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Empowering the Shari'ah Committee towards Strengthening Shari'ah Governance Practices in Islamic Financial Institutions

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Abstract

The Islamic finance industry is growing at a rapid rate. Its products and services are widely offered all over the world. The ultimate vision of the emergence of Islamic finance industry is to avoid the prohibited practices of conventional financial institutions such as interest, uncertainty, gambling, and investment in prohibited items. If Islamic Financial Institutions (IFIs) manifest by excluding this vision, then they have failed in their mission. Consequently, *shari'ah* risk, i.e., non-*shari'ah* compliant risk is the main risk that IFIs must manage to maintain its distinguished status as *shari'ah* compliant institutions. *Shari'ah* governance is used as the guideline to mold the operational practices of IFIs to achieve the mission of *shari'ah* compliance. For this purpose, the *shari'ah* committee members are the main players for implementing good *shari'ah* governance practices. However, due to the limited authority of *Shari'ah* committee members in performing their tasks, IFIs are voluntarily exposed to *Shari'ah* risk. This paper highlights the current *Shari'ah* governance problems and proposes that the authority of *Shari'ah* committee should be enhanced for better *Shari'ah* governance practices. Problems with current *Shari'ah* governance practices are mostly due to *fatawa* variation, non-harmonization of *Shari'ah* governance practices and products, variance in the four schools of thought, and limited support from IFI management in discharging their full responsibilities such as their involvement in the *Shari'ah* review process and audit. This paper is set to develop *Shari'ah* governance guidelines.

Keywords: Shari'ah governance, Shari'ah committee, Islamic financial institutions

1. Introduction

Financial institutions play a significant role in any country to mobilise funds and stabilise the economy. Failure of financial markets can have the major negative impacts and consequence on the economy. No country can sustain without a properly designed and regulated financial system. The conventional finance industry is not free from interest, uncertainty, gambling, and investment in prohibited items. These elements are major prohibited practices in Islam due to their unfair and unjust business practices. As an alternative, Islamic finance has been introduced by *Shari'ah* scholars which is free from these prohibited elements. Similar to the conventional financial industry, IFIs are able to provide the products and services needed by the society with the only difference between these two industries being *Shari'ah* compliance. IFIs offers *Shari'ah* compliant products and use *Shari'ah* compliant contracts such as *Mudarabah*, *Musharakah*, *Murabahah*, *Ijarah*, *Istisna*, *Salam* etc. to replace the prohibited practices of conventional finance system.

Similar to the conventional financial industry, IFIs face credit risk, operational risk, legal risk, liquidity risk, and reputational risk. Additionally, IFIs are facing the unique risk of *Shari'ah* risk as opposed to the conventional finance industry. Accordingly, IFIs require a *Shari'ah* governance framework on top of conventional governance codes and guidelines (Abdullah et al., 2015). *Shari'ah* principles provide the foundation for the practice of Islamic finance through the observance of the tenets, conditions, and principles propagated by Islam.

A review of the history of *Shari'ah* governance reveals that there was no formal or specific *Shari'ah* body incorporated within the structure of IFIs when they first emerged with the institutions seeking the advice of *Shari'ah* scholars only if they encounter issues related to the *Shari'ah*. However, this does not mean that

Shari'ah governance was ignored during the early emergence of IFIs. The first internal *Shari'ah* committee was established by Faisal Islamic Bank of Egypt in 1976, followed by Jordan Islamic Bank and the Faisal Islamic Bank of Sudan in 1978, Kuwait Finance House in 1979, and Bank Islam Malaysia Berhad in 1983. Later on, to strengthen the *Shari'ah* governance practices, international bodies such as Accounting and Auditing Organization of IFIs (AAOIFI) in 1999 and Islamic Financial Service Board (IFSB) in 2006 issued *Shari'ah* governance guidelines which are referred to references for developing national and institutional *Shari'ah* governance practices.

Shari'ah governance practices are critical activities within IFIs, however, unfavourable *Shari'ah* governance issues are increasing. Thus, this paper critically analyses the reasons for weakness and loopholes in the current *Shari'ah* governance practices and proposes enhancing the authority and involvement of *Shari'ah* committee members in IFIs for improved *Shari'ah* governance practices. This paper is discussed in six sections. Section two focuses on *Shari'ah* governance definitions and standards from different bodies. Section three explains *Shari'ah* risk while section four discusses *Shari'ah* risk management and *Shari'ah* governance guidelines. Section five talks about the limited authority of the *Shari'ah* committee while the last section concludes the paper with proposed solutions.

2. Shari'ah Governance

IFSB defines the *Shari'ah* governance system as a set of institutional and organisational arrangements through which an Islamic financial institution ensures that there is effective independent oversight of *Shari'ah* compliance over each of the following structures and process:

a) Issuance of relevant *Shari'ah* pronouncement or resolution. This refers to a juristic opinion on any matter pertaining to *Shari'ah* issues in Islamic finance given by the appropriately mandated *Shari'ah* board.

b) Dissemination of information on such *Shari'ah* pronouncement or resolutions to the operative personnel of the IFIs who monitor the day-to-day compliance with the *Shari'ah* resolutions vis-à-vis every level of operations and each transaction. However, this task would normally be done by the internal *Shari'ah* compliance department.

c) An internal *Shari'ah* compliance review or audit reports that if there is any incident of non-compliance, it should be recorded and addressed and rectified. With regard to this, IFSB-3 sets that *Shari'ah* resolution issued by the *Shari'ah* boards should be strictly adhered to.

d) An annual *Shari'ah* compliance review or audit for verifying that internal *Shari'ah* compliance review or audit has been appropriately carried out and its findings have been duly noted by the *Shari'ah* boards.

The *Shari'ah* Governance Framework issued by BNM states that:

"*Shari'ah* principles are the foundation for the practice of Islamic finance through the observance of the tenets, conditions and principles espoused by *Shari'ah*. Comprehensive compliance with *Shari'ah* would bring confidence to the general public and the financial markets on the credibility of the Islamic finance operations".

As far as AAOIFI is concerned, it does not provide the definition of *Shari'ah* governance but provides several standards for *Shari'ah* governance. Standard No.1 provides the guidelines for the appointment and composition of *Shari'ah* board members. Standard No.2 discusses *Shari'ah* review while Standard No.3 elaborates on the internal *Shari'ah* review. Standard No.4 elaborates on the audit and governance committee and Standard No.5 presents the important role of the independence of the *Shari'ah* supervisory board. Standard No.6 states the statement on governance principles and Standard No.7 on corporate social responsibility conducts and disclosure for Islamic financial institutions.

From the definitions and standards of *Shari'ah* governance, it can be derived that it is a set of rulings for IFIs to ensure that the all IFI operating activities are able to provide the products and services to fulfil the needs of the society under the umbrella of the *Shari'ah* in order to promote fair and just financial business transactions for the benefit of all involved parties. This *Shari'ah* umbrella can be termed the *Shari'ah* governance framework. Several researchers have highlighted the difference between conventional and *Shari'ah* governance. According to Grassa and Matoussi (2014) the governance practices in IFIs must be found in *Shari'ah* law. Ahmad and Chapra (2002) mentioned that *Shari'ah* governance emphasises on fairness to all stakeholders by enhancing transparency and accountability which are in line with the teachings of the *Shari'ah*. Transparency and accountability are also emphasised in conventional corporate governance but it is for the betterment of shareholders whereas in *Shari'ah* governance, it is for all the stakeholders (Mohamad et al., 2015).

The prevailing *Shari'ah* governance guidelines focus on the responsibility of the *Shari'ah* committee to ensure the *Shari'ah* compliance of all aspects of IFIs. The *Shari'ah* committee should be accountable and responsible to all the stakeholders to ensure the *Shari'ah* compliance of the institutions under their advisement. In addition, they are required to be independent form management to provide objective judgments and decisions and must be competent to monitor and provide guidance to the IFIs. Moreover, they are asked to preserve the confidential information of the IFIs and provide consistent *Shari'ah* decisions to IFIs. *Shari'ah* committee members are supposed to conduct research for IFIs (*Shari'ah* Governance Framework for Islamic Financial Institutions, 2012; AAOIFI *Shari'ah* Governance Framework, IFSB *Shari'ah* Governance Framework). Thus, the responsibility of *Shari'ah* compliance of IFIs rests on the shoulder of the *Shari'ah* committee. As such, the *Shari'ah* committee is the heart of the *Shari'ah* governance practices.

The important role of good *Shari'ah* governance practices cannot be ignored because its failure is the failure of IFIs. Failure of Ikhlas Finance in Turkey, Islamic Bank of South Africa and Islamic Investment Companies in Egypt, and the commercial losses of Dubai Islamic Bank and Bank Islam Malaysia Berhad are all due to the failure of *Shari'ah* governance practices (Muhamad et al., 2015).

3. Shari'ah Risk

Shari'ah literally means the way or the path which governs all aspects of daily life. It is based on the sources of the *Shari'ah*, i.e., Quran (the words of Allah), Sunnah (practices and traditions of Prophet Muhammad), *Ijtihad* (legal reasoning), *Ijma* (consensus by Islamic scholars), and *Qiyas* (analogy if the precedence exists). Islamic laws and principles which can be directly extracted from the Quran and Sunnah are not subject to interpretation. However, the business and economic situations are dissimilar with the situation in earlier periods and hence *Shari'ah* scholars try to derive the sources of law and interpret them to suit current business needs (Aziah Abu Kasim, 2015). Interpretations from one *Shari'ah* scholars to another may vary and the existence of differences among the Islamic legal schools of thoughts results in different *fatawa* consequently exposing IFIs to *Shari'ah* risk.

According to Ayedh and Echchabi (2015), the four different legal schools are *Hanafi*, *Maliki*, *Shafi*, and *Hambali*. Since these Islamic school of thoughts can have different opinions on the same issues, this variance can effect Islamic finance. According to their interview results, it can result in "*fatwa* fishing" whereby someone chooses one among the available school of thought without consistency in referring to one school of thought with the aim to favour their need and convenience. This can have serious negative impacts on IFIs by exposing the industry to *Shari'ah* risk. They further mentioned that in order for the entire process of the Islamic finance industry to be in line with *Shari'ah* there is a need for both certification of the products (i.e., ex-ante *Shari'ah* audit) and verification of the transactions' compliance (i.e., ex-post *Shari'ah* audit). Currently, different institutes have different standards and practices which is one of the major flaws of the Islamic finance industry. Grassa (2013) mentions countries differ in their approach to *Shari'ah* governance. For instance, Bahrain has both a *Shari'ah* governance committee at the institutional level and the National *Shari'ah* Advisory Board at the national level, i.e., in the Central Bank of Bahrain. However, its role is limited to advise the central bank on *Shari'ah* matters. Malaysia and Indonesia have a higher *Shari'ah* authority at the national level to standardise *fatwa* and *Shari'ah* practices in IFIs. In the case of other GCC countries such as Kuwait, UAE, and Qatar, they have their own *Shari'ah* committee at the institutional level and there is another independent body, i.e., the Ministry of Awqaf and Religious Affairs or the Ministry of Justice and Islamic Affairs which are given the authority to oversee *Shari'ah* governance practices. The higher *Shari'ah* authority in UAE, Qatar, and Kuwait act only when there are conflicts of opinions among *Shari'ah* scholars regarding *Shari'ah* rulings. In the case of Saudi Arabia, it prefers leaving the practices of *Shari'ah* governance practices at the voluntary choice of IFIs and at the influence of the market. They further state that the higher *Shari'ah* authority is not effective in controlling the *Shari'ah* compliance for IFIs resulting in negative impacts on the stability of the Islamic finance industry. Due to the limited supervision at the institutional level, there is the possibility that the questionable products or interest-based products are emerging from IFIs.

Shari'ah risk can arise due to the lack of standardised practices of IFI products or non-compliance with *Shari'ah* principles (IFSB, 2006). Standardisation of *Shari'ah* practices is essential. For instance, *Tawarruq* is declared as impermissible although it is used widely in Malaysia and the Middle-East. In addition, Malaysia has used *Bay' Bithaman Ajil* (BBA) products but it is not approved by Middle-Eastern *Shari'ah* advisors. In addition, when Taqi Usmani made a statement that more than 85% of existing *sukuk* are not *shari'ah*-compliant in 2007, the market price of the *sukuk* fell rapidly. Wish such variation in *fatwa*, investors will have less confidence in IFIs which will have a negative impact on the industry (Muhammad et al., 2015).

Ayedh and Echchabi (2015) believed that IFIs should harmonise and standardise the *Shari'ah* standards and guidelines to gain public confidence and promote the industry globally. He further stated that some of the obstacles which hinder the harmonisation and standardisation of *Shari'ah* standards includes IFIs trying to come out with products that do not conflict with the conventional regulatory framework. In addition, the nature of the shareholders contributes to the practices of IFIs, whereby some might be profit oriented and more interested in profit while others are more concerned with the *Shari'ah* compliance of IFIs. Moreover, IFIs are required to offer products and services which are comparable with well-established conventional financial institutions.

Moreover, the reputation of the IFIs will be damaged due to non-*Shari'ah* compliance. The practice of *Maslaha*, i.e., better of two evils or until the appropriate benchmark is available is essential especially when the industry is new. However, this permissibility should not be misused. Until now, the formula to compute the profit rate is the same with the conventional bond computation and the conventional interest benchmark like LIBOR (London Interbank Offer Rate) is still comfortably used by the industrial players (Muhamad et al., 2015). If these practices are prolonged, there is no point to have Islamic finance and it defeats the purpose of the emergence of IFIs.

4. Shari'ah Risk Management and Shari'ah Governance Practices

Exposure to *Shari'ah* risk is very serious in IFIs because it will be linked to other types of risks such as legal risk, reputational risk, and liquidity risk. *Shari'ah* risk management should be given attention by IFIs (Ginena, 2014). IFIs should not undermine their exposure to *Shari'ah* non-compliance risk because *Shari'ah* compliance is the main distinguishing factor between Islamic and conventional financial institutions. The common *Shari'ah* governance practice in IFIs is that the *Shari'ah* committee is appointed to mold the IFIs to comply with the *Shari'ah* in all aspects of their operational activities. Generally, all IFIs are required to get approval to offer new products before getting the approval from the *Shari'ah* board at the central government level. In addition, the responsibility of the *Shari'ah* compliance of IFIs is on the shoulders of the *Shari'ah* committee.

Malaysia as a hub of Islamic finance is used as a sample to discuss the ideal process of *Shari'ah* compliance and governance. IFIs should have their own internal *Shari'ah* audit department which conducts regular *Shari'ah* reviews and reports to the *Shari'ah* audit committee. The *Shari'ah* audit committee is required to prepare the *Shari'ah* audit report to be included in the annual reports of IFIs. Overall, the *Shari'ah* Advisory Council at the Central Bank of Malaysia is providing guidelines to all IFIs in Malaysia and its decisions are binding on IFIs. Although this arrangement and process seek to monitor the *Shari'ah* compliant nature of IFIs, many outstanding issues remain. These issues and challenges remain not only in Malaysia but also in all countries offering Islamic finance products due to the limited empowerment of *Shari'ah* committees in *Shari'ah* governance practices. The situation becomes worse when there is no *Shari'ah* advisory council at the country level.

Since the *Shari'ah* committee is at the heart of the *Shari'ah* governance practices, the responsibility of *Shari'ah* risk management is in the hands of *Shari'ah* committee. Unfortunately, the *Shari'ah* committees' authority and involvement in the operational activities of IFIs is rather limited in reality.

5. Limited Authority of the Shari'ah Committee

Prior researches such as Muhamad Sori et al. (2015), Muhammad et al. (2015), Grassa (2013), and Hasan (2014) highlight that the *Shari'ah* committee is given limited authority and participation in the operational and management activities of IFIs.

Muhamad Sori et al. (2015) interviewed 16 *Shari'ah* committee members from 16 Islamic financial institutions such as Islamic banks, development financial institutions, Takaful operators, and regulatory bodies to explore *Shari'ah* governance practices in Malaysia. They found that the *Shari'ah* audit committee does not include any member from the *Shari'ah* committee although in some cases, the *Shari'ah* committee members are invited to join the *Shari'ah* audit committee meetings. Although they are invited, they have no voting power since they are just invitees.

Similarly, Muhammad et al. (2015) examined the effectiveness of the *Shari'ah* committee in Islamic banks in Malaysia. They interviewed 17 chairmen of the *Shari'ah* committee of Islamic banks in Malaysia on the challenges faced in carrying out their responsibilities and their views on the effectiveness. They found that *Shari'ah* committee members have no place on the board and only the Chairperson of the *Shari'ah* committee is invited to join the board meeting and there is no vote from the representative of *Shari'ah* committee to represent their wishes in the board meeting. Thus, the current practice renders the role of the *Shari'ah* committee lower than their deserved positon.

Before Islamic financial products are launched, the first approval is from the *Shari'ah* committee and this stage is where the process is initiated. Thus, the *Shari'ah* committee members are the experts with knowledge about the products. They should know the findings of the *Shari'ah* audit conducted by the internal *Shari'ah* audit department or external *Shari'ah* auditors and they should be actively participating in the *Shari'ah* audit committee's functions. The role of the *Shari'ah* committee should not be stopped at the product approval stage, otherwise the practice will defeat the ultimate objective of having a *Shari'ah* committee, i.e., to ensure *Shari'ah* compliance in all activities of IFIs.

In addition to the structural issue, Muhamad Sori et al. (2015) pointed out the important role of qualified personnel for better *Shari'ah* risk management. They found that it is necessary for a person to know about risk management as well as *Shari'ah*. Moreover, their interview results highlight that a person who performs the *Shari'ah* risk management function should know the operations of the IFIs, *Shari'ah* requirements, and the contracts applied in IFIs. In addition, there is a need for the experts from *fiqh* and *usul fiqh* in IFIs and the role of research in Islamic finance should be enhanced. We believe that there are limited experts who are well-versed in all aspects of IFIs such as operation, risk management, and *Shari'ah* and hence, in order to have an effective team, the team members should comprise experts from different backgrounds and continuous training should be required by the *Shari'ah* committee members to update their knowledge.

Muhammad et al. (2015) raised the issue of the independence of the *Shari'ah* committee in IFIs because the remuneration for the committee members are paid by the IFIs in the case of Malaysia. This might impair the objective decision making of the *Shari'ah* committee members. They further raised issues such as multiple *Shari'ah* committee members on many IFIs in the same industry which add problems to the efficiency and effectiveness of the *Shari'ah* governance practices of the *Shari'ah* committee members. This practice is common in Middle-Eastern countries. The *Shari'ah* committee needs to maintain the confidentiality of the IFIs and if the interlock practice is allowed, there is possibility that confidentiality might be reduced among the competing institutions in the same industry.

Grassa (2013) stated that nowadays, the financial system is very complicated and hence, the IT system used in the IFIs should be approved by the *Shari'ah* committee to ensure that the financial flow is in line with the product manuals. He further stated that the industry does not have young *Shari'ah* scholars which might hinder the efficiency and performance of the *Shari'ah* committee. Young *Shari'ah* scholars should be recruited so that they can learn from the experienced scholars and continue their responsibility in the future.

Hasan (2014) examined the perceptions of *Shari'ah* board members towards the current *Shari'ah* governance practices. He conducted semi-structured interviews with 14 *Shari'ah* board members from Malaysia, UAE, and London. His findings revealed the major pitfalls of current *Shari'ah* governance practices. The first issue is the failure of the IFI management to understand the extent and seriousness of *Shari'ah* non-compliance risk. The current governance structure does not favour the *Shari'ah* scholars to promote Islamic values, especially when the IFIs management is more shareholder rather than stakeholder concentrated. Some of the *Shari'ah* committee members do not conduct *Shari'ah* review functions but focus on the ex-ante functions of *Shari'ah* governance. At the end of the financial year, they sign the declaration of *Shari'ah* compliance in the annual report without carrying out a proper *Shari'ah* review process. Even if they are conducting the *Shari'ah* review, they heavily rely on the internal audit department of IFIs and hence this practice is not healthy because *Shari'ah* compliance is not greatly determined by the internal audit department, but by the *Shari'ah* committee. Although *Shari'ah* advisors can assess the documents of IFIs, currently they refer to the documents presented to them only for the *Shari'ah* board meetings.

The majority of the interviewees focus on advising and supervising IFIs about the legitimacy of products and services rather than educating the IFIs about ethics and values. Moreover, there is no regular assessment on the performance of *Shari'ah* committee members and there is no established practice for such assessment although in Malaysia, the Central Bank of Malaysia evaluates the *Shari'ah* advisors before they are appointed as *Shari'ah* board members for the IFIs but there is no more assessment after approving the appointment of *Shari'ah* advisors. Due to the limited knowledge of *Shari'ah* advisors, it is permitted to appoint economists, accountants, bankers, lawyers to be the *Shari'ah* board members. The advantage of this is that they can provide the industrial operation information but the disadvantage is that they do not have adequate knowledge on *Shari'ah* and it could prevent the *Shari'ah* advisors from carrying out their responsibilities effectively.

6. Conclusion and Proposed Solution

This study has highlighted the major flaws in the *Shari'ah* governance practices of IFIs. These defects should be rectified soon, otherwise IFIs will end up with a bad reputation and losses. Current *Shari'ah* governance practices reveal that there are several variations from one country to another even in the same region. Some countries have a *Shari'ah* committee only at the institutional level and some have both at the institutional and national level. Among the countries that have *Shari'ah* supervisory boards, there are still differences in terms of their authority and influential power. In our opinion, the main important players are *Shari'ah* committee members since they are the experts who directly communicate with the IFIs and approve their products. They are directly responsible for the *Shari'ah* compliance of all IFIs' operations. However, the current situations such as profit oriented shareholders, lack of awareness of the consequences of non-*Shari'ah* compliance by the management, limited authority and role of *Shari'ah* committee to go beyond the approval of products such as disseminating on the knowledge on the ethical business practices and deep involvement in the *Shari'ah* review process are major weakness of the *shari'ah* committee members.

Therefore, this paper suggests that the ineffectiveness of the current *Shari'ah* governance practices will be resolved to a certain extent if *Shari'ah* committee members' authority is enhanced and IFIs create the working environment whereby the *Shari'ah* committee members are allowed to become actively involved in monitoring and overseeing the operations of IFIs. The S*hari'ah* committee members have the first-hand knowledge compared to other parties because the starting point to offer the products is their approval. They approve the product manuals and hence know the process and operational parts of the products. If they better monitor product development, IFIs will have effective *Shari'ah* compliant practices and it is easy for the employees of the companies to learn more about the *Shari'ah* compliant nature of the products.

In addition, there should be a policy that the *Shari'ah* committee members can be sued for breach of contract and negligence. The disclosure on *Shari'ah* governance should be given at least in the same weight as conventional governance. More detailed disclosure on the findings of the *Shari'ah* review and audit should be incorporated into the annual reports.

The highlights of this paper can be alarming for industrial players, researchers, investors and respective governing bodies to relook into the *Shari'ah* governance practices of IFIs for further enhancement of *shari'ah*-compliance.

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