

THE IMPORTANCE OF SHARI'AH SUPERVISION IN ISLAMIC FINANCIAL INSTITUTIONS

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Abstract

Islamic financing differs from conventional financing in that it prohibits the payment or receipt of interest. The concept of interest-free financing existed prior to the advent of Islam and was embraced in ancient Arabia. The concept was officially launched in the 1970's by the Organization of Islamic Countries (OIC) and introduced in most Muslim nations and some Non-Muslim nations. But while it has experienced phenomenal growth rate, the Islamic financial system has been criticized for failing to incorporate the true spirit of Shari'ah in their actions. Islamic financial institutions are also divided over the interpretation of which products are considered *halal* (acceptable under Islamic law). In order to overcome some of these issues, financial institutions dealing with Islamic products are required to utilize the services of a *Shari'ah* adviser or a *Shari'ah* Supervisory Board (SSB). The paper recommends a more collaborative effort between the central banks of Muslim nations and regulatory organizations.

Keywords: Islamic financing; Shari'ah supervisory boards; interest-free finance

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Islamic financing or interest-free financing has experienced rapid growth and is now practiced worldwide in Muslim and Non-Muslim countries. To ensure that the products offered to the clients fulfill the criteria of being *halal* (acceptable under Islamic law), Islamic financial institutions seek the advice of Muslim scholars. These scholars are known as *Shari'ah* advisers, and are usually part of *Shari'ah* supervisory boards (SSBs).

But there has been growing criticism that the Islamic financial institutions are essentially providing interest-bearing products under the guise of profit and mark-up, and are justifying these with the help of SSBs. This study aims to address these issues by clarifying the role and functioning of the SSBs in Islamic financial institutions.

History of Islamic financing

The guiding principle in Islamic Financing is the prohibition of *Riba* (interest) in the light of the *Shari'ah* ruling. *Shari'ah* refers to Islamic law, which is based on the teachings of the Quran. Since Muslims are not permitted to receive or pay interest, they are unable to conduct business with conventional banks (Ariff 1998; Jaffe 2002). To service this niche market, Islamic financial institutions have developed a range of interest-free financing instruments that conform to *Shari'ah* ruling, and therefore are acceptable to their clients

(Malaysian Business 2001). While interest-free financing was practiced prior to the advent of Islam, the first successful application of Islamic finance in the modern era was undertaken in 1963 by Egypt's Mit Ghamr Savings Banks, which earned its income from profit-sharing investments rather than from interest (Lewis & Algaoud 2001). By the 1970's, the push for Islamic finance had gained momentum. In 1973 the conference of foreign ministers of Muslim countries decided to establish the Islamic Development Bank with the aim of fostering economic development and social progress of Muslim countries in accordance with the principles of *Shari'ah* (Saeed 1996). This marked the first major collective step taken by Muslim countries to promote Islamic finance (Rammal 2004). Since then Islamic financing has witnessed rapid success with holdings of more than US\$147 billion and growing by 15 percent per year (Ghannadian & Goswami 2004).

The market leaders in this industry are Citigroup, HSBC, J.P. Morgan, and Standard Chartered who provide Islamic financing products through the use of Islamic windows (Day 2003). The main Islamic financial products include the profit-and-loss sharing instruments of *Mudaraba* (finance trusteeship) and *Musharaka* (equity partnership), cost plus mark-up, and leasing (Rammal 2003). Although Islam excludes interest earnings from financial activities, it does not necessarily mean that the financier cannot earn a

profit. In order to do so, the financier has to ensure that gains made on the original amount are directly related to the risk undertaken on the investment (Siddiqui 1987). If there is no risk involved, the gains made represent interest rather than profit.

In order to understand how the Islamic system differentiates between profit and interest, one has to look at the differences in the economic ideology. In a capitalist system, capital and entrepreneurs are treated as two separate factors of production. The return on capital is interest, whereas the entrepreneurs' return can be profits or losses. While interest is a fixed return for providing capital, profit can only be earned after distributing the fixed return to land, labour and capital (in the form of rent, wage and interest). Thus, the capitalist system seems to favor capital investors by providing them a secure return while the entrepreneurs bear the risks of incurring losses and still making interest payments on borrowed capital (Rammal & Zurbruegg 2004).

In comparison Islamic economic system does not consider capital and entrepreneur as separate factors of production. It believes that every person who contributes capital in the form of money to a business venture assumes the risk of loss and therefore is entitled to a proportional share in the actual profit (Siddiqui 1994). The system is protective of the entrepreneur, who in a capitalist economy would have to make fixed interest repayments even when the venture is making a loss (Usmani, M.I. 2002). Capital has an intrinsic element of entrepreneurship, so far as the risk of the business is concerned and therefore, instead of a fixed return as interest, it derives profit. The more the profit of the business is, the higher the return on capital will be. With no fixed interest repayments, the profit in an Islamic economic system would be higher than in the capitalist economy. The system ensures that profits generated by the commercial activities in the society are distributed equally amongst those who have contributed capital to the enterprise.

Another difference between the two economic systems lies in the way money is used. In economic terms money has no intrinsic value; it is only a medium of exchange, therefore earning interest on a medium of exchange without bearing any risks does not sit well in the Islamic system (Rahman 1994). Islamic financing is therefore an asset-backed financing. When a financier contributes money on the basis of the profit-and-loss sharing instruments, it is bound to be converted into assets having intrinsic value (Usmani, M.T. 1998).

***Shari'ah* supervisory boards (SSBs)**

Islamic financial institutions are guided by a legitimate control body known as the *Shari'ah*

Supervisory Board (SSB). The purpose of the SSB is to ensure that the financial institutions operate in conformity with *Shari'ah* and are usually made up of a number of jurists who provide clarification in regards to any questions that the financial institutions may have (Usmani 1998). These SSBs consist of *Shari'ah* advisers who are hired by the financial institutions and act as an internal control body in the organization, therefore, enhancing the credibility of the institutions in the eyes of its customers, and bolstering their Islamic credentials.

Although nearly all organizations dealing with Islamic products utilize the services of a religious scholar, the level of involvement of the adviser varies depending on the size of the institution. Thus, large organizations tend to hire a board, whereas smaller organizations dealing with Islamic products would hire the services of just one adviser. A review of four Islamic financial institution's website was undertaken to determine the structure of the SSBs in different organizations around the world. These institutions were:

- Muslim Community Co-Operative Australia (MCCA)-Australia
- Iskan Finance-Australia
- Meezan Bank-Pakistan
- LaRiba American Finance House-USA

This sample revealed that Iskan finance did not have a *Shari'ah* adviser or SSB, instead the organization models its programs on the various *fatwas*¹ issued by leading Islamic scholars, and on opinions it seeks from Al Azhar University in Egypt (Iskan 2004). MCCA, the largest Islamic financial services provider in Australia (Saeed 2001), has two *Shari'ah* advisers (MCCA 2004), whereas LaRiba relies on one resident *Shari'ah* adviser (LaRiba 2004). Meezan Bank, the first scheduled Islamic commercial bank in Pakistan, relies on a SSB whose members are also on other boards around the world, including the Dow Jones Islamic Index (Meezan 2004).

The presence of a *Shari'ah* board in Islamic banks was determined as a prerequisite for admission into the International Association of Islamic Banks (IAIB). The general characteristics of the *Shari'ah* Board were described in an IAIB document by El-Nagar (1980). According to the document, a *Shari'ah* board should be formed of a number of members chosen from among Jurists and men of Islamic jurisprudence and of comparative law who have conviction and firm belief in the idea of Islamic Banks. To ensure freedom of initiating the board's opinion, members of the board must not be working as personnel in the bank, and are not subject to the authority of the board of directors. The board

¹ Fatwa is a legal statement in Islam, issued by a religious scholar or a religious lawyer, on a specific issue.

should be appointed by the general assembly, as it is the case of the auditors of accounts, and the general assembly should fix their remuneration. And finally according to the IAIB document, the board has the same means and jurisdictions as the auditors of accounts.

Banaga, Ray and Tomkins (1994, pp. 10-11) list the functions of the SSB as:

- Answering the enquiries that come from the community at large.
- Issuing formal legal opinions according to the Islamic law and enquiries submitted by bank management or any other interested party.
- Reviewing and revising all the dealings and transactions, which the bank enters into which clients so as to ensure that these agree with *Shari'ah*. If any deals or transactions contradict *Shari'ah* principles, such transactions would not be approved.
- Reviewing researchers on any particular subject and issuing their opinion.
- Holding regular meetings to discuss all enquiries received. The minutes of these meetings are usually recorded.
- Receiving enquiries from the management or others and presenting them to the board of directors.
- Preparing draft opinions and delivering them to all those who are concerned.
- Issuing opinions in final form if the Board does not have any second opinion on the subject.
- Preparing contracts in collaboration with the legal adviser of the bank.
- Participating in the preparation of drafts of decrees, decisions and orders presented by the bank, and preparing explanatory notes thereto.
- Preparing the studies and researches required to direct the *zakat*² resources towards the deserving parties and determining the rate or the percentage that in the light of the *Shari'ah* rules could be invested from the resources of the *zakat*.
- Carrying out the technical review and follow up to make sure that the *Shari'ah* controls are implemented by the bank, its branches and its affiliated companies.

² Zakat is the amount of money that every adult, mentally stable, free, and financially able Muslim, male and female, has to pay to support specific categories people. Zakat is obligatory after a time span of one lunar year passes with the money in the control of its owner. Then the owner needs to pay 2.5% (or 1/40) of the money as Zakat. (A lunar year is approximately 355 days).

The role of the SSB is therefore similar to that of the account auditors. Even though, the financial institution compensates them, the SSB members are expected to retain their independence. Just like auditors, SSBs certify at the end of the year whether the financial institutions operations were in conformity with *Shari'ah*. This task includes reviewing products and policies of the financial institution, and deciding on whether a new financial instrument introduced by the organization is religiously acceptable.

According to Lewis and Algaoud (2001, p.181), when the SSB feels that a transaction may not accord fully with, or be in breach of the *Shari'ah*, the board should find alternative ways to make the transaction accord with *Shari'ah*. If no alternative suggestions can be made, the transaction should not be processed. If, however, the transaction has been executed and later on it is discovered that it has violated *Shari'ah*, the SSB should put its qualified opinion to shareholders and the management make steps to take out the income generated from that transaction from the income account and have it distributed to a charity account. There is thus a potential financial penalty for non-compliance as well as adverse publicity.

Theoretically if the SSB refuses to endorse a product, the financial institution should automatically scrap that product. Also in theory, the SSB would perform a religious audit of all accounts (Warde 2000). The reality however is more complicated. A survey conducted by Warde (1998) revealed that in many cases the review is treated as a routine matter, with boards approving decisions already made by the bank's management.

The exact roles of SSBs differ between institutions. Although SSBs have similar supervisory procedures; there remain differences in interpretation. Karim (1990, p.39) points this out by stating that SSBs 'are guided by their moral beliefs and obligations to religious peers and community'.

Issues relating to the working of SSBs

A number of issues have been raised in connection with SSBs. One is in relation to their independence. Since SSB members receive remuneration from the financial institution, there seems to exist a potential for conflict of interest. The concern is that members of the SSB may legitimize dubious operations to ensure that they remain active on the board.

Another issue is that of the relationship between the SSBs and the external auditors. Some observers believe that since SSBs are present in financial institutions, the external auditors are not qualified to contribute to religious supervision. Others argue that the external auditors are

necessary since they act as an external control body that ensures that the financial institutions are adhering to *Shari'ah* (Usmani 2001). In studies conducted by Algaoud and Lewis (1997, 1999) it was revealed that the Islamic banks had no formal interaction between the SSBs and the external auditors.

There have also been questions asked about the need for SSBs. With employees of financial institutions now being able to access the latest research and training programs related to Islamic finance from organizations such as the Institute of Islamic Banking and Insurance, the presence of SSBs is viewed by some as fulfillment of a formality rather than an active control body (Warde 2000).

In relation to the global growth and application of Islamic finance, the major criticism is that the practice of financial institutions having their own *Shari'ah* boards adds to the differences in application. This makes it difficult to agree on globally acceptable products and procedures. For example, some financial institutions have been guaranteeing profits and effectively taking the risk factor out of the financial transactions. Thus the guaranteed return resembles interest rather than a *halal* payment.

Role of central banks and regulatory bodies

Differences in application and procedures not only exist between nations but also within a nation. To overcome the concerns about SSBs, the Islamic finance community can undertake a number of steps to standardize activities at the national and international levels. According to Warde (2000), this can be achieved by placing more emphasis on encouraging group *Ijtihad*³ through international conferences, symposia, and convocations. By bringing people together from around the world, there can be more opportunities for discussions on the grey areas in Islamic finance, and for possible consensus on the global practice and applications of the system (Siddiqi 1994).

At the national level, the Central banks of the Muslim countries have to take a more proactive role in order to co-ordinate activities within the national boundaries (Gafoor 1996). There are already moves being made in this direction with some central banks appointing their own *Shari'ah* advisers to oversee national operations. One of the most significant attempts at national harmonization occurred in Malaysia where a National Syariah (*Shari'ah*) Board was established in 1997 to harmonize financial practices and

review the compatibility of new financial products with religion, as well as advise the Central Bank on religious matters. A similar move has recently been made by the State Bank of Pakistan, which has established an Islamic Banking Unit. But despite of these efforts, the two nations differ in their application of Islamic finance. While Malaysia is pursuing a dual finance system where both conventional and Islamic financing options will be available, the Pakistani government has in the past tried to enforce Islamic finance as the only available option.

Finally, to streamline activities at the international level, regulatory bodies need to be formed and policies made that would ensure uniformity in procedure and applications. The recently formed Islamic Financial Services Board (IFSB) aims to do just that. The IFSB serves as an international standard setting body of the regulatory and supervisory agencies that have vested interest in ensuring the soundness and stability of the Islamic financial services industry.

The establishment of the IFSB in Malaysia in late 2002 was the result of a two-year consultative process initiated by a group of governors and senior officials of central banks of various countries, together with the support from the Islamic Development Bank, the International Monetary Fund, and the Accounting and Auditing Organization for Islamic Financial Institutions. The IFSB is at currently attempting to prepare a standard on Corporate Governance, and has also begun on development of two prudential standards for the Islamic financial services industry namely, Capital Adequacy and Risk Management standards (IFSB 2004). The IFSB is in its infancy stage, and its effectiveness will become clearer over time.

By regulating the system, including the activities of the SSBs, through an active participation of academics, scholars, Central banks, and regulatory bodies, there is hope that Islamic financial system can be streamlined and criticism leveled against the system can be deflected.

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³ Exerting the sum total of one's ability attempting to uncover Allah's rulings on issues from their sources, such as the Quran.

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