Toward A Comprehensive Sharia Governance Framework for Islamic Finance: A Contribution to the Debate

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Abstract
Islamic Financial Institutions (IFIs) must comply with the key principles of Sharia which prohibits interest, gambling and speculation and requires profit and loss sharing (equity-based) as well as backing by a real asset. In addition to the traditional corporate governance requirements for financial institutions (FIs), Sharia governance is key to ensure the stability of the Islamic finance industry. As IFIs gain in strength and spread, the importance of standardized processes and regulated systems becomes increasingly crucial. We believe that Sharia governance will become an important subject to IF regulators and standard setting bodies. The past years have seen encouraging progress on the governance front with significant steps taken by market players and local regulators. Nevertheless, we believe that existing Sharia governance frameworks show a number of shortcomings and a room for improvement, especially in Islamic finance core markets. In particular, we think that the industry should move from ex-ante Sharia approval to ex-post Sharia external audit.

Keywords: Islamic finance, corporate governance, Sharia governance

Introduction
The history of corporate governance can be traced back to the emergence of corporations where shareholders are separated from management. Broadly speaking, it is defined as a set of instruments that impact how a corporation operates and « how the suppliers of finance to corporations assure themselves of getting a return on their investment » (Shleifer and Vishny (1997).

Corporate governance has gained a renewed interest and prominence among academics and policymakers over the last decade particularly during and after the global financial crisis. The inadequacy of risk management by the executives and the lack of oversight by the boards of directors were among the main reasons behind the collapse of credit offering structures and the ensuing global financial crisis. Boards of directors failed to exert an effective oversight of risk management structures and to implement adequate policies to ensure a proper corporate governance framework.

Corporate governance is of greater importance for Islamic finance because of its specific features. IFIs must abide by Sharia principles, which require among others the equitable profit and loss sharing between parties in a given transaction. Such principle demands a high level of financial disclosure and transparency, which in turn creates significant requirements for the corporate governance framework of IFIs. In addition to the traditional corporate governance requirements for financial institutions, Sharia governance is key to ensure the stability of the industry. As IFIs gain in strength and spread, the importance of standardized processes and regulated systems becomes increasingly crucial.

During the last three decades, Islamic finance experienced remarkable growth and transformation demonstrated its potential as a competitive alternative for financial intermediation. Besides its core markets (Gulf Cooperation Council countries, Iran and Malaysia), which contribute to around 80% of its assets, the industry is extending its turf to other countries with large Muslim communities (Indonesia, United Kingdom, etc.)

The industry has also developed a comprehensive range of products serving a broad spectrum of consumers and businesses. Globally, Islamic finance was one of the fastest growing sectors in the international financial system. Experts estimate the industry assets have reached USD 2.1 trillion at year-end 2016 and maintained a growth rate of around 5% in 2017. They also expect that the industry will be worth USD 3 trillion sometime in the next decade.

Chart: Islamic Banking Assets (2008-2015*)

In light of the industry’s commendable progress and spread over the past decade, we believe that Sharia governance will become a more important subject to Islamic finance regulators and standard setting bodies. The past years have in fact seen encouraging progress on the governance front with significant steps taken by market players and local regulators. Nevertheless, we believe that existing Sharia governance frameworks show a number of shortcomings and a room for improvement, especially in Islamic finance core markets. Accordingly, the main questions of this paper are 1) where do we stand today in terms of Sharia governance on a global scale? 2) What are the main issues and concerns related to the Sharia governance of IFIs, and 3) How to improve the existing frameworks with the ultimate goal of enhancing the stability and integration of the industry.

The paper is organized into four sections. The first section includes a description of the core principles of Islamic finance. The second section reviews the literature on the main mechanisms of corporate governance for banks. It also focuses on the specificities of Islamic finance and provides an overview of the existing regulatory and corporate governance framework of IFIs. In the third section, we analyse the rationale for Sharia governance in Islamic finance and provide the features (definition, objectives, and scope) of a Sharia governance framework. Finally, we analyse the main issues related to the existing Sharia governance framework as well as the main challenges and recommendations that would help monitor the performance of the IFIs and the whole industry faithfulness and integrity.

I. Key requirements for Islamic finance

Islamic Financial Institutions (IFIs) must comply with the principles of Sharia, consisting primarily of Quran and Hadith (Sunna) and secondly Ijmaa and Qiyas. More generally, IFI should comply with the following principles:

- **Prohibition of interest (Riba):**
  Sharia strictly prohibits Riba or the charging of interest on financial transactions. Riba is defined as “an excess” and interpreted as “an unjustifiable increase of capital whether in loans or sales.” It also means a fixed positive rate of return tied to the maturity and amount of the principal regardless of the performance of the underlying investment.”

- **Profit/Loss Sharing (PLS):**
  The Islamic financial system promotes the concept of participation in a transaction backed by real assets, utilizing the funds on a profit-and-loss-sharing basis. Such participatory modes used by Islamic banks are known as Musharakah and Mudarabah. This profit and loss sharing mechanism encourages participants to a transaction to become partners and work together rather than to enter into a creditor-debtor relationship. Within a mudarabah partnership, for instance, the capital-owner (Rabb Al Mal) provides the capital and the other party (Mudharib) contributes to his expertise and management skills. The capital-owner is not involved in the actual day-to-day operations of the business but is free to stipulate certain conditions that he may deem necessary to ensure the best use of his funds. After the expiry of the period, which may be the termination of the contract or such time that returns are obtained from the business, the capital-owner gets back his capital together with a pre-agreed share of the profit. In the case of misperformance and absent any mismanagement from the Mudharib, the capital-owner will bear the financial loss. This partnership, backed by a real asset, aims to promote mutual responsibility for the outcome of the financial project which is believed to increase the likelihood of success of the venture. Shanmugam and Zahari (2009) show that the partnership aims to increase successful projects that provide stimulus to the economy.

- **Prohibition of speculative behavior (Mayseer) and avoidance of uncertainty (Gharar):**
  Sharia prohibits transactions featuring uncertainty, speculation and unlawful activities such as alcohol, gambling, and casinos. The underlying motivation of these prohibitions is to ensure a fair and socially responsible financial system.

- **Sanctity of contracts:**
  The consideration of the general sanctity of contracts in Islamic finance is vital. Sanctity of contract is not just about the parties to the contract keeping their promises; the proposition is deeper. Islam holds that a person’s property is inviolable. It forbids the unlawful depletion of other people’s property by way of theft, embezzlement, bribery and all other unlawful means of acquiring property and wealth. Therefore, contracts must not violate the

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1 In capital participation, several partners fund a business, share profits according to a pre-defined rate while losses are devided amongst themselves according to the level of their participation in the capital. The management of the company is entrusted either to all partners or to part of only one of them.

In profit participation, the profit is shared between the two players on a basis agreed upon in advance but capital losses are assumed by the provider of the capital.

The difference between Musharaka and Mudharaba is that for the former, the client makes also a financial contribution to the project/enterprise financed and the financier can be involved in the management of the project/enterprise.

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Islamic, religious and moral principles otherwise they will be considered illegal and unenforceable (Hussain and al (2015))

II. The definition of corporate governance
The term “corporate governance” was used from the 1980s, and all its ramifications have not yet become fully spelled out even though a substantial volume of literature became available on the subject. There is no single definition of corporate governance, and it has been defined in different ways depending upon the author's center of interest. According to some researchers, the governance structure is industry specific (Adams and Mehran (2003) and Macey and O’Hara (2003)). While the usual corporate governance mechanisms are applied to the governance of financial institutions, the debate on the structure and mechanisms of corporate governance in these organisations has evolved and broadened over the past decades due to the special nature of these organisations. In fact, studies on banks’ corporate governance (Levine (2004), Macey and O’Hara (2003)) acknowledge the existence of difficulties such as opacity or complexity and regulation in the governance of financial institutions. Moreover, the nature of the corporate governance framework for banks is important as it affects the value, the cost of capital, the performance, and the strategic decisions and thus the risk position of the bank.

Several definitions of corporate governance in banking are available, but the best-known concept for a sound corporate governance is the one first endorsed by the OECD in 1999 than revised and updated several times (June 2004, September 2015) and also adopted by the Bank of International Settlements (BIS) in 2014, which became an international benchmark for policymakers, investors and other stakeholders worldwide.

According to this definition, corporate governance aims at providing institutions with a body of rules and principles, with a view to insuring that good practices guide their overall management. A more contemporary definition of corporate governance concerns the whole process of managing a company and the incentive structure to address principal-agent issues and ensure that executive management serves the long term best interests of the shareholders and sustainable value of the company in conformity with the laws and ethics of the country. The corporate governance framework according to The BIS Committee’s 2010 guideline summarizing the OECD principles, may be defined as “all of the complex internal factors that are involved in balancing the power between the Chief Executive Officer (CEO), the Board, the shareholders and other stakeholders (ownership structure) including auditing balance sheet and off-balance disclosure, and transparency as well the external governance that involves to take over market and legal system.”

Hence corporate governance refers to the method by which a corporation is directed, administrated and controlled. Corporate governance mechanisms, incentives, and controls are designed to reduce the inefficiencies that arise from moral hazard and adverse selection and constitute a process of monitoring and promoting economic performance. The core principles of corporate governance advocated for conventional banks by OECD and BIS respectively are related. These are summarized in the following table.

**OECD CORE PRINCIPLES FOR BANK CORPORATE GOVERNANCE**

| 1. Ensuring the basis for an effective corporate governance framework |
| 2. The rights of shareholders and ownership functions |
| 3. Equitable treatment of shareholders |
| 4. Role of stakeholders in corporate governance |
| 5. Disclosure and transparency |
| 6. Role of the board |

**BIS CORE BANK CORPORATE GOVERNANCE**

| 1. Board’s overall responsibilities |
| 2. Board qualifications and composition |
| 3. Board own structure and practices |
| 4. Senior management |
| 5. Governance of group structures |
| 6. Risk management |
| 7. Risk identification, monitoring and controlling |
| 8. Risk communication |
| 9. Compliance |
| 10. Internal audit |
| 11. Compensation |
| 12. Disclosure and transparency |
| 13. The role of supervisors |
To sum up, the table below summarizes the typical regulatory and corporate governance framework for financial institutions.

### Regulatory and corporate governance framework for conventional banks

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<th>I-</th>
<th>The national corporate governance framework</th>
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<td></td>
<td>- Banking sector specific laws/codes / guidelines</td>
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<td>- Stock exchanges listing rules and regulations</td>
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<td>II-</td>
<td>International standards and codes</td>
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<td></td>
<td>- The OCED principles of corporate governance (2014)</td>
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<td>- Guidance by the BCBS on enhancing corporate governance for banking organisations (2015)</td>
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Source: Author's own elaboration

Islamic banks are subject to the same basic guidelines and codes for the best practices of corporate governance as the conventional banks stressing the three main areas of accountability, transparency, and worthiness. However, PLS principle implies different stakeholders relationships and by corollary different governance structures and practices from the conventional model. For example, Profit Sharing Investment Accounts (PSIAs) holders are supposed to have a stake in the bank’s investment and equity participation.

Hasan (2009, 2012) for example provides a literature review featuring the corporate governance structures of Islamic organizations and how those differ from conventional organization's governance models. He argued that the Islamic corporate governance model could be distinguished by “the aspects of episteme, corporate objective, the nature of management, the management board and the capital-related ownership structure” (Hasan (2009)).

In addition to the common regulatory environnement with conventional banks, in the context of their compliance with Sharia, Islamic banks are subject to an additional layer of governance or Sharia governance. The industry has created its own standard setting bodies such as the Accounting and Auditing Organization for the Islamic Financial Institutions (AAOIFI) or the Islamic Finance Service Board (IFSB), which provide guidelines and governance standards tailored to the specific case of Islamic banks.

### III. Regulatory and corporate governance framework of Islamic financial institutions

In addition to the above, Islamic banks are subject to:

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<th>I-</th>
<th>Islamic Finance and Sharia specific codes and standards</th>
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<td>- IFSB Guidances principles on Sharia’s Governance systems for institutions offering Islamic Financial Services 2009</td>
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<td>- IFSB Guiding Principles On the conduct of Business for institutions Offering Islamic Financial Services 2009</td>
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<td></td>
<td>- Core Principles for Islamic Finance Regulation (banking segment ) CPIFR (2015)</td>
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<td></td>
<td>AAOIFI Accounting, Auditing and governance Standards for islamic financial institutions</td>
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### 3.1. Standard setting bodies and other organisations in Islamic finance

Since the mid-1990s, Islamic financial products attracted a growing number of countries and public interest. Central banks and regulatory authorities in these countries have agreed on the need of a regulatory framework and began to call for regulation and supervision of the Islamic finance industry. To that end, standard setting bodies such as AAOIFI, IFSB, and International Islamic Financial Market (IIFM) were created to issue international standards and guidelines, insuring the homogeneous interpretation of Islamic jurisprudence and deal with the corporate governance issues. The industry has also created a rating agency, the Islamic International Rating Agency (IIR) to respond to the needs of independent and objective credit quality opinions. More recently, the International Liquidity Management Corporation (ILM) was established to assist Islamic financial institutions in addressing their liquidity management issues and primarily the lack of high quality liquid assets, in an effective manner.

#### 3.1.1. The Islamic Financial Services Board (IFSB)

The Islamic Financial Services Board (IFSB) started operations in 2003. Its relation to the Islamic financial countries is similar to that of BIS for the major developed countries. It serves as an international standard-setting body of regulatory and supervisory agencies that have vested interest in ensuring the soundness and stability of the Islamic financial services industry including banking, capital markets and takaful (or Islamic insurance). The IFSB promotes

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1 IFSB council members is composed of the Central Banks of 20 countries that are: Bahrain, Bangladesh, Brunei, Djibouti, Egypt, Indonesia, Iran, Jordan, Kuwait, Malaysia, Maldives, Mauritius, Nigeria, Pakistan, Qatar, Saudi Arabia, Singapore, Sudan, Syria and the United Arab Emirates.

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the development of a prudent and transparent Islamic financial services industry through introducing new or adapting existing international standards consistent with the specific nature of IFIs and recommend them for adoption. Particularly, in the area of corporate governance, the IFSB has set a number of guiding principles on prudential requirements for institutions offering only Islamic financial services (IFIS) (excluding Islamic Insurance (Takaful) and Islamic Mutual Funds).

These guiding principles are divided into four parts:

1. General governance approach of IFIs
2. Rights of investment account holders (IAH)
3. Compliance with Sharia rules and principles, as determined by the respective national authorities
4. Transparency of financial reporting in respect of investment accounts

3.1.2. The Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI)

The Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) is an international institution that prepares accounting, auditing, governance, ethics and Sharia standards for Islamic financial institutions. Based in Bahrain, it was established in accordance with the Agreement of Association which was signed by Islamic financial institutions on Feb. 26th, 1990 in Algiers. It has 200 members from 45 countries. Its membership includes central banks, IFIs and other bodies in the Islamic banking and finance industry. IFIs are not obliged to adopt AAOIFI standards and guidelines. However, regulatory and supervisory authorities around the world are increasingly relying on them and aligning their standards to them.

Among others, the AAOIFI issued
- 25 accounting standards,
- 5 auditing standards,
- 7 corporate governance standards, and
- 2 codes of ethics for employees and auditors

The AAOIFI is focusing on the auditing and accounting side where processes and transactions need to be handled differently from the conventional banking practices (Faiz (2011)) but does not have the power of the central banks and national regulators to impose these standards and guidelines and ensure compliance.

3.1.3. The Islamic International Rating Agency (IIRA)

The Islamic International Rating agency (IIRA), based in Bahrain, started operations in 2005. It provides an assessment of the risk profile of entities and instruments and helps the financial institutions adhering to greater standards and disclosure to gain recognition at the national and international levels. Thus, it is supposed to exercise the role of a market discipline force for an effective corporate governance of these institutions. The IIRA competes with the leading international rating agencies that are Fitch, Moody’s and S&P Global Ratings (formely Standard & Poor’s) and aims to become a significant player on which investors and IFIs can rely to achieve quality in terms of compliance with Sharia rules and principles.

3.1.4. The international Islamic Financial Market (IIFM)

The international Islamic Financial market is the global standard setting body for the Islamic Capital and Money Market segment of IFIs. It started its activities in 2002. Its main objectives are:
- Standardization of Islamic financial products and the development of an international financial market consistent with the Sharia rules and principles.
- Addressing the issue of liquidity management of IFIs with the help of the IILM
- Developing an active secondary market and creating the environment that will encourage Islamic and non-Islamic institutions to participate in a secondary market actively.

IV. The rationale of Sharia governance

The most important feature in the IFI business model is that IFIs have the duty to ensure compliance with the Islamic Sharia principles in all aspects of their products, instruments, operations, practices, and management. Comprehensive

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4 For instance, Greuning and Iqbal (2008) notice that the private rating agencies have not yet developed the important skills or found enough incentives to monitor islamic bank compliance with the sharia principles.

5 The International Islamic Liquidity Management Corporation (IILM) shareholders are 11 central banks as well as two multilateral organisations and was created to assist institutions offering Islamic financial services in addressing challenges related to their liquidity management. For more information about this body, please refer to “corporate governance in Islamic finance (Elasrag (2014))"
compliance with Sharia principles would bring confidence to the general public and the financial markets on the credibility of the Islamic finance industry.

That said, apart from the natural agent/principal relationship between the bank and depositors/investors, this relationship distinguishes Islamic banking from conventional banks by an implicit trust to fully comply with the Sharia. In case of non-compliance, the bank would entail a reputation risk which would lead to serious consequences including the withdrawal of funds and insolvency risk. In order to preserve their credibility, IFIs need to have a proper Sharia governance framework.

The rationale for Sharia governance system is derived from 4 different sources namely religious, social, economic and legal. The religious position is derived from the ability of Sharia scholars in understanding and interpreting Sharia principles. The social power of the Sharia governance provides confidence to the stakeholders about the legitimacy of the activities of the IFI. The economic power can be seen from the fact that the profitability and the performance (capital adequacy ratio impact and thus creditworthiness) of an IFI depend on the performance of Sharia scholars. In fact, some authors demonstrated that Sharia supervision boards positively impact on Islamic banks’ performance when they perform at the same time an advisory and supervisory role (Mollah and Zaman (2015)). Finally, the legal power is derived from a variety of sources including regulators of respective countries. The hierarchical position of Sharia governance framework under the shareholders of the IFI emphasizes its supremacy over other governance organs to achieve a general strengthening of good corporate governance culture.

For all these reasons, IFIs need to undertake proper Sharia governance mechanisms where the compliance is only one component of a general Sharia governance framework.

4.1. Definition, objectives, and scope of the Sharia governance framework
The AAOIFI and the IFSB are the main bodies that set standards for Islamic financial intermediaries, and they have each compiled a list of guiding principles for Sharia governance. Despite the fact that the expression « Sharia governance framework » is being commonly used within the Islamic financial industry to refer to structures and processes adopted by stakeholders to ensure an active role of the Sharia board and the compliance with Sharia rules and principles, it has not been properly defined. The IFSB is the only organization to provide the definition of Sharia governance in its guiding principles as: “a set of institutional and organizational arrangements through which an Islamic financial institution ensures that there is effective independent oversight of Sharia compliance aspects in IFI.” Sharia non-compliance risk can have significant impacts on IFIs including the risk of default. In order to meet the compliance requirement, the IF needs:

1- A clearance from its Sharia Board regarding the compliance of its products.
2- An assurance that all Sharia board ruling was implemented effectively.

Accordingly, the general approach to Sharia governance system mentions that IFIs should have both ex-ante and ex-post functions of governance that include Sharia a) pronouncement/resolution, b) supervision and c) control. A comprehensive Sharia governance framework should, therefore, include the following:

**Ex-ante aspects of Sharia governance**
- Issuance of relevant Sharia pronouncement or resolution by the mandated Sharia board.
- Dissemination of information on such Sharia pronouncement or resolution to the operational personnel of the IFIs and ensuring the compliance. This task is generally performed by the Sharia Compliance Internal Control Unit (ISCU).

**Export aspects of sharia governance**
- An internal Sharia compliance review/audit Unit (ISRU) to ensure the compliance. This unit typically records and reports any incident related to non-compliance and makes sure that it is addressed. 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 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.
- An annual Sharia compliance review/audit to check that internal Sharia compliance review/audit has been appropriately carried out, and its findings have been resolved.

The table below summarises the scope of Sharia governance framework compared with the conventional system.
From this analysis, it appears that in addition to the board of directors, the Sharia board is the main element of Sharia governance for Islamic institutions. It plays the dual role of consultation and supervision.

The AAOIFI and the IFSB also issued a number of guiding principles and standards that define the duties and responsibilities of the Sharia board. For instance, the AAOIFI provides standards regarding the Appointment, Composition, Reporting, and Independence of the Sharia Supervisory Board. On the other hand, the IFSB further provides guiding principles in five sections covering the general approach to Sharia governance system, competency, independence, confidentiality, and consistency.

The Sharia board is defined as “independent body of specialized jurists in fiqh al mu’amalat (Islamic commercial jurisprudence).” Nevertheless, the Sharia board is allowed to seek the service of consultants who have the expertise in business, economics, law, accounting, etc. The duty of the Sharia board is to make sure that banks engaged in Islamic operations remain compliant with Sharia. Its areas of intervention and responsibilities cover the following main subjects:

1. Certification of permissible financial instruments through fatwas
2. Verification of transactions compliance with issued fatwas
3. The calculation and payment of Zakat (almsgiving)
4. Disposal on non-Sharia-compliant earnings
5. Advice on the distribution of income or expenses among the bank’s shareholders and investment account holders.

According to the AAOIFI, the Sharia board should consist of at least three members who are recommended by the Board of Directors before they are appointed by the shareholders in the annual general meeting. Shareholders may also authorize the board of directors to set the remuneration of the Sharia board.

4.2. Issues and challenges related to the existing Sharia governance framework

The functioning of the existing Sharia governance mechanisms raises a number of issues, including:

- **Sharia compliance risk**

  Sharia compliance risk is related to the structure and functioning of the Sharia Boards at the institutional and systemic level. It consists of 1) non-standard and non-formalised practices in respect of different contracts in different jurisdictions; and 2) failure to comply with Sharia rules and its financial and non-financial implications. Moreover, different adoption of Sharia rules results in differences in financial reporting, auditing, and accounting treatment. For example, some sharia scholars consider the terms of Murabahah contracts to be binding on the buyer; others argue that the buyer has the option to decline after placing an order and paying the commitment fee. The bank risk is higher in non-binding cases, and it may lead to potential litigation problems in the case of unsettled transactions.

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The financial impacts would be the invalidation of contracts, non-halal income, low profitability and performance.

The non-financial impacts: the bank reputation, moral and ethical (against the command of Allah), contravention of the provision of the Islamic Banking law.
- The heterogeneity of the Sharia governance models across countries

It appears from the examination of different countries and institutions experience that there is a variety of systems in place. This pluralistic approach seems natural as the legal environments within which Islamic financial institution operate differ not only in terms of the status of the Sharia but also depending on whether the countries use common or civil law. In fact, the majority of IFIs have established their in-house Sharia board as part of the internal governance structure. In some countries, regulators created centralized Sharia board at their level with the status of final arbiter for matters related to compliance. For instance, in some countries, the Sharia board governance is ruled independently on an institutional bank level while it is organised on a state level in Malaysia with additional individual Sharia board in Islamic banks. The decentralized (internal) solution is more market oriented and thus open to innovation while the external (centralized) approach in Malaysia is more state-oriented. It worth noticing, however, that until now, there is still no evidence on whether greater involvement of regulatory authorities or otherwise is more effective. Alman (2012) for instance show that supervisory effectiveness and disciplining power of individual bank Sharia board towards the risk taking in the loan portefolio of IF decreases in a decentralized Sharia compliant governance structure but not the other way around. Annex 1 shows the disparities in the Sharia governance models between different countries.

4.3. Issues related to the characteristics of the Sharia board

There are many issues related to the Sharia board characteristics and functioning. They mainly cover the competency, independence, confidentiality, and consistency of the SB members. First, the nomination and election process of the Sharia board members may lead to a Sharia board being dependent from the Board of Directors and shareholders, more so when Sharia board members are interested in continuing their mandates (being reelected) (see Rammal (2006), Farook and Farooq (2011)). Thus, Sharia board members are subject to a conflict of interest because of the dual relationship with the Islamic bank as a provider of remunerated services and as assessor of the nature of operations. Furthermore, the size of the Sharia board may have an impact on the effectiveness of the Sharia board governance. For instance, using cross country bank level data from MENA during the period 2000-2010, Alman (2012) conclude that increasing the size of Sharia board, multiple memberships of to twenty ranked Sharia scholars and annual changes in the composition of Sharia board are accomodative to increasing the loan risk taking of IFI.

In the same vein, as the sources of the Sharia are especially relevant for certification and monitoring, they can allow some scope in the interpretation from strictly prohibited to permissible elements (Alexander (2010) and Rider (2012). For instance, empirical evidence from Adams and Ferreira (2007) shows that a less independent Sharia Board may decide in the interest of the management and shareholders and may not monitor the management stringently mainly in the context of high competition. This problem would be recurrent in case of reappointment of a Sharia, board member. Third, given that a limited number of Sharia scholars have the required qualifications; this may lead to multiple memberships and appointments. Although, this concentration of Sharia board positions would have benefits when results in an informal standardisation of the operations and again from experience and reputation (Ferris (2003), Fich and Shivadasani (2006)), it can lead to a succession risk and to further conflicts of interest because one scholar or a network of scholars has access to internal bank data of competing for Islamic banks (see Grai and Pellegrini (2006), Wilson (2009), Rider (2012)). Finally, one of the most controversial and sensitive issues facing the IF industry is that of scholar remuneration. While it is fair and reasonable that scholars receive remuneration, given the complexity of their role and the requirement for detailed knowledge of Sharia as well as an understanding of complex financial transactions, more transparency is needed. Some countries, such as Oman, require the declaration of Sharia board members remuneration and restrict the number of boards on which scholars may sit. More recently Bahrain also proposed new disclosure requirements that require the publication of aggregate remuneration paid to in-house scholars. However, these requirements remain the exception rather than the rule.

4.4. Issues related to the relationship to depositors in IFIs

Profit & loss sharing (PLS) matters

Unlike a conventional bank that is a borrower and lender of funds and guided by the “maximisation of value”, the nature of the relationship between an Islamic bank and its investors/depositors is not solely of principal/agent but is also based on implicit trust that the institution will remain compliant with Sharia (at least for a category of the clients that are looking for Shaira compliance). Islamic banks are generally financed to a large extent by deposits because of restricted access to other financing options. These deposits can be either: current accounts (Wadiah, Qard Hassan) or investment accounts unrestricted or restricted. Although they share risks with the bank due to profit and loss sharing

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8 Iran, Pakistan and Sudan are the only countries entirely based on Islamic financial system where the Central Bank guarantees and monitors compliance of the whole banking system with Sharia. (Greuning and Iqbal (2008)).
9 The top twenty scholars hold 621 positions, which constitutes almost 54% of total available seats, see Unal (2011), Farook and Farooq (2011))
principle, investment account holders have no governance or monitoring rights\textsuperscript{10}. Besides, there is no implicit or explicit deposit insurance which would lead to stronger monitoring incentives by depositors, and the SB is responsible for protecting the interests of deposits from excessive risk taking (El-Havary and al (2007), Greuning and Iqbal (2008), Errico ad Frahbaksh (1998)). But, this function is weakened by the dependence of the Sharia board on the management and on shareholders that result from the nomination and appointment process. Furthermore, PLS might result in a conflict of interest if shareholders are able to use depositors’ funds to minimize losses on their investments, hence the importance of checks and balances to mitigate this risk. On this matter, only a handful of Islamic banks disclose their profit and loss sharing formulas, profit equalization reserves or investment risk reserves\textsuperscript{11}.

4.5. Challenges and recommendations

The discussion on the shortcomings of the prevalent Sharia governance models shows room for improvements, which could help to enhance the stability of the industry. First, in order to maintain the independence of Sharia board, the members are not to subordinate their judgment on Sharia supervision matters and should not be involved in any matter with respect to managerial decisions and operational responsibilities of the IFI. In this context, the oversight of remuneration should also be seen as part of the wider question of the overall regulation of Scholars which should be done in a way that maintains their integrity and credibility. On this subject, many experts argue that the establishment of a regulatory body to govern Sharia scholars is perhaps now well overdue, and an organization able to provide a full code of conduct (in line with professions such as law and accountancy) would go a long way toward assuaging concerns and increasing confidence in the role of Sharia scholars on both a jurisdictional and a global basis. Second, greater harmonisation of the Sharia governance structures and procedures across jurisdictions is needed, especially since there are increasing numbers of IFIs with cross operations. The harmonisation of practices will serve as a catalyst for the development and promotion of a larger supply of Sharia compliant financial instruments. Third, consistency in terms of compliance and judgment across IFI over time is important. The IFI should fully understand the legal and regulatory framework for the issuance of Sharia pronouncement or resolutions in jurisdictions where it operates. As the industry is growing, the number of conflicting rulings on the permissibility of an instrument is likely to grow also if no efforts are made to harmonize the standards at a country level and across countries. Such standardisation will pave the way for higher global integration of the industry.

Finally, Sharia governance should be able to educate the clients that are sensitive to Sharia about the most significant part of the Sharia law since it has numerous sources\textsuperscript{12}. In conjunction of that, since clients expectations on what constitutes acceptable and effective Sharia governance differ broadly, SB should organize training for clients to provide extra knowledge for better understanding of ethical business. Otherwise, the client will depend mostly on the Sharia board due to the absence of self-monitoring which prove very risky for them for the reasons discussed earlier.

4.6. External Audit could become the way of the future

The existence of shortcomings and issues related to the delicate structure of the Sharia governance framework on one hand (relationship between Sharia scholars and the board of directors, management, conflicting tasks, etc.), and the growth and complexity of the Islamic finance industry, has raised the function of external audit to a position of critical importance in the Islamic financial system as it is already done in Pakistan and Oman. It would be necessary for the external auditors to ensure not only that banks’ financial statements are prepared in all material respects in conformity with the professionally accepted financial reporting standards but also that the profit or loss declared by the bank truly reflects the banks’ condition and that its profit has been derived without violating the requirements of the Sharia. Internal Sharia auditors have played this role so far. Their responsibility is generally to verify whether the activity of the bank was performed according to the ruling of the Sharia board. This model helped to create a new level of control, sometimes reinforced by the local regulations requiring the independence of the internal audit department. However, the findings of internal auditors are rarely disclosed to the public. Therefore, shifting the needle from ex-ante Sharia approval to ex-post Sharia audit with full transparency of the audit findings would strengthen the IF industry and shield it from risks related to credibility.

Moreover, it is conventionally not considered to be the task of the existing external auditors to perform Sharia audit. They are not even equipped at present to do so. However, if this task is assigned to them in the light of what has been discussed above on the matter of the existing Sharia governance systems, then the external auditors will have to create

\textsuperscript{10} Mudaraba contract may create a complex agency problem. The conflict arises since the bank as Mudarib works as an agent for the investment holders while the management protects the shareholder interest. R. Ghayad (2008) mentions that Mudaraba financing practice does not give investment account holder any authority to vote or assign the auditors and thus reduce their influential power in this regard.

\textsuperscript{11} These mechanisms were created by the industry to help smooth the return on PSEAs during economic downturns and reduce liquidity risks inherent to PLS.

\textsuperscript{12} Main sources of Sharia law are Quran, Sunnah, Hadith, Qiyas, Ijma and Ijtihad (for more details on that see “corporate governance in Islamic finance, basic concepts and issues”, Helasrag (2014))
the necessary expertise to perform this task. This would require that the training of auditors also includes necessary training in the financial aspects of Sharia just as it includes relevant training in auditing and law. If such training proves to be too cumbersome for the auditors, it may also be possible for the auditing firm to hire Sharia scholars and provide them some necessary background in auditing with the requirements of independence, and objectivity. In our opinion, it would be more efficient to create a new industry to perform the external audit of IFIs. Such industry will have to design and carry out audit procedures including inspection, observation, inquiry, confirmation, computation, and analysis, in a way that would help reduce to an acceptably low level the risk of giving an inappropriate audit opinion. The audit report cannot, however, provide an assurance about the future profitability or viability of the bank, or the efficiency and effectiveness with which the Management has conducted its affairs. This would be the job of a consulting firm, and not that of the external auditor, even in an Islamic system. They will also have to report their findings to the shareholders, depositors and the general public. Such reporting could encourage Islamic banks to be more careful in their dealings and operations. However, in order to get there, the industry needs to decide on whether the audit should be done based on a set of standards that would be acceptable globally (similar to IFRS) or locally (to be defined by local regulators) or if it should be done based on the initial Fatwa issued by the bank’s Sharia boards. If the industry decides to go with the global standards, AAOIFI and IFSB could play a role in designing these standards. Such a solution could be more cost effective for small banks and reduces the risks of conflicting opinions, inconsistency and uncertainty. In between, the industry could rely on centralized Sharia Boards such as what is done in Malaysia, Kuwait and the UAE. This would undoubtedly help to clear the Sharia compatibility and the standardisation of various modes and instruments of finance used by banks. However, in our opinion, this would also require a clear definition of the standards that external auditors need to measure across countries mainly those where the Islamic industry is systemically important. Although the AAOIFI has published numerous standards, Sharia boards appear to have significant leeway in making decisions regarding compliance. This has resulted in variations in Sharia requirements across the industry, with Malaysia being seen by market participants as the least conservative jurisdiction and Saudi Arabia as the most conservative.

Finally, in theory, holders of Islamic bank PLS accounts are entitled to share not only the profits related to activities of their deposits but also the losses. To our knowledge, this principle has not been applied consistency in the past, and no Islamic bank has transferred losses to consumers over the past 30 years. Giver, the delicate and close relationship between the IFI and the depositor under the postulate of PLS, another indispensable need of the Islamic financial system, is the availability of some judicial facility that would protect the bank or the depositor and help to get prompt verdicts on the disputes of banks with their depositors.

V. Conclusion
Sharia governance is an important component of the Islamic financial industry. While the industry has managed to grow strongly over the past three decades and gain in credibility, we are of the view that it now requires further refinement of its Sharia governance framework as it matures. The risks related to being perceived as non-Sharia compliance and the ensuing impacts on financial stability could act as catalysts for the regulators of countries where Islamic finance became systemic. To that end, we think that the industry should move from ex-ante Sharia approval to ex-post Sharia external audit. While internal Sharia audit has to some extent responded to this gap, we think that the lack of transparency of the findings of internal Sharia auditors and their potential conflict of interest provided only a partial solution to this risk. In order to minimize the risk of financial instability due to Sharia compliance perception, we believe that an alternative solution could be to create an external audit industry that would be tasked with performing the audit and disclosing its findings to the market to encourage market discipline. However, getting there would require a clear definition of a set of Sharia standards similar to the International Financial Reporting Standards for Accounting. While this task is significant in our opinion, it remains achievable in light of the existing infrastructure in the Islamic finance industry. Local regulators being on the Boards of the industry standard-setting bodies and the Sharia Board of Islamic international financial institutions, such as the Islamic Development Bank, could help to steer the industry in this direction. Moreover, we strongly believe that the creation of clearly defined Sharia standards will not only help to improve the industry financial stability but could also encourage more integration of the industry. It would finally make it easier for countries that are looking eagerly to the opportunities offered by the Islamic finance industry to develop their own strategies building on the industry significant achievements of the last three decades.

13 A number of countries such as Qatar, Malaysia have already made significant strides in this area and standardised their instruments, but much is to be done for other countries and the establishment of the International Islamic Rating Agency (IIRA) is a step further to pursuit this goal.
Annexe 1: Examples of Shariah governance approaches

<table>
<thead>
<tr>
<th>Sharia governance Model</th>
<th>Reactive approach</th>
<th>Passive approach</th>
<th>Minimalist approach</th>
<th>Pro-active approach</th>
<th>Interventionist approach</th>
</tr>
</thead>
<tbody>
<tr>
<td>Countries</td>
<td>UK, Turkey</td>
<td>Saudi Arabia</td>
<td>UAE, Qatar, Bahrain</td>
<td>Malaysia</td>
<td>Pakistan</td>
</tr>
<tr>
<td>Key features</td>
<td>Prevalent in non-Islamic legal environment countries</td>
<td>No national Sharia advisory board or any institutions to be the sole authoritative body in IF.</td>
<td>Slight intervention on the part of regulatory authorities.</td>
<td>Regulatory-based approach bylaws</td>
<td>Sharia Federal Court the highest authority</td>
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<td></td>
<td>Regulatory authorities are silent on the Sharia governance framework, compliance, and no specific legislation or directive governing IFIs.</td>
<td>Self-initiative rather than regulatory requirements or regulator’s direction</td>
<td>The regulatory authority expect IFIs to have proper Sharia governance system without specifying the requirements in details (possibility for multiple seats and appointments)</td>
<td>National Sharia Advisory Council (SAC) as the final arbiter.</td>
<td>Sharia board at the State Bank of Pakistan.</td>
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<td>Concerns only the advisory and supervisory role of the Sharia board.</td>
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<td></td>
<td>The intervention of regulators only in case of the significant issue which may affect the industry</td>
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</tbody>
</table>

Author’s own compilation from Hasan (2009) and Chowdhury (2015)
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