

SHARI'AH GOVERNANCE REGIMES FOR ISLAMIC FINANCE: TYPES AND APPRAISAL

1. INTRODUCTION

A unique feature of Islamic finance is the compliance of all its operations with the principles and goals of Islamic law (*Shari'ah*). To ensure the *Shari'ah* requirements in the operations of Islamic financial institutions, a *Shari'ah* governance mechanism must exist. During its short history of more than three decades, the Islamic financial industry has expanded and diversified to become a significant global phenomenon. The growth path that the Islamic financial industry has taken, however, has been censured from various quarters for not fulfilling its overall objectives (*maqasid al Shari'ah*). Increasing there is a feeling that *Shari'ah* governance mechanisms have failed to ensure compliance with the principles and goals of Islamic law.

Shari'ah governance has to be understood in the context of overall corporate governance mechanism. Corporate governance in turn is affected partly by the law, partly by the participants themselves and more widely by the society (Cadbury, 2003). While there are various *Shari'ah* governance models, a key component of these will be to have a framework of *Shari'ah* supervision that ensures that *Shari'ah* requirements are fulfilled. A key element in *Shari'ah* governance is the *Shari'ah* Supervisory Board (SSB) constituting groups of scholars/jurists who oversee and sanction the 'Islamic' nature of products and operations of Islamic banks.

Given the above, the purpose of this paper is to examine the features of *Shari'ah* governance regimes and identify an appropriate framework that can aptly fulfill the *Shari'ah* requirements. The paper is organized as follows. Section 2 discusses the basic features of Islamic banking and the need for legal and regulatory regimes to support the sector. In Section 3, the stakeholders of Islamic financial industry and the *Shari'ah* requirements are identified. After presenting various *Shari'ah* governance regimes in Section 4, the following Section evaluates these and suggests a robust regulatory framework for *Shari'ah* governance. The last section concludes the paper.

2. ISLAMIC BANKING AND LEGAL AND REGULATORY ENVIRONMENT

Compliance with *Shari'ah* makes Islamic banks fundamentally different from their conventional counterparts. The dominant model of Islamic banking is the one-tier *mudarabah* model with multiple investment instruments. In this model, on the liability side of the balance sheet, the current or checking accounts are considered *qard hasan* (interest-free loan) and these have to be fully returned to depositors on demand. Profit-sharing investment accounts (PSIA) in Islamic banks take the form of *mudarabah*, in which the investors use the bank to manage his/her funds on a profit-loss sharing principle¹. The assets side of the balance is dominated by fixed-income modes of financing that include *murabahah* (cost-plus or mark-up sale), *istisna/salaam* (pre-paid sale with deferred delivery of object) and *ijarah* (leasing)².

Errico and Farahbaksh (1998) maintain that there is a need for legal foundation for Islamic banks either in form of general banking law or specific law that define the nature of these banks and their relationship with the central bank and other banks in details. Other than having provisions related to legal and regulatory issues (such as licensing, compliance with laws and regulations, and the supervisory authority), these laws should also define issues related to operational matters (such as nature of deposits, permissible modes of financing, etc.). For example, whereas main activities of Islamic banks are trading (*murabahah*) and investing in equities (*musharakah* and *mudarabah*), current banking laws and regulations in most jurisdictions forbids such activities by commercial banks. An Islamic banking law would make these activities legal and enable Islamic banks to provide *Shari'ah* compliant financial services.

Regulators are external public institutions that ensure the stability and soundness of the financial system and protect stakeholders who are not taken care of at organizational level. An appropriate regulatory framework for the Islamic financial industry will protect the rights of the PSIA depositors, remove the impediments for Islamic banks to provide *Shari'ah* compliant financial services and minimize risks arising due to the introduction of *Shari'ah* principles in banking operations.

Chapra and Khan (2000) identify some elements of the regulatory

¹ Under the *mudarabah* contract, while the profit is shared between the financier and the manager, loss is borne by the financiers only.

² For a discussion on these modes of financing see Ayub (2007) and Iqbal and Mirakhor (2007).

framework of Islamic banks related to protection of both the demand and investment depositors. As demand deposits in Islamic banks are loans (*qard hassan*) given to banks without interest, the regulators must have some guidelines to protect these depositors by requiring banks to minimize risks in using these funds. The use of profit-sharing modes of financing to reward PSIA depositors introduces some additional risks in Islamic banks³. As investment depositors share the profits of the bank, it may lead to withdrawal risks. If a bank fails to pay depositors comparable rates then there is a risk that the depositors will move their funds to other banks⁴. This can cause systemic risks and affect the whole financial sector.

As most of the depositors use Islamic banks for religious reasons, the regulators have to ensure that the banks perform their fiduciary duty by complying with the principles of *Shari'ah*. This requires greater transparency regarding the products offered and the operations of banks and having an adequate framework for *Shari'ah* governance. While an Islamic financial institution will have various organs and processes in the *Shari'ah* governance system, a key component of this system will be oversight by a SSB to ensure that *Shari'ah* requirements are fulfilled. Just as regulators ensure that the members of board of directors and senior management of individual banks are fulfilling their duties and responsibilities, there is a need to have a *Shari'ah* governance mechanism in place and ensure appropriate standards for membership in SSBs.

3. SHARI'AH GOVERNANCE AND ISLAMIC FINANCE

Grais and Pellegrini (2006a) maintain that

“the core mission of an Islamic financial institution is to meet its stakeholders’ desire to conduct their financial business according to *Shariah* principles”.

Along with economic benefits that different stakeholders anticipate while dealing with an Islamic bank, they also expect fulfilment of *Shari'ah* requirements in its operations. To fulfil the desire of stakeholders to comply with *Shari'ah* requirements, there is a need to

³ For details of these risks see Khan and Ahmed (2001).

⁴ A survey of depositors of Islamic banks confirms this. See Chapra and Ahmed (2002) for the survey.

have a *Shari'ah* governance mechanism in place. *Shari'ah* governance can be defined as the structures and processes in place to ensure that principles and requirements of Islamic law are fulfilled in all contractual and operational aspects of an Islamic financial institution from the perspectives of different stakeholders. Appraising the status of *Shari'ah* governance and supervision for Islamic financial sector would require identifying the *Shari'ah* requirements and stakeholders of the Islamic financial industry.

3.1 *Shari'ah Requirements*

Grais and Pellegrini (2006a: 13) identify three aspects of *Shari'ah* requirements for the Islamic financial industry. First, conducting financial transactions in accordance to the laws of *Shari'ah* (avoid *riba'* and *gharar*). Second, activities of the industry should foster social objectives by promoting social benevolence. Finally, developing an integrated Islamic financial system based on the principles and goals of *Shari'ah*. Aspects of these *Shari'ah* requirements are presented next.

Shari'ah Compliant Products and Operations

The products used by an Islamic financial institution on the asset and liability sides should comply with the principles and goals of *Shari'ah*. This would require contracts and all necessary supporting documentations including the legal papers, forms and processes to be *Shari'ah* compliant. After the product is launched in the market, there is a need to ensure that the procedures and processes are implemented in accordance with approved *Shari'ah* guidelines.

There are several issues related to operations of an Islamic financial institution that must be compliant with the principles and goals of Islamic law. All contractual obligations must be fulfilled by the Islamic financial institution. For example, the fulfilment of stipulations of contracts with depositors in terms of profit-sharing has to be ensured. Other than ensuring that the sequence of transactions takes place as approved by the SSB, operational issues will include treatment of interest-based calculations, discounting, early and late payments, defaults, etc. To maintain the Islamic nature of the organization, separation of penalty income (in case of default) and interest income (if any) from the income of the bank has to be assured. The unacceptable income has to be put in a special account and used for charitable purposes. Similarly, the payment of

obligatory alms (*zakah*) as an institution (or on behalf of its clients if it is deemed so) should also be implemented.

Satisfying the Social Goals

The proponents of Islamic economic system envisaged it would be one that realizes overall goals of Islamic law or *maqasid al-Shari'ah* (Siddiqi, 2006). Islamic financial sector being an integral component of an Islamic economy is expected to fulfil these goals. At a broadest level, *maqasid* includes growth (*tazkiyah*) and justice (*qist*) (Siddiqi, 2004). Kahf (2006) discusses *maqasid* at the product level. He identifies some of the objectives at the transactions level to include upholding property rights, respecting consistency of entitlements with the rights of ownership, linking transaction to real life activity and prohibiting sale of debt.

The broader *maqasid* perspective implies inclusion of social dimensions in Islamic finance. To achieve social goals an Islamic financial institution would not only avoid activities that are exploitative and harmful to the society, but also engage in ones that promote social welfare (Grais and Pellegrini, 2006a). Given this characteristic, it is imperative for Islamic banks to include social dimensions in their operations along with the normal banking practices.

An Integrated Credible Islamic Financial System

The stability and performance of an organization and the industry depend on the trust and confidence of the stakeholders on the system. This emanates from the nature of financial institutions which act as 'fiduciary trustee' on behalf of the depositors and investors (Grais and Pellegrini, 2006a: 5). An important fiduciary duty in case of Islamic financial institution is to conduct all business in accordance to the *Shari'ah* principles. Thus, consistency of the practice of an integrated Islamic financial sector with the spirit and principles of Islamic law will build trust and confidence among the customers and the community and ensure sustainability and growth of the industry in the long-run.

Note that a key factor that determines three *Shari'ah* requirements is the type of products marketed by different Islamic financial institutions. For example, the nature of the products offered will have implications regarding the fulfilment of *maqasid al-Shari'ah*

and the direction the industry takes in the long-run. The types of products used will determine whether the financial system will be stable and resilient. They will also shape the perceptions of the customers and community and determine the level of trust and credibility stakeholders have on the sector in the long-run.

3.2 Stakeholders

Grais and Pellegrini (2006b) identify four stakeholders of Islamic financial institution as shareholders, depositors, borrowers, and the socially vulnerable groups. IFSB (2006: 27) identifies stakeholders for the Islamic financial sector in a broader perspective and includes employees, customers, suppliers, the Muslim community (*Ummah*), supervisors and the government. From the above, four stakeholders of an Islamic financial institution are identified for this paper: shareholders, depositors/investors, Muslim community at large and the regulators.

From a governance perspective, the owners of a bank or the shareholders constitute one of the important stakeholders. The Board of Directors (BOD) oversees interests of shareholders by setting the overall strategy and policies of the organization and guiding the senior management to achieve the goals. While one of the main goals of shareholders of Islamic banks will be to maximize profit, the BOD has to ensure that this is done by using *Shari'ah* compliant methods.

The depositors and investors form the second important stakeholders of Islamic financial institutions as they provide the bulk of the funds in the form of demand deposits and profit-sharing investment accounts (PSIA). The funds are provided with expectations of good services, competitive returns and compliance with the principles of Islamic law.

The aspiration of the community is to have a just, stable and resilient Islamic financial industry fulfilling the goals of *Shari'ah*. The Muslim community is represented by individuals (political activists, academics, intellectuals, etc.), civil societies and organizations who desire a financial system based on Islamic values and principles. While well-wishers of the industry include many individuals who are contributing to the industry, some organizations in the form of associations and academic bodies also serve different needs of the industry⁵.

⁵ These would include *fiqh* bodies (such as Islamic Fiqh Academy,

In a well-functioning financial system, the regulators are stakeholders acting on behalf of the society at large. Llewellyn (1999: 9) identifies three core objectives of regulation:

“to sustain systemic stability, to maintain the safety and soundness of financial institutions, and to protect the consumer”.

An important aspect of bringing stability and efficiency in the banking sector is to require good governance practices and structures. To reduce *Shari'ah* compliance risks and ensure that the Islamic banks fulfil their fiduciary duties of conducting business according to *Shari'ah* principles, the regulatory bodies can provide *Shari'ah* governance framework and guidelines.

4. SHARI'AH GOVERNANCE FRAMEWORK

The *Shari'ah* governance structure becomes an important determinant of Islamic banking practice and types of products offered. Four factors are used to classify *Shari'ah* governance regimes. The first is the existence of an appropriate legal and/or regulatory framework. This would be in form of having an Islamic banking law and/or special regulatory framework for Islamic banking. While some countries will have both, Islamic banking law and regulations for Islamic banks, others may just have robust regulations for the industry.

The second factor relates to the regulatory framework to strengthen the organizational *Shari'ah* governance structures and processes in Islamic banks. Other than requiring Islamic banks to have a *Shari'ah* Unit/Department, other elements of the governance regime can include overview over various aspects of the organisational SSB. The issues under purview can include the terms of reference of SSB, defining the duties and role of SSB members, approving appointments of SSB members, specifying the qualifications and minimum number of members in the SSB, and identifying the position of SSB in the governance structure. The code of conduct of SSB members can include limits on the number of banks they can

AAOIFI Shari'ah Board, etc.), academic and research institutions (such as the Islamic Research and Training Institute of the Islamic Development Bank Group) and organizations representing the industry like CIBAFI, an umbrella organization of the OIFS.

serve in, avoid conflict of interest, maintain independence, etc. The operational issues related to *Shari'ah* governance would be to ensure information disclosure related to products, proper use of charity fund and separation of funds and risks if Islamic windows exist.

The third element of the regime is a complementary *Shari'ah* supervision mechanism at regulatory level by establishing an active National *Shari'ah* Authority (NSA). The NSA can address *Shari'ah* related issues by harmonizing *Shari'ah* interpretations and ensuring compliance with *Shari'ah* principles. The national *Shari'ah* governance framework can also accomplish the broader *Shari'ah* requirements of the industry and protect the interests of stakeholders not served at organizational level.

The final aspect of *Shari'ah* governance framework relates to SSBs at organizational levels. Even in the absence of regulatory requirements, Islamic financial institutions would establish SSBs to enhance the legitimacy and credibility of their operations. Given the above four elements, the following four types of *Shari'ah* governance regimes can be identified.

Legally Constructed

This system is similar to the conventional financial system whereby the banking law broadly determines the operations of Islamic banks. Under this structure, the *Shari'ah* framework is determined by law with no supporting *Shari'ah* bodies at national or organizational levels. Example of this system is the *Shari'ah* governance regime in Iran where the products that can be offered by banks are identified by the Usury Free Banking Act (1983). While the central bank is responsible to implement the law, there is neither a NSA at national level nor is there any requirement to have SSB at organizational level. The central bank has identified the permissible modes of financing and the banks are free to choose any one or combination of these (Khan and Mirakhor, 1990). If a new product is introduced, the central bank seeks advice and endorsement on the *Shari'ah* related issues from a well-respected *Shari'ah* scholar.

Robust Shari'ah Governance

This regime will have Islamic banking laws to support the Islamic banking industry and an active *Shari'ah* governance system both at

national and organizational levels. Not only do the regulatory bodies provide detailed guidelines that strengthen the *Shari'ah* supervision at organizational level, the NSA also plays an active role in *Shari'ah* issues of the industry. Examples in this category include Indonesia, Pakistan and Malaysia. Indonesia introduced the Islamic Banking Act No. 10 in 1992 and amended it in 1998. The country further introduced the Central Banking Act in 1999 to support creation of instruments of liquidity management for Islamic banks. The National *Shari'ah* Board (*Dewan Sharia Nasional* or DSN) is an independent body under the Ministry of Religion. All new products coming to the market must be approved by this national *Shari'ah* body.

Pakistan amended laws to accommodate Islamic finance including the enactment of Banking and Financial Services Ordinance (1984). The State Bank of Pakistan (SBP) established a central *Shari'ah* Board (SB) to guide the Islamic financial sector and SBP regarding matters related to the Islamic finance. Other than *Shari'ah* scholars, the SB has members from various fields such as banking, accounting, law, etc. The roles of SB include reviewing and approving *Shari'ah* compliant products developed by the SBP. The SB provides the broad guidelines of the model agreements of various permissible products which all Islamic financial institutions must abide by. The rulings of SB are binding on all Islamic banks.

Malaysia enacted Islamic Banking Act (IBA, 1983) and Bank and Financial Institutions Act (BAFIA, 1993, amended) to cater to the Islamic banking practices. The central bank of Malaysia (Bank Negara Malaysia or BNM) established a national *Shari'ah* Advisory Council (SAC) in 1997 as the highest authority for *Shari'ah* related issues in Islamic banking and *takaful* (Islamic insurance) industry. Among others, the SAC advises BNM on Islamic banking and *takaful* issues, coordinates *Shari'ah* matters and evaluates *Shari'ah* aspects of new products submitted by the Islamic banks. Islamic banks have their own *Shari'ah* Committees, which are guided by the *Guidelines of the Governance of Shari'ah Committee for the Islamic Financial Institutions* provided by BNM. All new products developed must be submitted to BNM for scrutiny which includes review and approval by the SAC.

Passive Shari'ah Governance

While this category of countries has Islamic banking laws or regulations, the framework of *Shari'ah* governance at national level

is passive. Islamic banks in these countries have active SSBs at organizational level. These countries may have a NSA, but their role is limited and does not include approval of new products. Examples of countries with Passive *Shari'ah* Governance regimes are UAE and Kuwait. The UAE Federal Law No. 6 of 1985 calls for the creation of a Higher *Shari'ah* Authority comprising people with backgrounds in *Shari'ah*, legal and banking backgrounds to ensure the legitimacy of the transactions according to the provisions of *Shari'ah*. The law also requires the creation of SSB with at least three members Islamic banks to ensure that the transactions are in accordance with principle of Islamic law.

Similarly, the Central Bank of Kuwait Law of 1968 stipulates that Islamic banks should have SSB of at least three members appointed by the General Assembly; higher level Fatwa Board of the Ministry of *Awqaf* is consulted only in case of conflict of opinions among the members of the SSB. In both cases, neither are there any specific provisions in the law for the higher *Shari'ah* body to either clear the products approved by the SSB at organizational level nor any specific directives issued to strengthen the structure and processes of *Shari'ah* supervision at organizational level.

Market Driven

Under the market driven regime, there are no specific banking laws or regulations for Islamic banks. The role and functions of the different *Shari'ah* organs including the SSB are defined by guidelines and/or terms of references prepared by the shareholders at General Assembly/BOD/the articles of association of the Islamic financial institutions. There is no regulatory oversight by a NSA of the products being marketed and no regulatory guidelines for SSB at organizational level⁶. The system is market driven whereby new Islamic products are cleared by the SSBs at organizational level and *Shari'ah* compliance is left to the banks. Market driven practice of Islamic banking is found in Kingdom of Saudi Arabia and United Kingdom.

⁶ Note that even though NSA may not exist, Islamic bank may still have to get their new products approved by the regulatory authorities. The regulatory authorities check the risk features of the product before approving it and not the *Shari'ah* related issues.

Table 1 shows the features of different *Shari'ah* governance regimes discussed above. As can be seen, a legally constructed system does not have any role of SSBs, either at national or organizational levels. The most vigorous *Shari'ah* governance regime appears to be the robust governance model, where the banking law provides a framework for the operations and a sound regulatory framework for SSBs at organizational levels exists along with a national level *Shari'ah* authority. Although a national *Shari'ah* body may exist in a passive *Shari'ah* governance regime, its role is narrowly defined. In this regime the SSBs in the banks play a dominant role. The market driven system depends on SSBs at organizational level only, without any regulatory overview over the *Shari'ah* related issues.

TABLE 1 - *Features of Shari'ah Governance Regimes*

Features	<i>Legally Constructed</i>	<i>Robust Shari'ah Governance</i>	<i>Passive Shari'ah Governance</i>	<i>Market Driven</i>
IB Law/Regulation	x	x	x	
Regulatory Requirements for SSB		x	?	
National <i>Shari'ah</i> Authority		x	?	
Organizational SSBs		x	x	x

5. SHARI'AH GOVERNANCE REGIMES: AN APPRAISAL

Before evaluating different *Shari'ah* governance models, there is a need to point out some of the concerns arising in Islamic finance practice. While Islamic finance has been criticised for not fulfilling the social goals, there are apprehensions that even some of the legal *Shari'ah* requirements may be compromised. The problems of *Shari'ah* compliance in the practice of Islamic finance are increasingly becoming evident in academic writings, rulings of scholarly *Shari'ah* bodies and court cases. In a recent study examining 560 *sukuk* (Islamic bonds) issues, Dusuki and Mokhtar (2010) find that 98 percent of these replicate conventional unsecured bonds and do not fulfil the legal *Shari'ah* requirements of an actual sale

of the underlying asset to the investors. This finding concurs with the assertion of Usmani (2007), a senior *Shari'ah* scholar, that the majority of the *sukuk* (Islamic bonds) issues in the market replicate conventional bonds and are not in line with the spirit of Islamic law.

In 2009, the Islamic Fiqh Academy, an international authoritative body of Islamic jurisprudence, issued an edict that organized *tawarruq*, that is practiced widely in the GCC region, is not lawful as it has elements of forbidden *riba*⁷. Recently, the Investment Dar, an Islamic financial institution based in Kuwait, argued in an English court that the agency contract used to raise investments amounting to USD 10.7 million was not compliant with *Shari'ah*. It argued that the 5 percent return promised to the investor, Blom Bank can be construed as prohibited interest and, as such, cannot be paid in accordance with its charter.

Of the *Shari'ah* governance regimes discussed above, the dilution of *Shari'ah* principles is most likely to occur in countries without regulatory oversight (that either have the passive *Shari'ah* governance or market driven regimes). In countries with regulatory purview, a process of check and balance of *Shari'ah* compliance exists. For example, in Indonesia the National *Shari'ah* Board (*Dewan Shariah Nasional* or DSN) must approve all new products coming to the market. One bank wanted to introduce *tawarruq* based product in the country in 2005. The DSN gave conditional approval to the product with 14 conditions attached. The conditions are stringent and essentially convert the product into a *murabahah* type product. As a result, the bank decided to delay the introduction of *tawarruq* based product.

There are two interrelated areas of concerns related to *Shari'ah* governance that rely on SSBs at organizational levels only. First, the selection of *Shari'ah* scholars and the structure and functions of SSBs are determined at organizational level. As *Shari'ah* governance and supervision becomes a sub-system of the overall governance system of a bank, there are chances that the SSB members are selected to serve the interests of the shareholders, and not all the stakeholders. A critical issue in *Shari'ah* governance in Islamic banks is the use of control and authority by the BOD and management to serve their needs. As the BOD and senior management of Islamic banks decide

⁷ The ruling was issued by the International Fiqh Academy in its 19th session which was held in Sharjah, United Arab Emirates during 26-30 April 2009.

who can sit in the SSB and also that fact that the members are paid by banks can raise conflict of interests and lead to situations whereby the independence of the SSB may be compromised. Selecting the SSB members who are more inclined to fulfil the economic objectives of the Islamic banks can create incentives for 'fatwa shopping' and limit and compromise the role of SSBs (Graiss and Pellegrini, 2006c).

The second area of concern, emanating from the first, relates to clearance of new products that dilute *Shari'ah* requirements. As the approach of the Islamic banking industry has been predominantly to design products taking conventional products as benchmarks, cases can arise when there may be trade-offs between the *Shari'ah* requirements and economic factors. If the SSB is permissive, the economic factors will be given more weight at the cost of *Shari'ah* principles. This may result in opting for controversial Islamic products even when *Shari'ah* compliant alternatives are available. This raises questions about the objectivity of the *Shari'ah* scholars in SSBs as Kahf (2004b: 27) points out that

"many of them are now accused of being bankers' window dressing and of over-stretching the rules of *Shari'ah* to provide easy *fatwas* for the new breed of bankers".

The above concerns of objectivity and conflict of interests of the SSB at organizational level may necessitate regulatory intervention. One key reason for a regulatory oversight of the *Shari'ah* governance process is to protect the rights of other stakeholders, who expect the industry to conduct all its operations in a *Shari'ah* compliant manner. *Shari'ah* governance, from the regulators perspective, will consider the interests of all stakeholders, including depositors, whose interests may not always be recognized at bank level.

From a regulatory standpoint, there are additional reasons to have *Shari'ah* overview at national level. Leaving *Shari'ah* governance at bank level can generate different risks that can adversely affect the stability and growth of the industry. Qattan (2006) points out that *Shari'ah* non-compliance can be a reason for reputation risk that can trigger bank failure and cause systemic risk and instability. The same can happen if the perception of stakeholders about the Islamic products becomes negative causing a serious loss of trust and credibility⁸.

⁸ Chapra and Ahmed (2002) report that a survey shows that 381 (81.4 percent) total number of 468 depositors from Bahrain, Bangladesh and

Another risk that may require regulatory attention is the legal risks arising from diversity of *fatwas* issued by various SSBs within the same country. As SSBs produce *fatwas* by interpreting different legal sources, the likelihood of coming up with conflicting opinions exists. With the expansion of the industry, the possibility of conflicting *fatwas* will undermine the customer confidence in the industry (Graiss and Pellegrini, 2006c). This calls for maintaining credibility of the edicts issued within a jurisdiction by harmonizing the *Shari'ah* rulings at national level.

The above discussions indicate two broad categories of regulatory measures that can improve the *Shari'ah* governance for the industry. The first regulatory action relates strengthening the organizational *Shari'ah* governance structures and processes. This can be done by providing regulatory guidelines for delineating the qualifications and requirements of scholars who can serve in the SSB at bank level and having appropriate structure and processes to ensure *Shari'ah* compliance of the operations of Islamic banks. IFSB (2009) provides guidelines for operations of SSBs and other mechanisms that can make the *Shari'ah* supervision system at organizational level robust. Islamic financial institutions must have terms of reference (TOR) that address various issues related to the SSB. Among others, the reporting structure, the primary duties, appointment and termination of service and delegation of powers should be included in the TOR. While IFSB (2009) does not obligate the regulators to enforce these terms on the banks, the regulators can improve *Shari'ah* governance at organizational levels if the guidelines were obligatory.

The second regulatory measure would be establishing a complementary *Shari'ah* supervision mechanism at regulatory level to accomplish the broader *Shari'ah* requirements of the industry. Other than minimizing the reputation and legal risks, establishing a national *Shari'ah* authority (NSA) can provide oversight of the *Shari'ah* related aspects of Islamic financial sector in general and the products in particular. As the members of the NSA would not operate in an organizational environment, they are expected to be free of conflicting interests. Another important area that would help reduce legal risks is the product clearance role. The NSA would clear all the products coming into the market and also identify

Sudan will move funds to other banks due to non-compliance of *Shari'ah* and a total 328 (70 percent) would move funds if they learnt that the income of the banks come from interest earnings.

the permissible modes of financing/investment. While scrutinizing and approving the products, the NSA will be able to integrate the *maqasid al-Shari'ah* in Islamic finance and promote products that ensure the stability of the sector.

The ideal regulatory environment related to *Shari'ah* governance would be one that would balance mitigation of *Shari'ah* risks and demands for innovation. A good example of the proposed *Shari'ah* regulatory regime is the robust *Shari'ah* governance regime existing in Malaysia. Other than having guidelines for *Shari'ah* governance at bank level, Malaysia has a national *Shari'ah* Advisory Council housed at the central bank that, among others, reviews and approves new products introduced in the market. The country is in the forefronts of Islamic finance pioneering many new products under a robust *Shari'ah* regulatory regime that provides check and balance to the industry.

6. CONCLUSION

Given the distinct features of Islamic financial institutions arising from their commitment to the principles of the *Shari'ah*, corporate governance in these institutions would encompass as additional feature of *Shari'ah* governance. After identifying the stakeholders of the Islamic financial industry, the paper distinguishes four *Shari'ah* governance regimes. The regimes with lack of regulatory oversight on *Shari'ah* governance can potentially lead to situations where the *Shari'ah* requirements are compromised. As sound *Shari'ah* governance framework is needed to ensure that the aspirations of different stakeholders of the Islamic financial industry are fulfilled, the paper argues for a robust *Shari'ah* governance regime at regulatory level. Providing regulatory guidelines to banks will ensure the quality of *Shari'ah* governance at organizational level. Furthermore, establishing a national *Shari'ah* authority would minimize the *Shari'ah* compliance, reputation and legal risks arising in Islamic financing practices and bring about stability in the industry. The future direction and uniqueness of the Islamic financial industry will partly be determined by the robustness of *Shari'ah* governance mechanisms, both at organizational and regulatory levels.

HABIB AHMED

*Institute of Middle Eastern & Islamic Studies, School of Government
& International Affairs, Durham University, Durham, UK*

APPENDIX I: KEY ISLAMIC MODES OF FINANCING

The features of key Islamic modes of financing are given below.

- a) *Musharakah*: *Sharikah* is a partnership between parties in which financial capital and/or labour act as shared inputs and profit is distributed according to an agreed upon ratio. The loss, however, is distributed according to the share of the capital. Though there can be different kinds of partnerships based on money, labour, and reputation, one case of *sharikah* is participation financing or *musharakah* in which partners share both in capital and management of the business enterprise. Thus partners in *musharakah* have both control rights and claims to the profit.
- b) *Mudarabah* (or *qirad* or *muqadarah*): *Mudarabah* is similar to the concept of silent partnership in which financial capital is provided by one or more partner(s) (*rab ul mal*) and the work is carried out by the other partner(s) *mudarib*. The funds are used in some activity for a fixed period of time. The financiers and the managers of the project share the profit in an agreed upon ratio. The loss, however, is borne by the financiers according to their share in the capital. The manager's loss is not getting any reward for his services. As the *rab ul mal* is sleeping partner, he/she has a claim on profit without any say in the management of the firm.
- c) *Murabahah/Bay Muajjal*: *Murabahah* is a sale contract at a mark-up. The seller adds a profit component (mark-up) to the cost of the item being sold. When the purchase is on credit and the payment for a good/asset is delayed, then the contract is called *bai-muajjal*. A variant would be a sale where the payments are made in instalments. These contracts create debt that can have both short and long-term tenors. In these debt contracts the supplier of the good has claims on a fixed amount that must be paid before arriving at profits.
- d) *Salam*: *Salam* sale is an advance purchase or product-deferred sale of a generic good. In a *salam* contract, the buyer of a product pays in advance for a good that is produced and delivered later. The contract applies mainly for agricultural goods.
- e) *Istisna*: *Istisna* contract is similar to the *salam* contract with the difference that in *istisna* the good is produced according to the specifications given by the buyer. This applies mainly

to manufactured goods and real estate. Furthermore, in *istisna* the payments can be made in instalments over time with the progression of the production. Note that in case of financing a firm *istisna* can be used in a couple of ways. First, the firm can get funds to finance its working capital needs. This *istisna* contract is a debt contract that can be used only if the financier is willing to purchase the goods at the stipulated time of delivery. The second approach would be for the firm to ask the financier to provide an asset (like real estate) built and the payments are made over a period of time in the future. In this case the financier may need to have a parallel *istisna* and sub-contract the project to a third party for its completion.

- f) *Ijarah*: *Ijarah* is a lease contract in which the lessee pays rent to the lessor for use of usufruct. In *ijarah* the ownership and right to use an asset (usufruct) are separated. It falls under a sale-based contract as it involves the sale of usufructs. A lease contract that results in the transfer of an asset to the lessee at the end of the contract is called *ijarah wa iqtina* or *ijarah muntahia bittamleek*. *Ijarah wa iqtina* combine sale and leasing contracts and use the hire-purchase or rent-sharing principles. The ownership of the asset is transferred to the lessee as payments for the asset are also made along with the rent. After the contract period is over, the lessee assumes the ownership of the asset. Note that in a simple *ijarah*, the rental payments made are captured in the current liabilities in the balance sheet. In case of *ijarah wa iqtinah*, however, the leased item would be in form of a debt during the period of lease.

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ABSTRACT

Islamic financial institutions provide financial services that abide by the principles and goals of Islamic law (*Shari'ah*). To ensure the compliance of the operations and products with Islamic law, a *Shari'ah* governance mechanism must be established. To understand the scope of *Shari'ah* governance the stakeholders of the Islamic banking industry and *Shari'ah* requirements need to be identified. The type of *Shari'ah* governance framework for Islamic finance will depend on the legal and regulatory environment in different jurisdictions. At organizational level, the overall corporate governance framework in Islamic banks will define the role of *Shari'ah* governance. After identifying four *Shari'ah* governance regimes existing in different countries, the paper suggests an optimal *Shari'ah* governance framework that can reduce the *Shari'ah* complaint risks and ensure long-term growth of the industry.

Keywords: Islamic Finance, Shari'ah Governance, Shari'ah Supervisory Boards

JEL Classification: G39, P59

RIASSUNTO

*I regimi di governance conformi alla shari'ah nella finanza islamica:
tipologia e valutazione*

Le istituzioni finanziarie islamiche forniscono servizi nel rispetto dei principi e degli obiettivi della legge islamica (la *Shari'ah*). Al fine di assicurare che le operazioni e i prodotti finanziari si conformino alla legge islamica devono essere adottati adeguati sistemi di *governance*. Per capire le modalità di tale *governance* è necessario identificare gli *stakeholder* del sistema bancario islamico e i requisiti necessari secondo la *Shari'ah*. Il tipo di struttura della *governance* dipenderà a livello legale e regolatorio da diverse giurisdizioni. Dopo aver individuato quattro regimi di *governance* che rispettano la *Shari'ah* applicati in diversi paesi, questo studio delinea una *governance* ideale in grado di ridurre i rischi e assicurare la crescita del settore nel lungo periodo.