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EXPLORING THE WORKINGS OF SHARI'AH SUPERVISORY BOARD IN ISLAMIC FINANCE: A PERSPECTIVE OF SHARI'AH SCHOLARS FROM GCC

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Abstract

Islamic finance continues to gain popularity regionally, internationally and both among the Muslim and non-Muslim countries. The Islamic Financial Institution (IFI) differs from its conventional counterpart in its governance structure. It is imperative for the IFI to maintain *Shari'ah* compliance in all its dealings. Hence, an essential element in the IFI is its *Shari'ah* Supervisory Board (SSB) and its *Shari'ah* Governance system. This paper empirically examines the SSB's structure, and *Shari'ah* supervision function directly from the SSB members themselves. Right from their appointment, mandates and responsibilities, how they function, to their views on *Shari'ah* risk, *Shari'ah* compliance, and to how *Shari'ah* review and reporting is performed. The findings reveal issues related to the flow of information, governance of SSB and independence of *Shari'ah* supervision and *Shari'ah* review as some of the key issues that would need to be addressed/strengthened to enhance confidence, and contribute to the credibility of the IFI and the Islamic finance market. The opinions expressed are towards having some regulatory involvement that would contribute to the enhancement of supervision.

Highlights

- Being in line with *Shari'ah*, is paramount to the IFI maintaining its creditability.
- SSB members prefer having some form of obligations, so that everything is clear.
- The selection process of the SSB members is not completely independent.
- Independence is an important element in the *Shari'ah* governance framework.
- *Shari'ah* compliance is maintained through performing *Shari'ah* audit.
- Details of the outcome of the *Shari'ah* audit performed is not always reported.

Keywords

Shari'ah Supervisory Board, *Shari'ah* Governance, *Shari'ah* independence, Islamic Financial Institutions, Gulf Cooperation Council (GCC).

Classification Code

G2, G3, G34

Exploring the Workings of the *Shari'ah* Supervisory Board in Islamic Finance: Perspective of *Shari'ah* Scholars from the GCC

1. INTRODUCTION

A unique feature of Islamic finance is the compliance of its products and operations with *Shari'ah* principles and values. The requirement of *Shari'ah* compliance introduces two essential risks: *Shari'ah* risk and legal risk. *Shari'ah* risk occurs when an Islamic Financial Institution (IFI) fails to comply with *Shari'ah* rules and principles. Legal risk arises when an IFI enters into/undertakes an investment contract and fails to validate and meet the terms of the undertaking/contract (Ginena, 2015:85). These two risks are somewhat related: the terms of a contractual relationship is set in line with *Shari'ah* rules and principles, and, by maintaining and abiding by the *Shari'ah* rules and principles, non-compliance of both risks can be reduced. The IFI non-compliance of the two *Shari'ah* related risks can result in both financial and non-financial consequences. The non-compliance could invalidate the investment contract and/or generate *non-halal* income which has to be set aside and cannot be added into the income of the IFI. This, along with legal risks arising in legal disputes, can tarnish their reputation and thus affect their future business/investments (Ginena & Hamid, 2015: 84-85; Hamza, 2013: 227). Thus, there is a need to introduce a proper *Shari'ah* governance system/framework to ensure the *Shari'ah* compliance of products and operations.

International standard setting bodies such as the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and the Islamic Financial Services Board (IFSB) have come up with guidelines that define the parameters of a sound *Shari'ah* governance regime. A key element of this framework is a *Shari'ah* Supervisory Board (SSB) made up of a number of *Shari'ah* scholars who review and approve all the products offered by the IFI. While some countries' regulators require Islamic banks to set up *Shari'ah* governance structures that include an independent SSB, other jurisdictions do not have any legal/regulatory framework. In these countries, *Shari'ah* governance and the SSB are instituted by Islamic financial institutions to gain the trust of Muslim customers. However, lack of clear regulatory guidelines can compromise the independence of the SSB and dilute *Shari'ah* compliance (Alkhamees, 2012).

While there is a large literature discussing various issues related to *Shari'ah* governance structures and regimes (Ahmed, 2011; Grais & Pellegrinni, 2006; Rammal, 2006; Suleiman, 2000; Alman, 2012; Grass, 2013; Malkawi, 2013; Injas et al., 2016), studies examining the

operations of the SSB are rare. As such, very little is known about the way the SSB operates and how decisions are made. This paper contributes to this specific area by exploring the black-box and presenting the views of *Shari'ah* scholars on different aspects of *Shari'ah* governance in IFIs. Specifically, the paper presents the opinions of 13 *Shari'ah* scholars from the Gulf Cooperation Council (GCC) region gathered through interviews on various issues related to *Shari'ah* governance such as SSB structure, framework and *Shari'ah* process and views on the strengths and weaknesses of the current practice.

2. *SHARI'AH* GOVERNANCE: AN OVERVIEW OF THE STANDARDS AND LITERATURE

The Islamic Financial Services Board (IFSB) defines *Shari'ah* non-compliance risk as “The risk that arises from the IIFS’s failure to comply with the *Shari'ah* rules and principles determined by the *Shari'ah* board of the IIFS or the relevant Body in the Jurisdiction in which the IIFS operates” (IFSB-5, 2005: 26). It puts forth the requirements for a *Shari'ah* governance system that the supervisory authorities are recommended to implement. According to Principle 1.2 of IFSB-10, the IFI, upon appointment of an independent SSB, should have in place “...clear terms of reference regarding its mandates and responsibilities... well defined operating procedures and line of reporting...” (IFSB-10, 2009: 9). The supervisory authority is to ensure that the IFI has a proper pre- and post-*Shari'ah* compliance monitoring mechanism in place (IFSB-10-3).¹

AAOIFI’s governance standards lists the three main key components of *Shari'ah* supervision and compliance for the IFIs as follows: *Shari'ah* Supervisory Board, *Shari'ah* Review and Internal *Shari'ah* Review. In the AAOIFI Governance Standards (GS-1), the IFI is to have an independent *Shari'ah* Supervisory Board (SSB) to be appointed/dismissed by the shareholders upon nomination of the board of directors (GS-1/3 and GS-1/8)². The IFI is to have a minimum of three SSB members and the agreed terms of engagement are to be recorded in the appointment letter signed between the IFI and the SSB member (GS-1/4). Furthermore, the SSB “shall appoint from among its members or any person a supervisor(s) to help it in performing its duties” (GS-1/6). In addition, to reduce the risk of independence of the SSB, the SSB is to be rotated every 5 years³.

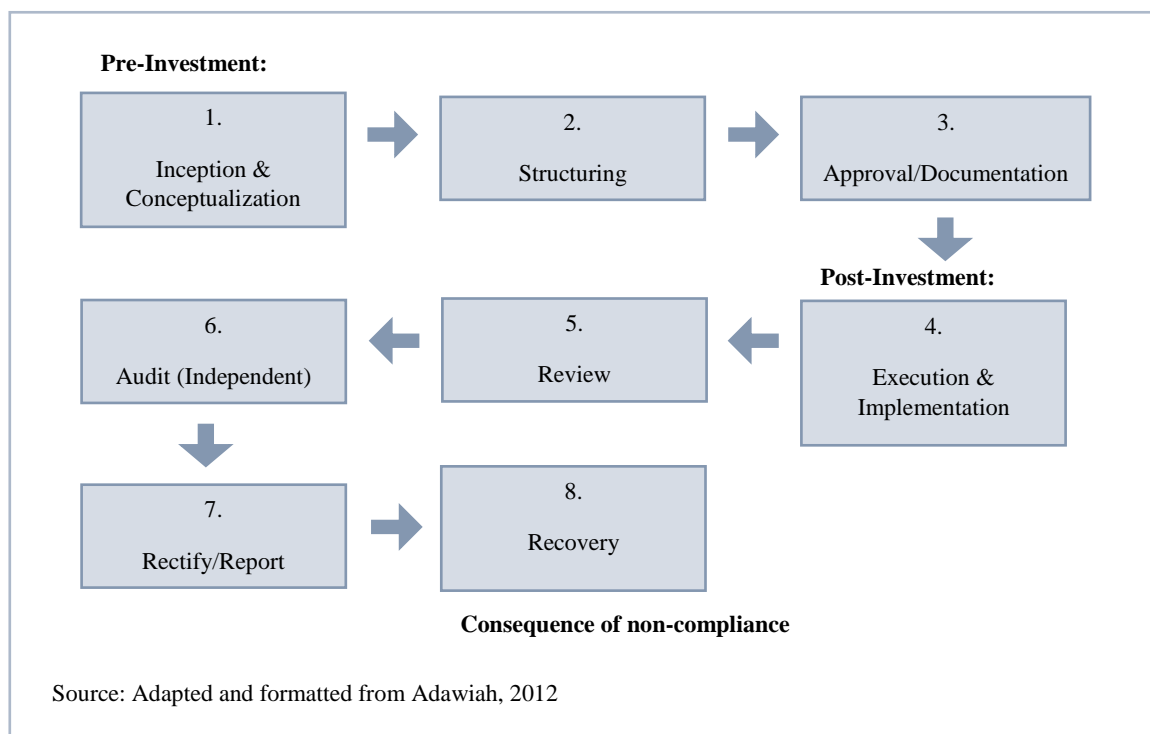
¹ IFSB. (2009). Guiding Principles on *Shari'ah* Governance Systems For Institutions Offering Islamic Financial Services-IFSB 10.

² AAOIFI Governance Standards (1): “*Shari'a* Supervisory Board: Appointment, Composition and Report”.

³ AAOIFI Governance standard (5): “Independence of *Shari'a* Supervisory Board”.

The *Shari'ah* compliance system is an ongoing process that starts at the pre-investment stage and continues in the post-investment phase. As can be seen from Figure 1 below, the process begins from the inception stage. This is followed by the pre-launch/pre-entry to the product/investment stage and then to agreeing on the structure/legal set-up followed by documenting and obtaining the SSB's approval and continuing through to the post launch/investment/transaction stage with a proper implementation. This is followed-up by a review and audit by examination and evaluation of the extent of compliance. Then, the outcome of the proper execution is reported and any non-compliance matters are rectified. Failure to do so (rectifying non-compliance) could result in enforcement measures either by the regulator (withdrawal of license) or by the court (due to a legal case against the IFI by investors) (Adawiah, 2012).

Figure 1: Mechanism of *Shari'ah* Compliance Process



Shari'ah compliance/assurance is maintained by the *Shari'ah* compliance review/audit that is carried out by the *Shari'ah* Review. The IFSB principles refer to both internal and external *Shari'ah* compliance review. Principle 3.1 (clause 107) of IFSB-3 stipulates that the IFI should undertake internal *Shari'ah* compliance review to follow-up on the implementation and to monitor *Shari'ah* compliance. In addition, Principle 3.1 (clause 106) of IFSB-3 maintains that *Shari'ah* review is to take place following the issuing of the SSB

decision/ruling to ensure its compliance with the ruling through an external *Shari'ah* review. Meanwhile, the AAOIFI *Shari'ah* governance standards⁴ place obligations on the IFI for a quarterly internal *Shari'ah* review to be performed on the *Shari'ah* compliance of the IFI, in line with the *Shari'ah* Supervisory Board's (SSB) approvals/decisions. Furthermore, the IFI's SSBs are to review and determine whether the investments entered into by the IFI are (and continue to be) *Shari'ah* compliant throughout the investment term, and to produce an annual *Shari'ah* compliance report on the matter. The *Shari'ah* compliance review/audit report that is prepared by the SSB (with the assistance of the IFI's internal *Shari'ah* department report⁵) is to be reviewed by the external auditor of the IFI and will then form part of the annual financial report⁶. The AAOIFI standards, at the time of conducting the study/interviews, did not specify that an external *Shari'ah* audit is to be performed by an external *Shari'ah* party/auditor.⁷ Rather, the requirement of an external audit is embedded within the requirement of issuing the external audit of the financial statement. The SSBs are required to report any violations in their opinion statement in the SSB report that they produce.⁸ Although the standards do not specifically address the details of the format of the *Shari'ah* decision/fatwa, when the SSB produces the *Shari'ah* decision/fatwa it is expected that it is detailed, clear and transparent so as to increase awareness.⁹

Independence is an important element in the *Shari'ah* governance framework. It adds credibility and enhances confidence (public confidence) in the IFI. The IFSB in its definition of *Shari'ah* governance system emphasises the importance of independence by stating: "A set of institutional and organizational arrangements through which IFIs ensure that there is an effective independent oversight of *Shari'ah* compliance over the issuance of relevant *Shari'ah* pronouncements...dissemination of information andan internal *Shari'ah* compliance review" (IFSB-10, 2009, 2-3). However, the matter of effective implementation of independence has resulted in differences in opinion. In AAOIFI, the independence is reflected in the requirement that the internal *Shari'ah* review is to be carried out by "an independent division/department or part of the internal audit department,

⁴ AAOIFI Governance Standards (3.20).

⁵ AAOIFI Governance Standard (3.20)

⁶ AAOIFI Auditing Standards (4).

⁷ AAOIFI, in December 2016 following the conclusion of its 3rd Governance and Ethics Board meeting, announced that it was working on standards on External *Shari'ah* Audit, which were issued later in March 2018. The AAOIFI standards set out the principles applicable to the external *Shari'ah* audit that is conducted by an independent external *Shari'ah* auditor. The role of an external *Shari'ah* audit is to provide independent assurance to ensure compliance of an IFI with the *Shari'ah* principles and rules (AAOIFI-Audit Standards (AS)-6:7-8). The standards encourage IFIs to have at least one external *Shari'ah* audit a year, in line with the standards. These standards are officially effective for the external *Shari'ah* auditor's report covering periods on or after 1st January 2019.

⁸ AAOIFI Governance Standard (1.21).

⁹ IFSB-3.54.

depending on the size of an IFI, it shall be established within the IFI to examine and evaluate the extent of compliance with the IFI's SSB..." (AAOIFI GS-3). In addition, the SSB is to produce a report at the end of the year on the extent of the IFI's *Shari'ah* compliance (AAOIFI-GS-2). Such steps in establishing independence have generated some concerns.

Concerns arise from the SSBs having to produce an independent opinion where conflicts of interest may exist. The independence can be affected when the SSB has some form of "economic stake" (remuneration and renewal) with the IFI, in addition to basing its review on the internal *Shari'ah* department that also has some economic stake with the IFI (Grais & Pellegrini, 2006). Furthermore, the SSB members will be expressing their opinion on the level of compliance of a *Shari'ah* matter that they have already given approval on earlier based on the details and information provided beforehand (Hamza, 2013: 228). To remedy this, there are suggestions in the industry to rotate the SSB, as has been the case with auditors. However, rotating the whole board could compromise the quality of audit since the new board would not be familiar with the IFI's business and its management (FEE, 2004). Grais and Pellegrini (2006: 16), in defence of the arguments of the proposals to rotate the SSB in order to achieve greater independence and the inefficiencies that may result (from the experience faced with internal auditors in the past) suggest that: "an alternative may be found in the practice of periodically rotating SSB members rather the entire boards. This would infuse fresh approaches in the SSB and may increase independence through peer review; it would not necessarily compromise audit quality, as the continuing members would assure continuity".

Moreover, independence could be increased by delinking the economic benefits of the SSB from the IFI to an independent body. Hamza (2013: 235), in relation to this, recommends "the appointment and the remuneration of the SB [*Shari'ah* Board] members should be done by another body like central bank or government to ensure the independence of the SB which is crucial for credibility". The reinforcement of the independence of the SSB's role would reduce the conflict of interest concerns, enhance creditability of the *Shari'ah* compliance process and increase investors' confidence in the IFI.

The discussion on the relevant literature on *Shari'ah* governance matters shows that a vital component of *Shari'ah* governance systems is the SSB (Grass, 2013: 334). The investors rely on the effective role and monitoring of the SSB since they are expected to have access to internal information similar to that of the IFI's management (AlJifri & Khanselwal,

2013). Hence, SSBs' decisions are only as good as the information that they are provided with. Therefore, for an effective implementation of the above process (shown in Figure 1) and for the efficient functioning of the SSB, establishment of an effective *Shari'ah* supervisory set-up is required within the IFI. The proper selection of products being in compliance with the *Shari'ah*, the proper use by the IFI of the funds collected and invested in accordance with the IFI-investor agreement¹⁰, and the maintenance of *Shari'ah* compliance throughout the term of agreement are paramount to the IFI maintaining its creditability. In carrying out its obligations, the SSB needs a "clear framework and structure to ensure its independence and effectiveness" (Malkawi, 2013:544). Framework and structure (appointment, composition, procedures, qualifications, audit and *Shari'ah* report) form essential elements in the *Shari'ah* governance process (Malkawi, 2013:552).

Most studies in the past in relation to the *Shari'ah* governance system have been either theoretical or based on secondary data (Ahmed, 2011, Grais & Pellegrinni, 2006; Rammal, 2006; Suleiman, 2000; Alman, 2012; Grass, 2013; Malkawi, 2013; Injas et al., 2016). Theoretical studies examine the role of *Shari'ah* governance in the framework of overall corporate governance (Chapra and Ahmed 2002; Hasan, 2009; Iqbal and Mirakhor, 2004) and compare the *Shari'ah* governance system with the conventional system (Abu-Tapanjeh, 2009; Saif Alnasser & Muhammed, 2012). Other studies cover SSBs and their role in the governance of IFIs (Garas & Pierce, 2010, Grais and Pelligrini 2006), *Shari'ah* audit (Lahsasna, Ibrahim & Othman, n.d.) and audit and *Shari'ah* control (Shaii & Salleh, 2010).

There are a few studies that report information on *Shari'ah* Scholars/SSBs based on primary data collected from interviews with *Shari'ah* scholars that were not only SSB members but *Shari'ah* scholars involved in the IFI. Ullah, Harwood and Jamali (2016) report issues relating to fatwa rather than the *Shari'ah* governance system. Other primary data studies examine the SSB performance via seeking feedback/input from the Board of Directors and SSB members using survey questionnaires (scaling and multi-choice questions) on SSB performance (Nathan, 2010). A more recent study based on primary data collected from the SSB members, mostly from Malaysia, deals with some of the contemporary *Shari'ah* governance issues (Hasan, 2014).

3. DATA AND RESEARCH METHODS

¹⁰ AAOIFI Governance Standard (4.9).

The research aims to examine the *Shari'ah* operations/governance set-up of IFIs across the GCC from the perspectives of *Shari'ah* scholars. As an exploratory approach, it gathered information from face-to-face semi-structured interviews with 13 *Shari'ah* Scholars (ShSc)¹¹ who are members of *Shari'ah* Supervisory Boards of Islamic financial institutions (IFI) from across the GCC. The interviews were based on a set of questions prepared beforehand, as guidance to providing a consistent framework. The interviews were conducted over a four month period (December 2015 - March 2016). All scholars were comfortable with taking the interview and with the recording. The interviews were conducted in Arabic as the scholars were from the GCC and preferred to converse in Arabic. Below is a summary of the profile of the interviewed ShScs.

Table 1- *Shari'ah* Scholar's Profile

<i>Shari'ah</i> Scholar	Location	Number of <i>Shari'ah</i> Supervisory Board (SSB)	Academia/ Independent
ShSc-01	Bahrain	10+	Independent
ShSc-02	Kuwait	5-10	Academia
ShSc-03	Kuwait	5-10 *	Independent
ShSc-04	Kuwait	5-10 *	Academia
ShSc-05	Kuwait	5-10 Banks**	Academia
ShSc-06	UAE	Less than 5 Banks**	Academia
ShSc-07	Bahrain	5 Locally	Independent
ShSc-08	Bahrain	5	Independent
ShSc-09	Bahrain	5-10	Independent
ShSc-10	Saudi Arabia	10+	Academia
ShSc-11	Qatar	5-10	Independent
ShSc-12	Kuwait	10 +	Independent
ShSc-13	Qatar	5-10	Independent

*On SSB of the main IFI and its overseas branches and companies the IFI owns 100%.

**Reference is to being a member on SSBs of banks, they could also be members of SSBs in other sectors.

The responses were analysed using a content and thematic analysis (DeHoyos & Barnes, 2011; Rayan & Russell, 2003 and Schreier, 2012). Initially the responses were transcribed and translated into English after which the content analysis was carried out manually. The responses are reported in a summarized form and are supported by relevant quotations from the scholars.

4. FINDINGS & ANALYSES

¹¹ In presenting the results, the ShSc interviewed will be represented in code form (ShSc-01, ShSc-02, etc.) to preserve the confidentiality and the identity of the ShSc. While the *Shari'ah* scholars cannot be identified due to confidentiality, their basic characteristics are given in Table 1.

In analysing the responses of the ShScs, the general themes are first examined. These themes are then further elaborated by focusing on the subthemes.

4.1.Terms of Reference

The SSB is bound by its terms of reference that engages its members with the IFI. Hence, having clear terms of reference (TOR) and proper working procedures in place is the core to the relationship between the SSB and the IFI. This section examines the ShScs' contractual agreement, appointment, responsibilities and working procedures and the responses received on those matters.

Contractual Agreement

Questions on contractual agreement included whether the ShScs had signed an agreement upon being appointed as a member of the IFI's SSB, the details of their appointment clearly stated in writing, and whether other than the agreement their roles were defined by the internal procedures document of the IFI.

As not all jurisdictions in the GCC region require a contractual agreement between the SSB members and the IFI itself, not all scholars had a contractual agreement with the IFIs where he was a member of the SSB. Three scholars, constituting 23.08% of the sample, were on SSBs across different jurisdictions and indicated that they could have signed with an IFI in one jurisdiction and not in another. It appears that the reason behind not signing an agreement goes back to the initial concept on which the *Shari'ah* supervisory board was appointed. Initially, their role was considered as providing a voluntary service. However, with time, the work that the SSB performed, or was expected to perform, developed as the industry grew, and their role/function could no longer be considered as a voluntary service. The specialization required to perform the role of SSBs developed into a profession. As clarified by ShSc-05:

“Initially when Shaikh X first established the *Shari'ah* supervisory board in [Jurisdiction] he had the concept that this duty should be performed voluntarily. And so, we did not need a contractual agreement between the *Shari'ah* supervisory board and the institution...And that is why here in [Jurisdiction] the *Shari'ah* supervisory board are assigned and the board of directors decides on their terms. Even we do not know how much we take, because it is not determined [the remuneration is considered as a gift]. I don't think it is right, because the *Shari'ah* supervisory board role is no longer a *fatwa* process or a calculation process; it is a specialization, a profession...”.

Three scholars (23.08%) in the sample had detailed contracts signed with the IFI. ShSc-06 noted contracts stated “what are your powers, your responsibilities from a confidentially aspect, from the aspect of the things you undertake”. A number of scholars (15.38%) who had signed agreements stated that the details of their responsibilities and obligations were not in the agreement but in the internal procedures. ShSc-10 confirmed this:

“For every *Shari’ah* supervisory board there are procedures. And the procedures display the member’s responsibilities, the committee’s¹² responsibilities, the bank’s obligations and all the matters related to the *Shari’ah* supervisory board’s work, ... in all the institutions without exception ... the level of details varies from one institution to another, but the main issues, like number of meetings, the decision process, these are in all of them.”

In some institutions, the agreements covered the SSB’s mandates, roles and responsibilities in detail while in others this was not the case. The former were in countries where regulators had specified (and in some a specimen was provided) and enforced such a requirement. In countries where such a requirement was not part of the regulatory requirement, the terms of reference were usually only outlined in the agreement. As explained by ShSc-12:

“The level of detail varies. In some banks that are under the supervision of central banks there is a certain level of detail since the central bank places upon them a specimen of the agreement that is very detailed. In other cases, agreements only summarise the main duties...while these are adequate, they are not in such detail as those in countries where central banks enforce the specimen contracts”.

In jurisdictions where the regulators have set guidelines for the SSB, the procedures are set by the SSB as per the regulatory requirements. ShSc-03 notes “in [Jurisdiction] ... it is left to the parties involved... we perform our role as per what is stated by the central bank, and as per the duties endorsed by the SSB itself as procedures and we perform accordingly. We prepare it [working procedures], but we have to have it endorsed by the central bank...”. In jurisdictions where the SSB’s terms of reference (TOR) are not clear, the SSBs have tried to overcome this by having internal procedures. ShSc-05 notes, “In [Jurisdiction] the practice is still vague...and as such we do not have agreements. The SSB has prepared internal procedures where it identifies the role and responsibilities of the SSB and the related parties.

¹² Reference is to the executive committee that is a subset of the SSB. For more details, see section 4.3.1 under SSB’s Members Performance-Function.

The board of directors has endorsed these procedures and accordingly, they have been adopted. This at least compensates for this deficiency”. However, not all procedures were detailed as confirmed by ShSc-11: “there are banks that have procedures that are of one page and those that are of 10 pages”.

Shari’ah scholars prefer to have some form of obligations so that everything is clear among the parties. They prefer to see the guidelines in the regulations that are made obligatory. ShSch-04 asserted “today there are no agreements. In some institutions agreements used to take place at the request of the *Shari’ah* Board. We feel there is a need for a law...this is supposed to be the work of the central bank. It is supposed to determine the duties and responsibilities of the *Shari’ah* board and enforce them on the institution.”.

Though the preference is to have such a requirement in the regulation, it appears that it is not always followed where such regulation exists. Two *Shari’ah* scholars (15.38%) did not have internal procedures and did not sign a contractual agreement with the IFI even though it is a requirement. The reason cited by one of the *Shari’ah* Scholars was that since the details (the SSB’s roles and responsibilities) are in the regulations which are more than sufficient, there is no need to have a signed agreement. The understanding is that the regulation’s (the Law’s) power and status of enforcement is higher than a contractual agreement, as ShSc-13 explains:

“We have an Ameer Law issued by his highness the Ameer with regards to organizing the *Shari’ah* boards and their powers and there are instructions issued by the [Regulator] on the duties of *Shari’ah* boards... We don’t have an agreement. It is assumed that we have agreements, but we have instructions [i.e., regulations] and the system [being the law] which are stronger than the agreement. There are no internal procedures at the IFI. We have endorsed resolutions from one of the forums that had taken place with regards to the fatwa procedures and how they are conducted.”¹³

Appointment

Appointment in general gives an indication of the line of reporting, or, in reality, who has the influence in those reports and to whom one is accountable to. Overall, as part of the SSB’s function in the organization chart, its line of reporting is to the general assembly, the

¹³ The following are the headings in the two-page procedure that was provided to the researcher: The adaptation of contract (relationship between SSB and the SSB and the *Fatwa* process); Rules on IFI asking for another opinion from other SSB; Controls in prohibiting of financial *fatwas*; Controls of consenting and permitting in financial *fatwas*.

shareholders, and the owners of the IFI. In order for the SSB to obtain and maintain independence, the SSB insists on certain matters, as ShSc-02 notes:

“We always place a condition on the IFI that the SSB is appointed by the general assembly, and not the board of directors. Secondly, we make ensure that the organizational chart shows us as an independent party from the executive management and that we don’t follow the executive management. Thirdly, we insist that there is a permanent *Shari’ah* supervision department. That it has employees, and submits its reports to the SSB and informs the executive management ”

The SSB is appointed at the Annual General Assembly (AGM) by the shareholders of the IFI. While in some jurisdictions the SSB member is appointed by name by the general assembly, in other jurisdictions the board of directors (BOD) selects him after having been given the authorization to do so by the general assembly. Two *Shari’ah* scholars (15.38%) indicate that in some cases the shareholders do not always appoint them by name but leave it to the IFI’s senior management to select the members of the SSB. As ShSc-05 explains: “here in [Jurisdiction], the *Shari’ah* supervisory board is assigned by the AGM and the board of directors are authorized to decide and hire them.” However, in most cases (6 ShScs - 46.15%), the SSB is appointed by the general assembly by name, and “After the names are approved by the general assembly, the board of directors are delegated to contract them, so we sign [the contract] with the board of directors” (ShSc-05).

Although the appointment of the SSB is at the general assembly, the selection process is not completely independent. The shareholders base their selection on the nomination provided by the BODs, and this matter is a cause of concern with some of the SSB members. They are concerned that, at times, this process of the nomination of a scholar depends on how cooperative he is with the IFI and in approving their products, as expressed by ShSc-06:

“For independence purposes, we are supposed to follow the general assembly... but, what is currently happening, unfortunately, is that the board of directors are nominating. No doubt because most of the shareholders don’t know the scholars. So they [BOD] recommend and nominate and in the event of any dispute, it goes back to the general assembly to decide. But in some places this is not the case, and it is the BOD that is making the decisions [selecting the SSB members]...of course this is not right. Because you cannot have independence, when you feel you are threatened at any moment, if you did not approve this product, it means *ma’salama* [farewell]”.

Even though the mechanism is better than it used to be (the appointment was previously made by the BOD and now it is made by the general assembly), there is still room for improvement. Since in most of cases the shareholders rely on the BOD and rarely question their decisions, the aspiration of the scholars is to get the regulator to intervene more so that the threat to independence is reduced. One scholar explains the reason for this is that it is human nature that certain things affect them unconsciously, even if they do not admit it. Specifically, ShSc-07 states that it is important

“...to make sure that no member is dismissed without providing a comprehensive and clear statement and obtaining the approval of the central bank and not by just giving him a notice. I don’t think these things have been treated in a satisfactory manner. Leaving it to every member and his conscience [in that his *Shari’ah* decisions are not affected by the concern of being re-appointed]. And even though many members say that these things do not affect their independence ... we are kidding ourselves.”

The hope is to get the regulators to intervene, as expressed by ShSc-04: “in my opinion the central bank needs to have a role. Any *Shari’ah* member whose contract does not get renewed needs to attend the general assembly and talk in front of the shareholders”. In some jurisdictions, however, the approval of the regulator is a must as indicated by ShSch-13 “appointment is through the General Meeting of each bank and the final approval of [the Regulator] is a must.”

4.2. Mandates and Responsibilities

For the effective performance of the SSB, its mandates and responsibilities need to be clear and understood. The following section looks into the ShScs understanding of their mandates and responsibilities as members of the IFI’s SSB.

In general, the main understanding of the SSB mandate is to give its *Shari’ah* opinion (i.e., *fatwa*). In addition, there is an overall understanding to the requirement of follow-up on the proper implementation of the *fatwa*. Despite this, the *Shari’ah* scholars’ views differ on whether the follow-up is to be performed directly or indirectly by the SSB. Specifically, there are differences of opinions on whether the SSB should conduct the follow-up itself or assign it to the *Shari’ah* department of the IFI with the SSB performing supervision through the reports that the *Shari’ah* department produces.

The overall understanding from among the scholars is that the role of the SSB is to provide its *Shari’ah* opinion and *fatwa* and to supervise its implementation (12 ShScs-

92.31%). Their role is to respond to inquiries/questions and provide their *Shari'ah* opinion on products/investments presented to them. In addition to the issuance of a *Fatwa*, there is a need to ensure that the *Shari'ah* department performs its role in the implementation. The *Shari'ah* department's role is to pass the *fatwa* on to the related department and to follow-up on the proper execution of the *fatwa* by performing an audit. As elaborated by ShSc-03:

“We are divided into two divisions: the first is *fatwa* or what we call the decisions made, and the second is supervision. The *fatwa* relates to decisions on questions and agreements... and supervision is most of the time executed by appointing supervisors [within the *Shari'ah* department]. We supervise those supervisors... so it's two parallel tasks. Making the decision and the following up on the implementation and the soundness of the decision both take place at the same time...”

Whether the SSB is appointed directly or indirectly by the general assembly, it produces a report as part of the IFI's *Shari'ah* compliance which is presented to the shareholders at the annual general assembly. As indicated by ShSC-08, “usually the SSB submits it [the SSB report] to the general assembly through the board of directors.” The *Shari'ah* department usually generates regular reports to the SSB on the extent of compliance of the IFI, as noted by ShSc-10 “the *Shari'ah* board...look at the reports either quarterly, semi-annually and annually on the activities of the institution and its compliance with *Shari'ah* board's decisions.” Furthermore, the SSB reviews these reports for any violations or shortcomings in compliance, which it then discusses with the *Shari'ah* department. ShSc-02 notes “we review these reports and if there is any shortfalls we call upon the department to discuss such shortfalls...”

Even though in some instances the title of the SSB indicates that supervision is to be undertaken by the SSB member directly, the SSB does not do so themselves and the practice is to give this role to the audit department. This was acknowledged by ShSc-13: “...in actual fact the board should perform the role of *fatwa* and the role of supervision, meaning audit. But from long ago there has always been a *Shari'ah* audit set-up at the IFI that performs this [audit] role and raises its observations to the *Shari'ah* board.”

It appears that the weight of following up on the implementation of the SSB's decisions falls heavily on the internal *Shari'ah* department of the IFI. This is due to the fact that not all the members of the SSB are available full time and that the *Shari'ah* department is in contact on a regular daily basis with the IFI. Such a responsibility makes it important that the

Shari'ah department is independent from the influence of the IFI's senior management and employees. ShSc-06 confirms the importance of independence and explains the current set-up of the *Shari'ah* department as follows:

“...it is expected in every financial institution that there is a supervision department and internal *Shari'ah* department. This internal *Shari'ah* supervisor [member of the *Shari'ah* department] technically follows the *Shari'ah* board, but administratively is under the board of directors. The supervisor is the eye of the *Shari'ah* board and for this he needs to be independent. The board of directors has no right to dismiss him without the *Shari'ah* board's approval and justification”.

However, since the internal audit function itself is not independent from the IFI, some scholars consider the *Shari'ah* department's supervisors/officers to also be falling administratively under the IFI management which affects their independence and therefore their performance. The IFI's management controls the appointment and salaries of those officers/supervisors, and, as such, this has an effect on the employees. Since such matters are under the IFI's control, the employees of the *Shari'ah* department might be influenced to try and keep on IFI management's good side, which could jeopardize the quality of the compliance/audit reports being generated. Therefore, the matter of independence remains a concern as expressed by ShSc-04:

“I consider it problematic that for the supervision to be in a strong position, administratively it should follow the board [the SSB]. This is my opinion. But, unfortunately, till today this does not exist in Islamic banks overall. If you do not provide them with the sense of security, whether he is the member or a supervisor, how is he going to perform his role?”

While in most cases the scholars viewed their role in audit as being similar to supervision, one of the scholars stated otherwise. ShSc-12 claimed that the SBB performs both roles: “The *Shari'ah* board member in all the boards performs fatwa and *Shari'ah* audit. A *Shari'ah* audit that he submits to the general assembly. Which as per the terminology is known as external *Shari'ah* audit...we in the *Shari'ah* board that we have, the level of control in it, is high... Meaning the *Shari'ah* board audits all the authorized transactions to arrive at the information and provide its final decision on the extent of compliance to the general assembly. The *Shari'ah* board's report is directed to the shareholders.” Being a *Shari'ah* firm they were able to perform both roles (*fatwa* and audit) and had the adequate staff to perform both roles, reducing reliance on the IFI's internal *Shari'ah* department and enhancing independence.

ShSc-12 elaborated: “we as a *Shari’ah* board are a part of an advisory firm, we offer the service. As such this weak point [the SSB reliance on the internal *Shari’ah* audit performed internally] does not exist.”

4.3. SSB Member’s Performance and Independence

The skills and tools that the SSB members are required to perform and function efficiently and effectively are examined in this section. In addition, the independence of the members and the SSB, which is an essential feature that cannot be compromised in order to maintain the credibility of the SSB’s decisions and performance, is also presented.

4.3.1. SSB Member’s Performance-Function

Shari’ah scholars try to perform their duties and responsibilities as efficiently as they can, since it affects their reputation. Their outcomes and decisions are usually based on the information provided and the documents presented to them by the IFI and its employees. However, there are times when decisions that were made were not as proficient as they ought to be as adequate information was not provided at the time. This was, confirmed by ShSc-06: “Employees sometimes do not provide you with a true picture of the matter, so you decide on something differently to what is its true image. You provide your opinion on the information provided and image of the thing. Then after that, you discover that the matter was not like that. Now you can withdraw. You can eliminate or you can object on the structure.” There are also times when employees of IFIs take up the initiative of introducing new products prior to obtaining the SSB’s approval, thinking that it is similar to a product already introduced, as ShSc-06 continues to explain:

“Sometimes some employees conjecture and offer a product [without SSB approval], thinking that there is nothing wrong from a conceptual point of view. But there could be one condition that damages everything and he offers it and then the *Shari’ah* board hears that there is a product that was launched. Or after offering it they put it forward to the SSB. He [the IFI’s employee] is at fault. Now, either the IFI stops it or amends it, if it is possible to amend, and reprimands the employee...”

In order to be able to perform one’s duties, *Shari’ah* scholars indicate that certain administrative skills are required along with having procedural systems in place. Five scholars (38.46%) were able to carry out their duties and responsibilities by proper time management and some of them through regular weekly meetings. In addition, some request that they be provided with the documents for review ahead of time to prepare, as put forward

by ShSc-07: “I have to do whatever I can to meet the responsibilities appointed to me. So if there is a set meeting and there are agreements to be discussed in the meeting, I make sure that they send the agreements within adequate time, not two days before the meeting or at the *Shari’ah* board meeting itself, so it’s just a quick read. This doesn’t work.”

Moreover, technology has contributed to the time management as it has facilitated communication and coordinating for a smoother performance. ShSC-05 states that “time management and the modern means of communication have now smoothened things. Instead of, for example, having to travel back and forth every week, they send you the agreements through e-mails and you review it and send it back. The modern communication has reduced the load of work.”

In addition to handling their time efficiently, three scholars (23.08%) considered experience and knowledge to contribute greatly to their ability to perform. Due to experience, they are able to identify the weak areas and concentrate on them during the review of the document. To this, ShSc-02 claims: “When one has spent a long time in this area, he knows the areas of weaknesses in the agreements, where are the areas that need focusing on...we concentrate on the origins of the agreement, on what it is built on, the price, the underlying asset, the conditions required. Hence, even reading the agreement is reduced due to experience...”

Shari’ah scholars have also benefited from being members of several SSBs, whereby similar matters/products are sometimes discussed, and, by reviewing and commenting on one SSB, the work is also done towards their input in other SSBs. Moreover, scholars have also started to share work with newly established IFIs. Some documents that are common in IFIs which they have reviewed and have a standardized format are shared with the newly established IFI. To this ShSc-02 confirms:

“After a period of close to 45 years, many agreements have become normal, and new agreements are few. I wouldn’t say rare, but have become less. For example, after a bank is established, we bring them our agreements. We have read and approved them; we give it to them. How much effort have we saved them? And we do not have to review them. The bank discusses with us any changes it makes on them and not the whole agreement. This without doubt reduced a lot of time for us.”

With time, some scholars have gained profound understanding and experience that has led to not only providing an opinion but also helped them to resolve matters. ShSc-04 says:

“The experience broadens the perspectives a lot on how to handle matters and ways to deal with it. If you face a problem, you have to think how you are going to resolve it. Meaning I do not stop at the problem and that’s it, I think how I can resolve it.”

Some scholars, even with proper time management and experience cannot see themselves as being able to handle being on too many SSBs. As such, they have limited their *Shari’ah* board memberships, as noted by ShSc-11: “Before I was on many *Shari’ah* boards, but now I have limited it to less than 10.” Similarly, ShSc-06 adds “sometimes some people, without doubt, they have over 200 [SBB membership], they are to be asked about, how do they cope? Maybe by virtue of their long years of experience, the matter has become easy...But I do not see this capability in me”. Meanwhile other scholars view it differently and handle the matter of being on many boards as professionals. The IFI, prior to appointing them, is aware of their multiple *Shari’ah* board seats and they are bound by the confidentiality agreement that they sign with the IFI. Furthermore, the SSB’s responsibility is not a promotional one but rather is limited to *Shari’ah* products and their compliance, as ShSc-07 explains:

“I don’t think there is a problem [with being a member on several boards]. You have the legal institutions providing advice, financial audit institutions performing audit and they provide these services to more than one institution. The *Shari’ah* board’s role has nothing to do with marketing and promoting. The *Shari’ah* board’s responsibility is limited to the extent of the product and the working environment as whole being *Shari’ah* compliant or not, our work is only within this framework.”

However, ShSc-07 also notes that although the role the SSB member performs is a professional one (meaning a member can be on the SBB of several competing IFIs), in order to do it professionally and efficiently he would need to be solely dedicated to this role. He asserts “No doubt if a *Shari’ah* board member has a job commitment, meaning for example he teaches at the university and even if it is only one or two subjects in a term. And at the same time he is a member in let us say 60 *Shari’ah* boards, off course it affects [his performance-function adversely].”

Four scholars (30.77%) indicate that they performed their duties and responsibilities as per the agreed upon working procedures. The issues included in the procedures include how matters are handled, how the review process is undertaken, how inquiries are put forward, and how they are dealt with and so forth, with all those involved performing their expected

role. The SSB tries to be involved right from the beginning of the process, as ShSc-13 comments: “it is necessary that all the transactions are presented to us from the beginning; from when they first start working on it till it ends. All of it, we are with them step by step, until we place the controls and the standards and we look at it from a *Shari’ah* perspective only. This is before the execution of the transaction and after the execution we also audit the transaction [through supervising the audit process].”

In order to be able to implement the working procedures, four scholars (30.77%) indicate that SSBs have created an executive committee from within its members that deal with urgent matters, undertake further research when needed for any inquiry or product/investment, review documents, and coordinate with the IFI’s internal *Shari’ah* department. In dealing with urgent matters ShSc-02 explains:

“We have set up an executive committee which, in reality, deals with the urgent, quick matters that the bank wants to make quick decisions on. ...and so there are no delays on their investment decisions. The executive committee most of the time looks into the urgent matters and gives the opinion. After that, at the earliest *Shari’ah* board meeting, it puts forward its decision, the executive committee’s decision to the *Shari’ah* board for endorsement or amendment or to see what they say.”

Five scholars (38.46%) opined that once the SSB makes a decision on an agreement/contract, it is taken as a standard which the *Shari’ah* department uses as default when reviewing the agreements that are submitted for the SSB’s approval. Agreements that are submitted to the *Shari’ah* department that are similar to previously submitted agreements are reviewed by the *Shari’ah* department and only the changes/differences are put forward to the SSB for their input. The *Shari’ah* department follows the same concept on all matters/transactions that the IFI considers entering into and puts forward for a *Shari’ah* opinion, as ShSc-01 explains:

“When an institution is considering entering into a project, it from the start gets the *Shari’ah* department involved, at the least. The *Shari’ah* department sees if there are *fatwa/Shari’ah* decisions around the subject, if it has been reviewed before or not. So if it is something new, then it has to be presented to the SSB.”

Such a process has reduced the load on the SSB as admitted by ShSc-02: “this has simplified a lot of things... through *Shari’ah* supervision department, we check that it has not been changed; in that all the agreements that the *Shari’ah* board has approved are the ones that are

being used.” Similarly, the same concept applies to supervising *Shari’ah* audit. Those performing the audit have a checklist upon which they base their review of the compliance of a product/investment.

4.3.2. SSB Member’s Independence

This section looks into the independence of the *Shari’ah* scholars and how they try to maintain their independence, so as to not affect their performance and hence decisions.

The ability to main independence as per IFSB-10 (2009, 15) is “when none of its members has a blood or intimate relationship with the IIFS, its related companies or its officers that could interfere, or be reasonably perceived to interfere, with the exercise of independent judgement in the best of the IIFS by the *Shari’ah* Board”. Two scholars (15.38%) linked independence to the ability to perform their role without transferring information from one IFI to another. They looked at it by their ability to maintain confidentiality and compared it to other professions that deal with several competing organizations at the same time, as commented by ShSc-01: “Auditors provide services to several establishments and consultants provide services to several establishments. They all sign to maintain confidentiality.”

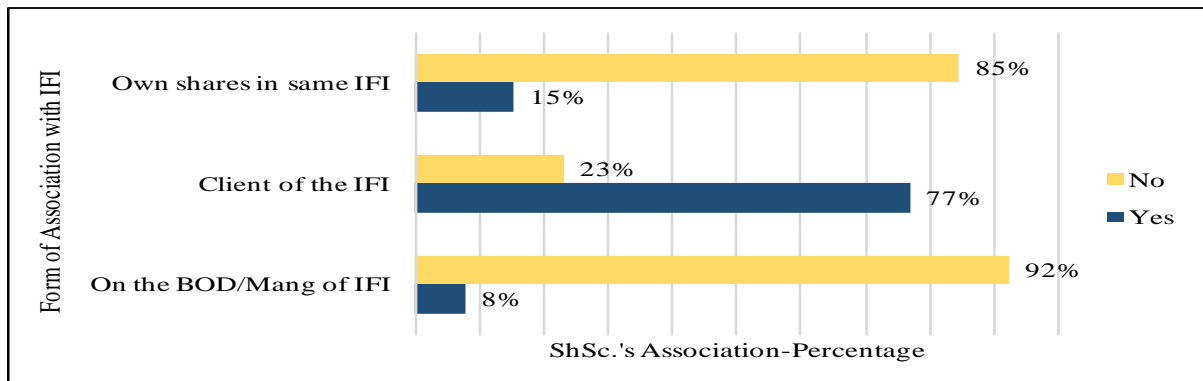
Even though many see that maintaining independence is not easy when the *Shari’ah* scholar is in multiple boards, not all see it as a concern and treat it as any other profession, as ShSc-09 explains: “There is no conflict, because I am only an independent member. My situation is like any external advisory company...like E&Y auditing several banks. This does not affect that it audits this bank and this bank. The same thing with the scholar... this does not intervene with his work, never.”

A number of scholars (15.38%) think that they attain their independence by not being associated with or being disconnected from the IFI in some form or another, physically and mentally. ShSc-12 explains this: “Independence has to be real. That the scholar is not an employee of the institution. He has not received any financial facility. Not a significant shareholder or a board member or so and so.” Moreover, he goes on to emphasise the importance of physical disassociation to the extent of personal relationships and dealings: “also in his practice, the scholar has to also be independent, to be mentally independent. Meaning that he does not fall under, or place himself in position that tarnishes his independence; like personal relationships, through financial relationships and so forth.”

The question on principle of association was included whether the scholar was on the BOD or part of the management, or if he was a client of the IFI or had ownership in the IFI.

Figure 2 presents the level of the interviewed *Shari'ah* scholars association with the IFI in which they were on the SSB.

Figure 2-*Shari'ah* Scholar's Association with the IFI



From the responses, it appears that with exception of one scholar¹⁴ they (92.31% - 12 of them) are not part of the BODs nor its management. To not be on the BOD or management was taken as standard rule and was the understanding of almost all scholars. Two scholars who owned shares in the IFI indicated that their ownership was not significant (less than 5%). One of the scholar mentioned that even though it is not a significant percentage, he abides by the insider rules of reporting such ownership. Meanwhile, another stated that he has, as a rule, taken care to not own shares in the IFI in which he is an SSB member. According to him, the idea of ownership (less than 5%) creates a conflict of interest that is not seen in such a way by all. According to ShSc-05, there are two views on this: “One that does not consider owning shares (a non-controlling interest) in the IFI as a conflict of interest and the other that considers owning shares (a non-controlling interest) in IFI as a conflict of interest.” The majority of the scholars (10 or 76.92%) were clients of the IFI since they needed to have accounts with IFI, especially since they were preaching Islamic banking. However, in addition to having an account, some scholars also used financial facilities from the IFI. Some scholars used financial services from the same IFI in which they were an SSB member and in such cases disclosed it. Others made the effort to take financial facilities from an IFI that they were not associated with.

Having another job and not depending on the remuneration received from the IFI as a source of income provides the scholar with the ability to leave, in the event he thinks it is affecting his performance (2 ShScs - 15.38%). As ShSc-05 explains: “first thing I am not an

¹⁴ He is head of Internal *Shari'ah* Supervision and a member of SSB of the same IFI. He is also a member on other IFI's SSB.

employee at the bank. And if I felt that there was any pressure, I would resign. Since I am a lecturer at the university, I do not have a problem. The one who has a problem is who is an employee. Not being an employee of the bank gives him strength with regards to being independent *Shari'ah* board member, in my opinion. No one can impose their opinion on you”.

One scholar indicated that scholars draw their independence from the regulations. ShSc-13 confirms this by saying, “I do not have any connection with them [the financial institutions]. We have our full independence, backed by the Law and the central bank’s instructions”.

For a number of scholars (15.38%), it is a matter of trying to maintain reputation, “the scholar, like the institution has his reputation. He quickly loses his reputation if he falls into such a problem [not able to resist pressure]. The strength of the member and its importance and its status is derived from many things, the most important of which is independence” (ShSc-10). Furthermore, ShSc-03 asserts that to perform one’s duties and responsibilities effectively is a matter of being able to handle the duties that have been assigned as per the role to be performed. He states, “if one can handle the assigned duties he accepts, if he can’t [handle what is being assigned due to added pressure], he decides, accordingly if he accepts or not. Because in return his contract will not be renewed. For it is an annual relationship. The general assembly has the right not to renew”.

With others, maintaining independence is a matter of conscience, as ShSc-04 notes: “This means questioning, what we call self-censorship. A responsibility in front of Allah before the people.” On this note, ShSc-07 comments that conscience is not sufficient to maintain independence, especially if performance is linked to remuneration and renewal with the IFI. He considers that this can only be controlled by an independent and authoritative third party. He states, “This third party can only be the governmental, central authority. To make sure that the *Shari'ah* board performs its duties with adequate freedom ... to make sure a member is not disposed of without a clear comprehensive statement and approval of the central bank, and not only by notification” (ShSc-07).

In addition to the observation of ShSc-07 concerning independence, attention to the number of terms a scholar can be reappointed needs to be looked into. Other than what was discussed above concerning the member’s selection and appointment, the *Shari'ah* scholar’s term is open, both with regards to the number of terms he can serve along with the length of

his terms, as indicated by ShSc-03, “for us it is open, there is no limit imposed...” (ShSc-03). With no regulatory cap, the number of terms that a scholar can be re-appointed is open which can affect the scholar’s independence by being associated with an IFI for too long.

4.4. *Shari’ah* Compliance and *Shari’ah* Risk

As seen under the Mandates and Responsibilities section above, the internal *Shari’ah* audit/review is performed mainly by the internal *Shari’ah* department of the IFI. All departments within the IFI undergo audit, and, depending on the importance of the department audit, can be undertaken more than once a year. Usually, the *Shari’ah* audit plan is reviewed earlier in the year with the SSB and, once agreed upon by the *Shari’ah* auditors, the executed transactions are checked to ensure their implementation as per the SSB’s decisions.

4.4.1. *Shari’ah* Compliance Reporting

Shari’ah compliance is maintained through performing *Shari’ah* audit. However, the results of the review/audit that are undertaken do not necessarily get reported in the annual report that is presented to the shareholders at the general assembly. It appears that it is not always the case that the details of the outcome of the *Shari’ah* audit are reported. Although correction of *Shari’ah* non-compliance matters are taken up, the disclosure of it depends mainly on the SSB’s policy on disclosure.

Two *Shari’ah* scholars (15.38%) indicate that when non-compliance matters arise during the review, it is looked at from the aspect of whether it was an intentional mistake or not. If the IFI’s policy is not to violate the *Shari’ah* principles and the errors that occurred were related to an employee’s lack of understanding and improper procedures, it is usually rectified and not disclosed in the annual *Shari’ah* report. Any violations/non-compliance are reviewed and are appraised to certain criteria or colour coding schemes to decide whether they are reported in the annual report or not. As ShSc-04 explains: “the level of error [as per the financial institution’s criteria] affects my appraisal. A mistake is classified as a big mistake, medium mistake, no mistake. So if the mistake is big and the bank has generated profits, we purify it... It is mentioned [in the annual report] especially when the mistake is big.”

Another instance where the SSB does report to the general assembly is when the IFI is not listening to them and keeps repeating the mistake. As a form of indirect reprimand, the

mistake is disclosed as noted by ShSc-11: “If the management overdid the matter or repeated the error, it is written [in the report]. For example, this time [reference to the last report produced] ...we found they repeated, so we put it in the report. So that the shareholders know and they faulted the management harshly.”

However, three scholars (23.08%) mention that when the reporting takes place on significant matters, it is not always in detail, and, more often than not, it is in a general form. A term of ‘routine mistakes’ has been developed and used so as to give a general idea of compliance. ShSc-13 elaborates: “we derived this phrase: the *Shari’ah* board has reviewed the products, agreements and transactions and they were in accordance with the *Shari’ah* principles and rules, in whole. Why we say this. There is a difference in the language from when I say ‘in whole’ and ‘as a whole’. ‘As a whole’ means all the transactions are correct while ‘in whole’ means two to three four mistakes; that is normal in all institutions”.

Such non-compliance details are not always reported to the regulator either, yet they are accessible to them if they want to view/inspect it. This is confirmed by ShSc-06, “We don’t report it to the central bank, but it is available in the minutes. The minutes are assumed confidential, but the central bank can look at what it wants. Sometimes they ask.”

In most institutions, violations are internally documented based on the severity of the violation. Some rank them as high, medium and low while others colour code them (as mentioned above). There are no set ways of documenting non-compliance. In addition to the criteria of ranking, what is set is subjective and differs from one SSB/IFI to another. The way they are reported/documented and categorized varies from one institution to the other. There is no set standard (set specimen) of such a non-compliance report, similar to how it is with conventional audit, as ShSc-09 notes:

“Everyone has his way [of classifying compliance and documenting the audit]. Unlike the external auditors who have procedures that they follow internationally, we as *Shari’ah* auditors have our own way. It can be developed, because we are still developing. So you will find one *Shari’ah* auditor has his way in writing it, I write my report in a different way, a third *Shari’ah* auditor might write it better than us.”

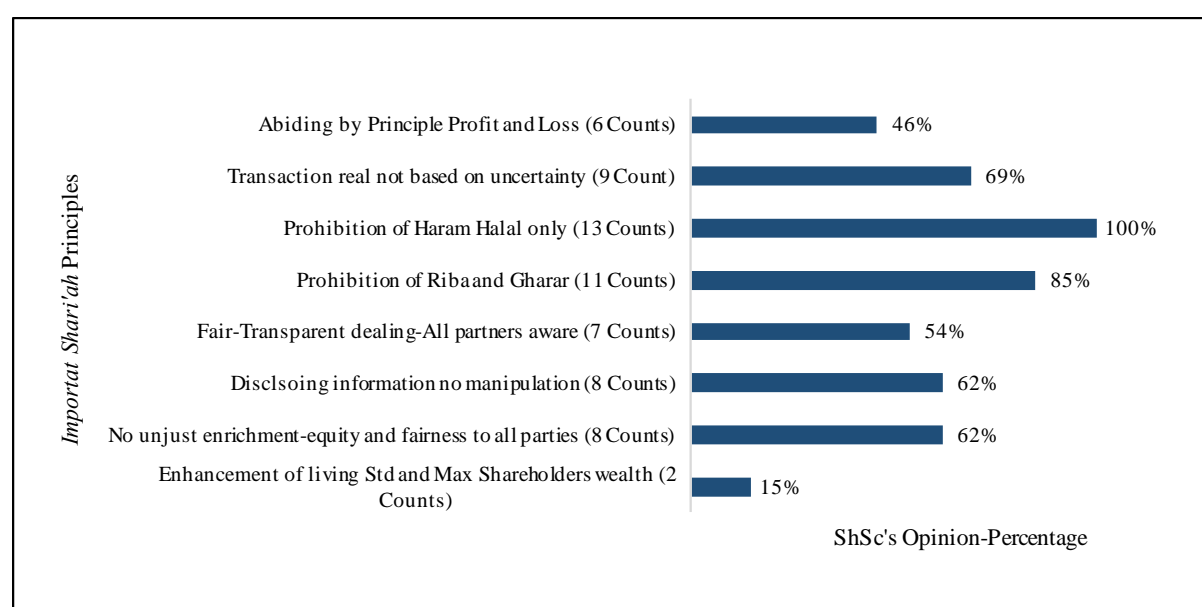
There are times when the SSB does not see the value of reporting a non-compliance matter, especially if it does not have any financial effect. It depends on the SSB’s policy on disclosure and reporting as to whether these are reported or not. Three scholars (23.08%) indicate that reputation usually is a factor in the matter and at times reputational impact can

be greater than the financial impact. There are times when, as per *Shari'ah* principles, the violation is considered severe, yet its financial effect is much less and if reported would have a negative impact. In such instances, the SSB records it in the minutes of the meeting and follows-up with management so that it gets rectified and is not necessarily reported in the annual report. Sh.Sc-03 rationalizes: “it [the SSB] forced the executive committee to follow-up and provide it with regular updates till it is informed that it has been internally rectified, instead of putting it forward in the report, because this could open doors of inquiries.” Furthermore, non-compliance matters that occur are usually only reported to the general assembly when it is a significant matter since it is an open public meeting and could cause a serious negative reputational effect on the IFI. ShSc-09 remarks: “You are now at the general assembly, meaning shareholders are sitting, the ministry of commerce is present, the central bank is present, auditors are present, the press is present; so the meeting is open. So it can't be that I expose them unless it's a major wrong doing.”

4.4.2. *Shari'ah* Risk

The *Shari'ah* scholars' views on the main issues that they consider are related to *Shari'ah* matters and impose a risk on a transaction from being *Shari'ah* compliant are summarized in Figure 3.

Figure 3-The *Shari'ah* Scholar's Opinion on the *Shari'ah* Principles



As can be seen from the Figure 3 above, of the 8 principles put forward to the scholars, all (100%) agreed that ‘prohibiting in dealing in items which are *haram* and the requirement

to deal only in *halal* items’ was the main principle. As ShSc-10 explains: “If a mistake occurred, for example that does not have an effect from the *Shari’ah* aspect of the *halal* *haram*, but it violates, for example, the decision taken by the *Shari’ah* board [in implementation], in such incident, we can’t say that it violated *Shari’ah*. But we can’t leave the matter be, we record it in the minutes that this and this was noticed... after which follow-up and correction is taken.” Quite a few scholars considered other principles as a means to decide on the *halal* and *haram* principle. For example, disclosure and clarity of information, and elimination of *gharar* are needed to be able to have a full picture in order to determine whether it meets the *halal* principle, as ShSc-03 explains: “This is not important as much as it is a ‘means’. The most important thing is *halal* and *haram*. Transparency is a means to achieve them. How do I know the *halal* and *haram* without knowing the true facts? Deciding on a matter before being able to imagine it... the *Shari’ah* board is captive to the information that it is provided with.”

Eleven scholars (85%) selected the principles of ‘prohibition of *Riba* and *Gharar*’ and eight (62%) of them viewed ‘Abiding by *Shari’ah* principles of clarity, and disclosing information, so as not to be manipulating’ as important. ShSc-07 explains, “the most important thing is that the IFI abides at a minimum, the red line, that can’t be forgiven with the issue of *riba* and *gharar*. The IFI in all cases must avoid *riba* and *gharar* in all its degree and forms. And then the other matters, depending on the strength of the institution and its size can be considered.” Nearly half of the scholars (7 or 54%) held transparent dealings to be a *Shari’ah* risk. One scholar thought clarity and the disclosing of information is a matter for the regulators and two respondents (15%) considered abiding by the principle ‘requirement for fair and transparent dealings to ensure all partners are aware of their rights and obligations’ to be a part of the regulator’s role. One of them considered it to be the IFI’s role.

Nine of the 13 scholars (69%) identified ‘transaction have to be real and be certain and not based on uncertainty or speculation’ as a *Shari’ah* risk. Meanwhile, one of the scholars considered the matter of the transaction being real as a subjective matter depending on which school of thought is being looked at. Meanwhile, eight scholars (62%) thought that the principle of ‘No unjust enrichment, equity and fairness to all parties’ could also affect the *Shari’ah*. To this, ShSc-01 commented: “if we hold by the Islamic principle, then *Shari’ah* contracts has within it what assures this matter [referring to no unjust principle]. If you notice most of the *Shari’ah* principles are related to the lifting of *gharar* and *jahalalah* between parties and transparency.” One of the scholars considered it as a part of the IFI’s role while

another thought that in principle justice is required and the term/phrase is too wide and hence too ambiguous to consider.

With regards to the principle ‘the goal of the IFI is not limited to the maximization of shareholders’ wealth but also includes enhancement of the standard of living and welfare of the community’, six scholars (46%) mentioned that this is too wide a *Shari’ah* principle and too much to impose on the IFI; it should be taken care of by the government. Only two scholars (15%) considered it a matter to look into, and one scholar thought it should be a part of corporate governance and social responsibility.

Six scholars (46%) were of the view that the principle of profit and loss is a characteristic in all investments and others thought it is not a requirement for transactions to be Islamic. The sharing of loss and profit is only one of the several ways of transacting in a *Shari’ah* way (*Musharakah, Mudarabah, Wakala*). Furthermore, there was also the understanding that risk-sharing is not *Shari’ah* related. The concept of risk sharing was not associated with the principle of profit and loss, and the Scholars were defensive. They asserted that losses incurred was not a *Shari’ah* issue and the SSB had nothing to do with it. ShSc-09 clarified this by saying, “Some people say you are the *Shari’ah* board and the bank lost because you the *Shari’ah* board closed on them in the transactions [in that the SSB’s *Shari’ah* decision placed restrictions on the investment/IFI) ...I tell them I have no relationship, whether the bank made profits, the bank made losses, I’m not related...”.

While bearing these in mind, the link between the IFI and the investor is the agreement that they sign and the content of the agreement determines the causes or effects of violation. In the *Shari’ah*, no agreement takes place without both parties being satisfied and consenting to the agreement. As such, whether any *Shari’ah* risk is incurred depends on the type of agreement that is signed and the conditions of the specific type of agreement. ShSc-10 elaborates on this:

“Agreements, are not valid if they [parties] aren’t satisfied... so being satisfied, is an important matter for the validation of agreements. And satisfaction is not achievable without knowledge; it is associated with knowledge...So providing information is something essential and holding it back is what spoils it. It is important to ensure what matters are in the text of the agreements ...it [an incident/matter that occurred and is not meeting a clause in a contract or has been left out] is considered a deficiency, and is looked at ... whether the contravention affects significantly its *Shari’ah* features, that it

transforms the agreement from a valid agreement to void agreement, or it is just a violation and no harm has been inflicted on the others”.

5. CONCLUSION AND RECOMENDATIONS

This paper presented the findings of the interviews conducted with *Shari'ah* scholars who are members of SSBs of IFIs across the GCC. The paper explored in depth the organizational and work relationship of the SSB with its IFI, how the *Shari'ah* function is undertaken and what could jeopardize its quality. The findings present the scholars' responses starting from being appointed, the performance of their duties as part of a team/board, and the decisions made pre- and post-investment/product launch. It also looked into *Shari'ah* compliance issues and how the *Shari'ah* audit function is performed. Scholars' concerns about *Shari'ah* governance issues were also presented for it is an essential component to improve the SSB's role and the *Shari'ah* supervisory function within an IFI.

From the interviews, it appears that the operations of the *Shari'ah* supervision of the IFI can impose operational risk in the form of *Shari'ah* compliance risk that can affect the performance of the SSB function. There appears to be internal and external causes. Some of the internal causes, as seen from the findings of this paper, can occur due to the SSB having unclear roles and responsibilities. It can also be due to the lack of independence of both the SSB from the IFI (remuneration dependence) and those performing *Shari'ah* audit internally when administratively they fall under the IFI. Furthermore, issues arise in the approval of products (before, and in some cases, after it is launched), full transparency, and asymmetric information from the employees of the IFI. In addition, along with there being no set standard on the classification of *Shari'ah* compliance and compliance process documentation, the lack of transparency in the reporting of non-compliance affects accountability/responsibility.

The external causes appear to be shortfalls in the laws and regulations of the *Shari'ah* supervision function. In addition to the fact that regulations vary from one jurisdiction to another, the matters mentioned above also need to be addressed. Issues such as independence/conflict of interest, *Shari'ah* audit, *Shari'ah* non-compliance reporting, standardization of the compliance process and classification are but a few issues that need to be regulated and effectively enforced. One way to improve the overall *Shari'ah* governance regimes at the national level is to introduce governance standards issued by IFSB and AAOIFI.

As the role of the SSB is an independent form of supervision, its independence is crucial. Although, the SSB's appointment is approved by the shareholders, they are usually based on the recommendation of the IFI's board of directors. Moreover, re-election of the *Shari'ah* scholars to SSBs is open. The longevity through the continuous re-appointment of the same SSB member, along with the IFI's board/management's continuous nomination, affects the true independence of the SSB and its work. As noted above, not all non-compliance matters are reported, especially if they are resolved prior to the date of the report. AAOIFI Governance Standards (5) also refer to this matter as a matter of concern and suggest rotating at least one SSB member every 5 years. Yet this was not mentioned by any interviewee implying that it does not appear to be observed even in jurisdictions where the AAOIFI standards are obligatory.¹⁵ Moreover, in some jurisdictions, recently a cap¹⁶ on the term a scholar can serve at an IFI has been introduced. Yet no mention of it was made in the interviews. Hence, it appears that enforcement of those adopting the AAOIFI standards or the recent requirements, in addition to regulations on the terms of reference and appointment of the SSB, still need to be addressed.

The SSB in performing their duties rely heavily on the work of the IFI's *Shari'ah* team/members which can jeopardize the quality of their independence. As per the AAOIFI Governance Standards (1.14), it is the responsibility of the SSB to provide an independent opinion based on their review of the operations of the IFI, and among the documents that are to be examined is the internal audit report. Hence, basing its opinion on the Internal *Shari'ah* Review reports raises the question on whether the SSB's opinion report is comprehensive and independent as per the Standards. Moreover, even though the IFI's *Shari'ah* team/member are supervised by the SSB, they fall under the IFI's management and administration, which could have an effect on the quality of the information they provide. On a similar note, concern is expressed by *Shari'ah* scholars about providing full information and an accurate picture while obtaining the SSB's approval. Hence, this raises the question on whether all matters are reported and brought to the attention of the SSB by those performing the review?¹⁷

¹⁵ Currently, as per AAOIFI's website: "Adaptation of Standards", dated 30/4/2017, the AAOIFI Accounting Standards are mandatory in Bahrain, Oman and Qatar, and are voluntarily used in Kuwait, Saudi Arabia, and UAE.

¹⁶ The Central Bank of Oman's law is in line with AAOIFI *Shari'ah* governance standards, and places a requirement that an SSB member can only be appointed/selected for two consecutive terms.

¹⁷ Consideration is to be given that it could also be related to audit/accounting matters, an area where the *Shari'ah* scholars are not necessarily knowledgeable in. This is an area to be considered for further study/research.

As the situation stands in the GCC (at the time of the study), the complete independence of the SSB members is questionable, even among the SSB members themselves. The SSB was a setup put forth initially as part of the IFI organizational structure as an independent board. However, time has shown that such independence is questionable, which places risk on the quality of the SSB's role and purpose. Recently, some regulators have moved towards strengthening *Shari'ah* governance and have created a central *Shari'ah* Board (SB) at the central bank. Instances where the SB's role is to perform the function of SSBs for all IFIs would be a good, though incomplete, step towards resolving the matter. There will still be *Shari'ah* scholars and *Shari'ah* compliance officers at the IFI level who will be performing *Shari'ah* reviews and making *Shari'ah* decisions.

Indications from the study imply that regulators should consider disassociating the *Shari'ah* scholars/*Shari'ah* compliance officers' remuneration from the IFI to achieve effective independence. Some suggestions of outsourcing the function have been made, yet that would not resolve it completely because the IFI would still be indirectly paying for their services. The recommendation is to establish an independent organization that provides these services. The organization could be funded by the membership fees that IFIs pay on an annual basis and in return such services of SSB members and *Shari'ah* compliance officers would be made available to all.

The setup suggested above would contribute towards developing other related matters too. Both *Shari'ah* and financial/auditing know-how skills would be developed by the organization, ensuring the availability of the appropriate persons/skills/expertise. The organization can also work on unifying the TOR and define the roles and responsibilities of the SSB function. Furthermore, the external *Shari'ah* audit/review can be performed, resulting in an independent *Shari'ah* report. The quality of undertaking the compliance review and generating the compliance report could be developed and standardized among industry players. This would also apply to the pronouncements being produced by the SSB, whereby detailed *Shari'ah* certifications on the investment/product would form part of the information and documentation provided to clients and investors. The independent report/review performed on the extent of *Shari'ah* compliance would enhance the quality of the report and the confidence of the stakeholders and would improve the credibility and reputation of the industry.

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