duties in an appropriate manner. However, there are no direct provisions with regard to their duty of care, or to the legal action (if any) that may be taken against them.

This is true in Bahrain, Dubai and Kuwait. However, it does not mean that SSB members are immune from the provisions of criminal law. Although Dubai and Oman have free zones, their law clearly stipulates that they are excluded from the application of civil and commercial law, but not from criminal law.

However, in Oman section (2.5.1.7) of the Islamic Banking Regulatory Framework of 2012 requires that *sharia* audit officers, in their capacity as employees of the IFI, shall exercise due professional care in performing their work, and shall be alert to the possibility of intentional wrongdoing. However, this provision does not affect members of the SSB, as they are independent from the management of the IFI and appointed by the shareholders. Nonetheless, the existence of this provision addressing *sharia* officers is a good step towards establishing their responsibility as professionals, which is hoped will be extended to cover SSB members.

Similarly in Malaysia, section (29/6) states that any person who fails to comply with any standards specified by the BNM (in accordance with the advice or ruling of the SAC on *sharia* matters and to give effect to its advice or rulings) commits an offence and shall, on conviction, be liable to imprisonment for a term not exceeding eight years or to a fine not exceeding 25 million ringgit or to both. Further, section (36) states that "a member of a *sharia* committee shall not be liable for the discharge of his duties and performance of his functions, which was done or made in good faith; or to be sued in any court for defamation in respect

of any statement made by the member without malice in the discharge of his duties under this Act".

Finally, the restriction on SSB membership as applied in Oman and Malaysia suggests the accountability of *sharia* scholars to the central bank. In addition, the *sharia* committees in Malaysia need to adhere to the rulings of the *Sharia* Advisory Council, which suggests their accountability to the Council and the BNM in this regard.

Nevertheless, the fact remains that no provisions impose any kind of legal liability for any violation committed in this regard, except perhaps for the dismissal or removal by the central bank or the Council, as discussed above.

6.7 CONCLUSION

This chapter addressed the main legal and practical issues resulting from the current *sharia* governance system and supervision frameworks. Acknowledging the obvious reliance on the internal tools of *sharia* governance at the institutional level, a number of common practical concerns and issues are raised.

These are related in main to the shortage of *sharia* scholars, the scope of *sharia*-compliance supervision, the concept and use of external auditors, independence and conflicts of interest, the legal status of the SSB and its pronouncements, and the accountability of the SSB. The existence of these issues or concerns actually varies across nations, depending on the regulatory and supervisory frameworks they have adopted, as detailed in the previous chapter.

The shortage of well qualified and experienced *sharia* scholars is an issue that affects all Muslim countries. It is evident therefore, that none of the countries requires *sharia* scholars to be their own citizens, although this is encouraged. Oman is the only country, where the regulatory provisions clearly encourages the appointment of its nationals to the SSB.

Most of the countries allow *sharia* scholars to be members of any number of SSB. This is the case in Bahrain, Kuwait and Dubai. Oman and Malaysia, however, choose to restrict the membership of *sharia* scholars to a single SSB in any given industry, and limit the overall number of SSB to which a *sharia* scholar can belong.

Also, it was argued that AAOIFI governance standards (No. 1, 2 and 3) as detailed in chapter two, establish the minimum requirements for *sharia*-compliance supervision. Accordingly, the regulatory authorities in countries adopting or referring to these standards, as discussed, are assumed not to impose a comprehensive revision of *sharia*-compliance on IFI as they suggest only limited scope of review. This is believed to be the situation in most Muslim countries, which actually follow the AAOIFI standards without clearly stating this.

A point in further support of this argument is the fact that such countries do not demand a high level of qualifications or experience for members of SSB or *sharia* reviewers/auditors. It is evident that only Oman and Malaysia require a university degree as a proof of qualification. Oman even goes a step further in distinguishing the qualification requirements of *sharia* scholars from non-*sharia* scholars of the SSB. Specific experience and qualifications are required for *sharia* review, and a *sharia* audit function is added to the governance structure.

Further, it was argued that the SSB should act as an external *sharia* auditor, especially if appointed by shareholders rather than the BOD. In practice however, the SSB just exercises its ex-ante role, and relies mainly of the findings of the *sharia* review function for forming its independent opinion on *sharia*-compliance and submitting its report.

The IFSB guidelines as detailed in chapter two, suggest an annual external audit function performed by a third party to help in reassuring the degree of compliance of the IFI with *sharia*. The need for such external audit is significant because the review performed by the ISRU, although accepted and approved by

the SSB, is done in their capacity as employees of the IFI, and because of the use of the SSB as an internal tool of *sharia* governance.

However, the financial regulators in Muslim countries differ in their recognition and demands for such audit. Although the CBB demands the IFI use external auditors and requires they attend the general meeting of shareholders, the provisions do not specify their involvement in *sharia* auditing. Similar provisions exist in regard of financial institutions in Dubai, but the IFR of DFSA makes no mention of external auditors in regard of IFI and Islamic-banks.

On the other hand, the CBK instruction specifically provides that the task of external audit must cover the examination of new products and modification of existing products in order to ensure that they are compliant with *sharia* principles. This should include the review undertaken by the management and the SSB. In its report, the external auditor should indicate the degree of IFI compliance with the *fatawa* issued by its SSB.

The CBO requires the IFI to use external audit to conduct an accounting audit in accordance with the AAOIFI standards and international standards of auditing. Nonetheless, there is no specific mention of a *sharia*-compliance audit. Similarly, the BNM requires the use of external audit without referring to AAOIFI accounting standards or any special check on *sharia*-compliance.

This role however, as currently fulfilled by the chartered external audit, does not exercise an independent assessment of *sharia*-compliance. Therefore, there is an argument for the establishment and involvement of *sharia* consultancy firms, which is further addressed in the next chapter.

Following the concerns about independence and conflicts of interest, it was argued that appointment and dismissal of SSB members and reporting mechanisms are the main features in this regard. The members of the SSB are normally appointed by the shareholders and report their findings in the general meeting. The exception is Oman, which requires that the SSB report to the BOD

though they are appointed by the shareholders. In Malaysia however, the SSB is appointed by the BOD and reports directly to them.

However, the fact remains that the shareholders usually appoint the SSB members upon the recommendation of the BOD. In turn, this raises questions concerning the true independence of *sharia* scholars and the risk of factual dependence regarding membership of the SSB.

This concern is further supported by the lengthy contracts with SSB members. There is no limit to the duration of membership in most of the Muslim countries. In Bahrain, there is no indication as to the duration of SSB membership, reflecting the omission of this in AAOIFI standards. This is also the situation in Kuwait, where some *sharia* scholars obtain open-ended contracts with IFI.

In Malaysia, no provisions exist which determine the minimum or maximum period of SSB membership. Although there is no direct limitation on the duration of membership of SSB in Dubai, the provision of maintaining records for a minimum of six years suggests that a *sharia* scholar is allowed to be member for this period or longer. In Oman, the maximum duration for SSB membership is six years, consistent with serving two three-year terms. Such lengthy membership of an SSB is argued to be beneficial in enabling the members to work in parallel with the BOD and be able to oversee long-approved investments.

Being free of conflicts of interest is another important indication of true independence, which may arise for various reasons. While, there are no provisions in the instructions of the CBK on this issue, the CBB provides that the head of *sharia* review must avoid conflicts of interest when performing his duties.

On the other hand, the IFR of DFSA requires members of an SSB to notify the IFI of any position that might result in a conflict of interest, and the member should be dismissed if the issue is not resolvable. The regulatory framework of the CBO also provides that members of an SSB should identify any situations that may impair their independence and the member should resign if the issue was not

resolvable. It is further provided that the directors shall be responsible for conducting an annual check on the SSB to ensure its independence and freedom from conflicts of interest.

In addition, restrictions on SSB membership further support its independence and avoid the conflict of interests taking place because of multiple appointment of *sharia* scholars. However, it was explained that only Oman and Malaysia apply such restrictions and limit the overall number of SSB that a single *sharia* scholar is allowed to sit on. Therefore, the risk of conflict of interest is potentially raised in other countries, allowing multiple appointment of *sharia* scholars, as in Bahrain, Kuwait and Dubai.

In turn, this opens a back door for the issue known as "renting a sheikh". Although *sharia* scholars argue that this issue is actually mitigated by the high moral and ethical standards of Islam, many writers cited incidents of an SSB being more permissive and less restrictive.

In terms of the legal status of the SSB and its pronouncements, it has been established that the IFI remains primarily responsible for complying with *sharia*, and the SSB is a mere internal tool that helps it undertake this responsibility. It can be seen that, for the most part, the SSB plays an advisory role by exercising an ex-ante function only. The ex-post function is very much reliant on the work done by the ISRU and ISAU, which are employed by the management rather than the SSB.

As Bahrain promotes the AAOIFI standards, the SSB rulings should be binding on the IFI and they report directly to the shareholders. Also, an ISRU must be established by the management to oversee the implementation of the SSB's rulings. In Kuwait, the same is applied without any particular reference to AAOIFI standards or the *sharia* review function.

In Dubai, there is no provision with regard to the binding nature of its rulings. However, this should be the case, as there is a requirement for *sharia* review

functions according to the AAOIFI standards. In Oman, the rulings of the SSB should be binding on the IFI and it should be supported by an independent *sharia* reviewer who heads an ISRU as well as ISAU. This independent *sharia* reviewer reports to the SSB with administrative reporting to the CEO as well.

In Malaysia, the SSB then falls under the BOD authority and reports directly to it. Further, *sharia* review and *sharia* audit are supportive of the work of the SSB. Nonetheless, the audit function is decided and related directly to the audit committee of the IFI.

As such, the role of the SSB is actually confined to expressing an independent and unbiased judgement or opinion on the *sharia*-compliance of the IFI. Currently, most of the national laws of Muslim countries are silent in respect of the accountability of *sharia* scholars. There are no provisions on this matter in Bahrain, Dubai or Kuwait.

Although there is no provision that expressly address the SSB members responsibility, *sharia* audit officers in Oman are required to exercise professional care in their capacity as employees of the IFI. The existence of such provision is considered as a positive step toward the general accountability of *sharia* scholars. In Malaysia however, it is provided that an SSB member shall not be liable for discharging his duties in good faith or sued in courts without malice. The counter understanding of this provision suggests that SSB members shall be liable and could be sued in court if they do not act in good faith, or for proved malice.

Having addressed a number of legal and practical concerns that result from the current *sharia* governance system and supervisory frameworks of the selected Muslim countries, the next chapter addresses and evaluates a number of practical solutions to these concerns.

CHAPTER SEVEN: EVALUATION OF THE PROPOSED SOLUTIONS

7.0 INTRODUCTION

This chapter addresses and evaluates a number of practical solutions to the concerns raised in the previous chapter. They include measures at the institutional, national and international levels.

As argued throughout this thesis, *sharia* assurance in IFB is the cornerstone of this industry, and a valid mechanism or framework for *sharia* governance and supervision is the only guarantee of such assurance.

Because the current *sharia* governance mechanism is now and will for the foreseeable future rely on the role undertaken by *sharia* scholars, the practical solutions chiefly relate to changes in the deployment and functions of these scholars. This approach is supported by the number of concerns arising from the shortage of prominent *sharia* scholars, as explained in the previous chapter.

7.1 SEGREGATION OF ROLES

The degree of an SSB's independence is significantly affected by the responsibilities assigned to it, its position within the institution's organisational structure, and the reporting structure adopted. As discussed in the previous chapter, the national laws regulating these aspects vary.

Malaysia is the only country where SSB members are appointed directly by the BOD, reporting back to them; in the remaining countries the shareholders are responsible for such appointments and reports are primarily directed at them. The latter approach is considered to place the SSB on a par with the BOD, while the former seems to place it below the Board and perhaps to require it to work under its authority.

In both situations, any reviewing or auditing unit exists to help the SSB to perform its tasks. They are appointed by management, so fall under their authority not the SSB's.

Considering the current structure of these internal tools for *sharia* governance, several theoretical and practical proposals are worth consideration, mainly revolving around segregation of the two tasks of *sharia* governance originally assigned to the SSB: ex-ante and ex-post.

The ex-ante function, i.e. certifying conformity of financial products with *sharia* law, is usually undertaken by the SSB itself, and the ex-post function, i.e. supervising the implementation of its rulings, assigned to the a review unit established for this purpose.

Given that the review unit is technically mandated by the SSB to perform *sharia* review, separation of the *sharia* scholars who undertake the design of a product from those who are involved in the supervision of its implementation is proposed. Therefore, the manual of the SSB should explicitly state which of the *sharia* scholars' tasks are deemed to contribute to the design of a product (to avoid the risk of self-review); and the charter of the review unit should explicitly state its members' role and responsibilities in exercising the review function. Further, it is suggested that periodic rotation of *sharia* scholars would lead to greater independence, bringing fresh approaches to the SSB and increasing objectivity through peer review; this would not compromise the quality of the review, as the continuing members would assure compliance and consistency with regard to *sharia* governance.

Proponents argue that, considering the shortage of well qualified *sharia* scholars, the SSB members should consider erecting ethical barriers to promote separate design and compliance activities, by nominating one of the SSB members to be the exclusive lead on review. As there is a minimum of three members on an SSB, appointing one as the review lead, perhaps on a rotating basis, should not be a problem. For example, at an SSB meeting where the client desires to discuss details of product development and design, the lead audit member can withdraw.

Opponents of this measure argue that a long-term relationship might impair the scholar's objectivity and undermine incentives for building up a reputation of honesty. Instead, they contend, allowing competition in the scholar market may be a better safeguard of their independence. An independent study of the practice of rotation of conventional auditors, by Bocconi University, concluded that the rotation compromises the quality of the review, which depends heavily on a good knowledge of the business and its management.[499]

Nonetheless, the IFI should provide the necessary training for the rotating member, to enable him to fulfil his role as lead reviewer. For example, the Certified *Sharia* Adviser and Auditor qualification of the AAOIFI programme would be a good start. However, such relatively short courses or certificates do not constitute sufficient training for performing a major task such as *sharia* review. The presumption is that the lead reviewer, being a member of the SSB, already possesses the knowledge and qualifications in *sharia* matters, unlike the members of an independent review unit.

In this context, Rahman (2008) emphasises that a specialised audit programme is required to cater for the *sharia* audit. *Sharia* scholars should therefore be equipped with two types of basic knowledge, i.e. the specialised *sharia* scholar knowledge as applied in Islamic banking, and accounting and auditing skills. However, the lack of well qualified auditors and/or accountants who possess the required *sharia* knowledge and training negatively affects this approach.[500]

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[499] Grais and Pellegrini, "Corporate Governance in Institutions Offering Islamic Financial Services: Issues and Options," P: 16.

[500] Abdul Rahim Abdul Rahman, "*Shari'ah* Audit for Islamic Financial Services: The Needs and Challenges" (*ISRA Islamic finance seminar*, 2008), P: 5 & 12, http://kantakji.com/fiqh/Files/Accountancy/0308923101.pdf.

7.2 THE EMERGENCE OF EXTERNAL SHARIA CONSULTANCIES

The role undertaken by the SSB and review unit is completed by the audit unit. Again, this unit answers not to the SSB but to management, namely the audit committee, and reports back to it. It is different from the review unit because its role is confined to auditing the *sharia*-compliance of the financial transactions, including the products approved by the SSB and reviewed by the review unit. It is intended to offer an independent assessment of the IFI's *sharia*-compliance to the management.

As discussed in the previous chapter, only Malaysia and Oman requires the existence of *sharia* audit function alongside the review function and Oman in particular demands the establishment of ISAU for to undertake the audit. This is a unique and crucial step forward in terms of *sharia* assurance of IFB. In practice, besides the SSB, this unit's work is valuable to the external auditors who may be involved in the process.

Recent literature and practice seem to be focusing more on external arrangements to ensure *sharia*-compliance and supervision. As the qualifications of the external auditors are generally set out in legislation in each jurisdiction, there have been suggestions that the traditional professional accountants and auditors need to be well versed in *sharia* in order to perform the task of external *sharia* auditing .[501] For instance, Chapra and Habib (2002) argue that chartered audit firms should acquire the necessary knowledge and personnel to undertake *sharia* audit.[502]

Perhaps it was the evolution of this idea that produced the argument for establishing *sharia* Consulting Firms, in the belief that there would be an eventual

[501] Kasim, Ibrahim, and Sulaiman, "*Shari'ah* Auditing in Islamic Financial Institutions: Exploring the Gap between the "Desired' and the 'Actual.'"

[502] Chapra and Ahmed, "Corporate Governance in Islamic Financial Institutions," P: 35 & 45.

phasing out of individual scholars sitting on the SSB in favour of a consultancy composed of full-time *sharia* scholars ready to meet their clients' needs at any time.

However, the *sharia* consultancy has only recently emerged, particularly in the GCC region, in an attempt to overcome the shortage of qualified *sharia* scholars. These firms offer the same services on a timely basis at less cost. The first appearance of a *sharia* consultancy was in Kuwait in 2003, and they have since been approved by the central banks in Kuwait, Qatar, Bahrain and the UAE, and the Ministry of Commerce in Saudi Arabia.[503]

The case of Malaysia and Oman is unique, because of the requirement imposed on *sharia* scholars, particularly SSB members, to be Muslim individuals. Obviously, this limits the use of the services offered by consultancies in these two countries or any other country that wishes to follow their model.

Nonetheless, the imposed requirement seems to be confined to the use of *sharia* scholars as internal tools of *sharia* governance, such as being members of the SSB and/or review unit. This suggests that the use of scholars from consultancies in their capacity of external auditors remains a valid choice. This assumption is further supported by the fact that few IFI in Malaysia have chosen to use the services of consultancies.[504]

Basically, the *sharia* consultancies are expected to offer all the services the SSB would provide, including, issuing *fatawa*, improving products, supervising the process of conversion of a conventional financial institution into an IFI, and conducting both the internal and external *sharia* audits. However, it should be

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[503] Garas, "The Role of the *Shari'a* Supervisory Board in the Governance of Islamic Financial Institutions in the Gulf Cooperation Council Countries," P: 73–77.

[504] Zurina Shafii, Supiah Salleh, and Syahidawati Hj Shahwan, "Management of *Shariah* Non-Compliance Audit Risk in the Islamic Financial Institutions via the Development of *Shariah* Compliance Audit Framework and *Shariah* Audit Programme," *Kyoto Bulletin of Islamic Area Studies* 3, no. 2 (March 2010): P: 6.

noted that the consultancy maintains a distance from the ex-post compliance services, despite occasional involvement in the ex-ante compliance services, especially for institutions not under the supervision of a central bank. In certain instances, the consultancy will forego audit engagements in order to provide non-audit advisory services. This has a twofold advantage: firstly, there will be less restriction on the number and nature of services that the audit firm can provide (e.g. tax, transaction advice, restructuring, operational improvements, etc.); and secondly, the fees generated from non-audit services are likely to be significantly higher.[505]

Garas (2010) emphasises that the consultancies are still immature in the services they provide, illustrating the following concerns. Firstly, there is no standard law to guide their relations with clients. Secondly, there is no standard framework for the *sharia* auditing process. Thirdly, some of the consultancies issue *fatawa* without complementary auditing to ensure the correct implementation; this might lead management to improper actions during the implementation. In addition, some consultancies use inappropriate advertising to deliver their message, while others are involved in activities that have no relation to *sharia* supervision, such as underwriting initial public offerings for IFI.[506]

A further point worth consideration is the fact that such consultancies do not exist in Sudan, Iran or Pakistan, where allegedly the economy, and therefore the financial system, is fully Islamised. Claiming to have fully Islamised financial systems does not eliminate the practical need for a *sharia* governance system, so the absence of supportive institutions such as consultancies is significant.

Nonetheless, the supervision and auditing services provided by external auditors such as consultancies could be of some use to IFI. For instance, they could be

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[505] *Enhancing Shari'ah Assurance*, P: 12.

[506] Garas, "The Role of the *Shari'a* Supervisory Board in the Governance of Islamic Financial Institutions in the Gulf Cooperation Council Countries," P: 73–77.

appointed to execute a limited-scope *sharia* audit. This would include selected *sharia*-compliance work, and reporting their findings directly to either the SSB or the internal auditor of the IFI, and perhaps the central bank or any National *Sharia* Authority. Limited-scope audit findings would provide higher assurance to an SSB, given that it had been performed by an independent external auditor with the specific required skills and experience. The limits of the scope could be agreed by the SSB to cover selected sensitive balances and gain additional assurance where the SSB and the IFI management feel they could place only limited reliance on the work of the review unit.[507] In this sense, the consultancy is not a substitute for the SSB but complements its work by performing the specific tasks assigned to it.

Although such a role for consultancies might be desirable, there is currently a lack of the necessary infrastructure; nor is one likely to be established in the near future. Moreover, if a framework were developed, would the use of consultants' services be preferable and appealing to IFI and financial regulators? As already discussed, Malaysia and Oman are jurisdictions where the use and functioning of *sharia* consultancies is limited by the requirements imposed on the membership of *sharia* scholars.

Conflicts of interest may arise if the same group of *sharia* scholars is appointed by different IFI to perform different *sharia*-related tasks, especially in countries where there is no restriction on the membership of *sharia* scholars: conflicts not only in the case of performing the same task for several IFI at the same time, but also, if the tasks are different, such as auditing one institution and serving as a member of the SSB in another. Since the number of *sharia* scholars in the consultancies, itself encouraging the establishment of the service, then the use of the same scholars would be inevitable. Such concerns might be more common if the multiple appointments of scholars were permitted in and between the

[507] *Enhancing Shari'ah Assurance*, P: 16–17.

consultancies, with no restrictions on membership of the SSB and consultancies. Therefore, the implementation of professional standards is essential for these *sharia* services, as is a standards framework for *sharia* audit.

It remains uncertain whether the use of external auditors would bring tangible guarantees of *sharia*-compliance. Scholars like Rahman (2008) consider internal auditors to be more efficient because they are generally more familiar with the record systems, policies and procedures of the institution and can provide quick responses to managers, resulting in more detailed and exhaustive *sharia*-compliance.[508]

However, it is generally believed that the use of complementary internal audit units and external auditors under a comprehensive audit programme is an emerging need if an acceptable level of *sharia* assurance in regard of IFB is to be reached.

7.3 GLOBAL PROFESSIONAL BODY FOR SHARIA SCHOLARS

The creation of a global *sharia* authority is a first step if the comprehensive and reliable *sharia* review and audit framework proposed above is to come into existence.

Despite its apparent advantages, however, the creation of a global *sharia* authority is likely to meet with resistance from some scholars, especially Islamic jurists who regard the Islamic *fiqh* as a pluralist body of knowledge.[509] These opponents argue that divergence in Islam is considered as a mercy and this is what explains the existence of different *madahib*; diversity is the essence of Islam and an advantage regarding Islamic rulings. The *ijtihad* should not be

[508] Rahman, "*Shari'ah* Audit for Islamic Financial Services: The Needs and Challenges," P: 5–6.

[509] Grais and Pellegrini, "Corporate Governance in Institutions Offering Islamic Financial Services: Issues and Options," P: 23.

confined to a number of *sharia* scholars, no matter how profound their knowledge, a strong argument against the establishment or appointment of a global regulatory body for *sharia* scholars.

It can be argued that scholars who are against restricting the multiple appointment of *sharia* scholars can be added to the opponents of this proposed movement, as well as those who support the idea of creating an open labour market for *sharia* scholars. This is because the establishment of a global authority implies a threat to the alleged benefits of multiple appointments for *sharia* scholars, and to the creation of the labour market they are supporting.

Proponents of a global authority, such as Rahman (2012), express the view that the lack of a standardised framework and clear ethical guidelines within which scholars can work has resulted in confusion. This has led to severe problems for the industry in terms of both operation and reputation.[510] On the other hand, Wilson (2009) states that although arguments regarding this lack of standardisation have caused confusion and uncertainty, they have resulted in healthy discussion which in many respects has been helpful for Islamic financial development in, for example, the GCC where there is no comparable framework for *sharia* governance and supervision.[511] Accordingly, others who may not oppose the establishment of a global *sharia* authority, hold the view that the centralisation of *sharia*-compliance may undermine product innovation and financial engineering. However, this would obviously depend on the degree of power transferred to such an organisation. For instance, the State Bank of Pakistan has issued the 'Essentials of Islamic Modes of Financing' to ensure

[510] "The Great Debate: Seeking a Standardized Framework for Scholars," *Islamic Finance News*, November 13, 2012, Volume 9 Issue 45 edition, P: 1, www.islamicfinancenews.com.

[511] Wilson, "The Development of Islamic Finance in the GCC," P: 8–9.

compliance with minimum *sharia* standards, which is purported not to present an obstacle to innovation but to contribute to harmonising permissible contracts.[512]

Although organisations such as the AAOIFI, IFSB and BNM have developed numerous guidelines on *sharia* governance, these are inconsistent. According to Abdul (2012), this is a result of the adoption of a principles-based approach, whereby guidelines to operational rules and procedures are absent. He emphasises that the need now is for a more rigorous, mandatory scheme supported and enforced by supervisory authorities rather than just encouraged by IFB bodies. However, the problem is how to develop a scheme that suits everyone; and how to ensure its enforcement.[513]

Ismail and Mikail (2013) state that there is still a perception that the *sharia* experts generally have not undergone any of the robust and transparent tests on their credibility and integrity that are normally undertaken by other financial professionals such as lawyers, accountants and bankers, who are regulated by their respective professional bodies, and therefore bound by specific professional ethics. However, they stress that this is certainly not the fault of the *sharia* experts, as they have no legal or professional requirements , because to be a professional requires a standardised framework from the relevant regulatory authorities. Hence, steps need to be taken to gain more credibility for *sharia* experts and confirm their high integrity through a set of common and transparent minimum best practices, which *sharia* experts would observe throughout the *sharia* governance process; for example, in the issue of *sharia* pronouncements, as well as in conducting *sharia* audits.[514]

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[512] Grais and Pellegrini, "Corporate Governance in Institutions Offering Islamic Financial Services: Issues and Options," P: 23.

[513] "The Great Debate: Seeking a Standardized Framework for Scholars," P: 4.

[514] Abdussalam Ismail and Abdussalam Mikail, "*Shari'ah* Governance System: A Need for Professional Approach," in *Sharia Economics Conference* (Hannover, Germany, 2013), P: 72, http://jistecs.org/content/shari%E2%80%99ah-governance-system-need-professional-approach.

The lack of a professional services authority for *sharia* scholars is an obvious gap in the IFB sector today. Therefore, calls are becoming louder for the establishment of an international *sharia* governance framework that could enhance competitiveness and the growth of the industry. In this context, Haniffa (2007) states that there is little doubt that the auditing of IFI will have to change to meet these challenges, and that a new *sharia* auditing professional body might soon emerge.[515] Grais and Pellegrini (2006) propose the creation of a new self-regulating non-profit association of *fiqh-almuamalat* experts.[516] Others call for the establishment of a professional body to which *sharia* scholars can annually self-certify their continuous professional development goals as having been met. Individual scholars would therefore maintain a record of their personal learning plan and development roadmap. It is argued that such a programme would assist scholars in keeping up to date with new product features and contemporary issues. Governing bodies should consider setting aside a minimum number of hours annually for professional development, and the IFI should issue a declaration that their SSB members have met the necessary requirements.[517]

Perhaps the steps towards this goal have been already initiated. In August 2012, the fledgling Association of *Sharia* Advisers in Islamic Finance announced a plan to offer a test and a voluntary code of ethics for scholars, along with a points-based system of accreditation. However, this organisation faces barriers in terms of its inexperience and credibility, as well as the standard issues of operational complexity, cross-border conflict, global participation and enforcement challenges. A more senior and authoritative body may therefore be needed if any

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[515] Roszaini Haniffa, "Auditing Islamic Financial Institutions," *Qfinance* 2007, P: 4, http://www.financepractitioner.com/contentFiles/QF02/glus0fcl/1p/0/auditing-islamic-financial-institutions.pdf.

[516] Grais and Pellegrini, "Corporate Governance and Shariah Compliance in Institutions Offering Islamic Financial Services," *World*, 2006, P: 23.

[517] *Enhancing Shari'ah Assurance*, P: 21.

proposal along these lines is to be a success, rather than simply adding another layer of confusion to an already opaque and overcrowded issue.[518]

In October 2012, the Malaysian based International *Sharia* Research Academy, in partnership with the Saudi Arabian Islamic Research and Training Institute, announced its intention to renew efforts to create a standardised global accreditation system. This proposal, which seems more promising, is to develop a code of conduct for the *sharia* scholar that is ratified by the regulatory authorities of the relevant countries in order to support the *sharia* governance framework that already exists. As it is based on existing structures, it should offer a clearer and more organised approach. Eventually, the goal is to develop a globally accepted governing organisation which issues licences to qualified scholars who comply with its code of conduct.[519] Nonetheless, the challenge is how to implement and enforce it. Since, both these bodies are only research institutes without any enforcement authority, the support of the central banks is essential.

Wilson (2003) states that, in the absence of any formalised system of accreditation or even a professional association of *sharia* scholars, the regulators have to accept the assurance of the Islamic financial service provider that its *sharia* scholars are competent to fulfil their duties.[520] It has been established that, ultimately, the reputation of the IFI and Islamic banks for *sharia*-compliance is dependent on the reputation and integrity of the scholars involved in the governance and supervision of *sharia*-compliance. Therefore, the pro-active role of regulators to the employment of only well-qualified *sharia* scholars is needed to allow the development of the IFB sector.

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[518] "The Great Debate: Seeking a Standardized Framework for Scholars," P: 3–4.

[519] Ibid., P: 3–4.

[520] Wilson, "Regulatory Challenges Posed by Islamic Capital Market Products and Services," P: 13.

7.4 ESTABLISHMENT OF AN INTERNATIONAL SHARIA RATING SYSTEM

As a concept, the rating of the compliance of IFI with *sharia* appears relevant in the context of the external *sharia* auditing measures. It is suggested that an external body could provide a *sharia*-compliance rating service, whereby institutions are given a rating which reflects the degree of their compliance with *sharia* principles.

Chapra and Khan (2000) explain the external rating of businesses and banks as an important aspect for Islamic banking, emphasising the need for an Islamic rating agency. The unique products and procedures of Islamic-banks require a specialised rating process. Therefore, the process should include specialised models and rating systems designed in accordance with the Islamic banks' work and their associated risks.[521]

Grais and Pellegrini (2006) count reputable *sharia* rating agencies amongst those agencies that would help to sustain the growth of IFB by channelling signals to market players and tnerefore enhancing public understanding of the requirements of *sharia*. This would be conducive to the development of market discipline and ensure consistency in interpretation.[522]

Zaidi (2008) agrees that a comprehensive rating approach should act as an additional medium of control that complements the regulator's supervision of Islamic products and institutions. This would reduce transaction costs in the market and help both the market and regulators.[523]

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[521] Chapra and Khan, "Regulation and Supervision of Islamic-banks," P: 67.

[522] Grais and Pellegrini, "Corporate Governance and Shariah Compliance in Institutions Offering Islamic Financial Services," P: 26.

[523] Zaidi, "*Shari'a* Harmonization, Regulation and Supervision," P: 8.

Therefore, it is argued that such a mission should be assigned to the sole rating agency now in existence, the Islamic International Rating Agency, which has already formulated a comprehensive system for rating IFI in terms of *sharia*-compliance. The *sharia* quality rating considers all general as well as specific issues that may arise within each institution. The value expressed in this rating is derived from the *sharia* scholars on the agency's own SSB, who decide the criteria for rating and collaborate with workers in issuing the final rating decision and rating report. This opinion is reviewed on a periodic basis for any changes in the *sharia*-compliance elements, which would be reflected in an adjusted rating grade. The insight provided by the rating encourages appropriate application of *sharia* principles, including the degree of cooperation with the SSB of the IFI. The rating is delivered to the IFI management with a detailed report exploring the mechanisms of their *sharia*-compliance.

Zaidi (2008) emphasises that, as an employee of the Islamic rating agency, he has witnessed many *sharia*-compliance failures, some of which are acutely embarrassing. For instance, some of the IFI have insufficient numbers of members on their SSB or review departments. There were also some incidents where these arbiters' requests to reform obvious mistakes went unheeded, and without the SSB being able to resolve the issues. Review departments commonly lack a reporting line to the audit committee, despite this being required by the AAOIFI's governance standards.[524]

On the other hand, Rethel (2011) states that the international rating agency lacks the decades of reputation that other conventional rating agencies have been able to build. Furthermore, Islamic and financial legitimacy were established in separate rating processes. Most importantly, however, the agency's *sharia*-quality ratings focus on procedural elements such as the composition of the SSB, its position within the financial institution and more general aspects of *sharia*-

[524] Ibid., P: 7.

compliance. The score on the *sharia*-quality rating scale is dependent on the degree of compliance with the *sharia* requirements and not on the quality of the outcome (in terms of greater social justice and fairness).[525]

It has been argued that IFI need to find ways to be accepted by the internationally recognised financial ratings agencies.[526] In fact, the two biggest agencies, Standard & Poor's Financial Services and Moody's Corporation, have only recently started to rate Islamic financial instruments and entities on their financial creditworthiness.

However, Rethel (2011) points out that the issue remains unchanged, as these agencies do not assess the *sharia*-compliance of a product. An earlier Standard & Poor's report (2006: p. 35) explicitly states that, "Standard & Poor's does not form opinions on whether a financial instrument is in accordance with the *sharia* principles, but analyses creditworthiness in the context of a broad array of capabilities and incentives". The financial products assessed by the agencies are ranked according to their financial creditworthiness, thus making some products more investable (or cheaper for the issuer) than others.

In focusing solely on creditworthiness, in terms of debt repayment, rating agencies deny Islamic financial products their deserved position. From an Islamic point of view, the question is how important an investment must be to obtain credit from an ethically responsible investor. Using financial creditworthiness as an indicator of the quality of an investment is just a shortcut, which essentially does not work for Islamic finance, as the rating legitimises Islamic products as investable financial products. However, what they do not do is create ethical legitimacy. It is solely the financial creditworthiness that is rated, not the economic, social and Islamic-worthiness of the project.

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[525] Rethel, "Whose Legitimacy? Islamic Finance and the Global Financial Order," P: 92.

[526] Garas, "Internationalization of Islamic Financial Institutions: Challenges and Paths to Solution," P: 16.

However, the power of the rating agencies should not be underestimated. The ongoing contest between financial and religious norms sometimes results in a trade-off between the increasing institutionalisation of Islamic finance and its ethical character. This was evident in the disagreement among Islamic scholars as to the extent to which *sukuk* issues should be structured in such a way as to be rateable by the international agencies, and how this affects their *sharia*-compliance.[527]

7.5 THE EMERGING TREND OF CENTRALISATION

A framework of co-existing internal and external *sharia* governance and supervision may not resolve all the difficulties and issues previously outlined. In fact, many aspects need standardisation; centralisation of practices arguably raises the overall efficiency of *sharia* governance and supervision.

7.5.1 PREVIOUS ATTEMPTS

The idea of having a Central *Sharia* Authority is not new, dating from the 1970s when several regional and international *Sharia* Supervisory Committees were formed to supervise the institutional SSB. Since the inception of Islamic banks, attempts have been made to unify Islamic banking practices. For instance, the International Islamic *Fiqh* Academy in Jeddah was established with the intention of unifying *fatawa* and issuing opinions from a multitude of scholars rather than individual experts. However, there is no standardisation in practice amongst the institutional SSB in the Organisation of Islamic Cooperation member countries, so if one SSB approves transactions in one country, it does not follow that it can secure the approval of other SSB within the other member countries.

[527] Rethel, "Whose Legitimacy? Islamic Finance and the Global Financial Order," P: 91.

The first attempt to establish a regional or international *sharia* supervisory committee was made by the International Association of Islamic Banks, which is known today as the General Council for Islamic Banks and Financial Institutions. The *sharia* supervisory committee of this organisation was founded in 1977-78 to monitor the institutional SSB in member countries. The Association used to have a local office in Sudan presided over by Professor Mohamed Hashim, an economics academic at Khartoum University. The initial idea was to group the representatives of the institutional SSB at the Cooperative Development Bank headquarters, in order to introduce current issues. The Association established the first High SSB in 1983 under the patronage of the Dubai Islamic Bank and held a number of meetings under the supervision of the Union Secretariat General. However, this very first attempt was not successful due to the short life of the International Association of Islamic Banks itself.[528]

The second regional, or perhaps international, supervisory committee was established by the AAOIFI in 1991, to:

- Prepare and adopt *sharia* standards for the modes of investment financing, insurance, and Islamic financial services.
- Create innovative *sharia* devices that would enable the IFI to keep up to date with the innovations taking place in the global financial and capital market.
- To consider matters submitted by the IFI or their *sharia* boards for *sharia* opinion or arbitration on a particular issue.

The AAOIFI's group of religious scholars sitting on this committee were authorised to issue Islamic legal opinions or decisions on Islamic financial products, and to supervise the institutional SSB of AAOIFI members on a voluntary basis. That is, the committee was established with the clear mandate of issuing *sharia* and governance standards to guide the IFI.

[528] Ray, *Arab Islamic Banking and the Renewal of Islamic Law*, P: 7.

Others regional or international *Sharia* Supervisory Committees followed, for example, those of the International Islamic Financial Market in 2001, and the International Islamic Rating Agency in 2005, to provide an optional service to any institutional SSB in the IFI in any jurisdiction of measuring governance and credit rating. The Islamic Development Bank and LMC have their own *Sharia* Supervisory Committees, however, and the refers its draft proposals to the Organisation of Islamic Cooperation's and International Islamic *Fiqh* Academy.

All of these *Sharia* Supervisory Committees were established to fulfil objectives set out by their originating organisations. As part of these larger bodies, it is hoped that they will play a regional or international role and help the development of the IFB industry within their area of expertise.

Although their contribution is undeniable, they are not considered as the ultimate *sharia* authority at either regional or international levels. Nonetheless, they are highly respected and certainly their opinions are considered by *sharia* scholars, Islamic finance practitioners and policymakers, especially the supervisory committee of the AAOIFI, which is the active standard setter for the IFI.

However, it is necessary to emphasise that there are a number of aspects of *sharia* application not covered in the AAOIFI standards, such as the development of products and services, failing to address the issue of the diversity of *sharia* opinions which limits the global expansion of applicable *sharia* standards. Although most of the IFI comply with these standards, this compliance remains voluntary, and there is no enforceable power in the majority of countries.

A prominent scholar has indicated the need for a universal Supreme *Sharia* Board that bears the responsibility of supervising the activities and *fatawa* of the rest of the institutional and regional SSB. In one of its publications, the AAOIFI makes a similar suggestion stating that this would facilitate the harmonisation of

the *fatawa* from different SSB, lessen the variety of differences, and assist in the application of the *fatawa*.[529]

7.5.2 RECENT SUGGESTIONS

In acknowledgment of the attempts made to establish regional or international *sharia* boards, the desire of the UAE to set up a regional United or Higher *Sharia* Authority for the IFB of the GCC is most relevant. Whilst a united body might be thought to propose the elimination of institutional SSB, a higher body implies a possible limitation or restriction of the multiple appointment of *sharia* scholars.

Therefore, a Final *Sharia* Authority might be preferable to serve the overall GCC, without imposing any restrictions on *sharia* scholars' membership. Its functions would be complementary to the work already done by the AAOIFI. Obviously, this project would require the cooperation of the GCC, to circumvent any additional difficulties and barriers resulting from individual sovereignty with different legal and financial systems.

It is also important to note the limited confidence in governments and the absence of appropriate regulatory authorities. Critics might regard a government's active role in respect of *sharia* governance and supervision as politicising the practice, especially if the appointed *fiqh-almuamalat* experts were seen as being closely connected with the government. Wilson (2009) indicates that there is such an issue in the GCC and concludes that it is debatable whether greater involvement of their governments in *sharia* Governance would actually provide greater assurance to bank clients.[530]

Nonetheless, the establishment of a *sharia* authority at the GCC level needs reconsideration, in view of the latest developments by the central banks of the

[529] Zaidi, "*Shari'a* Harmonization, Regulation and Supervision," P: 5.

[530] Wilson, "The Development of Islamic Finance in the GCC," P: 8–9.

GCC. As explained in the previous chapter, steps have been taken to establish central *sharia* boards at the central bank level. The central banks of in Oman, Bahrain and the UAE already support such a movement. Therefore, it remains to be seen whether the establishment of such a central *sharia* board would affect negatively the existence of a united or supreme *sharia* authority for the Gulf region, or whether it would encourage such a step to be taken in the near future.

Nonetheless, a united framework of *sharia* governance at the national level would greatly help in bringing Muslim-countries closer to establishing a United *Sharia* Supervisory Authority at the regional level. Should this occur, then this would lead to steps for the formation of an International SSB. At the present time, arrangements at the national level would constitute a more appropriate and adequate solution, offering a feasible and practical approach.

Alongside this is the interesting proposition made by Rachagan (2005), who called for the implementation of a new and superior *sharia* governance and supervisory framework headed by a body referred to in Malaysia as the National *Sharia* Advisory Council . This would require the merging of all the existing institutional SSB and dispensing with the requirement for every Islamic bank licensed under the IBA of 1983 to have its own SSB. She further states that the composition of the national council should be broadened to include, in addition to Islamic scholars and jurists, bankers, lawyers and academics so that the advice of the council could incorporate the requirements of the banking community and of the law in everyday practice and also take into account current trends and thoughts. This would be necessary in order to make the rulings of the council both contemporary and relevant. It would also help integrate Islamic banking law into the existing legal system.[531]

This proposal was made in 2005, whereas the Central Bank of Malaysia Act No (701) was issued in 2009 and the Islamic Financial Services Act No (759) in

[531] Rachagan, "Islamic Banking in Malaysia," at 94.

2013. According to both acts, the SAC is considered the sole authority on *sharia* matters pertaining to IFB, although the establishment of institutional SSB remains a requirement under these laws.

With regard to creating a unique reference body for the IFB industry at large, reference should be made to the recent proposal by Mohamed Youssef (2012),

which recommends the establishment of an independent International SSB to serve the IFB industry worldwide; such a creation would be affiliated to a reputable international organisation such as the Organisation of Islamic Cooperation, in order to gain recognition.[532] Obviously, the preference for this organisation is derived from the fact that it is an inter-governmental body which represents 57 member states, with the purpose of utilising their combined efforts to safeguard the interests of the *ummah.* In this way the IFB industry would gain greater authenticity and credibility.

The *sharia* representative of all the Organisation of Islamic Cooperation member countries should be eligible to sit on this international SSB, in addition to being members of their respective institutional and national SSB. Youssef (2012) suggests the following internal organisational structure for the international SSB:[533]

- A board of trustees
- Members of the international SSB
- Executive committee
- Sub-committees
- Experts
- Secretariat-general

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[532] Mohamed Youssef, "*Shariah* Supervisory Boards: Existing Models and Suggested Comprehensive Alternative" (M.B.A Degree, School of Business, Open University Malaysia, 2012), P: 53–54.

[533] Ibid., P: 45–46.

In line with the its pronouncements, that the central SSB of each country shall be entitled to issue their own rulings and resolutions that are enforceable and binding to the institutional SSB and the central bank. The central SSB shall meet annually under the umbrella of the international SSB to ensure homogeneity in the latter, thereby ensuring conformity to the international standards issued by reputable bodies such as the AAOIFI, in terms of *sharia* and accounting standards and the IFSB in terms of *sharia* governance standards.

In the event of a *fatwa* being issued by a central SSB, no institutional SSB will be entitled to issue a contradictory *fatwa*, and periodically a manual of *fatawa* and rulings shall be issued by the central SSB. The international SSB is to be fully independent of the central SSB and central banks, and should have legal authority to take corrective measures in the event of any *sharia* offence, through a series of enforceable procedures adopted and stipulated by the central bank through its affiliation with the central SSB.[534]

7.6 Conclusion

After addressing common concerns resulting from the dependence on the internal *sharia* governance system, this chapter discussed the efficacy of a number of practical solutions at institutional, national and international levels. These represent internal and external measures for *sharia* governance system and supervision frameworks, namely segregation of roles, the emergence of *sharia* consultancies, a global professional body for *sharia* scholars, the establishment of an international *sharia* rating system, and the emerging trend of centralisation.

At the institutional level, separation of scholars who are mainly involved in the design and development of products from those who supervise the function of

[534] Ibid., P: 49–50.

sharia review was recommended. This actually enhances the independence of the scholars, and avoids risks such as self-review or conflicts of interests.

In addition, it was proposed that periodic rotation of *sharia* scholars in performing both tasks should lead to greater independence and enable peer-review. Since the SSB consists of at least three members, one could be appointed as lead of review on a rotating basis, withdrawing from meetings of the SSB concerning product design and development.

At the national level, the establishment of *sharia* consultancy firms is regarded as helpful in overcoming the issue of shortage of *sharia* scholars and ensuring the independence of *sharia* review/audit functions. However, it is noticed that current chartered auditing firms are not necessarily qualified in *sharia* auditing. In fact, when auditing an IFI, the external auditors do not perform a full *sharia*-compliance check, but merely make sure that the relevant accounting standards and control systems are applied.

The existence of such firms was first evident in 2003 in Kuwait, followed by Saudi Arabia, the UAE and Bahrain. However, to date they offer limited services, and the current tendency of GCC to centralise *sharia* governance could further limit their role or questions their need. In fact, Oman and Malaysia, do not encourage their use as they require that members of SSB be Muslim individuals.

At the international level, support for and against a global professional body for *sharia* scholars was illustrated, and previous and more recent proposals outlined. Forming such a body is not a new idea. Despite its need, establishing such a body remains challenging because of national and international obstacles confronting the IFB. Also, none of the existing regional or international Islamic bodies is considered able to fulfil this role for different reasons.

In terms of an international *sharia* rating system, the existence of the Islamic International Rating Agency was noted. Although the concept of rating IFB products as well as IFI for quality *sharia*-compliance is appealing and useful, the

sole rating agency faces obstacles in terms of experience and reputation. it is evident that the agency's *sharia* quality focus is on more general procedural aspects, such as the number of SSB members, rather than the quality of its outcome. On the other hand, the experienced chartered rating agencies that tried to provide *sharia* rating services, actually rate the creditworthiness instead of the *sharia*-compliance of Islamic financial products.

In terms of the emerging trend for centralisation in IFB, previous and more recent proposals to establish a central reference for *sharia* matters pertaining to IFB were underlined. It was argued that none of the *sharia* boards of established regional or international organisations serves or is accepted as a central *sharia* authority regarding IFB.

The establishment of stronger *sharia* governance and supervision requires the joint effort and integrated work of all the stakeholders, and the direct involvement of the financial regulator to develop a strong framework to ensure that institutional SSB play their role effectively. The existence of a central *sharia* board at the national level adds a further dimension to *sharia* governance and supervision. Countries with few scholars would benefit more from having a central *sharia* board because of their dearth of qualified *sharia* scholars. This would assist in expediting the approval and introduction of new financial instruments into the IFB and give all the IFI nationwide access to the services of the most eminent *sharia* scholars.

It is believed that standardised and centralised *sharia* governance and supervision will help to increase public confidence countrywide, as it would help in overcoming most of the practical concerns that are raised. In turn, there is an obvious trend to centralised *sharia* governance and supervision at the national level. Malaysia is considered the leading model in central *sharia* governance and supervision. Also, in October 2014 Oman established a national *sharia* authority at the CBO, indicating a model that is close to the Malaysian one. In December

2014 the governor of the CBB announced a plan to set up a central *sharia* board, as did the central bank of UAE more recently in March 2015.

However, it remains to be seen which model of future central *sharia* boards has the better structure and conveys acceptable *sharia* assurance at the national level. Also, it would be interesting to see what authority these central *sharia* boards command over the central banks.

Having a central *sharia* board with extended *sharia* authority could, at a later stage, make the institutional SSB obsolete. The IFI could refer *sharia* matters directly to the central *sharia* board, with an internal *sharia* officer acting as *sharia* reviewer/auditor to ensure the implementation of its requirements.

Following the above recommendations for the internal and external measures discussed throughout the thesis would lead to a stronger and more comprehensive *sharia* assurance of IFB at the national level.

CHAPTER EIGHT: CONCLUDING SUMMARY

8.0 CONCLUDING SUMMARY

This research illustrated a library-based study of the current *sharia* governance system as implemented at the institutional level, and the *sharia* supervision frameworks adopted by financial regulators in selected Muslim countries.

It aimed to explain the need for *sharia* governance in the IFB of modern Muslim countries and to evaluate the efficiency of the current institutional *sharia* governance system. In addition, it analysed and compared the ability of the *sharia* supervision frameworks of selected countries, where Islamic and conventional financial institutions coexist, to minimise the governance concerns raised at the institutional level.

After addressing the main issues and concerns, the study provided recommendations for a stronger *sharia* governance system at the institutional level, and a more comprehensive *sharia* supervision framework at the national level. It suggested the use of internal and external measures where appropriate, and promotes the centralisation of *sharia* governance and supervision. In fact, the research showed that this is the current trend in the selected Muslim countries, as centralisation is thought to bring consistency to the practices of IFB and enhance the level of *sharia* governance by minimising or overcoming the main outlined concerns.

To present the subject matter of this study more concisely, the thesis aimed to answer the following research questions:

- Does the current *sharia* governance system at the institutional level, backed by the different *sharia* supervisory frameworks at the national level, offer sufficient *sharia* assurance for the Islamic banking sector in the selected Muslim countries?

- What concerns and challenges do the current institutional *sharia* governance system and national supervision frameworks raise?

- How such concerns could be minimised?

To answer these research questions, the study was divided into eight chapters. The first chapter served as an important introduction to the research and the last chapter as a concluding summary of the study. Chapters two to seven formed the main body of this thesis, and each chapter addressed a certain area related to the subject matter of the research to help in answering the above questions.

In conclusion, the thesis found that the current *sharia* governance system at the institutional level, being reliant on the internal tools, does not in fact convey a high level of *sharia* assurance in the IFB of selected Muslim countries, nor do the different *sharia* supervisory frameworks adopted at the national level offer sufficient or comprehensive *sharia* monitoring of the system. In fact, a number of concerns and issues are potentially raised from the current institutional *sharia* governance system and national supervision frameworks. In main, issues related to the shortage of *sharia* scholars, the scope of *sharia*-compliance supervision, the concept and use of external auditors, independence and conflicts of interest, the legal status of the SSB and its pronouncements, and the accountability of the SSB. Finally, the thesis underlined and discussed the efficacy of a number of practical solutions at institutional, national and international levels. These represent internal and external measures for *sharia* governance and supervision, namely segregation of roles, the emergence of *sharia* consultancies, a global professional body for *sharia* scholars, the establishment of an international *sharia* rating system, and the emerging trend of centralisation. In evaluation of the proposed solutions, the thesis notes and promotes the growing trend of centralisation of *sharia* governance and supervision at the national level, which is believed to help in resolving or at least minimizing the main concerns addressed in this thesis. However, it remains to be seen which emerging model of central *sharia* authority in the selected Muslim countries would prove to be more efficient in this regard.

This conclusion and answers of the above questions actually were embodied throughout the thesis in the chapters, which are summarised as follows. To understand the current legal standpoint of IFB, chapter two provided the necessary historical background. It identified that the conventional financial system remains dominant even in the recently emerged and reformed Islamic states, and highlighted the fact that IFB in the Islamic region was initiated without any special regulatory framework, since their legal, judicial, and financial systems were constructed on Western models.

With the emergence of strong Islamist movements In the late 19th and beginning of the 20th century, demands for political and economic reform were raised. Accordingly, individual attempts to establish Islamic banking were made in the 1940s-50s. However, the first successful initiatives were those of the Mit Ghamr Savings Bank in 1961-1964 and Tabung Haji in 1962. Nonetheless, these Islamic banks were supervised by the central banks in the same way as their conventional counterparts.

Although the application of conventional standards to Islamic banks actually encouraged the acceptance of their operations at the international level, this led to the appearance of organisational support needed to back up IFB. A number of bodies were founded in support of the unique requirements of the emerging IFB. In terms of the regulatory infrastructure, each has a specific role contributing to the development of an appropriate framework and working environment at local, regional or international level.

In the absence of a global *sharia* authority, these organisations play a role in defining and harmonising Islamic financial services. According to each organisation's nature and purpose, their influence over the IFI varies across nations.

As this study is centred on the regulatory perspective of *sharia* governance and supervision, attention was particularly paid to the role and efforts of the IFSB and

AAOIFI as standard-setting international bodies. The standards issued by the IFSB, although aiming to provide a favourable regulatory and supervisory environment for IFI, remain optional for central banks. The AAOIFI standards are more closely related to the governance standards of the SSB of IFI; they are mostly applied by IFI and recommended by financial regulators. Nonetheless, they are not binding unless the regulatory authorities have chosen to implement and impose them, or the IFI willingly accepts them.

Therefore, the standards issued by the IFSB and AAOIFI are useful in their capacity to form what is known as 'soft law'. All of the related standards issued by both organisations to date are listed in this chapter, with explanation only of the main ones referred to in this study, namely:

- IFSB-3 (December, 2006) on Guiding Principles on Corporate Governance for IFI.
- IFSB-10 (December, 2009) on Guiding Principles on *Sharia* Governance Systems for IFI.
- IFSB-16 (March, 2014) on Revised Guidance on Key Elements in the Supervisory Review Process of Islamic Financial Institutions.
- AAOIFI-1 Governance Standard for IFI on SSB: Appointment, Composition and Report.
- AAOIFI-2 Governance Standard for IFI on *Sharia* Review.
- AAOIFI-3 Governance Standard for IFI on Internal *Sharia* Review
- AAOIFI-5 Governance Standard for IFI on Independence of SSB

These standards are discussed throughout the thesis from chapter four onwards. Since AAOIFI was established earlier than IFSB and worked first on providing standards for IFI, special attention was paid to its standards directly concerned

with the *sharia* governance of IFI, particularly the SSB. The IFSB standards address central banks with regard to *sharia* governance, and in fact re-state the same requirements for *sharia* governance as AAOIFI's.

After explaining the historical background and the legal position of IFB through the establishment of the supportive regulatory environment provided by the relevant international organisations, chapter three provided further concise justification for the need for *sharia* governance in IFB by discussing the distinctive nature of IFB. It addressed the implementation of ancient Islamic financial principles in modern IFB and the modifications applied to the original structures of classical Islamic financial instruments to allow their use in modern IFB. Further, it highlighted some of the genuine differences between Islamic and conventional financial products, arguing for the relevance and importance of the existence and decision-making function of an SSB within the governance structure of an IFI.

In this respect, the chapter underlined a consistent set of Islamic moral and ethical standards that IFI need to adhere to in full and that should not be undermined in any way in fulfilling their Islamic identity. Nonetheless, it argued that detecting Islamic prohibitions such as *riba* and *gharar* are always challenging, as is the case for recognising fully or partly productive and *halal* transactions in today's interactive international markets. Also, the absence of a globally accepted *sharia* authority makes conclusions about the Islamic permissibility of modern financial products or transactions an even more difficult task for IFI.

In addition, the resemblance of the Islamic financial products to conventional ones has questioned the distinct nature and validity of IFB as an industry. In fact, Muslims remains sceptical about the IFB operations because the Islamic financial products do not look different from conventional products, and the industry is still functioning within the conventional banking framework.

Despite the existence of a number of controversial Islamic financial products that are currently used in IFB, it was nonetheless acknowledged that Islamic products occupy a different ground from conventional ones and need to be treated as such. Accordingly, it was argued that the design and use of innovative instruments requires more complex financing tasks and increases the need for *sharia*-compliant approval for the practices operated by Islamic banks. The use of modified and innovative versions of the traditional Islamic financial instruments demands special attention and in-depth interpretation of *sharia* as well as financial knowledge. In return, this supports the genuine argument that is brought forward for the need for *sharia* governance at the institutional level and therefore encourages the existence of an SSB within the governance structure of an IFI.

This need is further supported by the different judgements on English and Malaysian cases. It is significant that most of the reported cases were in relation to debt-like financing, and that the defence of *sharia* non-compliance was used by the defendants who basically defaulted on payment despite the fact that they entered the contract knowing or acknowledging that it was an Islamic one. Interestingly, in *Investment Dar Co KSSC v Blom Developments Bank Sal* for example the defendant argued for the non-compliance of the contract which had been approved by its own *sharia* board.

To mitigate the risk of *sharia* non-compliance, there is a need for sound institutional *sharia* governance supervised at the national level. The regulatory authorities should give due attention to the suitability and procedures of *sharia* governance, particularly the legal status of *fatawa*, dispute-resolving mechanisms, monitoring and supervisory tools for *sharia*-compliance.

On these lines, chapter four identified the need for *sharia* governance in modern Islamic states and the system that is applied at the institutional level. It addressed *sharia* governance as an additional layer of the corporate governance

of IFI, arguing for the wider concept of *sharia*-compliance in terms of the IFI and all its operations.

It was established that the authority for *sharia* matters is delegated to the respective SSB, and the ISRU is a key pillar in the current *sharia* corporate governance system. In fact, the SSB in the public perception confirms the legality of an IFI's practices from the *sharia* perspective. Therefore, the qualifications, professionalism and integrity of *sharia* scholars constitute the only guarantee of *sharia*-compliance of the IFI with *sharia* laws.

In discussing the current *sharia* governance system commonly implemented by IFI, this chapter mainly referred to the relevant standards of the IFSB and AAOIFI that were detailed in chapter two: the definition, appointment, position and functions of the SSB and ISRD in their capacity as internal tools of *sharia* governance.

Although, the SSB provides some degree of comfort in assuring compliance of the IFI with *sharia*, its role does not convey the high levels of *sharia*-compliance needed in practice. To evaluate the role and efficiency of the institutional *sharia* governance system, chapter five analysed and compared the national frameworks of *sharia* supervision in selected Muslim countries in an attempt to understand and underline the possible issues raised from the current institutional *sharia* governance system. For the benefit of this study, the countries studied were chosen from those considered as pioneers in the industry and where Islamic and conventional banks co-exist, namely the kingdom of Bahrain, the United Arab Emirates (Dubai), the State of Kuwait, the Sultanate of Oman and the Federation of Malaysia. The analysis and comparison was based on two main elements, the legal position of *sharia* in the country, and the existence of a higher *sharia* authority for the IFB.

In terms of the legal position of *sharia* and its influence, the thesis demonstrated the limited role and influence of *sharia* in IFB. It mainly explained the laws

allowing interest in commercial practices including finance and banking, and the positioning or order of *sharia* in these positive laws.

In Bahrain, *sharia* is a recognised source of law, which is only applied after other certain positive laws. In UAE, *sharia* is recognised as the prime source of law, and in Kuwait as the source of law. If fact, the CBK provides that Islamic banks should be subject to its laws without prejudice to *sharia* principles. In a more powerful position, Oman considers *sharia* as the basis of legislation. In Malaysia, however, *sharia* is not acknowledged as a source of law. In fact, the application and influence of *sharia* is confined in all these countries to family and personal matters.

In terms of the existence of a higher *sharia* authority regarding the IFB, it was established that the supervisory frameworks of financial regulators varies across the nations. In Bahrain and UAE (Dubai), the role of a higher *sharia* authority is not assigned to any entity. Although a national *sharia* board has been established by the CBB, its role is confined to serving the CBB as a bank; it has no regulatory or supervisory authority over the institutional SSB. In Kuwait, there is no national *sharia* board at the CBK, but disputes are referred to the *Fatwa* Board of the Ministry of *Awqaf* and Islamic Affairs. Nonetheless, the role of this *Fatwa* Board is argued to be theoretical, and the status of its rulings or *fatawa* is undetermined. Oman has the most recent experience in IFB and established a national *sharia* board at the CBO as recently as October 2014, so its role and authority remain unknown. Malaysia's SAC, established by the BNM in 1997, is a higher *sharia* authority. However, its role as a final *sharia* authority was confirmed only with the issuing of the Islamic Financial Services Act of 2013.

Nonetheless, the recent announcements by regulatory authorities in Bahrain and the UAE are in favour of the imminent adoption of a centralised framework of *sharia* governance and supervision. Until this is done, the current supervisory frameworks continue to permit financial institutions to develop their own

framework without undue interference from the regulatory authorities. There is freedom in deciding the *sharia* requirements and a lack of restrictions on the work of the *sharia* scholars.

In Bahrain, the CBB clearly promotes the AAOIFI governance standards. It requires the IFI to establish an independent SSB consisting of at least three members, in compliance with AAOIFI-1 and AAOIFI-2, as well as a *sharia* review function in compliance with AAOIFI-3. In addition, there is no restriction on membership of the SSB, no minimum or maximum term for membership, and no specific qualification or university degree is required for SSB membership. On the other hand, the head of *sharia* review must have certain university qualifications and experience.

Although not referring to AAOIFI standards, the IFR of DIFA requires the IFI to establish an SSB of at least three competent members, leaving it to the IFI to decide the appointment and dismissal mechanism. There is no restriction on the membership of the SSB, no minimum or maximum term for membership, and no specific qualification or university degree is required for SSB membership.

However, the IFR refers to AAOIFI-2 and AAOIFI-3 in terms of its *sharia* review function in compliance with AAOIFI-3; the annual report of the SSB should also be in compliance with AAOIFI-1.

In Kuwait, the CBK requires the IFI to establish an SSB consisting of three members of recognised efficiency and experience in the area of transactional jurisprudence, which will present an annual report to the general meeting. There is no reference to any AAOIFI standards, including *sharia* review. There is no restriction on the membership of the SSB, no minimum or maximum term for membership, and no specific qualification or university degree is required for SSB membership.

Oman and Malaysia similarly do not refer to AAOIFI standards, although they have a more controlled and comprehensive *sharia* governance system. Oman,

however, refers to IFSB-3 and IFSB-10, which reflect the same requirements as the AAOIFI. The definition of SSB and conditions of appointment are close to those of AAOIFI-1, requiring the IFI to have an SSB consisting of at least three members specialising in *figh-almuamalat.* It adds that, one or more non-voting members could be appointed to the SSB with relevant experience other than *figh-almuamalat.* Although they are appointed in the general meeting, their charter is approved by the BOD and they are to report to the BOD.

Unlike the other countries' central banks, the CBO determined that the duration of membership is three years with renewal on only one occasion; members can be non-Omani nationals, although Omani is preferred. In terms of qualifications, non-*sharia* scholar members are required to hold higher university qualifications and to have more experience than *sharia* scholars.

To avoid conflicts of interest, an SSB member cannot be a member of more than one competing institution, and may not hold more than four memberships overall. A further restriction is that an SSB member should be a Muslim individual, which excludes *sharia* firms from exercising the role performed by the SSB. In addition, the CBO provides a list of grounds for the dismissal of membership.

In terms of SSB functions, the BOD mentions a list of functions that are normally undertaken by the members. To fulfil its responsibility, the SSB shall make use of an internal *sharia* reviewer, who heads both the ISCU and ISAU. The work of these units is complemented by an annual external audit performed by a third party.

In Malaysia, the BOD of the IFI is required to appoint an SSB of not less than five members, and it may consider the appointment of at least one member of the BOD. In terms of qualification, members, whether being *sharia* scholars or non-*sharia* scholars, are required to have a university degree. Also, there is no specific requirement for experience.

Like Oman, the restriction on membership of the SSB to Muslim individuals excludes the use of *sharia* firms. In addition, no member shall be an employee of the IFI in the current or previous year. A similar list of grounds for dismissal is provided, as well as a list of functions that includes *sharia* review and *sharia* audit. In addition, the BNM states the relationship between SSB and the SAC in its capacity as a higher *sharia* authority, which is lacking in the Omani version.

The obvious reliance on the internal tools of *sharia* governance at the institutional level results in some common practical concerns and issues, which are further addressed in chapter six. This chapter discussed issues related to the shortage of *sharia* scholars, the scope of *sharia*-compliance supervision, the concept and use of external auditors, independence and conflicts of interest, the legal status of the SSB and its pronouncements, and the accountability of the SSB.

It was demonstrated that, the existence of these concerns varies across nations, depending on the regulatory and supervisory frameworks they have adopted, as detailed in chapter five.

The shortage of *sharia* scholars is an issue that affects all Muslim countries. It was made clear, however, that the there is no shortage of *sharia* scholars as such, but of well qualified and experienced *sharia* scholars in IFB. For this reason, none of the countries studied requires *sharia* scholars to be their own citizens, although Oman for example does clearly encourage the appointment of its nationals to SSB.

Some countries allow *sharia* scholars to be members of any number of SSB. This is the case in Bahrain, Kuwait and Dubai .Oman and Malaysia, however, choose to restrict the membership of *sharia* scholars to a single SSB in any given industry, and limit the overall number of SSB to which a *sharia* scholar can belong.

In terms of the scope of *sharia*-compliance supervision, it was argued that AAOIFI governance standards (No. 1, 2 and 3), as detailed in chapter two,

establish the minimum requirements for *sharia* review. Accordingly, the regulatory authorities in countries adopting or referring to these standards are assumed not to impose a comprehensive revision of *sharia*-compliance on IFI since they are required only to comply with the minimum practices that the AAOIFI standards suggest, as explained in chapter five. This is actually the situation in countries that basically follow the AAOIFI standards without clearly stating this, which is believed to be the situation in most Muslim countries. A point in further support of this argument is the fact that such countries do not demand a high level of qualifications or experience for members of SSB or *sharia* review.

On the other hand, Oman and Malaysia require a university degree as a proof of qualification. Oman even goes a step further in distinguishing the qualification requirements of *sharia* scholars from non-*sharia* scholars of the SSB. Specific experience and qualifications are required for *sharia* review, and a *sharia* audit function is added to the governance structure.

In terms of using external auditors, it was argued that the SSB should act as an external *sharia* auditor, especially if appointed by shareholders rather than the BOD. Nonetheless, it is evident in practice that the SSB exercises its ex-ante role, and relies largely of the findings of the *sharia* review/audit function for forming its independent opinion on *sharia*-compliance and submitting its report.

Therefore, an annual external audit function performed by a third party helps in reassuring the degree of compliance of the IFI with *sharia*, as suggested by the IFSB guidelines detailed in chapter two. The need for such external audit is significant because the review performed by the ISRU, although accepted and approved by the SSB, is done in their capacity as employees of the IFI, and because of the use of the SSB as an internal tool of *sharia* governance.

Although the CBB demands the IFI use external auditors and requires they attend the general meeting of shareholders, the provisions do not specify their

involvement in *sharia* auditing. The IFR of DFSA makes no mention of external auditors, but similar provisions to those in the CBB rulebook exist in regard of other financial institutions.

The CBK instruction, however, provides that the task of external audit must cover the examination of new products and modification of existing products in order to ensure that they are compliant with *sharia* principles. This should include the review undertaken by the management and the SSB. In its report, the external auditor should indicate the degree of IFI compliance with the *fatawa* issued by its SSB.

On the other hand, the CBO requires the IFI to use external audit to conduct an accounting audit in accordance with the AAOIFI standards and international standards of auditing. There is no specific mention of a *sharia*-compliance audit. Similarly, the BNM requires the use of external audit without referring to AAOIFI accounting standards or any special check on *sharia*-compliance.

Nonetheless, this role, as currently fulfilled by the chartered external audit, does not exercise an independent assessment of *sharia*-compliance. Therefore, there is an argument for the establishment and involvement of *sharia* consultancy firms.

In terms of independence and conflicts of interest, the organisational status of the SSB is of significance. The appointment and dismissal of SSB members and reporting mechanisms are the main features in this regard. The members of the SSB are normally appointed by the shareholders, as in Bahrain, Kuwait and Oman. Hence, they report their findings to the shareholders in the general meeting, except for Oman which requires that the SSB report to the BOD. In Dubai the SSB members are appointed by the governing body of the financial institution, usually either the shareholders or BOD. In Malaysia, the SSB is appointed by and reports directly to the BOD.

The appointment of the SSB directly by the shareholders is preferable and conveys more confidence in the independence of the SSB. Being assigned by the same authority as that of BOD supports the assumption that the SSB stands on an equal or parallel level to the BOD. It does not come under the authority of the BOD and is not required to report back to them. The opposite would be true in giving authority to the BOD to appoint the members of the SSB. However, the fact remains that the shareholders usually appoint the SSB members upon the recommendation of the BOD.

This being the case in the current *sharia* governance system actually raises questions concerning the true independence of *sharia* scholars and the risk of factual dependence regarding membership of the SSB. Such concerns are further supported by the employment status of the *sharia* scholars in *sharia* review and *sharia* audit functions, as well as the lengthy contracts with SSB members.

There is no limit to the duration of membership in most of the Muslim countries. In Bahrain, there is no direct provision or indication as to the duration of SSB membership, reflecting the omission of this in AAOIFI standards. This is also the situation in Kuwait and Malaysia. In fact, it was noticed that some *sharia* scholars obtain open-ended contracts with IFI, in particular in Kuwait.

Although there is no direct limitation on the duration of membership of SSB in Dubai, the provision of maintaining records for a minimum of six years suggests that a *sharia* scholar is allowed to be member for this period or longer. In Oman, the maximum duration for SSB membership is six years, consistent with serving two three-year terms.

It is argued that such lengthy membership of an SSB is beneficial in enabling the members to work in parallel with the BOD and be able to oversee long-approved investments.

Another important element and indication of true independence is being free of conflicts of interest, which may arise for various reasons. However, there are no provisions in the instructions of the CBK on this issue. The CBB provides that the head of *sharia* review must avoid conflicts of interest while performing his duties. The IFR of DFSA requires members of an SSB to notify the IFI of any position that might result in a conflict of interest, and the member should be dismissed if the issue is not resolvable. The regulatory framework of the CBO provides that members of an SSB should identify any situations that may impair their independence and agree on an action plan to resolve such an issue. If the issue is not resolvable, the member should resign. It is further provided that the directors shall be responsible for conducting an annual check on the SSB to ensure its independence and freedom from conflicts of interest. The BNM provides direct provisions to remove SSB members in the occurrence of certain situations and in such cases the member is not entitled to any compensation.

In addition, the restrictions on SSB membership further support the independence and avoid the conflict of interest taking place as a result of multiple appointment of *sharia* scholars. As indicated earlier, only Oman and Malaysia apply restrictions on SSB membership and limit the overall number of SSB that a single *sharia* scholar is allowed to sit on.

As such, the risk of conflict of interest is raised in other countries, allowing multiple appointment of *sharia* scholars, as in Bahrain, Kuwait and Dubai. Although the financial regulator requires SSB members to solve this issue as already indicated, the potential occurrence of this issue is revived by the unavoidable multiple appointment of *sharia* scholars.

In addition, this opens a back door for the issue known as "renting a sheikh", with high returns paid to scholars to approve certain products. Although *sharia* scholars argue that this issue is actually mitigated by the high moral and ethical

standards of Islam, many writers cite incidents of an SSB being more permissive and less restrictive.

In terms of the legal status of the SSB and its pronouncements, it has been established that an IFI, represented by management and its BOD, must adhere to the rulings of the SSB. Nonetheless, this does not necessarily mean that the SSB is placed in a higher position than the BOD in the organisational structure of the IFI. As demonstrated earlier, the SSB is either appointed directly by the BOD or on its recommendation. In fact, the IFI remains primarily responsible for complying with *sharia*, and the SSB is a mere internal tool that helps it undertake this responsibility.

As Bahrain promotes the AAOIFI standards, the SSB is appointed by the shareholders and report directly to them. According to AAOIFI standards, its rulings should be binding on the IFI, and an ISRU must be established by the management to oversee the implementation of the SSB's rulings. In Kuwait, the same is applied without any particular reference to AAOIFI standards or the *sharia* review function.

In Dubai, the governing body of the IFI has authority to appoint the SSB members, and there is no provision with regard to the binding nature of its rulings. However, this should be the case, as there is a requirement for *sharia* review functions according to the AAOIFI standards.

Although the shareholders appoint the SSB in Oman, they report directly to the SSB. Nonetheless, the rulings of the SSB should be binding on the IFI and it should be supported by an independent *sharia* reviewer who heads an ISRU as well as ISAU. This independent *sharia* reviewer reports to the SSB with administrative reporting to the CEO as well.

In Malaysia, the BOD has the power to appoint the SSB, which then falls under its authority and reports directly to it. Further, *sharia* review and *sharia* audit are

supportive to the work of the SSB. Nonetheless, the audit function is decided and related directly to the audit committee of the IFI.

It can be seen that, for the most part, the SSB plays an advisory role by exercising an ex-ante function only. The ex-post function is very much reliant on the work done by the ISRU and ISAU, which are employed by the management rather than the SSB.

In terms of accountability of the SSB, their role is confined to expressing an independent and unbiased judgement or opinion on the *sharia*-compliance of the IFI. The IFI holds the ultimate responsibility for complying with *sharia*, regardless of the indispensable role of the SSB.

Currently, most of the national laws of Muslim countries are silent in respect of the accountability of *sharia* scholars. There are no provisions on this matter in Bahrain, Dubai or Kuwait. In Oman, *sharia* audit officers are required to exercise professional care in their capacity as employees of the IFI. Although this provision does not expressly address the SSB members, its existence is valuable and considered as an appropriate step toward the general accountability of *sharia* scholars. In Malaysia, it is provided that an SSB member shall not be liable for discharging his duties in good faith or sued in courts without malice. The counter understanding of this provision suggests that SSB members shall be liable and could be sued in court if they do not act in good faith, or for proved malice.

Nonetheless, it has recently been argued that the SSB should be more responsible and accountable for its work. For instance, it should be liable if conformity of a product was not given at the beginning or through its life-cycle, especially if the interpretation provided was unacceptable or illegitimate.

After addressing common concerns resulting from the dependence on the internal *sharia* governance systems, chapter seven highlighted the efficacy of a number of practical solutions at institutional, national and international levels.

These represent internal and external measures for *sharia* governance and supervision, namely segregation of roles, the emergence of *sharia* consultancies, a global professional body for *sharia* scholars, the establishment of an international *sharia* rating system, and the emerging trend of centralisation.

Given the shortage of *sharia* scholars and the necessity of the SSB to fulfil ex-ante and ex-post functions, separation of scholars who are mainly involved in the design and development of products from those who supervise the function of *sharia* review is recommended. This should help in ensuring the independence of the scholar by playing the roles separately, and avoid risks such as self-review or potential conflicts of interest. In addition, the periodic rotation of *sharia* scholars in performing both tasks should lead to greater independence of the SSB members and enhance their work by applying peer review. Since the SSB consists of at least three members, one could be appointed as lead of review on a rotating basis, withdrawing from meetings of the SSB concerning product design and development. Nonetheless, such a scholar needs to be well trained in *sharia* reviewing.

In terms of the emergence of external *sharia* consultancies, the establishment of *sharia* consultancy firms could be one solution, overcoming the issue of shortage of *sharia* scholars and ensuring the *sharia* review and/or audit functions. However, chartered auditing firms are not necessarily qualified in *sharia* auditing. In fact, when auditing an IFI the external auditors do not perform a full *sharia* check, but merely make sure that the relevant accounting standards and control systems are applied. They do not go beyond the point at which the IFI obtains *sharia* clearance from its SSB, or the correct disposal of an unislamic gain.

Therefore, the use of specialist *sharia* firms that are well qualified and experienced to undertake a *sharia* review or audit could prove beneficial to the IFB. Nonetheless, this approach needs to be supported by a regulatory and supervisory framework, which is still lacking. The existence of such firms was first

evident on 2003 in Kuwait, followed by Saudi Arabia, the UAE and Bahrain. However, to date they offer limited services and do not play the role that they were expected to play. In fact, the current tendency of GCC to centralise *sharia* governance could jeopardise their existence. Oman and Malaysia, in particular, may not encourage this approach since they require that members of SSB be Muslim individuals.

In terms of a global professional body for *sharia* scholars, support for and against was illustrated, and previous and more recent proposals outlined. Forming such a body is not a new idea. Despite its need, establishing such a body remains challenging because of local and international obstacles confronting the IFB. Also, none of the existing regional or international Islamic bodies is considered able to fulfil this role. In fact, there are proposals for establishing a new body instead of assigning this role to any of the existing entities.

In terms of the establishment of an international *sharia* rating system, the existence of the Islamic International Rating Agency, based in Bahrain, was noted. Although the concept of rating IFB products as well as IFI for *sharia*-compliance might be useful in the quality supervision of the IFI and their operations, the sole rating agency faces obstacles in terms of experience and reputation, besides the regulatory environment. Also, the agency's *sharia* quality focus is on procedural elements such as the number of SSB members and other more general aspects rather than the quality of its outcome. Although the experienced chartered rating agencies have tried to provide *sharia* rating services, they lack the necessary staff for this task and actually rate the creditworthiness instead of the *sharia*-compliance of Islamic financial products.

In terms of the emerging trend for centralisation in IFB, previous and more recent proposals to establish a central reference for *sharia* matters pertaining to IFB were underlined. It was argued that none of the *sharia* boards of established regional or international organisations serves or is accepted as a central *sharia*

authority regarding IFB. Although, the idea is compelling and not new, the existing regional and international *sharia* boards of different organisations is proof that this approach currently lacks support. Nonetheless, these boards serve in different capacities for the needs of their organisations.

In turn, there is an obvious trend to centralised *sharia* governance and supervision at the national level. Malaysia is considered the leading model in central *sharia* governance and supervision. Also, in October 2014 Oman established a national *sharia* authority at the CBO, indicating a model that is close to the Malaysian one. In December 2014 the governor of the CBB announced a plan to set up a central *sharia* board, as did the central bank of UAE in March 2015.

It is believed that standardised and centralised *sharia* governance and supervision will help to increase public confidence countrywide, as it would help in overcoming most of the practical concerns that are raised.

Sharia governance and supervision should be a shared responsibly. The IFI primarily ensures that its activities are *sharia*-compliant through its internal governance mechanism. Nonetheless, determining the adequacy of this mechanism and supervising the governance standards are responsibilities that a central *sharia* board should undertake.

The establishment of stronger *sharia* governance and supervision therefore requires the joint effort and integrated work of all the stakeholders, and the direct involvement of the financial regulator to develop a strong framework to ensure that institutional SSB play their role effectively.

The existence of a central *sharia* board at the national level adds a further dimension to *sharia* governance and supervision. Countries with few scholars would benefit more from having a central *sharia* board because of their dearth of qualified *sharia* scholars. This would assist in expediting the approval and

introduction of new financial instruments into the IFB and give all the IFI nationwide access to the services of the most eminent *sharia* scholars.

This would certainly meet the much needed requirement for the harmonisation of IFB practices and supervision of institutional SSB to ensure the correct level of *sharia*-compliance of the IFI. However, it remains to be seen which model of future central *sharia* boards has the better structure and conveys acceptable *sharia* assurance at the national level. Also, it would be interesting to see what authority these central *sharia* boards command over the central banks.

RECOMMENDATIONS FOR FURTHER STUDIES

This study has laid a good foundation for the work that has to follow, in discovering and further assessing the concerns surrounding the *sharia* governance system and national supervision frameworks. Further research is required, not only in investigating the efficiency of proposed solutions but by collecting evidence-based data for the central models of *sharia* governance and supervision that are to be emerged soon.

Also, an interesting point that is worth researching is whether having a central *sharia* board with extended *sharia* authority could, at a later stage, make the institutional SSB obsolete. Since the IFI could refer *sharia* matters directly to the central *sharia* board, and an internal *sharia* officer acting as *sharia* reviewer/auditor would be sufficient to ensure the implementation of its requirements.

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APPENDIX: GLOSSARY OF ISLAMIC TERMS

APPENDIX: GLOSSARY OF ISLAMIC TERMS

- *Akhlaq*: virtue, morality and manners in Islamic theology
- *Allah (SWT)*: the Name of the Lord, the Exalted. It is said that *Allah* is the Greatest Name of *Allah*, because it is referred to when describing Allah by the various attributes.[535] The word *Allah,* according to several Arabic lexicons, means "the Being Who comprises all the attributes of perfection", i.e. the Being Who is perfect in every way (in His knowledge, power, etc.), and possesses the best and the noblest qualities imaginable in the highest degree.[536] When writing the name of God (*Allah*), Muslims often follow it with the abbreviation *SWT*. These letters stand for the Arabic words *Subhanahu wa-ta'ala*, an Islamic Arabic phrase meaning, "glorious and exalted is He (Allah)." The phrase appears after the name of Allah in Islamic texts such as the Qur'an and the Hadith. Saying this phrase is seen as an act of reverence and devotion towards Allah among Muslims.
- *Bai-al-Dayn* (debt financing): the provision of financial resources required for production, commerce and services through the sale and purchase of trade documents and papers. *Bai-al-Dayn* is a short-term facility with a year or less maturity. Only documents evidencing debts arising from bona fide commercial transactions can be traded.
- *Bai-al-Ina* (sale and buy-back): the sale and buy-back of an asset for a higher price than that for which the seller originally sold it. A seller immediately buys back the asset he has sold on a deferred payment basis at a price higher than the original price. This can be seen as a loan in the form of a sale.
- *Bai-al-Tawliya:* sale at cost price to facilitate or serve others.
- *Bai-Bithaman-Ajil* or *Bai-Muajjal* (deferred payment sale): some Islamic banks carry out a transaction of this name in which goods are requested

[535] "eMuslim," *Meaning of Allah*, April 18, 2015, http://www.emuslim.com/whoisallah.asp.

[536] "The Unique Name of God," April 18, 2015, http://www.muslim.org/islam/allah.htm.

by a client, purchased by the bank and then sold to the client at an agreed price which includes the bank's mark-up. Often the client is offered the option of paying by instalments. This is essentially identical to the *Murabaha* financing used throughout the Islamic banking sector.

- *Bai-al-Salam* (future delivery): a contract whereby the payment is made in cash at the point of contract but delivery of the asset purchased will be deferred to a predetermined date.
- *Bayt-ul-Mal* (the treasury of the Muslim State and Community): is an Arabic term that is translated as "House of Money" or "House of Wealth." Historically, it was a financial institution responsible for the administration of taxes in Islamic states, particularly in the early Islamic Caliphate. It served as a royal treasury for the caliphs and sultans, managing personal finances and government expenditure. Further, it administered distributions of *zakah* revenues for public works. In the time of Mohammad (*SAWS*) there was no permanent *Bayt-ul-Mal* or public treasury. Any revenue that was received was distributed immediately. The funds contained in the *Bayt-ul-Mal* were meant to be spent on the needs of the *ummah* (the Muslim-community) e. g. supporting the needy.[537]
- *Fatwa* (a religious decree), plural is *fatawa*: a formal response issued by an expert *faqih*, called a *mufti* (a highly qualified Islamic jurist) in response to a question.
- *Faqih* (Muslim jurist): a Muslim who is an expert in *fiqh*, is knowledgeable about the rules of *sharia* and knows how these rules are related to the source texts upon which they are based.
- *Fiqh* (Islamic jurisprudence): the science of the *sharia*, an important source of Islamic economics.

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[537] "What Is a 'Bayt Ul-Mal'?," *The WayFarer*, April 18, 2015, http://www.the-wayfarer.com/index.php?option=com_content&view=article&id=380:whatisbaytulmal&catid=81:baytulmal&Itemid=88.

- *Fiqh-almuamalat* (Islamic commercial jurisprudence): the traditional Islamic discipline concerned with the jurisprudence of financial transactions.
- *Gharar* (uncertainty): *gharar* is derived from the verbal noun *taghreer* which means deception or misrepresentation and refers in legal terms to unfair business conduct. It is one of three fundamental prohibitions in Islamic finance (the other two being *riba* and *maysir*). *Gharar* is a sophisticated concept that covers certain types of *haram* uncertainty in a contract. It is an exchange in which one or more parties stand to be deceived through ignorance of an essential element of the exchange. Gambling is a form of *gharar* because the gambler is ignorant of the result. The prohibition on *gharar* is often used as the grounds for criticism of conventional financial practices such as short selling, speculation and derivatives.
- *Ghara Al-kathir* (excessive *gharar*): concerning the subject matter of a sale, i.e. a sale in which the price or the subject matter is unknown; sales in which delivery is not attainable will render the transaction invalid. The contract contains excessive *gharar* when the subject matter neither exists at the time of contract nor in its essence as well as in the future.
- *Gharar al-mutawassit* (average *gharar*): falls between the two extremes and may be judged differently under different circumstances.
- *Gharar al-yasir* (trifling *gharar*): this type of *gharar* exists when the subject matter is only available in essence and came into completion thereafter or when the subject matter, although non-existent at the time of contract but was certain to exist in the future, are considered negligible. For example, the sale of fish in a small pond or the sale of a bird in a confined space.
- *Hajj* (pilgrim): the fifth pillar of Islam is the duty of every Muslim who is financially and physically able to carry out *hajj*, i.e. pilgrimage to Makkah, at least once in his lifetime. The pilgrimage takes place in the week from the 8th until the 13th day of the 12th Islamic month of *Dhul-Hijjah*.

- *Halal* (permissible and lawful): is said of a deed which is not prohibited (*haram*) by *Allah (SWT)*. The concept of *halal* has spiritual overtones. In Islam there are activities, professions, contracts and transactions that are explicitly prohibited (*haram*) by the *Qur'an* or *Sunnah*. All other activities, professions, contracts and transactions are *halal*. This concept differentiates Islamic economics from conventional economics. In Western finance all activities are judged by their economic utility. In Islamic economics, spiritual and moral factors are also involved; an activity may be economically sound but may not be allowed in Islamic society if it is forbidden by the *sharia*.
- *Hanafi*: one of the four well known schools of thought in Islamic jurisprudence or religious law engaged in the interpretation of the *Qur'an* and *Sunnah*. Founded by one of the classical jurists, *Imam Abu Hanifa al-Numan bin Thabit* (d. 765 AD).
- *Hanbali:* one of the four well known schools of thought in Islamic jurisprudence or religious law engaged in the interpretation of the *Qur'an* and *Sunnah*. Founded by one of the classical jurists, *Imam Ahmad bin Hanbal* (d. 855 AD). The *hanbali* is considered the hardest in terms of social and personal rules.
- *Hawala* (debt transfer): bill of exchange, a contract which allows a debtor to transfer his debt obligation to a third party who owes the former a debt. The mechanism of *hawala* is used for settling international accounts by book transfers, thus obviating the need for a physical transfer of cash.
- *Hibah* (gift): transfer of a determinate property (*mal*) without any material consideration. It may be something given on a voluntary basis by a debtor to a creditor as a token of appreciation at the time of returning an interest-free loan. Islamic banks can use their discretion to make a payment by way of *hibah* to their customers on non-investment account balances and to attract more deposits for the bank. While such a 'gift' appears similar to interest and may, in effect, have the same outcome, *hibah* is a voluntary

payment made (or not made) at the bank's own discretion, and is not guaranteed.

- *Hijaz*: the territory containing the Islamic holy cities of Medina and Makkah in Saudi Arabia.
- *Hijra* (the beginning of the Islamic calendar): is the emigration of Prophet Mohammad (*SAWS*) and his followers to the city of Medina in 622 AD,, marking the first year of the Islamic calendar.
- *Ijara* (leasing): a lease agreement whereby a bank or financier buys an item for a customer and then leases it to him over a specific period, thus earning profit for the bank by charging rental. The duration of the lease and the fee are set in advance. During the period of the lease, the asset remains in the ownership of the lessor (the bank), but the lessee has the right to use it. After the expiry of the lease agreement, this right reverts back to the lessor. This is a classic Islamic financial product.
- *Ijara-Muntahia-Bittamleek* (buy-back leasing): a hire and purchase mode of financing where an Islamic bank finances equipment, a building or other facility for the client against an agreed rental, together with an undertaking from the client to repurchase the facility at the end of the contract. The rental and the purchase price are fixed so that the bank gets back its principal sum along with some predetermined profit.
- *Ijtihad* (effort or exertion): a *faqhi's* endeavour to formulate a rule on the basis of evidence found in the Islamic sources. The process by which a qualified Islamic jurist (a *mujtahid*) endeavours to arrive at the correct ruling on a given issue by reflecting on texts from the fundamental sources of the *sharia*: the *Qur'an* and *Sunnah*.
- *Istisna* (a forward sale): a contract of sale of specified goods that have to be manufactured before delivery is possible; specified goods can be sold before the manufactured product comes into existence; an order to manufacture (for purchase) allowing the buyer to pay the price progressively in accordance with the progress of a job or project or against

delivery in stages. It takes the form of progressive financing. It is a condition of *istisna* that the seller provides either the raw material or the cost of manufacturing the goods. There is an obligation on the manufacturer to deliver the goods on completion according to the buyer's specifications. *Istisna* may include any process of manufacturing including construction, assembling or packaging. Islamic banks commonly adopt it to provide financing for large projects such as to construct a building, a road or highway, develop an industrial project, build a ship or an aircraft or assemble a factory or machinery. The bank releases finance in phases commensurate with the progress of the manufacturing schedule. The bank first takes on the role of the seller under an *istisna* contract with a customer with the obligation to manufacture goods required by the customer at a certain price; it then takes on the role of buyer and enters into a separate *istisna* contract with a supplier to have the goods manufactured at a lower price, the difference being the bank's profit. Thus, the bank acts as a financial intermediary without being required to actually manufacture the goods required by the customer. Under the *sharia*, a sale cannot normally be effected unless the goods are in existence at the time of the contract; however, it is argued that it is justified in the case of *istisna* as the need for the goods is such that they cannot be sold until they are manufactured. The order to manufacture is a demonstration of the general need and the availability of the manufactured goods is relatively certain.

- *Madhab* (Islamic juristic school), plural *Madahib*: *madhab* is a *fiqh* school or orientation characterised by differences in the methods or approaches by which certain sources and texts are understood and therefore differences in the *sharia* rulings which are deduced from them.
- *Majelle* or *Majalat al-Ahkam al-Adaliyah:* a codification of civil law following a Western model that was originally prepared by Ottoman scholars of the *Hanafi* school of Islamic jurisprudence for use throughout the courts of the Ottoman Empire, ca1839 CE/1285 AH. It was translated into the English

language by the British jurist and scholar of Arabic, Judge C.A. Hooper, and was published in 1936. It was re-published, in instalments, by the *Arab Law Quarterly* in 1986.

- *Maliki:* one of the four well known schools of thought in Islamic jurisprudence or religious law engaged in the interpretation of the *Qur'an* and *Sunnah.* Founded by one of the classical jurists, *Imam Malik bin Anas* (d. 795 AD).
- *Maqasid-al-sharia* (the objectives of the *sharia*): the purpose or ultimate wisdom behind a law or legal ruling. The general objectives of Islamic law, *sharia.* The term *Maqasid-al-sharia* refers to a juristic-philosophical concept developed by later generations of the classical *fuqaha*, who attempted to formulate the goals and purposes of the *sharia* in a comprehensive manner to aid the process of investigating new cases and organising existing rulings.
- *Maysir* (gambling or speculation): games of chance or gambling, trying to earn easy money without having to provide equivalent consideration. A prohibited activity, as it is a zero-sum game transferring rather than creating new wealth. One of three fundamental prohibitions in Islamic finance, the other two being *riba* and *gharar.* The prohibition on *maysir* is often used as the grounds for criticism of conventional financial practices such as speculation, conventional insurance and derivatives.
- *Mudaraba* (trust financing): an investment partnership, whereby the investor (the *rab al maal*) provides capital to the entrepreneur (the *mudarib*) in order to undertake a business or investment activity. While profits are shared on a pre-agreed ratio, losses are borne by the investor alone. The *mudarib* loses only his share of the expected income. The investor has no right to interfere in the management of the business, but he can specify conditions that would ensure better management of his money. In this way *mudaraba* is sometimes referred to as a sleeping partnership. A joint *mudaraba* can exist between investors and a bank on

a continuing basis. The investors keep their funds in a special fund and share the profits before the liquidation of those financing operations that have not yet reached the stage of final settlement. Many Islamic investment funds operate on the basis of joint *mudaraba*.

- *Mudarib* (entrepreneur in a *mudaraba* contract): the entrepreneur or investment manager in a *mudaraba* who puts the investor's funds in a project or portfolio in exchange for a share of the profits. A *mudaraba* is similar to a diversified pool of assets held in a discretionary asset management portfolio.
- *Murabaha* (cost-plus financing): a form of credit that enables customers to make a purchase without having to take out an interest-bearing loan. The bank buys an item and sells it to the customer on a deferred basis. The price includes a profit margin agreed by both parties. Repayment, usually in instalments, is specified in the contract. The legality of this financing technique has been questioned because of its similarity to *riba*. However, the modern *murabaha* has become the most popular financing technique among Islamic banks, used widely for consumer finance, real estate, the purchase of machinery and for financing short-term trade.
- *Musharaka* (joint venture): an investment partnership in which all partners are entitled to a share in the profits of a project in a mutually agreed ratio. Losses are shared in proportion to the amount invested. All partners to a *musharaka* contribute funds and have the right to exercise executive powers in that project, similar to a conventional partnership structure and the holding of voting stock in a limited company. This equity financing arrangement is widely regarded as the purest form of Islamic financing. The two main forms of *musharaka* are, first Permanent *Musharaka*: an Islamic bank participates in the equity of a project and receives a share of the profit on a pro rata basis. The length of contract is unspecified, making it suitable for financing projects where funds are committed over a long period. Second is Diminishing *Musharaka*: this allows equity participation

and sharing of profits on a pro rata basis, and provides a method through which the bank keeps on reducing its equity in the project, ultimately transferring ownership of the asset to the participants. The contract provides for payment over and above the bank's share in the profit for the equity held by the bank. Simultaneously the entrepreneur purchases some of the bank's equity, progressively reducing it until the bank has no equity and thus ceases to be a partner.

PLS: Profit-and-Loss-Sharing. The term used to describe a mode of financing based on the principle of interest-free lending and featuring the use of *mudaraba* and *musharaka*

- Muslim (one who submits himself to *Allah*): a Muslim is a person whose religion is Islam (willing submission to *Allah*, Lord of the Universe) and who formally announces his Islam by testifying to the fact that there is none deserving of worship except *Allah* and that Prophet Mohammad (*SAWS*) is the Messenger of *Allah*.
- Prophet Mohammad (*SAWS*): when writing the name of the Prophet Mohammad, Muslims often follow it with the abbreviation PBUH, standing for the English words "peace be upon him." Muslims use these words to show respect to one of God's Prophets when mentioning his name. It is also abbreviated as *SAWS* for the Arabic words of similar meaning *sallallahu alayhi wa salaam*.[538]
- *Qur'an*: the sacred book of Islam. The literal meaning is "the recitation". Muslims believe the *Qur'an* is God's final message to all of mankind. It is a book which emphasises deed rather than idea. The rules laid down in the *Qur'an* are universal and not restricted to one ethnic group or a specific area or time. The *Qur'an* is fundamentally different from all other sacred scriptures, placing an emphasis on reason as a valid way to faith as well as its insistence on the inseparability of the spiritual and the physical (and,

[538] "Islamic Abbreviation," *SAWS*, April 18, 2015, http://islam.about.com/od/glossary/g/pbuh.htm.

therefore, also social) spheres of human existence; the inseparability of daily actions and behaviour of human beings, however mundane, from the spiritual life and destiny. The *Qur'an* is a revealed Book in the spiritual tradition of the Torah and the Gospels transmitted by Moses and the evangelists. Connecting itself and these distinguished predecessors to even earlier dispensations of original religion, the *Qur'an* represents its teachings as confirming and clarifying the truth of what was in those messages. As the last link in a chain of revelation going back to time immemorial, even to the very origin of humankind, the *Qur'an* has the special function of recollecting the essential message of all revealed Books and distinguishing this from the opinions and reactions later interpolated into ancient texts whose original dispensation had taken place in remote and even unknown times.

- *Qardh-al-Hasan* (benevolent loan): a loan contract between two parties for social welfare or for short-term bridging finance. Repayment is for the same amount as the amount borrowed. The borrower can pay more than the amount borrowed so long as it is not stated by contract. Most Islamic banks provide interest-free loans to customers who are in need. The Islamic view of loans (*qard*) is that there is a moral duty to give them to borrowers free of charge, as a person seeks a loan only if he is in need of it. Some Islamic banks give interest-free loans only to their holders of investment accounts; some extend them to all bank clients; some restrict them to needy students and other economically weaker sections of society; and some provide interest-free loans to small producers, farmers and entrepreneurs who cannot get finance from other sources.
- *Riba* (interest): an increase, addition, unjust return, or advantage obtained by the lender as a condition of a loan. Any risk-free or guaranteed rate of return on a loan or investment is *riba*. *riba* in all its forms is prohibited in Islam. In conventional terms, *riba* and "interest" are used interchangeably, although the legal notion extends beyond interest.

- *Riba-al-buyu or Riba-al-fadl* (usury of trade): a sale transaction in which a commodity is exchanged for an unequal amount of the same commodity and delivery is delayed. To avoid *riba-al-buyu*, the exchange of commodities from both sides must be equal and instant. *Riba-al-buyu* was prohibited by the prophet Mohammad to forestall *riba* (interest) from creeping into the economy.
- *Riba-al-nasiah* or *riba-al-diyun* (usury debt): the usury of debt was an established practice amongst Arabs during the pre-Islamic period. It can occur as an excess increment on top of the principal, which is incorporated as an obligatory condition of the giving of a loan. Alternatively, an excess amount is imposed on top of the principal if the borrower fails to repay on the due date. More time is permitted for repayment in return for an additional amount. If the borrower fails again to pay, a further excess amount is imposed, etc.
- *Ribh* (profit): root of *murabaha* cost-plus-profit, *ribh* refers to a sale where a vendor sells an object to others, where the cost of the object is known by the buyer.
- *Shafi:* one of the four well-known schools of thought in Islamic jurisprudence or religious law engaged in the interpretation of the *Qur'an* and *Sunnah*. Founded by one of the classical jurists, *Imam Abdullah Muhammad bin Idris al-Shafei* (d. 804 AD).
- *Sheikh*: a term commonly used for Islamic scholars; *Sheikal-alAzhar* is the head scholar of the religious institution *Al-Azhjar*.
- *Sharia* (Islamic jurisprudence): often referred to as Islamic law. *Sharia* as a legal case did not exist at the time the *Qur'an* was revealed. It is a system that is all too often misunderstood and misinterpreted in the West. It refers to the rulings contained in and derived from the *Qur'an* and the *Sunnah* (sayings and living example of the Prophet Muhammad (*SAWS*). These cover every action performed by an individual or society. *Sharia* is primarily concerned with a set of values that are essential to Islam and the

best manner of their protection. The essential values of the *sharia* include those of faith, life, intellect, lineage, property, protection of honour, fulfilment of contracts, preservation of ties of kinship, honouring the rights of one's neighbour in so far as the affairs of this world are concerned; and the love of God, sincerity, trustworthiness and moral purity, in relationship to the hereafter. The linguistic meaning of the word *sharia* is a non-exhaustive source of water from which people satisfy their thirst. Thus, the linguistic significance of *sharia* is that the Islamic rulings are effectively a source of guidance. As water is the fundamental basis for life, the Islamic rulings are an essential source for guiding human life. The method of finding solutions to new issues in the light of the goals and principles of Islam are *ijtihad* (independent reasoning), *ijma* (consensus) and *qiyas* (analogy), all upheld by the *Qur'an* and the *Sunnah*.

- *Sukuk* (Islamic bond): an asset-backed bond which is structured in accordance with *sharia* and may be traded in the market. A *sukuk* represents proportionate beneficial ownership in the underlying asset, which will be leased to the client to yield the return on the *sukuk*.
- *Sunnah* (custom, habit or way of life): commonly understood as the sayings and living example of the Prophet Muhammad (pbuh) as recorded in the books of *Hadith*. *Sunnah* is a legislative source along with the *Qur'an*, which cannot be understood without the application of *Sunnah*.
- *Takaful* (Islamic insurance): based on the principle of mutual assistance, *takaful* provides mutual protection of assets and property and offers joint risk-sharing in the event of a loss by one of the participants. *Takaful* is similar to mutual insurance in that members are the insurers as well as the insured. Conventional insurance is prohibited in Islam because its dealings contain several *haram* elements, such as *gharar* and *riba*.
- *Tawarruq* (reverse *murabaha*): in personal financing, a client with a genuine need buys an item on credit from the bank on a deferred payment basis and then immediately resells it for cash to a third party. In this way,

the client can obtain cash without taking out an interest-based loan. It has two forms: *tawarruq munazzam* (organised *tawarruq*), in which the client simply seeks credit and has no interest in the original asset for sale; and *tawarruq al Asli*, where the client buys goods on credit and then sells them for cash.

- *Ummah* (Muslim community): the diaspora or Community of the Believers (*ummat al muminin*), the worldwide community of Muslims.
- *Usul-al-fiqh* (Islamic jurisprudence): Islamic legal theory.
- *Wakala* (agency): .a contract of agency in which one party appoints another party to perform a certain task on its behalf, usually for payment of a fee or commission. An agency arrangement without provision for payment cannot be considered irrevocable, thus giving an agent the right to terminate the agency at any time. *Wakala* can be commutative or non-commutative. A bank may charge fees or provide certain services to its customers; the bank can also pay a fee for performing an activity on behalf of the bank, such as an agent taking delivery of goods or investing the bank's funds.
- *Zakah* (tax for the purification of wealth): an obligatory contribution or tax which is prescribed by Islam on all Muslim persons having wealth above an exemption limit at a rate fixed by the *sharia*. *Zakah* is the third pillar of Islam. According to Islamic belief, *zakah* purifies wealth and souls. The objective is to take away a part of the wealth of the well-to-do and pay it to the Islamic state or distribute it among the poor and needy. It is levied on cash, cattle, agricultural produce, valuable assets, capital invested in industry or business or any other forms that could be termed as wealth.