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 fulfill 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 accountibility which are in line with the teachings of the Shari’ah. Transparency and accountibility 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 (Muhammad 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 fatwa consequently exposing IFIs to Shari‘ah risk.

According to Ayedh and Echchabi (2015), the four different legal schools are Hanafi, Maliki, Shafi, and Hanbali. 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, Muhamad 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 position.

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
members do not conduct the IFIs management is more shareholder rather than stakeholder concentrated. Some of the bankers, lawyers to be the

countries have a prevention of the operation information but the disadvantage is that they do not have adequate knowledge on advisors. Due to the limited knowledge of

6. Conclusion and Proposed Solution

rectified soon, otherwise IFIs will end up with a bad reputation and losses. Current governance structure does not favour the failure of the IFI management to understand the extent and seriousness of

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

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.

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.

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 fiqih 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.
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 Shari’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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